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ENCLOSED MATERIALS:

(1) FHFA Answers to the PWG Working Group on Supervision Questionnaire

Contact: Alfred M. Pollard, General Counsel

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PURSUANT TO CONFIDENTIALITY AGREEMENT
OF JANUARY 21, 2010

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April 29, 2010

Gary J. Cohen, Esq.
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Financial Crisis Inquiry Commission
1717 Pennsylvania Avenue, N.W.
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Washington, D.C. 20006-4614

Dear ~~Mr. Cohen:~~ Gary

Thank you for your inquiry regarding the Federal Housing Finance Agency's response to a questionnaire sent by the President's Working Group (PWG), Group on Supervision. Enclosed is the response prepared by senior FHFA staff as a staff document and transmitted to PWG staff at Treasury for preparation of a PWG report on lessons learned about the conduct of supervision and proposed changes to strengthen it.

By way of background, I would like to describe our understanding of the nature of the PWG endeavor and the spirit in which FHFA staff responded to the questionnaire. As you know, the PWG gathers information and develops and vets policy recommendations concerning financial markets, financial institutions and their supervision and regulation for the President. The work group on supervision was one of several work groups created in the wake of the recent crisis. The questionnaire it developed aimed to assess lessons learned from the financial crisis about the supervision of financial institutions and markets and identify ways to improve that supervision and systemic stability based on input from across PWG member agencies. In that spirit, FHFA staff developed a candid response based on the experiences of its predecessor agencies— OFHEO and the Federal Housing Finance Board— with systemically important institutions at the heart of U.S. mortgage markets.

The response was informed by OFHEO's previous work on systemic risk and its ongoing struggles to apply its relatively weak supervisory authorities to the often recalcitrant housing GSEs. The weakness of that authority was largely remedied with the passage of HERA. While FHFA staff noted that in hindsight certain actions might have been taken to diminish the buildup of risk within the housing GSEs, whether those actions would have been within the statutory or regulatory authorities of OFHEO or the FHFB or would have been effective in altering the course of the crisis is not addressed and is difficult to know.

I hope the above discussion and the attached document are helpful to the Commission. The document was prepared as and remains confidential. FHFA staff is prepared to meet with you to discuss specific points or conclusions that you may draw from the document. Feel free to contact me at 202 414 3788 if you wish to arrange such a meeting.

With all best wishes, I am

Sincerely,

Alfred M. Pollard

Alfred M. Pollard
General Counsel

FHFA Answers to the PWG Working Group on Supervision Questionnaire

1. **Regulation and guidance**
   - **Overview**
     a. What weaknesses have we discovered in our regulations and guidance during the crisis?

The Housing and Economic Recovery Act of 2008 (HERA) created the Federal Housing Finance Agency (FHFA) through the merger and reorganization of predecessor entities that included the Office of Federal Housing Enterprise Oversight (OFHEO), which regulated Fannie Mae and Freddie Mac ("the Enterprises"), those parts of Department of Housing and Urban Development (HUD) involved in regulating the public mission of the Enterprises, and the Federal Housing Finance Board (FHFB), which regulated the Federal Home Loan Bank System (FHLBank System). Weaknesses in the regulations and guidances of FHFA and its predecessors can be divided into structural and implementation components. Structural weaknesses can be thought of as areas or issues not contemplated by existing regulations or guidance, either because of limitations in authorizing legislation or because of a lack of understanding and foresight in advance of the onset of a macroeconomic crisis strongly linked to excesses in the housing sector. Implementation weaknesses are those that require correction—and may have had a significant impact on the course of the crisis—but do not require a rethinking of the overall, pre-existing regulatory framework.

OFHEO had been confronting many structural weaknesses related to its authorizing legislation and had been advocating legislative changes for more than five years prior to the passage of HERA. The push for legislative changes increased markedly with the appointment of James B. Lockhart III as Director of OFHEO and the publication in May 2006 of the *Report of the Special Examination of Fannie Mae*. Such weaknesses included resource and funding constraints on OFHEO connected to the annual appropriations process, the separation of mission regulation (which was the purview of to HUD) from safety and soundness regulation (which was the purview of OFHEO), a rigid and far-too-low leverage requirement, the inability to appoint a receiver or to fund losses related to a conservatorship or receivership, and the inability to place permanent limits on the Enterprises' retained portfolios.

Compared to other federal financial regulatory agencies, OFHEO was unusually exposed to political pressures brought to bear by regulated firms and allied interests. A key element of that exposure was that OFHEO, by legislation, was funded through the annual appropriations process. The inflexibility of that process also contributed budget uncertainties and resource constraints at OFHEO. For example, after accounting irregularities were uncovered at Freddie Mac in 2003, OFHEO initiated special examinations of both Enterprises. Those examinations, related legal actions, and the pursuit of legislative remedies consumed a large share of OFHEO's budget allocation.

Other structural weaknesses related to legislative constraints directly affected OFHEO's ability to supervise safety and soundness. The separation of mission and safety and soundness regulation for the Enterprises contributed to inadequate attention to the impact of mission related decisions on safety and soundness. In particular, interaction between the Enterprises' efforts to meet the HUD-designated housing goals and other Enterprise goals, such as profitability and market share, combined to undermine risk management at the Enterprises and ultimately their safety and soundness. The legislated minimum-leverage ratio allowed capital for credit risk to be leveraged 200 to 1 and capital for interest rate risk to be leveraged by 50 to 1. While the Enterprises have sustained considerable losses from their guarantees on MBS backed by conforming mortgages, the retained portfolios were a major source of the Enterprises' accounting problems and ultimately the locus of many of the credit losses that led to the conservatorships. In particular, private-label, mortgage-backed securities (MBS) and whole loans held in portfolio, particularly those related to meeting HUD-designated housing goals, appear to have contributed disproportionately to credit losses.

HERA addressed these structural shortcomings, but came too late. Further details of changes to OFHEO regulatory authorities provided by HERA are described in (b) below.

Other structural shortcomings involved weaknesses not contemplated in pre-existing regulations and guidances. For example, FHFA and its predecessors failed to adequately incorporate systemic considerations into their regulations and guidances. Although OFHEO was well aware of the systemic importance of Fannie Mae and Freddie Mac (see, for example, OFHEO's 2003 white paper, *Systemic Risk: Fannie Mae, Freddie Mac and the Role of OFHEO*), the agency failed to anticipate a prolonged loss of liquidity in the markets for asset-backed securities (including MBS). The procyclical impacts of OFHEO's and other regulators' capital, PCA, liquidity, and other regulations contributed to the overall systemic breakdown. Ultimately, the Enterprises' inability to raise adequate capital, the accumulating losses to both Enterprises, and the eroding confidence of investors in Enterprise securities, led FHFA place them in conservatorships to reduce the systemic effects of further shrinkage in the mortgage markets. Congress also failed to appreciate the systemic risk posed by the Enterprises.

Both OFHEO and FHFB (and the entities they regulated) also underestimated the extent of overall credit risk accumulation and especially that associated with investments in highly-rated tranches of private-label MBS, and in the case of the Enterprises, whole loans held in portfolio. In retrospect, the agencies could have required the Enterprises and the FHLBanks to perform greater due diligence on their investments in such securities rather than rely so heavily on NRSRO ratings to justify the reasonableness of their investments.

An important implementation weakness has been the time needed to develop, publish, and implement regulations and coordinate actions with other regulators. A primary example of this weakness relates to the regulatory guidance with respect to non-traditional and subprime mortgages. Although other regulatory agencies were working (without OFHEO input) on guidance to restrict practices with respect to those mortgages in 2005, final rules were not published until mid-2006, and full implementation was delayed until late 2007. Enterprises business processes contributed to this problem. Despite their growing awareness of problems with underwriting practices and pricing, outstanding contracts with high-volume mortgage originators left the Enterprises unable to address those problems.

The crisis revealed other implementation shortcomings in areas of regulation and guidance, including capital adequacy, prompt corrective action, activity limits or prohibitions, emergency liquidity requirements, new products, and mortgage fraud. In particular, OFHEO regulations with respect to its risk-based capital requirement proved to be too rigid to accommodate changes in underwriting standards and the formation of the house price bubble, among other things. In some instances, OFHEO and FHFB regulations relied too heavily on NRSRO ratings, for example, in determining eligibility and capital requirements with respect to investments in structured credit products. With respect to prompt corrective action, regulations and legislation failed to contemplate how accounting changes and the statutory capital measures could interact to affect the speed with which capital and retained earnings could dissipate, especially when important credit markets became illiquid.

The crisis also demonstrated shortcomings in the Enterprises' and the FHLBanks' approaches to and assumptions regarding liquidity management. The primary assumption underlying the Enterprises' and the FHLBanks' liquidity plans had been that if the Agency debt markets became illiquid, the Enterprises and the FHLBanks would be able to convert MBS or short-term assets into cash. OFHEO had warned the Enterprises that this was a questionable assumption and it proved not to be true during the current crisis. Repo funding dried up as balance sheets across the financial services sector contracted, while foreign buyers of Agency debt pulled back causing Agency long-term debt markets to become illiquid. As a result, the Enterprises and the FHLBanks were more exposed to discount note roll-over risk with short-term relative to long-term debt representing a greater portion of the debt funding mix than would be the case under healthier market conditions.

What changes have been made to address these weaknesses?

The passage of the Housing and Economic Recovery Act of 2008 (HERA), which created FHFA through the merger of predecessor entities, directly addressed many of those weaknesses (discussed further below). HERA strengthened the independence of FHFA, relative to OFHEO[1], by providing for

- independent budget and assessment authority, which frees the agency from the highly politicized apportionment and appropriations processes,
- independent litigation authority, which permits FHFA to defend its own regulations and enforcement actions--ensuring adequate resources and lack of political interference, and
- independent regulatory authority, which permits issuance of regulations without OMB review and approval.

In addition, HERA strengthened FHFA regulatory authority by providing

- authority to set more rigorous capital standards than specified in the statute, including broad authority to design and establish risk-based capital standards for the Enterprises,
- responsibility to set capital classification standards for the FHLBanks and report on them quarterly;
- authority to set standards for and limits on the retained portfolios,
- authority to set and enforce housing goals (formerly with HUD, now with FHFA), effectively merging mission and safety and soundness regulation within FHFA,
- authority to approve new products (after public notice and comment) (interim final rule has just been published),
- authority to disapprove new activities,
- authority to prescribe prudential standards for management and operations,

[1] The FHFB already had most of these authorities.

- authority to bring enforcement actions against entity-affiliated parties (which include employees, attorneys, agents, and others)
- authority to remove or suspend entity-affiliated parties,
- authority to appoint a receiver,
- enhanced conservator and receiver authorities, including subpoena power,
- explicit authority to create a "bridge bank," called a "limited-life regulated entity" for any GSE in receivership,
- an extended statute of limitations (from 2 to 6 years) for enforcement actions, and
- funding for conservatorship or receivership through December 31, 2009.

Since the onset of the crisis, FHFA and its predecessors have issued new rules, guidances, supervisory letters, or negotiated commitments with regulated entities concerning, for example,

- non-traditional and subprime mortgages,
- executive compensation, including golden parachute and indemnification payments,
- mortgage fraud,
- operational risk management,
- accounting practices,
- raising additional capital,
- the eligibility and elections of FHLBank directors,
- affordable housing and other mission-related programs,
- the retained portfolios of the Enterprises, and
- capital classification and critical capital levels of the FHLBanks.

To address liquidity-related concerns, FHFA now asks the Enterprises to calibrate the size of their liquidity portfolios based on calendar days of net cash needs rather than a percent of total assets (a metric established in 2000) and to reduce longer-maturity and less-liquid investments in their liquidity portfolios. New liquidity standards have been established for the FHLBanks as well. The Enterprises and the FHLBanks also have access to the Treasury Department's GSE credit facility, which was created in conjunction with the conservatorships and is scheduled to end at year-end 2009. In addition, the Treasury has committed to providing each Enterprise with up to $200 billion through the senior preferred stock purchase agreements which have no expiration dates.

What further changes to regulations or guidance in these areas should be considered?

FHFA sees benefit to considering the following changes:

- greater flexibility to adjust the definition of capital and adjust capital requirements, as appropriate, to keep up with changes in GAAP,
- greater flexibility with respect to the appointment of a receiver for a distressed firm, and
- systemic, coordinated approaches across regulators with respect to residential (single and multifamily) mortgage lending.

With respect to the Enterprises, FHFA is required to apply the prompt corrective action triggers based on capital measures determined under generally accepted accounting principles (GAAP). Several changes to GAAP, particularly in the treatment of interest rate risk hedges and in the extent and methodologies associated with mark-to-market requirements have had substantial impact on the effective stringency of statutory capital and prompt corrective action provisions. Perhaps the most extreme example is the change, effective next year, that will require the Enterprises to consolidate entities that under previous accounting standards were off-balance sheet securitization vehicles. This change will move the bulk of the Enterprises' guaranteed mortgage-backed securities on to their balance sheets. The statutory minimum capital requirement for the Enterprises assigns a significantly higher capital charge to mortgage assets on the balance sheet than to these mortgage guarantees. The accounting change could be viewed as implying more than a doubling of statutory required capital without any change in economic risk.

While, FHFA has limited flexibility to interpret whether changes in GAAP are consistent with Congressional intent regarding capital adequacy as reflected in legislation, it would be able to respond best to evolving GAAP rules if legislation explicitly gave greater flexibility to FHFA to adjust capital definitions and prompt corrective action triggers to keep capital rules consistent with Congressional intent.

Another area where recent events have shown that legislation should be amended to provide greater flexibility concerns the decision to appoint a receiver. Under current law, receivership is mandatory within a short time frame in certain extreme circumstances.[2] While a strong presumption in favor of receivership is appropriate in these circumstances, recent experience has demonstrated that prompt receivership is not always the best option, even in dire conditions. Such flexibility would be analogous to the "systemic risk" exception to least cost resolution embedded in FDICIA.

Finally, FHFA supports developing a systemic, coordinated approach to mortgage and mortgage market regulation. The absence of such regulation contributed to the current crisis in a number of ways.

The organization as well as the regulation of U.S. mortgage markets is being reconsidered. In particular, the institutions and role of the secondary mortgage market are in flux. The charters of Fannie Mae and Freddie Mac have been criticized for creating conflicts of interest within those firms related to profit goals, public missions, and taxpayer-borne risk taking. A variety of options are under discussion, and FHFA has proposed the following principles to guide that discussion.

- Decide what the secondary market should look like.

[2] Section 1367(a)(4) provides mandatory receivership upon FHFA written determination that the assets of a regulated entity are and during the preceding 60 calendar days less than the obligations, or that the regulated entity is not paying and during the preceding 60 calendar days has not paid its debts as such debts come due.

- Establish well-defined and consistent mission.
- Clear demarcation of private and public sector roles
- Regulatory and governance structure to ensure prudent risk taking based on sound insurance principles
- Systemically prudent supervision that incorporates countercyclical capital to limit booms and busts

b. Do we need to reconsider the balance between guidance and rules?

Guidances have been particularly useful. In a setting where examiners and supervisory personnel need the ability to make prudential changes or respond to reasonable requests for interpretations, guidances provided useful features short of having to revise existing regulation. Experience has been that properly crafted rules, that provide clear directions, may be applied through carefully drafted guidances that remain open to revision as markets and economic conditions evolve. Guidances afford regulators flexibility in dealing with regulated entities, especially where regulations fix goals and directions, but where adjustments must be made over time to accommodate changes in legislation or regulation relating to FHFA or to other organizations. For example, a guidance on accounting was crafted by the agency in lieu of a regulation as much accounting is set forth in rules of the Securities and Exchange Commission. FHFA employed a guidance to address how it would implement its supervisory and oversight function as well as its expectations of the Enterprises, while not employing a rule that might create terms contradictory to those of the SEC. FHFA may create rule as it builds its body of accounting directives. In short, here a guidance provides a time to develop practice that may later prove useful to codify in a regulation.

Another example is provided in the crafting of the first specific mortgage fraud rule by a federal agency where FHFA employed a guidance in support of a rule. This has proved to be a balanced and workable approach. The rule provided foundation goals and requirements, such as reporting on suspected mortgage fraud employing a form developed by FHFA. The form was varied over time to adapt to new measures for detecting mortgage fraud, to conform the filing with FHFA to the needs of law enforcement and the Financial Crimes Enforcement Network (FinCEN), and to meet changing computer-based filing needs. This proved beneficial to the government in securing the most up-to-date information, to FHFA in permitting examiners to receive information in a workable framework, and to the regulated firms to adapt to changing data and software opportunities.

FHFA believes that a proper mix of rules and guidances provide for an efficient administration of its statutory responsibilities. Rules on critical topics provide clearly enforceable terms; guidances provide specialized expectations to instruct FHFA personnel and regulated entities of the agency's expectations. During the recent crisis, FHFA did not have in place rules on certain critical topics due to the late enactment of the Housing and Economic Recovery Act. FHFA is now putting rules in place and will employ guidances where beneficial.

c. Any other comments?

2. Execution of supervision

- **Consolidated supervision of large, complex firms**
  Critics have argued that supervisors failed to identify key risks developing at large, complex financial institutions. In some cases, they argue, where supervisors did identify key risk areas, they failed to react with timely and appropriate measures.
  a. What processes does your agency have in place to identify and continuously monitor emerging risks at major financial institutions?

Until last year's merger creating FHFA, two separate agencies, OFHEO and the FHFB, regulated the safety and soundness of the Enterprises and the FHLBanks, respectively. HERA established within FHFA separate divisions for carrying on those missions. FHFA's Division of FHLBank Regulation (DBR) is responsible the examination and supervision of the Federal Home Loan Banks (FHLBanks) and the Office of Finance (collectively, the FHLBank System) and FHFA's Division of Enterprise Regulation (DER) is responsible for the examination and supervision of Fannie Mae and Freddie Mac. The harmonization of the safety and soundness regulation of all housing GSEs at FHFA is a work in progress. Therefore, some of the discussion that follows identifies, as appropriate, the somewhat different approaches of the two divisions.

FHFA follows a risk-based approach to supervision. Central to that approach are the following processes: (i) identification of risks as market, credit or operational; (ii) measurement of risks; and (iii) evaluation of the effectiveness of the risk management processes employed by a regulated entity's board of directors and senior management.

FHFA's examination program promotes safe and sound operations at each housing GSE and the achievement of their housing finance and community investment missions. DBR undertakes periodic on-site visitations, off-site monitoring, and System-wide or "horizontal" reviews (which focus on a specific FHLBank activity, function, or program) to assess the operations of FHLBanks. DER has teams of on-site examiners at Fannie Mae and Freddie Mac to continuously monitor operations using the GSE Enterprise Risk (GSEER) risk-rating structure, consult with management on key matters relating to safety and soundness, and conduct targeted examinations on matters relating to governance, credit, market, and operational risks, including risks relating to the use of models. Most deficiencies identified through supervisory activities are resolved in the normal course of business. For more serious situations, FHFA may issue a supervisory determination that requires corrective action.

Both DBR and DER also have analysts continuously assessing financial results for their regulated entities and the economic drivers behind those results, monitoring legal compliance and actions taken in response to previously-identified deficiencies, and stress-testing the balance sheets of the regulated entities. FHFA's Office of the Chief Accountant devotes resources to detecting emerging risks relating to the implementation of key accounting policies across all the housing GSEs.

Finally, by combining safety and soundness and mission oversight responsibilities in one agency, FHFA monitors market developments both from the perspective of safety and soundness and mission and oversees the GSEs with an eye towards each of these considerations.

b. What processes does your agency have in place to make sure that risks and vulnerabilities at individual firms that have been identified are escalated within the supervisory function?

FHFA uses several processes to escalate significant risks and issues of the regulated entities. The DER risk assessment process incorporates analyses derived from targeted examinations, continuous supervision, remediation activities, and special projects to determine a composite risk rating as well as ratings for DER's specific risk areas (governance, solvency, credit risk, market risk, model processes, and operational risk). Each quarter DER holds a forum to highlight the most significant concerns from both a current and prospective basis and to recommend ratings to the Director. DER executives also provide a high-level discussion of corrective action on the most significant concerns. A more detailed discussion of matters requiring attention takes place during the Enforcement Oversight Committee meetings. Following the quarterly risk assessments DER managers make adjustments to their supervisory work plans as necessary to reflect emerging risks and other DER priorities.

The DER supervision planning process includes the development of a division-level calendar-year supervisory strategy that focuses DER's efforts on the most significant safety and soundness areas and provides the flexibility to adapt to changing circumstances. This planning function escalates the most significant risks and issues through the allocation of resources. DER utilizes a reporting process for matters requiring attention to facilitate follow-up and to support further escalation of issues.

DER executives participate in a number of formal and informal meetings that are held on a regular basis, including formal weekly meetings with the Director of FHFA to discuss key supervisory issues. DER executives also participate in other standing meetings with broader participation within FHFA where supervisory matters are discussed, regular meetings on matters pertaining to conservatorship, and regularly scheduled meetings among DER executives to exchange information among the teams within DER as well as with other divisions within FHFA.

DBR follows much the same approach except that, with 12 FHLBanks spread across the country, its exam teams move from one FHLBank to the next in carrying out annual exams of each FHLBank. Senior DBR staff participate in regularly scheduled meetings to discuss the current status of examinations and other current supervisory issues. In addition, DBR's Findings Review Committee provides a collaborative forum to review and discuss findings, assess whether those findings are Matters Requiring Attention (MRAs), and promote consistency across the FHLBanks. Through this process, senior division management learns about findings before they are formally presented to an FHLBank's board of directors. (The MRA process itself establishes a time frame for the FHLBank to remediate the finding and for the examination teams to monitor during ongoing supervision.) When an MRA is particularly urgent, division staff can raise the issue through their chain of command directly to the Deputy Director of DBR. Senior DBR managers meet weekly with the Director to review supervisory activities and issues.

c. What processes does your agency have in place to review examination reports and examiners?

For examinations of the Enterprises, the Associate Directors of the offices within DER (Office of Capital Supervision, Office of Credit Risk, Office of Financial Analysis, Office of Governance, Office of Market Risk, Office of Model Risk, and Office of Operational Risk) each contribute findings to the semi-annual Report of Examination (ROE). The draft ROE is reviewed by DER executives. The final report is approved by the General Counsel, the Deputy Director of DER, the Senior Deputy Director of FHFA, and the FHFA Director. Results of individual targeted examinations are provided through conclusion letters. These letters are reviewed by all Associate Directors, the General Counsel, the Deputy Director of DER, the Senior Deputy Director of the FHFA, and the Director of the FHFA before they are sent. In addition, the Office of Supervision Infrastructure within DER provides a quality management function, periodically reviewing a sample of DER's final work products for compliance with policy.

For examinations of the FHLBanks, the examiner-in-charge prepares the Report of Examination (ROE) which then undergoes review by the team's portfolio manger (examination team supervisor) and by the other safety and soundness portfolio managers to help maintain consistency in the review and rating process. The Deputy Director of DBR also reviews the ROE and then routes it to the Senior Deputy Director and the Director of FHFA for final review. DBR's quality assurance staff also conduct independent reviews of workpapers and conclusion memoranda to ensure that the ROE conforms to the agency's standards and that the workpaper documentation is complete and sufficient to support the analysis, conclusions, and ratings in the ROE.

All FHFA examiners are reviewed using a results-based performance management system. Sustaining a results-oriented performance culture is critical to successfully achieving organization goals and objectives. The performance management system provides a means for managers to link employee performance to agency goals, promote accountability for meeting goals, identifying developmental needs, and recognizing and rewarding good performance. At the beginning of the year the manager and the examiner jointly establish performance expectations. At the end of the year the manager assesses the examiner's performance relative to those expectations.

d. What were the strengths and weaknesses in the processes described above in 2a, 2b, and 2c? Did they identify key risks and result in timely and appropriate actions in the run-up to the current financial crisis – particularly with respect to risks posed by complex structured products, securitization, and nontraditional mortgage lending? Which important emerging risks were identified early but did not get appropriately addressed? Are there other examples where these processes worked well or broke down? What changes has your agency made or is it considering to these processes?

Throughout the emergence of the crisis, particularly since July 2007, OFHEO and FHFA staff have provided the Director and others with timely information and recommended actions. Before the onset of the crisis, OFHEO had placed limits on the retained portfolios of the Enterprises and imposed a 30 percent capital add-on in response to accounting and other problems at both Enterprises.

However, in the years leading up to the crisis, OFHEO did not fully appreciate the level of credit risk accumulating on the balance sheets of the two Enterprises and the damage that would eventually result from pervasive and severe house price declines nationwide. In part, that shortcoming reflects the limits of OFHEO's risk-based capital model which did not address separately nonprime lending. In addition, OFHEO did not adequately assess the risk of sharp house price reductions and a serious economic recession led by the housing sector. While OFHEO can point to many specific examination findings of particular weaknesses that examiners identified with respect to the management of credit risk, and while OFHEO's Director spoke urgently and frequently of the dangerously low capital requirements in effect before HERA, there are specific areas regarding the management of credit risk at both Enterprises where examination and supervisory staff could have recommended stronger actions to curb the growth in their exposure to non-traditional mortgages. Although, in late 2006, OFHEO issued letters directing the Enterprises to comply with the FFIEC's guidance on non-traditional mortgages, those actions came too late. Since that time, OFHEO and FHFA have made changes to improve supervision, including the creation of teams devoted to specific areas of risk. Previously, OFHEO had examination teams dedicated to each enterprise. The new organization has facilitated analysis and comparisons of practices across the Enterprises.

For those FHLBanks with large private-label MBS portfolios, the credit and liquidity risk has proven to be sizable and in some cases in excess of the FHLBank's retained earnings. A 2008 targeted review of investment practices concluded that FHLBanks' overreliance on NRSRO ratings in making their investment decisions and unprecedented deterioration in the housing and mortgage markets contributed to the underestimation of credit risk in those investments. FHFA continues to monitor the condition of those portfolios and is adopting an adverse classification policy explicitly developed for them.

e. How does your agency identify large, complex firms? What factors are considered or should be considered in the future?

FHFA considers all housing GSEs to be large and systemic, even though their operations or business lines are not complex. Fannie Mae and Freddie Mac manage $3.1 trillion and $2.2 trillion of mortgage risk, respectively. The FHLBank System has total assets of $1.2 trillion, the vast majority of which are tied directly or indirectly to residential mortgages. Mortgages are inherently complex (for example, the "plain vanilla" 30-year fixed-rate mortgage is prepayable at no cost by the borrower, which makes it challenging to manage interest rate risk).

f. What is your agency's process for setting and implementing supervisory priorities for individual institutions? What are your lessons learned from the current crisis? What changes has your agency made or is it considering?

All FHFA examinations are risk-based. Senior supervision staff assess current conditions and past examination results to prioritize and focus examinations resources. FHFA maintains ongoing, year-round examination activities at the Enterprises. .

FHFA develops a supervisory strategy for each individual FHLBank as follows. At the conclusion of an examination of an FHLBank and after meeting with the institution's board of directors, the examiner-in-charge develops a supervisory strategy that identifies key areas of risk and addresses the timeframe and the focus of the supervision of the FHLBank for the next year. The supervisory strategy is developed in consultation with modelers, accountants, analysts, and other staff and serves to alert FHFA officials as to the general supervisory direction that will be taken with regard to the FHLBank. For example, a supervisory strategy for an FHLBank might state that the focus for the next year will be on the quality of risk management and financial accounting. The on-site portion of the examination would focus heavily on those areas to determine their adequacy. An intervening visitation and the next examination would focus on those areas and follow up on remedial actions taken by the FHLBank to address deficiencies reported at the last examination.

g. How does your agency conduct supervision of non-depository subsidiaries of banks, bank holding companies, and financial holding companies? What are your lessons learned? What changes has your agency made or is it considering? Are sufficient resources available and allocated to this task?

No comment. The question is not applicable to FHFA or its supervised institutions.

h. How does your agency identify and evaluate the risks of new products to individual institutions?

Prior to HERA, OFHEO did not have new product approval authority. Pursuant to HERA, FHFA now has an interim rule on new products and activities and is establishing a process to ensure that new products and activities are assessed by appropriate agency staff.

The FHFB had authority over new business activities and FHFA continues to exercise that authority. FHFA responds to notices of new business activities that must by regulation[3] be submitted prior to any FHLBank undertaking an activity that involves collateral, risks, or operations that the institution has not previously accepted, managed, or undertaken. A notice of new business activity submitted by an FHLBank must include a description of the new business activity, the FHLBank's assessment of the risks associated with the activity and the FHLBank's capacity to safely administer and address such risks, the FHLBank's criteria to determine

[3] In accordance with HERA, the FHLBanks continue to operate under regulations promulgated by the former Federal Housing Finance Board (Finance Board) until FHFA issues its own regulations.

member or housing associate eligibility to participate in the activity, a good faith estimate of the dollar volume of the new activity over the short- and long-term, and an opinion of counsel citing legal authority for the activity. In its review and response to such a notice, FHFA analyzes the proposed new activity and its potential risks; the FHLBank's condition, performance, and ability to manage those risks; the activity's charter compliance; and assesses its implications for the safety and soundness of the FHLBank and the FHLBank System.

> To what extent does your agency rely on examiner evaluations of banks' internal risk management processes for evaluating new products?

Examiners participate in FHFA's evaluation of new products and activities.

> What are your lessons learned, particularly with respect to complex structured products and nontraditional mortgages?

Many non-traditional mortgage products were initially developed to serve the specialized needs of certain financially sophisticated borrowers. The suitability of such products for a broader customer base is highly questionable, and when those products became treated as "affordability products," both borrowers and investors suffered. The Enterprises as the major buyers of mortgages can help enforce best practices. For instance, they strongly reinforced FFIEC's rules regarding subprime and non-traditional mortgage when they announced, under pressure from OFHEO, that mortgages that they purchased or that backed MBS that they guaranteed or held in portfolio, including private-label MBS, would have to comply with those rules. Providing FHFA liaison membership in FFIEC would greatly facilitate such actions, and FHFA recommends the PWG promote such membership.

> What changes has your agency made or is it considering, to your approach to new products?

Given that FHFA has new product approval authority with respect to the Enterprises under HERA, it is establishing review and approval processes for new products and activities.

i. To what extent does the supervisory process incorporate an explicit focus on factors such as "tail risks," inherent limitations of quantitative risk management, and forecasting uncertainties? What specific "tail risks" are considered (e.g., credit, liquidity, asset prices) and how are co-movements in tail risk incorporated into the analysis? What recent changes has your agency made or is it considering?

With respect to Fannie Mae and Freddie Mac, a key part of OFHEO's previous supervisory process included the quarterly production of an estimate of "risk-based capital requirement," mandated by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, the legislation that created OFHEO. The legislation prescribed the broad parameters of the stress-tests for credit and market risk used to estimate risk-based capital. In retrospect, the credit stress scenarios incorporated into the model were not as stressful as what has actually occurred, and the model did not adequately account for such factors as the poorer credit quality of mortgages with reduced documentation. The OFHEO model (as well as some of its other qualitative supervisory assessments) incorporated some dependencies on ratings from nationally recognized statistical rating organizations, whose models for mortgage-related securities proved to be quite brittle during periods of pervasive and nationwide house price declines. In addition, OFHEO had the Enterprises run market and credit risk "stress tests," but in retrospect the scenarios considered turned out not to be extreme "tail events." With the flexibilities afforded by HERA, FHFA is exploring a more robust economic capital model approach to setting the risk-based capital requirement. FHFA staff also monitor and assess each Enterprise's internal stress test analyses. FHFA has requested that the Enterprises undertake SCAP-type scenario analyses.

With respect to the FHLBanks, FHFA incorporates an explicit focus on "tail risks" in its off-site and on-site monitoring of interest rate (asset price) risk by requiring the FHLBanks to report results from interest rate shock scenarios that are likely to be in the tails of the distribution of interest rate shocks. FHLBanks report, and often have limits associated with, positive and negative interest rate shocks of 100 and 200 basis points. FHFA considers the estimated effects of these shocks on the FHLBanks' income and market value of equity.

"Tail risks" are also an explicit focus with respect to FHFA assessments of FHLBank credit risk. DBR is working to enhance its credit risk modeling and monitoring efforts across the entire range of FHLBank investments, including the analysis of the FHLBanks holdings of private-label mortgage-backed securities (PLS). Rather than calculating an expected default rate on a given security, FHFA modeling efforts estimate the default rate necessary for an FHLBank to suffer a loss of contractually mandated payments on its PLS investments. FHFA also examines the effects of various stress scenarios affecting the FHLBanks' PLS investments.

FHFA also examines the interest rate risk models and their application for all regulated entities. Such model risk examinations are one way of addressing the inherent limitations of quantitative risk management and forecasting uncertainties. FHFA assesses the sensitivity of the models to changes in assumptions such as prepayment speeds and discount curves and also uses its own model to test and verify the estimated scenario results that derive from the models.

j. How does the supervisory process address the risk of prolonged periods of market illiquidity? How is such risk measured? What changes has your agency made or is it considering in its approach to such risk?

FHFA and its predecessors have faced numerous challenges with respect to market illiquidity. Indeed, neither FHFA nor the GSEs gave adequate consideration to the possibility of an illiquidity event of the breadth and duration of what actually occurred.

Well before the magnitude of the current crisis was known, OFHEO directed Fannie Mae to address illiquidity in their retained mortgage portfolio by securitizing whole loans that could not be pledged as collateral, and this process continues. Further, in the most recent Report of Examination, FHFA directed both Enterprises to establish revised liquidity plans that reflect current market conditions and the lessons learned from the prolonged market illiquidity of 2008.

FHFA has drafted a liquidity metric for its Prompt Supervisory Response (PSR) regulation – a limit of short-term to total debt of 45 percent. FHFA also worked with the Enterprises to assess the potential liquidity risks relating to put-backs of variable-rate demand notes.

By regulation, FHFA's predecessor, the FHFB, established minimum liquidity requirements for the FHLBanks. Specifically, that regulation requires that each FHLBank shall hold contingency liquidity in an amount sufficient to enable the FHLBank to meet its liquidity needs, which shall, at a minimum, cover five business days of inability to access the consolidated obligation debt markets. The regulation defines contingency liquidity as the sources of cash an FHLBank may use to meet its operational requirements when its access to the capital markets is impeded, and includes:

(1) Marketable assets with a maturity of one year or less;
(2) Self-liquidating assets with a maturity of seven days or less;
(3) Assets that are generally accepted as collateral in the repurchase agreement market; and
(4) Irrevocable lines of credit from financial institutions rated not lower than the second highest credit rating category by an NRSRO.

Accordingly, the regulation assumes FHLBanks can sell or conduct repo transactions during a lack of confidence in and inability to issue consolidated obligations (COs).

As financial markets seized in 2007 and 2008, the FHLBanks played a critical role in providing liquidity to member institutions, with advances growing to more than $1 trillion at September 30, 2008. As advances began their rapid increase during the late summer of 2007, the FHFB Office of Supervision instituted a periodic—at times weekly—report on FHLBank advances to stay on top of market conditions. During September 2008, when the FHLBank system's access to capital markets was strained, as indicated by a widening of spreads between the yields on COs and Treasury obligations, FHFA initiated daily liquidity reporting by the FHLBanks and established liquidity guidelines. These reports required the FHLBanks to estimate the number of days of liquidity remaining under various advance renewal or roll off scenarios, assuming that the FHLBank System could not issue debt but that maturing debt obligations would continue to be serviced. The FHLBanks now report bi-weekly on their liquidity.

k. How much of supervision is currently "audit" related (i.e., checking assertions of the firms themselves) vs. independent analysis? Is this the right balance?

Annual examinations of each of the FHLBanks and the Office of Finance have a "safety and soundness" orientation. By their very nature, examinations have some elements of an audit; however, the focus of an examination is to come to an independent determination regarding the condition and practices of the FHLBanks and the Office of Finance, including governance and the effectiveness of management. The examination work programs and guidance issued to Division of FHLBank Regulation examiners and shared with the regulated FHLBanks are periodically reviewed and updated to ensure timeliness and appropriate emphasis. Further, offsite monitoring provides another view of the activities of the FHLBanks and the Office of Finance.

With the Enterprises in conservatorships, this question is less relevant than in ordinary circumstances.

l. What does your agency do to assure that supervisors continue to enforce strong risk management practices – for example, underwriting standards – during long periods of market stability and limited credit losses? What lessons has your agency learned?

No comment. The combination of the Enterprises' accounting problems and then the housing sector problems has meant that there has not been a period of calm for at least 6 years.

m. Any other comments?

A safety-and-soundness regulator cannot be effective by only assessing the activities of the companies in its jurisdiction. Regulators must also understand the workings and interactions of the various institutions and actors within the financial "ecosystem" in which regulated entities operate. This requires closer collaboration with other regulators and improvements in gathering and organizing market intelligence.

- **Supervision of smaller institutions**
  In many ways, smaller institutions face different challenges from larger institutions.
  a. What lessons has your agency learned from the crisis with respect to the supervision of smaller institutions?
  b. What processes does your agency have in place to make sure that concentration risks and vulnerabilities at individual firms are identified and escalated for attention within the supervision function?
  c. How should the supervision of smaller, simpler firms differ from supervision of larger, more complex firms?
  d. How does your agency allocate resources between large and small banks and other financial firms? For example, does your agency allocate resources based on charter, assets, or some measure of complexity? If your agency charges examination fees, do assessments on large firms subsidize small firms or vice versa?
  e. Any other comments?

No comment. The question is not applicable to FHFA or its supervised institutions.

- **Examination programs**
  Critics have argued that supervisors in the run-up to the current crisis failed at the basic tasks of a bank examiner: for instance, testing credits and monitoring liquidity.
  a. What lessons has your agency learned from the crisis with respect to the execution of the basic tasks of the examination function?

No comment.

b. Did supervisors rely too heavily on banks' internal models?

Yes, OFHEO relied too heavily on the Enterprises' forecasts and models.

Did examiners do enough loan sampling?

No comment.

Did they do enough model testing and validation?

DER examiners did considerable model testing and validation. Actual experience has been outside that used to calibrate the models. Also, the application of existing models to untested products failed to capture the degree of differences in actual performance between traditional and non-traditional mortgages.

c. Did the risk-focused approach to supervision help or interfere with the identification of emerging issues?

FHFA's supervision program is risk-focused, but the key is to focus on the right risk. The inherently large interest-rate risk from maintaining huge retained mortgage portfolios was always a key concern of OFHEO. OFHEO had many successes in recent years in getting the Enterprises to reduce interest rate risk, culminating in portfolio limits in 2006. However, reductions in interest-rate risk were more than offset in recent years by increases in credit risk from non-traditional mortgages.

d. Any other comments?

- **Systemic risk and the Financial Services Oversight Council**
  Supervisors are tasked to protect the safety and soundness of individual financial institutions. The Treasury recommended in its white paper the creation of a Financial Services Oversight Council—to take a broader view, considering risks to the financial stability of the system as a whole. The Council would have a staff at the Treasury. Its mandate would be to facilitate information sharing and coordination among agencies, identify emerging risks, advise the Federal Reserve on the identification of firms whose failure could pose a threat to financial stability due to their combination of size, leverage, and interconnectedness, and provide a forum to discuss cross-cutting issues among regulators. An analogy could be the National Intelligence Council, which reports to the Director of National Intelligence, is staffed by expert National Intelligence Officers, works closely with staff at the intelligence agencies, and reports on emerging issues and broad trends.
  a. What are your suggestions for how the Council should implement these responsibilities?

The FSOC should emphasize that it is a responsibility of each primary regulator to consider the systemic risk posed by, and imposed on, its regulated entities. FHFA supports the concept of a council of equals chaired by the Secretary of the Treasury and urges that the functions of FSOC extend to whole process of systemic regulation, including, but not limited to, the functions described above. As part of the process of systemic risk regulation, FHFA also urges the council to think beyond the identification of systemically important institutions. Smaller institutions and linkages among institutions (e.g., markets, infrastructure, products, etc.) are also potential sources of systemic risk that should be monitored. To minimize distortions and unintended consequences, rules or other fees intended to mitigate systemic risk should be based, to the extent practicable, on continuous rather than discrete measures of systemic influence. While the FSOC could indeed have a permanent staff, perhaps housed in but independent from Treasury, the bulk of the staff should be supplied through the affiliated regulatory agencies including a senior-level liaison from each. Thus, each agency should expect to detail staff of various levels of seniority to the Council on a regular basis. By law, FSOC staff should receive compensation commensurate with that at other federal financial regulatory agencies. Steps should also be taken to ensure the Council's independence from Treasury and undue exposure to political pressures.

To achieve its primary functions of information sharing, regulatory coordination, and threat assessment, FSOC should develop

- means of systematic information collection regarding threats to financial system stability and functionality involving national and international financial regulatory agencies, financial trade associations, self-regulating entities, and other cogent parties,
- means to foster information exchange and dissemination, especially among financial regulators,
- means to determine the immediacy of threats and reasonable and appropriate mitigants, and
- means to hasten and/or coordinate regulatory action when threats are rising or imminent.

One way of approaching those functions would be to conduct tabletop exercises that involve identifying potential systemic events, mapping how each might unfold, and planning a coordinated regulatory response, including the resolution of one or more systemically important institutions. Such exercises could help identify interconnections among institutions and across markets that may not be immediately apparent. FHFA believes that the decision and process of implementing the conservatorships of Fannie Mae and Freddie Mac were improved by a relatively modest planning window of just over one month compared to certain other systemic failures and near failures that have occurred during this crisis. For example, such an exercise, if conducted sufficiently in advance of a crisis, might have revealed the dangers of treating Enterprise preferred stock as a safe investment and resulted in more limited exposure of regulated depositories to that stock. In addition, such exercises could reveal the adequacy of regulatory access to data in terms of both volume and speed. FDIC already has real-time access to information on insured deposits at large institutions.

Actual failure determinations would remain the purview of the appropriate primary federal regulator, but carrying out a resolution strategy could be greatly enhanced by a well-functioning and prepared FSOC and coordination among FSOC-affiliated agencies. Such resolutions would also be greatly aided if Congress granted FSOC standing emergency fiscal authority to facilitate systemic resolutions. One decision-making role of the FSOC could be to certify a systemic event (in consultation with the Federal Reserve and President as required for the FDICIA systemic risk exception). Such a certification could be tied to the use of emergency fiscal authority. A special bankruptcy court could also be established to oversee FSOC-facilitated resolutions of non-bank systemic financial institution failures.

b. How would your agency view its role in helping to implement the Council?

FHFA and its predecessors have recognized for some time that the institutions they regulate are systemically important and have posed significant systemic risks. In October 1999, then-Secretary of the Treasury Lawrence Summers stated that "[d]ebates about systemic risk should also now include government-sponsored enterprises, which are large and growing rapidly." In March 2000, then-Under Secretary of the Treasury for Domestic Finance Gary Gensler testified before the House Banking Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises. In his testimony he cited a number of ways to reduce the systemic threat posed by the housing GSEs, including increasing private market discipline, increasing transparency, promoting competition, imposing limits on the exposure of regulated banks and thrifts to the GSEs debt, and greater and more flexible regulatory authority for OFHEO. A few years later, OFHEO released a white paper, *Systemic Risk: Fannie Mae, Freddie Mac, and the Role of OFHEO*, which was so politically sensitive that OFHEO faced tremendous outside pressure to prevent its release. More recently, OFHEO's last director and the current director of FHFA, James B. Lockhart III, was taken to task by members of Congress when he testified that systemic risk was being concentrated in the housing GSEs, and faced stiff Congressional resistance to any mention of systemic risk in then-pending legislation.

FHFA remains committed to reducing the systemic risk associated with the housing GSEs. To do so, the agency is considering a variety of options, including the imposition of countercyclical capital or loss provisioning requirements, exploration of mechanisms to automatically recapitalize a distressed GSE, and other supervisory actions to reduce the cyclical impact of GSE activity. Separately, diminishing systemic risk should be an important consideration as policymakers develop recommendations regarding the future of the secondary mortgage market.

As the regulator of the housing GSEs, FHFA is knowledgeable about housing finance issues and in a position to contribute to the coordination of policies and regulatory actions across the regulatory community to reduce the systemic risk associated with the housing finance markets.

c. The intent is that the Council would offer an independent view on emerging systemic risks. This goal may not be achievable if the work of the Council must represent a consensus of its members. How can the structure and mandate of the Council be designed so that there is a proper balance between independence and originality, on the one hand, and serving many masters, on the other?

The answer depends in part on what decision-making responsibilities the Council is expected to have in making ongoing assessments of *potential* systemic risks. Typically, such problems are solved by providing a structure for decision-making that reflects both the will of the majority while providing minorities with certain options, such as the right to publish dissenting opinions or limit the extent to which a dissenting agency is obligated to follow through.

d. Should the FSOC or another entity issue regular financial stability reports such as those issued by the Bank of England, the *Banque de France*, and the IMF? If so, how should such reports be structured, how often should they be issued?

Yes, such reports should be produced either by the FSOC or by the financial stability regulator, if different. The structure should include a summary of macroeconomic imbalances, innovations, and other measures of emerging threats to systemic stability; identification of asset markets where prices have been deviating from long-term trends; systemwide stress tests; measures of industry-wide correlations, including those among distance-to-default measures; analysis of how risks could propagate through and across financial products, markets, institutions, and networks and related mitigation options or activities; progress on resolution mechanisms for large, complex financial firms and other initiatives to mitigate systemic risks. A minimal core set of statistics should be published semi-annually with more comprehensive reports produced at least annually. Less frequent publication would be inadequate given fluidity of modern financial firms and markets. Ideally, such reports should reflect near continuous monitoring for markets and for firms with large trading books.

- **Shadow banking system**
  Critics have said that supervisors did not understand or appropriately address the risks posed to supervised institutions and to the system as a whole by their interactions with the shadow banking system.
  a. What lessons did your agency learn about the losses incurred on structured credit products by banks and other financial institutions during the crisis?

While Fannie Mae and Freddie Mac had little to no exposure to highly complex structures such as structured investments vehicles ("SIVs") and collateralized debt obligations ("CDOs"), even the seemingly simple senior/subordinated structures that comprised nearly all of the Enterprises exposure to private-label mortgage-backed securities can result in problems, due to the highly idiosyncratic nature of individual deals. A more obvious lesson learned is that ratings from NRSROs on residential mortgage-backed securities were not comparable to ratings on corporate debt, even though the NRSROs use the same rating scales for both.

b. How should supervisors approach activities by non-supervised institutions that have an impact on markets in which supervised institutions participate? For example, if supervisors at the time had a better appreciation of the systemic risks posed by the lower underwriting standards of mortgage brokers who were following the originate-to-distribute model, what measures could they have taken?

Supervisors have a variety of levers to influence non-supervised institutions through their interactions with supervised firms as customers, product or service providers, partners, or counterparties. Those levers include continuing supervision of relevant policies and practices and the issuance and enforcement of safety and soundness regulations, guidances, and supervisory letters. For example, Fannie Mae and Freddie Mac have a large number of seller-servicer agreements and guides for third parties, many of whom may be unregulated. The Enterprises' adoption of the non-traditional mortgage guidance and statement on subprime lending effectively extended those guidelines to unregulated mortgage originators. In addition to examination of these policies and seller-servicer guides, FHFA has a series of guidances relating to safe and sound practices. These guidances deal with such diverse topics as information security (including dealings with third parties) to dealing with outside accountants and auditors (which address their impact on the regulated firms). In a recent amendment to their appraisal guides, the Enterprises required that all appraisal management companies, whether regulated or not, follow rules of conduct to avoid improper influence on the appraisal process.

In order to use those levers effectively, supervisors or regulated firms with appropriate oversight must commit to active monitoring of market conditions, new products and practices, risk positions and risk-bearing capacity among non-supervised firms, innovations, and imbalances. To the extent that the supervisory agencies commit to direct or indirect monitoring activities, much could be efficiently accomplished through interagency cooperation and coordination. When emerging risks are identified with respect to the activities of unsupervised institutions, supervisory agencies can have a substantial impact through coordinated action. Such action could include additional capital requirements on regulated entities for exposures to third parties or their risky products and prohibitions or limits on new or risky products, where new products are defined to those that have not been around through serious cyclical downturn. A key challenge is to identify risks and take actions in a timely way without stifling innovation and competition.

If financial institution supervisors had had a better appreciation of the potential damage from mortgages flowing through the broker channel, regulators could have been much more proactive in providing guidance to lending institutions for certifying mortgage brokers and tracking mortgages from specific brokers. Lenders could also have taken steps to defer compensation to brokers for mortgages coming through that channel, at least long enough to prevent early payment defaults, or otherwise ensure that those brokers had "skin in the game."

More generally, if supervisors are aware that non-supervised institutions are engaging in practices that could harm supervised institutions, then they should take steps to make sure that the supervised institutions are fully aware of those practices and caution or prohibit them against engaging in activities with those institutions.

c. How did your agency evaluate asset quality in the area of structured products?

As the Enterprises expanded their purchases of private label securities, OFHEO examiners reviewed the policies, personnel, processes, and reports that were used to manage those assets. Those reviews included the following:

1. Policies: Examiners evaluated the policies to ensure proper delegation of authorities, appropriate risk limits, escalation clauses, and required processes for limit breaches.
2. Personnel: Examiners evaluated Enterprise personnel to determine if they had the necessary skills and sufficient staff for the size, riskiness, and complexity of the portfolio. Examiners also evaluated how duties were separated.
3. Procedures: Examiners evaluated Enterprise processes (routine and escalation) and models, and compared them to the best industry practices. Additionally, examiners evaluated cash flow analyses, credit assumptions, pricing models, and data.
4. Reports: Examiners compared Enterprise reports against industry research and evaluated how well management understood and used these reports for strategic decision making.

For instance, in the beginning of 2007, Fannie Mae senior management decided to purchase subprime, private-label mortgage-backed securities below the AAA rating. OFHEO evaluated Fannie Mae's capacity to manage the risk of such assets and determined Fannie Mae needed to improve their models, increase participation of the chief risk officer, and limit program size, which was initially proposed at $3 billion. OFHEO limited Fannie Mae to a smaller pilot program that started and ended in 2007.

Did examiners rely on credit quality assessments of ratings agencies and the supervised institutions themselves?

OFHEO staff had direct expertise in structured, fixed-income products and evaluated those products using third party systems (*e.g.,* Intex, Bloomberg, and Wall Street Research) and best industry practices. Most sophisticated investors use internal evaluation methodologies to determine if subordination levels were consistent with NRSRO ratings and the price of the security. OFHEO staff compared the supervised institution's structured product evaluations to industry practices and required significant improvements to policies, processes, reports, and models. As it turned out, most models failed to consider severe enough stresses. Ultimately, too much deference was given to NRSRO ratings as the regulated entities accumulated their PLS portfolios.

What changes has your agency made or is it considering?

Although new issuance of private-label securitizations has come to a standstill, FHFA continues to evaluate credit models used by the FHLBanks and the Enterprises to assess valuations and judgments regarding the likelihood of loss on their holdings of private-label MBS. Accounting standards require that losses expected to materialize in those securities be recognized in current period earnings under certain circumstances. Such losses are referred to as "other-than-temporary-impairments." To further enhance FHFA's ability to assess judgments made by FHLBank and Enterprise managements regarding other-than-temporary impairments, FHFA also developed an internal model to provide an independent view of the likelihood of loss on those securities. The FHLBanks have developed a common approach, and FHFA is in the process of examining it.

d. Any other comments on the shadow banking system?

- **Peer comparisons and stress tests**
  Supervisors conduct stress tests and use a number of other tools to encourage examiners and analysts to compare the financial soundness and risk management of peer institutions. The stress test conducted in the first half of 2009 on 19 large firms took a more comprehensive approach to peer or "horizontal" analysis of individual firms.

a. What stress testing has your agency conducted on large banks in the past?

OFHEO was required by statute to run stress tests to establish risk-based capital ("RBC") requirements for Fannie Mae and Freddie Mac. The broad parameters of the RBC test were mandated by The Federal Housing Enterprises Financial Safety and Soundness Act of 1992, which created OFHEO.

Has it been firm- or enterprise-wide or limited to specific products?

The model for determining RBC requirements forecast cash-flows for ten years for the entire balance sheet, including guarantee obligations for "off-balance sheet" securitizations.

What lessons did your agency learn from previous efforts to promote peer comparisons among similar institutions?

The only firm comparable to Fannie Mae is Freddie Mac and vice versa. While mortgage insurers and S&Ls share similar concentrations to mortgage credit exposure, and S&Ls also have to manage mortgage interest-rate risk, those institutions have different sources of funding and far smaller operations.

With respect to the FHLBanks, FHFA conducts horizontal reviews to assess given activities, functions, or programs across all twelve of the FHLBanks. Those reviews lend themselves to timely comparison of the operations, strategies, and policies in place at the FHLBanks, enabling FHFA to identify best practices, supervisory concerns, deficiencies, and other matters throughout the FHLBank System. Findings from horizontal reviews are often addressed in advisory bulletins issued following each review.

b. What lessons did your agency learn from the 2009 stress test?

FHFA worked with Federal Reserve staff to gain an understanding of the SCAP process, particularly relating to the assessment of mortgage risk. Getting estimates of future mortgage losses among the institutions participating in SCAP provided FHFA with useful benchmark to assess estimates of losses by the Enterprises. The SCAP scenarios were similar to stress tests that FHFA was already requiring of the Enterprises.

Should supervisors institutionalize the use of stress tests to complement the supervisory process – if so, how frequent should such tests be, and how specific should the supervisors be in defining parameters and benchmarks?

Yes.

Did our understanding of the businesses and risks of individual institutions increase?

Yes. FHFA found the information from SCAP useful for comparing the mortgage risk borne by other large financial institutions to that borne by the Enterprises.

c. Do your supervisors conduct their own modeling of credit and other risks facing individual firms and the financial system overall?

In addition to OFHEO's earlier work in the development of the RBC models for the Enterprises, FHFA is now developing an economic capital model that includes a component for estimating credit risk. *(Note: FHFA does not have a model of the entire financial system.)*

d. Should supervisors strengthen the supervisory process by reinforcing horizontal analysis of firms in other ways?

Yes. The horizontal analysis of firms is necessary given the interconnectedness of financial institutions worldwide and the highly correlated exposures among these firms. To facilitate better horizontal analysis, regulatory agencies at the federal level must cooperate more closely, not only with each other, but with state, local, and international agencies as well.

e. Should uniform stress tests be mandated and regularly run?

FHFA is developing an economic capital model that will provide the capacity to stress-test each Enterprise's balance sheet each quarter. As noted earlier, OFHEO ran quarterly stress tests to determine risk-based capital requirements for the Enterprises. Uniform stress tests run at regular intervals can provide useful information to supervisors, including the raw, granular data from institutions, which can be analyzed in numerous ways. However, regulators must be alert to the potential for gaming that may result from the uniformity and regularity of such testing.

If so, who should decide which scenarios to evaluate and how should such stress tests be selected and changed over time?

It is folly to presume that anyone could assign with any certainty a probability to the occurrence of any particular stress scenario. Thus, scenarios should be selected primarily to determine the range of possible outcomes when adversity arises. The current crisis demonstrates that reality can far exceed the most pessimistic vision of many risk managers and supervisors.

How should such tests measure and evaluate correlations across institutions?

Supervisors must understand that in a highly stressed economic environment, financial risk across many asset classes and institutions can become highly correlated in a manner that increases systemic risk. Thus, risk models must not assume that financial instruments and institutions that are uncorrelated in times of economic expansion and low volatility will remain uncorrelated.

f. Any other comments?

- **Information-gathering**

  A great deal of information about individual institutions is available to bank supervisors, some through mandatory filing of regulatory reports and public disclosures, and some through the provision of internal reports such as risk reports to company boards of directors.

  a. What lessons did your agency learn from the current crisis with respect to the information supervisors had and should have had about individual institutions?

With respect to the FHLBanks, FHFA learned a number of lessons. First, FHFA learned that it needed to capture additional information. For example, FHFA began collecting more detailed on FHLBank advances, FHLBank liquidity, and FHLBank holdings of MBS and that information was collected on a more frequent basis than the normal monthly and quarterly reporting cycle.

Second, FHFA learned that the information needed from supervised institutions is not always readily available from those institutions. For example, some FHLBanks did not have the in-house capability to perform sophisticated cash flow analysis on their holding of MBS. FHFA was able to obtain the information needed by getting the FHLBanks to share expertise throughout the FHLBank System.

Third, FHFA learned that information on certain financial items is not necessarily comparable across institutions. For example, fair value estimates related to financial assets and liabilities may not be comparable due to differences across institutions in the models and assumptions used in deriving them.

In contrast, FHFA faced no shortage of information with respect to particular financial instruments owned or guaranteed by the Enterprises. At least quarterly, FHFA receives detailed information on nearly all assets and liabilities owned by the Enterprises. Much of this information is on an instrument-by-instrument level of detail, and is used for FHFA's own risk-based and economic capital models. Indeed, the problem is not a lack of pure financial data with respect to the Enterprises, but rather the means and time to better exploit this data beyond modeling capital adequacy.

Importantly, FHFA needs to know more regarding the true financial condition of key counterparties, particularly mortgage insurers, investment banks that serve as derivatives counterparties, and large mortgage seller/servicers. In this regard, closer coordination with other financial regulators is required.

b. What additional information should supervisors obtain from regulated firms on a regular basis, particularly large and highly integrated institutions – for example, to facilitate the ability of supervisors and market participants to conduct analysis and stress tests as described in the previous question?

Supervisors could collect selected information on each investment security held in a supervised entity's portfolio. For example, they could collect the CUSIP number, the purchase price per share, the book value per share, and the fair market value per share. The information would allow supervisors to compare the differences in the fair values assigned to specific securities that are held by two or more institutions.

Supervisors could also collect more information on the market risk exposures of regulated institutions. For example, supervisors could collect information on the duration of each major asset and liability category. Supervisors could also collect information on key interest rate risk metrics for each supervised entity so as to enable the supervisor to measure the earnings-at-risk and market value-at-risk due to changes in interest rates.

c. Should the agencies issue guidance on the format and content of information that large institutions should provide to their own boards of directors?

This question is under review at FHFA as it develops prudential management standards as required by HERA.

d. Any other comments?

- **Market discipline and transparency**
  Some observers have argued that the capital markets, through shareholders, creditors, and counterparties, can play a positive role in the governance of bank behavior.
  a. What role should market indicators such as bond and equity prices and credit default swap spreads play in the supervisory process?

Market prices undoubtedly contain useful and forward looking information. Exactly how supervisors should incorporate such prices into their processes remains uncertain. Besides the difficulties of teasing out firm or sector specific signals from prices on multiple financial instruments, supervisors also face the conundrums that overreliance on market prices can increase the procyclicality of regulatory actions, prices can at times be lagging indicators, and such reliance can be a mechanism that coordinates "systemic in a herd" behavior. Thus, supervisors must balance the implications of market prices for firm safety and soundness with the implications for systemic stability. In addition, supervisors should take care not to blindly play into the self-serving strategies of short sellers.

In the case of the GSEs, senior and subordinated bond prices provided limited market discipline because of the "implicit guarantee" ascribed to them by many market participants. Falling stock prices were a good indicator or distress, but led to a perverse result: resistance by Enterprise managements to the issuance of common stock as the crisis unfolded.

b. Is the current balance of supervisory information made public appropriate? Would greater disclosure of supervisory analysis be useful to strengthen the supervisory toolkit and promote market discipline? How would greater disclosure impact supervisory behavior and the relationship between the bank and its supervisor?

c. Were the disclosures of regulated financial firms and their supervisors sufficiently transparent for investors, customers, and counterparties to comprehend the nature and magnitude of risk taking and the quality of risk management practices?

d. Should supervisors make public information about individual institutions or regarding horizontal stress test results, to strengthen the supervisory toolkit and promote market discipline?

Yes. FHFA is required by statute to submit an annual report to Congress on all fourteen housing GSEs and has released results of its risk-based capital model which are based on stress tests. Generally, broad disclosure provides the regulator with additional supervisory leverage. For example, if managers know its problems will be disclosed to the public, they are more likely to exert effort to avoid problems and to comply with supervisory guidance. If problems arise, disclosure helps hasten remediation and reassure business partners that problems are being addressed and contained. Benefits also accrue to market participants as the recent experience with disclosures related to the 2009 stress tests shows. Also, as shown by that experience, it is often futile or counterproductive to not disclose such results.

e. Any other comments?

Unique among federal financial regulators, FHFA is required by statute to report publicly the results of its annual examinations to Congress.

3. **Structure of supervision**
   - **Cooperation and collaboration among supervisors**
     With more than one federal financial supervisor, it is critical that they share information and collaborate closely, particularly in order **to** ***effectively supervise large institutions.***

a. What lessons did your agency learn from the current crisis with respect to cooperation, coordination, and collaboration among supervisors, for example, between consolidated supervisors and functional and bank supervisors?

b. How do functional and bank supervisors interact with consolidated holding company supervisors to ensure strong and thorough consolidated supervision? What works and what doesn't work?

No comment.

c. How can supervisory agencies better coordinate their examination and analysis activities and share information? Is there information that your agency needs but has trouble getting from another supervisor?

[Combined answer to a, and c]

FHFA has generally found such collaboration beneficial, although at times sharing has been fairly one-sided. The basis of interagency collaboration has been MOUs to share information regarding supervisory practices, which FHFA has with financial services regulators, the SEC, and state regulators. Through the MOUs, FHFA has shared certain regulatory information, participated in examiner trainings, and consulted on important regulatory decisions. The highest profile consultation (which involved OCC, OTS, the Federal Reserve, and the Treasury) preceded the decision to place Fannie Mae and Freddie Mac in conservatorships last September. FHFA benefited from the expertise, alternative approaches of other regulators, and the support of other regulators in arriving at that decision.

In addition to conservatorship decision, FHFA has worked with the FBI and Justice Department on a regular basis regarding mortgage fraud and has worked with state government regulators on topics such as registration of regulated or unregulated mortgage originators, mortgage fraud, and actions to address poorly constructed energy efficiency lending programs.

In general, the benefits from collaboration arise from the sharing of resources and perspectives among regulatory agencies. In addition, gains may arise from the potential stiffening of regulatory resolve that accompanies verification or validation of an agency's observations by others with similar missions—with the potential to reduce regulatory capture. However, too much collaboration can also be detrimental. At some point, potential benefits from collaboration are diminished to the point where they no longer justify the costs, which may include groupthink, resulting in regulatory blind spots, or overly burdensome regulation. In addition, too much harmonization across regulators can increase herding behavior among financial firms and market participants that can heighten overall systemic risk.

FHFA sees benefit in membership to FFIEC. The housing GSEs can promote best practices within housing finance.

d. How do federal and state supervisors coordinate with foreign supervisors in the supervision of multi-national financial firms? What works and what doesn't work? Are there specific instances in which it would have been helpful to have more information from the home supervisor to understand a troubled foreign-owned institution during the current crisis?

No comment.

e. How should the *incentives* and *organizational structure* of the agencies' supervision of firms with more than one supervisor be revised to strengthen cooperation and collaboration among supervisors? For example, what kind of coordination mechanism or legal mechanism might help resolve differences?

No comment.

f. Should consolidated supervisors and functional and bank supervisors be required to collaborate on a single, consolidated supervisory plan for large institutions?

No comment.

g. How can supervisors further encourage the development of a sense of shared mission and increase interagency expertise – for example, would you support staff rotations or secondments among agencies?

No comment.

h. There are many examples of collaboration among agencies that follow different models, such as SNC, FFIEC, supervision of TSPs, and the recent SCAP stress test. What works and doesn't work?

No comment.

i. Has the Federal Financial Institutions Examination Council satisfactorily fulfilled its role as a forum for discussion of policy-setting among the agencies? Could your agency provide specific examples where it worked or failed to work well?

Neither FHFA nor its predecessor agencies have been full or liaison members of FFIEC. FHFA has pressed for inclusion in the Federal Financial Institutions Examination Committee, in an observer status, so it may gain information and more effectively coordinate with federal regulators in matters relating to the mortgage finance system and core examination practices.

j. Any other comments?

- **Regulatory arbitrage**
  Critics have noted that the existence of competing charters creates the opportunity for regulatory arbitrage or charter-swapping among agencies. In some cases, financial institutions have been able to avoid serious regulation by finding loopholes in the supervisory structure.
  a. How does your agency define its mission, and how does its mission differ from the other federal agencies?
  b. Is regulatory arbitrage a problem? What is your understanding of the scope of the problem and what causes it? How should regulatory arbitrage be addressed?
  c. One issue is what activities should be allowed to occur within an insured depository, and when an activity should be undertaken only in a non-depository affiliate of the bank. Should existing law and regulations on what activities are appropriate within a state or federal insured depository be changed and, if so, how? Should supervisors have some measure of discretion in making that determination? What would the guiding principles be?
  d. What measures could be taken to reduce undesirable outcomes such as, for example, firms seeking to switch charter in the hope of finding a more favorable supervisory regime? Does your agency have any data or examples explaining why institutions convert charter?
  e. To what extent is regulatory competition impacted by how supervisory agencies are funded and structured? How can that issue be addressed?
  f. Does competition between regulated and unregulated entities undermine the ability of your agency or its regulated entities to maintain safety and soundness? If so, what steps can be taken to mitigate that effect?
  g. Critics also have noted that an uneven approach to supervision across types of financial services firms (e.g., commercial banks and thrifts, investment banks, insurance companies, unregulated finance companies, investment companies and others) may complicate the ability of bank regulators to impose prudential requirements that are not readily avoided. How important is this concern and what should be done about it?
  h. Any other comments?

FHFA-supervised institutions cannot change their charters without congressional action, so many of these question are not applicable to the housing GSEs. Looking forward, FHFA believes it would be helpful for regulators to consider possible arbitrage opportunities arising from differences in regulatory capital requirements for mortgages.

- **Oversight of the supervision function**
  Supervisory agencies, like the institutions they regulate, rely on policies and procedures, internal controls, and management information systems to elevate issues to senior management or Board members, ensure quality of the supervisory product, and assure appropriate checks and balances.
    a. Describe your agency's policies and procedures, internal controls, and management information systems – for instance, the role of the internal audit or inspector general function; the review and approval of examination findings and enforcement actions; the oversight of examiners by peers or headquarters.

The policies and procedures FHFA uses with respect to the Enterprises are established in the Supervision Handbook, Supervisory Guide, and Supervision Reference and Procedures Manuals. The Supervision Handbook establishes the overall regulatory framework and defines the supervisory rating scheme used to evaluate the Enterprises. The Supervisory Guide provides detailed instructions on the workflows and documentation requirements for examiners. The Supervision Reference and Procedures Manuals provide examination procedures for use by the staff when conducting supervisory activities. In addition, the quality management function provides a three-part review: quality control or front-end controls, quality assurance in the form of after-the-fact quality reviews, and quality improvement to enhance business processes based on the results of the quality assurance reviews. DER supervisory documentation is maintained electronically in an automated supervisory tool, Examiner Workstation. Examiner Workstation enforces certain quality controls such as manager approvals and documentation requirements automatically. Quality assurance reviews are presented to the Executive Committee on Internal Controls so that the findings can be incorporated into the agency's A-123 assessments.

A newly formed enforcement oversight committee has recently started providing oversight of all matters requiring attention through a roundtable discussion of each conclusion letter. Review by the committee ensures that conclusion letters are appropriately focused on root causes of issues at the Enterprises. Consideration of new enforcement actions will also be through this committee.

Similarly, with respect to the FHLBank System, the FHFA's FHLBank safety and soundness examination manual addresses the risk-based supervisory examination standards, expectations, and requirements. The manual promotes consistency by providing guidance on identifying and analyzing the key risks, procedures, and controls applicable to Federal Home Loan Bank activities. FHFA/DBR issues Advisory Bulletins and Examiner Guidance Bulletins that provide clarification and guidance on specific supervisory issues, examination standards, practices, and requirements. Management communicates with staff on an ongoing basis to ensure consistency with established standards, expectations, and requirements.

Policies, procedures, and internal controls related to the supervision of the FHLBanks include the following:

- Qualified personnel. Management and staff have technical knowledge and expertise in banking, the financial services service industry, and the Federal Home Loan Bank environment. The risk-based supervisory process emphasizes collaboration and sharing of technical knowledge and expertise in the evaluation of Federal Home Loan Bank activities. Other FHFA personnel such as accountants and legal counsel are integrated in the collaborative process of assessing significant risks and exposures, and developing supervisory strategies. In addition, management collaborates with legal counsel on applicable enforcement actions.

- Designated staff assigned to Federal Home Loan Banks. Portfolio managers and examiners in-charge manage the on-going supervision of specific Federal Home Loan Banks. Their responsibilities include reviewing the examination workpaper documentation to support the analyses, conclusions, findings, ratings and the Report of Examination. Also, they keep management informed of activities that may warrant supervisory or examination attention.

- On-going monitoring. FHFA examiners conduct on-going assessments (off-site monitoring and periodic on-site visitations) of key financial data and other indicators (e.g., interest rate sensitivity, credit concentrations, member performance) that may warrant further investigation.

- Internal assessments. FHFA performs internal assessments (including a Findings Review Committee, collaborative review of draft Reports of Examination, workpaper reviews and quality assurance evaluations) to evaluate the adequacy of its risk-based supervisory processes and identify potential opportunities to enhance the effectiveness and control environment for FHLBank supervision. Staff have opportunities to provide feedback on the enhancement or streamlining of control activities (e.g., e-mail account for examination manual updates and staff meetings).

Information related to the supervision of the Federal Home Loan Banks is stored on a secure server and selected information is kept on a restricted drive. Other management information systems include extranet, intranet, and SharePoint sites and the agency's e-mail application.

b. How does your agency monitor the quality of the conduct of the supervision function, and how can that be improved?

Each supervision manager is responsible for quality control over the work of subordinates. Examiner Workstation reminds managers of this responsibility when they provide approval to work products within the system. Independent quality assurance reviews are conducted using a risk-based schedule. Those reviews identify shortcomings in the compliance with policy and in the quality control activities of managers. FHFA undertakes corrective action based on the recommendations in the quality assurance reviews.

FHFA is also subject to independent external audits performed by the Government Accounting Office (GAO) and in the future by an Office of Inspector General (OIG).

These audits provide feedback on the adequacy and effectiveness of policies, procedures, operating practices and internal controls. Management initiates corrective action based on a collaborative evaluation of the relevant facts, risks, costs and benefits, potential changes in policies, procedures, controls, and other priorities. Management and quality assurance personnel track the status of relevant issues and corrective action. Internal assessments evaluate the adequacy of corrective action, and if applicable, relevant issues and corrective action are reevaluated when policies, procedures, and controls are revised. One opportunity for improvement is in developing and implementing an electronic workpaper standardization tool that facilitates information sharing and improves control over workpaper documentation. Several options are being considered.

- **Regulatory independence**
  Critics argue that supervisors may get too close to the institutions they supervise, impeding the appropriate skeptical and independent approach.
  a. Other national supervisors have chosen not to exercise supervision through on-site examiners, preferring instead roving teams of examiners or reliance on outside auditors. The UK FSA recently considered, and again rejected, the on-site examination model. Similarly, within the US, other types of government supervisors follow varied models. What are the costs and benefits of relying on on-site examiners? What would be the benefits and risks of enlisting the expertise of outside experts?

The supervision of the FHLBank System, described in more detail above, combines on-site and off-site reviews. On average, examiners are on site at an FHLBank for about six to eight weeks to conduct the annual examination. In addition, the examiner-in-charge conducts one or more additional visitations during the year. Other supervisory personnel, including analysts, accountants, and economists, perform most of their work off-site, but may make on-site visits as part of their analyses. The on-site and off-site approaches complement one another. Technological advances allow for greater use of off-site analysis than would have been feasible in the past and enhance the consistency of reviews across institutions, and DBR will be expanding its off-site analysis and monitoring program in the upcoming year. Relying solely on off-site analysis, however, could limit the understanding of institution-specific characteristics and thus present only a partial picture of its condition, performance, and risk-taking. Outside experts could be valuable in providing a fresh perspective on supervisory issues, but may be less familiar with unique features of those institutions or may have a narrow perspective based on their area of specialty.

Similarly, DER combines on-site examiners and off-site monitoring. DER reorganized exam teams from an Enterprise-based to a risk-based structure to help prevent "regulatory capture." Enterprise supervision has sometimes relied on outside experts both from private firms and from other federal financial regulators to provide added perspective and expertise. Going forward, FHFA anticipates encouraging greater movement of supervision staff within the agency (a benefit made available with the creation of FHFA) and greater sharing of supervision resources with the federal banking agencies.

b. What measures or policies does your agency have to prevent examiners and their program managers from getting too close to supervised institutions – for example, mandatory rotations of examiners and/or their program managers? What are your processes for exemptions to those processes?

FHFA has agency-wide ethics and conflict-of-interest policies. For example, FHFA examiners and personnel supervising Fannie Mae and Freddie Mac at certain job levels may not receive compensation in any form from those Enterprises for two years post-employment. FHFA also complies with Office of Government Ethics regulations that require the filing of financial disclosure reports. All employees over a certain grade-level file a public financial disclosure report. Employees below that grade-level but who are in examiner and contracting positions file a confidential financial disclosure report. Both public and confidential financial disclosure reports are reviewed for conflicts of interest. FHFA employees receive ethics training at the time of employment, annually thereafter, and at the time of separation from federal employment. In addition, the FHLBank examination manual includes guidance on examiner conduct that addresses a range of issues including professional and ethical conduct and interactions with FHLBank System personnel.

FHFA also strives to ensure that assessments are reasonably consistent across the regulated entities, accounting for differences between the Enterprises and the FHLBanks in their respective business plans. These efforts include all supervisory activities. On the examination side, DBR rotates the specific FHLBanks that each examination team reviews and most examiners perform reviews at four FHLBanks during the course of a year. In addition, the portfolio managers (who manage the four FHLBank examination teams) collaborate on their assessments of key issues and review and comment on all examination reports. Specialist working groups focused on credit, market, and operational risk meet regularly to discuss developments in their areas and consider how to address them consistently across the FHLBanks. Functions performed off-site by analysts, accountants, economists, and others typically examine issues and provide a consistent set of information across all FHLBanks.

DER reorganized its examination function in 2008. One of the goals of the reorganization was to have examiners work at both Enterprises, not exclusively at one or the other, as had previously been the case. Although the main goal of this reorganization was to provide staff with better perspectives when conducting their analyses and examinations, it also served to reduce the likelihood of regulatory capture.

c. What are your agency's lessons learned from the crisis with respect to the incentives and behavior of supervisors relative to the firms they supervise? Is your agency contemplating any change to your current organizational structure?

If they didn't already know this, DER staff have learned that they must view with appropriate skepticism any assertions made by management and executives of the institutions that they regulate. It is best to maintain relationships that are professional but arms-length. Now that Fannie Mae and Freddie Mac are under conservatorship, and FHFA has delegated many of the agency's conservatorship authorities to the Boards of Directors and management, the nature of our relationship has, in many respects, changed to one of closer collaboration than before, but there is still a need for examination staff to maintain an air of professional skepticism.

The conservatorship has give rise to some organizational changes within FHFA, including a specially designated Office of Conservatorship Operations to ensure the separation of those responsibilities from the examination process. We continuously assess other aspects of our organizational framework to ensure that it maximizes our effectiveness.

FHFA recently published in the Federal Register a proposed rule regarding post-employment restrictions for senior examiners. The proposed rule is very similar to rules already in place at other regulators. It would restrict certain senior examiners with substantial contacts with the Federal Home Loan Banks, the Office of Finance, Fannie Mae, or Freddie Mac from working at that entity for one year after leaving FHFA (two years in the case of the Enterprises).

d. What incentives are in place to ensure examiners and their program managers will feel unimpeded in their ability to challenge the firm's management and to take a skeptical and independent approach?

FHFA has taken several actions to reinforce examiner independence. For example, examiners now meet on a regular basis to discuss trends and developments in credit, market, and operational risk areas and recommend improvements to examination practices and procedures.

In addition, the Director of FHFA and other senior executives have led by example by being visibly forthright in their dealings with executives at the housing GSEs. This gives assurance to examiners and other supervisory staff that they can challenge management when necessary and get support from the leadership of our agency.

e. How does your agency monitor the skepticism and independence exhibited by examiners and program managers in the exercise of their supervisory judgments? What checks and balances does your agency have in place? What further steps is your agency contemplating?

The workpaper documentation and reviews performed by the examiner-in-charge, examination specialists, portfolio managers, and supervision executives provide checks and balances to ensure the identification, evaluation, and appropriate reporting of findings.

A quality assurance process also reviews and assesses workpapers and other documentation to ensure that the analysis and conclusions are supported. Further, given the number of the staff supervising the FHLBanks, managers can monitor supervisory staff more closely than may be possible in larger agencies or offices.

The FHLBank supervisory program itself demonstrates independence in assessments, regularly reviewing its regulations and supervisory polices on risk management practices to ensure that such regulations and policies are appropriate given the risk exposures of the FHLBanks and conditions in the economy and financial markets. As an example, despite the fact that the FHLBanks have never suffered any credit losses on their advances, the FHLBank supervisory program undertook a comprehensive review of each FHLBank's collateral and credit underwriting policies and practices during the 2008 and 2009 examination cycles. Because of those reviews, FHFA learned that the FHLBanks needed to strengthen their collateral and credit review practices.

For DER, examination reports and conclusion letters, along with supporting documentation, go through a thorough review process. Draft reports and conclusion letters are circulated among Associate Directors within DER, and major findings are now discussed at a bi-weekly Enforcement Oversight Committee. These documents are reviewed and signed-off by examination managers, the Associate Director of the office in which they originated, the FHFA General Counsel, the Deputy Director of DER, the Senior Deputy Director of FHFA, and the Director of FHFA. The Director of FHFA reads all of supervisory documents and provides detailed comments and suggestions, particularly if findings and conclusions are not well supported or if some weakness of the Enterprise is not properly addressed.

In addition, the Office of Supervision Infrastructure within DER has a quality assurance function to ensure that our reports and letters adhere to our internal policies, and DER is subject to review by FHFA's Office of Inspector General.

f. Any other comments?

- **Resources**
  Insufficient examiner resources and expertise may have been a significant cause of supervisory failure during the financial crisis.

  a. What are your agency's lessons learned about staffing, resources, and expertise?

  During the six years prior to HERA, the emphasis of the supervisory program overseeing the FHLBanks changed substantially from a compliance-based to a risk-based focus. To enhance the identification and evaluation of the relevant risk exposures of the FHLBank System, the FHFB more than tripled examination staffing resources.

  The meltdown of the mortgage market has caused FHFA to reassess the specific skills of agency staff. That assessment showed, for example, insufficient "street" knowledge of the mortgage market, particularly with respect to fully understanding processes for sourcing mortgages and deal-making at the seller/servicer level. Given that contractual arrangements with large seller/servicers can have a profound effect on the Enterprises' guarantee obligations, DER needs the expertise of people who understand sourcing. Indeed, this may be an area where FHFA could employ outside experts on a temporary basis to enhance our understanding.

  b. How can we ensure that individuals in the examination process have adequate resources, including analytical tools and expertise, to effectively question and challenge the firm's management regarding key risks and vulnerabilities?

  The sheer scale of the housing GSEs demands that FHFA examiners and other supervision staff have access to a variety of analytical tools to understand the mountains of information that comes their way. The agency has plenty of tools at its disposal; the challenge is to ensure that staff have appropriate expertise and are adequately trained to use those tools. FHFA is in the process of developing new risk-based, economic capital models and has issued an RFP for that purpose.

c. Are there impediments to acquiring and retaining subject-matter experts or other qualified staff – for example, compensation, or non-pecuniary rewards such as opportunities for personal development, training, and rotations? What changes has your agency made or is it considering?

FHFA is implementing a new benefits and pay system, so it is difficult to respond to this question. One issue that has arisen is the rate of annual leave accruals and the ceilings on accruing annual leave for senior examiners recruited from industry rather than from government.

d. Any other comments?