# Federal Housing Finance Agency Office of Inspector General

## Semiannual Report to the Congress

April 1, 2012, through September 30, 2012

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# Office of Inspector General

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# OIG's Mission

The mission of the Federal Housing Finance Agency Office of Inspector General (OIG) is to: promote the economy, efficiency, and effectiveness of Federal Housing Finance Agency (FHFA or Agency) programs and operations; prevent and detect fraud, waste, or abuse in FHFA's programs and operations; review and, if appropriate, comment on pending legislation and regulations; and seek administrative sanctions, civil recoveries, and criminal prosecutions of those responsible for fraud, waste, or abuse in connection with the programs and operations of FHFA.

In carrying out its mission, OIG conducts independent and objective audits, evaluations, investigations, surveys, and risk assessments of FHFA's programs and operations; keeps the head of FHFA, Congress, and the American people fully and currently informed of problems and deficiencies relating to such programs and operations; and works collaboratively with FHFA staff and program participants to ensure the effectiveness, efficiency, and integrity of FHFA's programs and operations.

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# A Message from the Inspector General

I am pleased to present OIG's fourth Semiannual Report to the Congress, which covers OIG's activities and operations from April 1, 2012, through September 30, 2012.

OIG provides independent, objective oversight of FHFA's programs and operations, including its regulation of the housing government-sponsored enterprises (GSEs) – the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Home Loan Bank System (FHLBank System). Since September 2008, FHFA has also served as the conservator of Fannie Mae and Freddie Mac (collectively, the Enterprises).

At a time when housing markets across the nation remain fragile, FHFA, the Enterprises, and the Federal Home Loan Banks (FHLBanks) continue to be key players in the nation's housing finance system. Further, their future role in that system remains a topic of debate. The work performed by OIG during this period – and summarized in this report – illustrates the challenges that confront FHFA, the Enterprises, and the FHLBanks, and we hope that it will help to inform the debate surrounding the future of the housing finance system.

Our reports during this period address the challenges the GSEs encounter when operating in distressed housing markets. One report focuses on the Enterprises' management of their inventories of foreclosed properties and highlights the significant "shadow inventory" of properties awaiting foreclosure in the coming months. Another describes the process by which Fannie Mae has attempted to control its ongoing credit losses through the transfer of over one million loans to specialty mortgage servicers. Still another analyzes how a Freddie Mac process change affecting loan repurchase claims – a change supported by OIG and Freddie Mac's internal auditors – may produce an additional $1 billion in income for the Enterprise in 2012 alone.

OIG has also been active on the law enforcement front. During this period, multiple individuals were charged, convicted, and/or sentenced to significant prison terms based on their participation in a variety of mortgage fraud schemes impacting the GSEs. OIG investigators and attorneys made significant contributions to these cases, which were brought by federal, state, and local partners across the nation.

We remain mindful of our privilege to serve the public and grateful for the support of Congress, FHFA, and others as we carry out our important mission.

Steve A. Linick
Inspector General
October 31, 2012

Steve A. Linick
*Inspector General of the Federal Housing Finance Agency*

EXECUTIVE SUMMARY

# Executive Summary

## OVERVIEW

This Semiannual Report discusses FHFA developments and the operations of OIG from April 1, 2012, through September 30, 2012.[a]

## FHFA DEVELOPMENTS

FHFA is the safety, soundness, and mission regulator of the housing **GSEs**: Fannie Mae, Freddie Mac, and the FHLBank System. The FHLBank System is comprised of 12 regional FHLBanks and the Office of Finance. FHFA has also been the conservator of the Enterprises since September 2008.

**Government-Sponsored Enterprises (GSEs):**
Business organizations chartered and sponsored by the federal government.

As conservator, FHFA's powers include:

- taking over the assets of and operating the Enterprises with all the powers of their shareholders, directors, and officers; and
- preserving and conserving the assets and property of the Enterprises.

During the semiannual period, FHFA has exercised those powers by, among other things, concluding that the Enterprises should not participate in principal reduction programs; announcing further increases to guarantee fees; continuing implementation of a real estate owned (REO) pilot program; and agreeing to the revision of the terms of the Enterprises' stock purchase agreements with the Department of the Treasury (Treasury).

After extensive analysis, FHFA indicated that Enterprise participation in the Home Affordable Modification Program Principal Reduction Alternative (HAMP PRA) would not meaningfully reduce foreclosures in a cost-effective way for taxpayers. FHFA asserts that in order to strengthen the Enterprises' loss mitigation and borrower assistance efforts and improve the operation of the housing finance market, actions should focus on further streamlining refinance opportunities, enhancing the short sale process, and reducing lender uncertainty that could inhibit new mortgage lending.

FHFA also announced that the Enterprises will further raise guarantee fees on single-family mortgages by an average of 10 **basis points** beginning later this year as a step toward encouraging greater participation in the mortgage market by private firms. The Agency also announced a proposal to implement new risk-based pricing for its mortgage guarantees based on state-level factors, which would result in increased upfront guarantee fees of between 15 and 30 basis points for mortgages on properties located in Connecticut, Florida, Illinois, New Jersey, and New York.

**Basis Points:**
Refers to hundredths of 1 percentage point. For example, 1 basis point is equivalent to 1/100 of 1 percentage point.

Additionally, the Agency continued implementation of its REO pilot program launched earlier in the year by soliciting bids from qualified investors on a pool of single-family properties and announcing the first winning bidder.

[a] The Inspector General Act of 1978, 5 U.S.C. App. 3 § 5, requires that each inspector general compile a report of his or her office's operations for each six-month period ending Mar. 31 and Sept. 30.

As announced by Treasury, FHFA signed a third amendment to the Senior Preferred Stock Purchase Agreements (PSPAs) that govern the assistance provided by Treasury to the Enterprises. Notably, the amendments accelerate the reduction of the Enterprises' retained mortgage investment portfolios and change the 10% per annum dividend payment to a quarterly sweep of all positive net worth each Enterprise accrues going forward.

These and other FHFA developments are discussed in detail in this Semiannual Report.

## OIG OPERATIONS

During the semiannual period, OIG published 14 reports relating to FHFA's oversight of significant GSE issues. Among the effects of OIG's reporting efforts is Freddie Mac's likely recovery of approximately $1 billion in added income in 2012 and up to $3.4 billion in later years. Further, to date, OIG has made over 80 recommendations to improve the transparency, efficiency, and effectiveness of FHFA's operations and aid in the prevention and detection of fraud, waste, and abuse. FHFA fully or partially agreed to the overwhelming majority of OIG's recommendations.

Several of the reports issued during this semiannual period continue to reflect two themes OIG has identified in its overall body of work: first, with regard to the conservatorships, FHFA has often relied on determinations of the Enterprises without independently testing and validating them, thereby giving undue deference to Enterprise decision making, and second, with regard to its regulatory responsibilities, FHFA faces challenges in risk management, including its ability to identify new and emerging risks potentially impacting the GSEs; issue guidance and regulations governing risk management oversight at the GSEs; and provide strong, consistent enforcement for violations of policy.

*For information about these themes, see Appendix A of* FHFA-OIG's Current Assessment of FHFA's Conservatorships of Fannie Mae and Freddie Mac *(WPR-2012-001, March 28, 2012) available at www.fhfaoig.gov/Content/Files/WPR-2012-001.pdf.*

### Conservator Issues

Given the importance of FHFA's role as conservator, OIG has prioritized work involving the conservatorships and issued four reports that touch upon the first theme. In *FHFA's Conservator Approval Process for Fannie Mae and Freddie Mac Business Decisions* (AUD-2012-008, September 27, 2012),[b] OIG audited FHFA's process for approving matters under the conservatorships and concluded that the Agency can better accomplish its oversight mission by proactively exerting greater control over its conservator approval process. Among other aspects, the Agency can improve how it processes requests for conservatorship decisions. For example, OIG determined that FHFA approved a multimillion dollar loan purchase without independently verifying the underlying conditions, stating, "[g]iven the complex nature of this transaction and the short time in which a decision must be made, it is not possible for us to assess the reasonableness of this proposal."

[b] The full report is available at www.fhfaoig.gov/Content/Files/AUD-2012-008_2.pdf.

In *Evaluation of FHFA's Oversight of Fannie Mae's Transfer of Mortgage Servicing Rights from Bank of America to High Touch Servicers* (EVL-2012-008, September 18, 2012),[c] OIG analyzed Fannie Mae's purchase from Bank of America (BOA) – for $421 million – of mortgage servicing rights (MSR) for approximately 384,000 mortgage loans owned or guaranteed by Fannie Mae. Fannie Mae's purchase of MSR from BOA was part of an ongoing initiative – the High Touch Servicing Program – that utilizes specialty servicers who work with at-risk borrowers to help reduce the number of defaults in mortgages owned or guaranteed by Fannie Mae. Although FHFA reviewed the BOA transaction and allowed it to proceed, it did not conduct similar reviews of other transactions in the High Touch Servicing Program nor did it analyze the program as a whole, despite the fact that it involved multiple transfers of servicing rights for over 700,000 loans with an unpaid principal balance in excess of $130 billion.

Two other reports suggest positive movement towards additional testing and validation by FHFA as conservator. In *FHFA's Certifications for the Preferred Stock Purchase Agreements* (EVL-2012-006, August 23, 2012),[d] OIG evaluated FHFA's adherence to certain requirements under the PSPAs, pursuant to which Treasury commits funds to the Enterprises. As part of the security for Treasury's investments, the PSPAs require FHFA to make three certifications. However, OIG determined that FHFA was making only one of the three required certifications and for the other two was relying on the work and certifications of the Enterprises. Upon learning of OIG's preliminary evaluation findings, FHFA began providing Treasury with all three of the required certifications.

Similarly, in *Follow-up on Freddie Mac's Loan Repurchase Process* (EVL-2012-007, September 13, 2012),[e] OIG followed up on a prior report that raised concerns about the method Freddie Mac used to review non-performing loans for repurchase claims. Freddie Mac followed a practice of only reviewing intensively for repurchase claims those loans that became non-performing or had payment problems during the first two years following origination – effectively excluding from review housing boom loans that became troubled in years three through five. This practice limited Freddie Mac's potential recoveries from repurchase requests, and – in its original report – OIG recommended that FHFA promptly act on the concerns raised about Freddie Mac's loan review process. In the follow-up report, OIG found that FHFA and Freddie Mac have acted on the concerns by adopting a more expansive review process and reviewing a significantly larger number of loans defaulting more than two years after origination. It is estimated that the expanded review process will generate additional recoveries ranging from $0.8 billion to $1.2 billion for loans selected for review in 2012 and $2.2 billion to $3.4 billion overall.

[c] The full report is available at www.fhfaoig.gov/Content/Files/EVL-2012-008.pdf.

[d] The full report is available at www.fhfaoig.gov/Content/Files/EVL-2012-006_3.pdf.

[e] The full report is available at www.fhfaoig.gov/Content/Files/EVL-2012-007.pdf.

## Regulator Issues

In an additional five reports, OIG identified instances in which FHFA could be more proactive in risk oversight and enforcement. Accordingly, within its regulatory functions, the Agency continues to face challenges in its ability to identify new and emerging risks potentially impacting the GSEs; issue guidance and manage risks that have been identified; and provide strong, consistent enforcement for violations of policy.

The Enterprises work with numerous seller/servicers for post-origination mortgage work, such as collecting mortgage payments, and these seller/servicers represent an important risk to the Enterprises. Yet, as OIG found in *FHFA's Oversight of the Enterprises' Management of High-Risk Seller/Servicers* (AUD-2012-007, September 18, 2012),[f] FHFA can strengthen the Enterprises' counterparty risk management by, among other things, publishing standards for the development of contingency plans related to failing or failed high-risk counterparties. Contingency plans help to manage such risks because they identify actions to pursue when a counterparty's changing financial or other circumstances pose a financial threat to an Enterprise. Counterparty contingency plans will not eliminate losses, but they can serve as a road map to help reduce the Enterprises' risk exposure. Contingency plans can also prepare the Enterprises for unexpected collapses of counterparties that handle a concentrated, high-volume of their business. The report underscored the importance of managing such seller/servicer risk, noting that the Enterprises have incurred losses of $6.1 billion from failures at just four of their counterparties since 2008.

Another report, *FHFA's Supervisory Risk Assessment for Single-Family Real Estate Owned* (AUD-2012-005, July 19, 2012),[g] examined one way FHFA can better identify, understand, and mitigate the risks related to Enterprise REO. Since 2008, FHFA has consistently listed the Enterprises' large inventories of REO as contributing to "critical concern" ratings in their quarterly risk assessments. However, in spite of FHFA's identification of REO as a prominent and ascending risk, OIG found that FHFA did not conduct targeted examinations or similar focused reviews of REO until 2011. To strengthen its supervision of Enterprise REO, FHFA will benefit from more comprehensive REO risk assessments and using the results of such assessments when planning examination work. Further, in *FHFA's Call Report System* (AUD-2012-006, July 19, 2012),[h] OIG found that the call report system (CRS) – a centralized information system that can provide data for various oversight analyses – offers another avenue for FHFA to improve its understanding of and response to emerging and other risks confronting the Enterprises. However, FHFA has not fully implemented its use of the system with respect to the Enterprises.

OIG analyzed risk management among the FHLBanks in two additional reports. In *FHFA's Supervisory Framework for Federal Home Loan Banks' Advances and Collateral Risk Management* (AUD-2012-004, June 1, 2012),[i]

[f] The full report is available at www.fhfaoig.gov/Content/Files/AUD-2012-007.pdf.

[g] The full report is available at www.fhfaoig.gov/Content/Files/AUD-2012-005_2.pdf.

[h] The full report is available at www.fhfaoig.gov/Content/Files/AUD-2012-006_1.pdf.

[i] The full report is available at www.fhfaoig.gov/Content/Files/AUD-2012-004.pdf.

OIG found that FHFA can improve its framework for supervising advances and collateral risk management practices for institutions presenting heightened supervisory concerns. Although FHFA conducted a system-wide horizontal review of secured credit among the FHLBanks and an internal study that identified numerous significant risks, the Agency did not take sufficient steps to ensure that the FHLBanks effectively managed risks posed by member banks that represented heightened supervisory concerns.

In the second report, *FHFA's Oversight of the Federal Home Loan Banks' Unsecured Credit Risk Management Practices* (EVL-2012-005, June 28, 2012),[j] OIG found a lack of appreciation for the risk associated with unsecured lending and a lack of enforcement of existing risk management standards. The FHLBanks extend unsecured short-term credit (namely, loans not backed by collateral) to domestic and foreign financial institutions. Extensions of unsecured credit by the FHLBanks to, among others, European financial institutions increased substantially in 2010 and 2011, even as the risks associated with doing so were escalating. Unsecured lending by the FHLBanks had grown to more than $120 billion by early 2011 but declined sharply by year-end 2011 as the European sovereign debt crisis intensified. Although FHFA identified extensions of unsecured credit as a risk confronting the FHLBanks, it did not prioritize the risk in its examinations until 2011 and 2012. OIG also identified potential un-remediated violations by the FHLBanks of the Agency's regulations governing extensions of unsecured credit.

## Other Activities

In addition to publishing reports covering various aspects of FHFA's oversight of the GSEs, OIG engaged in significant investigative and outreach efforts. For example, OIG's investigations resulted in:

- an indictment of 11 former employees of Abacus Federal Savings Bank, as well as guilty pleas of 8 former employees, in connection with a mortgage fraud scheme involving the sale to Fannie Mae of hundreds of millions of dollars worth of fraudulent loans;
- indictments of 10 defendants in connection with fraudulently obtaining $39 million in mortgages – that were later sold to the Enterprises – for the purchase of condominium units at Marina Oaks Condominiums in Fort Lauderdale, Florida;
- a guilty plea from the former chief credit officer for Appalachian Community Bank – a member of the Atlanta FHLBank – for conspiracy to commit bank fraud for participating in a scheme involving two Florida condominiums valued at $3.7 million and another $13 million in property flips;

[j] The full report is available at www.fhfaoig.gov/Content/Files/EVL-2012-005_1_0.pdf.

- an indictment of 11 employees of 21st Century Real Estate Investment Corporation in connection with an alleged mortgage modification scheme that fraudulently collected over $7 million from over 4,000 homeowners; and

- a guilty plea from the former president of American Mortgage Field Services LLC, who conspired to commit wire fraud by submitting approximately $13.5 million worth of fraudulent inspection reports related to foreclosed properties owned by the Enterprises.

Further, OIG also worked closely with Treasury's Financial Crimes Enforcement Network (FinCEN) to review allegations of mortgage fraud; OIG assigned an investigative analyst to work embedded within FinCEN's Office of Law Enforcement Support to further refine its analytical efforts to support complex mortgage fraud cases nationwide.

All of OIG's publicly disclosed reports, investigations, and other activities are discussed in detail in this Semiannual Report.

## REPORT ORGANIZATION

This Semiannual Report is organized as follows:

- Section 1, *OIG Description*, provides a brief overview of the organization.

- Section 2, *FHFA and GSE Operations*, describes the organization and operation of FHFA, Fannie Mae, Freddie Mac, and the FHLBanks. It also discusses notable developments related to these organizations.

- Section 3, *OIG's Accomplishments and Strategy*, describes OIG's oversight activities, including audits, evaluations, and investigations. It also discusses OIG's current priorities and future goals.

- Section 4, *OIG's Recommendations*, discusses OIG recommendations to improve FHFA and GSE operations and transparency and reports the implementation status for outstanding recommendations.

Additionally, this Semiannual Report includes Section 5, *An Overview of the FHLBank System's Structure, Operations, and Challenges*, which is a detailed discussion of the FHLBank System.

## OIG REPORTING REQUIREMENTS

The Inspector General Act states that each inspector general is required, no later than April 30 and October 31 each year, to prepare semiannual reports summarizing the activities of his or her office during the preceding six-month periods ending March 31 and September 30.[k] The specific reporting requirements, as specified in the Inspector General Act, are listed in Appendix B.

[k] The Inspector General Act of 1978, 5 U.S.C. App. 3 § 5.

# SECTION 1

## OIG DESCRIPTION

# Section 1: OIG Description

OIG began operations on October 12, 2010. It was established by the Housing and Economic Recovery Act of 2008 (HERA), which amended the Inspector General Act. OIG conducts audits, evaluations, investigations, and other law enforcement activities relating to FHFA's programs and operations.

## LEADERSHIP AND ORGANIZATION

On April 12, 2010, President Barack Obama nominated FHFA's first Inspector General, Steve A. Linick, who was confirmed by the Senate on September 29, 2010, and sworn into office on October 12, 2010. Previously, Mr. Linick held several leadership positions at the Department of Justice (DOJ) between 2006 and 2010. Prior to that, Mr. Linick was an Assistant U.S. Attorney in the Central District of California (1994-1999) and later in the Eastern District of Virginia (1999-2006).

Mr. Linick received his Bachelor of Arts (1985) and Master of Arts (1990) in Philosophy from Georgetown University and his Juris Doctor (1990) from the Georgetown University Law Center.

OIG consists of the Inspector General, his senior staff, and OIG offices, principally: the Office of Audits (OA), the Office of Evaluations (OE), and the Office of Investigations (OI). Additionally, OIG's Executive Office (EO) and Office of Administration (OAd) provide organization-wide supervision and support. (See Appendix D for OIG's organizational chart.)

### Office of Audits

OA provides a full range of professional audit and attestation services for FHFA's programs and operations. Through its performance audits and attestation engagements, OA helps FHFA: (1) promote economy, efficiency, and effectiveness; (2) detect and deter fraud, waste, and abuse; and (3) ensure compliance with applicable laws and regulations. Under the Inspector General Act, inspectors general are required to comply with the *Government Auditing Standards*, commonly referred to as the "Yellow Book," issued by the Government Accountability Office (GAO). OA performs its audits and attestation engagements in accordance with the Yellow Book.

### Office of Evaluations

OE provides independent and objective reviews, studies, survey reports, and analyses of FHFA's programs and operations. OE's evaluations are generally limited in scope. The Inspector General Reform Act of 2008 requires that inspectors general adhere to the *Quality Standards for Inspection and Evaluation*, commonly referred to as the "Blue Book," issued by the Council of the Inspectors General on Integrity and Efficiency (CIGIE). OE performs its evaluations in accordance with the Blue Book.

## Office of Investigations

OI investigates allegations of misconduct and fraud involving FHFA and the GSEs in accordance with CIGIE's *Quality Standards for Investigations* and guidelines that the Attorney General issues.

OI's investigations may address administrative, civil, and criminal violations of laws and regulations. Investigations may relate to FHFA or GSE employees, contractors, consultants, and any alleged wrongdoing involving FHFA's or the GSEs' programs and operations. Offenses investigated may include mail, wire, bank, accounting, securities, or mortgage fraud, as well as violations of the tax code, obstruction of justice, and laundering money.

To date, OI has opened numerous criminal and civil investigations, but by their nature, these investigations and their resulting reports are not generally made public. However, if an investigation reveals criminal activity, OI refers the matter to DOJ for possible prosecution or recovery of monetary damages and penalties. OI reports administrative misconduct to management officials for consideration of disciplinary or remedial action.

OI also manages OIG's **Hotline**, which receives tips and complaints of fraud, waste, or abuse in FHFA's programs and operations. The Hotline allows concerned parties to report their allegations to OIG directly and confidentially. OI honors all applicable whistleblower protections. As part of its effort to raise awareness of fraud, OI actively promotes the Hotline through OIG's website, posters, e-mails to FHFA and GSE employees, and OIG's semiannual reports.

*OIG's **Hotline**:*
*(800) 793-7724 or*
*OIGHOTLINE@FHFAOIG.GOV.*

## Executive Office

EO provides leadership and programmatic direction for OIG's offices and activities.

EO includes the Office of Counsel (OC), which serves as the chief legal advisor to the Inspector General and provides independent legal advice, counseling, and opinions to OIG about its programs and operations. OC reviews audit and evaluation reports for legal sufficiency and compliance with OIG's policies and priorities. It also reviews drafts of FHFA regulations and policies and prepares comments as appropriate. Additionally, OC coordinates with FHFA's Office of General Counsel (OGC) and manages OIG's responses to requests and appeals made under the Freedom of Information Act and the Privacy Act.

EO also includes the Office of Policy, Oversight, and Review (OPOR), which provides advice, consultation, and assistance regarding OIG's priorities and the scope of its evaluations, audits, and all other published reports. In addition, OPOR is responsible for conducting special studies, developing the semiannual reports, and drafting reports and white papers addressing complex housing finance issues.

The Office of External Affairs is also within EO, and it responds to inquiries from the press and members of Congress.

The Office of Special Projects is also within EO, and it supports other OIG offices on high-impact projects.

### Office of Administration

OAd manages and oversees OIG administration, including budget, human resources, safety, facilities, financial management, information technology, and continuity of operations. For human resources, OAd develops policies to attract, develop, and retain exceptional people, with an emphasis on linking performance planning and evaluation to organizational and individual accomplishment of goals and objectives. Regarding OIG's budget and financial management, OAd coordinates budget planning and execution and oversees all of OIG's procedural guidance for financial management and procurement integrity.

OAd also administratively supports the Chief of Staff and the Deputy Inspector General for Audits as they implement OIG's Internal Management Assessment Program, which requires the routine inspection of each OIG office to ensure that it complies with applicable requirements. OAd also administers OIG's Equal Employment Opportunities program.

*OIG's full Strategic Plan is available at www.fhfaoig.gov/Content/Files/Strategic%20 Plan_0.pdf.*

## OIG'S STRATEGIC PLAN

On September 7, 2011, OIG published a Strategic Plan to define its goals and objectives, guide development of its performance criteria, establish measures to assess accomplishments, create budgets, and report on progress. OIG will continue to monitor events; make changes to its Strategic Plan as circumstances warrant; and strive to remain relevant regarding areas of concern to FHFA, the GSEs, Congress, and the American people.

Within the Strategic Plan, OIG has established several goals that align with FHFA's strategic goals.

### Strategic Goal 1 – Adding Value

OIG will promote the economy, efficiency, and effectiveness of FHFA's programs and operations and assist FHFA and its stakeholders to solve problems related to the conservatorships and the conditions that led to them.

### Strategic Goal 2 – Operating with Integrity

OIG will promote the integrity of FHFA's programs and operations through the identification and prevention of fraud, waste, or abuse.

### Strategic Goal 3 – Promoting Productivity

OIG will deliver quality products and services to its stakeholders by maintaining an effective and efficient internal quality control program to ensure that OIG's results withstand professional scrutiny.

### Strategic Goal 4 – Valuing OIG Employees

OIG will maximize the performance of its employees and the organization.

## ORGANIZATIONAL GUIDANCE

OIG has developed and promulgated policies and procedures manuals for each of its offices. These manuals set forth uniform standards and guidelines for the performance of each office's essential responsibilities and are intended to help ensure the consistency and integrity of OIG's operations.

# FHFA AND GSE OPERATIONS

# Section 2: FHFA and GSE Operations

## FHFA

HERA created FHFA in July 2008, as the successor to the Office of Federal Housing Enterprise Oversight and the Federal Housing Finance Board. The Agency now supervises the Enterprises and the FHLBanks, which previously had been respectively regulated by the two predecessor entities. HERA also expanded Treasury's authority to financially support the GSEs.[1]

Six weeks later, on September 6, 2008, the Enterprises entered conservatorships overseen by FHFA. At the time of the conservatorships, Treasury exercised its authority to financially support the Enterprises by making **preferred stock** investments in them pursuant to the **PSPAs**.

**Preferred Stock:**
A security that usually pays a fixed dividend and gives the holder a claim on corporate earnings and assets superior to that of holders of common stock but inferior to that of investors in the corporation's debt securities.

**Senior Preferred Stock Purchase Agreements (PSPAs):**
Entered into at the time the conservatorships were created, the PSPAs authorize the Enterprises to request and obtain funds from Treasury. Under the PSPAs, the Enterprises agreed to consult with Treasury concerning a variety of significant business activities, capital stock issuance, dividend payments, ending the conservatorships, transferring assets, and awarding executive compensation.

## FHFA AUTHORITY

FHFA serves as the regulator of the GSEs and conservator of the Enterprises. As regulator, the Agency's mission is to ensure that the GSEs operate in a safe and sound manner. As conservator, the Agency seeks to conserve and preserve Enterprise assets. FHFA also has property management responsibilities under the Emergency Economic Stabilization Act (EESA).

### FHFA's Duties as Regulator Under HERA

The principal duties of FHFA, as a regulator, are to oversee the prudential operations of each regulated entity and to ensure:

- each regulated entity operates in a safe and sound manner and maintains adequate capital and internal controls;
- the operations and activities of each regulated entity foster liquid, efficient, competitive, and resilient national housing finance markets, including activities relating to mortgages on housing for low- and moderate-income families;
- each regulated entity complies with the rules, regulations, guidelines, and orders issued under law;
- each regulated entity carries out its statutory mission only through activities that are authorized under law and consistent with the law; and
- the activities and procedures of each regulated entity are consistent with the public interest.[1]

HERA also requires that the Enterprises obtain Agency approval before offering new products; prohibits the Enterprises from providing unreasonable executive compensation; requires FHFA to establish prudential management and operational standards for the regulated entities; and forbids high-ranking

[1] See 12 U.S.C. §§ 4513 et seq. for more information on FHFA's statutory duties as a regulator.

FHFA officials from receiving compensation from the Enterprises within two years of their departure from FHFA.

### FHFA's Authority as Conservator

As a conservator, FHFA generally may conserve and preserve the assets of the Enterprises and specifically is authorized to:

- succeed to all rights, titles, powers, and privileges of the Enterprises and any shareholders, officers, or directors of them;
- operate the Enterprises; and
- take such action as may be:
  - necessary to put the Enterprises in sound and solvent conditions; and
  - appropriate to carry on the businesses of the Enterprises and preserve and conserve their assets and property.[m]

In addition to those powers enumerated by HERA, FHFA has "such incidental powers as shall be necessary to carry out" its enumerated powers.[2] In 2009, FHFA interpreted its authorization to conserve and preserve the Enterprises' assets as its "top goal" for its conservatorships[3] and often cites this goal.[n]

### FHFA's Duties Under EESA

EESA requires that FHFA:

- implement a plan to maximize assistance to homeowners;
- use its authority to encourage the servicers of the Enterprises' mortgages, considering net present value, to take advantage of federal programs to minimize foreclosures;
- coordinate within the federal government concerning homeowner assistance plans; and
- submit monthly reports to Congress detailing the progress of its efforts.[4]

## FANNIE MAE AND FREDDIE MAC

In 1938, Congress chartered Fannie Mae to help create stable funding for the U.S. housing and mortgage markets. Freddie Mac was established in 1970 with a similar mission of supporting residential mortgage markets in addition to expanding opportunities for homeownership and affordable rentals.

[m] HERA at § 1145. For example, under HERA, FHFA can: (1) promulgate regulations regarding the conduct of the conservatorship; (2) take title to all books, records, or assets of the Enterprises; (3) take over the assets of the Enterprises; (4) collect all obligations and money due to the Enterprises; (5) act in the name of the Enterprises; and (6) create contracts to aid in its role.

[n] See Statement of Edward J. DeMarco Before the House Financial Services Committee, Subcommittee on Oversight and Investigations (Dec. 1, 2011) at 3; see also *A Strategic Plan for Enterprise Conservatorships: The Next Chapter in a Story That Needs an Ending* (Feb. 21, 2012) at 10 ("FHFA has reported on numerous occasions that, with taxpayers providing the capital supporting Enterprise operations, this 'preserve and conserve' mandate directs FHFA to minimize losses on behalf of taxpayers").

**Conventional Conforming Mortgage Loans:**
Mortgages that are not insured or guaranteed by the Federal Housing Administration, the Department of Veterans Affairs, or the Department of Agriculture and that meet the Enterprises' underwriting standards. Conforming mortgage loans have original balances below a specific threshold, published by FHFA, known as the "conforming loan limit." For 2012, the conforming loan limit is $417,000 for most areas of the contiguous United States, although generally it can increase to a maximum of $625,500 in specific higher-cost areas.

**Mortgage-Backed Securities (MBS):**
MBS are debt securities that represent interests in the cash flows – anticipated principal and interest payments – from pools of mortgage loans, most commonly on residential property.

**Guarantee:**
A pledge to investors that the guarantor will bear the default risk on a pool of loans or other collateral.

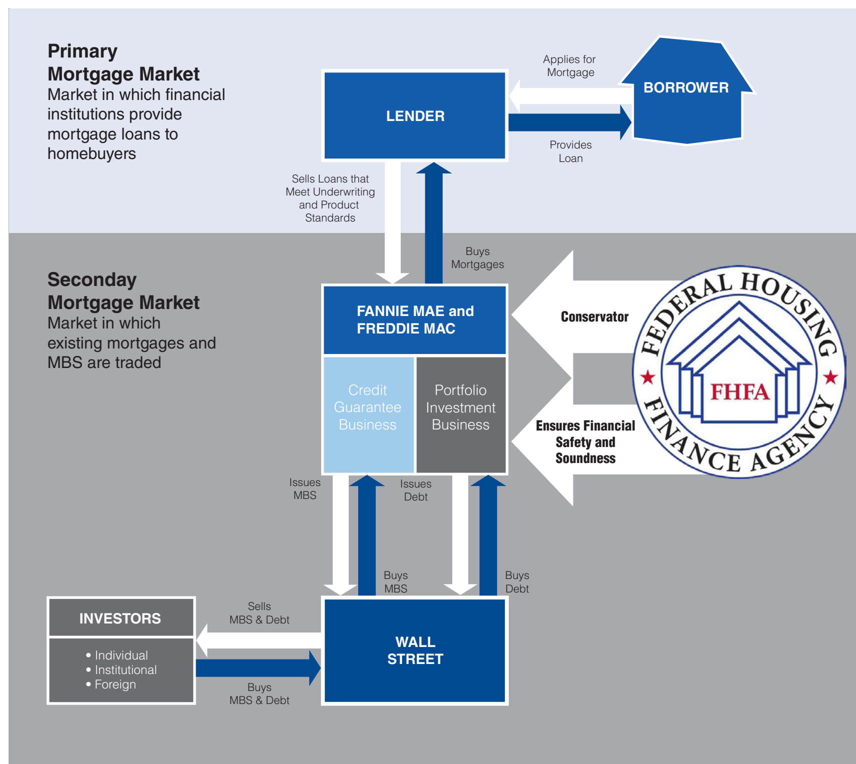
**Implied Guarantee:**
The assumption, prevalent in the financial markets, that the federal government will cover Enterprise debt obligations.

As Figure 1 (see below) illustrates, the Enterprises support the nation's housing finance system through the secondary mortgage market, but neither entity makes home loans directly. Instead, banks, credit unions, and other retail financial institutions originate home loans. Generally, lenders do not keep the mortgages they originate but instead sell **conventional conforming mortgage loans** to the Enterprises.

The Enterprises typically securitize the loans they purchase by pooling them into **mortgage-backed securities (MBS)**, which are then sold to investors. As part of this process, for a fee, the Enterprises **guarantee** payment of principal and interest on the MBS they sell. Alternatively, the Enterprises may hold these loans or buy MBS for their own investment portfolios, which are funded by issuing debt obligations.

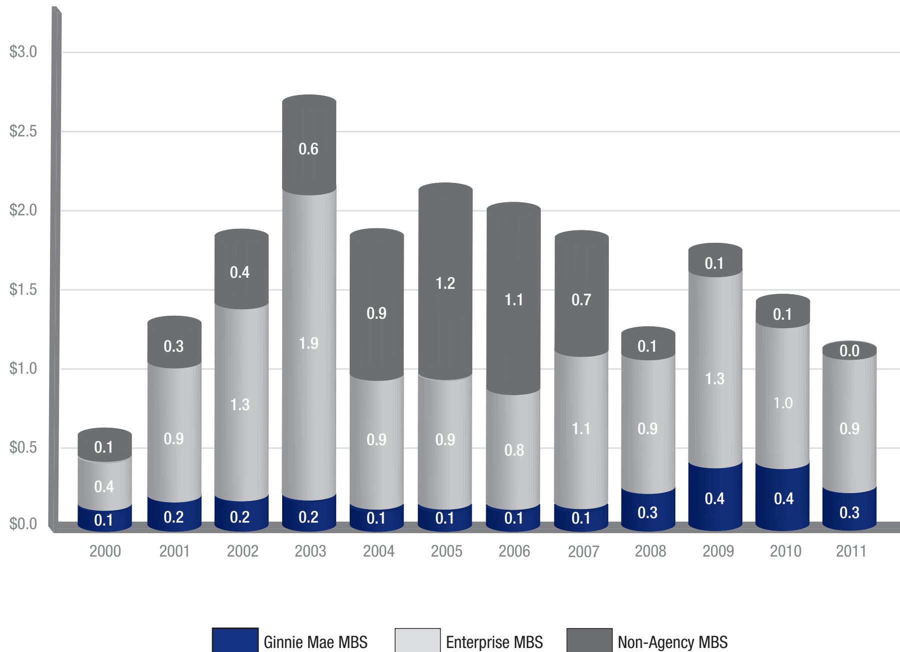
Historically, the Enterprises have benefited from an **implied guarantee** that the federal government would prevent default on their financial obligations. As a result, over time, the Enterprises' borrowing costs have been lower than those of other for-profit companies,[5] and the Enterprises assumed dominant positions in the residential housing finance market. (After the Enterprises were placed into conservatorships, the implied guarantee effectively became explicit.)[6]

**Figure 1. Overview of the Enterprises and FHFA's Role**




Source: Government Accountability Office, *Financial Audit: Federal Housing Finance Agency's Fiscal Years 2011 and 2010 Financial Statements*, at 17 (Nov. 2011) (GAO/12-161) (online at http://gao.gov/assets/590/586278.pdf).

**Figure 2. Primary Sources of MBS Issuances from 2000 to 2011 ($ trillions)**




Source: Inside Mortgage Finance, *Volume II: Secondary Market: Mortgage Market Statistical Annual*, at 6 (2012).

As Figure 2 (see above) illustrates, after losing market share to non-agency competitors from 2004 through 2007, the Enterprises added to their dominant position in the residential housing finance market (with the federal government's financial support) as the financial crisis continued and private-sector financing for the secondary market nearly disappeared.

## Enterprise Financial Performance and Government Support

As shown in Figure 3 (see page 22), the Enterprises securitized more lower-quality mortgages in 2006 and 2007 than in subsequent years. The 2006 and 2007 mortgages' higher default and delinquency rates stemmed from a greater percentage of **Alternative A** loans, interest-only loans, and loans made to borrowers with below average credit scores. These mortgages have caused the largest share of the Enterprises' credit-related losses over the last several years.

**Alternative A:**
A classification of mortgages in which the risk profile falls between prime and subprime. Alternative A mortgages are generally considered higher risk than prime due to factors that may include higher loan-to-value and debt-to-income ratios or limited documentation of the borrower's income.

**Figure 3. Mortgage Credit Quality by Origination Year**

| | Fannie Mae | | Freddie Mac | |
|---|---|---|---|---|
| Year Originated | Serious Delinquency Rate[a] | Cumulative Default Rate | Serious Delinquency Rate[b] | Cumulative Default Rate |
| 2006 | 11.66% | 9.60% | 11.20% | 7.82% |
| 2007 | 12.38% | 10.30% | 12.05% | 8.65% |
| 2008 | 5.98% | 3.10% | 6.30% | 2.74% |
| 2009 | 0.69% | 0.30% | 0.68% | 0.25% |
| 2010 | 0.34% | 0.10% | 0.38% | 0.11% |
| 2011 | 0.11% | 0.00% | 0.13% | 0.02% |
| Q2 2012 | 0.01% | 0.00% | 0.00% | 0.00% |

Sources: Fannie Mae, *2012 Second-Quarter Credit Supplement*, at 7 (Aug. 8, 2012) (online at www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2012/q22012_credit_summary.pdf); Freddie Mac, *Second Quarter 2012 Financial Results Supplement*, at 26 (online at www.freddiemac.com/investors/er/pdf/supplement_2q12.pdf) (accessed Aug. 30, 2012); Freddie Mac, *Form 10-Q for the Quarterly Period Ended June 30, 2012*, at 79 (online at www.sec.gov/Archives/edgar/data/1026214/000119312512339405/d378248d10q.htm) (accessed Aug. 30, 2012).

Notes:

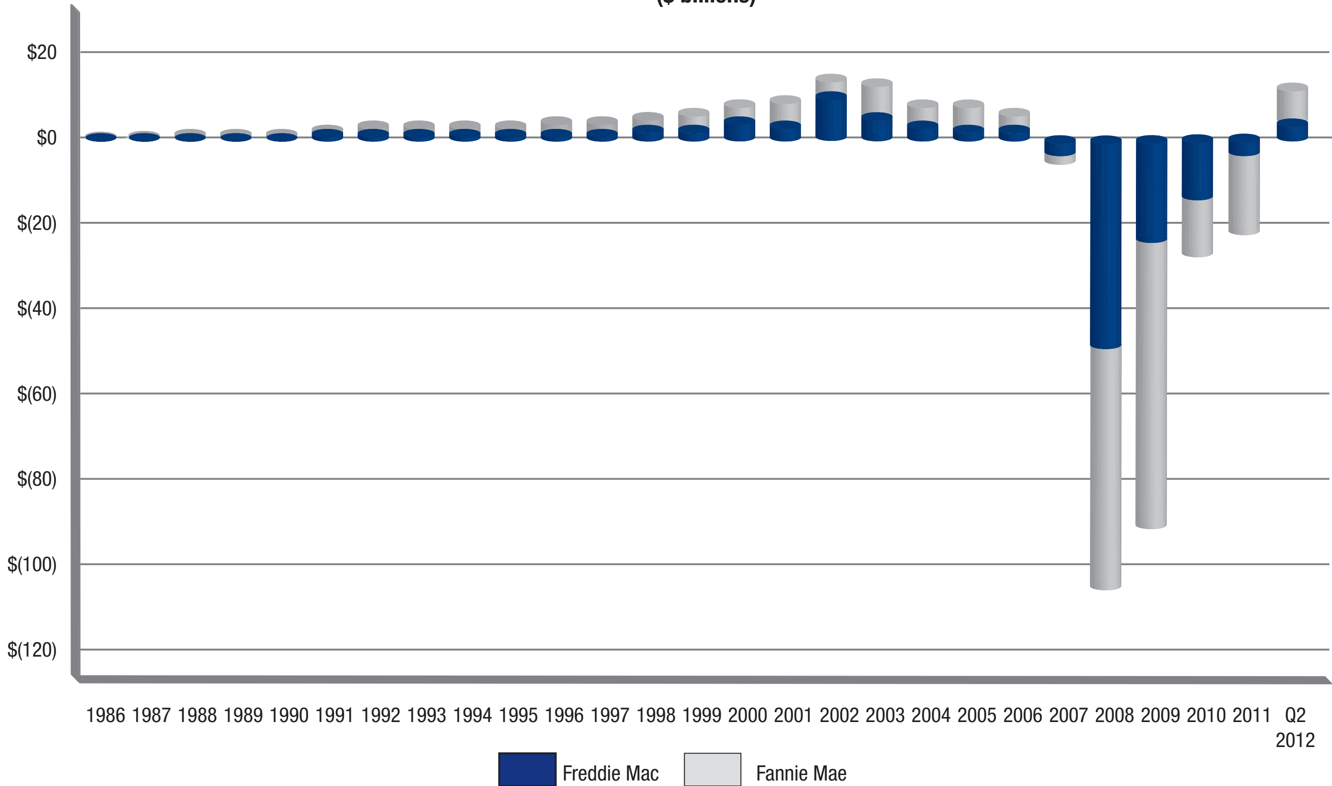
[a] Serious delinquencies include loans past due 90 days or more and those where Fannie Mae or the mortgage holder has started the process to foreclose on the loan.

[b] Based on the number of loans that are three monthly payments or more past due or in the process of foreclosure.

Due to continued delinquencies and defaults, losses escalated and contributed to the Enterprises' rapid financial deterioration. In 2008, the year the Enterprises entered conservatorship, they reported combined losses of $109 billion, exceeding their total earnings for the preceding 21 years (see Figure 4, page 23).

However, conditions have begun to improve. For the six months ended June 30, 2012, Fannie Mae and Freddie Mac reported net income of $7.8 billion and $3.6 billion, respectively. The Enterprises' net income was primarily the result of lower credit-related losses than in prior years (see Figure 5, page 23).

**Figure 4. Enterprises' Annual Net Income (Loss) 1986 Through Second Quarter 2012 ($ billions)**




Sources: Federal Housing Finance Agency, *2011 Report to Congress*, at 72, 89 (online at www.fhfa.gov/webfiles/24009/FHFA_RepToCongr11_6_14_508.pdf) (accessed Aug. 30, 2012); Fannie Mae, *Form 10-Q for the Quarterly Period Ended June 30, 2012*, at 86 (online at www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2012/q22012.pdf) (accessed Aug. 30, 2012); Freddie Mac, *Form 10-Q for the Quarterly Period Ended June 30, 2012*, at 106 (online at www.sec.gov/Archives/edgar/data/1026214/000119312512339405/d378248d10q.htm) (accessed Aug. 30, 2012).

**Figure 5. Enterprises' Summary of Net Income from Operations for the Six Months Ended June 30, 2012 ($ billions)**

| | Fannie Mae | Freddie Mac |
|---|---|---|
| Net Interest Income | $ 10.63 | $ 8.89 |
| Credit-related Income (Expenses) | 0.77 | (2.12) |
| Loss on Derivative Agreements | (2.41)[a] | (1.94) |
| Impairment of Securities Considered Other than Temporary | (0.66) | (0.66) |
| Other Net Expense | (0.49) | (0.57) |
| **Net Income from Operations** | **$ 7.84** | **$ 3.60** |

Sources: Fannie Mae, *Form 10-Q for the Quarterly Period Ended June 30, 2012*, at 19 (online at www.sec.gov/Archives/edgar/data/310522/000031052212000090/fanniemaeq206302012.htm) (accessed Oct. 18, 2012); Freddie Mac, *Form 10-Q for the Quarterly Period Ended June 30, 2012*, at 13 (online at www.sec.gov/Archives/edgar/data/1026214/000119312512339405/d378248d10q.htm) (accessed Sept. 30, 2012).

Notes:

[a] Loss on Derivatives referenced to Table 10, p. 24 in the Fannie Mae Second Quarter 2012 10-Q Report.

To offset the losses shown above, government support of the Enterprises since 2008 has totaled $187.5 billion. Figure 6 (see below) breaks down, by quarter, Treasury's investment in the Enterprises through September 30, 2012.

In accordance with the PSPAs' terms, the Enterprises are required to make quarterly dividend payments to Treasury at an annual rate equal to 10% of the outstanding investment. The rate was to increase to 12% if, in any quarter, the dividends were not paid in cash until all accrued dividends had been paid in cash. On August 17, 2012, Treasury and FHFA agreed to a third amendment to the terms of the PSPAs that terminates the Enterprises' 10% per annum dividend requirement, effective January 1, 2013. Instead, the dividend paid by the Enterprises each quarter will consist of all positive net worth accrued during that quarter. The development update entitled "Modifications to Senior Preferred Stock Purchase Agreements" (see page 30) provides further information on the modifications to the PSPAs.

**Figure 6. Treasury Capital and Dividends Due Under PSPAs ($ billions)**

| Period Covered | Freddie Mac | | | Fannie Mae | | | Combined | | |
|---|---|---|---|---|---|---|---|---|---|
| | Treasury Investment Under PSPA[a] | Dividends Due Treasury Under PSPA | Net Capital Provided to Enterprise | Treasury Investment Under PSPA[a] | Dividends Due Treasury Under PSPA | Net Capital Provided to Enterprise | Treasury Investment Under PSPAs[a] | Dividends Due Treasury Under PSPAs | Net Capital Provided to Enterprises |
| Third Quarter 2008 | $13.8 | $ - | $13.8 | $ - | $ - | $ - | $13.8 | $ - | $13.8 |
| Fourth Quarter 2008 | 30.8 | 0.2 | 30.6 | 15.2 | - | 15.2 | 46.0 | 0.2 | 45.8 |
| First Quarter 2009 | 6.1 | 0.4 | 5.7 | 19.0 | - | 19.0 | 25.1 | 0.4 | 24.7 |
| Second Quarter 2009 | - | 1.1 | (1.1) | 10.7 | 0.4 | 10.3 | 10.7 | 1.5 | 9.2 |
| Third Quarter 2009 | - | 1.3 | (1.3) | 15.0 | 0.9 | 14.1 | 15.0 | 2.2 | 12.8 |
| Fourth Quarter 2009 | - | 1.3 | (1.3) | 15.3 | 1.2 | 14.1 | 15.3 | 2.5 | 12.8 |
| First Quarter 2010 | 10.6 | 1.3 | 9.3 | 8.4 | 1.5 | 6.9 | 19.0 | 2.8 | 16.2 |
| Second Quarter 2010 | 1.8 | 1.3 | 0.5 | 1.5 | 1.9 | (0.4) | 3.3 | 3.2 | 0.1 |
| Third Quarter 2010 | 0.1 | 1.6 | (1.5) | 2.5 | 2.1 | 0.4 | 2.6 | 3.7 | (1.1) |
| Fourth Quarter 2010 | 0.5 | 1.6 | (1.1) | 2.6 | 2.2 | 0.4 | 3.1 | 3.8 | (0.7) |
| First Quarter 2011 | - | 1.6 | (1.6) | 8.5 | 2.2 | 6.3 | 8.5 | 3.8 | 4.7 |
| Second Quarter 2011 | 1.5 | 1.6 | (0.1) | 5.1 | 2.3 | 2.8 | 6.6 | 3.9 | 2.7 |
| Third Quarter 2011 | 6.0 | 1.6 | 4.4 | 7.8 | 2.5 | 5.3 | 13.8 | 4.1 | 9.7 |
| Fourth Quarter 2011 | 0.1 | 1.7 | (1.6) | 4.6 | 2.6 | 2.0 | 4.7 | 4.3 | 0.4 |
| First Quarter 2012 | - | 1.8 | (1.8) | - | 2.8 | (2.8) | - | 4.6 | (4.6) |
| Second Quarter 2012 | - | 1.8 | (1.8) | - | 2.9 | (2.9) | - | 4.7 | (4.7) |
| Third Quarter 2012 | - | 1.8 | (1.8) | - | 2.9 | (2.9) | - | 4.7 | (4.7) |
| **Total as of September 30, 2012** | $71.3 | $22.0 | $49.3 | $116.2 | $28.4 | $87.8 | **$187.5** | $50.4 | **$137.1** |

Source: Federal Housing Finance Agency, *Data as of September 28, 2012 on Treasury and Federal Reserve Purchase Programs for GSE and Mortgage-Related Securities*, at Tables 1-2 (online at www.fhfa.gov/webfiles/24571/TSYSupport%202012-09-28.pdf) (accessed Oct. 8, 2012).

Notes: Nonzero numbers may display as zero due to rounding.

[a] Excludes $1 billion in liquidation preference on the senior preferred stock position obtained by Treasury from each Enterprise upon initiation of the PSPA. The initial $1 billion is not a draw on Treasury's commitment under the agreement.

## Additional Government Support

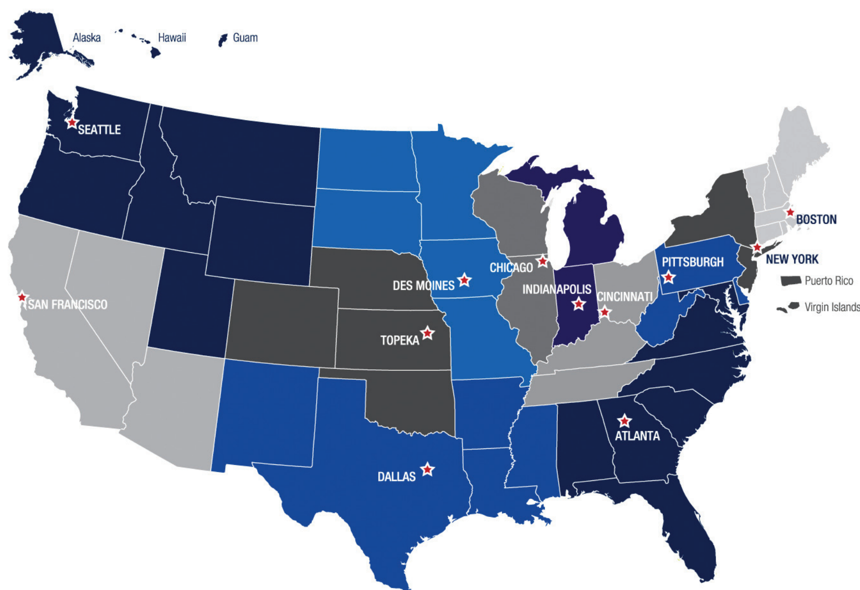
The Enterprises also benefited from extraordinary government measures to support the housing market overall. Since September 2008, the Federal Reserve and Treasury have purchased more than $1.3 trillion in Enterprise MBS, and the Federal Reserve has purchased an additional $135 billion of bonds issued by the Enterprises.[7]

## FHLBANKS

In 1932, Congress chartered the FHLBank System to make additional funding available for residential mortgage lending. The FHLBank System is currently comprised of 12 regional FHLBanks and the Office of Finance, which issues debt (i.e., consolidated obligations) on the FHLBanks' behalf.[8] Each FHLBank is a separate legal entity that must adhere to specific management and **capitalization** criteria.[9] Figure 7 (see below) shows the FHLBanks' geographic areas.

**Capitalization:**
In the context of bank supervision, capitalization refers to the funds a bank holds as a buffer against unexpected losses. It includes shareholders' equity, loss reserves, and retained earnings. Bank capitalization plays a critical role in the safety and soundness of individual banks and the banking system. In most cases, federal regulators set requirements for adequate bank capitalization.

**Figure 7. Regional FHLBanks**




Source: Federal Home Loan Bank of Boston, *Federal Home Loan Bank System* (online at www.fhlbboston.com/aboutus/thebank/06_01_04_fhlb_system.jsp) (accessed Sept. 10, 2012).

The FHLBanks are privately capitalized and each is cooperatively owned by the members it serves, which include financial institutions such as commercial banks, thrifts, insurance companies, and credit unions. To become members, eligible financial institutions invest in FHLBank stock, which is not publicly traded.[10]

**Collateral:**
Assets used as security for a loan that can be seized by the lender if the borrower fails to repay the loan.

**Private-Label MBS:**
MBS derived from mortgage loan pools assembled by entities other than GSEs or federal government agencies. They do not carry an explicit or implicit government guarantee, and the private-label MBS investor bears the risk of losses on its investment.

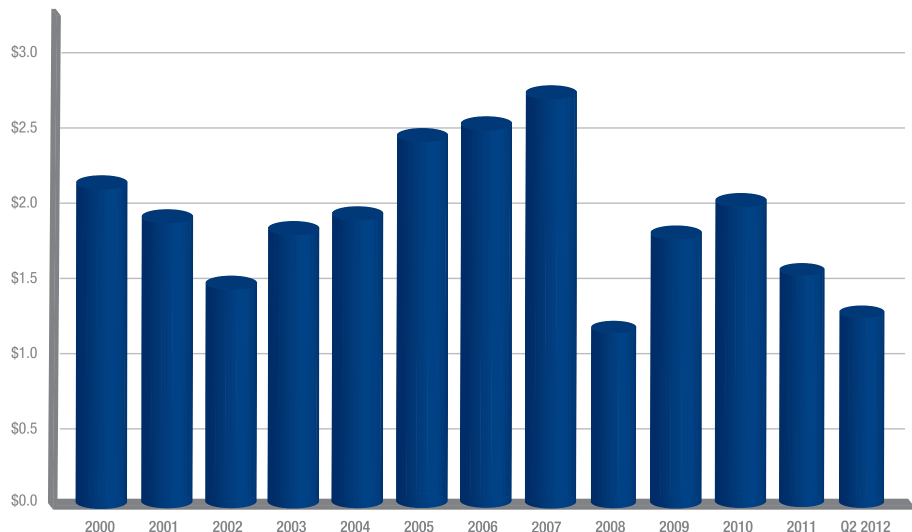
**Joint and Several Liability:**
The concept of joint and several liability provides that each obligor in a group is responsible for the debts of all in that group. In the case of the FHLBanks, if any individual FHLBank were unable to pay a creditor, the other 11 – or any 1 or more of them – would be required to step in and cover that debt.

The primary business of the FHLBanks is to provide their members with low-cost funding for mortgage lending and other purposes. To do so, each FHLBank makes advances (i.e., loans) in a variety of maturities and structures to its members. Such advances are **collateralized** by mortgage assets, investment-grade securities, or, in some cases, agricultural and small business loans. Interest earned on advances is a primary revenue source for the FHLBanks.

The FHLBanks also maintain investment portfolios containing mortgage-related assets, and some face heightened credit risks due to their holdings of **private-label MBS**.

To fund member advances, the FHLBanks issue consolidated obligations through their Office of Finance.[11] In the event of a default on a consolidated obligation, each FHLBank is **jointly and severally liable** for losses incurred by other FHLBanks. Like the Enterprises, the FHLBank System has also historically enjoyed cost benefits stemming from an implicit government guarantee of its consolidated obligations.

**Figure 8. FHLBanks' Annual Net Income 2000 Through Second Quarter 2012 ($ billions)**




Sources: Federal Housing Finance Agency, *2010 Report to Congress*, at 143 (online at www.fhfa.gov/webfiles/21570/FHFA2010RepToCongress61311.pdf) (accessed Aug. 30, 2012); Federal Home Loan Banks, *Combined Financial Report for the Year Ended December 31, 2011*, at F-5 (online at www.fhlb-of.com/ofweb_userWeb/resources/11yrend.pdf) (accessed Aug. 30, 2012); Federal Home Loan Banks, *Combined Financial Report for the Quarterly Period Ended June 30, 2012*, at F-2 (online at www.fhlb-of.com/ofweb_userWeb/resources/12Q2end.pdf) (accessed Aug. 30, 2012).

## SELECTED FHFA, GSE, AND OTHER ACTIVITIES

OIG follows significant developments pertaining to FHFA and the GSEs, as discussed below.

### FHFA's Federal Register Notice on State-Level Guarantee Fee Pricing

On September 20, 2012, FHFA posted a notice in the Federal Register regarding the adjustment of guarantee fees the Enterprises charge on single-family mortgages for properties located in states where foreclosure costs are statistically higher than the national average. The fee adjustments are intended to reflect the disparity in costs compared to the national average. The notice seeks public input on the state-level fee adjustment proposal. The Agency will review the public's input before determining a final methodology for state-level guarantee fee pricing.[12]

### The Enterprises Launch New Representation and Warranty Framework

On September 11, 2012, FHFA announced that the Enterprises will launch a new representation and warranty framework for conventional loans sold or delivered on or after January 1, 2013. The framework aims to clarify lenders' repurchase exposure and liability for future mortgage sales. It is part of a broader series of strategic initiatives directed toward seller/servicer contract harmonization, as outlined in FHFA's white paper, *A Strategic Plan for Enterprise Conservatorships: The Next Chapter in a Story That Needs an Ending*, which was released in February 2012.

Pursuant to the revised representation and warranty framework:

- lenders will be relieved of certain repurchase obligations for loans that meet specific payment requirements; for example, representation and warranty relief will be provided for loans with 36 months of consecutive, on-time payments;
- Home Affordable Refinance Program loans will be eligible for representation and warranty relief after an acceptable payment history of 12 months following the acquisition date;
- information about exclusions from representation and warranty relief, such as violations of state, federal, and local laws and regulations, will be detailed; and
- the Enterprises will continue to develop tools to help improve loan quality.

According to FHFA, the new representation and warranty model will allow the Enterprises to:

- conduct quality control reviews earlier in the loan process, generally between 30 and 120 days after loan purchase;

- establish consistent timelines for lenders to submit requested loan files for review;
- evaluate loan files on a more comprehensive basis to ensure a focus on identifying significant deficiencies;
- leverage data from the tools currently used by the Enterprises to enable earlier identification of potentially defective loans; and
- make more transparent appeals processes available for lenders to appeal repurchase requests.[13]

### FHFA's Next Steps in REO Pilot Program

In August 2011, FHFA, Treasury, and the Department of Housing and Urban Development (HUD) issued a Request for Information, soliciting public comment on new and advantageous ways to sell single-family REO properties held in the portfolios of the Enterprises and the Federal Housing Administration. In February 2012, FHFA launched a pilot REO program. In the second quarter, bids were solicited from qualified investors to purchase approximately 2,500 of Fannie Mae's foreclosed single-family properties that were located in geographically concentrated areas across the United States.

On September 10, 2012, FHFA announced Pacifica Companies LLC as the first winning bidder in the REO pilot initiative.[14] This follows FHFA's announcement on July 3, 2012, that the winning bidders in the pilot REO initiative had been selected. Investors were qualified to bid after an evaluation process, in which they were evaluated on the basis of their financial strength, asset management experience, property management expertise, and experience in the geographic area.[15]

### FHFA Increases Guarantee Fees

On August 31, 2012, FHFA announced that the Enterprises will raise guarantee fees on single-family mortgages by an average of 10 basis points. In its announcement, FHFA explains that the guarantee fee increases are a step toward the goal of encouraging greater participation in the mortgage market by private firms. This goal was set forth in FHFA's *A Strategic Plan for Enterprise Conservatorships: The Next Chapter in a Story That Needs an Ending*.

The increase will go into effect on December 1, 2012, for loans exchanged for MBS. For loans sold for cash, increases will go into effect on November 1, 2012.

On August 31, 2012, FHFA also released its fourth annual report on single-family guarantee fees for the years 2010 and 2011. The report noted that the average guarantee fee charged by the Enterprises increased from 26 basis points in 2010 to 28 basis points in 2011. In addition, mortgages that posed higher credit risk were subsidized by lower-risk loans and a majority of the single-family mortgages acquired by the Enterprises were from a small group

of large lenders. FHFA's guarantee fee modifications were designed to address these issues by:

- making more uniform the guarantee fees that the Enterprises charge lenders who deliver large volumes of loans as compared to those who deliver smaller volumes; and
- reducing cross-subsidies between higher-risk and lower-risk mortgages by increasing guarantee fees on loans with maturities longer than 15 years more than on shorter maturity loans.[16]

## New Standard Short Sale Guidelines for the Enterprises

On August 21, 2012, FHFA announced the Enterprises' issuance of new mortgage servicer guidelines designed to align and consolidate existing short sales programs into one standard short sale program. In its announcement, FHFA asserts that the revised rules will enable lenders and servicers to qualify eligible borrowers for a short sale promptly and effectively. The guidelines will permit short sales by homeowners with an Enterprise mortgage who have an eligible hardship – even if they are current on their mortgage. Servicers will be able to expedite short sales for borrowers with hardships, such as death of a borrower or co-borrower, divorce, disability, or job relocation, without additional Enterprise approval. The new guidelines go into effect November 1, 2012, and include the following:

- ***Streamlining short sale approach for borrowers most in need.*** The documentation required to demonstrate need has been reduced or eliminated for borrowers who have missed several mortgage payments, have low credit scores, or experience serious financial hardships.
- ***Enabling servicers to quickly and easily qualify borrowers current on their mortgages for short sales.*** Common reasons for borrower hardship are death, divorce, disability, or relocation (i.e., relocations of more than 50 miles from the borrower's home for a job transfer or new employment opportunity). The program changes allow servicers to process short sales for borrowers with such hardships without additional Enterprise approval, even if the borrowers are current on their mortgage payments.
- ***Waiving the Enterprises' right to pursue deficiency judgments in exchange for a financial contribution when a borrower has sufficient income or assets to make cash contributions or sign promissory notes***. Servicers will evaluate borrowers for additional capacity to cover the shortfall between the outstanding loan balance and the property sales price as part of approving the short sale.
- ***Giving special treatment to military personnel with Permanent Change of Station (PCS) orders***. Service members who are being

relocated will automatically be eligible for short sales, even if they are current on their existing mortgages. Further, they will be under no obligation to contribute funds to cover the shortfall between the outstanding loan balance and the sales price on their homes.

- ***Consolidating existing short sales programs into a single uniform program***. Servicers will have clearer and more consistent guidelines, making it easier to process and execute short sales.
- ***Providing servicers and borrowers clarity on processing a short sale when a foreclosure sale is pending***. The new guidance will stipulate when a borrower must submit his or her application and a sales offer to be considered for a short sale. Therefore, last minute communications and negotiations may be handled in a uniform and fair manner.
- ***Offering up to $6,000 to second lien holders to expedite a short sale***. Previously, second lien holders could slow down the short sale process by negotiating for higher amounts.

These guidelines are part of a broader FHFA effort, the Servicing Alignment Initiative, designed to streamline the Enterprises' short sale programs and other foreclosure alternatives to assist struggling homeowners.[17]

## Modifications to Senior Preferred Stock Purchase Agreements

On August 17, 2012, Treasury announced the third amendments to the Enterprises' PSPAs. In its announcement, Treasury claims that the modifications will assist in expediting the wind down of the Enterprises, ensure that their earnings are used to benefit taxpayers, and support the continued flow of mortgage credit. The key components of the PSPA modifications include the following:

- ***Accelerated wind down of the Enterprises' retained mortgage investment portfolios***. The size of the Enterprises' investment portfolios will be decreased at an annual rate of 15%, an increase from the 10% annual reduction required in the previous iterations of the PSPAs. Due to this change, the Enterprises' investment portfolios must be reduced to a $250 billion target four years earlier than previously scheduled.
- ***Income sweep of future Enterprise earnings to benefit taxpayers***. The 10% per annum dividends the Enterprises pay to Treasury on its preferred stock investments have been eliminated. Instead, the fixed dividend will change to a quarterly sweep of all positive net worth each Enterprise earns going forward.

According to Treasury, the modifications are intended to assist in achieving the following objectives:

- Ensuring every dollar of Enterprise earnings will be used to benefit taxpayers;
- Ending the circular practice of Treasury advancing funds to the Enterprises to pay dividends back to Treasury;
- Winding down the Enterprises as stipulated in the Administration's 2011 white paper, *Reforming America's Housing Finance Market*, and not permitting them to retain profits, rebuild capital, or return to the market in their prior form;
- Supporting the continued flow of mortgage credit; and
- Providing greater market certainty regarding the Enterprises' financial strength.[18]

*For further information on the Administration's white paper, see page 24 of* OIG's Inaugural Semiannual Report to the Congress.

## FHFA's Federal Register Notice on Use of Eminent Domain to Restructure Performing Loans

On August 9, 2012, FHFA published a notice in the Federal Register seeking public comments on the use of **eminent domain** to restructure performing home loans. Local governments have expressed interest in using their eminent domain power to seize and restructure the mortgages of homeowners that are current but underwater on their loans. In its notice, FHFA states that it has significant concerns regarding the use of eminent domain to revise existing financial contracts and alter the value of the GSEs' securities holdings and their liability on MBS guarantees. FHFA adds that it may need to take action to mitigate risks to the GSEs' safe and sound operations and avoid taxpayer expense. FHFA invited public input on this issue.[19]

**Eminent Domain:**
An exercise of the power of government or quasi-government agencies (such as airport authorities, highway commissions, community development agencies, and utility companies) to take private property for public use.

## FHFA Opposes the Use of Principal Forgiveness by the Enterprises

On July 31, 2012, FHFA's Acting Director responded to congressional inquiries regarding whether FHFA would authorize the Enterprises to use principal forgiveness as a method to assist borrowers by implementing HAMP PRA. After extensive analysis of the revised HAMP PRA, including Treasury's commitment to use Troubled Asset Relief Program (TARP) funds to make incentive payments to the Enterprises, FHFA announced that HAMP PRA would not meaningfully reduce foreclosures in a cost-effective way for taxpayers. Instead, FHFA asserts that in order to strengthen the Enterprises' loss mitigation and borrower assistance efforts and improve the operation of the housing finance market, efforts should focus on further streamlining refinance opportunities, enhancing the short sale process, and reducing lender uncertainty that could inhibit new mortgage lending.[20]

## FHFA's Lawsuit Against the State of Illinois

On June 22, 2012, FHFA filed a lawsuit against the State of Illinois and several counties for imposing real estate transfer taxes on the Enterprises. According to FHFA, federal statutes and Supreme Court rulings preclude states, counties, and municipalities from imposing real estate transfer taxes on the Enterprises. In its lawsuit, FHFA explains that pursuant to federal law, the Enterprises are required to pay real estate taxes on the value of their real estate holdings but not on the transfer of properties. Accordingly, the Agency claims that the Enterprises are exempt from the Illinois transfer taxes and requests that the court block this taxation.[21]

## FHFA's Short Sale Assistance for Military Homeowners with Enterprise Loans

On June 21, 2012, FHFA announced changes to short sale policies. The changes are intended to make it easier for military homeowners with Enterprise loans to honor their financial commitments if they are required to move. Under the new policy, military homeowners receiving PCS orders will be eligible to sell their homes in a short sale, even if they are current on their mortgage. Further, the Enterprises will not pursue a deficiency judgment against – or seek a cash contribution or promissory note from – them. Because PCS orders require military homeowners to move quickly, the new policy may help alleviate some of the hardships experienced by military homeowners with underwater loans who cannot sell their homes without taking a loss. To be eligible, service members with PCS orders must have a Fannie Mae or Freddie Mac loan for any property purchased on or before June 30, 2012.[22]

## FHFA Establishes Additional Anti-Fraud Measure for the Enterprises and the FHLBanks

*In its report*, FHFA's Oversight of Fannie Mae's Default-Related Legal Services *(AUD-2011-004, September 30, 2011), OIG noted instances in which Freddie Mac terminated law firms for poor performance, but Fannie Mae continued to use the firms. Similarly, Freddie Mac continued to do business with a seller/servicer that Fannie Mae had terminated. See* FHFA's Oversight of the Enterprises' Management of High-Risk Seller/Servicers *(AUD-2012-007, September 18, 2012).*

On June 18, 2012, FHFA announced a new initiative called the Suspended Counterparty Program (SCP) that will complement current fraud reporting by the Enterprises and the FHLBanks. SCP requires the Enterprises and the FHLBanks to notify FHFA when an organization or individual with whom they conduct business is adjudicated to have engaged in fraud or other financial misconduct. FHFA implemented SCP to ensure the Enterprises and the FHLBanks are not exposed to unnecessary risk from conducting business with individuals or organizations that have exhibited fraudulent conduct in the past.

Under SCP, FHFA will determine whether an organization or individual should be suspended from doing business with the GSEs. Any party found to be associated with fraudulent activity will be able to defend himself/herself/itself against the possibility of suspension. In appropriate cases, FHFA will issue orders directing the GSEs to cease business activities with individuals or organizations that are determined to have a history of fraud.

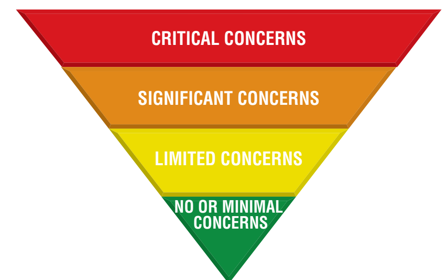
OIG assisted FHFA with the development of SCP, which became effective on August 15, 2012.[23]

## FHFA's 2011 Annual Report to Congress

On June 13, 2012, FHFA released its 2011 *Report to Congress*, which detailed the Agency's examinations of the Enterprises, the 12 FHLBanks, and the FHLBank System's Office of Finance.

The Enterprises received composite examination ratings reflecting "critical supervisory concerns." In its report, FHFA indicates the ratings resulted from continuing credit losses from loans originated in 2005 through 2007 and forecasts losses yet to be realized from loans originated during that time period. Credit risk from the pre-conservatorship book of business and operational risk were cited as the most significant concerns. The key challenges facing each of the Enterprises included the ongoing stress in the nation's housing markets, the difficult economic environment, and the uncertain future of the Enterprises. FHFA also notes that the Enterprises are challenged by planned actions to build a new infrastructure for the secondary mortgage market, contract the Enterprises' dominant presence in the marketplace while simplifying and shrinking their operations, and maintain foreclosure prevention activities and mortgage credit availability. According to FHFA, during 2011, the Enterprises' management and boards of directors were responsive to its findings and took appropriate steps to begin resolving identified issues.

FHFA Supervisory Rating Scale




Source: Federal Housing Finance Agency, *Division of Enterprise Regulation Supervision Handbook 2.1*, at 14-15 (June 16, 2009) (online at www.fhfa.gov/webfiles/2921/DERHandbook21.pdf).

FHFA's examination of the FHLBank System indicated that the FHLBanks of Boston, Chicago, and San Francisco presented "limited supervisory concerns," while the FHLBanks of Pittsburgh and Seattle presented "supervisory concerns." The FHLBanks of New York, Atlanta, Cincinnati, Indianapolis, Des Moines, Dallas, and Topeka were described as "satisfactory." The FHLBank System's financial condition and performance was described as fairly stable in 2011 but continued to be negatively affected by declines in advance balances, pay down of higher-yielding investments, and exposure to private-label MBS.

FHFA's examination of the Office of Finance noted both improvements and continued deficiencies in corporate governance and operations, as well as other "supervisory concerns."[24]

## The Enterprises' Chief Executive Officers

On June 5, 2012, Fannie Mae announced the appointment of Timothy J. Mayopoulos as President and Chief Executive Officer (CEO) and a member of the Board of Directors, effective June 18, 2012. Mr. Mayopoulos succeeds Michael J. Williams, who announced he would resign as CEO in January 2012. Mr. Mayopoulos joined Fannie Mae in 2009. Prior to his appointment

as CEO, he served as the company's Executive Vice President, Chief Administrative Officer, and General Counsel.[25]

On May 10, 2012, Freddie Mac announced the appointment of Donald H. Layton as CEO and a member of the Board of Directors. Mr. Layton officially joined the company on May 21, 2012. He succeeds Charles E. Haldeman Jr., who announced in October 2011 that he would be resigning as CEO. Prior to Mr. Layton's appointment as CEO, he served as a senior executive in two financial institutions, was a member of the boards of several financial services firms, and was a senior adviser to an industry association.[26]

## FHFA's Draft Strategic Plan

On May 14, 2012, FHFA released the Agency's draft *Strategic Plan: Fiscal Years 2013-2017*. The strategic plan highlights four strategic goals for the Agency:

- Safe and sound housing GSEs;
- Stability, liquidity, and access in housing finance;
- Preserving and conserving Enterprise assets; and
- Preparing for the future of housing finance in the United States.

FHFA indicates it will pursue a series of initiatives and strategies set forth in the strategic plan in order to improve current mortgage processes, inspire greater confidence among prospective market participants, and set the stage for an improved future system of housing finance.[27]

## The Enterprises to Streamline Short Sales to Help Borrowers and Communities

On April 17, 2012, FHFA announced that it has directed the Enterprises to develop enhanced and aligned strategies for facilitating short sales and other foreclosure alternatives, so that more homeowners can avoid foreclosure. FHFA intends that the effort will be completed in stages. (See pages 29, 30, and 32 for later developments related to short sales.)

FHFA noted the Enterprises would, by the end of 2012, announce further enhancements that address borrower eligibility and evaluation, documentation simplification, property valuation, fraud mitigation, payments to subordinate lien holders, and mortgage insurance.[28]

# SECTION 3

## OIG’S ACCOMPLISHMENTS AND STRATEGY

# Section 3: OIG's Accomplishments and Strategy

From April 1, 2012, through September 30, 2012, OIG's significant accomplishments included: (1) issuing 14 audit, evaluation, and white paper reports; (2) participating in a number of criminal and civil investigations; and (3) reviewing and commenting on proposed FHFA rules.

## OIG AUDITS AND EVALUATIONS

During this semiannual period, OIG released 14 reports, which are briefly summarized below.

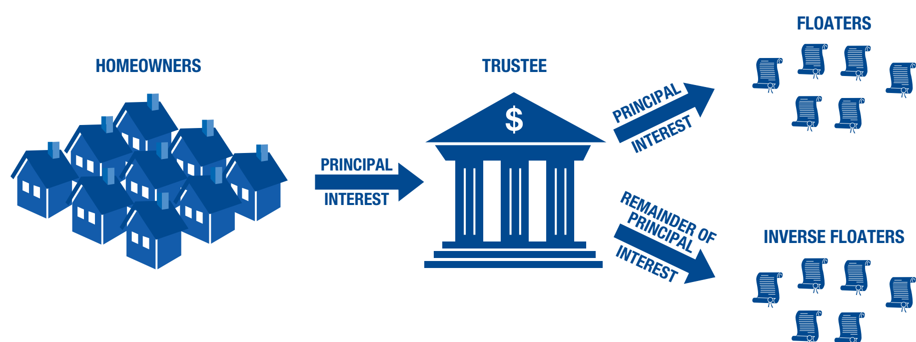
*The title of each audit, evaluation, and white paper report in this section is linked to the report on OIG's website.*

### Evaluations and White Papers

#### FHFA's Oversight of Freddie Mac's Investment in Inverse Floaters (EVL-2012-009, September 26, 2012)

This evaluation report considered the circumstances surrounding Freddie Mac's investment in inverse floaters. Freddie Mac's capital markets business structures and markets a family of bonds known as collateralized mortgage obligations. Freddie Mac may tailor these products to the investment preferences of its investors. As investor appetite for floating-rate bonds increased, Freddie Mac began to issue these bonds by carving them out of securitized mortgages. In the process, it retained by-product variable-rate bonds. These variable-rate bonds are known as inverse floaters, as depicted in Figure 9 (see below).

**Figure 9. Collateralized Mortgage Obligations**




In January 2012, Freddie Mac's retention of inverse floaters attracted public and congressional attention. Questions arose regarding whether Freddie Mac might be deliberately limiting loan refinancings in order to protect the value of its inverse floaters, because the value of inverse floaters decreases when the underlying mortgages are refinanced.

OIG found no evidence that Freddie Mac had obstructed homeowners' abilities to refinance their mortgages in an effort to influence the yields on its inverse floating-rate bonds. Rather, inverse floaters represent an extremely small portion of the Enterprise's portfolio, and efforts to manipulate refinancings could have an impact elsewhere among the Enterprise's investments and activities. Freddie Mac continually monitors and adjusts its diverse investment portfolio and hedges disparate risks according to a "net zero" strategy, whereby the Enterprise attempts to minimize losses but at the same time these attempts could limit gains.

Moreover, OIG found that Freddie Mac has an "information wall" policy to prevent its capital markets business from using nonpublic information to guide its investments. This policy would appear to apply to nonpublic information about homeowner refinancing. OIG found no evidence that this policy had been violated or that Freddie Mac's capital markets executives were in any way utilizing nonpublic information about refinancing to make investment decisions.

However, OIG found that some of FHFA's public statements about inverse floaters (issued in the wake of the increased public and congressional attention) could have been more clearly articulated.

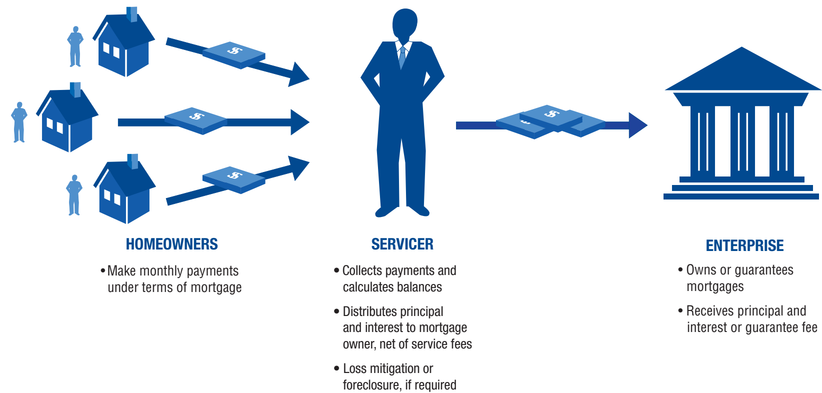
OIG recommended that FHFA: (1) conduct periodic tests of Freddie Mac's information wall; (2) monitor Freddie Mac's investment models; (3) ensure its supervisory policies are well founded and properly communicated; and (4) exercise care to ensure public statements include all relevant facts.

*A complete listing of all of OIG's recommendations and their status is set forth in Section 4 of this Semiannual Report.*

### Evaluation of FHFA's Oversight of Fannie Mae's Transfer of Mortgage Servicing Rights from Bank of America to High Touch Servicers (EVL-2012-008, September 18, 2012)

This evaluation report considered FHFA's oversight of a transaction between Fannie Mae and BOA, in which Fannie Mae paid BOA $421 million for the transfer of servicing rights to a portfolio of mortgages serviced by BOA but owned or guaranteed by Fannie Mae. (Figure 10, see page 40, depicts the mortgage servicing process.)

**Figure 10. The Mortgage Servicing Process**




The transaction was one of a series arising from Fannie Mae's High Touch Servicing Program. Under this program, the servicing rights to mortgages with a high risk of default are transferred by Fannie Mae to specialty servicers who have a better record of working with borrowers to prevent defaults. Fannie Mae hopes to realize credit loss savings of up to 20% through the High Touch Servicing Program.

In reviewing the BOA transaction, OIG determined that the transfer fee paid by Fannie Mae to BOA was consistent with the fees paid in similar transactions with other institutions. Further, OIG found that FHFA, prior to the BOA transaction, questioned the amounts paid by Fannie Mae to transfer MSR and directed the Enterprise to take steps to ensure that it did not overpay in such transactions.

However, OIG questioned whether Fannie Mae had relied too heavily on the work of one independent valuation firm when it considered the BOA transfer fee. Further, OIG questioned whether FHFA's oversight of the High Touch Servicing Program, in general, had been sufficient, in light of both the novelty and size of the program.

In its report, OIG recommended that FHFA: (1) consider revising its Delegation of Authorities to the Enterprises to require FHFA approval of unusual or high-cost new initiatives; (2) ensure Fannie Mae applies additional scrutiny to pricing significant MSR transactions; (3) review the assumptions underlying the High Touch Servicing Program and re-evaluate performance criteria for the program; and (4) ensure Fannie Mae fully implements FHFA's earlier direction regarding possible overpayments for MSR.

### Follow-up on Freddie Mac's Loan Repurchase Process (EVL-2012-007, September 13, 2012)

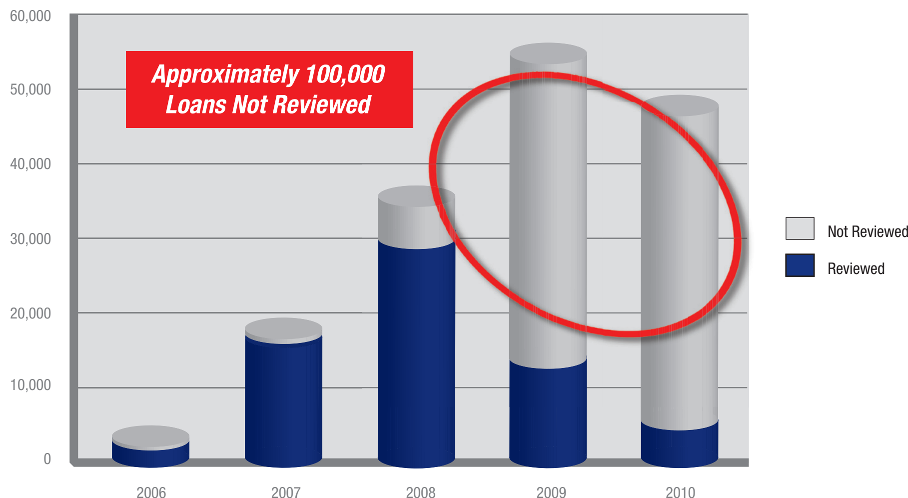
*The prior loan repurchase report is available for review at www.fhfaoig.gov/Content/Files/EVL-2011-006.pdf.*

This follow-up evaluation report assessed the likely savings that will result from acting on concerns raised by OIG in a prior report, *Evaluation of the Federal*

*Housing Finance Agency's Oversight of Freddie Mac's Repurchase Settlement with Bank of America* (EVL-2011-006, September 27, 2011).

In January 2011, FHFA announced that BOA had agreed to pay $1.35 billion to Freddie Mac to settle existing and possible future repurchase claims arising from its sale of mortgages (originated by Countrywide Financial Corporation) to Freddie Mac. OIG's initial evaluation report raised concerns about the methodology Freddie Mac used to determine the number of defective loans purchased from BOA that were eligible for repurchase. OIG determined that Freddie Mac's methodology underestimated the number of defective loans that should have been covered by the settlement because it tended to exclude from its review defective loans that were originated more than two years prior to default. Thus, for loans originated in 2006 alone, nearly 100,000 loans were not reviewed for possible repurchase claims, as depicted in Figure 11 (see below).

**Figure 11. Loans Purchased by Freddie Mac in 2006 That Entered Foreclosure**




Source: Freddie Mac, *QC Disposition of Foreclosures by Funding Year and Foreclosure Year* (Jan. 11, 2011).

OIG found in the follow-up report that FHFA and Freddie Mac have acted on the concerns raised in the initial report by adopting a more expansive loan review process. Specifically, Freddie Mac changed its policy to review for potential repurchase claims significantly larger numbers of loans that defaulted more than two years after origination.

OIG determined that, as a result of its new loan review process, Freddie Mac will realize additional recoveries ranging from $0.8 billion to $1.2 billion for loans selected for review in 2012 and $2.2 billion to $3.4 billion overall. Because these recoveries had not been anticipated and accounted for, the added income will increase Freddie Mac's profits and hence the amount paid to Treasury.

### FHFA's Certifications for the Preferred Stock Purchase Agreements (EVL-2012-006, August 23, 2012)

In order to keep the mortgage market liquid following the 2008 housing crisis, Treasury has invested $187.5 billion in the Enterprises. Pursuant to the PSPAs, Treasury committed to making this investment and investing additional funds if necessary. In return, FHFA committed to several conditions, termed "covenants," on the Enterprises' and its own behalf.

Among other things, these covenants obligate FHFA to provide certifications to Treasury that: (1) the Enterprises have complied with the covenants; (2) the Enterprises' financial statements and related documents sent to Treasury under the PSPAs contained no representations that were materially false or misleading when made; and (3) the funds sought by the Enterprises each quarter do not exceed the amount allowed under the PSPAs.

OIG conducted this evaluation to determine if and how FHFA was meeting its obligations under the PSPAs. OIG determined that FHFA provided Treasury with only one of the three certifications, namely, that the Enterprises are seeking no more funds from Treasury than they are allowed. FHFA did not provide the other two certifications covering covenant compliance and financial statement representations.

With respect to the certification covering covenant compliance, OIG found that FHFA had been forwarding to Treasury certifications made by the Enterprises concerning their compliance with the covenants. After OIG began this evaluation, however, FHFA strengthened its oversight of the Enterprises' certifications by participating in Enterprise certification meetings and by requiring reviews of Enterprise certifications by external audit firms. Further, after OIG alerted the Agency to its tentative findings, FHFA began to provide the certification covering covenant compliance.

Regarding the certification about financial statements, FHFA had not been providing any certifications to Treasury. However, OIG found that FHFA conducted significant oversight of the Enterprises' financial statements and their Securities and Exchange Commission (SEC) filings, which were independently audited. Furthermore, pursuant to federal statute, the Enterprises' executive officers certified that there were no material misstatements in the filings. Nonetheless, FHFA was silent on the required certifications until OIG provided to the Agency its preliminary findings in this evaluation.

In response to these findings, FHFA began to provide Treasury with the required certifications.

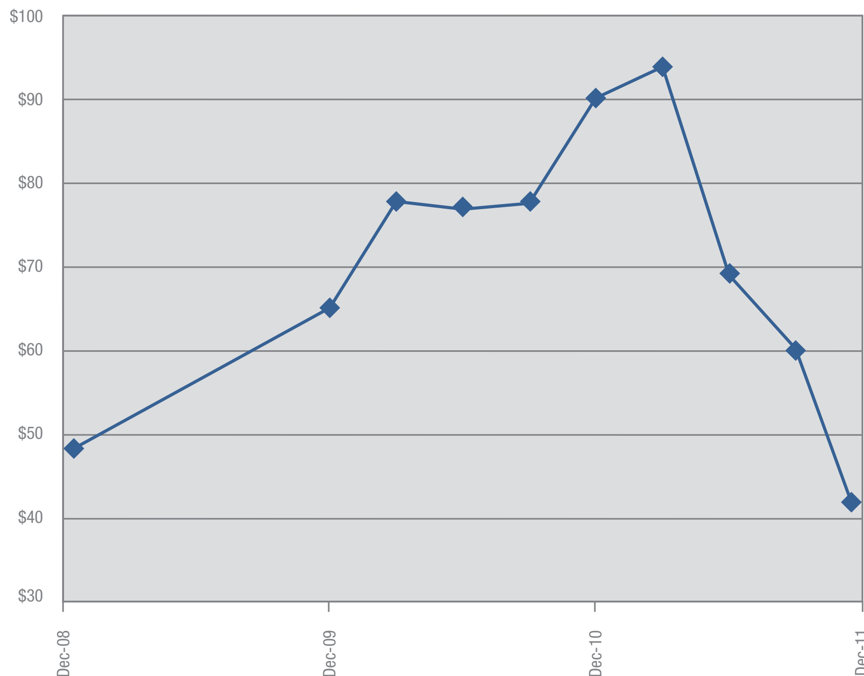
OIG recommended and FHFA agreed to: (1) adhere to the requirements that it certify both that the Enterprises have complied with the PSPA covenants and that their financial statements and related documents are free of materially false or misleading representations; and (2) monitor the implementation of its

oversight procedures to ensure that they are effective. These certifications enhance oversight of the PSPAs and reduce the potential for errors and waste of taxpayer dollars.

## FHFA's Oversight of the Federal Home Loan Banks' Unsecured Credit Risk Management Practices (EVL-2012-005, June 28, 2012)

To carry out its mission, the FHLBank System's Office of Finance issues debt (i.e., consolidated obligations) at the relatively favorable rates available to the GSEs. The FHLBanks use the consolidated obligation proceeds to make secured loans, also known as advances, to member financial institutions, such as banks. The FHLBanks may also extend unsecured short-term credit (i.e., loans not backed by collateral) to domestic and foreign financial institutions. Extensions of unsecured credit by the FHLBanks to, among others, European banks grew rapidly to more than $120 billion by early 2011. However, they declined sharply by the end of 2011 as the European sovereign debt crisis intensified, as depicted in Figure 12 (see below). OIG initiated this evaluation to assess FHFA's oversight of the FHLBanks' unsecured credit risk management practices.

**Figure 12. FHLBanks' Extensions of Unsecured Credit to Foreign Financial Institutions 2008 Through 2011 ($ billions)**




Source: Federal Home Loan Banks Office of Finance, *Trends in FHLBank System Unsecured Credit* (no date).

Note: The data for 2008 and 2009 are end of the year data. For 2010 and 2011, data are available for each quarter.

Extensions of unsecured credit by the FHLBanks to, among others, European financial institutions increased substantially in 2010 and 2011, even as the risks associated with doing so were intensifying. For example, OIG found that in 2011 one FHLBank extended more than $1 billion of unsecured credit to a European bank despite indications of increased risks associated with doing so (e.g., the bank's credit rating was downgraded and it later suffered a multibillion dollar loss). FHFA internal documents from that period also noted the rapid, system-wide growth of unsecured credit; certain FHLBanks' large exposures to particular financial institutions; and the increasing credit and other risks associated with such lending.

Although FHFA identified extensions of unsecured credit by the FHLBanks as an increasing risk in early 2010, the Agency did not immediately prioritize it in its examination process. In 2011, however, FHFA initiated a range of oversight measures that focused on credit extensions, including prioritizing them in the supervisory process and increasing the frequency with which the FHLBanks report on their unsecured credit portfolios.

OIG found that FHFA's initiatives contributed to the significant decline in the amount of unsecured credit the FHLBanks were extending by the end of 2011. However, OIG also noted that FHFA could take additional actions that would further strengthen its oversight efforts. For example, OIG recommended that FHFA investigate potential violations of its regulations governing extensions of unsecured credit. Further, OIG recommended that FHFA should consider revising current regulatory limits to mitigate the risks associated with extensions of unsecured credit by the FHLBanks. FHFA agreed with these recommendations.

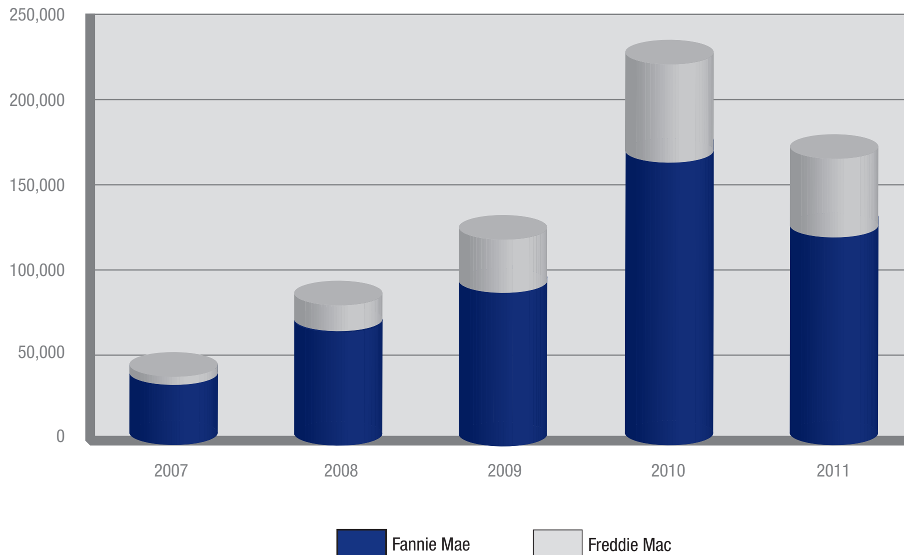
### White Paper: Overview of the Risks and Challenges the Enterprises Face in Managing Their Inventories of Foreclosed Properties (WPR-2012-003, June 14, 2012)

The Enterprises purchase mortgages from lenders and then keep them as investments or package them into securities that are sold to investors. When borrowers default on such mortgages, they may become subject to foreclosure proceedings. In many cases, the Enterprises take possession of foreclosed properties and resell them in an effort to recover some of their losses. The process of securing, maintaining, repairing, and selling foreclosed properties is often referred to as REO management.

Since the onset of the U.S. housing and financial crises in 2007 and 2008, the Enterprises have been dealing with surging foreclosure rates, rising REO inventories, and associated costs. By the end of 2011, their REO inventories had more than tripled to nearly 180,000 units and their related expenses totaled $8.5 billion. (Figure 13, see page 45, depicts fluctuations in the Enterprises' REO inventories between 2007 and 2011.) Further, given the financial distress many American homeowners continue to experience, the

Enterprises are likely to face elevated REO inventories and costs for years to come.

**Figure 13. Enterprises' REO Inventories 2007-2011 (number of properties)**




Sources: Fannie Mae, *Form 10-K for the Fiscal Year Ended December 31, 2008*, at 187 (online at www.sec.gov/Archives/edgar/data/310522/000095013309000487/w72716e10vk.htm) (accessed Oct. 8, 2012); Fannie Mae, *Form 10-K for the Fiscal Year Ended December 31, 2011*, at 168, 173 (online at www.sec.gov/Archives/edgar/data/310522/000119312512087297/d282546d10k.htm) (accessed Oct. 8, 2012); Freddie Mac, *Form 10-K for the Fiscal Year Ended December 31, 2008*, at 160 (online at www.freddiemac.com/investors/sec_filings/index.html) (accessed Oct. 8, 2012); Freddie Mac, *Form 10-K for the Fiscal Year Ended December 31, 2011*, at 167 (online at www.freddiemac.com/investors/sec_filings/index.html) (accessed Oct. 8, 2012).

Note: Freddie Mac did not publish a breakdown of its multifamily inventory data in its annual filings for 2007 and 2008. For consistency across the years, OIG has included Freddie Mac's multifamily inventory in this data. The impact upon Freddie Mac's total REO volume is likely to be negligible: for the years 2009 to 2011, the multifamily inventory comprised less than 0.05% of all REO units and never exceeded 20 properties.

In this white paper, OIG discussed: (1) the basics of the foreclosure and REO management processes; (2) the critical role that Enterprise contractor oversight plays in REO management; (3) key Enterprise REO management challenges; (4) FHFA's oversight of the Enterprises' REO management; and (5) FHFA's and Fannie Mae's development of a REO pilot program under which investors can purchase, in bulk, foreclosed properties with rental commitments. The white paper also identified OIG's strategy for assessing FHFA's oversight of the Enterprises' REO management efforts.

### White Paper: Fannie Mae and Freddie Mac: Where the Taxpayers' Money Went (WPR-2012-002, May 24, 2012)

Shortly after the Enterprises entered the conservatorships in September 2008, Treasury began making quarterly investments in the Enterprises to prevent their insolvency because they were rapidly losing billions of dollars. By March 31, 2012, U.S. taxpayers had invested nearly $187.5 billion in the Enterprises.

Questions have arisen regarding why Fannie Mae and Freddie Mac required such federal intervention, how the Enterprises have used Treasury's extraordinary investment, and who may have benefited from it. In this white paper, OIG attempted to answer these and other questions relating to Treasury's investments in the Enterprises. Understanding the answers to these questions will be important for policymakers as they determine the future of the Enterprises and the nation's housing and related financial markets.

OIG reported that, when U.S. housing prices began declining rapidly in 2006-2007, the Enterprises owned or guaranteed mortgages worth more than $5 trillion, nearly half of the U.S. mortgage market. They did not have adequate capital reserves to continue operating in the face of the growing losses on their mortgage portfolios.

Accordingly, Treasury's quarterly investments have been used primarily to cover losses stemming from single-family mortgage loans that the Enterprises had acquired from 2004 through 2008. In addition, Treasury's investments have covered dividend payments owed to Treasury under the terms of the PSPAs, as well as losses from investments and other expenses.

Also, Treasury's intervention protected numerous creditors – both domestic and foreign – who had purchased bonds and MBS issued by the Enterprises.

Without assistance from Treasury, the Enterprises likely would not have been able to repay their debts or honor their MBS guarantees. Further, they likely would have been unable to finance new mortgages or create new MBS, two of the cornerstones of the U.S. housing finance system.

However, the cost of rescuing the Enterprises has been high, with total Treasury support for the Enterprises currently expected to range from $191 billion to $209 billion.[29]

## Audits

### FHFA's Conservator Approval Process for Fannie Mae and Freddie Mac Business Decisions (AUD-2012-008, September 27, 2012)

As conservator, FHFA has extensive authority over the Enterprises' operations; however, in November 2008, the Agency broadly delegated most of its conservatorship authority back to the Enterprises. As part of the delegation, the Agency required the Enterprises to obtain Agency approval for selected business decisions, such as those involving legal settlements over $50 million and counterparty risk limit increases. OIG audited FHFA's process for approving these non-delegated Enterprise business decisions.

OIG concluded that the Agency can better accomplish its oversight mission by proactively exerting greater control over its conservator approval process. As of May 17, 2012, FHFA had received and tracked 611 requests for the

conservator's approval of actions that the Enterprises proposed to take and had closed 583 of these requests, as shown in Figure 14 (see below).

**Figure 14. Tracked Requests for Conservator Approval**

| Fannie Mae | | |
|---|---|---|
| Year | No. Received | Closed |
| 2009 | 46 | 26 |
| 2010 | 94 | 90 |
| 2011 | 104 | 105 |
| 2012 (as of 5/17) | 64 | 69 |
| **Total** | **308** | **290** |

| Freddie Mac | | |
|---|---|---|
| Year | No. Received | Closed |
| 2009 | 68 | 46 |
| 2010 | 108 | 104 |
| 2011 | 74 | 84 |
| 2012 (as of 5/17) | 53 | 59 |
| **Total** | **303** | **293** |

Source: Federal Housing Finance Agency Office of Inspector General, *FHFA's Conservator Approval Process for Fannie Mae and Freddie Mac Business Decisions*, at 10 (Sept. 27, 2012) (AUD-2012-008) (online at www.fhfaoig.gov/Content/Files/AUD-2012-008_2.pdf).

However, OIG found that FHFA did not require conservatorship approval for various major business decisions, such as reviewing and approving Fannie Mae's single-family underwriting standards and its High Touch Servicing Program.

Moreover, even when conservatorship approval of Enterprise business decisions is required, FHFA cannot be assured that the Enterprises always request such approval. FHFA has informed the Enterprises which actions remain under FHFA's authority, but the Agency primarily relies on the Enterprises to decide when to seek approval for their actions. As a consequence, Enterprise requests for approval have been inconsistent. For example, OIG determined that Fannie Mae executed seven insurance settlement discounts totaling over $306 million that should have been approved by FHFA in advance but were not submitted for review. By contrast, Freddie Mac executed similar settlements after seeking FHFA's approval. OIG also found that over a three-year period Fannie Mae took over 4,500 actions to increase the Enterprise's counterparty risk limits without first obtaining conservator approval. Freddie Mac, by contrast, had a process for requesting and receiving approval for risk limit increases.

Additionally, the Agency can improve how it processes requests for conservatorship decisions and follows up on the decisions it makes. OIG determined that FHFA has not established criteria or policies to ensure rigorous review of Enterprise business decisions. OIG also found that FHFA does not have a formal process to verify that the Enterprises abide by conservatorship decisions but instead has relied on informal conversations and unrelated reviews (e.g., routine examinations) to assess compliance.

OIG recommended that the Agency: (1) revisit FHFA's non-delegated authorities to ensure that significant Enterprise business decisions are sent to the conservator for approval; (2) guide the Enterprises to establish processes to ensure that actions requiring conservator approval are properly submitted for consideration; (3) properly analyze, document, and support conservator decisions; and (4) confirm compliance by the Enterprises with conservator decisions.

### FHFA's Oversight of the Enterprises' Management of High-Risk Seller/Servicers (AUD-2012-007, September 18, 2012)

The Enterprises buy mortgages from lenders, such as banks, and primarily rely on servicing counterparties for post-origination mortgage-related work, such as collecting payments. The Enterprises monitor counterparties that they have identified as high risk (e.g., seller/servicers whose circumstances represent a financial threat to the Enterprises). As of the third quarter of 2011, the Enterprises had placed more than 300 high-risk counterparties on watch lists and stopped doing business with more than 40 of them. Since 2008, the Enterprises estimate that they have incurred losses of up to $6.1 billion from the failures of just four of their counterparties. The Enterprises estimate their remaining risk exposure to high-risk seller/servicers to be approximately $7.2 billion, based on these counterparties' mortgage portfolios totaling $955 billion. OIG undertook this audit to assess how the Agency oversees the Enterprises' controls over their high-risk counterparties.

OIG found that FHFA can strengthen the Enterprises' counterparty risk management by, among other things, publishing standards for the development of contingency plans related to failing or failed high-risk counterparties. Contingency plans help to manage risks by identifying actions to pursue when a counterparty's changing financial or other circumstances pose a financial threat to an Enterprise.

FHFA's 2012 draft examination manual provides guidance to Agency examiners concerning how to review contingency plans. FHFA has been field testing the draft manual and expecting that the Enterprises will develop contingency plans after learning that the Agency instructs its examiners to look for their plans during examinations. However, the Agency has not published guidance requiring the Enterprises to develop plans or governing the contents of such plans. Accordingly, as of April 2012, the Enterprises had not developed comprehensive contingency plans for any of their approximately 300 high-risk counterparties.

Contingency plans can also help prepare the Enterprises for unexpected collapses of counterparties that handle a concentrated, high-volume of their business. As of September 2011, 70% (or $3.1 trillion) of the Enterprises' mortgage portfolios were controlled by their top 10 single-family mortgage servicers. Although these counterparties may not be on watch lists, their high

concentration of the Enterprises' business significantly increases the financial and operational consequences of their failure. Accordingly, the Enterprises can benefit from published FHFA guidance about when counterparties' volume and concentration of business raise their risk enough to warrant contingency plans.

OIG recommended that FHFA issue standards for the Enterprises to develop comprehensive contingency plans for high-risk and high-volume seller/servicers and that the Agency finalize its examination guidance regarding contingency planning.

### FHFA's Call Report System (AUD-2012-006, July 19, 2012)

OIG found that FHFA can enhance its supervision of the Enterprises by analyzing additional opportunities to use the Agency's CRS. CRS gathers GSE data and funnels valuable oversight information, such as quarterly financial reports, into a central database that FHFA divisions can access to monitor and examine GSE activity. For example, CRS contains data on the $5.3 trillion total net assets held by the Enterprises through 2011.

However, despite requiring the Enterprises to enter data into CRS, FHFA has not optimized its use of the system to enhance its oversight. For example, two FHFA supervisory divisions rarely use CRS in their analysis and oversight of the Enterprises; instead, they receive from the Enterprises routine submissions of loan-level data and standard management reports containing relevant metrics and data. These submissions are supplemented by ad hoc requests for additional data.

In addition, data produced pursuant to ad hoc requests may not be subject to the same integrity controls as are associated with CRS information. For example, CRS security controls have been independently evaluated in accordance with federal guidelines. Also, FHLBank and Enterprise management attest to the accuracy of CRS data in their respective call reports.

OIG recommended that FHFA ensure that it: (1) analyzes opportunities to use CRS information to facilitate supervision of the Enterprises; (2) supports identified opportunities with detailed supervisory and support division requirements for using CRS in its oversight planning and monitoring; and (3) directs divisions to work with FHFA's Office of Technology and Information Management and CRS system owners to enhance CRS to meet the Agency's supervisory needs.

### FHFA's Supervisory Risk Assessment for Single-Family Real Estate Owned (AUD-2012-005, July 19, 2012)

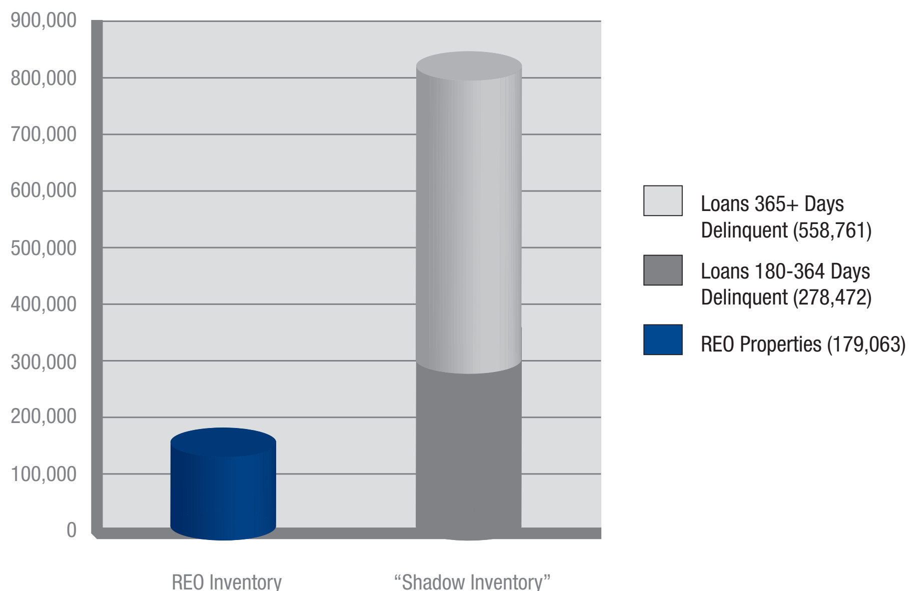
The Enterprises purchase mortgages in the secondary mortgage market. Typically, when borrowers default on these mortgages and efforts to cure the defaults fail or do not materialize, the mortgages are foreclosed upon. Through

foreclosure, properties that secure the defaulted mortgages revert back to the Enterprises as REO.

Since 2008, FHFA has consistently listed the Enterprises' large inventories of REO as contributing to "critical concern" ratings in their quarterly risk assessments. However, in spite of FHFA's identification of REO as a prominent and ascending risk, FHFA did not conduct targeted examinations or similar focused reviews of REO until 2011. In the second quarter of 2011, FHFA began examination planning and risk assessment work in preparation for a supervisory review of the REO management activities of the Enterprises. In June 2011, OIG announced an audit of FHFA's oversight of the Enterprises' REO. Subsequently, in July 2011, FHFA announced plans to conduct targeted examinations of risks arising from the Enterprises' use of contractors to manage (e.g., appraise, maintain, and sell) REO and their efforts to mitigate losses from problematic properties (e.g., unmarketable homes and cancelled foreclosures).

OIG found that FHFA's targeted examinations, which were completed in 2012, are positive supervisory steps that the Agency can supplement in the future by closely assessing other REO risk areas that need focused supervision (i.e., areas in addition to contractor management and the management of unmarketable homes and cancelled foreclosures). For example, the Enterprises have hundreds of thousands of properties that are in or near foreclosure (the "shadow inventory," see Figure 15, below), which may stress their systems for cost-effectively managing, marketing, and disposing of REO.

**Figure 15. Enterprises' REO Properties and Shadow Inventory for the Year Ended December 31, 2011 (number of loans/properties)**




Source: Federal Housing Finance Agency, *Foreclosure Prevention & Refinance Report Fourth Quarter 2011*, at 44-45 (online at www.fhfa.gov/webfiles/23522/4q11_fpr_finalv2i.pdf) (accessed Oct. 8, 2012).

OIG also found that FHFA will benefit from using a more comprehensive REO risk assessment and from using this assessment to enhance its planning of supervisory activities. According to FHFA's *Supervision Handbook*, risk assessment is the process of developing a comprehensive, risk-focused view of an Enterprise that presents a current look at its emerging and existing risk characteristics. The handbook specifies that the comprehensive, risk-focused view of an Enterprise should be used as a blueprint for planning supervisory activities. However, until early in 2011, FHFA's supervisory planning did not focus on the significant risks associated with the Enterprises' REO, and the Agency can focus better on emerging risks like the shadow inventory.

OIG recommended that FHFA implement a more comprehensive performance risk assessment of REO and link the results to supervisory plans that address those risks through specific supervisory activities.

### FHFA's Supervisory Framework for Federal Home Loan Banks' Advances and Collateral Risk Management (AUD-2012-004, June 1, 2012)

After having increased in prior years, the FHLBank System's combined outstanding advances decreased from over $1 trillion to approximately $415 billion between September 2008 and September 2011. The decrease was due in part to many member banks' financial deterioration and to weakened economic conditions generally.

Advances must be secured by collateral to protect the security interest of the lending FHLBank. The FHLBanks have a claim on the collateral of failed member banks with outstanding advances, but historically, they have not experienced losses on their advances. However, when a member bank fails, its chartering agency closes the institution and appoints the Federal Deposit Insurance Corporation (FDIC) as receiver to resolve the failure. This resolution process includes outstanding advances either being repaid or assumed by the acquirer of the failed member bank's assets. Either way, the process effectively shields the FHLBanks from losses on their advances to member banks that have FDIC-insured deposits.

OIG initiated this audit to assess FHFA's supervisory framework related to the FHLBanks' advances and collateral risk management practices for problem member banks. OIG found that although FHFA has taken steps to mitigate risk at the FHLBanks related to advances and collateral, it can strengthen its supervisory framework.

FHFA's mitigation efforts include regular, onsite, annual examinations and the use of offsite monitoring. In 2009, FHFA completed two reviews concerning collateral management practices. The first review, a horizontal (i.e., system-wide) review of the FHLBanks, included seven recommendations to ensure that FHFA and the FHLBanks implement corrective actions to address identified collateral management risks. The other review included a suggestion

that the FHLBanks reassess business plans that rely on troubled (otherwise referred to as problem) member banks for growth in advances.

However, as of December 2011, FHFA had implemented only one of seven recommendations from its horizontal review; six recommendations had not been implemented. Additionally, the other review's suggestion had not been implemented.

The sole recommendation that FHFA implemented is important and pertains to ensuring that the FHLBanks take corrective actions regarding collateral management deficiencies that the Agency identified during its examinations. However, in spite of the importance of the recommendation, OIG determined that FHFA does not adequately document its examination follow-up activities so that it can accurately assess the FHLBanks' corrective actions.

The six recommendations that FHFA had not implemented are also important and include updating the Agency's examination guidance for collateral reviews, providing guidance to the FHLBanks about effective collateral risk management, and offering relevant training to FHFA examiners. Agency officials acknowledged the importance of implementing these recommendations but, as of December 2011, FHFA had not approved an implementation plan or schedule for the outstanding recommendations.

OIG also found that FHFA does not have access to data that could enable it to better assess the risk of losses on advances and other risks posed to the FHLBanks. For example, FHFA does not avail itself of existing access agreements or request that the FDIC and other federal banking agencies provide it with copies of examination reports for problem member banks. Additionally, FHFA does not maintain a central listing of problem member banks identified by the FHLBanks. FHFA would have greater insight into the risks posed to the FHLBanks by problem members if it were to have greater access to external examination information.

In light of these findings, OIG recommended that FHFA implement its outstanding review recommendations, strengthen its supervisory framework, enhance its coordination with other federal banking agencies, and improve its oversight of problem member banks. FHFA agreed with OIG's recommendations.

## Other Reports

Finally, in two other reports, *CliftonLarsonAllen LLP's Audit of FHFA's Controls and Protocols over Sensitive and Proprietary Information Collected and Exchanged with the Financial Stability Oversight Council* (AUD-2012-009, September 28, 2012) and *CliftonLarsonAllen LLP's Audit of the Federal Housing Finance Agency's Risk Management Process for External Network Vulnerabilities* (AUD-2012-010, September 28, 2012), OIG's contract auditor offered recommendations to help FHFA mitigate risks related to the Agency's information technology.

Because information in these reports could be abused to circumvent FHFA's information technology controls, they have not been released publicly.

## OIG AUDIT AND EVALUATION PLAN

OIG maintains an Audit and Evaluation Plan that focuses strategically on the areas of FHFA's operations posing the greatest risks and providing the greatest benefits to the Agency, Congress, and the public. The plan responds to current events and feedback from FHFA officials, members of Congress, and others.

*OIG's most recent plan is available at www.fhfaoig.gov/Content/Files/Audit%20and%20Eval%20Plan%20Oct%202012.pdf.*

## OIG INVESTIGATIONS

OIG investigators have participated in numerous criminal, civil, and administrative investigations, which during the semiannual period resulted in the indictment of over 60 individuals and the conviction of over 20 individuals. In many of these investigations, OIG worked in conjunction with one or more other law enforcement agencies, such as DOJ, the Office of the Special Inspector General for the Troubled Asset Relief Program (SIGTARP), the Federal Bureau of Investigation (FBI), the Department of Housing and Urban Development Office of Inspector General (HUD-OIG), the Federal Deposit Insurance Corporation Office of Inspector General (FDIC-OIG), or state and local entities nationwide. Further, in several investigations, OIG investigative counsel were appointed as Special Assistant U.S. Attorneys and supported the prosecutions. Although most of these investigations remain confidential, details about several of them have been publicly disclosed, as described below.

### American Mortgage Specialists

On September 28, 2012, in the U.S. District Court for the District of North Dakota, criminal charges were filed against Scott Powers, David McMasters, Lauretta Horton, and David Kaufman, all former employees of American Mortgage Specialists (AMS). Powers, McMasters, and Horton were charged with conspiracy to commit bank and wire fraud in connection with a scheme to defraud BNC National Bank (BNC). In addition, Kaufman was charged with obstruction of justice for lying to an OIG special agent during the course of the investigation.

AMS was a mortgage company with headquarters in Mesa, Arizona, that originated residential mortgage loans, which were later sold to the Enterprises. BNC is a member of the FHLBank of Des Moines.

BNC funded all mortgages that AMS originated. After AMS sold the mortgages to investors, such as the Enterprises, AMS was required to repay BNC. However, the defendants allegedly delayed payoffs and diverted the funds for personal, payroll, and operating expenses. The defendants temporarily covered up their diversions by using sales proceeds from mortgages originated

later to pay BNC for mortgages originated earlier. When the fraud was discovered, AMS shut down, owing BNC approximately $27.5 million.

This is a joint investigation with SIGTARP and the DOJ Criminal Division's Fraud Section. Additionally, FinCEN supported the investigation.

### Sky Investments

On September 25, 2012, in the U.S. District Court for the Southern District of Florida, indictments were returned against Yakov "Jack" Alfasi and Rafael "Rafi" Rubinez. Alfasi and Rubinez, owners and officers of Sky Investments, were charged with conspiracy and wire fraud in connection with a scheme to defraud Fannie Mae. Sky Investments serviced Fannie Mae loans. Through Sky Investments, Alfasi and Rubinez allegedly misappropriated approximately $2.6 million from Fannie Mae's taxes and insurance escrow account and concealed the misappropriations by submitting false and misleading financial reports to Fannie Mae.

This is a joint investigation with the FBI and is being prosecuted with assistance from an OIG investigative counsel. The Fannie Mae Mortgage Fraud Program provided assistance during the course of this investigation.

### Michael Ybarra, Jeremy Lloyd, and Stephan Benjamin

On September 19, 2012, in the U.S. District Court for the Central District of California, a criminal indictment was filed against Michael Ybarra, Jeremy Lloyd, and Stephan Benjamin, charging them with conspiracy, bankruptcy fraud, and perjury. The indictment alleges the defendants conspired to commit bankruptcy fraud by operating businesses that falsely purported to provide assistance to homeowners seeking to delay or avoid mortgage foreclosures and/or eviction proceedings.

According to the indictment, the defendants advised homeowners seeking to delay or avoid foreclosure and/or eviction that, for a fee, they could assist them to keep their homes. After receiving fees from the homeowners, the defendants caused the preparation of documents that falsely indicated that tenants resided at the homeowners' properties. Additionally, the defendants allegedly caused false bankruptcy petitions to be prepared, signed, and filed on behalf of the fictitious tenants, frustrating eviction efforts. The tenancy assertions and the fraudulent bankruptcy petitions did not, and could not, provide lasting assistance to the struggling homeowners. In total, the defendants collected over $1.3 million in upfront fees from approximately 250 homeowners, including some whose mortgages were owned by Fannie Mae.

This is a joint investigation with the FBI.

### Dean Counce

On September 14, 2012, in the U.S. District Court for the Middle District of Florida, Dean Counce, the former president of American Mortgage Field Services LLC (AMFS), pleaded guilty to conspiracy to commit wire fraud.

According to the plea agreement, AMFS performed preservation and inspection work for homes in various phases of foreclosure, including homes that were owned by the Enterprises. AMFS's inspection work required Counce and other AMFS employees to visit properties and fill out inspection reports. They then compiled these inspection reports and transmitted them electronically to the Enterprises' servicer. The servicer paid AMFS a fee per inspection, and the Enterprises covered the fee.

As the real estate market declined in Florida and throughout the country, Counce and AMFS began to receive an increasing number of requests for inspections on properties in foreclosure. The requests far exceeded AMFS's capacity to deliver, and Counce and other AMFS employees began fabricating inspection reports. It is estimated that 70% of AMFS's inspection reports submitted between 2009 and March 13, 2012, which cost as much as $13.5 million, were fraudulent.

This is a joint investigation with HUD-OIG and the Secret Service. The Fannie Mae Mortgage Fraud Program provided assistance during the course of the investigation.

### Harriet Taylor

On September 12, 2012, in the U.S. District Court for the District of Maryland, Harriet Taylor pleaded guilty to wire fraud in connection with a scheme to divert over $1.5 million in mortgage closing funds for her personal use or for the use of her companies.

According to her plea agreement, Taylor co-owned and managed two title insurance companies, Regal Title Company LLC (Regal) and Loyalty Title Company LLC (Loyalty). Taylor entered into an agreement with a national title insurance underwriter, Old Republic National Title Insurance Company (Old Republic), to establish escrow accounts for her companies, separate from company operating accounts, for the purpose of holding and disbursing funds received from lenders for real estate closings. Beginning in 2009, however, Taylor caused mortgage lenders to wire their funds entrusted for real estate settlements to her companies' operating accounts, rather than to the escrow accounts. Taylor also caused funds in Regal's and Loyalty's escrow accounts to be transferred back and forth between their respective operating accounts. By using commingled funds throughout 2009, Taylor kept her two businesses afloat, while enriching herself with both company and escrow funds. From January through December 2009, Taylor paid herself $477,877 from three company operating accounts.

As shortfalls in the escrow accounts increased, Taylor failed to remit insurance premiums to Old Republic; pay recording fees for deeds; and pay off prior liens, including four which belonged to the Enterprises. Old Republic incurred a total loss of $1,518,532 that resulted from paying off prior liens, paying recording fees, and insurance premiums collected by Regal and Loyalty but not forwarded to Old Republic.

Taylor is scheduled to be sentenced on January 17, 2013. This is a joint investigation with the FBI, and OIG investigative counsel assisted in the prosecution.

### 21st Century Real Estate Investment Corporation

In September 2012, in the U.S. District Court for the Central District of California, a criminal indictment was unsealed, charging 11 defendants with conspiracy, wire fraud, and mail fraud. The 11 defendants, all employees of 21st Century Real Estate Investment Corporation (21st Century) or related businesses, defrauded financially distressed homeowners by making false promises and guarantees regarding 21st Century's ability to obtain loan modifications from the homeowners' mortgage lenders.

Specifically, the defendants are alleged to have falsely represented that 21st Century was operating a loan modification program sponsored by the U.S. government and instructed the homeowners to cease communicating with their mortgage lenders and making their mortgage payments. In total, the defendants collected over $7 million in fees from over 4,000 defrauded homeowners. Further, as directed by 21st Century employees, many homeowners stopped making their mortgages payments, causing mortgage defaults. Many of these mortgages were owned by the Enterprises.

This is a joint investigation with the FBI, SIGTARP, the Internal Revenue Service-Criminal Investigation (IRS-CI), and the U.S. Postal Inspection Service (USPIS).

### Adam Teague

On August 22, 2012, in the U.S. District Court for the Northern District of Georgia, Adam Teague, a former senior vice president of Appalachian Community Bank (ACB), pleaded guilty to conspiracy to commit bank fraud. Teague and other co-conspirators engaged in illegal schemes to unjustly enrich themselves at the expense of ACB and prevented the FDIC from discovering certain past due loans on ACB's books. ACB was a member of the FHLBank of Atlanta. ACB received advances from the FHLBank of Atlanta and pledged portfolios of its loans as collateral for those advances. Due to its poor financial condition, ACB was closed on March 19, 2010, and the FDIC was appointed as receiver. At that time, ACB owed the FHLBank of Atlanta approximately $67 million.

Teague and another co-conspirator used shell corporations to purchase two condominiums in Panama City Beach, Florida, and caused ACB to finance them at a total cost of approximately $566,000. Approximately two months later, they refinanced their mortgages and pocketed more than $875,000, which they then used to pay other personal debts, make monthly loan payments on the refinanced mortgages, pay condominium fees, and purchase new furniture for their condominiums. The new loan issued to defendant Teague was pledged to the FHLBank of Atlanta.

To conceal bad debts from the FDIC, Teague and a co-conspirator created two shell companies, GPH Investments LLC (GPH) and PHL Investments LLC. Through the use of these companies, they engaged in a sham real estate transaction designed to make it appear that GPH had purchased 11 residential properties from ACB's foreclosure inventory for approximately $3.7 million. They also caused ACB to loan GPH 90% of the purchase price and caused GPH to represent at closing that GPH was paying the other 10% of the purchase price out of its own funds, even though Teague and his co-conspirator knew that to be untrue. Further, in a separate scheme, in which they attempted to prevent the FDIC from discovering certain past due loans on ACB's books, they arranged a number of sham real estate transactions and caused ACB to make approximately $7 million in bogus loans to another co-conspirator in an effort to make it appear that this co-conspirator had purchased certain properties from ACB's foreclosure inventory and was making regular monthly payments on the purchases.

This is a joint investigation with the FDIC-OIG, SIGTARP, and the FBI.

### Menachem Yosef Levitin, Jeffrey Weisman, Charles Lesser, and Bradford J. Rieger

In July 2012, in the U.S. District Court for the District of Connecticut, Menachem Yosef Levitin, Jeffery Weisman, Charles Lesser, and Bradford J. Rieger pleaded guilty to participating in a multimillion dollar fraud scheme located in New Haven, Connecticut. According to court documents, between 2006 and 2008, Levitin, Weisman, Lesser, Rieger, and others conspired to defraud mortgage lenders and financial institutions by obtaining millions of dollars in fraudulent mortgages for the purchase of dozens of properties in New Haven, Connecticut. As part of the scheme, sellers of the properties agreed to accept sales prices that were significantly lower than the contract prices. The lower prices were not disclosed to the lenders, from which the buyers obtained financing to purchase the properties. The scheme participants submitted to the mortgage lenders false HUD-1 forms (i.e., real estate settlement disbursement forms) that often did not match undisclosed HUD-1 forms that were used to disburse the fraudulently obtained proceeds at the closings. Based upon the false HUD-1 forms and other false documentation in support of the loans, including falsified monthly rental income assertions and fictitious leases, mortgage lenders issued mortgages based on inflated

sales prices. As a result, scheme participants paid themselves and others with fraudulently obtained mortgage proceeds.

In most of the fraudulent transactions, the buyers did not make any deposits or down payments for the properties they purchased. Rather, the co-conspirators used some of the fraudulently obtained mortgage proceeds to cover the down payments and deposits. In addition, at or shortly after closing, borrowers received payments of several thousand dollars that were not disclosed to the lenders.

Levitin, a licensed real estate agent, identified most of the properties involved in the scheme and negotiated with the sellers concerning the sales price. Weisman and Rieger acted as closing attorneys. In total, more than $10 million in fraudulently obtained mortgages, which were owned or guaranteed by Fannie Mae or Freddie Mac, on more than 40 properties were involved in the conspiracy. Many of the houses purchased during the scheme went into default and have been foreclosed upon, causing losses of more than $7 million.

This is a joint investigation with the FBI, USPIS, and HUD-OIG, in coordination with the Financial Fraud Enforcement Task Force (FFETF).

### David C. Christian

On June 29, 2012, in the U.S. District Court for the District of Maryland, real estate appraiser David C. Christian pleaded guilty to a multimillion dollar conspiracy to commit wire fraud. Christian appraised properties for purchasers seeking financing through a mortgage brokerage company operating in Baltimore, Maryland. Between April 2004 and April 2008, Christian prepared at least 17 fraudulent appraisals totaling $4.3 million for loans originated by the mortgage brokerage firm. Christian developed false appraisals by misrepresenting the condition of the properties, providing doctored photos and property descriptions, and using inappropriate comparable properties.

Further, in 2007, Christian refinanced a property that he owned through the mortgage brokerage company. Christian inflated the property value by using false appraisals and had another appraiser sign the documents to avoid the conflict of performing an appraisal on his own property. The mortgage brokerage company processed the loan. Freddie Mac purchased Christian's flawed loan and incurred a loss of nearly $140,000 when Christian defaulted.

This is a joint investigation with the FBI and USPIS.

### Taylor, Bean & Whitaker

On June 15, 2012, Delton DeArmas, the former chief financial officer of Taylor, Bean & Whitaker Mortgage Corporation (TBW), was sentenced to 60 months in prison for his role in a more than $2.9 billion fraud scheme that contributed to the failures of TBW and Colonial Bank. DeArmas had previously pleaded guilty to one count of conspiracy to commit bank and wire

fraud and one count of making false statements. From 2005 through August 2009, he and other co-conspirators engaged in a scheme to defraud financial institutions that had invested in a TBW-owned lending facility called Ocala Funding LLC (Ocala).

DeArmas admitted he was aware that, in an effort to mislead investors, a subordinate who reported to him had falsified Ocala collateral reports and periodically sent the falsified reports to Ocala's investors and to other third parties. DeArmas also acknowledged that he knew the falsified financial reports were subsequently provided to Freddie Mac to support the renewal of TBW's authority to sell and service securities issued by it.

In addition to DeArmas, in June 2011, Lee Bentley Farkas, the chairman of TBW, was sentenced to 30 years in prison, after having been found guilty of 14 counts of conspiracy and bank, securities, and wire fraud. Six other individuals have also been convicted and sentenced for their roles in the TBW fraud scheme, including: Paul Allen, former CEO of TBW, who was sentenced to 40 months in prison; Raymond Bowman, former president of TBW, who was sentenced to 30 months in prison; Desiree Brown, former treasurer of TBW, who was sentenced to 72 months in prison; Catherine Kissick, former senior vice president of Colonial Bank and head of its Mortgage Warehouse Lending Division (MWLD), who was sentenced to 96 months in prison; Teresa Kelly, former operations supervisor for Colonial Bank's MWLD, who was sentenced to 3 months in prison; and Sean Ragland, a former senior financial analyst at TBW, who was sentenced to 3 months in prison.

In addition, all of the TBW conspirators have been suspended and debarred from doing business with the federal government or have debarment proceedings pending against them.

The case was prosecuted by the DOJ Criminal Division's Fraud Section and the U.S. Attorney's Office for the Eastern District of Virginia. The investigation was conducted jointly with SIGTARP, the FBI, HUD-OIG, and the FDIC-OIG. FinCEN, the SEC, and the Freddie Mac Fraud Investigation Unit also provided support to the investigation.

### Dennis O. Edwards

On June 12, 2012, in the U.S. District Court for the District of Maryland, Dennis O. Edwards pleaded guilty to conspiracy to commit bank fraud in connection with a scheme, in which he submitted fraudulent mortgage applications to obtain over $2.2 million to purchase or refinance multiple residences.

Among other matters to which he pleaded guilty, in early January 2006, Edwards purchased a home in Silver Spring, Maryland, claiming on the mortgage application that he earned a total of $6,000 a month from two employers. In fact, Edwards was unemployed at the time. Edwards obtained

a mortgage loan totaling $342,000, based upon the fraudulent mortgage application.

Edwards purchased another property in Hyattsville, Maryland, with a $384,750 loan that was also based upon false information. The loans were purchased by Freddie Mac, and the latter loan fell into delinquency. Edwards submitted additional fraudulent mortgage applications for other properties.

In his plea, Edwards admitted that, given his limited income, he did not qualify to borrow in excess of $1.5 million and, by signing the mortgage applications, he was facilitating a fraud.

This case was investigated jointly with the FBI and was prosecuted with assistance from an OIG investigative counsel.

### Robert P. George III and Rachel Lynn Randall

On June 7, 2012, in the U.S. District Court for the District of Arizona, Robert P. George III and Rachel Lynn Randall were indicted on wire fraud charges. According to the indictment, George and Randall fraudulently represented that they worked in the real estate industry and advertised residential property that they did not own for lease. They then signed leases and collected the rents on such properties.

They, along with co-defendants, Marshall Home and Margaret Broderick, allegedly describe themselves as "sovereign citizens" of the Independent Rights Party (IRP). Home allegedly registered a trade name affiliating himself with Fannie Mae and subsequently conveyed to IRP titles of foreclosed and REO properties actually owned by Fannie Mae in Arizona. IRP members then allegedly forcibly entered the properties and prevented foreclosure sales.

This is a joint investigation with the FBI.

### Abacus Federal Savings Bank

On May 17, 2012, the Manhattan District Attorney announced the unsealing of an 184-count indictment of Abacus Federal Savings Bank (Abacus), a federally chartered deposit and lending institution headquartered in New York City, and 11 of its former employees. The indictment charges violations of New York State law including mortgage fraud, securities fraud, grand larceny, conspiracy, and falsifying business records. According to the indictment, the Abacus employees allegedly participated in a mortgage fraud scheme resulting in the sale of hundreds of millions of dollars worth of fraudulently obtained loans to Fannie Mae. At the time of the public announcement, it was also disclosed that an additional 8 former employees of Abacus had pleaded guilty in connection with this fraud scheme.

The indictment alleges that Abacus, its employees, and its managers engaged in a conspiracy involving the regular and systematic falsification of residential

mortgage application documents. It alleges that the defendants falsified these documents so that they could earn commissions and fees by ensuring that otherwise unqualified borrowers would receive loans, which Abacus then sold to Fannie Mae pursuant to an ongoing agreement. After purchasing these fraudulent mortgages, Fannie Mae repackaged them into MBS and sold them to third-party investors. By originating hundreds of millions of dollars in fraudulent loans, the indictment charges, Abacus earned many millions of dollars in loan origination, purchasing, and servicing fees.

This is a joint investigation with the Manhattan District Attorney's Office, the Office of the Comptroller of the Currency, the IRS-CI, and the FDIC. This investigation is being coordinated by the Residential Mortgage-Backed Securities (RMBS) Working Group. The Fannie Mae Mortgage Fraud Program provided assistance during the course of the investigation.

Manhattan District Attorney Cyrus Vance Jr. (left), Inspector General of the Federal Housing Finance Agency Steve A. Linick (to the right of Vance), and members of the Major Economic Crimes Bureau of the District Attorney's office held a news conference about the Abacus Federal Savings Bank mortgage fraud conspiracy.

## Southern California Fraud Scheme

Five defendants have been charged or convicted in the U.S. District Court for the Southern District of California based on their alleged participation in a multimillion dollar mortgage loan origination fraud and kickback scheme. Mary Armstrong, William Fountain, and John Allen have been charged; Justin Mensen and Teresa Rose pleaded guilty on April 18, 2012, and May 30, 2012, respectively.

As alleged in the indictment, the defendants carried out their scheme by recruiting investors through advertisements in the Los Angeles Times and online and encouraging them to purchase homes in Ramona, California, and elsewhere. The advertisements offered investors who had good credit the chance to buy property with no money down, and the defendants falsely claimed they would make the mortgage payments on the investors' behalf using rental income they generated by renting and managing the properties. However, the indictment alleges that these investors were nothing more than straw buyers who were promised $10,000 for each property purchased. The defendants were able to secure mortgages for the properties by falsifying loan applications for the straw buyers. Among other things, the loan applications falsely claimed exorbitant income from fake employers and used sham companies to verify the borrowers' fabricated employment and rental histories. The defendants used these loan applications to obtain mortgages with 100% financing, thus avoiding having to make down payments on the properties.

The bulk of the profits the defendants allegedly made from the scheme resulted from convincing sellers to inflate the purchase price of the properties by approximately $100,000, which was supposed to be used for construction improvements to the properties. In fact, no construction work was ever performed and the funds were instead diverted (or "kicked back") to bank accounts controlled by the defendants. The defendants allegedly pocketed this money; made few, if any, mortgage payments; and allowed nearly all of the properties to fall swiftly into foreclosure.

The indictment alleges that Armstrong, Rose, and Fountain purchased at least 16 properties in California and Washington, secured over $11 million in mortgage loans, diverted over $1.5 million in sham construction kickbacks, and earned hundreds of thousands of dollars in additional proceeds through commissions and fees listed as part of the closing costs for each transaction. As a result of the foreclosures and defaults caused by the defendants' failure to make the mortgage payments, the defrauded mortgage lenders suffered losses of approximately $5 million. Fannie Mae purchased some of these fraudulently obtained mortgages on the secondary market and suffered losses as a result of the defaults.

This is a joint investigation with the FBI, USPIS, and HUD-OIG, in coordination with FFETF. An OIG investigative counsel assisted the prosecution.

### South Florida Fraud Scheme

On April 2, 2012, in the U.S. District Court for the Southern District of Florida, an indictment was unsealed against eight defendants in connection with fraudulently obtaining mortgages for the purchase of condominium units at Marina Oaks Condominiums in Fort Lauderdale, Florida. The indictment charged the defendants, Juan Carlos Sanchez, Quelyory Rigal, Sandra P. Campo, Osbelia Lazardi, Dayanara Montero, Edward R. Mena,

Celeste Mota, and David Arboleda, with conspiracy, wire fraud, and mail fraud. On September 25, 2012, a second indictment was filed against Marina Superlano and Marisa Perez, charging them with conspiracy to commit wire and mail fraud.

The indictments allege that from January 2007 through November 2008, the defendants conspired to recruit individuals to purchase condominium units at Marina Oaks Condominiums. These buyers were promised a "buyers' incentive," a payment which was not disclosed to the lenders or reflected on any of the closing documents. The conspirators would then prepare false mortgage applications for the buyers. These applications contained false information regarding the borrowers' creditworthiness in order to qualify them for mortgages to purchase the condominiums. The indictments allege that the conspirators fraudulently obtained approximately $39 million in mortgage loans, which were purchased by the Enterprises.

OIG special agents arrested Ocampo, who had been a fugitive, on September 5, 2012. Mota and Arboleda pleaded guilty on September 7 and 26, 2012, respectively.

This is a joint investigation with the IRS-CI and the Broward County, Florida, Sheriff's Office. The Fannie Mae Mortgage Fraud Program and the Freddie Mac Fraud Investigation Unit provided assistance during the course of this investigation.

### Bank of America

On March 12, 2012, the federal government and several states filed a federal civil complaint against BOA and its subsidiaries. It is alleged that BOA violated the terms of the Servicer Participation Agreement, signed with Treasury on April 17, 2009. The Servicer Participation Agreement required BOA to use reasonable efforts to assist U.S. homeowners in obtaining mortgage modifications under the Home Affordable Modification Program (HAMP), which includes loans owned by the Enterprises. On April 4, 2012, BOA entered into a consent judgment and financial settlement totaling $6.5 million.

OIG worked on this case with SIGTARP and the U.S. Attorney for the Eastern District of New York.

## OIG INVESTIGATIONS STRATEGY

OIG intends to further develop close working relationships with other law enforcement agencies, including DOJ and the U.S. Attorneys' Offices; state attorneys general; mortgage fraud working groups; the Secret Service; the FBI; HUD-OIG; the FDIC-OIG; the IRS-CI; SIGTARP; FinCEN; and other federal, state, and local agencies.

During this reporting period, OI has continued to work closely with FinCEN to review allegations of mortgage fraud for follow-up investigations and to determine where OIG can best assign special agents to investigate fraud against the GSEs. OIG also pursues innovative approaches to ensure its investigations are prosecuted timely. For example, OIG has provided dedicated OIG investigative counsels with substantial criminal prosecution experience to U.S. Attorneys' Offices to help prosecute OIG's investigations. In addition, OIG has partnered with a number of state attorneys general to pursue shared law enforcement goals.

## OIG REGULATORY ACTIVITIES

Consistent with the Inspector General Act, OIG considers whether proposed legislation, regulations, and policies related to FHFA are efficient, economical, legal, and susceptible to fraud and abuse. During the semiannual period, OIG made substantive comments on one proposal[o] and a rule that OIG previously commented upon was finalized and published.

1. **Draft Advisory Bulletin: Collateralization of Advances and Other Credit Products Provided by FHLBanks to Insurance Companies (OIG Comments Submitted on September 21, 2012)**

   FHFA forwarded to OIG a draft advisory bulletin to establish controls over the FHLBanks' advances to insurance company members. Due to ongoing discussions between FHFA and OIG regarding this draft, the substance of OIG's comments and their resolution will be published at a later date.

2. **FHFA Final Rule: Prudential Management and Operations Standards (RIN 2590-AA13, OIG Comments Submitted on January 20, 2012)**

   HERA requires FHFA to establish and enforce prudential standards relating to the management and operations of Fannie Mae, Freddie Mac, and the FHLBanks. These standards must address certain specified topics, including but not limited to the GSEs' internal controls; information systems; internal audit systems; and management of risk, liquidity, and asset and investment portfolio growth. FHFA circulated to OIG a draft rule addressing the prudential standards for the GSEs. OIG recommended that FHFA revise its original draft standards in various respects to provide the GSEs with greater clarity and specificity regarding the plans, practices, and policies FHFA requires that they implement. OIG contended that doing so might help improve the due process available to the GSEs and would assist OIG in evaluating the efficacy and efficiency of FHFA's examination processes. On June 8, 2012, FHFA issued a final rule to establish the required prudential standards. The final rule is substantially similar to the proposed

[o] As a matter of policy, OIG notes that it has commented on a draft rule during the semiannual period when a comment is made, and then OIG discusses the substance of its comment in a later semiannual report once the rule is finalized and published.

rule and, therefore, cannot be said to appreciate OIG's recommendation that the draft rule would benefit from further clarification.

## OIG COMMUNICATIONS AND OUTREACH EFFORTS

A key component of OIG's mission is to communicate clearly with the GSEs, industry groups, other federal agencies, Congress, and the public. OIG facilitates clear communications through its Hotline, coordination with other oversight organizations, and congressional statements and testimony.

### Hotline

OI operates a **Hotline**, which allows concerned parties to report directly and in confidence information regarding possible fraud, waste, or abuse related to FHFA or the GSEs. OIG honors all applicable whistleblower protections. As part of its effort to raise awareness of fraud and how to combat it, OIG promotes the Hotline through its website, posters, e-mails targeted to FHFA and GSE employees, and its semiannual reports.

*OIG's **Hotline**:*
*(800) 793-7724 or*
*OIGHOTLINE@FHFAOIG.GOV.*

### Coordinating with Other Oversight Organizations

OIG shares oversight of federal housing program administration with several other federal agencies including HUD, the Department of Veterans Affairs, the Department of Agriculture, and Treasury's Office of Financial Stability (which manages TARP); their inspectors general; and other law enforcement organizations. To further its mission, OIG coordinates with these entities to exchange best practices, case information, and professional expertise. During the semiannual period ended September 30, 2012, representatives of OIG participated in the following cooperative activities:

- ***RMBS Working Group***. On January 27, 2012, the Attorney General issued a memorandum announcing the formation of the RMBS Working Group as a part of the federal FFETF. The RMBS Working Group is led by five co-chairs: the Assistant Attorney General of the DOJ Criminal Division, the SEC's Director of Enforcement, the Attorney General of the State of New York, the U.S. Attorney for the District of Colorado, and the Assistant Attorney General of the DOJ Civil Division. The RMBS Working Group is designed to investigate misconduct in the market for MBS. Specifically, it seeks to streamline and strengthen current and future efforts to identify, investigate, and prosecute instances of wrongdoing in packaging, selling, and valuing RMBS. The RMBS Working Group consists of federal, state, and local partners including OIG, HUD, DOJ, FinCEN, the SEC, the FBI, the IRS-CI, and the Consumer Financial Protection Bureau. As

a member of the RMBS Working Group since its formation, OIG has made a number of significant contributions to the joint effort.

- ***Mortgage Fraud Summits.*** DOJ, HUD-OIG, OIG, and other federal and state partners held mortgage fraud summits in Las Vegas and Los Angeles to assist homeowners in areas hit hardest by the foreclosure crisis. The summits were organized by the FFETF Mortgage Fraud Working Group and provided homeowners with the opportunity to learn about mortgage fraud trends, the impact of mortgage fraud on the community, and how to avoid becoming a victim of a mortgage fraud offense.
- ***CIGIE.*** OIG actively participates in CIGIE.
    - The Inspector General serves on the CIGIE Inspection and Evaluation Committee, which provides leadership for improving agency effectiveness by maintaining professional standards; develops protocols for reviewing management issues that cut across departments and agencies; promotes advanced program evaluation techniques; and fosters awareness of evaluation and inspection practices in the inspector general community. The Inspection and Evaluation Committee also provides input to CIGIE's Professional Development Committee with regard to employees' training and development needs.
    - The Inspector General also serves as vice chairman of the CIGIE Suspension and Debarment Working Group, which is charged with improving the effectiveness of federal suspension and debarment practices.
- ***Council of Inspectors General on Financial Oversight.*** The Inspector General is an active member of the Council of Inspectors General on Financial Oversight, which was established by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 to facilitate information sharing among member agencies that are responsible for financial oversight.
- ***Federal Housing Inspectors General.*** As noted in the second Semiannual Report, OIG spearheaded the creation of a new interagency working group, the Federal Housing Inspectors General. In addition to OIG, this group includes the Offices of Inspector General for other federal agencies with primary responsibility for federal housing, including HUD, the Department of Veterans Affairs, and the Department of Agriculture. The Federal Housing Inspectors General continue to collaborate on multiple joint initiatives.
- ***FFETF.*** OIG actively participates in FFETF, a coalition of state and federal law enforcement agencies, prosecutors, and other entities. The President established FFETF in November 2009 to investigate and prosecute significant financial crimes, ensure just and effective

punishment for those who perpetrate them, recover proceeds for victims, and address discrimination in the lending and financial markets. Within FFETF, OIG has begun working with its task force partners to combat mission-relevant financial crimes. In addition to the RMBS Working Group discussed above, OIG also participates in FFETF's:

- Mortgage Fraud Working Group;
- Recovery Act, Procurement, and Grant Fraud Working Group; and
- Securities and Commodities Fraud Working Group.

- ***Other Partnerships.*** OIG has established partnerships with several federal agencies to share data, analyze internal complaints, and identify trends. These agencies include FinCEN, SIGTARP, HUD-OIG, the FBI, and the Secret Service. In addition, OIG has partnered with state and local law enforcement agencies across the nation, including State Attorneys General in New York and California. Each of OIG's partnerships is designed to enhance interagency cooperation. These partnerships focus the participating agencies' combined investigative resources on identifying, investigating, and prosecuting those involved in fraud related to the entities regulated by the participants.

## Communicating with Congress

To fulfill his responsibility to keep Congress fully apprised of OIG's oversight of FHFA, the Inspector General meets regularly with members of Congress and their staffs to brief them on OIG's reports, organization, and strategy.

Copies of the Inspector General's written testimony to Congress are available at www.fhfaoig.gov/testimony.

# SECTION 4

## OIG'S RECOMMENDATIONS

# Section 4: OIG's Recommendations

In accordance with the provisions of the Inspector General Act, one of the key duties of OIG is to provide recommendations to FHFA that promote the transparency, efficiency, and effectiveness of the Agency's operations and aid in the prevention and detection of fraud, waste, or abuse. The following table summarizes OIG's formal recommendations to date and notes the status of their implementation.

**Figure 16. Summary of OIG's Recommendations**

| No. | Recommendation | Report | Status |
|---|---|---|---|
| **EVL-2012-009-1** | FHFA should continue to monitor Freddie Mac's hedges and models to ensure the Enterprise's portfolio is hedged within its approved interest rate limits. | *FHFA's Oversight of Freddie Mac's Investment in Inverse Floaters* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| **EVL-2012-009-2** | FHFA should conduct periodic reviews and tests of Freddie Mac's information wall to confirm that the Enterprise is not trading on non-public information. | *FHFA's Oversight of Freddie Mac's Investment in Inverse Floaters* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| **EVL-2012-009-3** | FHFA should ensure that supervisory policies are well-founded and coordinated and that the Agency speaks with one voice by:<br>• if FHFA is going to take a position or believes it has come to an agreement with Freddie Mac regarding a particular investment product, confirming its position or the agreement in writing as soon as practical; and<br>• ensuring that supervisory policies are based on the robust work of Agency personnel and not reactions to media or other public scrutiny. | *FHFA's Oversight of Freddie Mac's Investment in Inverse Floaters* | Recommendation partially agreed to by FHFA; implementation of recommendation pending. |
| **EVL-2012-009-4** | Prior to issuing any public statement, FHFA should exercise due diligence to ensure that statements accurately reflect all relevant facts. | *FHFA's Oversight of Freddie Mac's Investment in Inverse Floaters* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| **EVL-2012-008-1** | FHFA should consider revising FHFA's Delegation of Authorities to require FHFA approval of unusual, high-cost, new initiatives, like the High Touch Servicing Program. | *Evaluation of FHFA's Oversight of Fannie Mae's Transfer of Mortgage Servicing Rights from Bank of America to High Touch Servicers* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| **EVL-2012-008-2** | FHFA should ensure that Fannie Mae does not have to pay a premium to transfer inadequately performing portfolios. | *Evaluation of FHFA's Oversight of Fannie Mae's Transfer of Mortgage Servicing Rights from Bank of America to High Touch Servicers* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| **EVL-2012-008-3** | Consistent with the control issues found in Fannie Mae's internal audit report on the High Touch Servicing Program, FHFA should ensure that Fannie Mae applies additional scrutiny and rigor to pricing significant MSR transactions. FHFA should:<br>• consider requiring Fannie Mae to assess the valuation methods of multiple MSR valuators in order to discern best practices; and<br>• consider requiring two independent valuations in the case of larger MSR transactions (at a threshold to be determined by FHFA). | *Evaluation of FHFA's Oversight of Fannie Mae's Transfer of Mortgage Servicing Rights from Bank of America to High Touch Servicers* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| **EVL-2012-008-4** | FHFA should assess the efficacy of the program and direct any necessary modifications. As the portfolios purchased under the program approach the five-year mark, FHFA should review both the underlying assumptions and the performance criteria for the High Touch Servicing Program. | *Evaluation of FHFA's Oversight of Fannie Mae's Transfer of Mortgage Servicing Rights from Bank of America to High Touch Servicers* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| **EVL-2012-007-1** | FHFA and Freddie Mac should continue to carry out the loan review and related reforms they have initiated since OIG's original report on the BOA settlement with Freddie Mac was issued. | *Follow-up on Freddie Mac's Loan Repurchase Process* | The recommendation is unresolved and a management decision has not been made as of September 30, 2012. |
| **EVL-2012-006-1** | FHFA should adhere to the requirements in the PSPAs that it certify: (1) that the Enterprises have complied with the PSPA covenants and (2) that the Enterprises' financial statements and related documents provided to Treasury under the PSPAs are free of materially false or misleading representations. | *FHFA's Certifications for the Preferred Stock Purchase Agreements* | Closed – Final action taken by FHFA. |

| No. | Recommendation | Report | Status |
|---|---|---|---|
| **EVL-2012-006-2** | FHFA should implement oversight procedures to ensure the Enterprises' compliance with PSPA requirements. | *FHFA's Certifications for the Preferred Stock Purchase Agreements* | Closed – Final action taken by FHFA. |
| **EVL-2012-005-1** | FHFA should continue its ongoing horizontal review of unsecured credit practices at the FHLBanks by:<br>• following up on any potential evidence of violations of the existing regulatory limits and taking supervisory and enforcement actions as warranted; and<br>• determining the extent to which inadequate systems and controls may compromise the FHLBanks' capacity to comply with regulatory limits and taking any supervisory actions necessary to correct such deficiencies as warranted. | *FHFA's Oversight of the Federal Home Loan Banks' Unsecured Credit Risk Management Practices* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| **EVL-2012-005-2** | FHFA should strengthen the regulatory framework around the FHLBanks' extension of unsecured credit by:<br>• establishing maximum overall exposure limits;<br>• lowering the existing individual counterparty limits; and<br>• ensuring that the unsecured exposure limits are consistent with the FHLBank System's housing mission. | *FHFA's Oversight of the Federal Home Loan Banks' Unsecured Credit Risk Management Practices* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| **ESR-2012-004-1** | FHFA should ensure that the Enterprises conduct a comprehensive review of their travel and entertainment policies and revise them in a manner consistent with the January 25, 2012, guidance. | *Fannie Mae's and Freddie Mac's Participation in the 2011 Mortgage Bankers Association Annual Convention and Exposition* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| **ESR-2012-004-2** | FHFA should review the Enterprises' proposed revisions to ensure that they are drafted in a manner consistent with the guidance provided by FHFA and that the Enterprises have established appropriate controls to monitor compliance. | *Fannie Mae's and Freddie Mac's Participation in the 2011 Mortgage Bankers Association Annual Convention and Exposition* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| **ESR-2012-003-1** | FHFA should continue to monitor the Enterprises' progress in phasing out their charitable activities. | *FHFA's Oversight of the Enterprises' Charitable Activities* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| **ESR-2012-003-2** | FHFA should continue to require the Enterprises to issue timely, quarterly reports on their charitable activities via their websites. | *FHFA's Oversight of the Enterprises' Charitable Activities* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| **EVL-2012-002-1** | FHFA should work to limit legal expenses to the extent possible and reasonable by:<br>• narrowing the reach of future indemnification agreements;<br>• considering making greater use of Directors & Officers insurance; and<br>• continuing to invoke the new FHFA regulation establishing the primacy of claims in a receivership in an effort to curtail costly litigation. | *Evaluation of FHFA's Management of Legal Fees for Indemnified Executives* | Closed – Final action taken by FHFA. |
| **EVL-2012-002-2** | FHFA should continue to control costs of legal expenses by:<br>• identifying the best elements of Fannie Mae's and Freddie Mac's programs for administering advances and indemnification of legal expenses and developing standardized legal billing practices for both Enterprises; and<br>• further developing FHFA oversight procedures. | *Evaluation of FHFA's Management of Legal Fees for Indemnified Executives* | Closed – Final action taken by FHFA. |

| No. | Recommendation | Report | Status |
|---|---|---|---|
| EVL-2012-001-1 | FHFA should develop and implement a clear, consistent, and transparent written enforcement policy that:<br>• requires troubled FHLBanks (those classified as having supervisory concerns) to correct identified deficiencies within specified timeframes;<br>• establishes consequences for their not doing so; and<br>• defines exceptions to the policy. | *FHFA's Oversight of Troubled Federal Home Loan Banks* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| EVL-2012-001-2 | FHFA should develop and implement a reporting system that permits Agency managers and outside reviewers to assess readily examination report findings, planned corrective actions and timeframes, and their status. | *FHFA's Oversight of Troubled Federal Home Loan Banks* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| EVL-2012-001-3 | FHFA should document consistently key activities, including recommendations to remove and replace senior officers and other personnel actions involving FHLBanks. | *FHFA's Oversight of Troubled Federal Home Loan Banks* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| EVL-2011-006-1 | FHFA should promptly act on the specific, significant concerns raised by FHFA staff and Freddie Mac internal auditors about its loan review process. | *Evaluation of the Federal Housing Finance Agency's Oversight of Freddie Mac's Repurchase Settlement with Bank of America* | Recommendation partially agreed to by FHFA; implementation of recommendation pending. |
| EVL-2011-006-2 | FHFA should initiate reforms to ensure that senior managers are apprised of and timely act on significant concerns brought to their attention, particularly when they receive reports that the normal reporting and supervisory process is not working properly. | *Evaluation of Federal Housing Finance Agency's Oversight of Freddie Mac's Repurchase Settlement with Bank of America* | Closed – Final action taken by FHFA. |
| EVL-2011-005-1 | FHFA should assess: (1) the extent to which examination capacity shortfalls may have adversely affected the examination program and (2) potential strategies to mitigate risks, such as achieving efficiencies in the assignment of examiners or the examination process. | *Evaluation of Whether FHFA Has Sufficient Capacity to Examine the GSEs* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| EVL-2011-005-2 | FHFA should monitor the development and implementation of the examiner accreditation program and take needed actions to address any shortfalls. | *Evaluation of Whether FHFA Has Sufficient Capacity to Examine the GSEs* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| EVL-2011-005-3 | FHFA should consider using detailees from other federal agencies, retired annuitants, or contractors to augment its examination program in the near term to midterm. | *Evaluation of Whether FHFA Has Sufficient Capacity to Examine the GSEs* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| EVL-2011-005-4 | FHFA should report periodically to Congress and the public, which might include the augmentation of existing reports, on the Agency's examiner capacity shortfalls, such as the number of examiners needed to meet its responsibilities; the progress in addressing these shortfalls, including status of examiner recruitment and retention efforts; and the development and implementation of its examiner accreditation program. | *Evaluation of Whether FHFA Has Sufficient Capacity to Examine the GSEs* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| EVL-2011-004-1 | FHFA should closely monitor Fannie Mae's implementation of its operational risk management program. | *Evaluation of FHFA's Oversight of Fannie Mae's Management of Operational Risk* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| EVL-2011-004-2 | FHFA should take decisive and timely actions to ensure the implementation of the program if Fannie Mae fails to establish an acceptable and effective operational risk program by the end of the first quarter of 2012. | *Evaluation of FHFA's Oversight of Fannie Mae's Management of Operational Risk* | Recommendation agreed to by FHFA; implementation of recommendation pending. |

| No. | Recommendation | Report | Status |
|---|---|---|---|
| **EVL-2011-004-3** | FHFA should ensure that Fannie Mae has qualified personnel to implement its operational risk management program. | *Evaluation of FHFA's Oversight of Fannie Mae's Management of Operational Risk* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| **EVL-2011-003-1** | FHFA should engage in negotiations with Treasury and the Enterprises to amend the Financial Agency Agreements, under which the Enterprises administer and enforce HAMP, by incorporating specific dispute resolution provisions so that the parties may discuss differences that arise in its administration and establish strategies by which to resolve or mitigate them. | *Evaluation of FHFA's Role in Negotiating Fannie Mae's and Freddie Mac's Responsibilities in Treasury's Making Home Affordable Program* | Closed – Final action taken by FHFA. |
| **EVL-2011-002-1A** | FHFA should review the disparity in compensation levels between the Enterprises' executives and the senior executives of housing-related federal entities that are providing critical support to the housing finance system. | *Evaluation of Federal Housing Finance Agency's Oversight of Fannie Mae's and Freddie Mac's Executive Compensation Programs* | Closed – Final action taken by FHFA. |
| **EVL-2011-002-1B** | FHFA should review the extent to which federal financial support for the Enterprises may facilitate their capacity to meet certain performance targets and, by extension, the capacity of their executives to achieve high levels of compensation that may not be warranted. | *Evaluation of Federal Housing Finance Agency's Oversight of Fannie Mae's and Freddie Mac's Executive Compensation Programs* | Closed – Final action taken by FHFA. |
| **EVL-2011-002-1C** | FHFA should review the potential challenges the Enterprises might face in recruiting and retaining technical expertise, which might include the employment of objective metrics to assess these issues and the extent to which existing compensation levels may need to be revised. | *Evaluation of Federal Housing Finance Agency's Oversight of Fannie Mae's and Freddie Mac's Executive Compensation Programs* | Closed – Final action taken by FHFA. |
| **EVL-2011-002-2A** | FHFA should establish written criteria and procedures for reviewing annual performance and assessment data, as well as their recommended executive compensation levels. | *Evaluation of Federal Housing Finance Agency's Oversight of Fannie Mae's and Freddie Mac's Executive Compensation Programs* | Closed – Final action taken by FHFA. |
| **EVL-2011-002-2B** | FHFA should conduct independent testing and verification, perhaps on a random basis, to gain assurance that the Enterprises' bases for developing recommended individual executive compensation levels is reasonable and justified. | *Evaluation of Federal Housing Finance Agency's Oversight of Fannie Mae's and Freddie Mac's Executive Compensation Programs* | Closed – Final action taken by FHFA. |
| **EVL-2011-002-2C** | FHFA should create and implement policies to ensure that all key executive compensation documents are stored consistently and remain readily accessible to appropriate Agency officials and staff. | *Evaluation of Federal Housing Finance Agency's Oversight of Fannie Mae's and Freddie Mac's Executive Compensation Programs* | Closed – Final action taken by FHFA. |
| **EVL-2011-002-3A** | To improve transparency, FHFA should post on its website information about executive compensation packages, the Enterprises' corporate performance goals and performance against those goals, and related trend data. | *Evaluation of Federal Housing Finance Agency's Oversight of Fannie Mae's and Freddie Mac's Executive Compensation Programs* | Closed – Final action taken by FHFA. |
| **EVL-2011-002-3B** | To improve transparency, FHFA should post on its website links to the Enterprises' securities filings. | *Evaluation of Federal Housing Finance Agency's Oversight of Fannie Mae's and Freddie Mac's Executive Compensation Programs* | Closed – Final action taken by FHFA. |
| **EVL-2011-001-1** | FHFA should establish timeframes and milestones, descriptions of methodologies to be used, criteria for evaluating the implementation of the initiatives, and budget and financing information necessary to carry out its responsibilities. | *Federal Housing Finance Agency's Exit Strategy and Planning Process for the Enterprises' Structural Reform* | Closed – Final action taken by FHFA. |

| No. | Recommendation | Report | Status |
|---|---|---|---|
| **EVL-2011-001-2** | FHFA should develop an external reporting strategy, which might include the augmentation of existing reports, to chronicle FHFA's progress, including the adequacy of its resources and capacity to meet multiple responsibilities and mitigate any shortfalls. | *Federal Housing Finance Agency's Exit Strategy and Planning Process for the Enterprises' Structural Reform* | Closed – Final action taken by FHFA. |
| **AUD-2012-008-1** | FHFA should reassess the non-delegated authorities to ensure sufficient FHFA involvement with major business decisions. | *FHFA's Conservator Approval Process for Fannie Mae and Freddie Mac Business Decisions* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| **AUD-2012-008-2** | FHFA should evaluate the internal controls established by the Enterprises, including policies and procedures, to ensure they communicate all major business decisions requiring approval to the Agency. | *FHFA's Conservator Approval Process for Fannie Mae and Freddie Mac Business Decisions* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| **AUD-2012-008-3A** | FHFA should evaluate Fannie Mae's mortgage pool policy commutations to determine whether these transactions were appropriate and in the best interest of the Enterprise and taxpayers. This evaluation should include an assessment of Fannie Mae's methodology used to determine the economic value of the seven mortgage pool policy commutations (this assessment should include a documented review of Fannie Mae's analysis, the adequacy of the model(s) and assumptions used by Fannie Mae to determine the amount of insurance in force, fair value of the mortgage pool policies, premiums forgone, any other factors incorporated into Fannie Mae's analysis, and the accuracy of the information supplied to FHFA). | *FHFA's Conservator Approval Process for Fannie Mae and Freddie Mac Business Decisions* | The recommendation is unresolved and a management decision has not been made as of September 30, 2012. OIG has requested additional management comments. |
| **AUD-2012-008-3B** | FHFA should evaluate Fannie Mae's mortgage pool policy commutations to determine whether these transactions were appropriate and in the best interest of the Enterprise and taxpayers. This evaluation should include a full accounting and validation of all of the cost components that comprise each settlement discount (risk in force minus fee charged), such as insurance premiums and time value of money applicable to each listed cost component. | *FHFA's Conservator Approval Process for Fannie Mae and Freddie Mac Business Decisions* | The recommendation is unresolved and a management decision has not been made as of September 30, 2012. OIG has requested additional management comments. |
| **AUD-2012-008-4** | FHFA should develop a methodology and process for conservator review of proposed mortgage pool policy commutations to ensure that there is a documented, sound basis for any pool policy commutations executed in the future. | *FHFA's Conservator Approval Process for Fannie Mae and Freddie Mac Business Decisions* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| **AUD-2012-008-5** | FHFA should complete actions to establish a governance structure at Fannie Mae for obtaining conservator approval of counterparty risk limit increases. | *FHFA's Conservator Approval Process for Fannie Mae and Freddie Mac Business Decisions* | Recommendation partially agreed to by FHFA; implementation of recommendation pending. |
| **AUD-2012-008-6** | FHFA should establish a clear timetable and deadlines for Enterprise submission of transactions to FHFA for conservatorship approval. | *FHFA's Conservator Approval Process for Fannie Mae and Freddie Mac Business Decisions* | The recommendation is unresolved and a management decision has not been made as of September 30, 2012. OIG has requested additional management comments. |
| **AUD-2012-008-7** | FHFA should develop criteria for conducting business case analyses and substantiating conservator decisions. | *FHFA's Conservator Approval Process for Fannie Mae and Freddie Mac Business Decisions* | The recommendation is unresolved and a management decision has not been made as of September 30, 2012. OIG has requested additional management comments. |

| No. | Recommendation | Report | Status |
|---|---|---|---|
| **AUD-2012-008-8** | FHFA should issue a directive to the Enterprises requiring them to notify FHFA of any deviation from any previously reviewed action so that FHFA may consider the change and revisit its conservatorship decision. | *FHFA's Conservator Approval Process for Fannie Mae and Freddie Mac Business Decisions* | The recommendation is unresolved and a management decision has not been made as of September 30, 2012. OIG has requested additional management comments. |
| **AUD-2012-008-9** | FHFA should implement a risk-based examination plan to review the Enterprises' execution of and adherence to conservatorship decisions. | *FHFA's Conservator Approval Process for Fannie Mae and Freddie Mac Business Decisions* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| **AUD-2012-007-1** | FHFA should issue standards, by regulation or guidelines, for the Enterprises to develop comprehensive contingency plans for their high-risk and high-volume seller/servicers (individually or by group). At a minimum, these standards should include quantitative assessment, event management (e.g., curtailing business with or transferring business from a seller/servicer or specifying reasonable timeframes for reducing risks), monitoring, and testing elements. | *FHFA's Oversight of the Enterprises' Management of High-Risk Seller/Servicers* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| **AUD-2012-007-2** | FHFA should finalize its February 2012 draft examination manual to include elements related to contingency planning. | *FHFA's Oversight of the Enterprises' Management of High-Risk Seller/Servicers* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| **AUD-2012-006-1** | FHFA's Deputy Director of the Division of Enterprise Regulation (DER) and Office of Financial Analysis' Senior Associate Director should ensure that the Agency analyzes opportunities to use CRS information to facilitate supervision and regulation of the Enterprises. | *FHFA's Call Report System* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| **AUD-2012-006-2** | FHFA's Deputy Director of DER and Office of Financial Analysis' Senior Associate Director should ensure that the Agency supports identified opportunities for using CRS in its oversight planning and monitoring with detailed supervisory and support division requirements. | *FHFA's Call Report System* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| **AUD-2012-006-3** | FHFA's Deputy Director of DER and Office of Financial Analysis' Senior Associate Director should ensure that the Agency, if current CRS capabilities need improvement, directs divisions to work with FHFA's Office of Technology and Information Management and CRS system owners to enhance and improve CRS to meet FHFA's supervisory needs. | *FHFA's Call Report System* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| **AUD-2012-005-1** | FHFA's Deputy Director of DER should implement the performance of risk assessments of REO that are more comprehensive and link the results to supervisory plans that address those risks through specific supervisory activities. | *FHFA's Supervisory Risk Assessment for Single-Family Real Estate Owned* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| **AUD-2012-004-1** | FHFA should document fully its efforts to ensure that FHLBanks correct identified deficiencies in collateral risk management. | *FHFA's Supervisory Framework for Federal Home Loan Banks' Advances and Collateral Risk Management* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| **AUD-2012-004-2** | FHFA should implement and follow-up on the horizontal review recommendations related to the need for additional guidance and training and the need to conduct a follow-up horizontal review of secured credit. | *FHFA's Supervisory Framework for Federal Home Loan Banks' Advances and Collateral Risk Management* | Recommendation agreed to by FHFA; implementation of recommendation pending. |

| No. | Recommendation | Report | Status |
|---|---|---|---|
| **AUD-2012-004-3** | FHFA should advise FHLBanks to reassess business plans periodically that rely on troubled members for advance growth. | *FHFA's Supervisory Framework for Federal Home Loan Banks' Advances and Collateral Risk Management* | Closed – Final action taken by FHFA. |
| **AUD-2012-004-4** | FHFA should develop policies and procedures to ensure that offsite monitoring analyses relevant to supervisory issues, including those related to advances and collateral risk management, are distributed to examination staff and are used to enhance examinations. | *FHFA's Supervisory Framework for Federal Home Loan Banks' Advances and Collateral Risk Management* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| **AUD-2012-004-5** | FHFA should continue to enhance coordination with the federal banking agencies and the FHLBanks, including the use of established memoranda of understanding or other written agreements, to obtain bank examinations and other supervisory information as warranted to ensure improved collateral risk management and to facilitate information sharing related to member banks that present heightened supervisory concerns or that have advance concentrations. | *FHFA's Supervisory Framework for Federal Home Loan Banks' Advances and Collateral Risk Management* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| **AUD-2012-004-6** | FHFA should continue to pursue greater participation in the Federal Financial Institutions Examination Council to enhance the Agency's coordination with federal banking agencies and state regulatory authorities responsible for supervising and regulating FHLBank member banks. | *FHFA's Supervisory Framework for Federal Home Loan Banks' Advances and Collateral Risk Management* | Closed – Final action taken by FHFA. |
| **AUD-2012-004-7** | FHFA should establish a consolidated global watch list of member banks identified by the FHLBanks or by FHFA that present heightened supervisory concern and use the global watch list to enhance the Agency's supervision of the FHLBanks. | *FHFA's Supervisory Framework for Federal Home Loan Banks' Advances and Collateral Risk Management* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| **AUD-2012-003-1** | FHFA's Division of Housing Mission and Goals should formally establish a policy for its review process of underwriting standards and variances including escalation of unresolved issues reflecting potential lack of agreement. | *FHFA's Oversight of Fannie Mae's Single-Family Underwriting Standards* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| **AUD-2012-003-2** | FHFA's Division of Examination Program and Support should enhance existing examination guidance for assessing adherence to underwriting standards and variances from them. | *FHFA's Oversight of Fannie Mae's Single-Family Underwriting Standards* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| **AUD-2012-001-1A** | FHFA's DER should establish and implement more robust regulations or guidance governing counterparty oversight and risk management for mortgage servicing. The regulations or guidance should include requirements for contracting with servicers, including a contractual provision authorizing FHFA's access to relevant servicer information. | *FHFA's Supervision of Freddie Mac's Controls over Mortgage Servicing Contractors* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| **AUD-2012-001-1B** | FHFA's DER should establish and implement more robust regulations or guidance governing counterparty oversight and risk management for mortgage servicing. The regulations or guidance should include requirements for promptly reporting on material poor performance and noncompliance by servicers. | *FHFA's Supervision of Freddie Mac's Controls over Mortgage Servicing Contractors* | Closed – Final action taken by FHFA. |
| **AUD-2012-001-1C** | FHFA's DER should establish and implement more robust regulations or guidance governing counterparty oversight and risk management for mortgage servicing. The regulations or guidance should include requirements for minimum, uniform standards for servicing mortgages owned or guaranteed by the Enterprises. | *FHFA's Supervision of Freddie Mac's Controls over Mortgage Servicing Contractors* | Recommendation agreed to by FHFA; implementation of recommendation pending. |

| No. | Recommendation | Report | Status |
|---|---|---|---|
| **AUD-2012-001-2** | FHFA's DER should direct Freddie Mac to take the necessary steps to monitor and track the performance of its servicers to reasonably assure achievement of credit loss savings by: (1) implementing servicer account plans for the servicers without account plans that are under consideration to receive a plan and (2) taking action to maximize credit loss savings among the remaining servicers that are not under consideration for account plans. | *FHFA's Supervision of Freddie Mac's Controls over Mortgage Servicing Contractors* | Recommendation agreed to by FHFA; implementation of recommendation pending. |
| **AUD-2012-001-3** | FHFA's DER should improve its existing procedures and controls governing coordination with other federal agencies that have oversight jurisdiction with respect to the Enterprises' mortgage servicers. | *FHFA's Supervision of Freddie Mac's Controls over Mortgage Servicing Contractors* | Closed – Final action taken by FHFA. |
| **AUD-2011-004-1** | FHFA should review the circumstances surrounding its not identifying the foreclosure abuses at an earlier stage and develop potential enhancements to its capacity to identify new and emerging risks. | *FHFA's Oversight of Fannie Mae's Default-Related Legal Services* | Closed – Final action taken by FHFA. |
| **AUD-2011-004-2** | FHFA should develop and implement comprehensive examination guidance and procedures, together with supervisory plans, for default-related legal services. | *FHFA's Oversight of Fannie Mae's Default-Related Legal Services* | Closed – Final action taken by FHFA. |
| **AUD-2011-004-3** | FHFA should develop and implement policies and procedures to address poor performance by default-related legal services vendors that have contractual relationships with both of the Enterprises. | *FHFA's Oversight of Fannie Mae's Default-Related Legal Services* | Closed – Final action taken by FHFA. |
| **AUD-2011-003-1** | FHFA should document, disseminate, and implement a privacy training plan and implementation approach. | *Clifton Gunderson LLP's Independent Audit of the Federal Housing Finance Agency's Privacy Program and Implementation – 2011* | Closed – Final action taken by FHFA. |
| **AUD-2011-003-2** | FHFA should identify those employees that would benefit from additional job-specific or role-based privacy training based on increased responsibilities related to personally identifiable information (PII). | *Clifton Gunderson LLP's Independent Audit of the Federal Housing Finance Agency's Privacy Program and Implementation – 2011* | Closed – Final action taken by FHFA. |
| **AUD-2011-003-3** | FHFA should develop and implement targeted, role-based training for employees whose job functions require additional job-specific or role-based privacy training. | *Clifton Gunderson LLP's Independent Audit of the Federal Housing Finance Agency's Privacy Program and Implementation – 2011* | Closed – Final action taken by FHFA. |
| **AUD-2011-003-4** | FHFA should develop and implement additional training for employees about System of Records Notice (SORN) requirements, focusing on the inadvertent creation of systems of records. This training should stress the legal ramifications potentially associated with creating systems of records prior to publishing a SORN. | *Clifton Gunderson LLP's Independent Audit of the Federal Housing Finance Agency's Privacy Program and Implementation – 2011* | Closed – Final action taken by FHFA. |
| **AUD-2011-003-5** | FHFA should strengthen its privacy-related procedures to ensure SORNs are completed prior to systems becoming operational. | *Clifton Gunderson LLP's Independent Audit of the Federal Housing Finance Agency's Privacy Program and Implementation – 2011* | Closed – Final action taken by FHFA. |

| No. | Recommendation | Report | Status |
|---|---|---|---|
| **AUD-2011-003-6** | FHFA should require system owners of four FHFA systems with PII to prepare privacy impact assessments according to a checklist or template. | *Clifton Gunderson LLP's Independent Audit of the Federal Housing Finance Agency's Privacy Program and Implementation – 2011* | Closed – Final action taken by FHFA. |
| **AUD-2011-003-7** | FHFA should document the privacy impact assessments conducted for proposed rules of the Agency as required by Section 522. | *Clifton Gunderson LLP's Independent Audit of the Federal Housing Finance Agency's Privacy Program and Implementation – 2011* | Closed – Final action taken by FHFA. |
| **AUD-2011-003-8** | FHFA should establish a process for the completion of template- or checklist-based privacy impact assessments and modify policies and procedures as necessary. | *Clifton Gunderson LLP's Independent Audit of the Federal Housing Finance Agency's Privacy Program and Implementation – 2011* | Closed – Final action taken by FHFA. |
| **AUD-2011-003-9** | FHFA should ensure privacy risk is continuously assessed on systems in production, including when functionalities change or when a major update is done. The Chief Privacy Officer should document, disseminate (to system owners and the Chief Information Security Officer), and implement policies and procedures for continuous monitoring of information systems containing PII after they are placed in production. The policies and procedures at a minimum should:<br>• document the privacy-related security controls that are to be monitored to protect information in an identifiable form and information systems from unauthorized access, use, disclosure, disruption, modification, or destruction;<br>• determine the frequency of the privacy-related security controls monitoring and reporting process to the privacy office;<br>• document review of reports generated by the monitoring of the privacy-related security controls; and<br>• if necessary, take action on results of monitoring and document results of action taken. | *Clifton Gunderson LLP's Independent Audit of the Federal Housing Finance Agency's Privacy Program and Implementation – 2011* | Closed – Final action taken by FHFA. |
| **AUD-2011-002-1** | FHFA should finalize, disseminate, and implement an Agency-wide information security program plan in accordance with NIST SP 800-53 Rev.3. | *Clifton Gunderson LLP's Independent Audit of the Federal Housing Finance Agency's Information Security Program – 2011* | Closed – Final action taken by FHFA. |
| **AUD-2011-002-2** | FHFA should update its information security policies and procedures to address all applicable NIST SP 800-53 Rev.3 components. | *Clifton Gunderson LLP's Independent Audit of the Federal Housing Finance Agency's Information Security Program – 2011* | Closed – Final action taken by FHFA. |
| **AUD-2011-002-3** | FHFA should develop, disseminate, and implement an Agency-wide information categorization policy and methodology. | *Clifton Gunderson LLP's Independent Audit of the Federal Housing Finance Agency's Information Security Program – 2011* | Recommendation agreed to by FHFA; implementation of recommendation pending. |

| No. | Recommendation | Report | Status |
| --- | --- | --- | --- |
| **AUD-2011-002-4** | FHFA should develop, disseminate, and implement a process to monitor compliance with Plans of Action and Milestones. | *Clifton Gunderson LLP's Independent Audit of the Federal Housing Finance Agency's Information Security Program – 2011* | Closed – Final action taken by FHFA. |
| **AUD-2011-002-5** | FHFA should establish controls for tracking, monitoring, and remediating weaknesses noted in vulnerability scans. | *Clifton Gunderson LLP's Independent Audit of the Federal Housing Finance Agency's Information Security Program – 2011* | Closed – Final action taken by FHFA. |
| **AUD-2011-001-1A** | FHFA should design and implement written policies, procedures, and controls governing the receipt, processing, and disposition of consumer complaints that:<br>• define FHFA's and the Enterprises' roles and responsibilities regarding consumer complaints;<br>• require the retention of supporting documentation for all processing and disposition actions;<br>• require a consolidated management reporting system, including standard record formats and data elements, and procedures for categorizing and prioritizing consumer complaints;<br>• ensure timely and accurate responses to complaints;<br>• facilitate the analysis of trends in consumer complaints received and use the resulting analyses to mitigate areas of risk to the Agency;<br>• safeguard PII; and<br>• ensure coordination with OIG regarding allegations involving fraud, waste, or abuse. | *Audit of the Federal Housing Finance Agency's Consumer Complaints Process* | Closed – Final action taken by FHFA. |
| **AUD-2011-001-1B** | FHFA should assess the sufficiency of allocated resources, inclusive of staffing, in light of the additional controls implemented to strengthen the consumer complaints process. | *Audit of the Federal Housing Finance Agency's Consumer Complaints Process* | Closed – Final action taken by FHFA. |
| **AUD-2011-001-1C** | FHFA should determine if there are unresolved consumer complaints alleging fraud to ensure that appropriate action is taken promptly. | *Audit of the Federal Housing Finance Agency's Consumer Complaints Process* | Closed – Final action taken by FHFA. |

# AN OVERVIEW OF THE FHLBANK SYSTEM'S STRUCTURE, OPERATIONS, AND CHALLENGES

# Section 5: An Overview of the FHLBank System's Structure, Operations, and Challenges

The FHLBank System, which is sometimes referred to as the "other housing GSE,"[30] receives much less attention than the Enterprises. Yet, the FHLBank System deserves notice, among other reasons, because it currently has more than $600 billion in debt outstanding that is potentially taxpayer guaranteed,[31] and in recent years, it has faced a number of challenges in terms of its safety, soundness, and housing mission achievement. Some of these challenges include:

- Several FHLBanks made investments in mortgage securities during the housing boom years – from 2005 through 2007 – that later generated billions of dollars of losses and continue to present financial challenges.
- The FHLBank System has faced plummeting member demand for advances that negatively affects the FHLBanks' financial performance. Declining advance demand has led the FHLBanks to engage in potentially risky non-housing mission activities, such as making unsecured loans to foreign banks. Advances to insurance companies have also increased, exposing new risks, such as the fact that the FDIC does not cover the obligations of insurance companies in the event of a failure.
- The Administration has made proposals to reform the FHLBank System that may inadvertently pose challenges. These proposals include limiting FHLBank advances to small- and medium-sized members and reducing their investment portfolios. Although these proposals are intended to strengthen the FHLBank System's safety and soundness and its focus on housing mission achievement, they involve substantial revisions to some FHLBanks' current business models.

In light of these challenges and the potential risk that the FHLBank System represents, this section is intended to provide an overview of the FHLBank System's structure, operations, risks, and oversight by FHFA. It also summarizes several of the key differences between the FHLBank System and the Enterprises and discusses in detail a number of the critical challenges facing the FHLBanks and FHFA.

## BACKGROUND

### Overview of the FHLBank System's Structure

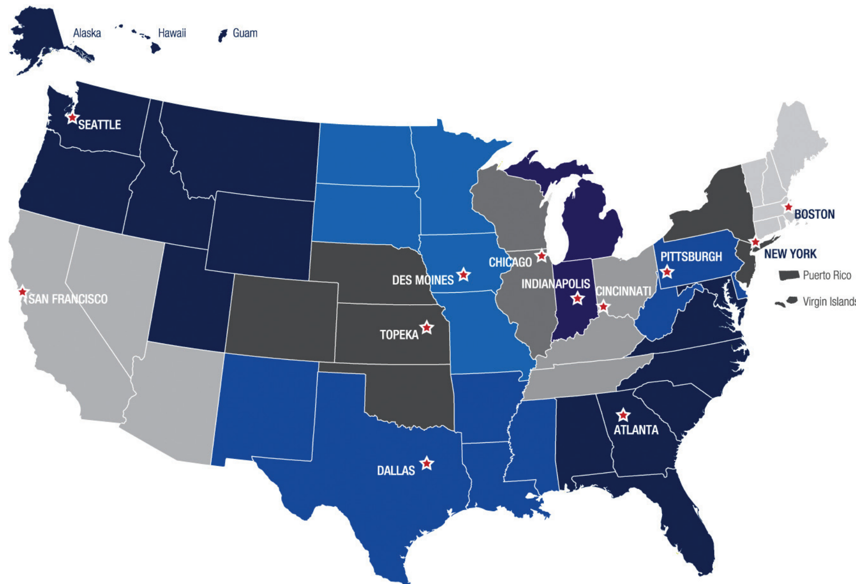
The FHLBank System was created in 1932 to improve the availability of funds for home ownership. It is organized under the authority of the Federal Home Loan Bank Act of 1932, and its mission is to provide local lenders with readily

available, low-cost funding to finance housing, jobs, and economic growth.[32] The 12 FHLBanks fulfill this mission by providing liquidity to their members through advances, resulting in an increased availability of credit for residential mortgages, community investments, and other housing and community development services.[33]

The FHLBanks are cooperatives that are owned privately and wholly by their members. Each FHLBank operates as a separate entity within a defined geographic region of the country, known as its district, with its own board of directors, management, and employees. Each member of an FHLBank must purchase and maintain capital stock as a condition of its membership. FHLBank stock is held at **par value** and is not traded. FHLBank members may receive dividends on their investment in capital stock from the earnings of their bank.[34] Figure 17 (see below) provides a map of the locations of the 12 FHLBanks.

**Par Value:**
The face value of a security.

**Figure 17. Regional FHLBanks**




Source: Federal Home Loan Bank of Boston, *Federal Home Loan Bank System* (online at www.fhlbboston.com/aboutus/thebank/06_01_04_fhlb_system.jsp) (accessed Aug. 8, 2012).

**Commercial Banks:**
Commercial banks are establishments primarily engaged in accepting demand and other deposits and making commercial, industrial, and consumer loans. Commercial banks provide significant services in originating, servicing, and enhancing the liquidity and quality of credit that is ultimately funded elsewhere.

**Thrifts:**
A financial institution that ordinarily possesses the same depository, credit, financial intermediary, and account transactional functions as a bank but that is chiefly organized and primarily operates to promote savings and home mortgage lending rather than commercial lending.

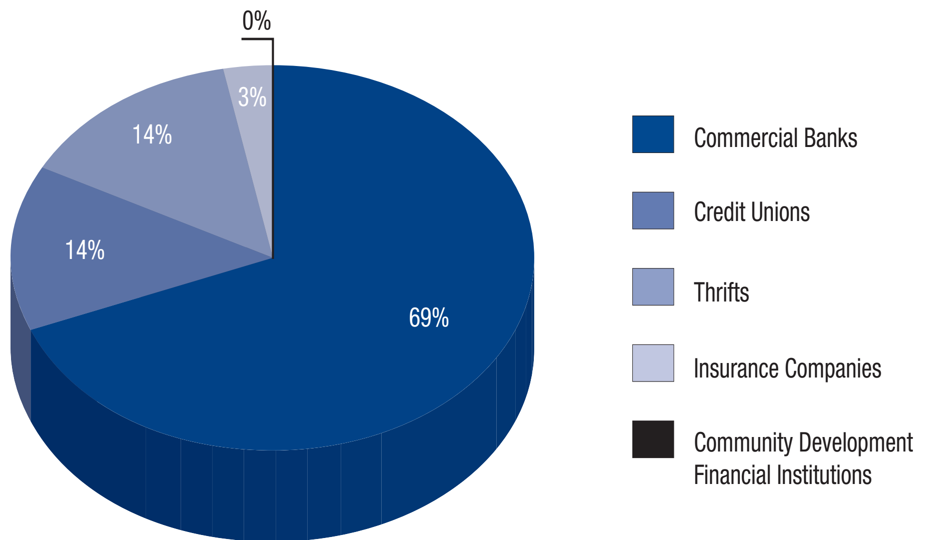
**Credit Unions:**
Member-owned, not-for-profit financial cooperatives that provide savings, credit, and other financial services to their members. Credit unions pool their members' savings deposits and shares to finance their own loan portfolios rather than rely on outside capital. Members benefit from higher returns on savings, lower rates on loans, and fewer fees on average.

**Insurance Companies:**
A company whose primary and predominant business activity is the writing of insurance and issuing or underwriting "covered products."

**Community Development Financial Institutions:**
A specialized financial institution that works in market niches that are underserved by traditional financial institutions. Community development financial institutions provide a unique range of financial products and services in economically distressed target markets, such as mortgage financing for low-income and first-time homebuyers and not-for-profit developers; flexible underwriting and risk capital for needed community facilities; and technical assistance, commercial loans, and investments to small start-up or expanding businesses in low-income areas. Community development financial institutions include regulated institutions such as community development banks and credit unions and non-regulated institutions such as loan and venture capital funds.

Currently, more than 7,700 financial institutions comprise the membership of the FHLBanks. These financial institutions include **banks**, **thrifts**, **credit unions**, **insurance companies**, and **community development financial institutions**.[35] Figure 18 (see below) shows the composition of the FHLBanks by member type. Commercial banks are the largest class of members at 69%. Thrifts and credit unions each comprise 14%. Insurance companies comprise 3% and community development financial institutions 0.1%.

**Figure 18. 2011 FHLBank Composition by Member Type**




Source: Federal Home Loan Banks, *Combined Financial Report for the Year Ended December 31, 2011*, at 30 (online at www.fhlb-of.com/ofweb_userWeb/resources/11yrend.pdf) (accessed Aug. 16, 2012).

Note: Numbers may be affected by rounding.

Each FHLBank has a board of directors that governs the bank. These boards range in size from 13 to 18 directors, as determined by FHFA. The directors are elected by member institutions and serve a four-year term.[36] Each FHLBank also has a president that reports to the board of directors of the respective FHLBank. The president's responsibilities include managing the FHLBank, administering the FHLBank's programs, and ensuring compliance with the regulations and policies of FHFA.

The compensation of FHLBank officers and employees is subject to the approval of management and the board of directors of each individual FHLBank. FHFA has established principles and guidelines for the FHLBanks and the Office of Finance in setting executive compensation policies and practices. However, each FHLBank is responsible for creating its own compensation philosophy and objectives.[37] Accordingly, compensation packages for the presidents and CEOs of the 12 FHLBanks ranged from approximately $1.2 million to $3.4 million for the year ended 2011.[38]

**Figure 19. 2011 CEO Compensation for the Enterprises and the FHLBanks (whole dollars)**

| Organization | Base Salary | Bonus | Other Deferred Salary | Non-Equity Incentive Plan Compensation | Change in Pension Value and Nonqualified Deferred Compensation | Other | Total |
|---|---|---|---|---|---|---|---|
| Fannie Mae[p] | $900,000 | $ - | $1,550,000 | $2,808,500 | $1,268,300 | $11,300 | $6,538,100 |
| Freddie Mac | $900,000 | $ - | $1,550,000 | $1,348,500 | $239,255 | $72,915 | $4,110,670 |
| Cincinnati | $621,150 | $ - | $ - | $512,671 | $2,217,000 | $25,932 | $3,376,753 |
| Indianapolis | $555,438 | $ - | $ - | $504,294 | $2,083,000 | $14,805 | $3,157,537 |
| New York | $709,263 | $ - | $ - | $523,180 | $1,444,000 | $120,417 | $2,796,860 |
| San Francisco | $902,967 | $ - | $ - | $869,500 | $732,778 | $63,580 | $2,568,825 |
| Topeka | $627,500 | $ - | $ - | $606,062 | $1,169,289 | $55,792 | $2,458,643 |
| Atlanta | $650,000 | $148 | $ - | $599,362 | $1,089,000 | $58,710 | $2,397,220 |
| Chicago | $695,000 | $ - | $ - | $1,081,420 | $409,000 | $14,700 | $2,200,120 |
| Seattle | $391,616 | $ - | $ - | $ - | $1,557,435 | $181,473 | $2,130,524 |
| Dallas | $745,000 | $ - | $ - | $334,557 | $373,000 | $600,458 | $2,053,015 |
| Des Moines | $620,833 | $ - | $ - | $487,835 | $441,000 | $64,351 | $1,614,019 |
| Pittsburgh | $625,000 | $ - | $ - | $593,156 | $104,000 | $40,508 | $1,362,664 |
| Boston | $595,000 | $ - | $ - | $213,242 | $325,000 | $62,666 | $1,195,908 |

Sources: Fannie Mae, *Form 10-K/A (Amendment No. 1) for the Fiscal Year Ended December 31, 2011*, at 9, 25 (online at www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2011/10ka_2011.pdf) (accessed July 26, 2012); Freddie Mac, *Form 10-K for the Fiscal Year Ended December 31, 2011*, at 335, 338, 340, 347 (online at www.freddiemac.com/investors/sec_filings/index.html) (accessed July 26, 2012); Federal Home Loan Banks, *Combined Financial Report for the Year Ended December 31, 2011*, at S-11 (online at www.fhlb-of.com/ofweb_userWeb/resources/11yrend.pdf) (accessed July 30, 2012).

Figure 19 (see above) provides information on the 2011 executive compensation for the Enterprises' CEOs and the CEOs of the 12 FHLBanks.

## FHLBank System Assets, Liabilities, and Capital

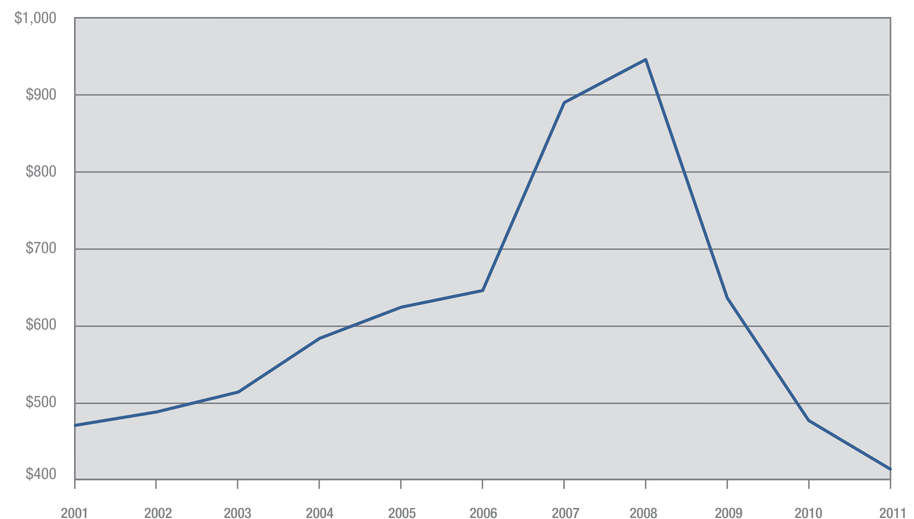
### Assets

Advances are the FHLBanks' largest assets and they support members' local lending activities. In order to qualify for an advance, an FHLBank member must pledge high-quality collateral, such as government securities; mortgage loans; non-residential real estate loans; or loans for small business, agriculture, or community development. In addition, the FHLBank member must purchase additional stock in its FHLBank proportionate to the new borrowing.[39]

[p] On Mar. 9, 2012, FHFA released the report, *FHFA Announces New Conservatorship Scorecard for Fannie Mae and Freddie Mac; Reduces Executive Compensation* (Mar. 9, 2012) (online at www.fhfa.gov/webfiles/23438/ExecComp3912F.pdf). This report announced a new 2012 executive compensation program for the Enterprises, which eliminates bonuses, establishes a compensation target for new CEOs at $500,000 per year, and reduces compensation for top executives by roughly 75% since the advent of the conservatorships.

Figure 20 (see below) illustrates trends in FHLBank advances over the past 11 years. From 2005 to 2008, outstanding advances to members increased from approximately $600 billion to over $900 billion. However, as of December 2011, outstanding advances to members dropped by more than 50% to approximately $418 billion.[40] As discussed later in this section, the substantial decline in advance demand has presented considerable financial challenges to the FHLBank System.

**Figure 20. FHLBank System Advances from 2001 to 2011 ($ billions)**




Sources: Federal Home Loan Banks, *Combined Financial Report for the Year Ended December 31, 2011*, at 34 (online at www.fhlb-of.com/ofweb_userWeb/resources/11yrend.pdf) (accessed Aug. 8, 2012); Federal Home Loan Banks, *2006 Combined Financial Report*, at 41 (online at www.fhlb-of.com/ofweb_userWeb/resources/06yrend.pdf) (accessed Aug. 8, 2012); Federal Home Loan Banks, *2001 Unaudited Combined Financial Information*, at 5 (online at www.fhlb-of.com/ofweb_userWeb/resources/01yrend.pdf) (accessed Aug. 8, 2012).

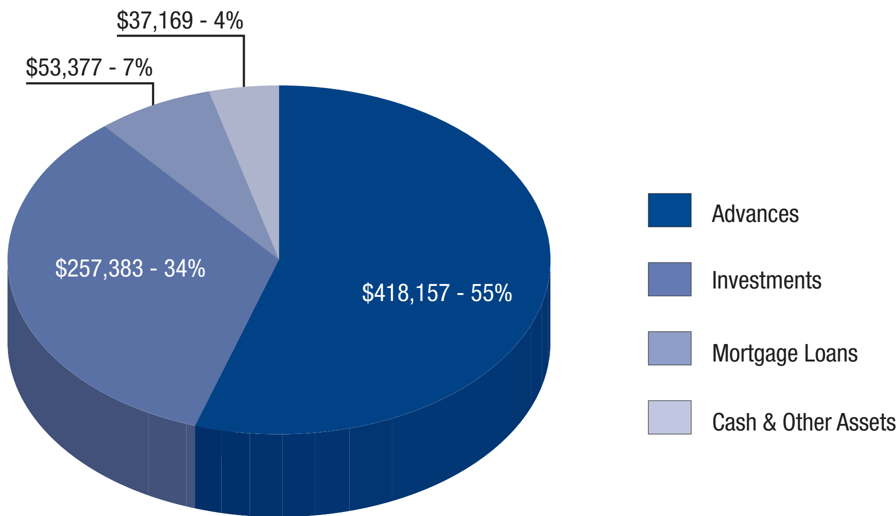
The FHLBanks also maintain investment portfolios for liquidity purposes and to generate income. These investments include **federal funds**, **certificates of deposits**, MBS, and private-label MBS. The FHLBanks' investment portfolios may also include unsecured short-term loans to domestic and foreign financial institutions. Some FHLBanks may also purchase certain whole mortgages on single-family properties directly from participating member institutions.[41]

As shown in Figure 21 (see page 89), advances represented 55% of the FHLBank System's total assets as of the end of 2011. Investments such as MBS and private-label MBS represented another 34% of total assets, and whole mortgages comprised 7%. Cash and miscellaneous assets equaled 4% of total assets.

**Federal Funds:**
Extensions of unsecured credit between financial institutions that are generally made on an overnight basis.

**Certificate of Deposit:**
A certificate of deposit is a relatively low-risk investment in a special deposit account with a bank or thrift institution. Investors commit a fixed sum of money for a fixed period of time – six months, one year, five years, or more. A certificate of deposit typically offers a higher rate of interest than a regular savings account. Interest is paid at regular intervals by the issuing bank, and when the deposit matures, the investor receives the original investment amount plus accrued interest. If the deposit is redeemed prior to the maturity date, there may be penalties associated with early withdrawal.

**Figure 21. 2011 FHLBank System Consolidated Assets ($ millions)**




Source: Federal Home Loan Banks, *Combined Financial Report for the Year Ended December 31, 2011*, at F-4 (online at www.fhlb-of.com/ofweb_userWeb/resources/11yrend.pdf) (accessed Aug. 7, 2012).

## Liabilities

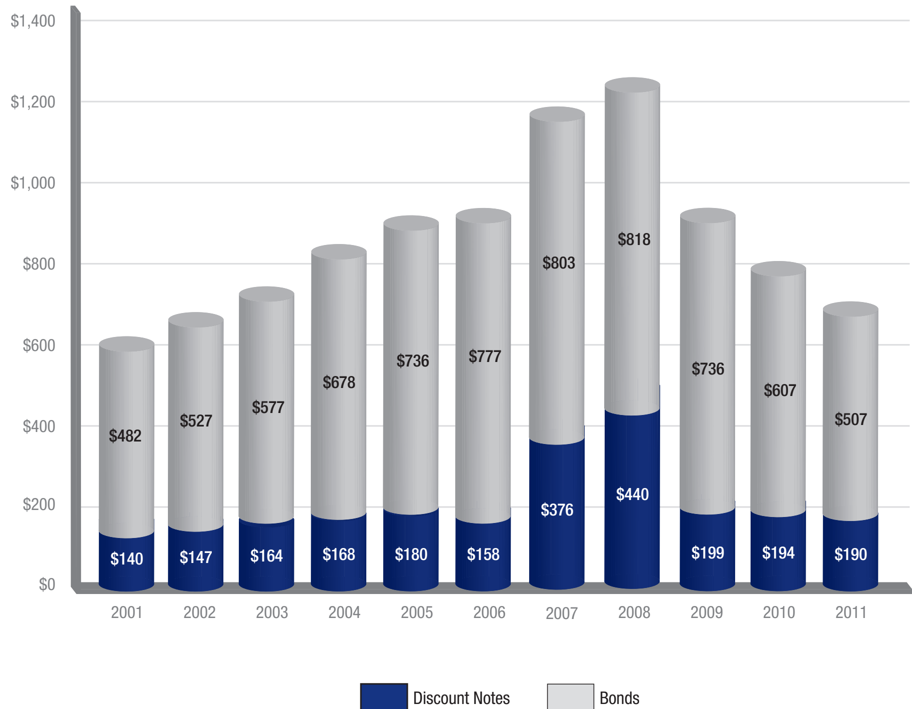
The FHLBanks fund their operations through the sale of consolidated obligations, which are **bonds** and **discount notes** issued to the public through the Office of Finance.[42] The FHLBanks issue discount notes in maturities ranging from 1 day to 1 year and bonds with maturities of 6 months to 30 years. The majority of consolidated obligation maturities are between 1 and 5 years after issuance, and the sizes of these obligations can range from $10 million to several billion dollars. The Office of Finance sells the FHLBanks' debt through a wide international network of underwriters,[43] and the FHLBanks are jointly and severally liable for their debt. Therefore, if an individual bank is unable to pay a creditor, the other 11 banks – or any 1 or more of them – are required to step in and cover the debt.[44]

**Bonds:**
Obligations by a borrower to eventually repay money obtained from a lender. The bondholder buying the investment is entitled to receive both principal and interest payments from the borrower.

**Discount Notes:**
Short-term obligations (debt instruments) issued at a discount from face value with maturities ranging from overnight to 360 days. Discount notes have no periodic interest payments; the investor receives the note's face value at maturity.

Figure 22 (see page 90) shows the trends in consolidated obligations over the last 11 years. In 2007 and 2008, bond and discount note issuances peaked as FHLBank members' demand for advances soared. However, the FHLBanks' outstanding bonds and discount notes subsequently declined as demand for advances waned over the past several years.

**Figure 22. FHLBank System Consolidated Obligations from 2001 to 2011 ($ billions)**




Sources: Federal Home Loan Banks, *Combined Financial Report for the Year Ended December 31, 2011*, at 34 (online at www.fhlb-of.com/ofweb_userWeb/resources/11yrend.pdf) (accessed Aug. 15, 2012); Federal Home Loan Banks, *2006 Combined Financial Report*, at 120 (online at www.fhlb-of.com/ofweb_userWeb/resources/06yrend.pdf) (accessed Aug. 15, 2012); Federal Home Loan Banks, *2004 Unaudited Combined Financial Information*, at 16 (online at www.fhlb-of.com/ofweb_userWeb/resources/04yrend.pdf) (accessed Aug. 15, 2012); Federal Home Loan Banks, *2003 Unaudited Combined Financial Information*, at 90 (online at www.fhlb-of.com/ofweb_userWeb/resources/03yrend.pdf) (accessed Aug. 15, 2012); Federal Home Loan Banks, *2001 Unaudited Combined Financial Information*, at 37 (online at www.fhlb-of.com/ofweb_userWeb/resources/01yrend.pdf) (accessed Aug. 15, 2012).

As discussed in previous OIG reports, the FHLBank System generally can issue debt at favorable interest rates compared to other financial institutions due to the implicit federal guarantee on its financial obligations.[45]

**Class A Stock:**
Common stock issued by the FHLBanks to member institutions at a stated par value of $100 per share. Class A stock is redeemable by members at par value with six months written notice.

**Class B Stock:**
Common stock issued by the FHLBanks to member institutions at a stated par value of $100 per share. Class B stock is redeemable by members at par value with five years written notice.

## Capital

The Gramm-Leach-Bliley Act of 1999 requires each of the 12 FHLBanks to maintain sufficient capital pursuant to a capital structure plan. Each FHLBank is subject to three capital requirements under its plan: (1) total regulatory capital compliance, (2) leverage capital compliance, and (3) risk-based capital compliance.[46] These capital requirements serve as a cushion that protects against unanticipated losses and asset declines that could cause an FHLBank to fail, and FHFA reviews them to ensure the financial soundness and adequate capitalization of the FHLBanks.[47]

Figure 23 (see below) summarizes the capital standards of the FHLBank System.

**Figure 23. FHLBank Capital Standards**

| | Capital Standard | Definition | Requirement |
|---|---|---|---|
| **Capital Compliance[48]** | • Total Regulatory Capital | • Sum of permanent capital, **Class A stock** outstanding, general loss allowance, and other amounts from sources determined by FHFA as available to absorb losses | • 4% of assets |
| | • Leverage Capital | • Sum of permanent capital weighted 1.5 times and all other capital without a weighting factor | • 5% of assets |
| | • Risk-based Capital | • Permanent capital equal to at least the sum of its credit risk, market risk, and operations risk requirements | • Permanent capital equal to at least the sum of: (1) credit risk measured by the weighted sum of asset classes, (2) market risk measured by a value-at-risk model and market value that falls below 85% of book value, and (3) operations risk equal to 30% of total credit and market risk |

## Housing Mission Related Programs and Activities

In addition to their traditional advance business, the FHLBanks support economic and community development through affordable housing and other programs, as summarized below.

### Affordable Housing Program

The FHLBanks are required to contribute at least 10% of their net earnings to affordable housing efforts established through the Affordable Housing Program (AHP), which includes a competitive program that subsidizes the cost of owner-occupied housing for individuals and families with incomes at or below 80% of the area median income and rental housing in which at least 20% of the units are reserved for households with incomes at or below 50% of the area median income. Members submit applications on behalf of one or more sponsors of eligible housing projects. Projects must meet certain eligibility criteria and score successfully in order to obtain funding.

AHP funds are also awarded through a homeownership set-aside program, under which an FHLBank may set aside up to $4.5 million or 35% of its AHP funds each year to assist low- and moderate-income households to purchase homes. At least one-third of the FHLBank's set-aside allocation must be made available to assist first-time homebuyers. Members disburse AHP home ownership set-aside funds as grants to eligible households. Set-aside funds can be used for down payment, closing costs, counseling, or rehabilitation assistance in connection with the purchase or rehabilitation of an owner-occupied unit. Each FHLBank sets its maximum grant amount, which may not exceed $15,000 per household.[49]

To ensure that AHP projects serve local housing needs, each FHLBank is advised by a 15-member Affordable Housing Advisory Council.[50] OIG is currently conducting an evaluation of FHFA's Oversight of AHP.

### Community Investment Program

Each FHLBank also operates a Community Investment Program (CIP) that offers below market rate loans to members in need of long-term financing for housing and economic development that benefits low- and moderate-income families and neighborhoods. Members use CIP to fund owner-occupied and rental housing; construct roads, bridges, retail stores, and sewage treatment plants; and provide small business loans.[51]

### Economic Community Development Programs

The FHLBanks also offer long-term advances at below market interest rates through Community Investment Cash Advance (CICA) programs. CICA programs provide financing for economic development projects. CICA lending is targeted to specific beneficiaries that include small businesses and certain geographic areas.

Each FHLBank has a Community Lending Plan that describes its program objectives for economic development. Additionally, several of the FHLBanks operate other voluntary programs for affordable housing, small business lending, foreclosure prevention, and financial literacy.[52]

## FHLBANK SYSTEM RISKS AND THEIR MANAGEMENT

The FHLBanks, like other financial institutions, face risks related to business operations. The following provides an overview of major risk categories and how the FHLBanks mitigate these risks. Credit risks, interest rate risks, operational risks, and housing and "image" risks are the primary risks encountered by the FHLBanks.

### Credit Risks

Credit risk relates to the possibility that borrowers will fail to meet their obligations in accordance with agreed terms (e.g., that they will default on their loans).[53] The FHLBanks face credit risks to varying degrees related to their advances, unsecured credit extensions, private-label MBS, and whole mortgages, and they have a variety of options available to mitigate the risks.

#### *Advances*

The credit risk associated with advances is that a member financial institution will fail or otherwise default on an advance from an FHLBank. The potential exists that such a failure or default could result in the FHLBank incurring a loss on the advance.[54] FHFA has stated that the credit risks associated with advances, although generally viewed as low, have increased over the past few years due to the weakening financial condition of many FHLBank member institutions.[55]

The FHLBanks primarily manage the credit risks associated with advances by monitoring their members' financial health and through collateral requirements. FHLBank members are required to fully secure all advances with eligible collateral,[56] which include: (1) residential mortgage loans (the principal form of collateral),[57] (2) cash deposits held by the FHLBanks, (3) Treasury and agency securities, and (4) "other real estate related" collateral.[58] Additionally, the FHLBanks apply a percentage discount to the market value of collateral used to secure an advance; this practice is known as a "haircut."[59] An FHLBank might apply a haircut of 25% to an advance secured by investment grade securities, which means the advance would have a value equal to only 75% of the collateral. By this procedure, the FHLBanks can ensure that the value of their collateral exceeds the value of their advances and that there will be sufficient collateral available to offset any potential losses associated with a member's default on an advance.[60]

The FHLBanks use a variety of other means to mitigate the credit risks associated with advances. For example, each FHLBank establishes an

**Delivery Collateral:**
The most stringent collateral status used for securing advances. Under it, the FHLBanks require the member bank to deliver collateral to them or to a third-party custodian. It allows the FHLBank to have greater control of the collateral.

overall credit limit for borrowers designed to mitigate the FHLBank's credit exposure.[61] The FHLBanks may also require a troubled member to list or **deliver collateral** to a third party to ensure it is available in the event it were to fail or default on its outstanding advances.[62]

Additionally, if an FHLBank member institution fails, the FHLBanks have a first lien on the member's assets. Therefore, the banks have priority over all other creditors, including the FDIC, to obtain the collateral necessary to protect against losses on outstanding advances. Typically in a bank failure, the FDIC pays off outstanding FHLBank advances in full then takes possession of the collateral on the institution's books to help offset its losses.[63]

*The featured report is available at www.fhfaoig.gov/Content/Files/AUD-2012-004.pdf.*

According to FHFA, no FHLBank has ever suffered a loss on an advance.[64] However, in June 2012, OIG issued an audit assessing FHFA's oversight of the FHLBanks' advances and recommended improvements in the Agency's related oversight framework.[65]

### *Unsecured Loans*

Unsecured loans, such as short-term loans to domestic or foreign lenders, are generally viewed as having higher credit risks than advances because they are not backed by collateral.[66] However, the short-term nature of unsecured lending helps to mitigate the credit risk. Further, the FHLBanks' unsecured loans are generally made only to highly rated private institutions (i.e., institutions rated at the "A" level or above). The FHLBanks also mitigate risks by periodically reviewing borrowers and adjusting limits on borrower exposure.[67]

*The featured report is available at www.fhfaoig.gov/Content/Files/EVL-2012-005_1_0.pdf.*

As discussed in Section 3, OIG recently issued an evaluation report that raised questions about the FHLBanks' extensions of unsecured credit primarily to European banks in 2010 and 2011. The report recommended that FHFA take steps to strengthen its oversight process and the regulatory framework for such unsecured credit extensions.[68]

### *Private-Label MBS*

The credit risk associated with private-label MBS is that the underlying mortgages that support such securities will default and result in a loss. As discussed later in this section, several FHLBanks' investments in private-label MBS generated substantial losses in recent years.[69] To mitigate such risks, FHFA regulations place limits on the FHLBanks' overall investments in MBS to 300% of its regulatory capital. However, FHFA stated it will revisit the 300% ceiling in a future rulemaking.[70]

### *Whole Mortgages*

As is the case with other mortgage assets, the credit risk associated with the FHLBanks' whole mortgages is that borrowers will default on such mortgages.

This risk is mitigated by insurance and other credit enhancements. For example, member institutions obtain mortgage insurance for the mortgages they sell to the FHLBanks. Further, according to FHFA, the FHLBanks' mortgage holdings have fixed rates and are well seasoned, soundly underwritten, and supported by qualified borrowers.[71]

## Interest Rate Risks

Interest rate risk refers to how changes in interest rates may have an adverse effect on an institution's financial condition.[72] As stated above, FHLBank operations (e.g., advances and unsecured lending) are typically funded through debt issuances (i.e., bonds or discount notes). In other words, the FHLBanks borrow at one rate and may lend at another. Thus, depending on the terms of these transactions (i.e., maturity and yield), interest rate risk can be significant.

Prepayment offers a helpful illustration of this risk. Prepayments represent risk because they can lower the FHLBanks' expected revenues from their various asset classes, while their costs of operation remain flat or increase.[73]

### *Advances*

Prepayments of advances can lead to lower net returns if the prepayments are reinvested in assets yielding lower returns. Further, the risk can be particularly acute if an advance was financed by a higher-cost debt.[74]

Charging members a prepayment fee is one way the FHLBanks mitigate this risk. Because the FHLBanks would likely experience lower net returns due to prepayments, prepayment fees compensate for such losses, easing financial burdens. The FHLBanks also offer advances that a member may prepay without a fee. These advances are financed with instruments such as callable debt.[75] Callable debt allows an FHLBank, as the issuer, to buy back the debt when interest rates decline and prepayments are likely to increase.[76]

### *MBS and Whole Mortgage Loans*

Mortgage-related investments such as MBS and mortgage loans are also affected by prepayments. Because single-family mortgages routinely include prepayment options, interest rate changes – particularly decreasing interest rates – often stimulate prepayments.[77]

Mitigation of interest rate risk includes FHFA regulations governing the types of MBS the FHLBanks may own. Other mitigation methods include funding mortgage-related investments with callable debt.[78]

## Operational Risks

Operational risks occur due to potential losses from systems and people. According to *FHFA's Oversight of Troubled Federal Home Loan Banks*,

**Internal Controls:**
Internal controls are an integral component of an organization's management that provide reasonable assurance that the following objectives are achieved: (1) effectiveness and efficiency of operations, (2) reliability of financial reports, and (3) compliance with applicable laws and regulations. Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives and include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance.

operational risks can include poor collateral risk management, flaws in the institution's information technology systems, and weak corporate governance.[79]

The FHLBanks rely on business and financial models to manage financial risks and assist in making business decisions. Each FHLBank uses different models and assumptions to determine fair values of assets, liabilities, and derivatives. Models use assumptions to project future trends and performance, and any changes in the models' underlying assumptions can cause the results to be materially different. Therefore, the reliability of an FHLBank's models is key to making good business decisions and, thus, represents operational risk.[80]

The FHLBanks' significant reliance on information systems could have severe effects on their ability to effectively conduct business if an interruption or failure occurs. In addition, failures in their financial reporting controls and procedures could adversely affect the accuracy of information reported in the FHLBanks' financial reports.[81]

The FHLBanks mitigate operational risk by, among other means, **internal controls** and continuity plans and resources. Internal controls are a major technique used to detect and prevent operational issues. Each FHLBank has a business continuity plan and a backup location that is regularly evaluated by examiners.[82]

### Housing and "Image" Risks

The FHLBanks' core mission activities include advances; non-core mission activities include investing in unsecured credit, private-label MBS, and MBS.[83] A significant investment in these non-core areas exposes the FHLBanks to housing mission and "image" risks[84] and can impair their reputation. This risk is somewhat mitigated by a regulatory limit on investments in MBS (i.e., 300% of regulatory capital). However, no such ceiling controls unsecured lending.

## FHFA'S FHLBANK SYSTEM SAFETY, SOUNDNESS, AND MISSION OVERSIGHT ACTIVITIES

To carry out its responsibilities with respect to the FHLBanks, FHFA may issue regulations, establish capital standards, and conduct on-site safety and soundness or mission-related examinations. FHFA may also take enforcement actions, such as issuing cease and desist orders, or may place an FHLBank into conservatorship or receivership if it becomes undercapitalized or critically undercapitalized.[85]

FHFA issues regulatory guidance designed to ensure sufficient liquidity and to protect against temporary disruptions in the capital markets that affect the FHLBanks' access to funding.[86] The prompt corrective action provisions under HERA allow FHFA to determine each FHLBank's capital classification on at least a quarterly basis. If an FHLBank is determined to be other

than adequately capitalized, that FHLBank becomes subject to additional supervisory authority by FHFA.[87] If FHFA determines an FHLBank is unable to satisfy its repayment obligations, FHFA has the authority to liquidate or reorganize the FHLBank. The outstanding liabilities can then be allocated among the remaining FHLBanks in proportion to their participation in all consolidated obligations outstanding.[88]

FHFA's Division of FHLBank Regulation (DBR) is primarily responsible for ensuring that the FHLBanks operate in a financially safe and sound manner, remain adequately capitalized, raise funds in the capital markets, and operate in a manner consistent with their housing finance mission.[89] DBR oversees and directs all FHLBank examination activities, develops examination findings, and prepares reports of examination.[90]

DBR receives support from other FHFA offices. FHFA's Division of Examination Programs and Support is responsible for: (1) supporting FHFA examination activities, (2) developing and maintaining a consistent examination program, (3) developing examination policy, and (4) developing and providing FHLBank examiner training.[91] Additionally, OGC advises and supports FHFA on legal matters related to the functions, activities, and operations of FHFA and the GSEs. OGC also supports supervision functions, regulation writing, and enforcement actions when warranted.[92]

## FHLBANKS AND THE ENTERPRISES

Although the FHLBanks and the Enterprises are both classified as housing GSEs, there are substantial differences in terms of their structure and operations. For example, each FHLBank is a cooperative with its stock held by member institutions. In contrast, the Enterprises are corporations owned by investors including Treasury. The FHLBanks' primary means of facilitating housing finance is to make advances directly to their member financial institutions. Whereas, the Enterprises facilitate liquidity in the housing finance system by purchasing mortgages directly from lenders and either holding them in their portfolios or securitizing them. Figure 24 (see page 98) illustrates these and other differences between the FHLBank System and the Enterprises.

**Figure 24. Comparison of the FHLBanks and the Enterprises**

| | FHLBanks | The Enterprises |
|---|---|---|
| **Structure** | • Each FHLBank is privately owned by its members in a cooperative structure.[93]<br>• Members of an FHLBank must purchase capital stock in their region's FHLBank and the stock is not publicly traded.[94]<br>• FHLBank stock is purchased at the stated par value of $100 per share.[95]<br>• Stock may be redeemed or repurchased at its stated par value.[96]<br>• The Office of Finance issues debt on behalf of the FHLBanks. The FHLBanks are jointly and severally liable for their obligations.[97] | • Shareholder-owned companies that operate under congressional charter.[98]<br>• Each Enterprise was placed into conservatorship on September 6, 2008, and each organization has received capital support under the PSPAs since September 2008.[99] |
| **Governance** | • Each FHLBank has its own board of directors, comprised of members of that FHLBank and independent (non-member) directors.[100]<br>• By statute, two-fifths of the directors must be independent and at least two of those directors must be public interest directors with at least four years of experience in representing community or consumer interests.[101] | • The Enterprises' boards have a minimum of 9 and no more than 13 directors.[102]<br>• As a result of conservatorship, FHFA immediately succeeded to all rights, titles, powers, and privileges of the Enterprises and of any officers and directors of the Enterprises.[103]<br>• The board of directors no longer has the power or duty to manage, direct, or oversee the business and affairs of the Enterprises without approval from FHFA.[104] |
| **Primary Business Operations** | • The FHLBanks provide members with short- and long-term funding through advances, which may be used for mortgage lending and other purposes.[105] | • The Enterprises provide a secondary market for conventional conforming mortgage loans.[106]<br>• The Enterprises buy mortgages from lenders and either hold these mortgages in their portfolios or package them into MBS that are sold to the public.[107]<br>• Lenders use the cash raised by selling mortgages to the Enterprises to engage in further lending.[108]<br>• The Enterprises' purchases help ensure a continuous, stable supply of mortgage money.[109] |
| **Housing Mission** | • The FHLBanks contribute 10% of their net income to affordable housing through AHP.[110]<br>• The FHLBanks operate a CIP that offers below market rate loans to members in need of long-term financing for housing and economic development that benefits low- and moderate-income families and neighborhoods.[111]<br>• The FHLBanks offer long-term advances at below market interest rates through CICA programs that target economic development activities.[112] | • HERA requires that FHFA establish for the Enterprises four single-family housing goals, one multifamily special affordable housing goal, and requirements relating to multifamily housing for very low-income families.[113]<br>• Three of the single-family housing goals target purchase money mortgages for: (1) low-income families, (2) very low-income families, and (3) families that reside in low-income areas. The single-family housing goals also include one that targets refinancing mortgages for low-income families.[114]<br>• The multifamily special affordable housing goal targets multifamily rental housing affordable to low-income families. The multifamily special affordable housing subgoal targets multifamily rental housing affordable to very low-income families.[115]<br>• The Enterprises are also required to serve three underserved markets including: (1) manufactured housing, (2) affordable housing preservation, and (3) rural areas by developing loan products and flexible underwriting guidelines to facilitate a secondary market for mortgages for very low-, low-, and moderate-income families in those markets.[116] |

## CURRENT RISKS AND CHALLENGES FACING THE FHLBANK SYSTEM AND FHFA

The Agency, OIG, and others have identified a number of challenges facing the FHLBank System and FHFA. These include: housing boom era private-label MBS investments, declining member advances, large non-core mission asset portfolios, increasing advances to insurance companies, and significant advance concentrations. The FHLBank System is also challenged by a proposal that may involve substantial changes to the current business models of several FHLBanks. The following summarizes these challenges.

### Managing Losses Associated with Housing Boom Era Private-Label MBS Investments

From 2005 through 2007, several FHLBanks made substantial investments in private-label MBS because these securities offered higher returns than other investments in their portfolios.[117] During those years, private-label MBS were highly rated by credit rating agencies.[118]

Gains and losses on private-label MBS are dependent on the level and direction of housing prices.[119] Accordingly, when the housing market collapsed, the FHLBanks suffered significant losses on these investments, and they continue to suffer losses in their investment portfolios.[120] Four of the FHLBanks, with which FHFA has had supervisory concerns, collectively lost approximately $2 billion on their private-label MBS investments in 2009 and 2010, as shown in Figure 25 (see below).

**Figure 25. Four FHLBanks' Losses on Private-Label MBS Investments 2009 and 2010 ($ millions)**

| FHLBank | 2009 | 2010 | Total |
|---|---|---|---|
| Boston | $444 | $85 | $529 |
| Pittsburgh | 229 | 158 | 387 |
| Chicago | 437 | 163 | 600 |
| Seattle | 311 | 106 | 417 |
| **Total** | **$1,421** | **$512** | **$1,933** |

Sources: Federal Home Loan Bank of Boston, *Form 10-K for the Fiscal Year Ended December 31, 2010*, at 52 (online at www.sec.gov/Archives/edgar/data/1331463/000133146311000046/fhlbboston2010123110k.htm) (accessed Aug. 9, 2012); Federal Home Loan Bank of Pittsburgh, *Form 10-K for the Fiscal Year Ended December 31, 2010*, at 34 (online at www.sec.gov/Archives/edgar/data/1330399/000144530511000445/fhlbpit2010123110k.htm) (accessed Aug. 9, 2012); Federal Home Loan Bank of Chicago, *Form 10-K for the Fiscal Year Ended December 31, 2010*, at 30 (online at www.sec.gov/Archives/edgar/data/1331451/000133145111000053/fhlbchi2010123110k.htm) (accessed Aug. 9, 2012); Federal Home Loan Bank of Seattle, *Form 10-K for the Fiscal Year Ended December 31, 2010*, at 80 (online at www.sec.gov/Archives/edgar/data/1329701/000132970111000064/seattle1231201010k.htm) (accessed Aug. 9, 2012).

As illustrated in Figure 26 (see below), the FHLBanks experienced losses of $616 million on private-label MBS during the first six months of 2011. In contrast, through the first six months of 2012, the situation improved significantly as private-label MBS losses declined to $86 million.[121] However, as of June 30, 2012, the fair value of the FHLBanks' private-label MBS holdings hovered above $26 billion,[122] and these investments continue to be susceptible to deterioration in the housing market. Thus, the FHLBanks are at risk of further losses on their private-label MBS investments.[123]

**Figure 26. Losses on Private-Label MBS Investments for the Six Months Ended June 30, 2011 and 2012 ($ millions)**

| FHLBank | 2011 | 2012 | Total |
|---|---|---|---|
| San Francisco | $272 | $30 | $302 |
| Atlanta | 89 | 15 | 104 |
| Seattle | 88 | 6 | 94 |
| Boston | 66 | 5 | 71 |
| Chicago | 43 | 15 | 58 |
| Pittsburgh | 31 | 10 | 41 |
| Indianapolis | 21 | 3 | 24 |
| Dallas | 4 | - | 4 |
| Topeka | 2 | 1 | 3 |
| New York | - | 1 | 1 |
| **Total** | **$616** | **$86** | **$702** |

Source: Federal Home Loan Banks, *Combined Financial Report for the Quarterly Period Ended June 30, 2012*, at F-68, F-69 (online at www.fhlb-of.com/ofweb_userWeb/resources/12Q2end.pdf) (accessed Aug. 31, 2012).

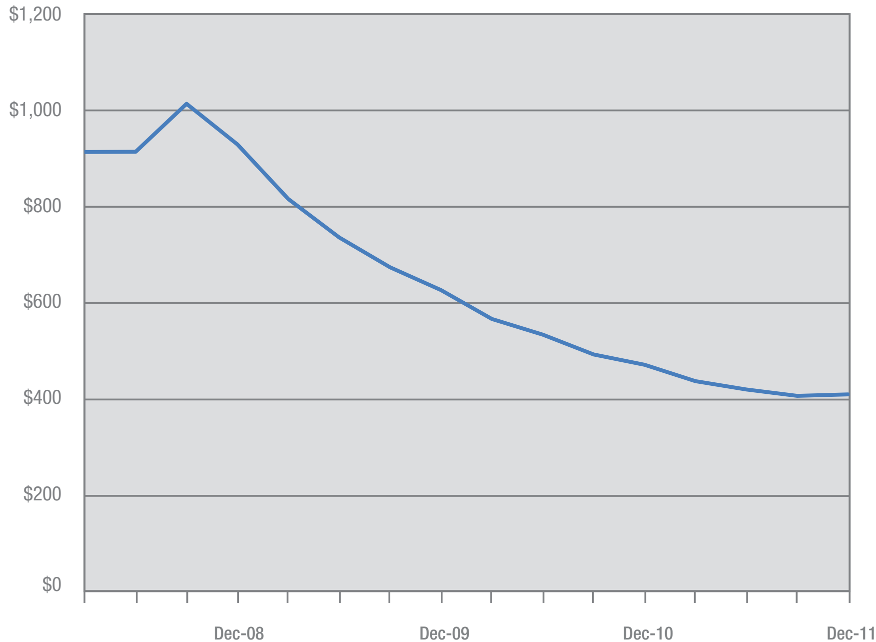
## Substantially Declining Advance Demand

As illustrated in Figure 27 (see page 101), member advances have declined by more than half since 2008. The reduced demand for advances is attributed to:

- the availability of lower-cost funding options (e.g., customer deposits);
- the deterioration of the housing market beginning in 2008;
- the increase in financial institution failures;
- voluntary or forced consolidations; and
- member withdrawals.[124]

As a result of these and other factors, the FHLBanks are earning less interest income on member advances. Specifically, the FHLBanks reported interest income from advances of just over $3 billion in 2011 compared to over $29 billion in 2008.[125]

**Figure 27. FHLBanks' Advances to Members 2008 Through 2011**
**($ billions)**




Sources: Federal Home Loan Banks, *Quarterly Combined Financial Report for the Three Months Ended March 31, 2008*, at 4 (online at www.fhlb-of.com/ofweb_userWeb/resources/08q1end.pdf) (accessed Aug. 14, 2012); Federal Home Loan Banks, *Quarterly Combined Financial Report for the Six Months Ended June 30, 2008*, at 4 (online at www.fhlb-of.com/ofweb_userWeb/resources/08q2end.pdf) (accessed Aug. 14, 2012); Federal Home Loan Banks, *Quarterly Combined Financial Report for the Nine Months Ended September 30, 2008*, at 4 (online at www.fhlb-of.com/ofweb_userWeb/resources/08q3end.pdf) (accessed Aug. 14, 2012); Federal Home Loan Banks, *2008 Combined Financial Report*, at 48 (online at www.fhlb-of.com/ofweb_userWeb/resources/08yrend.pdf) (accessed Aug. 14, 2012); Federal Home Loan Banks, *Quarterly Combined Financial Report for the Three Months Ended March 31, 2009*, at 4 (online at www.fhlb-of.com/ofweb_userWeb/resources/09q1end.pdf) (accessed Aug. 14, 2012); Federal Home Loan Banks, *Quarterly Combined Financial Report for the Six Months Ended June 30, 2009*, at 4 (online at www.fhlb-of.com/ofweb_userWeb/resources/09q2end.pdf) (accessed Aug. 14, 2012); Federal Home Loan Banks, *Quarterly Combined Financial Report for the Nine Months Ended September 30, 2009*, at 4 (online at www.fhlb-of.com/ofweb_userWeb/resources/09q3end.pdf) (accessed Aug. 14, 2012); Federal Home Loan Banks, *2009 Combined Financial Report*, at 49 (online at www.fhlb-of.com/ofweb_userWeb/resources/09yrend.pdf) (accessed Aug. 14, 2012); Federal Home Loan Banks, *Quarterly Combined Financial Report for the Three Months Ended March 31, 2010*, at 4 (online at www.fhlb-of.com/ofweb_userWeb/resources/10q1end.pdf) (accessed Aug. 14, 2012); Federal Home Loan Banks, *Quarterly Combined Financial Report for the Six Months Ended June 30, 2010*, at 4 (online at www.fhlb-of.com/ofweb_userWeb/resources/10q2end.pdf) (accessed Aug. 14, 2012); Federal Home Loan Banks, *Quarterly Combined Financial Report for the Nine Months Ended September 30, 2010*, at 4 (online at www.fhlb-of.com/ofweb_userWeb/resources/10q3end.pdf) (accessed Aug. 14, 2012); Federal Home Loan Banks, *Combined Financial Report for the Year Ended December 31, 2010*, at 36 (online at www.fhlb-of.com/ofweb_userWeb/resources/10yrend.pdf) (accessed Aug. 14, 2012); Federal Home Loan Banks, *Quarterly Combined Financial Report for the Three Months Ended March 31, 2011*, at F-2 (online at www.fhlb-of.com/ofweb_userWeb/resources/11Q1end.pdf) (accessed Aug. 14, 2012); Federal Home Loan Banks, *Combined Financial Report for the Quarterly Period Ended June 30, 2011*, at F-2 (online at www.fhlb-of.com/ofweb_userWeb/resources/11Q2end.pdf) (accessed Aug. 14, 2012); Federal Home Loan Banks, *Combined Financial Report for the Quarterly Period Ended September 30, 2011*, at F-2 (online at www.fhlb-of.com/ofweb_userWeb/resources/11Q3end.pdf) (accessed Aug. 14, 2012); Federal Home Loan Banks, *Combined Financial Report for the Year Ended December 31, 2011*, at 34 (online at www.fhlb-of.com/ofweb_userWeb/resources/11yrend.pdf) (accessed Aug. 14, 2012).

## Large Non-Core Mission Investment Portfolio and Advances to Insurance Companies

### *Non-Core Investment Portfolio*

To make up for declining advance demand, some FHLBanks made investments that involve significant risks and were not clearly consistent with their housing mission.[126] From September 2008, when advances peaked, to December 31, 2011, the proportion of advances to total assets on the FHLBanks' balance sheets decreased from 71% to 55%.[127] In contrast, during the same period of time, the proportion of investments to total assets on the FHLBanks' balance sheets increased from 23% to 34%.[128] These investments include non-core mission assets, such as unsecured credit extensions, MBS, and private-label MBS.

FHFA's Acting Director has expressed concern about the high level of non-core mission assets of certain FHLBanks. He has stated "…the FHLBanks' various financial problems of the past 20 years have not come from the traditional advance business. Instead, investments and mortgage purchase programs have been the source of deterioration in the financial condition of some FHLBanks …. [It] is not a sustainable operating condition for an FHLBank" to have a large investment portfolio.[129]

### *Advances to Insurance Companies*

Some FHLBanks have also sought to offset their declining advances to banks and other traditional members by increasing lending to insurance companies. Specifically, advances to insurance companies have increased from 3% of total advances in 2007 to 13% of total advances in 2011, as shown in Figures 28a and 28b (see page 103).

Although FHLBank advances to insurance companies are permitted, they present risks to the FHLBank System that are distinct from risks associated with other members. For example, when a failed member bank has outstanding FHLBank advances, the FDIC generally is responsible for resolving the member's obligations. To resolve the obligations, the FDIC repays the advances in order to obtain clear title to the assets securing the advances.[130] Conversely, the FDIC does not cover the obligations of failed insurance companies.[131] Therefore, member advances to a failed insurance company will only be covered to the extent the assigned collateral is sufficient or state insurance guarantee funds make up the difference.

FHFA has recognized these risks and has prioritized them in the oversight process. OIG has an ongoing survey that is assessing the effectiveness of this oversight.

**Figure 28a. 2007 FHLBank System Advances by Member Type**

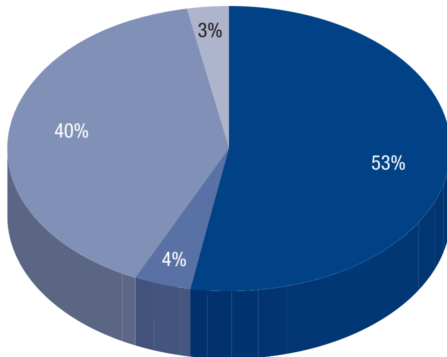
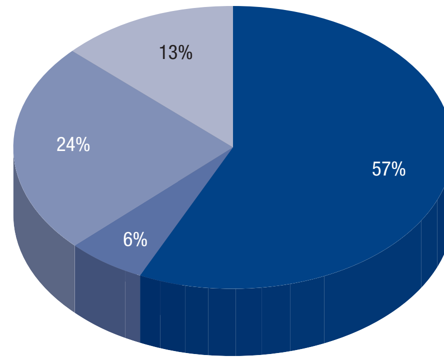
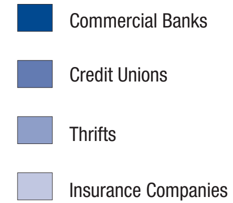



**Figure 28b. 2011 FHLBank System Advances by Member Type**



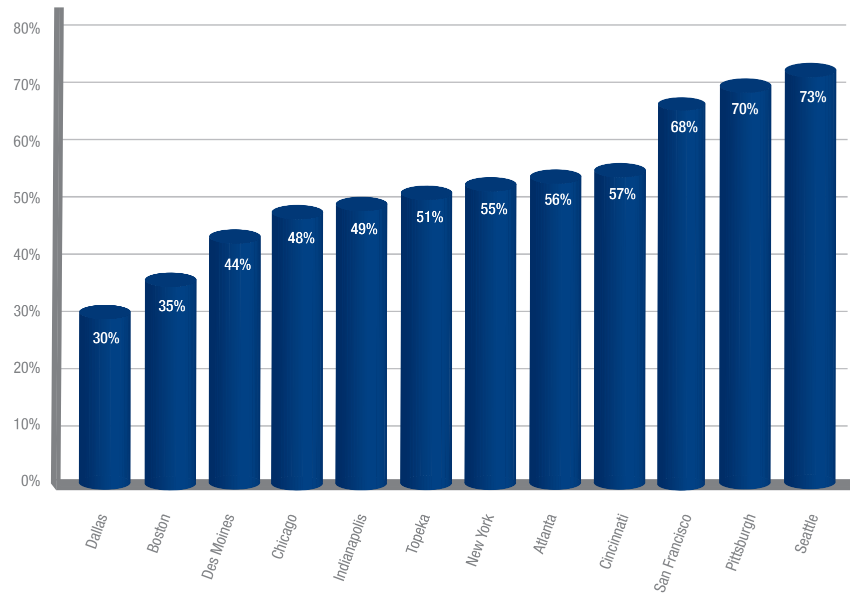




Sources: Federal Home Loan Banks, *2007 Combined Financial Report*, at 114 (online at www.fhlb-of.com/ofweb_userWeb/resources/07yrend.pdf) (accessed Aug. 20, 2012); Federal Home Loan Banks, *Combined Financial Report for the Year Ended December 31, 2011*, at 42 (online at www.fhlb-of.com/ofweb_userWeb/resources/11yrend.pdf) (accessed Aug. 20, 2012).

### *Advance Concentration Risk*

As illustrated in Figure 29 (see page 104), several of the FHLBanks have a large percentage of their member advances confined to a relatively small percentage of members; this creates a concentration of risk. The withdrawal or failure of one or more of these members could negatively affect an FHLBank by significantly reducing its net interest income on advances. In addition, failure of one or more members could cause large losses to an FHLBank if its advances are not properly collateralized.[132]

**Figure 29. 2011 FHLBanks' Advances to Their Top Five Members as a Percentage of Total Advances**




Sources: Federal Home Loan Banks, *Combined Financial Report for the Year Ended December 31, 2011*, at 44, 45 (online at www.fhlb-of.com/ofweb_userWeb/resources/11yrend.pdf) (accessed Aug. 20, 2012); Federal Home Loan Bank of Seattle, *Form 10-K for the Fiscal Year Ended December 31, 2011*, at 9, 13 (online at www.sec.gov/Archives/edgar/data/1329701/000132970112000049/seattle1231201110k.htm) (accessed Oct. 18, 2012).

## Proposals by the Administration That Would Significantly Alter Some FHLBanks' Current Business Models

On February 11, 2011, Treasury and HUD jointly issued a report to Congress on the future of housing finance, *Reforming America's Housing Finance Market* (the Plan), which outlines the Administration's position on reforming the U.S. housing finance market.

As with the Enterprises, the Plan proposes that the FHLBanks reduce the sizes of their investment portfolios and reorient themselves toward the core mission of providing readily available funding to FHLBank member institutions. Accordingly, the Plan advocates limiting levels of advances in order to focus FHLBank resources on small- and medium-sized financial institutions.[133]

The Plan is intended to strengthen the FHLBank System, but OIG notes that it may present substantial challenges to certain FHLBanks in the short- to medium-term. As stated earlier, many FHLBanks have significant advance concentrations with large members and, therefore, they depend on them for a significant portion of their advance revenues. Further, investment portfolios may comprise 50% or more of some FHLBanks' total assets.

Accomplishing the Plan's objectives would likely involve substantially downsizing and reorienting certain FHLBanks' current asset portfolios.[134]

FHFA has also stated that it may be necessary to merge certain FHLBanks to strengthen the FHLBank System.[135] FHFA and the FHLBanks would likely face substantial challenges in managing the transition to such a structure, and it is not clear how these changes would be accomplished.

## OUTLOOK

The outlook for the FHLBank System is uncertain as reduced demand for member advances, investments in risky non-core mission activities, and other factors challenge the economic viability of the FHLBanks. The FHLBanks have a role in the future of the housing finance system, but they need to focus on their core business and improve their business models to operate in profitable and sustainable manners.[136]

# APPENDICES

# Appendix A: Glossary and Acronyms

## GLOSSARY OF TERMS

**Alternative A:** A classification of mortgages in which the risk profile falls between prime and subprime. Alternative A mortgages are generally considered higher risk than prime due to factors that may include higher loan-to-value and debt-to-income ratios or limited documentation of the borrower's income.

**Bankruptcy:** A legal procedure for resolving debt problems of individuals and businesses; specifically, a case filed under one of the chapters of Title 11 of the U.S. Code.

**Basis Points:** Refers to hundredths of 1 percentage point. For example, 1 basis point is equivalent to 1/100 of 1 percentage point.

**Bonds:** Obligations by a borrower to eventually repay money obtained from a lender. The bondholder buying the investment is entitled to receive both principal and interest payments from the borrower.

**Capitalization:** In the context of bank supervision, capitalization refers to the funds a bank holds as a buffer against unexpected losses. It includes shareholders' equity, loss reserves, and retained earnings. Bank capitalization plays a critical role in the safety and soundness of individual banks and the banking system. In most cases, federal regulators set requirements for adequate bank capitalization.

**Certificate of Deposit:** A certificate of deposit is a relatively low-risk investment in a special deposit account with a bank or thrift institution. Investors commit a fixed sum of money for a fixed period of time – six months, one year, five years, or more. A certificate of deposit typically offers a higher rate of interest than a regular savings account. Interest is paid at regular intervals by the issuing bank, and when the deposit matures, the investor receives the original investment amount plus accrued interest. If the deposit is redeemed prior to the maturity date, there may be penalties associated with early withdrawal.

**Class A Stock:** Common stock issued by the FHLBanks to member institutions at a stated par value of $100 per share. Class A stock is redeemable by members at par value with six months written notice.

**Class B Stock:** Common stock issued by the FHLBanks to member institutions at a stated par value of $100 per share. Class B stock is redeemable by members at par value with five years written notice.

**Collateral:** Assets used as security for a loan that can be seized by the lender if the borrower fails to repay the loan.

**Commercial Banks:** Commercial banks are establishments primarily engaged in accepting demand and other deposits and making commercial, industrial, and consumer loans. Commercial banks provide significant services in originating, servicing, and enhancing the liquidity and quality of credit that is ultimately funded elsewhere.

**Community Development Financial Institutions:** A specialized financial institution that works in market niches that are underserved by traditional financial institutions. Community development financial institutions provide a unique range of financial products and services in economically distressed target markets, such as mortgage financing for low-income and first-time homebuyers and not-for-profit developers; flexible underwriting and risk capital for needed community facilities; and technical assistance, commercial loans, and investments to small start-up or expanding businesses in low-income areas. Community development financial institutions include regulated institutions such as community development banks and credit unions and non-regulated institutions such as loan and venture capital funds.

**Conservatorship:** Conservatorship is a legal procedure for the management of financial institutions for an interim period during which the institution's conservator assumes responsibility for operating the institution and conserving its assets. Under the Housing and Economic Recovery Act of 2008, the Enterprises entered into conservatorships overseen by FHFA. As conservator, FHFA has undertaken to preserve and conserve the assets of the Enterprises and restore them to safety and soundness. FHFA also has assumed the powers of the boards of directors, officers, and shareholders; however, the day-to-day operational decision making of each company is still with the Enterprises' existing management.

**Conventional Conforming Mortgage Loans:** Mortgages that are not insured or guaranteed by the Federal Housing Administration, the Department of Veterans Affairs, or the Department of Agriculture and that meet the Enterprises' underwriting standards. Conforming mortgage loans have original balances below a specific threshold, published by FHFA, known as the "conforming loan limit." For 2012, the conforming loan limit is $417,000 for most areas of the contiguous United States, although generally it can increase to a maximum of $625,500 in specific higher-cost areas.

**Credit Unions:** Member-owned, not-for-profit financial cooperatives that provide savings, credit, and other financial services to their members. Credit unions pool their members' savings deposits and shares to finance their own loan portfolios rather than rely on outside capital. Members benefit from higher returns on savings, lower rates on loans, and fewer fees on average.

**Debarment:** Disqualification of a firm or an individual from contracting with the government or participating in government non-procurement

transactions for a specific period of time. The grounds for debarment include conviction for fraud or similar offenses.

**Default:** Occurs when a mortgagor misses one or more payments.

**Delivery Collateral:** The most stringent collateral status used for securing advances. Under it, the FHLBanks require the member bank to deliver collateral to them or to a third-party custodian. It allows the FHLBank to have greater control of the collateral.

**Derivatives:** Securities whose value depends on that of another asset, such as a stock or bond. They may be used to hedge interest rate or other risks related to holding a mortgage.

**Discount Notes:** Short-term obligations (debt instruments) issued at a discount from face value with maturities ranging from overnight to 360 days. Discount notes have no periodic interest payments; the investor receives the note's face value at maturity.

**Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010:** Legislation that intends to promote the financial stability of the United States by improving accountability and transparency in the financial system, ending "too big to fail," protecting the American taxpayer by ending bailouts, and protecting consumers from abusive financial services practices.

**Emergency Economic Stabilization Act:** A 2008 statute that authorizes Treasury to undertake specific measures to provide stability and prevent disruption in the financial system and the economy. It also provides funds to preserve homeownership.

**Eminent Domain:** An exercise of the power of government or quasi-government agencies (such as airport authorities, highway commissions, community development agencies, and utility companies) to take private property for public use.

**Equity:** In the context of residential mortgage finance, equity is the difference between the fair market value of the borrower's home and the outstanding balance on the mortgage and any other debt secured by the home.

**Federal Funds:** Extensions of unsecured credit between financial institutions that are generally made on an overnight basis.

**Federal Home Loan Banks:** The FHLBanks are 12 regional cooperative banks that U.S. lending institutions use to finance housing and economic development in their communities. Created by Congress, the FHLBanks have been the largest source of funding for community lending for eight decades. The FHLBanks provide funding to other banks but not directly to individual borrowers.

**Federal Home Loan Mortgage Corporation:** A federally chartered corporation that purchases residential mortgages, securitizes them, and sells them to investors; thus, Freddie Mac provides lenders with funds that can be used to make loans to homebuyers.

**Federal Housing Administration:** Part of HUD, the Federal Housing Administration insures residential mortgages made by approved lenders against payment losses. It is the largest insurer of mortgages in the world, insuring over 34 million properties since its inception in 1934.

**Federal National Mortgage Association:** A federally chartered corporation that purchases residential mortgages and converts them into securities for sale to investors; by purchasing mortgages, Fannie Mae supplies funds to lenders so they may make loans to homebuyers.

**Foreclosure:** The legal process used by a lender to obtain possession of a mortgaged property.

**Government National Mortgage Association:** A government-owned corporation within HUD. Ginnie Mae guarantees investors the timely payment of principal and interest on privately issued MBS backed by pools of government-insured and government-guaranteed mortgages.

**Government-Sponsored Enterprises:** Business organizations chartered and sponsored by the federal government.

**Guarantee:** A pledge to investors that the guarantor will bear the default risk on a pool of loans or other collateral.

**Hedging:** The practice of taking an additional step, such as buying or selling a derivative, to offset certain risks of holding a particular investment, such as MBS.

**Housing and Economic Recovery Act:** HERA, enacted in 2008, establishes OIG and FHFA, which oversee the GSEs' operations. HERA also expands Treasury's authority to provide financial support to the GSEs.

**Implied Guarantee:** The assumption, prevalent in the financial markets, that the federal government will cover Enterprise debt obligations.

**Inspector General Act:** Enacted in 1978, this statute authorizes establishment of offices of inspectors general, "independent and objective units" within federal agencies, that: (1) conduct and supervise audits and investigations relating to the programs and operations of their agencies; (2) provide leadership and coordination and recommend policies for activities designed to promote economy, efficiency, and effectiveness in the administration of agency programs and to prevent and detect fraud, waste, or abuse in such programs and operations; and (3) provide a means for keeping the head of the agency and Congress fully and currently informed about problems and

deficiencies relating to the administration of such programs and operations and the necessity for and progress of corrective action.

**Inspector General Reform Act:** Enacted in 2008, this statute amends the Inspector General Act to enhance the independence of inspectors general and to create the Council of the Inspectors General on Integrity and Efficiency.

**Insurance Companies:** A company whose primary and predominant business activity is the writing of insurance and issuing or underwriting "covered products."

**Internal Controls:** Internal controls are an integral component of an organization's management that provide reasonable assurance that the following objectives are achieved: (1) effectiveness and efficiency of operations, (2) reliability of financial reports, and (3) compliance with applicable laws and regulations. Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives and include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance.

**Joint and Several Liability:** The concept of joint and several liability provides that each obligor in a group is responsible for the debts of all in that group. In the case of the FHLBanks, if any individual FHLBank were unable to pay a creditor, the other 11 – or any 1 or more of them – would be required to step in and cover that debt.

**Lien:** The lender's right to have a specific piece of the debtor's property sold if the debt is not repaid. With respect to residential mortgages, the noteholder retains a lien on the house (as evidenced by the mortgage or deed of trust) until the loan is repaid.

**Mortgage-Backed Securities:** MBS are debt securities that represent interests in the cash flows – anticipated principal and interest payments – from pools of mortgage loans, most commonly on residential property.

**Operational Risk:** Exposure to loss resulting from inadequate or failed internal processes, people, and systems or from external events (including legal events).

**Par Value:** The face value of a security.

**Personally Identifiable Information:** Information that can be used to identify an individual, such as name, date of birth, social security number, or address.

**Preferred Stock:** A security that usually pays a fixed dividend and gives the holder a claim on corporate earnings and assets superior to that of holders of common stock but inferior to that of investors in the corporation's debt securities.

**Principal Reduction:** A write down or forgiveness of a borrower's principal balance, in part or whole.

**Private-Label Mortgage-Backed Securities:** MBS derived from mortgage loan pools assembled by entities other than GSEs or federal government agencies. They do not carry an explicit or implicit government guarantee, and the private-label MBS investor bears the risk of losses on its investment.

**Real Estate Owned:** Foreclosed homes owned by government agencies or financial institutions, such as the Enterprises or real estate investors. REO homes represent collateral seized to satisfy unpaid mortgage loans. The investor or its representative then must sell the property on its own.

**Securitization:** A process whereby a financial institution assembles pools of income-producing assets (such as loans) and then sells an interest in the assets' cash flows as securities to investors.

**Senior Preferred Stock Purchase Agreements:** Entered into at the time the conservatorships were created, the PSPAs authorize the Enterprises to request and obtain funds from Treasury. Under the PSPAs, the Enterprises agreed to consult with Treasury concerning a variety of significant business activities, capital stock issuance, dividend payments, ending the conservatorships, transferring assets, and awarding executive compensation.

**Servicer:** Servicers act as intermediaries between mortgage borrowers and owners of the loans, such as the Enterprises or MBS investors. They collect the homeowners' mortgage payments, remit them to the owners of the loans, maintain appropriate records, and address delinquencies or defaults on behalf of the owners of the loans. For their services, they typically receive a percentage of the unpaid principal balance of the mortgage loans they service. The recent financial crisis has put more emphasis on servicers' handling of defaults, modifications, short sales, and foreclosures, in addition to their more traditional duty of collecting and distributing monthly mortgage payments.

**Short Sale:** The sale of a mortgaged property for less than what is owed on the mortgage.

**Suspension:** The temporary disqualification of a firm or individual from contracting with the government or participating in government programs, pending the outcome of an investigation or an indictment or based upon adequate evidence that supports claims of program violations. A suspension means that an individual or entity is immediately excluded from participating in further federal executive branch procurement and non-procurement programs. Suspension frequently leads to debarment.

**Thrifts:** A financial institution that ordinarily possesses the same depository, credit, financial intermediary, and account transactional functions as a bank but that is chiefly organized and primarily operates to promote savings and home mortgage lending rather than commercial lending.

**Underwater:** Term used to describe situations in which the homeowner's equity is below zero (i.e., the home is worth less than the balance of the loan(s) it secures).

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## ACRONYMS AND ABBREVIATIONS

**Abacus**- Abacus Federal Savings Bank

**ACB**- Appalachian Community Bank

**Agency**- Federal Housing Finance Agency

**AHP**- Affordable Housing Program

**AMFS**- American Mortgage Field Services LLC

**AMS**- American Mortgage Specialists

**Blue Book**- Quality Standards for Inspection and Evaluation

**BNC**- BNC National Bank

**BOA**- Bank of America

**CEO**- Chief Executive Officer

**CICA**- Community Investment Cash Advance

**CIGIE**- Council of the Inspectors General on Integrity and Efficiency

**CIP**- Community Investment Program

**CRS**- Call Report System

**DBR**- Division of FHLBank Regulation

**DER**- Division of Enterprise Regulation

**DOJ**- United States Department of Justice

**EESA**- Emergency Economic Stabilization Act

**Enterprises**- Fannie Mae and Freddie Mac

**EO**- Executive Office

**Fannie Mae**- Federal National Mortgage Association

**FBI**- Federal Bureau of Investigation

**FDIC**- Federal Deposit Insurance Corporation

**FDIC-OIG**- Federal Deposit Insurance Corporation Office of Inspector General

**FFETF**- Financial Fraud Enforcement Task Force

**FHFA**- Federal Housing Finance Agency

**FHLBanks**- Federal Home Loan Banks

**FHLBank System**- Federal Home Loan Bank System

**FinCEN**- Financial Crimes Enforcement Network

**Freddie Mac**- Federal Home Loan Mortgage Corporation

**GAO**- United States Government Accountability Office

**Ginnie Mae**- Government National Mortgage Association

**GPH**- GPH Investments LLC

**GSEs**- Government-Sponsored Enterprises

**HAMP**- Home Affordable Modification Program

**HAMP PRA**- Home Affordable Modification Program Principal Reduction Alternative

**HERA**- Housing and Economic Recovery Act of 2008

**HUD**- United States Department of Housing and Urban Development

**HUD-OIG**- United States Department of Housing and Urban Development Office of Inspector General

**IRP**- Independent Rights Party

**IRS-CI**- Internal Revenue Service-Criminal Investigation

**Loyalty**- Loyalty Title Company LLC

**MBS**- Mortgage-Backed Securities

**MSR**- Mortgage Servicing Rights

**MWLD**- Mortgage Warehouse Lending Division

**OA**- Office of Audits

**OAd**- Office of Administration

**OC**- Office of Counsel

**Ocala**- Ocala Funding LLC

**OE**- Office of Evaluations

**OGC**- Office of General Counsel

**OI**- Office of Investigations

**OIG**- Federal Housing Finance Agency Office of Inspector General

**Old Republic**- Old Republic National Title Insurance Company

**OPOR**- Office of Policy, Oversight, and Review

**PCS**- Permanent Change of Station

**PII**- Personally Identifiable Information

**Plan**- Reforming America's Housing Finance Market

**PSPAs**- Senior Preferred Stock Purchase Agreements

**Regal**- Regal Title Company LLC

**REO**- Real Estate Owned

**RMBS**- Residential Mortgage-Backed Securities

**SCP**- Suspended Counterparty Program

**SEC**- Securities and Exchange Commission

**SIGTARP**- Office of the Special Inspector General for the Troubled Asset Relief Program

**SORN**- System of Records Notice

**TARP**- Troubled Asset Relief Program

**TBW**- Taylor, Bean & Whitaker Mortgage Corporation

**Treasury**- United States Department of the Treasury

**21st Century**- 21st Century Real Estate Investment Corporation

**USPIS**- U.S. Postal Inspection Service

**Yellow Book**- Government Auditing Standards

# Appendix B: Information Required by the Inspector General Act

Section 5(a) of the Inspector General Act provides that OIG shall, not later than April 30 and October 31 of each year, prepare semiannual reports summarizing its activities during the immediately preceding six-month periods ending March 31 and September 30. Further, Section 5(a) lists more than a dozen categories of information that OIG must include in its semiannual reports.

Below, OIG presents a table that directs the reader to the pages of this report where the information required by the Inspector General Act may be found.

| Source/Requirement | Pages |
|---|---|
| Section 5(a)(1)- A description of significant problems, abuses, and deficiencies relating to the administration of programs and operations of FHFA. | 5-8<br>38-53 |
| Section 5(a)(2)- A description of the recommendations for corrective action made by OIG with respect to significant problems, abuses, or deficiencies. | 38-53<br>71-80 |
| Section 5(a)(3)- An identification of each significant recommendation described in previous semiannual reports on which corrective action has not been completed. | 72, 73, 74, 77, 78, 79 |
| Section 5(a)(4)- A summary of matters referred to prosecutive authorities and the prosecutions and convictions that have resulted. | 53-63 |
| Section 5(a)(5)- A summary of each report made to the Director of FHFA. | 38-53 |
| Section 5(a)(6)- A listing, subdivided according to subject matter, of each audit and evaluation report issued by OIG during the reporting period and for each report, where applicable, the total dollar value of questioned costs (including a separate category for the dollar value of unsupported costs) and the dollar value of recommendations that funds be put to better use. | 38-53 |
| Section 5(a)(7)- A summary of each particularly significant report. | 38-53 |
| Section 5(a)(8)- Statistical tables showing the total number of audit and evaluation reports and the total dollar value of questioned and unsupported costs. | 38-53 |
| Section 5(a)(9)- Statistical tables showing the total number of audit and evaluation reports and the dollar value of recommendations that funds be put to better use by management. | 124 |
| Section 5(a)(10)- A summary of each audit and evaluation report issued before the commencement of the reporting period for which no management decision has been made by the end of the reporting period. | 124 |
| Section 5(a)(11)- A description and explanation of the reasons for any significant revised management decision made during the reporting period. | 124 |
| Section 5(a)(12)- Information concerning any significant management decision with which the Inspector General is in disagreement. | 124 |
| Section 5(a)(13)- The information described under section 05(b) of the Federal Financial Management Improvement Act of 1996. | 125 |

The paragraphs below further address the status of OIG's compliance with Sections 5(a)(9), (10), (11), (12), and (13) of the Inspector General Act.

## AUDIT AND EVALUATION REPORTS WITH RECOMMENDATIONS THAT FUNDS BE PUT TO BETTER USE BY MANAGEMENT

Section 5(a)(9) of the Inspector General Act, as amended, requires that OIG disclose the dollar value of recommendations that funds be put to better use by management in its reports. In *Follow-up on Freddie Mac's Loan Repurchase Process* (EVL-2012-007, September 13, 2012), OIG determined that, as a result of Freddie Mac's new loan review process, the Enterprise will realize additional recoveries of approximately $1 billion (i.e., $0.8 billion to $1.2 billion) for loans selected for review in 2012. Total recoveries are estimated to be approximately $2.8 billion (i.e., $2.2 billion to $3.4 billion). Because these recoveries had not been anticipated and accounted for, the added income will increase Freddie Mac's profits and hence the amount paid to (or will reduce its losses and hence the amount drawn from) Treasury. FHFA and OIG are negotiating a mechanism and criteria to track Freddie Mac's unaccounted for recoveries, and OIG will monitor and report on them in subsequent semiannual reports.

## AUDIT AND EVALUATION REPORTS WITH NO MANAGEMENT DECISION

Section 5(a)(10) of the Inspector General Act, as amended, requires that OIG report on each audit and evaluation report issued before the commencement of the reporting period for which no management decision has been made by the end of the reporting period. There were no audit or evaluation reports issued before the beginning of the reporting period that are awaiting a management decision.

## SIGNIFICANTLY REVISED MANAGEMENT DECISIONS

Section 5(a)(11) of the Inspector General Act, as amended, requires that OIG report information concerning the reasons for any significant revised management decision made during the reporting period. During the six-month reporting period ended September 30, 2012, there were no significant revised management decisions on OIG's audits and evaluations.

## SIGNIFICANT MANAGEMENT DECISION WITH WHICH THE INSPECTOR GENERAL DISAGREES

Section 5(a)(12) of the Inspector General Act, as amended, requires that OIG report information concerning any significant management decision with which the Inspector General is in disagreement. During the current reporting period, there were no management decisions with which the Inspector General disagreed.

## FEDERAL FINANCIAL MANAGEMENT IMPROVEMENT ACT OF 1996

The provisions of HERA require FHFA to implement and maintain financial management systems that comply substantially with federal financial management systems requirements, applicable federal accounting standards, and the U.S Government Standard General Ledger at the transaction level.

For fiscal year 2011, FHFA received from GAO an unqualified (clean) audit opinion on its annual financial statements and internal control over financial reporting. GAO also reported that it identified no material weaknesses in internal controls or instances of noncompliance with laws or regulations. GAO is required to perform this audit in accordance with HERA.

Several OIG reports published during the semiannual period identified specific opportunities to strengthen FHFA's internal controls. These reports are summarized on pages 38 through 53.

# Appendix C: OIG Reports

See www.fhfaoig.gov for complete copies of OIG's reports.

## EVALUATION REPORTS

*FHFA's Oversight of Freddie Mac's Investment in Inverse Floaters* (EVL-2012-009, September 26, 2012).

*Evaluation of FHFA's Oversight of Fannie Mae's Transfer of Mortgage Servicing Rights from Bank of America to High Touch Servicers* (EVL-2012-008, September 18, 2012).

*Follow-up on Freddie Mac's Loan Repurchase Process* (EVL-2012-007, September 13, 2012).

*FHFA's Certifications for the Preferred Stock Purchase Agreements* (EVL-2012-006, August 23, 2012).

*FHFA's Oversight of the Federal Home Loan Banks' Unsecured Credit Risk Management Practices* (EVL-2012-005, June 28, 2012).

## AUDIT REPORTS

*CliftonLarsonAllen LLP's Audit of the Federal Housing Finance Agency's Risk Management Process for External Network Vulnerabilities* (AUD-2012-010, September 28, 2012).

*CliftonLarsonAllen LLP's Audit of FHFA's Controls and Protocols over Sensitive and Proprietary Information Collected and Exchanged with the Financial Stability Oversight Council* (AUD-2012-009, September 28, 2012).

*FHFA's Conservator Approval Process for Fannie Mae and Freddie Mac Business Decisions* (AUD-2012-008, September 27, 2012).

*FHFA's Oversight of the Enterprises' Management of High-Risk Seller/Servicers* (AUD-2012-007, September 18, 2012).

*FHFA's Call Report System* (AUD-2012-006, July 19, 2012).

*FHFA's Supervisory Risk Assessment for Single-Family Real Estate Owned* (AUD-2012-005, July 19, 2012).

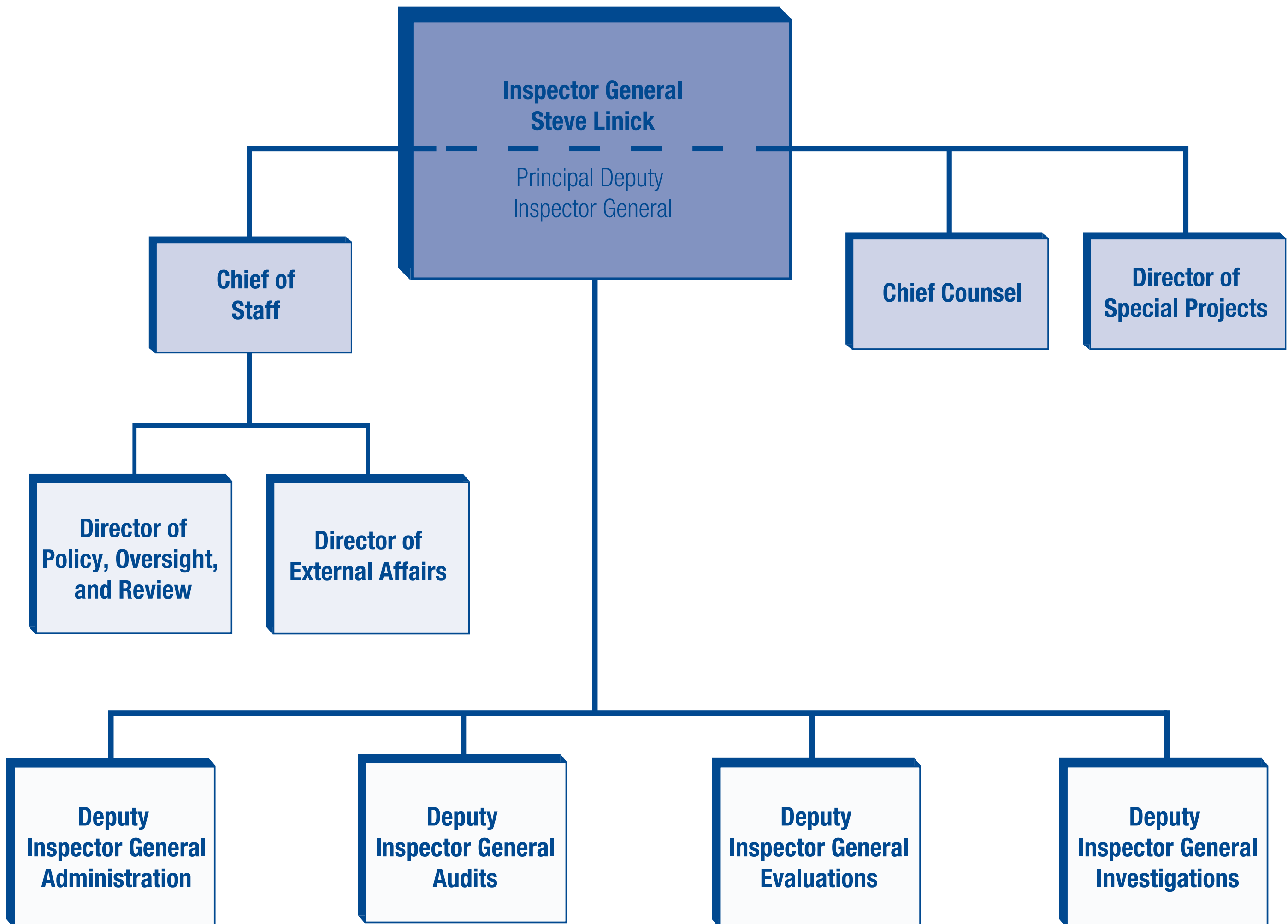
*FHFA's Supervisory Framework for Federal Home Loan Banks' Advances and Collateral Risk Management* (AUD-2012-004, June 1, 2012).

## OTHER REPORTS

*Overview of the Risks and Challenges the Enterprises Face in Managing Their Inventories of Foreclosed Properties* (WPR-2012-003, June 14, 2012).

*Fannie Mae and Freddie Mac: Where the Taxpayers' Money Went* (WPR-2012-002, May 24, 2012).

# Appendix D: OIG Organizational Chart



# Appendix E: Enterprises' Performance Metrics

**Figure 30. The Enterprises' Earnings and Profitability for the Six Months Ended June 30, 2012 ($ millions)**

| Earnings and Profitability | Fannie Mae | Freddie Mac |
|---|---|---|
| Mortgage Loans | $ 64,593 | $ 38,810 |
| Investment Securities | 2,241 | 5,715 |
| Other Interest Earning Assets | 121 | 34 |
| Interest Expense on Debt Obligations | (56,330) | (35,673) |
| Net Interest Income | 10,625 | 8,886 |
| Credit-related Income (Expenses) | 772 | (2,121) |
| Loss on Derivative Agreements | (2,409)[a] | (1,938) |
| Impairment of Securities Considered Other than Temporary | (663) | (662) |
| Administrative Expenses | (1,131) | (738) |
| Other, Net | 643 | 170 |
| **Net Income from Operations** | **$ 7,837** | **$ 3,597** |

Sources: Fannie Mae, *Form 10-Q for the Quarterly Period Ended June 30, 2012*, at 19, 21 (online at www.sec.gov/Archives/edgar/data/310522/000031052212000090/fanniemaeq206302012.htm) (accessed Oct. 18, 2012); Freddie Mac, *Form 10-Q for the Quarterly Period Ended June 30, 2012*, at 13, 14 (online at www.sec.gov/Archives/edgar/data/1026214/000119312512339405/d378248d10q.htm) (accessed Sept. 10, 2012).

Notes:

[a] Loss on Derivatives referenced to Table 10, p. 24 in the Fannie Mae Second Quarter 2012 10-Q Report.

**Figure 31. The Enterprises' Single-Family REO Activity Summary for the Six Months Ended June 30, 2012 (number of properties)**

| REO Activity | Fannie Mae | Freddie Mac |
|---|---|---|
| Beginning Balance | 118,528 | 60,555 |
| Total Acquisitions | 91,483 | 43,840 |
| Total Dispositions | (100,745) | (51,113) |
| **Ending Inventory** | **109,266** | **53,282** |

Sources: Fannie Mae, *Form 10-Q for the Quarterly Period Ended June 30, 2012*, at 66 (online at www.sec.gov/Archives/edgar/data/310522/000031052212000090/fanniemaeq206302012.htm) (accessed Oct. 18, 2012); Freddie Mac, *Form 10-Q for the Quarterly Period Ended June 30, 2012*, at 83 (online at www.sec.gov/Archives/edgar/data/1026214/000119312512339405/d378248d10q.htm) (accessed Sept. 10, 2012).

# Appendix F: Endnotes

1. Housing and Economic Recovery Act of 2008 (HERA), Pub. L. No. 110-289, § 1117.

2. HERA at § 1145.

3. Federal Housing Finance Agency, *Statement of Director James B. Lockhart*, at 12 (July 30, 2009) (online at www.fhfa.gov/webfiles/14715/FHFA1stAnnSpeechandPPT73009.pdf).

4. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 110.

5. Government Accountability Office, *Fannie Mae and Freddie Mac: Analysis of Options for Revising the Housing Enterprises' Long-term Structures*, at 3 (Sept. 2009) (GAO/09-782) (online at www.gao.gov/new.items/d09782.pdf).

6. Department of the Treasury, Written Testimony by Secretary of the Treasury Timothy F. Geithner Before the Senate Committee on Banking, Housing & Urban Affairs (Mar. 15, 2011) (online at www.treasury.gov/press-center/press-releases/Pages/tg1103.aspx).

7. Federal Housing Finance Agency, *Data as of August 8, 2012 on Treasury and Federal Reserve Purchase Programs for GSE and Mortgage-Related Securities*, at Tables 3-5 (online at www.fhfa.gov/webfiles/24145/TSYSupport%202012-08-08.pdf) (accessed Sept. 10, 2012).

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9. Federal Home Loan Banks Office of Finance, *History of Service* (online at www.fhlb-of.com/ofweb_userWeb/pageBuilder/mission--history-29) (accessed Sept. 10, 2012).

10. *Id.*; Federal Home Loan Banks, *Frequently Asked Questions: Federal Home Loan Bank Advances* (online at www.fhlbanks.com/overview_faqs_advances.htm) (accessed Sept. 10, 2012).

11. Federal Home Loan Banks Office of Finance, *Funding* (online at www.fhlb-of.com//ofweb_userWeb/pageBuilder/funding-30) (accessed Sept. 10, 2012); Federal Home Loan Banks, *Frequently Asked Questions: Federal Home Loan Bank Advances* (online at

www.fhlbanks.com/overview_faqs_advances.htm) (accessed Sept. 10, 2012).

12. Federal Housing Finance Agency, *FHFA Sends Notice to Federal Register on State-Level Guarantee Fee Pricing* (Sept. 20, 2012) (online at www.fhfa.gov/webfiles/24526/G-fee_State-level_pricingFINAL.pdf).

13. Federal Housing Finance Agency, *FHFA, Fannie Mae and Freddie Mac Launch New Representation and Warranty Framework, Increased Transparency and Certainty for Lenders* (Sept. 11, 2012) (online at www.fhfa.gov/webfiles/24366/Reps_and_Warrants_Release_and_FAQs_091112.pdf).

14. Federal Housing Finance Agency, *FHFA Announces First Winning Bidder in REO Pilot Initiative* (Sept. 10, 2012) (online at www.fhfa.gov/webfiles/24273/REOInvestor91012.pdf).

15. Federal Housing Finance Agency, *FHFA Announces Next Steps in REO Pilot Program* (July 3, 2012) (online at www.fhfa.gov/webfiles/24041/REOInitiative7312.pdf).

16. Federal Housing Finance Agency, *FHFA Announces Increase in Guarantee Fees, G-fee Report for 2010-2011 Released* (Aug. 31, 2012) (online at www.fhfa.gov/webfiles/24259/Gfee083112.pdf).

17. Federal Housing Finance Agency, *FHFA Announces New Standard Short Sale Guidelines for Fannie Mae and Freddie Mac; Programs Aligned to Expedite Assistance to Borrowers* (Aug. 21, 2012) (online at www.fhfa.gov/webfiles/24211/Shortsales82112Final.pdf).

18. Department of the Treasury, *Treasury Department Announces Further Steps to Expedite Wind Down of Fannie Mae and Freddie Mac* (Aug. 17, 2012) (online at www.treasury.gov/press-center/press-releases/Pages/tg1684.aspx).

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Acting Director, FHFA, to Tim Johnson, Chairman, Committee on Banking, Housing and Urban Affairs, and Richard C. Shelby, Ranking Member, Committee on Banking, Housing and Urban Affairs (July 31, 2012) (online at www.fhfa.gov/webfiles/24110/PF_LettertoCong73112.pdf).

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*Fiscal Years 2013-2017* (online at www.fhfa.gov/webfiles/23930/FHFA%20Draft%20Strategic%20Plan%202013-2017.pdf) (accessed June 22, 2012). On October 9, 2012, FHFA released its final plan. See www.fhfa.gov/webfiles/24577/FHFAStrategicPlan10912Final.pdf.

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29. Federal Housing Finance Agency, *Projections of the Enterprises' Financial Performance* (Oct. 2012) (online at www.fhfa.gov/webfiles/24611/Projections102612.pdf).

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31. The FHLBank System can borrow at favorable rates due to the perception in financial markets that the federal government will guarantee repayment of its debt even though such a guarantee has not been made explicitly. This phenomenon is known as the "implicit guarantee." See Federal Housing Finance Agency Office of Inspector General, *FHFA's Oversight of Troubled Federal Home Loan Banks* (Jan. 11, 2012) (EVL-2012-001) (online at www.fhfaoig.gov/Content/Files/Troubled%20Banks%20EVL-2012-001.pdf).

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34. *Id.* at 3, 30.

35. Federal Home Loan Banks, *The Federal Home Loan Banks: The Basics*, at 2 (online at www.fhlbanks.com/assets/pdfs/sidebar/FHLBanks_TheBasics_4_2012.pdf) (accessed July 24, 2012).

36. Federal Housing Finance Agency, *2011 Report to Congress*, at 48 (June 13, 2012) (online at www.fhfa.gov/webfiles/24009/FHFA_RepToCongr11_6_13_FINAL.pdf); Federal Home Loan Banks, *Combined Financial Report for the Year Ended December 31, 2011*, at S-1 (online at www.fhlb-of.com/ofweb_userWeb/resources/11yrend.pdf) (accessed Oct. 12, 2012).

37. Federal Home Loan Banks, *Combined Financial Report for the Year Ended December 31, 2011*, at S-6, S-10 (online at www.fhlb-of.com/ofweb_userWeb/resources/11yrend.pdf) (accessed July 24, 2012).

38. *Id*. at S-11. FHFA is authorized to review the compensation packages of FHLBank executives and to prohibit compensation that it deems unreasonable or not comparable to compensation of employees in similar businesses. See 12 U.S.C. § 4518.

39. Federal Home Loan Banks, *Frequently Asked Questions: Federal Home Loan Bank Advances* (online at www.fhlbanks.com/overview_faqs_advances.htm) (accessed July 26, 2012); Federal Home Loan Banks, *Combined Financial Report for the Year Ended December 31, 2011*, at 4 (online at www.fhlb-of.com/ofweb_userWeb/resources/11yrend.pdf) (accessed Oct. 12, 2012).

    Community development financial institutions (depository institutions insured by the FDIC with average total assets over the preceding three-year period of less than $1.076 billion) are eligible to use expanded statutory collateral provisions for small business, agriculture, and community development loans to the extent that their FHLBanks accept such loans as collateral for advances. See Federal Home Loan Banks, *Combined Financial Report for the Year Ended December 31, 2011*, at 93, F-45 (online at www.fhlb-of.com/ofweb_userWeb/resources/11yrend.pdf) (accessed Aug. 24, 2012).

40. Federal Housing Finance Agency, *2011 Report to Congress*, at 31 (June 13, 2012) (online at www.fhfa.gov/webfiles/24009/FHFA_RepToCongr11_6_14_508.pdf).

41. Federal Reserve Bank of Atlanta, *The Federal Home Loan Bank System: The "Other" Housing GSE*, at 39, 40 (Third Quarter 2006) (online at www.frbatlanta.org/filelegacydocs/erq306_frame.pdf) (accessed July 26, 2012); Federal Housing Finance Agency Office of Inspector General, *FHFA's Oversight of the Federal Home Loan Banks' Unsecured Credit Risk Management Practices*, at 8, 9, 11, 12 (June 28, 2012) (EVL-2012-005) (online at www.fhfaoig.gov/Content/Files/EVL-2012-005_1_0.pdf).

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45. Consequently, the FHLBanks can conceivably rely indefinitely on debt issued at favorable interest rates to engage in higher-risk financial transactions that could result in significant financial losses over time. Therefore, FHFA has a critical responsibility to conduct vigorous oversight of the FHLBanks to help ensure their safety and soundness and housing mission achievement. See Federal Housing Finance Agency Office of Inspector General, *FHFA's Oversight of Troubled Federal Home Loan Banks*, at 6 (Jan. 11, 2012) (EVL-2012-001) (online at www.fhfaoig.gov/Content/Files/Troubled%20Banks%20EVL-2012-001.pdf).

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54. Government Accountability Office, Testimony Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, *Federal Home Loan Bank System: An Overview of Changes and Current Issues Affecting the System: Statement of Thomas J. McCool, Managing Director Financial Markets and Community Investment*, at 2 footnote 2 (Apr. 13, 2005) (GAO/05-489T) (online at www.gao.gov/assets/120/111492.pdf).

55. Federal Housing Finance Agency, *2011 Report to Congress*, at 32 (June 13, 2012) (online at www.fhfa.gov/webfiles/24009/FHFA_RepToCongr11_6_13_FINAL.pdf).

56. Federal Housing Finance Agency Office of Inspector General, *FHFA's Supervisory Framework for Federal Home Loan Banks' Advances and Collateral Risk Management*, at 10 (June 1, 2012) (AUD-2012-004) (online at www.fhfaoig.gov/Content/Files/AUD-2012-004.pdf).

57. Federal Home Loan Banks, *Combined Financial Report for the Year Ended December 31, 2011*, at 90 (online at www.fhlb-of.com/ofweb_userWeb/resources/11yrend.pdf) (accessed Aug. 8, 2012).

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(EVL-2012-005) (online at www.fhfaoig.gov/Content/Files/EVL-2012-005_1_0.pdf).

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85. Government Accountability Office, *Federal Housing Finance Agency: Oversight of the Federal Home Loan Banks' Agricultural and Small Business Collateral Policies Could Be Improved*, at 9, 10 (July 2010) (GAO/10-92) (online at www.gao.gov/assets/310/307593.pdf).

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# Federal Housing Finance Agency Office of Inspector General

## Semiannual Report to the Congress

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