Federal Housing Finance Agency
Office of Inspector General

Compliance Review of FHFA's Oversight of Enterprise Executive Compensation Based on Corporate Scorecard Performance

Compliance Review • COM-2016-002 • March 17, 2016

COM-2016-002

March 17, 2016

Executive Summary

The Federal Housing Finance Agency (FHFA or the Agency) Office of Inspector General (OIG) stated in an evaluation report issued on March 31, 2011, *Evaluation of Federal Housing Finance Agency's Oversight of Fannie Mae's and Freddie Mac's Executive Compensation Programs* (2011 Evaluation Report) that Fannie Mae and Freddie Mac (the Enterprises) paid their top six executives more than $35 million in compensation in 2009 and 2010. Based on our review of the oversight process used by FHFA, the Enterprises' conservator, to assess the appropriateness of this compensation, we found that FHFA's process was insufficiently robust because it generally accepted the Enterprises' annual at-risk compensation proposals rather than verifying and testing the accuracy of the reported information and conclusions. We recommended that FHFA strengthen its oversight over compensation for Enterprise executives by, among other things, testing and verifying the Enterprises' proposals for the at-risk element of executive compensation, which has been estimated by FHFA to have constituted 70% of an executive's annual compensation.

In December 2011, FHFA advised us that it had adopted enhanced controls, including testing and verification procedures, to strengthen its oversight of Enterprise proposals for at-risk compensation for Enterprise executives. We closed our recommendation on February 27, 2012, based on our determination that the controls, as drafted, addressed the deficiencies we identified.

On September 16, 2015, we initiated this compliance review to test FHFA's implementation of the controls it adopted in response to our 2011 recommendation. We learned, however, that FHFA discontinued the implementation of the controls as of March 9, 2012, upon adoption of a new Enterprise executive compensation structure. Adoption of that structure came less than two weeks after OIG closed the 2011 Evaluation Report recommendation. According to FHFA, it determined that its March 2012 compensation structure rendered the 2011 controls obsolete and it did not use them.

We recognize that FHFA acted within its discretion in establishing the new executive compensation structure in March 2012. However, FHFA's abandonment of the testing and verification controls it adopted in 2011 has limited its capacity to review and oversee the Enterprises' annual proposals for the at-risk compensation element for executives, based on the executives' contributions in meeting corporate financial and performance goals (also referred to as Corporate Scorecard goals).

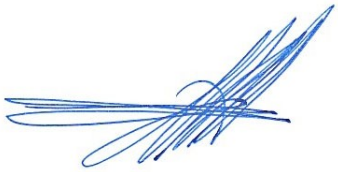
COM-2016-002

March 17, 2016

For calendar year 2014, FHFA approved total compensation payments of approximately $80 million to 85 Enterprise executives, $11.7 million of which was comprised of at-risk incentive pay, based on their performance in meeting the Enterprises' Corporate Scorecard goals. In light of these considerable expenditures and the importance of the executives' responsibilities, OIG recommends that FHFA develop controls to test and verify that Enterprise proposals for the at-risk element of compensation based on Corporate Scorecard performance are reasonable and justified. OIG also recommends that FHFA notify OIG when it does not fully implement, substantially alters, or abandons controls or other corrective actions that served as OIG's basis for closing a report recommendation. FHFA disagreed with these recommendations.

This compliance review was led by Alisa Davis, Senior Policy Advisor, and Wesley M. Phillips, Senior Policy Advisor, with assistance from Andrew Gegor, Jr., Senior Auditor, and Patrice Wilson, Senior Investigative Evaluator. We appreciate the cooperation of FHFA staff, as well as the assistance of all those who contributed to the preparation of this report.

This compliance review report has been distributed to Congress, the Office of Management and Budget, and others and will be posted on our website, www.fhfaoig.gov.



Richard Parker
Deputy Inspector General, Compliance & Special Projects

TABLE OF CONTENTS

ABBREVIATIONS

CEO	Chief Executive Officer
CFO	Chief Financial Officer
DER	Division of Enterprise Regulation
ECB	Executive Compensation Branch
Enterprises	Fannie Mae and Freddie Mac
Fannie Mae	Federal National Mortgage Association
FHFA or Agency	Federal Housing Finance Agency
Freddie Mac	Federal Home Loan Mortgage Corporation
OIG	Federal Housing Finance Agency Office of Inspector General
Procedure Guide	FHFA Procedural Guide for Enterprise Executive Compensation Scorecards

BACKGROUND

In our 2011 Evaluation Report, we explained the process used by the Enterprises to compensate their executives. We outlined that, at the beginning of each year, each Enterprise established its financial and performance goals, and at year-end, each Enterprise assessed corporate performance against the goals. At that time, each Enterprise also determined whether each executive's contributions to its overall performance warranted an award to that executive of all, or only a portion of, her or his "at risk" compensation, such as bonuses. During this compliance review, an FHFA official estimated that in 2011 70% of each executive's annual **total compensation** was "at-risk" while the remaining 30% was fixed, base salary.

Total Compensation is the maximum compensation an Enterprise executive may receive and is based on data for comparable positions at other financial institutions. Total compensation is comprised of base salary and deferred compensation, with the latter having fixed and at-risk components.

Our 2011 Evaluation Report identified deficiencies in FHFA's oversight of the Enterprises' corporate performance and executive compensation processes. We found that individual offices within FHFA that reviewed and approved the Enterprises' financial and performance goals and measured performance against those goals did not do so using established, written criteria and did not document their findings, thereby preventing any assessment by the FHFA Director or a third party (like OIG) of the consistency and effectiveness of their oversight. Further, we found that FHFA generally accepted the Enterprises' annual compensation determinations, without testing and verifying the adequacy of those determinations. Based on our review, we found that FHFA's approach was inconsistent with commonly accepted examination and auditing procedures and concluded that, absent testing and verification, FHFA lacked an empirical basis for approving Enterprise executive compensation.[1]

[1] FHFA stated that it might question an Enterprise's proposed compensation for an individual executive if it seemed inconsistent with the Agency's experience with a particular executive or if the proposed compensation was inconsistent with compensation paid to executives in comparable positions with other financial institutions.

We recommended that FHFA strengthen its oversight of the Enterprises' executive compensation by:

1. Establishing written criteria and procedures for reviewing the Enterprises' annual performance measures and year-end performance assessment data, as well as their recommended executive compensation levels; and

2. Conducting independent testing and verification, perhaps on a randomized basis, to gain assurance that the Enterprises' bases for developing recommended individual executive compensation levels are reasonable and justified.

FHFA agreed with the first part of our recommendation in March 2011, but it disagreed with the second part regarding the establishment of testing and verification procedures for individual executive compensation levels. When FHFA provided us with its Procedural Guide for Enterprise Executive Compensation Scorecards (Procedure Guide) on December 30, 2011, the Procedure Guide set forth criteria and procedures for review and approval of Enterprise proposals for at-risk compensation, as well as requirements for annual testing of a random sample of individual executive compensation decisions,[2] by FHFA's Division of Enterprise Regulation (DER).[3]

We reviewed the written criteria and requirements in the Procedure Guide and determined that it remediated the deficiencies identified in our 2011 Evaluation Report; we closed our recommendation on February 27, 2012. At that time, we were generally aware that FHFA was considering revisions to the Enterprises' executive compensation structure, as discussed below.[4] However, we were not advised until we conducted the fieldwork for this compliance review that FHFA determined, upon adopting its revised compensation structure on March 9, 2012, that this structure rendered obsolete the controls in the Procedure Guide.

---

[2] According to the Procedure Guide, the goals of this testing were to verify that individual executive performance ratings were reasonable and appropriately documented, assess whether governing policies and procedures were followed, and assure that Enterprise processes for determining individual compensation payments were sound and accurate based on individual and corporate performance results.

[3] The Procedure Guide also included procedures for FHFA's review and approval of the Enterprises' proposed Corporate Scorecards at the beginning of each calendar year and the Agency's assessments of the Enterprises collective performance against the Corporate Scorecards at year-end.

[4] In FHFA's December 30, 2011, letter to OIG, to which the Procedure Guide was appended, FHFA advised that it was, "also considering modifications to the executive compensation structure, possibly coupled with some lowering of non-CEO compensation. This work is underway, with decisions anticipated before the Enterprises file their 10-Ks for 2011." Freddie Mac included the information in its 2011 10-K, and Fannie Mae amended its 2011 10-K to include the information.

FHFA's March 2012 Enterprise Executive Compensation Structure

The **Conservatorship Scorecard** is a weighted scorecard with specific objectives for the Enterprises to achieve in support of FHFA's strategic plan, such as maintaining credit availability and reducing taxpayer risk, among other items.

In February 2012, FHFA issued its Strategic Plan for the conservatorship in which it identified three broad goals for its conservation of the Enterprises. On March 9, 2012, FHFA issued its first annual guidance to the Enterprises containing specific actions they were expected to take to achieve the goals set forth in the Strategic Plan. These actions are referred to as the **Conservatorship Scorecard** goals. That day, FHFA also publicly announced that it had adopted a new Enterprise executive compensation structure, the purpose of which was to balance "prudent" executive pay with the need to retain "quality" executives.[5] Among other things,[6] the revised executive compensation structure established that fixed compensation accounted for 70% of each executive's total compensation and the at-risk portion accounted for the remaining 30%. As shown in Figure 1, below, and stated earlier in this report, FHFA estimates that the at-risk component of each executive's total compensation was approximately 70% prior to 2012, with the fixed component representing the remaining 30%.

FIGURE 1.
TOTAL COMPENSATION
PRE-2012 VS CURRENT

Source: OIG analysis of information provided by FHFA.

Each of the fixed and at-risk elements of the revised executive compensation structure is made up of two parts:

- Fixed Element, totaling 70% of total compensation, includes base salary, which is paid on a recurring basis throughout the year and is capped at $500,000 for every Enterprise executive, save for Chief Executive Officers (CEOs) and Chief Financial Officers (CFOs).[7] The remainder of this fixed element is referred to as deferred salary, which is payable in quarterly installments after a one-year deferral period.

[5] Press Release, FHFA Announces New Conservatorship Scorecard for Fannie Mae and Freddie Mac; Reduces Executive Compensation (Mar. 9, 2012) (online at www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-New-Conservatorship-Scorecard-for-Fannie-Mae-and-Freddie-Mac.aspx).

[6] The new structure included an average reduction of 10% in executives' total compensation and the elimination of bonuses and long-term incentive payments.

[7] CEO compensation is capped at $600,000 annually. CFO base salary can exceed $500,000.

- At-risk Element, totaling 30% of total compensation, all of which is deferred and is subject to performance-based reduction:
    - Half of this at-risk deferred compensation (or 15% of total compensation) is subject to a reduction based on FHFA's determination of how each Enterprise performed against FHFA's annual Conservatorship Scorecard measures, so that all executives at an Enterprise receive the same percentage.
    - The remaining half of this at-risk deferred compensation (or 15% of total compensation) is subject to a reduction based on the Enterprise CEO's and Board of Directors' evaluation of an individual executive's performance against annual Enterprise **Corporate Scorecard** performance measures.[8], [9]

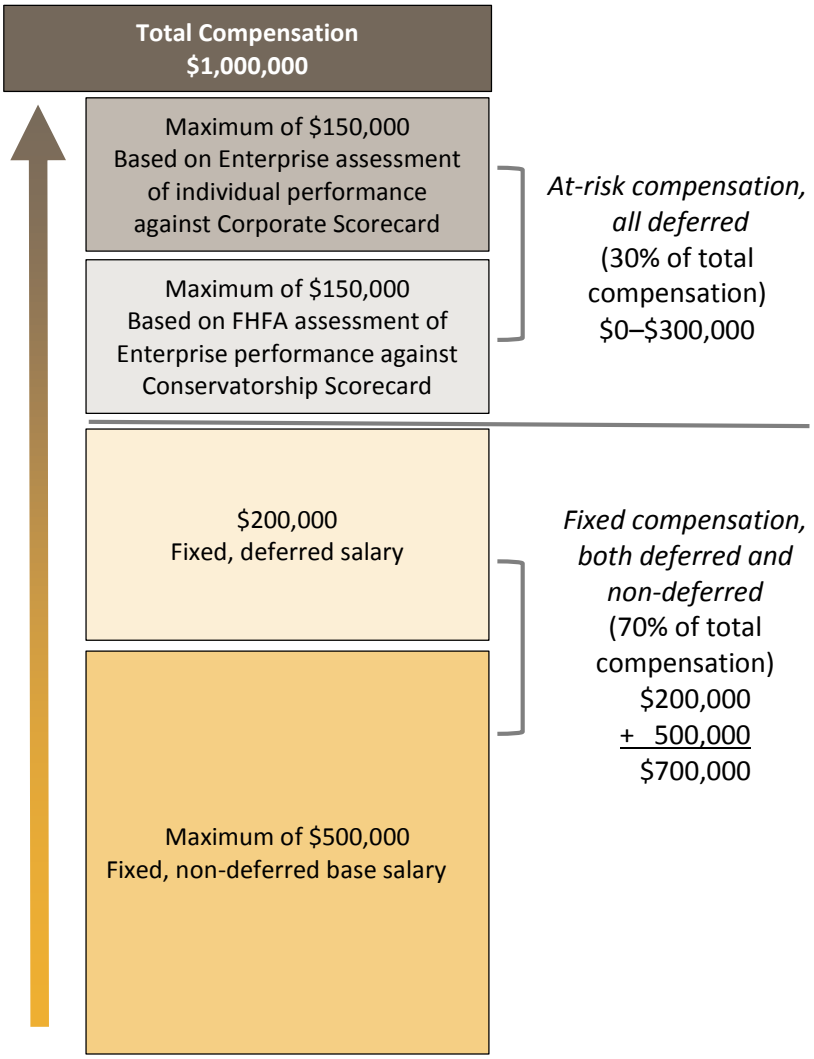
The **Corporate Scorecards**, also referred to as financial and performance targets, contain goals set by the Enterprises for their financial, operations, and mission-related activities, among other items.

[8] FHFA reported to us that Enterprise executives' compensation may be tied to specific Corporate Scorecard goals or other financial and performance objectives that are not specifically in the goals. For presentational purposes, in this report we use the term "Corporate Scorecard goals" to refer to all such standards against which the Enterprises measured the performance of their executives.

[9] One of the Enterprises uses a separate Internal Audit Scorecard to determine the at-risk portion of total compensation for the executive in charge of its Internal Audit function.

Figure 2 provides an illustration of the compensation of a hypothetical Enterprise executive with a $1 million total compensation, under the March 2012 executive compensation structure.

FIGURE 2. CALCULATION OF A HYPOTHETICAL ENTERPRISE EXECUTIVE'S TOTAL COMPENSATION



Source: OIG analysis of information provided by FHFA.

FHFA Determined that the March 2012 Revisions to the Enterprises' Executive Compensation Structure Rendered Obsolete the Controls in the Procedure Guide

During this compliance review, FHFA advised us that it determined that the March 2012 revisions to the Enterprise executive compensation structure rendered the Procedure Guide's requirements obsolete; accordingly, it did not use them subsequently.[10] FHFA explained that its revised executive compensation structure reduced the percentage of at-risk compensation determined by the Enterprises from an estimated 70% of each executive's total compensation in 2011 to 30%, of which 15% would be based on an executive's Corporate Scorecard performance. FHFA determined that it was "reasonable" to delegate to the Enterprises responsibility for developing annual Corporate

[10] The only evidence we found of application of any of the requirements in the Procedure Guide was in a January 2012 DER special examination of the controls over the Enterprises' processes for developing their 2011 executive compensation proposals based on 2011 performance. FHFA reported to us that DER has not examined the effectiveness of the Enterprises' controls in subsequent years. Further, although the Procedure Guide required FHFA to review and approve the Enterprises' Corporate Scorecards at the start of each year and their performance against them at year-end, FHFA has not done so since the establishment of the 2011 Procedure Guide.

Scorecards, measuring their individual executive performance against the scorecards, and determining the 15% at-risk compensation for each individual executive based on that assessment. As discussed below, FHFA requires the Enterprises to submit their annual determinations of individual executive compensation to the Agency for its review and approval.

We are not suggesting that FHFA intended to mislead OIG when it submitted the Procedure Guide on December 30, 2011. Based on our review of documents and information garnered during interviews, we understand there were considerable deliberations in the Agency about the elements of the revised executive compensation structure during the first two months of 2012, and the Agency did not finalize the details of the revised structure until shortly before it was announced on March 9, 2012.[11] We closed our recommendation on February 27, 2012, based upon the Procedure Guide as it was submitted to us by the Agency in December 2011. The Agency subsequently determined, less than 2 weeks later, that this 2011 Procedure Guide was obsolete, but it did not advise us of its determination until we commenced this compliance review in September 2015.

FHFA Review of Enterprise Proposals for Executive At-Risk Compensation Based on Individual Corporate Scorecard Performance

Although FHFA has delegated most of the responsibilities delineated in the 2011 Procedure Guide to the Enterprises, the Agency reported to us that it continues to review and approve the Enterprises' annual determinations of executive at-risk compensation based on individual Corporate Scorecard performance. The Agency's stated purposes for its reviews are to (1) meet a statutory and regulatory requirement to approve executive compensation payments and ensure those payments are "reasonable" and "comparable,"[12] and (2) to ensure the proposed compensation is consistent with the Agency's experiences with particular executives. To achieve these purposes, FHFA conducts limited reviews of information provided by the Enterprise and engages in internal consultations.

According to FHFA, each January the Enterprises submit their proposals for providing each executive with up to 15% of her or his total compensation. The proposals are based upon Enterprise assessments of an individual executive's performance as measured against the Enterprises' Corporate Scorecards for the prior calendar year. FHFA has charged its

[11] For example, an FHFA official said that it was not until the first quarter of 2012 that FHFA began to consider using a Conservatorship Scorecard as a means to assess the Enterprises' performance and to determine a portion of their executives' at-risk compensation.

[12] *See* 12 U.S.C. § 4518(a); 12 C.F.R. § 1230.3(a).

Executive Compensation Branch (ECB)[13] with responsibility for reviewing the materials submitted by the Enterprises and preparing a memorandum to the FHFA Director with recommendations to approve, reject, or revise the Enterprises' proposals for each executive.[14] The Director typically informs the Enterprises of his decision in February each year.

ECB has not established written procedures for its annual reviews of the Enterprises' compensation proposals. An ECB official characterized the ECB's reviews as an informal "sanity check," which we found to be quite limited in scope. According to the ECB official, the office reviews the materials provided by the Enterprises and does not challenge an Enterprise's compensation proposal for an individual executive unless: (a) it would award an executive an amount in excess of 15% of the executive's total compensation, or (b) it conflicts with information (good or bad) that came to ECB's attention during the year. For example, ECB explained to us that it might question an Enterprise proposal to award an executive the full 15% of her or his total compensation if its own experience with that executive was negative, or if it received negative information about that executive's performance from other Agency officials, or from the Enterprises' compensation committees, internal audit groups, or risk managers.

ECB's Review of the Enterprises' Compensation Proposals for the 2014 Corporate Scorecard Performance Demonstrates the Limited Nature of its Review Process

We analyzed the process by which ECB reviewed in early 2015 the Enterprises' executive compensation proposals based on Corporate Scorecard performance in calendar year 2014. We sought, and were provided with, the Enterprises' proposals to compensate all executives covered by the revised compensation structure, except their CEOs, for the 15% at-risk element based on achievement of the 2014 Corporate Scorecard goals, all documentation the Enterprises provided in support of their proposals, and ECB's material evidencing its review of the Enterprises' proposals. Our review identified significant limitations in the materials provided to ECB by the Enterprises in support of their executive compensation proposals, as well as in ECB's review of those materials:[15]

---

[13] ECB consists of its Manager and three staff members. The Manager oversees one staff member who focuses on Enterprise oversight and two staff members who focus on Federal Home Loan Bank compensation oversight.

[14] ECB also attends meetings of the Enterprises' boards of directors during which annual executive compensation proposals are made by their compensation committees.

[15] FHFA has not updated and standardized the content requirements for the Enterprises' executive compensation proposals since 2012. The 2012 requirements for executive compensation state that the Enterprises must "provide sufficient, relevant information to support a meaningful evaluation by the Conservator of requests for approval." If, after reviewing a proposal, ECB believes that it has not received information sufficient to support it, then ECB can request additional information from the Enterprise.

- One Enterprise submitted compensation proposals to FHFA for 50 of the 85 total executive proposals submitted by both Enterprises. For 41 of the 50 executives, the only information that the Enterprise submitted was the proposed percentage and compensation amount (e.g., 15% of an executive's total compensation). The Enterprise did not provide any other supporting documentation or materials, such as the Corporate Scorecard goal(s) for which each executive was responsible or the basis for the proposed compensation amounts. ECB did not request additional documentation and, in February 2015, FHFA's Director approved the Enterprise's proposals for these 41 executives without exception or comment. As proposed by the Enterprise, 37 of the 41 executives received the full targeted amount (15% of her or his total compensation), and 4 received 95% of the targeted amount.

- The other Enterprise submitted compensation proposals for the remaining 35 of the 85 total executives. For 26 of these 35 executives, the Enterprise submitted to FHFA the proposed compensation amount (e.g., 15% of total compensation) and a qualitative rating of each executive's performance, i.e., "Exceeds," "Achieves," or "Needs Improvement." The Enterprise, however, did not provide information on the specific Corporate Scorecard goal(s) for which each executive was responsible, or how it arrived at its ratings. ECB did not request additional documentation and, in February 2015, FHFA's Director approved the Enterprise's proposals for these 26 executives: 14 of them received the full targeted amount (15% of their total compensation) and 8 of them received 95% of the targeted amount.[16]

The discussion above relates to 67 of the 85 executive compensation proposals submitted by the Enterprises to FHFA for calendar year 2014 (41 at the first Enterprise and 26 at the second Enterprise). The compensation proposals submitted by the Enterprises for the remaining 18 executives (9 at one Enterprise and 9 at the other) were distinguished by the fact that they identified the Corporate Scorecard goal(s) for which each executive was responsible, as well as the Enterprises' assessment of whether or not they were on track to meet these goals. In February 2015, FHFA's Director approved the Enterprises' proposals for these 18 executives: 14 received the full targeted amount (15% of total compensation), and 4 received 95% of the targeted amount.

We analyzed the Enterprises' proposals for these 18 executives. For 4 of the 18 individuals, the Enterprises proposed that the individual executives receive the full 15% even though the Enterprises were not on track to meet some of the Corporate Scorecard goals for which the

[16] For various reasons, FHFA approved payments of less than 95% of the targeted amounts for the other four executives as requested by the Enterprise.

executives were accountable.[17] We discussed with ECB two of these four proposals—one from each Enterprise. ECB did not follow up with the Enterprises in these particular cases before the FHFA Director approved the Enterprises' proposals , underscoring the fact that ECB does not have written procedures that specify when it should question the Enterprises' executive compensation recommendations. Although ECB did not follow up in either of these cases, it observed that the Enterprises were on track to meet other Corporate Scorecard goals for which the two executives were responsible, and the executives had substantial responsibilities and were well regarded.

COMPLIANCE REVIEW RESULTS .....

As discussed earlier, in our 2011 Evaluation Report we identified significant limitations in FHFA's process for reviewing and approving the Enterprises' annual executive compensation proposals for at-risk compensation based on corporate performance. Specifically, FHFA generally accepted the Enterprises' proposals rather than testing and verifying them to ensure their appropriateness. We recommended that FHFA establish testing and verification procedures. In response, FHFA advised us on December 30, 2011, that it adopted the Procedure Guide, which included such procedures. On March 9, 2012, FHFA introduced a new executive compensation structure which, it determined, rendered obsolete the testing and verification requirements contained in the Procedure Guide. Since that time, ECB has conducted only limited reviews of the Enterprises' compensation payment proposals for individual executives for at-risk deferred compensation based on Corporate Scorecard performance.

ECB's Limited Reviews are Substantially Similar to the Deficient FHFA Executive Compensation Oversight Process Identified by OIG in the 2011 Evaluation Report

ECB's limited reviews, characterized by an ECB official as a "sanity check," are substantially similar to the ad hoc review that FHFA conducted at the time of our 2011 Evaluation Report. Per the current review process, ECB accepts each of the Enterprises' proposals, unless a proposal for an individual executive is inconsistent with information that ECB may have obtained from its own experience or another source. ECB does not have a systematic process in place by which to evaluate the appropriateness of the Enterprises' proposals, nor does it test and verify them. Moreover, it does not necessarily follow up on indications that a particular compensation recommendation might be questionable. As we found, FHFA approved one Enterprise's proposals to provide all or nearly all the entire targeted amount (15% of total

[17] FHFA approved the recommended amounts in these four cases—as it did in the other 14 cases (total of 18 executive compensation proposals).

compensation) to 41 executives, even though the Enterprise provided no documentation or information to support its proposed compensation of those executives.

FHFA justifies ECB's limited reviews on the grounds that the percentage of executive compensation determined by the Enterprises through the Corporate Scorecard process is sufficiently small (i.e., 15% of an individual's total compensation) so additional review is unnecessary. The Enterprises, however, remain in conservatorship, and compensation of Enterprise executives is considerable. Something more than a limited review is needed to ensure that Enterprise proposals for executive compensation are based on demonstrated individual performance.

CONCLUSION

Although FHFA finalized criteria and procedures for review and approval of Enterprise proposals for at-risk compensation and for annual testing of a random sample of individual executive compensation decisions to implement the recommendation in our 2011 Evaluation Report, it discontinued those requirements in March 2012 without informing OIG. All at-risk individual executive compensation decisions made by FHFA since March 2012 have been subject to an ad hoc limited review, which amounts to the same process used by FHFA that gave rise to our 2011 evaluation. Absent clear documentation from the Enterprises, the FHFA Director approves the Enterprises' annual compensation proposals without adequate assurance that they are reasonable and justified.

RECOMMENDATIONS

OIG recommends that FHFA develop a strategy to enhance ECB's capacity to review the reasonableness and justification of the Enterprises' annual proposals to compensate their executives based on Corporate Scorecard performance. To this end, FHFA should ensure that: the Enterprises submit proposals containing information sufficient to facilitate a comprehensive review by ECB; ECB tests and verifies the information in the Enterprises' proposals, perhaps on a randomized basis; and ECB follows up with the Enterprises to resolve any proposals that do not appear to be reasonable and justified.

OIG recommends that FHFA develop a policy under which it is required to notify OIG within 10 days of its decision not to fully implement, substantially alter, or abandon a corrective action that served as the basis for OIG's decision to close a recommendation.

FHFA'S COMMENTS AND OUR RESPONSE

We provided a draft of this evaluation to FHFA for its review and comment. On March 10, 2016, FHFA's Acting Deputy Director, Division of Conservatorship, and its Chief Financial Officer provided the Agency's written comments, including its rejection of both of our recommendations. The Agency's comments are published verbatim in Appendix A.

In response to our first recommendation, FHFA declined to develop a strategy to enhance its reviews of the Enterprises' annual executive compensation proposals based on Corporate Scorecard performance. Instead, the Agency will continue to perform "high level review[s]" of the Enterprises' proposals, which it deems sufficient. As demonstrated in this report, however, FHFA's current "high level review" does not provide it with assurance that the Enterprises' executive compensation recommendations are reasonable or justified.

In February 2015, the Agency approved all of the Enterprises' compensation proposals, even though it lacked basic information necessary to evaluate properly many of those proposals. The Agency also approved the payment of full at-risk compensation for some executives despite the fact that the Enterprises were not on track to meet some of the Corporate Scorecard goals for which the executives were responsible. In these cases, the Agency did not follow-up with the Enterprises to gather basic information about their compensation proposals, much less challenge any of them. These facts demonstrate that the Agency's high level review process is flawed, and does not permit it to ensure that Enterprise executive compensation based on Corporate Scorecard performance is reasonable or justified. Our recommendation provides FHFA with significant flexibility in developing a strategy to address the shortcomings in its review process; we urge FHFA to reconsider its decision to reject it.

FHFA also disagreed with the second recommendation, stating that it would be "impracticable" for FHFA to notify OIG of material changes to corrective actions in light of the regularity with which it revises its processes. In the absence of such notification, OIG may be left with the erroneous impression that the Agency is implementing a corrective action that has, in fact, been abandoned. Moreover, failure to inform us when a corrective action is not fully implemented, or is substantially altered, may impede our oversight; it would render us unable to assess whether any alternative action taken by the Agency remedied the deficiency noted in our underlying report. Given the benefits of providing OIG with notification, and the likely consequences of failing to undertake such a simple action, OIG submits that the Agency should reconsider its decision in this regard.

FHFA also provided technical comments on a draft of this report which we incorporated as appropriate.

OBJECTIVE, SCOPE, AND METHODOLOGY .....

The original objective of this compliance review was to test FHFA's implementation of the requirements in the 2011 Procedure Guide. However, as outlined in the report, FHFA discontinued these requirements as of March 2012. Accordingly, our revised objective for this compliance review was to assess ECB's processes for identifying and following up on proposed Enterprise compensation payments based on Corporate Scorecard results.

To address the objective, we evaluated the effectiveness of ECB's review process for the Enterprises' proposed payments for 2014 Corporate Scorecard performance. In the absence of a written procedure about ECB's review of Corporate Scorecard executive payments, we identified criteria from the Government Accountability Office's *Standards for Internal Control in the Federal Government* (September 2014) concerning information principles against which to assess ECB's oversight. We analyzed key documents provided by the Agency and questioned ECB regarding its oversight and follow-up on information contained in those documents. We also verified the mathematical accuracy of the proposed payments.

In addition, we interviewed Agency and Enterprise personnel and reviewed other public and internal Agency documents relating to Enterprise executive compensation. Further, we reviewed materials related to ECB's administration of Conservatorship Scorecard processes.

We conducted our compliance review during the period September 2015 to January 2016 under the authority of the Inspector General Act of 1978, as amended and in accordance with the *Quality Standards for Inspection and Evaluation* (January 2012), which were promulgated by the Council for the Inspectors General on Integrity and Efficiency.

APPENDIX A .....

FHFA's Comments on OIG's Findings and Recommendation

Federal Housing Finance Agency

MEMORANDUM

TO: Richard Parker, Deputy Inspector General for Compliance

FROM: Bob Ryan, Acting Deputy Director, Division of Conservatorship
Mark Kinsey, Chief Financial Officer

SUBJECT: Compliance Report: *Compliance Review of FHFA's Oversight of Enterprise Executive Compensation Based on Corporate Scorecard Performance*

DATE: March 10, 2016

This memorandum transmits the management response of the Federal Housing Finance Agency (FHFA) to the recommendations in the FHFA OIG draft compliance report, *Compliance Review of FHFA's Oversight of Enterprise Executive Compensation Based on Corporate Scorecard Performance* (Report). FHFA appreciates the opportunity to review the Report, and management's response to the recommendation(s) is below.

Recommendation 1:
OIG recommends that FHFA develop a strategy to enhance ECB's capacity to review the appropriateness and justification of the Enterprises' annual proposals to compensate their executives based on Corporate Scorecard performance. To this end, FHFA should ensure that: the Enterprises submit proposals containing information sufficient to facilitate a comprehensive review by ECB; ECB tests and verifies the information in the Enterprises' proposals, perhaps on a randomized basis; and ECB follows-up with the Enterprises to resolve any proposals that do not appear to be substantiated and appropriate.

Management Response to Recommendation 1:
FHFA disagrees with the recommendation. In 2012, FHFA substantially revised the Enterprises' executive compensation structure and strengthened its oversight of Enterprise compensation for senior executives following the 2011 FHFA OIG evaluation report. As a result, FHFA now reviews and approves the Total Direct Compensation (TDC) for senior executives, which establishes the maximum total compensation an executive can earn in a given year. In reviewing and approving the TDC, FHFA also reviews each element of compensation: base salary, fixed deferred salary, deferred at-risk salary based on achievement of Conservatorship Scorecard objectives, and the

deferred at-risk salary based on the Enterprises' Internal Corporate Scorecard. At the time of the 2011 FHFA OIG evaluation report, the at-risk component of executive compensation tied to corporate goals was approximately 70 percent; it is now just 15 percent of TDC. Assessment of this 15 percent component of TDC based on the Internal Corporate Scorecard has been delegated to the Enterprises. All at-risk compensation may only be reduced; FHFA eliminated any discretion to increase this part of compensation in 2012. The respective Board of Directors and CEO determine any reductions in this 15 percent of at-risk compensation based on individual performance. FHFA will continue to perform a high level review of the Enterprises' determinations for this 15 percent for non-objection, which we believe is an appropriate level of review based on the executive compensation structure and the roles of FHFA and the Board of Directors.

Recommendation 2:
OIG recommends that FHFA develop a policy under which it is required to notify OIG within 10 days of its decision not to fully implement, abandon, or substantially alter a corrective action that served as the basis for OIG's decision to close a recommendation.

Management Response to Recommendation 2:
FHFA disagrees with this recommendation. In 2011, when FHFA shared the Procedure Guide discussed in the Report, FHFA notified the FHFA OIG that it was considering changing the compensation structure for the Enterprises. Those changes were made and publicly announced. We believe that this Recommendation, and the specific procedures that would be required to ensure compliance with it, would be impracticable to implement in light of regular changes to processes.

cc: John Major, Internal Controls and Audit Follow-up Manager

APPENDIX B.....

Summary of Management's Comments on the Recommendations

This table presents management's response to the recommendations in the OIG report and the status of the recommendations as of when the report was issued.

Rec. No.	Corrective Action: Taken or Planned	Expected Completion Date	Monetary Benefits	Resolved Yes or No[a]	Open or Closed[b]
1.	FHFA disagreed with our recommendation to develop a strategy to enhance its review of the Enterprises' annual proposals based on Corporate Scorecard performance.	Not applicable	$0	No	Closed
2	FHFA disagreed with our recommendation to notify us of material changes in the corrective action that served as a basis for our recommendation closure.	Not applicable	$0	No	Closed

[a] Resolved means: (1) management concurs with the recommendation, and the planned, ongoing, or completed corrective action is consistent with the recommendation; (2) management does not concur with the recommendation, but alternative action meets the intent of the recommendation; or (3) management agrees to the OIG monetary benefits, a different amount, or no amount ($0). Monetary benefits are considered resolved as long as management provides an amount.

[b] Once OIG determines that agreed-upon corrective actions have been completed and are responsive, the recommendation can be closed.

ADDITIONAL INFORMATION AND COPIES.....

For additional copies of this report:

- Call: 202-730-0880
- Fax: 202-318-0239
- Visit: www.fhfaoig.gov

To report potential fraud, waste, abuse, mismanagement, or any other kind of criminal or noncriminal misconduct relative to FHFA's programs or operations:

- Call: 1-800-793-7724
- Fax: 202-318-0358
- Visit: www.fhfaoig.gov/ReportFraud
- Write:

  FHFA Office of Inspector General
  Attn: Office of Investigations – Hotline
  400 Seventh Street SW
  Washington, DC 20219