Federal Housing Finance Agency
Office of Inspector General

FHFA's Oversight of Capital Markets Human Capital

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OFFICE OF INSPECTOR GENERAL
Federal Housing Finance Agency
400 7th Street, S.W., Washington DC 20024

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TO: Jon Greenlee, Deputy Director, Division of Enterprise Regulation

George Grob

FROM: George Grob, Deputy Inspector General for Evaluations

SUBJECT: FHFA's Oversight of Capital Markets Human Capital (ESR-2013-007)

Summary

This report closes the evaluation by the Federal Housing Finance Agency (FHFA) Office of Inspector General (OIG) of FHFA's oversight of human capital resources and planning associated with the capital markets businesses of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, the Enterprises). In particular, this report addresses human capital risk in the Enterprises' capital markets businesses. It concludes that, during the period reviewed, human capital risks associated with voluntary attrition within the Enterprises' capital market businesses—that led to the initiation of this evaluation—had been managed to the point that, although still a concern, no additional study of this topic is needed. However, because voluntary attrition rates are not static, OIG will continue to monitor the situation and initiate additional work on this topic if necessary.

Background

Introduction

The Enterprises' combined capital markets businesses, which include their funding, hedging, and investment activities, manage portfolios of more than $1.1 trillion of mortgage-related assets. These portfolios share certain characteristics with a hedge fund and, like a hedge fund, they may sustain significant financial losses. Accordingly, although the Enterprises' capital markets businesses have generally been profitable, certain elements have incurred tens of billions of dollars in losses since the Enterprises entered into conservatorships overseen by FHFA in

September 2008. For this reason, OIG initiated a series of evaluations relating to FHFA's supervision of the Enterprises' capital markets businesses.[1]

OIG began this evaluation after the Enterprises disclosed in their 2011 annual filings concerns regarding voluntary attrition among employees with specialized skill sets. Earlier, in a November 2011 congressional hearing, Fannie Mae's CEO testified that Fannie Mae's 2011 voluntary attrition rate was "already double our historical experience."[2] Similarly, Freddie Mac's CEO testified that "voluntary attrition rates for high performing employees have risen markedly since we were placed into conservatorship."[3] FHFA confirmed these concerns in its 2011 annual report to Congress.[4] Further, in its 2011 annual examination reports of the Enterprises, FHFA described human capital risk as one of the most significant risks facing the Enterprises.

Although the immediate concerns that gave rise to OIG's evaluation were the Enterprises' disclosures of human capital risk across the Enterprises generally, OIG focused on the Enterprises' capital markets businesses because of their portfolios' size, complexity, and susceptibility to sustaining significant losses.

Fannie Mae's Attrition Rate

Fannie Mae's Capital Markets Group (CMG) manages Fannie Mae's investment activity in mortgage-related assets and other interest-earning non-mortgage investments. Fannie Mae funds these investments with proceeds from debt issuances. These investments are hedged using derivatives.

In late 2012, Fannie Mae provided FHFA with voluntary attrition rate and employee headcount data for CMG. Based on that data, OIG determined CMG's total cumulative voluntary attrition rate for January 2010 through September 2012. The total cumulative voluntary attrition rate is

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[1] *See, e.g.*, OIG, *Case Study: Freddie Mac's Unsecured Lending to Lehman Brothers Prior to Lehman Brothers' Bankruptcy*, EVL-2013-03 (Mar. 14, 2013) (online at: http://www.fhfaoig.gov/Content/Files/EVL-2013-03_1.pdf); OIG, *The Housing Government-Sponsored Enterprises' Challenges in Managing Interest Rate Risks*, WPR-2013-01 (Mar. 11, 2013) (online at: http://www.fhfaoig.gov/Content/Files/WPR-2013-01_2.pdf); and OIG, *FHFA's Oversight of Freddie Mac's Investment in Inverse Floaters*, EVL-2012-009 (Sept. 26, 2012) (online at: http://www.fhfaoig.gov/Content/Files/EVL-2012-009.pdf).

[2] Fannie Mae, *Testimony of Michael J. Williams, President and Chief Executive Officer, Before the U.S. House of Representatives Committee on Oversight and Government Reform, Pay for Performace: Should Fannie and Freddie Executives Be Receiving Millions In Bonuses?* (November 16, 2011) (online at: http://www.oversight.house.gov/wp-content/uploads/2012/01/11-16-11_Full_Williams_Testimony.pdf).

OIG did not independently obtain and verify the data underlying Fannie Mae's CEO's testimony.

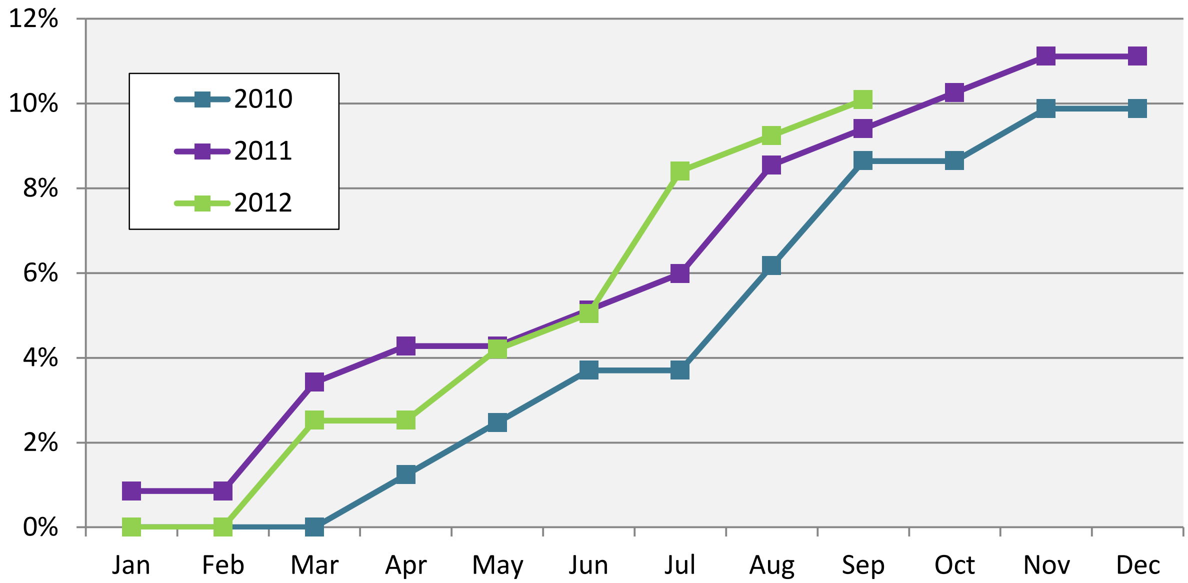
[3] Freddie Mac, *Testimony of Charles E. Haldeman, Chief Executive Officer, Before the U.S. House of Representatives Committee on Oversight and Government Reform, Pay for Performace: Should Fannie and Freddie Executives Be Receiving Millions In Bonuses?* (November 16, 2011) (online at: http://www.oversight.house.gov/wp-content/uploads/2012/01/11-16-11_Full_Haldeman_Testimony.pdf).

OIG did not independently obtain and verify the data underlying Freddie Mac's CEO's testimony.

[4] FHFA, *Report to Congress 2011*, at IV and 7 (June 13, 2012) (online at: http://www.fhfa.gov/webfiles/24009/FHFA_RepToCongr11_6_14_508.pdf).

calculated as a ratio of cumulative monthly voluntary terminations over the total number of employees at CMG at the end of the prior year. OIG found that CMG's total cumulative voluntary attrition rate increased somewhat from January 2010 through September 2012. However, over the same period, CMG's headcount grew from 108 to 143, suggesting that, although still a concern, the human capital risk posed by the increase in attrition rates is mitigated as CMG was able to grow its ranks.

FIGURE 1. Fannie Mae CMG – Cumulative Voluntary Attrition Rate

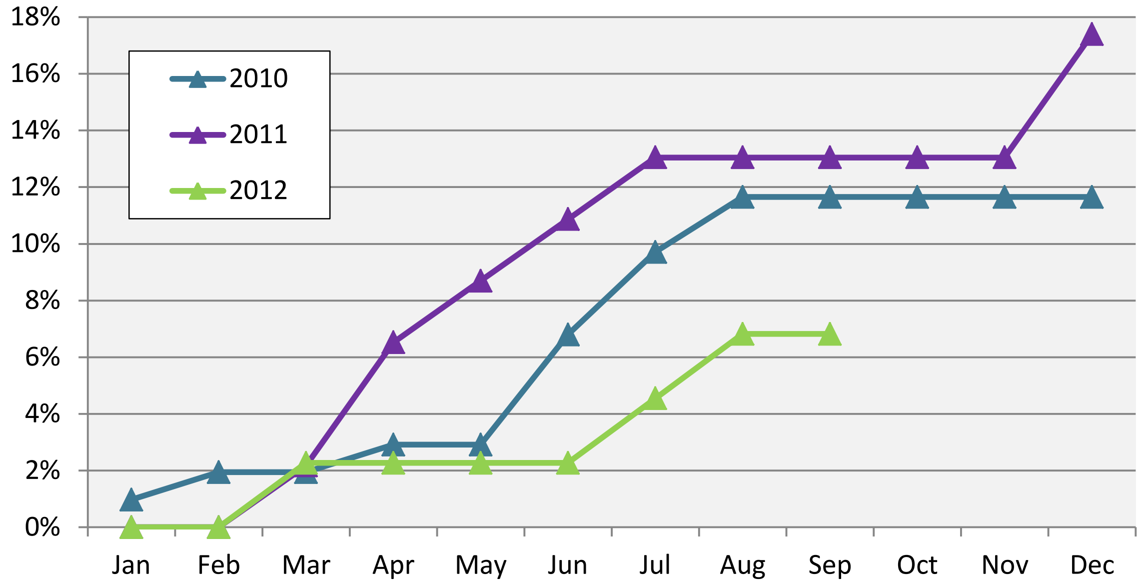


Freddie Mac's Attrition Rate

Freddie Mac's Investments & Capital Markets Division (ICM) manages Freddie Mac's investment activity in mortgage-related assets and other interest-earning non-mortgage investments. As is the case with Fannie Mae's CMG, Freddie Mac's ICM funds these investments with proceeds from debt issuances. Similarly, these investments are hedged using derivatives.

In the first half of 2013, OIG obtained voluntary attrition rate and employee headcount data for ICM. Based on that data, OIG determined ICM's total cumulative voluntary attrition rate for January 2010 through September 2012. Although ICM's 2011 total cumulative voluntary attrition rate was noticeably higher than its 2010 rate, its 2012 rate was lower than its 2011 rate, implying a stabilization of staff retention rates over the period reviewed.

FIGURE 2. Freddie Mac ICM – Cumulative Voluntary Attrition Rate



This result is consistent with statements made in Freddie Mac's 2012 annual disclosure that, although the Enterprise may find it difficult to attract and retain skilled employees, voluntary turnover moderated in 2012 compared to 2011.[5]

Findings

1. Since the beginning of conservatorship, voluntary attrition of employees with specialized skill sets has risen markedly. The Enterprises' significant human capital risk is described by FHFA in its 2011 annual report to Congress and its examination reports of the Enterprises, and by the Enterprises in their public disclosures.

2. As of late 2012, human capital risk posed by voluntary attrition within the Enterprises' capital market businesses, while still a concern, appears to have been mitigated. This addressed, in part, OIG concerns regarding human capital risk.

Conclusion

OIG found that human capital risk posed by voluntary attrition rates within the Enterprises' capital market businesses that led to the initiation of this evaluation, although still a concern, had been managed to the point that no additional study on this topic is needed. However, voluntary attrition rates are not static; rather, they fluctuate over time. An improving economy puts additional pressure on the Enterprises' attrition rates as attractive opportunities become available to their employees. Therefore, OIG will continue to monitor FHFA's oversight of the

[5] Freddie Mac, *Form 10-K for the Fiscal Year Ended December 31, 2012*, at 9, 55, 177, and 332 (Feb. 28, 2013) (online at: http://www.freddiemac.com/investors/er/pdf/10k_022813.pdf).

Enterprises' human capital resources and planning associated with the human capital risk and initiate additional work on this topic if necessary.

Scope and Methodology

The purpose of this evaluation was to assess human capital risk associated with voluntary attrition in the Enterprises' capital markets activities.

As noted above, OIG obtained attrition and employee headcount data for the capital markets offices of both Enterprises. Using this data, OIG calculated the total cumulative voluntary attrition rate for each capital markets office from January 2010 through September 2012. This rate is defined as the ratio of cumulative monthly voluntary terminations over the total number of employees at CMG or ICM, as the case may be, at the end of the prior year. OIG did not independently test the reliability of the Enterprises' data.

The preparation for this evaluation closeout report was conducted under the authority of the Inspector General Act, and is in accordance with the *Quality Standards for Inspection and Evaluation* (January 2012), which was promulgated by the Council of the Inspectors General on Integrity and Efficiency. These standards require OIG to plan and perform an evaluation that obtains evidence sufficient to provide reasonable bases to support the findings made herein. OIG believes that the findings discussed in this report meet these standards.

This study was conducted by David P. Bloch, Director, Division of Mortgage, Investments, and Risk Analysis; Ezra Bronstein, Investigative Counsel; and Simon Z. Wu, Ph.D., Chief Economist. OIG appreciates the cooperation of FHFA and Enterprise staff, as well as the assistance of all those who contributed to the preparation of this report. It has been distributed to Congress, the Office of Management and Budget, and others and will be posted on OIG's website, www.fhfaoig.gov.

The performance period for this evaluation closeout report was from May 2012 to June 2013.

cc: Edward DeMarco, Acting Director
Rick Hornsby, Chief Operating Officer
John Major, Manager, Internal Controls and Audit Follow-Up

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