Federal Housing Finance Agency
Office of Inspector General

FHFA's Oversight of Two Mission-Related Requirements for Federal Home Loan Bank Long-Term Advances

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OFFICE OF INSPECTOR GENERAL
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TO: Sandra Thompson, Deputy Director, Division of Housing Mission and Goals
Fred Graham, Deputy Director, Division of Federal Home Loan Bank Regulation

FROM: Kyle D. Roberts, Acting Deputy Inspector General for Evaluations

SUBJECT: FHFA's Oversight of Two Mission-Related Requirements for Federal Home Loan Bank Long-Term Advances (ESR-2015-005)

Summary

This memorandum closes our evaluation of the Federal Housing Finance Agency's (FHFA or Agency) oversight of two mission-related requirements for long-term advances.

Our review identified instances in which FHFA's implementation of the community support requirement for long-term advances greater than one year fell short of the Agency's regulatory requirements. Although these deficiencies have not been fully remediated, FHFA has represented to us that it is in the process of addressing them. We also conducted a limited review of FHFA's oversight of the residential housing finance requirement for long-term advances greater than five years and found no material noncompliance.

This closing memorandum is intended to promote the Agency's efficient administration of its own regulations setting forth the terms under which the Federal Home Loan Banks (FHLBanks) can make long-term advances to FHLBank members. We intend to monitor developments on these issues and will subsequently test whether FHFA has fulfilled its responsibility to remediate deficiencies.

Facts

The FHLBank Act, as amended, authorized the FHLBanks to provide secured loans, known as advances, to their members.[1] For long-term advances, the FHLBank Act provided that certain mission-related requirements had to be met.[2] The FHLBank Act directed the Federal Housing Finance Board (FHFB), FHFA's predecessor, to "adopt regulations establishing standards of community investment or service for members . . . to maintain continued access to long-term advances" and specified that these standards include "factors such as a member's performance under the Community Reinvestment Act" and "the member's record of lending to first-time homebuyers."[3] Pursuant to this statutory directive, FHFB issued regulations, which are now enforced by FHFA, defining any advance with an original maturity greater than one year as a "long-term advance."[4] Additionally, the FHLBank Act required that long-term advances generally had to be made for residential housing finance, defined for this purpose by regulations as advances with original maturities greater than five years.[5]

Analysis

FHFA's Implementation of the Community Support Requirement

FHFA regulations require the Agency to review FHLBank members approximately every two years to determine whether they meet the standards to FHFA's satisfaction.[6] An FHLBank member selected for community support review must provide to FHFA: (1) its Community Reinvestment Act (CRA) rating, if it is subject to the CRA, and (2) information about its support for first-time homebuyers.[7] As implemented, the first-time homebuyer support standard is satisfied by a showing of one of a number of specified activities.[8] As FHFA Director Watt

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[1] 12 U.S.C. § 1430(a)(1). The FHLBank System was created by the FHLBank Act of 1932 to support mortgage lending. The FHLBank System is currently comprised of 12 regional banks and the FHLBank System's fiscal agent, the Office of Finance. In total, the FHLBanks have approximately 7,500 members. Members of the FHLBanks include banks, thrift institutions, credit unions, insurance companies, and community development financial institutions. For a description of the FHLBank System and its operations, see FHFA Office of Inspector General, *Semiannual Report to the Congress: April 1, 2014, through September 30, 2014*, at 56-58 (Oct. 31, 2014) (online at: www.fhfaoig.gov/Content/Files/EighthSemiannualReport_0.pdf).

[2] As the Office of Inspector General (OIG) for FHFA, one aspect of our mission is to "conduct . . . activities . . . for the purpose of promoting economy and efficiency in the administration of [the Agency]." Inspector General Act of 1978, 5 U.S.C. App. § 4(a)(3).

[3] 12 U.S.C. § 1430(g)(1), (2).

[4] 12 C.F.R. § 1290.1. One year was chosen so that the requirement would apply to more advances. *See* 56 Fed. Reg. 58639, 58642 (Nov. 21, 1991).

[5] 12 U.S.C. § 1430(a)(2)(A); 12 C.F.R. § 1266.1.

[6] 12 C.F.R. §§ 1290.2(a), 1290.3(c).

[7] *See* 12 C.F.R. §§ 1290.2(c), 1290.3(a)-(c).

[8] The list of activities tracks a list specified in the regulations at 12 C.F.R. § 1290.3(c)(1)(i)-(iv):

recently testified: "The mission focus of the FHLBank System is an important component of FHFA's regulatory activities."[9] Within FHFA, the Division of Housing Mission and Goals (DHMG) is responsible for conducting the biennial community support reviews.

Our evaluation showed that FHFA failed to follow its own regulatory requirements, in several respects:

- **Failure to conduct biennial reviews.** By regulation, FHFA reviews FHLBank members for community support approximately every two years. FHFA has recognized the importance of these biennial reviews, stating: "[i]f FHFA did not collect the information at least biennially, it would be unable to determine effectively

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(i) Has an established record of lending to first-time homebuyers;

(ii) Has a program whereby it actively seeks to lend or support lending to first-time homebuyers, including, but not limited to, the following—

(A) Providing special credit products with flexible underwriting standards for first-time homebuyers;

(B) Participating in Federal, State, or local government, or nationwide homeownership lending programs that benefit, serve, or are targeted to, first-time homebuyers; or

(C) Participating in loan consortia for first-time homebuyer loans or loans that serve predominantly low- or moderate-income borrowers;

(iii) Has a program whereby it actively seeks to assist or support organizations that assist potential first-time homebuyers to qualify for mortgage loans, including, but not limited to, the following—

(A) Providing, participating in, or supporting special counseling programs or other homeownership education activities that benefit, serve, or are targeted to, first-time homebuyers;

(B) Providing or participating in marketing plans and related outreach programs targeted to first-time homebuyers;

(C) Providing technical assistance of financial support to organizations that assist first-time homebuyers;

(D) Participating with or financially supporting community or nonprofit groups that assist first-time homebuyers;

(E) Holding investments or making loans that support first-time homebuyer programs;

(F) Holding mortgage-backed securities that may include a pool of loans to low- and moderate-income homebuyers;

(G) Participating or investing in service organizations that assist credit unions in providing mortgages; or

(H) Participating in Bank targeted community lending programs; or

(iv) Has any combination of the elements described in paragraphs (c)(1)(i), (ii), or (iii) of this section.

[9] U.S. House of Representatives Committee on Financial Services, Written Testimony of FHFA Director Melvin L. Watt, *Sustainable Housing Finance: An Update from the Director of the Federal Housing Finance Agency*, at 17 (Jan. 27, 2015) (online at http://financialservices.house.gov/UploadedFiles/HHRG-114-BA00-WState-MWatt-20150127.pdf).

whether [FHLBank] members satisfy the community support standards they are required by statute to meet in order to maintain access to long-term [FHLBank] advances."[10] FHFA launched the 2010-2011 review cycle in 2010 but did not complete that review cycle until 2013. As a result, the Agency never conducted the 2012-2013 review cycle.

A DHMG employee reported to us that one employee had been conducting community support reviews, with the help of some interns. According to a May 2012 email from a DHMG employee to the Deputy Director of FHFA's Division of Federal Home Loan Bank Regulation (DBR), other assignments pushed the community support work to the back burner. FHFA's tardy completion of the 2010-2011 review cycle in 2013 meant that FHLBank members were reviewed once, rather than twice, during this four-year period.

We identified a member that received long-term advances even though it would have been restricted if FHFA had conducted a timely 2012-2013 review.[11] As a result of its failure to conduct the 2012-2013 review cycle, FHFA, the FHLBanks, and the public lack assurance that FHLBank members that received long-term advances were, in fact, eligible for them.

- **Failure to include all FHLBank members subject to community support review in the 2010-2011 review cycle.** Our evaluation showed that FHFA failed to review all FHLBank members that were subject to community support review during the 2010-2011 review cycle, which was the last completed review cycle, and we drew the following observations:
    - The database DHMG uses to select members for community support reviews is missing a substantial number of members. For the 2010-2011 review cycle, FHFA reviewed nearly 6,000 FHLBank members,[12] but the Office of Finance reports that the number of FHLBank members exceeded 7,500 at year-end 2010 through 2013.[13] OIG asked FHFA to provide the DHMG community

[10] FHFA, *Community Support Requirements* (OMB Number 2590-0005) (online at www.reginfo.gov/public/do/DownloadDocument?documentID=357846&version=0).

[11] In July 2012, the member received a CRA rating of "substantial noncompliance," which should have resulted in its access to long-term advances being restricted subsequently. FHFA did not conduct the 2012-2013 review cycle, however, and the member received an additional $35 million in long-term advances.

[12] For the 2010-2011 cycle, conducted from 2010 through 2013, FHFA told OIG that it reviewed 5,954 members.

[13] FHLBank members totaled 7,849 at year-end 2010; 7,774 at year-end 2011; 7,635 at year-end 2012; and 7,504 at year-end 2013. OIG recognizes that not all of the FHLBank members should be reviewed: new members are not reviewed in their first year of membership; some FHLBank members leave the FHLBank System, and community development financial institutions are not subject to community support reviews. After accounting for these factors, OIG estimates that more than 700 members were omitted from the 2010-2011 review cycle.

support database, in database format, to allow comparison with DBR's spreadsheet of FHLBank members used for other business purposes. Instead, FHFA provided a hard-copy list of members in the DHMG database, noting that this format would maintain the integrity of the data. OIG compared DHMG's list to DBR's and noted more than 1,000 active members missing from DHMG's list, many of which joined the FHLBank System after October 2008.[14] DHMG officials confirmed to us that the DHMG database used to identify FHLBank members for community support reviews did not include all FHLBank members.[15] OIG observed that FHFA did not routinely add new members to the community support database.

- In addition, some members in the DHMG database were not reviewed. By way of example, information provided by FHFA on 120 large borrowers showed that, for the 2010-2011 cycle, FHFA did not review 19 large insurance company borrowers that were in DHMG's database.[16] Six of these omitted insurance companies had been reviewed in prior cycles. An FHFA official was unable to explain why some previously reviewed members were not reviewed in the 2010-2011 cycle.

FHFA officials advised OIG that efforts are underway to reconcile DHMG's community support database with DBR's membership database.[17] In addition, based on the work done to date for the 2014-2015 review cycle, an FHFA employee projected to us that this review cycle is on track to be completed on time. FHFA reported to us that it is drafting policies and procedures for its community support reviews, with an estimated completion date of the second quarter of 2015.

[14] However, OIG also identified several FHLBank members that were not on the hard copy list but, according to FHFA, were reviewed in the 2010-2011 cycle, raising questions about the accuracy of the list DHMG provided.

[15] An FHFA official who formerly oversaw this area told OIG he was aware that a significant number of members were not included in the community support database. He speculated that FHFA's proposal to shift responsibility for community support reviews to the FHLBanks might have led FHFA to defer database upgrades. For the proposal, see 76 Fed. Reg. 70069 (Nov. 10, 2011).

[16] FHFA provided OIG with the most recent community support review for the 10 largest advance borrowers for each of the 12 FHLBanks as of the end of 2013. These 120 members accounted for nearly three-quarters of advances outstanding. Of these 120 members, 30 were insurance companies, 20 of which should have been reviewed in the 2010-2011 cycle (i.e., they were not in their first year of membership). However, FHFA did not review any of these 20 insurance companies in that cycle. Together they held between approximately $31 billion and $39 billion of long-term advances with original terms greater than one year at year-end 2013. All FHLBank members combined held $341 billion of long-term advances. Of these 20 non-reviewed insurance companies, 19 were in DHMG's database and 1 was missing. In contrast to insurance companies, FHFA did review most other large borrowers during the 2010-2011 cycle. The omission of insurance company members is notable given that nearly 90% of insurance company advances outstanding were long term at year-end 2013, and insurance companies are not subject to CRA.

[17] OIG observed that, during the 2014-2015 cycle, FHFA selected some new FHLBank members for review.

OIG considers these steps responsive to deficiencies identified during our work and anticipates that FHFA will take the actions necessary to comply with its regulations.

FHFA's Oversight of the Residential Housing Finance Requirement

Under the FHLBank Act, as amended, long-term advances generally "may only be made for the purposes of . . . providing funds to any member for residential housing finance."[18] Governing regulations define long-term advances for this purpose as advances with original maturities greater than five years.[19] To satisfy this statutory directive, FHFB adopted a proxy test:[20] prior to approving a long-term advance, the FHLBank must determine that the total dollar amount of the member's long-term advances is equal to or less than the total book value of the member's residential housing finance assets.[21] Satisfaction of the proxy test is not an ongoing requirement. Members can sell residential housing finance assets after receiving a long-term advance as long as the advance remains collateralized.

According to FHFA officials, its examiners typically do not assess the FHLBanks' administration of the proxy test during annual examinations. FHFA considers this area to be a low risk for two reasons: advances are frequently collateralized with residential housing finance assets in an amount sufficient to pass the proxy test,[22] and most advances are short-term advances not subject to the residential housing finance requirement.

OIG reviewed data on recent long-term advances made by five FHLBanks to 41 large borrowers. This review identified only one instance of technical noncompliance with FHFA's regulatory requirements.[23] FHFA represented to us that it discussed the matter with the affected FHLBank and that the FHLBank committed to consider improvements to its processes.

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[18] 12 U.S.C. § 1430(a)(2).

[19] 12 C.F.R. § 1266.1.

[20] FHFB recognized that "the fungibility of money makes it very difficult and costly to track the actual use of an advance." 58 Fed. Reg. 29456, 29465-67 (May 20, 1993).

[21] Residential housing finance assets are defined in regulations as: (1) loans secured by residential real property; (2) mortgage-backed securities (MBS); (3) participations in loans secured by residential real property; (4) loans or investments providing financing for economic development projects for targeted beneficiaries; (5) loans secured by manufactured housing; (6) any loans or investments which FHFA, in its discretion, otherwise determines to be residential housing finance assets; and (7) for community financial institution (CFI) members, small business loans, small farm loans, small agribusiness loans, or community development loans. 12 C.F.R. § 1266.1. A CFI is a depository institution member insured by the Federal Deposit Insurance Corporation with assets below a cap (approximately $1.1 billion for 2014). *See* 12 U.S.C. § 1422(10).

[22] In contrast to the proxy test, collateral is an ongoing requirement. Collateral is often but not necessarily residential housing finance assets.

[23] In this instance, the proxy test was met using outdated member financial information. FHFA advised us that it believes the proxy test would have been met using current information, but it was unfortunate that the FHLBank relied on outdated information.

Conclusion

This memorandum closes OIG's survey of FHFA's oversight of the community support and residential housing finance requirements for long-term advances.

Scope and Methodology

The objective of this evaluation was to assess FHFA's oversight of two mission-related requirements for FHLBank long-term advances. To address this objective, OIG interviewed officials and reviewed documents from FHFA and from five FHLBanks. The sample of FHLBanks included FHLBanks with varying percentages of long-term advances outstanding. It was not chosen as a statistical sample, and OIG does not project the results to the other FHLBanks. OIG obtained information from a sixth FHLBank about advances to one of its members. The documents OIG reviewed included the five FHLBanks' policies and procedures related to community support reviews and to the proxy test. OIG also reviewed documents such as the FHLBank Act, regulations regarding community support reviews and the proxy test, FHFA's notices published in the Federal Register listing FHLBank members selected to be reviewed for community support, related FHFA examination modules, and recent FHFA Reports of Examination of the FHLBanks.

Regarding the community support requirement, OIG obtained a summary of the results of FHFA's reviews by review cycle. OIG also obtained FHFA's most recent community support review for the ten largest advance borrowers from each of the 12 FHLBanks based on advances outstanding at year-end 2013; these 120 members accounted for nearly three-quarters of advances outstanding. OIG obtained the dates individual members joined the FHLBank System in order to determine whether the members without community support reviews should have been reviewed in the 2010-2011 cycle. OIG also compared the number of members FHFA reviewed for community support during the 2010-2011 review cycle to the number of FHLBank members, considering changes in membership. In addition, OIG compared DBR's list of active FHLBank members with the members in DHMG's community support database. OIG also identified FHLBank members that had received CRA ratings of "substantial noncompliance" in recent years and whether they had received long-term advances. OIG reviewed email correspondence of a former FHFA employee who had managed the Agency's community support review process. OIG also reviewed all comments FHFA received from the public regarding FHLBank members being reviewed for community support in the 2010-2011 cycle.

Regarding the residential housing finance requirement, OIG asked five FHLBanks to identify their three largest long-term (greater than five years) advance borrowers in 2013 for each of three member types: commercial banks, thrift institutions, and insurance companies. For these nine FHLBank members (or seven members in two cases where the FHLBank had only one insurance company that received long-term advances in 2013), OIG obtained information about their long-term advances made in 2012 and 2013. For each such advance, the information included the member's total long-term advances and residential housing finance assets so that OIG could assess whether, based on the data provided, the proxy test was met.

OIG did not independently test the reliability of FHFA's or the FHLBanks' data systems.

This review was conducted under the authority of the Inspector General Act 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 a reasonable basis to support its conclusions. OIG believes that this review meets these standards.

A draft of this memorandum was sent to FHFA.

The performance period for this review was April 2014 to February 2015.

This review was led by Beth Preiss, Senior Investigative Evaluator, in collaboration with Ezra Bronstein, Investigative Counsel, and Angela Choy, Director, Division of Program Oversight.

We appreciate the cooperation of FHFA and the FHLBanks and 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.

cc: The Honorable Melvin L. Watt, FHFA Director

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