# FEDERAL HOUSING FINANCE AGENCY

# OFFICE OF INSPECTOR GENERAL

## Federal Housing Finance Agency's Exit Strategy and Planning Process for the Enterprises' Structural Reform

EVALUATION REPORT: EVL 2011 001 DATED: MARCH 31, 2011

# AT A GLANCE

**EVALUATION REPORT: EVL 2011 001** **DATED: MARCH 31, 2011**

## Why We Did This Evaluation

The housing government-sponsored enterprises, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (collectively, the Enterprises), suffered billions of dollars in losses in 2007 and 2008. The Enterprises' regulator, the Federal Housing Finance Agency (FHFA), placed them into conservatorships in September 2008, and the U.S. Department of Treasury (Treasury) agreed to provide substantial financial support to them. To date, Treasury has invested more than $153 billion in the Enterprises, and as of the third quarter of 2010 they financed approximately 67 percent of newly-issued mortgage-backed securities.

On February 11, 2011, the Administration proposed reforms to the Enterprises' fundamental roles and structures. The FHFA Office of Inspector General (FHFA-OIG) initiated this evaluation to identify the steps FHFA is expected to take in the short- to medium-term under the Administration's proposal and the adequacy of its planning efforts to do so.

## What We Recommend

The FHFA should take specific steps to help ensure the effective implementation of its responsibilities, including: (1) establishing 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; and (2) developing 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. FHFA agreed with these recommendations.

## What We Found

The Administration's February 11, 2011, proposal recommends that FHFA implement several steps under its regulatory authority in the short- to medium-term to significantly reduce the Enterprises' dominant position in the housing finance system, which the Administration views as contributing to excessive risk-taking and exposing taxpayers to significant losses. These short- to medium-term regulatory steps, including requiring the Enterprises to raise guarantee fees on the mortgage-backed securities they issue, are intended to offset their cost advantages over potential competition and thereby encourage greater private sector participation and capital in mortgage finance. Over the longer-term, the Administration proposes that Congress should enact legislation that could further restrict the Enterprises' role in housing finance or eliminate them altogether.

FHFA-OIG views FHFA's potential implementation of its regulatory authorities under the Administration's proposal in the short- to medium-term as an area of significant risk because, if not managed effectively, its actions could have negative consequences such as unnecessarily limiting mortgage credit.

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# ABBREVIATIONS

| | |
|---|---|
| DODD FRANK | Dodd-Frank Wall Street Reform and Consumer Protection Act |
| FANNIE MAE | Federal National Mortgage Association |
| FHA | Federal Housing Administration |
| FHFA | Federal Housing Finance Agency |
| FHFA-OIG | Federal Housing Finance Agency, Office of Inspector General |
| FHFB | Federal Housing Finance Board |
| FHLBANKS | Federal Home Loan Banks |
| FREDDIE MAC | Federal Home Loan Mortgage Corporation |
| GAO | Government Accountability Office |
| GINNIE MAE | Government National Mortgage Association |
| GPRA | Government Performance and Results Modernization Act of 2010 |
| GSE | Government-Sponsored Enterprises |
| HERA | Housing and Economic Recovery Act of 2008 |
| HUD | Department of Housing and Urban Development |
| MBS | Mortgage-Backed Securities |
| OFHEO | Office of Federal Housing Enterprise Oversight |
| OMB | Office of Management and Budget |
| TREASURY | U.S. Department of the Treasury |

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Office of Inspector General
**Federal Housing Finance Agency**
Washington, DC

# PREFACE

The Federal Housing Finance Agency (FHFA/Agency) Office of Inspector General (OIG) was established by the Housing and Economic Recovery Act of 2008 (HERA) (Public Law No. 110-289), which amended the Inspector General Act of 1978 (Public Law No. 95-452), to conduct audits, investigations, and other activities of the programs and operations of FHFA, to recommend policies that promote economy and efficiency in the administration of such programs and operations, and to prevent and detect fraud and abuse in them. This is one of a series of audits, evaluations, and special reports published as part of FHFA-OIG's oversight responsibilities to promote economy and efficiency in the administration of FHFA's programs.

This evaluation assesses the adequacy of the FHFA plans to effectively implement the short- to medium-term elements of the Administration's proposal to reduce the roles of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) in the U.S. housing finance system. The evaluation is based on interviews with FHFA employees and officials, direct observations, and a review of applicable documents.

The recommendations herein have been developed with the best knowledge available to FHFA-OIG and have been discussed in draft with those responsible for implementation. FHFA-OIG trusts that this evaluation will result in more effective, efficient, and economical operations. FHFA-OIG expresses our appreciation to all those who contributed to the preparation of this evaluation.

This evaluation has been distributed to Congress, FHFA, the Office of Management and Budget, and others, and will be posted on FHFA-OIG's website, http://www.fhfaoig.gov/.

Richard Parker
Acting Deputy Inspector General for Evaluation

# PURPOSE OF EVALUATION

The purpose of this evaluation was to assess the adequacy of the Federal Housing Finance Agency's (FHFA/Agency) plans to implement effectively the short- to medium-term elements of the Administration's proposal to reduce the roles of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) in the U.S. housing finance system.

# INTRODUCTION

The financial conditions of Fannie Mae and Freddie Mac (collectively, the Enterprises) were dramatically weakened by the housing finance crisis, but since the onset of the crisis their share of the U.S. housing finance market has grown. Fannie Mae and Freddie Mac are housing government-sponsored enterprises (GSEs) that were established, among other reasons, to help provide liquidity to the housing finance system, including during periods of economic stress. In 2007 and 2008, the U.S. housing finance system began to suffer its worst downturn since the Great Depression, and Fannie Mae and Freddie Mac lost billions of dollars. In September 2008, as the Enterprises' losses mounted, FHFA placed them into conservatorships, and the U.S. Department of Treasury (Treasury) began providing substantial financial support that purportedly has stabilized their financial conditions.[1] The conservatorships were viewed as a temporary measure to stabilize the Enterprises' financial conditions; they were not intended to be permanent. Further, as of February 25, 2011, Treasury has invested more than $153 billion in the Enterprises. FHFA estimates that the total taxpayer investment could range from $221 billion to $363 billion through 2013.[2]

As the housing finance crisis continued and private sector financing plummeted, the federal government - through the Enterprises, the Federal Housing Administration (FHA), and the Government National Mortgage Association (Ginnie Mae) - assumed a dominant position in mortgage finance.[3] Specifically, as of the third quarter of 2010, the Enterprises financed approximately 67 percent of all newly originated mortgage securities, and Ginnie Mae financed about 29 percent.[4] Meanwhile, FHFA, other federal financial

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[1] Additionally, in November 2008, the Federal Reserve announced a program to purchase up to $1.25 trillion of the Enterprises' mortgage-backed securities.

[2] FHFA press release, October 21, 2010, available at http://www.fhfa.gov/webfiles/19409/Projections_102110.pdf.

[3] FHA is an agency within the Department of Housing and Urban Development (HUD) that provides insurance on certain mortgages and compensates lenders for borrower defaults and foreclosures on these mortgages. Ginnie Mae is a government corporation that guarantees investors will receive the timely payment of principal and interest on mortgage securities collateralized by FHA-insured and other government-guaranteed mortgages.

[4] FHFA, Third Quarter 2010 Conservator Report, available at http://www.fhfa.gov/webfiles/19585/Conservator's_Report112910.pdf.

regulators and agencies, financial observers, trade groups, and academics have observed that Congress and the Administration need to reach agreement on fundamental, permanent reforms to the housing finance system, including the nature and scope of the Enterprises. Moreover, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), required Treasury to submit a plan to Congress to reform key components of the housing finance system.

On February 11, 2011, the Administration submitted its plan, which recommends the wind down of the Enterprises, and that FHFA institute a serie-s of initiatives under its regulatory authority in the short- to medium-term. Such initiatives include: increasing guarantee fees and down-payment requirements that are intended to reduce gradually the Enterprises' dominant role in the housing finance system; encouraging greater private sector participation and capital in mortgage finance; and minimizing risks and potential taxpayer losses. The Administration's proposal thus seeks to reduce the federal role in housing finance by leveling the playing field and encouraging the private sector.

On the day that the Administration's proposal was released, FHFA's Acting Director stated that he was pleased the Administration had put forward a framework to strengthen the Nation's housing finance system, restore the critical role of private capital, and identify options for the long-term structure of housing finance.[5] Further, the Acting Director said he will consider and discuss with the Administration the details of the framework, consistent with its responsibilities as both conservator and regulator, and looks forward to working with the Administration and Congress to restore the functioning of private markets and preserve the stability and liquidity of the secondary mortgage market.

Given the significant impact that FHFA's actions under the Administration's proposal will likely have upon the Enterprises and the housing finance system, FHFA-OIG commenced a review of the Agency's planning processes to implement the Administration's short- to medium-term initiatives. Specifically, our objectives were to:

1. Identify FHFA's efforts to prepare and plan for the Enterprises' eventual exits from their conservatorships prior to the announcement of the Administration's proposal on February 11, 2011;
2. Identify FHFA's specific roles and responsibilities under the Administration's proposal, and assess whether the Agency has an effective planning process for implementation; and
3. Provide early insights into FHFA's resources and capacity to implement effectively the Administration's short- to medium-term plans to limit the Enterprises' role in the housing finance system, as well as meet its responsibilities as both conservator and regulator.

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[5] Statement of FHFA Acting Director Edward DeMarco on February 11, 2011, available at http://www.fhfa.gov/webfiles/19696/Statement_021111.pdf.

# SCOPE AND METHODOLOGY

To complete our work, we:

- Reviewed the Administration's proposal, FHFA documents, and the Government Performance and Results Modernization Act of 2010 (GPRA), which establishes federal planning standards;
- Interviewed FHFA officials regarding their participation in the development of the Administration's proposal to reform the Enterprises' structures, as well as how they plan to implement the proposal's various requirements; and
- Analyzed FHFA materials pertaining to its organizational structure and the number of examiners that it has to carry out its existing mission, and discussed these issues with Agency management.

The scope of our work was largely confined to those portions of the Administration's proposal that FHFA can implement under its existing regulatory authority, such as raising the Enterprises' guarantee fees or down-payment requirements. Based upon the Acting FHFA Director's statements, we understand that the Agency is evaluating the Administration's short- to medium-term proposals. We do not comment on the appropriateness of any particular long-term reform policy option included in the Administration's proposal, which FHFA may not have existing regulatory authority to implement.

We conducted our evaluation under the authority of the Inspector General Act of 1978, as amended, and according to the Quality Standards for Inspection and Evaluation (January 2011) which has been promulgated by the Council of Inspectors General on Integrity and Efficiency. These standards, which are generally accepted across the federal government, require us to plan and perform our evaluations so as to obtain evidence sufficient to provide reasonable bases for our findings and conclusions. We trust that the evidence set forth herein meets these standards. We performed our evaluation during the period November 2010 to March 2011.

We provided FHFA staff with briefings and presentations concerning the results of our fieldwork and the information summarized in this evaluation.

We appreciate the efforts of FHFA management and staff in providing the information and access to necessary documents to accomplish this evaluation. Appendix B identifies major FHFA-OIG contributors to this evaluation.

# BACKGROUND

To fulfill their charter and legislative obligations to provide liquidity to and support the mortgage finance system, the Enterprises helped develop what is commonly known as the secondary mortgage market. As leaders in the secondary mortgage market, they purchase mortgages that meet their underwriting standards.[6] Such mortgages are referred to as conventional, conforming mortgages, and the Enterprises purchase them from mortgage originators such as banks and thrifts. In turn, the originators can use the proceeds of the sales of mortgages to the Enterprises to make additional mortgages. The Enterprises hold some of the mortgages that they purchase in their retained portfolios. Their combined mortgage portfolios stood at about $1.5 trillion at year-end 2010 (*see* Figure 1). The Enterprises may also package mortgages that they purchase into **Mortgage-Backed Securities (MBS)**, which are then sold to other investors in the secondary mortgage market. In exchange for a fee (the "guarantee fee"), the Enterprises guarantee the timely payment of mortgage interest and principal on MBS that they compile, package, and sell. As shown in Figure 1, as of year-end 2010, the Enterprises had outstanding guarantees on approximately $4.9 trillion worth of MBS.[7]

**Mortgage Backed Securities are created when the sponsor buys up mortgages from lenders, pools them, and packages them for sale to the public, a process known as securitization. *See* http://financial dictionary.thefreedictionary.com /Mortgage Backed+Security**

As their share of the U.S. housing finance market deteriorated in the middle of the last decade, the Enterprises increasingly supplemented their earnings with non-traditional investments. From about 2004 through 2007, the Enterprises purchased large volumes of **private-label MBS**, which at the time had investment grade ratings, but, nonetheless, were backed by subprime mortgage assets. Further, the Enterprises purchased large volumes of what are known as Alt-A mortgages (mortgages that lack documentation of key items such as borrowers' incomes), and packaged them into guaranteed MBS, which were sold to investors. When the housing finance system suffered a substantial downturn in 2007 and 2008, the Enterprises suffered billions of dollars in losses on these investments and guarantees. As a

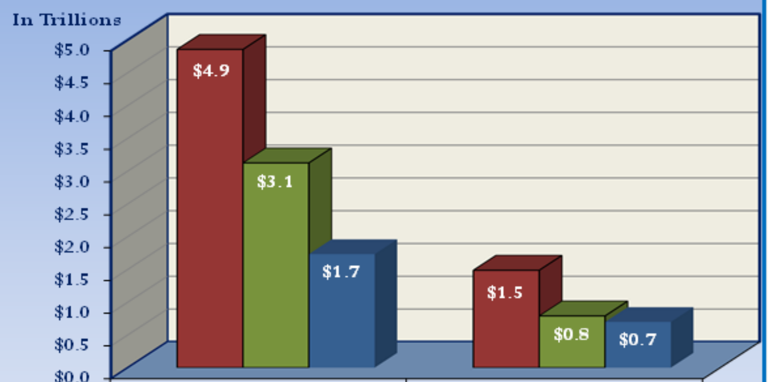
**Private Label MBS are securitized mortgages that do not conform to the criteria set by the Enterprises and Ginnie Mae. *See* http://securitization.weekly.com/ private label mbs.html.**

[6] These standards include limits on the size of loans the Enterprises may purchase, referred to as the conforming loan limit, which varies by region and currently has a maximum value of $729,750 for single-family properties in the contiguous U.S. The Enterprises also have traditionally required 20 percent homeowner equity (*i.e.*, down-payments) in mortgages that they purchase (loan to value ratio of 80 percent) or required mortgage insurance on mortgages with less than 20 percent equity (*i.e.*, loan to value ratios that exceed 80 percent).

[7] The Enterprises may also hold their own MBS in their retained mortgage portfolios.

consequence of these and additional losses, the Enterprises were placed into conservatorships in September 2008.

**Figure 1: Financial Obligations of Fannie Mae and Freddie Mac**
As of December 31, 2010




| | Guaranteed MBS Outstanding (a) | Retained Mortgage Portfolio (a) |
|---|---|---|
| Total | $4,854,368 | $1,485,645 |
| Fannie Mae (b) | $3,122,780 | $788,771 |
| Freddie Mac (c) | $1,731,588 | $696,874 |

Notes/Source:
(a) Dollars set forth in units of millions.
(b) Fannie Mae "Monthly Summary, December 2010."
(c) Freddie Mac "Monthly Volume Summary, December 2010."

The FHLBank System is a housing GSE that consists of 12 regionally-based Federal Home Loan Banks (FHLBanks). The FHLBank System's primary mission is to support housing finance and community and economic development. To carry out its mission, the FHLBank System issues debt in capital markets, generally at relatively favorable rates due to its GSE status, and each FHLBank makes loans (advances) to member financial institutions, such as banks and thrifts, located in its region. Traditionally, member institutions have secured advances by pledging single-family mortgages or investment-grade securities as collateral to their FHLBank. Like the Enterprises, FHLBanks also generally have investment portfolios that hold mortgage-related securities. Several FHLBanks invested in subprime MBS prior to 2008, and have subsequently suffered significant losses due to these investments. As of September 30, 2010, the FHLBanks had total assets of $903 billion of which advances and investments constituted approximately 90 percent (about $830 billion).

FHFA was established by the Housing and Economic Recovery Act of 2008 (HERA). Prior to the enactment of HERA, the Office of Federal Housing Enterprise Oversight (OFHEO), which was an independent entity within HUD, was responsible for Fannie Mae's and Freddie Mac's safety and soundness oversight. HUD, on the other hand, was responsible for overseeing their housing mission achievement. Unlike other federal banking regulators, OFHEO lacked authority to set appropriate capital standards for the Enterprises. Another agency, the Federal Housing Finance Board (FHFB), was the safety and soundness and mission regulator of the FHLBank System. HERA established FHFA as the expert safety and soundness and housing mission regulator for all of the housing GSEs and provided the Agency with authorities similar to those of bank regulators, such as added flexibility to set capital standards. FHFA is authorized to conduct examinations, develop regulations, and issue enforcement orders, as deemed appropriate. Like other federal financial regulators, such as the Federal Deposit Insurance Corporation, FHFA finances its activities through assessments on its regulated entities, the housing GSEs, as opposed to through the Congressional appropriations process.

# FINDINGS

### *1. FHFA Has Taken Steps to Improve the Enterprises' Finances and Operations During Their Conservatorships*

FHFA officials have advised that, since the establishment of the Enterprises' conservatorships in September 2008, the Agency has taken several steps to strengthen the Enterprises' financial condition and operational practices. FHFA officials view these steps as consistent with the overall purposes of a conservatorship to preserve and maintain assets, and an eventual exit strategy. In particular, pursuant to its authority under HERA, FHFA removed certain members of the Enterprises' boards of directors and certain senior officers, and replaced them with new officials. FHFA officials have mentioned that, since the inception of the conservatorships, the Enterprises have adopted much more conservative mortgage purchase, underwriting, and investment standards. For example, the Enterprises have increased their standards regarding mortgage borrowers' credit scores and down-payment requirements, and they have raised their MBS guarantee fees to help offset potential risks. Further, the Enterprises' purchases of private-label MBS backed by subprime mortgages and of Alt-A mortgages have ceased. FHFA officials also have stated that restoring the Enterprises' financial condition and operational practices will likely facilitate their transition to whichever long-term reform option is decided upon.

Although FHFA has taken steps to improve the Enterprises' financial condition and operational practices, it has not developed an overall Agency planning strategy for the Enterprises to exit the conservatorships. According to FHFA officials, their decision not to engage in any such planning was due to several factors. Foremost among them is the scope of the effort involved in establishing new missions and structures for the Enterprises. In particular, they said that purported flaws in the Enterprises' corporate structures can only be addressed through legislation. FHFA officials and others have often stated that the Enterprises' status as GSEs allowed them to issue debt at relatively favorable rates, operate with limited capital, and engage in excessive risk-taking with taxpayers potentially exposed to resulting losses.

To address the Enterprises' alleged structural and systemic defects, the Administration has developed and evaluated reform strategies for nearly a year. In April 2010, Treasury and HUD issued for public comment seven questions regarding the future of the housing finance system. One question related to the future roles of Fannie Mae and Freddie Mac. Treasury and HUD received approximately 300 public comments, and held a conference in August 2010 regarding the future of the housing finance system and the appropriate roles of the Enterprises. Dodd-Frank also required Treasury to submit a plan for the future of the housing finance system, including the Enterprises' roles. The Administration submitted such a plan on February 11, 2011.

To assist in the Administration's planning process, FHFA officials said that the Agency hosted several meetings with Treasury and other officials to help explain how the Enterprises operate. They also provided technical assistance to Treasury and other officials, upon request. However, FHFA officials stated that they did not actively participate in the development of the policy options that the Administration forwarded to Congress on February 11, 2011. These FHFA officials explained that they believe it would not have been appropriate for the Agency, as the Enterprises' conservator and independent regulator, to actively participate in the development of such broad policy options.

### *2. FHFA Has a Significant Role in Implementing the Administration's Enterprise Reform Proposal in the Short- To Medium-Term, and Careful Planning Is Essential*

According to the Administration's proposal, gradually decreasing the Enterprises' role in the housing finance system is a primary goal of overall reform of the system. The proposal identifies a variety of problems with the Enterprises' current structures, which need to be addressed to encourage the private sector and capital to return to the housing finance system, and to limit future taxpayer losses similar to those associated with the conservatorships.

Over the long-term, the Administration's proposal, as it relates to reducing the role of the Enterprises, lays out three options for Congress to consider. Namely, eliminating the Enterprises:

- In their entirety;
- In their entirety, but establishing an insurer to protect against catastrophic mortgage insurance losses; and
- In their current form, but allowing private companies to issue MBS that would be protected by a government reinsurance guarantee program.

The proposal also includes an analysis of the various advantages and disadvantages associated with each long-term option. Further, the proposal states that the FHLBank System's mission should be to focus its advance business on small- and medium-sized lenders rather than large lenders. Narrowing the FHLBank System's focus would reduce the housing GSEs' role in mortgage finance. Similar to the approach for reducing the Enterprises' role in the housing finance system, the proposal would limit FHA's role by raising its mortgage insurance premiums.

In addition to these long-term structural options, the Administration's proposal recommends that FHFA, under its existing regulatory authority, take several steps in the short- to medium-term to further its overall goal of limiting the Enterprises' existing role in the housing finance system. The Administration also articulates its support for other actions that FHFA is in a position to influence. These actions are intended to raise gradually the Enterprises' cost of doing business or the costs associated with the mortgages that they finance, and, thereby, encourage private lenders and others to compete with the Enterprises. In particular, the proposal recommends or supports that, under FHFA oversight, the Enterprises:

- Increase guarantee fees on their MBS;

- Increase the down-payment requirements for the mortgages that they purchase; and
- Decrease their mortgage investment portfolios.

In carrying out these responsibilities, the proposal recommends that FHFA serve on a joint working group with FHA to consider changes to pricing and other standards. It also recommends that FHFA and FHA seek public comment on the appropriate pace of the transition, issue a timeline for tightening standards and raising pricing, and provide regular reports to various entities within the executive branch, specifically the Financial Housing Finance Oversight Board and the Financial Stability Oversight Council.

Although the Administration's short- to medium-term recommendations are new and FHFA is in the process of evaluating them, we believe that planning is essential to their efficient and successful implementation. For example, the establishment of timelines and benchmarks is critical to assess progress in implementing plans, and is consistent with GPRA planning requirements. The Administration's proposal contemplates substantial changes to the housing finance system, and in particular the Enterprises' dominant role in it. The Enterprises' domination has evolved over many years, and change likely will be challenging. Accordingly, it will be critical for market participants and others to understand FHFA's timelines, benchmarks, and methodologies for, among other initiatives, raising guarantee fees and down-payment requirements. This way they can judge whether FHFA's actions are achieving their intended results of reducing the Enterprises' role in the housing finance system. Further, without such information, market participants may lack the ability to adjust to the proposed changes, which could potentially affect financial market stability and mortgage availability and terms.

Moreover, to the extent FHFA implements the Administration's short- to medium-term initiatives, the Agency will need to establish robust protocols to apprise the public of its efforts. The Administration's proposal does not recommend that FHFA establish an external communication strategy. It is critical, however, that federal agencies are transparent and open when implementing strategies, and that they establish methods to provide information to external stakeholders, such as Congress, on an ongoing basis. The Administration, Congress, market participants, and others will need ongoing information and analysis about the contemplated changes to the Enterprises' role in the housing finance system. Without such information, the potential exists that external stakeholders will not understand FHFA's planning and strategies, or changes thereto, and their impact on the mortgage finance system. Further, the Administration and Congress may not be adequately informed about any changes that may be necessary to FHFA's plans and strategies, and, thus, will be unable to make necessary adjustments to help ensure FHFA's success.

### *3. FHFA's Capability to Meet Multiple Responsibilities Raises Concerns*

Although FHFA's resources and capacity to carry out its multiple responsibilities, including those contained in the Administration's proposal, have not yet been the subject of a formal FHFA-OIG audit or evaluation, they raise concerns and are a major priority for our future work. Created in 2008, FHFA is a relatively new agency that replaced the previously fragmented regulatory structure for the housing GSEs. Prior to 2008, three agencies, OFHEO, HUD, and FHFB, independently provided oversight of the GSEs. Establishing a common culture, singular regulatory approach, and consistent policies would have been challenging under normal circumstances, but in FHFA's case these challenges were further aggravated by the housing finance crisis and the weakened financial condition and operational practices of the Enterprises. For example, within weeks of its establishment, FHFA appointed itself as the Enterprises' conservator, an unprecedented action given the Enterprises' size and substantial roles in the housing finance system. Under the conservatorships, FHFA staff members have multiple responsibilities not ordinarily required of a federal financial regulator. These responsibilities include appointing senior officers, approving their performance and compensation levels, attending boards of directors meetings (and in some cases participating in them), and reviewing the regulated entities' required financial statements. It also should be noted that FHFA staff have had to cope with the fact that several FHLBanks have experienced financial and operational challenges in recent years, largely due to their investments in subprime mortgage assets.

Under current circumstances, it is unclear whether FHFA has sufficient resources to meet its existing responsibilities as conservator for the Enterprises as well as impending responsibilities contained in the Administration's proposal. Prior to the publication of the Administration's proposal, FHFA announced a reorganization and staffing increase. FHFA's Acting Director announced plans for the Agency to hire approximately 75 to 80 additional staff, which represents an increase of about 16 percent (FHFA has approximately 466 positions filled). According to the Acting Director, the strain placed on FHFA by the conservatorships is a major contributing factor for the reorganization and the plan to hire additional staff. Regulatory responsibilities under Dodd-Frank are another factor. On the other hand, the Acting Director did not mention the then unpublished Administration proposal to reform the housing finance system as a factor in his decision to reorganize and augment staff.

Moreover, it is not clear at this point whether FHFA will be able to attract a sufficient number of skilled individuals to occupy the new positions. The planned hires cover a range of responsibilities, particularly bank examiners with experience gained from other federal financial regulatory agencies. However, FHFA's Acting Director advised that it may be difficult to hire the desired personnel for a number of reasons, including:

- An unwillingness to move to the Washington, D.C. area, which is where the Enterprises are located; and
- The Administration's stated intention to wind down the Enterprises over time, which could affect FHFA's long-term viability.

FHFA must compete with, among others, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, as well as state regulatory agencies, for experienced staff, and the other agencies have offices throughout the nation and offer perceptibly better job security.

As discussed previously, the Administration's proposal calls for FHFA to play a critical role in efforts over the short- to medium-term to reduce the Enterprises' current role in the housing finance system. This supplemental responsibility will be challenging and delicate, given that, as of the third quarter of 2010, the Enterprises financed about 67 percent of new MBS issuances, market participants are familiar with their general business practices, and the housing finance system remains fragile. In the latter regard, for example, if FHFA causes the Enterprises to raise guarantee fees too quickly, there could be a negative reaction within the housing finance system that could unnecessarily restrict the availability of mortgage credit or result in mortgage terms, such as interest rates, that are unaffordable to many potential borrowers. This and other new responsibilities associated with FHFA's implementation of the Administration's proposal could further stress FHFA staff. Therefore, FHFA-OIG is concerned about the breadth of FHFA's responsibilities and its capacity to fulfill them. FHFA-OIG plans to monitor carefully these issues over time.

# CONCLUSIONS

To the extent that FHFA implements the Administration's short- to medium-term recommendations to limit the Enterprises' dominant positions in the housing finance system, it is essential that the Agency develop a systematic planning process to do so. As the Enterprises' regulator and conservator, FHFA is uniquely positioned to assess such factors as the appropriateness of their guarantee fees and down-payment requirements and how much higher those standards would need to be to offset the Enterprises' current cost advantages over private sector competitors. Further, FHFA is positioned to assess how market participants and borrowers might react to changes in the Enterprises' roles and whether any further changes are necessary to ensure a better transition. Failure on the part of FHFA to adopt critical elements of effective planning such as timelines, benchmarks, criteria, methodologies, information requirements, and an external reporting strategy could hinder its success.

Finally, it is critical that FHFA have the capacity to meet both its existing responsibilities as conservator and regulator of the Enterprises and its new responsibility under the Administration's proposal to manage a short- to medium-term effort to limit the Enterprises' presence in the housing finance system.

Going forward, these issues will require careful monitoring by the FHFA, the FHFA-OIG, the Administration, Congress, and others.

# RECOMMENDATIONS

We recommend that FHFA take the following steps as it implements its regulatory responsibilities in the short- to medium-term under the Administration's proposal:

1. 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; and
2. Develop an external reporting strategy, which might include the augmentation of existing reports, to chronicle its progress, including the adequacy of its resources and capacity to meet multiple responsibilities and mitigate any shortfalls.

# FHFA COMMENTS AND FHFA-OIG'S RESPONSE

FHFA-OIG provided a draft of this evaluation to FHFA for its review and comment. On March 22, 2011, FHFA's Senior Associate Director for Conservatorship Operations provided the Agency's written comments, which are published verbatim in Appendix A. FHFA agreed with the draft evaluation's recommendations in its written comments.

# APPENDIX A: MANAGEMENT COMMENTS TO THE DRAFT REPORT

Federal Housing Finance Agency

**MEMORANDUM**

TO: Richard Parker, Acting Deputy Inspector General for Evaluations

FROM: Jeffrey Spohn, Senior Associate Director for Conservatorship Operations

SUBJECT: Evaluation Report on the Federal Housing Finance Agency's Exit Strategy and Planning Process for the Enterprises' Structural Reform (Report No. EVL-2011-001)

DATE: March 22, 2011

This memorandum transmits the Federal Housing Finance Agency's (FHFA) management responses for the two recommendations resulting from the evaluation performed by your staff from November, 2010 to March, 2011.

This memorandum: (1) identifies management's agreement with the recommendations; and (2) identifies the actions that FHFA will take to address the recommendations.

**Recommendation 1:** Establishing 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.

**Management Response:**
FHFA agrees with the recommendation. As noted within this report, the Administration's white paper recommends a gradual transition to greater private capital participation in housing finance and greater distribution of mortgage risk to participants other than the government. FHFA has already begun implementing several aspects to further this transition. Specifically, in conservatorship the Enterprises have greatly strengthened their underwriting standards and improved the risk sensitivity of their pricing.

The white paper calls for further steps in this direction. It also calls for a review of ways to bring greater private capital to the mortgage market, including increased down payments, expanded private sector risk-sharing, and further adjusting pricing to reflect as one can the pricing that would result in a more purely private-sector operated market. Such steps are consistent with actions FHFA has already taken in conservatorship and we are examining further options along these lines in support of a stable transition over time.

Once final decisions are made regarding these future actions and initiatives, FHFA agrees that developing appropriate tracking and monitoring systems are necessary. Accordingly, the development of these systems will be commensurate with the level and scope of the initiative.

**Recommendation 2:** Developing an external reporting strategy, which might include the augmentation of existing reports, to report on its progress, including the adequacy of its resources and capacity to meet multiple responsibilities and mitigate any shortfalls.

**Management Response:**
FHFA agrees with the recommendation. FHFA agrees that transparency in external reporting is necessary. At the present time, we have a variety of external reporting vehicles and we will continue to augment those reports as appropriate. The reports will also include the adequacy of resources to meet our objectives and initiative.

# APPENDIX B: MAJOR CONTRIBUTORS TO THIS REPORT

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- Call: OIG Hotline at 1-800-793-7724
- Fax: 202-408-2972
- Visit: www.fhfaoig.gov or
- Write to us at:

Federal Housing Finance Agency
Office of Inspector General
1625 Eye Street, NW
Washington, DC 20006-4001