

**FEDERAL HOUSING FINANCE AGENCY
OFFICE OF INSPECTOR GENERAL**

**Evaluation of FHFA's Role in Negotiating
Fannie Mae's and Freddie Mac's Responsibilities in
Treasury's Making Home Affordable Program**





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AT A GLANCE

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Why FHFA-OIG Did This Evaluation

In early 2009, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively the Enterprises) began participating in the Department of the Treasury's (Treasury's) Making Home Affordable Program (MHA). One key MHA initiative, the Home Affordable Modification Program (HAMP), involves mortgage servicers agreeing to modify mortgage terms (e.g., lower the monthly payment) for borrowers facing imminent default or foreclosure.

The Enterprises participate in HAMP and modify loans in their portfolios. They also administer and enforce the program for other loan servicers as Treasury's financial agents under Financial Agency Agreements (FAAs).

Questions have arisen concerning the Enterprises' participation in MHA. Some argue that Treasury has employed the Enterprises to manage the MHA program in ways that jeopardize their financial interests and has done so without adequate consultation and coordination with the Federal Housing Finance Agency (FHFA), potentially compromising its independence as the Enterprises' conservator and regulator.

The FHFA Office of Inspector General (FHFA-OIG) initiated this evaluation to assess the relationship between FHFA and Treasury in the context of FHFA's oversight of Fannie Mae's and Freddie Mac's participation in MHA programs.

What FHFA-OIG Recommends

FHFA-OIG recommends that FHFA engage in negotiations with Treasury and the Enterprises to amend the FAAs by incorporating a specific dispute resolution process under which the parties may discuss differences that arise in the Enterprises' administration of HAMP and establish strategies by which to resolve or mitigate them.

What FHFA-OIG Found

FHFA-OIG found no evidence that in developing and implementing MHA programs Treasury has compromised FHFA's independence as the Enterprises' conservator and regulator. The Emergency Economic Stabilization Act of 2008 (EESA) requires FHFA to coordinate within the federal government in developing and implementing loan modification programs such as HAMP. FHFA has supported HAMP as a means to limit the Enterprises' credit losses by minimizing costly foreclosures. At the same time, FHFA has exhibited independence by prohibiting the Enterprises from participating in other MHA programs that it views as being inconsistent with their financial soundness.

However, FHFA did not play an active role in reviewing and negotiating Treasury's FAAs with the Enterprises. The FAAs represented long-term commitments of significant resources at a time when there were substantial concerns about the Enterprises' financial and operational capacity. Nevertheless, FHFA limited its review to ensuring that the Enterprises were legally authorized to enter into the FAAs and did not review their substance. As a consequence, two key terms were left undefined: the scope of the work to be performed by the Enterprises, and the terms under which they would be compensated. Significant problems developed in both of these areas almost from the beginning, requiring FHFA and the Enterprises to devote substantial time and resources to their resolution. Thus, FHFA-OIG finds that FHFA's conservatorship interests would have been better served if FHFA had played a greater role during the negotiation and review of the FAAs.

In early 2010, Treasury, FHFA, and the Enterprises developed a new method for reviewing and approving tasks assigned to the Enterprises under the FAAs. It represents a significant improvement over the process contained in the initial FAAs. However, the lack of a specific dispute resolution process in the revised approach increases the risk that disputes among parties will not be resolved efficiently.

TABLE OF CONTENTS

ABBREVIATIONS	4
PREFACE	5
BACKGROUND	8
Overview of the Enterprises’ Activities, FHFA’s Conservatorship Authority, and Treasury’s Financial Support for the Enterprises	8
Overview of Treasury’s MHA Programs.....	10
The Enterprises Administer MHA Programs Such as HAMP on Treasury’s Behalf.....	11
Treasury’s Initial FAAs with the Enterprises in 2009 Did Not Define Key Terms, Leading to Significant Disputes.....	12
Treasury, FHFA, and the Enterprises Developed a More Formalized Process in 2010	14
FINDINGS	16
CONCLUSIONS.....	21
RECOMMENDATION	21
SCOPE AND METHODOLOGY	22
APPENDIX A.....	23
FHFA’s Comments on Findings and Recommendation	23
APPENDIX B	25
FHFA-OIG’s Response to FHFA’s Comments	25
APPENDIX C	26
Major FHFA-OIG Contributors to the Evaluation.....	26
ADDITIONAL INFORMATION AND COPIES	27

ABBREVIATIONS

BOS.....	Business Objectives Statement
EESA.....	Emergency Economic Stabilization Act
FAA.....	Financial Agency Agreement
Fannie Mae.....	Federal National Mortgage Association
FHFA	Federal Housing Finance Agency
FHFA-OIG	Federal Housing Finance Agency Office of Inspector General
Freddie Mac	Federal Home Loan Mortgage Corporation
HAMP	Home Affordable Modification Program
HERA.....	Housing and Economic Recovery Act of 2008
MHA	Making Home Affordable Program
PSPAs	Preferred Stock Purchase Agreements
TARP	Troubled Asset Relief Program
Treasury	U.S. Department of the Treasury

Federal Housing Finance Agency

Office of Inspector General

Washington, DC

PREFACE

FHFA-OIG was established by the Housing and Economic Recovery Act of 2008 (HERA),¹ which amended the Inspector General Act of 1978,² 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 evaluation is one of a series of audits, evaluations, and special reports published as part of FHFA-OIG's oversight responsibilities.

Fannie Mae and Freddie Mac are government-sponsored enterprises that support the nation's housing finance system. To do so, Fannie Mae and Freddie Mac purchase mortgages from loan sellers; they can then use the sales proceeds to originate additional mortgages.

In September 2008, due to the Enterprises' mounting mortgage-related losses, FHFA placed them into conservatorships. FHFA, as the Enterprises' conservator and regulator, is responsible for preserving their assets and minimizing taxpayer losses. At the same time, Treasury agreed to provide financial support to the Enterprises to help stabilize their financial condition. As of June 30, 2011, Treasury had invested a total of \$162.4 billion in the Enterprises.

In February 2009, the Enterprises began participating in Treasury's MHA Program. MHA is comprised of several programs, the largest of which is HAMP, a loan modification program.³ Under HAMP, certain borrowers who are delinquent on their mortgages are offered the opportunity to restructure them. With respect to loans that they own, the Enterprises offer borrowers the opportunity to participate in HAMP. The Enterprises have also entered into FAAs with Treasury under which the Enterprises administer some MHA programs. Pursuant to the FAAs, Fannie Mae administers the implementation of HAMP programs, policies, and procedures, and Freddie Mac ensures that HAMP participants comply with applicable policies and procedures.

A number of risks are associated with the Enterprises' participation in MHA programs. The Enterprises have noted in their public securities filings that their participation in loan

¹ Public Law No. 110-289.

² Public Law No. 95-452.

³ It was not an objective of this evaluation to analyze the merits or accomplishments of HAMP and other MHA programs, and FHFA-OIG makes no findings or recommendations regarding them.

modification programs exposes them to financial risks, such as the costs associated with contacting delinquent borrowers and administering loan modifications, as well as the high potential for borrowers with modified mortgages to re-default on their loans. Moreover, the Enterprises' administration of HAMP causes them to incur additional costs and to divert resources from managing their business operations.

Since the Enterprises' participation in MHA began, concerns have been raised that Treasury has employed the Enterprises to manage the MHA program in ways that jeopardizes their financial stability. Some have questioned whether Treasury adequately consulted with FHFA in the design and implementation of MHA.

Senator David Vitter requested that FHFA-OIG assess the relationship between FHFA and Treasury. FHFA-OIG then commenced this evaluation and found:

- **No evidence that Treasury's actions with respect to its MHA programs have compromised FHFA's independence as the Enterprises' conservator and regulator.** FHFA has statutory responsibilities under EESA⁴ to assist homeowners to avoid foreclosures and to coordinate within the federal government to improve loan modification and restructuring efforts. FHFA considers the Enterprises' participation in HAMP to be consistent with EESA's mandates, as well as a means to limit the credit losses associated with foreclosures. Further, FHFA has not permitted the Enterprises to participate in other MHA programs that Agency officials believe would jeopardize the Enterprises' financial conditions.
- **FHFA could have played a greater role during the negotiation and review of Treasury's FAAs with the Enterprises in 2009.** A greater role was appropriate because: (1) the FAAs involved five-year commitments by the Enterprises to administer efforts to potentially modify millions of delinquent mortgages; and (2) the Enterprises' capacity to meet this administrative responsibility was uncertain due to their compromised financial and operational conditions. Despite these risks, FHFA largely confined its oversight role to determining whether the Enterprises were legally authorized to enter into the FAAs; it did not substantively review the agreements' contents. Additionally, it did not identify key unresolved issues, such as the terms under which Treasury would reimburse the Enterprises and the scope of administrative work they were expected to perform. As a result, throughout 2009 and early 2010, FHFA had to resolve a number of issues associated with its inaction: that Treasury did not compensate adequately the Enterprises for their work; that the Enterprises were asked to initiate risky and costly projects that were outside of the scope of the FAAs; and that the

⁴ Public Law No. 110-343.

Enterprises were diverting their limited resources away from higher priority projects.

- **The revised FAAs establish a more formal administrative process, but do not include specific dispute resolution provisions.** Since early 2010, Treasury, FHFA, and the Enterprises have taken steps to develop a formal process of proposing, reviewing, and budgeting new MHA administrative work covered by the FAAs. Although the results of these efforts represent a significant improvement over the initial FAAs, the revised agreements do not establish specific procedures for resolving disputes among the parties. Consequently, a risk remains that such disputes will not be resolved efficiently.

In light of these findings, FHFA-OIG recommends that FHFA, Treasury, and the Enterprises incorporate dispute resolution provisions into the FAAs. FHFA-OIG believes that this recommendation will result in more economical, effective, and efficient operations.

FHFA-OIG appreciates the assistance of all those who contributed to the preparation of this report.

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



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BACKGROUND

Overview of the Enterprises' Activities, FHFA's Conservatorship Authority, and Treasury's Financial Support for the Enterprises

To fulfill their charter and legislative obligations to provide liquidity to and support for the mortgage finance system, Fannie Mae and Freddie Mac developed and support what is commonly known as the secondary mortgage market. In the secondary mortgage market, the Enterprises purchase mortgages that meet their underwriting criteria from loan sellers such as banks and other mortgage originators. These loan sellers can use the sales proceeds to originate additional mortgages. The Enterprises may hold the mortgages that they purchase in their investment portfolios, or they may securitize them by pooling them into mortgage-backed securities, which are sold to investors.⁵

With respect to the mortgages that they purchase and hold, the Enterprises have contractual relationships with loan servicers, such as mortgage originators or commercial banks, to carry out key post-origination functions. These functions include providing borrowers with monthly account statements, handling customer service inquiries, collecting monthly mortgage payments, administering tax and insurance escrow accounts, and forwarding mortgage payments to the Enterprises. Additionally, if borrowers fail to make payments according to the terms of their mortgage notes, the Enterprises' loan servicers are responsible for initiating loss mitigation strategies, such as working with delinquent borrowers to modify or restructure their loans. Ultimately, if a borrower's ability to repay the mortgage is not restored, then the loan servicer is responsible for commencing foreclosure proceedings. Foreclosures are generally viewed as the last step in the loss mitigation process because borrowers lose their homes, and foreclosures can be costly to lenders and the Enterprises.

On September 6, 2008, due to the Enterprises' mounting mortgage-related losses, FHFA employed its authority under HERA to declare them "critically undercapitalized" and placed them into conservatorships. FHFA's powers as the Enterprises' conservator include:

- Taking over the assets of and operating the regulated entity with all the powers of the shareholders, directors, and officers of the entity;
- Performing all functions of the regulated entity; and
- Preserving and conserving the assets and property of the regulated entity.⁶

⁵ In exchange for a fee, the Enterprises guarantee that the mortgage-backed securities investors will receive timely payment of principal and interest on their investments.

⁶ See 12 U.S.C. § 4617.

On November 24, 2008, FHFA clarified its role as conservator by identifying the activities of the Enterprises that require FHFA approval. In that regard, FHFA advised that its approval was required for, among other things:

- Actions involving capital stock, dividends, the Preferred Stock Purchase Agreements (PSPAs), an increase in risk limits, material changes in accounting policy, and reasonably foreseeable material increases in operational risk;⁷ and
- Actions that, in the reasonable business judgment of the Board at the time that the action is taken, are likely to cause significant reputational risk.

Later, in July 2009, FHFA further clarified its role by issuing a regulation requiring FHFA pre-approval of all new products offered by the Enterprises and activities in which they seek to engage.⁸

HERA also expanded Treasury's authority to provide financial support to the Enterprises,⁹ and in September 2008, Treasury entered into PSPAs with the Enterprises. The PSPAs provide that, upon determination by FHFA that an Enterprise's liabilities exceed its assets, Treasury will contribute cash capital in an amount equal to the difference and in return will receive preferred shares.¹⁰ Under the PSPAs, Treasury is obligated to provide up to \$200 billion through 2012,¹¹ and as of June 30, 2011, Treasury had invested a total of \$162.4 billion in the Enterprises.

On October 3, 2008, EESA was enacted. The Act's purposes include:

- Protection of home values and investments;
- Preservation of homeownership and promotion of jobs and economic growth; and
- Maximization of overall returns to taxpayers.¹²

⁷ "Operational risk can be defined as the risk of monetary losses resulting from inadequate or failed internal processes, people, and systems or from external events." See <http://www.frbsf.org/publications/economics/letter/2002/el2002-02.html>.

⁸ See 74 Fed. Reg. 31602 (July 2, 2009).

⁹ Public Law No. 110-289 § 1117.

¹⁰ Under the agreements, Treasury must consent and/or be consulted before the Enterprises are permitted to take certain actions including issuing capital stock, terminating conservatorship, increasing debt beyond certain limits, acquiring or merging into another entity, and entering into executive compensation arrangements.

¹¹ Treasury Fact Sheet, September 7, 2008; FHFA Mortgage Market Note 10-1, Jan. 20, 2010. Note, however, that the initial \$200 billion limitation was replaced in December 2009 "with a formulaic limit that will automatically adjust upward quarterly by the amount of any cumulative reduction in net worth over the next three years." U.S. Department of the Treasury, *Housing Government Sponsored Enterprises Programs* at GSE 9 (Feb. 14, 2011) (online at www.treasury.gov/about/budget-performance/Documents/CJ_FY2012_GSE_508.pdf).

¹² Public Law No. 110-343 § 2.

To effectuate these purposes, EESA authorized Treasury to initiate the Troubled Asset Relief Program (TARP) to purchase and fund commitments to purchase “troubled assets” from financial institutions.¹³ Additionally, EESA required that FHFA: implement a plan to maximize assistance to homeowners; use its authority to encourage the servicers of Fannie Mae and Freddie Mac mortgages to take advantage of federal programs to minimize foreclosures; coordinate within the federal government concerning homeowner assistance plans; and submit monthly reports to Congress detailing the progress of its efforts.¹⁴

Overview of Treasury’s MHA Programs

On February 18, 2009, Treasury announced the Homeowner Affordability and Stability Plan (later referred to as the MHA Program). MHA is one of the Administration’s primary strategies for addressing the foreclosure crisis. The overall purpose of MHA is to promote stability for both the housing market and homeowners by providing responsible homeowners with an opportunity to remain in their homes while they recover financially or relocate to a more sustainable living situation.

HAMP is a key component of MHA.¹⁵ It was launched as an official program of Treasury and the Department of Housing and Urban Development.¹⁶ HAMP is intended to help struggling homeowners stay in their homes by reducing their monthly mortgage payments to no more than 31% of their pre-tax monthly income. Under HAMP, participating loan servicers are required to identify and communicate with delinquent borrowers who meet the program’s guidelines.¹⁷ To reduce these borrowers’ mortgage payments, servicers may modify their loans by lowering the interest rates, extending the amortization periods, or forbearing principal. Servicers may receive incentive payments for completed permanent modifications. According to Treasury officials, the

¹³ Public Law No. 110-343 § 101. EESA defines “troubled assets” to include “any financial instrument that the Secretary ... determines the purchase of which is necessary to promote financial market stability.” *Id.* at § 3.

¹⁴ Public Law No. 110-343 § 110.

¹⁵ Prior to EESA’s enactment in October 2008, FHFA and the Enterprises had already established programs to assist borrowers who were unable to meet their monthly mortgage obligations. These programs provided for, among other things, repayment plans, forbearance arrangements, short-sales, third-party sales, and deeds-in-lieu of foreclosure. Additionally, prior to HAMP, FHFA and the Enterprises had devoted substantial resources to the joint development of the Streamlined Modification Program. It was rolled-out by FHFA and the Enterprises in November 2008. However, once it became clear that the Administration was going to launch HAMP, FHFA and the Enterprises turned their attention to that program’s development and implementation.

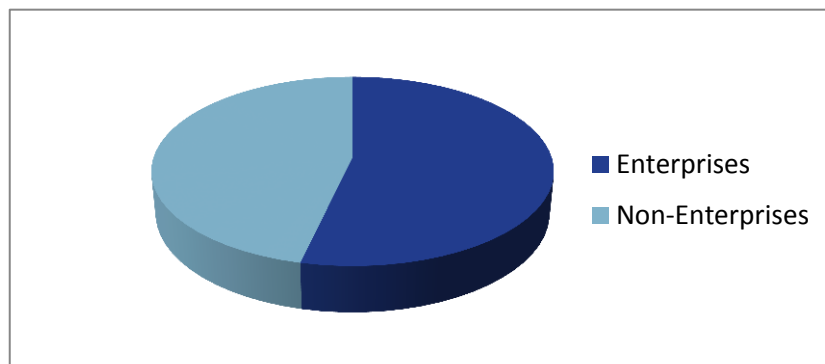
¹⁶ Another MHA program, the Home Affordable Refinance Program (HARP), was launched at the same time as HAMP. HARP is designed to assist underwater homeowners with Enterprise-owned loans to refinance them with a lower market-rate mortgage loan. HARP refinancing is not within the scope of this report.

¹⁷ Servicers, for example, may receive \$1,000 for each completed modification, an additional \$500 if the modification is for a borrower who is not yet delinquent, and an additional \$1,000 annually for up to five years if the modified loan performs well.

program was initially intended to offer reduced monthly payments to up to 3 to 4 million homeowners who were delinquent or at risk of becoming delinquent on their mortgages.¹⁸

HAMP applies to mortgages that the Enterprises own or guarantee, as well as to participating servicers' non-Enterprise mortgages that meet the program's criteria (see Figure 1). The Enterprises' mortgage servicers are generally responsible for contacting eligible borrowers and arranging loan modifications with them. Likewise, participating servicers may also make HAMP modifications to mortgages they administer but that are not owned or guaranteed by the Enterprises, such as subprime mortgages, which typically do not meet the Enterprises' underwriting criteria.

Figure 1: Break-out of Enterprise and Non-Enterprise HAMP Permanent Mortgage Loan Modifications¹⁹



The Enterprises Administer MHA Programs Such as HAMP on Treasury's Behalf

EESA provides a statutory basis for Treasury to contract with financial institutions such as the Enterprises to facilitate the implementation of TARP/MHA programs. Specifically, EESA authorizes Treasury to designate a financial institution as a "financial agent" to perform "all reasonable duties as may be required" to fulfill its duties under EESA.²⁰

Treasury selected the Enterprises to administer HAMP and certain other MHA programs. Together the Enterprises own or guarantee approximately 60% of the U.S. residential mortgage loan market. Treasury's decision was premised on the fact that they have extensive existing

¹⁸ See *Homeowner Affordability and Stability Fact Sheet*, Feb. 18, 2009, <http://www.treasury.gov/press-center/press-releases/Pages/20092181117388144.aspx>. Thus far, however, HAMP has resulted in far fewer loan modifications than initially anticipated.

¹⁹ Through June 30, 2011, there were 763,071 permanent HAMP loan modifications. Fannie Mae and Freddie Mac together owned 408,958 of the modified loans, and the remaining 354,113 modified loans were owned by entities other than the Enterprises.

²⁰ Public Law No. 110-343 § 101(c)(3).

relationships with the financial institutions that service their mortgages. Further, the Enterprises have the personnel, information systems, and other infrastructure necessary to the daily functioning of the housing finance system.

On February 18, 2009, Treasury entered into FAAs with the Enterprises, giving them a central role in executing and administering many of Treasury's MHA-related objectives.²¹ Fannie Mae acts as the program administrator for all mortgage servicers, lenders, and financial institutions that participate in HAMP. Fannie Mae's specific responsibilities include: implementing program policies and guidelines; serving as record keeper for executed modifications and program administration; and coordinating with Treasury and other parties on developments aimed at achieving programmatic goals. Additionally, Fannie Mae provides information and resources to servicers to assist them in implementing the program and helping distressed borrowers. To fulfill its role as program administrator, Fannie Mae has established a Program Management Office and dedicated other resources to the support of the program.

Freddie Mac is responsible for ensuring that all mortgage servicers and other financial institutions that participate in HAMP comply with their obligations under the HAMP Servicer Participation Agreements. Freddie Mac's specific compliance activities include reviewing the effectiveness of servicers' recruitment of eligible borrowers for HAMP and ensuring that servicers do not improperly deny eligible borrowers the opportunity to participate in the programs. In addition, Treasury requested that Freddie Mac develop a "second look" process pursuant to which it audits a sample of HAMP modification requests to assess the quality of servicer decisions. Freddie Mac has established a separate division to conduct its compliance activities, Making Home Affordable-Compliance.

Treasury's Initial FAAs with the Enterprises in 2009 Did Not Define Key Terms, Leading to Significant Disputes

Although the FAAs established essential responsibilities for the Enterprises in administering HAMP, the agreements leave critical terms undefined. As a result, FHFA and Treasury subsequently engaged in a series of disputes regarding the amount of Treasury's reimbursement of the Enterprises as well as the scope of the work that Treasury expected them to perform. As described later in this report, FHFA's lack of involvement in and oversight of the Enterprises' negotiations with Treasury concerning the FAAs in early 2009 likely contributed to these challenges.

Fannie Mae's FAA with Treasury lacks specificity as to the work Treasury expected the Enterprise to perform in its role as HAMP's administrator. For example, Fannie Mae's FAA states that the services it is to provide are "described in Exhibits A and C" of the agreement.

²¹ Since EESA, Treasury has entered into 14 FAAs with private entities. Fannie Mae and Freddie Mac's agreements are the largest, worth \$160,271,050.00 and \$111,956,539.59, respectively. See U.S. Department of Treasury, Listing of Financial Agreements (online at www.treasury.gov/initiatives/financialstability/procurement/faa/Pages/faa.aspx).

Exhibit A provides a general description of work Fannie Mae is obligated to perform to assist Treasury in designing and executing mortgage modification programs, including such things as developing a marketing plan, customer service call center, and standardized documentation. Exhibit C, however, which was entitled “Program Guidelines” and was to describe the loan modification programs to be implemented, was left blank except for the phrase “To Be Issued by the Treasury.” Freddie Mac’s FAA as the HAMP compliance agent is structured in the same incomplete manner. As described later in this report, the lack of detail in Exhibit C, combined with FHFA’s lack of oversight of the negotiations of the FAAs, led to substantial avoidable conflict.

The FAAs are also vague with respect to the terms under which Treasury will reimburse (or compensate) the Enterprises for their efforts. Both FAAs include a section on compensation and refer to payment “in accordance with Exhibit B, as amended from time to time.” Exhibit B, entitled “Budget, Funding, and Compensation” contains broad cost categories to be used in computing the program budget (i.e., personnel compensation, travel, information technology, etc.); a general description of reimbursement on a monthly basis; and a routine provision for performance incentive payments. Neither the text of the FAAs nor Exhibit B, however, address the rate at which the Enterprises may be compensated for their work, the propriety of using TARP funds for that purpose, or whether work relative to loans owned or guaranteed by the Enterprises is eligible for reimbursement.

Moreover, the FAAs were not substantively reviewed by FHFA, and FHFA is not a party to the agreements. Neither of the FAAs acknowledge FHFA’s role as the Enterprises’ conservator and regulator, nor do they reflect that the Enterprises are required to seek and obtain approval from FHFA before engaging in many activities.

As a likely consequence of the FAAs’ lack of specificity, significant disputes developed throughout 2009 and early 2010 regarding the Enterprises’ reimbursement and the appropriate scope of their work. Examples of these disputes include:

- **Enterprise Cost Reimbursement.** FHFA and Treasury engaged in a dispute over the reimbursement of the Enterprises for costs associated with administering the HAMP program with respect to loans that they owned or guaranteed. From the beginning, FHFA and the Enterprises operated under the assumption that Treasury had agreed to reimburse the Enterprises for the full costs associated with administering HAMP without differentiation between mortgages the Enterprises owned or guaranteed and all other mortgages. Conversely, Treasury took the position that TARP funds could not be used to reimburse the Enterprises for loans they owned or guaranteed. In support of the Enterprises, FHFA’s Acting Director wrote two letters to Treasury contesting Treasury’s decision not to reimburse fully the Enterprises. In letters dated December 1, 2009, and February 22, 2010, the Acting Director pointed to the absence of specific statements regarding the scope of work and operating budgets in the FAAs. He added that HAMP created

operational risks for the Enterprises and diverted staff and resources from other critical priorities. Nevertheless, the position of Treasury – which controlled the purse strings – prevailed, and the Enterprises have not been reimbursed for work related to mortgages they own or guarantee that have gone through the HAMP programs.

- **Website Development.** FHFA and Treasury also engaged in a significant dispute over Treasury’s request in November 2009 that Fannie Mae develop an Internet website associated with HAMP. As envisioned by Treasury, the website would provide borrowers with assistance in completing HAMP-related documents and submitting them to their loan servicers. However, officials in FHFA’s Office of Conservatorship Operations opined that Fannie Mae lacked the in-house expertise to complete the project, and they also raised operational and cost-based objections. Ultimately, Treasury agreed to remove Fannie Mae from the website development project.

Treasury, FHFA, and the Enterprises Developed a More Formalized Process in 2010

In an effort to limit further controversies, Treasury, FHFA, and the Enterprises took steps to develop a more formalized process to address disputes surrounding the Enterprises’ roles as HAMP administrators. In February 2010, Treasury initiated use of the Business Objectives Statement (BOS) process. The BOS process was developed jointly by Treasury, FHFA, and the Enterprises, and is designed to facilitate review and planning of additional MHA program initiatives. It has since been formalized and included in an amendment to Fannie Mae’s FAA, which was executed on February 10, 2011. A similar amendment to Freddie Mac’s agreement is being finalized and adoption is expected shortly.

The BOS process begins with a letter prepared by Treasury and transmitted to one or both of the Enterprises when a new or modified business need arises. The BOS letter identifies: (1) the program outcome that Treasury seeks to achieve, along with related high-level business requirements; and (2) the information that each Enterprise must include in a “Project Authorization Package” that is required to be provided to Treasury after considering the BOS letter.

The Project Authorization Packages prepared by the Enterprises, in turn, provide Treasury with: (1) project overview and cost estimates; (2) a statement of the budgetary impact on the Enterprises’ established and forecasted budgets; (3) an identification of any resource concerns related to organizational capacity or operations, or to financial condition or non-MHA operations of the Enterprises; and (4) an analysis of whether the Enterprises’ proposed solution is within the scope of the current FAA. Based on this information, Treasury decides whether to authorize an Enterprise to proceed with the new project.

While its role is not mentioned in Fannie Mae's amended FAA, FHFA is supervising the Enterprises' participation in the BOS process. FHFA receives a copy of each BOS letter at the time it is sent by Treasury to the Enterprises; and each Enterprise is required to submit its draft Project Authorization Packages to FHFA for review and approval before sending it to Treasury. FHFA prohibits the Enterprises from beginning work or incurring any expenses prior to Treasury authorizing the project and validating the budget.

The BOS process represents an improvement over the initial FAAs. Since the BOS process commenced, approximately 25 BOS letters have been issued by Treasury. Some of those letters have been closed or withdrawn without action by the Enterprises, and others have progressed through the Project Authorization Package stage to approval and performance.

Although the BOS process represents an improvement over the initial FAAs, Fannie Mae's revised agreement does not include a specific dispute resolution process for situations in which Treasury and the Enterprise cannot resolve their differences. As discussed later in this evaluation report, the lack of a specific dispute resolution process in the revised approach increases the risk that disputes among parties will not be resolved efficiently.

FINDINGS

On the basis of the foregoing record and interviews with FHFA and Enterprise officials, as well as reviews of relevant Agency documents, FHFA-OIG finds:

1. **No evidence that in developing and implementing HAMP Treasury has compromised FHFA's independence as the Enterprises' conservator and regulator.** EESA requires FHFA to coordinate within the federal government in the development and implementation of loan modification programs such as HAMP. FHFA has supported HAMP as a means to limit the Enterprises' credit losses by minimizing costly foreclosures. At the same time, FHFA has exhibited independence by prohibiting the Enterprises from participating in other MHA programs that it views as being inconsistent with their financial soundness.
2. **FHFA could have played a greater role during the negotiation and review of Treasury's FAAs with the Enterprises in 2009.** A greater role was appropriate because the FAAs represent long-term commitments of substantial resources at a time when there were substantial concerns about the Enterprises' financial and operational capacity. Nevertheless, FHFA did not review the substance of the FAAs prior to their finalization. Instead, FHFA confined its review to ensuring that the Enterprises were legally authorized to enter into the FAAs. By not reviewing the substance of the FAAs, FHFA failed to appreciate the impact of leaving key terms undefined.
3. **The revised FAAs establish a more formal administrative process, but do not include specific dispute resolution provisions.** In early 2010, Treasury, FHFA, and the Enterprises developed the BOS process, which represents a significant improvement over the initial FAAs. However, the lack of a specific dispute resolution process in the revised approach increases the risk that disputes among parties will not be resolved efficiently.

As a consequence of these findings, FHFA-OIG recommends that FHFA seek agreement among Treasury and the Enterprises to further amend the FAAs by including within them a specific dispute resolution process. In doing so, FHFA should look to well-established procedures within the federal government related to the management of intergovernmental business disputes, especially those that contain time limits for identifying disputes, use of a specified deciding body, and requirements for documentation of the reasoning behind an agency's disputed position.²² The inclusion of such a process within the FAAs would permit the parties to discuss

²² For example, the Office of Management and Budget directs federal agencies to follow "Business Rules for Intra-governmental Transactions" that have been developed collaboratively by the Office of Management and Budget and Treasury. *Memorandum for the Heads of Departments and Agencies*, Rob Portman, Nov. 13, 2006. The Treasury Financial Manual on Intra-governmental Business Rules provides specific guidance and requirements for resolving intra-governmental disputes and major differences. *See* Treasury Financial Manual, Bulletin Nos. 2007-03 and 2011-04.

fully the basis of any dispute between them, weigh the pros and cons of alternative courses of action, and seek consensus short of initiating potentially costly litigation.

1. No Evidence that in Developing and Implementing HAMP Treasury Has Compromised FHFA's Independence as the Enterprises' Conservator and Regulator

EESA requires FHFA to implement a plan to maximize assistance to homeowners and use its authority to encourage Fannie Mae's and Freddie Mac's mortgage servicers to take advantage of federal programs to minimize foreclosures. In addition, EESA requires FHFA to coordinate within the federal government concerning homeowner assistance plans. Since HAMP's inception in early 2009, FHFA has supported the Enterprises' participation in the program and views their participation as being consistent with the Agency's responsibilities under EESA and as a means to limit the Enterprises' credit risk exposure. The Enterprises' loan portfolios contain significant numbers of mortgages at risk of entering foreclosure thereby causing further losses to the Enterprises. But, FHFA believes that such losses can be reduced if the loans at risk can be modified through HAMP.

In the course of this evaluation, FHFA-OIG staff, who interviewed FHFA and Enterprise officials and reviewed e-mails and documents, did not identify any evidence suggesting that FHFA's internal views about the Enterprises' participation in HAMP are inconsistent with the Agency's public statements of support for the Enterprises' participation. Rather, information compiled by FHFA-OIG confirms that FHFA's private views and public assertions were consistent.

FHFA-OIG also notes that FHFA has demonstrated its independence in connection with the Enterprises' participation in Treasury's MHA. Specifically, FHFA has not permitted the Enterprises to participate in some MHA programs that the Agency views as unacceptable credit risks. For example, on January 31, 2011, FHFA formally notified Treasury of its refusal to permit the Enterprises to participate in both the HAMP Principal Reduction Alternative and the Department of Housing and Urban Development's Short Refinance programs with respect to loans that they own or guarantee.²³ The HAMP Principal Reduction program, which is currently in effect for non-Enterprise loans, requires servicers to consider HAMP-eligible borrowers with greater than a 115% loan-to-value ratio for reduction of the loan's unpaid principal balance. Similarly, the Short Refinance program offers underwater borrowers who are current on their mortgages the opportunity to refinance their mortgage with a write-off or debt-forgiveness of at least 10% of the unpaid principal balance. FHFA concluded that it would be imprudent for the Enterprises to participate in either program, claiming that a very small percentage of their borrowers would qualify and the programs carry significant costs for the Enterprises.

²³ It was not an objective of this evaluation to analyze the merits of principal reduction programs or their potential applicability to the Enterprises, and FHFA-OIG makes no findings or recommendations regarding these topics.

2. FHFA Could Have Played a Greater Role During the Negotiation and Review of Treasury's FAAs with the Enterprises in 2009

According to FHFA and Enterprise officials, as well as Agency internal documents, the initial FAAs were negotiated in early 2009 under tight time constraints and great pressure to respond to the housing crisis. These factors may have contributed to the parties leaving key provisions of the FAAs, such as cost reimbursement guidelines, undefined.

FHFA-OIG has determined that FHFA largely removed itself from the oversight of the negotiation of the FAAs. FHFA believed that its appropriate role was to ensure that the Enterprises were legally authorized to administer MHA, and not to participate actively in the negotiations between the Enterprises and Treasury. Thus, FHFA did not engage in any formal substantive review designed to evaluate the FAAs' feasibility, risks, or the suitability of the Enterprises to serve as Treasury's financial agents. This lack of engagement may have contributed to the FAAs' omission of significant details concerning payments to the Enterprises and the scope of the Enterprises' responsibilities. FHFA cannot ensure that the assets of the Enterprises are conserved and preserved if it does not exercise due diligence by substantively reviewing significant Enterprise contracts such as the FAAs.

FHFA's General Counsel informed FHFA-OIG that members of his staff limited their review of the FAAs in early 2009 to determining whether, under the Enterprises' charters and authorizing legislation, they were authorized to serve as financial agents for Treasury. In a memorandum to FHFA-OIG, the General Counsel stated that the Office of General Counsel's role:

was to consider the legal foundations for an agent role for the Enterprises; it is spelled out in their charters. After that, discussions occurred between the Treasury Department and the Enterprises on the contours of the Financial Agency Agreements. At their conclusion, FHFA indicated that it did not object to the entry into Agreements and that this was founded in law.

To that end, on February 18, 2009, FHFA's Director sent letters to Fannie Mae and Freddie Mac stating that it had reviewed the FAAs under which the Enterprises would act as Treasury's financial agents for MHA; FHFA agreed that it was an appropriate exercise of each Enterprise's authority and consistent with their existing activities, and the activities to be performed by the Enterprises did not constitute a "new product" offering that required FHFA approval.²⁴ The

²⁴ FHFA's assertion that its approval was unnecessary because a "new product" was not involved missed the point. First, the February 18 letter constituted FHFA's approval of the Enterprises' services as financial agents for Treasury. Second, although the "new product" pre-approval requirement may not have been applicable to the FAAs, other FHFA requirements may have implicated FHFA's pre-approval restrictions. For example, FHFA's February 18 letter does not contain an evaluation of whether the Agency's approval was required because of the operational risks that the Enterprises would assume under the FAAs. The Enterprises' exposure to such risks as a consequence of their duties as financial agents under the FAAs was noted by FHFA's Acting Director in his February 22, 2011, letter to Treasury. Third, the question that FHFA should have considered was whether a more substantive review of the FAAs could have improved the substance of the agreements and, thereby, furthered the interests of the Enterprises and the taxpayers who support them.

FHFA Acting Director added that he considered the activities the Enterprises would undertake as financial agents supporting Treasury's mortgage relief efforts to be consistent with their charters and existing business practices.

FHFA-OIG considers FHFA's lack of involvement in the negotiations leading up to the initial execution of the FAAs to be inconsistent with its role as the Enterprises' conservator.²⁵ FHFA is authorized to preserve and conserve the assets of the Enterprises, and it has reserved to itself the right to preapprove most of the Enterprises' non-routine activities. Nonetheless, without FHFA having substantively reviewed the FAAs, the Enterprises committed to administer, for a five-year period, a program that was expected to assist millions of borrowers in modifying their mortgages or otherwise avoiding foreclosures. At the time, the Enterprises were in the early stages of the conservatorships that saved them from financial collapse, and there was no certainty that they would be able to effectuate their new administrative responsibilities.

At a minimum, FHFA had a responsibility to monitor closely the negotiations and review the final FAAs in detail to ensure their feasibility and assess their likely impact on the Enterprises. Even a cursory review would have raised significant questions about the omission from the FAAs of details concerning key terms, such as reimbursement for work related to Enterprise owned or guaranteed mortgages. The initial FAAs did not specify the extent to which Treasury would use TARP funds to reimburse the Enterprises for their administrative activities or whether the reimbursement would cover Enterprise owned or guaranteed loans. That omission later became a cause of significant controversy when Treasury refused to use TARP funds to reimburse the Enterprises for HAMP program administration costs covering mortgages they own or guarantee.

Similarly, the initial FAAs were devoid of detail regarding the activities that the Enterprises were expected to administer despite the fact that an outline of what the HAMP program would entail was then available. In the period following the execution of the FAAs, the Enterprises were repeatedly presented with new project proposals from Treasury that FHFA considered to be unduly burdensome. FHFA-OIG finds that the potential for FHFA to avoid disputes over compensation and the scope of the Enterprises' work existed at the time that the FAAs were being negotiated. FHFA did not exploit that potential by playing a more proactive role in the initial FAA negotiation and review processes.

3. The Revised FAAs Establish a More Formal Administrative Process, But Do Not Include Specific Dispute Resolution Provisions

Beginning in 2010, Treasury, FHFA, and the Enterprises established the BOS process to guide new administrative work that Treasury expects the Enterprises to perform. The BOS process helps ensure that Treasury has clearly articulated new program requirements. It also ensures that

²⁵ FHFA-OIG notes that shortly after the FAAs were executed on February 18, 2009, FHFA assigned an OGC staff member to monitor the FAAs and participate in negotiations with the Enterprises and Treasury regarding billing, new work requests, and drafting amendments to the FAAs.

the Enterprises have assessed whether they can meet those needs, as well as the impact that such potential new work may have on their existing operations. Finally, the BOS process also helps ensure that FHFA is provided with an opportunity to review Treasury's proposals, and that all parties have reached agreement on allowable costs in performing the new work.²⁶

Although the BOS process represents a significant improvement over the initial FAAs, it does not contain robust dispute resolution procedures. Rather, the limited "Disputes" paragraph in the initial FAAs continues to provide the only mechanism by which to resolve potential conflicts among Treasury, FHFA, and the Enterprises. That paragraph merely states that it is in the parties' "mutual interests to resolve disputes by agreement," and that disputes that cannot be resolved informally shall be referred up through each party's chain of command. It does not set forth a process by which the parties may resolve such continuing disagreements. Ultimately, the dispute language in the FAAs relies on the parties' reservation of rights to pursue any legal and equitable claims they may have through litigation or other means. FHFA-OIG finds that the lack of a specific dispute resolution process in the revised approach increases the risk that disputes among parties will not be resolved efficiently.

²⁶ Although Treasury and Fannie Mae formally amended their FAA to incorporate the BOS process in February 2011, Freddie Mac does not yet have an amendment to its FAA in place as of the date of this report. Nonetheless, FHFA reported to FHFA-OIG that Treasury has been following the BOS process for both Enterprises even though the relevant amendments to Freddie Mac's FAA have not been finalized.

CONCLUSIONS

FHFA-OIG has not identified any evidence to suggest that the development and implementation of Treasury's MHA program has compromised FHFA's independence as the Enterprises' conservator and regulator. FHFA has supported the Enterprises' participation in HAMP as a means to mitigate foreclosures and credit losses, and the Agency has not permitted the Enterprises to participate in other MHA initiatives that it views as potentially presenting unreasonable financial risks. On the other hand, FHFA could have played a greater role in the negotiation and review of the initial FAAs between Treasury and the Enterprises. By not monitoring the negotiations or substantively reviewing and approving the final FAAs, FHFA did not ensure that the Enterprises' valuable resources were conserved and preserved. Consequently, FHFA, Treasury, and the Enterprises committed valuable resources to the resolution of disputes arising from ambiguities in the initial FAAs that potentially could have been avoided.

To their credit, Treasury, FHFA, and the Enterprises established the BOS process in early 2010 to address some of the weaknesses of the FAAs. However, the lack of specific dispute resolution provisions in the revised agreements increases the risk that disputes among parties will not be resolved efficiently.

RECOMMENDATION

To ensure that FHFA meets its conservatorship obligations to protect the Enterprises from expending unbudgeted funds or being tasked by Treasury to perform work that is beyond the scope of the FAAs or the Enterprises' capabilities, FHFA-OIG recommends that FHFA engage in negotiations with Treasury and the Enterprises to amend the FAAs to incorporate specific dispute resolution provisions under which the parties discuss such disputes and establish a strategy to resolve or mitigate them.

SCOPE AND METHODOLOGY

The objective of this evaluation was to assess the relationship between FHFA and Treasury in the context of FHFA's oversight of the Enterprises' participation in MHA. To gain an understanding of this relationship, FHFA-OIG conducted a range of interviews with FHFA staff and senior officials. In particular, FHFA-OIG interviewed Office of Conservatorship Operations personnel and Office of General Counsel staff. FHFA-OIG also interviewed employees of Fannie Mae and Freddie Mac who were responsible for negotiating the FAAs with Treasury and leading the Enterprises' MHA work. Some individuals were interviewed more than once.

FHFA-OIG also requested that FHFA, Fannie Mae, and Freddie Mac provide documentation related to their communications with Treasury. FHFA-OIG reviewed all the documentation provided by FHFA and the Enterprises and examined other documents in the public domain including materials on FHFA's website; SEC filings; information posted on Fannie Mae's, Freddie Mac's, and the MHA's websites; and data supplied by Treasury's Office of Financial Stability, which administers TARP programs.

This evaluation was conducted under the authority of the Inspector General Act and in accordance with the Quality Standards for Inspection and Evaluation (January 2011), which was promulgated by the Council of Inspectors General on Integrity and Efficiency. These standards require FHFA-OIG to plan and perform an evaluation that obtains evidence sufficient to provide reasonable bases to support the findings and recommendation made herein. FHFA-OIG trusts that the findings and recommendation discussed in this report meet these standards.

The performance period for this evaluation was from December 2010 to June 2011.

FHFA-OIG provided FHFA staff with briefings and presentations concerning the results of its fieldwork, and provided FHFA with an opportunity to respond to a draft report of this evaluation. FHFA's comments on FHFA-OIG's draft report are reprinted in their entirety at Appendix A.

FHFA-OIG appreciates the efforts of FHFA, Fannie Mae, and Freddie Mac management and staff in providing information and access to necessary documents to accomplish this evaluation.

Appendix C identifies major FHFA-OIG contributors to this evaluation.

APPENDIX A

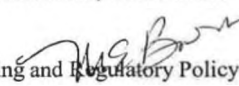
FHFA'S Comments on Findings and Recommendation



Federal Housing Finance Agency

MEMORANDUM

TO: Richard Parker, Acting Deputy Inspector General for Evaluations, Office of the Inspector General (OIG)

FROM: Meg Burns, Senior Associate Director, Office of Housing and Regulatory Policy 

SUBJECT: Evaluation Report: Evaluation of the Federal Housing Finance Agency's Relationship with the Department of the Treasury (EVL-2011-003)

DATE: July 27, 2011

This memorandum transmits the Federal Housing Finance Agency's (FHFA) management response to the recommendation resulting from the subject evaluation performed by your staff from December 2010 to June 2011. As stated in the report, the purpose of the evaluation was to assess the relationship between FHFA and Treasury in the context of FHFA's oversight of Fannie Mae's and Freddie Mac's (collectively, the Enterprises) participation in the Making Home Affordable (MHA) program.

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

Background: On February 18, 2009, Fannie Mae and Freddie Mac each entered a Financial Agency Agreement (FAA) with the Department of the Treasury. At the time the Enterprises entered the agreements, the housing finance system in the United States was in extreme distress, requiring rapid action to implement policies and programs supported by the Administration and both Houses of Congress. Credit for home mortgages had seized. Attempts to increase liquidity while stabilizing home ownership were of the highest priority. The FAAs were special agreements authorized by Congress in a time of severe market distress.

Treasury entered into separate FAAs with the Enterprises to implement and administer objectives of the Making Home Affordable program. Although the FAAs set forth the Enterprises' basic responsibilities, they did not set forth in depth certain terms relating to compensation and the programs to be implemented. These gaps were purposeful with full anticipation that negotiations would continue and significant amendments were required to the agreements entered. In other words, the FAAs as executed initially were not considered finalized documents. FHFA, through its Office of General Counsel, reviewed the FAAs, discussed them with the Enterprises, analyzed the authority to enter into them, and considered whether Conservator approval was a legal requirement. FHFA, as Conservator through its Office of Conservatorship Operations and various agency executives, considered whether entering them committed the Enterprises to appropriate business activities. Continuing negotiations throughout 2009 and 2010 addressed

additions to the initial documents, the appropriate scope of work, and the Enterprises' reimbursement.

FHFA's response to the OIG recommendation follows:

Recommendation: FHFA should seek Treasury and Enterprise agreement to further amend their respective FAAs to establish more specific dispute resolution procedures. The FAAs should be amended to establish a formal process to resolve significant disputes that cannot be resolved informally among the parties. FHFA should look to well-established procedures within the Federal government related to the management of intergovernmental business disputes, especially those that contain time limits for identifying disputes, use of a specified deciding body, and requirements for documentation of the reasoning behind an agency's disputed position.

Management Response: FHFA agrees with the recommendation. FHFA will engage the Enterprises (separately) and Treasury to establish more specific dispute resolution procedures. We believe the specific dispute resolution measures should be appropriate for the different roles each Enterprise has in the MHA program and we will look to existing models in the federal government that address, among other things, time limits for identifying disputes, use of a specified deciding body, and requirements for documentation of the reasoning behind an agency's disputed position. This work will be completed by December 31, 2011.

APPENDIX B

FHFA-OIG'S Response to FHFA'S Comments

FHFA-OIG provided a draft of this evaluation to FHFA for its review and comment. On July 27, 2011, a Senior Associate Director of the Office of Housing and Regulatory Policy provided the Agency's written comments, which are published verbatim in Appendix A. In them, FHFA agreed to:

1. Engage each of the Enterprises and Treasury in discussions aimed at establishing more specific dispute resolution procedures;
2. Look to existing models for dispute resolution procedures currently existing within the federal government that address, among other things, time limits for identifying disputes, use of a specified deciding body, and requirements for documentation of the reasoning behind an agency's disputed position; and
3. Complete this work by December 31, 2011.

In its written comments, FHFA states that gaps in the original FAAs relating to compensation and the programs to be implemented were purposeful; FHFA expected that negotiations would continue; and that significant amendments to the FAAs would follow. FHFA also stated that, as executed, the FAAs were not considered to be finalized documents. Finally, FHFA makes the point that its Office of General Counsel reviewed the FAAs, discussed them with the Enterprises, analyzed the authority to enter into them, and considered whether the Enterprises were legally required to obtain FHFA's approval to undertake the duties described in them.

As set forth in the body of this Evaluation Report, FHFA's review of the initial FAAs was limited. It did not encompass key terms of the agreements, such as the scope of the work to be performed by the Enterprises and the terms under which they would be compensated. Significant problems developed in both of these areas almost from the beginning, causing FHFA and the Enterprises to divert significant resources to their resolution and away from other priorities. Consequently, FHFA-OIG continues to believe that FHFA's conservatorship interests would have been better served had FHFA taken a more expansive view of its role in the negotiation and review of the FAAs. Moreover, FHFA-OIG's concerns are not mitigated by the prospect that deficiencies in the FAAs – and the resulting controversies that stemmed from them – were intentional as opposed to the product of insufficient substantive review. The outcome was the same: diversion of significant resources.

APPENDIX C

Major FHFA-OIG Contributors to the Evaluation

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