

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

**Evaluation of Whether FHFA Has Sufficient Capacity  
to Examine the GSEs**





# **FEDERAL HOUSING FINANCE AGENCY**

## **OFFICE OF INSPECTOR GENERAL**

### **AT A GLANCE**

#### **Evaluation of Whether FHFA Has Sufficient Capacity to Examine the GSEs**

#### **Why FHFA-OIG Did This Evaluation**

The Housing and Economic Recovery Act of 2008 (HERA) established the Federal Housing Finance Agency (FHFA or Agency) as the supervisor and regulator of the housing government-sponsored enterprises (GSEs): the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Home Loan Banks (FHLBanks).

In September 2008, FHFA placed Fannie Mae and Freddie Mac (collectively, the Enterprises) into conservatorships out of concern that their deteriorating financial conditions threatened the stability of the financial markets. Further, the U.S. Department of Treasury (Treasury) has invested more than \$162 billion in the Enterprises to offset their losses and prevent their insolvency. Additionally, several FHLBanks have faced significant financial deterioration due to investments in certain mortgage-related assets.

FHFA's examination program – targeted examinations, continuous supervision, supervisory analyses, and remediation activities – is the primary means by which it supervises and regulates the GSEs. The Agency's 120 line examiners carry out the program through periodic examinations, and FHFA's Acting Director has stated that it has too few examiners to fulfill its oversight responsibilities.

In 2011, to its credit, FHFA initiated efforts to address the shortage of examiners. First, it developed a plan to hire about 26 examiners, which will increase the Agency's examination staff by about 22%. Second, FHFA reorganized the structure of its examination program in order to strengthen its oversight of the GSEs.

FHFA's Office of Inspector General (FHFA-OIG) initiated this evaluation to assess both the extent of FHFA's current examination capacity and its efforts to hire examination staff.

#### **What FHFA-OIG Recommends**

FHFA-OIG recommends that FHFA: study the impact of the examiner shortage; fully implement an examiner accreditation program; implement an interim remedial measure, such as using contractors or detailees to mitigate the impact of the examiner shortage; and report annually on its examiner hiring efforts.

#### **What FHFA-OIG Found**

FHFA-OIG has identified shortfalls in the Agency's examination coverage, particularly in the areas of Real Estate Owned and default-related legal services. Furthermore, statements by senior FHFA officials and internal Agency reviews corroborate that FHFA has too few examiners overall to ensure the efficiency and effectiveness of its examination program. Due to examiner shortages, FHFA has scaled back planned work during examinations, and examinations have often taken much longer than expected to complete.

Further, the efficiency and effectiveness of FHFA's examination program is at risk due to a shortage of accredited examiners. Although FHFA's examiners staff have diverse professional skills, Agency data indicate that only 34% of the Agency's 120 non-executive examiners are accredited federal financial examiners. However, the Agency does not yet have an accreditation program in place to improve this condition. Other federal financial regulators, such as the Federal Deposit Insurance Corporation (FDIC), generally require all of their examiners to be accredited or enrolled in accreditation programs as a condition of employment.

FHFA, to its credit, has sought to address these challenges. Although this is a positive response, FHFA has expressed concern that its current hiring initiative will neither enable it to overcome its examination capacity shortfalls nor ensure the effectiveness of its 2011 reorganization. For example, FHFA's Enterprise core examination teams will be staffed by only 13 examiners each – approximately half of the 20-25 examiners that FHFA estimates to be necessary. FHFA also said that there will be too few examiners to help ensure the success of the Agency's 2011 reorganization of its GSE examination structure.

Moreover, FHFA has not reported upon its examination capacity shortfalls in a systematic manner. Given FHFA's critical responsibilities, it is essential that it keeps Congress, the Executive Branch, and the public fully and currently informed about its examination capacity.

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# ABBREVIATIONS

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COO .....	Chief Operating Officer
DBR .....	Division of Banking Regulation
DCP .....	Designated Counsel Program
DEPS .....	Division of Examination Policy and Support
DER .....	Division of Enterprise Regulation
Dodd-Frank .....	Dodd-Frank Wall Street Reform and Consumer Protection Act
Fannie Mae .....	Federal National Mortgage Association
FDIC .....	Federal Deposit Insurance Corporation
FHFA .....	Federal Housing Finance Agency
FHFB .....	Federal Housing Finance Board
FHFA-OIG .....	Federal Housing Finance Agency Office of Inspector General
FHLBanks .....	Federal Home Loan Banks
Freddie Mac .....	Federal Home Loan Mortgage Corporation
GAO .....	Government Accountability Office
GSE .....	Government-Sponsored Enterprise
HAMP .....	Home Affordable Modification Program
HERA .....	Housing and Economic Recovery Act of 2008
MBS .....	Mortgage-Backed Securities
MRA .....	Matters Requiring Attention
OCC .....	Office of the Comptroller of the Currency
OFHEO .....	Office of Federal Housing Enterprise Oversight
OTS .....	Office of Thrift Supervision
QA .....	Office of Quality Assurance
RAN .....	Retained Attorney Network
REO .....	Real Estate Owned

# **Federal Housing Finance Agency**

## **Office of Inspector General**

Washington, DC

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# **PREFACE**

FHFA-OIG was established by HERA,<sup>1</sup> which amended the Inspector General Act of 1978.<sup>2</sup> FHFA-OIG is authorized 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 in a series of audits, evaluations, and special reports published as part of FHFA-OIG's oversight responsibilities, and it is intended to assess FHFA's capacity to carry out its examination program.

HERA established FHFA as supervisor and regulator of the housing GSEs: Fannie Mae, Freddie Mac, and the 12 FHLBanks.<sup>3</sup> FHFA's mission is to provide effective supervision, regulation, and housing mission oversight of the GSEs to promote their safety and soundness, to support housing finance and affordable housing goals, and to provide for a stable and liquid mortgage market. In September 2008, due to the Enterprises' mounting mortgage-related losses, FHFA determined that they were "critically undercapitalized" and, as authorized by HERA, placed them into conservatorships.

FHFA's examination program is the primary means by which it monitors the GSEs' financial safety and soundness and their compliance with applicable laws, regulations, and policies. FHFA's approximately 120 non-executive examiners<sup>4</sup> administer the Agency's examination program through, among other things, reviews of the GSEs' financial data, periodic on-site examinations, and ongoing contacts with the GSEs' boards of directors. FHFA can take a variety of supervisory actions to require the GSEs to correct deficiencies identified during the examination process, including issuing cease and desist orders and imposing civil monetary penalties.

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<sup>1</sup> Public Law No. 110-289.

<sup>2</sup> Public Law No. 95-452.

<sup>3</sup> Other GSEs, such as the Farm Credit System, support credit programs that do not involve housing finance and are not regulated by FHFA.

<sup>4</sup> This number does not include executive positions, such as the directors of examination offices.

FHFA's examination program faces challenges. As discussed in a recent FHFA-OIG evaluation report,<sup>5</sup> FHFA's Acting Director has raised concerns about the Agency's capacity to meet its multiple responsibilities as the GSEs' regulator, the Enterprises' conservator, and as a participant in the Administration's efforts to respond to the housing crisis.<sup>6</sup> According to the Acting Director, FHFA does not have enough examiners to satisfy all of its responsibilities. The Agency also faces major stumbling blocks in its effort to fix this problem by hiring experienced examiners from other federal financial regulatory agencies.<sup>7</sup> FHFA advised FHFA-OIG that these obstacles include: (1) the reluctance on the part of some examiners to move to the Washington, D.C., area where the Enterprises are located; and (2) the perception that the Enterprises may be wound-down or phased-out over time.<sup>8</sup>

FHFA has recognized the examination capacity shortfalls it faces and has taken steps to help mitigate them. In early 2011, FHFA reorganized its GSE examination program and began recruiting examiners in earnest. Specifically, FHFA announced plans to hire approximately 26 additional examiners by September 2011, and thereby increase the size of its non-executive examination staff by about 22%. In furtherance of these plans, FHFA has done a variety of things to attract and recruit examiners, including posting relevant information on its website and advertising in newspapers and financial periodicals. Further, FHFA has actively recruited examiners from OTS, which was phased-out under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank).<sup>9</sup> FHFA officials have said that the Agency has prioritized the hiring of OTS examiners due to their backgrounds in mortgage finance.

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<sup>5</sup> See FHFA-OIG, *Federal Housing Finance Agency's Exit Strategy and Planning Process for the Enterprises' Structural Reform* (EVL-2011-001, March 31, 2011), at [www.fhfaoig.gov/Content/Files/EVL%20Exit%20Strategy%20-%20DrRpt%2003302011-final,%20signed.pdf](http://www.fhfaoig.gov/Content/Files/EVL%20Exit%20Strategy%20-%20DrRpt%2003302011-final,%20signed.pdf). See also, FHFA-OIG, *Evaluation of FHFA's Role in Negotiating Fannie Mae's and Freddie Mac's Responsibilities in Treasury's Making Home Affordable Program*, (EVL-2011-003, August 12, 2011) (FHFA reassigned Enterprise-based examiners to oversee the Enterprises' administration of Treasury's Making Home Affordable Program), at [www.fhfa-oig.gov/Content/Files/EVL-2011-003.pdf](http://www.fhfa-oig.gov/Content/Files/EVL-2011-003.pdf).

<sup>6</sup> In this report, "capacity" is defined as the overall number of examiners available to carry out GSE examinations as well as the number that are accredited examiners.

<sup>7</sup> FHFA has attempted to recruit examiners from, among other agencies, the Office of Thrift Supervision (OTS), the Office of the Comptroller of the Currency (OCC), FDIC, and the Federal Reserve.

<sup>8</sup> In February 2011, the Administration proposed to Congress several alternatives for reforming the housing finance system. Some of these proposals will significantly limit the Enterprises' current dominance of the housing finance system or potentially eliminate them altogether over time.

<sup>9</sup> See Public Law No. 111-203 §§ 311-314. OTS regulated nationally- and state-chartered thrifts, and OCC regulates nationally-chartered banks. OTS became part of OCC on July 21, 2011, as provided by sections 311 and 312 of Dodd-Frank. Thrifts have traditionally focused their lending on home mortgages and, thus, OTS examiners have focused their examinations on such lending.

However, by August 2011, FHFA had fallen behind schedule in its hiring efforts. It currently estimates that all 26 examiners will be hired and working by the end of 2011, rather than September 2011.

Given FHFA's critical examination responsibilities, FHFA-OIG initiated this evaluation to assess the extent of the Agency's present examination capacity and its efforts to hire examiners. FHFA-OIG finds that FHFA's current examination program faces a number of potential shortfalls:

- FHFA-OIG identified possible shortfalls in examination coverage, specifically in the areas of Real Estate Owned (REO) and default-related legal services.
- Senior FHFA officials and supervisory examiners corroborated FHFA-OIG's findings, advising FHFA-OIG that the Agency has too few examiners to carry out an efficient and effective GSE examination program. As a result of the limited number of examiners, Agency officials stated that FHFA has not reviewed key areas such as REO, has scaled back planned work during examinations, and often has taken much longer than expected to complete examinations. Internal FHFA reviews further support FHFA officials' concerns about the shortage of examiners and the potentially adverse consequences for the examination program flowing from this limitation.
- The efficiency and effectiveness of FHFA's examination program is also at risk due to its relatively small number of accredited examiners. FHFA's examiners have diverse professional backgrounds in areas such as financial analysis and accounting. Agency officials said that this diversity strengthens its examinations. However, only about 34% of FHFA's examiners have completed structured classroom and on the job examiner accreditation programs. In contrast, at other financial regulators, such as the FDIC, generally all examiners have either completed accreditation programs or are enrolled in them as a condition of employment. With accreditation, FHFA officials said examiners could potentially be more efficient at conducting examinations within specified periods and more effective in completing key examination tasks, such as independently testing and verifying Enterprise financial data and other information. FHFA plans to establish an examiner accreditation program, but it is still in the early stages of development and implementation.
- Senior FHFA officials and line examiners stated that at the conclusion of the Agency's hiring initiative, currently scheduled for late 2011, there may still be too few examiners for the Agency to ensure the efficiency and effectiveness of its examination program.<sup>10</sup>

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<sup>10</sup> The scope of FHFA-OIG's evaluation did not include assessing the number of examiners FHFA would need to address its capacity shortfalls. Such an assessment is primarily the responsibility of the Agency's managers.



For example, FHFA plans to assign approximately 13 examiners to each Enterprise core examination team, which is substantially less than the 20 to 25 core team examiners that the Agency's Chief Operating Officer (COO) views as necessary.<sup>11</sup> Additionally, FHFA officials have said that the 26 examiners to be hired may not be a sufficient number to ensure the success of the Agency's 2011 reorganization of its GSE examination program.

- FHFA has not provided detailed information about its examination capacity shortfalls and the status of its efforts to address them in its reports to Congress and the public.

FHFA-OIG recommends that FHFA: (1) assess the extent to which examination capacity shortfalls may have adversely affected the examination program and develop strategies to mitigate these effects; (2) complete the development and implementation of the examiner accreditation program; (3) implement an interim remedial measure, such as using contractors and/or detailees from other federal regulatory agencies, to alleviate its examination capacity shortfalls in the near- to mid-term; and (4) report annually to Congress on its examination capacity shortfalls and the status of its efforts to mitigate them.

FHFA-OIG believes that the recommendations contained in this report will help the Agency achieve more economical, effective, and efficient operations. FHFA-OIG appreciates the assistance of all those who contributed to this evaluation.

The evaluation was led by David Bloch, Investigative Counsel, and Wesley Philips, Senior Policy Advisor.

This report has been distributed to Congress, 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 Evaluations

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<sup>11</sup> FHFA's two Enterprise core examination teams are housed within the Division of Enterprise Regulation, and the teams include approximately eight members each. The Division of Banking Regulation examines the FHLBanks and, depending on the quarterly examination schedule, it deploys three or four core examination teams of eight or six members, respectively. As described in this report, FHFA has recently reorganized its examination function and created the Division of Examination Policy and Support, which will assist the core examination teams. Thus, of FHFA's 120 non-executive examiners, only about 60 examiners are deployed on-site as the GSE core examination teams. The remaining examiners serve in various support functions, including operations risk, credit risk, market risk, and modeling.



# BACKGROUND

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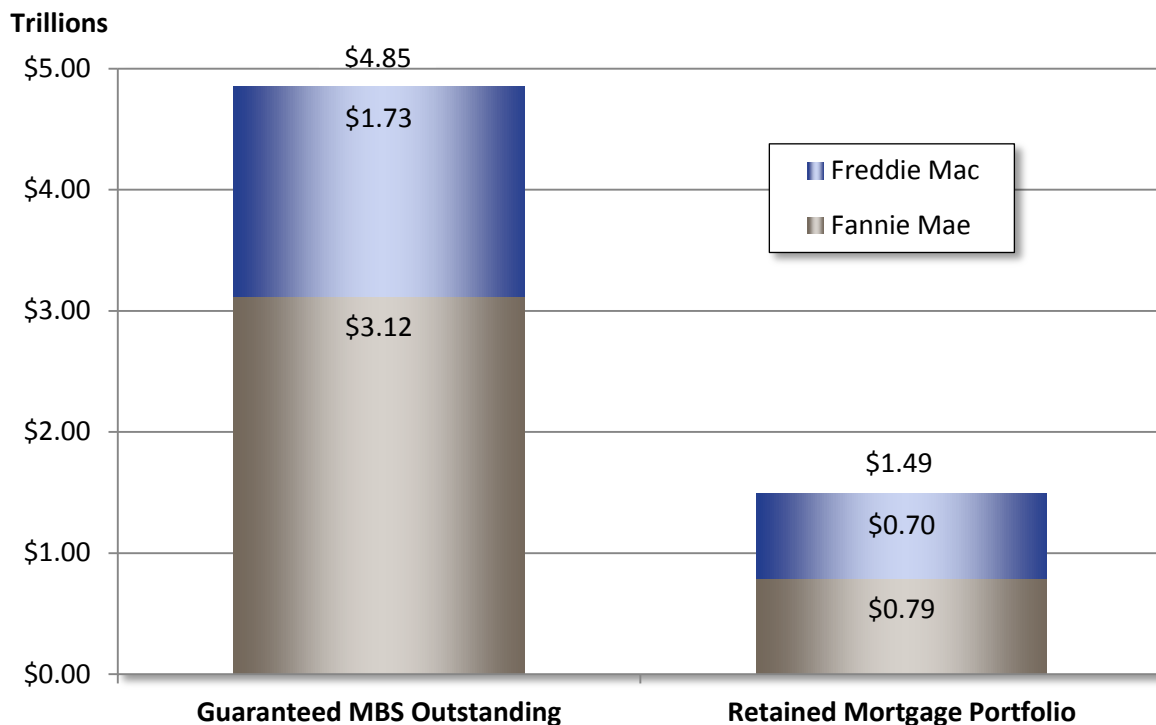
## **Fannie Mae and Freddie Mac, the FHLBanks, and FHFA**

### *Fannie Mae and Freddie Mac*

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 from loan sellers mortgages that meet their underwriting criteria. The loan sellers can then use the proceeds from these sales to originate additional mortgages. The Enterprises may hold the mortgages they purchase in their investment portfolios or securitize and sell them to investors as mortgage-backed securities (MBS). In exchange for a fee, the Enterprises guarantee that MBS investors will receive timely payment of principal and interest on their investments. Regarding the Enterprises' investment portfolios, in addition to mortgages that they purchase on the secondary market, the portfolios may include MBS (their own or private-label MBS) and Treasury securities.

The Enterprises are very large and complex financial institutions. As shown in Figure 1, they had approximately \$4.9 trillion in outstanding MBS guarantees and \$1.5 trillion in assets in their retained mortgage portfolios at the end of 2010. Further, due to the ongoing fragility of the U.S. housing market, the Enterprises continue to play a dominant role in mortgage finance. For example, they issued approximately 70% of all MBS in 2010. Given their size, complexity, and dominant role in mortgage finance, the Enterprises pose a significant oversight challenge to FHFA.

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



### *FHLBanks*

The FHLBank System is comprised of 12 regionally based FHLBanks. Their primary mission is to support housing finance and community and economic development by issuing debt in the capital markets, generally at favorable rates because of their status as GSEs. FHLBanks make loans (called “advances”) to their member financial institutions, such as banks and thrifts, located in their regions. Traditionally, member institutions have secured these advances by pledging as collateral single-family mortgages or investment grade securities. FHLBanks may hold such mortgage-related securities in their investment portfolios. The FHLBank System had approximately \$878 billion in total assets at the end of 2010.

### *FHFA*

HERA, enacted on July 30, 2008, established FHFA as the single federal regulator responsible for oversight of the GSEs’ safety and soundness and achievement of their affordable housing mission.<sup>12</sup> Prior to FHFA’s establishment, the Enterprises and the FHLBanks were overseen by

<sup>12</sup> See Public Law No. 110-289 § 1101.

different regulators. The safety and soundness of the Enterprises was the responsibility of the Office of Federal Housing Enterprise Oversight (OFHEO), an independent office within the Department of Housing and Urban Development (HUD). HUD itself was responsible for ensuring that the Enterprises accomplished their affordable housing mission.<sup>13</sup> The Federal Housing Finance Board (FHFB) was responsible for the FHLBanks' safety and soundness as well as the achievement of their affordable housing mission.

FHFA is required to oversee the prudential operations of the GSEs and – through examinations – determines whether they operate in a safe and sound manner; maintain adequate capital and internal controls; foster liquid, efficient, competitive, and resilient housing finance markets; and operate consistent with the public interest.

Like other federal financial regulators, FHFA is not funded by the appropriations process. Rather, HERA authorizes FHFA to collect from the GSEs “annual assessments in an amount . . . sufficient to provide for the reasonable costs (including administrative costs) and expenses of the Agency, including . . . the expenses of any examinations . . . .”<sup>14</sup>

In September 2008, due to the Enterprises' mounting mortgage-related losses, FHFA found that they were “critically undercapitalized” and, as authorized by HERA, placed them into conservatorships. As the Enterprises' conservator, FHFA assumed responsibility for preserving and conserving their assets. To facilitate FHFA's efforts, HERA vested the Agency with all of the powers of the Enterprises' shareholders, directors, and officers.<sup>15</sup>

On November 24, 2008, FHFA identified certain Enterprise activities that require its approval in advance. FHFA's Acting Director has stated that, beyond these specified activities, the Enterprises are generally responsible for their daily operations and business activities despite their having been placed into conservatorships.<sup>16</sup>

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<sup>13</sup> Overseeing the Enterprises' housing mission means ensuring that they comply with, among other things, their annual mortgage purchase goals. For example, the Enterprises are required to ensure that a certain percentage of mortgages that they purchase meet the needs of particular segments of the population, such as low-income borrowers.

<sup>14</sup> See Public Law No. 110-289 § 1106.

<sup>15</sup> See Public Law No. 110-289 § 1145.

<sup>16</sup> Statement of Edward J. Demarco, Acting Director, FHFA before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Sept. 15, 2010. See <http://www.fhfa.gov/web-files/16726/DeMarcoTestimony15Sept2010final.pdf>.

## FHFA's Examination Program

FHFA's examination program is the primary means by which it monitors the GSEs' financial conditions and operations. FHFA uses the program to conduct periodic examinations of the Enterprises to assess, among other things, their credit, market, and operational risk management programs and practices.<sup>17</sup> FHFA's examination program is also the primary means by which the Agency monitors the Enterprises' conservatorships.

In conducting its examinations, FHFA seeks to identify the highest financial and operational risks confronting the GSEs. Once these risks have been identified, the examinations seek to assess control measures that may be employed to mitigate them. FHFA examiners maintain ongoing discussions with members of the GSEs' boards of directors as well as their managers in order to identify high-risk areas and to assess mitigation strategies.

FHFA's Examination Manual for the Enterprises identifies four types of supervisory activities:<sup>18</sup>

- Targeted examinations. These are in-depth, focused evaluations of a specific risk or risk management system. Targeted examinations focus on a single business line or parts of a business line; a functional area; a specific risk or program area; a business process; or an issue of supervisory concern. Examination procedures are tailored to the overall supervisory objective and can involve assessing safety and soundness, performing an in-depth assessment of a risk exposure or risk management, or reviewing corrective action taken in response to previously cited deficiencies.
- Continuous supervision. The term "continuous supervision" encompasses a wide range of ongoing activities designed to monitor and analyze an Enterprise's overall business profile, including any trends or associated emerging risks. Examples of continuous supervision activities include periodic analyses of Enterprise-prepared management or board reports; discussions with management regarding a risk exposure or risk management systems; and assessments economic or industry trends or other external environment risks and emerging issues.

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<sup>17</sup> Credit risk is the risk that borrowers will default on their obligations such as mortgage loans. Market risk, which includes interest rate risk, arises from the adverse effects of changes in interest rates or foreign exchange rates. FHFA guidance states that market risk can also cause liquidity risk which arises when an Enterprise is unable to: (1) liquidate assets or obtain adequate funding in order to meet obligations when they come due; or (2) easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or large market disruptions. Operational risk is exposure to loss resulting from inadequate or failed internal processes, people, and systems, or from external events (including legal events).

<sup>18</sup> FHFA's examination manual for the FHLBanks describes a generally similar supervisory approach but differs in some respects. FHFA plans to develop more consistent GSE examination procedures as part of its reorganization of its examination program.

- Supervisory analyses. These are initiatives conducted to enhance FHFA’s assessment of the risks to, and risk management programs of, the Enterprises. Supervisory analyses often involve detailed research activities that bear upon, and contribute directly to, an improved understanding of one or both of the Enterprises. Supervisory analyses are usually conducted by cross-functional teams comprised of examiners and analysts.
- Remediation activities. These activities are the means by which FHFA assesses an Enterprise’s progress in correcting identified deficiencies. Remediation activities may follow up on previously identified Matters Requiring Attention (MRA), supervisory letters, or enforcement actions. Documentation of remediation activities includes the information submitted by the Enterprises as well as internal memoranda describing FHFA’s assessment of those submissions. FHFA notifies the Enterprises of its conclusions regarding the success of remediation activities through formal correspondence known as Correction Letters.

Regarding remediation activities, FHFA can take a variety of steps based upon its examination findings to ensure that the Enterprises correct deficiencies noted by Agency examiners. Among such steps is the creation of an MRA, which is used to identify issues of supervisory concern that warrant special attention by the Enterprise to ensure that corrective action is appropriately planned and executed. FHFA’s policy is to follow up on MRAs “to ensure that the Enterprise’s response is appropriate, timely, and effective.” Further, FHFA also has authority to initiate formal enforcement actions, such as the issuance of cease and desist orders and the imposition of civil monetary penalties, to compel the Enterprises to correct deficiencies identified in examinations or through other means.<sup>19</sup>

## **FHFA Reorganization**

In February 2011, FHFA announced the reorganization of its GSE examination program. The reorganization is intended to establish consistent examination procedures and practices for the GSEs and to maximize the efficiency and effectiveness of its examination teams. FHFA officials also have said that the reorganized examination program is consistent with HERA’s structural requirements for the Agency.

According to FHFA’s Acting Director, when the Agency was created in 2008, integrating OFHEO’s and FHFB’s administrative functions was the Agency’s top priority, which took precedence over integrating examination functions. As a result, FHFA’s original examination programs for the GSEs did not differ significantly from those of OFHEO and FHFB. Examinations at the Enterprises were carried out under OFHEO examination procedures, and

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<sup>19</sup> FHFA also has broad conservatorship powers, including the authority to remove and appoint Enterprise officers and directors.

examinations at the FHLBanks were carried out under FHFB procedures. These examination programs were created by separate organizations, and, thus, no effort was made to develop them consistently.

Prior to the Agency's 2011 reorganization, FHFA's safety and soundness examination program for the GSEs was divided between two divisions: the Division of Enterprise Regulation (DER) was responsible for safety and soundness oversight at Fannie Mae and Freddie Mac; and the Division of Banking Regulation (DBR) performed the same function at the FHLBanks. A separate office, the Office of Housing Mission and Goals, was responsible for housing mission oversight at all of the GSEs. Thus, prior to its reorganization, FHFA had a unified approach to mission oversight across the GSEs, but lacked a unified approach to safety and soundness oversight.

FHFA's Acting Director and other senior officials said that, although they recognized the limitations inherent in their original safety and soundness examination programs, they did not restructure them during 2008 and much of 2009. At that time, FHFA was engaged in establishing and operating the Enterprise conservatorships and closely monitoring the financial difficulties at several of the FHLBanks. Accordingly, these officials said it would have been impractical to attempt to reorganize the GSE examination programs at that time. The Acting Director, however, appointed a steering committee comprised of three senior Agency officials and charged the committee with determining the best manner in which to reorganize the Agency's examination programs.<sup>20</sup>

FHFA's Acting Director largely accepted the steering committee's recommendations, and he announced a reorganization in February 2011. Under reorganization, DER and DBR remain intact,<sup>21</sup> but they will be assisted by a new division, the Division of Examination Policy and Support (DEPS), which is intended to provide consistency and effectiveness across FHFA's entire examination program.<sup>22</sup>

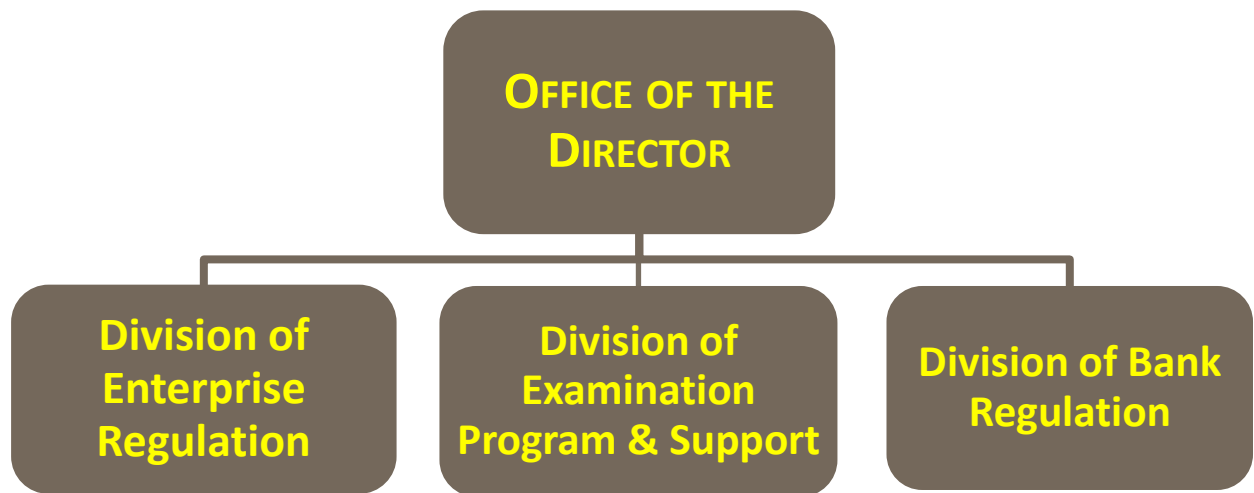
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<sup>20</sup> It was not an objective of this evaluation to assess FHFA's basis for reorganizing the Agency's GSE examination programs or the process by which it did so. Accordingly, FHFA-OIG makes no findings or recommendations on these topics.

<sup>21</sup> The reorganization also left the Office of Housing Mission and Goals largely intact.

<sup>22</sup> FHFA officials noted that HERA requires FHFA to maintain separate divisions for Enterprise and FHLBank System oversight. Accordingly, Agency officials claim that they achieved the maximum efficiency permissible under law by maintaining DER and DBR and chartering DEPS to create common examination policies and procedures for the GSEs.

**Figure 2: FHFA’s 2011 Reorganized Safety and Soundness Examination Structure, February 2011**



Source: FHFA.<sup>23</sup>

According to FHFA officials, DEPS’s three primary responsibilities are to:

- Create common examination policies and procedures for the GSEs;
- Establish a corps of examiners with expertise in key areas<sup>24</sup> that can augment DER’s and DBR’s core examination teams; and
- Create an examiner development program under which commissions or accreditation can be conferred upon FHFA examiners.

### **FHFA’s Initiative to Hire Additional Examiners Is Behind Schedule**

In early 2011, FHFA employed about 120 non-executive examiners<sup>25</sup> to carry out GSE examination duties. In February 2011, FHFA launched an initiative to hire an additional 26 examiners. According to FHFA’s Acting Director, the Agency began its hiring initiative because it recognized that it lacked the examiner capacity necessary to carry out its safety and soundness and conservatorship responsibilities, as well as several new responsibilities set forth in Dodd-Frank.<sup>26</sup> The Acting Director and senior FHFA officials also said that hiring additional

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<sup>23</sup> This is a simplified depiction of FHFA’s organizational structure.

<sup>24</sup> These key areas include, among others, financial modeling, credit risk, market risk, and operations risk.

<sup>25</sup> As used herein, “non-executive examiners” includes Exam Managers, Principal/Senior Examiners, and Senior Examiners. The phrase does not include 12 Leadership Level (LL) – FHFA’s highest grade – supervisors.

<sup>26</sup> These requirements include: (1) reporting to Congress on FHFA’s plans to continue to support and maintain the U.S. housing industry while also guaranteeing taxpayers will not suffer unnecessary losses; (2) in coordination with



examiners was necessary to the success of the 2011 reorganization of the examination program. In this regard, the Acting Director explained that FHFA determined that risk examination staff – particularly credit risk and operational risk staff – were spending an inordinate amount of time on foreclosure alternative programs and servicer issues rather than on direct examination work. Because FHFA needed to provide oversight of each of these areas, it concluded that it needed to augment its examination staff. FHFA also determined that it needed to add more experienced examiners to its staff.

FHFA officials said that they engaged in a process to determine the number of examiners the Agency would need to hire to meet existing examination staff shortfalls and help ensure the effectiveness of the 2011 reorganization. This process included reviewing existing examination requirements and considering input from members of the examination staff. Further, FHFA assessed its examination program requirements through the 2010 and 2011 budget processes.<sup>27</sup>

To accomplish its hiring goal, FHFA has taken a variety of steps to attract and recruit examiners. For example, it has advertised in financial periodicals, posted hiring information on websites, and conducted outreach with organizations representing minorities, women, and veterans. FHFA has also attempted to recruit examiners from OTS, which merged into OCC under Dodd-Frank. Specifically, FHFA's Acting Director held a teleconference with the OTS Director in 2011, during which they encouraged OTS examiners to consider transferring to FHFA while OTS wound-down its operations. FHFA officials explained that the merger presented the Agency with an opportunity to recruit examiners with housing finance experience because OTS regulated thrifts, which have traditionally focused their lending on residential mortgages.

To date, however, FHFA has not met its hiring goals. The Agency planned to make job offers to 26 examiners by July 31, 2011, and have them working by September 30, 2011. But, as of August 2011, the examiner hiring initiative had fallen behind schedule. FHFA had hired only 6 examiners, 20 short of its July 31, 2011 goal. FHFA officials advised that hiring experienced examiners from other agencies has proven to be challenging for several reasons, including reluctance on the part of some examiners to move to the Washington, D.C. area where the Enterprises are located; and a perception by some potential applicants that the Enterprises may be phased-out under various plans to reform the U.S. housing finance system.

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the Federal Reserve, issuing “consistent and comparable” regulations to conduct annual stress tests of any regulated entity with total consolidated assets of \$10 billion or more; and (3) identifying financial activities or practices that could create or increase risks of significant liquidity, credit, or other problems spreading among bank holding companies, non-bank financial companies, and U.S. financial markets.

<sup>27</sup> FHFA's analysis could not reasonably have included appropriations issues, however, because HERA empowers FHFA to annually assess the GSEs for the “expenses of any examinations.”

Perhaps in recognition of these challenges, FHFA compensates examiners at very competitive rates. FHFA pays its examiners on average more than similarly situated employees at other federal financial regulatory agencies.<sup>28</sup>

FHFA officials recently revised their recruitment schedule and now expect to hire the remaining examiners over the next several months with the goal of having them working by the close of 2011.

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<sup>28</sup> Additionally, FHFA's benefits are comparable to those offered by federal financial regulators.

# FINDINGS

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FHFA-OIG finds that:

## **1. Capacity Shortfalls Have Impeded the Efficiency and Effectiveness of FHFA's Examination Program**

### *a. FHFA-OIG Finds Staff Shortages May Have Adversely Affected FHFA's Examination Program*

FHFA-OIG has identified a number of such shortfalls in the Agency's examination coverage:

- **Generally.** On March 31, 2011, FHFA-OIG issued an evaluation report assessing the adequacy of FHFA's plans to implement effectively the short- to medium-term elements of the Administration's proposal to reduce the roles of the Enterprises in the U.S. housing finance system. Among other things, FHFA-OIG found that the breadth of FHFA's administrative, supervisory, and conservatorship responsibilities, combined with new responsibilities associated with the Agency's implementation of the Administration's proposal, raise questions about its capacity to fulfill its responsibilities.
- **REO properties (properties the Enterprises have foreclosed upon and now own).** FHFA has yet to conduct a targeted examination of the Enterprises' management of their REO inventories, despite the surging number of foreclosures since 2007.<sup>29</sup> For example, Fannie Mae's REO inventory increased in size by more than 6 times, growing from 25,125 properties in January 2007 to 162,489 at the end of 2010. REO represents a significant financial risk to the Enterprises since they incur taxes and fees on the properties in their inventories, these costs increase the longer it takes to resell the REO, and all the while the value of the properties may be declining. FHFA cited the Enterprises' REO management as a primary reason that it has classified operational risks at both entities as a "Critical Concern" from 2008 through early 2011.<sup>30</sup> FHFA-OIG views the fact that FHFA has not examined a critical risk area like REO as indicative of the adverse impact of staffing shortages on the Agency's examination program.

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<sup>29</sup> The Enterprises maintain and sell such properties in an effort to recover their foreclosure-related losses. The Enterprises' inventories of foreclosed properties are referred to as REO.

<sup>30</sup> FHFA defines operational risk as the risk of loss associated with failed people, processes, or systems and from external events (such as litigation). "Critical Concern" represents the highest designation of risk within FHFA's supervisory classification system and is indicative of "...critical safety and soundness concerns... (and)...severe financial, operational, or compliance issues."

- **Default-related legal services.** The Agency did not conduct an examination of Fannie Mae's management of its retained attorney network (RAN) or Freddie Mac's management of its Designated Counsel Program (DCP) until late 2010. The law firms provide a variety of default-related legal services, such as foreclosure processing. The Enterprises initiated RAN and DCP to control the costs and promote the efficiency of their vast foreclosure activities. In the summer of 2010, a widely circulated news article reported that Fannie Mae and Freddie Mac had failed to oversee their networks of law firms, and that some of those firms had filed false documents in foreclosure proceedings.<sup>31</sup> After the article surfaced, FHFA commenced a special examination of RAN and DCP. To date, the Enterprises have incurred increased legal costs as a result of the foreclosure abuses of certain law firms within their networks.
- **Lack of Basic Data.** FHFA has not kept track of the precise number of examiners (and accredited examiners) on its staff. In order to further analyze the adequacy of examiner capacity, FHFA-OIG requested from FHFA trend data showing the number of Agency examiners (accredited and un-accredited) and the number of examinations conducted from 2008 through 2010. FHFA was unable to provide accurate data.<sup>32</sup>

*b. Corroboration by Senior FHFA Officials*

Senior FHFA officials corroborated FHFA-OIG's observations regarding the Agency's examination program. They said that the limited number of examiners in place to oversee the GSEs, combined with the Agency's increasing responsibilities, has adversely affected the examination program. The following summarizes several of the key points made by these officials:

- **Insufficient Number of Examiners Conducting Examinations at Fannie Mae and Freddie Mac.** The senior DER manager responsible for the day-to-day oversight of FHFA's examinations of the Enterprises estimated that the Agency should assign approximately 30 to 40 examiners to each team conducting examinations at the Enterprises. But the official said that FHFA has only assigned about 20 to 30 examiners recently,<sup>33</sup> which could

***Targeted Examinations***  
*are in-depth focused evaluations of a specific risk or risk management system*

***Continuous Supervision***  
*is a wide range of ongoing activities designed to monitor and analyze an Enterprise's overall business profile, including any trends or associated emerging risks*

<sup>31</sup> *Fannie and Freddie's Foreclosure Barons*, Mother Jones, August 4, 2010.

<sup>32</sup> Throughout the fieldwork of this evaluation – up until the day that FHFA submitted its formal comments to FHFA-OIG's draft report – the Agency experienced difficulties identifying how many examiners it has on staff. FHFA's estimates ranged from 173 to 119.

<sup>33</sup> This includes the eight core team members, DEPS members, and other staff as applicable. Historically, OHFEO had 24 to 30 member examination teams.

result in shortfalls of as many as 10 examiners per examination. As a result, the FHFA official said that the Agency has not been able to examine critical Enterprise business lines, such as multi-family housing finance. He also corroborated FHFA-OIG's concerns that inadequate examination staffing was a reason that the Agency has not conducted targeted Enterprise REO examinations.

- **Assignment of FHFA Staff Unfamiliar with the Enterprises to Examination Teams.** The senior DER manager further noted that several examiners on the Fannie Mae and Freddie Mac teams had been temporarily assigned to the teams from other units within the Agency, particularly DBR, which supervises the FHLBanks. In other words, the temporary examiners assigned to the Enterprise examination teams were relatively unfamiliar with the operations of and unique issues confronting the Enterprises.<sup>34</sup> As a consequence of their unfamiliarity, the reassigned staff may not be in a position to develop plans and procedures to examine Enterprise-specific risks effectively without an extensive learning curve.
- **Insufficient Number of Examiners Assigned to FHLBanks.** The DBR Director and a senior DBR official both said that the Agency's FHLBank oversight program is understaffed. FHFA currently assigns teams of approximately 6 to 8 examiners to review each of the 12 FHLBanks.<sup>35</sup> However, the senior DBR official said that ideally there should be teams of between 10 to 12 examiners assigned to each FHLBank examination. Thus, the DBR official concluded that the examination teams were too small to carry out their work effectively. The senior DBR official added that FHFA has limited its reviews of FHLBanks as a result of its examination shortfalls.<sup>36</sup>
- **Diversion of Examination Staff to Other Projects.** FHFA's Acting Director and the Acting DER Director both said that in 2009 and 2010 Agency examiners responsible for monitoring the Enterprises' credit risks were diverted from their normal tasks to work on the Administration's Home Affordable Modification Program (HAMP). Under HAMP, the Enterprises and loan servicers modify the loans of certain borrowers in default as a way to prevent costly foreclosures. The Enterprises also administer the HAMP program on Treasury's behalf. FHFA assigned credit risk examiners to ensure that the Enterprises

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<sup>34</sup> For example, the Enterprises generally use different strategies to manage interest rate risk.

<sup>35</sup> Historically, FHFB had 12-member teams.

<sup>36</sup> As a result of staffing shortages DBR has prioritized FHLBank secured credit, liquidity, and investments as high risk issues that must be examined on an annual basis. Other modules, such as insurance management, safekeeping of securities, and business continuity plans, have been determined to be a lesser priority and have been "off-cycled" (*i.e.*, placed on an examination cycle of two to three years).

The DBR official also said that FHFA examinations take longer to complete than scheduled.

performed their HAMP duties in a safe and sound manner.<sup>37</sup> However, FHFA did not have a sufficient number of trained examiners to take the place of the credit risk examiners reassigned to work on HAMP-related activities. As a result, the Enterprises' credit risk operations were insufficiently covered during FHFA's 2009 and 2010 examination cycles. That examination staff shortage is significant because credit risk represents the greatest area of financial vulnerability to the Enterprises – credit losses account for over \$100 billion in losses to Fannie Mae and Freddie Mac.

- **No or Reduced Independent Testing by FHFA Examiners.** The Acting DER Director said that examination staffing shortages have limited the amount of “transaction testing” that takes place.<sup>38</sup> Transaction testing is the method employed by examiners to arrive at independent impressions about the financial and operational conditions of an institution, as well as its compliance with applicable laws and regulations. An example of transaction testing would be reviewing a regulated entity's loan files to test the veracity of statements made by its managers and members of its board of directors. Given FHFA's examination shortages, the Acting DER Director said that examiners must often accept the assertions made by Enterprise managers rather than validate them through appropriate transaction testing.<sup>39</sup> Areas where the Acting DER Director advised that transaction testing was deficient include underwriting, quality control for new loans, continuous service operations for performing loans, and default asset management.<sup>40</sup>

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<sup>37</sup> For a more detailed discussion of FHFA's and the Enterprises' involvement in HAMP, see FHFA-OIG, *Evaluation of FHFA's Role in Negotiating Fannie Mae's and Freddie Mac's Responsibilities in Treasury's Making Home Affordable Program*, (EVL-2011-003, August 12, 2011), at [www.fhfaoig.gov/Content/Files/EVL-2011-003.pdf](http://www.fhfaoig.gov/Content/Files/EVL-2011-003.pdf).

<sup>38</sup> There were only 16 credit risk examiners assigned to the Enterprises, but their small number alone does not fully explain the lack of transactional testing. The Acting DER Director clarified that the limitation is both a qualitative and a quantitative issue. In the former regard, what constitutes an adequate transactional test is often dependent on the skill level of the examiner, and, thus, an experienced examiner may believe that sufficient evidence to render a decision is obtained after a single or a few steps (e.g., document reviews, meetings, transaction tests, etc.). On the other hand, a less experienced examiner may require twice as many steps before he/she is satisfied, or *vice versa*. Regarding quantity, a less experienced examiner may take longer to perform each step.

<sup>39</sup> FHFA-OIG has observed the absence of independent testing in other contexts as well. This absence poses significant risks to the Enterprises and the Agency. For an example of FHFA's reliance on Enterprise data without validating the same through transaction testing, see FHFA-OIG, *Evaluation of Federal Housing Finance Agency's Oversight of Fannie Mae's and Freddie Mac's Executive Compensation Programs*, (EVL-2011-002, March 31, 2011), at [www.fhfaoig.gov/Content/Files/Exec%20Comp%20Dr-Rpt%2003302011%20final,%20signed.pdf](http://www.fhfaoig.gov/Content/Files/Exec%20Comp%20Dr-Rpt%2003302011%20final,%20signed.pdf). Additionally, FHFA-OIG plans to release *Evaluation of the Federal Housing Finance Agency's Oversight of Freddie Mac's Repurchase Settlement with Bank of America*, which, among other things, discusses FHFA's reliance on Freddie Mac's assessment of its loan review process.

<sup>40</sup> A senior FHFA official said that FHFA is developing new examination guidance which will stress the importance of transaction testing for GSE examinations.

### *c. Corroboration from FHFA Internal Analyses*

FHFA internal analyses corroborate FHFA-OIG's findings and the senior FHFA officials' assertions that the shortfall in the number of examiners impedes the efficiency and effectiveness of Agency examinations. For example, in a report dated April 1, 2010, FHFA's Office of Internal Audit identified risks and potential vulnerabilities associated with DER's examination and supervisory functions. The report states that, among other things:

- DER officials and staff believed that increased staffing and better staff resource allocation was needed, yet DER did not have a plan for identifying staffing requirements and obtaining the necessary staffing; and
- Examiners did not consistently perform independent transaction testing and analyses of the Enterprises' work during examinations. Rather, examiners relied on analyses prepared by the Enterprises themselves.

Moreover, in March 2011, FHFA's Office of Quality Assurance (QA) found that the limited number of examiners negatively affected a 2010 FHLBank examination. The FHLBank in question is one of four that FHFA has deemed to be in an "unacceptable" financial condition due primarily to its large investment in private-label MBS. Although such a high-risk FHLBank warranted close supervision by FHFA, the QA analysis found that as a result of an insufficient number of examiners FHFA:

- Scaled back its examination of the FHLBank's Information Technology programs because examiners had been reassigned to other projects; and
- Did not review the FHLBank's internal audit department as planned because of examination staffing limitations.

### *d. Summary and FHFA-OIG Assessment*

The evidence shows that FHFA examination staff shortages may have adversely affected its examination program. FHFA management has a responsibility to review its GSE examinations to determine the depth of this problem and take reasonable measures to mitigate the same. The potential exists that FHFA could achieve efficiencies in the assignment of examiners or how examinations are conducted. Or, FHFA could identify the highest risks associated with current examinations – potentially to include limited transaction testing – and assign newly hired commissioned examiners to address these risks in the near- to mid-term. Alternatively, FHFA could consider using detailees from other federal financial agencies, retired annuitants, or



possibly contractors to alleviate its examination capacity shortfalls in the near- to mid-term.<sup>41</sup> Through such means, FHFA could potentially better use existing staff, pending the acquisition of supplemental resources.

*e. Limited Staff Accreditation also Reduces the Efficiency and Effectiveness of FHFA's Examination Program*

FHFA data indicate that only 34% of its 120 non-executive examiners are accredited (or commissioned) financial institution examiners. In other words, two-thirds of FHFA's examiners are not accredited. Accreditation (or commissioning) is a structured process of classroom and on the job training that provides examiners with technical competencies and practical examination experiences. However, to date FHFA has not established a program under which its examination staff can become accredited. This lack of accreditation represents a significant risk to the accomplishment of FHFA's mission and, thus, warrants close attention.

Federal financial regulators typically deploy accredited financial examiners, who have received formal instruction in the principles and techniques of their profession, to conduct examinations.

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<sup>41</sup> Unlike FHFA's predecessor agency, FHFA does not now use contractors or detailees from other federal financial agencies to alleviate its near- and mid-term examination capacity shortfalls, and it has not formally assessed doing so. FHFA-OIG notes that there is precedent for FHFA to explore the use of outside parties, such as contractors or detailees, to augment the Agency's examination program. For example, in July and August 2008, examiners from OCC and the Federal Reserve participated in OFHEO/FHFA examinations of the Enterprises to determine the full extent of their financial deterioration and whether an investment of taxpayer dollars was needed to support them. According to FHFA, the detailed examiners provided important assistance to the Agency in assessing the Enterprises' finances and operations and establishing that they were critically undercapitalized and should be placed into conservatorships.

Moreover, FHFA's predecessor agency, OFHEO, used an examiner detailee program in the 1990s to facilitate its start-up operations. According to a Government Accountability Office (GAO) report, OFHEO used both contractors and detailees from other federal financial regulatory agencies to conduct on-site examinations of the Enterprises. See GAO, *Office Federal Housing Enterprises: OFHEO Faces Challenges in Implementing a Comprehensive Oversight Program* GAO/GGD-98-6 (Oct. 22, 1997), at [www.gao.gov/archive/1998/gg98006.pdf](http://www.gao.gov/archive/1998/gg98006.pdf). The GAO report also noted that the cost of detailees to OFHEO was generally comparable to that of the Agency's full-time examiners, whereas contractors were considerably more expensive. In its comments to the GAO report, OFHEO agreed that the use of detailees supplemented the expertise of its examination staff.

In discussions with FHFA-OIG, FHFA's COO said that the Agency is open to using outside parties to augment its examination program. For example, he pointed out that FHFA is currently using reappointed annuitants to augment its examination program. Indeed, the Agency official currently responsible for day-to-day examinations of Fannie Mae and Freddie Mac is a retired annuitant. The Acting COO also said that he would "welcome" the establishment of a detailee program, if feasible, because even a few highly trained examiners from other financial regulators would enhance FHFA's examination program. Further, he said that in late 2010 he met with OCC officials to discuss the establishment of such a program, but OCC could not then spare any examiners. The COO said he has not spoken to OCC subsequently, nor has he raised the issue with FDIC or Federal Reserve officials.

Accreditation of examiners is crucial because it ensures:

- Technical competency in all major functional areas of the subject regulated entities;
- Standardization of examination processes; and
- Uniform application of the risk matrix.

Additionally, the accreditation process invests personnel with valuable fundamentals, such as clear and concise writing and critical listening skills.

The large proportion of FHFA examiners without accreditation has led senior FHFA officials to note that FHFA does not follow the practices of other federal financial regulators. For example, FDIC examiners are generally required to be accredited or at least enrolled in their agency's accreditation program as a prerequisite to undertaking examination activities.

Although only one-third of FHFA's examiners are accredited, Agency officials told FHFA-OIG that the professional diversity of the examination staff enhances the quality of the Agency's work products, including its examinations. FHFA officials added that the Agency's examiners have credentials and expertise in critical areas such as financial analysis and accounting as well as the mortgage industry. The officials said that such expertise can be of great assistance to the Agency in its efforts to assess complex GSE business activities and risks.

Nonetheless, FHFA officials conceded that the lack of accreditation of many of its examiners impedes the efficiency and effectiveness of the Agency's examination program. With accreditation, examiners could potentially be more efficient at conducting examinations within specified periods and more effective in completing key examination tasks. For example, the officials said that accredited examiners would generally be more proficient at conducting critical transaction testing, which one senior Agency official said was the foundation of the examination program.

To FHFA's credit, Agency officials are in the process of establishing an examiner accreditation program, which FHFA expects to be in place by late 2011. FHFA officials added that the program will be similar to accreditation programs at other federal financial regulatory agencies and will provide classroom training as well as practical examination experience. FHFA officials also noted, however, that the Agency faces challenges in implementing its accreditation program. In particular, many of FHFA's unaccredited examiners have been conducting examinations for years and may resist participating in accreditation training, especially when the accreditation program might take as long as three to five years to complete. FHFA officials said that they will continue to work with the examination staff to stress the importance of the accreditation program and mitigate their concerns.

Although FHFA deserves credit for developing an examiner accreditation program, FHFA-OIG is concerned that, in the three years following the establishment of FHFA, there is still a significant shortage of accredited financial examiners. This poses a risk that warrants Agency management attention and monitoring.

## **2. FHFA May Face Examiner Staff Shortages Even After It Completes the Current Examiner Hiring Initiative**

Although FHFA's hiring initiative is a positive development, there is substantial uncertainty about the sufficiency of the proposed staffing levels across the offices that administer FHFA's examination program. Senior Agency officials and senior examiners assigned to the Enterprises advised FHFA-OIG that FHFA's current hiring effort will neither enable it to overcome its examination capacity shortfalls nor ensure the effectiveness of the 2011 reorganization. The following summarizes several of the key points made by these senior officials:

- **Insufficient Number of Fannie Mae and Freddie Mac Examiners.** The DER official responsible for day-to-day oversight of the Enterprise core examination teams stated that the current hiring plan envisions increasing team size from 8 to 13 examiners. He further stated that 13 examiners per core team would still be insufficient to ensure effective oversight of the Enterprises. The Acting DER Director and senior DER examiners concurred with this assessment.<sup>42</sup>
- **Insufficient Number of FHLBank Examiners.** A senior official within DBR said that the planned size of the DBR staff, even as augmented by credit and market specialists from DEPS, would be insufficient to ensure effective examination oversight of the FHLBanks. The DBR official and others said that the size of both the planned FHLBank examination teams and DEPS must be significantly increased in order to ensure their effectiveness.
- **Insufficient Number of Risk Specialists.** Several officials within DEPS said that the new division will lack a sufficient number of examiners to carry out its responsibilities, even after the current hiring initiative is completed. Specifically, one official said that there would be an insufficient number of risk specialists within DEPS to support DER's Enterprise core examination teams; another official said that her unit would need additional examiners to carry out successfully its responsibilities; and a third official estimated that she would need 50 staff members in order to meet the requirements placed upon her unit, but that the plan was to provide her with a staff of only 16 individuals.

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<sup>42</sup> The Acting DER Director agreed that the core teams would be too small after the hiring initiative is completed, and further stated that their constrained size will prohibit them from fully examining governance, compliance, ethics, and market risk issues at the Enterprises.

FHFA's COO acknowledged to FHFA-OIG that the Agency may need to increase examination staffing after the current hiring initiative is completed. In particular, he said that 13 examiners per DER core team are insufficient given their duties, and that the size of the teams could potentially increase to 20 or 25 members each. He further acknowledged that FHFA may need to increase DBR staffing beyond the currently planned levels to help ensure their ability to oversee the FHLBanks.

The COO also noted that FHFA will have a better understanding of its long-term examination staffing needs once the changes envisioned under the 2011 reorganization plan take effect. For example, the COO stated that the appropriate size of the DEPS staff will not be known until after DEPS's role in the 2012 examinations is decided. DEPS staff members are playing a greater role in the 2011 examinations of the Enterprises than is likely to be the case once the DER core teams are increased in size beyond their current levels of eight per team. The increase in the size of the core teams will, in turn, relieve DEPS of its current duties and enable its staff to play a more targeted role in Enterprise examinations as envisioned in the reorganization plan. Thus, the COO said that FHFA soon will be able to evaluate such reorganization staffing issues, reach agreement on appropriate staff sizes for all of its examination offices, and develop an appropriate recruitment strategy.

### **3. FHFA Has Not Reported Detailed Information About Its Examination Capacity Shortfalls**

Given FHFA's significant role as the GSEs' regulator and the Enterprises' conservator, it has a critical responsibility to keep Congress, the Executive Branch, and the public informed about its ongoing efforts to satisfy its examination capacity shortfalls. However, FHFA has not provided detailed information in its public reports. For example, FHFA's 2010 Report to Congress makes no mention of examination capacity issues other than to state that the Agency hired more examiners in 2010 and planned to continue doing so in 2011. Moreover, FHFA's 2010 Performance and Accountability Report does not discuss FHFA's examination capacity shortfalls or how they may limit its overall GSE examination program.<sup>43</sup> Without more detailed discussions and analysis about FHFA's progress in meeting examiner recruitment goals and the development and implementation of the Agency's examiner accreditation program, Congress, the Executive Branch, and the public will lack information necessary to assess FHFA's performance in GSE oversight and conservatorships management. Further, Congress and the Executive Branch will lack information and analyses that may be necessary to assist FHFA in meeting its responsibilities.

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<sup>43</sup> FHFA's 2010 Performance and Accountability Report and its 2010 Annual Performance Plan provide very limited information related to the Agency's examiner capacity shortfalls and status of efforts to address them. See [www.fhfa.gov/webfiles/19480/2010%20FHFA%20PAR\\_11-150.pdf](http://www.fhfa.gov/webfiles/19480/2010%20FHFA%20PAR_11-150.pdf) and [www.fhfa.gov/webfiles/21006/FHFA%20FY%202011%20APP-508%20READY.pdf](http://www.fhfa.gov/webfiles/21006/FHFA%20FY%202011%20APP-508%20READY.pdf).

# CONCLUSION

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FHFA-OIG's work has identified possible shortfalls in the Agency's examination coverage. Statements by senior FHFA officials, internal Agency reviews, and examiner accreditation data corroborate that FHFA lacks a sufficient number of accredited examiners to ensure the efficiency and effectiveness of GSE oversight. To its credit, however, FHFA has recognized these capacity shortfalls, developed plans to address them, and is in the process of implementing those plans. But FHFA officials across the Agency's examination community told FHFA-OIG that significant examination capacity shortfalls will likely remain at the conclusion of the Agency's current reorganization and recruitment efforts.

FHFA management has a critical and ongoing responsibility to monitor the Agency's examination capacity shortfalls and the consequences of those shortfalls, to develop mitigation strategies, and to keep Congress, the Executive Branch, and the public informed of its efforts. Without such actions, the Agency's long-term capacity to meet its GSE oversight and Enterprise conservatorship responsibilities is open to question.

# RECOMMENDATIONS

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FHFA-OIG recommends that FHFA:

- Assess: (1) the extent to which examination capacity shortfalls may have adversely affected the examination program; and (2) potential strategies to mitigate risks, such as achieving efficiencies in the assignment of examiners or the examination process;
- Monitor the development and implementation of the examiner accreditation program and take needed actions to address any shortfalls;
- Consider using detailees from other federal agencies, retired annuitants, or contractors to augment its examination program in the near- to mid-term; and
- Report periodically to Congress and the public, which might include the augmentation of existing reports, on the Agency's examiner capacity shortfalls, such as the number of examiners needed to meet its responsibilities; the progress in addressing these shortfalls, including status of examiner recruitment and retention efforts; and the development and implementation of its examiner accreditation program.

# SCOPE AND METHODOLOGY

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The objectives of this evaluation were to determine the extent of FHFA's current examination capacity and to assess its ongoing efforts to hire examiners. FHFA-OIG defined "capacity" as the overall number of examiners available to carry out GSE examinations as well as the number that are accredited examiners.

To gain an understanding of these issues, FHFA-OIG interviewed FHFA's Acting Director, COO, and senior officials within DER, DBR, and DEPS. Further, FHFA-OIG interviewed FHFA examiners assigned to the core examination teams at Fannie Mae and Freddie Mac. Some individuals were interviewed more than once.

FHFA-OIG also reviewed reports prepared about FHFA's examination program by its Office of Internal Audit and QA. Further, FHFA-OIG reviewed reports prepared by GAO and a transcript of an interview that FHFA's Acting Director provided to the Financial Crisis Inquiry Commission in 2010. During that interview, the Acting Director discussed the role that OCC and Federal Reserve examiners played in FHFA's examinations of the Enterprises.

Additionally, FHFA-OIG staff reviewed FHFA statistics concerning the number of Agency examiners who are accredited as financial institution examiners, as well as data on the state of FHFA's examiner hiring initiative. FHFA-OIG also reviewed FHFA materials on the 2011 reorganization of its examination function; the analysis for its examiner hiring initiative; and FHFA's planned examiner accreditation program. The scope of this evaluation did not include assessments of the processes or analytical bases for either the reorganization or the hiring initiative.

FHFA-OIG notes that a potential limitation of this evaluation is that its staff did not review Agency examinations to determine independently the extent to which examiner capacity shortfalls may have limited the quality of GSE examinations. FHFA-OIG believes this methodological limitation is mitigated by the fact that the primary data it relies upon are the views of senior Agency officials and internal Agency documents that acknowledge and identify limitations in the current examination program as well as potential ongoing challenges associated with the examiner hiring initiative.

This evaluation was conducted under the authority of the Inspector General Act of 1978, as amended, and in accordance with the *Quality Standards for Inspection and Evaluation* (January 2011), which were promulgated by the Council of Inspectors General on Integrity and Efficiency. These standards require FHFA-OIG to plan and perform evaluations that obtain evidence sufficient to provide reasonable bases for its findings and recommendations. FHFA-OIG trusts that the findings and recommendations contained in this report meet these standards.



The performance period for this evaluation was from May 2011 to August 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 and its staff in providing information and access to necessary documents to accomplish this evaluation.

# APPENDIX A

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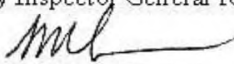
## FHFA's Comments on Findings and Recommendations



### Federal Housing Finance Agency

#### MEMORANDUM

**TO:** Richard Parker, Deputy Inspector General for Evaluations (Acting)

**FROM:** Stephen M. Cross   
Deputy Director, Division of FHLBank Regulation

**SUBJECT:** FHFA Comments on FHFA-OIG "Evaluation of Whether FHFA Has Sufficient Capacity to Examine the GSEs"

**DATE:** September 21, 2011

Thank you for the opportunity to provide comments on the "Evaluation of Whether FHFA Has Sufficient Capacity to Examine the GSEs" (Report or Evaluation). The FHFA also appreciates the attention paid by FHFA-OIG to the detailed feedback the Agency provided on an earlier draft of the Report.

FHFA-OIG makes four recommendations in the Evaluation. The FHFA-OIG recommends FHFA:

- Assess (1) the extent to which examination capacity shortfalls may have adversely affected GSE examination quality; and (2) potential strategies to mitigate risks, such as achieving efficiencies in the assignment of examiners or the examination process;
- Monitor the development and implementation of the examiner accreditation program and take needed actions to address any shortfalls;
- Consider using detailees from other federal agencies, retired annuitants, or contractors to augment its examination program in the near to mid-term; and
- Report periodically to Congress and the public, which might include the augmentation of existing reports, on the Agency's examiner capacity shortfalls, such as the number of examiners needed to meet its responsibilities; progress in addressing these shortfalls, including status of examiner recruitment and retention efforts; and the development and implementation of its examiner accreditation program.

The FHFA agrees with these recommendations. The Agency's 2011 restructuring of its supervisory program, including its plans to develop an examiner accreditation program, largely supports the first three recommendations. In addition, the Agency will include in its annual Report to Congress and its annual Performance and Accountability Report (PAR) a discussion of staffing levels and goals, examiner recruitment and retention, and its examiner accreditation program.

While FHFA agrees in principle with the Report's recommendations, several assertions and conclusions in the Evaluation warrant additional comment.

Quality of Examinations. The Report calls into question the quality of FHFA examinations of the GSEs. For example, the Report states that "the shortfall in the number of examiners compromises the quality of its examinations" and "FHFA examination staff shortages have put its GSE examination program at risk." Yet a statement on the scope and methodology of the report acknowledges that FHFA-OIG staff "did not review Agency examinations to determine independently the extent to which examiner capacity shortfalls may have limited the quality of GSE examinations." We suggest the Report be modified if its conclusion about examination quality is attributable solely to statements by "Senior Agency officials and internal Agency documents."

FHFA agrees that it should hire additional examiners, and it has been actively hiring examiners all year. FHFA has added 18 examiners since January 1. However, it is one thing to say that the Agency should increase examination staffing or that the hiring of examiners is behind schedule, but quite another to say that FHFA cannot carry out a credible or effective examination program with the staff available. The Report offers no evidence to support the conclusion that an examination staff shortage has compromised examination quality and seems to rely on unattributed comments to support that conclusion without noting the context of the remarks or whether alternative views were expressed by other FHFA officials.

Quality of Examination Staff. The Evaluation states that among FHFA examination staff "only about 34% have completed structured classroom and on the job examiner accreditation programs." Similar data are repeated in several places in the Evaluation. On this basis, the Report concludes that FHFA lacks examination expertise. FHFA does not agree with this conclusion, particularly given that 66 percent of non-executive examiners are commissioned and/or have a professional certification corresponding to their level of responsibilities. Others were hired with private-sector experience in the financial services industry, which also can provide a valuable complement to the work of commissioned examiners.

We have found that the quality of work products, including examination reports, is enhanced through collaboration. This involves bringing together individuals in the Agency with diverse skills and backgrounds – examiners as well as non-examiners – to work collaboratively on examinations. We believe that collaboration among individuals with diverse skills and backgrounds can raise the quality of examination reports by bringing new insights, different thought processes, and a range of analytical approaches to the examination process. FHFA's supervisory programs, therefore, rely on a staff with advanced degrees in economics, finance, business, and accounting who perform on-site examination work and off-site monitoring and analysis. As such, FHFA's examination and supervision efforts comprise more than the 120 non-executive examiners cited in the Report.

FHFA believes the Report should recognize the value of these other participants to the agency's examination program. FHFA also believes that the Report should recognize not just the value to the agency from expanding the number of commissioned examiners through an accreditation program, but also the value to its supervision program from its commitment to funding training and providing institutional support for its employees seeking professional designations, such as a CFA, CPA, or CISA.



Transaction Testing. As the Report acknowledges, the Agency has committed to developing a unified set of examination procedures to replace the separate procedures previously in place for Enterprise examinations and FHLBank examinations. The unified procedures build principally on the FHLBank examination manual. Unfortunately, the Report focuses on the Enterprise examination manual, which is being phased out, even at the Enterprises.

The distinction is important when considering concerns expressed by FHFA officials about limited transaction testing at the Enterprises and the diversion of examiners to other projects in 2009 and 2010. Organizational and procedural changes in place or underway now emphasize transactions testing in both Enterprise and FHLBank examinations. The 11-step interim examination procedure document in place for 2011 Enterprise examinations explicitly incorporates transaction testing, but is not mentioned in the Report.

We appreciate the opportunity to provide these comments on the Evaluation and the earlier opportunities to provide more detailed comments to the FHFA-OIG on an earlier draft of the Report.

# APPENDIX B

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## FHFA-OIG's Response to FHFA's Comments

FHFA-OIG is pleased that FHFA generally agrees with the report's recommendations. With respect to FHFA's comments concerning the Quality of Examinations, Transaction Testing, Quality of Examination Staff, and Number of Examiners Compared to Assets Under the Control of Regulated Entities, FHFA-OIG has considered carefully FHFA's comments and revised the draft report to reflect those comments, as appropriate.

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