OFFICE OF INSPECTOR GENERAL

Federal Housing Finance Agency

400 7th Street, S.W., Washington DC 20024

February 25, 2014

To: Melvin L. Watt, Director

Michael P. Stephens

From: Michael P. Stephens, Acting Inspector General

Subject: Update on FHFA's Oversight of the Enterprises' Non-Executive Compensation Practices (EVL-2014-004)

Please find attached a staff memorandum report detailing our review of the examination work conducted on the Enterprises' non-executive compensation practices in 2013. FHFA examiners found that neither Enterprise was able to document full compliance with FHFA's pay freeze directives covering calendar years 2011 and 2012. Moreover, FHFA has established supervisory directives that the Enterprises address these weaknesses.

Enterprise executive and non-executive compensation were the subject of our December 2012 report entitled *FHFA's Oversight of the Enterprises' Compensation of Their Executives and Senior Professionals*, and we believe that they remain important oversight areas pursued under our mission of preventing and detecting waste, fraud, and abuse in the programs and operations of FHFA and its regulated entities.

Please do not hesitate to contact me if you have any questions about this matter.

EXPLANATION OF REDACTIONS IN THIS REPORT

Redactions in this report were made at the request of the Federal Housing Finance Agency (FHFA). According to FHFA, the redacted information falls within the bank examination privilege, which prohibits the disclosure of information compiled as part of examinations of the Enterprises.

OFFICE OF INSPECTOR GENERAL

Federal Housing Finance Agency

400 7th Street, S.W., Washington DC 20024

January 28, 2014

Memorandum for: Jon Greenlee, Deputy Director, Division of Enterprise Regulation

From: Richard Parker, Deputy Inspector General for Evaluations

Subject: Draft on Update on FHFA's Oversight of the Enterprises' Non-Executive Compensation Practices

Enclosed for the Agency's consideration is a draft of our memorandum report entitled: *Update on FHFA's Oversight of the Enterprises' Non-Executive Compensation Practices.*

We request that appropriate FHFA officials review the draft for factual accuracy and assess the analysis contained in it. We would appreciate receiving the Agency's official comments by Wednesday, February 12, 2014. Further, we propose to meet with the reviewing officials during the week of February 3rd.

Recipients of this draft must not, under any circumstances, employ it for purposes other than official review and comment. At all times, the draft report must be safeguarded to prevent publication or other improper disclosure of the information contained in it. This draft, and all copies thereof, remain the property of, and must be returned on demand to, OIG. This draft may not be released outside FHFA without the express written approval of the Acting Inspector General.

Please e-mail or call me at (202) 730-0889 if you have any questions in this regard. Many thanks for the good help.

cc: John Major, Manager, Internal Controls and Audit Follow-Up

OFFICE OF INSPECTOR GENERAL

Federal Housing Finance Agency

400 7th Street, S.W., Washington DC 20024

February 25, 2014

TO: Michael P. Stephens, Acting Inspector General

FROM: Richard Parker, Deputy Inspector General for Evaluations

SUBJECT: Update on FHFA's Oversight of the Enterprises' Non-Executive Compensation Practices

Summary

This memorandum updates and closes out our evaluation of the Federal Housing Finance Agency's (FHFA) oversight of Fannie Mae's and Freddie Mac's (collectively, the Enterprises) non-executive compensation practices.

In December 2012, we published an evaluation report on FHFA's oversight of the Enterprises' compensation of their nearly 2,100 highest paid employees, i.e., about 90 executives and 2,000 non-executive senior professionals.[1]

We concluded that FHFA had reviewed and examined the Enterprises' executive compensation practices, but not their non-executive senior professional compensation practices. Therefore, the Agency had not ensured that the costs associated with the Enterprises' non-executive compensation practices were warranted.[2] Accordingly, we recommended that FHFA strengthen its oversight of this area because, other than their executives, the Enterprises' senior professionals are their most highly compensated employees.[3]

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[1] *See* OIG, *FHFA's Oversight of the Enterprises' Compensation of Their Executives and Senior Professionals* (EVL-2013-001, December 10, 2012) (online at http://www.fhfaoig.gov/Content/Files/EVL-2013-001.pdf).

For the purposes of the report, the Enterprise "executives" were their Chief Executive Officers, Executive Vice Presidents, and Senior Vice Presidents. The Enterprises' "senior professionals" were their Vice Presidents and Directors.

[2] The Enterprises' non-executive corps contain their senior professional personnel. We estimated that costs associated with the Enterprises' compensation of their senior professionals were approximately $455 million in 2011.

[3] On December 16, 2010, the former Acting Director of FHFA issued a pay freeze directive for 2011, limiting individual salaries and pay scales at the Enterprises to 2010 levels, with some exceptions for "[a]ppropriately modest pay increases associated with promotions or significant changes in an employee's duties...consistent with your

In accordance with our recommendation, FHFA conducted targeted examinations in 2013 of the Enterprises' compliance with the Agency's directive to freeze their employees' pay during 2011 and 2012. FHFA found deficiencies in the Enterprises' compliance with the directive and with their controls over senior professional compensation. For example, [redacted] FHFA subsequently instituted supervisory directives that require the Enterprises to remediate identified deficiencies.

Context

The Inspector General's 2012 Report Identified Limitations in FHFA's Oversight of the Enterprises' Senior Professional Compensation Practices

In our 2012 report, we noted that FHFA directly oversees the Enterprises' compensation of their executives as required by the Housing and Economic Recovery Act of 2008[4] and the Agency's senior preferred stock purchase agreements (PSPAs).[5] We also noted that FHFA had not reviewed, examined, or tested the structures, processes, or controls by which the Enterprises compensate their non-executive employees, including their senior professionals.

FHFA explained this distinction in oversight by noting that the Agency had largely delegated to the Enterprises the responsibility to determine the compensation of their non-executive employees.[6] An Agency official told us that such delegations of day-to-day business responsibilities are the most effective means by which to manage the Enterprises in their conservatorships.[7]

We acknowledged the Agency's rationale for delegating some day-to-day responsibilities to the Enterprises. However, we noted that by delegating the responsibility for non-executive compensation, the Agency severely constrained its ability to ensure that the costs incurred by the Enterprises in compensating their senior professionals were, in fact, warranted.

Further, we conducted a limited review of this area and identified evidence indicating that, in the absence of FHFA oversight, the Enterprises did not always effectively control their senior

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current pay programs." The former Acting Director later extended the pay freeze to 2012 in a letter to the Enterprises dated December 13, 2011. FHFA lifted the pay freeze for calendar year 2013.

[4] See 12 U.S.C. §§ 4502(12), 4518(a).

[5] Under the PSPAs, the Treasury Department has invested $187.5 billion in the Enterprises, thereby enabling them to remain solvent and continue their operations. The PSPAs state that the Enterprises may not enter into any new compensation arrangements with, or increase the benefits payable under, existing compensation arrangements of any named executive officer without obtaining the consent of the Director of FHFA, in consultation with the Treasury Department.

[6] An Agency official told us that she reviewed some requests from the Enterprises concerning non-executive pay that related primarily to retention payments.

[7] FHFA became the Enterprises' conservator in September 2008. For a discussion of FHFA's duties and responsibilities in this capacity, *see* OIG, *White Paper: FHFA-OIG's Current Assessment of FHFA's Conservatorships of Fannie Mae and Freddie Mac* (WPR-2012-001, March 28, 2012) (online at http://www.fhfaoig.gov/Content/Files/WPR-2012-001.pdf).

professional compensation costs. Specifically, we determined that during 2011 – the first year of the Agency-directed pay freeze – the following occurred:

- The median compensation paid to the Enterprises' senior professionals increased by as much as 5%;[8] and
- Salary offers to candidates for senior professional positions at one of the Enterprises exceeded the target median of comparable private sector salaries in 8 of 10 cases we examined. In 2 of the 8 cases, the Enterprise offered a salary that was over 20 percentage points above the median.

To address this situation we recommended that the Agency strengthen its oversight of non-executive compensation and consider reviewing the Enterprises':

- Structures, processes, and cost controls for senior professional compensation;
- Controls over compensation offers to new hires; and
- Compliance with the Agency-directed pay freeze.

FHFA agreed with our recommendation.

FHFA Conducted Examinations in 2013 that Identified Deficiencies in the Enterprises' Compliance with the Agency-Directed Pay Freeze

In accordance with our recommendation, FHFA conducted targeted examinations in 2013 of the Enterprises' compliance with the Agency-directed pay freeze during 2011 and 2012. The examiners found that neither Enterprise was able to demonstrate that it had complied fully with the pay freeze. We describe their compliance deficiencies below.

a. Fannie Mae

The examination of Fannie Mae revealed that in 2011 and 2012 its management [redacted]

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[8] Enterprise officials explained that the increase was likely due to the disbursement in 2011 of long-term incentive payments earned in prior years. In addition, one official said that promotions and changes in responsibility might have accounted for some of the increase in pay.

[9] FHFA documentation indicates that [redacted]

[10] According to an FHFA analysis, [redacted]

[redacted]

The examiners determined that [redacted]

On November 19, 2013, FHFA directed Fannie Mae to improve "its policies, procedures, supporting documentation, and governance over compensation programs in a manner that will ensure its ability to demonstrate that these programs are being implemented in an appropriate, consistent, and transparent manner."

b. Freddie Mac

As part of its 2013 examination of Freddie Mac's compliance with the pay freeze, FHFA identified [redacted]

FHFA examiners also concluded that [redacted] In June 2013, FHFA issued a binding supervisory requirement to the Enterprise. Under it, Freddie Mac must implement a formal oversight program to ensure compliance with

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[11] In their analysis memorandum, the FHFA examiners said that [redacted]

[12] The examiners defined [redacted]

[13] Freddie Mac officials told FHFA examiners that [redacted]

[14] FHFA examiners determined that in 2012 [redacted]

FHFA's conservatorship directives. The Enterprise submitted a remediation plan in August, which FHFA reviewed and accepted.

FHFA Has Instituted an Oversight Program for Senior Professional Hires and Promotions

In 2013, in response to our recommendation, FHFA instituted a procedure under which it reviews the Enterprises' compensation of their senior professionals. Specifically, FHFA reviews quarterly reports prepared by the Enterprises in which the salaries paid to new hires and recently promoted employees are compared to the median pay offered to similar private sector positions. We believe that this procedure is a step in the right direction in that it provides FHFA with some ability to assess Enterprise senior professional compensation practices going forward. However, reviewing the Agency's implementation of this procedure exceeded the scope of our work.

Conclusion

In accordance with our recommendation, FHFA conducted targeted examinations in 2013 of the Enterprises' non-executive compensation practices. Its examiners identified a number of issues that validate the need for FHFA to conduct ongoing monitoring in this area. To its credit, FHFA undertook corrective measures, and it has begun a limited oversight regimen based upon the quarterly reporting of senior professional salaries by the Enterprises. FHFA's examination findings also demonstrate the importance of ongoing Agency oversight of the Enterprises' compliance with its conservatorship directives, which we discussed in a previous report.[15]

[15] See OIG, *FHFA's Conservator Approval Process for Fannie Mae and Freddie Mac Business Decisions* (AUD-2012-008, September 27, 2012) (online at http://www.fhfaoig.gov/Content/Files/AUD-2012-008_2.pdf).