



FEDERAL HOUSING FINANCE AGENCY OFFICE OF INSPECTOR GENERAL

INAUGURAL SEMIANNUAL REPORT TO THE CONGRESS

October 12, 2010, through March 31, 2011



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FHFA-OIG and its Mission

The mission of the Federal Housing Finance Agency Office of Inspector General (“FHFA-OIG”) is to: promote the economy, efficiency, and effectiveness of Federal Housing Finance Agency (“FHFA”) programs; prevent and detect fraud, waste, and abuse in FHFA programs; and seek sanctions and prosecutions against those responsible for such fraud, waste, and abuse.

FHFA-OIG provides independent and objective reporting to the FHFA Director, Congress, and the American people through audits, evaluations, and investigations.

*Federal Housing Finance Agency
Office of Inspector General
1625 Eye Street, NW
Washington, DC 20006-4001
Main (202) 408-2544
Hotline (800) 793-7724
www.fhfaoig.gov*

A Message from the Inspector General

I am pleased to present the Inaugural Semiannual Report of the Federal Housing Finance Agency Office of Inspector General (“FHFA-OIG”). It describes FHFA-OIG’s initial achievements and explains our future plans and strategies.

FHFA-OIG was established in the aftermath of the worst economic crisis in generations. Congress assigned FHFA-OIG the mission of overseeing FHFA, which serves as the regulator and conservator of the Federal National Mortgage Association (“Fannie Mae”) and the Federal Home Loan Mortgage Corporation (“Freddie Mac”), as well as the regulator of the Federal Home Loan Banks (“FHLBanks”).

The need for effectiveness, integrity, and transparency in FHFA’s programs and operations cannot be overstated. Fannie Mae and Freddie Mac have received almost \$154 billion in taxpayer funding to support the still-fragile housing market. In addition, they own or guarantee about \$5.4 trillion in residential mortgage obligations. The FHLBanks have almost \$900 billion in assets, and several face financial difficulties.

I was sworn in as the first Inspector General for FHFA in October 2010. Since that time, I have recruited seasoned professionals with backgrounds in housing, securities, finance, investigations, and auditing. More importantly, FHFA-OIG already has made significant oversight progress. For the semiannual period ending March 31, 2011, FHFA-OIG commenced multiple audits, evaluations, surveys, and special reports; two have been completed and are discussed in this Report. In addition, FHFA-OIG has initiated and participated in criminal, civil, and administrative investigations.

An important objective of FHFA-OIG is the issuance of clear, informative, and timely reports to FHFA, Congress, policymakers, and the public we serve. FHFA-OIG will continue to review key aspects of FHFA’s operations in a way that materially contributes to the Agency’s regulatory and conservatorship activities. FHFA-OIG also seeks to promote public understanding and informed debate about housing finance policy. This topic affects every homeowner and taxpayer in the nation.

FHFA-OIG looks forward to helping ensure the effectiveness, integrity, and transparency of FHFA’s programs and operations. We are grateful for the support of Congress, FHFA, and others in this effort.



Steve A. Linick
Inspector General

April 29, 2011



Steve A. Linick
Inspector General of the Federal
Housing Finance Agency



EXECUTIVE SUMMARY

Executive Summary

OVERVIEW

This Semiannual Report (“Report”) is the inaugural Report of the Federal Housing Finance Agency Office of Inspector General (“FHFA-OIG”). Required under the Inspector General Act, this Report discusses FHFA-OIG’s activities through March 31, 2011. FHFA-OIG began operations in October 2010, when the Inspector General was sworn into office.

FHFA-OIG oversees the Federal Housing Finance Agency (“FHFA” or the “Agency”). FHFA, in turn, is the safety, soundness, and mission 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 Bank System, comprised of 12 regional Federal Home Loan Banks (“FHLBanks”). FHFA also has been the conservator of Fannie Mae and Freddie Mac since September 2008.

This Executive Summary provides an overview of FHFA and the housing GSEs, FHFA-OIG’s initial staffing and organizational development efforts, key FHFA-OIG accomplishments during the reporting period, and FHFA-OIG’s future plans and strategy. The Executive Summary also describes this Report’s structure and Inspector General Act reporting requirements.

FHFA AND THE HOUSING GSEs

FHFA was established by the Housing and Economic Recovery Act of 2008 (“HERA”), which authorizes FHFA to conduct examinations, develop regulations, issue enforcement orders, and appoint itself conservator or receiver of the GSEs. Like other federal financial regulators, such as the Federal Deposit Insurance Corporation, FHFA finances its activities through assessments on its regulated entities, the housing GSEs, rather than through the Congressional appropriations process.

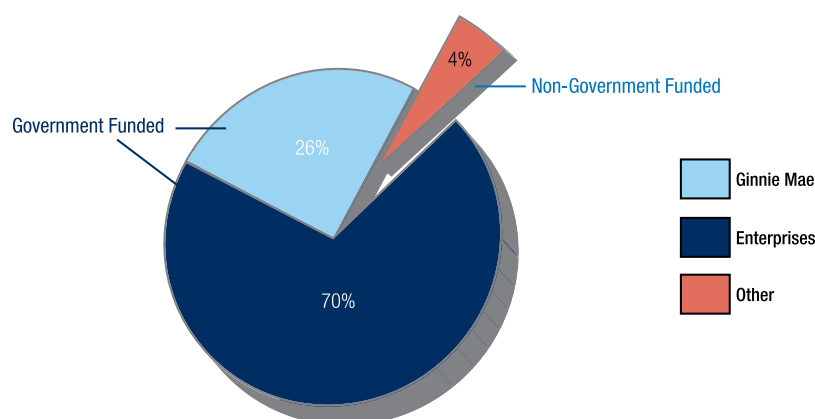
Fannie Mae and Freddie Mac (collectively, “the Enterprises”) have charter and legislative obligations to provide liquidity and support to the residential mortgage finance system and serve the mortgage credit needs of targeted groups, such as low-income borrowers.¹ To do so, the Enterprises have participated in the creation and development of the secondary mortgage market. They purchase residential mortgages from originators such as banks and thrifts, which can use the sales proceeds to originate additional mortgages. The Enterprises hold some of the mortgages they purchase in their retained investment portfolios and package the remainder into mortgage-backed securities (“MBS”), which they sell to investors. For a fee, the Enterprises also guarantee the timely payment of interest and principal on MBS that they issue. As of March 31, 2011, the Enterprises’ combined mortgage investment portfolios and outstanding guarantees stood at \$5.4 trillion.²

For a description of the GSEs, see Section 2: “Operations of FHFA and the GSEs, Federal Housing Finance Agency.”

For further information on Fannie Mae’s and Freddie Mac’s business model, see Section 2: “Operations of FHFA and the GSEs, Fannie Mae and Freddie Mac.”

In 2007 and 2008, the U.S. housing finance system suffered its worst downturn since the Great Depression, and the Enterprises lost billions of dollars. In September 2008, as the Enterprises' losses mounted, FHFA placed them into conservatorships, and the U.S. Department of the Treasury ("Treasury") began providing them unprecedented financial support. As of March 31, 2011, Treasury had invested nearly \$154 billion in the Enterprises, and FHFA estimates that the total taxpayer commitment to the Enterprises could range from \$221 billion to \$363 billion through 2013.³ The Federal Reserve also has taken steps to support the Enterprises, such as committing to purchase up to \$1.25 trillion⁴ of their MBS. Aided by federal financial assistance, the Enterprises added to their dominant position in the housing finance system as the housing finance crisis continued and private-sector financing plummeted. As illustrated in Figure 1 (*below*), during 2010, federal government-supported entities accounted for 96% of MBS issuances: 70% by the Enterprises, and 26% by the Government National Mortgage Association ("Ginnie Mae").

Figure 1. Mortgage Market Share, 2010



Source: Federal Housing Finance Agency. *Conservator's Report on the Enterprises' Financial Performance: Fourth Quarter 2010*. <http://www.fhfa.gov/webfiles/21169/Conservator's_Report_4Q_4_20_11.pdf>, p. 5, accessed 4/27/2011.

The 12 FHLBanks support housing finance and community and economic development. To carry out their missions, the FHLBanks make loans, also known as advances, to member financial institutions. Some also hold mortgage investment portfolios. As of December 31, 2010, the FHLBanks had \$878 billion in assets.⁵ Although no FHLBank is in conservatorship, several face financial challenges.

Congress is considering various proposals to reform the housing finance system, including a plan offered by the Administration on February 11, 2011. Many such proposals call for the wind down and ultimate elimination of the Enterprises. But these same proposals recognize that such reforms will take time to implement, especially in light of the dominant roles of the GSEs in the housing markets. In the meantime, FHFA must manage the conservatorships effectively in order to minimize taxpayer losses and to prepare for the future.

FHFA-OIG'S INITIAL STAFFING AND ORGANIZATIONAL DEVELOPMENT EFFORTS

Since FHFA-OIG started operations in October 2010, it has moved proactively to ensure that it has sufficient staffing and resources to assess FHFA's critical responsibilities as conservator and regulator. FHFA-OIG has taken steps to ensure that it is well positioned to detect and prevent mortgage fraud, which may directly threaten the financial soundness of the housing GSEs. As of March 31, 2011, FHFA-OIG had hired more than 50 staff members with a range of critical skills to carry out its responsibilities. This team includes seasoned investigators, evaluators, auditors, attorneys, subject matter experts, and administrative support staff. FHFA-OIG has established an organizational structure that will enable it to carry out its responsibilities in an efficient and effective manner. With FHFA's assistance, FHFA-OIG has also developed and obtained the infrastructure necessary to fulfill its mission, including office space, information technology, and communications systems.

KEY FHFA-OIG ACCOMPLISHMENTS DURING THE INAUGURAL PERIOD

Both reports are available at www.fhfaoig.gov.

Reports: From a standing start, with no staff or resources, FHFA-OIG commenced operations and completed two reports, briefly summarized here:

- **Fannie Mae and Freddie Mac Executive Compensation:** In an evaluation report issued on March 31, 2011, FHFA-OIG noted that FHFA did not have adequate processes in place to manage executive compensation programs for the Enterprises' senior officers. As conservator, FHFA can appoint senior officers and has the authority to review and approve their compensation packages. The top six senior officers at the Enterprises received combined total compensation of \$34.4 million in 2009 and 2010 under FHFA-approved compensation packages, and Agency officials believe such compensation is necessary to recruit and retain senior officers. However, FHFA-OIG found that FHFA had not considered factors that might have resulted in reduced executive compensation costs, such as the impact that federal financial support has on corporate executive performance and the compensation paid to senior officials at federal entities that also play a critical role in housing finance. Further, FHFA-OIG found that FHFA had neither developed written criteria to assess the Enterprises' executive compensation levels, nor required Agency staff to verify and test the means by which the Enterprises calculated their recommended compensation levels. FHFA-OIG made recommendations based on its findings, and FHFA agreed to implement most but not all of them.
- **FHFA Conservatorship Exit Planning Strategy:** In an evaluation also issued on March 31, 2011, FHFA-OIG noted that FHFA would need to develop a careful planning strategy to implement the recommended actions in the Administration's February 11, 2011, housing finance system reform plan. The FHFA-OIG report identified the actions

FHFA would be expected to take under the plan, such as requiring the Enterprises to raise their MBS guarantee fees or down-payment requirements for mortgages they purchase. The report noted that such steps involve potential risks to housing finance if not managed carefully. For example, raising the Enterprises' guarantee fees and underwriting standards too quickly could unnecessarily restrict the availability of mortgage credit. Careful planning by FHFA would require it to, among other things, establish planning timelines and external reporting strategies to keep mortgage market participants, Congress, and others apprised of its activities and progress. The FHFA-OIG evaluation report also noted that FHFA faces challenges in hiring staff necessary to manage its role as conservator and regulator as well as additional responsibilities under the Administration's proposal. FHFA agreed to implement the report's recommendations.

Independent Third-Party Risk Assessment: To gain a deeper understanding of the risk landscape, FHFA-OIG hired BDO USA LLP, a professional services firm, to provide an independent assessment of the risks confronting the GSEs and FHFA. FHFA-OIG intends to use that recently completed assessment to inform its operations and goals.

Criminal and Civil Investigation: FHFA-OIG has initiated and participated in numerous criminal, civil, and administrative investigations. FHFA-OIG has made significant contributions to the investigation and prosecution of individuals connected to Taylor, Bean & Whitaker Mortgage Corporation and Colonial Bank who defrauded, among others, Freddie Mac. With total losses now estimated at \$2.9 billion, the case represents one of the largest mortgage frauds in U.S. history. Six individuals have pled guilty to federal criminal charges. On April 19, 2011, a seventh individual – the lead defendant – was convicted on 14 counts following a jury trial. FHFA-OIG also continues to develop working partnerships and information-sharing relationships with federal and other law enforcement agencies.

Hotline: The FHFA-OIG Hotline allows concerned parties to report directly and in confidence information regarding possible fraud, waste, or abuse related to FHFA or the GSEs. FHFA-OIG honors all applicable whistleblower protections. As part of its effort to raise awareness of fraud and how to combat it, FHFA-OIG is actively promoting the Hotline through the FHFA-OIG website, posters, targeted emails to FHFA and GSE employees, and the Semiannual Report.

Regulatory Activity: FHFA-OIG has provided comments on proposed FHFA policies and regulations. Those comments have led FHFA to revise or withdraw a number of proposals.

The FHFA-OIG **Hotline** can be reached at (800) 793-7724 or via email at OIGHOTLINE@FHFA.GOV.

The full Audit and Evaluation Plan is available at www.fhfaig.gov.

FHFA-OIG PLANS AND STRATEGY

FHFA-OIG has prepared an Audit and Evaluation Plan^a and is following an ongoing strategy of identifying vulnerabilities and risk areas in FHFA and GSE programs. It is aided by: the independent risk assessment discussed above; reviews of relevant reports and documents; interviews with FHFA officials; and consultations with Members of Congress and other government officials.

Key aspects of the strategy include ongoing reviews of FHFA's:

- Regulatory efforts and its management of the Enterprise conservatorships. Areas of focus include: FHFA staff capacity, Enterprise executive compensation, Enterprise mortgage buyback settlements, foreclosure prevention and loss mitigation efforts, mortgage loan servicing controls, foreclosed property management and sales processes, and payment of legal fees. These are potentially high-risk areas, all the more so because Treasury has invested nearly \$154 billion of taxpayer funds in the Enterprises. FHFA must regulate and oversee (as conservator) the GSEs in an efficient, effective, and transparent manner to minimize taxpayer costs, conserve Enterprise resources, and meet all statutory mandates;
- Oversight of the FHLBanks and their associated risks;
- Internal operations, such as information security, privacy, and the handling of consumer complaints and allegations of fraud, waste, and abuse; and
- Oversight of the GSEs' housing missions.

FHFA-OIG will continue its work with law enforcement partners, whistleblowers, and other parties concerned with eliminating fraud, waste, and abuse.

Finally, FHFA-OIG expects to continue to review and comment on proposed FHFA rules as warranted.

ORGANIZATION OF THIS REPORT

This Report covers the inaugural period of FHFA-OIG's operations, from October 2010 through March 2011. It is organized as follows:

- Section 1, *Description of FHFA-OIG*, provides a brief overview of the organization.
- Section 2, *Operations of FHFA and the GSEs*, describes the organization and operation of FHFA, Fannie Mae, Freddie Mac, and the FHLBanks and discusses notable developments related to FHFA-OIG's oversight of these organizations.

^a FHFA-OIG's plan is dynamic and will be revised as necessary.

- Section 3, *Accomplishments of FHFA-OIG*, describes FHFA-OIG's oversight activities, including audits, evaluations, and investigations.
- Section 4, *FHFA-OIG's Oversight Strategy*, describes FHFA-OIG's strategy for the future.
- Additionally, the Report includes, as background, *A Brief History of the Housing Government-Sponsored Enterprises*.

FHFA-OIG REPORTING REQUIREMENTS

The Inspector General Act states that each Inspector General is required, no later than April 30 and October 31 each year, to prepare semiannual reports summarizing the activities of the Offices of Inspectors General during the immediately preceding six-month periods ending March 31 and September 30. The specific reporting requirements, as stipulated in the Inspector General Act, are listed in Appendix B.



SECTION 1

DESCRIPTION OF FHFA-OIG

Section 1: Description of FHFA-OIG

The Federal Housing Finance Agency Office of Inspector General (“FHFA-OIG”) began operations on October 12, 2010. Established by the Housing and Economic Recovery Act of 2008 (“HERA”), which amended the Inspector General Act, FHFA-OIG conducts, supervises, and coordinates audits, investigations, and other activities relating to the programs and operations of the Federal Housing Finance Agency (“FHFA” or the “Agency”).

FHFA-OIG’S VISION, MISSION, AND CORE VALUES

FHFA-OIG’s vision is to be an efficient and effective organization that promotes excellence and trust through its service to FHFA, Congress, the Administration, and the American public.

FHFA-OIG’s mission is to:

- Promote the economy, efficiency, and effectiveness of FHFA’s programs and operations;
- Prevent and detect fraud, waste, and abuse in the programs and operations of FHFA; and
- Seek administrative sanctions, civil recoveries, and/or criminal prosecutions of those responsible for fraud, waste, and abuse in connection with FHFA’s programs and operations.

In carrying out its mission, FHFA-OIG:

- Keeps the Director of FHFA, Congress, and the American people fully and currently informed of problems and deficiencies relating to FHFA’s programs and operations; and
- Works with FHFA staff and program participants to improve FHFA’s programs and operations.

FHFA-OIG adheres to a defined set of core values:

- **Mission Driven.** FHFA-OIG is committed to excellence with the aim of providing transparency and accountability in FHFA’s programs and operations and improving its performance through measurable results;
- **Integrity.** FHFA-OIG strives to maintain trust and integrity;
- **Professionalism.** FHFA-OIG is committed to the highest standards of professional conduct;
- **Equal Employment Opportunity.** FHFA-OIG promotes equal employment opportunity for all employees and job applicants; and

- **Confidentiality.** FHFA-OIG is committed to maintaining the confidentiality of whistleblowers and others.

LEADERSHIP AND ORGANIZATIONAL STRUCTURE

The first FHFA Inspector General, Steve A. Linick, was nominated by President Barack Obama on April 12, 2010, confirmed by the United States Senate on September 29, 2010, and sworn into office on October 12, 2010. Prior to commencing service as the FHFA Inspector General, Mr. Linick served from 2006 to 2010 in several leadership positions at the U.S. Department of Justice (“DOJ”). Previously, Mr. Linick was an Assistant United States Attorney, first in the Central District of California (1994-1999), and subsequently in the Eastern District of Virginia (1999-2006).

FHFA-OIG is comprised of the Inspector General, his Senior Staff, and the FHFA-OIG Offices. The Inspector General’s Senior Staff includes the Chief of Staff, Chief Counsel, Director of External Affairs, and the Deputy Inspectors General for Audits, Evaluations, Investigations, and Administration. FHFA-OIG’s principal operating Offices are the Office of Audits (“OA”), the Office of Evaluations (“OE”), and the Office of Investigations (“OI”). Offices with OIG-wide responsibilities are the Office of Counsel (“OC”), the Office of Policy, Oversight, and Review (“OP”), and the Office of Administration (“OAd”). FHFA-OIG’s organizational chart can be found in Appendix D.

Office of Audits

OA provides audit and related services covering the programs and operations of FHFA. Through its financial and performance audits and attestation engagements, OA seeks to: (1) promote economy, efficiency, and effectiveness in the administration of FHFA’s programs; (2) detect and deter fraud, waste, and abuse in FHFA’s activities and operations; and (3) ensure compliance with applicable laws and regulations. Under the Inspector General Act, federal inspectors general are required to comply with standards established by the Comptroller General of the United States for audits of federal establishments, organizations, programs, activities, and functions. These standards, referred to as Generally Accepted Government Auditing Standards, are prescribed in the *Government Auditing Standards*, commonly referred to as the “Yellow Book.” OA performs its audits and attestation engagements in accordance with applicable Generally Accepted Government Auditing Standards.

Office of Evaluations

OE reviews, studies, and analyzes FHFA’s programmatic and operational activities and provides independent and objective analyses to FHFA. OE’s evaluations are generally limited in scope and completed more quickly than traditional audits. When OE observes significant deficiencies in the effectiveness or efficiency of FHFA’s programs and operations, it assists the Inspector General in developing recommendations to resolve them.

The Inspector General Reform Act of 2008 requires that federal inspectors general adhere to professional standards developed by the Council of the Inspectors General on Integrity and Efficiency (“CIGIE”). Evaluation standards are prescribed by CIGIE in its *Quality Standards for Inspection and Evaluation*, commonly referred to as the “Blue Book.” OE performs its evaluations in accordance with these standards.

Office of Investigations

OI investigates allegations of misconduct or fraud involving the programs and operations of FHFA and the GSEs. OI Special Agents develop criminal and civil cases for referral to DOJ and other law enforcement agencies.^b OI adheres to CIGIE’s *Quality Standards for Investigations* and fully complies with guidelines issued by the Attorney General.

OI also generates administrative cases for presentation to FHFA and administers the FHFA-OIG Hotline.

Office of Counsel

OC supports FHFA-OIG by providing independent legal advice, counseling, and opinions concerning FHFA-OIG’s programs and operations. OC also reviews audit, investigation, and evaluation reports for legal sufficiency. It reviews drafts of FHFA regulations and policies and prepares comments as appropriate. OC also coordinates with the FHFA Office of General Counsel and manages FHFA-OIG’s responses to requests and appeals made under the Freedom of Information Act and the Privacy Act.

Office of Policy, Oversight, and Review

OP provides advice, consultation, and assistance regarding FHFA-OIG’s priorities, the scope of its evaluations and audits, and all reports published by FHFA-OIG. In addition, OP is responsible for conducting special studies and developing the Semiannual Report. Finally, OP plays an integral role in reviewing audits and evaluations and in identifying issues for review that are timely to FHFA, Congress, and the public.

Office of Administration

OAd is responsible for FHFA-OIG’s human resources, budget development and execution, financial management, information technology, facilities and property management, safety, and continuity of operations.

PROGRESS IN BUILDING FHFA-OIG ORGANIZATION

FHFA-OIG began operations in October 2010 with no staff or infrastructure. Since then, FHFA-OIG has made significant progress in building its organization and capabilities, as detailed below.

^b On April 5, 2011, Attorney General Eric Holder authorized FHFA-OIG to exercise statutory law enforcement powers pursuant to the Inspector General Act.

Personnel

FHFA-OIG had over 50 full-time personnel as of March 31, 2011. FHFA-OIG has recruited seasoned investigators, evaluators, auditors, attorneys, subject matter experts, and administrative support staff.

Infrastructure

FHFA-OIG occupies the seventh floor of 1625 Eye Street, NW, Washington, DC. Many FHFA staff members occupy the third and fourth floors of the same building, and additional FHFA offices are nearby. FHFA (including FHFA-OIG) intends to consolidate in a new headquarters building in 2012.

FHFA-OIG's website (www.fhfaoig.gov) is now fully operational. FHFA-OIG posts all of its reports, testimony, and investigations (when permitted to be made available to the public) on the website as soon as possible.

Contracting

FHFA-OIG has entered into a number of contracts, both with other federal government agencies and private sector organizations, in order to obtain essential equipment and services as quickly and efficiently as possible. Major service providers under these contracts include:

- U.S. Department of the Treasury, Bureau of the Public Debt, which provides administrative services;
- U.S. Department of Commerce, National Technical Information Service, which provides computer network integration and hosting services;
- U.S. Government Printing Office, which provides printing and website services;
- BDO USA, LLP, which provided risk assessment services; and
- Reznick Group, P.C., which provides research, writing, and editing services.

Budget

Unlike most other federal agencies, FHFA and FHFA-OIG are not funded through Congressional appropriations. Rather, under HERA, FHFA and FHFA-OIG are funded through the collection of annual assessments levied on the GSEs. For fiscal year 2011, \$29 million was assessed to fund the operations of FHFA-OIG.



SECTION 2

OPERATIONS OF FHFA AND THE GSEs

Section 2: Operations of FHFA and the GSEs

FEDERAL HOUSING FINANCE AGENCY

In the midst of the financial crisis, the Housing and Economic Recovery Act (“HERA”) was enacted on July 30, 2008. HERA created the Federal Housing Finance Agency (“FHFA”) as the successor agency to the Office of Federal Housing Enterprise Oversight (“OFHEO”) and the Federal Housing Finance Board (“FHFB”). OFHEO had been established in 1992 to regulate the Federal National Mortgage Association (“Fannie Mae”) and the Federal Home Loan Mortgage Corporation (“Freddie Mac”). Prior to HERA’s enactment, OFHEO had functioned as an independent agency within the U.S. Department of Housing and Urban Development (“HUD”). FHFB had been established in 1989 as the regulator of the nation’s 12 Federal Home Loan Banks (“FHLBanks”). FHFA now regulates and supervises Fannie Mae, Freddie Mac, and the FHLBanks (collectively, the **Government-Sponsored Enterprises (“GSEs”)**).

Government-Sponsored Enterprises (“GSEs”):

Business organizations chartered and sponsored by the federal government, which include Fannie Mae, Freddie Mac, and the FHLBanks.

FHFA AUTHORITIES

Housing and Economic Recovery Act

Under HERA, FHFA oversees the GSEs’ operations. HERA authorizes FHFA to:

- Ensure that the GSEs operate “in a safe and sound manner, including maintenance of adequate capital and internal controls;”
- Establish criteria for investments that the GSEs may hold in their portfolios;
- Establish risk-based capital requirements for the GSEs;
- Require the GSEs to increase their capital;
- Review and approve GSE executive compensation;
- Review and approve any new products that Fannie Mae or Freddie Mac propose to offer;
- Establish affordable housing goals for Fannie Mae and Freddie Mac (together, the “Enterprises”);
- Enforce compliance with housing goals; and
- Appoint FHFA as a conservator or receiver of the GSEs.

On September 6, 2008, weeks after HERA’s enactment, the Enterprises were placed into conservatorships overseen by FHFA. As conservator, FHFA assumed all the powers of the shareholders, directors, and officers, with the goal of preserving and conserving the assets and property of the Enterprises.⁶

HERA also expanded the authority of the U.S. Department of the Treasury (“Treasury”) to provide financial support to the GSEs.⁷ Treasury exercised that authority when it began – at the time the conservatorships were created – to purchase **preferred stock** issued by Fannie Mae and Freddie Mac pursuant to **Senior Preferred Stock Purchase Agreements (“PSPAs”)**.

The PSPAs require the Enterprises to pay Treasury a 10% annual dividend (the rate shall increase to 12% if, in any quarter, the dividends are not paid in cash, until all accrued dividends have been paid in cash) on its outstanding investment. As of March 31, 2011, Treasury has invested a total of \$153.9 billion in the Enterprises. Under the PSPAs, the Enterprises have been obligated to pay Treasury \$24.1 billion in dividends. But the Enterprises have been unable to make such payments on their own, and Treasury has had to increase its investment to cover these dividend payments and make up additional capital deficiencies.

Emergency Economic Stabilization Act

Soon after the Enterprises were placed into conservatorships and as the financial crisis continued, the Emergency Economic Stabilization Act (“EESA”) was enacted on October 3, 2008. With respect to the housing market, EESA was intended to: protect home values and investments; preserve homeownership and promote economic growth; and maximize returns to the taxpayer.⁸

To preserve homeownership, EESA requires FHFA to implement a plan to maximize assistance to homeowners and to use its authority to encourage the servicers of Fannie Mae and Freddie Mac mortgages to take advantage of federal programs to minimize foreclosures.⁹ In addition, EESA requires FHFA to coordinate with Treasury on homeowner assistance plans and to submit monthly reports to Congress detailing the progress of its efforts.

FANNIE MAE AND FREDDIE MAC

Fannie Mae was chartered in 1938 to support the creation of stable funding in the U.S. housing and mortgage markets. Freddie Mac was chartered in 1970 with a similar mission to provide stability for the nation’s residential mortgage markets and expand opportunities for home ownership and affordable rental housing.

As Figure 2 (*see page 20*) illustrates, Fannie Mae and Freddie Mac support the nation’s housing finance system through the **secondary mortgage market**. Neither Enterprise makes home loans directly to borrowers; rather, banks, credit unions, and other retail financial institutions originate home loans. Generally, lenders do not retain the mortgages they originate as assets on their own books. Instead, they often sell **conventional conforming mortgage loans** soon after origination to Fannie Mae or Freddie Mac. The Enterprises thus provide liquidity for mortgage lenders, which receive cash that can be used for additional mortgages.

Preferred Stock:

A security that usually pays a fixed dividend and gives the holder a claim on corporate earnings and assets that is superior to that of holders of common stock, but inferior to that of investors in the corporation’s debt securities.

Senior Preferred Stock Purchase Agreements (“PSPAs”):

Entered into at the time the conservatorships were created, the PSPAs authorize the Enterprises to request and obtain funds from Treasury, which in turn owns preferred stock in each Enterprise. Under the PSPAs, the Enterprises agreed to consult Treasury concerning a variety of significant business activities, capital stock issuance and dividend payments, ending the conservatorships, transferring assets, and awarding executive compensation.

Primary Mortgage Market:

The market for newly originated mortgages.

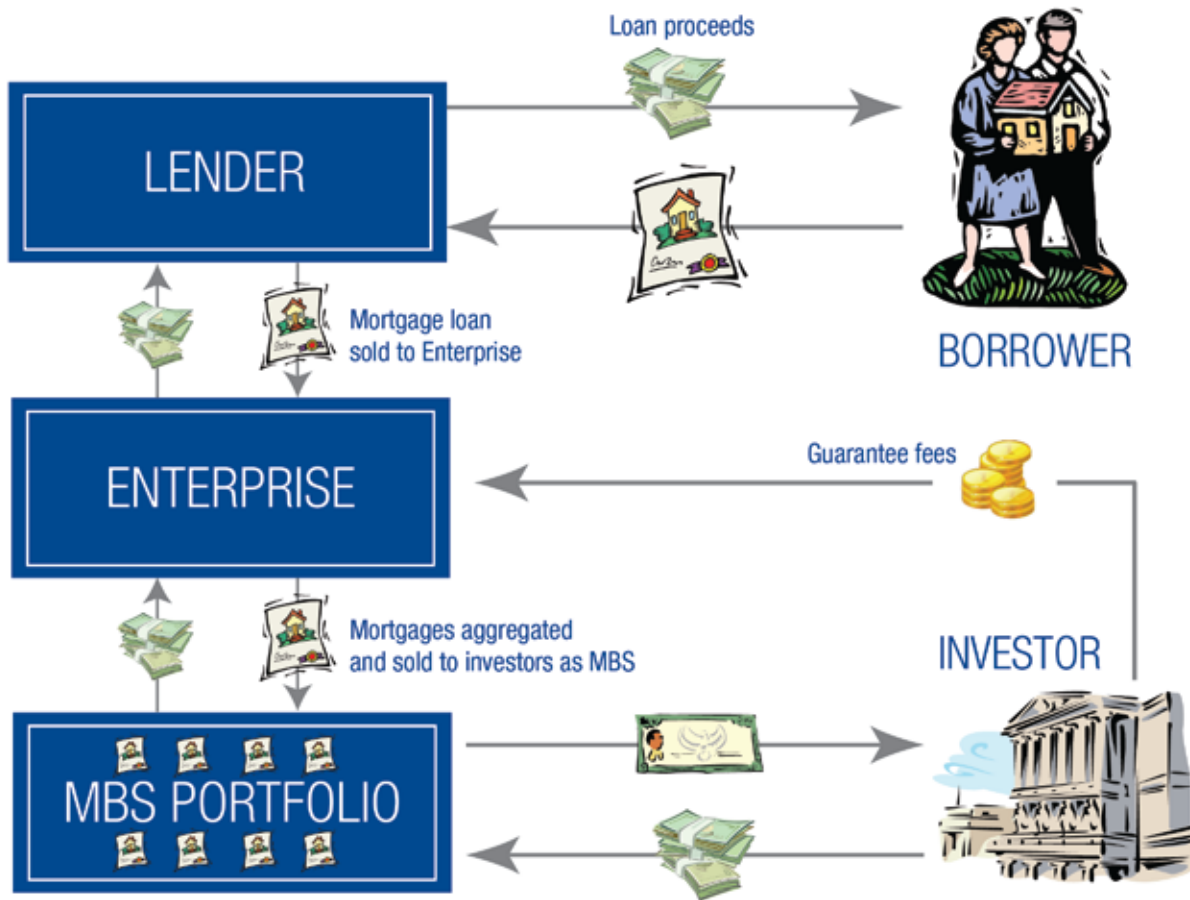
Secondary Mortgage Market:

The market for buying and selling existing mortgages; this could be in the form of whole mortgage or MBS sales.

Both the primary and secondary mortgage markets are over-the-counter markets — there is no central exchange. Rather, loans are bought and sold through personal and institutional networks.

Conventional Conforming Mortgage Loans:

Conventional mortgage loans are those mortgages that are not insured or guaranteed by the Federal Housing Administration, the U.S. Department of Veterans Affairs, or the U.S. Department of Agriculture and meet the Enterprises’ underwriting standards. Conforming mortgage loans have original balances below a specific threshold, set by law and published by FHFA, known as the “conforming loan limit.” For 2011, the conforming loan limit is \$417,000 for most areas of the contiguous United States, although higher limits apply in specific areas.

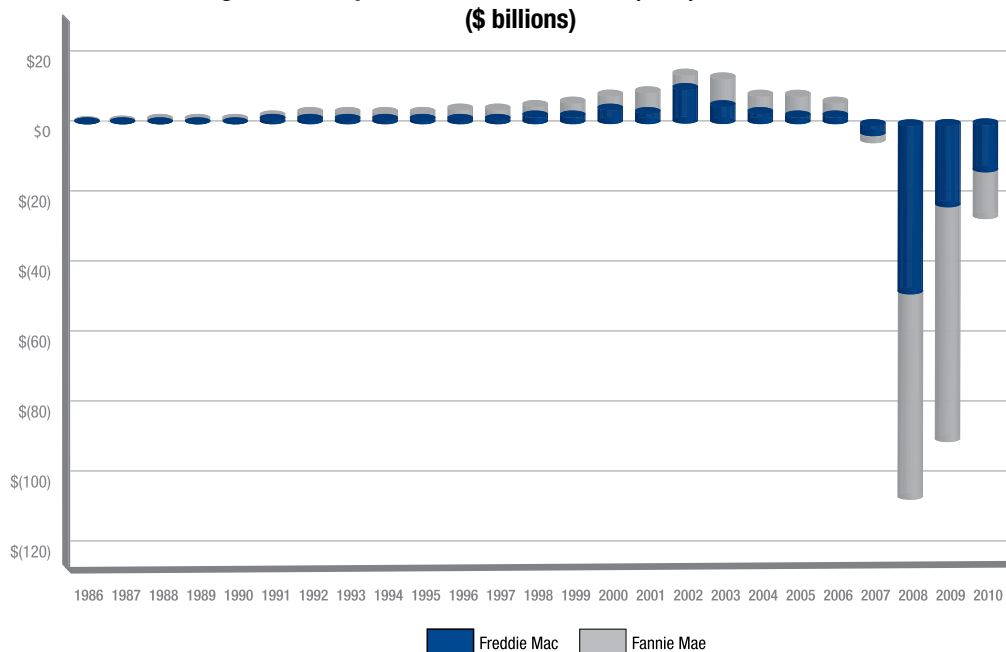
Figure 2. Mortgage Origination and Securitization Process**Mortgage-Backed Securities (“MBS”):**

MBS are debt securities that represent claims to the cash flows from pools of mortgage loans, most commonly on residential property. Mortgage loans are purchased from banks, mortgage companies, and other originators and then assembled into pools. The MBS represent claims on the principal and interest payments made by borrowers on the loans in the pool.

The Enterprises typically securitize the loans they purchase by aggregating or pooling them into debt securities called **mortgage-backed securities (“MBS”)**, which are sold to investors. As part of the securitization process, and to reduce investors’ risk, the Enterprises **guarantee** payment of principal and interest on their MBS in exchange for a fee. Alternatively, the Enterprises also may hold these loans or purchase MBS for their own investment portfolios, which are funded through issuance of debt obligations.

The Enterprises have historically benefited from an **implied guarantee** that the federal government would prevent default on their financial obligations.¹⁰ After the Enterprises were placed into conservatorships, this guarantee effectively became explicit.¹¹ As a result, over time the cost of borrowing for the Enterprises has been lower than that for other for-profit companies.¹² For example, according to FHFA, for the first quarter of 2011, comparable high-grade finance company debt paid an annual interest rate of 3.4%, versus 2.6% for the Enterprises.

Figure 3. Enterprises Annual Net Income (Loss) 1986 to 2010
(\$ billions)



Sources: Federal Housing Finance Agency. *2008 FHFA Annual Report to Congress*. <http://www.fhfa.gov/webfiles/2335/FHFA_ReportToCongress2008508rev.pdf>, p. 110, 127, accessed 4/27/2011; Fannie Mae. *2009 and 2010 Fannie Mae 10-K Reports*. <<http://www.fanniemae.com/ir/sec/index.jhtml?s=SEC+Filings>>, p. F-4, accessed 4/27/2011; Freddie Mac. *2009 and 2010 Freddie Mac 10-K Reports*. <http://www.freddiemac.com/investors/sec_filings/index.html>, p. 208, 174, accessed 4/27/2011.

Enterprise Financial Performance and Government Support

At the time they were placed into conservatorships, the Enterprises had experienced unprecedented financial losses. For example, as shown in Figure 3 (*above*), in a single year, 2008, the Enterprises reported combined losses of \$109 billion, a figure which exceeded their cumulative earnings over the preceding 21 years. The Enterprises have continued to lose money since, although the magnitude of losses has diminished somewhat more recently, to \$94 billion in 2009 and \$28 billion in 2010.

To offset these losses, government support of the Enterprises since 2008 also has been unprecedented. Figure 4 (*see page 22*) breaks down, by quarter, Treasury's investment in the Enterprises through March 31, 2011. Treasury has provided \$153.9 billion pursuant to the PSPAs. In accordance with the terms of the PSPAs, the Enterprises must make quarterly dividend payments to Treasury at an annual rate equal to 10% (the rate shall increase to 12% if, in any quarter, the dividends are not paid in cash, until all accrued dividends have been paid in cash) of the outstanding investment. To date, Treasury generally has had to increase its investment in the Enterprises to cover these dividend payments. As of March 31, 2011, \$24.1 billion of Treasury's investment had been used to pay dividends back to Treasury. FHFA estimates, based on the Enterprises' projected losses, that Treasury's investment in them could range from \$221 billion to \$363 billion through 2013.¹³

Guarantee:

A pledge to investors that the issuing company will bear the default risk on the collateral pool of loans, thereby ensuring the timely payment of principal and interest owed to investors.

Implied Guarantee:

The assumption, prevalent in the financial markets, that the federal government will cover GSE debt obligations.

Figure 4. Treasury Capital and Dividends Due Under PSPA (\$ billions)

Period Covered	Fannie Mae			Freddie Mac			Combined		
	Treasury Investment Under PSPAs	Treasury Funding to Pay Dividends Due Treasury	Net Capital Provided to Enterprises	Treasury Investment Under PSPAs	Treasury Funding to Pay Dividends Due Treasury	Net Capital Provided to Enterprises	Treasury Investment Under PSPAs	Treasury Funding to Pay Dividends Due Treasury	Net Capital Provided to Enterprises
Third Quarter 2008	\$13.8	\$0.0	\$13.8	\$ 0.0	\$0.0	\$0.0	\$13.8	\$0.0	\$13.8
Fourth Quarter 2008	30.8	0.2	30.6	15.2	0.0	15.2	46.0	0.2	45.8
First Quarter 2009	6.1	0.4	5.7	19.0	0.0	19.0	25.1	0.4	24.7
Second Quarter 2009	-	1.1	(1.1)	10.7	0.4	10.3	10.7	1.6	9.1
Third Quarter 2009	-	1.3	(1.3)	15.0	0.9	14.1	15.0	2.2	12.8
Fourth Quarter 2009	-	1.3	(1.3)	15.3	1.2	14.1	15.3	2.4	12.9
First Quarter 2010	10.6	1.3	9.3	8.4	1.5	6.9	19.0	2.8	16.2
Second Quarter 2010	1.8	1.3	0.5	1.5	1.9	(0.4)	3.3	3.2	0.1
Third Quarter 2010	0.1	1.6	(1.5)	2.5	2.1	0.4	2.6	3.7	(1.1)
Fourth Quarter 2010	0.5	1.6	(1.1)	2.6	2.2	0.4	3.1	3.8	(0.7)
First Quarter 2011	-	1.6	(1.6)	-	2.2	(2.2)	-	3.8	(3.8)
Total as of March 31, 2011	\$63.7	\$11.7	\$52.0	\$90.2	\$12.4	\$77.8	\$153.9	\$24.1	\$129.8

Source: Federal Housing Finance Agency. Data as of March 31, 2011 on Treasury and Federal Reserve Purchase Programs for GSE and Mortgage-Related Securities <<http://www.fhfa.gov/webfiles/20758/TreasFED033120111.pdf>>, accessed 4/27/2011. Nonzero numbers may display as zero due to rounding.

Additional Government Support

The Enterprises also benefited from exceptional government measures to support the housing market overall. Since September 2008, the Federal Reserve and Treasury have purchased over \$1.3 trillion in Enterprise MBS, and the Federal Reserve has purchased an additional \$135 billion in direct debt obligations of the Enterprises.¹⁴

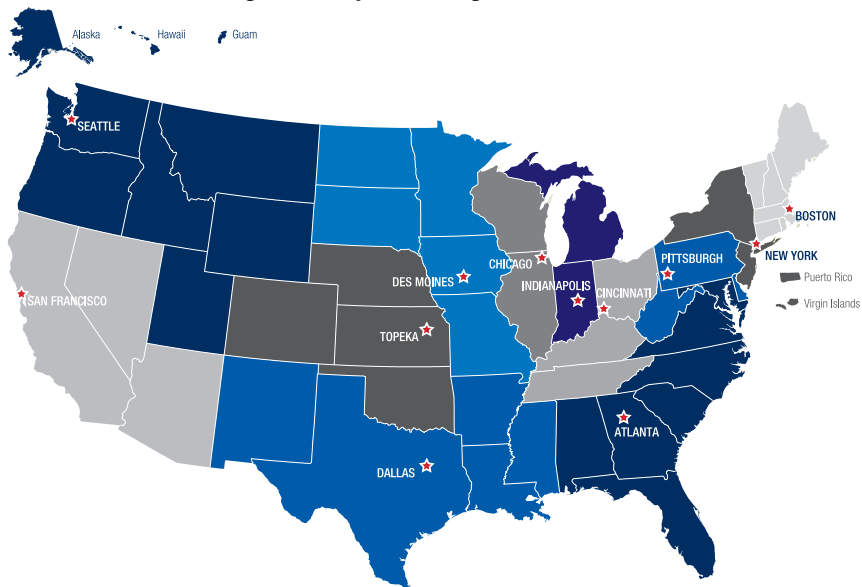
FEDERAL HOME LOAN BANKS

The FHLBanks were created in 1932 to improve the availability of funds for residential mortgage lending. The FHLBank System is currently comprised of 12 regional FHLBanks and the Office of Finance, which issues debt on the FHLBanks' behalf.¹⁵ The 12 FHLBanks are each separate legal entities that must adhere to specific management and capitalization criteria.¹⁶

Each FHLBank focuses on community credit needs throughout its geographical area. The areas that comprise the FHLBank System are shown in the map in Figure 5 (*see page 23*).

The 12 FHLBanks are privately capitalized. Each regional FHLBank is cooperatively owned by the members it serves, which include financial institutions such as commercial banks, thrifts, insurance companies, and credit unions. Eligible financial institutions invest in stock of the FHLBanks to become members. FHLBank stock is not publicly traded.¹⁷

Figure 5. Map of the Regional FHLBanks



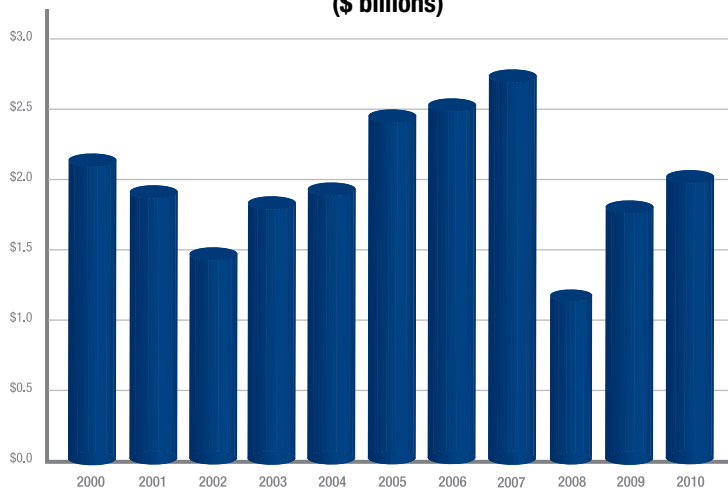
Source: FHLBBoston. *The Federal Home Loan Bank System*. <http://www.fhlbboston.com/aboutus/thebank/08_01_04_fhlb_system.jsp>, accessed 4/27/2011.

The primary business of the FHLBanks is providing their members with low-cost funding for mortgage lending and other purposes. To do so, each FHLBank makes loans (referred to as advances) to its members. FHLBank advances are available in a variety of maturities and structures. Such advances are **collateralized** by single-family mortgage assets, investment-grade securities, or in some cases, agricultural and small business loans.

Collateral:

Assets used as security for a loan that can be seized by the lender if the borrower fails to repay the loan.

**Figure 6. FHLBanks Annual Net Income 2000 to 2010
(\$ billions)**



Sources: Federal Home Loan Banks. *2010 Federal Home Loan Banks Combined Financial Report*. <http://www.fhlb-of.com/ofweb_userWeb/resources/10yrend.pdf>, p. F-5, accessed 4/27/2011; Federal Housing Finance Agency. *2008 FHFA Annual Report to Congress*. <http://www.fhfa.gov/webfiles/2335/FHFA_ReportToCongress2008508rev.pdf>, p. 141, accessed 4/27/2011.

Private-Label MBS:

MBS derived from mortgage loan pools assembled by entities other than GSEs or federal government agencies, such as private-sector finance companies. They do not carry an explicit or implicit government guarantee, and the private-label MBS investor bears the risk of losses on its investment.

FHFA-OIG recently released an evaluation discussing FHFA's exit strategy and planning process for the Enterprises' structural reform. The evaluation is available at www.fhfa.oig.gov. FHFA-OIG plans to review the capacity of FHFA's examination staff.

The FHLBanks also maintain investment portfolios that contain mortgage-related assets, and some face heightened credit risks due to their relatively larger holdings of **private-label MBS**.

To raise money to fund member advances, the FHLBanks issue debt securities through their Office of Finance.¹⁸ In the event of a default on these debt obligations, each FHLBank is jointly and severally liable for losses incurred by other FHLBanks. Like Fannie Mae and Freddie Mac, the FHLBank System has also historically enjoyed cost benefits stemming from the implicit government guarantee of its debt obligations.

SELECTED FHFA PROGRAMS AND ACTIVITIES

FHFA-OIG continues to follow developments in programs that affect the operations of FHFA and the GSEs. A number of them are discussed here, including the Administration's housing finance reform proposal, Enterprise mortgage buyback settlements, FHFA's reorganization, and the Seattle FHLBank consent order.

Administration's Housing Finance Reform Plan

On February 11, 2011, Treasury and HUD jointly issued a report to Congress on the future of housing finance, *Reforming America's Housing Finance Market* (the "Plan"), which outlines the Administration's position on reforming the U.S. housing finance market.

The Administration's Plan summarizes its view of the flaws underlying the housing market crisis and calls for the eventual wind down of Fannie Mae and Freddie Mac. According to the Plan, "The Administration will work with [FHFA] to develop a plan to responsibly reduce the role of [Fannie Mae] and [Freddie Mac] in the mortgage market and, ultimately, wind down both institutions." The Plan recommends that FHFA implement measures to transition the housing market from taxpayer funding to private capitalization. Relative to FHFA and the GSEs, specific policy prescriptions of the Plan include:

- Increasing guarantee fees;
- Increasing the involvement of private capital in the mortgage market, including privately funded credit-loss protection on mortgage portfolios and larger down payment requirements for borrowers;
- Reducing conforming loan limits; and
- Winding down the Enterprises' investment portfolios.

With respect to the FHLBanks, the Plan advocates limiting the level of advances in order to focus FHLBank resources on small- and medium-sized financial institutions. As with Fannie Mae and Freddie Mac, it proposes that the FHLBanks wind down their investment portfolios and reorient themselves

toward the core mission of providing readily available funding to FHLBank member institutions.

The Plan also outlines three options for the structure of the future U.S. housing finance system, ranging from less to more government involvement:

Option 1: Privatized system of housing finance with the government insurance role limited to FHA, USDA and Department of Veterans Affairs assistance for narrowly targeted groups of borrowers;

Option 2: Privatized system of housing finance with assistance from FHA, USDA and Department of Veterans Affairs for narrowly targeted groups of borrowers and a guarantee mechanism to scale up during times of crisis; and

Option 3: Privatized system of housing finance with FHA, USDA and Department of Veterans Affairs assistance for low- and moderate-income borrowers and catastrophic reinsurance behind significant private capital.

Buyback Settlement Agreements

FHFA recently approved buyback settlements between the Enterprises and two counterparties. On December 23, 2010, Fannie Mae concluded an agreement with Ally Financial for approximately \$462 million.¹⁹ On December 31, 2010, Fannie Mae and Freddie Mac concluded agreements with Bank of America totaling \$2.8 billion.²⁰ A buyback claim may arise when an Enterprise purchases a mortgage loan. The loan seller represents and warrants that the loan is free of defects by certifying that the information in the loan paperwork is true and correct. If the Enterprise later discovers that the purchased loan contains such a defect, it has the contractual right to demand that the loan seller buy back the loan. The Enterprises have made billions of dollars of buyback claims to these and other counterparties.

FHFA-OIG is reviewing FHFA's oversight of the Enterprises' buyback settlements.

FHFA Reorganization

FHFA announced an organizational restructuring of the Agency on February 2, 2011. According to FHFA, the restructuring is intended to promote greater uniformity and consistency in the examinations of Fannie Mae, Freddie Mac, and the FHLBanks. As part of the reorganization, a new housing mission team will focus on policy matters involving the conservatorships, including loss mitigation activities, public reporting on the activities of the GSEs, affordable housing, the state of the secondary mortgage market, and activities related to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

FHFA-OIG plans to review FHFA's institutional capacity to fulfill its regulatory and conservatorship mandates.

FHFA-OIG plans to review FHFA's oversight of the FHLBanks.

Capitalization:

In the context of bank supervision, capitalization refers to the funds a bank holds as a buffer against unexpected losses. It includes shareholders' equity, loss reserves, and retained earnings. Bank capitalization plays a critical role in the safety and soundness of individual banks and the banking system. In most cases, federal regulators set requirements for adequate bank capitalization.

Consent Order for Seattle FHLBank

FHFA currently classifies the Seattle FHLBank as **undercapitalized**. On October 25, 2010, FHFA and the Board of Directors of the Seattle FHLBank ("Seattle Board") agreed to the issuance of a Consent Order to address a number of outstanding capital and supervisory matters. The Consent Order sets forth requirements for capital management, asset composition, and other operational and risk management improvements. Additionally, FHFA and the Seattle Board agreed to a stabilization period that continues through the filing of the Seattle FHLBank's June 30, 2011, financial statement. The Seattle FHLBank's classification as undercapitalized will remain in place until the Consent Order is lifted.²¹



SECTION 3

ACCOMPLISHMENTS OF FHFA-OIG

Section 3: Accomplishments of FHFA-OIG

Although the Federal Housing Finance Agency Office of Inspector General (“FHFA-OIG”) has been in existence only since October 2010, and has been primarily focused on building the organization, it has recorded several significant accomplishments through March 31, 2011. These include: (1) the issuance of two evaluation reports of Federal Housing Finance Agency (“FHFA” or the “Agency”) activities; (2) participation in a significant mortgage fraud investigation; and (3) reviews and comments on proposed FHFA rules. Further, FHFA-OIG established and began to implement communication outreach strategies for the Government-Sponsored Enterprises (“GSEs”), Congress, and others.

FHFA-OIG AUDIT AND EVALUATION ACTIVITIES

Through March 31, 2011, FHFA-OIG has released two public reports, which are briefly summarized below.

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

Since placing the Federal National Mortgage Association (“Fannie Mae”) and the Federal Home Loan Mortgage Corporation (“Freddie Mac”) into conservatorships in September 2008, FHFA has taken a range of actions to improve their finances and operations, including removing and replacing senior executives and establishing new executive pay plans. FHFA oversees executive compensation levels for Fannie Mae and Freddie Mac (the “Enterprises”) and monitors their ongoing implementation. In 2009 and 2010, FHFA approved executive compensation packages totaling \$34.4 million in annual base salaries and deferred performance pay for the Enterprises’ top six officers.

Given the concerns about executive compensation levels at companies that have received federal financial support, FHFA-OIG initiated an evaluation to assess: (1) the processes used to develop Fannie Mae’s and Freddie Mac’s compensation packages; (2) FHFA’s ongoing oversight efforts; and (3) the transparency of the Enterprises’ executive compensation policies and practices.

In its evaluation, FHFA-OIG made several findings. FHFA coordinated with the U.S. Department of the Treasury (“Treasury”) and outside consultants to develop the Enterprises’ compensation programs. FHFA believes that such programs are necessary to recruit and retain talented executives. Enterprise executive compensation packages include provisions designed to mitigate abusive compensation practices, such as “golden parachute” arrangements that assure senior executives of significant benefits if their employment is terminated. However, FHFA has not considered factors that might have resulted in reduced executive compensation costs, such as the impact that

*A full copy of the report is available at
www.fhfaoig.gov.*

federal financial support has on the Enterprises' corporate and executive performance and the compensation paid to senior officials at federal entities that also play a critical role in housing finance.

FHFA-OIG also found that FHFA lacks key controls necessary to monitor the Enterprises' ongoing executive compensation decisions under the approved packages. Specifically, FHFA has neither developed written procedures to evaluate the Enterprises' recommended compensation levels each year, nor required FHFA staff to verify and test independently the means by which the Enterprises calculate their recommended compensation levels. Although the Agency apparently is enhancing its procedures, which is a positive development, the new procedures do not address all of FHFA-OIG's concerns, such as FHFA's lack of independent testing and verification of the Enterprises' submissions in support of executive compensation packages.

The report also found that FHFA does not provide sufficient transparency to the public regarding the Enterprises' executive compensation programs. Although the Enterprises report relevant information in public securities filings, more user-friendly information is generally unavailable. For example, FHFA does not post the Enterprises' executive compensation data or related trend data on its website.

In light of these observations, FHFA-OIG made several recommendations. FHFA should establish an ongoing review and analysis process to include issues such as the influence of federal support for the Enterprises and the compensation levels for the heads of housing-related federal entities. Additionally, FHFA should establish written criteria and procedures for reviewing performance data and conduct independent verification and testing of the basis for executive compensation levels. These factors may warrant lower compensation for Enterprise executives. Also, to improve transparency, FHFA should post information on its website about executive compensation and provide links to the securities filings.

FHFA agreed with most of these recommendations. FHFA did not agree, however, with FHFA-OIG's recommendations to: (1) assess disparities in compensation among senior officials at Fannie Mae and Freddie Mac, FHFA, the Federal Housing Administration, and the Government National Mortgage Association ("Ginnie Mae"); and (2) test and verify independently Fannie Mae's and Freddie Mac's annual salary recommendations for their individual executives.

Federal Housing Finance Agency's Exit Strategy and Planning Process for the Enterprises' Structural Reform, EVL-2011-001, March 31, 2011

On February 11, 2011, the Administration proposed reforms to Fannie Mae's and Freddie Mac's fundamental roles and structures. FHFA-OIG initiated a study to identify the steps FHFA is expected to take in the short to medium

A full copy of the report is available at www.fhfaig.gov.

term under the Administration's proposal and the adequacy of its planning efforts to do so.

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

FHFA-OIG found that FHFA has taken steps to improve the Enterprises' finances and operations during their conservatorships, including replacing board members and key executives and increasing underwriting standards and guarantee fees. However, FHFA has not developed an overall planning strategy for the Enterprises' exit from their conservatorships. Moreover, under current circumstances, it is unclear whether FHFA has sufficient resources to meet its existing responsibilities as conservator for the Enterprises as well as impending responsibilities contained in the Administration's proposal.

FHFA-OIG concluded that, because FHFA has a significant role in implementing the Administration's reform proposal, careful planning will be essential. FHFA-OIG views FHFA's potential implementation of its regulatory authorities under the Administration's proposal in the short to medium term as an area of significant risk because, if not managed effectively, its actions could have negative consequences, such as unnecessarily limiting mortgage credit.

FHFA-OIG recommended that FHFA take specific steps to help ensure the effective implementation of its responsibilities, including: (1) establishing timeframes and milestones, descriptions of methodologies to be used, criteria for evaluating the implementation of the initiatives, and budget and financing information necessary to carry out its responsibilities; and (2) developing an external reporting strategy, which might include the augmentation of existing reports, to chronicle FHFA's progress, including the adequacy of its resources and capacity to meet multiple responsibilities and mitigate any shortfalls. FHFA agreed with these recommendations.

FHFA-OIG INVESTIGATION ACTIVITIES

The Office of Investigations ("OI") has made a significant contribution to the investigation of fraud involving Colonial Bank and Taylor, Bean & Whitaker Mortgage Corporation ("TBW"), which, to date, has resulted in the conviction

of seven defendants. TBW was servicing \$51 billion in Freddie Mac loans when it ceased operations in August 2009. Freddie Mac suffered significant economic losses as a result of this fraud.

Colonial Bank/Taylor, Bean & Whitaker

TBW was one of the largest privately-held mortgage lending companies in the United States. TBW originated, purchased, sold, and serviced residential mortgage loans. TBW also pooled loans that it originated as collateral for mortgage-backed securities guaranteed by Freddie Mac and Ginnie Mae.

Beginning in early 2002, TBW began to experience significant cash flow problems. In an effort to cover these shortfalls, a group of conspirators devised various schemes, which involved defrauding Colonial Bank (which provided short term funding to mortgage lending companies like TBW), Ocala Funding LLC (“Ocala”), a TBW special purpose entity, and U.S. taxpayers. By the middle of 2009, the conspirators had diverted nearly \$3 billion from Colonial Bank and Ocala; attempted to misappropriate over \$500 million from Treasury; and filed numerous false records with Freddie Mac, Ginnie Mae, and the Securities and Exchange Commission (“SEC”). Additionally, the conspirators allegedly covered up the diversions by selling loans owned by Colonial Bank to Freddie Mac without paying Colonial Bank for the loans. As a result, the conspirators caused Freddie Mac and Colonial Bank to believe that each had an undivided ownership interest in thousands of the same loans. TBW and Colonial Bank both failed in 2009. Freddie Mac reported losses and filed a proof of claim of nearly \$1.8 billion in TBW’s bankruptcy proceeding.

Federal prosecutors have charged and convicted seven defendants. The status of cases against each defendant is described briefly below:

- Lee Bentley Farkas, the former Chairman of TBW, was charged in a multi-count indictment with offenses including conspiracy, wire fraud, bank fraud, and securities fraud. On April 19, 2011, Farkas was convicted on 14 counts following a jury trial. His sentencing is scheduled for July 2011.
- Paul R. Allen, the former Chief Executive Officer of TBW, pled guilty to one count of conspiracy to commit bank and wire fraud and one count of making false statements. He is scheduled to be sentenced in June 2011.
- Raymond Bowman, the former President of TBW, pled guilty to one count of conspiracy and one count of making false statements to federal agents on March 14, 2011. He is scheduled to be sentenced in June 2011.

More information on the TBW cases is available at www.fhfaoig.gov.

- Desiree Brown, the former Treasurer of TBW, pled guilty to one count of conspiracy on February 24, 2011. Her sentencing is scheduled for June 2011.
- Sean W. Ragland, a former Senior Financial Analyst for TBW, pled guilty to one count of conspiracy on March 31, 2011. His sentencing is scheduled for June 2011.
- Catherine Kissick, the former head of Colonial Bank's Mortgage Warehouse Lending Division, pled guilty to one count of conspiracy on March 2, 2011. She is scheduled to be sentenced in June 2011.
- Teresa Kelly, a former operations supervisor in Colonial Bank's Mortgage Warehouse Lending Division, pled guilty to one count of conspiracy on March 16, 2011. Her sentencing is scheduled for June 2011.

FHFA-OIG's investigation partners in these cases include the Office of the Special Inspector General for the Troubled Asset Relief Program ("SIGTARP"), the Federal Bureau of Investigation ("FBI"), the Office of Inspector General for the Federal Deposit Insurance Corporation ("FDIC-OIG"), the Office of Inspector General for the U.S. Department of Housing and Urban Development ("HUD-OIG"), and the Internal Revenue Service – Criminal Investigation ("IRS-CI"). The Financial Crimes Enforcement Network ("FinCEN") also provided investigative support. Additionally, the cases are being prosecuted by the Fraud Section of the Criminal Division at the U.S. Department of Justice ("DOJ") and the United States Attorney for the Eastern District of Virginia.

In related developments, the SEC has filed enforcement actions against Farkas, Brown, Kissick, and Kelly for violations of the antifraud, reporting, books and records, and internal controls provisions of federal securities laws.

FHFA-OIG REGULATORY ACTIVITIES

Consistent with the Inspector General Act, FHFA-OIG considers whether proposed legislation and regulations related to FHFA are effective, efficient, economical, legal, and susceptible to fraud and abuse.²² Through March 31, 2011, FHFA-OIG had reviewed 16 new or proposed FHFA policies and regulations and provided substantive comments on 7, which are discussed below.

1. FHFA Proposed Rule on Office of the Ombudsman (RIN 2590-AA20) (FHFA-OIG Comments submitted on December 3, 2010)

On August 6, 2010, FHFA published a proposed rule to establish an Office of the Ombudsman within FHFA, pursuant to the Federal Housing Enterprise Financial Safety and Soundness Act of 1992, as amended by the Housing and Economic Recovery Act of 2008 ("HERA").²³ According to the proposed rule,

the Ombudsman would consider complaints and appeals from: (1) the GSEs; and (2) parties that have a business relationship with them. The Ombudsman would consider only complaints and appeals pertaining to FHFA's oversight of the GSEs.

FHFA-OIG made two comments on the proposed rule. FHFA-OIG's first comment addressed the description of the Ombudsman's authority to "investigate" allegations that FHFA had retaliated against complaining entities for having contacted the Ombudsman. FHFA-OIG cautioned against using language that would permit the Ombudsman to conduct "investigations" because Congress has made clear that an agency's audit and investigative resources are "consolidated ... under the direction of the Inspector General."²⁴ FHFA-OIG suggested alternative language that would permit the Ombudsman to examine retaliation allegations in coordination with FHFA-OIG.

FHFA-OIG's second comment pertained to the proposed rule's guarantee of confidentiality to parties who request it, unless disclosure would be to "appropriate reviewing or investigating officials, or as required by law." To avoid future misunderstandings regarding FHFA-OIG's access to information in the Ombudsman's possession, FHFA-OIG recommended that the proposed rule's reference to "appropriate reviewing or investigative officials" be amended to include the Inspector General expressly.

FHFA published a final rule establishing an Office of the Ombudsman on February 10, 2011.²⁵ The final rule incorporates both of FHFA-OIG's comments in their entirety.

2. FHFA Draft Advisory Bulletin 2011-AB-01, "Operational Readiness for Swaps-Related Reporting, Clearing, Trading, and Recordkeeping Requirements." (FHFA-OIG Comments submitted on January 20, 2011)

FHFA developed a draft bulletin related to the FHLBanks' preparations for regulations proposed by the Commodity Futures Trading Commission ("CFTC"). The CFTC's regulations seek to implement Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"), which addresses **swaps**. These proposed regulations include: (1) "Process for Review of Swaps for Mandatory Clearing;"²⁶ (2) "Real-Time Public Reporting of Swap Transaction Data;"²⁷ and (3) "Swap Data Recordkeeping and Reporting Requirements."²⁸ To ensure that the FHLBanks would be ready to comply with these proposed regulations once they become final, the draft bulletin stated that they should undertake several substantial steps. All of these steps would constitute new duties for the FHLBanks to perform. The draft bulletin also stated that FHFA examiners would "review and assess" the FHLBanks' readiness to comply with the proposed regulations.

Swap:

An agreement between two parties to exchange cash flows of underlying securities. For example, in an interest rate swap, a common type of swap, one party agrees to pay a fixed interest rate in return for receiving a variable rate from the other party.

FHFA-OIG's primary comment on the draft bulletin was that FHFA should have engaged in notice-and-comment rulemaking in order to impose new duties on the FHLBanks. In FHFA-OIG's view, the draft bulletin constituted a "legislative rule" for purposes of the Administrative Procedure Act, 5 U.S.C. § 551 et seq. ("APA"), because it clearly imposed new responsibilities on the FHLBanks. As a legislative rule, the draft bulletin would be subject to the APA's notice-and-comment requirements at 5 U.S.C. § 553(a). Further, FHFA-OIG determined that the draft bulletin should not be characterized as merely interpretive – and therefore exempt from notice-and-comment requirements – because it did not interpret the proposed CFTC regulations. It only referenced them and referred readers seeking guidance to the CFTC website. For these reasons, FHFA-OIG concluded that if FHFA wished for the FHLBanks to comply with the draft bulletin's new duties, FHFA should undertake notice-and-comment rulemaking.

Based on FHFA-OIG's comments, FHFA revised the draft bulletin to clarify that the CFTC regulatory compliance steps described therein were "recommended" as opposed to "required." FHFA issued the revised advisory bulletin on March 4, 2011.

3. FHFA Draft Final Rule on Executive Compensation (RIN 2590-AA12) (FHFA-OIG Comments submitted on March 1, 2011)

FHFA drafted a proposed final rule to implement its responsibility to prohibit and withhold unreasonable compensation for executives of Fannie Mae and Freddie Mac, pursuant to HERA. Due to ongoing discussions between FHFA and FHFA-OIG on this issue, the substance of the comments and their resolution will be published at a later date.

4. FHFA Draft Re-Proposed Rule on Golden Parachute and Indemnification Payments (RIN 2590-AA08) (FHFA-OIG Comments submitted on March 1, 2011)

FHFA re-proposed a rule to implement its responsibility to regulate golden parachute and indemnification payments to parties affiliated with the GSEs, pursuant to HERA.²⁹ Due to ongoing discussions between FHFA and FHFA-OIG on this issue, the substance of the comments and their resolution will be published at a later date.

5. FHFA Draft Enterprise New Activity Protocol (RIN 2590-AA17) (FHFA-OIG Comments submitted on March 18, 2011)

FHFA drafted a proposed protocol to implement a requirement that the Enterprises submit for approval monthly reports describing new activities in which they would like to engage. It would also withdraw an existing regulation, 12 C.F.R. Part 1253. Due to ongoing discussions between FHFA and FHFA-OIG on this issue, the substance of the comments and their resolution will be published at a later date.

6. FHFA Draft Regulatory Policy Guidance on Reporting of Fraudulent Financial Instruments (FHFA-OIG Comments submitted on March 18, 2011)

FHFA proposed policy guidance to implement the fraud reporting requirements set forth in FHFA's regulation at 12 C.F.R. Part 1233. FHFA-OIG issued three comments regarding the policy guidance. First, FHFA-OIG recommended that FHFA consider adding to or revising definitions of the terms used in the guidance. Second, FHFA-OIG recommended that it be copied on all reports required by the policy guidance. As the only division within FHFA with criminal law enforcement authority, FHFA-OIG should receive copies of all reports of potential criminal activities, *e.g.*, fraudulent activities. Third, FHFA-OIG recommended that FHFA-OIG be afforded access to the records supporting fraud reports and that the GSEs maintain supporting records in an encrypted, web-based interface. In the latter regard, if the GSEs were required to store this information electronically, and if it were accessible remotely, the supporting records would be far more useful for investigators and evaluators.

FHFA issued the policy guidance on March 23, 2011.³⁰ FHFA adopted FHFA-OIG's recommendations concerning FHFA-OIG's access to information and accepted some of its suggested changes to the definitions, but did not implement its recommendation concerning the web-based interface for supporting records.

7. Joint Agency Steering Committee's Proposed Rules on Incentive-based Executive Compensation (RIN 2590-AA42) (FHFA-OIG Comments submitted on March 28, 2011)

Pursuant to Section 956 of the Dodd-Frank Act, seven federal financial regulators proposed jointly to issue rules requiring their respective regulated entities to disclose information pertaining to their "incentive-based compensation arrangements" and prohibiting any such arrangements that encourage inappropriate risk-taking. Due to ongoing discussions between FHFA and FHFA-OIG on this issue, the substance of the comments and their resolution will be published at a later date.

FHFA-OIG COMMUNICATIONS AND OUTREACH EFFORTS

A vital component of FHFA-OIG's mission is to communicate clearly with Congress, the GSEs and industry groups, the public, and colleagues at other federal agencies.

Hotline

FHFA-OIG OI operates the FHFA-OIG **Hotline**, which allows concerned parties to report directly and in confidence information regarding possible

The FHFA-OIG **Hotline** can be reached at (800) 793-7724 or via email at OIGHOTLINE@FHFA.GOV.

fraud, waste, or abuse related to FHFA or the GSEs. FHFA-OIG honors all applicable whistleblower protections. As part of its effort to raise awareness of fraud and how to combat it, FHFA-OIG is actively promoting the Hotline through the FHFA-OIG website, posters, targeted emails to FHFA and GSE employees, and the Semiannual Report.

Coordination with Other Oversight Bodies

FHFA-OIG shares oversight of federal housing program administration with several other federal agencies (including HUD, the U.S. Department of Veterans Affairs (“VA”), the U.S. Department of Agriculture, Treasury’s Office of Financial Stability (which manages the Troubled Asset Relief Program)), and their inspectors general, as well as other law enforcement organizations. To further its mission, FHFA-OIG participates in coordinating the efforts of these agencies and exchanging best practices, case information, and professional expertise. During the period ending March 31, 2011, representatives of FHFA-OIG participated in the following cooperative activities:

- The Council of the Inspectors General on Integrity and Efficiency (“CIGIE”), which meets monthly, seeks to increase the professionalism and effectiveness of offices of inspectors general. The FHFA Inspector General and his Chief Counsel are active participants in CIGIE activities and have attended all monthly CIGIE meetings.
- The Dodd-Frank Act established the Council of Inspectors General on Financial Oversight (“CIGFO”) to facilitate the sharing of information among inspectors general at agencies responsible for financial oversight. The FHFA Inspector General is an active member of CIGFO and has attended all of its meetings.
- FHFA-OIG works closely with FinCEN, which Treasury established in 1990 to provide, among other things, a government-wide, multisource financial intelligence and analysis network. Through its partnership with FinCEN, FHFA-OIG both provides and receives valuable financial intelligence in support of federal law enforcement activities. FHFA-OIG hosted a meeting with FinCEN on January 29, 2011.
- The Financial Fraud Enforcement Task Force (“FFETF”) is a broad coalition of state and federal law enforcement agencies, prosecutors, and other entities. President Obama established FFETF in November 2009 to investigate and prosecute significant financial crimes, ensure just and effective punishment for those who perpetrate them, recover proceeds for victims, and address financial discrimination in the lending and financial markets. FHFA-OIG is an active member of FFETF and has begun to work with FFETF partners to combat financial crimes relevant to FHFA-OIG’s mission. FHFA-OIG also participated in several FFETF working groups that, as described below, will enable FHFA-OIG to leverage other law enforcement entities’ knowledge and assets in various areas relevant to FHFA-OIG’s mission.

- o The FFETF Mortgage Fraud Working Group (“MFWG”) combats mortgage fraud related to the financial crisis. The FHFA Inspector General made a presentation on the role and mission of FHFA-OIG at the March 3, 2011, MFWG meeting.
 - o The Recovery Act, Procurement, and Grant Fraud Working Group addresses procurement and grant fraud, including fraud arising in connection with the expenditure of funds provided by the American Recovery and Reinvestment Act of 2009. The FHFA Inspector General made a presentation on **suspension** and **debarment** at the group’s March 9, 2011, meeting.
 - o FFETF’s Securities and Commodities Fraud Working Group works to eliminate fraud in America’s financial markets. FHFA-OIG participates in this working group with, among others, DOJ, SEC, and the CFTC.
- FHFA-OIG has established partnerships with several federal agencies to share data, analyze internal complaints, and identify trends. These agencies include the FBI, HUD-OIG, FinCEN, the Secret Service, and SIGTARP. Each of FHFA-OIG’s partnerships with these agencies is designed to enhance interagency cooperation. These partnerships focus the participating agencies’ combined investigative resources, powers, experience, and expertise on the identification, investigation, and prosecution of individuals and entities involved in fraud schemes related to the entities regulated by the participants.
- FHFA-OIG also has carried out additional outreach and coordination efforts to a wide range of government agencies, including DOJ, the Office of the Comptroller of the Currency, SEC, IRS-CI, United States Attorney’s Offices throughout the nation, and a number of state Attorneys General.
- The FHFA Inspector General is vice chair of the CIGIE Suspension and Debarment Working Group (the “Working Group”). The Working Group is a subcommittee of the CIGIE Investigations Committee, and its mission is to improve the effectiveness of suspension and debarment practices throughout the federal government.

Communications with the GSEs and Industry Groups

FHFA-OIG seeks to partner with private sector participants in the housing and financial markets in its effort to detect, combat, and prevent mortgage fraud and related crimes that directly affect the businesses and reputations of individuals, firms, and the industry as a whole. To that end, FHFA-OIG has undertaken industry outreach efforts, including:

- In December 2010, the FHFA Inspector General made a presentation to the executive committees of Fannie Mae and Freddie Mac regarding the role and mission of FHFA-OIG.

Suspension:

The temporary disqualification of a firm or individual from contracting with the government or participating in government programs, pending the outcome of an investigation, an indictment, or on adequate evidence that supports claims of program violations.

A suspension means that an individual or entity is immediately excluded from participating in further federal executive branch procurement and non-procurement programs. Suspension frequently leads to debarment.

Debarment:

Disqualification of a firm or individual from contracting with the government or participating in government non-procurement transactions for a specific period of time. The grounds for debarment may be either statutory or administrative.

- In February 2011, the FHFA Inspector General made a presentation on the role and mission of FHFA-OIG to the Presidents of the FHLBanks.
- In March 2011, the FHFA Inspector General made a presentation on FHFA-OIG's efforts to combat mortgage fraud to the Mortgage Bankers Association at their National Fraud Issues Conference.

Communications with Congress

To fulfill his responsibility to keep Congress fully apprised of developments concerning oversight of FHFA and the GSEs, the FHFA Inspector General meets regularly with Members of Congress and their staff. For example:

- In January 2011, the FHFA Inspector General briefed a bipartisan group of staff members of the House of Representatives. The briefing covered the background of FHFA-OIG, the Inspector General's vision, FHFA-OIG's progress at building infrastructure and recruiting staff, and ongoing audits and evaluations.
- In March 2011, the FHFA Inspector General briefed a bipartisan group of Senate staff members. Similar to the House of Representatives briefing, the Inspector General discussed background information, his vision and progress in launching FHFA-OIG, and ongoing audits and evaluations.
- The FHFA Inspector General has provided a number of briefings to individual Members of Congress.

Copies of the FHFA Inspector General's written testimony to Congress, hearing transcripts, and related materials are available at www.fhfaoig.gov.



SECTION 4

FHFA-OIG'S OVERSIGHT STRATEGY

Section 4: FHFA-OIG's Oversight Strategy

The Federal Housing Finance Agency Office of Inspector General ("FHFA-OIG") is following a strategy of identifying vulnerabilities and risk areas in Federal Housing Finance Agency ("FHFA" or the "Agency") and Government-Sponsored Enterprise ("GSE") programs and initiating audits, evaluations, and investigations where warranted. Based in part on identified risks, FHFA-OIG has developed an Audit and Evaluation Plan to guide its work relating to FHFA's oversight of the Federal National Mortgage Association ("Fannie Mae"), the Federal Home Loan Mortgage Corporation ("Freddie Mac"), and the Federal Home Loan Banks ("FHLBanks").

INDEPENDENT RISK ASSESSMENT

To deepen its understanding of the management and performance challenges facing FHFA, FHFA-OIG has established a continuing risk assessment process. As part of this process, FHFA-OIG contracted with an independent, third-party professional services firm, BDO USA, LLP ("BDO"), to identify the programs and activities that pose the greatest risk to FHFA and the GSEs. BDO reviewed and summarized existing reports and findings prepared by FHFA and the GSEs, including internal risk assessment materials. Although FHFA-OIG does not necessarily endorse BDO's findings and conclusions, FHFA-OIG plans to consider them, along with other materials, when planning future work.

BDO's assessment identified several risks confronting FHFA:

- Risk that FHFA's internal policies, procedures, and controls may not be adequate to manage the Agency effectively and efficiently in a number of critical areas, including human resource management, budgeting, procurement, and financial reporting;
- Risk that FHFA will not be able to manage the conservatorships effectively; and
- Risk that FHFA will not be able to manage and implement the Administration's current reforms and proposals for restructuring the housing finance system effectively.

BDO's assessment identified four categories of risk confronting the GSEs:

- **Financial Risk:** Risk that the GSEs will experience direct financial loss from market, model, credit, and liquidity risks;
- **Operational Risk:** Risk resulting from the failure of internal processes and controls, human capital, and information technology, including such items as financial reporting and employee recruitment and retention risks;

BDO's risk assessment is available at www.fhfaig.gov.

- **Compliance Risk:** Risk from failing to comply with legal or regulatory requirements (other than legal violations resulting from fraud or employment practices); and
- **Strategic Risk:** Risk of failing to meet strategic goals and objectives, including reputational and business direction risks.

The following are among the top risk areas identified by BDO for the GSEs:

Fannie Mae and Freddie Mac

- **Financial Model Risk:** Financial and other institutions regularly rely on **financial models** to manage their businesses and measure and monitor risk exposure. For Fannie Mae and Freddie Mac (the “Enterprises”), these models are used to measure, monitor, and forecast exposure to interest rate, credit, and market risks. This risk stems from the models’ reliance on parameters and processes that may vary with changing circumstances, as well as the exercise of subjective management judgment.
- **Real Estate Owned (“REO”) Risk:** REO refers to real estate the Enterprises own as a result of foreclosure-related activities. Since the start of the financial crisis, the Enterprises’ REO sales activities and portfolios have grown dramatically. Accordingly, the Enterprises face elevated financial risks associated with the ownership and disposition of these properties. The risks include: whether adequate systems and processes are in place to assure security and maintenance of REO properties; whether such properties can be sold at prices that will minimize financial losses; and deficiencies in loan servicer and law firm foreclosure processes. The Enterprises also face ongoing challenges in accurately estimating the full impact of the REO inventory on their future default losses.
- **Single-Family Lender Channel/Pricing Risk:** The Enterprises are in the business of providing loan guarantees to investors in exchange for fees. If fees are underpriced, the Enterprises experience financial losses. The Enterprises confront ongoing risks in accurately pricing guarantee fees, particularly with respect to single-family home loans, because of the need to rely on financial models and management judgment.
- **Single-Family Credit Loss Management Risk:** The Enterprises face continuing risks in their efforts to prevent foreclosures and reduce costs of defaulted loans through foreclosure alternatives.

Financial Models:

Financial models are computer simulations designed to forecast the financial performance of a company or project or estimate the impact of key parameters, such as interest rates.

Federal Home Loan Banks

While the BDO risk assessment concluded that the FHLBanks’ credit quality is currently better than that of Fannie Mae and Freddie Mac and the mortgage industry as a whole, it identified several important risks, including those described below:

The full Audit and Evaluation Plan is available at www.fhfaog.gov.

- Many FHLBanks face ongoing risks related to credit quality due to the private-label mortgage-backed securities (“MBS”) held in their portfolios. In particular, the risk assessment states that further decline in the value of private-label MBS could further degrade many of the FHLBanks’ financial condition and performance; and
- Because the lending portfolios of some FHLBanks are more concentrated among fewer large borrowers, the default or withdrawal of a major member institution poses a greater risk to the FHLBanks’ financial and operational performance.

FHFA-OIG AUDIT AND EVALUATION PLAN

FHFA-OIG has created a detailed audit and evaluation plan that focuses strategically on the areas of FHFA’s operations that pose the greatest risks and provide the greatest potential benefits to FHFA, Congress, and the public. The current plan was developed based on the independent BDO risk assessment, reviews of relevant reports and documentation, and interviews with FHFA officials, Members of Congress, and others.^c

Key aspects of the strategy include reviews of FHFA’s:

- Regulatory efforts and its management of the Enterprise conservatorships. Areas of focus include FHFA staff capacity, Enterprise executive compensation, Enterprise mortgage buyback settlements, foreclosure prevention and loss mitigation efforts, mortgage loan servicing controls, foreclosed property management and sales processes, model validation and risk-based guarantee pricing, and payment of legal fees. These are particularly high-risk areas because Treasury has invested nearly \$154 billion of taxpayer funds in the Enterprises. FHFA must regulate and oversee (as conservator) the GSEs in an efficient, effective, and transparent manner so as to minimize taxpayer costs, conserve Enterprise resources, and meet all statutory mandates;
- Oversight of the FHLBanks and their associated risks, including investment portfolio management, concentrations, and credit underwriting and administration;
- Oversight of the GSEs’ housing missions, including affordable housing programs; and
- Internal operations, such as information security, privacy, and the handling of consumer complaints and allegations of fraud, waste, and abuse.

As discussed in Section 3 of this Report, FHFA-OIG has issued two reports addressing issues in its highest priority area: FHFA’s oversight and conservatorships of the Enterprises. The Audit and Evaluation Plan identifies a number of other ongoing and planned reviews of specific FHFA programs

^c FHFA-OIG’s plan is dynamic and will be revised as necessary.

and activities that fall into each of the risk areas. The following summarizes some of the projects that are currently in the plan, arranged by their strategic risk area.^d

FHFA's Oversight and Conservatorships of the Enterprises

FHFA's Independence: This project will examine FHFA's independence and the processes it uses in exercising its decision-making authority, particularly in light of its multiple responsibilities. For example, FHFA has statutory obligations both to act as conservator for the Enterprises and to support the housing finance system, which often includes Treasury's mortgage loan modification programs. FHFA-OIG will assess whether balancing potentially competing responsibilities may test FHFA's capacity going forward and its ultimate effectiveness.

FHFA's Oversight of Fannie Mae's Network of Foreclosure Processing Attorneys: Concerns have emerged that many foreclosures in recent years may not have been conducted according to state laws and regulations, which may have resulted in individuals and families losing their homes improperly. This project will assess FHFA's oversight of Fannie Mae's selection, management, and oversight of foreclosure attorney networks. Future work may also address FHFA's oversight of Freddie Mac's attorney networks.

FHFA's Review and Approval of Freddie Mac Settlement with Bank of America Relating to Mortgage Buybacks: FHFA recently approved three settlements for more than \$3 billion between the Enterprises and Ally Financial (formerly GMAC) and Bank of America relating to Ally Financial's and Bank of America's buyback obligations. This project will assess FHFA's review and approval process for the settlement between Freddie Mac and Bank of America.

FHFA's Oversight of Fannie Mae's Loss Management Practices: As conservator, FHFA must preserve and conserve the assets of the Enterprises, including minimizing losses. This project will assess FHFA's oversight of Fannie Mae's loan loss analyses used to determine the least costly approach to addressing seriously delinquent loans.

FHFA's Oversight of Enterprise Real Estate Owned Contractors: The Enterprises engage contractors to handle the management and disposition of REO. These activities can significantly impact the sales proceeds received. This project will assess FHFA's oversight of the Enterprises' controls over REO contractors engaged to manage and market single-family residential properties.

Federal Home Loan Banks

FHFA's Oversight of Troubled FHLBanks: As discussed in the independent risk assessment by BDO, several FHLBanks face financial challenges due to their investments in private-label MBS, including those collateralized by

^d It should be noted, as described earlier, that FHFA-OIG may revise the plan as new information and priorities are identified, and therefore, not all of these projects may remain in the plan.

subprime mortgages that have been impacted by the decline in housing values. This project will assess the steps that FHFA is taking to help ensure that these troubled FHLBanks return to financial soundness.

FHFA's Examinations of FHLBank Advance and Collateral Management Practices: FHLBank advances to their member financial institutions are secured by pledged collateral, such as single-family residential mortgages. Due to the dramatic decline in housing values in recent years, concerns have arisen about the value of collateral securing advances and the FHLBanks' collateral management practices. Further, as stated in the BDO risk assessment, some FHLBanks face substantial credit risks due to their relatively large advances to a small number of very large financial institutions. This project will assess FHFA's oversight of the FHLBanks' controls over underwriting standards and their compliance with such standards relative to credit decisions for advances and collateral verification.

FHFA Operations

FHFA's Complaint Handling Process: As a consequence of the financial crisis, consumer complaints and allegations of fraud, waste, and abuse presented to the Enterprises and FHFA have increased dramatically. The objective of this ongoing audit is to assess the adequacy of FHFA's processing of complaints.

FHFA's Implementation of Information Security Requirements: The Federal Information System Management Act of 2002 ("FISMA") requires federal agencies, including FHFA, to have an annual independent evaluation of their information security program and practices and to report the results of the evaluation to the Office of Management and Budget. FISMA states that the independent evaluation is to be performed by the agency Inspector General or an independent external auditor, as determined by the Inspector General. This audit will assess FHFA's information security program and practices to determine whether they meet the security responsibilities outlined in FISMA.

FHFA-OIG INVESTIGATION STRATEGY

FHFA-OIG and its law enforcement partners are engaged in a number of non-public investigations. FHFA-OIG intends to develop further its close working relationships with other law enforcement agencies, including DOJ, the United States Attorney's Offices, the Financial Crimes Enforcement Network, the Mortgage Fraud Working Group, the United States Secret Service, the Federal Bureau of Investigation, the Office of Inspector General for the U.S. Department of Housing and Urban Development, the Office of Inspector General for the Federal Deposit Insurance Corporation, the Internal Revenue Service – Criminal Investigation, the Office of the Special Inspector General for the Troubled Asset Relief Program, and other federal, state, and local agencies. In addition, FHFA-OIG has undertaken law enforcement

outreach efforts to United States Attorney's Offices across the nation, as well as a number of state Attorneys General.

Moreover, FHFA-OIG will continue to use all sources at its disposal to identify and investigate mortgage frauds that jeopardize the finances and operations of the housing GSEs. To do so, FHFA-OIG will continue to work effectively with its law enforcement partners and whistleblowers. Further, FHFA-OIG has a **Hotline** to which tips and complaints may be made regarding potential mortgage fraud.

FHFA-OIG LEGAL REVIEWS AND COMMENTS ON PROPOSED FHFA RULES

Pursuant to its statutory authority, FHFA-OIG will continue to review all proposed FHFA rules to ensure their compliance with established requirements. FHFA-OIG will make recommendations to FHFA as deemed necessary and monitor its compliance with recommended courses of action.

The FHFA-OIG **Hotline** can be reached at (800) 793-7724 or via email at OIGHOTLINE@FHFA.GOV.



A BRIEF HISTORY OF THE HOUSING GOVERNMENT-SPONSORED ENTERPRISES

TIMELINE

1930s

- 1932** Federal Home Loan Bank Act is passed, creating the FHLBank System
- 1933** Home Owners' Loan Act is passed, creating the Home Owners' Loan Corporation
- 1934** National Housing Act enacted, establishing the Federal Housing Administration
- 1938** Fannie Mae established

1940s

- 1944** GI bill authorizes VA mortgage loans and Fannie Mae's purchases of such mortgages

1950s

- 1954** Charter Act reorganizes Fannie Mae

1960s

- 1968** Fannie Mae reorganized as publicly-traded, shareholder-owned company
- 1968** Housing and Urban Development Act of 1968 created the Government National Mortgage Association ("Ginnie Mae")

1970s

- 1970** Freddie Mac created
- 1971** Freddie Mac offers its first conventional Mortgage-Backed Security
- 1970s and early 1980s** Fannie Mae and Freddie Mac pursue differing business strategies: Fannie Mae holds mortgages in portfolio, while Freddie Mac securitizes them

1980s

- Early 1980s** Fannie Mae suffers financial deterioration due to rising interest rates, while Freddie Mac's losses are limited due to securitization strategy
- 1989** Financial Institutions Reform, Recovery, and Enforcement Act ("FIRREA") is passed to address the savings and loan crisis
- 1989** Freddie Mac becomes a publicly-traded, shareholder-owned company

1990s

- 1992** Federal Housing Enterprises Financial Safety and Soundness Act enacted, creating the Office of Federal Housing Enterprise Oversight
- 1995** HUD establishes new goals for Fannie Mae and Freddie Mac, requiring them to meet an "affirmative obligation to facilitate the financing of affordable housing for low-income and moderate-income families"

2000s

- 2000s** Fannie Mae and Freddie Mac began purchasing Alt-A and subprime mortgages
- 2006** Housing prices begin to fall nationwide for the first time since the 1930's
- 2008** Housing and Economic Recovery Act enacted, creating FHFA and FHFA-OIG
- 2008** Fannie Mae and Freddie Mac enter FHFA-supervised conservatorships

A Brief History of the Housing Government-Sponsored Enterprises

The housing Government-Sponsored Enterprises ("GSEs") have a long history. Understanding the role that these organizations played historically in the mortgage markets is important to understanding the financial crisis, its causes, and lessons for the future.

The housing GSEs are the Federal National Mortgage Association ("Fannie Mae"), the Federal Home Loan Mortgage Corporation ("Freddie Mac"), and the Federal Home Loan Bank System ("FHLBank System"), which currently consists of 12 Federal Home Loan Banks ("FHLBanks").

HOUSING FINANCE BEFORE FEDERAL INVOLVEMENT

Before the Great Depression of the 1930s, housing finance was exclusively the realm of the private sector. Housing finance generally consisted of short term renewable loans. The features of these loans, which included high down payments (approximately half the home's purchase price), short maturities (10 years or less), and large **balloon payments**, presented significant challenges to widespread home ownership.³¹ The primary source of mortgage funding came from life insurers, commercial banks, and **thrifts**.³² In the absence of a nationwide housing finance market, availability and pricing for mortgage loans varied widely across the country.³³

THE GREAT DEPRESSION

The Great Depression proved as traumatic to the nation's housing market as it was to the U.S. economy. By 1932, the unemployment rate had risen to 23.6%,³⁴ and by early 1933, the government estimated that 20% to 25% of the nation's home mortgage debt was in default.³⁵

FEDERAL RESPONSE TO THE DEPRESSION ERA HOUSING CRISIS

The federal government began its response to the housing crisis in 1932, with the enactment of the Federal Home Loan Bank Act (the "Bank Act"). The Bank Act created the FHLBank System and the Federal Home Loan Bank Board ("FHLBank Board") as its regulator.³⁶ The federal government also created the Home Owners' Loan Corporation ("HOLC"), the Federal Housing Administration ("FHA"), and Fannie Mae.

Federal Home Loan Bank System

The FHLBank System was designed to serve as a reserve credit system to support housing finance and provide relief to troubled homeowners and lending institutions.³⁷ Member institutions, including building and loan associations, cooperative banks, homestead associations, insurance companies, and savings

banks, were required to purchase the stock of the regional FHLBanks.³⁸ The Bank Act provided the FHLBanks with budgetary authority to borrow up to \$215 million from Treasury and issue tax-free bonds as a source of funds for the benefit of member institutions.³⁹

Creation of Home Owners' Loan Corporation

In June 1933, as part of the New Deal, President Roosevelt signed into law the Home Owners' Loan Act.⁴⁰ This Act established the HOLC. The HOLC was managed by the FHLBank Board, and its key role was to refinance mortgages to slow down the rate of foreclosures.⁴¹ The HOLC established a precedent by introducing long-term, fixed-rate mortgage financing, specifically a **self-amortizing**, fixed-rate mortgage. The HOLC stopped making loans in 1936 and ultimately ceased operations in 1951.⁴²

Creation of Federal Housing Administration

Another New Deal measure, the National Housing Act, was enacted in 1934. It established FHA to offer federally backed insurance for home mortgages made by **FHA approved lenders**.⁴³ FHA insurance protected approved lenders against losses on the mortgages they originated. FHA insurance gave lenders added security and expanded the pool of potential homebuyers for whom lenders were willing to underwrite loans.⁴⁴ FHA financed its operations through insurance premiums charged to borrowers and interest earned on its reserves.⁴⁵ Further, FHA expanded the use of fixed-rate, long-term mortgages.

Creation of Fannie Mae

A 1938 amendment to the National Housing Act established Fannie Mae.^e Originally, Fannie Mae was a federal government agency. Its mandate was to act as a secondary mortgage market facility that could purchase, hold, and sell FHA-insured loans. By purchasing FHA-insured loans from private lenders, Fannie Mae created liquidity in the mortgage market, providing lenders with cash to fund new home loans.

CREATION OF VETERANS ADMINISTRATION MORTGAGES

The mortgage market remained relatively unchanged following the establishment of Fannie Mae until 1944, when the Servicemen's Readjustment Act (commonly known as the "GI Bill") created the Veterans Administration ("VA") mortgage insurance program.⁴⁶ The program offered veterans long-term, low-cost mortgages. Fannie Mae began to purchase VA-insured loans in 1948, and its business grew rapidly.⁴⁷

Balloon Payment:

A payment the borrower must make to the lender at the mortgage term's end. This final payment is comparatively much larger than the payments that preceded it.

Thrift:

An organization that primarily accepts savings account deposits and invests most of the proceeds in mortgages. Savings banks and savings and loan associations are examples of thrift institutions.

Self-Amortizing Loans:

Loans in which periodic payments of principal and interest are scheduled over the life of the loan. Self-amortizing loans provide more opportunity for homeownership by allowing these scheduled payments, as opposed to large balloon payments at maturity (the end of the loan term).

FHA Approved Lenders:

Financial institutions that have been approved by FHA for the origination and servicing of FHA-insured mortgages.

Refer to Section 2: "Operations of FHFA and the GSEs, Fannie Mae and Freddie Mac" for a description of the Enterprises' business for secondary mortgages and liquidity.

^e Fannie Mae was originally chartered as the National Mortgage Association of Washington.

Refer to page 19 for an explanation of conventional conforming mortgage loans.

Interest Rate Risk:

The exposure of an institution's financial condition to adverse movements in interest rates.

REORGANIZATIONS OF FANNIE MAE

The Federal National Mortgage Association Charter Act of 1954 ("Charter Act") transformed Fannie Mae from a government agency into a public-private, mixed ownership corporation.^{f 48} The Charter Act also exempted Fannie Mae from all state and local taxes, except real property taxes.⁴⁹

The Housing and Urban Development Act of 1968 (the "1968 HUD Act") reorganized Fannie Mae from a mixed ownership corporation to a for-profit, shareholder-owned company.⁵⁰ This reorganization removed Fannie Mae from the federal budget,⁵¹ and Fannie Mae began funding its operations through the stock and bond markets.

The 1968 HUD Act also gave HUD regulatory authority over Fannie Mae, including authority to require that it devote a reasonable portion of mortgage purchases to low- and moderate-income housing.⁵²

CREATION OF GINNIE MAE

The 1968 HUD Act also created a new housing finance organization, the Government National Mortgage Association ("Ginnie Mae").⁵³ Unlike Fannie Mae, Ginnie Mae was established as a government owned corporation within HUD,⁵⁴ a structure it retains to this day. For a fee, Ginnie Mae guarantees timely payment of principal and interest on privately issued mortgage-backed securities ("MBS") collateralized by FHA, VA, or other government insured or guaranteed mortgages.⁵⁵ In contrast, Fannie Mae and Freddie Mac (the "Enterprises") typically purchase **conventional conforming mortgage loans**. They also issue and guarantee MBS collateralized by these mortgage loans or hold mortgage loans and MBS in their portfolios.

CREATION OF FREDDIE MAC

In 1970, the secondary mortgage market was expanded when Congress passed the Emergency Home Finance Act, which established Freddie Mac,⁵⁶ to help thrifts manage the challenges associated with **interest rate risk**.

The FHLBanks originally capitalized Freddie Mac with a \$100 million contribution.⁵⁷ Freddie Mac began to purchase long-term mortgages from thrifts, increasing their capacity to fund additional mortgages and reducing their interest rate risk. The Act also authorized Fannie Mae and Freddie Mac to buy and sell mortgages not insured or guaranteed by the federal government.⁵⁸ In 1971, Freddie Mac issued the first conventional loan MBS.

FANNIE MAE'S AND FREDDIE MAC'S BUSINESS PRACTICES IN THE 1970s AND 1980s

Although both Fannie Mae and Freddie Mac provided lenders a secondary market for conventional mortgages, they pursued different business strategies during the 1970s and 1980s. Freddie Mac focused its business activities on

^f In this case, the federal government owned the preferred stock, and the investors held the non-voting common stock.

purchasing conventional conforming mortgages from thrifts and issuing MBS rather than holding these mortgages in its portfolio. In doing so, Freddie Mac transferred the interest rate risks associated with the mortgages that it purchased to investors in its MBS. By contrast, Fannie Mae followed its traditional business strategy of purchasing mortgage loans and holding them in its portfolio, which increased its interest rate risk.⁵⁹

The inflation and recessions of the late 1970s and early 1980s and the sharp rises in interest rates that accompanied them put tremendous financial strain on Fannie Mae and many thrifts, which funded their mortgage holdings principally with short term obligations such as deposits. By contrast, Freddie Mac's financial performance was relatively unaffected because of its emphasis on issuing MBS.⁶⁰

During this period, the federal government provided financial benefits to Fannie Mae, such as regulatory forbearance and tax benefits, to help Fannie Mae recover from its financial losses.⁶¹ Additionally, the Garn-St. Germain Depository Institutions Act of 1982 permitted thrifts to diversify their investments into potentially more profitable, but riskier, investment and loan activities. Due to the associated risks, many thrifts experienced substantial losses because of risky loans and investments, a condition that was aggravated by the recession of the early 1980s.⁶²

FREDDIE MAC REORGANIZED

The savings and loan crisis of the 1980s resulted in billions of dollars of losses throughout the housing market. By 1989, the **Federal Savings and Loan Insurance Corporation ("FSLIC")**, which provided deposit insurance for thrift customers, was insolvent. In response, Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act ("FIRREA") in 1989. Among its provisions, FIRREA abolished the FSLIC, transferred its assets, liabilities, and operations to the newly created FSLIC Resolution Fund, and created a new insurance fund for thrift depositors known as the Savings Association Insurance Fund. FIRREA also created the Resolution Trust Corporation to resolve all troubled financial institutions placed into conservatorship or receivership.⁶³ Ultimately, the savings and loan crisis cost taxpayers about \$125 billion and the thrift industry \$29 billion.⁶⁴

FIRREA also reorganized Freddie Mac's corporate structure to one similar to Fannie Mae's: a for-profit corporation owned by private shareholders rather than by the FHLBanks.

FIRREA also restructured the regulatory framework for FHLBanks by abolishing the FHLBank Board. FIRREA assigned oversight responsibilities of the FHLBanks to the newly created Federal Housing Finance Board and opened membership in the FHLBank System to depository institutions (including eligible commercial banks and credit unions) that had more than 10% of their loan portfolios in residential mortgage-related assets.⁶⁵ As a

Federal Savings and Loan Insurance Corporation ("FSLIC"):

Created by the National Housing Act of 1934, the FSLIC, which was administered by the FHLBank Board, insured savings and loan deposits until 1989.

result of this change, despite the closing of troubled thrifts, FHLBank System membership increased between 1989 and 2005 from 3,200 to more than 8,000, and total assets grew from approximately \$175 billion to \$1 trillion.⁶⁶

1992 GSE REFORMS

Given ongoing concerns about regulatory oversight of Fannie Mae and Freddie Mac, Congress passed the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, which created the Office of Federal Housing Enterprise Oversight (“OFHEO”) as an independent regulator within HUD. OFHEO had the authority to conduct routine safety and soundness examinations of Fannie Mae and Freddie Mac and to take enforcement actions.⁶⁷

Further, the measure amended Fannie Mae’s and Freddie Mac’s charters, requiring them to meet an “affirmative obligation to facilitate the financing of affordable housing for low-income and moderate-income families.”⁶⁸ In 1995, HUD began to require Fannie Mae and Freddie Mac to meet certain mortgage purchase goals each year.⁶⁹

FANNIE MAE AND FREDDIE MAC: 2000-2008

In 2003 and 2004, controversy arose concerning the Enterprises’ accounting practices. Additionally, from about 2004 through 2007, Fannie Mae and Freddie Mac embarked on aggressive strategies to purchase mortgages and mortgage assets originated under questionable underwriting standards. For example, the Enterprises purchased large volumes of **Alt-A mortgages**, which typically lacked full documentation of borrowers’ incomes and had higher loan-to-value or debt-to-income ratios. They also purchased private-label MBS collateralized by **subprime mortgages**.

In 2007 and 2008, housing prices plummeted and loan delinquencies and defaults significantly increased. Fannie Mae and Freddie Mac lost billions of dollars on their investment portfolios and MBS guarantees, including MBS collateralized by Alt-A loans.⁷⁰ As foreclosures and losses increased, investor confidence in the Enterprises deteriorated. This led to a sharp increase in the Enterprises’ borrowing costs and drastic declines in shareholder equity, triggering concerns about their potential failure and its broader implications.

During the mid-2000s, several FHLBanks also purchased large volumes of private-label MBS for their mortgage investment portfolios. Subsequently, many FHLBanks suffered financial deterioration due to their investments in private-label MBS collateralized by subprime mortgages. For example, FHFA’s Acting Director stated that 6 of the 12 FHLBanks experienced financial challenges in 2009 primarily as a result of deterioration in the value of their private-label securities. Four of these six FHLBanks recorded cumulative net losses in the first three quarters of 2009: Boston, Chicago, Pittsburgh, and Seattle.⁷¹

Prime Mortgages:

A classification of mortgages that are considered to be of high quality.

Alt-A Mortgages:

A classification of mortgages in which the risk profile falls between prime and subprime. Alt-A mortgages are generally considered higher risk than prime due to factors that may include higher loan-to-value and debt-to-income ratios or limited documentation of the borrower’s income.

Subprime Mortgages:

A classification of mortgages with a higher perceived risk of default than prime and Alt-A loans. Interest rates on subprime mortgage loans are often higher, reflecting the greater risk.

Accounting Problems of Fannie Mae and Freddie Mac

In 2003, Freddie Mac disclosed it had used improper accounting. OFHEO found that Freddie Mac had misstated earnings by \$5 billion between 2000 and 2003 and fined Freddie Mac \$175 million.

OFHEO also investigated Fannie Mae accounting problems and reported:

- “during the period ... 1998 to mid-2004, Fannie Mae reported extremely smooth profit growth...those achievements were illusions deliberately and systematically created by the Enterprise’s senior management with the aid of inappropriate accounting and improper earnings management.”
- “...the Enterprise also had serious problems of internal control, financial reporting, and corporate governance.”
- Fannie Mae engaged in excessive risk-taking, which included increased holdings of subprime and Alt-A private-label MBS and the use of derivatives to manage the interest-rate risk of GSE investment portfolios.
- Those errors resulted in Fannie Mae overstating reported income and capital by an estimated \$10.6 billion.

Fannie Mae paid a \$400 million civil penalty.

The misapplication of accounting rules served to smooth out variations in the Enterprises’ reported earnings over time, masking their volatility and giving the Enterprises the appearance of low-risk companies. Among the accounting rule violations was their improper booking of derivatives, which the companies used to hedge against the effects of movements in interest rates on their investment portfolio of mortgages. These improper accounting practices ultimately led to the Securities and Exchange Commission directing Fannie Mae to restate its financial results for 2002 through mid-2004; the departure of the CEO, Franklin Raines, and the CFO, Timothy Howard; and losses of tens of billions of dollars in market capitalization for Fannie Mae shareholders. OFHEO estimated that expenses for the restatement process, regulatory examinations, investigations, and litigation would exceed \$1.3 billion in 2005 and 2006.

Sources:

Office of Federal Housing Enterprise Oversight. *Report of the Special Examination of Fannie Mae*. May 2006. <<http://www.fanniemae.com/media/pdf/newsreleases/FNMSPECIALEXAM.pdf>>, accessed 4/27/2011; United States Department of Housing and Urban Development, Office of Policy Development and Research, DiVenti, Theresa R. *Fannie Mae and Freddie Mac: Past, Present, and Future*. Volume II, Number 3 (2009), <<http://www.huduser.org/periodicals/cityscape/vol11num3/ch11.pdf>>, accessed 4/27/2011.

As discussed in Section 2, Congress enacted HERA in July 2008. Less than six weeks later, FHFA placed Fannie Mae and Freddie Mac into conservatorships, where they remain today. The FHFA Office of Inspector General, an independent oversight and law enforcement arm of FHFA, has begun an array of audits and evaluations examining FHFA’s regulation of the housing GSEs and its conservatorships of Fannie Mae and Freddie Mac, as noted in Sections 3 and 4.



APPENDICES

Appendix A: Glossary and Acronyms

GLOSSARY OF TERMS

Alt-A Mortgages: A classification of mortgages in which the risk profile falls between prime and subprime. Alt-A mortgages are generally considered higher risk than prime due to factors that may include higher loan-to-value and debt-to-income ratios or limited documentation of the borrower's income.

American Recovery and Reinvestment Act of 2009: Enacted in 2009, this Act authorized a series of measures intended to create jobs and promote investment and consumer spending.

Balloon Payment: A payment the borrower must make to the lender at the mortgage term's end. This final payment is comparatively much larger than the payments that preceded it.

Capitalization: In the context of bank supervision, capitalization refers to the funds a bank holds as a buffer against unexpected losses. It includes shareholders' equity, loss reserves, and retained earnings. Bank capitalization plays a critical role in the safety and soundness of individual banks and the banking system. In most cases, federal regulators set requirements for adequate bank capitalization.

Collateral: Assets used as security for a loan that can be seized by the lender if the borrower fails to repay the loan.

Conservatorship: Conservatorship is a legal procedure for the management of financial institutions for an interim period during which the institution's conservator assumes responsibility for operating the institution and conserving its assets. Under the Housing and Economic Recovery Act of 2008, the Federal Housing Finance Agency ("FHFA") placed Fannie Mae and Freddie Mac (collectively the "Enterprises") into conservatorships. The statutory role of FHFA as conservator requires FHFA to take actions to preserve and conserve the assets of the Enterprises and restore them to safety and soundness. FHFA assumed the powers of the board of directors, officers, and shareholders; however, the day-to-day operations of the company are still with the Enterprises' existing management.

Conventional Conforming Mortgage Loans: Conventional mortgage loans are those mortgages that are not insured or guaranteed by the Federal Housing Administration, the U.S. Department of Veterans Affairs, or the U.S. Department of Agriculture and meet the Enterprises' underwriting standards. Conforming mortgage loans have original balances below a specific threshold, set by law and published by FHFA, known as the "conforming loan limit." For 2011, the conforming loan limit is \$417,000 for most areas of the contiguous United States, although higher limits apply in specific areas.

Debarment: Disqualification of a firm or individual from contracting with the government or participating in government non-procurement transactions for a specific period of time. The grounds for debarment may be either statutory or administrative.

Default: Default is failure to comply with the terms of an obligation to such an extent that a judgment has been rendered in favor of a failed institution or, in the case of a secured obligation, when the property on which such obligation is secured is foreclosed.

Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”): Legislation intended to promote the financial stability of the United States by improving accountability and transparency in the financial system, end “too big to fail,” protect the American taxpayer by ending bailouts, and protect consumers from abusive financial services practices.

Emergency Economic Stabilization Act (“EESA”): A 2008 statute that authorized the U.S. Department of the Treasury to undertake specific measures to provide stability and prevent disruption in the financial system and the economy. It also provided funds to preserve homeownership.

Emergency Home Finance Act of 1970: The Emergency Home Finance Act of 1970 created Freddie Mac and authorized it to create a secondary market for conventional mortgages. Parallel authority and limitations to deal in conventional mortgages was given to Fannie Mae. To alleviate credit concerns raised by acquisition of conventional mortgages, several eligibility restrictions and/or risk sharing requirements were imposed on the mortgages Fannie Mae and Freddie Mac could buy.

Federal Home Loan Bank Act of 1932: This Act established the Federal Home Loan Bank Board (“FHLBank Board”), which charters and supervises Federal Savings and Loans Institutions (“S&Ls”). Additionally, the Act established the Federal Home Loan Banks (“FHLBanks”) and gave the FHLBank Board authority to regulate and supervise S&Ls. The FHLBanks were given the authority to lend to S&Ls to finance home mortgages.

Federal Home Loan Banks (“FHLBanks”): The Federal Home Loan Banks are 12 regional cooperative banks that U.S. lending institutions use to finance housing and economic development in their communities. Created by Congress, the FHLBanks have been the largest source of funding for community lending for eight decades. The FHLBanks provide funding to other banks, but not directly to individual borrowers.

Federal Home Loan Bank Board (“FHLBank Board”): A five-member board established in 1932 by the Federal Home Loan Bank Act. The FHLBank Board provided the FHLBanks with the authority to regulate and supervise savings and loan institutions (“S&Ls”), as well as to lend money to S&Ls, which would in turn finance home loans. The FHLBank Board retained these

basic responsibilities until the passage of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (“FIRREA”). FIRREA created the Federal Housing Finance Board to succeed the FHLBank Board, and some of the FHLBank Board’s functions were transferred to the Federal Deposit Insurance Corporation, the Resolution Trust Corporation, and the Office of Thrift Supervision.

Federal Home Loan Mortgage Corporation (“Freddie Mac”): A federally chartered corporation that purchases residential mortgages, securitizes them, and sells them to investors; this provides lenders with funds that can be used to make loans to homebuyers.

Federal Housing Administration (“FHA”): Part of the U.S. Department of Housing and Urban Development (“HUD”), FHA provides mortgage insurance on loans made by approved lenders throughout the United States and insures mortgages on single family and multifamily homes, including manufactured homes and hospitals. It is the largest insurer of mortgages in the world, insuring over 34 million properties since its inception in 1934.

Federal Housing Enterprises Financial Safety and Soundness Act of 1992: The Act modernized the regulatory oversight of Fannie Mae and Freddie Mac. It created the Office of Federal Housing Enterprise Oversight (“OFHEO”) as a new regulatory office within HUD with the responsibility to “ensure that Fannie Mae and Freddie Mac are adequately capitalized and operating safely.” OFHEO was funded by assessments on Fannie Mae and Freddie Mac. The Act established risk-based and minimum capital standards for Fannie Mae and Freddie Mac and established HUD-imposed housing goals for financing of affordable housing, housing in central cities, and other rural areas.

Federal National Mortgage Association (“Fannie Mae”): A federally chartered corporation that purchases residential mortgages and converts them into securities for sale to investors; by purchasing mortgages, Fannie Mae supplies funds to lenders so they may make loans to homebuyers.

Federal National Mortgage Association Charter Act of 1954 (“Charter Act”): The Charter Act transformed Fannie Mae from a government agency into a public-private, mixed ownership corporation. It also exempted Fannie Mae from all state and local taxes, except real property taxes.

Federal Savings and Loan Insurance Corporation (“FSLIC”): Created by the National Housing Act of 1934, the FSLIC, which was administered by the FHLBank Board, insured savings and loan deposits until 1989.

FHA Approved Lenders: Financial institutions that have been approved by FHA for the origination and servicing of FHA-insured mortgages.

Financial Institutions Reform, Recovery, and Enforcement Act (“FIRREA”): Enacted by Congress in 1989 in response to the savings and loan crisis of the 1980s, FIRREA abolished FSLIC, transferred its assets, liabilities,

and operations to the newly created FSLIC Resolution Fund, and created a new insurance fund for thrift depositors known as the Savings Association Insurance Fund. FIRREA also created the Resolution Trust Corporation to resolve all troubled financial institutions placed into conservatorship or receivership and reorganized Freddie Mac into a for-profit corporation owned by private shareholders.

Financial Models: Financial models are computer simulations designed to forecast the financial performance of a company or project or estimate the impact of key parameters, such as interest rates.

Garn-St. Germain Depository Institutions Act: Legislation enacted in 1982 that provided the thrift industry more flexibility in managing assets and liabilities. As a result, the thrifts were authorized to: (1) invest up to 50% of assets in construction and development loans; (2) invest up to 30% of assets in consumer loans, commercial paper, and corporate debt; (3) own real estate development companies; (4) use land and other noncash assets in the capitalization of new charters, instead of the previously required cash; and (5) offer money market deposit accounts.

Government National Mortgage Association (“Ginnie Mae”): A government-owned corporation within HUD. Ginnie Mae guarantees investors the timely payment of principal and interest on privately issued MBS backed by pools of government issued and guaranteed mortgages.

Government-Sponsored Enterprises (“GSEs”): Business organizations chartered and sponsored by the federal government, which include Fannie Mae, Freddie Mac, and the FHLBanks.

Guarantee: A pledge to investors that the issuing company will bear the default risk on the collateral pool of loans, thereby ensuring the timely payment of principal and interest owed to investors.

Home Owners’ Loan Act: Enacted in 1933, this Act established the Home Owners’ Loan Corporation and authorized steps to: provide emergency relief with respect to home mortgage indebtedness; refinance home mortgages; and extend relief to homeowners who were unable to pay their mortgages and faced foreclosure.

Housing and Economic Recovery Act (“HERA”): HERA was enacted in 2008, and it established FHFA-OIG and FHFA, which oversees the GSEs’ operations. HERA also expanded Treasury’s authority to provide financial support to the GSEs.

Housing and Urban Development Act: Enacted in 1968, this Act partitioned Fannie Mae into two separate organizations, a government-sponsored corporation (Fannie Mae) and a wholly-owned government corporation, Government National Mortgage Association (“Ginnie Mae”). Ginnie Mae expanded the availability of mortgage funds for moderate-income families

using government guaranteed mortgage-backed securities. The Act subjected Fannie Mae to the regulatory control of HUD, which had to approve the issuance of all stocks and other obligations by Fannie Mae and could require it to allocate a portion of its mortgage purchases to low- and moderate-income housing.

Implied Guarantee: The assumption, prevalent in the financial markets, that the federal government will cover GSE debt obligations.

Inspector General Act: Enacted in 1978, this Act authorized establishment of Offices of Inspectors General, “independent and objective units” within federal agencies that: (1) conduct and supervise audits and investigations relating to the programs and operations of their agencies; (2) provide leadership and coordination and recommend policies for activities designed to promote economy, efficiency, and effectiveness in the administration of agency programs, and to prevent and detect fraud and abuse in such programs and operations; and (3) provide a means for keeping the head of the agency and Congress fully and currently informed about problems and deficiencies relating to the administration of such programs and operations and the necessity for and progress of corrective action.

Inspector General Reform Act: Enacted in 2008, this Act amended the Inspector General Act to enhance the independence of inspectors general and to create a Council of the Inspectors General on Integrity and Efficiency. Further, it requires the inspectors general for designated federal entities to be appointed without regard to political affiliation and solely on the basis of integrity and demonstrated ability in accounting, auditing, financial analysis, law, management analysis, public administration, or investigations.

Interest Rate Risk: The exposure of an institution’s financial condition to adverse movements in interest rates.

Mortgage-Backed Securities (“MBS”): MBS are debt securities that represent claims to the cash flows from pools of mortgage loans, most commonly on residential property. Mortgage loans are purchased from banks, mortgage companies, and other originators and then assembled into pools. The MBS represent claims on the principal and interest payments made by borrowers on the loans in the pool.

Preferred Stock: A security that usually pays a fixed dividend and gives the holder a claim on corporate earnings and assets that is superior to that of holders of common stock, but inferior to that of investors in the corporation’s debt securities.

Primary Mortgage Market: The market for newly originated mortgages.

Prime Mortgages: A classification of mortgages that are considered to be of high quality.

Private-Label Mortgage-Backed Securities (“Private-label MBS”): MBS derived from mortgage loan pools assembled by entities other than GSEs or federal government agencies, such as private-sector finance companies. They do not carry an explicit or implicit government guarantee, and the private-label MBS investor bears the risk of losses on its investment.

Secondary Mortgage Market: The market for buying and selling existing mortgages; this could be in the form of whole mortgage or MBS sales. Both the primary and secondary mortgage markets are over-the-counter markets — there is no central exchange. Rather, loans are bought and sold through personal and institutional networks.

Securitization: A process whereby a financial institution assembles pools of income-producing assets (such as loans) and then sells an interest in the cash flows as securities to investors.

Self-Amortizing Loans: Loans in which periodic payments of principal and interest are scheduled over the life of the loan. Self-amortizing loans provide more opportunity for homeownership by allowing these scheduled payments, as opposed to large balloon payments at maturity (the end of the loan term).

Senior Preferred Stock Purchase Agreements (“PSPAs”): Entered into at the time the conservatorships were created, the PSPAs authorize the Enterprises to request and obtain funds from Treasury, which in turn owns preferred stock in each Enterprise. Under the PSPAs, the Enterprises agreed to consult Treasury concerning a variety of significant business activities, capital stock issuance and dividend payments, ending the conservatorships, transferring assets, and awarding executive compensation.

Servicemen’s Readjustment Act: Enacted in 1944 and also known as the GI Bill, this Act offered veterans of the Second World War educational and financial benefits, including long-term, low-cost mortgages.

Subprime Mortgages: A classification of mortgages with a higher perceived risk of default than prime and Alt-A loans. Interest rates on subprime mortgage loans are often higher, reflecting the greater risk.

Suspension: The temporary disqualification of a firm or individual from contracting with the government or participating in government programs, pending the outcome of an investigation, an indictment, or on adequate evidence that supports claims of program violations. A suspension means that an individual or entity is immediately excluded from participating in further federal executive branch procurement and non-procurement programs. Suspension frequently leads to debarment.

Swap: An agreement between two parties to exchange cash flows of underlying securities. For example, in an interest rate swap, a common type of swap, one party agrees to pay a fixed interest rate in return for receiving a variable rate from the other party.

Thrift: An organization that primarily accepts savings account deposits and invests most of the proceeds in mortgages. Savings banks and savings and loan associations are examples of thrift institutions.

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ACRONYMS AND ABBREVIATIONS

1968 HUD Act- Housing and Urban Development Act of 1968	FBI- Federal Bureau of Investigation
Alt-A- Alternative A-Paper Mortgages	FDIC-OIG- Federal Deposit Insurance Corporation Office of Inspector General
Agency- Federal Housing Finance Agency	FFETF- Financial Fraud Enforcement Task Force
APA- Administrative Procedure Act	FHA- Federal Housing Administration
Bank Act- The Federal Home Loan Bank Act	FHFA- Federal Housing Finance Agency
BDO- BDO USA, LLP	FHFA-OIG- Federal Housing Finance Agency Office of Inspector General
Blue Book- Standards for Inspection and Evaluation	FHFB- Federal Housing Finance Board
Charter Act- Federal National Mortgage Association Charter Act of 1954	FHLBanks- Federal Home Loan Banks
CFTC- Commodity Futures Trading Commission	FHLBank Board- Federal Home Loan Bank Board
CIGFO- Council of Inspectors General on Financial Oversight	FHLBank System- Federal Home Loan Bank System
CIGIE- Council of the Inspectors General on Integrity and Efficiency	FinCEN- Financial Crimes Enforcement Network
Dodd-Frank Act- Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010	FIRREA- Financial Institutions Reform, Recovery, and Enforcement Act of 1989
DOJ- United States Department of Justice	FISMA- Federal Information System Management Act of 2002
EESA- Emergency Economic Stabilization Act	Freddie Mac- Federal Home Loan Mortgage Corporation
Enterprises- Fannie Mae and Freddie Mac	FSLIC- Federal Savings and Loan Insurance Corporation
Fannie Mae- Federal National Mortgage Association	GI Bill- Servicemen's Readjustment Act

Ginnie Mae- Government National Mortgage Association

GSE- Government-Sponsored Enterprise

HERA- Housing and Economic Recovery Act of 2008

HOLC- Home Owners' Loan Corporation

HUD- United States Department of Housing and Urban Development

HUD-OIG- United States Department of Housing and Urban Development Office of Inspector General

IRS-CI- Internal Revenue Service-Criminal Investigation

MBS- Mortgage-Backed Securities

MFWG- Mortgage Fraud Working Group

NAAG- National Association of Attorneys General

OA- Office of Audits

OAd- Office of Administration

OC- Office of Counsel

Ocala- Ocala Funding LLC

OE- Office of Evaluations

OFHEO- Office of Federal Housing Enterprise Oversight

OI- Office of Investigations

OIG- Office of Inspector General

OP- Office of Policy, Oversight, and Review

Plan- Reforming America's Housing Finance Market

PSPAs- Senior Preferred Stock Purchase Agreements

Report- Semiannual Report

REO- Real Estate Owned

S&L- Savings and Loan Institutions

SEC- Securities and Exchange Commission

SIGTARP- Office of the Special Inspector General for the Troubled Asset Relief Program

Treasury- United States Department of the Treasury

TBW- Taylor, Bean & Whitaker Mortgage Corporation

USDA- United States Department of Agriculture

VA- United States Department of Veterans Affairs (formerly the Veterans Administration)

Yellow Book- Government Auditing Standards

Appendix B: Information Required by the Inspector General Act

Section 5(a) of the Inspector General Act provides that the Federal Housing Finance Agency Office of Inspector General (“FHFA-OIG”) shall, not later than April 30 and October 31 of each year, prepare semiannual reports summarizing its activities during the immediately preceding six-month periods ending March 31 and September 30. Further, Section 5(a) lists more than a dozen categories of information that FHFA-OIG must include in its semiannual reports. These categories include, among other things, “a summary of each audit report . . . issued before the commencement of the reporting period for which no management decision has been” rendered (Section 5(a)(10)), and “a description and explanation of the reasons for any significant revised management decision made during the reporting period” (Section 5(a)(11)).

Below, FHFA-OIG presents a table that directs the reader to the pages of this Report where the information required by the Inspector General Act may be found. However, FHFA-OIG commenced operations in October 2010, and, thus, some of the required information is not applicable. For example, FHFA-OIG did not issue an audit report prior to October 1, 2010, for which a management decision has not been rendered, nor have any management decisions been revised. Where the required information is not applicable, the table indicates accordingly.

Source/Requirement	Pages
Section 5(a)(1)- A description of significant problems, abuses, and deficiencies relating to the administration of programs and operations of FHFA.	28 – 30
Section 5(a)(2)- A description of the recommendations for corrective action made by FHFA-OIG with respect to significant problems, abuses, or deficiencies.	28 – 30, 32 – 35
Section 5(a)(3)- An identification of each significant recommendation described in previous semiannual reports on which corrective action has not been completed.	Not Applicable
Section 5(a)(4)- A summary of matters referred to prosecutive authorities and the prosecutions and convictions that have resulted.	30 – 32
Section 5(a)(5)- A summary of each report made to the Director of FHFA.	28 – 30
Section 5(a)(6)- A listing, subdivided according to subject matter, of each audit report issued by FHFA-OIG during the reporting period and for each audit report, where applicable, the total dollar value of questioned costs (including a separate category for the dollar value of unsupported costs) and the dollar value of recommendations that funds be put to better use.	28 – 30
Section 5(a)(7)- A summary of each particularly significant report.	28 – 30
Section 5(a)(8)- Statistical tables showing the total number of audit reports and the total dollar value of questioned and unsupported costs.	Not Applicable
Section 5(a)(9)- Statistical tables showing the total number of audit reports and the dollar value of recommendations that funds be put to better use by management.	Not Applicable

Source/Requirement	Pages
Section 5(a)(10)- A summary of each audit report issued before the commencement of the reporting period for which no management decision has been made by the end of the reporting period.	Not Applicable
Section 5(a)(11)- A description and explanation of the reasons for any significant revised management decision made during the reporting period.	Not Applicable
Section 5(a)(12)- Information concerning any significant management decision with which the Inspector General is in disagreement.	Not Applicable
Section 5(a)(13)- The information described under section 05(b) of the Federal Financial Management Improvement Act of 1996.	Not Applicable

Appendix C: FHFA-OIG Public Reports and Testimony

See www.fhfaoig.gov for complete copies of FHFA-OIG's reports and testimonies.

EVALUATION REPORTS

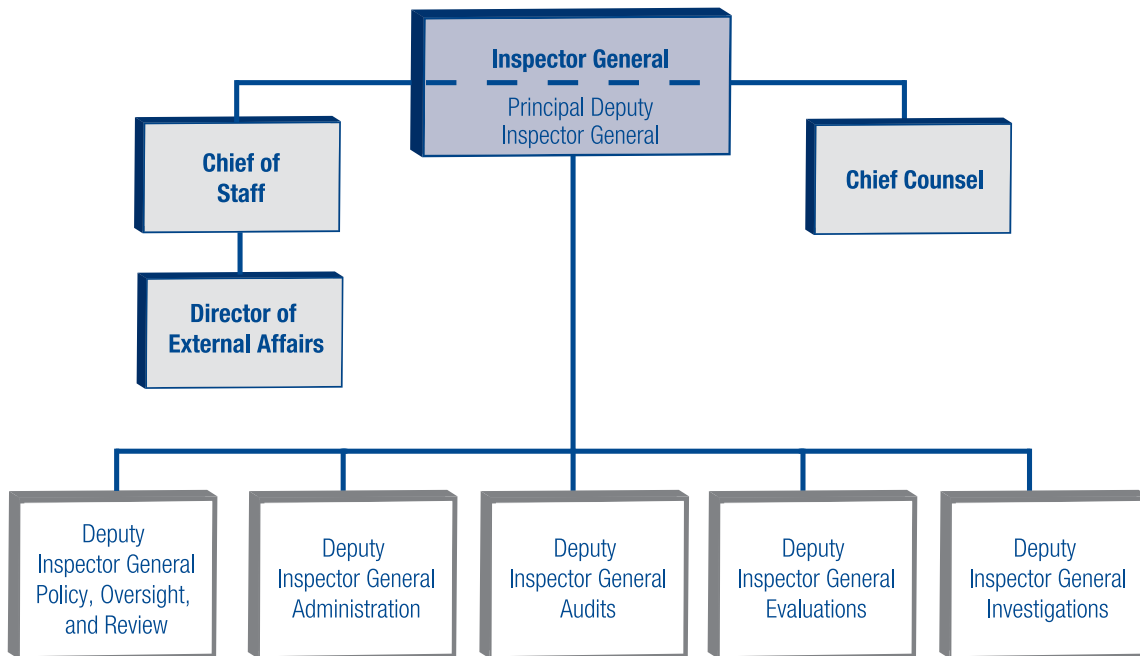
"Federal Housing Finance Agency's Exit Strategy and Planning Process for the Enterprises' Structural Reform," Evaluation Report: EVL-2011-001, dated March 31, 2011.

"Evaluation of Federal Housing Finance Agency's Oversight of Fannie Mae's and Freddie Mac's Executive Compensation Programs," Evaluation Report: EVL-2011-002, dated March 31, 2011.

TESTIMONY

Statement of Steve A. Linick, Nominee for Inspector General, Federal Housing Finance Agency
Before the Senate Committee on Banking, Housing, and Urban Affairs,
July 15, 2010.

Appendix D: FHFA-OIG Organizational Chart



Appendix E: Endnotes

- ¹ U.S. Government Accountability Office. *Fannie Mae and Freddie Mac: Analysis of Options for Revising the Housing Enterprises' Long-term Structures*. (September 2009) <<http://www.gao.gov/new.items/d09782.pdf>>. (hereinafter “GAO-09-782”), p. 2, accessed 4/27/2011.
- ² Fannie Mae. *Monthly Summary*. (March 2011) <<http://www.fanniemae.com/ir/pdf/monthly/2011/033111.pdf>>, accessed 5/19/2011.
Freddie Mac. *Monthly Volume Summary*. (March 2011) <<http://www.freddiemac.com/investors/volsum/pdf/0311mvs.pdf>>, accessed 5/19/2011.
- ³ Federal Housing Finance Agency. *FHFA Releases Projections Showing Range of Potential Draws for Fannie Mae and Freddie Mac*. (Oct. 21, 2010) <http://www.fhfa.gov/webfiles/19409/Projections_102110.pdf>. (hereinafter “FHFA Releases Projections Showing Range of Potential Draws for Fannie Mae and Freddie Mac”), accessed 4/27/2011.
- ⁴ Federal Reserve Bank of New York. *FAQs: MBS Purchase Program*. (Aug. 20, 2010) <http://www.newyorkfed.org/markets/mbs_faq.html>, accessed 4/27/2011.
- ⁵ Federal Home Loan Banks Office of Finance. *Federal Home Loan Banks: Combined Financial Report For the year ended December 31, 2010*. <http://www.fhfb-of.com/ofweb_userWeb/resources/10yrend.pdf>, accessed 4/27/2011.
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- ⁷ Public Law No. 110-289 (Housing and Economic Recovery Act of 2008), § 1117.
- ⁸ Public Law No. 110-343 (Emergency Economic Stabilization Act of 2008), § 2.
- ⁹ Public Law No. 110-343 (Emergency Economic Stabilization Act of 2008), § 110.
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Frequently Asked Questions: Federal Home Loan Bank Advances, *supra* note 17.
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The background of the entire page is a large, detailed, blue-toned seal of the Federal Housing Finance Agency. The seal features an eagle with wings spread, perched on a shield. Above the eagle is a banner with the word "UNUM". The eagle is surrounded by a circular border with stars and a wreath. The entire seal is set against a background of intricate, swirling patterns.

FEDERAL HOUSING FINANCE AGENCY OFFICE OF INSPECTOR GENERAL

INAUGURAL SEMIANNUAL REPORT TO THE CONGRESS

October 12, 2010, through March 31, 2011

Federal Housing Finance Agency
Office of Inspector General
1625 Eye Street, NW
Washington, DC 20006-4001
Main (202) 408-2544
Hotline (800) 793-7724
www.fhfaoig.gov