Federal Housing Finance Agency
Office of Inspector General

FHFA Letters of Instruction to the Enterprises

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Executive Summary

As conservator, FHFA has broad authority over Fannie Mae and Freddie Mac (Enterprises). It exercises control over trillions of dollars in assets and billions of dollars in revenue and makes business and policy decisions that influence and affect the entire mortgage finance industry. Pursuant to its powers under the Housing and Economic Recovery Act (HERA), FHFA has delegated authority for many matters to the Enterprises, although it has retained authority for certain significant decisions. Delegated authority can be revoked by FHFA at any time. As the Enterprises' conservator, FHFA is ultimately responsible for actions taken by the Enterprises pursuant to authority it has delegated to them. OIG has previously identified that FHFA is challenged to improve the quality of its oversight of matters delegated to the Enterprises.

Shortly after FHFA placed the Enterprises into conservatorship, it issued to the Enterprises' respective boards Letters of Instruction (LOI) that defined and outlined the scope of delegated and undelegated authorities. The 2008 LOI were revised in 2012. On December 18, 2017, FHFA issued another revision to the LOI, which became effective on March 31, 2018.

According to FHFA, the objective of the LOI has evolved over the years as the needs of the conservatorship have changed, and the most recent revision was intended to simplify and clarify matters requiring conservator decision or notice, given the extended duration of the conservatorships.

The 2017 LOI contain several significant changes from the 2012 LOI:

- An appendix with LOI Guiding Principles provides additional explanation for expectations and processes and standardizes timelines for the conservator notice and decision processes. FHFA guidance documents incorporated by reference also provide clarity on expectations and processes.

- Three matters for which FHFA decision was required in the 2012 LOI were deleted from the 2017 LOI, and several matters requiring FHFA decision were added to the 2017 LOI.

- Enterprise boards are vested with more discretion to determine their level of involvement on certain matters requiring FHFA decision.

- Matters requiring FHFA notice are described generally rather than identifying specific activities.

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This white paper summarizes the history of FHFA's LOI to Fannie Mae and Freddie Mac, FHFA's process to revise the LOI in 2017, and the changes to those LOI.

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ABBREVIATIONS ....

CRT	Credit Risk Transfer
CSS	Common Securitization Solutions, LLC
Enterprises	Fannie Mae and Freddie Mac, collectively
FHFA or Agency	Federal Housing Finance Agency
HERA	Housing and Economic Recovery Act of 2008
LOI	Letters of Instruction
MSR	Mortgage Servicing Rights
OIG	Federal Housing Finance Agency Office of Inspector General
PEM	Policy Engagement Model
PSPA	Senior Preferred Stock Purchase Agreement
2008 LOI	Letters of Instruction Issued on November 24, 2008
2008 Order	Conservatorship Order No. 2008-006
2012 LOI	Letters of Instruction Issued on November 15, 2012
2017 LOI	Letters of Instruction Issued on December 18, 2017
2017 Order	Conservatorship Order No. 2017-003

BACKGROUND

Under HERA, Congress granted FHFA sweeping conservatorship authority over Fannie Mae and Freddie Mac, which it exercised in September 2008 when it placed the Enterprises in conservatorship.[1] For reasons of efficiency, concordant goals with the Enterprises, and operational savings, FHFA determined to (1) delegate authority for general corporate governance and day-to-day matters to the Enterprises' boards of directors and executive management, and (2) retain authority for certain significant decisions. Delegations of authority from FHFA, as conservator, to the Enterprises' boards of directors (boards) and executive management are a defining feature of the conservatorships.[2]

On November 24, 2008, FHFA issued Conservatorship Order No. 2008-006 (2008 Order), which delegated general corporate governance responsibilities to the newly constituted boards. In conjunction with the 2008 Order, FHFA issued to the Enterprises' respective boards the first Letters of Instruction (LOI) that define and outline the scope of delegated and undelegated authorities (2008 LOI). Generally speaking, the 2008 LOI required the Enterprises to consult with, and obtain a decision[3] from, FHFA on specific significant matters.

On November 15, 2012, FHFA revised and replaced the 2008 LOI to provide more specificity regarding the responsibilities of FHFA, the boards, and Enterprise management (2012 LOI). As part of this revision, the 2012 LOI created three categories:

- **Part A**: matters requiring FHFA decision and consent[4] of or consultation with Treasury under the Senior Preferred Stock Purchase Agreements (PSPAs);[5]

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[1] HERA created FHFA and provides FHFA with its conservatorship powers. For additional detail on the powers provided by the Act, see OIG, *FHFA-OIG's Current Assessment of FHFA's Conservatorships of Fannie Mae and Freddie Mac* (Mar. 28, 2012) (WPR-2012-001) (online at www.fhfaoig.gov/Content/Files/WPR-2012-001.pdf). *See* 12 U.S.C. § 4617(b)(2)(C).

[2] For additional detail on the conservatorships of Fannie Mae and Freddie Mac, see OIG, *FHFA's Conservatorships of Fannie Mae and Freddie Mac: A Long and Complicated Journey* (Mar. 25, 2015) (WPR-2015-002) (online at www.fhfaoig.gov/Content/Files/WPR-2015-002_0.pdf).

[3] The 2008 and 2012 LOI used the term "approval" for matters requiring review and decision by FHFA. That term was changed in the 2017 LOI to "decision." We use the term "decision" throughout this white paper.

[4] The 2012 LOI used the term "approval" for matters requiring consent of or consultation with Treasury. That term was changed in the 2017 LOI to "consent." We use the term "consent" throughout this white paper.

[5] HERA also gave Treasury temporary authority to assist the Enterprises through the purchase of securities. Through the PSPAs, Treasury committed to provide funds to the Enterprises as necessary to prevent their liabilities from exceeding their assets, subject to a cap. The PSPAs were established between FHFA, as conservator for the Enterprises, and Treasury on September 7, 2008, and have been amended several times

- **Part B:** matters requiring FHFA decision; and
- **Part C:** matters requiring FHFA notice.

Matters that did not fall within any of the three categories were delegated to the Enterprises, and notice to FHFA (or its decision) was not required.

On July 12, 2017, FHFA issued Conservatorship Order No. 2017-003 (2017 Order) to the Enterprises' boards, replacing the 2008 Order. The 2017 Order outlines functions, responsibilities, and authorities of the Enterprises' boards.[6] The 2017 Order also clarified that FHFA, as conservator, was exercising its statutory authority under HERA by which it "may, by regulation or order, provide for the exercise of any function by any stockholder, director, or officer of any regulated entity for which [FHFA] has been named conservator or receiver." 12 U.S.C. § 4617(b)(2)(C). On December 18, 2017, FHFA issued another revision to the LOI, replacing all prior versions (2017 LOI). The 2017 LOI became effective on March 31, 2018.[7]

FHFA'S REVIEW AND REVISION PROCESS LEADING TO THE 2017 LOI

According to FHFA, the objective of the LOI has evolved over the years as the needs of the conservatorship have changed.

In 2014, FHFA initiated a review of the 2012 LOI, with an objective of revising, simplifying, and clarifying matters requiring conservator decision or notice, given the extended duration of the conservatorships. According to FHFA, it sought to "create efficient operations for the Enterprises and facilitate a more normal [] supervisory approach to monitoring Enterprise practices."

FHFA decided to use the existing 2012 LOI structure and format to provide consistency between versions. A working group created by FHFA, comprised of staff from various FHFA offices and divisions, identified twenty topics to review and/or address in the 2017 LOI. Members of the working group prepared staff analysis memoranda for each topic that included recommendations on matters to retain, remove, modify, or add to reflect existing

since. *See* OIG, *Analysis of the 2012 Amendments to the Senior Preferred Stock Purchase Agreements* (Mar. 20, 2013) (WPR-2013-002) (online at www.fhfaoig.gov/Content/Files/WPR-2013-002_2.pdf).

[6] On June 27, 2018, FHFA issued Conservatorship Order No. 2018-002, replacing the 2017 Order. Order No. 2018-002 carries over all provisions in the 2017 Order with added language to make the Conservator's authority more explicit.

[7] For the purposes of this white paper, the "2017 LOI," as with prior years, refer to two identical letters: one to the Fannie Mae board of directors and the other to the Freddie Mac board of directors.

views and practices and an assessment of the potential impacts of their recommendations. Those memoranda were provided to a clearing committee of senior Agency officials for review. FHFA explained to us that this clearing committee was a filtering body that either agreed, disagreed, or asked for more information on each staff memoranda. Where the clearing committee was satisfied with recommendations from the working group, those recommendations were incorporated into the draft 2017 LOI. FHFA provided the Enterprises two opportunities to review and submit comments on the draft 2017 LOI. Enterprise feedback was considered by FHFA internal stakeholders and, when appropriate, incorporated into revised drafts of the 2017 LOI.

FHFA Director Watt was provided with the final draft 2017 LOI, and the staff analysis memoranda, for review and approval. On December 18, 2017, the 2017 LOI were approved as submitted and issued directly to the Enterprises' respective boards and management with instructions to develop and submit to FHFA an LOI implementation plan. Both Enterprises submitted implementation plans in which they identified the need to update internal policies and procedures to ensure compliance with the 2017 LOI. The 2017 LOI became effective on March 31, 2018.

THE 2017 LETTERS OF INSTRUCTION

As noted earlier, FHFA used the existing 2012 LOI structure and format for the 2017 LOI. Like the 2012 LOI, the 2017 LOI define certain categories of matters as well as activities that require notice to or a decision from FHFA. According to FHFA, it did not seek to increase or decrease the amount of matters delegated to the Enterprises in the 2017 LOI. While FHFA was not able to quantify for OIG whether the amount of delegated matters increased (or decreased) from the 2012 LOI to the 2017 LOI, an FHFA working group staff analysis memorandum and comments from one Enterprise suggest that FHFA may have increased the amount of matters requiring FHFA decision in the 2017 LOI. As conservator, FHFA reserves the right to manage any aspect of the Enterprises it deems necessary, including directing them to undertake conservator-led strategic initiatives. It also reserves the right to modify the 2017 LOI at any time and/or issue clarifying guidance or policies without changing the 2017 LOI. It may also revoke any prior delegation of authority to the Enterprises at any time.

The 2017 LOI contain several significant changes from the 2012 LOI. First, FHFA established LOI Guiding Principles to provide additional explanation for the expectations and processes set out in the 2017 LOI, including standardizing the timelines for notice to and decision from it.[8] The LOI Guiding Principles are included as an Appendix to the 2017 LOI.[9] Similarly, a number of FHFA guidance documents are incorporated by reference in the 2017 LOI to provide additional clarity on expectations and processes.[10] Next, three matters for which FHFA decision was required in the 2012 LOI were deleted from the 2017 LOI, and several matters requiring FHFA decision were added to the 2017 LOI. Third, FHFA vested Enterprise boards with more discretion to determine their level of involvement on certain matters requiring FHFA decision. Last, the 2017 LOI generally describe categories of activities requiring FHFA notice, instead of identifying specific activities, as was done in the 2012 LOI. Below is a summary of key changes from the 2012 LOI to the 2017 LOI.

Matters Now Excluded from the 2017 LOI

FHFA excludes from the 2017 LOI three matters for which its decision was required in the 2012 LOI, two of which were addressed by FHFA subsequent to 2012.

Single-Family Seller/Servicer Master Agreements

Master agreements are umbrella agreements between seller/servicers and an Enterprise that supplement the general guidelines and requirements in the seller/servicer guide and set forth the additional terms under which an Enterprise does business with its sellers and servicers. The 2012 LOI required approval by an Enterprise board and decision by FHFA for material

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[8] The 2012 LOI did not include any specific timeframe; by contrast, the 2017 LOI specify that an FHFA decision will generally be provided to the Enterprise within 45 days after the request and the Enterprises should submit notice to FHFA a minimum of 15 days before a significant change in activity is scheduled to take place. Timelines may be expedited when matters requiring quick resolution arise.

[9] In addition to standardizing these timelines, the goals of the LOI Guiding Principles, according to FHFA, are to promote transparent information sharing between FHFA and the Enterprises to avoid "surprises," alert the Enterprises of FHFA's authority to escalate matters as necessary, and promote regular feedback between FHFA and the Enterprises to monitor the success of the LOI.

[10] The reference documents listed in the 2017 LOI include:

- Conservatorship Order No. 2017-003;*
- Principles of Corporate Governance in Conservatorship;
- Policy Engagement Model;
- Portal Submissions Policy Regarding Credit Risk Transfer;
- Mortgage Servicing Rights Sales and Transfer Policy;
- External Communication Standards for Enterprises in Conservatorship;
- Conservatorship Decision Policy; and
- Conservatorship Decision Procedures.

* As noted earlier, FHFA issued a new Conservatorship Order, No. 2018-002, on June 27, 2018. FHFA told OIG that the 2017 LOI will be amended to reflect the new Conservatorship Order as a reference document.

changes to and terminations of single-family seller/servicer master agreements for its top five sellers and servicers.

FHFA determined that it would rely on routine Enterprise management reporting and surveillance activities to monitor such matters because such reporting and surveillance provided it with “broad visibility into the Enterprises’ business and credit related policy activities and have been effective in identifying issues” for potential escalation within FHFA. Accordingly, FHFA excluded single-family seller/servicer master agreement changes and terminations from the 2017 LOI.

Scorecard Assessments

The 2012 LOI required each Enterprise to submit for FHFA decision any annual self-assessment of its performance against the conservatorship scorecard. FHFA told OIG that it considered the submissions in evaluating each Enterprise’s performance against the conservatorship scorecard. The Agency also reported to us that an annual self-assessment by the Enterprises was no longer needed once it implemented a formal quarterly assessment process of performance against the conservatorship scorecard, which includes an assessment by FHFA and a self-assessment by the Enterprises. FHFA retains the responsibility to make the final determination of the Enterprises’ performance against the conservatorship scorecard, utilizing information captured in the formal quarterly process. Accordingly, FHFA removed the requirement for FHFA decision on the Enterprises’ annual conservatorship scorecard assessment in August 2014 and did not reinstate that requirement in the 2017 LOI.

Select Executive Compensation

The 2012 LOI required conservator decision and Treasury consent or consultation on entering into new compensation arrangements or increasing amounts or benefits payable under existing arrangements for certain executive officers (Part A Executive Officers). That provision remains in the 2017 LOI. Separately, Part B of the 2012 LOI required approval by an Enterprise board and subsequent decision by FHFA for new and increased executive compensation arrangements for executives at the Senior Vice President level and above (Part B Executive Officers). FHFA’s final rule on executive compensation, effective February 27, 2014, requires FHFA notice and review on most changes to executive compensation. The rule provides the FHFA Director with the authority to prohibit any compensation that is not reasonable and “comparable with compensation paid by similar businesses involving similar duties and responsibilities.” The provision related to Part B Executive Officers was removed from the 2017 LOI in light of the Executive Compensation Rule requirements now in effect. According to FHFA, this change reflects current practice and is consistent with the original intent of the 2012 LOI.

Prior Review and Approval of Matters by an Enterprise Board of Directors

According to FHFA, Enterprise boards are "responsible for overseeing the Enterprises, including the establishment of appropriate delegations to management, policies, and procedures." Accordingly, FHFA examined the matters identified in Parts A and B of the 2012 LOI, all of which required review and approval by the Enterprise boards before the matters were sent to FHFA for decision, and determined to limit the matters requiring prior board approval. We now discuss the changes in the 2017 LOI that result from this, as well as other FHFA determinations.

Part A: Matters Requiring FHFA Decision and Consent of or Consultation with Treasury

As directed by the PSPAs, the Enterprises must obtain the consent of or consult with Treasury before taking action on certain matters. FHFA, as conservator, requires the Enterprises to first obtain FHFA decision before consulting with or seeking consent from Treasury. All such matters were identified in Part A of the 2012 LOI, and those matters remained substantively unchanged in Part A of the 2017 LOI (covered matter). By way of illustration, some of these covered matters include payment of dividends; issuance of subordinated debt; entering into a merger or consolidation with another entity; and sale, transfer, or other disposition of certain types of assets. According to FHFA, its role includes determining whether a covered matter requires consultation with Treasury or its consent, prior to submission of the covered matter to Treasury.

Part A of the 2012 LOI required an Enterprise board to review and approve a covered matter prior to submission of the matter to FHFA. Consistent with its view that Enterprise boards are "responsible for overseeing the Enterprises, including the establishment of appropriate delegations to management, policies, and procedures," FHFA revised Part A of the 2017 LOI to vest each Enterprise board with discretion to determine whether to approve a covered matter before submission to FHFA.

Part B: Matters Requiring FHFA Decision

Part B of the 2012 LOI sets forth specific matters that required approval by an Enterprise board and subsequent decision by FHFA. During its revision process, FHFA determined that review and approval by an Enterprise board should not be required for every specific matter in Part B before the matter was submitted for decision to FHFA. Accordingly, FHFA bifurcated Part B (matters requiring FHFA decision) into two parts, B.1 and B.2, in the 2017 LOI. Part B.1 identifies those specific matters requiring approval by an Enterprise board before the matter is submitted to FHFA for decision,[11] and Part B.2 sets forth matters requiring FHFA decision for which prior approval by an Enterprise board is not required.

Part B includes instructions for the Enterprises to submit "significant" changes for FHFA decision. FHFA advised us that it elected not to define the term "significant" in order to avoid setting arbitrary thresholds or boxing the Agency's requirements into specific measures or ratios. FHFA reported that it regularly communicates with each Enterprise to ensure that they share the Agency's understanding of the term. As we have previously reported, FHFA's use of the term "significant" in the 2012 LOI led to different interpretations and disparate practices between the Enterprises in the submission of proposed new and revised single-family mortgage selling policies to FHFA.[12] FHFA's continued use of the term "significant," without a definition of the term, in the 2017 LOI may lead to the same or similar issues.

Part B.1: Enumerated Matters Requiring Approval by an Enterprise Board Prior to Submission to FHFA for Decision

Each matter identified in Part B.1 of the 2017 LOI requires approval by an Enterprise board prior to submission to FHFA for its decision. Such matters include compensation of board members, some types of redemptions or repurchases of subordinated debt, retention and termination of certain external auditors, and the Enterprises' annual operating budgets. Part B.1 also includes one new matter that was not contained in the 2012 LOI: proposed amendments to bylaws and board committee charters. Part B.1 also altered the scope of two matters that had been included in Part B of the 2012 LOI: board risk limits and Enterprise transactions with subsidiaries or affiliates. We now summarize each of these three matters.

Amendments to Bylaws and Board Committee Charters

The 2012 LOI are silent about amendments to the bylaws and committee charters of an Enterprise board. The 2017 LOI provide that all proposed amendments to bylaws and board committee charters require approval by an Enterprise board and FHFA decision.

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[11] For all other parts of the 2017 LOI (Parts A, B.2, and C), the 2017 LOI specify that the board is expected to determine the level of engagement it believes is appropriate.

[12] *See* OIG, *Compliance Review of FHFA's Implementation of Its Procedures for Overseeing the Enterprises' Single-Family Mortgage Underwriting Standards and Variances* (Dec. 17, 2015) (COM-2016-001) (online at www.fhfaoig.gov/Content/Files/COM-2016-001_1.pdf). FHFA attempted to correct this issue with the adoption of the 2017 LOI; *see* OIG, *Update on FHFA's Implementation of its Revised Procedures for Overseeing the Enterprises' Single-Family Mortgage Underwriting Standards and Variances* (Mar. 27, 2018) (COM-2018-003) (online at www.fhfaoig.gov/Content/Files/Update%20on%20FHFA%20Procedures%20for%20Overseeing%20Enterprises%20Single-Family%20Mortgage%20Underwriting%20Standards%20%28COM-2018-003%29.pdf).

Board Risk Limits

Part B of the 2012 LOI aggregated matters of board risk limits, Enterprise accounting policies, and operational risks as matters requiring prior approval of an Enterprise board before submission to FHFA for decision. FHFA determined to separate these three matters in the 2017 LOI and only required prior board approval for risk limits. (Matters of accounting policy and operational risks continue to require FHFA decision but not prior board approval and were placed in Part B.2, discussed below.)

According to the 2012 LOI, all "increases in board risk limits" required prior board approval before decision by FHFA. Part B.1 of the 2017 LOI requires prior board approval for "changes to or removal of board risk limits that would result in an increase in the amount of risk that may be taken by the Enterprise."[13] The defined scope of board risk limits in Part B.1 is broader than the definition in Part B of the 2012 LOI because it also captures new board risk limits and removal of risk limits. According to FHFA, this change will not affect existing practice because the Enterprises were submitting new risk limits and other modifications to risk limits for FHFA decision, even though those actions were not explicitly required under the 2012 LOI.

Transactions with Subsidiaries and Affiliates

The 2012 LOI required FHFA review and decision of certain Enterprise transactions with subsidiaries or affiliates, after approval by an Enterprise board. The requirement was modified in the 2017 LOI to exclude routine ongoing transactions with Common Securitization Solutions, LLC (CSS). CSS was established in 2013—after FHFA issued the 2012 LOI—as a joint venture between Fannie Mae and Freddie Mac to build and operate the common securitization platform.[14] According to FHFA, routine transactions with CSS are already covered under the CSS operating agreement.

Part B.2: Other Matters Requiring FHFA Decision

Part B.2 identifies certain matters requiring FHFA decision for which Enterprise board approval is not required. FHFA previously required approval of an Enterprise board for some of these matters, including legal settlements over $50 million and matters related to the

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[13] Any changes to Enterprise models and methodology that are part of the Enterprises' annual review process regarding board risk limits, however, are not subject to this 2017 LOI provision. Instead, FHFA will rely on routine monitoring to identify methodology changes that may increase risk.

[14] The Common Securitization Platform will support the Enterprises' single-family mortgage securitization activities. For additional detail, see OIG, *Update on the Status of the Development of the Common Securitization Platform* (Dec. 9, 2016) (COM-2017-001) (online at www.fhfaoig.gov/Content/Files/COM-2017-001.pdf).

conservator's powers, such as might arise within the Enterprises' initiation or substantive response to litigation, in Part B of the 2012 LOI; it deleted those requirements in the 2017 LOI.[15] FHFA added four matters to Part B.2 that were not in the 2012 LOI, two of which were the subject of FHFA directives or guidance subsequent to 2012. These four matters include mergers and acquisitions, standards aligned across both Enterprises, mortgage servicing rights (MSR) transfers, and credit risk transfers. Part B.2 also revised the scope of two matters that had been in Part B of the 2012 LOI: increases in business risks (certain operational and reputation risks) and changes in accounting policy, as well as one matter that had been in Part C of the 2012 LOI: employee compensation.

We now summarize each of these seven matters.

Mergers and Acquisitions

The 2012 LOI did not specifically require the Enterprises to submit mergers, acquisitions, and divestitures of material counterparties (that require Enterprise approval) for FHFA decision. According to FHFA, recent transactions, which potentially impact the scope of the counterparty risk to the Enterprises, have led it to conclude that mergers, acquisitions, and changes in control of certain "key counterparties" be submitted for FHFA decision. Part B.2 incorporates that requirement and defines "key counterparties" as all mortgage insurers, the 20 largest Enterprise mortgage sellers, and the 20 largest Enterprise mortgage servicers.

Matters Aligned across Both Enterprises

Pursuant to FHFA's direction, Fannie Mae and Freddie Mac work jointly to align certain requirements, policies, frameworks, standards, or products. According to FHFA, alignment of requirements, policies, frameworks, standards, or products typically involves extensive collaboration between FHFA, the Enterprises, and industry stakeholders. For example, over the past several years, the Enterprises have collaborated, at FHFA's instruction, on the private mortgage insurer eligibility requirements, servicing alignment initiative, and minimum single-family seller/servicer financial eligibility requirements.

The 2012 LOI did not specifically require FHFA decision on changes to requirements, policies, frameworks, standards, or products that are aligned across the Enterprises pursuant to FHFA's direction. FHFA added this requirement to Part B.2 of the 2017 LOI, and an

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[15] In addition to no longer requiring prior board approval for legal settlements over $50 million, the 2017 LOI also updated the language to provide for FHFA conservator decision on certain agreements when the amount in dispute is more than $50 million.

appendix to the 2017 LOI lists the requirements, policies, frameworks, standards, or products subject to FHFA decision.[16]

Mortgage Servicing Rights Transfers

The 2012 LOI did not require FHFA decision of Enterprise transactions involving MSR transfers. After OIG identified weaknesses in FHFA's delegated approach to MSR transfers in 2013, FHFA modified the 2012 LOI to require FHFA decision on "significant" MSR transfers, which it defined, in separate guidance, to mean MSR transfers for 25,000 or more loans. In May 2016, the Agency further revised this guidance and defined "significant" transfers to mean MSR transfers of 100,000 or more loans to a non-bank servicer and certain higher-risk transfers involving 25,000 or more loans.[17] Part B.2 of the 2017 LOI continues the requirement for FHFA decision on "significant" MSR transfers, and incorporates the definition of "significant" transfers from FHFA's May 2016 guidance.

Credit Risk Transfers

Because the Enterprises did not implement their credit risk transfer (CRT) programs until 2013, the 2012 LOI did not specifically require FHFA decision on such matters. In September 2015, FHFA issued a policy that required each Enterprise to submit certain of its CRT transactions to FHFA for its decision. [18] The CRT provision in Part B.2 of the 2017 LOI incorporates language from this 2015 policy and directs the Enterprises to submit "Credit Risk Transfers that are new transaction types, recurring transactions with any material change in terms, and transactions that involve a collateral type not previously included in a risk-transfer transaction."

Increases in Business Risk

Part B of the 2012 LOI required FHFA decision for reasonably foreseeable material increases in Enterprise operational risk and actions likely to cause significant reputational risk to the Enterprise or result in substantial negative publicity. FHFA determined that the scope of operational and reputational risk did not adequately capture other significant risk categories and enlarged the matter to include "significant" increases in "credit, market, reputational, operational, and other key risks" as changes for which FHFA decision is required under Part B.2. Going forward, each Enterprise will need to assess whether a particular activity increases

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[16] The 2017 LOI also require, under Part C, timely notice for exceptions and waivers to aligned matters if not otherwise submitted to FHFA under the Part B.2 provision.

[17] For additional detail on MSR transfers and the amended instructions, see OIG, *Compliance Review of FHFA's Review Process for Transfers of Enterprise Mortgage Servicing Rights* (Feb. 6, 2018) (COM-2018-001) (online at www.fhfaoig.gov/Content/Files/MSR%20Transfers%20-%20COM-2018-001.pdf).

[18] The CRT policy, Portal Submissions Policy Regarding Credit Risk Transfer, is listed as a reference document in the 2017 LOI.

the significant risks identified in B.2 in order to determine whether to submit that activity to FHFA for decision.

Changes in Accounting Policy

As discussed, Part B of the 2012 LOI contained a provision requiring board approval and subsequent FHFA decision for material changes in accounting policy, board risk limits, and operational risk. Those three matters are treated differently in the 2017 LOI. Part B.2 requires FHFA decision for "material changes in accounting policy" and defines a "material change" to mean a change "material to the financial statements as a whole."[19]

Employee Compensation

The 2012 LOI did not require the Enterprises to submit certain employee compensation changes, such as retention awards, special incentive plans, and merit increase pool funding, to FHFA for decision. Part B.2 of the 2017 LOI now requires FHFA decision on such changes.

Part C: Matters Requiring FHFA Notice

FHFA revised both the substance and process of Part C of the 2017 LOI, which involves those activities for which the Enterprises must provide prior notice to FHFA. In the 2012 LOI, Part C set forth a list of specific business activities for which prior notice to FHFA was required. In Part C of the 2017 LOI, FHFA replaced the prior itemized list with descriptions of the types of activities that require prior notice to FHFA. Part C directs the Enterprises to establish and maintain "controls and processes reasonably capable of identifying matters that require conservator notice." FHFA now directs each "Enterprise to provide timely notice of activities that represent a significant change in current business practices, operations, policies, or strategies not otherwise addressed in Parts A and B."

Part C also incorporates by reference the Policy Engagement Model (PEM). The PEM provides guidance on when the Enterprises need to make a Part C submission so that if an issue gets to a specific level in an Enterprise, then it must be reported to FHFA.[20] According to FHFA, the PEM is a "framework that guides interaction between the Enterprises' Single-Family and Multifamily business units, and FHFA's Office of Housing and Regulatory

[19] FHFA also addresses accounting policy in Part C of the 2017 LOI. Specifically, Part C of the 2017 LOI requires the Enterprises to provide timely notice "for accounting error corrections to previously-issued financial statements that are not *de minimis.*"

[20] As we previously reported, FHFA advised us that it expects the Enterprises to follow the PEM submission standard for proposed new and revised single-family underwriting standards. *See* OIG, *Update on FHFA's Implementation of its Revised Procedures for Overseeing the Enterprises' Single-Family Mortgage Underwriting Standards and Variances* (Mar. 27, 2018) (COM-2018-003) (online at www.fhfaoig.gov/Content/Files/Update%20on%20FHFA%20Procedures%20for%20Overseeing%20Enterprises%20Single-Family%20Mortgage%20Underwriting%20Standards%20%28COM-2018-003%29.pdf).

Policy" in an effort to provide consistency in those interactions, ensure transparency of the Enterprises' credit-related policies and activities to FHFA, and address OIG audit and compliance findings.

Part C of the 2017 LOI also clarified the process to be used by the Enterprises to provide notice. According to FHFA, it always intended the activities identified in Part C to only require prior notice to FHFA, and not a decision by FHFA. During the revision process, FHFA recognized that the notice requirement in Part C of the 2012 LOI could be understood to restrain an Enterprise from moving forward unless it received an acknowledgement from FHFA, which is not what FHFA intended. Accordingly, FHFA clarified in Part C of the 2017 LOI that the requirement for "timely notice" means a minimum of 15 days before the activity is scheduled to take place. Part C cautions the Enterprises that FHFA may, upon receipt of timely notice, exercise its authority to require conservator decision for the activity.

CONCLUSION...

As conservator of the Enterprises, FHFA exercises control over trillions of dollars in assets and billions of dollars in revenue and makes business and policy decisions that influence and affect the entire mortgage finance industry. Pursuant to its powers under HERA, FHFA has delegated authority for many matters to the Enterprises, and it can revoke delegated authority at any time (and retains authority for certain significant decisions). As the Enterprises' conservator, FHFA is ultimately responsible for actions taken by the Enterprises, pursuant to authority it has delegated to them. OIG has previously identified that FHFA is challenged to improve the quality of its oversight of matters delegated to the Enterprises.

The LOI define and outline the scope of delegated and undelegated authorities and assert FHFA's authority over certain decisions. The 2017 LOI make several significant changes from the 2012 LOI, including incorporating greater information on expectations, processes, and timelines; deleting three matters from the list requiring FHFA decision and adding several others; vesting Enterprise boards with more discretion to determine their level of involvement on some matters; and describing matters requiring FHFA notice generally rather than identifying specific activities.

OBJECTIVE, SCOPE, AND METHODOLOGY ....

The objective of this white paper was to provide background information on the Letters of Instruction from FHFA to Fannie Mae and Freddie Mac. To achieve this objective, we reviewed internal FHFA documents as well as publicly available documents from FHFA and the Enterprises and interviewed FHFA staff.

We provided FHFA with the opportunity to respond to a draft of this white paper. We appreciate the cooperation of FHFA staff, as well as the assistance of all those who contributed to the preparation of this white paper.

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  Washington, DC 20219