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Federal Housing Finance Agency
Office of Inspector General

Compliance Review of FHFA's Revised Process for Reviewing the Enterprises' Annual Operating Budgets

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Executive Summary

In September 2008, the Federal Housing Finance Agency (FHFA or Agency) placed Fannie Mae and Freddie Mac (the Enterprises) into conservatorships, pursuant to its authority under the Housing and Economic Recovery Act of 2008 (HERA). For reasons of efficiency, concordant goals with the Enterprises, and operational savings, FHFA determined to delegate authority for general corporate governance and day-to-day matters to the Enterprises' boards of directors and executive management, subject to FHFA's right to revoke delegated authority at any time. Acting pursuant to this delegated authority, both Enterprises set their annual operating budgets for fiscal years 2009-2012. The Enterprises' operating budgets include base expenses, such as employee compensation and office costs, as well as the costs of strategic initiatives of varying duration.

In November 2012, FHFA, acting as conservator for the Enterprises, rescinded the Enterprises' authority to approve their annual budgets and required Agency review and approval. FHFA's stated purpose for that action was "to ensure that Enterprise budgets [are] properly aligned with both FHFA's strategic direction and its safety and soundness priorities." FHFA has reviewed and approved the Enterprises' annual operating budgets for fiscal years subsequent to 2012.

In September 2015, FHFA's Office of Inspector General (OIG) issued an evaluation report which assessed whether FHFA's budget approval process, as implemented, had been effective in ensuring that Enterprise budgets aligned with FHFA's strategic initiatives and safety and soundness priorities. We found that shortcomings in this process had not permitted FHFA to achieve the stated purpose for its required approval and made specific recommendations to address these shortcomings.

In May 2016, in response to our recommendations, FHFA issued its *Enterprise Administrative Budget Oversight Procedures* (*Procedures*), a set of procedures to enhance its budget review and approval process and to address the shortcomings we identified. According to the *Procedures*, they establish:

> a consistent approach for analyzing, deciding on, and monitoring Fannie Mae's and Freddie Mac's administrative operating budgets. The procedures detailed below apply to [the Division of Conservatorship's (DOC)] annual review of and decision on the Enterprises' proposed administrative budgets and DOC's monitoring of those budgets throughout the performance year.

Among other things, the *Procedures* require the Enterprises to: provide draft and final budgets to the Agency's DOC; establish a structured process to obtain the views of other FHFA divisions and offices and the Conservatorship Committee (CC), a group of senior FHFA executives, on the draft and final budgets; and direct DOC to conduct a three-part analysis of the "reasonableness" of each budget. The Agency also committed to staff its budget review process with a financial analyst and two support staff members within DOC. We closed the recommendations from our evaluation in September 2016 based on the Agency's issuance of the *Procedures* and its commitment to implement its revised budget review and approval process.

From 2012 to 2017, the Enterprises' combined operating expenses increased 28%, from $3.9 billion to over $5 billion, underscoring the need for effective FHFA review of Enterprise operating budgets. We conducted this compliance review to assess whether FHFA followed each of the key elements in its *Procedures* for the Enterprises' 2017 annual operating budgets, the first cycle governed by it. We found that FHFA required the Enterprises to submit draft operating budgets for 2017 during the fourth quarter of 2016 and that FHFA completed its review and approval of the final proposed budgets prior to December 31, 2016. As a result, Enterprise spending for 2017, both in amount and direction, was reviewed and approved by the FHFA Director prior to the start of 2017.

However, we found that several key elements in FHFA's revised budget review process either were not implemented, or were implemented but feedback was not provided by stakeholders to DOC to inform its review and analysis. In summary:

- On November 7, 2016, DOC circulated the Enterprises' 2017 draft budgets to 14 senior FHFA employees in other FHFA divisions and offices, with a cover email seeking "[a]ny thoughts or recommendations, from you or your staff, on the overall budget and particularly, the strategic initiatives . . . as they relate to FHFA priorities." DOC's email did not alert the recipients that Freddie Mac's draft budget proposed a 19% increase – $371 million – over forecasted spending for 2016. DOC requested responses by November 23, 2016, and sent a reminder email on November 21, 2016. According to DOC's Senior Associate Director, DOC affirmatively decided not to underscore the 19% requested increase because it sought to present the draft budgets as neutrally as possible. He reported to us that no FHFA division or office provided substantive input, either orally or in writing, on either Enterprise's draft budget or questioned the 19% increase proposed by Freddie Mac in its draft budget to DOC.

- Since 2009, FHFA has had a CC. Pursuant to its revised charter, effective May 26, 2015, the CC "provides senior executive review, direction, and oversight of the exercise of FHFA's conservatorship authority" and is a "forum for information sharing on conservatorship" issues among appropriate FHFA offices. Its members include "executives from functional areas so that multiple viewpoints can be raised and considered." Several CC members received the Enterprises' 2017 draft budgets on November 7, 2016, three days prior to the November 10, 2016, CC meeting at which DOC presented the draft budgets. At that meeting, DOC presented a series of slides summarizing the Enterprises' 2017 draft budgets. One slide reported that Freddie Mac proposed a 19% increase in its draft budget and that its Chief Executive Officer (CEO) directed management to significantly reduce the proposed increase. Minutes of this CC meeting reflect no input from CC members on whether FHFA should seek modifications to either draft budget or direction and/or guidance on which categories of either draft budget should be reduced. DOC's Senior Associate Director, who attended that meeting, advised that no Committee member provided any such guidance on either draft budget, either during or after this meeting. The lack of guidance from any CC member on the specific categories of spending where reductions could be made without undermining implementation of FHFA's strategic initiatives and/or directives limited DOC's ability to provide meaningful feedback to the Enterprise.

- After the Enterprises submitted their final proposed budgets in December 2016, DOC determined not to forward them to the CC for its review and guidance, despite the clear requirement in the *Procedures* that it do so. This decision deprived the FHFA Director of the perspectives of FHFA offices and divisions outside DOC.

- The DOC employees tasked with making a recommendation to the FHFA Director on the reasonableness of the Enterprises' final proposed budgets did not compare each Enterprise's performance ratios to those of peer organizations, one of the three analytical steps identified in the *Procedures*, which may have limited the thoroughness of its analysis.

We recognize that this year was the first year that DOC implemented its revised budget review process, and we suggest that DOC leadership more closely oversee this process in 2017 to ensure that all of its elements are implemented.

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September 19, 2017

This report was prepared by Karen Berry, Senior Investigative Counsel, and Gregg Schwind, Attorney Advisor, with assistance from Bruce McWilliams, Senior Investigative Evaluator. We appreciate the cooperation of FHFA staff, as well as the assistance of all those who contributed to the preparation of this report.

This report has been distributed to Congress, the Office of Management and Budget, and others and is posted on our website, www.fhfaoig.gov.

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TABLE OF CONTENTS ....

EXECUTIVE SUMMARY 2

ABBREVIATIONS 7

BACKGROUND 8

OIG's 2015 Evaluation Report Identified Deficiencies in FHFA's Review of the Enterprises' Annual Operating Budgets 8

FHFA's Revised Process for Review and Approval of the Enterprises' Annual Operating Budgets 9

COMPLIANCE REVIEW RESULTS...11

CONCLUSION..19

OBJECTIVE, SCOPE, AND METHODOLOGY 20

APPENDIX A: FHFA MANAGEMENT RESPONSE..21

APPENDIX B: GROWTH IN THE ENTERPRISES' OPERATING BUDGETS SINCE 2012 23

ADDITIONAL INFORMATION AND COPIES 24

ABBREVIATIONS

CC	Conservatorship Committee
CEO	Chief Executive Officer
DER	Division of Enterprise Regulation
DHMG	Division of Housing Mission and Goals
DOC	Division of Conservatorship
Enterprises	Fannie Mae and Freddie Mac
FHFA or Agency	Federal Housing Finance Agency
OIG	Federal Housing Finance Agency Office of Inspector General
Procedures	*Enterprise Administrative Budget Oversight Procedures*

BACKGROUND..

OIG's 2015 Evaluation Report Identified Deficiencies in FHFA's Review of the Enterprises' Annual Operating Budgets

In September 2008, FHFA placed Fannie Mae and Freddie Mac into conservatorships, pursuant to its authority under HERA. HERA vests FHFA with sweeping powers as conservator. For reasons of efficiency, concordant goals with the Enterprises, and operational savings, FHFA determined to delegate authority for general corporate governance and day-to-day matters to the Enterprises' boards of directors and executive management, subject to FHFA's right to revoke delegated authority at any time. Acting pursuant to this delegated authority, both Enterprises set their annual operating budgets for fiscal years 2009-2012.

In November 2012, FHFA, acting as conservator for the Enterprises, rescinded the Enterprises' authority to approve their annual budgets and required Agency review and approval. FHFA's stated purpose for that action was "to ensure that Enterprise budgets [are] properly aligned with both FHFA's strategic direction and its safety and soundness priorities."

In a September 2015 OIG evaluation report, we reviewed the effectiveness of FHFA's budget review and approval process and found that FHFA's stated purpose for requiring conservator approval of the Enterprises' budgets had not been achieved.[1] Specifically, we found that the Enterprises generally submitted their proposed budgets after the start of their fiscal years and, once the budgets were submitted, FHFA's approval occurred between two and six months after the start of the fiscal years.[2] As a result, the Enterprises operated under proposed budgets for months, and FHFA lacked the information to identify and correct any priority misalignment until well into the year.

We also found that FHFA review of the proposed budgets had been largely based on spending totals organized into broad categories, significantly limiting FHFA's ability to analyze or understand the budgets with any granularity. We reported that FHFA acknowledged that the resources allocated to review the Enterprises' proposed budgets, summarize their content, and prepare DOC's recommendation were insufficient to perform substantive critical analyses. We also found that the budget review process within DOC did not contain any independent analysis by DOC of the reasonableness of the proposed budgets or whether they aligned with FHFA's strategic direction and safety and soundness objectives, nor did it seek formal input from FHFA employees in other FHFA divisions with programmatic expertise in the

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[1] *See* OIG, *FHFA's Exercise of Its Conservatorship Powers to Review and Approve the Enterprises' Annual Operating Budgets Has Not Achieved FHFA's Stated Purpose* (Sept. 30, 2015) (EVL-2015-006).

[2] Both Enterprises align their fiscal years with the calendar year.

Enterprises' programs. As we explained, DOC's lack of sufficient information and dedicated resources needed to critically analyze the proposed budgets caused DOC to rely largely upon the Enterprises' own analyses of their proposed budgets.

We made several recommendations to FHFA to remediate these shortcomings. We recommended that FHFA:

1. Direct the Enterprises to submit their proposed annual operating budgets prior to the start of the next fiscal year to provide FHFA with sufficient time to adequately analyze them;

2. Revise the budget review process and staff it with qualified and experienced employees capable of making critical financial assessments of the Enterprises' proposed budgets and determining whether each Enterprise's budget aligns with FHFA's strategic direction and its safety and soundness priorities; and

3. Set a date certain, prior to January 31 of each fiscal year after 2016, by which FHFA will take final action on each proposed annual operating budget and approve the budget by that date.[3]

In response, FHFA agreed with our first and second recommendations and "generally" agreed with the third. In May 2016, the Agency issued its *Procedures* that, along with its formal management response to our 2015 report, established a revised budget review process for the Enterprises' annual budgets. Under this revised process, the Agency accelerated the timeline of the Enterprises' budget submissions, as well as its review and approval of those submissions. Additionally, FHFA committed to assigning qualified staff to the budget review process, to improving the quality of its analysis, and to fostering collaboration among Agency divisions and offices with insights into the Enterprises' budgets.

FHFA's Revised Process for Review and Approval of the Enterprises' Annual Operating Budgets

FHFA's *Procedures*, FHFA's management response to our 2015 evaluation, and DOC's November 10, 2016, written presentation to the CC on FHFA's budget review process identify the following elements in FHFA's revised budget review process:

[3] OIG also recommended that FHFA set a date certain in the first quarter of 2016 by which FHFA would take final action on the 2016 operating budgets and approve the budgets by that date. Although this recommendation is outside the scope of this compliance review, we note that FHFA approved both Enterprises' 2016 budgets on February 5, 2016, i.e., within the first quarter of the year.

1. Each Enterprise provides DOC with a draft budget for the following year, although the revised process does not set a specific date by which the Enterprises must do so;

2. DOC circulates the Enterprises' draft budgets to other FHFA divisions and offices to "obtain their view[s] on the type of spending proposed for the year and to obtain input on spending that may be of particular interest to each division and/or office";

3. DOC presents the Enterprises' draft budgets to the CC.[4] Its presentation outlines "proposed administrative and strategic initiative spending as well as any potential issues or concerns that have been raised to the Enterprises and their responses" and DOC "obtains guidance" from the CC "on whether to approve, request modifications, or disapprove the budgets";

4. After receiving any feedback from FHFA on their draft budgets, the Enterprises submit to DOC their final, proposed budgets, approved by their respective boards of directors in late November or early December;

5. DOC presents the final proposed budget submitted by each Enterprise to the CC "for final guidance on action to take";

6. DOC prepares an analysis memorandum for the FHFA Director for each Enterprise's final proposed budget that includes its evaluation of the reasonableness of each budget and a recommendation whether to approve each budget. Pursuant to FHFA's *Procedures*, DOC's analysis contains three elements:

    - A review of proposed changes to each Enterprise's **core expenses** on a year-over-year basis;

> **Core Expenses** are generally those incurred to run a business, including employee compensation, equipment costs, and office expenses.

[4] The CC is comprised of the FHFA Director (who serves as its chair), the Deputy Director of DOC, General Counsel, the Deputy Director for the Division of Housing Mission and Goals (DHMG), the Deputy Director for the Division of Enterprise Regulation (DER), the Director of the Office of Minority and Women Inclusion, special advisors, the Chief of Staff, and includes "executives from functional areas so that multiple viewpoints can be raised and considered."

- A comparison of each Enterprise's **performance ratios** to those of peer organizations,[5] for core expenses, if available; and

- A review of each Enterprise's proposed **strategic initiatives** and determination whether these initiatives align with FHFA's expectations or directives, and the Enterprises' strategic plans.

Performance Ratios are comparative financial ratios used to assess a financial institution's financial condition and performance. For example, an expense performance ratio is an institution's annual operating expenses divided by its average assets.

Strategic Initiatives are generally long-term, large-scale projects; for example, the Enterprises' credit risk transfer programs and the development of the common securitization platform.

FHFA's goal is to act on each final, proposed budget by December 31 or, at the latest, January 31 of the following year.

FHFA reported to us that it intended to augment these elements with the knowledge gained through attendance at Enterprise meetings during each calendar year in which proposed budgets for the following fiscal year are discussed.

Based on the Agency's issuance of the *Procedures* and its commitment to implement its revised budget review and approval process, we closed the recommendations from our 2015 evaluation report as of September 2016.

COMPLIANCE REVIEW RESULTS ....

In March 2017, we initiated this compliance review to determine whether FHFA's review and approval of the Enterprises' proposed budgets for fiscal year 2017 satisfied the requirements set forth in its *Procedures* and FHFA's response to our 2015 evaluation report. We found that several key elements in FHFA's revised budget review process either were not implemented, or were implemented but feedback was not provided by stakeholders to DOC to inform its review and analysis. We discuss each element in turn.

1. **Enterprise draft budgets provided to DOC**. According to DOC records, Fannie Mae provided draft versions of its budget to DOC on August 19, September 14, and

[5] The Senior Associate Director for DOC (Senior Associate Director) responsible for overseeing the budget review process stated that the Enterprises' peers could include each other as well as large financial firms or insurance companies.

November 1, 2016, and Freddie Mac provided its latest available draft budget to DOC on October 26, 2016.

The percentage and dollar increases in the Enterprises' respective draft budgets were significantly different. Fannie Mae's draft budget included total expenditures of $2.909 billion, a 4.3% increase ($121 million) over its forecasted 2016 expenditures of $2.788 billion. In contrast, Freddie Mac's 2017 draft budget included total expenditures of $2.356 billion, a 19% increase ($371 million) over its forecasted 2016 expenditures of $1.985 billion.

We reviewed an October 19, 2016, presentation by Freddie Mac management to its CEO, a copy of which was provided shortly thereafter to DOC. It itemized the additional expenditures that comprised the 19% increase: additional staff, information technology support, a CEO contingency, increases in private label securities litigation expenses, and costs to implement FHFA directives. The DOC financial analyst reported to us that she attended a meeting at Freddie Mac on October 19, 2016, during which management made this presentation to the CEO and heard Freddie Mac's CEO direct the Chief Financial Officer to work with the divisions to reduce the proposed budget increases to less than 10%. Nevertheless, the draft budget Freddie Mac provided to DOC on October 26 retained the proposed 19% increase of $371 million. To put the proposed increase in context, for the four-year period 2012 to 2015, Freddie Mac's expenses increased from $1.561 billion in 2012 to a projected $1.927 billion in 2015, a net increase of 23.45%, or $366 million.

In its technical comments on the draft of this report, FHFA took issue with our statement that Freddie Mac's submission to FHFA on October 26, 2016, constituted a draft budget in which it proposed a 19% increase for 2017. According to FHFA, the submission was made at its request and was "merely an aggregation of numerous investment options" and ideas submitted by its business units, amounting to a "bottoms up" roll-up at an "early stage in the budgeting process." FHFA's assertions cannot be squared with its written *Procedures* and contemporaneous documents. Its *Procedures* require the Enterprises to submit "draft budgets" that DOC presents to the CC for its review and guidance. As discussed below, DOC referred to these submissions as the "Fannie Mae and Freddie Mac 2017 Budgets" and DOC's presentation to the CC on Freddie Mac's submission repeatedly called it a "draft budget."

2. **Effort to obtain views and input from other FHFA divisions and offices on the Enterprises' draft budgets**. On November 7, 2016, DOC circulated by email the "Fannie Mae and Freddie Mac 2017 Budgets" to 14 senior FHFA employees in other FHFA divisions and offices (several of whom were members of the CC), seeking

"[a]ny thoughts or recommendations, from you or your staff, on the overall budget and particularly, the strategic initiatives . . . as they relate to FHFA priorities."[6] According to DOC's Senior Associate Director, DOC affirmatively decided not to underscore the 19% increase because it sought to present the draft budget as neutrally as possible. He reported to us that DOC received no substantive input, either orally or in writing, from any of these 14 recipients in response to DOC's request.[7]

3. **Presentation of draft budgets to Conservatorship Committee for guidance**. Pursuant to the *Procedures*, DOC presented the Enterprises' draft budgets to the CC at the CC's meeting on November 10, 2016. That presentation, titled "Enterprises' 2017 Administrative Budget Review," explained the process used by each Enterprise to formulate its draft budget for 2017. With respect to Freddie Mac, DOC observed that Freddie Mac's CEO was "deeply involved in budget formulation process; provided consistent direction to divisions for spending" and that the Enterprise had engaged in "[s]trong and detailed discussions around spending." DOC explained that the draft budget submitted by Freddie Mac was "19% higher than [the] prior year forecast" for 2016 and that the CEO provided direction to each division to better coordinate and prioritize three lines of defense initiatives, focus on high headcount, and look for "productivity/cost cutting." DOC advised that Freddie Mac's "[f]inal budget request will be finalized closer to Board Meeting (December 1)."

   While the *Procedures* explain that one purpose of DOC's presentation of the Enterprises' draft budgets is for DOC to "obtain[ ] guidance" from the CC "on whether to approve, request modification, or disapprove" the drafts, minutes of the November 10, 2016, CC meeting reflect no guidance from any CC member on categories of proposed spending by Freddie Mac that should be reviewed and reduced. DOC's Senior Associate Director, who attended this meeting, reported to us that no CC member provided any such feedback about Freddie Mac's draft budget either during or after this meeting.[8]

[6] Among these 14 recipients were: the Deputy Director of DHMG; the Deputy Director for DER; the DER Examiner-in-Charge for Fannie Mae; the DER Examiner-in-Charge for Freddie Mac; FHFA's Chief Accountant; the head of DER's Office of Governance, Compliance and Operational Risk; the DER Supervision Advisor; the head of the Office of Technology and Information Management; the head of the Office of Financial Analysis, Modeling & Simulations; FHFA's Chief Financial Officer; the head of the Housing Policy Branch; the Associate Director for Financial Modeling; and the Acting Chief Operating Officer.

[7] Two recipients provided written non-substantive responses. During the same time period, the DOC financial analyst and the Agency's chief accountant engaged in a narrowly focused discussion by email about the Enterprises' and Common Securitization Solution's policies on the capitalization and depreciation of IT software.

[8] His recollection was confirmed by the DOC financial analyst who was involved in the revised budget review process and who also attended the meeting.

In its technical comments, FHFA offered two explanations for the CC's lack of guidance on Freddie Mac's proposed 19% increase in its draft budget, neither of which we find persuasive. First, the Agency maintained that the FHFA Director's bi-weekly meetings with the Enterprise CEOs provided him with "continuous updates on the status of the budget evolution." That assertion ignores the significantly different roles played by the Enterprise CEOs and the CC in the budget review process. Each Enterprise CEO sponsors management's draft and proposed final annual budgets to FHFA and, as such, is an advocate for his Enterprise's budget. In contrast, the role contemplated for the CC in its charter and in the *Procedures* is to provide independent review of, and guidance on, proposed draft and final Enterprise budgets. Thus, the bi-weekly meetings between the Director and the Enterprise CEOs are not a substitute for the independent review and guidance to be provided by the CC.

Next, FHFA asserted that the FHFA Director and CC members were aware of the proposed 19% increase at the time of the November 10, 2016, meeting but had no "need to request particular modifications because Freddie Mac was already taking those steps" as its CEO had directed his leadership team to reduce the proposed budget increase. As we now discuss, that explanation rings hollow.

In November 2012, FHFA, acting as conservator for the Enterprises, rescinded the Enterprises' authority to approve their annual budgets "to ensure that Enterprise budgets [are] properly aligned with both FHFA's strategic direction and its safety and soundness priorities." Pursuant to its revised 2015 charter, the purpose of the CC is to provide "senior executive review, direction and oversight of the exercise of FHFA's conservatorship authority, under applicable law." The charter explains that CC meetings "serve as a forum for briefing the Director and committee members on key conservatorship issues." The *Procedures* direct DOC to present the Enterprises' draft budgets to the CC to obtain guidance from executives working in a range of "functional areas" so that "multiple viewpoints can be raised and considered." The *Procedures* contemplate review and guidance from the CC on the draft budgets of both Enterprises.

The lack of guidance from any CC member on the specific categories of proposed spending where reductions could be made without undermining Freddie Mac's implementation of FHFA's strategic initiatives and/or directives limited DOC's ability to provide meaningful feedback to Freddie Mac.[9] And FHFA's attempts to excuse the

[9] FHFA also claimed, without providing documentary support, that "the EICs of each Enterprise have recurring meetings with Enterprise senior leadership teams, who also provide them feedback on the status of the budget." Assuming that the recurring meetings between Enterprise leadership and the EICs for each supervision team provide "feedback" on the status of the budget, FHFA did not suggest how this "feedback" would supplant the obligations of CC members.

lack of input from the CC on the Freddie Mac draft budget did not explain why the CC offered no guidance on Fannie Mae's draft budget.

4. **Enterprise submission of final proposed budgets to DOC by late November or early December.** Fannie Mae's board of directors approved its final, proposed budget on November 29, 2016, and submitted it to DOC on December 1. Freddie Mac's board of directors approved its final, proposed 2017 budget on November 30, 2016, and submitted it to FHFA on December 8, 2016.

   Fannie Mae's final budget was $2.909 billion – essentially the same as its draft budget – representing a 4.3% increase over its then-forecasted 2016 expenditures of $2.788 billion. Freddie Mac's final proposed budget of $2.115 billion was significantly lower than its draft budget, with a 7.1% increase ($140 million) over its then-forecasted 2016 expenditures of $1.975 billion. Our comparison of Freddie Mac's draft and final proposed budgets found that a reduction of $241 million was achieved primarily through cuts to nearly all Freddie Mac divisions and other spending containment initiatives.[10]

5. **Presentation of Enterprises' final proposed budgets to the Conservatorship Committee for guidance.** FHFA's *Procedures* require DOC to present the Enterprises' final, board-approved proposed budgets to the CC for its guidance on what action to take. Together, the final proposed budgets amounted to approximately $5 billion in spending, a total increase of $261 million, or 5.5%, over forecasted 2016 expenditures.

   Notwithstanding the clear requirement in the *Procedures* to present the final proposed Enterprise budgets to the CC, DOC's Senior Associate Director reported to us that he and the Acting Director of DOC agreed not to do so, and no such presentation was made.

   The Senior Associate Director provided two reasons for DOC's decision. First, he opined that the FHFA Director was aware of the changes to Freddie Mac's budget from regular meetings with Freddie Mac's CEO and from DOC. Second, he stated that the Acting Director of DOC and another senior DOC official attended Enterprise board and management meetings and kept DOC staff informed about the status of the Enterprises' budgets. For these reasons, DOC's Senior Associate Director reported to us that he concluded that the *Procedures* requirement that DOC present final proposed

[10] Freddie Mac reduced its proposed increase from 19% to 7.1% by, among other things, [redacted]

Enterprise budgets to the CC was not "a useful expenditure of senior management time." That decision deprived senior FHFA executives of the opportunity to collectively consider and assess the merits of the proposed $261 million in increased expenditures, and provide Agency-wide guidance to DOC on the budget, which undercut FHFA's efforts to exercise effective control over Enterprise spending, both in amount and direction.

In its technical comments, FHFA offered several other explanations for DOC's decision not to present the final budgets to the CC. First, FHFA asserted that its recently adopted *Procedures* are no more than "internal guidelines" and "were not intended to establish mandatory requirements." That claim is inconsistent with the recitals on the first page of the May 9, 2016, *Procedures*, which state that the purpose of the *Procedures* is to "establish[] a consistent approach for analyzing, deciding on, and monitoring" the Enterprise budgets and "apply to DOC's annual review of and decision on the Enterprises' proposed administrative budgets." We found no provision in the *Procedures* that authorizes DOC employees to pick and choose which of its requirements DOC will follow.

FHFA maintained that the "objective" of the *Procedures* "was to ensure that the Director was fully briefed on the budgets and that he had the information needed to make a decision on the proposed budgets" and that this objective was accomplished through "various meetings" and "the formal red folder process." FHFA did not identify the participants in these "various meetings" or when they occurred. To the extent that these meetings refer to the FHFA Director's bi-weekly meetings with the Enterprise CEOs, we explained previously why such meetings were not a substitute for the independent review and guidance from the CC. Similarly, the "formal red folder process" was not a substitute for review by the CC.[11] Most members of the CC, including the deputy directors of various FHFA divisions, were not included in the formal red folder process for approval of the 2017 Enterprise budgets. The formal red folder process has been used by FHFA since at least 2012. Had FHFA concluded that this process was sufficiently robust to ensure that the FHFA Director was fully briefed on the Enterprises' proposed final budgets, it would not have added the requirement of CC review of these budgets in its May 2016 *Procedures*.

[11] In a 2012 audit report, we explained the formal red folder process used by the FHFA Acting Director. *See* OIG, *FHFA's Conservator Approval Process for Fannie Mae and Freddie Mac Business Decisions* (Sept. 27, 2012) (AUD-2012-008). A similar process is currently used by the FHFA Director. Because FHFA approval of the Enterprises' proposed final operating 2017 budgets was required, DOC prepared analysis memoranda of the budgets and recommendations for the FHFA Director to approve them. The red folders, with DOC's analysis memoranda, were circulated to the Senior Associate Director of DOC, the Acting Deputy Director of DOC, the General Counsel, the Deputy General Counsel, and the Chief of Staff for their review and sign-off, and then to the FHFA Director.

6. **Preparation of analysis and recommendation memorandum for the FHFA Director.** FHFA committed to staff DOC's budget review and approval process with an analyst and two support staff members. Our review of DOC documentation found that FHFA honored its staffing commitment for the 2017 budget review cycle.

   The *Procedures* direct DOC to advise the FHFA Director on the "reasonableness" of each Enterprise's final proposed budget, based upon the results of a three-part analysis. Our review of the analysis performed by DOC in making its "reasonableness" recommendation found that DOC did not conduct one of the three elements of the analysis.

   We found that DOC performed the first element of the specified analysis: it compared the proposed 2017 core expenses to those forecasted for 2016.[12]

   We found that DOC did not perform the second element of the analysis: it did not compare each Enterprise's performance ratios to those of peer organizations, for core expenses. DOC's Senior Associate Director represented to us that he recognized the utility of performance ratio comparisons to peer organizations as part of budget reviews and asserted that the Enterprises could be compared to each other as well as to large financial firms or insurance companies. He offered a number of performance ratio comparisons that he considered useful, such as ratios of specific division expenses (e.g., Human Resources, Legal, or IT) to total operating expenses, and total operating expenses to total assets. He confirmed that DOC intended to compare the Enterprises' performance ratios to those of peer organizations in its future analyses of proposed Enterprise budgets. He explained, however, that other priorities caused him to direct the DOC financial analyst to skip this element of the analysis for the 2017 budget review cycle.

   FHFA, in its technical comments, claimed that the *Procedures* only contemplated that DOC will conduct a peer-to-peer analysis of performance ratios in the event that such data would be "available" and asserted that the Enterprises were "only beginning to potentially evaluate the use of ratios in their budget planning process and as a result, none were available for the 2017 budget process." That contention overlooks a June 8, 2016, presentation by Freddie Mac management to the Freddie Mac board in which management conducted a similar peer-to-peer analysis against Fannie Mae, mortgage insurers, and a number of large financial institutions with relevant data.

[12] The Senior Associate Director and the analyst told us that DOC interprets the year-over-year language to mean either on a one-year basis, as happened during its review of the Enterprises' proposed 2017 operating budgets, or multiple years.

Last, we found that DOC performed the third element of the analysis: it determined that the Enterprises' proposed strategic initiative expenditures were appropriately aligned with strategic plans and corporate goals, and consistent with FHFA guidance.

7. **The FHFA Director approved each Enterprise's final, proposed budget prior to December 31, 2016**. DOC prepared written analyses of the reasonableness of each Enterprise's final, proposed budget for the FHFA Director in December 2016. In an analysis memorandum dated December 7, 2016, DOC concluded that Fannie Mae's final budget of $2.909 billion was reasonable and recommended that the Director approve it without conditions. In an analysis memorandum dated December 13, 2016, DOC concluded that Freddie Mac's budget of $2.115 billion was reasonable, but recommended that the Director approve it with conditions related to unallocated costs and other matters.[13]

   Agency records confirm that the Director reviewed DOC's analysis memorandum for Fannie Mae and approved DOC's recommendation on December 15, 2016. FHFA records reflect that the Director reviewed DOC's analysis memorandum for Freddie Mac's proposed 2017 budget, and on December 20, 2017, approved DOC's recommendation.[14]

[13] FHFA approved Freddie Mac's budget with conditions. Freddie Mac had to: account for [redacted] unallocated expenses among its divisions, make a final decision on amending its depreciation policy and describe how any changes would affect the budget, identify how IT costs would be allocated by division, and provide an updated budget once these items were finalized.

[14] See Appendix B to this report for trend data on the Enterprises' operating expenses from 2012 through 2017.

CONCLUSION

We determined in this compliance review that for the 2017 budget review and approval cycle – the first review cycle for which the revised process was implemented – FHFA met its commitment to improve the timeliness of the process. FHFA reviewed and approved Enterprise spending for 2017, both in amount and direction, prior to the start of 2017. FHFA also met its commitment to assign DOC staff members to the budget review process.

However, we identified several limitations in implementing the revised budget review process. FHFA's divisions and offices outside of DOC did not provide any substantive feedback to DOC on the Enterprises' draft budgets; the CC provided no guidance to DOC on the Enterprises' draft budgets; and DOC chose not to present the final proposed Enterprise budgets to the CC for its review, which deprived the FHFA Director of the perspectives of FHFA offices and divisions outside DOC. In addition, DOC's employees tasked with making a recommendation to the FHFA Director on the reasonableness of the final proposed budgets did not compare each Enterprise's performance ratios to those of peer organizations, one of the three analytical steps set forth in the *Procedures*, which may have limited the thoroughness of DOC's analysis.

We recognize that this year was the first year that DOC implemented its revised budget review process, and we suggest that DOC leadership more closely oversee this process in 2017 to ensure that all of its elements are implemented.

We provided a draft of this report to FHFA for its review and comment. On September 15, 2017, the Agency provided its management response, which is reprinted at Appendix A.

OBJECTIVE, SCOPE, AND METHODOLOGY ....

Our objective for this compliance review was to determine whether FHFA took the actions to which it committed in response to recommendations in the 2015 OIG evaluation report, as well as completed the key steps set forth in its May 2016 *Procedures*.

To do so, we analyzed relevant documents related to FHFA's review of the Enterprises' 2017 operating budgets, including the Enterprises' draft and final budget submissions, documentation of FHFA's analysis, records of consultations with other FHFA divisions/ offices, and CC materials. We also interviewed the Senior Associate Director from DOC and the DOC analyst tasked with reviewing the Enterprises' budgets and budget formulation processes.

To understand the context of the 2017 budget review, we also reviewed documentation of DOC's budget review in previous years.

We conducted our review during the period March to July 2017 under the authority of the Inspector General Act of 1978, as amended, and in accordance with the *Quality Standards for Inspection and Evaluation* (January 2012), which were promulgated by the Council of the Inspectors General on Integrity and Efficiency.

We provided a draft of this report to FHFA for its review and comment.

Federal Housing Finance Agency

MEMORANDUM

TO: Richard Parker, Deputy Inspector General, Compliance & Special Projects

FROM: Bob Ryan, Acting Deputy Director, Division of Conservatorship BR

SUBJECT: Draft Report: *Compliance Review of FHFA's Process for Reviewing the Enterprises' Annual Operating Budgets*

DATE: September 15, 2017

Thank you for your compliance review referenced above (draft Report) and for noting that the Federal Housing Finance Agency (FHFA) met its commitment to improve the timeliness of and staffing for our budget review process in the first year of implementing its revised process. While FHFA appreciates the draft Report and will continue to refine its budget oversight process, it notes the following information:

The draft Report takes issue with the Conservatorship Committee members not providing comments or guidance on a preliminary budget development document for Freddie Mac. As noted in our technical comments, at a preliminary stage in the budgeting process, Freddie Mac shared with FHFA, per FHFA's request, a roll up of potential expenditures submitted in a bottoms up process. As a result, the draft budget document shared at the Conservatorship Committee meeting was not a final, internally-approved budget. Not only had it not been approved by senior Freddie Mac management or the Board of Directors, it had not been officially submitted to FHFA for approval. The Committee was informed that it was a preliminary document and that Freddie Mac was in the middle of a process to substantially reduce the numbers, as it did in developing the final budget that FHFA subsequently approved. Given the preliminary nature of the document and the fact that Freddie Mac was in the midst of a process to substantially reduce the numbers, providing comments from FHFA at that stage would have been premature and likely unhelpful. We also note that the budgeting process involves on-going

1

engagement with and general budgeting guidance to the Enterprises, including direction to exercise prudence and align with Conservatorship priorities.

cc: John Major, Internal Controls and Audit Follow-up Manager
Larry Stauffer, Acting Chief Operating Officer

APPENDIX B: GROWTH IN THE ENTERPRISES' OPERATING BUDGETS SINCE 2012 ....

The table below shows how the Enterprises' final, FHFA-approved budgets for 2017 compare to their actual expenses since 2012, when FHFA began reviewing and approving the budgets under its conservatorship authority. The Enterprises' combined operating budgets have grown by about 28% during that period, from $3.928 billion to $5.024 billion.

The table includes actual expenses for the years 2012 to 2016. At the time FHFA approved the Enterprises' 2017 budgets in December 2016, actual expenses for 2016 were not yet known. Therefore, FHFA used projected expenses for 2016 of $2.788 billion for Fannie Mae and $1.975 billion for Freddie Mac, and approved budget increases of 4.3% for Fannie Mae and 7.1% for Freddie Mac.

Enterprise Budgets, 2012 to present

	2012	**2013**	**2014**	**2015**	**2016**	**2017 (p)**
	Fannie Mae					
Admin. Expenses ($B)	2.367	2.545	2.777	3.050	2.741	2.909
Change from prev. year (%)		7.5%	9.1%	9.8%	-10.1%	6.1%
	Freddie Mac					
Admin. Expenses ($B)	1.561	1.805	1.881	1.927	2.005	2.115
Change from prev. year (%)		15.6%	4.2%	2.4%	4.0%	5.5%
	Enterprises' Combined Budgets					
Admin. Expenses ($B)	3.928	4.350	4.658	4.977	4.746	5.024
Change from prev. year (%)		10.7%	7.1%	6.8%	-4.6%	5.9%

(p) – Enterprises' approved budget plans for 2017.

Source for 2012-16 figures: Fannie Mae and Freddie Mac Annual Reports, 2013-2016.

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