FEDERAL HOUSING FINANCE AGENCY
OFFICE OF INSPECTOR GENERAL

FHFA's Oversight of the Enterprises' Compensation of Their Executives and Senior Professionals

EVALUATION REPORT: EVL-2013-001

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FEDERAL HOUSING FINANCE AGENCY
OFFICE OF INSPECTOR GENERAL

AT A GLANCE

FHFA's Oversight of the Enterprises' Compensation of Their Executives and Senior Professionals

Why FHFA-OIG Did This Report

The Housing and Economic Recovery Act of 2008 (HERA) established the Federal Housing Finance Agency (FHFA or Agency) as the supervisor and regulator of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, the Enterprises). In September 2008, FHFA placed the Enterprises into conservatorships.

In its role as the Enterprises' conservator, FHFA oversees the compensation of their executives, including their Chief Executive Officers (CEOs), but it generally delegates to the Enterprises responsibility for determining the compensation levels of their approximately 11,900 non-executive employees.

There has been considerable Congressional interest in, and public debate about, the compensation paid by the Enterprises. In March 2011, the FHFA Office of Inspector General (FHFA-OIG) issued a report that evaluated the Enterprises' executive compensation programs and specifically examined pay practices for the six most-senior executives at both Fannie Mae and Freddie Mac. This report examines pay practices affecting the Enterprises' approximately 2,100 highest paid employees, including nearly 90 executives (CEOs, Executive Vice Presidents (EVPs), and Senior Vice Presidents (SVPs)) and 2,000 senior professionals (Vice Presidents (VPs) and Directors).

What FHFA-OIG Found

The Enterprises use market data from consulting firms as part of the process to set executive and senior professional target compensation at levels that are competitive with compensation offered by comparable financial firms to facilitate recruitment and retention.

For 2011, the Enterprises' combined median compensation levels for executives and senior professionals were as follows.

Title	Number of Employees	Median Cash Compensation
Executives		
EVP	23	$1,718,200
SVP	62	$723,500
Senior Professionals		
VP	333	$388,000
Director	1,650	$205,300
Total	2,068	

Since FHFA-OIG's March 2011 report, FHFA has taken action to strengthen its control of executive compensation. In March 2012, FHFA implemented a revised compensation program that reduces the annual compensation of the Enterprises' CEOs nearly 90% from about $5 million to $600,000 each. The Agency has also enhanced its oversight of executive compensation by implementing recommendations made by FHFA-OIG in the March 2011 report, such as conducting examinations of the Enterprises' executive compensation procedures.

On the other hand, FHFA's oversight of senior professional compensation is comparatively limited. For example, FHFA has not reviewed, examined, or tested the structures, processes, or controls by which the Enterprises compensate their senior professionals to gain assurance of their effectiveness. FHFA-OIG recognizes that FHFA has delegated non-executive compensation to the Enterprises, having determined that doing so is the best way to manage them in conservatorship. However, FHFA-OIG believes that the Agency's lack of independent assessment limits its capacity to ensure that the costs associated with senior professional compensation are warranted.

What FHFA-OIG Recommends

FHFA-OIG recommends that FHFA develop a plan to strengthen its oversight of the Enterprises' compensation of their senior professionals through reviews or examinations. FHFA agreed with this recommendation.

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ABBREVIATIONS

CEO	Chief Executive Officer
CFO	Chief Financial Officer
COO	Chief Operating Officer
EVP	Executive Vice President
Fannie Mae	Federal National Mortgage Association
FHFA	Federal Housing Finance Agency
FHFA-OIG	Federal Housing Finance Agency Office of Inspector General
Freddie Mac	Federal Home Loan Mortgage Corporation
GAO	U.S. Government Accountability Office
HERA	Housing and Economic Recovery Act of 2008
LTI	Long-Term Incentive Award
MBS	Mortgage-Backed Securities
PSPA	Senior Preferred Stock Purchase Agreement
SVP	Senior Vice President
TARP	Troubled Asset Relief Program
Treasury	U.S. Department of the Treasury
VP	Vice President

Federal Housing Finance Agency
Office of Inspector General
Washington, DC

PREFACE

As the Enterprises' conservator, FHFA is responsible for preserving and protecting their assets and mitigating their costs to limit further taxpayer exposure. A significant cost is the compensation the Enterprises provide to their approximately 11,900 employees. Specifically, FHFA-OIG estimates that in 2011 the two Enterprises collectively paid approximately 90 executives a total of $92 million, and 2,000 senior professionals a total of approximately $455 million.[1] Since 2009, FHFA has directly overseen the Enterprises' compensation of their two CEOs and approximately 90 other executives. On the other hand, FHFA has delegated to the Enterprises the responsibility for setting the compensation levels for all other employees. FHFA views the delegation of this and other day-to-day business decisions to be the most effective and efficient means by which to manage the conservatorships.

Although FHFA directly oversees the Enterprises' compensation of their executives, there remains considerable Congressional interest in, and public debate about, the compensation paid to Enterprise employees and FHFA's oversight of this area. FHFA and the Enterprises have stated that the Enterprises' current levels of compensation are necessary to recruit and retain talented executives and other employees. In 2011, Congress held oversight hearings on the appropriateness of Enterprise executive compensation, and legislative measures limiting Enterprise executive compensation were introduced.[2] In March 2011, FHFA-OIG issued a report

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[1] The Congressional Budget Office estimates that the Enterprises' total compensation costs—including salary and benefits—for all employees is $2 billion annually. *See* Congressional Budget Office, *Cost Estimate for H.R. 1221 Equity in Government Compensation Act of 2011* (January 4, 2012) (online at http://www.cbo.gov/publication/42821).

[2] *See, e.g.*, U.S. Senate Committee on Banking, Housing, and Urban Affairs, *Oversight of the Federal Housing Finance Agency*, 112th Cong. (November 15, 2011); House Committee on Oversight and Government Reform, *Pay for Performance: Should Fannie and Freddie Executives Be Receiving Millions in Bonuses?*, 112th Cong. (November 16, 2011) (H. Rept. 112-94); Stop the Outrageous Pay at Fannie and Freddie Act, S.2054, 112th Congress; Equity in Government Compensation Act of 2011, H.R.1221, 112th Congress; and Stop Trading on Congressional Knowledge Act of 2012, Pub. L. No. 112-105, § 16, 126 Stat. 303.

that evaluated FHFA's oversight of the Enterprises' executive compensation programs and specifically examined pay practices for their six most-senior executives.[3]

This report examines FHFA's oversight of pay practices affecting the Enterprises' approximately 2,100 most highly compensated employees and it covers three areas. First, it updates FHFA-OIG's March 2011 report on executive compensation by detailing FHFA's late-2011 and 2012 initiatives in this area, and provides current data on executive compensation levels.[4] Second, the report assesses FHFA's oversight of Enterprise non-executive employee compensation structures, controls, and processes, with a focus on senior professional compensation.[5] Finally, the report provides comprehensive data on the Enterprises' compensation of their senior professionals in 2010 and 2011.

This report was prepared by Wesley M. Phillips, Senior Policy Advisor; Simon Z. Wu, Chief Economist; and Jon A. Anders, Program Analyst. FHFA-OIG appreciates the assistance of all those who contributed to the completion of the evaluation or who cooperated with FHFA-OIG personnel during the process.

This evaluation report has been distributed to Congress, the Office of Management and Budget, and others, and will be posted on FHFA-OIG's website, www.fhfaoig.gov.

Richard Parker
Director, Office of Policy, Oversight, and Review

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[3] *See* FHFA-OIG, *Evaluation of Federal Housing Finance Agency's Oversight of Fannie Mae's and Freddie Mac's Executive Compensation Programs* (EVL-2011-002) (March 31, 2011) (online at http://www.fhfaoig.gov/Content/Files/Exec%20Comp%20DrRpt%2003302011%20final%2C%20signed.pdf).

[4] In the March 2011 report, FHFA-OIG assessed FHFA's oversight of the Enterprises' compensation of their top six executives. In this report, FHFA-OIG provides an update on the prior findings, including actions taken by the Agency to implement the recommendations contained in the March 2011 report. This report also contains an analysis of FHFA's oversight of the Enterprises' compensation of all of their nearly 90 executives in 2010 and 2011, including the top six executives whose compensation was the subject of the March 2011 report.

[5] FHFA-OIG has focused on senior professionals because they are the most highly compensated group of non-executive employees. FHFA-OIG estimates that in 2011 the Enterprises paid their 2,000 senior professionals about $455 million in cash compensation.

BACKGROUND

I. About the Enterprises and FHFA

A. The Enterprises

The Enterprises support the secondary mortgage market by purchasing residential mortgages from loan originators such as banks and credit unions. The loan originators may then use the proceeds of these transactions to originate more mortgages. The Enterprises may hold mortgages in their investment portfolios or package them into mortgage-backed securities (MBS) that they sell to investors. In exchange for a fee, the Enterprises guarantee that MBS investors will receive timely payment of principal and interest on their MBS investments.

B. FHFA and Treasury

On July 30, 2008, HERA established FHFA as the regulator of Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System.[6] Generally, FHFA is responsible for overseeing the safety and soundness of the regulated entities (i.e., Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System), supervising their efforts to support housing finance and affordable housing goals, and facilitating a stable and liquid mortgage market.

With respect to compensation, HERA requires FHFA to prohibit the regulated entities from paying any compensation to their executives that is not "reasonable and comparable with compensation for employment in other similar businesses (including other publicly held financial institutions or major financial services companies) involving similar duties and responsibilities."[7]

Further, HERA authorizes FHFA's Director to "appoint the Agency as conservator or receiver for a regulated entity" for a variety of reasons, including insolvency or inadequate capitalization.[8] On September 6, 2008, FHFA became Fannie Mae's and Freddie Mac's conservator and, as such, the Agency has the authority to conserve and preserve their assets.

HERA also expanded Treasury's authority to provide financial support to the Enterprises.[9] Pursuant to its authority under HERA, Treasury entered into senior preferred stock purchase agreements (PSPAs) with the Enterprises in which it agreed to provide financial support to them

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6 Pub. L. No. 110-289, § 1101, 122 Stat. 2661.

7 12 U.S.C. §§ 4502(12), 4518(a).

8 12 U.S.C. § 4617.

9 *See* 12 U.S.C. § 1719(g).

during their conservatorships.[10] As of September 30, 2012, Treasury has invested $187.5 billion in the Enterprises, thereby enabling them to remain solvent and continue their operations.

As the Enterprises' conservator, FHFA has broad powers to control and direct their business activities. Thus, in 2009 FHFA established compensation programs to govern their executives' annual compensation levels; the Agency oversees the Enterprises' implementation of these programs.[11] However, FHFA has delegated to the Enterprises responsibility for setting the compensation paid to all of their non-executive employees and other day-to-day business decisions. The Agency believes that its delegation of the authority to make decisions in areas such as non-executive compensation is the most efficient and cost-effective means of managing the conservatorships.[12]

On December 16, 2010, however, FHFA exercised its conservatorship authority and imposed a pay freeze on general merit pay increases and cost of living adjustments to be paid to all Enterprise employees during 2011. The pay freeze was subsequently extended to cover 2012. FHFA stated that the pay freeze is intended to limit Enterprise expenditures in a manner consistent with the pay freeze imposed upon the executive agencies of the federal government. While the pay freeze is in effect, and as a general matter, an employee may not receive an increase in compensation unless the employee is promoted or there is a significant change in the employee's duties and responsibilities.

II. FHFA's Control and Oversight of Enterprise Executive Compensation

Since FHFA-OIG issued its March 2011 report, FHFA has taken several steps to strengthen its control and oversight of Enterprise executive compensation.[13] For example, in March 2012, FHFA revised the Enterprises' executive compensation packages. The revisions will result in significant reductions in the compensation of the Enterprises' CEOs as well as much smaller reductions in the compensation of other executives. Further, FHFA has issued a written policy

[10] Specifically, pursuant to the PSPAs, the Enterprises request and obtain funds from Treasury, which owns preferred stock in them. Under the agreements, the liquidation value of Treasury's stock increases as the Enterprises obtain additional Treasury funds. In exchange for Treasury's investment in them the Enterprises must consult with Treasury on a variety of significant business activities, including awards of executive compensation.

[11] With respect to executive compensation, the PSPAs state that the Enterprises may not enter into any new compensation arrangements with, or increase the benefits payable under, existing compensation arrangements of any executive officer without obtaining the consent of the Director of FHFA, in consultation with Treasury.

[12] For a detailed discussion and analysis of FHFA's delegations under the conservatorships, *see* FHFA-OIG, *FHFA-OIG's Current Assessment of FHFA's Conservatorships of Fannie Mae and Freddie Mac* (WPR-2012-001) (March 28, 2012) (online at http://www.fhfaoig.gov/Content/Files/WPR-2012-001.pdf).

[13] *See* FHFA-OIG, *Evaluation of Federal Housing Finance Agency's Oversight of Fannie Mae's and Freddie Mac's Executive Compensation Programs* (EVL-2011-002) (March 31, 2011) (online at http://www.fhfaoig.gov/Content/Files/Exec%20Comp%20DrRpt%2003302011%20final%2C%20signed.pdf).

governing its oversight of executive compensation and conducted examinations to assess Enterprise compensation procedures.

A. FHFA Initially Established Compensation Packages for the Enterprises' Executives in 2009[14]

As described in FHFA-OIG's 2011 evaluation report, in late 2008 and early 2009, FHFA, in coordination with Treasury, developed compensation packages for the Enterprises' executives.[15] FHFA's Acting Director said that, among others things, the goals of the packages were to align executive decision-making with the long-term financial prospects of the Enterprises and to minimize costs to taxpayers. FHFA also sought to ensure that the Enterprises could recruit and retain talented executives and professionals.

The key elements of the Enterprises' executives' 2009 compensation packages were: Base Salary, Deferred Base Salary, and Long-Term Incentive Awards (LTI).[16] Each of these elements is summarized below.[17]

- **Base Salary:** Base salary was tied to the individual executive's level of responsibility and was intended to provide the executive with a fixed level of annual compensation. Under the 2009 program, base salary could not exceed $500,000 per year, except for each Enterprise's CEO, COO, and CFO, whose base salaries ranged from $600,000 to $900,000.

- **Deferred Base Salary:** Deferred base salary was a separate salary component. It consisted of two elements: a fixed portion and a performance-based portion. Payments of such salary were to be made during the calendar year following the year for which the executive's performance was being rated. The deferred base salary earned during each

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[14] Enterprise executives were paid in accordance with the 2009 packages until the packages were revised in 2012. The major elements of the 2009 packages, with the exception of long-term incentive awards, form the basis of the 2012 packages under which the executives are now compensated.

[15] For a full description of this process, *see* FHFA-OIG, *Evaluation of Federal Housing Finance Agency's Oversight of Fannie Mae's and Freddie Mac's Executive Compensation Programs* (EVL-2011-002) (March 31, 2011) (online at http://www.fhfaoig.gov/Content/Files/Exec%20Comp%20DrRpt%2003302011%20final%2C%20signed.pdf).

[16] FHFA-OIG also observes that the 2009 compensation packages included provisions intended to address some of the problematic issues associated with corporate executive compensation programs. For example, the packages required FHFA approval for "golden parachute" executive severance packages, thereby mitigating the possibility that Enterprise executives could leave with large payouts even as the financial conditions of their companies deteriorated.

[17] The 2009 executive compensation packages also included certain compensation earned prior to the Enterprises' entry into conservatorship.

quarter was paid on the last business day of the calendar quarter in the year following the performance year.

- **LTIs:**[18] LTIs were designed to provide executives with incentives to meet specific corporate and individual performance measures over the long-term, as well as to remain with the Enterprises for extended periods. LTI payments were approved by each Enterprise's compensation committee and by FHFA. They were paid in two parts; the first LTI payment was made by March 15th of the year immediately following the performance year, and the second was made one year later.

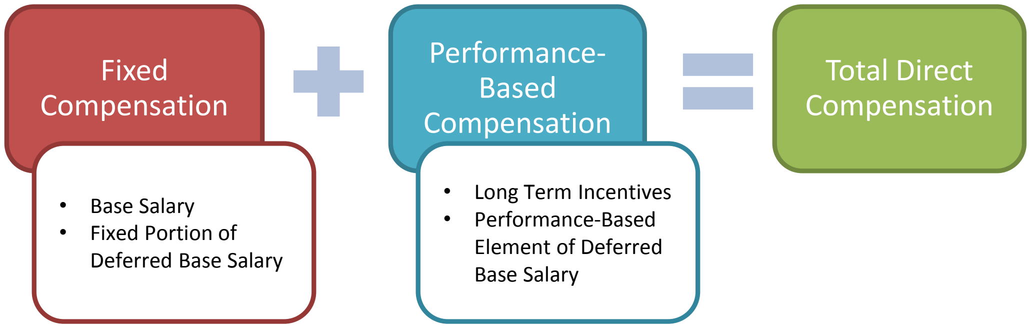
The three elements described above were combined to form each executive's target "total direct compensation" (see Figure 1 below).[19] Although the target total direct compensation for each executive was determined annually, deferred base salary and LTI payments were paid in subsequent years (e.g., for calendar year 2009, deferred base salary was paid in 2010 and LTI payments were to be made by March 15, 2011). Thus, actual or cash compensation paid in any given year could vary from the target total direct compensation approved by FHFA for an executive. Compensation payments for executives also required the approval of the Compensation Committees of the Enterprises' Boards of Directors and FHFA prior to payment.

[18] Compensation terminology used in this report may vary from that used by the Enterprises. For example, Freddie Mac uses the term "Target Incentive Opportunity" rather than LTI. This report uses the term "LTI" for consistency and presentational purposes.

[19] In 2009, FHFA approved total direct compensation targets for each "named executive officer," as well as all EVPs, based upon the position's requirements, the executive officer's expertise, and benchmarks based on the market median of direct compensation offered at comparable financial firms. Each year thereafter the Enterprises established corporate goals that were approved by FHFA and formed the basis by which the executives' performance was evaluated for the performance-based elements of their compensation. The evaluation of corporate and individual performance occurs at the end of the year when the Enterprises establish the funding levels for LTI and deferred base salary payments. The "actual" total direct compensation levels are approved by FHFA and are typically less than the "target" levels. For example, in 2011 FHFA approved funding levels at Fannie Mae for LTI and deferred base salary at 85% of target.

"Named executive officers" are all individuals serving as a company's CEO, CFO, and the three most highly compensated executive officers other than the CEO and CFO, as well as up to two additional individuals who would have qualified as one of the registrant's three most highly compensated executive officers but for the fact that the individual was not serving as an executive officer at the end of the last completed fiscal year. *See* 17 C.F.R. § 229.402(a)(3).

Figure 1: Calculation of Enterprise Executives' Total Direct Compensation[20]



B. Enterprises' Compensation of Their Executives in 2010 and 2011

In 2011, FHFA reviewed and approved compensation packages for a total of 87 executives at Fannie Mae and Freddie Mac (see Figure 2 below).

Figure 2: Combined Enterprise Executive Compensation Subject to FHFA Oversight in 2011[21]

Title	Number of Employees
CEO	2
EVP	23
SVP	62
Total	87

Fannie Mae's and Freddie Mac's former CEOs received a total of $10.7 million in cash compensation or "take home pay" pursuant to the FHFA-approved compensation packages.[22] Figure 3 below shows the median cash compensation paid in 2010 and 2011 to the 85 other

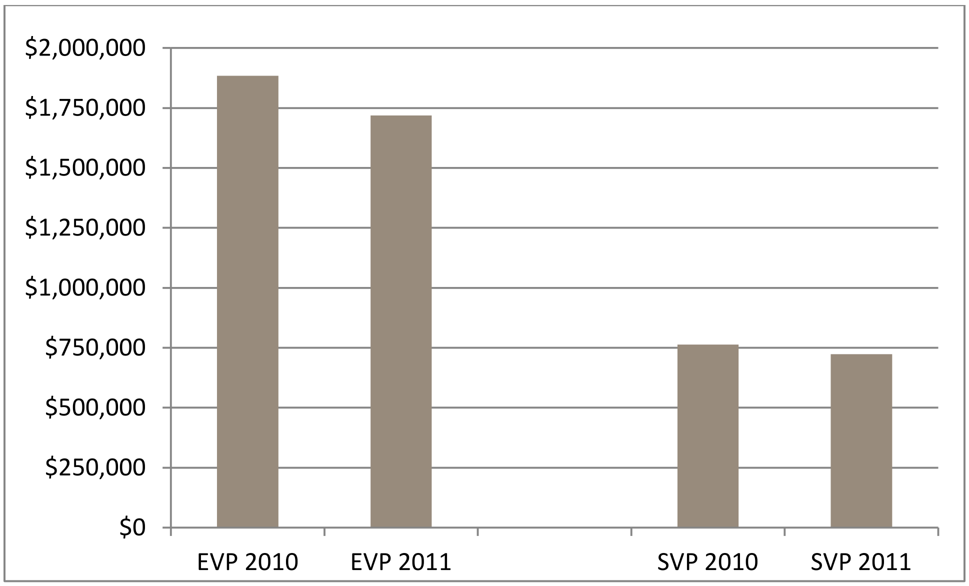
[20] Source: FHFA Testimony and Fannie Mae and Freddie Mac 10-K annual reports.

[21] Source: Enterprise data provided to FHFA-OIG. The number of employees includes all executives who were on the Enterprises' payrolls during any portion of the calendar year.

[22] This evaluation report uses a different methodology than total direct compensation to describe executive and senior professional compensation levels. This methodology, which FHFA-OIG refers to as "cash compensation paid," shows cash income received from all sources in a particular calendar year. This includes current-year base salary and deferred base salary and LTI payments earned in previous years. FHFA-OIG believes that the cash compensation paid methodology—or "take home pay" analysis—offers advantages in terms of comparing compensation trend data over time. *See* Objectives, Scope, and Methodology section of this evaluation report for further information.

Enterprise executives.[23] The median cash compensation level for the Enterprises' EVPs declined by 8.8%, from $1.9 million in 2010 to $1.7 million in 2011. Similarly, the median cash compensation level for their SVPs declined 5.2% from $763,000 to $724,000 from 2010 to 2011. According to Enterprise officials, this decline is likely due to a variety of factors, such as the ongoing pay freeze, the departures of relatively high-paid executives, and their replacement with lower-paid executives.

Figure 3: Median Cash Compensation Paid to Enterprise EVPs and SVPs in 2010 and 2011[24]



C. FHFA Revised the Enterprises' Compensation Packages to Reduce Executive Compensation

On March 9, 2012, FHFA revised the Enterprises' 2009 executive compensation packages, reducing the amount of compensation paid to Enterprise executives for 2012 and future years.[25] Specifically, FHFA stated that there were plans to hire new CEOs at compensation levels that would be sharply lower than had been the case in the past (e.g., the targeted total direct compensation for the CEOs was set at $500,000 each by FHFA in consultation with the

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[23] The median is described as the numerical value separating the higher from the lower half of data observations. Statistically, a median is less likely than an average to be a skewed number, as an average can be dramatically affected by a few exceptionally high or low paid individuals in the group.

[24] Source: Enterprise data provided to FHFA-OIG.

[25] *See* FHFA, *FHFA Announces New Conservatorship Scorecard for Fannie Mae and Freddie Mac; Reduces Executive Compensation* (March 9, 2012) (online at http://www.fhfa.gov/webfiles/23438/ExecComp3912F.pdf).

Enterprises). Further, FHFA stated that the revised packages would, among other things, (1) eliminate bonuses (e.g., LTI) as a component of executive compensation, and (2) reduce executives' annual compensation, other than that of the CEOs, by 10%.[26]

In May and June 2012, respectively, Freddie Mac and Fannie Mae appointed, with FHFA's review and consent, new CEOs, each of whom is subject to the 2012 changes in executive compensation. Although FHFA initially targeted CEO total direct compensation at $500,000, Freddie Mac's new CEO will earn $600,000 in total direct compensation in 2012 and subsequent years. As shown in Figure 4 below, this represents a reduction of cash compensation of 88% from the $5.1 million that the former CEO received in 2011.[27] An FHFA official explained that the Agency agreed to the $600,000 figure to incorporate all factors necessary to attract the candidate, including his commuting and living expenses.[28] The new CEO will not receive any deferred compensation or bonuses.

Fannie Mae's new CEO was already an employee of the Enterprise, and FHFA agreed that he would be compensated in accordance with the terms of his previous position as Chief Administrative Officer, General Counsel, and Corporate Secretary for 2012.[29] However, his total direct compensation will be reduced to $600,000 starting on January 1, 2013, which is 89% lower than the $5.6 million that Fannie Mae's former CEO received in 2011.

Figure 4: 2011 CEO Cash Compensation Compared with Total Compensation Under the New Compensation Packages[30]

Enterprise	2011 Total Cash Compensation	Total Compensation Under New Packages	Percent Decline
Fannie Mae	$5,609,117	$600,000	89.3%
Freddie Mac	$5,134,700	$600,000	88.3%

Although the 2012 revisions to the pay packages and the ongoing pay freeze will reduce executive compensation costs, Agency and Enterprise officials have expressed concern that such reductions in compensation could make it more difficult for the Enterprises to recruit and retain executives and other employees. For example, an Enterprise official said that the FHFA pay

[26] The policy is designed to reduce each executive's total direct compensation by 10% with a few exceptions.

[27] In effect, he will receive a base salary of $600,000 and nothing more.

[28] The new CEO plans to commute between New York and Freddie Mac's headquarters in McLean, Virginia.

[29] The official's target total direct compensation is $2.655 million for 2012, according to FHFA.

[30] Source: Enterprise data provided to FHFA-OIG and testimony from FHFA officials. As noted above, Freddie Mac's CEO will receive $600,000 in total direct compensation for 2012, and the total direct compensation for Fannie Mae's CEO will be reduced to $600,000 starting on January 1, 2013.

freeze could have detrimental effects on recruitment and retention if it remains in effect indefinitely. FHFA officials said that they will continue to monitor the effects of the 2012 revision to the executive compensation packages and the pay freeze on Enterprise recruitment and retention efforts.[31] Appendix A contains data on attrition rates for Enterprise executives and senior professionals for the period 2004 through 2012. The data reveal significant fluctuations over time: substantial increases in voluntary attrition rates at both Enterprises in 2009 (the year after they entered conservatorship), decreases in 2010, increases in 2011, and decreases to date in 2012.

D. FHFA Has Taken Other Steps to Strengthen Its Oversight of Enterprise Executive Compensation

FHFA has taken several other steps to strengthen its oversight of executive compensation:

- FHFA has completed its implementation of the recommendations contained in FHFA-OIG's March 2011 report on its oversight of executive compensation.[32] Specifically, FHFA: (1) developed written guidelines governing its oversight and reviews of executive compensation; and (2) completed examinations to assess the Enterprises' processes for setting individual executive compensation levels.

- FHFA has also established procedures to review the Enterprises' implementation of the Agency's December 2010 pay freeze directive.[33] As discussed previously, FHFA stated in its pay freeze directive that increases in compensation for employees would only be permitted in connection with promotions and changes in duty. According to an FHFA

[31] FHFA officials said that they receive periodic attrition rate data by business line from the Enterprises, and that the data include the Enterprises' assessment of the impact of various Agency initiatives on their rates of attrition. An FHFA official also told FHFA-OIG that discussions were recently held among the Agency and the Enterprises concerning the impact of the 2011-2012 pay freezes upon the Enterprises. The Agency official also provided supporting documentation to FHFA-OIG.

[32] *See* FHFA-OIG, *Evaluation of Federal Housing Finance Agency's Oversight of Fannie Mae's and Freddie Mac's Executive Compensation Programs* (EVL-2011-002) (March 31, 2011) (online at http://www.fhfaoig.gov/Content/Files/Exec%20Comp%20DrRpt%2003302011%20final%2C%20signed.pdf).

[33] In his December 16, 2010, letter to the Enterprises, Acting Director DeMarco wrote, "[a]s Conservator I am directing each of you to maintain individual salaries and wage rates at 2010 levels for 2011. Pay bands or pay scales should remain at 2010 levels. Appropriately modest pay increases associated with promotions or significant changes in an employee's duties are permitted, consistent with your current pay programs. The Federal Housing Finance Agency (FHFA) will work with you and your respective Human Resource teams on implementation questions. We will be examining implementation of this directive." Letter from Edward DeMarco, Acting Director of FHFA, to the CEOs of Freddie Mac and Fannie Mae (December 16, 2010).

compensation official and documents received by FHFA-OIG, the Agency routinely reviews Enterprise requests to promote their executives.[34]

III. FHFA's Oversight of Non-Executive Compensation

As compared to its oversight of executive compensation, FHFA's oversight of the Enterprises' compensation of their approximately 11,900 non-executive employees, including about 2,000 senior professionals, has been limited. Specifically, FHFA imposed an Enterprise-wide pay freeze, commented on proposed changes to Freddie Mac's compensation structure for non-executives in 2012, and approved several employee retention payments.[35] However, FHFA has not reviewed, examined, or tested the Enterprises' compensation programs to ensure that they are effective in mitigating costs. Neither has the Agency assessed the Enterprises' use of promotions and changes in responsibility to determine if they are being used to avoid the strictures of the pay freeze.

FHFA's relatively limited oversight of non-executive employee compensation is consistent with its view that delegating such day-to-day business decisions to the Enterprises is the most effective means of managing the conservatorships. One FHFA official explained that the Agency has focused its oversight on Enterprise executive compensation for several reasons, including its relatively high level on a per capita basis as compared to other positions.

FHFA-OIG recognizes that the Agency views delegating responsibility for many day-to-day business decisions as the most effective means to manage the Enterprises' conservatorships. Nevertheless, as described in this evaluation report, FHFA-OIG also believes that as the Enterprises' conservator, FHFA has a responsibility to gain reasonable assurance that the Enterprises' compensation controls effectively preserve and conserve their assets and limit taxpayer-related costs.[36] Moreover, it may be appropriate to enhance oversight of the

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[34] An FHFA official said that since 2011 the Agency has reviewed and approved a total of 24 requests from the Enterprises to promote their executives. The official also said that the Agency has disagreed with the Enterprises over proposed compensation levels for newly promoted executives. In light of these disagreements, the official said, the Enterprises will often revise their proposals.

[35] An FHFA compensation official said that in early 2012 the Agency commented on Freddie Mac's proposed changes to its compensation structure for senior professionals and other employees. These proposed changes, which have been implemented, are discussed later in this evaluation report. The FHFA official also said that the Agency approved proposed Enterprise retention payments for non-executive employees.

[36] FHFA-OIG is not necessarily advocating that FHFA exercise the same level of oversight and control of non-executive compensation as is the case with executives (e.g., reviewing and approving total direct compensation levels). Rather, FHFA-OIG believes the Agency should, either through reviews or examinations, independently validate the Enterprises' compensation structures, processes, or controls to gain assurance of their effectiveness. FHFA-OIG made a similar recommendation with respect to FHFA's oversight of certain Enterprise legal expenditures. *See* FHFA-OIG, *Evaluation of FHFA's Management of Legal Fees for Indemnified Executives*, (EVL-2012-002) (February 22, 2012) (online at http://www.fhfaoig.gov/Content/Files/EVL-2012-002_0.pdf).

Enterprises' senior professionals since they are the most highly compensated group of employees after executives and they—as a group of fewer than 2,000 individuals—collectively received $455 million in cash compensation in 2011.

To foster a better understanding of areas where FHFA's enhanced oversight may improve the Enterprises' effectiveness and efficiency, the following sections provide basic information about the Enterprises' senior professionals' roles and responsibilities, the Enterprises' approaches to establishing their compensation, and their compensation levels in 2010 and 2011.

A. The Enterprises' Senior Professionals and Their Roles and Responsibilities

At the end of 2011, the Enterprises' senior professionals numbered approximately 2,000, and constituted about 14% of the Enterprises' combined 11,900 member workforce.[37] Figure 5, below, shows the total number of VPs and Directors on the Enterprises' payrolls in 2011, including those who were onboard for only a portion of the year.

Figure 5: Senior Professionals at Both Enterprises in 2011[38]

Title	Number of Employees
VP	333
Director	1,650
Total	1,983

According to the Enterprises, senior professionals serve throughout their organizations, occupying positions in a range of divisions responsible for single-family mortgage finance underwriting and pricing, modeling and analytics, and legal support, among many others. By way of illustration, and according to officials at one of the Enterprises, senior professionals are responsible for the following business activities:

- *Vice Presidents* generally report to SVPs or EVPs and are responsible for staff management and work products within individual divisions, such as single-family mortgage underwriting. Among their responsibilities, VPs: (1) implement strategies set by division heads; (2) guide the resolution of complex business decisions; and (3) focus approximately 70% of their time on either customer or regulatory relations. Typically, a VP has 10 or more years of experience in his or her area of expertise.

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[37] The 14% figure breaks down as follows: VPs made up 2.3% and Directors made up 11.7%.

[38] Source: Enterprise data provided to FHFA-OIG. The number of employees includes all senior professionals who were on the Enterprises' payrolls during any portion of the calendar year.

- *Directors* generally report to VPs or SVPs and are responsible for one or more departmental areas within a division. Among their responsibilities, Directors implement strategies set by division heads, have day-to-day responsibility for the work product produced by their departments, and interpret departmental and divisional directives for their staffs. They typically have eight or more years of relevant experience.

B. Overview of the Enterprises' Senior Professional Compensation Packages

According to officials from both Enterprises, the general structure of their senior professionals' compensation packages is similar to the structure of their executives' compensation packages. That is, senior professional compensation includes annual base pay plus other forms of remunerations that can be referred to as "other compensation." However, Enterprise officials said that base salary accounts for a relatively larger share of senior professional compensation than is the case with executives, and "other compensation" accounts for a relatively smaller share.[39] This is because senior professionals—as compared to executives—are less directly accountable for the Enterprises' overall performance. The "other compensation" category includes elements such as short-term incentives and LTIs that can vary significantly based on the Enterprises' performance in meeting financial goals, as well as the individual employee's performance in attaining such goals.[40]

The Enterprises' approaches to setting senior professional target compensation levels are generally similar, but there are differences between them. They are similar in that both Enterprises use market data as part of the process to establish compensation levels.[41] Both employ compensation consulting firms that conduct confidential market surveys intended to identify compensation levels by position within a range of industries including the financial services industry. Officials from both Enterprises also said that they seek to establish target compensation for all of their employees, in the aggregate, at the median market level as identified through their analyses of market data provided by consultants.[42]

[39] One Enterprise's officials said that LTIs account for the overwhelming majority of its senior professionals' other compensation. Officials at both Enterprises said that retention and one-time cash awards are made on a very selective basis.

[40] Freddie Mac implemented a revised compensation structure in 2012 that further reduces other compensation as a component of senior professional compensation.

[41] Enterprise officials said that it is critical that they offer compensation that is competitive with that offered by financial services firms to ensure they could recruit and retain staff with the expertise and experience necessary to run their large and complex operations.

[42] However, Enterprise officials emphasized that target compensation levels for individual employees may be above or below the median for a variety of reasons including the employee's skill levels and expertise.

The two Enterprises' structures for senior professional compensation differ as follows:

- Since 2009 Fannie Mae has employed market data provided by its consulting firm to establish a series of pay grades for senior professionals and other employees. The pay grades each have a salary range associated with them—minimum, midpoint, and maximum—as well as incentive award eligibility, all of which are informed by the market comparison data and other factors, including the criticality of the position to the Enterprise (e.g., senior professional positions with greater criticality are assigned higher grade and compensation levels).[43] There may be a variety of senior professional and other positions grouped within each of the pay grades.

- Between 2008 and 2010, Freddie Mac transitioned from a pay grade system for senior professionals, such as the one used by Fannie Mae, to one in which compensation levels are determined on a position-by-position basis using the median points of market data.[44] Freddie Mac officials told FHFA-OIG that its human resource professionals identify comparable positions and attendant compensation levels for senior professionals and other positions by employing financial service industry compensation data provided by third party consulting firms.

According to officials from both Enterprises, the ongoing FHFA-established pay freeze has generally kept overall compensation at 2010 levels. As discussed previously, senior professionals and other employees will only receive increases in compensation if they are promoted or there is a substantial increase in their duties and responsibilities.

C. Enterprise Senior Professional Compensation in 2010 and 2011

Figure 6, below, shows the median total cash compensation paid to the Enterprises' senior professionals in 2011. The median value of the VPs' total cash compensation paid was $388,000 and the median for Directors was $205,300.

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[43] According to Fannie Mae, the midpoint for each pay grade represents the market median.

[44] Freddie Mac officials said that the new structure has several benefits, including flexibility and the ability to offer targeted compensation levels more directly tied to particular positions than possible under a pay grade structure. Further, the officials said that the new structure was critical to the Enterprise's ability to recruit and retain employees to fill critical roles.

Figure 6: Median Cash Compensation Paid to Senior Professionals at the Enterprises in 2011[45, 46]

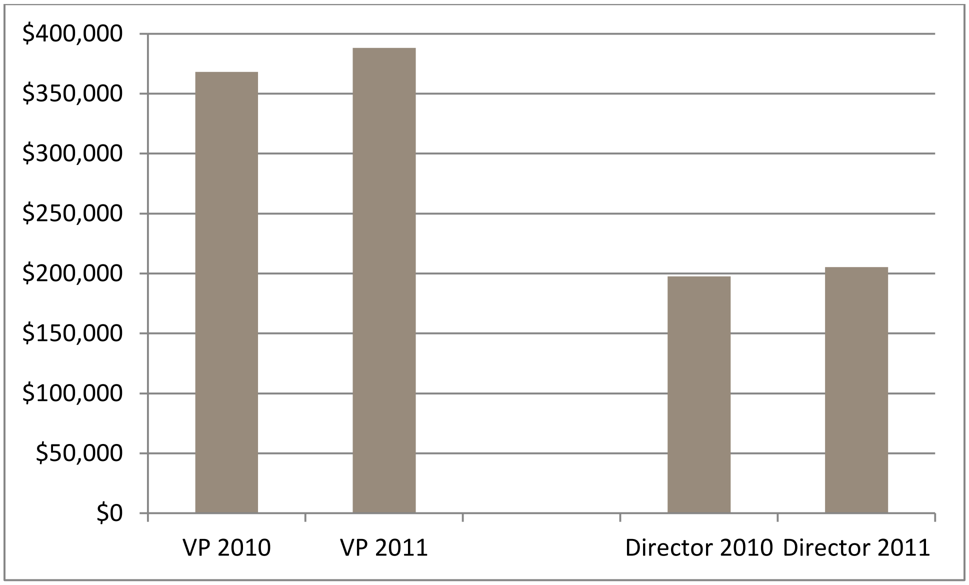
Title	Number of Employees	Total Cash Compensation
VP	333	$388,000
Director	1,650	$205,300

Figure 7, below, shows that the median cash compensation paid to VPs and Directors in 2011 increased about 5.4% and 3.9%, respectively, from 2010, despite FHFA's imposition of a general pay freeze during that period. Enterprise officials explained that this increase is largely attributable to the structure of their LTI payments under 2009 compensation packages. LTI payments at both Enterprises are disbursed in installments over the course of two years. For example, in 2010 Enterprise senior professionals would have received only the first portion of their 2009 LTI payments, and in 2011 they would have received the second portion of their 2009 LTI payments and the first portion of their 2010 LTI payments. However, as described later in this evaluation report, one Enterprise official told FHFA-OIG that promotions and changes in responsibility also may have played a role in the increase in median compensation from 2010 to 2011. FHFA has not examined the implementation of the pay freeze to determine whether the Enterprises may be using promotions and changes in responsibility to offset the impact of the pay freeze.

[45] Source: Enterprise data provided to FHFA-OIG. For VPs and Directors, total cash compensation paid includes base salary and "other compensation" such as cash bonuses, LTI payments, short-term incentive payments, retention awards, vested restricted stock, sign-on bonuses, referral bonuses, variable compensation plan awards, and merit awards. The number of employees includes all senior professionals who were on the Enterprises' payrolls during any portion of the calendar year.

[46] The median compensation numbers provided in Figure 6 represent a mid-point of all employees' compensation within each rank. By definition, half of all employees are compensated at levels higher than the median and the other half are compensated at levels lower than the median. In addition, very few, if any, employees are compensated exactly at the median due to the natural dispersion of compensation data points.

Figure 7: Median Cash Compensation Paid to Enterprise Senior Professionals in 2010 and 2011[47]



[47] Source: Enterprise data provided to FHFA-OIG.

FINDINGS

Generally, FHFA can enhance its oversight of the Enterprises' non-executive compensation structures, processes, and controls. Although FHFA has controlled the Enterprises' non-executive compensation levels through the ongoing pay freeze, the Agency's oversight of the related compensation structures and processes has been limited.[48] FHFA has not conducted any reviews or examinations to gain assurance that the Enterprises' non-executive compensation costs are reasonable and justified, even though, according to FHFA-OIG estimates, senior professional compensation costs alone were approximately $455 million in 2011. As the Enterprises' conservator, FHFA has a responsibility to preserve and conserve effectively their assets and limit taxpayer costs. To help do so, FHFA-OIG believes that the Agency should gain reasonable assurance that the Enterprises' compensation controls are effective. Thus, FHFA should enhance its current non-executive compensation oversight efforts. FHFA-OIG also believes it may be sufficient for FHFA to focus this enhanced oversight on the Enterprises' compensation of their senior professionals given that they are the next most highly compensated group after executives.[49]

The remainder of this section discusses: (1) general senior professional compensation issues and risks potentially meriting FHFA's review; (2) the potential need for FHFA to review Enterprise controls pertaining to compensation offers to senior professional candidates; and (3) the potential need for FHFA to review the Enterprises' compliance with the terms of its pay freeze directive.

1. Several General Issues and Risks Associated with Enterprise Senior Professional Compensation Structures Merit Review by FHFA

During the course of this evaluation, FHFA-OIG identified several potential issues and risks associated with the Enterprises' senior professional compensation systems, processes, and controls that FHFA should consider reviewing. Specifically:

- The Enterprises employ different structures for compensating senior professionals and other employees. Fannie Mae uses a pay grade structure whereas Freddie Mac sets target compensation for each position. It is possible that one structure offers greater benefits

[48] As discussed previously, FHFA reviewed and commented on proposed changes to Freddie Mac's compensation structure for senior professionals in 2012 and reviewed the Enterprises' proposals to make retention payments to senior professionals and other employees.

[49] Although the Enterprises' EVPs and SVPs individually may have much higher compensation levels than VPs or Directors, the estimated $455 million in cash compensation paid to the Enterprises' 2,000 senior professionals was almost five times higher than the estimated $92 million in cash compensation paid to their nearly 90 executives in 2011.

than the other with respect to, among other things, managing the costs associated with senior professional compensation.[50] FHFA could assess this issue and determine whether it would be appropriate to adopt a standard approach that would enable the Enterprises to achieve greater efficiencies.[51]

- The Enterprises use market compensation data provided by consulting firms as part of the process to establish senior professionals' and other employees' target compensation levels. There is a risk that there may be differences in the use of this market data that could result in one Enterprise paying materially higher compensation for similar senior professional positions than the other Enterprise. FHFA could assess this risk and take actions to ensure consistency in the use of market data and, thereby, control costs appropriately.[52]

- The Enterprises seek to control the costs associated with senior professional and other employee compensation by targeting such costs—in the aggregate—to the median market level. However, it is not clear that the Enterprises have sufficient reporting systems to ensure that this objective is being met.[53] Officials from both Enterprises said they do not routinely prepare reports for senior management and the Boards of Directors showing whether the targeted compensation levels are being met, although officials from one Enterprise claimed that such reports are prepared on an "ad hoc" basis.[54] FHFA could

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[50] As noted earlier, this observation concerning the potential economies and efficiencies that could be achieved through a standardized approach to the compensation of senior professionals is consistent with an observation in a previous FHFA-OIG report in which it was observed that the Agency has a responsibility to ensure that, when appropriate, the Enterprises achieve greater efficiency in their management of certain legal expenses through the use of a standardized approach to the management of such costs. *See* FHFA-OIG, *Evaluation of FHFA's Management of Legal Fees for Indemnified Executives* (EVL-2012-002), (February 22, 2012), (online at http://www.fhfaoig.gov/Content/Files/EVL-2012-002.pdf).

[51] FHFA-OIG observes that the Agency is taking a number of steps to align the Enterprises' operations to ensure consistency. For example, FHFA is working with the Enterprises to develop a uniform platform for their MBS issuances. For more detail, *see* FHFA, *The Conservatorships of Fannie Mae and Freddie Mac: An Update on Current and Future Operations,* Remarks as Delivered by Acting Director Edward J. DeMarco at the American Mortgage Conference, at 8, 9 (September 10, 2012), (online at http://www.fhfa.gov/webfiles/24365/2012DeMarcoNCSpeechFinal.pdf).

[52] An FHFA official said that the Agency recently reached an agreement with the Boards of Directors of the Enterprises in which the Enterprises will use the same financial services industry comparator group to establish executive compensation levels. The official also said that the Enterprises will use the same consulting firm to provide this data.

[53] The U.S. Government Accountability Office (GAO) has stated that internal and external financial reporting is a critical internal control. *See* GAO, *Standards for Internal Control in the Federal Government* (GAO-AIMD-OC-21.3.1) (November 1999).

[54] FHFA-OIG requested that the Enterprises provide copies of past reports showing compliance with the targeted compensation levels. In response, the Enterprises did not produce evidence of prior reporting, but instead provided reports that were generated specifically in response to FHFA-OIG's request. The reports indicate that the

assess the extent to which, in the absence of such routine reports, the Enterprises can be assured that their compensation targets are being met and corrective actions are being undertaken to ensure compliance with them.

2. A Limited Test by FHFA-OIG Indicates That FHFA Should Consider Assessing Enterprise Compensation Offers to Newly Hired Senior Professionals

FHFA-OIG tested compensation offers made in 2011 by the Enterprises to prospective employees at a particular senior professional rank.[55] The results of the limited test suggest the need for FHFA to consider assessing the effectiveness of the Enterprises' controls over the offers of compensation they make to newly-employed senior professionals. Specifically, both Enterprises use the median market compensation level as a reference point in developing such offers of compensation. However, FHFA-OIG's test found that one Enterprise's compensation offers were consistently higher than the established median.[56]

FHFA-OIG reviewed offers of compensation made by the Enterprises to 19 of 21 individuals hired to fill a specific type of senior professional rank in 2011. Enterprise A hired 9 of these 19 individuals, and Enterprise B hired the complementary 10 individuals (see Figure 8 below).[57] Enterprise A offered five of its nine candidates (55%) base salaries below the position's median, and it offered the remaining four candidates (45%) salaries above the median.[58] In only 1 of these 4 cases did the compensation offer exceed the median by 10 or more percentage points.

Enterprise B, on the other hand, offered 8 of its 10 hires (80%) base salaries that exceeded the established median level. In 2 of the 8 cases the base salary offered exceeded the median by 20

Enterprises generally paid their senior professionals base salaries that were at or below the median level, but in some cases the averages were higher than the median level. FHFA-OIG further notes that the reports do not "tell the whole story" in that they do not include information about other compensation, such as bonuses, received by the senior professionals. Finally, FHFA-OIG notes that it was not within the scope of this evaluation to test the methodology employed by the Enterprises in preparing these reports or to determine independently the reliability of the data underlying them.

[55] FHFA-OIG is not disclosing additional information about the senior professional rank out of concern that doing so could have a negative impact on the Enterprises' capacity to negotiate compensation with individuals seeking employment at this rank.

[56] FHFA-OIG's test focused on the base salary offered to these senior professional job candidates and excludes various forms of "other compensation."

[57] The Enterprises hired approximately 100 senior professionals in 2011. Consequently, the FHFA-OIG test covered nearly 20% of these new hires. Enterprise B could not establish a median base salary for two of the senior professionals it hired and, therefore, these two cases were excluded from the FHFA-OIG review.

[58] FHFA-OIG determined that the median compensation levels offered by the Enterprises for these particular senior professionals were generally similar.

percentage points or more. In another case, the compensation offered exceeded the median by 18 percentage points.

Enterprise B officials emphasized that it targets total employee compensation in the aggregate—rather than the compensation of any individual employee—to the median market level. The officials also said that compensation can exceed the median level based on a candidate's skills and expertise. Finally, the officials said that in some cases it was necessary to offer compensation well above the median level in order to persuade candidates who already had comparable offers from other organizations or to fill positions that had been vacant for extended periods.[59]

Figure 8: Base Salaries for Nineteen Senior Professionals Hired in 2011 Compared to the Market or Grade-Level Median Base Salary Amount[60]

Title	New Hires	Above the Median	>10 Percentage Points Above the Median	Samples' Average Percent Ratio Above or Below the Median
Enterprise A	9	4	1	-2%
Enterprise B	10	8	3	+7%

Although the reasons supporting individual compensation will necessarily vary by circumstances, FHFA-OIG believes that the aggregate data discussed above suggest the existence of variation sufficient to warrant further scrutiny by FHFA. Both Enterprises use median market data as a reference point in making compensation offers, yet Enterprise B exceeded the median level 80% of the time. Additionally, in 3 of the cases, the offers exceeded the standard by 18 percentage points or more. Further, although several of the justifications offered by Enterprise B officials are plausible (e.g., the need to offer relatively high compensation to attract candidates with other outstanding offers), they have not been independently tested and verified. Without such testing and verification on a larger scale, FHFA lacks assurance that Enterprise compensation offers to senior professionals, which translate into compensation levels, can be supported.

59 Officials from the Enterprise said that in one case they offered compensation above the median to a candidate who would assist the Enterprise in designing and implementing a key business objective.

60 Source: Enterprise data sampled by FHFA-OIG.

3. FHFA Has Not Examined the Enterprises' Implementation of the Pay Freeze for Senior Professionals

In furtherance of its December 2010 directive to the Enterprises, the Agency has established a process to review their implementation of the mandated pay freeze with respect to their executives. Specifically, the Enterprises submit proposed executive promotions to the Agency for review and approval.

On the other hand, FHFA has not conducted any similar reviews or examinations with respect to the Enterprises' senior professionals and other employees, but Agency officials said they are planning to do so. FHFA-OIG observes that the median cash compensation paid to the Enterprises' senior professionals increased as much as 5% in 2011, despite the imposition of the pay freeze. It is possible that the structure of the Enterprises' LTI payments accounts for much of this increase, but promotions and changes in responsibility also may have played a role.[61] However, because FHFA has not yet conducted any reviews or examinations, it is not in a position to determine whether the Enterprises are enforcing consistently the pay freeze or, alternatively, are using promotions and/or changes in responsibility as a means to offset the effects of the pay freeze on senior professional compensation.

[61] One Enterprise official advised that a portion of the increase in median compensation may be attributed to promotion-based pay increases.

CONCLUSIONS

Over the past year, FHFA has increased its control and oversight of the Enterprises' executive compensation, which amounts to an estimated $92 million annually. Although this focus is appropriate, executive compensation is a comparatively small portion of the Enterprises' overall expenditures in this area. Indeed, senior professional compensation alone amounts to $455 million annually. Accordingly, FHFA-OIG believes that FHFA has a responsibility to enhance its current non-executive compensation oversight through reviews or examinations. By focusing this increased oversight on senior professional compensation, FHFA could assess the effectiveness of the processes and controls in place for a relatively highly compensated group of employees while mitigating the impact on the Agency's available resources.

RECOMMENDATION

FHFA should develop a long term plan to strengthen its oversight of the Enterprises' non-executive compensation through reviews or examinations, focusing on senior professional compensation. The plan should set priorities, ensure that available staffing resources are commensurate with them, and establish an appropriate timeframe for its implementation. With respect to the reviews and examinations contemplated by its plan, the Agency should consider including the following items as priorities:

- the Enterprises' general structures, processes, and cost controls for senior professional compensation;
- the Enterprises' controls over compensation offers to new hires; and
- the Enterprises' compliance with the pay freeze with respect to the use of promotions and changes in responsibility.

OBJECTIVES, SCOPE, AND METHODOLOGY

Objectives

In March 2011, FHFA-OIG issued a report that evaluated the Enterprises' executive compensation programs and specifically examined pay practices for their six most senior executives. This report examines pay practices affecting the Enterprises' approximately 2,100 most highly compensated employees, including all 90 executives and 2,000 senior professionals. The objectives of this report were to: (1) provide an update on: (a) the steps FHFA has taken since the issuance of FHFA-OIG's report on the Agency's oversight of executive compensation, and (b) executive compensation levels in 2010 and 2011;[62] and (2) evaluate the Agency's approach to non-executive compensation oversight with a focus on the compensation of senior professionals in 2010 and 2011.

General Methodology

To meet these objectives generally, FHFA-OIG interviewed FHFA officials responsible for the Agency's Enterprise compensation oversight analysis. Further, FHFA-OIG interviewed compensation officials at both Enterprises. Additionally, FHFA-OIG reviewed FHFA and Enterprise compensation oversight documents, including the Enterprises' Form 10-K filings with the U.S. Securities and Exchange Commission and documents that describe the process for "benchmarking" executive and senior professional compensation against compensation in the financial services industry. FHFA-OIG also reviewed federal standards for internal controls.[63]

Enterprise Compensation Analysis Methodology

With respect to executive and senior professional compensation levels for 2010 and 2011, the evaluation uses the "cash compensation paid out annually" approach. This approach shows the cash compensation that the Enterprises paid to their executives and senior professionals in 2010

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[62] *See* FHFA-OIG, *Evaluation of Federal Housing Finance Agency's Oversight of Fannie Mae's and Freddie Mac's Executive Compensation Programs* (EVL-2011-002) (March 31, 2011) (online at http://www.fhfaoig.gov/Content/Files/Exec%20Comp%20DrRpt%2003302011%20final%2C%20signed.pdf).

[63] *See* GAO, *Standards for Internal Control in the Federal Government*, GAO/AIMD–00.21.3.1 (November 1999) (online at http://www.gao.gov/special.pubs/ai00021p.pdf); and Office of Management and Budget, *Management's Responsibility for Internal Control, OMB Circular No. A-123 Revised* (December 2004) (online at http://www.whitehouse.gov/omb/circulars_a123_rev/).

and 2011. Thus, it differs somewhat from the "total direct compensation" approach, which is employed by the Agency and the Enterprises.[64]

FHFA-OIG believes the cash compensation paid approach represents an appropriate basis for the compensation analysis used in the evaluation for the following reasons:

- It captures all forms of cash compensation paid in a given year. For example, in some cases Enterprise executives received cash income in 2010 that was earned in and related to a prior period and that, therefore, was not a component of their FHFA-approved total direct compensation packages. Without using the cash compensation paid approach this cash income would not be reflected in the reported compensation for Enterprise executives in 2010 and 2011.

- It allows for consistent comparisons over time for approximately 2,100 Enterprise executives and senior professionals. It would be impossible to make such large comparisons using executive or senior professional compensation plans upon which their "total direct compensation" is generally based because such plans vary by position and by individual and are generally carried out over a period of several years, rather than in one calendar year. Moreover, the cash compensation paid approach is often used in large-scale compensation analyses similar to the one contained in this report.[65]

FHFA-OIG requested Enterprise cash compensation paid data for all executives and senior professionals for calendar years 2009, 2010, and 2011.[66] FHFA-OIG performed some data

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[64] FHFA-OIG, however, recognizes that executives' "total direct compensation" largely governs the cash compensation they will receive each year.

[65] For example, the widely cited triennial publication of the *Survey of Consumer Finances* by the Federal Reserve Board uses a family's cash income, before all taxes, for the full calendar year. *See* Board of Governors of the Federal Reserve System, *Changes in U.S. Family Finances from 2007 to 2010: Evidence from the Survey of Consumer Finances*, Federal Reserve Bulletin, Vol. 98, No. 2, at 5, footnote 4 (June 2012) (online at http://www.federalreserve.gov/pubs/bulletin/2012/PDF/scf12.pdf). In addition, many compensation studies rely on income data from individual and corporate IRS filings, such as Form 1040 and Form 990, which summarize all cash compensation paid-out in a given calendar year. For example, Charity Navigator frequently publishes reports on Charity CEOs' compensation utilizing data from Form 990 filings. *See* Charity Navigator, *2010 CEO Compensation Study* (August 2010) (online at http://www.charitynavigator.org/__asset__/studies/2010_CEO_Compensation_Study_Revised_Final.pdf). Finally, the United States Census Bureau conducts household income surveys annually. These surveys ask for the total household income received during a 12-month period. *See* United States Census Bureau, *American Community Survey, Income Questions* (online at http://www.census.gov/acs/www/about_the_survey/income_questions/).

[66] Based on discussions with FHFA and Enterprise officials, FHFA-OIG concludes that 2009 was a transition year for both Enterprises during which they were migrating from their legacy compensation structures to a new framework devised by FHFA in consultation with Treasury that was not entirely implemented for a full year (i.e., until calendar year 2010). Consequently, FHFA-OIG has decided not to present the 2009 compensation and other information in this report.

quality analyses to help ensure the accuracy and completeness of the cash compensation paid data submitted by the Enterprises. For example, FHFA-OIG compared compensation levels provided by the Enterprises for particular position categories (e.g., VPs and Directors) to ensure that compensation levels were in the same general range. In addition, FHFA-OIG performed an analysis on each employee's start date and/or termination date to ensure the completeness of the data. FHFA-OIG also engaged in extensive discussions with FHFA and Enterprise officials regarding the data it was provided by the Enterprises and, in one case, FHFA-OIG identified missing data. FHFA-OIG notified the Enterprise in question about the omissions and the Enterprise was able to provide the missing data.

Aggregation of the Enterprises' Compensation Data

Although both Enterprises individually provided their executive and senior professional compensation data to FHFA-OIG, the data have been aggregated in this report. That is, FHFA-OIG combined the reported data for both Enterprises (except for their CEOs) rather than reporting it separately for each Enterprise. FHFA-OIG did so to address Agency and Enterprise concerns about the confidentiality of the compensation data. FHFA-OIG does not believe that aggregating the data has had a material effect on the analyses contained in this evaluation report.

Median Level of Compensation

For most compensation calculations in this evaluation report, FHFA-OIG presents a "median" measure for each group of employees, rather than an "average" or "mean" measure. In statistics, the median is described as the numerical value separating the higher half of observations from the lower half. The median of a finite list of numbers can be found by arranging all the observations from lowest value to highest value and then picking the middle value. If there is an even number of observations, then there is no single middle value; the median is, therefore, defined as the mean of the two middle values. The median is sometimes also referred to as the 50^{th} percentile number.

Statistically, a median is less likely to be a skewed number than an average because an average can be dramatically affected by a few exceptionally high or low paid individuals in the group (i.e., outliers). Therefore, the median is a more representative figure of the center of a series of compensation values than the average.

Partial-Year Employee Compensation Adjustment

In the case of an employee who was, for whatever reason, at an Enterprise only for part of a year, FHFA-OIG annualized the employee's base salary for the full calendar year. The annualization process, however, is not applicable to "other compensation" (e.g., LTI or short-term incentive awards). This is because many components of other compensation have a one-time payout feature and, therefore, they are not replicated in constant increments throughout a calendar year.

The partial-year adjustment methodology has the advantage of keeping necessary data points while not skewing the median for each employee rank. For example, take the case of an Enterprise VP on the payroll for the four-month period from January through April who receives a base salary of $100,000 and is replaced in September by a second VP who receives a base salary of $90,000 for the four-month period from September through December. FHFA-OIG's adjustment will show the first VP's annualized base salary to be $300,000 ($100,000 times three) and the second VP's annualized base salary to be $270,000 ($90,000 times three). The median for this group would be $285,000 per annum.

Using the partial-year adjustment method FHFA-OIG was able to retain in the analysis both data points from the above example. If, on the other hand, FHFA-OIG had excluded all partial-year employees, neither of the above two VPs would be included in the median calculation. Given the small size and relatively high turnover rate in some executive ranks, excluding partial-year employees would nearly eliminate all data points in the analysis.

The preparation of this evaluation report was conducted under the authority of the Inspector General Act 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. These standards require FHFA-OIG to plan and perform evaluations that, among other things, result in evidence sufficient to provide a reasonable basis for findings and recommendations. FHFA-OIG believes that the findings and conclusions contained in this report meet these standards.

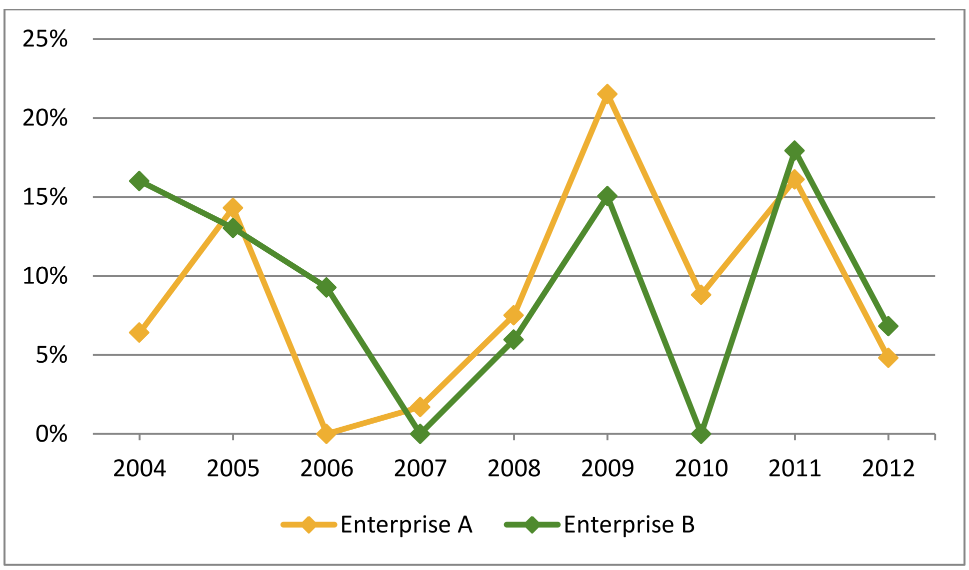
FHFA-OIG provided FHFA staff with briefings and presentations concerning the results of its field work and provided FHFA with an opportunity to respond to a draft of this evaluation. In its comments, which are reprinted in their entirely in Appendix B, FHFA agreed with the evaluation report's recommendation.

APPENDIX A

Enterprise Executive and Senior Professional Attrition Rates

FHFA-OIG obtained trend data related to the voluntary attrition of executives from the Enterprises over the period 2004 through 2012.[67] The data indicate that the rate at which executives voluntarily left the Enterprises has fluctuated significantly over time (see Figure 9 below).[68] For example, the voluntary attrition rates for EVPs and SVPs at Enterprise A ranged from 0% at the height of the housing boom in 2006 to more than 20% during the initial stages of the FHFA conservatorship in 2009.[69] Over the past several years Enterprise B's executive voluntary attrition rates have followed a similar fluctuating pattern: they fell to 0% in 2010, rose dramatically to more than 15% in 2011, and then declined substantially to about 5% in 2012.

Figure 9: Annual Voluntary Attrition Rates for the Enterprises' EVPs and SVPs over the Period 2004 Through 2012[70]



[67] These data include resignations, retirements, and all other departures with the exception of those by non-voluntary means, such as layoffs. The Enterprises use voluntary attrition rates to assess retention trends and employee morale.

[68] The relatively small number of Enterprise executives (about 90 in 2011) could help explain these seemingly wide fluctuations. For example, the departure of 5 executives in 1 year would represent a 10% voluntary attrition rate for an Enterprise with 50 executives, whereas the departure of 2 in another year would be just 4%.

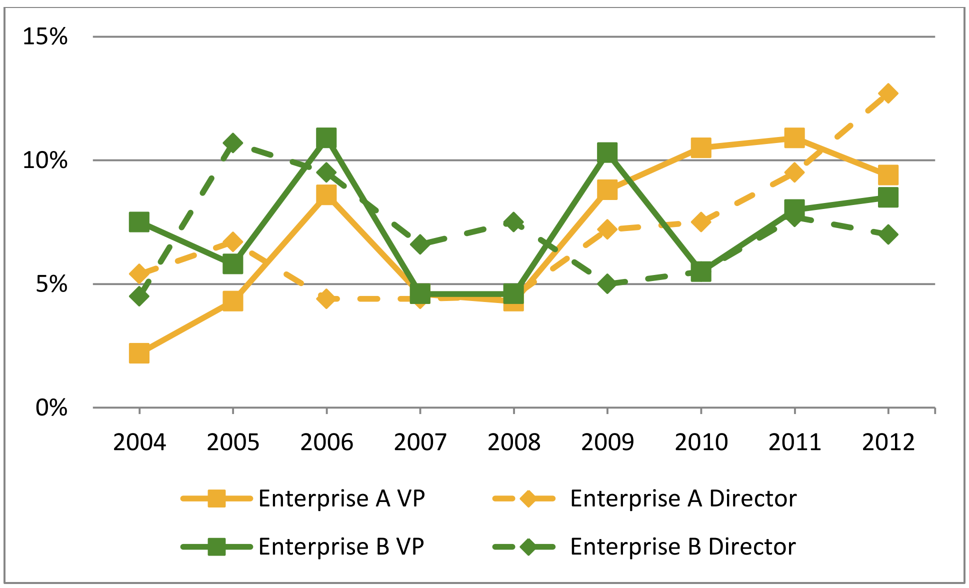
[69] FHFA-OIG has not identified the Enterprises in connection with the attrition data discussed in this report given the Enterprises' concerns about the confidentiality of the data.

[70] Source: Enterprise data provided to FHFA-OIG. The voluntary attrition rates for 2012 have been annualized based on year-to-date data (June 20, 2012 for Fannie Mae and August 7, 2012 for Freddie Mac).

As depicted in Figure 10, below, annual senior professional voluntary attrition rates at both Enterprises generally fluctuated within a range of 5% to 10% during the period 2004 through 2012. The data indicate that the voluntary attrition rate of Directors at Enterprise A has steadily increased since 2008; it rose from below 5% to 12% on an annualized basis from 2008 through 2012. Although the voluntary attrition of Enterprise A's VPs more than doubled from 2008 to 2010 (from 4.3% to 10.5%), it remained relatively stable in 2011 and has declined on an annualized basis to about 9% in 2012.

Meanwhile, voluntary attrition for Directors at Enterprise B has remained below 10% since 2006, and its VP attrition rate has performed similarly since 2010. However, Enterprise B officials told FHFA-OIG that they have faced challenges in retaining individuals with specialized skills, such as information security experts and internal auditors.

Figure 10: Annual Voluntary Attrition Rates for the Senior Professionals at the Enterprises During the Period of 2004 Through 2012[71]



[71] Source: Enterprise data provided to FHFA-OIG. The voluntary attrition rates for 2012 have been annualized based on year-to-date data (June 20, 2012 for Fannie Mae and August 7, 2012 for Freddie Mac).

APPENDIX B

FHFA's Comments on FHFA-OIG's Findings and Recommendation

Federal Housing Finance Agency

MEMORANDUM

TO: Richard Parker, Director of the Office of Policy, Oversight, and Review, FHFA-OIG

FROM: Jon Greenlee, Deputy Director, Division of Enterprise Regulation
Jeffrey Spohn, Senior Associate Director, Office of Conservatorship Operations
Patrick Lawler, Chief Economist

SUBJECT: FHFA Response: *FHFA's Oversight of the Enterprises' Compensation of their Executives and Senior Professionals* (SUR-2012-011)

DATE: November 29, 2012

This is a response to FHFA-OIG's draft evaluation report regarding FHFA's oversight of the Enterprises' compensation of their executives and senior professionals. FHFA recognizes the importance of having a robust approach to executive compensation and has recently enhanced its control and oversight of the Enterprises' executive compensation in its role as both the conservator and supervisor of Fannie Mae and Freddie Mac. The enhancements to our oversight process will include the addition of dedicated resources within the Division of Supervision Policy and Support who will focus solely on FHFA's supervisory policies and examination activities related to the design, controls and execution of executive compensation arrangements for all Enterprise employees. Further, FHFA agrees with FHFA-OIG that senior professional compensation merits enhanced review by FHFA, and we will be addressing that consistent with your recommendations as described below. The following is FHFA's response to the FHFA-OIG recommendations:

OIG Recommendation

FHFA should develop a long term plan to strengthen its current oversight of the Enterprises' non-executive compensation through reviews or examinations, focusing upon senior professional compensation. The plan should set priorities, ensure that available staffing resources are commensurate with them, and establish an appropriate timeframe for its implementation. With respect to the reviews and examinations contemplated by its plan, the Agency should consider including the following items as priorities:

- The Enterprises' general structures, processes, and cost controls for senior professional compensation;
- The Enterprises' controls over compensation offers to new hires; and

- The Enterprises' compliance with the pay freeze with respect to the use of promotions and changes in responsibility.

Conservatorship Response:

To set the context for the important matters covered by this report, it is important to provide a broad perspective on the agency's approach to the conservatorship. FHFA clearly stated long ago that, after changing the boards, CEOs and other executives at the start of the conservatorships, it was delegating most business decisions back to the two companies. FHFA views part of its "preserve and conserve" mandate to include preserving the entities as private companies with the capacity and responsibility to make business decisions following normal corporate governance procedures. This requires a careful balance between FHFA being informed of all key decisions and selectively asserting FHFA's right to review or alter decisions whether delegated or not, and encouraging the companies themselves to make sound decisions in light of broad conservatorship goals. This balancing has existed since the beginning of the conservatorship and will continue. With regard to the subject of this report, FHFA currently reviews and either approves or disapproves all decisions on executive compensation at the Enterprises, defined as those at the Senior Vice President (SVP) level and above, and reviews and consults on changes to plans affecting those below the SVP level. We regularly review executive compensation levels in comparison with market norms, and generally require pay to be at or below market medians. During the course of the conservatorships from 2008 to 2012, aggregate target pay for top tier executives at the Enterprises has fallen by roughly 75 percent. Compensation for new non-executive employees is targeted at market medians, in order to ensure that taxpayer risks are adequately managed and conservatorship goals are addressed, but pay levels have been frozen for existing employees for the past three years.

FHFA agrees that it would be prudent and is feasible for FHFA to improve our monitoring of the promotions and new hires at the Vice President and Director levels. We have developed a template for a report to be completed by each Enterprise and sent to FHFA monthly for our review and analysis. This report will allow us to monitor promotions, increases and new hires on a continuous basis and identify any issues as they come up.

While we agree with the recommendation included in the report and will take appropriate action as noted above, we would also like to note that the report analyzes pay trends differently than we do. The Inspector General's compensation analysis was based on the cash paid in a given year, and though we understand the reasoning for conducting the analysis using this method, the industry and FHFA focus on target total direct compensation (TDC). TDC includes all compensation that is earned for a given performance year: cash base salary paid during the performance year, deferred salary that will not be paid until sometime in the future and target incentives for that year. On the other hand the cash paid methodology includes base salary for the year identified and incentives and deferred compensation based on performance in prior years. FHFA and the Enterprises have made significant changes to both compensation levels and plans which are not yet reflected in the cash paid data and can be seen clearly using the TDC methodology.

Supervision Response:

FHFA's Enterprise supervision activities are performed pursuant to our annual supervisory strategy and examination plan for each Enterprise. In 2012, FHFA supervision did some review of compensation practices and controls in place for the 2011 calendar year; this work will help to build a foundation for examination work to be done in 2013. While there will not be a separate supervision plan covering examination of compensation issues, we will incorporate review of the design, controls and execution of the Enterprises' compensation programs from the standpoint of safety and soundness and compliance with conservatorship directives into our regular supervision of Fannie Mae and Freddie Mac. The 2013 examination plan is expected to be prepared by year end 2012.

FHFA follows a risk-based approach in determining which areas of Enterprise operations to review and in selecting samples of files for review. We anticipate that the risk-based approach will guide our review of compensation structures and processes at the Enterprises, which will be performed as a component of a broader review of compliance by the Enterprises with conservatorship directives. We anticipate that examination work to review compliance with the directives regarding pay increases will be performed in the first quarter of 2013.

APPENDIX C

FHFA-OIG's Response to FHFA's Comments

On November 29, 2012, FHFA provided comments on a draft of this report in which it agreed with the recommendation and identified the actions that it will take to implement it. FHFA-OIG considers FHFA's proposed actions to be sufficient to resolve the recommendation, which will remain open until FHFA-OIG determines that the Agency's corrective actions are completed in a manner that is responsive to the recommendation. FHFA-OIG has attached the Agency's full response (see Appendix B), which was considered in finalizing this report.

ADDITIONAL INFORMATION AND COPIES

For additional copies of this report:

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