Federal Housing Finance Agency
Office of Inspector General

FHFA's Exercise of Its Conservatorship Powers to Review and Approve the Enterprises' Annual Operating Budgets Has Not Achieved FHFA's Stated Purpose

Evaluation Report • EVL-2015-006 • September 30, 2015

EXPLANATION OF REDACTIONS IN REPORT

Redactions in this report were made at the request of the Federal Housing Finance Agency (FHFA). According to FHFA, the redactions are intended to protect from disclosure material that is confidential financial, proprietary business, and/or trade secret information. FHFA claims further that the redacted information would not ordinarily be publicly disclosed, and, if disclosed, could disadvantage Freddie Mac and Fannie Mae.

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Executive Summary

Fannie Mae and Freddie Mac (collectively, the Enterprises) have been under the conservatorship of the Federal Housing Finance Agency (FHFA) since September 2008. In our annual Audit and Evaluation Plan, the Federal Housing Finance Agency Office of Inspector General (OIG) identified the operation of the conservatorships as a strategic risk and a focus of OIG's work. This evaluation is the first of a number of projects in which OIG examines actions taken by FHFA as conservator for the Enterprises.

In the beginning of the conservatorships, FHFA delegated to the Enterprises the authority to establish their annual operating budgets. Acting pursuant to this delegated authority, both Enterprises set their annual operating budgets for fiscal years 2009-2012. (The fiscal year for each Enterprise runs concurrently with the calendar year.) In November 2012, FHFA, acting as conservator, rescinded that delegation and determined to require review and approval of the Enterprises' annual operating budgets. FHFA's stated purpose for that action was to ensure that the budgets aligned with FHFA's strategic direction and safety and soundness priorities.

In 2012, the last year before FHFA required that the Enterprises obtain its approval for their budgets, the combined spending by both Enterprises totaled \$3.9 billion. FHFA has approved the annual operating budgets for both Enterprises for fiscal years 2013, 2014, and 2015. For fiscal year 2015, FHFA approved spending in the combined Enterprise budgets that totaled \$5.1 billion—an increase of more than \$1.2 billion, or approximately 31%, over 2012 spending.

This evaluation looks at whether the conservator's budget approval process has been effective in ensuring that the budgets align with FHFA's strategic initiatives and safety and soundness priorities.

We found that FHFA's budget review and approval process has not achieved FHFA's stated purpose for re-asserting its approval authority because of late timing, cursory-level analysis, and inadequate resources. These shortcomings prevent FHFA from exercising effective control over Enterprise spending, both in amount and direction. As a consequence, FHFA's budget review and approval process has imposed virtually no budget control on the Enterprises, and FHFA's approval of the budgets creates the risk that it has endorsed Enterprise spending that has not been well understood by FHFA.

After OIG finished its review for this evaluation in June 2015, FHFA determined in late July 2015 to enhance its budget review and approval process. OIG cannot assess the sufficiency of the newly approved changes

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to the budget review process until they are fully implemented. Based on the deficiencies identified by OIG in this evaluation, we make four recommendations to strengthen the budget review process. FHFA has agreed to three recommendations and generally agreed to one recommendation.

This evaluation was led by Brian Stief, Investigative Counsel, who was assisted by Moira Roberts, Special Counsel. 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 will be posted on our website, www.fhfaoig.gov.

Kyle D. Roberts
Deputy Inspector General for Evaluations

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ABBREVIATIONS ....

Boards	Enterprises' Boards of Directors
DOC	Division of Conservatorship
Enterprises	Fannie Mae and Freddie Mac, collectively
Fannie Mae	Federal National Mortgage Association
FHFA or Conservator	Federal Housing Finance Agency
Freddie Mac	Federal Home Loan Mortgage Corporation
HERA	Housing and Economic Recovery Act of 2008
LOIs	Letters of Instruction
OIG	Federal Housing Finance Agency Office of Inspector General
Treasury	U.S. Department of the Treasury

BACKGROUND

In September 2008, FHFA placed Fannie Mae and Freddie Mac into conservatorships pursuant to its authority under the Housing and Economic Recovery Act of 2008 (HERA).[1] HERA vested FHFA with sweeping powers as conservator.[2] Since 2008, FHFA has administered two conservatorships of unprecedented scope and undeterminable duration, and simultaneously served as the regulator for two large, complex companies that dominate the secondary mortgage market and the mortgage securitization sector of the U.S. housing finance industry.

As conservator, FHFA is vested with express authority under HERA to operate the Enterprises and has expansive authority over trillions of dollars in assets and billions of dollars in revenue. FHFA also makes business and policy decisions that influence and impact the entire mortgage finance industry. For reasons of efficiency, concordant goals with the Enterprises, and operational savings, FHFA has determined to delegate authority for general corporate governance and day-to-day matters to the Enterprises' boards of directors (boards) and executive management. As both Enterprises acknowledge, their directors serve on behalf of the conservator and exercise their authority as directed by the conservator.[3] The conservator can revoke delegated authority at any time, and retain authority for certain significant decisions. In practice, these are not bright lines; the conservator can intervene in any issue or matter at the FHFA Director's discretion.

In November 2008, FHFA issued "letters of instruction" (LOIs) to the Enterprises that defined certain authorities it would retain as conservator, and delegated all others to the Enterprises. Establishing annual operating budgets for the Enterprises was not a specific authority retained by FHFA in these LOIs. Acting pursuant to this delegated authority, both Enterprises set their annual operating budgets for fiscal years 2009-2012. (The fiscal year for each Enterprise runs

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[1] Pub. L. No. 110-289, 122 Stat. 2654 (2008). HERA extensively amended the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, 12 U.S.C. §§ 4501-4642.

[2] For a full discussion of the conservator's powers over the Enterprises, *see* OIG, *FHFA-OIG' s Current Assessment of FHFA's Conservatorships of Fannie Mae and Freddie Mac*, at 26-28 (Mar. 28, 2012) (WPR-2012-001) (online at www.fhfaoig.gov/Content/Files/WPR-2012-001.pdf); OIG, *FHFA's Conservatorships of Fannie Mae and Freddie Mac: A Long and Complicated Journey* (Mar. 25, 2015) (WPR-2015-002) (online at www.fhfaoig.gov/Content/Files/WPR-2015-002_0.pdf) [hereinafter 2015 White Paper].

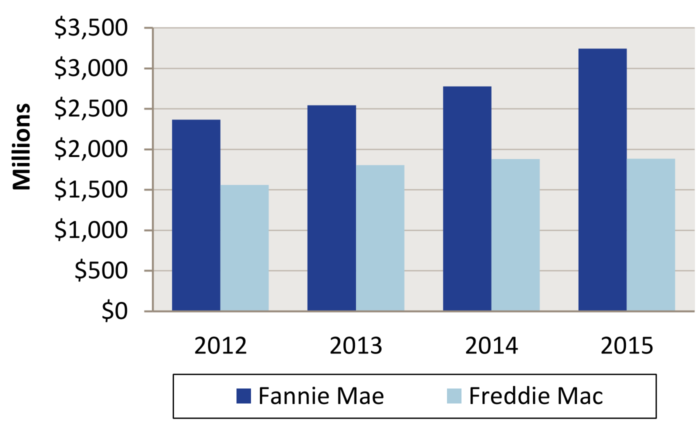
This report uses the term "conservator" to mean either FHFA or its Director, who exercises conservatorship powers.

[3] Both Enterprises acknowledged this relationship in their 2014 Annual Reports. *See, e.g.,* Fannie Mae, *Annual Report (Form 10-K)*, at 25 (Feb. 21, 2014); Freddie Mac, *Annual Report (Form 10-K)*, at 20 (Feb. 27, 2014).

concurrently with the calendar year.) In 2012, the combined spending by both Enterprises totaled $3.9 billion.[4]

In November 2012, FHFA modified the LOIs to, among other things, revoke the delegation of authority to the Enterprises to establish annual operating budgets without approval. As a result, the Enterprises now are required to obtain FHFA's approval of their annual budgets.[5] Specifically, the 2012 LOIs issued by FHFA direct that Enterprise management must "consult with and obtain the written approval of the conservator before taking action" to establish their annual operating budgets.[6] FHFA's rationale for rescinding the Enterprises' budget approval authority and requiring FHFA review and approval was "to ensure that the [Enterprises'] budgets [are] properly aligned with both FHFA's strategic direction and its safety and soundness priorities."

FIGURE 1: ENTERPRISE ACTUAL (2012-2014) AND PROJECTED (2015) SPENDING



Source: FHFA.

FHFA, as conservator, has reviewed and approved the Enterprises' operating budgets for 2013, 2014, and 2015. Combined 2015 Enterprise budgets total $5.1 billion—a $1.2 billion increase, or approximately 31%, over actual spending in 2012. Combined year-over-year actual spending increased by $422 million (11%) in 2013, $308 million (7%) in 2014, and is projected to increase by $480 million (10%) in 2015. Individually, Fannie Mae's 2015 budget represents an $875 million (37%) increase from 2012 actual spending levels, while Freddie Mac's 2015 budget represents a $335 million (21%) increase over the same period (see Figure 1). To be sure, the Enterprises reported record profits in 2013 of $132.6 billion in net income, of which $79 billion (60%) came from non-recurring events and in 2014 of $21.9 billion in net income, of which $10 billion (45%) came from non-recurring events.[7] Through the second quarter of

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[4] Spending refers to the amount of actual expenses for a past fiscal year. Budget refers to the amount of projected expenses.

[5] FHFA uses the term "administrative expenses" when it refers to the monies projected to be spent in the Enterprises' proposed operating budgets.

[6] FHFA, *2012 Letter of Instruction to Fannie Mae*, at 2-4 (Nov. 15, 2012); FHFA, *2012 Letter of Instruction to Freddie Mac*, at 2-4 (Nov. 15, 2012).

[7] *See* OIG, *The Continued Profitability of Fannie Mae and Freddie Mac Is Not Assured* (Mar. 18, 2015) (WPR-2015-001) (online at www.fhfaoig.gov/Content/Files/WPR-2015-001.pdf).

2015, the Enterprises have paid to the U.S. Department of the Treasury (Treasury) approximately $239 billion in dividends for the U.S. taxpayers' investment of $187.5 billion. Their core earnings, from single-family, multifamily, and portfolio investment business segments, increased from $27 billion in 2012 to $53 billion in 2013, but decreased to $12 billion in 2014.[8]

Governance Incentives

In most public companies, shareholders elect the board of directors. Typically, a public company board of directors reviews and approves an annual operating budget proposed by company management before the beginning of the company's fiscal year. Because most directors of public companies are subject to shareholder election every year (or every three years for a staggered board), these directors are incentivized to improve shareholder returns by controlling costs, increasing earnings, and building corporate net worth.[9]

Here, too, the boards of each Enterprise are required to approve management's proposed annual operating budgets before the proposed budgets are sent to FHFA for its review and final approval. However, the corporate governance incentives that animate directors' conduct in most public companies are largely absent in board governance of the Enterprises. Because the Enterprises are in conservatorship, their conservator, FHFA, retains ultimate authority to appoint or remove Enterprise directors. Pursuant to the Enterprises' agreements with the Treasury, the Enterprises must sweep any excess of net worth (over a small capital reserve) to Treasury.[10] This mandatory sweep means that controlling costs and increasing net income will not increase the net worth of the Enterprises. As a result, the Enterprises' boards lack the same incentives as boards of most public companies to build capital and enhance stock performance by controlling costs and increasing earnings.[11] This atypical governance environment increases the importance of FHFA's review of the Enterprises' proposed annual operating budgets.

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[8] *Id.* at 8.

[9] *See* Robert A.G. Monks and Nell Minow, *Corporate Governance* (4th ed. 2008), at 223-235. *See also, e.g.*, Michael McGrail, *What Decisions Need Approval from Your Board of Directors*, Cooley LLP (online at www.cooleygo.com/decisions-need-approval-board-directors/).

[10] The agreements are the foundation for the $187.5 billion of taxpayer money invested in the Enterprises in the wake of the financial crisis. As explained in OIG's 2015 White Paper, the Enterprises have not drawn on the Treasury commitment since 2012. Under the terms of their agreements with Treasury, Fannie Mae and Freddie Mac may draw, if necessary, up to an additional $117.6 billion and $140.5 billion, respectively.

[11] Fannie Mae's 2014 Annual Report expressly acknowledges this lack of incentive: "we are no longer managed with a strategy to maximize shareholder returns." Fannie Mae, *Annual Report (Form 10-K)*, at 25 (Feb. 21, 2014).

Because HERA insulates FHFA's actions as conservator from judicial review or intervention,[12] OIG's oversight of FHFA's ongoing work as conservator serves to review whether FHFA is fulfilling its statutory responsibilities, with transparent reporting of its results, in order to protect the interests of American taxpayers who have funded Treasury's $187.5 billion investment in the Enterprises. In this evaluation, OIG reviewed the effectiveness of FHFA's budget review and approval process. In a subsequent project, OIG will trace where each Enterprise spent these increases. Forthcoming OIG evaluations and audits will look at other aspects of FHFA's management of the conservatorships.

[12] HERA states that "no court may take any action to restrain or affect the exercise of powers or functions of [FHFA] as a conservator or receiver." 12 U.S.C. § 4617(f). *See*, *e.g.*, *Babylon v. FHFA*, 699 F.3d 221, 228 (2d Cir. 2012) ("A conclusion that the challenged acts were directed to an institution in conservatorship and within the powers given to the conservator ends the [Court's] inquiry."). Two courts have held that FHFA's actions are subject to judicial review when FHFA acts beyond the scope of the conservatorship powers authorized by HERA. *See, e.g., Cf. Sonoma v. FHFA*, 710 F.3d 987, 992 (9th Cir. 2013) ("[T]he anti-judicial review provision is inapplicable when FHFA acts beyond the scope of its conservator power."); *Leon Cnty. v. FHFA*, 700 F.3d 1273, 1278 (11th Cir. 2012) ("The FHFA cannot evade judicial scrutiny by merely labeling its actions with a conservator stamp.").

FACTS ....

Review and Approval Process for Enterprise Proposed Annual Budgets

The process established by FHFA for its review and approval of the Enterprises' budgets consists of a number of steps:

1. FHFA staff attend internal budget meetings at each Enterprise during the last quarter of the fiscal year to gain information about proposed increases to each budget and proposed funding for major initiatives;

2. The Enterprises submit proposed operating budgets for the next fiscal year that have been approved by their respective boards, supporting materials, and requests for conservator approval, to FHFA's Division of Conservatorship (DOC);

3. DOC reviews and analyzes the submissions, seeks clarification when needed, and summarizes its findings;

4. DOC prepares memoranda for the Director setting forth its views on whether the proposed operating budgets should be approved;

5. DOC reports its summary findings in a PowerPoint presentation to FHFA's Conservatorship Committee, a forum in which senior FHFA officials and the FHFA Director discuss conservatorship-related issues and pending Enterprise requests;[13]

6. DOC works to address any questions or resolve any concerns raised by the Conservatorship Committee;

7. The Director reviews the DOC memoranda and supporting materials, and determines whether to endorse the DOC recommendations; and

8. DOC communicates the Director's decisions to the Enterprises.[14]

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[13] The FHFA Director chairs the Committee, and its members consist of FHFA executives, such as the Director's Special Advisors; the FHFA General Counsel; and the Deputy Directors of DOC, the Division of Housing Mission and Goals, and the Division of Enterprise Regulation. For more background on the Conservatorship Committee and its role, *see* 2015 White Paper.

[14] After FHFA approval of the proposed operating budgets, DOC monitors the Enterprises' spending against the operating budgets during the year and, on a quarterly basis, updates the Conservatorship Committee on actual spending against budget. Should an Enterprise project that its actual spending will exceed 7% of its approved operating budget, it must seek conservator approval for this additional spending.

As implemented within FHFA for the last three years, significant aspects of this budget review process have undermined the robustness of FHFA's budget review. We now discuss each of these aspects.

Timeliness

For the last three years, all Enterprise proposed operating budgets but one were submitted to FHFA **after** the start of the fiscal year. FHFA's review of the proposed budgets consumed up to three months. As a result, the Enterprises operated without conservator-approved budgets in 2013, 2014, and 2015 for periods ranging from almost two months to almost six months.

- For fiscal year 2013, which began on January 1, 2013, Fannie Mae submitted its proposed budget to FHFA after January 1, while Freddie Mac submitted its proposed budget on December 21, 2012. FHFA approved Freddie Mac's proposed budget in February 2013 and Fannie Mae's proposed budget in June 2013.

- For fiscal year 2014, which began on January 1, 2014, both Enterprises submitted their proposed budgets to FHFA after January 1. A new FHFA Director began at FHFA in January 2014 and FHFA's Conservatorship Scorecard, which tracks Enterprise compliance with FHFA's Strategic Plan for the Conservatorships,[15] was issued in May of that year. FHFA approved the proposed budgets for both Enterprises in June 2014.

- For fiscal year 2015, which began on January 1, 2015, both Enterprises submitted their proposed budgets to FHFA after January 1. FHFA approved Fannie Mae's proposed budget in February 2015 and Freddie Mac's proposed budget in April 2015.

The timing of budget submissions and approvals is shown in Figure 2. With the exception of the 2013 Fannie Mae proposed budget,[16] FHFA approved every submitted budget for the past three years without any changes.

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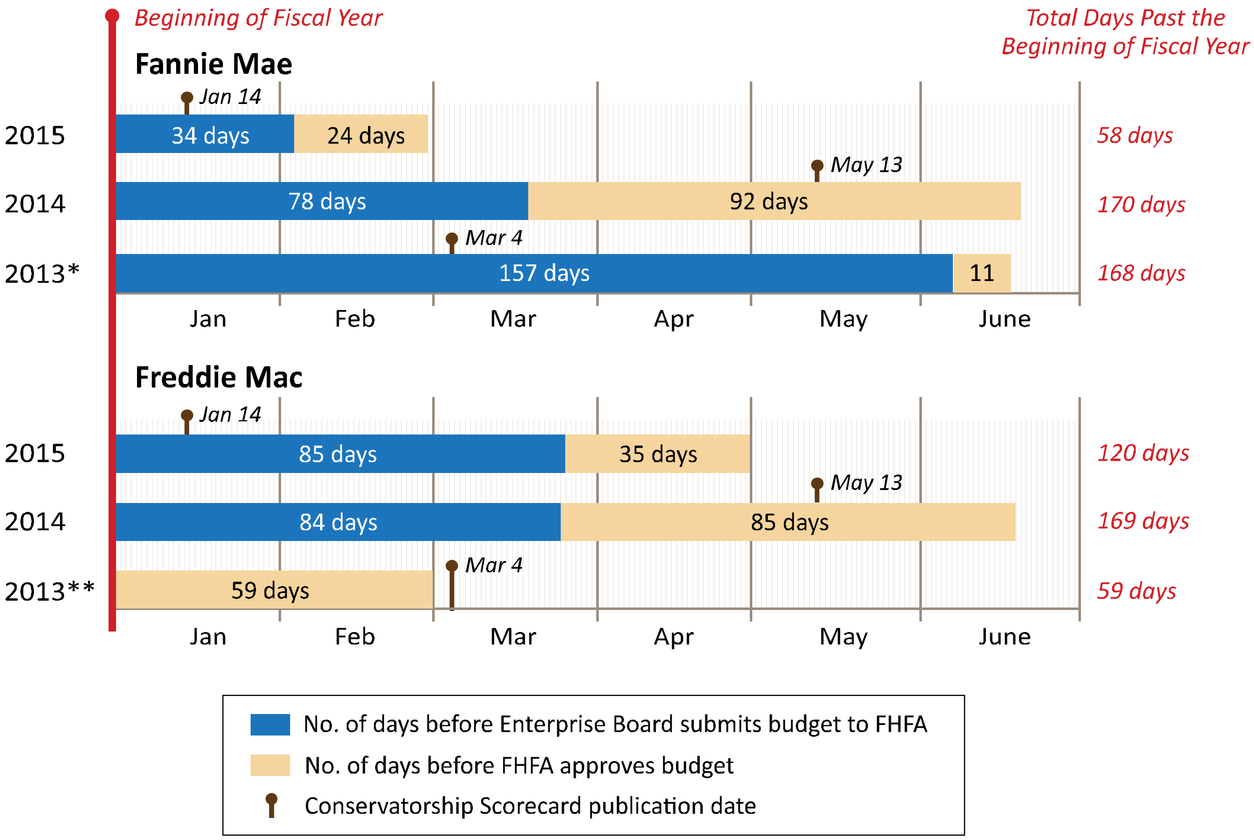
[15] FHFA's 2014 Strategic Plan for the Conservatorships of Fannie Mae and Freddie Mac provides FHFA's vision for its implementation of the Agency's obligations as conservator of the Enterprises. FHFA, *The 2014 Strategic Plan for the Conservatorships of Fannie Mae and Freddie Mac* (May 13, 2014) (online at www.fhfa.gov/AboutUs/Reports/ReportDocuments/2014StrategicPlan05132014Final.pdf).

[16] For 2013, Fannie Mae submitted a proposed operating budget on January 25, 2013, with a 14% overall increase. That day, FHFA directed Fannie Mae to revise its proposed budget to reduce its overall year-over-year budget increase from 14% to below 10%.

FIGURE 2: THE TIMING OF ENTERPRISE BOARD AND FHFA APPROVAL, 2013-2015



* Fannie Mae submitted its board-approved proposed 2013 operating budget to FHFA on January 25, 2013, and was directed by FHFA that same day to reduce its overall year-over-year budget increase from 14% to below 10%. Fannie Mae revised its proposed 2013 budget and resubmitted the proposed budget on June 6, 2013.

** Freddie Mac submitted its proposed budget for 2013 to FHFA on December 21, 2012.

Depth of DOC Analysis

The Enterprises' submissions to FHFA consist largely of the proposed operating budgets and high-level spending data organized into broad categories of expenditures.[17] One set of categories presents spending totals for more than a dozen divisions (e.g., legal, human resources, and multi-family divisions). Another set of categories presents total spending for specific projects and particular purposes (e.g., spending related to safety and soundness priorities and base operations). Where DOC identifies ambiguities or inconsistencies in the budgeted numbers, DOC can seek supplementary materials from the affected Enterprise. DOC's analysis of core business items—which generally amount to at least 75% of the annual

[17] Submissions also generally include budget-related materials presented by Enterprise management to the Enterprise board.

budgets—is very limited. According to DOC, its review of those items was essentially limited to tracking overall trends in spending and number of employees.

DOC conducts a somewhat more focused review of the Enterprises' investment budgets—proposed spending relating to the Enterprises' corporate priorities. In 2014, proposed spending for these priorities comprised 24% and 16% of Fannie Mae's and Freddie Mac's proposed budgets, respectively, according to DOC. The additional attention DOC paid to this spending was limited to whether the Enterprises' priorities aligned with FHFA priorities and did not include an effort to assess the appropriateness of the proposed spending.[18]

The DOC presentations to the Conservatorship Committee and its recommendation memoranda to the Director generally summarized and reorganized the materials provided by the Enterprises. For example, Appendix B contains tables in redacted form prepared by DOC for the Conservatorship Committee for the proposed 2015 operating budgets that identify the proposed monies budgeted for broad categories of expenditures for each Enterprise. OIG's review of DOC's presentations to the Conservatorship Committee found that these presentations did not contain any independent analysis by DOC of the proposed budgets. In its recommendation memoranda from 2014 and 2015, DOC never concluded that the proposed operating budgets were reasonable or aligned with FHFA's strategic direction and safety and soundness objectives. OIG found that DOC's approval recommendations in these memoranda stated that the Enterprise budgets "seem" reasonable and "appear" to align, without any explanation of the basis for its statements. DOC has recommended FHFA approval of each proposed operating budget it has reviewed.

In interviews with OIG, DOC officials offered several explanations for DOC's lack of in-depth analysis. A senior DOC official explained to OIG that FHFA exercised its conservatorship authority to review and approve Enterprise budgets in order to educate senior FHFA officials on Enterprise expenditures and provide a high-level review. Lacking sufficient information and dedicated resources needed to critically analyze the budgets proposed by the Enterprises, DOC relied largely upon the Enterprises' analyses. DOC asserted that the FHFA approval requirement imposed a discipline on the Enterprises in developing proposed budgets.

OIG's review found that DOC employees involved with the review of the proposed budgets questioned the rigor of the Enterprises' analyses on which FHFA largely relied for its review.

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[18] In February 2015, FHFA asked the Enterprises to estimate the amounts in their budgets directed to Conservatorship Scorecard items. FHFA uses its annual Conservatorship Scorecard to track Enterprise compliance with FHFA's Strategic Plan. Because FHFA requested this estimate after it approved Fannie Mae's proposed budget, Fannie Mae's subsequent estimate played no role in FHFA's budget review and approval. In response, each Enterprise estimated that Scorecard-related expenditures totaled under 5% of its budget, according to DOC.

Level and Quality of DOC Resources

The level of resources dedicated to the budget review by FHFA is limited. For DOC review of the Enterprises' proposed operating budgets for 2015, DOC assigned principal responsibility for review of the proposals and preparation of the Conservatorship Committee presentation and DOC recommendation memoranda to one employee. Other DOC employees reviewed that employee's work, and DOC employees also attended Enterprise board meetings during the year and assisted in reviewing materials submitted by the Enterprises. Internally, DOC officials estimated that these combined reviews required the equivalent of one-half to three-quarters of a full-time employee. DOC's budget review process did not seek formal input from FHFA employees in other FHFA divisions with programmatic expertise in the Enterprises' programs.

DOC's Acknowledgement of Deficiencies in its Budget Review Process

In December 2014, the DOC employee tasked with primary responsibility for DOC's budget review highlighted two significant shortcomings with DOC's budget review process in a memorandum to DOC senior officials. The first identified shortcoming was DOC's reliance on Enterprise justifications for the amounts budgeted for specific projects other than those related to FHFA priorities and the high-level review of proposed budgets by DOC. The second identified shortcoming was the lack of DOC resources dedicated to the budget review, both in terms of manpower and programmatic expertise.

The memorandum concluded that DOC's budget review and approval process did not achieve FHFA's stated goal of requiring conservator approval to ensure that the Enterprises pursue projects in alignment with FHFA's strategic direction or safety and soundness priorities.[19] It recommended that FHFA require conservator approval of Enterprise budgets only if an Enterprise proposed a 10% or greater year-over-year increase, or if a proposed budget would necessitate a draw from Treasury. After internal DOC review in which the recommendation changed to require FHFA approval if an Enterprise proposed a 5% or greater year-over-year trigger, DOC presented its revised memorandum to the Conservatorship Committee on February 5, 2015.

FHFA's Decision to Change its Budget Review Process

OIG advised FHFA in writing on February 2, 2015, that it commenced an evaluation of FHFA's budget review and approval process. At the Conservatorship Committee meeting on February 5, 2015, DOC recommended that FHFA reduce the scope of its budget review

[19] The memorandum recognized that the budget approval process assisted FHFA in cataloguing and comparing projects between the Enterprises, but noted that FHFA could obtain the same information without retaining budget approval authority.

and approval process. According to FHFA documents and officials, the recommendation was rejected by the Committee because the conservatorship of the Enterprises warranted FHFA's continued review and approval of annual Enterprise budgets. OIG's evaluation, including review of requested materials and interviews of FHFA employees, ran from February 2, 2015, through June 30, 2015. During our fact-finding process, OIG learned that DOC was evaluating "lessons learned" from previous budget review cycles to propose improvements to the budget process to the Conservatorship Committee. As of June 30, 2015, OIG understood that DOC had not made a proposal to that Committee. In late July 2015, the Conservatorship Committee agreed to enhance the existing budget review process. OIG cannot assess the sufficiency of the newly approved changes to the budget review process until they are fully implemented.

FINDINGS ....

1. Late budget submissions, cursory-level analysis, and inadequate resources undermine FHFA's budget review process.

Save for one proposed Enterprise budget submitted prior to the beginning of the fiscal year, over the past three years, the Enterprises submitted proposed annual operating budgets after the start of their fiscal years, and FHFA approved those budgets anywhere from two to six months after the start of the fiscal year. 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.

FHFA review of the proposed budgets has been largely based on spending totals organized into broad categories. This high-level of summary information significantly limits FHFA's ability to analyze or understand the budgets with any granularity. As a consequence, FHFA's budget review process did little more than observe year-over-year budget trends and educate FHFA staff. DOC has acknowledged that DOC employees assigned to review the Enterprises' proposed budgets, summarize their content, and prepare DOC's recommendation for two budgets now totaling more than $5 billion are insufficient to perform substantive and critical analyses.

2. FHFA's budget review process has not achieved FHFA's stated purpose of aligning Enterprise spending with FHFA's strategic direction and safety and soundness priorities.

Robust review by FHFA of the Enterprises' annual budgets is especially important because the Enterprises, both of which are public companies, are in conservatorship and must sweep any excess of net worth (over a small capital reserve) to Treasury in dividends for Treasury's $187.5 billion investment in them. While the boards of each Enterprise are required to approve management's proposed annual operating budgets before the proposed budgets are sent to FHFA for its review and final approval, the corporate governance incentives that animate directors' conduct in most public companies are largely absent in board governance of the Enterprises, because the sweep of excess net worth means Enterprise boards cannot build capital and enhance stock performance by controlling costs and increasing earnings.

This unique governance environment underscores the importance of FHFA's review of the Enterprises' proposed annual operating budgets to protect the taxpayers' investments and ensure that the Enterprises are satisfying their statutory responsibilities. Because FHFA's budget review process has been hampered by late timing, cursory-level analysis, and inadequate resources, FHFA's stated purpose for requiring conservator approval of the Enterprises' budgets has not been achieved.

CONCLUSION...

FHFA's stated rationale for requiring conservator approval of the Enterprises' annual budgets was to ensure that the budgets aligned with FHFA's strategic direction and safety and soundness priorities. FHFA's budget approval process, as implemented, has not permitted FHFA to achieve the stated purpose for its required approval. Cursory review of the Enterprises' proposed annual budgets by DOC, reliance on the Enterprises' analyses to support the proposed spending levels, and inadequate staff resources, combined with submission of all but one of the proposed budgets after the start of the fiscal year, meant that FHFA could not determine whether the proposed budgets aligned with FHFA's strategic direction and safety and soundness priorities. By approving the proposed budgets after a review that was constrained in scope and resources, FHFA created the risk that it approved spending that was unnecessary or wasteful, and/or inconsistent with its strategic direction or safety and soundness priorities.

FHFA approved changes to its budget review process in July 2015. OIG cannot assess the sufficiency of FHFA's changes to the process until they are fully implemented. Based on deficiencies identified by OIG in this evaluation, we make four recommendations to strengthen the budget review process.

RECOMMENDATIONS

We recommend that FHFA:

1. Direct each Enterprise to submit its proposed operating budget and supporting materials for the next fiscal year so that FHFA has sufficient time before the fiscal year begins to adequately analyze the proposals.

2. Revise the existing budget review process and staff the review process with employees who have the qualifications and experience needed for critical financial assessments of the proposed Enterprise budgets to permit FHFA to determine whether each Enterprise's budget aligns with FHFA's strategic direction and its safety and soundness priorities.

3. Set a date certain during the first quarter of 2016 by which FHFA will take final action on each proposed annual operating budget for 2016 and approve the budget by that date.

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

OIG provided FHFA an opportunity to respond to a draft report of this evaluation. In its comments, which are reprinted in their entirety in Appendix A, FHFA agreed with recommendations 1, 2, and 3, and "generally agreed" to recommendation 4. FHFA also provided technical comments on the draft report, which were incorporated as appropriate.

OBJECTIVE, SCOPE, AND METHODOLOGY ....

The objective of this report was to assess FHFA's process for review and approval of Fannie Mae's and Freddie Mac's annual operating budgets, as required under the Revised Letters of Instruction, against the stated purpose for the budget approval: ensuring budget alignment with FHFA's strategic direction and safety and soundness priorities.

To achieve this objective, we interviewed FHFA personnel involved with the creation and execution of the budget review and approval process. Those interviewed included the Deputy Director of DOC and the DOC staff who conducted the 2014 and 2015 annual budget reviews. We also reviewed publicly available documents, internal DOC documents, and non-public information provided by FHFA. Additionally, we reviewed relevant FHFA communications within FHFA and with the Enterprises. We drew all financial information from either FHFA internal documents or publicly available Enterprise financial statements.

Our work was conducted under the authority of the Inspector General Act and in accordance with the Council of the Inspectors General on Integrity and Efficiency's *Quality Standards for Inspection and Evaluation* (January 2012). These standards require us to plan and perform an evaluation based upon evidence sufficient to provide reasonable bases to support its findings and recommendations. We believe that the findings and recommendations discussed in this report meet these standards.

The fieldwork for this report was completed between February and June 2015. The performance period for this evaluation was between February and August 2015.

APPENDIX A ....

FHFA's Comments on OIG's Findings and Recommendations

Federal Housing Finance Agency

MEMORANDUM

TO: Kyle D. Roberts, Deputy Inspector General for Evaluations

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

SUBJECT: Evaluation Report: *FHFA's Exercise of Its Conservatorship Powers to Review and Approve the Enterprises' Annual Operating Budgets Has Not Achieved FHFA's Stated Purpose*

DATE: September 24, 2015

This memorandum transmits the Federal Housing Finance Agency's (FHFA) management response to the recommendations in the draft report prepared by FHFA OIG, *FHFA's Exercise of Its Conservatorship Powers to Review and Approve the Enterprises' Annual Operating Budgets Has Not Achieved FHFA's Stated Purpose* (Report).

FHFA has reviewed the Report and, as discussed below, concurs with the Report's recommendations. While we concur with the recommendations and have been taking steps to implement changes, we take issue with the following aspects of the Report for the reasons explained:

- The Report understates the level of involvement by FHFA in the decisions leading to the formulation of the Enterprises' budgets. As the 2012 Letter of Instructions provides, the management of both Enterprises must "consult with and obtain the written approval of the conservator before taking" action on their budgets. However, the Report's focus solely on the steps undertaken by the Division of Conservatorship (DOC) in the budget process does not take into account the substantial roles played by other Divisions within FHFA in meetings, discussions, analyses, consultations and decisions about the underlying work manifested in the budgets of the Enterprises. The Report's focus on one Division within FHFA may, therefore, lead some readers of the Report to conclude that FHFA and the Enterprises are not meeting their strategic and safety and soundness obligations, a conclusion that FHFA believes would be clearly erroneous.

- The Report's assertion that, because of their conservatorship status, "the corporate governance incentives that animate directors' conduct in most public companies are largely absent in board governance of the Enterprises" is unwarranted. While FHFA reviews and approves the Enterprises' budgets because of its ultimate responsibility as conservator, the boards of the Enterprises, in fact, continue to have strong corporate

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governance incentives. These incentives include, among others, the obligation to comply with all laws and FHFA's regulations that require the Enterprises to have corporate governance practices that are consistent with safe and sound operations (of which prudent management of budget and expenses is a core component), indirect accountability to the taxpayers, and exposure to substantial public scrutiny.

Recommendation 1:

Direct each Enterprise to submit its proposed operating budget and supporting materials for the next fiscal year so that FHFA has sufficient time before the fiscal year begins to adequately analyze the proposals.

Management Response to Recommendation 1:

FHFA agrees with this recommendation. FHFA's views on the appropriate level of control over the budget as well as a number of other matters have been evolving throughout the period of conservatorship and have been under more intense review throughout 2014 and 2015. This review led to a decision by FHFA in July 2015 to accelerate the timetable for the Enterprises to submit their proposed budgets and supporting materials for review and approval by FHFA. FHFA communicated that decision to the Enterprises in August 2015 and requested that the Enterprises submit information regarding their proposed significant strategic initiatives and baseline expenses for 2016 in October of 2015. While the revised timeline may not allow both Enterprises sufficient time to submit final board-approved 2016 budgets for review and approval by FHFA before the end of 2015, FHFA will require submissions by December for subsequent fiscal years.

Recommendation 2:

Revise the existing budget review process and staff the review process with employees who have the qualifications and experience needed for critical financial assessments of the proposed Enterprise budgets to permit FHFA to determine whether each Enterprise's budget aligns with FHFA's strategic direction and its safety and soundness priorities.

Management Response to Recommendation 2:

FHFA agrees with this recommendation. As outlined in 1 above, FHFA changed its review protocols in 2015. FHFA is in the process of hiring a Financial Analyst within DOC to lead the operating budget review and DOC has assigned two additional staff members with relevant technical qualification and experience to support the budget review process. In addition, DOC will strategically consult with staff from FHFA's Division of Housing Mission and Goals and Division of Enterprise Regulation with expertise on specific budget items and strategic initiatives and staff from FHFA's Office of Budget and Financial Management with expertise on baseline expenditures.

Recommendation 3:

Set a date certain during the first quarter of 2016 by which FHFA will take final action on each proposed annual operating budget for 2016 and approve the budget by that date.

Management Response to Recommendation 3:

FHFA agrees with this recommendation and will advise the OIG when each Enterprise's budget for 2016 is approved.

Recommendation 4:

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

Management Response to Recommendation 4:

FHFA generally agrees with this recommendation. FHFA has set as an objective taking final action on each Enterprise's budget by January 31 of each subsequent year and believes that FHFA's active engagement with the Enterprises throughout the budgeting process will usually enable FHFA to meet that objective. However, FHFA strongly believes that basing budget decisions on the most up to date financial information available and having prior review and approval of the budgets by the boards of the Enterprises are critically important. Consequently, FHFA approvals with conditions or disapprovals, which may cause FHFA to need additional time to receive supplemental information from the Enterprises and time for additional board approvals, may result in justifiable delays in providing final FHFA approval. FHFA will document the reasons for any such delays and will exercise appropriate conservatorship discretion to approve the budget as soon as practicable when such a delay occurs.

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

APPENDIX B...

2015 Freddie Mac Budget Summary Table by DOC [REDACTED]

($ in Millions)	Total Administrative Expense by Division				
Division	FY 2014 Budget	Actual FY 2014	Delta vs. FY 2014 Budget	Proposed FY 2015 Budget	Delta vs. 2014 Actuals
Single Family	$ [redacted]	$ [redacted]	$ [redacted]	$ [redacted]	$ [redacted]
Multifamily					
Capital Markets					
Information Technology					
Finance					
Legal					
Enterprise Risk Management					
Internal Audit					
Compliance					
Office of Chief Administrator					
Human Resources and Diversity					
Office of CEO					
Make Home Affordable					
Unallocated Expense ***					
	$	$	$	$	$

*** Represents the CEO's expectation of realized underspend across Divisions.

($ in Millions)	Freddie Mac 2014 Budget Performance		
Category:	FY 2014 Budget	Actual FY 2014	Delta vs. 2014 Budget
Divisional Base	[redacted]	[redacted]	[redacted]
Strategic Inititiatives:			
Core			
CSP / Single Security			
Subtotal =			
Extraordinary Items:			
SF Credit, QC and PC Recoveries			
PLS and Other Litigation			
Subtotal =			
Legacy Pension Expense			
Other G&A			
Total Administrative Expenses			
FTE Employee Headcount			
FTE Contractor Headcount			

2015 Fannie Mae Budget Summary Table by DOC [REDACTED]

($ in Millions)	FHFA Approved 2014 Budget Plan	Actual FY 2014	Proposed FY 2015 Plan	Delta vs 2014 Budget Plan	Delta vs 2014 Actuals
Divisional Base Expenses					
Customer Engagement	$ [redacted]	$ [redacted]	$ [redacted]	$ [redacted]	$ [redacted]
Underwriting & Pricing	$ [redacted]	$ [redacted]	$ [redacted]	$ [redacted]	$ [redacted]
Multifamily	$ [redacted]	$ [redacted]	$ [redacted]	$ [redacted]	$ [redacted]
Operations & Technology 1/	$ [redacted]	$ [redacted]	$ [redacted]	$ [redacted]	$ [redacted]
Finance	$ [redacted]	$ [redacted]	$ [redacted]	$ [redacted]	$ [redacted]
Communications	$ [redacted]	$ [redacted]	$ [redacted]	$ [redacted]	$ [redacted]
Human Resources 1/	$ [redacted]	$ [redacted]	$ [redacted]	$ [redacted]	$ [redacted]
Legal	$ [redacted]	$ [redacted]	$ [redacted]	$ [redacted]	$ [redacted]
Enterprise Risk Management	$ [redacted]	$ [redacted]	$ [redacted]	$ [redacted]	$ [redacted]
Internal Audit	$ [redacted]	$ [redacted]	$ [redacted]	$ [redacted]	$ [redacted]
Compliance & Ethics	$ [redacted]	$ [redacted]	$ [redacted]	$ [redacted]	$ [redacted]
Chief Operating Officer	[redacted]	$ [redacted]	$ [redacted]	$ [redacted]	$ [redacted]
Credit (Includes MHA)	$ [redacted]	$ [redacted]	$ [redacted]	$ [redacted]	$ [redacted]
Corporate Expenses (FHFA, Incentive) 2/	$ [redacted]	$ [redacted]	$ [redacted]	$ [redacted]	$ [redacted]
	$ [redacted]	$ [redacted]	$ [redacted]	$ [redacted]	$ [redacted]

($ in Millions)	2014 Budget Plan	Actual FY 2014	Proposed FY 2015 Plan	Delta vs. 2014 Actuals
Investment Initiatives				
CSP Critical Path Projects: ***	[redacted]	[redacted]	[redacted]	[redacted]
CSP Platform Integration	[redacted]	[redacted]	[redacted]	[redacted]
Loan Accounting Initiative	[redacted]	[redacted]	[redacted]	[redacted]
Enterprise Data Infrastructure	[redacted]	[redacted]	[redacted]	[redacted]
Single Family:	[redacted]	[redacted]	[redacted]	[redacted]
Front End Data and Delivery	[redacted]	[redacted]	[redacted]	[redacted]
Pricing & Whole Loan Execution	[redacted]	[redacted]	[redacted]	[redacted]
Credit Enhancement & Risk Transfer	[redacted]	[redacted]	[redacted]	[redacted]
Multifamily:	[redacted]	[redacted]	[redacted]	[redacted]
Multifamily Target State	[redacted]	[redacted]	[redacted]	[redacted]
Capital Markets:	[redacted]	[redacted]	[redacted]	[redacted]
Fannie Unified Securities Environment (FUSE)	[redacted]	[redacted]	[redacted]	[redacted]
Enterprise IT:	[redacted]	[redacted]	[redacted]	[redacted]
Enterprise Maintenance	[redacted]	[redacted]	[redacted]	[redacted]
Other	[redacted]	[redacted]	[redacted]	[redacted]
Depreciation	[redacted]	[redacted]	[redacted]	[redacted]
Reserve Funds	[redacted]	[redacted]	[redacted]	[redacted]
Total Strategic & Maintenance Expenses =	[redacted]	[redacted]	[redacted]	[redacted]

*** Estimated full-year project costs were not reflected in original 2014 Budget Plan.

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