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Thank you, Chairman Johnson and Ranking Member Crapo and Members of the Committee on Banking, Housing, and Urban Affairs, for inviting me to testify here today. I appreciate the opportunity to update the Committee on the work of the Federal Housing Finance Agency Office of Inspector General (OIG).

OIG began operations in October 2010, in the midst of an unprecedented housing and financial crisis of historic proportions. Since our beginning, we have published 49 reports and have commenced multiple criminal and civil investigations.

Today, I will discuss emerging trends based on our work to date, discuss the challenges associated with ongoing uncertainty about the future of Fannie Mae and Freddie Mac, describe our operations, and answer the Committee's questions.

About OIG

OIG oversees FHFA's operations and programs. This oversight includes the Agency's regulation of the housing government-sponsored enterprises (GSEs)—Fannie Mae, Freddie Mac, and the 12 Federal Home Loan Banks (FHLBanks); the GSEs' approximately 12,000 employees; as well as the conservatorships of Fannie Mae and Freddie Mac. Fannie Mae and Freddie Mac currently own or guarantee $5 trillion in mortgages. To date, they have received $187.5 billion in taxpayer money in order to ensure their continuing solvency.

OIG's mission is to promote the economy, efficiency, and effectiveness of FHFA's programs and operations. To carry out its mission, OIG conducts and coordinates audits and evaluations of FHFA's programs and operations. OIG also works to prevent and detect fraud, waste, and abuse in those programs and operations through investigations involving FHFA, Fannie Mae, Freddie Mac, and the FHLBanks. Important features of OIG's work are the promotion of transparency in FHFA programs and GSE oversight, as well as public understanding of matters affecting FHFA, the GSEs, and housing policy.

A. Emerging Trends

Since I last testified, we have seen a turnaround in the profitability of the Enterprises. This is the first period since 2008 in which the Enterprises, still under FHFA conservatorships, have returned to profitability; in 2012, they earned record profits of more than $28 billion.

1. FHFA is Making Progress

FHFA has made progress in its role as conservator and regulator of the Enterprises across a variety of fronts. For example, FHFA has launched a number of initiatives intended to address key objectives, such as aligning Enterprise practices, improving service to borrowers, and conserving and preserving Enterprise assets. These initiatives include the Servicing Alignment Initiative, Uniform Mortgage Data Program, Joint Servicing Initiative, and lawsuits that FHFA has filed against 18 investment banks to recover investment losses incurred on residential mortgage-backed securities issued by those firms.

FHFA has also accepted and begun to implement the vast majority of our audit and evaluation report recommendations. For example:

- In December 2010, FHFA approved a buyback settlement with Bank of America in which the bank agreed to pay $1.35 billion to settle loan repurchase claims asserted by Freddie Mac. A subsequent OIG report raised concerns about the adequacy of the review of non-performing loans for repurchase claims. Freddie Mac has since acted on our concerns and expanded its loan review process; it now believes that the expanded process may produce additional revenues ranging from $2.2 to $3.4 billion over three years.

- Since OIG's March 2011 report, FHFA has taken action to enhance its oversight and control of executive compensation. For instance, FHFA revised certain aspects of the compensation program, which, in the case of the Fannie Mae and Freddie Mac CEOs, significantly reduced their annual pay.

- In the aftermath of reports that the LIBOR rate affecting financial transactions was improperly manipulated, OIG began examining the potential impact of this manipulation on Fannie Mae and Freddie Mac. We concluded in a memorandum to FHFA that it was possible the Enterprises had suffered sizable losses, and we offered recommendations for Agency action to recover any such losses on behalf of the Enterprises. Subsequently, Freddie Mac has sued to recover its losses.

2. As Conservator FHFA Needs to be More Involved in Enterprise Decision-Making

Although the Agency has made progress, our work continues to show that FHFA can improve its role as conservator and regulator. As conservator of the Enterprises, FHFA's mission is to preserve and conserve Enterprise assets. Throughout our body of work we have identified instances in which FHFA has displayed undue deference to Enterprise decision-making in its capacity as conservator. Without adequately testing or validating data, FHFA has at times deferred to the Enterprises regarding key matters under the conservatorships. We believe the Agency's actions in these cases reflect its approach as conservator to delegate most business decisions to the Enterprises. In each case, it relied upon review and corporate governance processes already in place at the Enterprises. However, we have concluded that some matters are sufficiently important to warrant greater involvement and scrutiny by the Agency. In some cases, the deficiencies have been remediated, but in other cases they still persist. For example:

- *Conservatorship decision-making*. In a September 2012 report, we found that FHFA unduly relied on information provided by Fannie Mae when it issued a "no objection" response to Fannie Mae's last minute request to make a financial investment of between $55 and $70 million. Fannie Mae requested the Agency's approval as conservator to make the investment; FHFA approved the request that same day but stated that given the complex nature of the transaction and the short time frame for its decision, the Agency could not assess the reasonableness of the proposal.

- *Conservatorship decision-making*. In the same report, we also found that over a three-year period Fannie Mae took over 4,500 actions to increase the Enterprise's counterparty risk limits without first obtaining conservator approval, even though such approval was required and Freddie Mac had submitted such counterparty risk limit increases for conservator approval. We also found that FHFA had not discovered Fannie Mae's lapses. FHFA has subsequently revised its policies and procedures surrounding requests for conservatorship approval.

- *Underwriting*. In a March 2012 audit, we found that the Agency's oversight of underwriting, along with the accompanying variances that effectively further loosen underwriting standards, was limited; FHFA relied on the Enterprises to oversee and establish underwriting standards and to grant variances. Subsequent to our audit recommendations, FHFA established a formal process to review the Enterprises' underwriting standards and variances.

- *Transaction testing/exam capacity*. Transaction testing includes reviewing files to test the veracity of statements made by the Enterprises to examiners. In a September 2011 evaluation of FHFA's capacity to examine the GSEs, we found that examiners too often accept assertions made by Enterprise managers rather than independently validating such assertions through appropriate transaction testing.

- *Buybacks*. In approving the buybacks settlement discussed above, FHFA relied on Freddie Mac's analysis of the settlement without testing the assumptions underlying the Enterprise's existing loan review process. OIG found in a subsequent report that implementation of our changes may generate additional recoveries of $2.2 to $3.4 billion.

3. **As Regulator FHFA Can Be More Proactive in Managing Risk**

In multiple reports we identified instances in which FHFA was not proactive in risk management. In general, we have observed that FHFA has difficulties identifying new and emerging risks potentially affecting the GSEs, issuing guidance and regulations governing risk management at the GSEs, and providing strong and consistent enforcement for violations of policy. Some instances of risk management shortfalls identified by OIG have been addressed, nevertheless, FHFA still needs to do more to identify and manage risks and take enforcement action where warranted.

Identification of Risk

Our work has shown that the Agency's ability to identify new and emerging risks has been limited. Here are some examples:

- *Advances to Insurance Companies*. In a March 2013 report, we found that during the past eight years, FHLBanks' advances to insurance companies who are FHLBank members have more than quadrupled—from $11.5 billion in 2005 to $52.4 billion in 2012. Lending to insurance companies may present unique risks compared with lending to other FHLBank members. Yet, neither FHFA nor the FHLBanks obtain confidential supervisory or other regulatory information relating to insurance company members from state regulators or the National Association of Insurance Commissioners.

- *Default-related legal services*. In a September 2011 report, we found that there were indicators as early as 2006 that could have led FHFA (and its predecessor) to identify the heightened risk posed by foreclosure abuses associated with Fannie Mae's default-related legal services network. The indicators included the rise in foreclosures accompanying the deterioration of the housing market, increased consumer complaints alleging improper foreclosures, contemporaneous media reports of foreclosure abuses, and public court filings in Florida and elsewhere critical of such abuses. Notwithstanding these indicators, FHFA did not devote attention to the foreclosure abuse issues until August 2010. The Agency is now implementing changes intended to rectify that oversight.

- *REO*. In a July 2012 report, we found that since 2008, FHFA has consistently listed the Enterprises' large inventories of real-estate owned (REO) properties acquired in the foreclosure process as contributing to "critical concern" ratings in their quarterly risk assessments. FHFA did not conduct targeted examinations or focused reviews of REO until 2011. FHFA's eventual targeted examinations in 2012 were positive supervisory steps, but expanding the scope of the assessments to evaluate more risks can help the Agency improve its supervision of real-estate owned.

Risk Management

The Agency has not always managed identified risks by establishing sufficient regulations or guidance.

- *Servicing.* In a September 2012 report, we found that FHFA has not timely addressed known risks presented by mortgage servicing contractors. For example, FHFA has not developed sufficient regulations or guidance governing the Enterprises' oversight and risk management of counterparties, such as servicers. Specifically, FHFA had not established and implemented effective Enterprise regulations or guidance for controlling the reporting of critical servicer information and establishing baseline requirements for mortgage servicing. Instead, FHFA relied on the Enterprises to monitor counterparty risk as part of their ongoing risk management activities. Although FHFA has made progress in this area, servicing remains an ongoing challenge.

- *High-Risk Seller/Servicers*. In a September 2012 report, we found that FHFA has not addressed known risks presented by mortgage seller/servicers by developing sufficient regulations or guidance governing the Enterprises' oversight and risk management of such counterparties. The Enterprises work with numerous seller/servicers for post-origination mortgage work, such as collecting mortgage payments. These seller/servicers represent a significant risk to the Enterprises. Specifically, FHFA has not published standards for the development of contingency plans related to failing or failed high-risk counterparties. Counterparty contingency plans will not eliminate losses, but they can serve as a road map to help reduce the Enterprises' risk exposure. Managing such seller/servicer risk is important, as the Enterprises have incurred losses of $6.1 billion from failures at just four of their counterparties since 2008. FHFA recently issued an advisory bulletin containing guidance and outlining criteria on written contingency plans.

Enforcement

Even when FHFA has identified risks and taken steps to manage those risks, the Agency has not consistently enforced its directives to ensure that identified risks are adequately addressed. As conservator and regulator, FHFA's authority over the Enterprises is broad and includes the ability to discipline or remove Enterprise personnel in order to ensure compliance with Agency mandates. OIG has reported that FHFA's supervision and regulation of the GSEs is strengthened by exercising this authority where warranted.

- *Operational Risk at Fannie Mae*. In a September 2011 report, we found that FHFA had not compelled Fannie Mae's compliance with directives requiring it to establish an effective operational risk management program. Fannie Mae's lack of an acceptable and effective program may have resulted in missed opportunities to strengthen oversight of law firms with which it contracts to process foreclosures.

- *Troubled FHLBanks*. Benefit of stronger FHFA enforcement also extends to FHLBanks. For example, since 2008 at least four FHLBanks have faced significant financial and operational difficulties which classified them as institutions with "supervisory concerns." In a January 2012 report, we determined that FHFA had not established a consistent and transparent written enforcement policy for troubled FHLBanks having such a classification. This contributed to instances in which FHFA may not have held such banks and their officers sufficiently accountable for engaging in questionable risk taking.

- *Unsecured FHLBank Lending*. In a June 2012 report, we identified FHFA's current regulation governing unsecured lending by the FHLBanks as possibly outdated and overly permissive, as well as non-compliant with the Agency's existing regulation. More specifically, FHFA did not initially pursue potential evidence of FHLBanks' violations of the existing regulatory limits and take supervisory and enforcement actions as warranted. OIG is currently conducting a follow-up report on this topic.

Recent Examples

Two recent OIG reports exemplify multiple aspects of FHFA's shortfalls in risk management:

- *Consumer Protection*. The Enterprises' seller/servicer counterparties contractually agree to comply with all federal and state laws and regulations (including consumer protection statutes) applicable to originating, selling, and servicing loans. If a counterparty does not comply, the Enterprises can require it to repurchase the noncompliant loan. We found in a March 2013 report that FHFA does not examine how the Enterprises monitor compliance with consumer protection laws, and the Enterprises do not ensure that their counterparties from which they purchase loans comply with such laws. Because FHFA has not identified compliance as a risk, it has not issued any guidance to the Enterprises. Further, FHFA has not attempted to enforce compliance with contractual provisions. We recommended that FHFA develop a risk-based plan to monitor the Enterprises' oversight of their counterparties' contractual compliance with applicable laws and regulations. FHFA agreed with our recommendation.

- *Consumer Complaints*. The Enterprises pay mortgage servicers to collect payments, interact with borrowers, and handle their complaints. The more serious complaints are called "escalated cases" and include foreclosure actions that violate the Enterprises' guidelines, complaints that the borrower was not appropriately evaluated for a foreclosure alternative, and violations of the Enterprises' time frames for borrower outreach.

We found in another March 2013 report that between October 2011 and November 2012, Freddie Mac and its eight largest servicers received over 34,000 complaints that became escalated cases. A servicer's failure to quickly and accurately resolve these escalated cases can prevent foreclosure alternatives from being adequately explored with borrowers and may result in losses to the Enterprise.

In early 2011, FHFA announced its Servicing Alignment Initiative, which requires servicers to report on escalated cases they receive and resolve cases within 30 days of receiving them. We found that FHFA, Freddie Mac, and its servicers did not fulfill their respective responsibilities to address and resolve escalated cases. First, evidence suggests that most of Freddie Mac's servicers are not complying with reporting requirements for escalated cases. As of December 2012, 1,179 or 98% of Freddie Mac's servicers had not reported on any escalated cases even though they managed 6.6 million mortgages for Freddie Mac. Of Freddie Mac's eight largest servicers—which serviced nearly 70% of its loans—four did not report any information about escalated cases despite handling more than 20,000 such cases during the 14-month period between October 2011 and November 2012.

Further, of the 25,528 escalated cases resolved by the eight largest servicers during the 14-month period between October 2011 and November 2012, 5,372 or 21% were not timely resolved within 30 days. Additionally, Freddie Mac did identify this as a risk area yet did not implement independent testing procedures during its operational reviews of its largest national and regional servicers. As a result, it had findings related to escalated cases in only 1 of 38 reviews of its largest national and regional servicers that it conducted in 2012. Freddie Mac has also neglected to establish penalties (such as fines) for servicers that do not report escalated cases.

Finally, FHFA did not identify the foregoing problems through its own examination of Freddie Mac's implementation of the Servicing Alignment Initiative. Rather than independently testing servicers' compliance with complaint reporting requirements, the FHFA examination team relied exclusively on Freddie Mac's on-site operational review reports, which did not mention problems with servicer reporting. Thus, FHFA's examination of Freddie Mac's implementation of the Servicing Alignment Initiative did not identify servicers' failures to report escalated cases or resolve them in 30 days. Additionally, FHFA lacks guidance for examination teams to use when testing the implementation of directives, such as its Servicing Alignment Initiative.

To address and resolve escalated consumer complaints in a timely and consistent manner, we recommended that the Agency ensure Freddie Mac requires its servicers to report, timely resolve, and accurately categorize escalated cases; ensure that Freddie Mac enhances its oversight of the servicers through testing servicer performance and establishing fines for noncompliance; and improve its oversight of Freddie Mac by developing and implementing effective examination guidance. FHFA agreed with our recommendations.

4. FHFA May Not Have Enough Examiners

FHFA has critical regulatory responsibilities with respect to the GSEs and conservator responsibilities regarding the Enterprises. Nonetheless, in a 2011 report we found that the Agency had too few examiners to ensure the efficiency and effectiveness of its GSE oversight program; due to examiner shortages, FHFA had scaled back planned work during examinations, and examinations often took much longer than expected to complete. Additionally, we identified shortfalls in the Agency's examination coverage, particularly in the crucial area of REO. We also found that the majority of the Agency's examiners lacked the certification that is required at other federal financial regulatory examination divisions. Although the Agency has made progress since we issued this initial report by reorganizing the examination function and hiring new staff, it is not clear that FHFA has achieved adequate resources. Many of our subsequent reports continue to recommend expanded or improved examination coverage. We have initiated follow-up work to determine FHFA's progress in staffing its examination teams.

B. Challenges Associated with Ongoing Uncertainty

We are mindful that FHFA's long-term success—and our ability to assess the enduring effectiveness, efficiency, and economy of the Agency's actions—is necessarily affected by the uncertainty surrounding the fate of the Enterprises and that of the housing finance system. In other words, FHFA must effectively direct the Enterprises' operations while fundamental questions about its role and theirs remain unanswered.

In September 2008, when Fannie Mae and Freddie Mac entered into conservatorships overseen by FHFA, it was generally assumed that FHFA's role as conservator would be temporary and short-lived. Yet, nearly five years later, Fannie Mae and Freddie Mac are still in conservatorships with no clear end in sight. Indeed, no one is sure how long the Enterprises will continue to exist in their current form or what their future roles, if any, will be. Thus, human resource issues have been and will remain a challenge for FHFA and the Enterprises. Not only does the uncertain future present a challenge in recruiting and retaining employees, the Agency and the Enterprises are hampered in making longer-term staffing allocations because their future roles remain uncertain.

Until the uncertainty is resolved, we will continue to focus on housing finance matters, such as managing risks and repaying taxpayers.

C. OIG Operations

1. OIG Audits and Evaluations

In addition to monitoring and reporting on FHFA's progress in implementing report recommendations, my office will continue to release new audits and evaluations covering key areas. OIG maintains an Audit and Evaluation Plan focused on the areas of FHFA's operations posing the greatest risks and providing the greatest potential benefits to FHFA, Congress, and the public. Originally developed with input from an independent, third-party risk assessment, the Audit and Evaluation Plan also takes into account the feedback we receive about our work from FHFA officials, members of Congress, and others. Broadly, OIG's audit and evaluation strategies include reviews of the following FHFA activities:

- Regulatory efforts and its management of the Fannie Mae and Freddie Mac conservatorships. The Enterprise conservatorships are particularly high-risk areas in which taxpayers have invested $187.5 billion to date. As conservator, FHFA must regulate and oversee the Enterprises in an efficient, effective, and transparent manner so as to minimize taxpayer costs, conserve and preserve Enterprise assets, and meet all statutory mandates.

- Oversight of the FHLBanks and their associated risks, including investment portfolio management and concentrations, credit underwriting, and administration.

- FHFA and GSE internal operations involving issues that relate to information security as well as allegations of fraud, waste, or abuse.

Given the Committee's interest, I want to highlight some of our projects that are currently underway. First, we are assessing a number of FHFA's new or expanded initiatives, including the Servicing Alignment Initiative, the proposed Common Securitization Platform for the Enterprises, the Fannie Mae REO pilot program, and HARP 2.0. Additionally, we are conducting further work to follow up on our December 2012 consumer protection report entitled *FHFA Should Develop and Implement a Risk-Based Plan to Monitor the Enterprises' Oversight of Their Counterparties' Compliance with Contractual Requirements Including Consumer Protection Laws*. There, we assessed FHFA's oversight of the Enterprises' monitoring of seller/servicer compliance with their contractual agreements, with an emphasis on their compliance with federal consumer protection laws. The next phase of our work will move from the Agency's oversight of the Enterprises to the Agency's oversight of servicers. However, I look forward to working with you and reporting our findings and recommendations in the coming months.

2. Investigations

Within OIG, the Office of Investigations is actively engaged in combating fraud, waste, and abuse. Thus far in FY 2013 alone, the Office of Investigations' activities have led to 53 indictments and 26 convictions; since our work began the Office of Investigations' activities have led to 156 indictments and 62 convictions.

OIG works with law enforcement partners across the nation, including other federal agencies, U.S. Attorneys' Offices, and state and local agencies. While many cases remain confidential, we have released details about mortgage fraud investigations once public charges have been filed, as is the case with the prosecutions of Colonial Bank and Taylor, Bean & Whitaker Mortgage Corporation, American Mortgage Field Services LLC, and Home Owners Protection Economics, Inc.

The Office of Investigations currently has a variety of open criminal and civil investigations involving a wide variety of allegations of wrongdoing. The Office of Investigations focuses on FHFA and the GSEs, both internally and externally, concentrating on those individuals and organizations that have victimized either FHFA or the GSEs or borrowers with GSE loans. Many of the cases fall into one or more of the following seven categories:

- Fraud involving residential mortgage-backed securities
- Mortgage origination related frauds
- Mortgage modification frauds
- Fraud involving REO transactions
- Builder bailouts and condo conversions
- Fraud involving mortgage servicing contractors
- FHFA or GSE employee misconduct

Fraud involving mortgage-backed securities is a key area of focus. During the housing boom, the GSEs purchased and guaranteed hundreds of billions of dollars of residential mortgage-backed securities. Since the collapse of the housing market in 2007, those investments have declined precipitously in value. The GSEs may have been victims of fraud in instances when the quality and value of the underlying assets they purchased or guaranteed was misrepresented to them. OIG is an active member of the Mortgage Fraud Working Group formed last year, and has assisted in civil cases filed in the second half of 2012 against JPMorgan Chase and Credit Suisse.

Mortgage origination fraud includes cases when the GSEs have been defrauded as a result of misrepresentations relating to the quality of the loans sold. These misrepresentations occur at the time the loan is originated. For instance, OIG is assisting in a federal civil case alleging that

Countrywide in 2008 implemented a new loan origination process called the "Hustle," which was intentionally designed to process loans at high speed and without quality checkpoints, and which generated thousands of fraudulent and otherwise defective residential mortgage loans sold to Fannie Mae and Freddie Mac that later defaulted, causing over $1 billion dollars in losses and countless foreclosures.

Mortgage modification fraud targets financially distressed homeowners who are underwater or have fallen behind on their mortgage payments. Some frauds involve advance fee schemes that require the homeowner to pay a fee for participating in supposedly "official" programs that are in fact completely fictitious or improperly imply participation in a U.S. government housing relief program. Other schemes are designed to force a distressed homeowner into default sooner than would otherwise be the case.

REO fraud may involve individuals connected to the foreclosure and subsequent resale of a property. For example, the Enterprises contract with asset managers to maintain and prepare the property for sale. But the asset managers may not maintain the properties and bill for fictitious maintenance expenses. REO fraud can also involve realtors who collude with investors or other realtors and appraisers to drive down the price of properties they are selling on behalf of the Enterprises.

Builder bailouts and condo conversions usually occur when a builder who obtained loans to build homes is unable to sell all the homes when built. To get rid of those unsold homes quickly, the builder may use a variety of illegal schemes, including using straw-buyers, paying undisclosed concessions to the buyer, or paying undisclosed marketing fees to brokers or real estate agents.

Fraud involving mortgage servicing contractors can include instances when a mortgage servicing contractor defrauds an Enterprise. For instance American Mortgage Field Services LLC was a property inspection company. From at least 2009 through March 2012, the president of American Mortgage Field Services and some of his employees submitted fraudulent reports describing numerous inspections of foreclosed properties that were paid for but never actually performed. Recently, American Mortgage Field Services' president was sentenced in federal court to over 8 years in prison and ordered to pay over $12.7 million in restitution.

FHFA or GSE employee misconduct involves cases alleging misconduct by FHFA or GSE employees or contractors. For instance, in a recently filed federal case, a Fannie Mae foreclosure specialist allegedly solicited $11,000 in payments from realtors in exchange for taking favorable actions.

Finally, I want to mention that the Office of Investigations operates the OIG Hotline, which allows concerned parties to report information directly and in confidence regarding possible fraud, waste, or abuse related to FHFA or the GSEs. OIG honors all applicable whistleblower protections. If anyone wishes to report allegations of fraud, waste, or abuse, the Hotline can be reached at 1-800-793-7724, by fax at (202) 318-0358, or through our website at www.fhfaoig.gov.

Conclusion

My staff and I look forward to continuing to work with your committee to provide independent, relevant, and objective assessments of FHFA's operations and programs. The continuing fragility of our nation's housing market remains a significant source of ongoing concern. Further, Fannie Mae, Freddie Mac, and the FHLBanks continue to be key market participants, and FHFA continues to face significant challenges. We are hopeful that our work will be of assistance in meeting those challenges.