OFFICE OF INSPECTOR GENERAL

Federal Housing Finance Agency

400 7th Street SW, Washington, DC 20219

July 26, 2018

TO: Melvin L. Watt, Director, Federal Housing Finance Agency

FROM: Laura S. Wertheimer, Inspector General, Federal Housing Finance Agency

SUBJECT: **Administrative Review of a Potential Conflict of Interest Matter Involving a Senior Executive Officer at an Enterprise (OIG-2018-001)**

Summary

This Management Alert reports the results of our administrative review of the adequacy of conflict of interest disclosures made in (b)(6) by Fannie Mae's (b)(6) (b)(6) (b)(6) regarding the employment of (b)(6) by (b)(6)

We reviewed Fannie Mae's Code of Conduct and Conflict of Interest Policy for Members of the Board of Directors (Director Code), Code of Conduct for Employees (Employee Code), and Conflict of Interest (COI) Policy, in effect through the period covered by our review. Each recognize that (b)(6) can give rise to potential, apparent, or actual conflicts of interest. The Employee Code and COI Policy require an employee with a potential conflict of interest to disclose all facts material to that potential conflict to Fannie Mae's Compliance and Ethics Office (FM Ethics). The Director Code requires the same disclosures by directors to the Nominating and Corporate Governance Committee (NGC) of the Fannie Mae Board of Directors (Board). Complete disclosure is necessary to facilitate a fully informed analysis of the existence of an actual or apparent conflict of interest and to develop and implement adequate controls to mitigate any conflict. To implement its ethics program, Fannie Mae maintains a confidential file of employee conflicts disclosures, conflicts determinations, recusal agreements, and supporting documents in an electronic case management system (CMS).

Entries in CMS reflect two disclosures by (b)(6) in (b)(6), regarding a potential conflict of interest relating to the potential and actual employment of (b)(6) (b)(6) by (b)(6), labeled an "interested party." Based on our review of these entries, Fannie Mae documents linked to and supporting these entries, and publicly available documents, it appears that (b)(6) did not disclose critical information about (b)(6) interests that was known, or should have been known, by (b)(that was significant to any conflicts of interest analysis and controls to mitigate the conflict. That information included: Fannie Mae's

ongoing assessment, pursuant to a mandate from the Federal Housing Finance Agency (FHFA or Agency), of the potential impact of updating Fannie Mae's and Freddie Mac's credit score requirement to (b)(6) (b)(6) FHFA's public announcement that it planned to reach a decision whether to update the credit score model requirements in 2018, a decision characterized by the FHFA Director as the "most difficult issue that I have had to deal with" during his tenure; and public recognition by FHFA, (b)(6) of the significant impact of FHFA's decision on the mortgage industry. Given the pendency of Fannie Mae's assessments and the time-sensitive nature of FHFA's decision on alternative credit score models, our review was confined to CMS entries, Fannie Mae documents linked to and supporting these entries, and publicly available documents.

On (b)(6), FM Ethics presented (b)(6) with a draft recusal agreement for (b)(review. Upon completing (b) review, (b)(6) knew, or should have known, that FM Ethics and the NGC did not consider any of the factors listed above in determining the existence of a potential conflict of interest with (b)(6). FM Ethics and the NGC were both focused on a considerably less critical matter—a potential conflict of interest arising out of (b)(6) interest as a potential (b)(6) (b)(6) We found nothing in the CMS entries or Fannie Mae documents linked to and supporting these entries to suggest that (b)(6) disclosed the broader extent of (b)(6) interests to FM Ethics or the NGC.

(b)(6), we found that (b)(6) failed to make a timely and complete disclosure about a potential conflict of interest involving (b)(6). In (b)(6), we issued a Management Alert in which we found repeated failures by (b)(6) regarding the timeliness and completeness of (b)(disclosure regarding (b)(6) (b)(6). We made two recommendations to the FHFA Director to address the repeated failures, including a recommendation that he take appropriate disciplinary action against (b)(6).

The FHFA Director reported to us that he (b)(6) and advised that (b)((b)(6) would (b)(6) (b)(6)

Based on our review of Fannie Mae's corporate records, it appears that (b)(6) did not fully disclose all information relating to a potential conflict to facilitate a fully-informed analysis whether a potential, apparent, or actual conflict of interest existed and to develop and implement the controls needed to mitigate the franchise risk to Fannie Mae (and FHFA) from the conflict. As a result, one cannot presume that the terms of the existing recusal—recusal of (b)((b)(6) from any business decision presented to him relating to (b)(6)—would prevent (b)(from participating in the assessment within Fannie Mae of the potential impact of

(b)(6) or in discussions with FHFA about Fannie Mae's assessment, or in participating in discussions with FHFA about implementation of steps required under the Economic Growth, Regulatory Relief, and Consumer Protection Act (Pub. L. No. 115-174, the "Act").

For those reasons, we recommend that, prior to the FHFA Director's final decision on alternative credit score models, FHFA:

- Promptly perform a comprehensive review of the conflict of interest implications arising from (b)(6) possible involvement in Fannie Mae's assessment of the potential impact of (b)(6) (b)(6) and possible discussions with FHFA about Fannie Mae's assessment, in light of (b)(6) employment of (b)(6), and
- Ensure appropriate controls are in place to mitigate any potential, apparent, or actual conflict of interest.

We provided a draft of this Management Alert to FHFA on July 16, 2018 for its response. We received the Agency's response on July 23, 2018, in which it agrees with our recommendations, and it is attached as Appendix A. (b)(6) (b)(6)

Background

FHFA's Consideration of the Enterprises' Use of Alternative Credit Scoring Models

According to their respective single-family selling guides, neither Fannie Mae nor Freddie Mac (the Enterprises) allows delivery of loans with a credit score other than Classic FICO.[1] For years, Congress, federal regulatory agencies, and policy advocates have considered whether Classic FICO excludes a large number of creditworthy potential homeowners and whether alternative credit scoring models should be accepted.

In its Conservator Scorecards for 2015- 2017, FHFA directed the Enterprises to undertake an assessment of the potential impact of updating the Enterprise credit score requirement from Classic FICO to another score or scores.[2] The Enterprises' 2017 assessments focused on updating the credit score requirement to include Classic FICO, FICO 9, and VantageScore 3.0.

[1] FHFA defined the term "Classic FICO" in its 2017 Credit Score Requests for Input: "The Enterprises use FICO 5 from Equifax, FICO 4 from TransUnion, and FICO Score 2 from Experian, which are collectively referred to as 'Classic FICO.'" Fannie Mae's Selling Guide requires the following versions of the classic FICO score for both Desktop Underwriter (Fannie Mae's proprietary automated underwriting system) and manually underwritten mortgage loans: Equifax Beacon 5.0; Experian/Fair Isaac Risk Model V2SM; and TransUnion FICO Risk Score, Classic 04. *See* Fannie Mae Selling Guide B3-5.1-01: General Requirements for Credit Scores, Credit Score Versions. Freddie Mac's Single-Family Seller/Servicer Guide has a similar requirement at Section 5203.2(a) ("Freddie Mac requires the Seller to use a FICO® score, whenever a usable Credit Score is required").

On December 20, 2017, FHFA issued its *Credit Score Request for Input* (RFI) seeking feedback "from interested parties that could be impacted by a change in the Enterprises' credit score requirements, including industry and consumer group stakeholders." The four options identified by FHFA in its RFI were: delivery of a single score, either FICO 9 or VantageScore 3.0; delivery of both scores, FICO 9 and VantageScore 3.0; delivery of loans with either a FICO 9 or Vantage Score 3.0 with constraints; and delivery of multiple scores through a waterfall approach that would establish both a primary and secondary credit score.[3]

The day following publication of its RFI, FHFA issued its 2018 Conservatorship Scorecard. That Scorecard directed the Enterprises to "conclude the assessment of updated credit score models and, as appropriate, plan for implementation," as "informed by [the RFI] feedback."

As of March 29, 2018, when the Agency's 2017 Scorecard Progress Report was published, FHFA planned on reaching a decision in 2018. FHFA announced on July 23, 2018, that it had "determined that proceeding with efforts to reach a decision based on [its] Conservatorship Scorecard Initiative process and timetable would be duplicative of, and in some respects inconsistent with, the work [it is] mandated to do under . . . the Act," FHFA reported that it is "communicating to Congress that [it is] transferring [its] full efforts to working with the Enterprises to implement the steps required" under the Act, including "developing a proposed rule, receiving and evaluating public comment on the proposed rule and issuing a Final Rule to govern the verification of credit score models. Thereafter, [it] will follow through on the steps required to implement the new Rule."[4]

Ownership of (b)(6)

According to FHFA's RFI, (b)(6)
(b)(6) which owns intellectual property rights to (b)(6) (b)(6)

[2] FHFA sets forth its priorities in annual Conservatorship Scorecards. Compensation for certain Enterprise executives is based, in part, on Enterprise achievement of Scorecard goals. *See further,* FHFA-OIG White Paper *FHFA's Conservatorships of Fannie Mae and Freddie Mac: A long and Complicated Journey* (WPR-2015-002), at 11 (FHFA issues annual conservatorship scorecards to set specific expectations for each strategic plan goal and a portion of annual compensation for certain senior executives of each Enterprise is tied to the Enterprise's performance against the scorecard goal).

[3] *See* FHFA, *FHFA Issues Request for Input on Fannie Mae and Freddie Mac Credit Score Requirements* (Dec. 20, 2017) (online at https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Issues-Request-for-Input-on-Fannie-Mae-and-Freddie-Mac-Credit-Score-Requirements.aspx).

[4] *See* FHFA, *FHFA Announces Decision to Stop Credit Score Initiative* (July 23, 2018) (online at https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-Decision-to-Stop-Credit-Score-Initiative.aspx). On May 24, 2018, President Trump signed the Act into law. The Act affects a number of provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and introduces specific requirements for the Enterprises and FHFA pertaining to credit scores and credit scoring models. According to one media report published before the law was enacted, this change is (b)(6)
(b)(6)

(b)(6) The RFI also states that (b)(6)
(b)(6) (b)(6)
(b)(6) (b)(6) has publicly reported that it (b)(6)
(b)(6) (b)(6) (b)(6)
(b)(6)

In its RFI, FHFA announced that it sought "feedback on the options from interested parties that could be impacted by a change in the Enterprises credit score requirements." In response,
(b)(6)

Potential Impact of a Decision by FHFA to Approve the Use of Alternative Credit Score Models

FHFA has publicly acknowledged that its decision on use of alternative credit scoring models "would generate industry-wide effects among stakeholders" and "other market participants" for years to come.[7] As FHFA Director Watt testified, in May 2018: "I've said **repeatedly** that of all of the challenges that I've faced at FHFA during the period I've been the [D]irector over that, this is clearly the most difficult issue that I have had to deal with…" (emphasis added).

(b)(6) recognize the significant impact from FHFA's decision to accept alternative credit scores. Commentators recognize that FHFA's (b)(6) (b)(6) could increase mortgage volume by expanding the pool of borrowers who currently lack a credit history. (b)(6)

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[5] *See* FHFA, *Credit Score Request for Input*, at 12 (Dec. 20, 2017) (online at https://www.fhfa.gov/Media/PublicAffairs/PublicAffairsDocuments/CreditScore_RFI-2017.pdf) (*hereinafter*, FHFA's RFI).

[6] (b)(6)
(b)(6)

[7] *See* FHFA's RFI at 4. In a subsequent blog post, FHFA used similar language to describe the importance of the Director's decision: "The credit score decision will impact the industry--including borrowers, lenders, servicers, mortgage insurers, and investors--for years to come." *See* FHFA, *FHFA Needs Your Feedback on Credit Score Requirements* (Jan. 18, 2018) (online at https://www.fhfa.gov/Media/Blog/Pages/FHFA-Needs-Your-Feedback-on-Credit-Score-Requirements.aspx). Press reports describe the competitive environment for credit score vendors and the shift in the landscape that may result as a consequence of FHFA's final decision. *See, e.g.*, AnnaMaria Andriotis and Christina Rexrode, *A Fight Over the Credit Score Lenders Use for Your Mortgage*, The Wall Street Journal (Jan. 3, 2018) (online at https://www.wsj.com/articles/a-fight-over-the-credit-score-lenders-use-for-your-mortgage-1514984400) and AnnaMaria Andriotis and Lalita Clozel, *FICO's Lock on Mortgage Credit Scores Comes Under Fire*, The Wall Street Journal (Mar. 14, 2018) (online at https://www.wsj.com/articles/ficos-lock-on-mortgage-credit-scores-comes-under-fire-1521019801).

(b)(6) as a credit scoring model.

In short, FHFA's decision whether to accept an alternative credit scoring model for the Enterprises is a high stakes decision, with long-term impact on the industry and on the financial interests of (b)(6)

Analysis

Fannie Mae's Ethics Authorities Require Prompt and Complete Disclosures of Potential Conflicts of Interest; Fannie Mae Has Established a Process to Analyze Whether an Actual or Apparent Conflict of Interest Exists and to Develop and Implement Controls Necessary to Mitigate the Risks from the Conflict

The Fannie Mae Director Code, Employee Code, and COI Policy in effect for the period covered by our review recognize that (b)(6) can give rise to potential, apparent, or actual conflicts of interest and require prompt and complete disclosure of circumstances, situations, and activities that may have conflict of interest implications. Fannie Mae maintains a system of records, CMS, in which employee disclosures about ethics issues, including conflicts of interest and their resolution, are documented. As the COI Procedure, that implements the Employee Code and COI Policy, explains: "To ensure that Fannie Mae consistently applies the [Employee] Code, the [COI] Policy, and this Procedure, FM Ethics maintains a confidential file of requests and determinations. All Conflict determinations, recusal notifications, and supporting documents are maintained in [CMS]." As a matter of internal decision-making within Fannie Mae, the NGC Charter vests sole authority in the NGC to review and make determinations regarding all conflicts of interest disclosures (b)(6) The NGC Charter also obligates the NGC to oversee implementation of and compliance with the Director Code.

(b)(6) *is Bound by Fannie Mae's Ethics Authorities*

Fannie Mae's Director Code states that a conflict of interest "arises when a person's private interest interferes in any way—or even appears to interfere—with the interests of the Corporation as a whole." Fannie Mae's ethics authorities require the affected employee and/or director to disclose fulsome information about any situation that involves, or appears to involve, a conflict of interest.[8] (b)(6) Fannie Mae and (b)(6) (b)(6) is bound by Fannie Mae's ethics authorities (b)(6) (b)(6) Fannie Mae's Employee Code (b)(6) (b)(6) employees to apply the "guiding principles" of the Code every day. (b)(6) employees to "always err

[8] *See* FHFA-OIG, *Management Alert: Administrative Investigation into Anonymous Hotline Complaints Concerning Timeliness and Completeness of Disclosures Regarding a Potential Conflict of Interest by a Senior Executive Officer of an Enterprise* (Mar. 23, 2017) (OIG-2017-004), attached Expert Report of Nell Minow at 3.

on the side of transparency" in their conflicts disclosures and "proceed in a manner that all concerned would agree is completely beyond reproach."[9]

Findings

1. Based on Our Review of Fannie Mae's Corporate Records, It Appears that (b)(6) Did Not Make Complete Disclosures of a Potential, Apparent, or Actual Conflict of Interest Arising from the Potential and Actual Employment of (b)(6) (b)(6) and FHFA's Decision on the Enterprises' Use of Alternative Credit Scoring Models

Entries in CMS and Fannie Mae documents referenced in, or linked to, these entries, show that on two separate occasions (b)(6) did not disclose information critical to determining whether (b) had a conflict of interest arising from the potential and actual employment of (b) (b)(6) Fannie Mae's assessment of and FHFA's decision on the use of alternative credit scoring models by the Enterprises. After we advised FHFA, on July 16, 2018, that we intended to send up later that day a draft Management Alert involving (b)(6) incomplete conflict of interest disclosures, FHFA provided us with a memorandum dated July 13, 2018, from FM Ethics to the NGC (FM Ethics' July 2018 memorandum), which FM Ethics had not yet circulated to the NGC, in which FM Ethics expressed its view that both disclosures by (b)(6) were appropriate and consistent with (b)(obligations under the Employee Code and the COI Policy. For the reasons we now discuss, both disclosures were incomplete and did not satisfy (b) obligations as (b (b)(6)

A CMS Entry Dated (b)(6) Reports that (b)(6) Disclosed that (b)(6) Was an "Interested Party"

An entry in CMS reports that, on (b)(6) disclosed to Fannie Mae's Chief Compliance and Ethics Officer (CCEO) that "an individual (b)(6) (b)(6) w[ould] be interviewing with an interested party, (b)(6) for a position (b)(6) The CMS entry relating to this disclosure provided no explanation of the reasons that (b)(6) was considered an "interested party" or the reasons why its interest could give rise to a potential, apparent, or actual conflict of interest. We also

[9] Fannie Mae's current Employee Code, adopted prior to the disclosures that are the subject of this Management Alert, can be accessed on Fannie Mae's website at http://www.fanniemae.com/portal/about-fm/employee-code.html. Fannie Mae's Employee Code requires employees to avoid any conflict or the appearance of a conflict between Fannie Mae's business interests and their personal interests. Its COI Policy defines a conflict of interest to reach situations which: impair an employee's objectivity; interfere with an employee's ability to execute his or her duties and responsibilities at Fannie Mae or embarrass Fannie Mae.

found no evidence in this entry that FM Ethics sought additional details from (b)(6) for an explanation of (b)(6) status as an interested party, or an explanation of how (b)(6) interest could give rise to a conflict.

Fact Gathering and Analysis by FM Ethics of (b)(6)
Disclosure

By email dated (b)(6), (b)(6) who reports to (b)(6) queried Fannie Mae's Risk Oversight group to obtain a "definitive answer" whether (b)(6) had a business relationship with Fannie Mae. The Risk Oversight group, which relies on information maintained in a Fannie Mae database to identify corporate counterparties, advised (b)(6) that (b)(6) was not a counterparty. According to the FM Ethics' (b)(6) memorandum, the standard process that had been used by FM Ethics seeks "to confirm if the entity in question has an active business relationship with Fannie Mae" and that process did not uncover contracts in effect prior to (b)(6) disclosure between (b)(6) and Fannie Mae.

(b)(6) also learned, in response to queries to other Fannie Mae personnel, that (b)(6) was one of (b)(6) being considered to provide (b)(6) (b)(6) at Fannie Mae. None of the Fannie Mae employees contacted by (b)(6) (b)(6) raised (b)(6) interests in Fannie Mae's assessment of the impact of (b)(6) (b)(6) (b)(6) in which (b)(6) (b)(6) or in FHFA's consideration of alternative credit scoring models, as potential data points for a conflicts analysis.

FM Ethics reported the information it had learned to the NGC, by memorandum (b)(6) (b)(6) That memorandum provided FM Ethics' understanding of the relationship between Fannie Mae and (b)(6) : "Fannie Mae does not have an active counterparty relationship with (b)(6) at this time." Contrary to the representation made in the FM Ethics' (b)(6) memorandum, FM Ethics' (b)(6) memorandum to the NGC went beyond existing counterparty relationships to determine the existence of a conflict of interest. (b)(6) (b)(6) memorandum reported: (b)(6) is currently under consideration (b)(6) (b)(6) to provide Fannie Mae with (b)(6) (b)(6) In the next section of this memorandum, titled "Analysis and Determination," FM Ethics concluded, from the information known to it, that no actual conflict of interest existed: it reasoned that (b)(6) employment discussions with (b)(6) did not interfere with (b)(6) ability to perform (b)(duties at Fannie Mae and did not have the potential to embarrass Fannie Mae. In its view, "Fannie Mae's current discussions with (b)(6) [to (b)(6) do not require (b)(6) approval to proceed forward nor has (b) been involved in [those] discussions." FM Ethics recognized that "[g]iven (b)(6) role at Fannie Mae and **the company's potential business relationship with** (b)(6) an appearance of a conflict of interest might arise due to (b)(6) employment discussions." (emphasis added).

FM Ethics' memorandum proposed to mitigate this potential conflict by recusing (b)((b)(6) "from any business decisions presented to (b)(related to (b)(6) during the course of (b)(6) employment discussions and the duration of (b) employment, if any, with (b)(6) Its memorandum does not identify (b)(6) (b)(6) Fannie Mae's assessment obligations in the 2018 Conservatorship Scorecard, or (b)(6) in the alternative credit scoring decision to be made by FHFA nor does the memorandum discuss the associated conflict of interest implications.

The NGC's Consideration of FM Ethics' Memorandum

Minutes of the NGC meeting on (b)(6), which report on the analysis, conclusion and recommended mitigation plan by FM Ethics to the NGC, contain no mention of (b)(6) interests relating to possible adoption of alternative credit scoring models. We found no evidence in the written materials provided to the NGC, or in the minutes for its (b)(6) meeting, that the NGC was made aware of (b)(6) interests in Fannie Mae's assessment of the impact of updating credit scoring models to include (b)(6) or in FHFA's pending decision. The minutes reflect that (b)(6) reported to the NGC that "Fannie Mae does not have an active counterparty relationship with (b)(6) currently under consideration to provide the Company with (b)(6) (b)(6) The minutes also state that (b)(6) advised the NGC: "[b]ecause (b)(6) has a potential business relationship with the Company, (b)(6) (b)(6) disclosed (b)(6) employment discussions" with (b)(6) to "Ethics for further consideration." According to the minutes, (b)(6) I explained to the NGC that "the appearance of a COI might arise from the employment discussions because of (b)(6) (b)(6) role at the Company and the Company's potential business relationship with (b)(6) The minutes report that the NGC "concurred with Ethics' analysis, conclusion, and the related mitigation plan" and the scope of the mitigating controls put into place to minimize the risk from the conflict.

When (b)(6) Reviewed and Executed (b) Recusal Agreement on (b)(6) (b)(6)(b)(Did Not Disclose Significant Information that (b Knew, or Should Have Known, Regarding (b)(6) Interest in Fannie Mae's Assessment of the Impact of Updating the Credit Score Requirement, and FHFA's Consideration Whether to Update the Credit Score Requirement

On (b)(6) FM Ethics sent a draft recusal agreement to (b)(6) setting forth the terms of (b) recusal. Our review of that draft agreement found it was virtually identical to the (b)(6) analysis memo from FM Ethics to the NGC, discussed above. This draft recited the same facts and conclusions and stated: "you will be required to recuse yourself from **any business decisions that are presented to you related to** (b)(6) " during the course of

employment discussions between (b)(6) and (b)(6) and, "if (b)(6) accepts employment with (b)(6), your recusal from business decisions regarding that entity will continue for the duration of (b)(6) employment." (emphasis added).[10] Less than an hour later, (b)(6) responded: "The memo looks fine. Please send it to me without the draft line and I will execute it." FM Ethics removed the draft watermark and (b)(6) executed the recusal agreement that same day.

From (b) review of (b)(recusal agreement on (b)(6) knew, or should have known, that (b)(6) interests were far more substantial than just its interest as a (b)(6) identified in (b) recusal agreement. Information that was known, or should have been known, to (b)(relating to (b)(6) interests, included:

- Fannie Mae's mandated assessment of updating the credit score requirement, during 2017, was (b)(6) (b)(6)
- FHFA's RFI, issued in December 2017, stated that (b)(6) (b)(6) and that it would reach a decision concerning the use of alternative credit score models in 2018.
- FHFA's Conservatorship Scorecard for 2018, issued in December 2017, required Fannie Mae to (b)(6) (b)(6)
- FHFA's public acknowledgement that its decision on use of alternative credit scoring models "would generate industry-wide effects among stakeholders" and "other market participants" for years to come and recognition by FHFA Director Watt "that of all of the challenges that I've faced at FHFA during the period I've been the Director over that, this is clearly the most difficult issue that I have had to deal with…"
- (b)(6) public statements underscoring the significant financial impact from FHFA's decision whether to accept alternative credit scores.

FHFA, in its Management Response, states that it considers "blanket recusals to be essential tools in controlling for conflicts of interest. A recusal should reflect assessments of the significance of relationships, nature of the conflict, and the potential for compromise or the appearance of compromise." Our review of CMS entries and Fannie Mae documents[11] found no

[10] The small modifications in the draft recusal agreement were along the following lines. References to (b)(6) and (b)(6) were changed to "you".

[11] These documents included: the CMS entries relating to (b)(6) conflict of interest disclosure; documents referenced in or linked to these entries; the FM Ethics analysis memorandum of (b)(6); materials sent by FM Ethics to the NGC for its (b)(6) meeting; minutes of the NGC meeting on (b)(6) (b)(6) reflecting the NGC's discussion and resolution of this conflict of interest issue; and the draft recusal agreement, reviewed by (b)(6) on (b)(6)

evidence that (b)(6) disclosed (b)(6) interests in Fannie Mae's assessment of (b)(6) (b)(6) and/or in FHFA's pending decision whether to accept alternative credit scoring models to FM Ethics and/or the NGC. These documents further show that the NGC lacked this critical information relevant to its conflict analysis and recusal remedy, so the blanket recusal could not, and did not, "reflect assessments of the significance of (b)(6) nature of the conflict, and the potential for compromise or the appearance of compromise."

> *The CMS Entry for* (b)(6) *Updated Conflicts Disclosure on* (b)(6) *Does Not Include the Significant Information that* (b)(6) *Knew, or Should Have Known, Regarding* (b)(6) *in Fannie Mae's Assessment, and FHFA's Consideration, of Alternative Credit Scoring Models*

The comment period for FHFA's RFI closed on March 30, 2018. FHFA, in its 2018 Conservatorship Scorecard, directed Fannie Mae to conclude its assessment of updated credit score models and, as appropriate, plan for implementation, as "[i]nformed by request for input feedback." A CMS entry dated (b)(6) reports that (b)(6) contacted (b)(6) (b)(6) to advise that (b)(6) had been offered, and had accepted, a position as (b)(6) That entry contains no further information regarding (b)(6) We found no evidence, in the entries of CMS relating to this second disclosure and linked and supporting documents, that (b)(6) disclosed (b)(6) interests in Fannie Mae's assessment of the impact of alternative credit scoring models and/or in FHFA's pending decision whether to accept alternative credit scoring models.

Fannie Mae emails reflect that (b)(6) again made internal queries to determine whether (b)(6) had a business relationship with Fannie Mae. According to these emails, (b) learned that (b)(6) was not selected as (b)(6) and confirmed that Fannie Mae's database showed no counterparty relationship between Fannie Mae and (b)(6). However, the (b)(6) group reported by email that a business relationship between (b)(6) and Fannie Mae existed as of (b)(6) and was ongoing.

FM Ethics prepared a written update to the NGC, in an (b)(6) memorandum, in which it reported that (b)(6) had accepted the position of (b)(6) (b)(6), and "consistent with Ethics' prior discussions with the Committee (b)(6) recusal from business decisions regarding (b)(6) will continue for the duration of (b)((b)(6) employment to address the potential conflict of interest presented by that employment relationship."

A (b)(6) presentation by FM Ethics to the NGC reported that "Given that Fannie Mae now has an active counterparty relationship with (b)(6) through Fannie Mae's (b)(6) (b)(6) a potential conflict of interest is presented by (b)(6) employment" of (b)(6) so the existing recusal related to (b)(6) "will continue for the

duration of (b)(6) employment with that entity." A "post closing notation" in CMS for this disclosure stated that (b)(6) conflicts matter "was reviewed and approved by the NGC" during its (b)(6) meeting.

Both the FM Ethics July Memorandum and FHFA's Management Response recognize that the review process by FM Ethics was deficient in that it failed to identify Fannie Mae's business relationship with (b)(6) prior to January 2018 and (b)(6) (b)(6) FHFA reports, in its Management Response, that the NCG will be considering the deficiencies in FM Ethics' review process "at the upcoming board meeting". We welcome all efforts to improve the robustness of the internal compliance function at Fannie Mae. This Management Alert, however, focuses on the incomplete disclosures by (b)((b)(6) , about (b)(6) While FHFA, in its Management Response, seeks to downplay the importance of these incomplete disclosures, we hold the view that these incomplete disclosures ran afoul of Fannie Mae's ethics authorities and of (b)(6) to Fannie Mae employees to "always err on the side of transparency" in conflicts disclosures and "proceed in a manner that all concerned would agree is completely beyond reproach."

2. (b)(6) FHFA-OIG Found That (b)(6) Failed to Make Timely and Complete Conflict of Interest Disclosures Relating to (b)((b)(6)

In (b)(6) we issued a Management Alert in which we reported the findings of our administrative investigation into anonymous hotline complaints concerning the timeliness and completeness of disclosures made by (b)(6) regarding (b)(6) (b)(6) During the period covered by that Management Alert, (b)(6) (b)(6) was (b)(6) a company with which Fannie Mae conducts billions of dollars of business. Our investigation identified repeated failures by (b)(6) to timely and fully disclose (b)(6) (b)(6) as a potential conflict of interest to the NGC and to FM Ethics.[12] We found that (b)(failures to disclose were consequential, both because they demonstrated repeated breaches of duty and because they deprived the NGC of the ability to exercise its essential oversight responsibilities to address (b)(6) actual or apparent conflict of interest arising from (b)(6) We made (b)(6 recommendations to address these repeated

[12] (b)(6)
(b)(6)

failures, including a recommendation that the FHFA (b)(6) (b)(6)

In response to our findings, the Board undertook its own review and reported to the FHFA Director that, in its view, (b)(6) disclosure of (b) personal relationship with (b)((b)(6) was permitted by Fannie Mae's codes of conduct and COI Policy. The FHFA Director reported to us that he found both the analysis by FHFA-OIG and the contradictory analysis by the Board to be reasonable. He advised that (b)(6) (b)(6) (b)(6) We closed our recommendations as rejected.

Like (b)(Prior Incomplete Disclosures, (b)(6) Disclosures Were Incomplete and Consequential

It appears to us that (b)(6) did not fully disclose all information relating to a potential conflict to facilitate a fully-informed conflicts analysis and to develop and implement appropriate mitigating controls. As we discussed earlier, the CMS entry relating to (b)(disclosure provided no explanation of the reasons that (b)(6) was considered an "interested party" or the reasons why its interest could give rise to a potential, apparent, or actual conflict of interest. (b)(6) was aware or should have been aware, from (b) review of (b) draft recusal agreement, that (b)(omissions deprived the NGC of significant information relevant to its determination of whether a potential, apparent, or actual conflict of interest existed and the appropriate mitigation.

The terms of (b)(6) current agreement recuse (b)(6) from any business decisions presented to (b)(that are related to (b)(6) for the duration of (b)(6) employment with (b)(6) We recognize that an argument could be made that the recusal is sufficiently broad to include "business decisions" involving (b)(6) because such decisions would be "related" to (b)(6) in light of its (b)(6) (b)(6) That argument, however, would ignore the efforts by (b)(6) to identify whether, and on what basis, (b)(6) was an "interested party" and the responses by Fannie Mae employees that did not flag (b)(6) interest in FHFA's consideration of alternative credit score(s). As a result, one cannot presume that the terms of the existing recusal – recusal of (b)((b)(6) from any business decision presented to (b)(relating to (b)(6) – would prevent (b)(6) from participating in the assessment within Fannie Mae of the potential impact of (b)(6) or in discussions with FHFA about Fannie Mae's assessment, or in participating in discussions with FHFA about implementation of steps required under the Act.

FHFA recognized, after review of our draft Management Alert, that the existing recusal may not have been understood within Fannie Mae to reach (b)(6) participation in this

assessment and discussion. It reports, in its Management Response, that it "conducted a preliminary review to determine the extent, if any, to which (b)(6) has been involved in any business decisions related to (b)(6) since the date of the recusal" and its "preliminary review has not found any involvement by (b)(" It further reports that the NGC, which has now been informed of (b)(6) (b)(6) will consider at the upcoming board meeting "revisions to the recusal."

Conclusion and Recommendation

FHFA has publicly acknowledged that its decision on alternative credit scoring models will have significant effects on the industry. A decision of this magnitude must be subject to a well-controlled process that ensures relevant information is taken into account when deliberating the merits of policy options under consideration. The Enterprises' participants in the process used by FHFA to reach a decision on whether to accept alternative credit scoring models must be free of potential, apparent, or actual conflicts of interest. FHFA has now determined not to proceed with efforts to reach such decision during 2018 and to transfer its full efforts to working with the Enterprises to implement the steps required under the Act.

As (b)(6) is bound by Fannie Mae's ethics authorities. Notwithstanding the commitment by the FHFA Director that (b)(6) (b)(6) based on Fannie Mae's corporate records, it appears that (b)(6) did not provide critical information that (b knew, or should have known, was relevant to (b)(conflicts disclosures. (b)(6) was aware or should have been aware, from (b)(review of (b) recusal agreement, that FM Ethics and the NGC were not privy to this critical information, which was relevant to any conflicts analysis and the scope of the mitigating controls put into place to minimize the franchise risk to Fannie Mae (and FHFA) from the conflict. As a result, one cannot presume that the terms of the existing recusal—recusal of (b)(6) from any business decision presented to (b)(relating to (b)(6) —would prevent (b)(from participating in the assessment within Fannie Mae of the potential impact of (b)(6) (b)(6) , or in discussions with FHFA about Fannie Mae's assessment, or in participating in discussions with FHFA about implementation of steps required under the Act.

For those reasons, we recommend that, prior to the FHFA Director's final decision on alternative credit score models, FHFA:

- Promptly perform a comprehensive review of the conflict of interest implications arising from (b)(6) possible involvement in Fannie Mae's assessment of the potential impact of (b)(6) and possible discussions with FHFA about Fannie Mae's assessment, in light of (b)(6) employment of (b)(6) as (b)(6) , and

- Ensure appropriate controls are in place to mitigate any potential, apparent, or actual conflict of interest.

Appendix A: FHFA's Response to OIG's Alert and Recommendations

Federal Housing Finance Agency

MEMORANDUM

TO: Laura Wertheimer, Inspector General

FROM: Melvin L. Watt, Director

SUBJECT: Response to Draft Management Alert – *Administrative Review of a Potential Conflict of Interest Matter Involving a Senior Executive Officer of an Enterprise*

DATE: July 23, 2018

Thank you for your draft Management Alert (Alert) referenced above (provided on July 16, 2018) and for the recommendations set out on page 15. While the Federal Housing Finance Agency (FHFA) certainly agrees to and will implement both of the recommendations you provided, I want to add the following responses and context.

As the Alert acknowledges, in (b)(6), shortly after (b)(6) timely disclosed that (b)(6) "w[ould] be interviewing with an interested party, (b)(6) for a position as (b)(6)" (b) executed a blanket recusal agreement covering any business decisions related to (b)(6) That recusal stated that it would continue in effect if (b)(6) accepted employment with (b)(6) and that (b)(6) agreed to communicate the recusal to the Management Committee. The recusal remains in effect today. (b)(6) has twice ((b)(6)) communicated the blanket recusal to the Fannie Mae Management Committee. It will "continue for the duration of (b)(6) employment." Further, in response to your draft Management Alert, we have conducted a preliminary review to determine the extent, if any, to which (b)(6) has been involved in any business decisions related to (b)(6) since the date of the recusal. This preliminary review has not found any involvement by (b)(6)

In addition, Fannie Mae Ethics has alerted the Nominating and Corporate Governance Committee (NCG) of the Fannie Mae Board both in (b)(and, (b)(6) of additional details of the (b)(6) relationship with Fannie Mae since the recusal was put in place in (b)(6) The (b)(6 update included business support activities by (b)(6) in

the (b)(6) business. The (b)(update included (b)(6) (b)(6) We recognize that Fannie Mae Ethics' review process was deficient in that it did not previously identify these aspects of the business relationship. The NCG will be considering this matter at the upcoming board meeting, including revisions to the recusal.

In light of several references in the Alert to FHFA's Conservatorship Scorecard project that was expected to lead to a decision by the end of 2018 on the Enterprises' use of updated credit scores, I note that FHFA announced today our decision to suspend the Scorecard project and, instead, turn our full attention to proposing and finalizing a regulation to implement Section 310 of the Economic Growth, Regulatory Relief, and Consumer Protection Act (the Act).

OIG Recommendations:

We recommend that, prior to the FHFA Director's final decision on alternative credit score models, FHFA:

- *Promptly perform a comprehensive review of the conflict of interest implications arising from (b)(6) possible involvement in Fannie Mae's assessment of the potential impact of (b)(6) and possible discussions with FHFA about Fannie Mae's assessment, in light of (b)(6) employment of (b)(6) as (b)(6) and*

- *Ensure appropriate controls are in place to mitigate any potential, apparent, or actual conflict of interest.*

Management Response to Recommendations:

FHFA agrees with both recommendations. FHFA has instructed Fannie Mae to conduct a comprehensive review of the conflict of interest implications of this matter and any appropriate measures needed to enhance the conflicts review process. Further, in order to ensure that appropriate controls are in place to mitigate any potential, apparent, or actual conflict of interest, FHFA has instructed Fannie Mae to follow through with its plan to have the NCG consider the sufficiency of the recusal. In the meantime, to eliminate any ambiguity, we have advised Fannie Mae that FHFA considers (b)(6) current recusal relating to (b)(6) to extend to participation in any matters relating to (b)(6) including Fannie Mae or FHFA deliberations, discussions, or decisions about the alternative credit score assessment. This includes discussions on implementation of Section 310 of the Act.

FHFA considers blanket recusals to be essential tools in controlling for conflicts of interest. A recusal should reflect assessments of the significance of relationships, nature of the conflict, and the potential for compromise or the appearance of compromise. Recusals should be reviewed

and, if necessary, updated as new information is discovered that either increases or decreases risk. FHFA does not believe, however, that every recusal (b)(6) must detail every separate project, proposal, or initiative that arises. Individual judgment, or lack thereof, in applying a recusal must be allowed and individuals held accountable for violations when they occur.

cc: Lawrence Stauffer, Acting Chief Operating Officer

John Major, Internal Controls and Audit Follow-up Manager