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FHFA's Conservatorships of Fannie Mae and Freddie Mac: A Long and Complicated Journey

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Federal Housing Finance Agency
Office of Inspector General



**FHFA's Conservatorships of
Fannie Mae and Freddie Mac:
A Long and Complicated Journey**

White Paper • WPR-2015-002 • March 25, 2015



WPR-2015-002

March 25, 2015

Executive Summary

The Federal Housing Finance Agency (FHFA) placed Fannie Mae and Freddie Mac (collectively, the Enterprises) in conservatorship in 2008. Risky business practices combined with catastrophic losses had depleted the Enterprises' capital and threatened their ability to provide liquidity to the secondary mortgage market. Since 2008, the Enterprises have required \$187.5 billion in financial support from the U.S. Department of the Treasury (Treasury) in order to avert insolvency and receivership.

Over the past six years, FHFA has administered two conservatorships of unprecedented scope and simultaneously served as the regulator for these large, complex companies that dominate the secondary mortgage market and the mortgage securitization sector of the U.S. housing finance industry. Congress granted FHFA sweeping conservatorship authority over the Enterprises. For example, as conservator, FHFA can exercise decision-making authority over the Enterprises' multi-trillion dollar books of business; it can direct the Enterprises to increase the fees they charge to guarantee mortgage-backed securities; it can mandate changes to the Enterprises' credit underwriting and servicing standards for single-family and multifamily mortgage products; and it can set policy governing the disposition of the Enterprises' inventory of approximately 121,000 real estate owned properties. Further, the conservator's actions are not subject to judicial review or intervention.

Given the taxpayers' enormous investment in the Enterprises and the Enterprises' critical role in the secondary housing finance market, FHFA Office of Inspector General (OIG) views its oversight of FHFA's administration of the conservatorships as crucial to determining whether FHFA is fulfilling its statutory duties and responsibilities and safeguarding taxpayers. OIG's reports and evaluations provide enhanced transparency and an objective assessment of FHFA's conservatorship activities.

This is the second white paper that OIG has issued on the conservatorships. The first white paper, published in March 2012 (2012 White Paper), set forth the history of the Enterprises leading up to the creation of the conservatorships in 2008 and described conservatorship operations during their first three years. From 2008 to March 2012, the Enterprises suffered significant losses. During that phase of the conservatorships, the objective of FHFA, under former Acting Director DeMarco, was to stabilize the operations of the Enterprises and ensure that the secondary mortgage market continued to function for the benefit of the country's housing market and financial system. For the conservatorship period covered by the 2012 White Paper, OIG found that FHFA had delegated day-to-day decision-making to the Enterprises, but retained authority to decide matters involving certain types of significant activities.



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Since that white paper was issued, the Enterprises' conditions stabilized and market conditions improved. The Enterprises returned to profitability in 2012 and have paid Treasury more than \$228 billion in dividends on its \$187.5 billion investment. Under Acting Director DeMarco, FHFA established three goals for the Enterprises:

- Build a new infrastructure for the secondary mortgage market;
- Gradually contract the Enterprises' dominant presence in the marketplace while simplifying and shrinking their operations; and
- Maintain foreclosure prevention activities and credit availability for new and refinanced mortgages.

Acting FHFA Director DeMarco sought to reorganize, rehabilitate, and wind up the affairs of the Enterprises to prepare for fundamental housing reform legislation. Like Acting Director DeMarco, Director Watt has repeatedly asserted that conservatorship "cannot and should not be a permanent state" for the Enterprises. Director Watt has indicated that under his stewardship FHFA will continue the conservatorships and build a bridge to a new housing finance system, whenever that system is put into place by Congress. In this phase of the conservatorships, FHFA seeks to place more decision-making in the hands of the Enterprises. This white paper first summarizes FHFA's evolving management of the conservatorships. Next, it summarizes findings of prior OIG reports that reviewed conservatorship decisions and practices. Last, it outlines OIG's planned work in the coming year to assess the conservator's governance practices, internal controls, decision-making process, and follow-up/compliance activities.

This report was led by Alexa Strear, Investigative Counsel, with assistance from Ezra Bronstein, Investigative Counsel, Brian Stief, Investigative Counsel, Shereefat Balogun, Investigative Counsel, and Brian Harris, Investigative 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 OIG's website, www.fhfaoig.gov.

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ABBREVIATIONS

CSP	Common Securitization Platform
DOC	Division of Conservatorship
Enterprises	Fannie Mae and Freddie Mac, collectively
Fannie Mae	Federal National Mortgage Association
FDIC	Federal Deposit Insurance Corporation
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
MSR	Mortgage Servicing Right
OCO	Office of Conservatorship Operations
OIG	Federal Housing Finance Agency Office of Inspector General
PSPAs	Senior Preferred Stock Purchase Agreements
Treasury	U.S. Department of the Treasury

HISTORY OF THE CONSERVATORSHIPS

Unprecedented Length of the Conservatorships

FHFA’s conservatorship powers substantially parallel those granted to the Federal Deposit Insurance Corporation (FDIC) by the Federal Deposit Insurance Act.¹ Essentially, those powers enable the conservator to maintain a troubled institution as an ongoing concern and protect its assets until either the institution (1) stabilizes or (2) is closed and a receiver appointed. As OIG explained in the 2012 White Paper, however, a comparison between FHFA’s conservatorships of the Enterprises and the FDIC’s conservatorships of depository institutions is not useful because of the significant differences in the nature and scope of the entities subject to conservatorships, the different sources of funding, and the duration of the conservatorships.²

As described by FHFA Director Watt, FHFA’s current strategy is to keep the Enterprises in conservatorship until Congress passes housing reform legislation. Absent congressional action or a change in FHFA’s strategy, the conservatorships will continue.

FHFA’s Extensive Powers and Discretion as Conservator

Congress vested FHFA with sweeping powers as conservator.³ These powers position FHFA to potentially control every aspect of the Enterprises. Director Watt recently testified that FHFA is involved in “virtually every decision” that Fannie Mae and Freddie Mac make.⁴ As conservator, FHFA possesses all rights and powers of any stockholder, officer, or director of

¹ See Congressional Research Service, *Financial Institution Insolvency: Federal Authority over Fannie Mae, Freddie Mac, and Depository Institutions*, at 1, 6 (Sept. 10, 2008).

² 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.fhfaig.gov/Content/Files/WPR-2012-001.pdf) [hereinafter *2012 White Paper*].

³ The Housing and Economic Recovery Act of 2008 (HERA), Pub. L. No. 110-289, created FHFA and provides FHFA with its conservatorship powers. OIG published a white paper in 2012 that provides additional detail on the conservatorships and powers provided by HERA. See OIG, *2012 White Paper*, *supra* note 2, at 18-19. HERA extensively amended the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, Pub. L. No. 102-550, 12 U.S.C. § 4501 et seq.

⁴ See House Committee on Financial Services, Testimony of FHFA Director Melvin L. Watt, *Hearing on Sustainable Housing Finance: An Update from the Director of the Federal Housing Finance Agency*, 114th Cong. (Jan. 27, 2015). However, as discussed *infra* pp. 15-16, OIG has published a number of reports that question FHFA’s oversight as conservator. In future work, OIG plans to review FHFA’s level of involvement in the conservatorships.

the Enterprises.⁵ FHFA may operate the Enterprises and conduct all of the Enterprises' business activities.⁶ FHFA also may take actions necessary to put the Enterprises in a sound and solvent condition, and FHFA may take such action as may be appropriate to carry on the Enterprises' business and preserve and conserve the Enterprises' assets and property.⁷ Congress also granted FHFA incidental powers necessary to carry out the conservator's express powers.⁸

In addition to these expansive powers, Congress provided FHFA with protections against interference in the exercise of its powers. Generally, HERA prohibits courts from taking any action to restrain or affect FHFA's exercise of its powers as conservator or from reviewing FHFA's actions as conservator.⁹ HERA prohibits any other Federal agency or any state from directing or supervising FHFA in the exercise of its conservator powers.¹⁰

At this time, the only meaningful constraint on the conservator's exercise of statutory authority is contained in the terms of the Senior Preferred Stock Purchase Agreements, as amended (PSPAs), which the conservator executed (on behalf of the Enterprises) with Treasury when FHFA placed the Enterprises in conservatorship.¹¹ Under the terms of the PSPAs, Treasury committed to provide support to the Enterprises as necessary, up to a specific cap.¹² As of December 31, 2014, Treasury has invested \$187.5 billion in the Enterprises.¹³ Under the PSPAs, FHFA agreed, as conservator, not to terminate the

⁵ 12 U.S.C. § 4617(b)(2)(A)(i).

⁶ 12 U.S.C. § 4617(b)(2)(B)(i).

⁷ 12 U.S.C. § 4617(b)(2)(D)(i)-(ii).

⁸ 12 U.S.C. § 4617(b)(2)(J)(i)-(ii).

⁹ 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."). 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.").

¹⁰ 12 U.S.C. § 4617(a)(7).

¹¹ The PSPAs were subsequently amended and restated on September 26, 2008, and have been amended three additional times: on May 6, 2009, December 24, 2009, and August 17, 2012.

¹² As of the date of this white paper, the maximum amount of remaining funding under the PSPAs is \$117.6 billion and \$140.5 billion for Fannie Mae and Freddie Mac, respectively.

¹³ See FHFA, *Treasury and Federal Reserve Purchase Programs for GSE and Mortgage-Related Securities, Data as of December 31, 2014*, at 2 (Dec. 31, 2014) (online at www.fhfa.gov/DataTools/Downloads/Documents/Market-Data/TsyFedPP_Dec31_2014R.pdf). Treasury holds senior preferred stock with a liquidation preference of \$189.5 billion for the two Enterprises combined. Upon initiation of the PSPAs, Treasury received senior preferred stock from each Enterprise with a combined

conservatorships without Treasury’s prior written approval.¹⁴ FHFA further agreed to direct the Enterprises to:

- Reduce the size of their retained investment portfolios, which historically had been the Enterprises’ most significant source of earnings, to \$250 billion by December 31, 2018; and
- Pay to Treasury each quarter a dividend equal to the excess of their net worth over an applicable capital reserve amount.¹⁵

FHFA’S CONSERVATORSHIPS IN PRACTICE

As a long-term conservator, FHFA is in a very unusual and challenging position.¹⁶ The Enterprises are in conservatorships of unknown duration and, as necessary, rely on Treasury for financial support.¹⁷ Although the Enterprises have been profitable since 2012, their ability to sustain profitability in the future is not knowable for a number of reasons: the winding down of their investment portfolios and loss of interest income; the level of guarantee fees

liquidation preference of \$2 billion. The liquidation preference has increased to \$189.5 billion as a result of \$187.5 billion in Enterprise draws.

¹⁴ The PSPAs also prohibit the Enterprises, without the consent of Treasury, from making any changes to their capital structures, issuing capital stock, increasing their debt significantly, paying any dividends (other than those to Treasury), engaging in certain transactions with affiliates, or disposing of any assets unless they are for “fair market value” in “the ordinary course of business.”

¹⁵ The applicable capital reserve amount will be reduced by \$600 million each calendar year until it reaches zero on January 1, 2018.

¹⁶ According to FHFA Director Watt, the “significant challenges” involved in managing the conservatorships include: serious delinquencies that have declined but remain historically high compared to pre-crisis levels; counterparty exposures; and shrinking revenues from the Enterprises’ mortgage-related investment portfolios. See Senate Committee on Banking, Housing, and Urban Affairs, *Hearing on the Federal Housing Finance Agency: Balancing Stability, Growth, and Affordability in the Mortgage Market*, Statement of FHFA Director Melvin L. Watt, at 3-4 (Nov. 19, 2014) (online at www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=5dc60283-09ab-437f-8484-b209c4df46a7).

¹⁷ In consideration of the PSPAs, FHFA has taken the position that “it is prudent and in the best interests of the market to suspend capital classifications of Fannie Mae and Freddie Mac during the conservatorship. FHFA will continue to closely monitor capital levels, but the existing statutory and FHFA-directed regulatory capital requirements will not be binding during the conservatorship.” FHFA, *Capital Requirements* (online at www.fhfa.gov/SupervisionRegulation/FannieMaeandFreddieMac/Pages/Capital-Requirements.aspx) (accessed Feb. 9, 2015). See also FHFA, *FHFA Announces Suspension of Capital Classifications During Conservatorship* (Oct. 9, 2008) (online at www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-Suspension-of-Capital-Classifications-During-Conservatorship-and-Discloses-Minimum-and-RiskBased-Cap.aspx).

they will be able to charge; the future performance of their business segments; the elimination of a capital cushion to buffer against losses; and the significant uncertainties involving key market drivers, such as mortgage rates, homes prices, credit standards, and short and long-term interest rates.¹⁸ In the face of these challenges, FHFA must ensure that the Enterprises continue to fulfill their statutory mission to provide liquidity and stability to the housing finance market.

FHFA administers the conservatorships through: a combination of communications with the Enterprises' respective boards of directors and management, a multi-year strategic plan for the conservatorships that defines general goals and initiatives, annual conservatorship scorecards that focus the Enterprises on short-term objectives to further the conservator's strategic goals, and governance practices and organizational infrastructure that support these activities. According to FHFA, the Director meets regularly with the Enterprises' respective CEOs to discuss business activities and emerging issues, and meets with the boards of directors to review the state of the conservatorships and key business matters. FHFA staff also attend board meetings, weekly management committee meetings, and meet at least weekly with senior Enterprise staff.¹⁹ The following sections provide pertinent details on FHFA's conservatorship-related practices.

Strategic Plan for the Conservatorships: Setting the Conservator's Strategic Goals and Priorities

The conservator has the authority to establish the Enterprises' strategic goals, major business initiatives, priorities, and general performance measures. Not surprisingly, the strategic goals and priorities set by FHFA have evolved over time, in response to changing market conditions and the different priorities of each incumbent FHFA Director. Beginning in 2012, FHFA has developed and published two formal strategic plans that establish strategic goals for the Enterprises.²⁰

¹⁸ OIG recently issued a white paper that discusses the challenges to the Enterprises' continued profitability in the future.

¹⁹ See FHFA Response – OIG Audit 2011-018, *FHFA's Conservator Approval Process for Fannie Mae and Freddie Mac Business Decisions*, at 32 (Sept. 27, 2012) (AUD-2012-008) (online at www.fhfaog.gov/Content/Files/AUD-2012-008_2.pdf).

²⁰ In 2010, the Acting FHFA Director submitted a letter to Congress that described conservatorship operations and how FHFA would accomplish conservatorship goals. See Letter from Edward DeMarco, Acting Director, FHFA, to Congress (Feb. 2, 2010) (online at www.fhfa.gov/Media/PublicAffairs/Documents/Letter_to_Dodd_Frank_Shelby_Bachus-02-02-2010_n508.pdf).

In February 2012, FHFA issued a strategic plan for the conservatorships and presented that plan to Congress (2012 Strategic Plan).²¹ The 2012 Strategic Plan introduced a “Build/Contract/Maintain” theme for the conservatorships and identified three strategic goals: (1) build a new infrastructure for the secondary mortgage market; (2) contract the Enterprises’ dominant presence in the marketplace while simplifying and shrinking their operations; and (3) maintain foreclosure prevention activities and credit availability for new and refinanced mortgages.²² The “build” goal of the 2012 Strategic Plan gave rise to the Common Securitization Platform (CSP). FHFA envisioned the CSP as a means to replace some parts of the Enterprises’ back office systems and to create an infrastructure for mortgage securitization that could be used to develop a future mortgage market without the Enterprises.²³ The “contract” goal led to increased guarantee fees, risk-sharing arrangements, and reductions in the multifamily businesses. The “maintain” goal continued loss mitigation efforts, including improvements to the Home Affordable Refinance Program and exploring foreclosure alternatives, such as short sales and deeds in lieu of foreclosure.

Two years later, FHFA issued a revised strategic plan (2014 Strategic Plan) that reformulated the strategic goals of the 2012 Plan.²⁴ The 2014 Strategic Plan adopts a “Maintain/Reduce/Build” theme that is similar to the 2012 Strategic Plan; however, it shifts away from the emphasis on contracting the Enterprises’ dominant presence in the marketplace and places greater importance on maintaining accessibility to mortgage credit. The “maintain” goal of the 2014 Strategic Plan emphasizes, among other things, increasing access to mortgage credit for underserved, creditworthy borrowers and working with small lenders, rural lenders, and housing finance agencies at the state level. As part of the “maintain” goal, the Enterprises revised their underwriting guidelines to permit mortgages with 97 percent loan-to-value for certain borrowers.²⁵ The “reduce” goal focuses on expanding the number of credit risk-sharing transactions in the single-family guarantee business and continuing multifamily transfers to share credit risk with private investors. The “build” goal shifts the

²¹ See FHFA, *A Strategic Plan for Enterprise Conservatorships: The Next Chapter in a Story that Needs an Ending* (Feb. 21, 2012) (online at www.fhfa.gov/Media/PublicAffairs/PublicAffairsDocuments/2012letterStrategicPlanConservatorshipsFINAL.pdf).

²² See *id.* at 1-2.

²³ See *id.* at 2-3, 13-14.

²⁴ See 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).

²⁵ The details of these guidelines were released in December 2014. See FHFA, *Statement of FHFA Director Melvin L. Watt on Release of Guidelines for Purchase of Low Down Payment Mortgages* (Dec. 8, 2014) (online at www.fhfa.gov/Media/PublicAffairs/Pages/Statement-of-FHFA-Director-Melvin-L-Watt-on-Release-of-Guidelines-for-Purchase-of-Low-Down-Payment-Mortgages.aspx).

focus of the CSP to the Enterprises' existing securitization operations, rather than on the needs of future market participants.

Annual Scorecards: Setting Expectations for Short-Term Enterprise Performance and Achievement of Strategic Goals

FHFA issues annual conservatorship scorecards to set specific expectations for each strategic plan goal, which enable FHFA and the Enterprises to track progress toward achieving the goals.²⁶ Each annual scorecard maps to the strategic plan in place at the time the scorecard is issued and describes the activities that further each strategic goal. For example, the 2015 Scorecard maps to the 2014 Strategic Plan and identifies 15 activities under the “maintain” goal, such as enhancing servicer eligibility standards for Enterprise counterparties and assessing the feasibility of alternate credit score models.

The annual scorecard assigns a weight to each strategic goal and thereby establishes the importance of each goal relative to the other goals. As with the strategic plan, the weightings reflect the views and priorities of the incumbent FHFA Director. For example, the 2015 Scorecard assigns a 40 percent weight to the “maintain” goal, which includes increased access to mortgage credit,²⁷ whereas the 2013 Scorecard (issued under the 2012 Strategic Plan) assigned a much lower weight, 20 percent, to the same goal.²⁸

Conservatorship Governance and Operations

As conservator, FHFA is vested with express authority to operate the Enterprises. However, for reasons of efficiency, concordant goals with the Enterprises, and operational savings,²⁹ FHFA has determined to (1) delegate authority for general corporate governance and day-to-day matters to the Enterprises' boards of directors and executive management, and (2) retain

²⁶ A portion of annual compensation for certain senior executives of each Enterprise is tied to the Enterprise's performance against the scorecard.

²⁷ The 2014 Scorecard was the first to reflect the change in the conservator's goals and priorities outlined in the 2014 Strategic Plan. Although underlying activities of the 2014 and 2015 Scorecards changed, the weightings for each strategic goal remained the same. See FHFA, *2014 Scorecard for Fannie Mae, Freddie Mac and Common Securitization Solutions* (May 13, 2014) (online at www.fhfa.gov/AboutUs/Reports/ReportDocuments/2014Scorecard051314FINAL.pdf); FHFA, *2015 Scorecard for Fannie Mae, Freddie Mac and Common Securitization Solutions* (Jan. 14, 2015) (online at www.fhfa.gov/AboutUs/Reports/ReportDocuments/2015-Scorecard.pdf).

²⁸ See FHFA, *Conservatorship Strategic Plan: Performance Goals for 2013* (Mar. 4, 2013) (online at www.fhfa.gov/Media/PublicAffairs/PublicAffairsDocuments/2013EnterpriseScorecard3413_N508.pdf).

²⁹ See OIG, *2012 White Paper*, *supra* note 2, at 23.

authority for certain significant decisions.³⁰ In practice, these are not bright lines; the conservator can intervene in any issue or matter at the Director's discretion. The Director is supported on conservatorship matters by FHFA's Division of Conservatorship (DOC). Generally, DOC manages conservatorship operations; coordinates with the Enterprises on FHFA's strategic goals, conservatorship scorecards, and performance assessments; and takes the lead on matters involving undelegated authorities that require the conservator's approval or that require Treasury approval under the PSPAs.

Delegated and Undelegated Authorities: Letters of Instruction

Delegations of authority from the conservator to the Enterprises' boards of directors and executive management are a defining feature of the conservatorships. However, FHFA emphasizes that it relies on frequent engagement with the Enterprises to consult, formally or informally, on a wide range of business activities whether delegated or not.³¹ FHFA has issued "letters of instruction" (LOIs) to the Enterprises' respective boards of directors that define and outline the scope of delegated and undelegated authorities. FHFA issued the current version of the LOIs in 2012.³² FHFA views the LOIs as necessary guideposts, but has cautioned that the Letters could not be written in a manner that covers all possible issues involving the Enterprises. The LOIs should be viewed as one means of communication, supplemented by engagement with Enterprise officials. That said, the LOIs require the Enterprises to consult with, and obtain approval from, the conservator on critical matters. Examples of these matters include:

- Actions involving the PSPAs;
- Executive compensation;
- Legal settlements over \$50 million;

³⁰ For general background on FHFA's delegations of authority to the Enterprises, see OIG, *FHFA's Conservator Approval Process for Fannie Mae and Freddie Mac Business Decisions*, at 5-6 (Sept. 27, 2012) (AUD-2012-008) (online at www.fhfa.gov/Content/Files/AUD-2012-008_2.pdf).

³¹ See FHFA Response – OIG Audit 2012-018, *FHFA's Conservator Approval Process for Fannie Mae and Freddie Mac Business Decisions*, at 31-32 (Sept. 27, 2012) (AUD-2012-008) (online at www.fhfa.gov/Content/Files/AUD-2012-008_2.pdf).

³² FHFA issued Order No. 2008-006 in November 2008 to the Enterprises' boards of directors, which delegated general corporate governance responsibilities to the newly constituted boards. The first LOIs were issued in 2008 in conjunction with the Order and revised in November 2012; the revisions expanded the matters for which the Enterprises are required to obtain the conservator's approval. OIG's *2012 White Paper* did not address the revised LOIs because FHFA's revisions occurred after publication. FHFA has advised OIG that it is again in the process of reviewing the LOIs and expects to make a number of modifications to the LOIs in 2015.

- Annual operating budgets;
- Material changes to contractual agreements with the top five single-family sellers and servicers; and
- Enterprise actions likely to cause significant reputational risk or result in substantial negative publicity.

The LOIs also require the Enterprises to promptly notify the conservator of significant changes to the Enterprises’ single-family and multifamily policies and loss mitigation strategies. FHFA reserves the right to manage any aspect of the Enterprises it deems necessary, including directing them to undertake conservator-led strategic initiatives (e.g., the CSP or the Servicing Alignment Initiative). FHFA also reserves the right to modify the LOIs at any time. For example, although the LOIs did not specifically require it, FHFA directed the Enterprises to submit certain transactions involving mortgage servicing right (MSR) sales and transfers to the conservator for approval prior to proceeding. FHFA also issues guidance related to the LOIs. For example, FHFA provided guidance to the Enterprises regarding business-related expenses and standards for communicating with external audiences. Further, the conservator requires the Enterprises to submit regular reports on significant business activities, such as quarterly business-related expense reports.

FHFA tracks actions that fall under the auspices of the conservatorships.³³ In 2014, for example, FHFA completed over 750 conservatorship actions. These actions include conservator directives to the Enterprises to undertake actions related to strategic goals and scorecard objectives, conservator approvals and denials of non-delegated activities, conservator acknowledgements of Enterprise reports submitted in accordance with conservator requirements, and conservator responses to policy changes proposed by the Enterprises.

Governance Practices

OIG described FHFA’s general conservatorship governance practices and the conservator approval process for Enterprise business decisions in its 2012 White Paper.³⁴ Although FHFA has made changes to its organizational structure since that time, its internal governance practices have not substantially changed. For example, the FHFA Director meets weekly with FHFA executives to discuss key issues. He also chairs a committee that focuses on conservatorship issues, which affords FHFA executives the opportunity to review and discuss

³³ For purposes of this white paper, the term “actions” refers to finalized decisions on matters in which the conservator is involved.

³⁴ See OIG, 2012 White Paper, *supra* note 2, at 20-24.

conservatorship-related matters. Additionally, a division of FHFA employees coordinates with the Enterprises to achieve strategic goals and provides support for conservatorship operations. The following discussion highlights noteworthy changes in FHFA's conservatorship governance that have occurred since 2012.

DOC replaced the Office of Conservatorship Operations (OCO) in 2013 as the lead group responsible for maintaining the governance structure and processes necessary to manage the conservatorships.³⁵ According to FHFA, DOC "facilitates communications between the Enterprises and the conservator to ensure the prompt identification of emerging issues and their timely resolution. The division also works with the Enterprises' boards and senior management to establish priorities and milestones for accomplishing the goals of the conservatorship."³⁶ DOC has 25 authorized positions (seven are vacant at this time), whereas OCO had six employees at the time OIG issued the 2012 White Paper.

The Conservatorship Committee replaced the Conservatorship Governance Committee described in OIG's 2012 reports; however, the Conservatorship Committee serves the same basic purpose: to provide an executive level review of issues related to FHFA's role as conservator.³⁷ The Committee is chaired by the FHFA Director, and its members are senior FHFA executives, such as the Director's Special Advisors; the FHFA General Counsel; and the Deputy Directors of DOC, the Division of Housing and Mission Goals, and the Division of Enterprise Regulation. The Conservatorship Committee provides a forum to discuss conservatorship-related issues and to provide advice to the Director on pending Enterprise requests. Notably, the Director has not delegated his decision-making authority to the Committee on matters that require conservator approval.

³⁵ FHFA created the Division of Conservatorship in late 2013, subsequent to the issuance of the *2012 White Paper* on the conservatorships. DOC succeeded OCO, which was established early in the conservatorships to coordinate and facilitate communications and decision-making for delegated and non-delegated matters. DOC's mandate is slightly broader in scope than OCO's former mandate; in addition to facilitating communication between the Enterprises and conservator, DOC oversees the implementation of FHFA's strategic plans for Enterprises' conservatorships.

³⁶ FHFA, *Leadership & Organization: Division of Conservatorship* (online at www.fhfa.gov/AboutUs/Pages/Leadership-Organization.aspx) (accessed on Jan. 22, 2015).

³⁷ The Conservatorship Committee replaced the Conservatorship Governance Committee in July 2014. According to FHFA, there are not substantive differences between the two committees. For information on the Conservatorship Governance Committee, see *FHFA's Conservator Approval Process for Fannie Mae and Freddie Mac Business Decisions*, at 10-11 (Sept. 27, 2012) (AUD-2012-008) (online at www.fhfa.org/Content/Files/AUD-2012-008_2.pdf); see also OIG, *2012 White Paper*, *supra* note 2, at 21.

OIG'S PAST OBSERVATIONS ON THE CONSERVATORSHIPS.....

OIG has published a number of reports that evaluated certain actions taken by FHFA acting as conservator. Prior OIG reports have flagged shortcomings in FHFA's governance practices as conservator for the Enterprises. These reports highlighted the following:

- FHFA lacked written criteria and procedures for submitting and reviewing the Enterprises' annual performance measures and year-end performance assessment data in connection with its oversight of Fannie Mae's and Freddie Mac's executive compensation programs.³⁸
- FHFA lacked a formal review process for compensatory fee settlements and significant MSR transfers.³⁹

Additionally, OIG has reviewed a number of actions taken by the Enterprises in response to direction from the conservator and found that FHFA lacked the tools to measure the effectiveness of such actions. These reports highlighted the following:

- FHFA lacked credible performance measures, specifically project schedules, timelines, and cost estimates, to track the progress of the development of the CSP.⁴⁰
- FHFA failed to develop fixed definitions or methods to measure whether guarantee fee increases would actually encourage private sector investment.⁴¹

OIG reports have also shown that FHFA, as conservator, at times has failed to independently test the Enterprises' decision-making and operations, and at times has failed to ensure the effective implementation of its directives. These reports highlighted the following:

³⁸ See OIG, *Evaluation of Federal Housing Finance Agency's Oversight of Fannie Mae's and Freddie Mac's Executive Compensation Programs*, at 22 (Mar. 31, 2011) (EVL-2011-002) (online at www.fhfa.gov/Content/Files/ExecCompDrRpt03302011finalsigned.pdf).

³⁹ See OIG, *FHFA's Oversight of Fannie Mae's 2013 Settlement with Bank of America*, at 16-17 (Aug. 22, 2013) (EVL-2013-009) (online at www.fhfa.gov/Content/Files/EVL-2013-009.pdf).

⁴⁰ See OIG, *Status of the Development of the Common Securitization Platform*, at 26-29 (May 21, 2014) (EVL-2014-008) (online at www.fhfa.gov/Content/Files/EVL-2014-008.pdf).

⁴¹ See OIG, *FHFA's Initiative to Reduce the Enterprises' Dominant Position in the Housing Finance System by Raising Gradually Their Guarantee Fees*, at 34 (July 16, 2013) (EVL-2013-005) (online at www.fhfa.gov/Content/Files/EVL-2013-005_4.pdf).

- The Enterprises suffered an estimated \$158 million in financial harm as a result of reimbursing their servicers for excessively priced lender-placed insurance coverage.⁴²
- Fannie Mae and Freddie Mac erroneously reimbursed servicers in the amount of \$89 million and \$70 million, respectively.⁴³
- FHFA did not sufficiently verify implementation of the Servicing Alignment Initiative or evaluate its effectiveness.⁴⁴
- Each Enterprise had different understandings of delegated and non-delegated authorities under the 2008 LOIs, which led to inconsistent decision-making.⁴⁵

OIG recently established the Office of Compliance and Special Projects to monitor FHFA’s efforts to implement controls responsive to recommendations in OIG reports because effective implementation is critical to the success of the recommended improvements. OIG will issue reports from the Office of Compliance and include these reports in its semiannual reports to Congress.

OIG’S INTENDED OVERSIGHT OF FHFA’S CONSERVATORSHIP ACTIVITIES

FHFA’s actions as conservator are not subject to judicial review or intervention; therefore strong, independent OIG oversight of FHFA conservatorship actions and processes is critical to safeguard taxpayer dollars and ensure that FHFA is fulfilling its statutory duties. OIG’s future work regarding the conservatorships will include:

- Identification of trends in conservator decisions and requests for conservator action;

⁴² See OIG, *FHFA’s Oversight of the Enterprises’ Lender-Placed Insurance Costs*, at 17 (June 25, 2014) (EVL-2014-009) (online at www.fhfaoig.gov/Content/Files/EVL-2014-009.pdf).

⁴³ See OIG, *Freddie Mac Could Further Reduce Reimbursement Errors by Reviewing More Servicer Claims*, at 15 (Aug. 27, 2014) (EVL-2014-011) (online at www.fhfaoig.gov/Content/Files/EVL_2014_011.pdf); OIG, *Evaluation of Fannie Mae’s Servicer Reimbursement Operations for Delinquency Expenses*, at 20-21 (Sept. 18, 2013) (EVL-2013-012) (online at www.fhfaoig.gov/Content/Files/EVL-2013-012.pdf).

⁴⁴ See OIG, *FHFA’s Oversight of the Servicing Alignment Initiative*, at 14 (Feb. 12, 2014) (EVL-2014-003) (online at www.fhfaoig.gov/Content/Files/EVL-2014-003.pdf).

⁴⁵ See OIG, *FHFA’s Conservator Approval Process for Fannie Mae and Freddie Mac Business Decisions*, at 14-15 (Sept. 27, 2012) (AUD-2012-008) (online at www.fhfaoig.gov/Content/Files/AUD-2012-008_2.pdf).

- Assessment of the efficiency and effectiveness of FHFA’s governance of conservator decisions and the monitoring of compliance with those decisions; and
- Evaluation of the efficiency and effectiveness of FHFA’s process for identifying, developing, and implementing conservator-sponsored initiatives, and for monitoring the success of those initiatives.

Beyond these areas of concentration, OIG will take a risk-based approach when identifying additional conservatorship activities to examine.

CONCLUSION.....

While there appears to be consensus that government-run conservatorships of the Enterprises are not sustainable in the long-term, there is little consensus in Congress about what the nation’s mortgage finance system should look like and what role, if any, the Enterprises should play in it. Until some resolution is achieved, the Enterprises will continue to operate under FHFA’s conservatorship, which according to FHFA Director Watt, continue to pose “significant challenges,” including serious delinquencies that have declined but remain historically high compared to pre-crisis levels; counterparty exposures; and shrinking revenues from the Enterprises’ mortgage-related investment portfolios.⁴⁶ The importance of OIG’s close oversight of FHFA’s conservatorship of the Enterprises, through independent fact finding, objective analysis, and reporting, is underscored by the sheer size of the \$187.5 billion taxpayer bailout of the Enterprises and their uncertain future.

⁴⁶ See Senate Committee on Banking, Housing, and Urban Affairs, *Hearing on the Federal Housing Finance Agency: Balancing Stability, Growth, and Affordability in the Mortgage Market*, Statement of FHFA Director Melvin L. Watt, at 3-4 (Nov. 19, 2014) (online at www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=5dc60283-09ab-437f-8484-b209c4df46a7).

OBJECTIVE, SCOPE, AND METHODOLOGY

The objectives of this white paper were to:

- Update stakeholders on the current state of FHFA’s conservatorships;
- Document any changes in FHFA’s conservatorship governance since we published the 2012 White Paper;
- Summarize findings of prior OIG reports that examined conservatorship decisions and practices; and
- Outline areas of interest for future OIG work pertaining to the conservatorships.

To address this report’s objectives, we interviewed key personnel at FHFA, including the Deputy Director of DOC. We also reviewed publicly available data from the Enterprises’ filings with the Securities and Exchange Commission, FHFA’s annual reports to Congress, and our previously published OIG reports. Additionally, we reviewed non-public information provided by FHFA and the Enterprises. The data used in this report covered the period from 2008 through the end of 2014, when available. We did not independently test the reliability of FHFA’s or the Enterprises’ data.

The preparation of this white paper was conducted under the authority of the Inspector General Act of 1978, and in accordance with *The Quality Control Standards for Inspection and Evaluation* (January 2012), which was issued by the Council of the Inspectors General on Integrity and Efficiency. These standards require OIG to plan and perform evaluations to obtain evidence sufficient to provide a reasonable basis for its findings and recommendations. We believe that this white paper meets these standards. The performance period for this white paper report was from November 2014 to February 2015.

We provided FHFA with the opportunity to respond to a draft of this white paper. We appreciate the efforts of FHFA, the Enterprises, and their staff in providing information and access to necessary documents to accomplish this study.

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