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Report to the Chairman, Senate
Committee on Banking, Housing, and
Urban Affairs, and the Chairman, House
Committee on Banking and Financial
Services

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GOVERNMENT- SPONSORED ENTERPRISES

Development of the Federal Housing Enterprise Financial Regulator





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The Federal Housing Enterprises Financial Safety and Soundness Act of 1992¹ established the Office of Federal Housing Enterprise Oversight (OFHEO) within the Department of Housing and Urban Development (HUD) as the independent financial regulator of the nation's two largest government-sponsored enterprises²—the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). OFHEO's mission is to ensure the safety and soundness of Fannie Mae and Freddie Mac (the enterprises), the major participants in the secondary mortgage market. For reasons relating to the federal charter and structure of the enterprises, investors and rating agencies perceive the enterprises' securities as implicitly guaranteed by the federal government, despite there being no statutory obligation. In December 1994, the enterprises held combined assets and mortgage-backed securities of more than \$1.3 trillion.

The act requires us to audit the operations of OFHEO annually during the first 2 fiscal years following the date of enactment and as appropriate after that. Because the act's requirement is broad, the objective of this initial report was to review the status of OFHEO's development, focusing on the progress made in designing and instituting key management systems.

¹Pub. L. 102-550, Title XIII, 12 U.S.C. 4501 *et. seq.* (Supp. IV 1992).

²As used in this report, government-sponsored enterprises (GSE) are federally chartered, privately owned corporations designed to provide a continuing source of credit nationwide to specific economic sectors. In addition to Fannie Mae and Freddie Mac, the Federal Home Loan Banks also promote housing lending, while other GSEs promote lending for agricultural purposes (e.g., the Farm Credit Banks) or higher education (e.g., the Student Loan Marketing Association, or "Sallie Mae.")

These include OFHEO's administrative infrastructure systems—the human resources and accounting and financial management systems—and the major mission-related systems—examinations and capital adequacy. The report also provides an overview of OFHEO's compliance with other operational and reporting requirements.

Results in Brief

OFHEO has made considerable progress toward setting up its key management systems since its first Director was sworn in on June 1, 1993. As of the end of February 1995, much of OFHEO's administrative structure was in place. OFHEO had hired 53 of its 65 authorized staff and was preparing for the initial implementation of its human resource management system. Additionally, OFHEO defined its financial and accounting system requirements and worked with HUD to meet its immediate accounting and administrative needs. However, OFHEO had not yet determined whether to continue using HUD systems, create and maintain its own, or contract those functions out to another federal agency.

OFHEO has also initiated its major mission-related programs—examining the enterprises and assessing their capital adequacy. During 1994, OFHEO established the fundamentals of its examination function, adopting an overall examination framework and setting out a 2-year workplan. OFHEO completed its first on-site examinations of the enterprises and initiated other supervisory monitoring activities. In addition, OFHEO completed the design, purchase, and installation of the computer hardware and software to support its financial modeling and research. This will allow OFHEO to determine how much capital the enterprises are required to hold to withstand a 10-year period of economic stress (the risk-based capital stress test). However, OFHEO did not complete the final regulations establishing the enterprises' risk-based capital test, which the act had called for to be in place by December 1, 1994. OFHEO has adopted intermediate milestones and now expects to publish final regulations in 1996.

Otherwise, OFHEO has generally met its legislated reporting requirements. Perhaps most importantly, it made the required quarterly reports of the enterprises' capital classifications. Applying definitions specified in the act, OFHEO classified the enterprises as adequately capitalized for the second, third, and fourth quarters of 1993 and for the first three quarters of 1994.

Background

Responding to the massive and expensive failure of federally insured savings and loans in the mid-1980s, Congress and the administration examined government-sponsored enterprises to ensure that they were operating in a manner that protected the taxpayers' interest and minimized the risk that these entities would fail. Prior GAO reports³ noted that the enterprises' ties to the government had weakened private market discipline to the point that creditors believed the government would likely assist an enterprise through financial difficulties, even though the government has no legal obligation to do so.⁴ This expectation is not without foundation; in 1987, Congress approved \$4 billion to help the ailing Farm Credit System.

According to a report from the Senate Committee on Banking, Housing, and Urban Affairs, this perception is based on the structure and privileges of the enterprises and the special treatment of their securities.⁵ The enterprises were created by statute, are exempt from state and local income taxes, and each has a line of credit with the Treasury of \$2.25 billion. Their securities are issued and paid through the facilities of the Federal Reserve Banks and are eligible for purchase by the Federal Reserve, for unlimited investment by Federal Reserve member banks and federally insured thrifts and as collateral for public deposits of the U.S. government and most state and local governments. As a result, the enterprises' debt trades at yields only marginally above those on Treasury debt of comparable maturity. This implicit credit enhancement allows the enterprises to operate with relatively little capital.

The enterprises' federally established charters set out specific purposes that they are to address. They are to provide stability in the secondary market of residential mortgages, respond appropriately to the private capital market, and provide ongoing assistance to the secondary market for residential mortgages. They are also to promote access to mortgage credit throughout the nation by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.

³See *Government-Sponsored Enterprises: The Government's Exposure to Risks* (GAO/GGD-90-97, August 15, 1990); and *Government-Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks* (GAO/GGD-91-90, May 22, 1991).

⁴Section 1302(4) (12 U.S.C. 4501(4)) specifically provides that "neither the enterprises . . . nor any securities or obligations issued by the enterprises . . . are backed by the full faith and credit of the United States . . ."

⁵S.R. 102-282, Federal Housing Enterprises Regulatory Reform Act of 1992, May 15, 1992, p. 9.

For these reasons, the government has an interest in seeing that these enterprises are managed and operated in a prudent and financially sound manner. Both enterprises have been highly profitable for several years,⁶ but Congress recognized that both may not always remain as profitable and well managed as they are today. Consequently, Congress reformed the enterprises' regulatory structure and established capital requirements by passing the Federal Housing Enterprises Financial Safety and Soundness Act of 1992. According to the Senate report accompanying the bill,⁷ the capital provisions are designed to ensure that the enterprises are financially sound. The primary emphasis of these provisions is on a risk-based capital standard that reflects risks the enterprises assume. The new regulatory structure was designed to address concerns over HUD's inadequate regulation and supervision of the enterprises.

The act established OFHEO as an independent entity within HUD. The act reserved for the Secretary of HUD certain authorities relating to HUD's responsibility to oversee the enterprises' efforts to meet housing goals.⁸ But the act also clarified that the duty to ensure that Fannie Mae and Freddie Mac are adequately capitalized and operate in a safe and sound manner, consistent with the achievement of their public purposes, belongs to OFHEO. Consequently, the act specifically delegated other responsibilities and authorities to the Director of OFHEO. OFHEO was intended to operate separately from HUD and be staffed with experts in financial management or financial institution oversight.

OFHEO is under the management of a presidentially appointed and Senate-confirmed Director. The act provided the Director with numerous exclusive authorities (i.e., without the review and approval of the Secretary of HUD), such as powers to examine the operations of the enterprises, determine capital levels, assign the enterprises capital classifications, and take certain enforcement actions. The act also gave the Director exclusive authority to manage OFHEO, including establishing and implementing annual budgets and hiring personnel. Thus, the Director leads and directs OFHEO's activities by setting internal and external policy, managing overall operations, and serving as the chief spokesperson for the

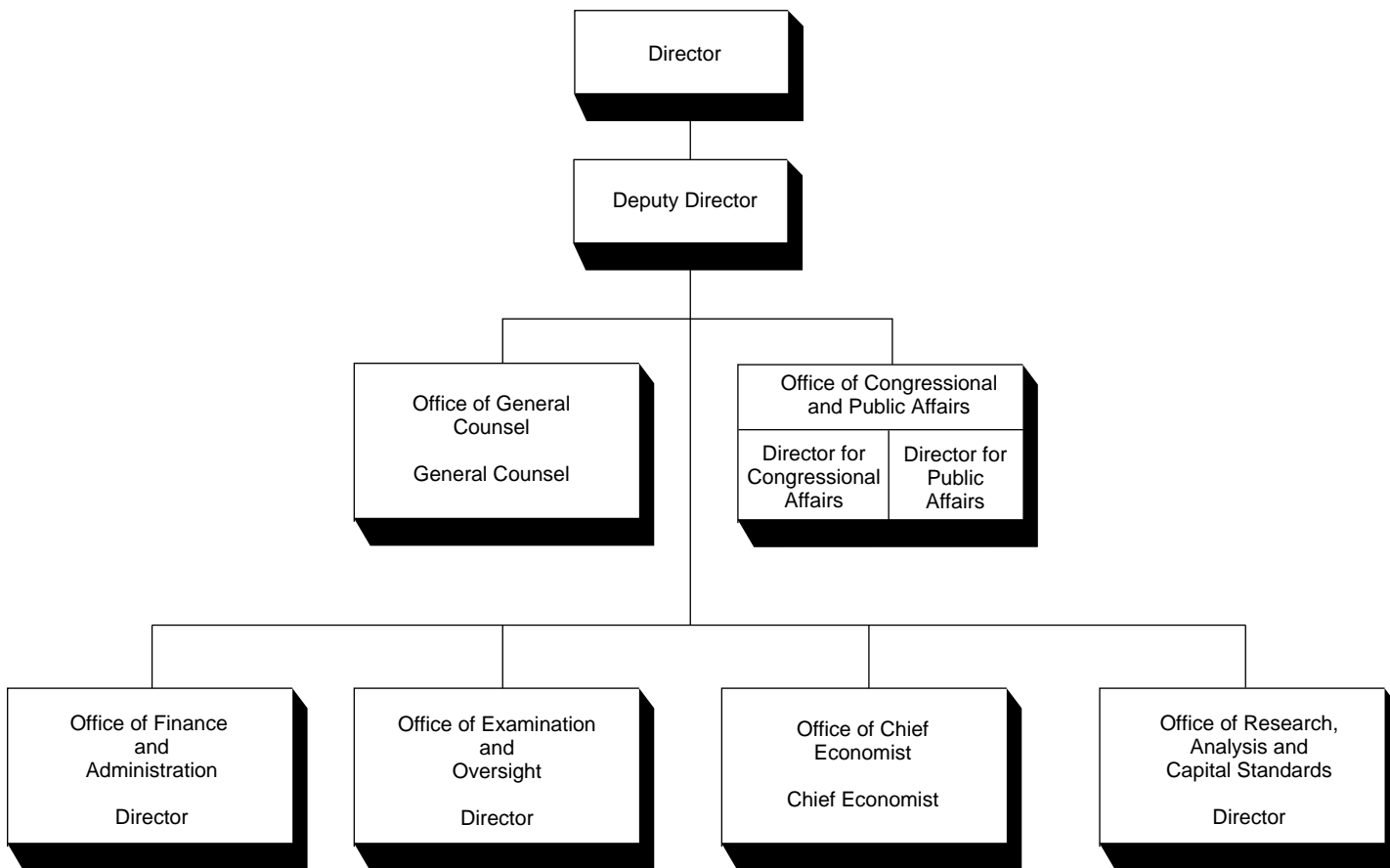
⁶Fannie Mae reported profits for calendar year 1994 of \$2.132 billion, an increase of 13.8 percent from the earnings of \$1.873 billion for 1993. Freddie Mac reported earnings of \$983 million for calendar year 1994, up 25.1 percent from its 1993 profits of \$786 million.

⁷S.R. 102-282, Federal Housing Enterprise Regulatory Reform Act of 1992, May 15, 1992, p. 19.

⁸Sections 1331-1334 of the act (12 U.S.C. 4561-4564) required the Secretary of HUD to establish housing goals for the enterprises in three areas: low- and moderate-income housing, "affordable" housing, and credit to underserved areas, with particular attention being given to central cities and rural areas.

organization. As of February 1995, OFHEO's six components reported to the Director and Deputy Director. Figure 1 illustrates OFHEO's organizational structure.

Figure 1: OFHEO Organizational Structure



Three line functions are directly responsible for carrying out OFHEO's mission:

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- The Office of Examination and Oversight (OEO) is responsible for designing and conducting annual on-site examinations of Fannie Mae and Freddie Mac, as required by law, and performing additional examinations as determined by the Director.
 - Research, Analysis and Capital Standards (RACS) is responsible for developing and implementing financial “stress tests,” which use interest rate and credit risk scenarios prescribed in the act to determine the enterprises’ risk-based capital requirements. This unit is responsible for conducting research and financial analysis on issues related to the enterprises’ activities, such as simulating Treasury yields and associated interest rate indices.
 - The General Counsel has responsibility for preparing the regulations required by the act and advising the Director on legal issues, including financial institution regulatory issues, applicable securities and corporate law principles, and administrative and general legal matters.

Three staff functions support OFHEO’s mission:

- Finance and Administration is responsible for ensuring that OFHEO has the infrastructure to function independently. This unit is to provide human resources management, budget formulation and execution, financial and strategic planning, contracting and purchasing, office automation, travel, records and document security, and related administrative support services. Finance and Administration is also responsible for developing annual budgets and serving as the liaison with the Office of Management and Budget.
- The Office of Chief Economist is responsible for providing and coordinating economic and policy advice to the Director on all issues related to the regulation and supervision of the enterprises. This office is also to direct and conduct research to assess the impact of issues and trends in the housing and mortgage markets on OFHEO’s regulatory responsibilities.
- The Office of Congressional and Public Affairs is responsible for handling public and press inquiries, briefing Members of Congress and staff on matters relating to OFHEO, monitoring legislative development, and bringing congressional concerns to the attention of the Director.

OFHEO’s staffing has grown slowly but steadily since the Director, its first employee, was sworn in on June 1, 1993. At the end of fiscal year 1993, five other employees were on board. According to testimony from the Director in October 1993, recruiting specialized staff was slowed somewhat by OFHEO’s need to first do such fundamental things as obtain hiring authority,

develop procedures, and obtain office space. By September 1994, however, OFHEO had 37 staff on board. And in February 1995, OFHEO's staff had grown to 53. OFHEO's budget projects filling 69 positions in fiscal year 1996. Table 1 compares the distribution of positions among OFHEO's different units at the end of fiscal year 1994 with that projected for fiscal year 1996.

Table 1: Actual and Projected Distribution of OFHEO Staff Resources, Fiscal Years 1994 and 1996

Unit	Staff on board, end of fiscal year 1994	Projected positions, fiscal year 1996
Office of the Director ^a	6	7
Office of Chief Economist ^a	3	5
Office of Examination and Oversight	7	19
Research, Analysis and Capital Standards	8	15
Office of General Counsel	3	7
Finance and Administration	6	11
Office of Congressional and Public Affairs	4	5
Total	37	69

^aA reorganization in early fiscal year 1995 separated the Office of Chief Economist from the Director's Office and moved two positions among units.

Source: GAO analysis of OFHEO data.

Relative to other federal financial regulatory agencies, OFHEO is a small organization. In testimony before the House Banking Committee in October 1993, OFHEO's Director spoke about the unique challenge facing OFHEO in regulating two entities as large, complex, and sophisticated as Fannie Mae and Freddie Mac. She compared OFHEO's regulatory task with that of other federal financial regulatory agencies. For example, OFHEO's fiscal year 1994 budget funded 45 positions to oversee the enterprises (1 employee for every \$23.1 billion in regulated assets). As a point of comparison, 2,500 Office of Thrift Supervision (OTS) employees oversaw institutions with \$800 billion in assets (1 employee per \$0.3 billion in assets).⁹ To address that challenge, OFHEO's philosophy was to create a lean and flat organization that would attract and retain a highly qualified, diverse staff with sophisticated financial, legal, and supervisory expertise.

Most OFHEO expenses cover personnel and contractor services. For fiscal year 1996, OFHEO estimates that it will spend \$7.9 million (53.3 percent of its \$14.9 million total) on personnel services (i.e., expenses related to personnel compensation and benefits, but exclusive of contractors).

⁹This information came from OTS' 1992 annual report.

According to OFHEO, it bases salaries and benefits on market rates for the required technical expertise comparably with those of other federal banking regulatory agencies.¹⁰ The second largest category of expenses (“Other services”) generally covers OFHEO’s contractor services.¹¹ In fiscal year 1996, OFHEO expects to spend \$4.4 million (29.7 percent) on specialized technical services associated with developing and maintaining its research capability and computer models, examination services, and specialized legal services. All other expenses constitute a smaller, but growing, proportion of OFHEO’s total obligations. These expenses cover such fundamental but crucial items as computer acquisition, travel, and rent, which fluctuate with changing numbers of staff and contractors on location.

Table 2 shows actual and estimated OFHEO obligations for fiscal years 1994 through 1996. Although OFHEO’s financial plans and forecasts are to be included in the budget of the United States and in HUD’s congressional justifications,¹² it is not funded with tax dollars through the congressional appropriations process. Rather, the act requires the enterprises to pay annual assessments to cover OFHEO’s costs.¹³ OFHEO’s fiscal year 1996 budget estimated that it would obligate nearly \$0.6 million less than was estimated for operations in fiscal year 1995. That estimate reflects a diminished reliance on other contractor services, especially in support areas, partially offset by increases in rent associated with the need for additional space and in personnel expenditures associated with four additional OFHEO positions.

¹⁰Section 1313(b)(9) of the act (12 U.S.C. 4513) authorizes the Director, without the review or approval of the Secretary of HUD, to take such actions necessary regarding the hiring of, and compensation levels for, OFHEO personnel. Section 1315 (12 U.S.C. 4515) further provides that OFHEO personnel may be paid without regard to certain provisions of title 5, United States Code, relating to classification and General Schedule pay rates, and comparably with the officers and employees in the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision.

¹¹Section 1315(e) of the act (12 U.S.C. 4515) authorizes the Director to employ outside experts and consultants as necessary.

¹²Section 1316(g)(3), 12 U.S.C. 4516.

¹³Section 1316 of the act (12 U.S.C. 4516) authorizes the Director to establish and collect annual assessments from the enterprises to cover “reasonable costs and expenses,” including the costs of any examinations. The initial assessment was to cover start-up costs and any anticipated costs and expenses for the next fiscal year. The enterprises are to make their payments in proportion to the ratio of their total assets. The assessments are to be paid semi-annually into a Treasury fund known as the Federal Housing Enterprises Oversight Fund.

Table 2: OFHEO Obligations, Fiscal Years 1994 Through 1996

Dollars in thousands

	Actual 1994	Estimated 1995	Estimated 1996	1995-1996 Change
Personnel services	\$2,690	\$7,300	\$7,944	\$644
Other services	2,473	5,875	4,422	-1,453
All other	1,323	2,276	2,529	253
Total	6,486	15,451	14,895	-556

Source: GAO analysis of OFHEO data.

Scope and Methodology

Because OFHEO continues to develop its major management systems, we limited the scope of our work for this report to the planning and initial implementation of those systems. As of February 1995, none of OFHEO's major management systems had been completely implemented. Consequently, we did not evaluate their ultimate implementation or effectiveness.

To develop our information, we interviewed OFHEO's senior management and HUD officials and reviewed OFHEO management systems documentation, focusing on the policies and procedures relating to OFHEO's human resource management and accounting and financial control systems. We reviewed changes in these plans and systems that OFHEO made over time. We also reviewed OFHEO's plans for its organizational development, particularly its examinations and capital adequacy functions, along with its completed examinations of the enterprises and the advance notice of proposed rulemaking on the risk-based capital regulation.

OFHEO provided written comments on a draft of this report. The comments are summarized on page 22 and reprinted in appendix I.

We did our work at OFHEO and HUD in Washington, D.C., between September 1994 and February 1995. This review was done according to generally accepted government auditing standards.

Development of OFHEO'S Infrastructure Generally on Schedule, but Challenge of Implementation Remains

Before OFHEO's Director was sworn in on June 1, 1993, OFHEO had no employees, no structure, no physical location, no policies or procedures, and no plan. Much has changed since then. OFHEO has made steady progress toward establishing administrative and financial management systems and controls designed to enable it to operate independently of HUD. OFHEO has nearly finished designing its human resource management system, worked with HUD to meet its initial financial and accounting needs, and begun exploring alternative arrangements for "cross-servicing," through which OFHEO would contract with another agency to provide administrative and financial management services. According to its September 1994 operational workplan, OFHEO is basically on schedule developing and installing its infrastructure. OFHEO now faces the challenge of implementing its systems and resolving unforeseen difficulties.

Human Resource Management System Nearing Initial Implementation

By February 1995, OFHEO had substantially completed the design of its human resource management system (called the Performance Evaluation Management System, or PEMS) and established milestones for pilot testing the system. OFHEO anticipates full implementation of PEMS at the beginning of fiscal year 1996.

Rather than adopting HUD's or another agency's human resource management system, OFHEO developed its own. Based on recommendations of two consulting firms, OFHEO's performance management system is intended to enable it to respond to changing regulatory needs and ease its developmental operations. PEMS' broad pay band structure reflects three general design elements: (1) salaries to help OFHEO recruit technical expertise, (2) pay ranges to provide management flexibility to make pay decisions that reflect labor market pay while providing internal equity, and (3) occupational levels to be significantly and recognizably different.

OFHEO classifies personnel by occupation and assigns them to one of seven pay bands. Occupations are based in part on the type of work done relative to OFHEO's mission, the nature and subject matter of the work, and the fundamental qualifications required. Pay levels and ranges are based on comparisons with similar occupations in other federal financial regulatory agencies. An individual's pay also depends on the complexity of the work, scope of responsibility, and supervisory content of the job. Changes in pay are to occur once a year, at the end of the review cycle. Individuals may receive pay increases within each pay band, unless they are at the band's ceiling. Those staff meeting qualifications for other

occupations and demonstrating the ability to perform the relevant duties and responsibilities may also be promoted. In 1994, pay could range from \$15,000 to \$135,000.

In March 1995, OFHEO was preparing to implement PEMS. Having obtained official approval of PEMS from the Office of Personnel Management (OPM) on February 23, 1995, OFHEO planned to implement PEMS in April 1995. OFHEO will abbreviate PEMS' initial performance cycle and begin regular, full-year cycles in fiscal year 1996.

Efforts to Establish OFHEO's Accounting and Financial Systems Have Proven More Difficult

Compared to the progress made with PEMS, OFHEO has experienced greater difficulty in establishing its accounting and financial systems and controls. OFHEO has worked with HUD to meet its immediate needs, but OFHEO is still uncertain as to whether HUD can meet its accounting and financial systems requirements. As of February 1995, OFHEO was still considering either establishing its own systems or arranging for cross-servicing with another federal agency.

OFHEO has established general requirements for its accounting and financial management system. According to OFHEO, the system must support all personnel and procurement components within an integrated automated accounting system and accommodate its classification and compensation system. In addition, the system must produce auditable financial statements. The system must maintain accounting records that accurately reflect expenses and income; provide monthly budget, accounting, and exception reports; and pay approved invoices.

OFHEO has used HUD's accounting and financial systems since its inception but experienced various difficulties. In the procurement area, for example, OFHEO used the services of HUD's Office of Procurement and Contracts. According to OFHEO, HUD's office was not staffed to provide the expedited procurement processing OFHEO's start-up mode of operation required. OFHEO eventually hired its own procurement contracting officer and exercised independent contracting authority. To date, HUD has handled OFHEO's payroll and other personnel processing actions. OFHEO inputs its time and attendance data directly but uses HUD's contract with the National Finance Center in New Orleans to process its payroll. HUD has serviced OFHEO's other personnel processing needs (such as processing tax forms, health benefits enrollments, and direct deposit forms), but not, according to OFHEO, without problems. During OFHEO's early months of existence, HUD did not understand or appreciate the significance of OFHEO's

Schedule A hiring authority and its authority to make independent appointments.¹⁴ This added considerable time to the processing of personnel actions, since individuals unfamiliar with OFHEO's exemptions subjected those actions to HUD's own internal review procedures. According to OFHEO, this processing relationship smoothed out over time.

Senior OFHEO officials expressed dissatisfaction with HUD's accounting and financial management systems. For example, OFHEO experienced substantial delays in how HUD recorded OFHEO obligations and expenses. Additionally, HUD restricted access to its accounting system, limiting the ability of OFHEO's finance and administration staff to retrieve their data to support budget formulation and financial management activities. HUD staff also confused OFHEO with another HUD agency, the Office of Fair Housing and Equal Opportunity (FHEO), causing them to confuse financial transactions and misdirect financial reports.

OFHEO had procedures and controls in place that enabled it to detect such problems. Consequently, HUD's errors were corrected and OFHEO ultimately was able to reconcile its fiscal year 1994 accounts. However, the lack of current accurate data during the year made it difficult for OFHEO to determine its unobligated balances on a monthly basis. In turn, this hampered OFHEO's ability to notify the enterprises with certainty what the next semiannual assessment would be.

Over time, OFHEO has recognized improvements in the data provided by HUD's accounting system. Senior OFHEO officials told us that they have noted fewer errors and that HUD has been able to provide information in a more timely manner. According to the Director of Finance and Administration, OFHEO had a great degree of confidence in the accounting data on which it based its March 1, 1995, assessment of the enterprises.

HUD officials acknowledged that some problems existed with the accounting system that processed OFHEO's financial data. They told us that HUD is replacing the system that generated many of the problems, and OFHEO is to be switched to the new system later in fiscal year 1995. According to those officials, the new system should fully meet OFHEO's

¹⁴Section 1315(a), 12 U.S.C. 4515. Schedule A hiring authority is one of the federal government's excepted appointing authorities used for hiring employees under special circumstances. This authority permits agencies to fill positions without following the extensive requirements of the competitive service. According to the Federal Personnel Manual, Schedule A authority may be used if, for example, a crash program must be staffed so quickly that there is no time for traditional examining. OPM also granted Schedule A hiring authority to the other financial regulatory agencies created by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 for use during their start-up phase.

needs and requirements, allowing OFHEO to access its financial data and generate its own unique reports.

As of February 1995, OFHEO had not yet decided how it would meet its future administrative and accounting needs. OFHEO has not determined whether to continue using HUD systems, create and maintain its own, or contract those functions out to another federal agency. Initially, OFHEO had decided against devoting its own staff to these functions, believing that it would not be a cost-effective use of its limited resources. It approached nine other federal agencies, focusing on financial regulators because they have similar missions and compensation systems. OFHEO eventually determined that none of them would fully meet its needs. In some cases, OFHEO questioned the agencies' capacity. In other cases, the agencies responded that entering into a cross-servicing arrangement would not be practicable or cost-effective. According to a senior OFHEO official, the biggest problem involved the particular systems OFHEO had implemented because of exemptions in its statute, such as that exempting OFHEO from certain provisions of Title 5 of the U.S. Code, relating to classification and General Schedule pay rates.¹⁵

Resolving the cross-servicing issue is a priority for OFHEO's Director of Finance and Administration. Because OFHEO has been unable to identify another agency that has the resources to meet its unique accounting system needs, and because the quality of the accounting information from HUD has improved significantly, OFHEO is considering continued use of HUD accounting and financial management systems. OFHEO officials have also been encouraged by HUD's willingness to work with them to ensure that the new accounting system meets OFHEO's requirements and needs.

Examinations and Capital Adequacy Functions: Approaches to Meeting Key Legislative Mandates Taking Longer Than Envisioned

OFHEO has made considerable progress in establishing its key functions—examining the enterprises' financial condition to ensure their financial safety and soundness as well as developing and implementing the required risk-based test to determine how much capital the enterprises need (the "stress test"). After having hired its key professional staff and establishing working relationships with the enterprises, OFHEO conducted its first examinations, purchased and installed the computer system needed to run the stress test, and obtained the data needed for the financial modeling and research that underlie the test. Additionally, OFHEO established plans to guide its work at least through the end of fiscal year 1995. OFHEO has met most of its legislated requirements, including making

¹⁵Section 1315(a), 12 U.S.C. 4515.

determinations of the enterprises' capital adequacy during the transition period prior to the release of the risk-based capital standards.

Despite this progress, OFHEO has experienced delays, causing some important activities to fall behind schedule. For example, OFHEO did not meet the legislatively mandated deadline for issuing final regulations establishing the risk-based test of the enterprises' capital adequacy.¹⁶ OFHEO has established intermediate milestones and now expects to publish proposed stress test regulations in late 1995 and final regulations in 1996. These delays, while unexpected, are not unusual; most, such as hiring qualified staff and creating internal processes, seem related to establishing a new organization. OFHEO has taken steps to address each problem encountered.

OFHEO Established Its Examination and Regulatory Oversight Function, but Has Been Unable to Meet Its Workplan

OFHEO has established its examination function, adopting a general examination methodology and setting out a 2-year workplan. In 1994, OFHEO completed its first examinations and began its second, along with some off-site supervisory monitoring activities. OFHEO has experienced some unexpected delays that are related to establishing a new organization. As a result of these setbacks, some activities scheduled to be done by the end of 1994 are behind schedule.

The act gave OFHEO broad authority to examine the enterprises. The act requires OFHEO to do an annual on-site examination of each enterprise to evaluate its financial condition for ensuring financial safety and soundness.¹⁷ In addition, the act authorizes OFHEO to do other examinations necessary to ensure the financial safety and soundness of the enterprises.¹⁸

OFHEO plans to meet its mandate by doing a combination of on-site examinations and off-site monitoring. Examinations are to assess the safety and soundness of the enterprises and the adequacy of their books and records. Supervisory monitoring is the ongoing assessment of the enterprises' financial condition and performance. Monitoring projects

¹⁶Section 1361(e), 12 U.S.C. 4611.

¹⁷Section 1317(a), 12 U.S.C. 4517.

¹⁸Section 1317(b), 12 U.S.C. 4517.

include special studies of enterprise activities, quarterly company analyses,¹⁹ and the development of a call report.²⁰

OFHEO uses a “top down” examination approach to identify the risks inherent in the enterprises’ activities and to determine whether risks are prudently managed and controlled. This approach has three levels. First, OFHEO examiners are to meet and evaluate senior management, analyze strategic and business plans, determine the quality of internal and external audits, and verify records and control systems. Second, the examiners are to expand the examination to include further testing, statistical sampling, and analyses of the enterprises’ systems. If the second-level review raises any questions, a team of examiners is to do a detailed third-level review of these concerns.

By September 1994, OEO had planned its activities through calendar year 1995. According to this schedule, OEO would have seven or more projects ongoing at all times—at least two examinations at each of the enterprises, along with at least three supervisory monitoring projects. OEO’s director characterized this workplan as “ambitious.”

Table 3 summarizes OEO’s workplan from July 1994 through the end of 1995. It shows, for example, that during the first half of 1995, OEO staff are to complete “general,” “specialty,” and books and records examinations of both enterprises. In the general examination, OEO staff will (1) examine each enterprise’s risk management by assessing the adequacy of management processes to identify, measure, monitor, and control the risk exposure of the enterprise; (2) examine a functional area of each enterprise’s secondary market operations, such as its marketing or mortgage securitization; or (3) assess the adequacy of some aspect of each enterprise’s business or product lines, such as its single- or multifamily guarantee programs. The specialty examination is to cover the enterprises’ electronic data processing (EDP). The objective of these examinations is to ensure that EDP systems used by the enterprises are adequate, reliable, accurate, and operated within a secure environment. OFHEO plans to test major systems to verify the data and report integrity. In the books and records examination, OEO staff are to evaluate the accounting and auditing to determine the reliability of the enterprises’ financial information.

¹⁹The quarterly company analyses are to focus on the financial safety and soundness of the enterprises and include related information on business activity, financial market measures, and analysis and opinions of financial analysts.

²⁰Call reports document an institution’s income and condition on a quarterly basis.

Table 3: Summary of OFHEO's Office of Examination and Oversight Plan

	Programs/projects	Second half 1994	First half 1995	Second half 1995
On-site examination of the enterprises	Safety and soundness/compliance			
	General	Corporate	Risks/functions/business	Risks/functions/business
	Specialty	Derivatives	EDP	Charters acts
	Books and records		Books and records	
	Examination manual			Draft manual
Off-site supervisory monitoring	Supervisory analysis	Strategic/business plans	MIS	Product lines
	Company analysis	Report on 3rd quarter	Report on 4th/1st quarters	Report on 2nd/3rd quarters
	Industry analysis		Annual analysis with RACS	
	Call report	Develop specifications	Implement in phases	Implement in phases

Source: OFHEO.

OEO's small staff has not been able to keep up with its workplan. OFHEO completed its first on-site examinations, focusing on the enterprises' use of off-balance sheet financial derivatives, in November 1994. OFHEO reported that the enterprises used derivatives for sound business purposes and that derivatives activities were consistent with the enterprises' objectives. OEO began its second examination of both enterprises, the corporate examinations, in October 1994 and anticipates completing those reports in April 1995, 4 months behind its original schedule. OEO has completed one part of its planned supervisory monitoring activities (an analysis of the enterprises' strategic and business plans). But two other activities that were scheduled to be done by the end of 1994—the development of OFHEO's call report and the third quarter company analysis of the enterprises—are also behind schedule. All activities planned for 1995 are also behind schedule.

The reasons OFHEO has fallen behind seem related to complications in establishing a new organization. First, according to the director of OEO, OFHEO had trouble hiring qualified examination staff. Occasionally, OFHEO found it hard to attract qualified candidates, because it was new and not well known. According to OFHEO's Director, there are a limited number of individuals with the particular skills that OFHEO needs, forcing it to compete with other financial regulators for qualified staff. OFHEO also noted that it had difficulty competing with private salary offers. In

addition, some employees who accepted employment with OFHEO were unable to begin as early as OFHEO management wanted.

Second, OFHEO needed to establish its internal review processes to help ensure quality reporting. Upon completing its first examinations, the draft report was reviewed by key OFHEO management officials while developing a review procedure. OFHEO hopes to streamline its review process in the future. Finally, senior OFHEO officials told us that the amount of information from the enterprises that its staff needs to review is voluminous. OFHEO may have underestimated the time needed for its small examination staff (five staff examiners and regulatory specialists at the end of the calendar year) to review and understand such large amounts of information. On the other hand, according to the director of OEO, the initial examination activities have proven to be valuable exercises in building OFHEO's overall knowledge and expertise, which should help focus subsequent work.

Research, Analysis and Capital Standards: Considerable Progress Made Toward Stress Test

The act requires OFHEO to establish a risk-based capital test for the enterprises (the stress test) to determine the amount of capital the enterprises must hold. That amount must be adequate to last during a 10-year period (the stress period), which the act defines with specific parameters relating to credit risk,²¹ interest rate risk,²² new business, and other activities.²³ The act defines an enterprise's required risk-based capital level as equal to the amount calculated by applying the stress test, along with an additional 30 percent to allow for management and operations risks.²⁴ Using this test, OFHEO is then to determine the enterprises' capital adequacy, using classifications established in the act. Further, the act also required the Director to issue final regulations establishing the stress test within 18 months of the Director's appointment²⁵ (i.e., by December 1, 1994).

²¹Credit risk is the risk of loss arising from borrowers failing to repay their loans and/or other parties failing to meet their obligations to administer or guarantee loans. Credit risk is inherent in the daily operations of all financial firms, including the enterprises.

²²In general, interest rate risk is the exposure to possible losses and changes in value arising from changes in interest rates.

²³Section 1361, 12 U.S.C. 4611.

²⁴Section 1361(c), 12 U.S.C. 4611. Management risk is the potential for losses resulting from the decisions or indecisiveness of a company's managers. Operations risk is the exposure to financial loss from inadequate systems, management failure, faulty controls, fraud, or human error.

²⁵Section 1361(e), 12 U.S.C. 4611.

The Research, Analysis and Capital Standards section (RACS) is responsible for developing and implementing the stress test. By the end of fiscal year 1994, OFHEO had hired the majority of its RACS staff and completed the design, purchase, and installation of the computer hardware and software (called the Research Systems Environment, or RSE) needed to establish the financial simulation modeling capability to run the stress test.²⁶ OFHEO has also begun developing the computer programs and databases that will allow it to simulate the enterprises' businesses for purposes of the stress test and other tasks, such as the analysis of various economic scenarios, new financial products, proposed policy initiatives, and new business scenarios. As of October 1994, RACS had received all historical data requested from the enterprises.²⁷ Among other things, RACS staff has transformed the data into a form necessary for simulation modeling, created historical data sets, begun building the algorithms, and has started drafting parts of the description of the stress test.

Despite these accomplishments, OFHEO did not meet the December 1, 1994, deadline imposed by its authorizing legislation regarding the development of the stress test. OFHEO published the Advanced Notice of Proposed Rulemaking in the Federal Register on February 8, 1995, announcing its intention to develop the regulation and soliciting public comment on a variety of issues. Following a 90-day comment period, OFHEO will consider those comments and incorporate them as appropriate into a proposed rule to be published later in 1995. OFHEO expects to publish the final regulations in 1996. The enterprises will then have 1 year to bring their capital levels into compliance.

OFHEO Has Fulfilled Other Operational and Reporting Requirements

Although not meeting the legislatively mandated deadline for issuing final regulations establishing the stress test of the enterprises' capital adequacy and slightly behind on its internal examinations workplan, OFHEO has met other important operational and reporting requirements. For example, OFHEO submitted annual written reports to the Senate and House Banking Committees as required by the act, covering such topics as actions taken by OFHEO and descriptions of the financial safety and soundness of each

²⁶OFHEO has since expanded the RSE's central storage to accommodate all the data received from the enterprises and expects to add additional workstations. According to RACS' director, this system will be similar to those used by research and financial firms that work with comparable types and amounts of data.

²⁷Data from the enterprises will support the functions of both RACS and OEO. Once OFHEO determines which data it requires for its ongoing research and examinations needs, it expects to receive monthly and quarterly updates.

enterprise.²⁸ In addition, OFHEO submitted its annual report to the President and Congress, as required by the Federal Managers' Financial Integrity Act of 1982 (FIA),²⁹ on December 20, 1994. The report noted that OFHEO as a whole complied with FIA.³⁰ Perhaps most important, OFHEO made quarterly determinations of the enterprises' capital adequacy. During the 18-month period following enactment (i.e., from October 28, 1992, through April 27, 1994), OFHEO was to classify the enterprises as "adequately capitalized" if they maintained an amount of core capital that equaled or exceeded certain minimum capital levels that were to apply only during that "transition" period.³¹ OFHEO determined the enterprises to be adequately capitalized for the second, third, and fourth quarters of 1993 and for the first quarter of 1994, applying those transitional minimum capital standards. For the second and third quarters of 1994, OFHEO determined the enterprises to be adequately capitalized, applying other minimum capital standards contained in the act. The transition minimum capital levels are lower than those effective following the transition period.

Table 4 summarizes the act's deadlines, other major requirements, and actions taken by OFHEO through the end of calendar year 1994.

²⁸Section 1319B of the Act (12 U.S.C. 4521) also requires the annual reports to include the results of OFHEO's examinations of the enterprises. Because OFHEO did not complete its first examinations of the enterprises until November 1994, its first two annual reports did not include those examination results.

²⁹31 U.S.C. 3512(d).

³⁰Because its financial data had been maintained in HUD's accounting system, OFHEO's report made note of HUD's having reported material weaknesses and nonconformance pertaining to its financial management system in its FIA report.

³¹Section 1362(b), 12 U.S.C. 4612; section 1364(d), 12 U.S.C. 4614.

Table 4: Chronology of OFHEO's Development and Actions on Legislative Mandates

Key date/deadline	Legislative mandate, with U.S. Code cite	Action
October 28, 1992	Pub. L. 102-550 signed into law.	
June 1, 1993		OFHEO Director sworn in.
June 15, 1993	General report due annually to House and Senate banking committees (§1319B(a)).	OFHEO issued written report on June 14, 1993, to House and Senate Banking Committees on operations of OFHEO, highlighting organizational structures created.
September 1, 1993	OFHEO is to complete first determination of capital adequacy of the enterprises. Subsequent determinations due quarterly (§1364(c)).	OFHEO issued first capital classification report on January 31, 1994, classifying the enterprises as adequately capitalized as of June 30, 1993.
November 27, 1993	OFHEO is to report on its equal opportunity, affirmative action, and minority business enterprise utilization programs (§1315(f)).	OFHEO issued report on its equal opportunity, affirmative action, and minority business enterprise utilization programs on December 1, 1993.
December 1, 1993	Quarterly capital classifications due (§1364(c)).	OFHEO issued report on April 15, 1994, classifying enterprises as adequately capitalized as of September 30, 1993.
March 1, 1994	— Establish and collect annual assessment (payable semiannually) from the enterprises (§1316(a) and §1316(b)(2)). — Quarterly capital classifications due (§1364(c)).	— OFHEO collected first semiannual assessment of enterprises. — OFHEO issued report on April 15, 1994, classifying enterprises as adequately capitalized as of December 31, 1993.
March 15, 1994	Report on enforcement actions due (§1319B(b)).	OFHEO reported that the Director had made no requests to the Attorney General for enforcement actions under subtitle C of the act.
June 1, 1994	Quarterly capital classifications due (§1364(c)).	OFHEO issued report on June 14, 1994, classifying enterprises as adequately capitalized as of March 31, 1994.

(continued)

Key date/deadline	Legislative mandate, with U.S. Code cite	Action
June 15, 1994	General report due annually to House and Senate banking committees (§1319B(a)).	OFHEO issued annual report to Congress covering examination of enterprises and organizational development of OFHEO.
September 1, 1994	<ul style="list-style-type: none"> — Establish and collect annual assessment (payable semiannually) from the enterprises (§1316(a) and §1316(b)(2)). — Quarterly capital classifications due (§1364(c)). 	<ul style="list-style-type: none"> — OFHEO collected semiannual assessments from enterprises. — On September 29, 1994, OFHEO issued reports classifying enterprises as adequately capitalized as of June 30, 1994.
December 1, 1994	<ul style="list-style-type: none"> — Final regulations and orders covering OFHEO operations due (§1319G(a)). — Final regulations on risk-based capital test due (§1361(e)(1)). — Quarterly capital classifications due (§1364(c)). 	<ul style="list-style-type: none"> — OFHEO's organizational regulation published in Federal Register on December 5, 1994. — OFHEO notified House and Senate Banking Committees in writing on November 2, 1994, that risk-based capital test would be late. — OFHEO issued report on December 29, 1994, classifying enterprises as adequately capitalized as of September 30, 1994.
December 31, 1994	Statement of compliance with Federal Managers Financial Integrity Act due. (31 U.S.C. 3512(d)).	OFHEO issued letter on December 20, 1994, noting that OFHEO as a whole complied with the act.

Summary

During its first 18 months, OFHEO has accomplished a great deal. The Director has filled all senior management staff and most key professional, technical, and analytic staff positions. OFHEO's human resource, accounting, and financial systems are approaching full implementation. OFHEO has established its central mission-related functions—examinations and capital adequacy—and met most of the act's requirements in these areas. Where OFHEO was unable to meet legislated deadlines, we believe it has taken reasonable steps to address its shortcomings.

We also believe, however, that more major challenges remain. All of OFHEO's major management systems have yet to be fully implemented. Perhaps most importantly, OFHEO must still complete and implement its risk-based capital stress test to determine the amount of capital the enterprises must hold. Along with its examination of the enterprises, the stress test is central to OFHEO's ability to accomplish its mission. We are legislatively required to study certain aspects of that test and will report our findings to the House and Senate Banking Committees.

Agency Comments

We requested comments on a draft of this report from the Director of OFHEO. In its written comments, OFHEO agreed with the content and conclusions. OFHEO's comments are reprinted in appendix I.

We are sending copies of this report to the Director, OFHEO; the Secretary, HUD; and other interested parties. We will also make copies available to others on request.

This report was prepared under the direction of William J. Kruvant, Assistant Director, Financial Institutions and Markets Issues. Other major contributors are shown in Appendix II. Please contact either Mr. Kruvant on (202) 942-3837 or me on (202) 512-8678 if you have any questions about this report.



James L. Bothwell
Director, Financial Institutions
and Market Issues

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Abbreviations

EDP	Electronic Data Processing
FIA	Federal Managers' Financial Integrity Act
GSE	government-sponsored enterprise
HUD	Department of Housing and Urban Development
OEO	Office of Examination and Oversight
OFHEO	Office of Federal Housing Enterprise Oversight
OPM	Office of Personnel Management
OTS	Office of Thrift Supervision
PEMS	Performance Evaluation Management System
RACS	Research, Analysis and Capital Standards
RSE	Research System Environment

Comments From OFHEO



OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT
1700 G STREET NW WASHINGTON DC 20552 (202) 414-3800

April 11, 1995

James L. Bothwell
Director, Financial Institutions and Market Issues
U.S. General Accounting Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Bothwell:

Thank you for the opportunity to comment on the draft report entitled "GOVERNMENT-SPONSORED ENTERPRISES: Development of the Federal Housing Enterprise Financial Regulator." This report is the first audit of the Office of Federal Housing Enterprise Oversight (OFHEO). We appreciate the professionalism with which the GAO auditors approached this assignment as well as the useful observations which they shared with us during the audit.

OFHEO was created by Congress in 1992 to ensure the capital adequacy and financial safety and soundness of the nation's two largest government-sponsored enterprises, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (the Enterprises). The Enterprises play a crucial role in the housing finance system, serving as the secondary market for residential mortgage loans.

The report recognizes the challenges faced by OFHEO after the appointment of our first Director in June 1993 to create the infrastructure necessary to begin operations and hire qualified staff while undertaking ongoing statutory responsibilities. During our less than two years of existence, we have completed all seven required quarterly capital classifications, which determined the Enterprises to be adequately capitalized for each quarter, and made substantial progress in the development of the capital stress test which will serve as the basis for the risk-based capital requirements.

Our examination staff, within eight months of the employment of its first chief examiner and office director, completed examinations of Fannie Mae and Freddie Mac, focusing on derivatives activities. OFHEO senior officials met with the management and board of directors

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of each Enterprise, reporting that each used derivatives for sound business purposes and that derivatives activities were consistent with the objectives of each. We also began corporate examinations of Fannie Mae and Freddie Mac, which have taken a broader perspective of the governance, management controls, and overall corporate structure of each.

In creating an organizational structure to carry out our statutory responsibilities, OFHEO is committed to the same principles embraced by those arms of the federal government which are in the forefront of the "reinvention" movement: namely, finding ways to make government more efficient and more effective. For OFHEO's examination effort, this translates into devising a process and procedures for the examination of two large, sophisticated financial entities which have never been examined before, while beginning to undertake examination activities. For example, after the purposes and scope of the derivatives examinations were determined and the on-site work was completed, OFHEO had to develop its internal quality control procedures in order to finalize the examination reports. Naturally, this involved a heavy investment of time devoted to process management, but has already resulted in more effective and efficient procedures going forward. OFHEO's examination program also utilizes an ambitious schedule in order to "stretch" staff. Such an aggressive timetable is difficult to meet in the early stages of development, while hiring is not yet complete. However, it provides an effective means to ensure that staff resources are being utilized at maximum capacity.

In the administrative area, the "reinvention" approach again requires an investment of time and resources into exploring alternatives until OFHEO finds the combination that best meets our needs cost effectively. For example, we have worked with the Department of Housing and Urban Development (HUD) in such areas as personnel and financial management. We have also inquired about the possibility of contracting with other federal agencies to provide "cross servicing" of these and other administrative functions. We have been pleased with the willingness of HUD and each of these entities to entertain our requests and work with us to determine whether their systems can meet our requirements. This has been particularly difficult for HUD and other agencies that are immersed in reinventing themselves. Further, OFHEO's small size and unique authorities would represent a challenge even to an agency with the most flexible and dynamic systems. We are confident that we will continue to move forward in these administrative areas.

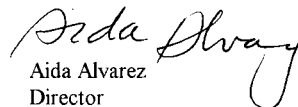
As noted in the draft report, OFHEO continues to evolve. We welcome the insights of GAO, as a knowledgeable and objective observer, as we continue to assess our effectiveness and make necessary adjustments. We are, for example, reviewing overall staffing levels, with particular attention to the examination and administrative areas, to ensure that OFHEO has adequate resources to enable us to fulfill the safety and soundness mission entrusted to us by the Congress.

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Again, we appreciate the opportunity to comment. Should you have any further questions or need additional information, please do not hesitate to contact us.

Sincerely,


Aida Alvarez
Director

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