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FEDERAL HOUSING FINANCE BOARD

Actions Needed to Improve Regulatory Oversight

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Federal Housing Finance Board: Actions Needed to Improve Regulatory Oversight

GAO's testimony, based on its recent report,[1] discusses weaknesses found and actions needed to improve the Federal Housing Finance Board's (FHFB) regulatory oversight of the Federal Home Loan Bank System (System). Four primary conclusions were reached about FHFB's oversight. First, FHFB's examination function did not ensure that annual examinations met FHFB's internal examination standards, including adequate documentation for work performed. The examinations included reviews of interest-rate and credit risk, two of the primary types of risk faced by the Federal Home Loan Banks (Banks). However, the examinations did not fully assess other areas that FHFB and others have identified as vital in evaluating an institution's risk-management capabilities, such as management and board of directors oversight, internal control systems, and internal audit function.

Second, weaknesses existed in FHFB's off-site monitoring and supervisory enforcement programs. FHFB lacks a coordinated off-site monitoring system, which is an important part of effective safety and soundness oversight, because it can provide an early warning of potential problems. FHFB also lacks an enforcement program that clearly articulates policies and procedures for taking corrective action. The situation is further aggravated because the statute grants only general authority to enforce the statute and make orders. The only authority delineated in the statute is the authority to remove or suspend Bank employees, directors, officers, or agents for cause.

Third, FHFB does not have policies or procedures, outside of its reviews of the special affordable housing and community investment programs, to determine whether or the extent to which Banks are supporting housing finance. FHFB recognized this omission and has begun to take steps to establish such a program, but no final actions have been taken to establish a regulatory framework to ensure mission compliance.

Fourth, FHFB continues to be involved in System business. Many of the authorities that involve FHFB in System business are specified in statute or are carryover regulations from its predecessor agency. FHFB began to devolve many of the functions in 1994, but it still plays a role in coordination and promotion of Banks. GAO continues to believe that such involvement in the System's business functions may undermine FHFB's independence and lead to questions about its objectivity.

[1]Federal Housing Finance Board: Actions Needed to Improve Regulatory Oversight (GAO/GGD-98-203, Sept. 18, 1998).

GAO makes recommendations to strengthen FHFB's primary oversight role as safety and soundness regulator of the System. GAO also continues to support its position that a single housing regulator be created to oversee the safety and soundness and mission compliance of the housing government-sponsored enterprises.

Federal Housing Finance Board: Actions Needed to Improve Regulatory Oversight

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss the Federal Housing Finance Board's (FHFB) regulatory oversight of the nation's third largest government-sponsored enterprise (GSE), the Federal Home Loan Bank System (System). At your request, we recently issued a report on FHFB's oversight.[1] The specific objectives of our review were to evaluate (1) FHFB's annual safety and soundness and mission compliance examinations of the Federal Home Loan Banks (Banks), (2) other aspects of FHFB's oversight, and (3) the status of FHFB's involvement in System business.

We reached four primary conclusions about FHFB's oversight which I will discuss today. First, FHFB did not ensure that all parts of the annual examinations we reviewed met their internal standards for assessing safety and soundness. Second, weaknesses exist in FHFB's off-site monitoring and supervisory enforcement programs. Third, FHFB does not have policies or procedures, outside of its reviews of the special affordable housing and community investment programs, to determine whether or the extent to which Banks are supporting their public mission of housing finance. Fourth, FHFB's involvement in promoting System programs and projects that it subsequently evaluates for mission compliance and safety and soundness could complicate its primary duty as safety and soundness regulator and may prompt questions about FHFB's objectivity.

In addition, I will discuss the concept of a single regulator for all the housing GSEs. We have suggested in past work that Congress consider creating one regulator to oversee the safety and soundness and mission compliance of the three largest GSEs. Our recent work at FHFB and the other GSE regulators has strengthened our belief that this single-regulator concept would be more effective than the existing regulatory structure.

As you know, FHFB is the safety and soundness and mission compliance regulator of the 12 Banks that, along with the Office of Finance, comprise the System. However, FHFB is more than just the System's regulator, it is also involved in various aspects of System business, including management decisionmaking. This type of regulator-manager structure is unique among GSE regulators. That is, while other GSE regulators may be responsible for mission and safety and soundness oversight, FHFB is the

[1] Federal Housing Finance Board: Actions Needed to Improve Regulatory Oversight (GAO/GGD-98-203, Sept. 18, 1998).

only regulator that remains involved in the business of the System it regulates. In certain instances, the Federal Home Loan Bank Act (Bank Act) provides for FHFB's involvement in System business. FHFB has devolved some business or governance and management activities to the Bank boards. However, FHFB continues to function as a promoter and coordinator for the System.

To complete our objectives, we reviewed FHFB's examination function and other relevant oversight activities, such as off-site monitoring and enforcement. This included a review of Bank examination reports and selected supporting work papers. We also reviewed off-site monitoring reports and related documents, as well as documents relevant to FHFB's enforcement activities. Finally, we reviewed information relevant to FHFB's managerial functions and the status of its devolution project.

FHFB Did Not Ensure Examinations Met Its Standards

As part of our evaluation of FHFB's examination program, we reviewed the 1996 and 1997 examinations and supporting work papers for a stratified, judgmental sample of six Banks whose assets represented 60 percent of System assets at year-end 1996. We found that examiners performed required examinations but failed to follow all the policies and procedures specified in their examination manual. Most notably, examiners did not always fully assess critical elements of Bank operations—such as internal controls, board of director and management oversight, and the reliability of internal audits—that FHFB, other financial regulators, and we have identified as vital in evaluating an institution's risk-management capabilities. None of the examinations we reviewed fully assessed more than one of the areas. All failed to assess board of director oversight. While examiners generally assessed management of interest-rate and credit risk, the critical elements just mentioned should be reviewed during every on-site examination to ensure that operations risk is being adequately managed. Operations risk poses the potential for unexpected financial loss due to such problems as inadequate internal controls or fraud.

Unlike other regulators, FHFB does not perform a top-down assessment of Bank operations. In contrast, we found, and FHFB officials confirmed, that examiners focus on identifying problems and then determining the causes of the problems. Such an approach may not identify weaknesses in control and management systems that could be identified through a broader assessment of Bank operations. Office of Supervision officials—the FHFB office whose primary responsibility is the examination function—said that, due to limited staff resources in their office, they were unable to take a top-down examination approach. In addition, we found that examiners relied on the work of Bank internal auditors without any regular assessment of the adequacy of their work.

In each of the 12 examinations we reviewed, more than half of the work in each area specified in FHFB's examination manual was not conducted in accordance with the manual's procedures. That is, examiners did not complete the examination program in the manual or use the manual's examination questionnaires. The examiners explained that they often did not have time to complete the procedures described in the manual and that the manual's procedures often were not useful for certain parts of the examination. In addition, we found that, for most areas covered in the examination, examiners did not document examination procedures or provide support for their conclusions, as required by FHFB standards.

In all but 1 of the 12 examinations reviewed, some planned examination procedures were not completed during the course of the examination. In each of the cases, examiners indicated in the work papers that those procedures were not completed because of time constraints. In 2 of the 12 examinations, examiners curtailed the scope but provided no explanation for the change in the work papers. OS officials told us that limited examination staff resources sometimes resulted in scope reductions, and that such reductions occurred in parts of the examination that examiners believed involved less risk.

Examiners also failed to expand the examination scope when potentially serious problems were found. Examiners found potentially serious internal control problems at one Bank in consecutive examinations but did not expand their reviews to determine whether there were additional related problems. FHFB did not view those internal control weaknesses as significant. Both cases involved an inadequate segregation of duties in a Bank's investment activities and were weaknesses that recurred at the same Bank. In spite of the fact that adequate segregation of duties involves a violation of fundamental principles of internal controls, FHFB did not believe it was necessary to expand its review to the Bank's system of internal controls.

Based on these findings, we recommended that FHFB strengthen its primary oversight role as the safety and soundness supervisor of the System by (1) ensuring that critical aspects of Bank operations are reviewed as part of every FHFB examination, (2) ensuring that examiners follow the guidance and complete the appropriate examination procedures described in the examination manual, and, (3) adequately documenting the work performed and conclusions drawn during examinations.

FHFB Is Now Developing a Mission Compliance Examination Program

In its almost 10 years of operation, FHFB has not developed a compliance program to ensure mission compliance, one of its statutory duties. Historically, mission compliance oversight included reviewing the Banks' compliance with affordable housing program and community investment program requirements—two programs mandated by law in 1989 that represented less than 1 percent of the System's total assets in 1997. More recently, FHFB's mission compliance efforts have included promoting certain mission-related activities; however, FHFB continues to lack policies and procedures that lay out how it will effectively regulate mission. Recently, FHFB has taken a number of steps to try to better ensure and assess mission compliance. Specifically, FHFB has (1) required that Banks submit annual reports that describe their new products, pricing, and investment partnerships; (2) commissioned a study to, among other purposes, assist in developing procedures to oversee Bank mission compliance; (3) tested draft examination procedures to ensure mission compliance; and (4) amended regulations for Bank member community support requirements, as well as FHFB's oversight activities, to ensure member compliance with those requirements. FHFB has also begun to study the System's investment activities and is considering whether it should limit non-mission related investments. We view these as positive steps because a high level of non-mission related investments would raise questions about how Banks are fulfilling their mission. Investments at the individual Banks ranged from 17 to 58 percent of assets at year-end 1997.

We encourage FHFB to continue its efforts to develop a regulatory framework for a mission compliance oversight program. To be effective we believe such a program must be based on well-defined policies that delineate what constitutes mission compliance and prescribe the methods to be used to measure whether Banks have fulfilled their mission.

Weaknesses Exist in Other Areas of FHFB's Regulatory Oversight Program

We found additional weaknesses in FHFB's off-site monitoring and enforcement programs that raise concerns about its regulatory effectiveness. Both functions are vital to ensure that any problems are identified promptly and that corrective action is taken when needed.

Recognizing the need for timely monitoring, the Office of Supervision developed a regulatory oversight and off-site monitoring system in 1996 that required monthly reviews of Bank data, including minutes of board of directors meetings, internal audit reports, and financial data. In 1997, the Office of Supervision suspended its monthly off-site monitoring due to staff constraints. We found that examiners primarily reviewed the periodic data submitted by the Banks to FHFB as part of their annual preparation for examinations. The Office of Supervision also prepared several periodic reports on financial management policy compliance and interest-rate risk exposures, financial trends, and debt-issuance activities. In addition, the Office of Policy produced several periodic monitoring reports, such as a quarterly profile report that tracks Bank statistics (including Bank membership), the affordable housing program, and unsecured credit. Both offices shared their reports with the board of directors but they generally did not coordinate their monitoring activities, which are viewed as having different purposes. FHFB lacked policies and procedures for off-site monitoring, and there appeared to be no correlation between Bank size or scope of activities and the level or type of off-site monitoring performed by these offices.

We found that FHFB's supervisory enforcement program lacks clear policies and procedures for taking enforcement actions and does not specify what actions would be taken if certain conditions existed. We recommended that FHFB clearly articulate and document its current enforcement mechanism, policies, and procedures. The Bank Act authorizes FHFB to "promulgate and enforce" regulations and orders but only delineates one enforcement power for FHFB—the authority to remove or suspend for cause any Bank director, officer, employee, or agent. FHFB officials told us that they believe that the general provision in the statute enables them to take corrective action, if necessary. The officials stated that they consider examination reports that include "findings" requiring corrective action the equivalent of an enforcement order. We did not find instances when FHFB had been unable to obtain Bank compliance with its findings. However, we believe, as we have recommended in past work for any GSE regulator, that the statute should specifically give FHFB all enforcement authorities granted other regulators. Further, in past GSE work, we identified certain principles necessary for effective enforcement of rules and regulations.[2] Two of these principles are that certain enforcement actions should be mandatory when previously specified conditions are met and should be the result of a clear and reasonable

[2]Government-Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks (GAO/GGD-91-90, May 22, 1991).

process. We believe FHFB would be better prepared and assured of its ability to take forceful action if its statute enumerated the authorities granted other GSE regulators, such as cease and desist and civil money penalty powers. Therefore, we suggest that Congress consider granting FHFB the specific enforcement authority provided other GSE regulators.

FHFB Remains Involved in System Business

Mr. Chairman, our review of FHFB oversight would not be complete without a consideration of its unique role in some aspects of System business. We remain concerned, as we have noted in the past, that combining the roles of oversight and involvement in System business may undermine the independence necessary for FHFB to be an effective safety and soundness and mission regulator.[3] We recognize that the responsibility for FHFB's involvement in System business is, in part, due to statutory authorities carried over from FHFB's predecessor, the Bank Board. For example, the Bank Act gives FHFB authority to issue the System's consolidated obligations and requires that FHFB approve Bank dividends and bylaws. FHFB and System officials agree that a regulator should not be involved in the day-to-day operations of Banks, but the degree and type of involvement they consider appropriate varies. Since 1994, FHFB has identified and devolved certain business or governance and management activities, within specified limits, to Banks' boards. These activities include the authority to establish presidents' salaries and incentive plans, approve affordable housing program applications, determine the compensation of Bank directors, and set Bank performance targets. Management activities identified by as yet to be devolved include the authority to approve dividends, certain general administrative matters, and setting credit policies. Although FHFB has delegated some of these functions to the bank boards, we suggest that Congress consider ensuring, through legislation, that FHFB not be involved in the business of the System. We are aware of and support the provisions of the legislation pending in the House and Senate that would begin to correct some of our concerns about FHFB's involvement in System business.

In 1993, we expressed concerns about FHFB acting as a promoter and coordinator for the System. On the basis of our latest review, we are still concerned with the degree to which FHFB remains involved in System business. Undertaking promotion and coordination activities may undermine FHFB's independence and raise questions about its objectivity as a regulator. The Banks have organized two central groups with the

[3] FHLBank System: Reforms Needed to Promote Its Safety, Soundness, and Effectiveness (GAO/T-GGD-95-244, Sept. 27, 1995).

potential to provide central coordination and promotion for the System. Nevertheless, FHFB officials view promotion as part of FHFB's role as a regulator. Its 5-year strategic plan, which FHFB says is integral to its budget and performance planning, illustrates the prominence of the promotion and coordination roles in agency operations. Of the plan's nine objectives, one addresses the examination function, and five address changes FHFB advocates to enhance Bank performance, such as expanding the acceptable uses for advances and expanding acceptable collateral on advances to include small business loans. Of the other three objectives, two address the devolution effort, and one deals with disseminating public information about FHFB's performance.

We identified other examples of the FHFB's promotion and coordination activities during our review. For example, the FHFB chairman coordinates and participates in periodic meetings with Bank chairs and vice chairs that include coordinating congressional lobbying efforts. FHFB's involvement with these bank officials—whom it appoints—in lobbying for statutory changes illustrates the potential FHFB has for influence over these positions. We believe FHFB should have regulatory authority over business functions to ensure safety and soundness and mission compliance, but we emphasize that having such regulatory authority differs from being a participant in System business on a regular basis and from promoting a particular program or activity over other mission-related activities. Further, mission promotion is not a substitute for mission regulation, which has to be built on measurable and enforceable regulations and policies.

A Single Housing Regulator Would Have Advantages Over FHFB

The last issue I want to address today is our suggestion that Congress consider creating a single regulator to oversee the safety and soundness and mission compliance of the three housing GSEs. In addition to the System, these include the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), which are regulated for safety and soundness by the Office of Federal Housing Enterprise Oversight (OFHEO), an independent regulator within the Department of Housing and Urban Development (HUD), and HUD itself, which has general regulatory authority and oversees Fannie Mae's and Freddie Mac's mission compliance.

In past work on the housing GSEs, we discussed the advantages and disadvantages of creating a single housing GSE regulator.[4] Since then, we have continued to monitor and evaluate the housing GSEs and their regulators. For example, we issued a report on OFHEO in October 1997 and updated that work in July 1998. We also reported on HUD's mission oversight of Fannie Mae and Freddie Mac in July 1998.[5]

We found that OFHEO had not fully completed two important duties: establishing risk-based capital standards and implementing a comprehensive and timely examination program. At your request, Mr. Chairman, we provided new information to this subcommittee in July regarding OFHEO's progress in implementing a comprehensive oversight program. We reported that OFHEO had made some progress but still faced challenges in completing those two important duties.[6]

Our work at HUD raised a number of issues about its oversight of Fannie Mae and Freddie Mac, some of which would be eliminated or at least mitigated if there were a single regulator for the housing GSEs. For example, HUD is required to establish goals for its GSEs' purchase of mortgages serving targeted groups and also maintain the GSEs financial soundness because such purchases could increase credit risk. We found that HUD had adopted a conservative approach to setting the goals that placed a high priority on maintaining the GSEs' financial soundness, but that HUD had not fully analyzed the financial consequences of setting higher goals.

As a result of our work at OFHEO and HUD, we found no evidence that would cause us to alter our previous position regarding a single regulator. In addition, our current work at FHFB has strengthened our conclusion that FHFB's, OFHEO's, and HUD's oversight of the housing GSEs would be more effective if combined. Thus, we continue to support our 1994 and 1997 positions that a single housing GSE regulator be created to oversee the safety and soundness and mission compliance oversight of the housing GSEs.

[4]Federal Home Loan Bank System: Reforms Needed to Promote Its Safety, Soundness, and Effectiveness (GAO/GGD-94-38, Dec. 8, 1993) and Government-Sponsored Enterprises: Advantages and Disadvantages of Creating a Single Housing GSE Regulator (GAO/GGD-97-139, July 19, 1997).

[5]Federal Housing Enterprises: OFHEO Faces Challenges In Implementing a Comprehensive Oversight Program (GAO/GGD-98-6, Oct. 22, 1997) and Federal Housing Enterprises: HUD's Mission Oversight Needs to Be Strengthened (GAO/GGD-98-173, July 28, 1998).

[6]OFHEO's Progress in Implementing a Comprehensive Oversight Program for Fannie Mae and Freddie Mac (GAO/GGD-98-182R, July 29, 1998).

A single regulator would be better able to evaluate the trade-off between mission and safety and soundness as well as evaluate the financial aspects of new mortgage products and other GSE activities, such as nonmission investments, because it would combine expertise in housing and finance. A single regulator would be more independent and objective than separate agencies, because it would not be affiliated with one particular GSE, or dependent on that GSE for its continued existence and thus subject to its influence. A single regulator would be more prominent in government than either FHFB or OFHEO is alone. This should further enhance the single regulator's independence and make it more competitive in attracting and retaining staff with appropriate expertise and experience. In addition, a single regulator could capitalize on sharing staff expertise in such areas as examinations, risk monitoring, financial analysis, and economic research. The examinations staffing constraints we identified at FHFB and similar staffing concerns identified at OFHEO might be alleviated by combining FHFB, OFHEO, and HUD resources. Similarly, OFHEO's work in setting capital standards and developing a stress test could be useful in oversight of the System.

This concludes my prepared statement, Mr. Chairman. My colleagues and I would be pleased to answer any questions.

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