



General Government Division

B-280527

July 29, 1998

The Honorable Richard H. Baker
Chairman, Subcommittee on Capital
Markets, Securities, and
Government Sponsored Enterprises
Committee on Banking and Financial Services
House of Representatives

Subject: OFHEO's Progress in Implementing a Comprehensive
Oversight Program for Fannie Mae and Freddie Mac.

Dear Mr. Chairman:

This letter responds to your request that we provide information on the progress of the Office of Federal Housing Enterprise Oversight (OFHEO) in implementing the recommendations in our October 1997 report¹ on OFHEO's efforts to help ensure the financial safety and soundness of Fannie Mae and Freddie Mac (the enterprises). Under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the 1992 Act), OFHEO's primary means of ensuring the enterprises' financial safety and soundness are the implementation of (1) risk-based capital standards based on a stress test² and (2) an on-site examination program. OFHEO's activities are essential to help ensure that the enterprises can continue to meet their housing mission while minimizing the possibility that the federal government would ever be called on to provide financial assistance to the enterprises, which had combined financial obligations of \$1.6 trillion at year-end 1997.

In our October 1997 report, we found that OFHEO was almost 3 years late in completing the risk-based capital standards and

¹Federal Housing Enterprises: OFHEO Faces Challenges in Implementing a Comprehensive Oversight Program (GAO/GGD-98-6, Oct. 22, 1997).

²The purpose of a stress test is to lower taxpayer risks by simulating, in a computer model, situations where the enterprises are exposed to adverse credit and interest rate scenarios and estimating the risk-based capital that the enterprises would be required to hold to withstand these scenarios for a period of 10 years, plus an additional 30 percent capital to cover management and operations risk.

had not yet fully implemented a comprehensive examination program. To address these issues, we recommended that OFHEO report to Congress periodically on its progress in completing a rule implementing the risk-based capital standards by 1999, which is the current plan. We also recommended that OFHEO consider corrective actions to strengthen its examination program, such as reallocating staff positions to the examinations office and filling existing vacancies. As agreed with your office, our objectives for this letter were to (1) report on OFHEO's progress in completing the risk-based capital rule by 1999 and (2) assess OFHEO's implementation of its financial safety and soundness examination responsibilities.

BACKGROUND

In our October 1997 report, we found that OFHEO had missed the 1994 statutory deadline for completing the risk-based capital rule for several reasons, including the complexity of the task, OFHEO's decision to develop a new and sophisticated stress test rather than adopt and modify existing stress tests, and key staff attrition. We also found that OFHEO had consistently underestimated the time necessary to complete the risk-based capital rule.

During our work on the report, OFHEO's acting director said that under the latest plan OFHEO would submit a proposed risk-based capital rule to the Office of Management and Budget (OMB) in September 1998. OFHEO officials assumed that OMB would then review the proposed rule during the fall of 1998, and, after OMB's final approval, the rule would be submitted for public comment in late 1998 or early 1999. OFHEO then planned to review the public comments and issue the final rule during 1999.

However, we also reported that OFHEO faced challenges in complying with the plan, such as the need to make key economic decisions about the stress test and to complete the complex process of drafting the proposed rule. We thus recommended that OFHEO report periodically to Congress on its progress towards complying with the plan.

In our report, we also found that OFHEO had not fully implemented a comprehensive safety and soundness examination program for the enterprises. In particular, we pointed out that OFHEO took 3 to 4 years to assess the major risks--such as credit and interest rate risks--facing the enterprises, rather than adhering to the 2-year cycle OFHEO established in 1994. We also found that examiner attrition and a lack of resources assigned to the examination office had contributed to OFHEO's inability to adhere to a 2-year examination cycle. We recommended that OFHEO assess the resources needed to implement a 1- or 2-year examination

cycle and develop a plan to obtain the necessary resources in order to implement the appropriate cycle.

RESULTS IN BRIEF

According to OFHEO officials, the organization has largely completed the economic and technical components of the stress test that are necessary to complete the proposed rule. For example, the officials said OFHEO has made key decisions regarding the interest rate and credit risk shock scenarios that comprise the stress test. OFHEO has also largely completed the version of the computer-based financial simulation model that serves as the basis of the stress test. The financial simulation model allows OFHEO to (1) analyze the financial consequences for the enterprises of various interest rate and credit shock scenarios and (2) determine the risk-based capital standards for the enterprises resulting from these analyses. Although some final software documentation work on the financial simulation model remains, OFHEO appears to have the major technical elements in place.

However, OFHEO continues to face significant challenges in ensuring that the proposed rule is completed by September 1998 and that the final rule is issued in 1999 as currently planned. First, OFHEO lost key senior staff members due to resignations in 1998, which could delay OFHEO's development of the proposed rule. Second, a proposed plan for OFHEO to provide technical details of the stress test and financial simulation model to staff from OMB, the Department of Housing and Urban Development (HUD), the Department of the Treasury, and federal bank regulators during the summer of 1998 has been cancelled. OFHEO officials said that this planned technical review would have facilitated the regulatory review process of the proposed rule. However, OMB decided not to proceed with the meetings, which could lengthen the time OMB takes to approve the proposal. Third, given the complexity of the financial simulation model and the stress test, the process by which the public comments on the proposed rule and OFHEO reviews these comments could take a substantial period of time, further limiting OFHEO's ability to issue the final rule in 1999.

Since 1997, OFHEO has made progress in implementing a revised financial safety and soundness examination program for the enterprises. For example, OFHEO hired the former chief risk-management specialist for the Office of the Comptroller of the Currency (OCC), which regulates national banks, to head the examinations office. OFHEO has also reallocated existing staff positions to the examinations office and filled existing examiner vacancies. In addition, OFHEO has implemented a new examination strategy designed to annually assess the major risks facing the

enterprises. According to OFHEO's examination office director, OFHEO has made significant progress during 1998 in implementing the annual plan, but some challenges remain, such as fully evaluating the enterprises' interest rate risk management systems.

DESPITE MAKING SIGNIFICANT PROGRESS, OFHEO CONTINUES TO FACE CHALLENGES IN COMPLETING THE FINAL RULE BY 1999

In July 1998, OFHEO officials said that they had largely completed the economic and technical work necessary to complete the proposed rule implementing the risk-based capital standards and the stress test. However, OFHEO continues to face significant challenges that call into question whether the final rule implementing the risk-based capital standards will be completed by 1999 as currently planned. These challenges are (1) the attrition of key staff; (2) the cancellation of a proposed series of meetings during the summer of 1998 at which OFHEO had planned to provide technical details of the stress test to OMB, Treasury, HUD, and bank regulatory agency staff; and (3) a potentially lengthy public comment and review period on the proposed rule.

OFHEO Said It Has Largely Completed the Development of the Stress Test

According to OFHEO officials, the agency has largely completed work on the stress test and the financial simulation model. For example, OFHEO's acting director said that, during 1998, the organization made final decisions on key economic factors necessary to complete the stress test, such as assumptions about future interest rates. The acting director also said that OFHEO has largely completed the version of the computer-based financial simulation model that serves as the basis of the stress test. With the financial simulation model largely completed, the acting director said that OFHEO can now (1) analyze the financial consequences for the enterprises of various interest rate and credit risk shock scenarios; (2) determine the risk-based capital requirements for the enterprises based on these analyses; and (3) finish drafting the proposed rule.

Although OFHEO officials said the financial simulation model is largely completed, some technical work remains. The director of OFHEO's Office of Research, Analysis and Capital Standards (ORACS) said that the software documentation³ of the major

³Software documentation involves documenting the computer code that runs the financial simulation model. Documentation is necessary so that the financial simulation model can be reviewed

modules that comprise the financial model, such as those modules that calculate enterprise cash flows and mortgage loss severities, has been completed. However, the documentation of less significant modules is either ongoing or yet to be started. Specifically, as of July 1998, the ORACS director said that the documentation for 11 of the 23 modules had been completed, documentation and review was ongoing in 6 modules, and documentation had yet to be started in 6 modules. OFHEO's acting director said that the documentation that has been completed represents about 80 percent of the required work. According to the ORACS director, it is not necessary to complete the documentation before the proposed rule is submitted to OMB. Rather, the ORACS director said, OFHEO's goal is to complete the software documentation for the current version of the financial simulation model before the proposed rule is submitted for public comment.

OFHEO Continues to Face Significant Challenges

Despite the progress OFHEO has made in developing the stress test, the organization faces major challenges in submitting a proposed rule to OMB in September 1998 and issuing the final rule as planned by 1999. In our October 1997 report, we found that the loss of several ORACS staff as well as staff from the Office of Policy Analysis (OPol) in 1996 and 1997 had contributed to the delay in the development of the proposed and final rules. During 1998, ORACS has continued to face attrition problems caused by the resignation of five staff members, including the manager of financial research, the senior financial analyst, and the manager of advanced systems development. Moreover, the deputy chief economist in OPol, who also had key stress test development responsibilities, resigned in July 1998. As of July 1998, OFHEO had replaced the manager of advanced systems development through an internal promotion.

According to OFHEO's acting director, the loss of the ORACS manager of financial research and senior financial analyst, as well as the OPol deputy chief economist, could delay the completion of the proposed rule currently scheduled for September 1998. The acting director said that these three individuals were responsible for writing portions of the proposed rule and testing financial models that comprise the stress test. The acting director said that he is distributing the responsibilities of the departed officials to existing OFHEO staff and contractor personnel as appropriate.

and replicated.

Another factor that could delay the completion of the proposed rule is that OMB decided not to proceed with a planned series of meetings during the summer of 1998 at which OFHEO was to provide technical details of the stress test to staff of OMB, Treasury, HUD, and federal bank regulatory agencies. In April 1998, OFHEO's acting director said that the planned meetings would be a key factor in facilitating the interagency review of OFHEO's stress test and would reduce the amount of time it would take OMB to approve the proposed rule. However, on June 18, 1998, OMB's general counsel wrote a letter to OFHEO's acting director stating that OMB would not participate in the meetings. The letter stated that OFHEO should submit the proposed risk-based capital rule to OMB when it is completed.

OFHEO's acting director said that OFHEO plans to work informally with Treasury and HUD staff during the summer of 1998 to explain the technical components of the stress test. Nevertheless, the possibility exists that OMB's decision not to participate could lengthen the time that it takes OMB to approve OFHEO's proposed rule. Further, OMB's letter to OFHEO stated that it may take longer than the customary 90 days for OMB to review the proposal.

Finally, given the complexity of the stress test and financial simulation model, it may take a significant amount of time for the public to review and comment on the proposed rule and for OFHEO to respond to the public's comments. According to OFHEO officials, the proposed rule will consist of from 500 to 1,000 pages covering complex and technical issues. Fannie Mae has already requested that OFHEO provide the public with a 9-month comment period rather than the normal 4-month period. OFHEO's acting director said that the organization had not made any final decisions on lengthening the review process, but may do so based on comments from public reviewers. If OFHEO determines that it is necessary to extend the public comment period significantly beyond 4 months, OFHEO's ability to issue the final rule in 1999 may be limited. Further, as has been the case in the past, the enterprises and other interested parties may submit extensive public comments on the proposed rule, which OFHEO then must review and respond to.

OFHEO'S EXAMINATION PROGRAM HAS MADE PROGRESS

Since our October 1997 report, OFHEO has made progress in implementing a comprehensive financial safety and soundness examination program for the enterprises. OFHEO has hired key senior staff for its Office of Examination and Oversight (OEO), reallocated existing staff positions to OEO, and filled existing examination staff vacancies through new hires. In addition, OFHEO significantly revised its examination program to annually address the major risks facing the enterprises. As of July 1998,

OEO's director stated, the agency had made significant progress in implementing the program, although some challenges remain in attempting to cover all potential risks in 1998.

OFHEO Has Increased OEO Staff Resources

During 1997, OFHEO hired key senior staff for OEO. OFHEO hired the former senior risk-management specialist for OCC to serve as the OEO director. In addition, OFHEO contracted with the former chief national bank examiner for OCC to assist in revising OFHEO's examination program. In June 1998, this individual's contract expired.

In March 1997, OEO had 6 vacant positions out of a total of 18 full-time positions⁴--a vacancy rate of 33 percent--which contributed to the organization's inability to implement a 2-year examination cycle. Since 1997, OFHEO has expanded the number of full-time OEO positions from 18 to 20. OFHEO reallocated two positions from other offices, such as the acting director's office, to increase OEO's staff resources. Moreover, OFHEO has hired examiners and financial specialists to fill the existing vacancies. Since July 1997, OFHEO has hired nine individuals--including the new OEO director--to fill existing vacancies, in addition to the two new positions allocated to OEO. As of June 30, 1998, OFHEO officials stated, all 20 full-time positions in OEO were filled.

OEO's director also told us that OFHEO has recently faced difficulties in obtaining examiners on detail from federal bank regulatory agencies, such as OCC.⁵ The OEO director said that federal bank regulatory agencies are in the process of hiring hundreds of examiners themselves, and that there is a tight labor market for examiners, particularly those with information systems expertise. As a result, the OEO director said, OFHEO's acting director has transferred existing financial resources for detailed examiners to create four new full-time examiner positions. The OEO director said that OFHEO is in the process of recruiting to fill these positions, which will increase the OEO full-time staff to 24.

⁴Of these 18 full-time positions, 17 were permanent positions and 1 was a temporary position.

⁵OFHEO has used detailees from bank regulatory agencies to assist in enterprise examinations, and OFHEO reimburses the bank regulatory agencies to cover salary and other expenses.

OEO Has Revised the Enterprise Examination Program

In early 1998, OEO significantly revised its examination program to annually review the major risks facing the enterprises. OEO has identified four risk categories--credit, market, operations, and corporate governance--that examiners are to assess at each enterprise annually. Under the revised program, OEO examiners are to develop written examination strategies and work plans to assess the key risks facing each enterprise. OEO has also developed procedures for its examiners to follow in assessing the enterprises' risk management practices. According to OEO's director, he has discussed the revised examination program with officials of both enterprises.

We further note that, contrary to OFHEO's prior practice--under which virtually all OEO examiners were assigned to a particular enterprise risk examination until it was completed--OEO examiners now specialize in particular risk categories. For example, OEO has assigned a team of five examiners to analyze credit risks at the enterprises generally on a full-time basis. OFHEO also has three OEO professional staff who conduct off-site monitoring of the enterprises' financial condition and prepare periodic risk reports to facilitate the on-site examination process.

OFHEO's Progress Towards Complying With the Annual Plan

According to OEO's director, the office has made significant progress in implementing the revised, risk-focused examination program during 1998. The OEO director said that he meets with risk management teams on a weekly basis to discuss both their progress towards completing examination objectives and their examination findings. Further, the OEO director said that examination findings and status are communicated to the enterprises' management on a quarterly basis.

Although the OEO director said that the office had made significant progress in complying with the annual plan, some challenges remain to covering all of the risks during 1998. For example, the OEO examiner who oversees the enterprises' market risks told us that the enterprises are implementing new systems and procedures to manage their interest rate risks. The OEO examiner said that reviewing these new systems will require a substantial effort by his team. Nevertheless, OEO's director said that he is confident that the risk-focused examinations of both enterprises will be completed by year-end 1998.

SCOPE AND METHODOLOGY

To report on OFHEO's development of the stress test and risk-based capital standards, we reviewed our October 1997 report and

interviewed OFHEO officials. We also reviewed several preliminary OFHEO reports--run on the financial simulation model--that reflect the impact of interest rate and credit risk shock scenarios on the enterprises' financial condition. In addition, we reviewed (1) OFHEO's progress reports on completing the software documentation of the modules that comprise the financial simulation model; (2) the documentation for three completed modules; and (3) ORACS attrition data for 1998.

We discussed OFHEO's examination program with OEO's director as well as with senior OEO professional staff. In addition, we reviewed OEO hiring data and its documentation that describes the revised enterprise examination program.

We performed our work from April to July 1998 in accordance with generally accepted auditing standards.

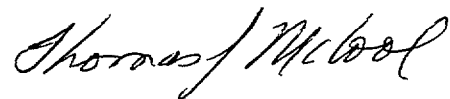
AGENCY COMMENTS

We obtained oral comments on a draft of this letter from the Acting Director of OFHEO. The Acting Director said that the draft letter accurately reflected OFHEO's progress in developing the risk-based capital rule and implementing the annual risk-focused examination program. OFHEO also provided technical comments, which have been incorporated where appropriate.

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We appreciate the opportunity to provide you with information about OFHEO's implementation of its financial safety and soundness mission for the enterprises. We are sending copies of this letter to the members of the House and Senate Banking Committees, the Acting Director of OFHEO, Fannie Mae and Freddie Mac, and other interested parties. In the event that you or your office have any further questions, please contact me on (202) 512-8678.

Sincerely yours,



Thomas J. McCool
Director, Financial Institutions
and Markets Issues

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