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FEDERAL HOUSING ENTERPRISES

OFHEO Faces Challenges In Implementing a Comprehensive Oversight Program

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Congressional Committees

This report addresses requirements that we assess the operations of the Office of Federal Housing Enterprise Oversight (OFHEO) contained in Sec. 430 of the Department of Veterans Affairs/Department of Housing and Urban Development Appropriations Act of 1997 (P.L. 104-204). The report assesses OFHEO's capacity to fulfill its mission of helping to ensure the safety and soundness of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation.

As such, the report provides information on OFHEO's development of risk-based capital standards, implementation of an examination program, establishment of mission support functions, and participation in a U.S. initiative to assist Mexico in developing a secondary mortgage loan market. We also provide recommendations to the acting director of OFHEO on strengthening reporting to Congress on the development of the risk-based capital standards and ensuring adequate resources for the examinations program.

We are sending copies of the report to other appropriate congressional committees, the Acting Director of OFHEO, the Chairman of the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and other interested parties. We will also make copies available to others upon request.

Major contributors to this report are listed in appendix V. If you have any questions about this report, please call me on (202) 512-8678.

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Executive Summary

Purpose

There is a widespread perception in the financial markets that, during a financial emergency, the U.S. government would rescue either or both of the two largest federal housing enterprises, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), which had combined financial obligations of $1.5 trillion at year-end 1996. To lower the probability that such a costly government intervention would ever be considered necessary, it is important that the Office of Federal Housing Enterprise Oversight (OFHEO) fulfill its mission of helping to ensure the safety and soundness of Fannie Mae and Freddie Mac (the enterprises) pursuant to the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the act). OFHEO's primary means for fulfilling its mission are establishing capital standards for the enterprises and conducting on-site examinations to assess their management practices and financial condition.

The Department of Veterans Affairs (VA)/Department of Housing and Urban Development (HUD) Appropriations Act of 1997 required GAO to assess OFHEO's fulfillment of its safety and soundness mission. Based on discussions with congressional staff, GAO established the following two major objectives to respond to the mandate: (1) identify the reasons why OFHEO has not issued final risk-based capital standards for the enterprises even though there was a December 1, 1994, deadline for doing so and (2) assess OFHEO's implementation of its safety and soundness examination responsibilities.

Background

Congress established and chartered the enterprises as government-sponsored, privately owned and operated corporations to enhance the availability of mortgage credit across the nation during both good and bad economic times. The enterprises are to accomplish this mission by purchasing mortgages from lenders (banks, thrifts, and mortgage bankers) who can then use the proceeds to make additional mortgage loans to home buyers. The enterprises issue debt to finance some of the mortgage assets that they retain in their portfolios. A majority of the mortgages, however, are pooled to create mortgage-backed securities (MBS) that may be sold to investors or repurchased by the enterprises and held in their portfolios. The enterprises charge fees for guaranteeing the timely payment of principal and interest on MBS held by investors. At year-end 1996, the enterprises had combined debt obligations of $487 billion and combined MBS obligations to investors of $1.021 trillion (a total of about $1.5 trillion).

The federal government's creation of and continued relationship with Fannie Mae and Freddie Mac have created the perception in the financial markets that it would not allow the enterprises to default on their debt and MBS obligations, even though there is no requirement that it do so. As a result, Fannie Mae and Freddie Mac can borrow money in the capital markets at lower interest rates than comparably creditworthy private corporations that do not enjoy federal sponsorship, and at least a portion of the financial benefits that accrue to the enterprises have been passed along to homeowners in the form of lower mortgage interest rates. However, the potential also exists that the government would choose to intervene to rescue the enterprises in a financial emergency. In fact, during the 1980s, the government did provide limited regulatory and financial relief to Fannie Mae when it experienced significant financial difficulties, and, in 1987, Congress authorized $4 billion to bail out the Farm Credit System, another government-sponsored enterprise.

Recognizing the potentially large costs that Fannie Mae and Freddie Mac pose to taxpayers, Congress passed the act, which established OFHEO as an independent regulator within HUD whose mission is to help ensure the enterprises' safety and soundness. Under the act, OFHEO's director, who is presidentially appointed and must be confirmed by the Senate, has wide independent authority to ensure that OFHEO fulfills its safety and soundness mission. For example, the director has the authority to take enforcement actions against the enterprises without the review and approval of the HUD Secretary. OFHEO had a budget of about $15.5 million in fiscal year 1997 and a professional staff of about 85 individuals consisting of full-time staff, temporary staff, contract employees, and detailees from bank regulatory agencies. OFHEO's budget is subject to the congressional appropriations process, but its expenditures are financed, to the extent provided in appropriations acts,[1] by annual assessments on Fannie Mae and Freddie Mac rather than with taxpayer funds.

As required by the act, OFHEO is to carry out its oversight function in part by establishing minimum capital standards. The act also mandated that OFHEO develop a stress test that serves as the basis for the risk-based capital standards. Under the act, the 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 requiring them to hold sufficient capital to withstand these scenarios for a 10-year period plus an additional 30 percent to cover management and operations risk. The act establishes the broad outlines of a stress test, but

[1]OFHEO's budget authority is included in the annual VA/HUD Appropriations Act.

OFHEO is required to complete several projects to further specify the adverse credit and interest rate scenarios and their impacts on the enterprises. Under the act, the stress test and risk-based capital standards were to have been completed by December 1, 1994. The act also requires OFHEO to conduct annual, on-site safety and soundness examinations of the enterprises to assess their operations and financial condition. In OFHEO's opinion, this requirement can be and has been met without conducting full-scope[2] enterprise examinations on an annual basis.

Since the mid-1980s, Fannie Mae and Freddie Mac have been consistently profitable, and, in 1997, the Standard & Poor's credit rating firm gave both enterprises relatively high "AA-" government risk credit ratings.[3] However, OFHEO officials have pointed out that current profitability does not guarantee future profitability. Since Congress passed the act, which established OFHEO in 1992, enterprise assets, which consist primarily of mortgages and MBS that the enterprises retain in their portfolios, have more than doubled. Although potentially more profitable than issuing MBS to investors, larger retained holdings of mortgages and MBS expose the enterprises to potentially greater losses resulting from fluctuations in interest rates.

To identify the reasons why OFHEO has not issued risk-based capital standards, GAO interviewed OFHEO and enterprise officials, as well as former HUD officials who worked on enterprise safety and soundness issues at HUD prior to OFHEO's creation. GAO also reviewed a variety of OFHEO documents, such as internal memorandums and written explanations of the stress test development process provided at GAO's request. GAO did not assess the adequacy or appropriateness of OFHEO's approach to developing the stress test. Since OFHEO has not completed its development of risk-based capital standards, GAO could not evaluate the usefulness of specific steps OFHEO has taken to reach a final rule promulgating a risk-based capital standard. GAO assessed OFHEO's implementation of its examination responsibilities by determining the organization's adherence to an examination schedule and plan that was established in September 1994.

[2]Full-scope examinations are generally understood to mean thorough assessments of all of the management practices and business strategies of a financial institution that could affect its safety and soundness.

[3]Standard & Poor's assessed the risks that the enterprises' financial activities pose to the U.S. government. The firm rates companies on a scale ranging from "AAA" for the lowest credit risks to "CC" for the greatest credit risks.

Results in Brief

To fulfill its statutory safety and soundness mission, OFHEO is to establish risk-based capital standards that are sufficient to withstand the rigors of a complex stress test and implement a comprehensive and timely examination program. To date, OFHEO has not fully completed either of these tasks.

OFHEO has not established the risk-based capital standards because it must first develop the stress test. Development of a stress test has been protracted primarily due to (1) the complexity of the development process as specified in the act and (2) OFHEO's initial decision in 1994 to develop its own sophisticated stress test rather than adopting and modifying stress tests that were already under development. OFHEO officials told GAO that they chose not to adopt existing stress tests because, in their judgment, those tests did not provide an adequate basis for understanding the risks facing the enterprises or the capital necessary to offset those risks. OFHEO officials also said that the organization faced significant and time-consuming challenges in acquiring expertise, obtaining accurate financial information from the enterprises, initiating the federal rulemaking process, and completing several financial modeling and computer programming projects.

OFHEO has already missed its December 1994 statutory deadline for completing a stress test and establishing risk-based capital standards by almost 3 years. Tasks remaining include making key policy decisions about the stress test and continuing to translate its components into proposed and final rules. OFHEO now estimates that it will not complete this part of the statutory mandate until 1999. Because the risk-based capital standards are among OFHEO's primary tools for helping to ensure the enterprises' safety and soundness, GAO believes that it is essential that OFHEO complete the tasks remaining to develop those standards as expeditiously as possible.

OFHEO has not fully implemented a timely and comprehensive enterprise safety and soundness examination program. OFHEO established an examination plan in September 1994 that provided for a 2-year cycle for the assessment of six "core" risks, such as interest rate and credit, facing the enterprises. As of May 1997, OFHEO had completed or initiated examinations covering five of these six "core" risks. However, OFHEO's current 3- to 4-year cycle for assessing the six core risks is considerably longer than the 2-year cycle established in the plan. In addition, OFHEO has scaled back the planned coverage of its most recently completed core risk examination.

GAO's analysis found that, among other factors, limited resources allocated to the examination office were largely responsible for OFHEO's inability to comply with the 1994 plan. According to OFHEO officials, the organization plans to reassess its examination strategy and make changes necessary by early 1998 to ensure that its examination staff cover all six core risk areas within a 1-year period. GAO believes that, without a reassessment and potentially a reallocation of resources, OFHEO may not be able to implement an annual examination cycle by early 1998 that fully covers all risk areas, since the organization has been unable to implement a 2-year cycle with the current assignment of staff to the examination function. Thus, GAO believes that, in the reassessment of its examination strategy, OFHEO could usefully include consideration of different examination cycles and related coverage that could be accomplished with alternative resource levels.

Principal Findings

OFHEO's Development of a Stress Test and Risk-Based Capital Standards Has Been Protracted

In OFHEO's planning process and its published documents, the organization has consistently underestimated the time necessary to complete major components of the stress test and risk-based capital standards. For example, in 1995 OFHEO estimated that the final rule would be issued in May 1997, but OFHEO now expects that the process will not be completed until 1999. GAO's review identified several reasons why OFHEO did not comply with the statutory deadline. GAO also found that OFHEO faces continuing challenges and may not meet its current estimate.

OFHEO's statutory mandate to develop a stress test and risk-based capital standards presented complex and time-consuming challenges to the organization. For example, according to OFHEO, the final stress test must be flexible and capable of assessing the effects of different credit and interest rate scenarios on differing components of the enterprises' mortgage portfolios, such as single family and multifamily mortgages, as well as new financial products. By contrast, the risk-based capital standards developed by federal banking regulators permit institutions to hold the same level of capital against corporate loans that represent high credit risks as against corporate loans that represent low credit risks.

During OFHEO's start-up phase in 1993 and 1994, there were strategies available that OFHEO could have pursued that might have resulted in the faster completion of a stress test and risk-based capital standards. As the foundation of the stress test, OFHEO could have adopted and modified a stress test under development by HUD in 1992, or the financial models that the enterprises had established to assess the potential impacts of alternative credit and interest rate scenarios. However, OFHEO officials determined that pursuing these strategies would have left the organization with an inadequate basis for assessing the risks facing the enterprises. For example, OFHEO officials determined that the available HUD stress test only allowed for very broad estimates of the potential impacts that different interest rate and credit scenarios would have on the enterprises' financial condition. Consequently, OFHEO concluded that it could develop capital standards that would be more closely related to enterprise risks by developing its own sophisticated stress test and associated financial modeling capability. GAO notes that the implementation of this strategy is requiring a substantial development period and resource costs.

Between 1994 and 1997, OFHEO experienced other sources of delay in completing the stress test and risk-based capital standards. For example, OFHEO had not completed hiring half of its full-time research staff until 1996. OFHEO officials also told GAO that the development of the stress test has been delayed by OFHEO's need to (1) obtain accurate enterprise financial data on a timely basis; (2) initiate the federal rulemaking process, which involved a substantial commitment of staff time; and (3) complete a variety of economic and financial modeling and computer programming projects that involved greater managerial and technical challenges than OFHEO initially anticipated. OFHEO officials told GAO that most of these financial modeling and computer programming projects had been completed by April 1997, although some final testing was required.

Given OFHEO's history of underestimating the time necessary to complete the stress test and risk-based capital standards and given the challenges that remain, GAO is concerned that OFHEO may not meet its current estimate of issuing a final rule by 1999. To comply with its plan, OFHEO has to initiate an interagency review of the proposed rule by the Office of Management and Budget (OMB) and other agencies, and has to make key policy decisions necessary to complete the stress test. OFHEO must also continue to translate the complex financial modeling components of the stress test and risk-based capital standards into proposed and final rules. GAO believes it is essential that OFHEO complete the tasks remaining to develop the stress test and establish the risk-based capital standards as expeditiously as possible because they are among OFHEO's primary tools for helping to ensure the enterprises' safety and soundness.

OFHEO Has Not Fully Implemented Its September 1994 Examination Plan

In September 1994, OFHEO established a "risk-focused" examination schedule and plan that senior OFHEO officials said they believed was necessary for helping to ensure the safety and soundness of Fannie Mae and Freddie Mac. The plan, as subsequently modified, identified six core risks facing the enterprises, such as credit and interest rate risks, and established a 2-year cycle for OFHEO examiners to assess each of these six risks. In addition, the plan identified specific areas that OFHEO examiners were to assess during each scheduled examination. OFHEO's risk-focused examination strategy is generally consistent in concept but not in timing with risk-focused examination strategies that the Office of the Comptroller of the Currency (OCC) and the Federal Reserve System have established to assess the safety and soundness of large commercial banks. For example, OCC and Federal Reserve System examiners are to assess the major risks—such as credit and interest rate—facing large commercial banks but, as required by law, they are to do so on an annual basis.[4]

Between September 1994 and May 1997, OFHEO made important progress in implementing the plan, such as completing or initiating examinations at both enterprises that addressed five of the six core risks. However, GAO found that OFHEO was not able to implement other important components of the 1994 plan. For example, OFHEO's current 3- to 4-year examination cycle for covering the six core risk areas is considerably longer than the 2-year cycle established in the 1994 plan. Moreover, OFHEO also scaled back the planned coverage of its core business risk examination. OFHEO completed this risk examination in May 1997 but covered only one of the four areas identified in the 1994 plan. OFHEO's relatively long examination cycle and limited examination coverage raise questions about the organization's ability to fully monitor the enterprises' financial activities and risks. In particular, with its current examination schedule, OFHEO may not be able to do another on-site examination of the enterprises' interest rate risks until 1999 or 2000, even though such risks may have increased because of increased holdings of debt-financed mortgage assets, since the previous interest risk examination was completed in 1996.

In May 1995, GAO reported that limited staff resources had impeded OFHEO's initial efforts to implement the 1994 plan.[5] This situation persisted between 1995 and 1997. As of June 1997, OFHEO's examination office had 17

[4]The Federal Deposit Insurance Corporation Improvement Act of 1991 (Pub. L. No. 102-242, as amended) requires bank regulators to do full-scope examinations of large banks (total assets of $250 million or more) on an annual basis.

[5]Government-Sponsored Enterprises: Development of the Federal Housing Enterprise Regulator (GAO/GGD-95-123, May 30, 1995).

authorized positions of which 12 were reserved for line examiners and specialists directly responsible for conducting examinations; the other 5 positions consisted of the office director and deputy director, executive secretary, and 2 financial analysts. In its two most recently completed core risk examinations, OFHEO assigned 9 and 8 of its line examiner and specialist positions, respectively, to each examination for 1 year to complete them. This significant staff commitment limits OFHEO's ability to complete examinations covering three core risks per year, the minimum necessary to cover all six risks in the 2-year period stipulated in the 1994 plan. In addition, as of March 31, 1997, OFHEO's examination office had five vacancies, including the director position, which had further limited its capacity to implement the 1994 plan. By August 1997, an OFHEO official reported that the organization had filled three of the examination office positions, including the director position, and the two others were in the process of being advertised.

OFHEO officials said that another important factor that has contributed to OFHEO's inability to fully implement the 1994 examination plan was the time that OFHEO examination staff needed to develop an understanding of the enterprises' operations and risk management. Prior to 1993 when OFHEO began operations, the enterprises had not been subjected to an examination oversight program. OFHEO officials said that the first round of examinations has taken longer than initially anticipated in 1994 because of the time necessary to obtain basic information about the enterprises' operations and risk management practices.

OFHEO officials told GAO that the organization plans to reassess its examination program and make changes as necessary to ensure that the enterprises' safety and soundness are adequately monitored. They also said that the planned reassessment is to include a review of the adequacy of OFHEO's examination staff resources to ensure that it has a sufficient number of line examiners and specialists to cover all core risk areas within a 1-year period. OFHEO's acting director said that OFHEO may have some flexibility to increase its examination staff resources by shifting staff from its research activities as the stress test and risk-based capital standards are completed.

GAO believes that, without a reassessment of resources, OFHEO may not be able to implement an annual examination cycle by early 1998, since it has not implemented a 2-year cycle with its existing allocation of resources to the examination function. In fact, as of June 1997, OFHEO had not yet initiated important components of the 1994 plan, such as the remaining core risk examination, which could take considerable time to complete. Thus, GAO believes that by including in the reassessment an analysis of the staff resources necessary to adequately carry out alternative examination cycles, such as 1 or 2 years, OFHEO could help ensure a fuller consideration of the trade-offs associated with examination coverage provided versus costs involved and thereby engage in a more informed decisionmaking process.

Recommendations

Because it is essential that OFHEO complete its efforts to develop and issue risk-based capital standards as soon as possible, it is important that congressional oversight be provided to help ensure that OFHEO's current plan to do so is accomplished in a timely manner. To that end, GAO recommends that OFHEO's director periodically report to Congress on OFHEO's progress toward complying with the current estimate of completing a stress test and risk-based capital standards by 1999. GAO also recommends that OFHEO's director (1) assess the examination staff resources necessary to adequately cover all risk areas on 1- and 2-year examination cycles, (2) identify the most appropriate examination cycle after considering the trade-offs between examination coverage and resource requirements that would be involved, and (3) develop a strategy for obtaining the necessary examination office resources, which may involve reallocating existing resources over time.

Agency Comments and GAO'S Evaluation

OFHEO's acting director provided written comments on a draft of this report, which are summarized in chapters 2 and 3 and reprinted in appendix IV. OFHEO also provided technical comments that were incorporated in the report where appropriate.

OFHEO generally agreed with the report's findings and recommendations. With respect to the reasons for the protracted development of the stress test and risk-based capital standards, OFHEO cited the complexity of the process as specified in the act and OFHEO's decision to develop its own stress test rather than redesigning existing stress tests. OFHEO also said that GAO's report should not be interpreted to suggest that using an existing stress test would have produced an acceptable result. With regard to OFHEO's examination program, OFHEO said that the office plans to transition to an annual cycle by year-end 1997. In addition, the acting director stated that OFHEO will review the adequacy of its examination staff resources to ensure that a comprehensive program can be implemented.

GAO did not take a position on the adequacy or appropriateness of OFHEO's approach to developing the stress test. To do so would have required that GAO demonstrate whether the other alternatives could have been modified sufficiently to meet the requirements of the act in a shorter period of time. Rather, GAO pointed out that there were potential trade-offs associated with the time that would have been required to adopt and modify existing stress tests compared to the comprehensive development approach that OFHEO chose. While OFHEO has agreed to review the adequacy of its examination resources, GAO believes it is essential that OFHEO promptly specify the resources necessary to carry out an appropriate examination cycle and develop a plan to obtain these resources as may be necessary.

Contents

Chapter 4 OFHEO's Implementation of Key Mission Support Functions

Appendixes

Tables

Figures

Abbreviations

ANPR	Advanced Notice of Proposed Rulemaking
APA	Administrative Procedure Act
FHEO	Office of Fair Housing and Equal Opportunity (HUD)
FMS	Financial Management System (Department of Veterans Affairs)
HAAS	HUD Administrative Accounting System
HUD	Department of Housing and Urban Development
HUDCAPS	HUD Central Accounting and Program System
LTV	loan-to-value ratio
MBS	Mortgage-Backed Security
NPR	Notice of Proposed Rulemaking
OCC	Office of the Comptroller of the Currency
OEO	Office of Examination and Oversight (OFHEO)
OFA	Office of Finance and Administration (OFHEO)
OFHEO	Office of Federal Housing Enterprise Oversight
OGC	Office of General Counsel (OFHEO)
OMB	Office of Management and Budget
OPA	Office of Policy Analysis (OFHEO)
ORACS	Office of Research and Capital Standards (OFHEO)
PASA	Participating Agency Service Agreement
PEMS	Performance Evaluation Management System (OFHEO)
SEDESOL	Mexico's Secretariat for Social Development
USAID	United States Agency for International Development
VA	Department of Veterans Affairs

Introduction

Congress has a long-standing concern that the safety and soundness of the two largest government-sponsored enterprises,[1] the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), be maintained so that they can meet their intended purposes and that their financial activities do not pose risks to taxpayers. Consequently, Congress passed the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the act),[2] which established the Office of Federal Housing Enterprise Oversight (OFHEO) within the Department of Housing and Urban Development (HUD) as an independent financial safety and soundness regulator of Fannie Mae and Freddie Mac (the enterprises). For reasons relating to the federal charters and structures of the enterprises—which had combined financial obligations of $1.5 trillion at year-end 1996—investors and rating agencies perceive the enterprises' securities as implicitly guaranteed by the federal government, despite there being no such statutory obligation. We have been mandated by the Department of Veterans Affairs (VA)/HUD Appropriations Act of 1997[3] to assess OFHEO's fulfillment of its safety and soundness mission. Based on discussions with congressional staff, our major objectives were to (1) identify why OFHEO has not finalized risk-based capital standards for the enterprises even though there was a December 1, 1994, deadline for doing so and (2) assess OFHEO's implementation of its enterprises' safety and soundness examination responsibility. We are also providing information on OFHEO's implementation of key mission support functions and participation in a U.S. government initiative to assist Mexico in developing a secondary mortgage loan market.

Background

The enterprises help ensure that mortgage funds are available to home buyers by buying mortgages from mortgage originators, such as commercial banks, thrifts, and mortgage bankers. In turn, the originators use the funds supplied by the enterprises to make additional mortgage loans thereby helping ensure a continuous supply of mortgage credit nationwide during both good and bad economic periods.

[1]Government-sponsored enterprises 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.

[2]Housing and Community Development Act of 1992, Pub. L. No. 102-550, Title XIII, 12 U.S.C. 4501, et. seq.

[3]Pub. L. No. 104-204 § 430, 110 Stat. 2874, 2930 (September 26, 1996).

The enterprises hold some of the mortgages they purchase in portfolio as direct investments on their books and issue debt and equity securities to finance these holdings. However, a majority of mortgages that the enterprises buy from mortgage originators are "securitized"—that is, the enterprises package them into mortgage pools to support mortgage-backed securities (MBS). These mortgage pools receive interest and principal payments from the mortgages in the pools and pass them on to the investors who purchased MBS. The enterprises guarantee the timely payment of principal and interest on MBS held by investors, administer the payments, and charge "guarantee fees" for providing these services. The enterprises may also repurchase MBS and hold the securities in their mortgage portfolios.

The enterprises are government-sponsored in that they operate under federal charters that convey certain benefits, impose certain restrictions, and permit the enterprises to earn a profit while serving public policy purposes, such as providing liquidity[4] to mortgage markets. In 1992, Congress expanded the enterprises' public purpose by requiring annual goals for the purchase of mortgages on housing serving very-low, low-, and moderate-income and other households that are underserved by the residential mortgage market.[5] These goals are to be set, monitored, and enforced by HUD. The charters restrict the enterprises to buying mortgages that do not exceed a set dollar amount, known as the conforming loan limit.[6]

A major factor that enhances the enterprises' profitability is the financial markets' perception that there exists an implied federal guarantee of their debt and MBS obligations. Investors perceive that this implied guarantee decreases the risk of default on the enterprises' financial obligations. Consequently, this perception reduces the enterprises' borrowing costs because investors are willing to accept lower expected returns on enterprise debt than they would for similar private firms without government ties. Likewise, interest rates on MBS are lowered by this

[4]A market is more liquid if investors can buy and sell large amounts of holdings without affecting the prices of the traded securities.

[5]Federal Housing Enterprises Safety and Soundness Act of 1992, Pub. L. No. 102-550, §§ 1331-1334, 12 U.S.C. §§ 4561-4564.

[6]The conforming loan limit depends on how many housing units are financed by a single residential mortgage loan. Currently, the conforming loan limit on a single-unit residence is $214,600.

perception.[7] Their lower funding costs allow the enterprises to increase their purchases and give them a cost advantage over their potential competitors. This perception of a federal guarantee remains, even though laws chartering the enterprises contain explicit language stating that there is no such guarantee.

The market perception of the implied federal guarantee is based on, among other things, federal ties to the enterprises, including government-sponsored status, each enterprise's $2.25 billion conditional line of credit with the Department of the Treasury, and their exemptions from state and local income taxes and securities registration fees imposed by the Securities and Exchange Commission. In 1996, we estimated that the financial benefits that accrue to the enterprises from their federal sponsorship ranged from about $2.2 billion to $8.3 billion on a pretax basis and from about $1.6 billion to $5.9 billion on an aftertax basis in 1995.[8] We also reported that approximately 80 percent to 95 percent of these estimated benefits were derived from the lower funding costs that the enterprises accrue as a result of the perception of a federal guarantee.

Enterprise Activities Benefit Homeowners but Pose Potential Financial Risks to Taxpayers

It is widely accepted that the enterprises' activities have generated benefits to mortgage borrowers, such as lower mortgage interest rates. For example, in our 1996 report, we estimated that the activities of the enterprises resulted in a savings on single-family fixed-rate home mortgages below the conforming loan limit of about 15 to 35 basis points.[9] Thus, a borrower with a $100,000 thirty-year, fixed-rate mortgage saves about $10 to $25 a month on mortgage payments as a result of the enterprises' activities.[10] For the approximately $2 trillion in outstanding

[7]Investors will accept lower expected returns on enterprise MBS, just as for enterprise debt, because of the perception of an implied federal guarantee. This, in turn, lowers the cost of funding mortgages through issuance of MBS.

[8]See Housing Enterprises: Potential Impacts of Severing Government Sponsorship (GAO/GGD-96-120, May 13, 1996). Some analysts contend that these benefits pass entirely through to mortgage borrowers in the form of lower mortgage rates, while others contend that some of the value of the benefits could be retained by the enterprises in the form of higher profits or higher expenditures, such as for compensation. See FNMA and FHLMC: Benefits Derived From Federal Ties (GAO/GGD-96-98R, Mar. 25, 1996).

[9]A basis point equals 1/100 of a percentage point. See Housing Enterprises: Potential Impacts of Severing Government Sponsorship (GAO/GGD-96-120, May 13, 1996).

[10]These estimates are based on an analysis of the increases in mortgage rates that would likely occur if the federal government fully severed its ties with the enterprises, and the perception of a federal guarantee were removed. Assuming that federal ties remain, we estimated that the rate on single-family fixed-rate housing mortgages below the conforming loan limit are lowered by 15 to 35 basis points. See Housing Enterprises: Potential Impacts of Severing Government Sponsorship (GAO/GGD-96-120, May 13, 1996).

conventional conforming fixed-rate mortgages in 1995, we estimated that the aggregate annual savings in mortgage payments were in the range of $3 billion to $7 billion. Other benefits of the enterprises are that they have reduced regional disparities in interest rates and mortgage availability, and spurred the development of new technologies that facilitate the home financing process.

However, the potential also exists that, in the event of a financial emergency, the federal government would choose to intervene and assist either Fannie Mae or Freddie Mac or both in meeting their debt and MBS obligations, which stood at a combined $1.5 trillion at year-end 1996 (see table 1.1),[11] potentially exposing the taxpayers to losses. In fact, during the early 1980s when short-term interest rates rose dramatically, Fannie Mae experienced substantial financial difficulties because the enterprise had funded its mortgage portfolio with short-term debt. As rates increased, Fannie Mae had to issue new short-term debt at higher rates to replace existing short-term debt that came due. Because interest earned on the old mortgages in portfolio was less than interest expenses on new debt, Fannie Mae experienced total losses of about $277 million between 1981 and 1984. (The type of risk Fannie Mae faced in the early 1980s is referred to as interest rate risk.) In response, the federal government provided limited tax relief and regulatory forbearance in the form of relaxed capital requirements. Similarly, in 1987, Congress authorized $4 billion to support the Farm Credit System—another government-sponsored enterprise—when it experienced financial difficulties.

Table 1.1: Total Enterprise Debt and Net MBS Outstanding as of December 31, 1996

Dollars in billions

Enterprise	Debt outstanding	Net MBS outstanding[a]	Total
Fannie Mae	$331	$548	**$879**
Freddie Mac	156	473	**630**
Total	**$487**	**$1,021**	**$1,509**

[a]Excludes MBS that the enterprises have repurchased and hold in their portfolios.

Sources: Fannie Mae and Freddie Mac.

[11]Even in the event of a major financial disaster and the insolvency of both enterprises, it is unlikely that the government would lose $1.5 trillion in providing support to the enterprises. This is because the government, as the conservator of the enterprises, would foreclose on the residences securing the mortgages, and the government could liquidate these properties to help offset its initial expenditures.

Congress Established OFHEO to Help Ensure the Safety and Soundness of the Enterprises

Recognizing the potentially large financial costs that Fannie Mae and Freddie Mac posed to taxpayers, in 1992, Congress passed the act, which established OFHEO as an independent regulator within HUD whose mission is to help ensure the enterprises' safety and soundness. One of OFHEO's most important means of helping to ensure the enterprises' financial soundness is to establish capital requirements that are related to potential risks that the enterprises face. Further, the act gave OFHEO broad authority to examine the activities of the enterprises, such as the requirement that OFHEO conduct annual on-site examinations of the enterprises to assess their financial condition. During fiscal year 1997, OFHEO had a budget of about $15.5 million and a total staff—full-time staff, temporary staff, contract employees, and detailees from bank regulatory agencies—of 85 individuals as of March 31, 1997,[12] to carry out its safety and soundness responsibilities and to perform administrative support functions.

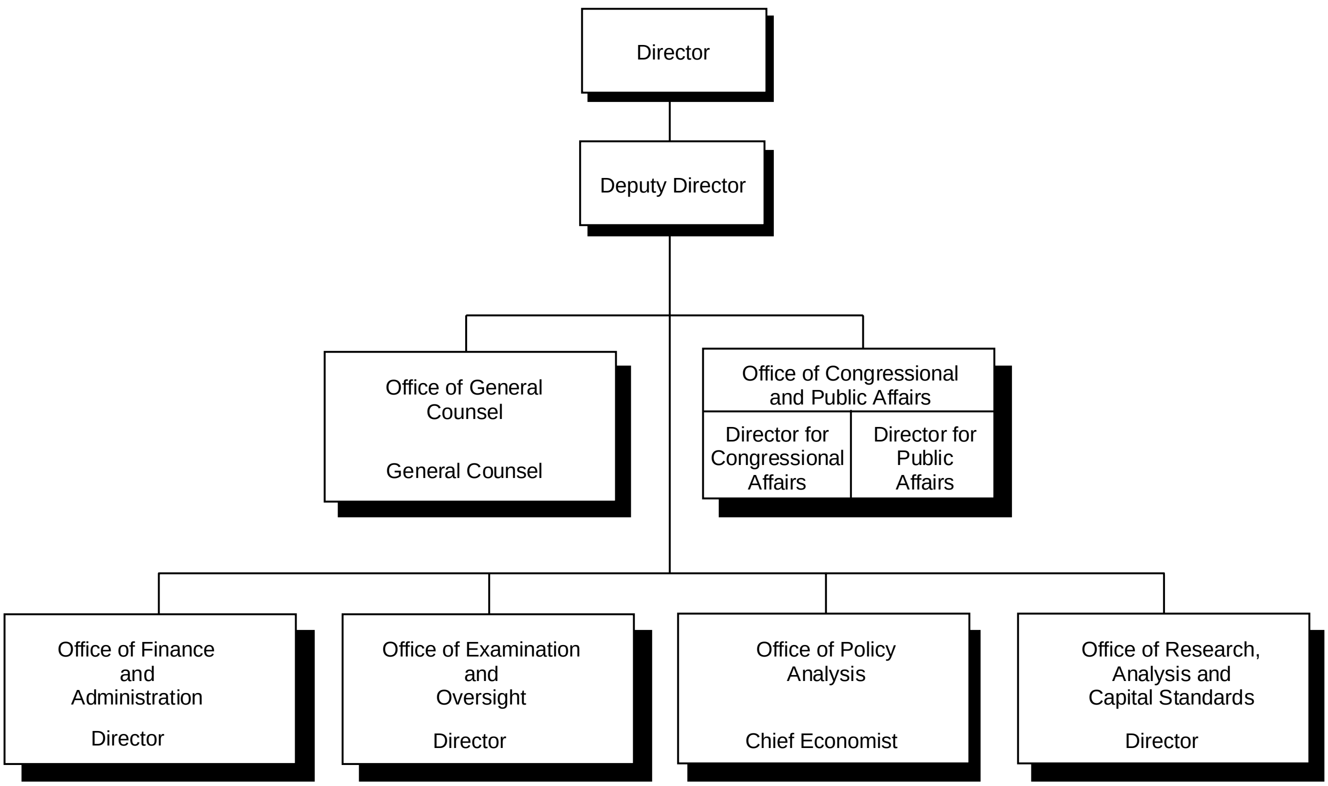
The act established OFHEO as an independent office within HUD with respect to safety and soundness matters, and reserved for the Secretary of HUD the responsibility to oversee the enterprises' efforts to meet the housing goals as well as general regulatory power over the enterprises. However, the act also clarified that the duty to ensure that Fannie Mae and Freddie Mac are adequately capitalized and operate in a safe and sound manner belongs to OFHEO exclusively. OFHEO was intended to operate separately from HUD as a safety and soundness regulator and to be staffed with experts in financial analysis 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 adequacy, and take enforcement actions. The act also gave the director exclusive authority to manage OFHEO, which includes preparing annual budgets and hiring personnel. Thus, the director leads and directs OFHEO's activities by setting internal and external policies, managing overall operations, and serving as the chief spokesperson for the organization. OFHEO's first director was appointed on June 1, 1993, and resigned on February 13, 1997, to become the Administrator of the Small Business Administration. As of June 1997, OFHEO was headed by the acting director, while the President and Congress considered potential candidates for the organization's new director.

[12]OFHEO's staffing levels tend to fluctuate throughout the year as full-time staff resign or are hired and contractors and detailees either complete or begin their assignments.

OFHEO is organized into six offices, which report to the director and deputy director. Figure 1.1 illustrates OFHEO's organizational structure.

Figure 1.1: OFHEO's Organizational Structure



- The Office of the General Counsel (OGC) has responsibility for preparing regulations required by the act and advising the director on legal issues, including financial institutions regulatory issues, applicable corporate law principles, and general legal matters.
- 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.

- The Office of Finance and Administration (OFA) is responsible for ensuring that OFHEO has the infrastructure to function independently. This office 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. OFA is also responsible for developing annual budgets and serving as the liaison with the Office of Management and Budget (OMB).
- 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.
- The Office of Policy Analysis (OPA) is responsible for providing and coordinating economic and policy advice to the director on all issues related to regulation and supervision of the enterprises. This office is also to direct and conduct research and assess the impact of issues and trends in the housing and mortgage markets on OFHEO's regulatory responsibilities.
- The Office of Research, Analysis and Capital Standards (ORACS) is responsible for developing and implementing a financial "stress test," which uses interest rate and credit risk scenarios prescribed in the act to determine the enterprises' risk-based capital requirements. The office is also responsible for conducting research and financial analysis on issues related to the enterprises' activities, such as simulating Treasury yields and associated interest rate movements.

Compared to other federal financial regulators, such as the Federal Reserve System and the Office of the Comptroller of the Currency (OCC), which have thousands of employees, OFHEO is a small organization. Table 1.2 shows the distribution of OFHEO's authorized and onboard permanent employees as of March 31, 1997, among the six offices discussed above. As table 1.2 indicates, OFHEO had an authorized staffing level of 72 full-time permanent positions but had only 58 full-time permanent staff on board as of March 31, 1997. OFHEO supplements its permanent full-time staff with full-time and part-time temporary employees, contractors, and detailees from other financial regulatory agencies that perform key functions on a reimbursable basis. For example, OFHEO has used contract staff and bank regulatory detailees to assist in developing capital standards and in performing on-site safety and soundness examinations. As of March 31, 1997, OFHEO had 6 full-time temporary staff, 1 part-time temporary staff, 19 contractor staff, and 1 bank regulatory detailee on board. Thus, OFHEO had a total onboard staff of 85 individuals (58 full-time permanent, 7 temporary, 19 contract, and 1 detailee).

Table 1.2: OFHEO's Full-Time, Temporary, Contractor, and Bank Regulator Detailee Staff as of March 31, 1997

Unit	Full-time permanent positions	Full-time permanent staff	Full-time temporary staff	Contract	Detail
Director	7	5			
Research, Analysis, and Capital Standards	17	14	4[a]	14	
Examination and Oversight	17	12		3	1
General Counsel	9	8	1		
Finance and Administration	11	11	1	2	
Policy Analysis	6	4	1		
Congressional and Public Affairs	5	4			
Total	**72**	**58**	**7**	**19**	**1**

[a]One of the four staff members was part-time.

Source: OFHEO.

Table 1.3 shows actual, estimated, and requested OFHEO obligations for fiscal years 1996 through 1998. Most OFHEO expenses cover personnel and contractor services. For fiscal year 1997, OFHEO estimated in its fiscal year 1998 budget request to Congress that it will spend about $9.1 million (about 59 percent of its $15.5 million total) on personnel services (i.e., expenses related to personnel compensation and benefits, but exclusive of contractors). According to OFHEO, it sets its salaries and benefits, as required by the act, by maintaining comparability with federal banking regulatory agencies. The second largest category of expenses ("other services") generally covers OFHEO's contractor services. In fiscal year 1997, OFHEO expects to spend nearly $3.8 million (about 25 percent of total obligations) 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 percentage of OFHEO's total obligations. These expenses cover such fundamental items as computer acquisition, travel, and rent, some of which fluctuate with changing numbers of staff and contractors on location.

Table 1.3: OFHEO's Obligations, Fiscal Years 1996 Through 1998

Dollars in thousands

Obligation category	Actual 1996	Estimated 1997	Requested 1998	1997-1998 change
Personnel services	$7,234	$9,119	$9,572	$453
Other services	4,800	3,793	3,664	–129
All other	2,758	2,588	3,076	488
Total	**$14,792**	**$15,500**	**$16,312**	**$ 812**

Source: OFHEO's fiscal year 1998 budget request to Congress.

Although OFHEO's financial plans and forecasts are to be included in the budget of the United States and are subject to the appropriations process,[13] the organization is not funded with tax dollars. Rather, the act requires the enterprises to pay annual assessments to cover OFHEO's costs. Each enterprise is required to pay an amount in proportion to the ratio of its individual assets to the total combined assets of both enterprises. The assessment is to be paid semiannually into a Department of Treasury fund, known as the Federal Housing Enterprises Oversight Fund.

OFHEO Carries Out Its Oversight Mission by Developing Capital Standards and Conducting Examinations

Under the act, OFHEO is to establish two sets of capital standards to help ensure the safety and soundness of the enterprises and minimize taxpayer risks. The first standard, which is called the "minimum capital" standard, requires a minimum amount of capital that an enterprise must hold. Minimum capital is computed on the basis of capital ratios specified in the act that are applied to certain on-balance-sheet and off-balance-sheet obligations of the enterprises. The ratios are (1) 2.50 percent of aggregate on-balance-sheet assets; (2) 0.45 percent of the unpaid principal balance of outstanding MBS and substantially equivalent instruments; and (3) 0.45 percent of other off-balance-sheet obligations (with some exclusions), except as the OFHEO Director adjusts the ratio to reflect differences between the credit risk of such obligations and MBS. OFHEO has classified Fannie Mae and Freddie Mac as "adequately capitalized" under the minimum standard in each quarter beginning in the quarter that ended on June 30, 1993.[14]

[13]OFHEO's budget authority is included in the annual VA/HUD Appropriations Act.

[14]OFHEO issued the final rule implementing the minimum capital standard on July 8, 1996, and the final rule was first used to classify the enterprises as adequately capitalized in the third quarter of 1996. Prior to the issuance of the final rule, OFHEO classified the enterprises as adequately capitalized under interim standards.

The act also requires OFHEO to establish a stress test to serve as the basis for the development of risk-based capital standards. The stress test is intended to lower taxpayer risks by simulating in a computer model situations where the enterprises are exposed to adverse credit and interest rate shocks, and requiring the enterprises to hold sufficient capital to withstand these shocks. The capital amount must be adequate to last during a 10-year period (the stress period), within specific parameters relating to credit risk,[15] interest rate risk,[16] new business, and other activities. 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 of that amount to allow for management and operations risk.[17] Further, the act required the director to issue final regulations establishing the stress test within 18 months of the Director's appointment (i.e., by December 1, 1994). However, as we discussed in our May 1995 report on OFHEO's operations,[18] OFHEO did not meet this deadline. As of April 1997, OFHEO's acting director said that OFHEO expects to issue a proposed rule implementing the stress test and risk-based capital standards by September 1998, with a final rule to be issued in 1999. We discuss OFHEO's development of the stress test and risk-based capital standards in chapter 2 of this report.

In the absence of risk-based capital standards, OFHEO's primary means of monitoring the safety and soundness of the enterprises is its examination program. The act gave OFHEO broad authority to examine the enterprises and requires annual on-site examinations. At such examinations, OFHEO full-time staff, with the assistance of temporary contractors and detailees from bank regulatory agencies, are to assess the financial condition of the enterprises and recommend improvements as necessary. OFHEO also has the authority to take enforcement actions against the enterprises, such as cease and desist orders, to stop unsafe and unsound practices. Further, OFHEO has the authority to place an enterprise into a conservatorship when certain circumstances exist and the enterprise is unable to meet its

[15]In general, credit 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.

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

[17]In general, management risk and operations risk are the exposure to financial loss from inadequate systems, management failure, faulty controls, or human error.

[18]Government Sponsored Enterprises: Development of the Federal Housing Enterprise Financial Regulator (GAO/GGD-95-123, May 30, 1995).

financial obligations or is critically undercapitalized. We discuss OFHEO's examination program and the adequacy of its resources in chapter 3.

Overview of the Enterprises' Financial Performance and Business Strategies

Since the mid-1980s, Fannie Mae and Freddie Mac have been consistently profitable. In 1997, the enterprises received relatively high ratings for financial performance and management from the Standard & Poor's credit rating company. Nevertheless, the enterprises have adopted business strategies in recent years that OFHEO officials believe could potentially weaken their future financial performance. For example, since OFHEO's creation in 1992, the enterprises have substantially increased their holdings of mortgage assets in lieu of issuing MBS to investors. According to OFHEO's former director, increased holdings of mortgage assets potentially expose the enterprises to greater interest rate risks. OFHEO has also reported that there is some evidence that the enterprises have taken on increased credit risk since 1992. The enterprises have also developed sophisticated strategies since the early 1980s that were intended to better manage the interest and credit risks that they face.

Enterprises Have Consistently Done Well Financially in Recent Years

Tables 1.4 and 1.5 show selected year-end profitability data for Fannie Mae and Freddie Mac for the years 1990 through 1996. As the tables indicate, during those years, the enterprises consistently earned profits for their stockholders; this occurred despite significant downturns in regional mortgage markets, such as those in New England and California during the early 1990s. In 1996, Fannie Mae had a net income of $2.7 billion, while Freddie Mac had a net income of about $1.2 billion. The financial data also indicate that since 1990 the enterprises have consistently achieved a return on average common equity, a common measure of profitability, exceeding 20 percent. By contrast, the return on average common equity for the commercial banking industry between 1990 and 1996 was about 12.5 percent.

Table 1.4: Fannie Mae Year-End Profitability Data, 1990 to 1996

Dollars in billions

Year	Net income	Return on average common equity
1990	$1.17	33.7%
1991	1.36	27.7
1992	1.62	26.5
1993	1.87	25.3
1994	2.13	24.3
1995	2.14	20.9
1996	2.73	24.1

Sources: Fannie Mae and OFHEO.

Table 1.5: Freddie Mac Year-End Profitability Data, 1990 to 1996

Dollars in billions

Year	Net income	Return on average common equity
1990	$ .41	20.5%
1991	.56	23.6
1992	.62	21.2
1993	.79	22.2
1994	.98	23.2
1995	1.09	21.9
1996	1.24	22.1

Sources: Freddie Mac and OFHEO.

On February 3, 1997, the Standard & Poor's rating firm gave both Fannie Mae and Freddie Mac a relatively high "point-in-time"[19] risk-to-the-government credit rating of "AA-."[20] OFHEO commissioned Standard & Poor's to evaluate the enterprises' financial condition and issue the ratings pursuant to its authority under the act. In the Standard & Poor's report accompanying the rating, the firm generally cited the enterprises for their consistent profitability, demonstrated ability to

[19]Under a "point-in-time" credit rating, Standard & Poor's rates the financial condition of a company on a single day; in the case of the enterprises, the ratings were for February 3, 1997. Standard & Poor's issued a point-in-time credit rating because OFHEO did not ask the firm to rate the enterprises on an ongoing basis.

[20]Standard & Poor's uses long-term issuer credit ratings ranging from "AAA" for the highest credit rating to "CC" for highly speculative. According to OFHEO, the risk-to-the-government rating evaluates the risk that Fannie Mae or Freddie Mac will become financially troubled and require government assistance. According to Standard & Poor's, the AA- rating is probably higher than the ratings that the enterprises would receive in the absence of government sponsorship.

withstand regional downturns in mortgage markets during the early 1990s, historically conservative credit and interest rate risk strategies, and the quality of their management. In addition, Standard & Poor's stated that the enterprises' domination of the secondary conforming mortgage market and the benefits of their ties to the federal government, such as relatively low borrowing costs, also justified the "AA-" rating. However, Standard & Poor's did find that both enterprises could face capital adequacy shortages if a severe, nationwide downturn occurred in the mortgage markets or interest rates rose precipitously.

Enterprise Growth Has Been Rapid, Which Has Implications for Interest and Credit Risks

Although Fannie Mae and Freddie Mac have been consistently profitable, the enterprises have adopted strategies that could potentially increase their interest rate and credit risks. Since 1992, when Congress passed the act that established OFHEO, the enterprises' combined assets have more than doubled in size, although Freddie Mac's growth has been relatively faster (see table 1.6). During 1996, Fannie Mae's total assets[21] grew at about an 11 percent annual rate, and Freddie Mac's assets grew at about a 27 percent annual rate. In 1995, Fannie Mae's total assets grew at about a 16 percent annual rate, and Freddie Mac's assets grew at about a 29 percent annual rate. Table 1.7 indicates that the enterprises' retained mortgage portfolios, which include whole mortgages and MBS that the enterprises have repurchased, have been growing as a percentage of their total mortgage portfolios (retained mortgages plus outstanding MBS held by investors), although this growth has also been relatively faster at Freddie Mac. For example, Freddie Mac's retained mortgage assets as a percentage of its total mortgage portfolio increased from about 8 percent at year-end 1992 to about 23 percent at year-end 1996. Fannie Mae's retained mortgage assets increased from about 27 percent of its total mortgage portfolio at year-end 1992 to about 34 percent at year-end 1996. In previous reports on bank and thrift failures, we found that rapid asset growth in the double digit range, unless carefully managed, can result in a deterioration in management controls and ultimately poor financial performance.[22]

[21]The enterprises' total assets generally consist of retained mortgages, investments, cash and cash equivalents, accrued interest receivable, receivables from currency swaps, acquired property and foreclosure claims, and other assets. MBS guarantees are off-balance-sheet items and therefore not part of total assets.

[22]See, for example, Deposit Insurance: A Strategy for Reform (GAO/GGD-91-26, Mar. 4, 1991).

Table 1.6: Fannie Mae and Freddie Mac Total Asset Growth Rates, 1992 to 1996

Dollars in billions

Growth rate	1992	1993	1994	1995	1996
Fannie Mae					
Total assets	$181	$217	$273	$317	$351
Annual growth	N/A	20%	26%	16%	11%
Freddie Mac					
Total assets	$60	$84	$106	$137	$174
Annual growth	N/A	40%	26%	29%	27%
Fannie Mae and Freddie Mac					
Total assets	$241	$301	$379	$454	$525
Annual growth	N/A	25%	26%	20%	16%

N/A = Not applicable.

Sources: Fannie Mae, Freddie Mac, and OFHEO.

Table 1.7: Growth of Enterprises' Retained Mortgage Assets as Percentage of Mortgages in Total Portfolio, 1992 to 1996

Dollars in billions

	1992	1993	1994	1995	1996
Fannie Mae					
Retained mortgage assets	$156	$190	$221	$253	$287
Net MBS[a]	$424	$471	$486	$513	$548
Retained as percentage of total portfolio	27%	29%	31%	33%	34%
Freddie Mac					
Retained mortgage assets	$34	$56	$73	$108	$138
Net MBS[a]	$408	$439	$461	$459	$473
Retained as percentage of total portfolio	8%	11%	14%	19%	23%

[a]Excludes MBS that the enterprises have repurchased and hold in their portfolios.

Sources: Fannie Mae, Freddie Mac, and OFHEO.

According to OFHEO's 1996 annual report, the enterprises' increasing reliance on retained mortgage assets, which are financed by debt and equity, potentially exposes them to greater interest rate risk. The enterprises have incentives to finance mortgages (or repurchase previously issued MBS) with debt because the difference between mortgage yields and borrowing costs generally exceeds MBS guarantee fees. However, the increased proportion of retained mortgage assets could expose Fannie Mae and Freddie Mac to greater interest rate risks because they assume the risks for changes in the market value of the retained mortgage assets due to fluctuations in interest rates. By contrast, when the enterprises issue MBS to investors, the investors who purchase the securities assume responsibility for losses due to interest rate fluctuations. In testimony before the House Subcommittee on Capital Markets, Securities, and Government-Sponsored Enterprises on April 17, 1996, OFHEO's former director expressed concern that the combined retained mortgage assets of the enterprises exceeded $360 billion at year-end 1995, which, at that time, was more than twice the combined portfolio that the enterprises had when OFHEO was created in 1992. Nevertheless, at year-end 1996, the enterprises' combined retained mortgage assets had grown another $63 billion to $424 billion, or about 17 percent, since year-end 1995.

OFHEO's 1996 annual report also suggested that the enterprises may be facing somewhat increased credit risks in the future. The report attributed the potentially increasing credit risks to the fact that fewer homeowners chose to refinance their existing mortgages in 1994 and 1995 because mortgage interest rates were higher than they had been in 1992 and 1993. According to the annual report, refinanced mortgages tend to be less risky than mortgages that have not been refinanced because they have lower loan-to-value (LTV) ratios,[23] and those who choose to refinance generally have equity in their homes. The enterprises have also embarked on business strategies that have resulted in a larger share of mortgage purchases with higher LTV ratios. Between year-end 1992 and year-end 1995, the percentage of Fannie Mae mortgage purchases with LTV ratios exceeding 90 percent rose from 6 percent of all purchases to 19 percent of all purchases. Freddie Mac's percentage of mortgage purchases with LTV ratios exceeding 90 percent increased from 3 percent of all purchases to 14 percent of all purchases. At Fannie Mae, credit losses, provision for loss expenses plus foreclosed property expenses, increased from $335 million in 1995 to $409 million in 1996 (about a 22-percent increase) while Freddie Mac's credit losses increased from $541 million in 1995 to $608 million in 1996 (a 12-percent increase).

[23]In general, loans with lower LTV ratios represent smaller borrower risks to mortgage loan originators and the enterprises than loans with higher LTV ratios. The LTV ratio is determined by dividing the balance of the mortgage loan outstanding by the estimated value of the residential property. Thus, the LTV ratio on an outstanding mortgage balance of $60,000 on a single-family residence with an estimated value of $100,000 would be 60 percent. The enterprises generally require private mortgage insurance or other credit enhancements on mortgage loans with LTV ratios exceeding 80 percent.

Enterprises Have Implemented Strategies to Mitigate Risks

The enterprises have developed strategies to lower the interest rate risks that they face from increased mortgage asset holdings. For example, both enterprises issue callable bonds that can be paid off early if interest rates fall. By calling the bonds and issuing new debt as interest rates fall, the enterprises curtail interest expenses. Conversely, if rates increase, the enterprises continue to pay below-market rates on their existing bonds. The enterprises have also developed other methods, including using certain derivative products, to control the volatility of their interest expenses as the economy varies.[24]

The enterprises also use strategies to minimize potential credit risks. For example, for mortgage purchases with LTV ratios exceeding 80 percent, the enterprises usually require mortgage insurance from highly rated providers or other kinds of credit protection. The enterprises also have nationwide, geographically diversified mortgage portfolios that afford protection against regional downturns in housing markets, as has been demonstrated in the past. In addition, according to OFHEO's 1996 annual report, the enterprises have further protected themselves against credit risk by shifting an increasing percentage of the primary risk of default to mortgage originators, such as commercial banks. Lenders bear primary default risk if they pledge collateral or agree to repurchase mortgages that default. The OFHEO report states that the percentage of Freddie Mac purchased mortgage loans where the lender bears primary default risks rose from 12 percent of purchases in 1994 to 22 percent in 1995.

Objectives, Scope, and Methodology

The VA/HUD Appropriations Act of 1997 required us to do a comprehensive audit of OFHEO's overall operations concerning staff organization, expertise, capacity, and contracting authority to ensure that OFHEO's resources are adequate and being used appropriately to ensure that the enterprises are adequately capitalized and being safely operated. Based on discussions with congressional staff, we established the following three objectives to assess OFHEO's overall operations and its capacity to fulfill its safety and soundness mission: (1) identify the reasons that OFHEO did not complete the stress test and risk-based capital standards by December 1, 1994, (2) assess OFHEO's implementation of its examination responsibilities, and (3) review the status of OFHEO's implementation of key mission support functions and determine whether OFHEO's participation in a U.S. government initiative to assist Mexico in developing a secondary

[24]Derivatives are financial products whose value is determined by an underlying reference rate, index, or asset. The underlying include stocks, bonds, commodities, interest rates, foreign currency exchange rates, and indexes that reflect the collective value of various financial products.

mortgage market has had a material impact on OFHEO's ability to fulfill its mission.[25]

To identify the reasons for OFHEO's delays in developing the stress test and risk-based capital standards, we interviewed senior officials in OFHEO's Office of Research and Capital Standards (ORACS), as well as former HUD officials who worked on enterprise safety and soundness issues prior to OFHEO's establishment in 1992. We also reviewed key OFHEO documents, such as internal memorandums, written explanations of the development of the stress test that OFHEO provided at our request, and staff vacancy and attrition data in ORACS. We also met with senior Fannie Mae and Freddie Mac officials to obtain their views on OFHEO's development of the stress test and capital standards. The scope of our work did not involve assessing the adequacy or the appropriateness of OFHEO's approach to developing the stress test. Since OFHEO has not yet completed the development of risk-based capital standards, we could not evaluate the usefulness of specific steps OFHEO has taken to reach a final rule promulgating a risk-based capital standard.

With respect to assessing OFHEO's implementation of its safety and soundness responsibilities, we interviewed senior examination officials and their counterparts at the enterprises. We also reviewed the following documents: (1) OFHEO's September 1994 examination schedule and plan, (2) OFHEO's draft examination handbook, (3) statistics on the number of staff assigned to each exam as well at the time needed to complete each exam, and (4) attrition and vacancy data for OFHEO examiners. We assessed OFHEO's compliance with the 1994 plan and compared OFHEO's plan with plans that the Office of the Comptroller of the Currency (OCC) and the Federal Reserve System have established for examining large commercial banks. The scope of our work did not involve making an independent assessment of the accuracy of OFHEO's examination findings, conclusions, and/or recommendations.

We reviewed the status of OFHEO's implementation of key mission support functions by interviewing officials in the Office of Finance and Administration. We also reviewed relevant documentation such as administrative policies and procedures, contracts, and cost data.

[25]In floor debate regarding the VA/HUD Appropriations Act of 1997, two Senators expressed concern that foreign travel by OFHEO officials had diverted the organization from completing the risk-based capital standards within established deadlines. OFHEO's participation in the Mexico initiative during 1995 and 1996 represented its largest foreign travel expense.

We assessed the impact of OFHEO's participation in the Mexico initiative by reviewing cost and travel data and identifying staff members who made foreign trips. We also asked senior OFHEO officials to estimate the amount of time that they have devoted to developing presentations for the initiative and going on foreign travel. We did not independently verify the cost and travel data or OFHEO officials' estimates of the time that they devoted to the Mexico initiative.

We did our work between December 1996 and April 1997 in accordance with generally accepted government auditing standards.

We provided copies of a draft of this report to OFHEO for review and comment. The Acting Director provided written comments on the draft report's analysis and recommendations, which are summarized in chapters 2 and 3 and reprinted in appendix IV. OFHEO also provided technical comments on the draft report, which have been incorporated where appropriate.

OFHEO's Development of a Stress Test and Risk-Based Capital Standards Has Been Protracted

The act required OFHEO to develop a stress test and risk-based capital standards as essential components of the organization's mission to help ensure the safety and soundness of Fannie Mae and Freddie Mac. Although OFHEO faced a deadline of December 1, 1994, to issue a final rule implementing the stress test and capital standards, OFHEO officials estimate that the final rule will not be issued until 1999.

Our review found that the delay in the ongoing development process had been caused primarily by (1) the complex challenges of developing the stress test as required by the act and (2) OFHEO officials' decision in 1994 that the organization develop its own sophisticated stress test rather than adopting and modifying stress tests that were already under development. OFHEO concluded that it could develop capital standards that would be more closely related to enterprise risks by developing its own sophisticated stress test and associated financial modeling capability. However, we note that it has also involved a substantial development period and resource costs. Related factors that have contributed to the delay in OFHEO's ongoing development of the stress test have included the time necessary to hire expert staff, obtain accurate financial data, and initiate the federal rulemaking process. These tasks have taken more time than OFHEO initially anticipated in 1994.

To meet its anticipated issuance of the final rule by 1999, OFHEO faces other important challenges. In particular, senior OFHEO officials must coordinate the issuance of the stress test with executive branch agencies, such as OMB, HUD, and the Department of the Treasury, and make key policy decisions about various components of the stress test. In addition, OFHEO's attorneys and others must continue to translate the economic and financial modeling components of the proposed stress test and capital standards into proposed and final rules that comply with applicable federal statutes. Given the importance of the risk-based capital standards, we believe it is essential that OFHEO complete the tasks remaining to develop those standards as expeditiously as possible.

OFHEO Has Consistently Underestimated the Time Necessary to Complete Stress Test Development

OFHEO's development of a stress test and risk-based capital standards is an essential component for helping to ensure the safety and soundness of Fannie Mae and Freddie Mac. Essentially, the purpose of the stress test that OFHEO is required to develop under the act is to lower potential taxpayer risks by requiring the enterprises to hold sufficient capital to withstand a severe interest rate shock coupled with adverse credit conditions over a 10-year period, plus an additional 30 percent to protect against management and operations risk. Under the act, OFHEO was to have completed the final rule implementing the stress test and risk-based capital standards by December 1, 1994, but, as discussed earlier and shown in table 2.1, OFHEO did not comply with this mandate.

Table 2:1: OFHEO's Planned Completion Dates for Developing the Stress Test and Issuing the Final Risk-Based Capital Standards

OFHEO plan	Estimated completion of major components of the stress test and capital standards
May 1994	Complete stress test by December 1995 and publish final rule by March 1996.
July 1995 plan	Complete stress test by January 1996 and publish final rule by May 1997.
September 1996 plan	Complete stress test by March 1997. OFHEO 1996 annual report stated that the completed stress test would be put forward for public comment in 1997.
April 1997 plan	Propose completed stress test by September 1998 and issue final rule in 1999.

Sources: OFHEO's acting director and OFHEO's 1996 annual report.

In OFHEO's planning process and its published documents, the organization has consistently underestimated the time necessary to complete major components of the stress test and resulting risk-based capital standards. For example, in its May 1994 plan for the development of the stress test, OFHEO estimated that the final rule would be issued in March 1996. Moreover, OFHEO's revised July 1995 and September 1996 plans also underestimated the time necessary to complete the stress test and risk-based capital standards. In OFHEO's 1996 annual report, the former director stated that in 1997 the organization would have developed, tested, and put forward for public comment an operational stress test. However, in April 1997, OFHEO's acting director said that the organization does not expect to submit an operational stress test for public comment until 1998, with the final rule expected to be issued in 1999.

The remainder of this chapter provides a general discussion of the reasons why OFHEO did not comply with the statutory deadline and points out several continuing challenges that the organization faces in complying with its current estimate for issuing a final rule.

The Complexity of the Development Process Has Contributed to Delays

The complex requirements of the stress test as specified in the act have contributed to the time being taken by OFHEO to complete the process. OFHEO is legislatively required to develop a stress test to establish risk-based capital standards. In addition, the act establishes the broad outlines of the stress test, but requires OFHEO to complete several important projects before the final rule can be issued.

OFHEO's Mandate to Develop Capital Standards Presented Complex Challenges

OFHEO's development of a stress test and risk-based capital standards for the enterprises presented highly complex challenges. According to OFHEO, the stress test should be flexible and allow OFHEO to adjust the enterprises' capital requirements on a periodic basis as the financial risks that they face change. For example, under the completed stress test, an enterprise would be required to hold additional capital if OFHEO determined that the enterprise had made changes in its asset and liability structure that would result in greater losses under alternative credit and interest rate shock scenarios. Similarly, OFHEO, via the stress test, could require Fannie Mae or Freddie Mac to hold additional capital against new activities that may represent greater risks than their more traditional activities.

By contrast, the risk-based capital standards that have been developed by OCC, the Federal Reserve System, and the Federal Deposit Insurance Corporation for federally regulated banks categorize assets into broad groups, which may not account for changes in the institutions' business practices that could affect their risk profiles. For example, banks are permitted to hold the same level of capital for loans made to corporations with high credit ratings as they are required to hold for corporations with speculative credit ratings. In addition, federal bank regulators have not established and implemented uniform risk-based capital standards to address interest rate risks.[26] Instead, regulators assess the interest rate risks facing banks during scheduled examinations and make case-by-case decisions as to whether the banks hold adequate capital to protect against these risks.

[26]Section 305 of the Federal Deposit Insurance Corporation Improvement Act of 1991 required bank and thrift regulators to revise risk-based capital standards in order to take adequate account of interest rate risk and other risk factors, such as concentrations of credit and nontraditional products risks. 12 U.S.C. 1828 note.

OFHEO Must Complete Several Complex Tasks to Develop the Stress Test and Risk-Based Capital Standards

The act establishes the broad outlines of a stress test involving the impact of adverse credit and interest scenarios on the enterprises' financial condition. According to OFHEO's 1995 and 1996 annual reports, OFHEO must further specify the adverse credit and interest rate scenarios for the stress test by carrying out the following complex tasks:

Develop a credit stress benchmark: Under conditions specified in the act,[27] OFHEO is required to identify the region and time period associated with the highest mortgage default and loss severity rates in the United States, and then simulate the effect of these stressful conditions on the enterprises' nationwide total mortgage portfolios.

Identify an appropriate house price index: Changes in home prices, and the corresponding changes in loan-to-value ratios (LTV), affect mortgage defaults and loss severity. The act requires that OFHEO reflect these factors by establishing the current LTV ratios of enterprise mortgages outstanding at the start of the stress test. For this purpose, the act specifies the use of an appropriate house price index, such as the Department of Commerce's Constant Quality Home Price Index or an index of similar quality used by the federal government.

Develop a methodology to assess the performance of various mortgage types, such as single and multifamily mortgages, under differing credit and interest rate risk scenarios: The act requires that the stress test reflect differing risk characteristics of various mortgage types. For example, the differences in risk for single-family home mortgages, which primarily serve as residences and capital investments, and multifamily building mortgages, which primarily serve as income-producing businesses. Multifamily loans are less homogeneous and tend to be subject to more diverse risks than single-family mortgages.

Determine the risks of enterprise commitments: In developing the stress test, OFHEO is required to assume that the enterprises fulfill all outstanding commitments to purchase mortgages or to issue securities. OFHEO must determine how to translate the contractual commitment into portfolio

[27]"With respect to mortgages owned or guaranteed by the enterprise and other obligations of the enterprise, losses occur throughout the United States at a rate of default and severity (based on any measurements of default reasonably related to prevailing practice for the industry in determining capital adequacy) reasonably related to the rate and severity that occurred in contiguous areas of the United States containing an aggregate of not less than 5 percent of the total population of the United States that, for a period of not less than 2 years, experienced the highest rates of default and mortgage losses, in comparison with such rates of default and severity of mortgage losses in other such areas for any period of such duration."

assets and associated funding, and into MBS, so that their credit and interest rate risk can be factored into the stress test.

Develop an interest rate model to better understand interest rate risks facing the enterprises: The act requires that the specified stressful credit conditions be combined with one of two interest rate scenarios that result in the highest capital requirement.[28] In one scenario, the 10-year constant Treasury yield rises during the first year of the stress period and remains at the new level for the remainder of the stress period.[29] In the other scenario, the 10-year yield decreases during the first year of the stress period and remains at that level for the remainder of the stress period.[30] Other market interest rates must be simulated relative to the 10-year note yield in a manner reasonably related to historical experience. OFHEO must develop appropriate interest rate models to simulate the specified interest rate changes on the enterprises' financial condition.

OFHEO's Decision to Develop a Sophisticated Stress Test Has Been a Key Factor in the Ongoing Development Process

When OFHEO began operations in June 1993, there were potential strategies that it could have pursued that might have resulted in the faster completion of a stress test and risk-based capital standards. For example, OFHEO could have adopted an enterprise stress test that had been under development by HUD after making several significant adjustments to bring it into compliance with the act. Or, Fannie Mae officials told us that OFHEO could have adopted an approach that the enterprise had developed to assess the impacts of various credit and interest rate shocks on its financial condition. Instead, OFHEO officials decided to create a new and comprehensive stress test that they believed would provide a better basis for establishing risk-based capital standards than modifying existing stress tests. OFHEO officials concluded that their strategy will result in capital standards that better reflect enterprise risk. However, we note that implementation of the strategy has resulted in the protracted period of

[28]Rising interest rates increase interest expenses as debt turns over and decrease the value of existing assets that are paying a below market rate. When interest rates decline, homeowners tend to prepay mortgages more quickly, resulting in a decrease of the net average interest rates received by the enterprises on mortgages held in their portfolios.

[29]Under the act, the 10-year constant maturity Treasury yield increases to the greater of (1) 600 basis points above the average yield during the preceding 9 months or (2) 160 percent of the average yield during the preceding 3 years, but in no case to a yield greater than 175 percent of the average yield during the preceding 9 months.

[30]The 10-year constant maturity Treasury yield decreases to the lesser of (1) 600 basis points below the average yield during the preceding 9 months or (2) 60 percent of the average yield during the preceding 3 years, but in no case to a yield less than 50 percent of the average yield during the preceding 9 months.

time and the substantial resources that are being devoted to completing the process.

OFHEO Had Alternative Strategies to Choose From in Developing a Stress Test

One possible strategy that OFHEO could have chosen was to make significant adaptations to a stress test for the enterprises that HUD had developed by 1992. HUD used the results of its stress test in its annual reports to Congress where it assessed the financial condition of the enterprises if subjected to mortgage credit conditions that existed during the Great Depression.[31] HUD's stress test, which was similar to that used by credit rating agencies, such as Moody's Investors Service, began with the development of economic relationships among key variables such as interest rates, house prices, and unemployment in the national economy. According to the former HUD officials who developed the stress test, they wanted a test that would be able to simulate the consequences of a variety of economic scenarios, such as rising unemployment rates and subsequent mortgage default rates, on the enterprises' financial condition.

However, these former HUD officials also said that the stress test would have required extensive development to meet the requirements of the act. The former officials said that the HUD stress test assigned enterprise balance sheet items into broad asset and liability categories, or "buckets,"[32] and would still have required the disaggregation of enterprise assets and liabilities based on risk characteristics. The former officials added that in 1992, HUD lacked the staff and computer resources necessary to make such detailed assessments. They also said that the HUD stress test did not meet the act's requirement that OFHEO specify credit risk relationships for the enterprises based on historic mortgage default rates in specific areas of the country (the credit stress benchmark).[33] The former HUD officials said that developing such a geographic credit stress benchmark would have

[31]U.S. Department of HUD, 1991 Report to Congress on the Federal Home Loan Mortgage Corporation (December 1992) and 1991 Report to Congress on the Federal National Mortgage Association (December 1992).

[32]In such a "bucket analysis," financial analysts normally create simplified, called synthetic, assets and liabilities that are meant to mimic the general characteristics of the overall assets or liabilities contained in the bucket. The approach lacks specificity but requires less time input by analysts and fewer computer resources.

[33]According to HUD's reports, the HUD stress test is perhaps more stringent than the one called for in the act; consequently, the HUD stress test may require higher capital levels at each enterprise at any one point in time than the capital levels ultimately established by OFHEO. We identified one source for this discrepancy: the HUD test postulated a Depression scenario. The credit risk specified in the act depends on default and loss severity data that lend themselves to statistical analysis. According to OFHEO, the enterprises' historical loan data are generally only statistically reliable since the first quarter of 1980. Credit conditions since 1980 have been more favorable than those that occurred during the Depression.

required substantial additional work. Nevertheless, the former officials said that they believed the adaptations necessary to bring the HUD stress test into compliance with the act could have been completed faster than the time it is taking OFHEO to develop its stress test.

Alternatively, Fannie Mae officials told us that OFHEO could have adopted an approach to developing the stress test similar to the approaches that Fannie Mae follows to assess the impacts of various credit and interest rate scenarios. The officials said that Fannie Mae's approach—which they referred to as "top down"—combines assets and liabilities with similar performance characteristics into aggregated categories and tests their performance under specified interest and credit risk scenarios.[34] Using such an approach, a Fannie Mae official said that OFHEO could possibly have met the 18-month deadline. In addition, Fannie Mae officials said that any stress test and risk-based capital standards that OFHEO ultimately develops must be consistent with the enterprises' capacity to implement them and the enterprises' business practices.

OFHEO could also have chosen other options requiring different levels of aggregation of enterprise assets and liabilities.[35] For such options, the trade-off between resource requirements and specificity in estimating enterprise risks would be similar to the two options previously discussed.

OFHEO Decided to Develop Its Own Sophisticated Stress Test

According to an internal OFHEO memorandum dated February 22, 1994, senior OFHEO officials determined that the alternative strategies discussed above were not sufficient to serve as the basis for the statutory stress test. For example, OFHEO officials determined that, among other limitations, the HUD stress test was insufficient because it would have limited OFHEO's ability to evaluate the impacts of various economic scenarios and business strategies on the enterprises' financial condition. In our discussions with OFHEO officials, they said that the HUD stress test had other significant limitations that made it unusable. For example, ORACS' director said that the HUD stress test lacked the capacity to assess the consequences of

[34]Our ability to demonstrate a comparison between Fannie Mae's approach and OFHEO's approach is limited because we cannot disclose information that Fannie Mae considers to be proprietary or components from OFHEO's stress test development that are not in the public domain.

[35]For example, 30-year fixed-rate mortgages can be aggregated according to coupon rates on the mortgage loans (i.e., the interest rates paid by borrowers). Aggregation simplifies the analysis at the possible loss of specificity in estimating risks. For example, homeowners with mortgage rates below prevailing mortgage rates on newly originated mortgage loans tend to default less frequently than homeowners paying higher interest rates.

adverse interest rate and credit scenarios on the enterprises' derivative instruments.

In 1994, OFHEO officials also determined that they could not use the enterprises' existing financial models for assessing the impact of various credit and interest rate scenarios and developing the stress test for several reasons. For example, OFHEO officials determined that, although the enterprises' financial models may have been sufficient to meet their business needs, the models were not adequate for meeting the requirements of the statutory stress test. OFHEO officials also decided that the financial models used by the enterprises differed substantially and, therefore, OFHEO needed to develop a common model to ensure regulatory consistency. In addition, OFHEO officials wanted the organization to develop an independent capacity to assess the risks facing the enterprises and to make regulatory decisions as it was deemed necessary.

Consequently, OFHEO officials told us that in 1994 they decided to develop a comprehensive and sophisticated stress test to comply with the act's requirements and establish the organization's regulatory independence. To develop such a stress test, OFHEO officials said that they needed to collect and test extensive data on the historical performance of enterprise loans as well as their current books of business on a disaggregated basis. OFHEO officials also determined that the organization needed to develop sophisticated models and computer programs to assess how alternative economic scenarios would affect the enterprises' financial condition and capital positions. OFHEO officials said that they believed that the final stress test will result in risk-based capital standards that better reflect the risks facing the enterprises.

OFHEO's Need to Hire Expertise and Obtain Accurate Financial Data Proved Time-Consuming

Our review identified several other factors that have contributed to OFHEO's ongoing development of the stress test and risk-based capital standards. First, once senior OFHEO officials had made the decision to develop a sophisticated stress test, the organization had to hire expert staff and purchase a powerful computer network system capable of running financial models. Second, OFHEO officials said the enterprises did not always provide accurate financial data on a timely basis. Third, OFHEO officials initiated the federal rulemaking process, which involved significant staff time and resources. Finally, between 1994 and 1997, OFHEO had to initiate and complete several economic modeling, financial modeling, and computer programming projects, which proved more challenging than the organization had initially anticipated.

OFHEO Had to Obtain Needed Expertise and a Computer Network

The need to hire expertise and acquire a sophisticated computer network are factors that contributed to the time needed for the ongoing development of the stress test and risk-based capital standards. According to the ORACS director, OFHEO viewed hiring and developing a capable staff of permanent employees and contractors as another means for the organization to establish itself as a viable, independent regulatory agency. ORACS has focused its hiring efforts on individuals who had substantial expertise in housing economics, the capital and mortgage markets, computer programming, or computer systems. We reviewed OFHEO personnel records and determined that the ORACS staff have extensive experience in housing economics, financial analysis, residential mortgage markets, and computer systems. In addition, senior ORACS officials have postgraduate degrees and experience in relevant settings, such as securities firms or other federal financial regulatory agencies.

However, OFHEO also provided hiring data that indicate that it took ORACS a substantial period of time to recruit the individuals deemed necessary to develop and implement the stress test and risk-based capital standards. For example, the data indicated that 7 of the 14 full-time staff in ORACS in May 1997 were hired in 1995 and 1996. In addition, OFHEO's acting director said that between October 1996 and April 1997, OFHEO lost several key staff members from ORACS and its Office of Policy Analysis, including a senior policy analyst, a senior economist, and a systems administrator, which further contributed to the challenges of completing the stress test and capital standards within established deadlines. Moreover, it has taken considerable time for OFHEO to hire key contract staff to develop essential components of the stress test. For example, OFHEO did not contract with Price Waterhouse to develop financial reporting software and a consolidated data format for both enterprises until August 1995.

OFHEO also needed to acquire a sophisticated computer network on which the financial models are to be run. In 1994, based on an analysis of available computer hardware and software, OFHEO officials decided to purchase a powerful computer network. According to OFHEO's acting director, the computer network did not become fully operational until late 1994. Without the computer network, OFHEO's growing ORACS staff could not make significant progress on many of the complex economic modeling, financial modeling, and computer software projects necessary to develop the stress test and risk-based capital standards.

OFHEO Encountered Some Difficulties Obtaining Accurate Financial Data on a Timely Basis

OFHEO officials said another factor that has contributed to the ongoing development of the stress test was that OFHEO and the enterprises had to establish a workable system for delivering large amounts of financial data. OFHEO required large amounts of historical and current financial data from the enterprises so that it could, among other tasks, determine the benchmark loss experience and develop models of mortgage performance; such work was necessary before the impact of the various credit and interest rate scenarios on the enterprises financial condition could be determined. OFHEO first requested that the enterprises provide comprehensive financial data on loan performance in May 1994 and the enterprises responded over the next 18 months. Although ORACS' director stated that the enterprises generally made good faith efforts to supply the requested data, various problems and delays were encountered. For example, he said that the enterprises did not always provide all necessary data in their initial submissions, which resulted in repeated follow-up requests. Also, he said that OFHEO technical staff sometimes encountered problems and delays contacting their counterparts at the enterprises without first being routed through regulatory compliance officials.

OFHEO officials also stated that they encountered some difficulties obtaining accurate financial data from Freddie Mac on a timely basis and that this has delayed the development of the stress test. OFHEO initiated a targeted examination of "data integrity" issues at Freddie Mac in August 1996 which, when completed in November 1996, stated that Freddie Mac had not established adequate controls to ensure the accuracy of information submitted to OFHEO. According to OFHEO, Freddie Mac has agreed to correct these problems. However, a Freddie Mac official told us that data integrity issues did not result in delayed completion of the stress test.[36]

Fannie Mae officials we contacted said that OFHEO's initial requests for information imposed certain regulatory burdens on the enterprise. In keeping with their view that OFHEO could have relied on a "top-down" approach to developing the stress test, Fannie Mae officials said they did not fully understand why OFHEO required such a substantial amount of data about individual mortgage loans. They said that requesting such detailed mortgage loan data is not necessary and slows the development of the stress test. OFHEO officials said they needed individualized loan data to

[36]The Freddie Mac official said that error-free data are not essential in the early stages of designing a financial model and that testing of data can be accomplished through the use of smaller data sets. In addition, the official said that Freddie Mac has provided OFHEO with substantial support in its development of the risk-based capital standards and associated financial models.

better model the enterprises' financial condition and better understand the potential impacts of various credit and interest rate scenarios.

Freddie Mac officials we interviewed had a different perspective toward OFHEO's development of the stress test and the potential for regulatory burden. Freddie Mac officials told us that they do not know what stress test OFHEO will ultimately develop. They said that OFHEO should take the time necessary to "do the job right," and attributed this view to the position that both enterprises are currently well capitalized and therefore the risk of delay is low. Freddie Mac officials also said that they understood OFHEO's position that developing an in-house understanding of enterprise risks was important. Freddie Mac officials, however, expressed the concern that OFHEO could end up developing a stress test that relied too heavily on disaggregated information. The officials said that their potential concerns with a highly refined stress test and capital standards were that they could create (1) a regulatory burden; and (2) unintended consequences by ignoring beneficial linkages, such as those associated with hedging activities, among financial assets and liabilities.

OFHEO Officials Initiated Rulemaking Process

OFHEO officials also cited the protracted federal rulemaking process as a factor that has contributed to the ongoing development of the stress test and risk-based capital standards. The officials said that complying with the federal rulemaking requirements placed important demands on the time of OFHEO's staff. For example, ORACS' director said that the office staff responsible for the development of the stress test worked with OFHEO attorneys in drafting rulemaking proposals, which are summarized below. ORACS' director and other officials said that OFHEO's staff must frequently assume such time-consuming responsibilities to compensate for the organization's relatively small size as compared to other federal financial regulators.

On February 8, 1995, OFHEO issued an Advance Notice of Proposed Rulemaking (ANPR), which solicited public comment for a period of 120 days on a variety of technical and policy issues and a range of alternative approaches to modeling the enterprises' credit and interest rate risks. ANPR covered such subjects as defining the credit stress benchmark, assessing the default and loss characteristics of a wide range of mortgage types, and the effects of high inflation rates on mortgage losses. When the period for public comment closed in June 1995, OFHEO had received a total of 15 comments from a variety of interested parties, including the enterprises and two mortgage banking firms, which OFHEO officials said they have considered in the development of the stress test. On June 10, 1996, OFHEO published a Notice of Proposed Rulemaking (NPR), which described two key elements of the stress test—the benchmark loss experience and the house price index. These issues are discussed below and in appendix I. During 1997, OFHEO staff are working on a second NPR that will cover issues not addressed in the first NPR, such as interest rates and mortgage performance.

OFHEO Managed Multiple Projects to Develop the Stress Test and Capital Standards

OFHEO also initiated and completed several complex and time-consuming projects between 1994 and 1997 to develop the stress test and risk-based capital standards. The projects that OFHEO initiated included (1) establishing the credit stress benchmark, (2) developing a consistent format for data provided by Fannie Mae and Freddie Mac, (3) identifying an appropriate house price index, and (4) developing econometric models and computer programs to simulate enterprise financial performance. Most of these projects had been completed by June 1997 (see app. I). According to OFHEO's acting director, OFHEO faced significantly greater technical and managerial challenges than initially anticipated, developing an integrated financial model to simulate the behavior of the enterprises' assets, liabilities, and off-balance-sheet obligations under adverse credit and interest rate conditions. This financial model is to serve as the foundation of the final stress test.[37] According to ORACS' director, however, OFHEO had largely completed the integrated financial model by April 1997, although some final testing and documentation projects were to have been completed during the summer of 1997.

OFHEO Faces Continuing Challenges in Implementing the Final Risk-Based Capital Rule by 1999

OFHEO faces continuing challenges in meeting its proposed deadline of issuing the final rule implementing the stress test and risk-based capital standards by 1999. In particular, OFHEO officials must coordinate the interagency review process and make key policy decisions about the stress test. Further, OFHEO must translate the components of the stress test and capital standards into proposed and final rules in compliance with federal statutes.

[37]OFHEO refers to the model as the Financial Simulation Model. OFHEO's work on the model includes assessing the impact of fluctuations in interest rates on mortgage performance, determining the impact of rising house prices on the enterprises' financial condition, estimating mortgage prepayment and default and loss severity rates, and simulating the cash flows of enterprise assets, liabilities, and off-balance-sheet obligations and translating these cash flows into pro forma accounting statements.

OFHEO Must Coordinate Interagency Review Process

OFHEO's acting director said that OFHEO plans to share the basic components of the stress test and related financial models on an informal basis with OMB, HUD, and Treasury in the summer of 1997. He said that given the complexity of the stress test and its related financial models, it will be important to provide information about them at the earliest possible stage. The acting director said the informal interagency review process can go forward before the stress test is finalized because the goal will be to explain the technical components of the stress test and related financial models to OMB and Treasury technical staff and to receive their comments and analysis.

OFHEO Needs to Make Key Policy Decisions About the Stress Test

OFHEO's acting director told us that the organization needs to make key policy decisions about various components of the stress test by early 1998. OFHEO's chief economist said that OFHEO's technical staff had the responsibility to lay out options on various complicated issues that are necessary to complete the stress test, such as assumptions about future interest rates, the shape of the yield curve, the enterprises' future debt issuances, and the relationship between home prices and interest rates, but it is up to OFHEO management to choose the appropriate option. Once these decisions have been made, then OFHEO will have a better idea as to how the stress test will affect the enterprises' financial condition and risk-based capital levels.

OFHEO Must Translate the Components of the Stress Test Into Proposed and Final Rules While Protecting Proprietary Enterprise Data

OFHEO's general counsel told us that once ORACS completes development of the stress test, OFHEO's staff will face the task of translating the stress test into proposed and final rules. The general counsel stated that OFHEO wants to avoid having the final rule successfully challenged in court under the Administrative Procedure Act (APA). OFHEO's general counsel said that another concern that will confront the organization in drawing up the proposed and final rules will be the need to give adequate notice to the public to provide for comment on the development of the stress test as required by APA without compromising proprietary enterprise data.

Enterprise officials we contacted said they are very concerned that OFHEO not disclose proprietary information during the rulemaking process. In fact, Fannie Mae officials told us that OFHEO has already publicly disclosed some proprietary information in research papers. Although the Fannie Mae officials said that OFHEO researchers attempted to disguise the proprietary data through high-level aggregation, the officials said that this high-level approach was not effective because OFHEO only supervises two companies. OFHEO's acting director stated that the research papers did not disclose proprietary enterprise data. He also said that OFHEO has established a rigorous policy for preventing the release of such proprietary data; for example, OFHEO researchers are to submit all proposed papers to senior officials who determine if the papers disclose confidential information.[38]

Conclusions

The stress test and risk-based capital standards that OFHEO is legislatively required to develop are essential means by which the organization is to fulfill its mission of helping to ensure the safety and soundness of Fannie Mae and Freddie Mac. The stress test is to simulate the effects that various adverse credit and interest rate shocks would have on the enterprises, and the risk-based capital standard is to be designed to ensure that the enterprises hold adequate capital to withstand such stress for a period of 10 years. OFHEO has already missed the December 1, 1994, deadline for completing the process by almost 3 years and estimates that it will be 1999 at the earliest before this statutorily mandated task is completed.

Although developing the stress test under the act presented complex challenges, OFHEO's decision in 1994 to develop its own sophisticated stress test rather than adopting and modifying stress tests that were already under development resulted in a substantial commitment of time and resources. Related factors contributing to the delay in implementing this decision included OFHEO (1) failing to hire its full complement of research staff until 1996 or get its computer network operational until late 1994, (2) experiencing delays in obtaining accurate enterprise financial data, (3) devoting considerable staff time and resources to the federal rulemaking process, and (4) encountering greater managerial and technical challenges than initially anticipated in developing an integrated financial model that serves as the basis of the stress test. An OFHEO official said that this financial model had largely been completed by April 1997, although final testing needed to be completed during the summer of 1997.

We recognize the complexity of the challenges that OFHEO has faced. However, we note that OFHEO has consistently underestimated the time needed to complete its tasks. Given OFHEO's history of failing to meet its own publicly announced completion targets and considering the challenges that remain, we are concerned that OFHEO may not meet its current estimate of issuing a final rule by 1999. For example, to meet the

[38]Fannie Mae and OFHEO officials have a basic disagreement as to what constitutes disclosure of proprietary information. On this subject, Freddie Mac officials also indicated a disagreement with OFHEO.

schedule in the current plan, OFHEO must coordinate the interagency review process and make key policy decisions, such as forecasts about future interest rates. In addition, OFHEO must translate the complex components of the stress test and capital standards into proposed and final rules as required by APA while protecting against the unauthorized disclosure of proprietary enterprise data.

We believe it is essential that OFHEO take all feasible steps to comply with its plan and complete the stress test and risk-based capital standards as soon as possible because they are critical to helping maintain the safety and soundness of Fannie Mae and Freddie Mac. Although the enterprises have been consistently profitable in recent years, their rapid growth and potentially increasing interest rate risks pose potential costs to taxpayers that exceeded $1.5 trillion at year-end 1996. Without a stress test and risk-based capital standards in place, OFHEO's capacity to lower such taxpayer risks is limited.

Recommendations

Given the history of OFHEO's failure to meet its own publicly announced plan to complete the stress test and risk-based capital standards, strong congressional oversight appears necessary to ensure that OFHEO issues its final rule in a timely manner. Accordingly, we recommend that OFHEO's director report to Congress periodically on the organization's progress towards compliance with its current plan. We also recommend that the director include in such reports information on the status of OFHEO's progress towards important milestones, such as its (1) projected completion of final testing on the financial model that comprises the stress test, (2) progress toward completing the interagency review process, (3) estimated completion of key policy decisions regarding the stress test by early 1998, and (4) progress in translating the components of the stress test into proposed and final rules. Finally, we recommend that the director inform Congress of any problems that may arise in completing the stress test and risk-based capital rules by 1999 and of actions that the organization plans to take to correct such problems.

Agency Comments and Our Evaluation

In written comments, OFHEO's acting director agreed with the report's analysis of why the development of the stress test and risk-based capital standards has been protracted and stated that OFHEO is implementing our recommendation that Congress be informed of progress in completing the final rule. He emphasized that the complexity of the development process as specified in the act and OFHEO's decision to develop its own sophisticated stress test have been the primary factors in delaying the completion of the final rule. The acting director also said that the report should not be interpreted to suggest that using the HUD stress test or using the enterprises' financial models would have produced an acceptable result. As examples, he said that the HUD stress test did not include the credit stress benchmark, and a simplified stress test would not adequately address the enterprises' increased interest rate risks resulting from their larger retained mortgage portfolios. He said that the enterprises' mortgage portfolios are becoming increasingly complex and involve large volumes of derivative instruments. Among other reasons, the acting director said that relying on the enterprises' financial models would not have been appropriate because it potentially would have jeopardized OFHEO's independence as a regulatory agency.

We did not take a position in the report on the adequacy or appropriateness of OFHEO's approach to developing the stress test and risk-based capital standards. To do so would have required that we demonstrate whether the other alternatives could have been modified sufficiently to meet the requirements of the act in a shorter period of time. Given that the time is long past when such a demonstration would have affected OFHEO's approach, we chose not to pursue such an assessment. Rather, we pointed out that there were potential trade-offs associated with the time that would have been necessary to adopt and modify the HUD stress test, or another aggregated type of stress test, and the comprehensive development approach that OFHEO has chosen.

OFHEO Has Not Fully Implemented a Comprehensive Enterprise Safety and Soundness Examination Program

OFHEO's examination program is its primary means of helping to ensure the safety and soundness of Fannie Mae and Freddie Mac in the absence of risk-based capital standards. Since 1994, OFHEO has made important progress in fulfilling its essential examination oversight function, such as by establishing a "risk-focused" examination strategy, defining six "core risks" facing the enterprises, and by completing or initiating on-site examinations to monitor five of these risks. However, OFHEO has also scaled back the implementation of a detailed examination schedule and plan that was developed in September 1994. In particular, OFHEO's current 3- to 4-year cycle for examining the six core risks facing the enterprises is considerably longer than the 2-year cycle established in its 1994 examination plan, and OFHEO's most recently completed core risk examination covered fewer areas than planned. Without a more timely and comprehensive examination program, OFHEO faces limitations in its ability to monitor the risks facing the enterprises, such as their potentially greater interest rate risks resulting from increasing holdings of debt-financed mortgage assets.

The evidence we obtained indicated that, among other factors, limited resources applied to the examination function were largely responsible for OFHEO's inability to fully implement the 1994 examination plan. Our analysis found that to complete each core risk examination, OFHEO was required to commit a significant majority of its 12 line examiner and specialist positions to the examination for a period of 1 year as well as noncore risk—or targeted risk—examinations that were required. As a result, OFHEO may lack the line examiner and specialist staff resources necessary to complete examinations covering three core risks per year, the minimum necessary to cover all six core risks in a 2-year cycle. In addition, staff attrition in 1996 and early 1997 left the examination office with 5 vacancies out of 17 authorized full-time positions—a vacancy rate of 30 percent—as of March 31, 1997, which further limited OFHEO's ability to implement the 1994 plan. By August 1997, an OFHEO official reported that the organization had filled three of the positions and two others were being advertised.

OFHEO officials said that they recognize the need to shorten the 3- to 4-year examination cycle to adequately assess the enterprises' financial condition and management practices. During 1997, OFHEO plans to reassess its examination strategy and make changes to shorten the examination cycle for all six core risks to 1 year. In the reassessment of its examination strategy, OFHEO could usefully include consideration of different examination cycles and related coverage that could be accomplished with alternative resource levels.

OFHEO Established a Detailed Enterprise Examination Schedule and Plan in 1994

In September 1994, OFHEO established a detailed examination strategy, schedule, and plan to help ensure the safety and soundness of Fannie Mae and Freddie Mac. The plan identified six "core risks," such as interest rate risk, facing the enterprises, and established a 2-year cycle for OFHEO examination staff to assess these risks. OFHEO's examination plan is generally consistent in substance but not in timing with risk-focused examination plans that OCC and the Federal Reserve System have established to annually assess the safety and soundness of large commercial banks. Although we recognize that large banks may engage in a wider variety of potentially risky activities than the enterprises, we believe a generally consistent examination approach by OFHEO and the bank regulators is important because the potential exists that a large bank or enterprise failure could cause substantial taxpayer losses.[39]

OFHEO's Examination Program Called for Assessing Enterprise Risks on a 2-Year Cycle

The act requires OFHEO to conduct annual, on-site safety and soundness examinations of the enterprises to assess their operations and financial condition. According to an OFHEO attorney, this requirement can be and has been met without conducting full-scope enterprise examinations on an annual basis. Full-scope examinations are generally understood to mean thorough assessments of all of the management practices and business strategies of a federally regulated financial institution that could affect its safety and soundness.

During 1994, senior OFHEO officials established a "risk-focused" examination schedule and plan to assess the risks facing Fannie Mae and Freddie Mac on a 2-year cycle. Under the plan OFHEO adopted in September 1994 and has subsequently modified,[40] OFHEO identified six core risks, which OFHEO officials believed represent the greatest risks to the enterprises. These six core risks are corporate governance, interest rate, credit, operations, business, and information technology. Although there are six core risks, OFHEO's plan stipulated that examiners could cover these

[39]The Federal Deposit Insurance Corporation administers the Bank Insurance Fund, which uses premiums paid by banks to protect the depositors of failed banks. The potential exists that during a financial emergency, a large bank failure or series of large bank failures could drain the Bank Insurance Fund, thereby requiring a taxpayer bailout. As discussed in the report, the potential exists that the government would choose to rescue the enterprises if they could not meet their debt and MBS obligations.

[40]For example, OFHEO did not identify information technology risks as a core risk until 1995.

risks in five exams by consolidating the credit risk and interest rate risk components into a single risk management examination (see table 3.1). The risk management examination was also intended to cover five other risk areas, such as asset growth and composition, which OFHEO does not consider to be core risks. Under the plan, the four other core risk examinations designated specific areas that OFHEO examiners were to cover. For example, the business line examination was to assess the adequacy of the enterprises' risk management of the following businesses: single-family mortgage guarantee, multifamily mortgage guarantee, portfolio, and financial services.

Table 3.1: OFHEO's Examination Plan for Monitoring the Six Core Risks on a 2-Year Cycle

Exam type	Summary of examination objectives
Corporate governance risk	Assess enterprise board of directors oversight, organization structure, internal controls, and information flows.
Risk management	Assess interest rate risk, credit risk, and five other risk areas.
Business risk	Assess risks in four enterprise business areas, including single-family mortgages, multifamily mortgages, portfolio, and financial services.
Operations risk	Assess operational practices in four areas, such as securitization.
Information technology risks	Assess the enterprises' use of computer technology and associated risks.[a]

[a]OFHEO did not identify information technology risk as a core risk until 1995. However, the September 1994 plan did identify information technology risk as an area that required a targeted examination.

Source: OFHEO.

OFHEO's 1994 examination plan also identified other risks that examiners were to assess within a 2-year period. These exams were considered to be more targeted than the exams established to assess the six core risks. In particular, OFHEO examiners were to assess the books and records of both enterprises to determine the accuracy and reliability of their financial reporting. These books and records examinations were to encompass the financial reporting underlying the enterprises' public financial statements and the internal reporting supporting management processes. The plan also called on OFHEO examiners to assess the enterprises' use of sophisticated derivative instruments. In addition, the plan called for OFHEO to develop the capacity to monitor the enterprises' financial condition on an off-site basis, such as by collecting periodic financial information from the enterprises that show trends in asset growth, financial performance, and funding.

OFHEO uses a “top-down” approach to examinations to assess the six core risks as well as targeted risks. The examination of a particular risk is to begin with a “Level I” review in which examiners evaluate board of directors oversight and planning and review internal and external audits. The examiner is to proceed to a Level II review if deficiencies in the management of risk are found. This level of review usually would involve additional testing of controls. If a Level II exam does not resolve all areas of concern, a Level III review—a detailed review of the control environment, including extensive transaction testing—is to be conducted.

OFHEO Examination Plan Is Generally Consistent in Substance but Not in Timing With Plans Developed by Bank Regulators

The risk-focused examination plan and 2-year cycle OFHEO established in 1994 is generally consistent in concept but not in timing with risk-focused examination plans that OCC and the Federal Reserve have recently established to examine large commercial banks. By law, bank regulators are required to conduct full-scope examinations of the financial condition and safety and soundness of large banks at least once a year.[41] OCC has chosen to implement the full-scope requirement by developing a risk-focused examination system that identifies nine major risks, such as interest rate and credit risks, facing national banks; some of these risks are similar to the core risks OFHEO has identified as facing the enterprises. According to OCC, its staff are to assess each of the risks facing particular national banks on an off-site basis prior to initiating an examination. These off-site assessments are to be accomplished by reviewing previous examination reports and available financial data among other documents. OCC staff are then to focus the majority of their time and resources on the greatest risks facing particular banks during the on-site examination process. The Federal Reserve System has established a risk-focused annual examination program, which is similar to that of OCC, for large banks under its supervisory responsibility.

We recognize that large commercial banks engage in a variety of potentially risky activities, such as trading securities and lending for many purposes, on a worldwide basis, while the enterprises’ activities are generally confined to a single line of business, mortgage purchases, in the United States. Consequently, it could be argued that large banks should be subjected to a more rigorous level of supervision and examination than the

[41]See Federal Deposit Insurance Corporation Act of 1991, Pub. L. No. 242, § 111(a), as amended, 12 U.S.C. § 1820d. Under this act, bank and thrift regulators are required to do annual, full-scope examinations of banks or thrifts with total assets of $250 million or more.

enterprises. However, as pointed out in our previous reports, we believe that the enterprises should generally be subjected to a similar level of supervision as banks, although some modifications to adjust for their differing risk characteristics may be necessary.[42] For example, banks and the enterprises share some risk characteristics, such as interest rate, credit, business, and management risks, and the failure of either an enterprise or a large commercial bank could potentially impose losses on taxpayers.

OFHEO Has Not Been Able to Fully Implement the 1994 Examination Plan

Our review found that, despite making important progress, OFHEO has not been able to fully implement the enterprise examination schedule and plan that was established in September 1994. Although OFHEO has completed or initiated examinations covering five of the six core risks, at its current rate it will take OFHEO 3 to 4 years to examine all six core risk areas, which is considerably longer than the 2-year cycle established in the 1994 plan. Moreover, OFHEO scaled back the planned coverage of the most recently completed core risk examination. OFHEO's relatively long examination cycle and limited examination coverage raise questions about its capacity to fully assess the enterprises' management, financial practices, and risks on a timely basis.

OFHEO Has Made Progress in Implementing the 1994 Plan

Between August 1994 and May 1997, OFHEO made important progress in implementing the 1994 examination schedule and plan. As of May 1997, OFHEO had completed or initiated examinations covering five of the six core risk areas, and OFHEO plans to initiate the remaining core examination covering operations risk in 1997 (see table 3.2). OFHEO also completed three targeted examinations covering the enterprises' use of nonmortgage derivative contracts, the enterprises' compliance with a flood insurance statute,[43] and data integrity issues at Freddie Mac.

[42]We have observed that bank regulation is a useful starting point for determining the regulatory structure that should apply to government-sponsored enterprises, such as Fannie Mae and Freddie Mac. As examples, we have stated that government-sponsored enterprises should be subject to capital standards and periodic on-site examinations. See Government-Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks (GAO/GGD-91-90, May 22, 1991) and Government-Sponsored Enterprises: The Government's Exposure to Risks (GAO/GGD-90-97, Aug. 15, 1990).

[43]The National Flood Insurance Reform Act of 1994 requires the enterprises to implement procedures that are reasonably designed to ensure that adequate flood control insurance is in place over the term of the mortgage loans the enterprises purchase after September 28, 1995. Pub. L. No. 103-325 § 522, 42 U.S.C. § 4012a(b)(3). According to an OFHEO official, OFHEO ensures that the enterprises comply with these requirements on a biennial basis.

Table 3.2: OFHEO's Completed, Ongoing, and Planned Examinations as of May 1997

Exam type	Start date[a]	End date[a]
Core risks		
Corporate governance	August 1994	June 1995
Risk management (credit and interest rate risks)	May 1995	June 1996
Business	June 1996	May 1997
Information technology	March 1997	Planned September 1997
Operations	Planned 1997	Planned 1997 or 1998
Targeted		
Nonmortgage derivatives	May 1994	November 1994
Flood insurance	January 1996	May 1996
Freddie Mac data integrity	August 1996	November 1996

[a]Includes both Fannie Mae and Freddie Mac exams. The end date is for the enterprise exam that OFHEO completed last. All of the Fannie Mae and Freddie Mac exams were completed within several weeks of one another.

Source: OFHEO.

OFHEO's examination office has also established an off-site capacity to monitor the enterprises' financial condition and safety and soundness as specified in the 1994 plan. The Office of Examination and Oversight (OEO) staff collects financial information from the enterprises and produces internal reports that discuss relevant supervisory issues. OEO's acting director said that the examination staff works closely with ORACS staff to develop a better understanding of the enterprises' financial activities. He also said that OFHEO plans to more fully integrate off-site monitoring into the examination process. For example, OFHEO plans to produce internal reports focusing on each of the six core risks. These reports would be reviewed by examiners prior to initiating a risk-based examination, potentially creating examination efficiencies.

OFHEO Has Not Implemented Other Important Components of the 1994 Examination Plan

Despite making progress, OFHEO has not implemented other important components of the 1994 examination plan. As shown in table 3.2, OFHEO completed examinations covering four—corporate governance, credit, interest rate, and business—of the six core risk areas between 1995 and 1997, plans to complete the information technology examination in 1997, and plans to initiate the operations risk examination in 1997, which may not be completed until 1998. Therefore, OFHEO's first cycle for covering all six core risk areas will take 3 to 4 years (1994 to 1997 or 1994 to 1998)[44] rather than the 2-year cycle established in the 1994 plan.

OFHEO also scaled back the planned coverage of its most recently completed core risk examination. The core business risk examination that OFHEO completed in May 1997 covered risk management in one of the four business areas specified in the 1994 plan—the single-family guarantee component. OFHEO's inability to cover the other three business areas (in particular, the multifamily mortgage guarantee business) has limited the organization's capacity to fully monitor the enterprises' safety and soundness. OFHEO's 1997 annual report states that the enterprises' purchases and new guarantees on multifamily mortgages tripled from $3 billion at year-end 1992 to $9 billion at year-end 1996. According to the annual report, multifamily mortgage loans are relatively risky. For example, although the delinquency rates on the enterprises' multifamily mortgages have improved significantly since 1992, they are still higher than the delinquency rates on the enterprises' single-family mortgages.[45]

In addition, OFHEO was not able to implement the objective in the 1994 examination schedule and plan that it assess the books and records of the enterprises to assess the accuracy of their financial reporting. We pointed out in chapter 2 that OFHEO did initiate a "data integrity" examination at Freddie Mac in 1996 that identified significant problems in the controls over data submitted to OFHEO for development of the stress test and risk-based capital standards. Thus, such examinations appear to be important for ensuring accurate enterprise financial data. OFHEO has not yet initiated a data integrity or books and records targeted examination at Fannie Mae, although it plans to do so as part of the information technology examination, according to OFHEO officials.

OFHEO's Capacity to Fully Assess Enterprise Risk-Taking Is Limited

OFHEO's inability to fully implement the 1994 examination schedule and plan limits its capacity to fully assess the enterprises' management practices, financial condition, and risks. For example, although Fannie Mae and Freddie Mac have been consistently profitable in recent years, we pointed out in chapter 1 that the enterprises have adopted business strategies that could potentially weaken their future financial

[44]OFHEO initiated the corporate governance risk exam in August 1994.

[45]Single-family mortgage loan delinquency rates at both enterprises equaled .58 percent of outstanding single-family mortgages in 1996. During 1996, Fannie Mae's delinquency rate on multifamily mortgages was .68 percent, which was well below the delinquency rate of 2.65 percent in 1992. Freddie Mac's delinquency rate on multifamily mortgages was 1.96 percent in 1996, having fallen from 4.45 percent in 1992.

performance, such as by growing at rapid rates and potentially incurring greater interest rate risks through increased holdings of debt-financed mortgage assets. Under its current 3- to 4-year examination cycle, however, OFHEO may not be able to do an on-site examination to assess the enterprises' interest rate risks until 1999 or 2000, since the previous risk management examination was completed in 1996.

Limited Examination Staff Resources Impeded OFHEO's Ability to Implement the 1994 Examination Schedule and Plan

The evidence indicates that limited examination staff resources were largely responsible for the fact that OFHEO has not been able to fully implement the 1994 examination plan. In particular, OFHEO has too few examiners and specialists to fully cover the six core risks within a 2-year period. Although OFHEO supplements its examination staff with temporary contractors and detailees, their use has not been sufficient to ensure compliance with the plan. OFHEO officials said that another contributing factor was the time that its examiners needed to develop an understanding of the enterprises' operations and risk management.

OFHEO's Limited Examination Staff Resources Have Been a Long-Standing Concern

In testimony before the House Banking, Finance, and Urban Affairs Committee, Subcommittee on Housing and Community Development on October 29, 1993, OFHEO's former director stated that the organization was relatively understaffed as compared to other federal financial regulators. For example, the former director said that OFHEO was relatively understaffed as compared to the Federal Housing Finance Board, the Office of Thrift Supervision, and OCC, and that OFHEO staff were responsible for assessing more assets per employee than other regulators. OFHEO's former director told us in December 1996 that the small size of the examination office remained an area of concern. In our 1995 report on OFHEO's development as an independent regulator, we also stated that limited staff resources had impeded OFHEO's ability to implement its examination program; for example, OFHEO had just seven staff members in its examination office at year-end 1994.[46] In addition, OFHEO officials we contacted said that limited staff resources impeded their ability to implement the 1994 plan.

Another factor that OFHEO officials cited for the organization's inability to fully comply with the 1994 plan was that the examination staff needed to take the time necessary to develop an understanding of the enterprises' operations and risk management practices. OFHEO's acting director said that prior to 1993 when OFHEO began operations, Fannie Mae and Freddie

[46] GAO/GGD-95-123.

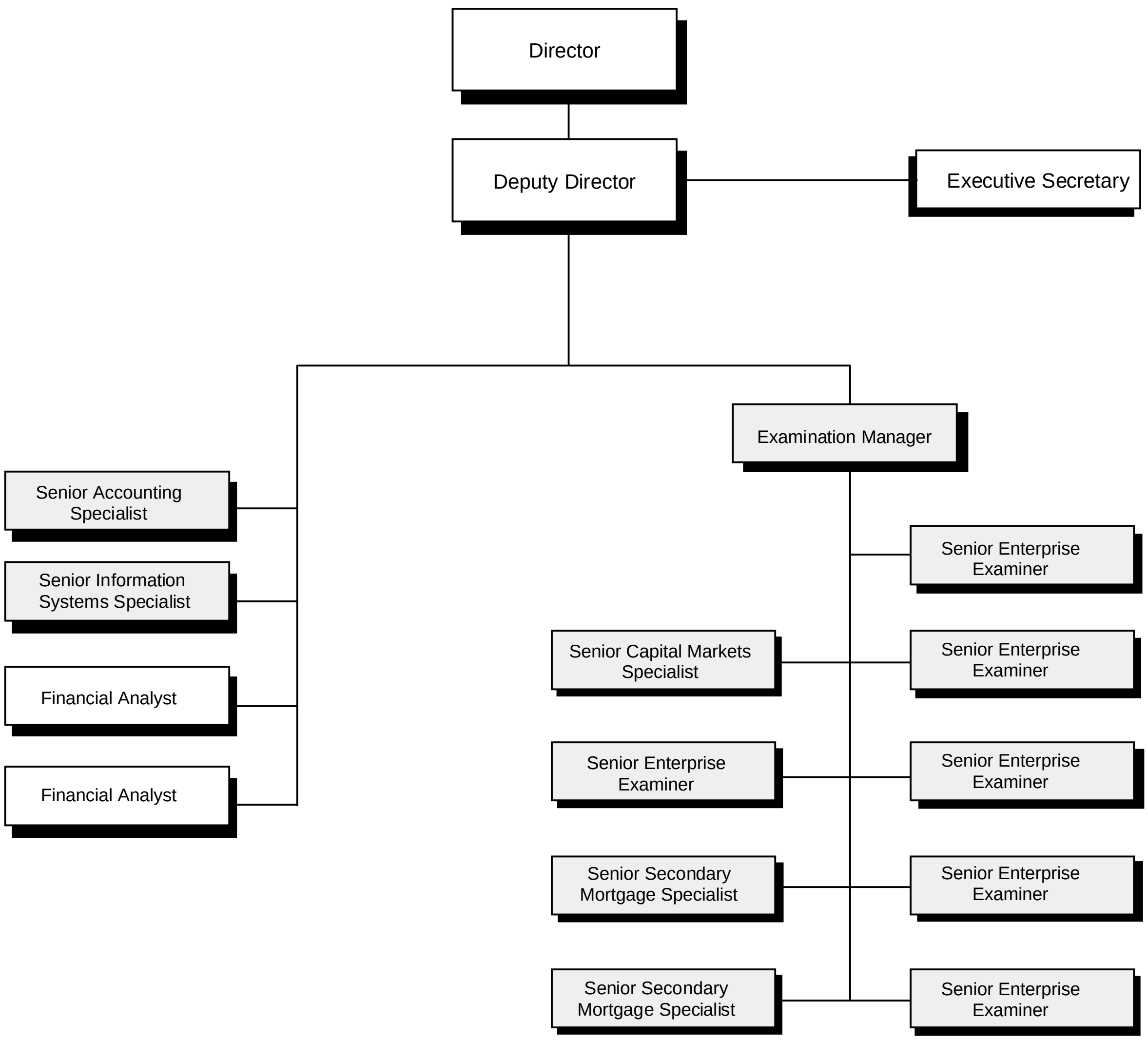
Mac had never been subjected to a safety and soundness examination program. Consequently, he said that OFHEO's first cycle of examinations has proved more time-consuming than OFHEO officials initially anticipated in 1994. He also said that subsequent examination cycles would proceed faster because of the experience gained during the first cycle.

Each Core Risk Examination That OFHEO Has Initiated Tied Up a Significant Majority of Line Examination Staff for About 1 Year

We analyzed OEO's allocation of examination staff resources and found that it appears to lack an adequate number of positions to cover the six core risks within a 2-year period. During fiscal year 1997, OEO had 17 authorized full-time permanent positions (see fig. 3.1). As the figure indicates, 12 of the 17 positions were assigned to line examiners and specialists, those individuals who are assigned full-time to conduct the labor-intensive tasks associated with core risk and targeted examinations (such as conducting and writing up interviews with enterprise officials, reviewing policies, collecting and analyzing financial data, reviewing the enterprises' asset and liability management practices, writing examination drafts, and documenting findings).

Although OEO's director and deputy director also play a vital role in the examination process, such as by reviewing examination reports and communicating findings to senior enterprise officials, they have other responsibilities that claim their time as well. As examples, the director and deputy director are to establish policies and plans for the office, prepare annual budgets, and conduct internal and external meetings, among other responsibilities. The two financial analyst positions are primarily responsible for conducting OFHEO's off-site financial monitoring program. The remaining position is for the executive secretary, who is responsible for maintaining the correspondence of the office and other administrative support functions.

Figure 3.1: Line and Nonline Full-Time Permanent Positions in OFHEO's Office of Examination and Oversight



Line examiner or specialist position
Nonline examiner or specialist position

In the two most recent core risk examinations,[47] OFHEO needed to commit a significant majority of its line examination staff to each exam for a period of about 1 year to complete them (see table 3.3). Specifically, OFHEO assigned nine of its line examiners and specialists full-time to the business risk examination and eight examiners full-time[48] to the risk management examination. In addition, OFHEO assigned a financial analyst to work on the risk management examination even though this individual's primary responsibility is to produce off-site financial reports. Further, OFHEO's staff of line examiners and specialists is required to do targeted examinations, such as of the enterprises' compliance with flood insurance requirements. With such a large majority of its line examination and specialist staff assigned to one core risk management examination for a whole year and with various targeted examination requirements, it appears that OFHEO lacks adequate examination resources to cover three core risks per year, the minimum necessary to cover all six core risk areas on a 2-year cycle as stipulated in the 1994 plan.

Table 3.3: OFHEO Line Examination Positions Assigned to Completed Enterprise Core Risk Examinations

Examination type	Line examiners and specialists assigned	Total line examiner and specialist positions	Exam start and end dates
Business	9	12	June 1996 to May 1997
Risk management	8[a]	12	May 1995 to June 1996

[a]Includes an examiner who resigned from OFHEO approximately 75 percent of the way through the examination. Also, excludes a financial analyst who was assigned to the examination.

Source: OFHEO.

Examination Office Has Had Attrition

During 1996 and 1997, OFHEO's examination office experienced significant attrition of permanent full-time staff, which has further limited its ability to implement the 1994 plan. During 1996, three full-time permanent staff—two examiners and a capital markets specialist —resigned, and, in January 1997, OEO's director passed away. As of March 31, 1997, OEO had five full-time permanent position openings, which represented a vacancy rate of 30 percent. Of the five vacancies in the examination office, one was

[47]We did not include OFHEO corporate government risk examination in this analysis because it was initiated in 1994 when the examination office only had a total of seven staff, including the director, deputy director, and executive secretary.

[48]One OFHEO examiner resigned approximately 75 percent of the way through the risk management examination.

for the director, three were for line examiner or specialist positions, and one was for a financial analyst.

According to OEO's acting director, the office places a high priority on filling these vacancies in 1997 through a competitive civil service announcement because the vacancies further limit OEO's capacity to do examinations on a timely basis. As of August 1997, an OFHEO official said that the organization had filled the OEO director position, a financial analyst position, and a specialist position. In addition, the official said that OFHEO was in the process of announcing the other two specialist positions.

OFHEO officials told us that the organization prefers to recruit senior-level examiners who have substantial experience in overseeing the operations of financial companies. OFHEO officials said they adopted this strategy for the following reasons: (1) experienced examiners can more quickly understand the operations of the enterprises, (2) OFHEO grants considerable latitude to its examiners so they must have credibility with senior enterprise officials, (3) senior examiners allow OFHEO to minimize its staffing levels, and (4) it is too expensive to establish an examiner development program that would focus on recruiting more junior-level examiners. However, OFHEO officials also said that it can be difficult to attract and retain senior examiners because they are also in demand by large financial corporations and other financial institution regulators that may be able to offer higher salaries and career opportunities than OFHEO.

We reviewed the backgrounds of OFHEO's full-time examination staff and found that they have substantial backgrounds in examining financial institutions and financial analysis. For example, the acting director had served a total of 15 years with the Office of Thrift Supervision and OCC. Other staff had also worked for financial regulators and had postgraduate degrees in finance, business, accounting, and/or professional certifications from relevant accrediting organizations.

OFHEO's Use of Contractors May Have Been Affected by Cost and Other Factors

OEO's acting director said that OFHEO plans to continue supplementing its examination staff with contract employees and detailees from other financial regulators. In the past, contract employees and detailees have performed most functions of OFHEO examiners, such as conducting examinations and documenting their findings. However, OEO officials said that OFHEO examiners make all final examination conclusions and recommendations that are based on the work of the contract employees and detailees. In April 1997, OFHEO's contract with a private firm for examination and related support services expired. The firm provided five examiners who worked on the risk management examination and three examiners who worked on the business risk examination. This contract was replaced by another contract that was signed in March 1997 to provide support for OFHEO's ongoing information technology risk examination. OFHEO plans to use its full-time staff, including new hires, to staff the operations risk examination that is also scheduled to begin in 1997.

Despite relying on contractors to supplement its full-time examination staff, OFHEO has not been able to fully implement the 1994 plan. One factor that may have limited OFHEO's use of contractors is cost. For example, OEO's acting director estimated that hiring a contractor full-time for 1 year costs approximately $175,000 to $200,000 per year.[49] By contrast, he estimated that OFHEO's compensation and travel costs for a full-time examiner are about $125,000. He also estimated that OFHEO's compensation and travel costs for a detailee from a bank regulatory agency vary from about $100,000 to $150,000, depending upon whether the detailee normally works in a regional office and OFHEO must pay temporary housing costs in the Washington, D.C., area.

Another factor that appears to have limited OFHEO's use of contractors is an ongoing dispute between Fannie Mae and OFHEO over the potential disclosure of proprietary information; OEO's acting director said that OFHEO temporarily stopped using contractors during the course of the risk management exam as a result of this dispute. Fannie Mae officials told us that they believe OFHEO lacks the statutory authority to use contractors as full-fledged examiners. Instead, Fannie Mae officials said they believe that OFHEO only has the authority to use contractors for temporary technical assistance. Fannie Mae officials said that contractors could disclose proprietary information gained during the examination process to the enterprise's direct competitors. In response, OFHEO's general counsel told us that the organization has statutory authority to use contractors during the examination process. The general counsel also said that OFHEO has implemented adequate procedures to protect proprietary enterprise information. Among other procedures, OFHEO generally requires contractors to (1) sign oaths to the effect that they will not disclose proprietary information obtained from the enterprises and (2) turn over to OFHEO officials materials obtained from the enterprises during the examination process.

[49]OFHEO limits its contractor costs by hiring on a part-time basis.

OFHEO Plans to Reassess Its Examination Strategy and Staff Resources

OEO's acting director stated to us that OFHEO plans to shorten the time that it takes to complete the core risk examinations. He said that OFHEO plans to initiate an assessment of its examination program during 1997 and to make procedural changes as necessary to enhance enterprise oversight by early 1998. The acting director stated that OFHEO plans to assess the appropriate mix of full-time staff, contractors, and detailees as well as potential examination strategies that would shorten the current examination cycle for assessing the core risks from 3 to 4 years to 1 year rather than the 2-year cycle in the 1994 plan. The acting director stated that shortening the examination cycle to 1 year is a reasonable goal because OFHEO plans to fill its five vacant positions during 1997, which would facilitate a faster examination cycle. Moreover, the acting director said that the experience OFHEO has gained during the first round of examinations should also shorten subsequent examination cycles. OFHEO has hired OCC's former Chief National Bank Examiner as a consultant to advise the organization on assessing its examination strategy.

OEO's acting director said that, as part of its reassessment, OFHEO plans to determine the appropriate number of examiners and specialists necessary to shorten the examination cycle to 1 year. According to OFHEO's acting director, OFHEO may shift resources from ORACS to OEO after the stress test and risk-based capital standards are completed. Consequently, OFHEO may have some flexibility over time to increase the resources in its examination office without necessarily increasing its overall staffing levels or budget.

Conclusions

OFHEO's examination program, along with the development of minimum and risk-based capital standards, is an essential component for helping to ensure the safety and soundness of Fannie Mae and Freddie Mac. Since OFHEO began operations in 1993, the organization has made important progress in developing a viable examination program. This progress included developing a risk-focused approach to examinations, identifying six core risks facing the enterprises, and completing or initiating examinations to cover five of those six risks. In addition, OFHEO has completed special exams of the enterprises' nonmortgage derivatives activities, compliance with flood insurance requirements, and data integrity issues at Freddie Mac.

OFHEO has also assembled an examination staff that has substantial experience in monitoring financial institutions. However, limited staffing levels and staff attrition—among other factors, such as the need for OFHEO to develop an understanding of the enterprises' operations and risk management—have compelled OFHEO to scale back the implementation of a detailed examination schedule and plan that it established in 1994. As a result, OFHEO has a 3- to 4-year cycle for examining the enterprises, which is considerably longer than the 2-year cycle in the plan. OFHEO also reduced the planned coverage of its business risk examination. In our view, OFHEO's inability to fully implement a comprehensive examination program limits the organization's ability to adequately monitor the enterprises' management practices and financial condition.

According to OFHEO officials, the organization plans to reassess its examination strategy and to make changes as necessary to shorten the examination cycle from 3 to 4 years to 1 year. We are concerned that, without a reassessment of resources, OFHEO may not be able to implement an annual enterprise examination program that adequately covers all risk areas by early 1998. Thus far, OFHEO has not been able to implement a 2-year examination cycle that fully covers all identified risk areas with examination office resources currently assigned. In fact, as of June 1997, OFHEO had not completed the first cycle of examinations and important tasks remained. Thus, OFHEO's plan to implement, even after it fills existing OEO vacancies, an annual examination strategy by early 1998 represents a substantial additional challenge to an examination staff that already has a significant workload.

Therefore, we believe that including in OFHEO's assessment an analysis of the staff resources necessary to adequately carry out alternative examination cycles, such as 1 or 2 years, could help ensure a fuller consideration of the trade-offs associated with examination coverage provided versus costs involved and thereby result in a more informed decisionmaking process.

Recommendations

We recommend that OFHEO's and OEO's director promptly (1) conduct an analysis to determine the examination office staff positions and financial resources that would be needed to cover all core and targeted risk areas within 1- or 2-year examination cycles; (2) identify the most appropriate examination cycle after considering the trade-offs between examination coverage and resource requirements that would be involved; and (3) develop a strategy for obtaining the necessary examination office resources, which may involve reallocating OFHEO's existing full-time and contracting positions over time.

Agency Comments and Our Evaluation

In written comments, the acting director of OFHEO agreed with our findings and recommendations regarding the examination program. The acting director attributed OFHEO's relatively long 3- to 4-year examination cycle to the fact that the enterprises had not been subjected to a safety and soundness examination program prior to OFHEO's creation. He also stated that upon completion of the first round of examinations at year-end 1997, OFHEO will have completed the “discovery” process that is essential to understanding the quantity and quality of risk at the enterprises. The acting director further stated that OFHEO will transition to a “continuous examination process” at year-end 1997 that will allow for an annual examination cycle. Moreover, the acting director said that OFHEO's previous examination work would allow it to prioritize future examination activities while dramatically increasing the efficiency of the examination process.

The acting director agreed with the report's finding that adequate resources must be committed to the examination program. He also said that OFHEO should be able to attract and retain qualified examiners in the future as a result of its increasing visibility in the regulatory community and efforts to ensure pay comparability. Further, the acting director stated that OFHEO will continue to review the adequacy of its examination staff resources and supplement its permanent examination staff with expertise from within OFHEO, bank regulatory detailees, and contractors.

While OFHEO has agreed to review the adequacy of its examination staff resources, we believe it is essential that OFHEO promptly specify the resources necessary to carry out an appropriate examination cycle and develop a plan to obtain the permanent staff, detailees, and contractors that may be required.

OFHEO's Implementation of Key Mission Support Functions

In response to our statutory mandate to assess OFHEO's overall operations, we reviewed OFHEO's implementation of key functions that support the organization's safety and soundness mission-related activities. These mission-related support functions are OFHEO's financial, human resources, and contract management systems. Despite some initial implementation challenges, OFHEO officials we contacted said that these mission-support functions are now operating satisfactorily.

We also assessed whether OFHEO's participation in a U.S. government initiative to assist Mexico in developing a secondary mortgage loan market has diverted OFHEO from fulfilling its safety and soundness mission. Although OFHEO officials made 10 trips to Mexico in 1995 and 1996 to support the initiative, the trips did not involve staffs directly responsible for developing the stress test or conducting examinations. In addition, most of OFHEO's foreign travel and related costs were paid by the United States Agency for International Development (USAID).

In this chapter, we also provide trend information on OFHEO's budget and staff resources and discuss OFHEO's relationship with HUD to provide further perspectives on how OFHEO has deployed its resources during its first 4 years of operations.

OFHEO Has Implemented Its Financial, Human Resources, and Contract Management Functions

Since our first report on OFHEO's operations,[50] the organization has implemented its financial management, human resource, and contracting mission support functions. According to OFHEO officials, the organization experienced some problems in making the support functions fully operational. In particular, OFHEO experienced repeated problems with HUD's operations of its financial management systems, which OFHEO officials said compelled them to convert to a different financial management system offered by VA. Nevertheless, OFHEO officials said that they are now generally satisfied with the operational performance of these support functions.

OFHEO Switched to a New Financial Management System in 1996 After Repeated Problems With HUD's Systems

When OFHEO began its operations in June 1993, it relied on HUD's financial management system, which was called the HUD Administrative Accounting System (HAAS). Under HAAS, OFHEO staff reviewed invoices and sent approved invoices to HUD for payment processing. However, we reported in 1995 that HAAS did not meet OFHEO's needs because, among other reasons, OFHEO staff had limited access to the system and experienced

[50]GAO/GGD-95-123.

substantial delays in how HUD recorded OFHEO obligations and expenses. Also, HUD staff confused OFHEO with another HUD agency, the Office of Fair Housing and Equal Opportunity (FHEO), which resulted in errors in OFHEO's financial reports. In October 1995, HUD converted OFHEO to its new accounting system, the HUD Central Accounting and Program System (HUDCAPS).

Although HUDCAPS offered improvements over HAAS, OFHEO officials said that they remained dissatisfied with system access and performance and the level of support provided by HUD. For example, OFHEO officials said that HUD staff continued to inaccurately record transactions and did not provide OFHEO with the support necessary to correct errors. In addition, OFHEO officials said that there were prolonged periods when HUDCAPS was unavailable, and OFHEO staff were unable to record transactions. These deficiencies with HAAS and HUDCAPS caused OFHEO officials to initiate a search for a new financial management system.

In 1996, OFHEO entered into a "cross-servicing" arrangement[51] with VA, a franchiser under the Government Management Reform Act,[52] to operate OFHEO's financial management system beginning in fiscal year 1997. During the first half of fiscal year 1997, OFHEO officials concentrated on the conversion of the organization's financial accounting activities from HUDCAPS to the VA Financial Management System (FMS).

OFHEO officials said that the VA FMS has met their initial performance expectations, but the conversion process was more difficult than initially planned due to the amount of reconciliation needed to the financial data contained in the HUD records. OFHEO officials said that they plan to have the organization's fiscal year 1997 financial statements audited by an independent accounting firm.

OFHEO Has Implemented Its Human Resource Management Systems

Under the act, OFHEO has exclusive authority over hiring and compensation levels for its personnel. The act further specifies that OFHEO personnel may be paid without regard to certain provisions of federal law[53] relating to

[51]A "cross-servicing" agreement is an interagency agreement where one agency agrees to provide specific services to another agency. As a small independent office, OFHEO is able to secure administrative services from larger organizations having the capability to provide services on a cost reimbursement basis.

[52]Pub. L. No. 103-356, § 403 (1994), 31 U.S.C. § 501 note. This act establishes pilot programs at six agencies designated by OMB to provide administrative support services to other agencies.

[53]The act provides that OFHEO personnel may be paid without regard to provisions of Title 5, United States Code, relating to classification and General Schedule pay rates. See 12 U.S.C. § 4515(a).

classification and general pay rates. In concert with the act, OFHEO has developed an independent classification and qualification system and pay structure. Occupations are to be 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. The act also provides that OFHEO's compensation levels should be comparable with those of OCC, the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision. According to OFHEO, pay band levels are based on comparisons with similar occupations in those other federal financial regulatory agencies. OFHEO's broad pay band structure is comprised of seven band levels, plus the executive-level director position, which is set by law. OFHEO's staff members' pay band levels also depend upon the complexity of the work, scope of responsibility, and supervisory responsibility. Table 4.1 shows the levels and number of positions assigned to those levels.

Table 4.1: OFHEO's Pay Band Levels and Positions in Each Band in 1996

Level	Pay range	Positions in level
I	$15,876 - 26,460	0
II	21,168 - 42,337	8
III	31,753 - 58,213	8
IV	42,337 - 79,381	5
V	52,921 - 105,842	22
VI	79,381 - 137,594	20
VII	89,966 - 142,886	8
Director	133,600	1
Total		**72**

Source: OFHEO.

OFHEO officials also said that the organization's performance management system, the Performance Evaluation Management System (PEMS), was fully implemented by March 31, 1995, and that OFHEO began its first rating cycle in April 1995. Changes in base pay occur once a year, at the end of the PEMS performance review cycle, and are to be based solely on merit. An OFHEO official said that the organization is currently evaluating PEMS to ensure that it remains an effective tool for assessing the performance of the staff.

According to an OFHEO official, on September 30, 1996, OFHEO's Schedule A authority[54] to hire employees expired and by January 1997, the organization had converted to the federal civil service competitive hiring system and procedures. OFHEO officials expressed generally negative views on the impact that the conversion from Schedule A hiring authority to civil service hiring authority will have on the organization. The director of ORACS said that the civil service procedures could impede OFHEO's capacity to hire necessary expert staff. OFHEO's Director of the Office of Finance and Administration said that it is too soon to evaluate the impact of the conversion. However, she did say that the competitive service requirements are much more time-consuming and cumbersome than the Schedule A procedures.

OFHEO's Contracting Authority Considered Adequate for Mission Support

During its start-up phase, OFHEO used HUD for procuring contracting services but experienced various difficulties. In our first report on OFHEO's operations,[55] we stated that HUD was not staffed to provide the expedited procurement processing that OFHEO's start-up mode of operations required. In June 1994, OFHEO hired its own procurement contracting officer and exercised its contracting authority as provided in the act. According to an OFHEO official, HUD's general counsel has written a legal opinion stating that OFHEO is subject to both the Competition in Contracting Act and the Federal Acquisition Regulation. OFHEO officials we contacted said that the organization has all of the contracting authority necessary to provide mission support. Table 4.2 lists all of the contracts OFHEO entered into between 1994 and the second quarter of fiscal year 1997. With the exception of one contract terminated because of nonperformance, OFHEO officials said they are generally satisfied with their contractors' performance.

[54]Schedule A hiring authority is one of the federal government's excepted appointing authorities used for hiring employees under special circumstances. This temporary authority, granted by the Office of Personnel Management, permits agencies to fill positions without following the extensive requirements of the competitive service. Schedule A hiring authority may be used if, for example, a crash program or a new organization must be staffed so quickly that there is not time for following established competitive service procedures.

[55]GAO/GGD-95-123.

Table 4.2: OFHEO Contracts by Value, 1994 to 1997

Contractor	Task description	Award date	End date	Contract amount
General Analytics Corporation	ADP-related work	07/06/94	09/30/97	$6,235,000
Haynes & Associates, Inc.	Examination-related work	06/02/95	04/12/97	1,911,000
Price Waterhouse	Design & development work for the financial simulation model	08/31/95	09/30/00	1,450,000
Computer Temporaries, Inc.	Various temporary services	04/04/94	09/30/97	1,057,000
Manufacturing Technology, Inc.	ORACS computer network	05/26/94	09/01/94	518,000
Strategic Compensation Association	Executive compensation study	09/27/96	09/30/00	289,000
Home Associates, Inc.	Construction of OFHEO space	03/31/97	03/31/97	234,000
Ernst & Young LLP	Information system & technical examination support	03/21/97	12/31/01	212,000
Standard & Poor's Rating Services	Credit rating of enterprises	09/30/96	03/31/97	200,000
INTEX Solutions, Inc.	Simulate cashflow performance of financial products	09/30/96	09/30/01	173,000
Risk Management Technologies	Design and development of financial database	08/08/95	03/07/96	101,000

Source: OFHEO.

OFHEO's Participation in Mexico Initiative Did Not Involve Research or Examination Staffs

We assessed whether OFHEO's participation in a U.S. government initiative to assist Mexico in developing a secondary market for mortgage loans has had a substantial impact on delaying the development of the stress test and risk-based capital standards. A total of 8 OFHEO officials—the former director, 4 senior officials, and 3 staff members—made a total of 10 foreign trips related to the Mexico initiative in 1995 and 1996.[56] Other participants in the initiative included officials from OCC, the enterprises, and private sector institutions that specialize in housing finance. Under an agreement with USAID, USAID provided about $159,000 to OFHEO in 1996 to provide technical assistance to Mexico and for travel-related purposes. See appendix II for a more detailed discussion of OFHEO's participation in the Mexico initiative and related costs.

Based on a review of OFHEO's travel records and discussions with senior staff, we do not believe that OFHEO's participation in the Mexico initiative was a significant factor in delaying the development of the stress tests and capital standards or OFHEO's inability to fully implement its examination program. For example, staff from OFHEO's two principal mission-related

[56]Except for the former director, OFHEO officials did not all participate in each of the 10 foreign trips. See appendix II of this report, table II.1.

offices, ORACS and OEO, did not participate in the initiative or foreign trips. Other than the former director, the four senior staff who did participate in the initiative, the current acting director, the chief economist, the director of congressional affairs, and the director of public affairs estimated that they spent less than 5 percent of their time in 1996 on the Mexico initiative.[57] For example, the chief economist estimated that he spent only about 2 weeks in 1996 traveling to Mexico and preparing for presentations. OFHEO officials said that the organization benefits from participating in outside activities, such as the Mexico initiative, because they increase staff development and allow the agency to gain exposure to and credibility with participants in the mortgage finance markets. The other three OFHEO officials who went on some of the foreign trips were staff members in OFHEO's Office of the Director.

OFHEO's Financial and Staff Resources, 1993-1997

Since OFHEO began its operations in June 1993, its obligations increased from about $2.1 million at fiscal year-end 1993 to about $14.8 million at fiscal year-end 1995 (see table 4.3). This growth reflects the staff and contractors hired that OFHEO considered necessary to carry out its mission, such as developing capital standards and conducting examinations. During fiscal year 1996, OFHEO's obligations remained flat at $14.8 million and then increased by an estimated 5 percent in fiscal year 1997. Table 4.4 shows the growth of OFHEO full-time, contractor, and detailee staff for fiscal years 1993 through 1997. Appendix III provides additional information about OFHEO's staffing resources.

Table 4.3: OFHEO's Obligations, Fiscal Years 1993 Through 1997

Dollars in thousands

Obligation category	Actual 1993	Actual 1994	Actual 1995	Actual 1996	Estimated 1997
Personnel services[a]	$163	$2,690	$5,783	$7,234	$9,119
Other services[b]	1,956	2,473	5,858	4,800	3,793
All other[c]	7	1,323	3,139	2,758	2,588
Total	**$2,126**	**$6,486**	**$14,780**	**$14,792**	**$15,500**
Growth (%)	N/A	205%	128%	N/A	5%

N/A = Not applicable.

[a]Obligations for the salaries and benefits of OFHEO personnel.

[b]Obligations for contractor services.

[c]Obligations for rent, travel, computer acquisition, etc.

Source: OFHEO.

[57]OFHEO did not provide an estimate of the time that the former director devoted to the Mexico initiative.

Table 4.4: OFHEO's Full-Time, Contractor, and Bank Regulatory Detailee Staff, at End of Fiscal Years 1993-1997

Staff	1993	1994	1995	1996	1997[a]
Full-time permanent	7	37	63	66	58
Full-time temporary	1	4	4	10	7[b]
Contract	N/A	N/A	24	20	19
Detailee	N/A	N/A	2	5	1
Total	**8**	**41**	**93**	**101**	**85**

N/A = Not applicable.

[a]As of March 31, 1997.

[b]Includes one part-time temporary staff member.

Source: OFHEO.

OFHEO's Relationship With HUD

OFHEO's relationship with HUD has provided mixed benefits. For example, OFHEO's acting director said that OFHEO's association with HUD allows OFHEO staff to keep apprised of developing housing and housing-finance issues. In addition, the acting director said that he believes that HUD has benefited from its relationship with OFHEO. For example, he said that OFHEO's review and comments on HUD's proposed regulations implementing its oversight of the enterprises' compliance with the act's housing-related goals resulted in improvements. However, OFHEO officials also said that HUD has not always been able to provide adequate support, such as in the case of its financial management systems.

In a previously issued report,[58] we commented on the current regulatory structure for the government-sponsored housing enterprises. One of the issues discussed was whether the regulation should be done in a stand-alone organization or an office within an executive branch agency.

[58]See Government-Sponsored Enterprises: Advantages and Disadvantages of Creating a Single Housing GSE Regulator (GAO/GGD-97-139, July 9, 1997). This report commented on the potential benefits of merging OFHEO with the Federal Housing Finance Board.

Financial Modeling and Computer Programming Projects OFHEO Has Initiated to Complete Development of the Stress Test and Risk-Based Capital Standards

Between 1994 and 1997, OFHEO initiated several financial modeling and computer programming projects to complete the development of the stress test and risk-based capital standards. Most of these projects had been completed by April 1997. The following summarizes several of the more important projects:

OFHEO developed the benchmark loss experience by November 1995: To develop the benchmark loss experience, OFHEO reviewed nationwide data provided by the enterprises that showed the loss histories on 5.6 million mortgage loans dating back to 1979. Based on this analysis, OFHEO has proposed that the benchmark loss experience be based on mortgage loans originated in Arkansas, Louisiana, Mississippi, and Oklahoma during 1983 and 1984.

OFHEO translated the enterprises' financial data into a common format. This project was completed by January 1996: According to OFHEO, the stress test and capital standards must treat the assets, liabilities, and off-balance-sheet obligations of both enterprises equally and consistently. OFHEO determined that the most efficient way of doing this was to translate both enterprise balance sheets into comparable standardized terms and units and run them through a single financial model. OFHEO has also reported that the most challenging aspect of this process was translating Fannie Mae and Freddie Mac's huge data files into a consistent format to support stress test research. The process was further complicated by the differences in the ways that the enterprises record and report financial information. According to OFHEO, a contractor, Price Waterhouse, is continuing to transform the data so that it can be accessed more efficiently by OFHEO staff.

OFHEO decided to create a house price index rather than relying on an existing index. This project was completed in March 1996: To respond to the act's stress test requirement that it assess the impact changing house prices would have on the enterprises' mortgage portfolios, OFHEO determined that it needed to develop a new house price index rather than rely on the one available from the Department of Commerce. OFHEO's house price index combines similar indexes that had been published jointly by Fannie Mae and Freddie Mac. OFHEO made some technical changes to publish an index that OFHEO officials said better met the organization's regulatory requirements. OFHEO's index, first published in March 1996, provides historical house price information on mortgage loans purchased by the enterprises since 1975. According to OFHEO, the organization's house price index is superior to the Department of

Commerce index for the purpose of determining the current values of single-family properties securing enterprise loans.[59]

OFHEO developed econometric models and computer programs to simulate the financial performance of the enterprises. This work was completed by June 1997. OFHEO developed software to simulate the cash flows of all enterprise financial instruments and contracts, based on interest rate and mortgage performance models. OFHEO also developed econometric models to estimate mortgage default rates and loss severities and developed computer programs to simulate operating decisions and translate cash flow simulations into pro forma financial statements.

[59]OFHEO's index is produced using data on single-family detached properties financed by conforming conventional mortgages purchased by the enterprises. Thus, mortgages on properties that exceed the conforming loan limit are excluded. The Department of Commerce index includes such nonconforming loans, which was a reason OFHEO determined that the index was not appropriate for the stress test.

OFHEO Officials Have Participated in a U.S. Government Initiative Assisting Mexico in Developing a Secondary Mortgage Loan Market

The proposal for OFHEO's collaborative efforts to facilitate a secondary mortgage market in Mexico resulted from the May 1995 U.S.-Mexico Binational Commission meeting during which the former HUD Secretary and Mexico's Secretariat of Social Development (SEDESOL) Minister proposed a conference to be held in Mexico City in July 1995, to explore relevant policy issues. On September 11, 1995, OFHEO officials met with a subgroup of participants from the Mexico City conference, including the World Bank, USAID, Freddie Mac, and U.S. private sector institutions, to discuss ways to facilitate the development of a Mexican secondary mortgage loan market.

Funding for most of OFHEO's initiative was provided by USAID in the form of a Participating Agency Service Agreement (PASA), which went into effect on September 30, 1995. Under this agreement, USAID funds were used to pay for direct expenses (travel, conferences, studies, etc.) related to providing technical assistance to Mexico's SEDESOL in the development of products, methodologies, and strategies to eliminate barriers to the successful development and implementation of a securitized secondary mortgage market in Mexico. Total PASA funds with USAID were $159,000 in fiscal year 1996, the first fiscal year of the agreement.

During fiscal year 1996, OFHEO used PASA USAID funds to provide technical assistance to Mexico. This assistance included sponsoring seminars and papers on mortgage markets and related issues. For example, in April 1996, OFHEO sponsored a seminar and incurred nontravel-related expenses of $6,850 for such services as interpretation, transcription (English and Spanish), video and recording coverage, printing, copying, postage, office materials, telephone and fax charges, and a $6,400 consulting fee for a summary of the proceedings and interviews with senior Mexican bankers in preparation for a project analyzing mortgage data. Other uses of PASA funds by OFHEO included shooting footage for a video on the development of a secondary mortgage market in Mexico and assembling a glossary, in Spanish, of housing finance and secondary mortgage market terms.

During fiscal years 1995 and 1996, 8 OFHEO officials—the former director, 4 senior officials, and 3 staff members—made 10 foreign trips related to the Mexico initiative (see table II.1). Travel expenses for these foreign trips totaled about $49,999 with USAID paying $27,018 in fiscal year 1996 and OFHEO expending a total of $22,981 of its own funds in fiscal years 1995 and 1996. The four senior OFHEO officials—the acting director, chief economist, director of congressional affairs, and director of public affairs—who participated in the foreign trips relating to the Mexico initiative estimated that they spent 5 percent or less of their time on Mexico-related work in fiscal year 1996. OFHEO did not provide any estimates on the amount of time that the former director spent on the Mexico initiative. Due to the relatively small amount of time committed to the Mexico initiative, OFHEO's acting director said he does not believe that the organization's participation had a material impact on the development of risk-based capital standards. In addition, he said that staff from OFHEO's ORACS and OEO did not participate in the initiative. OFHEO's support staff were used to create and distribute written materials and to administer the PASA agreement with USAID. The three other OFHEO employees who participated in some of the foreign trips are staff members in OFHEO's Office of the Director.

Table II.1 OFHEO's International Travel Related to the Mexico Initiative, Fiscal Years 1995 and 1996

Travel date	OFHEO employees	Itinerary	Funds	Cost
FY 1995				
June 1995	4	DC-Mexico-DC	OFHEO	$5,507
July 1995	5	DC-Mexico-DC	OFHEO	8,074
FY 1996				
November 1995	2	DC-Mexico-DC	USAID	3,401
February 1996	3	DC-Mexico-DC	USAID	3,063
April 1996	6	DC-Mexico-DC	USAID	10,353
May 1996	5	DC-Mexico-DC	OFHEO	5,988
May 1996	1	NY-Mexico-DC	OFHEO	617
June 1996	1	DC-Turkey-DC	OFHEO	2,795
August 1996	4	DC-Mexico-DC	USAID	5,384
September 1996	4	DC-Costa Rica-DC	USAID	4,817
Total				**$49,999**

Source: OFHEO.

OFHEO's acting director cited several benefits to OFHEO from its participation in initiatives undertaken with PASA funds. He said the primary benefit for OFHEO was that it allowed the organization to establish contacts with personnel in the mortgage industry and develop its stature as an independent regulator. In addition, he said that OFHEO was able to share information on its role and activities with interested parties.

OFHEO's Staffing Levels, Fiscal Years 1993 to 1997

Table III.1: OFHEO's Full-Time, Contractor, and Bank Regulatory Detailee Staff, Fiscal Year-End 1993

Unit	Full-time permanent positions	Full-time permanent staff	Full-time temporary staff	Contract	Detail
Director		3			
Research, Analysis, and Capital Standards		1	1		
Examination and Oversight					
General Counsel					
Finance and Administration		2			
Policy Analysis					
Congressional and Public Affairs		1			
Total		**7**	**1**		

Source: OFHEO.

Table III.2: OFHEO's Full-Time, Contractor, and Bank Regulatory Detailee Staff, Fiscal Year-End 1994

Unit	Full-time permanent positions	Full-time permanent staff	Full-time temporary staff	Contract	Detail
Director		6			
Research, Analysis, and Capital Standards		8	2		
Examination and Oversight		7			
General Counsel		3	2		
Finance and Administration		6			
Policy Analysis		3			
Congressional and Public Affairs		4			
Total	**45**	**37**	**4**		

Source: OFHEO.

Table III.3: OFHEO's Full-Time, Contractor, and Bank Regulatory Detailee Staff, Fiscal Year-End 1995

Unit	Full-time permanent positions	Full-time permanent staff	Full-time temporary staff	Contract	Detail
Director	7	7	1	1	
Research, Analysis, and Capital Standards	14	14	2	12	
Examination and Oversight	14	13		7	1
General Counsel	8	8	1		1
Finance and Administration	11	10		4	
Policy Analysis	6	6			
Congressional and Public Affairs	5	5			
Total	**65**	**63**	**4**	**24**	**2**

Source: OFHEO.

Table III.4: OFHEO's Full-Time, Contractor, and Bank Regulatory Detailee Staff, Fiscal Year-End 1996

Unit	Full-time permanent positions	Full-time permanent staff	Full-time temporary staff	Contract	Detail
Director	8	7	1		
Research, Analysis, and Capital Standards	17	15	5	11	
Examination and Oversight	17	14	1	7	4
General Counsel	8	9	1		1
Finance and Administration	11	11	1	2	
Policy Analysis	6	5	1		
Congressional and Public Affairs	5	5			
Total	**72**	**66**	**10**	**20**	**5**

Source: OFHEO.

Table III.5: OFHEO's Full-Time, Contractor, and Bank Regulator Detailee Staff as of March 31, 1997

Unit	Full-time permanent positions	Full-time permanent staff	Full-time temporary staff	Contract	Detail
Director	7	5			
Research, Analysis, and Capital Standards	17	14	4[a]	14	
Examination and Oversight	17	12		3	1
General Counsel	9	8	1		
Finance and Administration	11	11	1	2	
Policy Analysis	6	4	1		
Congressional and Public Affairs	5	4			
Total	**72**	**58**	**7**	**19**	**1**

[a]One of the four staff members was part-time.

Source: OFHEO.

Comments From the Office of Federal Housing Enterprise Oversight

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

August 4, 1997

Ms. Jean Gleason Stromberg
Director, Financial Institutions and Markets Issues
General Accounting Office
441 G Street, NW
Washington, DC 20548

Dear Ms. Stromberg:

We appreciate the opportunity to provide formal comments on the report entitled Federal Housing Enterprises: OFHEO Continues to Face Challenges Implementing a Comprehensive Oversight Program. Before we comment on the report, we would like to express our appreciation to the staff of the General Accounting Office (GAO) who performed the audit for their diligence in acquiring a thorough understanding of OFHEO's responsibilities, particularly the complex process of developing a risk-based capital standard for the Enterprises. As a result of their efforts, the report presents a cogent assessment of OFHEO's progress in implementing its safety and soundness mission.

We agree with and are implementing GAO's recommendations outlined in the report. At the same time, we want to highlight our views on key issues discussed in the report:

- Stress Test Completion - While OFHEO agrees with GAO's assessment concerning the challenges involved in completing the stress test, we would like to emphasize that we have made major strides towards completing the project. We have constructed a financial simulation model that we will use to run the stress test. Furthermore, we are confident that our decision to develop our own model, rather than relying on models or approaches developed by HUD or the Enterprises, will result in the most timely completion of a stress test that satisfies the requirements and the intent of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the 1992 Act).

- Examination Schedule - We agree with GAO's recommendations regarding the examination function at OFHEO. Our examination of the six core risks to which the Enterprises are exposed provide the necessary foundation to implement a continuous annual examination of all these risks. After completing the final core risk examination at the end of 1997, we will transition into this annual examination process.

Ms. Jean Gleason Stromberg
August 4, 1997
Page 2 of 4

Stress Test Completion

GAO concluded that two factors were primarily responsible for the length of time it has taken to develop a risk-based capital stress test. First, the requirements for the stress test in the 1992 Act are complex and challenging. Second, OFHEO decided to develop its own stress test instead of attempting to redesign stress tests that were under development. We agree.

In addressing the first point, GAO's report makes clear that a large number of tasks are involved in completing the risk-based capital regulation. OFHEO has a solid record of achievement in accomplishing these tasks. As a newly-created agency, we embarked on our mission with no staff and no equipment. After acquiring them, we developed a detailed understanding of both Enterprises. We issued an Advance Notice of Proposed Rulemaking (ANPR) to obtain the views of a wide variety of commenters about how the stress test should be developed. At the same time, we gathered, reformatted for comparability, and analyzed enormous amounts of data from the Enterprises. OFHEO had to acquire individual loan data not only to make the Enterprises' data comparable for purposes of developing "starting positions" for the stress test, but also to meet the legislation's requirement that we identify the benchmark loss experience, the unique combination of times and places that constituted the worst historical mortgage loss experience. We accomplished that task and published the results for comment. We also identified an appropriate House Price Index (HPI) and developed the capacity to produce it in-house to ensure that it met the quality, use, and public availability requirements of the 1992 Act.

Most importantly, we have now completed the construction of a financial simulation model that accurately reflects the Enterprises' key risk exposures and can be used to measure their performance under statutory stress conditions. The model projects the performance of a variety of different types of mortgages; accounts for different types of credit enhancements; generates accurate cash flows associated with the principal assets, liabilities, and off-balance sheet obligations; and produces *pro forma* income statements and balance sheets.

With respect to the second point, as GAO noted, OFHEO determined that it was necessary to develop our own stress test instead of adopting an existing model or approach. We think it is important, however, that the GAO's report not be interpreted as suggesting that using an existing model or approach might have produced an acceptable result. In fact, HUD officials noted that their stress tests would have required extensive development to meet the requirements in OFHEO's statute. The 1992 Act prescribes a stress test that is sufficiently complex to require OFHEO to develop a financial model with sophisticated analytical capabilities. For example, OFHEO had to identify a benchmark loss experience to which our stress test must be calibrated. In addition to credit risk, the stress test must also give careful consideration to interest rate risk. Since the early 1990s, interest rate risk has been growing in importance because, as the report notes, the retained mortgage portfolios of the Enterprises have swelled rapidly in recent years. These portfolios are more complex, include large volumes of REMIC securities, and are financed in an increasingly sophisticated manner, including the use of large volumes of derivatives. As a result, the Enterprises' portfolios have complicated performance characteristics that are sensitive to changes in interest rates. Excessive simplification in this area could produce inappropriate results.

OFHEO also determined that the Enterprises' own models and approaches, while they are useful internal management tools, were not appropriate for the risk-based capital stress test. The Enterprises tailor their models to meet their separate needs and different books of business. It is unlikely that one Enterprise's model would correctly reflect the risk profile of the other Enterprise. The use of Enterprise models, or models developed by any other interested party, could also potentially subject OFHEO to regulatory capture and diminish OFHEO's regulatory independence. Invariably, the builder of a complex model understands the intricacies of that model better than most of the educated users of the model.

OFHEO still needs to complete some important work. We need to run the model under a wide variety of different assumptions in order to understand the implications of a large number of stress test features that are left to the Director's discretion. We then need to complete the remainder of the rulemaking process. We are confident that the results will be more than worth the effort. A hasty job would inevitably ignore significant areas of risk and create unnecessary incentives to alter business decisions in ways that help meet the test but do not decrease risk.

Examination Schedule

We are pleased that the General Accounting Office has found that "OFHEO has made important progress in fulfilling its essential examination oversight function." We share your view that our risk-focused examination strategy is consistent in concept with the risk-focused examination process that the Office of the Comptroller of the Currency (OCC) and the Board of Governors of the Federal Reserve (Federal Reserve) have established to assess the safety and soundness of large commercial banks. Furthermore, as GAO's report notes, OFHEO's examination office has also established an off-site capacity to monitor the Enterprises' financial safety and soundness and that the Office of Examination and Oversight produces internal reports that discuss relevant supervisory issues. Based on our examination experience and our off-site monitoring capability, we believe that OFHEO has the ability to monitor fully the Enterprises' financial activities and risks.

From the beginning, OFHEO adopted a risk-focused approach to examination similar to the supervision by risk approach that was adopted by the OCC and the Federal Reserve in 1995 and 1996. Bank examiners, however, use prior examinations as the foundation for planning and scoping future examinations of commercial banks. Since neither of the Enterprises had been subject to safety and soundness examination prior to the creation of OFHEO we did not have the benefit of prior examinations. In order to establish a basis for our continuous risk focused examination approach, we developed a sequence of examinations to assess each of the six core risks that represent significant potential exposures to the Enterprises. The depth, breadth, and timing of these examinations was the result of our newness combined with the size and complexity of the Enterprise's businesses. While we are mindful that our first examination cycle was longer than anticipated, this examination approach was necessary and appropriate.

With the completion of the operations risk examinations this year, we will have completed the "discovery" process essential to understanding the quantity of risk and the quality of risk management practices at the Enterprises. At year end 1997, we will transition to a continuous annual examination process. Our prior comprehensive examinations will enable us to prioritize future examination activities, while dramatically increasing the efficiency of our examination processes. We have been fortunate to hire as a consultant the former Chief National Bank Examiner at the OCC to assist us in the transition to the continuous annual examination process.

As described in our Annual Reports to Congress, OFHEO has conducted comprehensive examinations of the most significant risk exposures to the Enterprises and has made many significant recommendations to enhance the risk management practices and internal controls at the Enterprises. Furthermore, as noted in your report, OFHEO has developed an off-site monitoring program to supplement our on-site examinations. These on-site examination activities and off-site monitoring are both essential elements of a comprehensive assessment of safety and soundness.

We agree with your recommendations concerning the examination function at OFHEO. We do recognize that your concerns with the implementation of timely safety and soundness examinations are related to staff resources rather than the nature of our examination strategy. We agree with you on the need to ensure that adequate resources are committed to the examination function. As your report notes, we have been successful in attracting a highly qualified staff. We realize, however, that we face challenges in recruiting and retaining staff with the competencies we need. We are confident that the combination of our increasing visibility in the regulatory community and of our efforts to ensure pay comparability will enable us to continue to attract the staff necessary to conduct effective and efficient examinations. We will continue to review the adequacy of staff resources to maintain skill sets to ensure a comprehensive examination program with a view to supplementing that function with staff support from the expertise available throughout OFHEO as well as enhancing our use of examiners detailed from other agencies and contractors.

Again, we appreciate the opportunity to comment on this report and we look forward to working with GAO in the future.

Sincerely,

Mark Kinsey

Mark Kinsey
Acting Director

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