Federal Housing Finance Agency
Office of Inspector General

FHFA's Visibility Into the Enterprises' Credit Risks Has Increased by Reviewing Significantly More of Their Proposed Mortgage Selling Policies Before Implementation

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Executive Summary

Fannie Mae and Freddie Mac (the Enterprises) collectively held more than $7.2 trillion in assets on their balance sheets by the end of 2021. These immense balance sheets expose the Enterprises to significant credit risk in the event of a downturn in the mortgage market should large numbers of borrowers fail to pay their mortgages as required or otherwise deteriorate in creditworthiness.

One means by which the Federal Housing Finance Agency (Agency or FHFA) oversees the Enterprises' credit risks is to review and approve their proposed single-family mortgage selling policies (MSPs), which are the Enterprises' underwriting standards for purchasing mortgages from loan sellers. For example, an Enterprise's borrower income requirements for its single-family mortgage purchases would constitute an MSP.

In 2015 and again in 2018, an Agency official acknowledged to FHFA's Office of Inspector General (OIG) that one Enterprise submitted fewer MSPs to FHFA for review and approval than required. For this reason, the FHFA official stated that the Agency lacked sufficient "visibility" into that Enterprise's credit risks.

In March 2018, revised FHFA instructions took effect that required the Enterprises to submit certain MSPs to the Agency for review and approval prior to implementation, which would mitigate FHFA's lack of visibility into the Enterprises' credit risks. We initiated this compliance review to determine whether the Enterprises complied with these revised instructions from April 1, 2019, through January 31, 2022 (the review period).

According to FHFA and Enterprise officials, the Enterprises now submit all or nearly all of their MSPs to the Agency rather than confining their submissions only to those MSPs required to be submitted by the March 2018 instructions. An FHFA official said that the Enterprises do this at their own discretion, based on their internal organizational structures and compliance practices.

FHFA officials said they do not object to the Enterprises' MSP submission practices, as reviewing all or nearly all of the Enterprises' MSP submissions has contributed to increased Agency visibility into their credit risks. Moreover, the Agency reports that reviewing all or virtually all of the Enterprises' MSPs has not overwhelmed its resources. The Enterprises' reported recent submission practices work in FHFA's favor, as the Agency had noted in 2015 and again in 2018 that it received too few MSPs to oversee one Enterprise's credit risks adequately. FHFA asserts that its MSP reviews under current practices, along with regular meetings on MSPs required by the

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revised instructions, provide the Agency with sufficient visibility into both of the Enterprises' credit risks.

This report was prepared by Wesley M. Phillips, Senior Policy Advisor, with assistance from Omolola Anderson, Senior Statistician, and David M. Frost, Assistant Inspector General, Office of Compliance & Special Projects. We appreciate the cooperation of FHFA and Enterprise staff, as well as the assistance of all those who contributed to the preparation of this report.

This report has been distributed to Congress, the Office of Management and Budget, and others and will be posted on our website, www.fhfaoig.gov.

/s/

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ABBREVIATIONS

Agency or FHFA	Federal Housing Finance Agency
Enterprises	Fannie Mae and Freddie Mac
ERM	Enterprise Risk Management
Fannie Mae	Federal National Mortgage Association
Freddie Mac	Federal Home Loan Mortgage Corporation
LOI	Letter of Instruction
MSP	Mortgage Selling Policy
OHRP	FHFA's Office of Housing and Regulatory Policy
OIG	FHFA's Office of Inspector General
PEM	Policy Engagement Model
SF Process	Single-Family Policy Review and Escalation Process
SVP	Senior Vice President
2012 RLOI	2012 Revised Letter of Instruction
2017 RLOI	2017 Revised Letter of Instruction

BACKGROUND

The Enterprises Face Significant Credit Risk

The Enterprises' statutory mission is to help keep the U.S. housing and mortgage markets liquid, stable, and affordable. They serve this mission by supporting the secondary mortgage market through buying residential mortgages from lenders; lenders can then use the sales proceeds to make more loans. The Enterprises can hold the mortgages they purchase in their own investment portfolios or package them into mortgage-backed securities for sale to investors. As we noted in our most recent semiannual report to Congress, collectively, the Enterprises held more than $7.2 trillion in assets on their balance sheets by the end of 2021.[1] These immense balance sheets expose the Enterprises to significant credit risk from a downturn in the mortgage market should large numbers of borrowers fail to pay their mortgages as required or otherwise deteriorate in creditworthiness.

FHFA Required the Enterprises to Submit Proposed MSPs for Review and Approval Prior to Implementation

The Enterprises have operated under Agency-issued Letters of Instruction (LOI) since FHFA placed them into conservatorships in September 2008. The LOIs specify the scope and extent of those authorities FHFA has elected to delegate back to the Enterprises while they remain in conservatorship.

FHFA's 2008 LOI to the Enterprises authorized them to establish and revise their single-family mortgage purchase underwriting standards (also known as mortgage selling policies, or MSPs) as well as variances to those standards. In a March 2012 audit, OIG concluded that FHFA should strengthen its oversight of the Enterprises' MSPs and variances.[2] FHFA agreed with our recommendation to establish a formal process to review the Enterprises' management of this delegated activity.

FHFA issued a revised LOI in November 2012 (2012 RLOI), which, in part, required the Enterprises to notify FHFA of "any planned changes in business processes or operations, including changes to Enterprise single-family credit policies . . . that management has determined in its reasonable business judgment to be significant." Under the 2012 RLOI, if

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[1] OIG, *Semiannual Report to the Congress, October 1, 2021 through March 31, 2022*.

[2] OIG, *FHFA's Oversight of Fannie Mae's Single-Family Underwriting Standards* (Mar. 22, 2012) (AUD-2012-003).

an Enterprise's management deemed a proposed new or revised MSP to be "significant," it was required to give timely notice to FHFA prior to implementing it.

In February 2013, FHFA's Office of Housing and Regulatory Policy (OHRP) specified in its Single-Family Policy Review and Escalation Process (SF Process) how it would review proposed new and revised MSPs. The SF Process also stated that OHRP would review all MSPs presented at the Enterprises' business and risk committees, and OHRP notified the Enterprises of these submission requirements in writing prior to the SF Process' adoption. OHRP understood these MSPs to generally present higher credit, operational, or headline risk for the Enterprises. OHRP believed that reviewing proposed MSPs would enable FHFA to develop an understanding of the Enterprises' single-family credit risks, provide it an opportunity to identify any questionable practices, and escalate them within the Agency for follow-up and remediation. After reviewing an MSP, OHRP could either notify an Enterprise that it had no objections to it, request additional information, or refer the MSP to FHFA's former Division of Conservatorship, which had the authority to approve or disapprove it.

In February 2013, we closed our 2012 recommendation on the basis of OHRP's issuance of the SF Process.

Our 2015 and 2018 Compliance Reviews Found that an Enterprise Continually Failed to Submit MSPs as Required

Our 2015 compliance review noted OHRP's observation that neither Enterprise was following the SF Process' submission requirements; rather, each submitted proposed new and revised MSPs for review pursuant to its own interpretation of the 2012 RLOI.[3] During the 15-month period assessed by the 2015 compliance review, one Enterprise submitted 52 MSPs to the Agency while the other submitted only those five policies that its management considered to be "significant."[4] An OHRP official said that the relatively few MSP submissions from this Enterprise limited the Agency's "visibility" into its MSPs and risks.

FHFA did not enforce its requirements for this particular Enterprise to submit additional MSPs; rather, OHRP tried unsuccessfully over several years to persuade it to do so.[5] As a result of the Agency's stated lack of visibility into that Enterprise's single-family credit

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[3] OIG, *Compliance Review of FHFA's Implementation of Its Procedures for Overseeing the Enterprises' Single-Family Mortgage Underwriting Standards and Variances* (Dec. 17, 2015) (COM-2016-001).

[4] Our 2015 compliance review found that OHRP followed its internal procedures for reviewing the 57 MSPs, with a few non-material exceptions.

[5] Our 2015 compliance review faulted FHFA for not directing the Enterprise to immediately increase its MSP submissions or setting a time frame within which the Enterprise must do so.

policies, among other reasons, we reopened our 2012 recommendation that FHFA formally establish a policy for reviewing MSPs and variances.

Our 2018 compliance review found that FHFA had still not succeeded in getting this Enterprise to submit all MSPs required by its guidance, so the Agency's visibility into the Enterprise's credit risks remained limited.[6] We left the 2012 recommendation open for this reason.

FHFA Revised Its MSP Submission Guidance to Increase Enterprise MSP Submissions

In December 2017, FHFA issued an updated LOI (the 2017 RLOI),[7] which incorporates OHRP's Policy Engagement Model (PEM). The PEM requires the Enterprises to submit the following MSPs to the Agency for review:

- Any MSP approved by an Enterprise Senior Vice President (SVP).
- Any MSP escalated to the Enterprise Risk Management (ERM) committees.[8]
- Any MSP as directed by FHFA, or any MSP that FHFA determines requires conservator approval under Part B of the LOI.[9]

The PEM also requires that the Enterprises regularly discuss proposed MSPs with OHRP. We closed the 2012 recommendation in March 2019 on the basis of the 2017 RLOI and its incorporation of the PEM's more rigorous MSP submission requirements.

FINDINGS ....

We initiated this compliance review to determine, for the period April 1, 2019, through January 31, 2022 (the review period), whether the Enterprises followed the 2017 RLOI's and

[6] OIG, *Update on FHFA's Implementation of its Revised Procedures for Overseeing the Enterprises' Single-Family Mortgage Underwriting Standards and Variances* (Mar. 27, 2018) (COM-2018-003).

[7] FHFA clarified in the 2017 RLOI that the requirement for "timely notice" of a significant change in a business practice means a minimum of 15 days before the activity is scheduled to take place. The 2017 RLOI became effective on March 31, 2018, shortly after the publication of COM-2018-003.

[8] OHRP stated that the Enterprises must submit to the Agency for review any MSP approved by an SVP or its ERM committee.

[9] Part B of the LOI identifies certain matters that require approval by an Enterprise board and subsequent approval by FHFA before the Enterprise may engage in those matters.

the PEM's MSP submission requirements, and thereby whether FHFA had improved its visibility into the Enterprises' credit risks.

With FHFA's Consent, the Enterprises Now Reportedly Submit All or Nearly All Proposed MSPs for Review and Approval

OHRP states that the Enterprises submit all or nearly all proposed MSPs to FHFA for review at their own discretion, based on their internal organizational structures and compliance practices. OHRP officials said that they did not specifically direct the Enterprises to submit all or virtually all of their proposed MSPs for review and approval, but they do not object to the practice.

OHRP officials reported that Fannie Mae submits all of its MSPs to the Agency for review. Fannie Mae reports that it discusses its proposed MSPs during biweekly meetings with OHRP. The Enterprise further states that, per its internal policies and a mutual "understanding" with FHFA, it submitted all of its proposed MSPs to the Agency, rather than only those MSPs required by the PEM. Fannie Mae officials said that they submit all MSPs to the Agency in case any are not discussed during the biweekly meetings.

OHRP officials report that, on a monthly basis, Freddie Mac submits all, or nearly all, of its MSPs to the Agency prior to implementation, rather than limiting submissions to the PEM's requirements.[10] Freddie Mac states that it meets with OHRP on a monthly basis to discuss all of their proposed MSPs, including any MSPs deemed "significant," all of which must be submitted to the Agency for review and approval.

OHRP Reports that It Has Gained Visibility into the Enterprises' Credit Risks

An OHRP official said that, as a result of the practice currently in use, FHFA's visibility into the Enterprises' credit risks has improved since our 2018 report. For example, the official said that Enterprises may approve MSPs at levels below that of the SVP or the ERM committee. Although the official said OHRP holds regular meetings with the Enterprises to discuss the MSP pipeline, their MSP submissions beyond the PEM's strict requirements ensure OHRP is aware of them.[11]

As a consequence of both the more fulsome submissions from the Enterprises and the regular meetings, OHRP officials advised us that, in general, they have advance notice of MSPs prior

[10] This Enterprise's internal policies state that MSP submissions are based in part on consultations with FHFA.

[11] OHRP provided documentation to OIG indicating that it does hold regular meetings with the Enterprises.

to their issuance by the Enterprises. Further, OHRP officials said that reviewing all or most MSPs has not overwhelmed OHRP's resources.[12]

For these reasons, OHRP states that it does not intend to direct the Enterprises to restrict their proposed MSP submissions to those required by the PEM to be submitted, as OHRP believes the current arrangement works for its purposes.[13]

CONCLUSION

The Enterprises' current practices for submitting proposed MSPs for review exceed the PEM's actual submission requirements. By permitting the Enterprises to employ these practices, FHFA has mitigated the primary finding from our 2015 and 2018 reports, which was that the Agency said it received too few MSPs to oversee one Enterprise's credit risks effectively. Under the current submission arrangement, FHFA's visibility into those credit risks has increased significantly.

OBJECTIVE, SCOPE, AND METHODOLOGY

We initiated this compliance review in January 2022 to determine whether, from April 1, 2019, through January 31, 2022, the Enterprises submitted MSPs to FHFA for review and approval prior to implementation, in accordance with the 2017 RLOI and the PEM. In making this determination, we did not independently assess the substance or quality of FHFA's MSP and credit risk oversight. Our review focused on whether OHRM had sufficient visibility into the Enterprises' MSPs by virtue of their having complied—or not—with the 2017 PEM.

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[12] According to the Enterprises, 40 (or 14%) of the 282 MSPs implemented during our review period met the PEM's specific submission standards. This compliance review did not assess whether the Enterprises submitted all 282 MSPs to FHFA.

[13] We asked OHRP what would happen if the Enterprises limited their submissions to the PEM's requirements. An OHRP official said the Agency would know quickly if this occurred, since OHRP meets with the Enterprises regularly regarding their MSP pipelines and since all MSPs are ultimately published on the Enterprises' public websites. The official said he believed that it was unlikely that the Enterprises would change the current arrangement where they submit all or nearly all of their MSPs to the Agency for review. OIG notes that FHFA has authority as the Enterprises' conservator to direct them to submit any MSPs that the Agency believes necessary to ensure the effectiveness of its credit risk oversight. OIG believes that it would be prudent for FHFA to commit in writing its current submission arrangement with the Enterprises, to lessen the possibility of either Enterprise failing to comply with the PEM's requirements going forward.

To accomplish our objective, we reviewed OHRP and Enterprise documentation as well as MSP data. We also interviewed OHRP and Enterprise officials.

We conducted our compliance review from February 2022 through April 2022 under the authority of the Inspector General Act of 1978, as amended, and in accordance with the *Quality Standards for Inspection and Evaluation* (December 2020), which were promulgated by the Council of the Inspectors General on Integrity and Efficiency.

We provided a draft of this report to FHFA for its review and comment.

ADDITIONAL INFORMATION AND COPIES................................

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