

Testimony of Federal Housing Finance Agency Inspector General Steve A. Linick
Hearing on “Oversight of the Federal Housing Finance Agency Part II”
Senate Committee on Banking, Housing, and Urban Affairs
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Thank you, Chairman Johnson and Ranking Member Shelby, for inviting me to testify before the Senate Banking Committee. I appreciate the opportunity to summarize the work and findings of the Federal Housing Finance Agency Office of Inspector General (FHFA-OIG) to date.

I am the Agency’s first Inspector General, and my office began operations following my swearing in on October 12, 2010, in the midst of a housing crisis of historic proportions. Over the past fourteen months, we have made great strides in hiring a professional staff and getting the organization up and running. We have published 10 audits and evaluations and have commenced numerous criminal and civil investigations. We also issued our second Semiannual Report to Congress two weeks ago.¹ Today, I will provide an assessment of emerging trends based on the work we have conducted to date, describe our operations, and answer the Committee’s questions.

FHFA-OIG oversees FHFA’s operations and programs. This oversight includes the Agency’s regulation of the housing government-sponsored enterprises (GSEs) -- Fannie Mae, Freddie Mac, and the 12 Federal Home Loan Banks; the GSEs’ approximately 12,000 employees; as well as the conservatorships of Fannie Mae and Freddie Mac. Fannie Mae and Freddie Mac currently own or guarantee home mortgages worth over \$5 trillion and account for 70 percent of the nation’s secondary mortgage market. To date, they have received \$183 billion in taxpayer money in order to ensure their continuing solvency.

FHFA-OIG’s mission is to promote the economy, efficiency, and effectiveness of FHFA’s programs and operations. To carry out its mission, FHFA-OIG conducts, supervises, and coordinates audits of FHFA’s programs and operations. FHFA-OIG also works to prevent and detect fraud, waste, and abuse in those programs and operations through investigations involving FHFA, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. Important features of FHFA-OIG’s work are the promotion of transparency in FHFA programs and GSE oversight, as well as public understanding of matters affecting FHFA, the GSEs, and housing policy.

¹ Available at <http://www.fhfaog.gov/Content/Files/second%20semiannual%20report.pdf>.

Emerging Trends

Our reports have revealed a number of emerging trends. These reports credit FHFA's work in several areas, both as regulator of the GSEs and conservator of Fannie Mae and Freddie Mac (the Enterprises). For example, FHFA-OIG has found:

- FHFA has eliminated golden parachute compensation awards to terminated Fannie Mae and Freddie Mac executives;
- FHFA has taken steps to mitigate its shortage of qualified examiners;
- FHFA has increased underwriting standards and raised guarantee fees;
- FHFA has taken steps that may improve Enterprise repurchase claims recoveries, thereby reducing Enterprise losses; and
- FHFA has positively responded to FHFA-OIG's recommendations to improve FHFA's effectiveness and efficiency and to reduce its vulnerability to fraud, waste, and abuse.

On the other hand, FHFA-OIG reports also have identified deficiencies in FHFA operations, and these deficiencies appear to reflect two significant and related trends. First, FHFA often relied on determinations of the Enterprises without independently testing and validating them, thereby giving undue deference to Enterprise decision-making. Second, FHFA was not proactive in oversight and enforcement, and accordingly, resource allocations may have affected its ability to oversee the GSEs and enforce its directives. Both trends have emerged in a number of our reports.

I. FHFA Has Not Independently Tested and Validated Enterprise Decision-Making

In four reports, FHFA-OIG identified significant instances in which FHFA has displayed undue deference to Enterprise decision-making. Without adequately testing or validating data, FHFA has deferred to the Enterprises regarding: (1) Freddie Mac's assessment of mortgage repurchase claim issues involving Bank of America; (2) the Enterprises' participation in the Making Home Affordable programs (MHA); (3) the Enterprises' decisions regarding executive compensation; and (4) numerous Enterprise transactions.

The Agency's actions in each case reflect its approach as conservator to delegate most business decisions to the Enterprises. In each case, it relied upon review and corporate governance processes already in place at the Enterprises. However, FHFA-OIG concluded that some matters are sufficiently important to warrant greater involvement and scrutiny by the Agency.

a. FHFA Deferred to Freddie Mac's Analysis of Repurchase Claim Exposure

At the end of 2010, FHFA approved a \$1.35 billion settlement of mortgage repurchase claims that Freddie Mac asserted against Bank of America. In approving the settlement, FHFA relied on Freddie Mac's analysis of the settlement without testing the assumptions underlying the

Enterprise's existing loan review process. An FHFA-OIG report found that FHFA did not act timely or test concerns raised by an FHFA senior examiner months prior to the settlement about limitations in Freddie Mac's existing loan review process for mortgage repurchase claims. The senior examiner was concerned that the loan review process Freddie Mac used for repurchase claims failed to account adequately for changes in foreclosure patterns among loans originated during the housing boom. According to the senior examiner, this could potentially cost the Enterprise a considerable amount of money.² Freddie Mac's internal auditors independently identified concerns about the process and in June 2011, recommended that the issue be studied further. Following initiation of FHFA-OIG's report, FHFA suspended future Enterprise mortgage repurchase settlements premised on the Freddie Mac loan review process and set in motion activities to test the assumptions underlying the loan review process.

b. FHFA Provided Limited Oversight of the Enterprises' Administration of the Home Affordable Modification Program

In early 2009, the Department of the Treasury initiated the Making Home Affordable (MHA) programs. A key initiative of MHA is the Home Affordable Modification Program (HAMP), which involves servicers agreeing to modify mortgages for borrowers facing default or foreclosure. In early 2009, the Enterprises began participating in HAMP. They started modifying mortgages in their portfolios and entered into five-year agreements with Treasury to manage the program and oversee participants' compliance with program requirements. An FHFA-OIG report found that FHFA largely removed itself from overseeing the negotiations of the five-year agreements. FHFA believed its appropriate role was to ensure the Enterprises were legally authorized to administer HAMP, not to participate actively in negotiations between the Enterprises and Treasury. In other words, FHFA did not engage in any formal substantive review to evaluate the agreements' feasibility, risks, or the suitability of the Enterprises to serve as Treasury's financial agents. This lack of engagement may have contributed to the agreements' omission of significant details concerning payments to the Enterprises, the scope of their responsibilities, and processes to resolve differences. As a consequence of the omissions, significant problems developed in these areas almost from the beginning, requiring FHFA and the Enterprises to devote substantial time and resources to resolve ambiguities.³

c. FHFA Did Not Fully Analyze Factors Related to Executive Compensation at Fannie Mae and Freddie Mac

For 2009 and 2010, the Enterprises awarded their top six officers a cumulative total of over \$35 million in compensation. FHFA reviewed and approved these compensation awards based on

² Available at <http://www.fhfa.gov/Content/Files/EVL-2011-006.pdf>.

³ Available at <http://www.fhfa.gov/Content/Files/EVL-2011-003.pdf>.

the Enterprises' determinations and recommendations. However, an FHFA-OIG report found that FHFA did not independently test or validate the means by which the Enterprises calculated their recommended compensation levels and did not consider factors that might have resulted in reduced executive compensation costs. These factors included the lower compensation levels paid to senior officials at federal agencies supporting the housing market and the extent to which federal support for the Enterprises may facilitate the ability of Enterprise officers to meet individual and corporate performance targets.⁴

d. FHFA Does Not Perform Sufficient Transaction Testing of Enterprise Activities

Transaction testing is the method employed by financial institution examiners to make independent judgments about the financial and operational conditions of an institution, as well as its compliance with applicable laws and regulations. An example of transaction testing would be reviewing a regulated entity's loan files to test the veracity of statements concerning loan underwriting and performance. During an evaluation of FHFA's capacity to examine the GSEs, a senior FHFA manager acknowledged to FHFA-OIG that examiners too often accept assertions made by Enterprise managers rather than independently validate such assertions through appropriate transaction testing.⁵

II. FHFA's Resource Allocations May Have Affected Its Ability to Oversee the GSEs and Enforce Its Directives

In four reports, FHFA-OIG identified instances in which FHFA was not proactive in oversight and enforcement, and accordingly, resource allocations may have affected its ability to oversee the GSEs and enforce its directives. For example, FHFA did not assign sufficient priority and resources to handle consumer complaints. Additionally, FHFA-OIG found that FHFA (along with its predecessor agency, the Office of Federal Housing Enterprise Oversight (OFHEO)) has permitted Fannie Mae to delay for five years the directives to implement an effective operational risk management program. Further, FHFA may not have allocated resources to or prioritized addressing new and emerging risks that may impact the GSEs. Finally, FHFA reported that it may have too few examiners to meet its oversight responsibilities. Some of FHFA's lack of oversight may have resulted from a lack of examination capacity, while other shortfalls may stem from a misallocation of resources.

⁴ Available at

<http://www.fhfa.gov/Content/Files/Exec%20Comp%20DrRpt%2003302011%20final,%20signed.pdf>.

⁵ Available at <http://www.fhfa.gov/Content/Files/EVL-2011-005.pdf>.

a. FHFA Did Not Allocate Sufficient Resources to Handle Consumer Complaints

Due in part to deteriorating financial conditions in the housing market, FHFA and OFHEO experienced a substantial increase in consumer complaints about the Enterprises. A number of these complaints contained important information about alleged foreclosure processing abuses and fraud. However, an FHFA-OIG report found that FHFA did not adequately process consumer complaints. For example, the Agency did not: develop and maintain a consolidated system for receiving or processing complaints; consistently follow up on complaints referred to the Enterprises; prioritize complaints or assess the timeliness of responses to complaints; refer complaints to law enforcement for evaluation or possible investigation; or perform substantive analyses to identify overall trends in complaints. These deficiencies occurred because FHFA did not establish adequate internal controls and did not assign sufficient priority and resources to complaint processing. FHFA-OIG found that FHFA assigned only two employees – on a part-time basis – to handle consumer complaints.⁶ FHFA’s lack of oversight and prioritization in this area stemmed from its view that, among other things, addressing consumer complaints was not its role.

b. FHFA Has Not Enforced Directives Regarding Fannie Mae’s Operational Risk Program

In 2006, OFHEO issued a Consent Order requiring Fannie Mae to establish an operational risk management program. FHFA views operational risk management as an important financial safety and soundness challenge facing the Enterprises. The Agency defines operational risk as the risk of loss resulting from failures in people, processes, systems, or from external events (such as foreclosure abuses). Between 2006 and 2011, FHFA and OFHEO repeatedly found that Fannie Mae had failed to establish an acceptable and effective program despite outstanding requirements to do so. As Fannie Mae’s conservator and regulator, FHFA’s authority over the Enterprise is broad and includes the ability to discipline or remove Enterprise personnel to ensure compliance with Agency mandates. However, an FHFA-OIG report found that FHFA has not exercised this or other authorities to compel Fannie Mae’s compliance with the operational risk requirement.⁷ Fannie Mae’s lack of an acceptable and effective operational risk management program may have resulted in missed opportunities to strengthen oversight of law firms with which it contracts to process foreclosures.

⁶ Available at <http://www.fhfa.ig.gov/Content/Files/AUD-2011-001.pdf>.

⁷ Available at <http://www.fhfa.ig.gov/Content/Files/EVL-2011-004.pdf>.

c. FHFA Did Not Identify and Address New and Emerging Risks Potentially Impacting the GSEs

Only after news of foreclosure abuses surfaced in mid-2010 did FHFA begin to schedule comprehensive examination coverage of foreclosure issues, including allegations of abuse by its default-related legal services vendors. FHFA had not previously considered risks associated with foreclosure processing to be significant. However, an FHFA-OIG report found that there were multiple indications of foreclosure issues prior to mid-2010 that could have led FHFA to foresee the heightened risk in foreclosure processing abuses. These indications included significant increases in the volume of foreclosures (which accompanied the collapse of the housing market), rising consumer complaints alleging improper foreclosures, contemporaneous media reports about foreclosure abuses by the Enterprises' law firms, and public court filings highlighting such abuses.⁸

d. FHFA May Not Have Enough Examiners to Meet Its Regulatory and Conservatorship Oversight Responsibilities

FHFA has critical regulatory responsibilities with respect to the GSEs and conservator responsibilities regarding the Enterprises. To satisfy these responsibilities, Congress provided FHFA significant budget and hiring authority. Nonetheless, an FHFA-OIG report noted that FHFA had found shortfalls in the Agency's examination coverage. Internal Agency reviews also corroborated that FHFA believes it has too few examiners to ensure the efficiency and effectiveness of its examination program. Additionally, only 34% of the Agency's line examiners are accredited federal financial examiners. FHFA has taken steps to mitigate its shortage of qualified examiners, but it needs to move quickly and aggressively in this area. Last winter, for example, the Acting Director announced and implemented a substantial restructuring of FHFA's supervision units and reassigned numerous staff. These steps, which also include plans to add examination staff and implement an examiner accreditation program, are designed to enhance FHFA's supervision program. Further, although FHFA's near-term plans include hiring up to 44 additional staff in the supervision divisions, FHFA believes there is substantial uncertainty as to whether this number of additional examiners will enable FHFA to overcome its examination capacity shortfalls and ensure the success of the Agency's 2011 reorganization of its examination structure.⁹ Insufficient examination capacity contributed to FHFA's lack of oversight by leaving key areas unchecked. For example, until recently there had been no targeted examinations involving the real estate owned (REO) area.

⁸ Available at <http://www.fhfaoig.gov/Content/Files/AUD-2011-004.pdf>.

⁹ Available at <http://www.fhfaoig.gov/Content/Files/EVL-2011-005.pdf>.

OIG Audits and Evaluations

In addition to monitoring and reporting on FHFA's progress in implementing report recommendations, FHFA-OIG will continue to release new audits and evaluations covering key areas. FHFA-OIG maintains a detailed Audit, Evaluation, and Survey Plan that focuses strategically on the areas of FHFA's operations posing the greatest risks and providing the greatest potential benefits to FHFA, Congress, and the public. Originally developed with input from an independent, third-party risk assessment, the Audit, Evaluation, and Survey Plan reflects continuous feedback from FHFA-OIG's reviews of current events and comments from FHFA officials, members of Congress, and others. Broadly, FHFA-OIG's audit and evaluation strategies include reviews of the following FHFA activities:

- Regulatory efforts and its management of the Enterprise conservatorships. This is a particularly high-risk area because Treasury has to date invested \$183 billion of taxpayer funds in the Enterprises. As conservator, FHFA must regulate and oversee the Enterprises in an efficient, effective, and transparent manner so as to minimize taxpayer costs, conserve Enterprise resources, and meet all statutory mandates.
- Oversight of the Federal Home Loan Banks and their associated risks, including investment portfolio management and concentrations, credit underwriting, and administration.
- Internal operations, such as privacy and allegations of fraud, waste, or abuse.

The Audit, Evaluation, and Survey Plan identifies a number of other ongoing and planned reviews of specific FHFA programs.

Given the Committee's interest, I want to highlight two projects currently underway. First, we are assessing whether FHFA has an effective supervisory control structure and sufficient examination coverage to adequately and timely identify and mitigate mortgage servicing risks. We are also assessing FHFA's oversight of Enterprise controls over real estate owned (REO) operations, including management and sales activities and contractor performance. Given the breadth and importance of issues relating to servicing and REO, no doubt we will continue to examine them from various angles for some time to come. We look forward to working with you on these matters and reporting our findings and recommendations to the Committee.

Investigations

As a further part of our mission to combat fraud, waste, and abuse, FHFA-OIG operates an active Office of Investigations that has made significant contributions to a range of mortgage-related investigations. While many remain confidential, FHFA-OIG and its law enforcement partners, which include federal agencies, U.S. Attorneys' Offices, and state and local agencies nationwide, have released details about several high-profile mortgage fraud investigations involving Colonial Bank and Taylor, Bean & Whitaker Mortgage Corporation, Marshall Home and Margaret Broderick, and Home Owners Protection Economics, Inc.

FHFA-OIG's Office of Investigations currently has numerous open criminal and civil investigations involving a wide variety of allegations of wrongdoing. The Office of Investigations focuses on FHFA and the GSEs, both internally and externally, concentrating on those individuals and organizations that have victimized either FHFA or the GSEs or borrowers with GSE loans. While I cannot comment on specific open cases, I can describe the trends we are seeing in fraud. The types of cases that we are actively investigating generally fall into the following six categories:

- Fraud involving mortgage-backed securities
- Mortgage origination related frauds
- Short sale and other mortgage modification frauds
- Fraud involving REO transactions
- Fraud involving mortgage servicing
- FHFA or GSE employee misconduct

Fraud Involving Mortgage-Backed Securities is a key area of focus. During the pre-crisis housing boom, the GSEs purchased and guaranteed hundreds of billions of dollars of residential mortgage-backed securities that have since declined precipitously in value due to the sharp deterioration in the value of those assets. The GSEs may have been victims of fraud in instances where the quality and value of the underlying assets they purchased or guaranteed was misrepresented to them.

Mortgage Origination related frauds include cases where the GSEs have been defrauded as the loan was being underwritten and sold to a GSE. These are the most commonly known frauds and could include schemes such as loan officers funding mortgages for otherwise ineligible borrowers. For example, one recent allegation reviewed by my office involved a borrower whose loan was funded despite the fact that the borrower was deceased. We have also seen schemes involving appraisers inflating the value of the property and straw buyers.

Short Sale frauds can include allegations of a non-arm's length transaction in which financial institutions are deceived into allowing a short sale through a straw buyer for a significantly lower price. Once the price decline is captured, the property is sold at the lower price to a relative or friend of the seller, with the owners ultimately staying in the property at a considerable loss to the GSE. In one of our cases, the average transaction loss to the GSE was approximately \$150,000.

Mortgage Modification frauds are a particularly insidious fraud. This type of fraud targets financially distressed homeowners who are underwater or have fallen behind on their mortgage payments. Some frauds involve advance fee schemes that require the homeowner to pay a fee for participating in supposedly "official" programs that are in fact completely fictitious or improperly imply participation in a U.S. government housing relief program. Besides scamming vulnerable homeowners out of money they can ill afford to lose, these schemes are particularly harmful because by the time borrowers recognize the scam, they may have been foreclosed upon and have little recourse. Other scams are designed to force a distressed homeowner into default sooner than would otherwise be the case.

REO Related frauds may involve individuals connected to the foreclosure and subsequent resale of a property. This situation provides multiple opportunities for fraud. For example, the GSEs contract with so-called asset managers to maintain and prepare the property for sale. These asset managers may sub-contract work to gardening companies to cut the grass, but the grass isn't cut; or they may contract with electricians for "required" maintenance that was neither required nor done, but still subsequently billed to a GSE. REO fraud can also involve realtors who collude with investors or other realtors and appraisers to drive down the price of properties they are selling on behalf of the GSEs. Over the past year, the Department of Justice's Anti-Trust Division has announced a number of convictions of real estate investors involved in such bid-rigging schemes designed to deflate property auction prices.

Fraud Involving Mortgage Servicing can include allegations that the mortgage servicer is not acting in the best interest of the GSE or the investor. For example, a mortgage servicer may make decisions regarding modifications or loan foreclosures with its own personal benefit in mind and contrary to GSE guidelines.

FHFA or GSE Employee Misconduct is another type of fraud. These are cases in which specific allegations are made involving administrative or criminal misconduct by FHFA or GSE employees or contractors.

Finally, I want to mention that the Office of Investigations operates the FHFA-OIG Hotline, which allows concerned parties to report information directly and in confidence regarding possible fraud, waste, or abuse related to FHFA or the GSEs. In the past year it has handled many allegations of wrongdoing or fraud. FHFA-OIG honors all applicable whistleblower

protections. Should you or your constituents wish to report any allegations of fraud, waste, or abuse, the Hotline can be reached at 1-800-793-7724, by fax at 202-408-2972, or through our website at www.fhfa.org.

My staff and I look forward to continuing to work with the Banking Committee to provide independent, relevant, and objective assessments of FHFA's operations and programs. The continuing fragility of our nation's housing market remains a significant source of ongoing concern. Further, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks continue to be key market participants, and FHFA continues to face significant challenges. We are hopeful that our work will be of assistance in meeting those challenges.