

# OFHEO's FY 1998-2003 STRATEGIC PLAN

## EXECUTIVE SUMMARY

### **Introduction**

The Office of Federal Housing Enterprise Oversight ("OFHEO" or the "Office") was established as an independent entity within the Department of Housing and Urban Development by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (Title XIII of P.L. 102-550). The Office is headed by a Director appointed by the President for a five-year term.

OFHEO is charged by law to ensure the capital adequacy and financial safety and soundness of two government-sponsored enterprises ("GSEs" or the "Enterprises") -- the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). OFHEO is funded through assessments on Fannie Mae and Freddie Mac. Thus, its operations represent no direct cost to the taxpayer.

Fannie Mae and Freddie Mac are the nation's largest housing finance institutions. They buy mortgages from commercial banks, thrift institutions, mortgage banks, and other primary lenders, and either hold these mortgages in their own portfolios or package them into mortgage-backed securities for resale to investors. These secondary mortgage market operations play a major role in creating a ready supply of mortgage funds for American homebuyers. Combined assets and off-balance sheet obligations of Fannie Mae and Freddie Mac were \$1.6 trillion at the end of 1997.

Fannie Mae and Freddie Mac are congressionally chartered, publicly owned corporations whose shares are listed on the New York Stock Exchange. Under terms of their GSE charters, they are exempt from state and local taxation and from registration requirements of the Securities and Exchange Commission. The Secretary of the Treasury is authorized to extend up to \$2.25 billion in credit to each Enterprise. In addition, the market perceives there to be an implied government guarantee on the financial obligations of the Enterprises.

### **Strategic and Annual Performance Plans**

#### Strategic Plan

There are four major components to OFHEO's Strategic Plan: (1) mission statement, (2) strategic goals, (3) strategic objectives and (4) strategies to achieve strategic goals.

OFHEO's *mission statement*, like its congressional mandate to ensure the safety and soundness of Fannie Mae and Freddie Mac, is very focused. The mission statement emphasizes protecting the taxpayer, contributing to the strength and vitality of the nation's housing finance system, and providing independent and fair regulation of the Enterprises. Since its inception, OFHEO has structured its regulatory activities around each of these tenets.

From its mission statement, the Office has developed three *strategic goals* which will enable it to accomplish its mission. These strategic goals provide long-term direction to the Office. OFHEO further defines its strategic goals with accompanying *strategic objectives*. The strategic objectives represent measurable goals that OFHEO plans to accomplish during the period covered by this Strategic Plan which are representative of the progress toward achieving its strategic goals. The accompanying measures are indicators to OFHEO that the Office is achieving its strategic objectives. The final component of OFHEO's Strategic Plan is comprised of specific *strategies to achieve strategic goals*. The resulting Strategic Plan, which includes each of the four components mentioned above as well as external factors that may affect OFHEO's regulation of the Enterprises, follows this Executive Summary.

### Annual Performance Plan

The strategic objectives and measures included in OFHEO's Strategic Plan will also be a part of OFHEO's Annual Performance Plans, the first of which was submitted to OMB and Congress in Fiscal Year (FY) 1997 for the FY 1999 budget (not included in this document). Because they are present in both the Strategic and Annual Performance Plans, the strategic objectives provide a valuable link between the two Plans and help ensure that goals, objectives, strategies, inputs, outputs, and outcomes are sufficiently integrated and tie into the mission.

The *performance goals* in the Annual Performance Plan link directly to each strategic objective included in OFHEO's Strategic Plan. The performance goals were chosen because they are intermediate outcomes or outputs necessary to achieve the strategic objectives which, in turn, lead to the accomplishment of a corresponding strategic goal. The Annual Performance Plan only includes those performance goals that OFHEO expects to achieve during the fiscal year covered by the Plan. In many cases, they represent incremental progress toward achieving the strategic objectives and goals.

As required by the Government Performance and Results Act of 1993, OFHEO will submit a performance report for FY 1999 by March 31, 2000, to discuss the Office's actual performance as compared with the FY 1999 Annual Performance Plan. During the operating year, OFHEO will evaluate its performance internally, make appropriate adjustments, and continue to analyze and reallocate its budgetary resources in a manner which will enable the Office to achieve its annual performance goals.

### **Program Evaluations**

OFHEO regularly evaluates its programs and progress towards achieving its goals in an ongoing manner throughout the year. The Office utilizes regular management meetings as well as management reports to communicate and discuss organizational goals and objectives, and the status of activities which further their achievement. OFHEO management also uses the budget formulation and execution processes as opportunities to determine resource needs and reallocate Office resources to meet its strategic goals. In its review, OFHEO uses cost-effectiveness as one of the primary criteria for determining the overall effectiveness in the achievement of the Office's mission.

With respect to external evaluations, OFHEO's enabling statute requires the General Accounting Office (GAO) to conduct two audits of OFHEO's operations. GAO's first audit was conducted during FY 1995 and focused on OFHEO's development and implementation of its primary management systems. In its report, GAO concluded that OFHEO had made significant progress in establishing such systems and that the Office had initiated its primary mission-related programs -- assessing the capital adequacy of the Enterprises and conducting examinations of Enterprise operations. OFHEO has used this report to complement internal evaluations of its operations.

GAO's second audit was conducted in the summer of 1997 with the final report released in October 1997. This report focused on (1) identifying the reasons why OFHEO has not issued final risk-based capital standards for the Enterprises, and (2) assessing OFHEO's implementation of its safety and soundness examination responsibilities. GAO correctly identified the challenges OFHEO faces in completing the stress test. The major reason GAO cited for the delay was OFHEO's decision to develop its own modeling capabilities to implement the stress test. OFHEO has developed a financial simulation model (FSM) that will be used to implement the stress test. We are currently testing this model and plan to complete a proposed risk-based capital regulation to send to OMB for clearance by the end of FY 1998.

GAO also recommended that OFHEO move toward a more timely examination cycle, while suggesting that additional resources would be needed to accomplish this. OFHEO agreed with GAO's recommendation and had already planned to alter its examination cycle. Beginning in January 1998, OFHEO moved to a comprehensive risk-based annual examination. Additional resources were allocated to the examination program to ensure that this could be accomplished.

### **Stakeholder Consultation**

Since it began operating in 1993, OFHEO has maintained communications with Congress on its objectives and regulatory activities. Similarly, OFHEO senior staff have met with Enterprise senior management in a variety of forums to enhance their understanding of OFHEO's plans and operations. In addition, OFHEO has also conveyed important information regarding its operations to other members of the financial community and has solicited the input of these and other stakeholders through participation in various mortgage industry forums as well as through communications during the comment periods on its proposed rules for risk-based capital.

Aside from the rulemaking process, OFHEO has had more specific consultations with several executive branch agencies during FY 1996 and FY 1997 while developing its Strategic Plan. The primary goal of these consultations was to work with OMB to develop shared expectations about the OFHEO Plan; learn from OMB and the executive branch agencies about their successes, pitfalls, and best examples; and learn from the other federal financial regulatory agencies about how they are addressing their goals, objectives, and performance measures in order to identify useful similarities and differences for OFHEO.

The departments and financial regulatory agencies consulted during the Strategic Plan development process included the Department of the Treasury, the Department of Housing and Urban Development, the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Housing Finance Board, the Securities and Exchange Commission, and the Farm Credit Administration. OFHEO solicited input on its draft Strategic Plan from selected federal departments and agencies, Congress, and OFHEO's two regulated entities -- Fannie Mae and Freddie Mac.

OFHEO received comments from several stakeholders. As a result of these comments, OFHEO made several changes to its draft Strategic Plan, including adding the third strategic goal and explicitly including performance measures for the strategic objectives. OFHEO will continue to welcome consultation and comments from stakeholders and congressional committees.

**OFHEO's Mission Statement**

*OFHEO effectively protects the interests of the American taxpayer and contributes to the strength and vitality of the nation's housing finance system through independent and fair safety and soundness regulation of Fannie Mae and Freddie Mac.*

OFHEO has *three strategic goals* which will enable us to realize our mission.

1. To effectively regulate the Enterprises by ensuring that they are adequately capitalized and operate in a safe and sound manner.
2. To promote an efficient secondary mortgage market through an independent and balanced approach to regulatory oversight of the Enterprises.
3. To effectively regulate the Enterprises by ensuring that they comply with all laws under our jurisdiction.

**Strategic Goal 1:** To effectively regulate the Enterprises by ensuring that they are adequately capitalized and operate in a safe and sound manner.

**Strategic Objectives<sup>1</sup>**

**1.1 To issue and implement the risk-based capital requirements to ensure that the Enterprises are adequately capitalized.**

*Measure:* Promulgation of risk-based capital regulation.

**1.2 To require the Enterprises to meet applicable capital standards.**

*Measure:* Comparison of actual capital to required capital on at least a quarterly basis.

**1.3 To implement a comprehensive, risk-based examination of each Enterprise to ensure that each operates in a safe and sound manner.**

*Measure:* Completion of an annual examination report for each Enterprise which covers all risk areas.

<sup>1</sup> The first and third strategic objectives may also be viewed as strategies. However, OFHEO has elevated the status of each to the strategic objective level because of their importance to achieving OFHEO's mission.

**Strategic Goal 1:** To effectively regulate the Enterprises by ensuring that they are adequately capitalized and operate in a safe and sound manner.

**Strategic Objectives (Cont.)**

**1.4 To ensure that the Enterprises adequately address examination recommendations.**

*Measure:* Percent of examination recommendations addressed.

**1.5 To ensure that future changes in risk do not impair the ability of the Enterprises to perform their missions in a safe and sound manner.**

*Measure:* Maintenance of ongoing monitoring and evaluation of Enterprise risks and activities through new program reviews, as well as periodic reports and studies.

**Strategies to Achieve Strategic Goal 1**

***We will complete development of the stress test and publish a risk-based capital rule.***

In order to effectively implement this strategy, we will:

- Evaluate alternative specifications of the risk-based capital regulation for their effects on Enterprise safety and soundness and their impact on the housing finance system.
- Publish a notice of proposed rulemaking (NPR) for all aspects of the risk-based capital rule not covered in the first NPR (which covered the benchmark loss experience and the selection of a house price index).
- Evaluate comments on both proposed rules and make any appropriate changes.
- Publish a final risk-based capital rule.
- Maintain and enhance communication with stakeholders, including the public, about OFHEO's risk-based capital regulatory proposals to facilitate OFHEO's understanding about stakeholder concerns and stakeholder understanding about the proposals in order to streamline the regulatory development and clearance process.

**Strategic Goal 1:** To effectively regulate the Enterprises by ensuring that they are adequately capitalized and operate in a safe and sound manner.

### Strategies to Achieve Strategic Goal 1 (Cont.)

*We will evaluate the adequacy of capital, conduct off-site monitoring of Enterprise risks and anticipate future changes in risk.*

In order to effectively implement this strategy, we will:

- Make capital classification determinations of the Enterprises on a quarterly basis, at minimum.
- Maintain, enhance and streamline a computer-based Financial Simulation Model used to develop, implement, and update the risk-based capital stress test, and facilitate independent quantitative assessment of credit and interest rate exposures at the Enterprises.
- Build, maintain, and enhance a database of Enterprise historic and current operations that translates Enterprise-specific data into a single consistent format and facilitates operation of the risk-based capital stress test and other research and analytic applications that enhance Enterprise safety and soundness, including the Financial Simulation Model applications generating reports to enhance off-site monitoring.
- Produce quarterly house price index which will be used in the stress test to assess credit risk.
- Evaluate new programs and monitor changes to existing programs, products, and other business activities of the Enterprises to assess their risk potential.
- Monitor and analyze current and prospective changes in the housing finance system to gauge their implications for Enterprise risks.
- Conduct research in areas of Enterprise risk to develop and enhance the risk-based capital regulation and otherwise help evaluate financial safety and soundness of the Enterprises, and to help anticipate potential future problems.

*We will conduct annual, comprehensive, risk-based examinations of the Enterprises.*

In order to effectively implement this strategy, we will:

- Identify and measure the significant sources of risks inherent in each Enterprise's current and planned business activities and products.
- Plan and scope the annual, comprehensive, risk-based examinations of the Enterprises, focusing on the significant sources of risk.

**Strategic Goal 1:** To effectively regulate the Enterprises by ensuring that they are adequately capitalized and operate in a safe and sound manner.

**Strategies to Achieve Strategic Goal 1 (Cont.)**

- Review examination standards for risk management and internal controls applicable to the risk profile of the Enterprises.
- Evaluate the effectiveness of each Enterprise's systems for identifying, measuring, controlling, and monitoring risks.
- Communicate examination findings, conclusions, and recommendations to each Enterprise's Board of Directors and management in a clear, concise, and timely manner.
- Obtain commitments from the Board of Directors and management for prompt correction of any significant deficiencies in risk management and internal controls, as well as violations of laws and regulations.
- Monitor the status of the disposition of recommendations and verify that deficiencies and violations are corrected in an effective and timely manner.
- Maintain an off-site monitoring system to identify changes to the risk profile, and to review and revise the supervisory strategy for the Enterprises.
- Maintain an open dialogue with relevant committees of each Enterprise's Board of Directors and the executive management teams through routinely scheduled meetings for the purpose of discussing supervisory issues.
- Maintain the certification and the competency of the examination staff through a formal program of training, professional development, and accreditation.
- Maintain dialogue with federal regulatory agencies, trade associations, and market participants to identify trends and developments of supervisory interest.

***We will require compliance.***

In order to effectively implement this strategy, we will:

- Use supervisory actions to ensure Enterprise compliance with capital requirements and exam recommendations.

**Strategic Goal 2:** To promote an efficient secondary mortgage market through an independent and balanced approach to regulatory oversight of the Enterprises.

### Strategic Objectives

#### 2.1 To maintain OFHEO's independence in its relationships with the Enterprises.

*Measures:* Use of internal modeling capacity to regularly analyze Enterprise risks.  
Use of examiners from other financial institution regulatory agencies.

#### 2.2 To ensure a balanced approach to regulation by providing the Enterprises and all other stakeholders the appropriate opportunity for input on regulatory activities.

*Measure:* Number of opportunities for public comment on proposed regulations.

### Strategies to Achieve Strategic Goal 2

***We will preserve our independent capacity to regulate the Enterprises by maintaining a professional staff and autonomous systems.***

In order to effectively implement this strategy, we will:

- Maintain and enhance a data warehouse that provides OFHEO with flexibility to develop appropriate safety and soundness reports and analysis when and as circumstances warrant.
- Maintain and enhance an OFHEO developed Financial Simulation Model that permits consistent evaluation of the two Enterprises' credit and interest rate risk exposures across a broad range of economic scenarios.
- Employ rotational assignments for examiners, and review processes to govern the accuracy of assessments and conclusions.
- Ensure that staffing provides the necessary skills and attributes to independently evaluate the Enterprises' activities and business decisions.

***We will maintain open communications with all stakeholders to ensure balanced regulatory oversight.***

In order to effectively implement this strategy, we will:

- Maintain and enhance communication with all stakeholders about OFHEO's regulatory activities.

**Strategic Goal 2:** To promote an efficient secondary mortgage market through an independent and balanced approach to regulatory oversight of the Enterprises.

**Strategies to Achieve Strategic Goal 2 (Cont.)**

- Provide input to the Secretary of HUD on programmatic regulation of the Enterprises.
- Conduct an open rulemaking process, with ample opportunity for comment, within the requirements of the Administrative Procedure Act, giving careful consideration to public comments.
- Provide adequate opportunity for Enterprise comments on examination findings and publicly report examination results and conclusions.
- Publish an examination handbook, specifying examination goals, policies, and procedures.
- Publish OFHEO Annual Report to Congress by June 15 and distribute to stakeholders and interested parties.
- Provide a report to Congress on Enforcement Actions every year (March 15) and, in every even numbered year, include a Flood Insurance Compliance Review in the OFHEO Annual Report.

**Strategic Goal 3:** To effectively regulate the Enterprises by ensuring that they comply with all laws under our jurisdiction.

### Strategic Objectives

#### 3.1 To prohibit excessive executive compensation at the Enterprises.

*Measures:* Percent of executive officer termination agreements acted upon by OFHEO.  
Percent of instances of excessive executive compensation acted upon by OFHEO.

#### 3.2 To prohibit the Enterprises from violating other provisions of their Charter Acts or of OFHEO's statute.

*Measure:* Percent of supervisory actions to remedy Charter Act and other violations that are successful.

### Strategies to Achieve Strategic Goal 3

*We will prohibit excessive executive compensation at the Enterprises.*

In order to effectively implement this strategy, we will:

- Make appropriate use of outside consultants with expertise in the discipline of executive compensation to make recommendations to us.
- Develop a framework for comparing executive compensation at the Enterprises with relevant public and private sector companies.
- Monitor the Enterprises' compensation practices to prevent excessive remuneration of executive officers.
- Act on termination agreements of the Enterprises which are subject to the prior approval of OFHEO.

**Strategic Goal 3:** To effectively regulate the Enterprises by ensuring that they comply with all laws under our jurisdiction.

**Strategies to Achieve Strategic Goal 3 (Cont.)**

*We will prohibit the Enterprises from violating provisions of their Charter Acts or OFHEO's statute.*

In order to effectively implement this strategy, we will:

- Propose and issue a regulation for rules of procedure to implement OFHEO's enforcement authorities.
- Analyze activities undertaken by an Enterprise as appropriate to determine whether they violate the Charter Act or provisions of OFHEO's statute.
- Take appropriate action (e.g., informal communication, examination recommendations, supervisory agreement, other enforcement action) to address the violation and follow up to effect full compliance.

**Overall Management Strategies to Achieve All Three Strategic Goals**

*We will maintain the resources necessary to effectively regulate the Enterprises, including a highly qualified staff with specialized skills, computer hardware and software, information resources, and contract support services.*

In order to effectively implement this strategy, we will:

- Use management practices that are performance-based and results-oriented.
- Maintain a management system that links strategic planning, program performance, and operational strategies.
- Maintain human, financial, technical, and physical resources in sufficient quantity and quality to provide fair and independent regulation.
- Provide training and development to our staff to enable us to maintain and enhance skills.
- Attract and retain a diverse, skilled work force.
- Maintain equal employment opportunity and minority business enterprise utilization.

## EXTERNAL FACTORS

*Our Plan in all respects assumes adequate budget resources. In addition, with respect to issuing the risk-based capital regulations, the Plan assumes (1) the OMB clearance process takes no more than 90 days and requires at most minor adjustments to the stress test, and (2) public comment on the second notice of proposed rulemaking on risk-based capital requires at most minor adjustments to the stress test. A number of other factors could affect Enterprise performance and, ultimately, our ability to ensure the safety and soundness of their operations and condition. These other factors include:*

- ***The economy.*** Significant increases in unemployment, significant decreases in house prices, or sharp, prolonged changes in interest rates could significantly affect the financial condition of the Enterprises. OFHEO can mitigate the consequences of such events through our stress test and the examination process, which are specifically designed to ensure that the Enterprises have sufficient capital and adequate risk management policies and controls to survive them. However, such severe conditions could prevent an Enterprise from meeting capital requirements for a while.
- ***Home mortgage delivery system.*** New methods of financing mortgages could result in new risk structures at the Enterprise that may not be well captured by our risk-based capital regulation. OFHEO can mitigate that risk by following market developments closely and conducting necessary research to modify the stress test and risk-based capital regulation to incorporate new risks.
- ***The Enterprises' competitive position.*** The Enterprises currently have a strong competitive position based on benefits they receive from their government-sponsored status. Institutional or market changes that significantly reduce the value of that status would adversely affect the Enterprises and could, in some circumstances, weaken their financial condition.
- ***Mortgage finance industry structure.*** Major changes in industry structure could substantially affect Enterprise risks. OFHEO can mitigate such risks by making appropriate adjustments to the stress test and risk-based capital regulation and maintaining a strong examination program.
- ***Management strategies of the Enterprises.*** Decisions to accept large increases in risk could tax the capacity of OFHEO's stress test, which must, of necessity, assume that current practices in many areas will continue. Careful examinations and adjustments to the stress test may not always be adequate. OFHEO can mitigate the impact of such decisions through the use of its broad range of enforcement authorities if necessary.