



SUITE 13 EAST
555 THIRTEENTH STREET, NW
WASHINGTON, DC 20004

202 637-8281
202-637-5910
WWW.FMPOLICYFOCUS.ORG

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THE HONORABLE J.C. WATTS
CHAIRMAN

MIKE HOUSE
EXECUTIVE DIRECTOR

Ms. Susan S. Jacobs
Chief Strategic Planning Officer
Office of Federal Housing Enterprise Oversight
1700 G Street, NW
Third Floor
Washington, DC 20552

Dear Ms. Jacobs:

FM Policy Focus is pleased to provide views on the Office of Federal Housing Enterprise Oversight (OFHEO) request for comment on "Updating the Strategic Plan" in the April 7, 2006 *Federal Register* [71 Fed. Reg. 17,899]. OFHEO is severely constrained under current law, but, given the huge size of the government-sponsored enterprises (GSEs) and the potential for serious systemic risk, OFHEO can and should do all within its power under current law to establish a robust framework of effective prudential supervision. To the extent possible under its current authorities, OFHEO should set as its objective to develop regulatory policies and procedures comparable to those of bank regulators.

The past three years in which the present strategic plan has been in place were, of course, very turbulent ones for both Fannie Mae and Freddie Mac. Non-stop revelations of questionable corporate behavior show a profound lack of appropriate internal controls, compliance, risk management and, most fundamentally, of dedication by the board of directors and senior management at both GSEs to these critical functions. FM Policy Focus thus suggests that OFHEO take as its top priority in its new strategic plan a set of supervisory and regulatory actions designed to ensure that all of these failings are quickly, demonstrably and lastingly remedied. As detailed below, we also believe OFHEO can and should update its regulations to ensure ample advance prudential scrutiny of any and all new GSE ventures. In recent years, both Fannie Mae and Freddie Mac have undertaken an array of high-risk activities without any of the internal controls, capital or other standards applicable for insured depositories in comparable business lines. This raises significant risk that should be remedied through action dictated by the new OFHEO strategic plan.

We suggest that the strategic plan not only address all of these critical issues, but also include specific steps to ensure OFHEO officials hold themselves accountable for action on them. We would be pleased to provide additional detail as desired.

I. Tone at the Top

As you know, “tone at the top” has become a major concern of all of the banking agencies in recent years, as a series of major addresses has shown.¹ The recent report by Paul, Weiss conducted by former Sen. Warren Rudman cited a major failure at Fannie Mae in this regard² and Freddie Mac clearly also has had substantive lapses. It has, for example, permitted its current chief operating officer to serve as both a member of the Freddie Mac board of directors and also as acting chief financial officer. As the Rudman report made clear, a comparable practice at Fannie Mae was a serious transgression of accepted corporate-governance norms.³

In recent years, OFHEO has issued appropriate corporate-governance regulations governing Fannie Mae and Freddie Mac.⁴ However, FM Policy Focus recommends that the agency’s new three-year strategic plan focus on supplementing these rules and ensuring that they are enforced. Specifically, we suggest that the strategic plan:

- Address the major internal audit, risk management and compliance failures at both GSEs, with OFHEO issuing enforceable guidance comparable to that in the banking agency examination manuals⁵ regarding the qualifications of key personnel, reporting lines, board access and similar matters. Outside auditors should attest to the quality of these internal controls, regardless whether or not the GSE has finalized its SEC registration in a fashion comparable to that required for insured depositories⁶;

¹Remarks by Governor Mark W. Olson at the Fiduciary and Investment Risk Management Association’s Twentieth Anniversary Training Conference, Washington, D.C., Enterprise-Wide Compliance-Risk Management, April 10, 2006, Remarks by Governor Susan Schmidt Bies at the Banking Institute, Charlotte, North Carolina, An Update on Regulatory Issues, March 31, 2006, Remarks by Jack Guynn, President and Chief Executive Officer, Federal Reserve Bank of Atlanta, at the Scott Symposium on Business Ethics at Bridgewater College, Bridgewater, Virginia, April 11, 2005, and Testimony of John Hawke, Comptroller of the Currency, before Senate Banking Committee, April 20, 2004.

² *A Report to the Special Review Committee of the Board of Directors of Fannie Mae*, Warren Rudman et. al. February 23, 2006, p.5.

³ *Ibid.* p. 401

⁴ *Corporate Governance*, Office of Federal Housing Enterprise Oversight, April 7, 2005 [70 Fed. Reg. 17,303] and *Corporate Governance*, Office of Federal Housing Enterprise Oversight, June 4, 2002 [67 Fed. Reg. 38,361].

⁵ See for example *Trading and Capital-Markets Activities Manual*, Federal Reserve Board, last updated September, 2003 <http://www.federalreserve.gov/boarddocs/supmanual/trading/trading.pdf> or *An Examiner’s Guide to Problem Bank Identification, Rehabilitation, and Resolution*, Office of the Comptroller of the Currency <http://www.occ.treas.gov/pubs1.htm>.

⁶ 12 U.S.C. §1831m

- Issue and make public guidance on GSE compensation practices to ensure that incentives are in line with the GSEs' safety and soundness and mission. Comparable guidance has been issued by the banking agencies⁷; and
- Assess the degree to which each GSE uses its market position to advance political objectives rather than its chartered mission. All business units should report separately from political operations and appropriate internal controls should ensure effective control, with new OFHEO standards stipulating how this should be done.

II. High-Risk Ventures

FM Policy Focus is well aware that the Department of Housing and Urban Development (HUD), not OFHEO, is required to review new GSE programs in advance. We have long opposed this divided responsibility and strongly support provisions in pending legislation that would give the prudential regulator express authority over new programs, products and activities in a far more transparent, risk-focused fashion. However, we believe that, even under current law, OFHEO can and should play a far broader role to ensure that all GSE activities are in full compliance with applicable charter requirements and pose no safety-and-soundness concern. To this end, we recommend that the strategic plan:

- Make clear that, going forward, OFHEO will review each new GSE venture in light of the then-applicable risk-based capital rules. To the degree a new activity is not covered by the rule – the case with virtually all recent GSE ventures – OFHEO will revise the risk-based capital rule in advance to ensure that adequate capital is in place as a new activity begins. In setting such risk-based capital requirements, OFHEO will be guided by comparable banking-agency standards, such as the substantive capital increase required for institutions with large positions in subprime mortgages,⁸
- Provide for the establishment of a public notice-and-comment process analogous to that required for Treasury and the Federal Reserve when new ventures are under consideration for financial subsidiaries [12 U.S.C. §24a(b)(B)]. In this regard, OFHEO must use its examination authority to monitor the GSEs to identify new GSE programs before they begin and to ensure the GSEs do not violate their charters by engaging in new programs without obtaining HUD's prior approval. Should OFHEO learn of new programs only after HUD has granted a GSE authority to engage in them, we believe OFHEO should still seek public comment to ensure appropriate prudential standards, internal controls and capital are in place as a venture commences; and

⁷ 12 CFR Appendix A to 570

⁸ *Subprime Lending: Expanded Guidance for Subprime Lending Programs*, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of Thrift Supervision, January 31, 2001.
<http://www.federalreserve.gov/boarddocs/press/boardacts/2001/20010131/attachment.pdf>

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- Address the lack of express prudential standards governing GSE operational, legal and reputational risk, including appropriate economic capital allocation for these prudential concerns. We refer OFHEO to the Federal Reserve's SR99-18 guidance and suggest the strategic plan commit OFHEO to a comparable standard as soon as practicable in the next three years.

As noted, we would be pleased to provide additional detail on any of these suggestions.

Sincerely,

A handwritten signature in black ink, appearing to be "J. [unclear]", written over a horizontal line.