FEDERAL HOUSING FINANCE AGENCY
OFFICE OF INSPECTOR GENERAL

FHFA's Oversight of Troubled Federal Home Loan Banks

Evaluation Report: EVL-2012-001 Dated: January 11, 2012

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AT A GLANCE

FHFA's Oversight of Troubled Federal Home Loan Banks

Why FHFA-OIG Did This Evaluation

The Federal Home Loan Bank System (FHLBank System) is a government-sponsored enterprise (GSE) consisting of 12 Federal Home Loan Banks (FHLBanks) whose primary mission is to support housing finance. To carry out this mission, the FHLBank System's central Office of Finance issues debt at the relatively favorable rates available to GSEs. The FHLBanks then use the proceeds of this debt to make secured loans, known as advances, to their member financial institutions. These member financial institutions can then use the advances to originate mortgages.

FHLBanks may also invest in mortgage-related securities. Since at least 2008, four FHLBanks have faced significant financial and operational difficulties, primarily due to their investments in certain high-risk mortgage securities.

The Federal Housing Finance Agency (FHFA or the Agency) has oversight responsibility for the FHLBanks and recognizes the need to ensure that they do not abuse their GSE status and engage in imprudent activities. To this end, FHFA examination guidance states that the Agency generally will initiate a formal enforcement action, such as a cease and desist order, when it classifies an FHLBank as having the most significant "supervisory concerns" within the FHLBank System. Nonetheless, with respect to the four FHLBanks discussed in this report (henceforth referred to "troubled FHLBanks"), all of which were classified as having supervisory concerns, formal enforcement actions were not taken on two of them.

FHFA's Office of Inspector General (FHFA-OIG) initiated this evaluation to assess the Agency's oversight of troubled FHLBanks.

What FHFA-OIG Recommends

FHFA-OIG recommends that FHFA: (1) develop and implement a written enforcement policy for troubled FHLBanks that ensures they correct significant deficiencies within specified periods and establishes consequences for not doing so; (2) develop and implement an automated management reporting system for FHLBank examination findings; and (3) consistently document key interactions with FHLBanks. FHFA agreed with these recommendations.

What FHFA-OIG Found

FHFA-OIG identified several positive actions FHFA has taken regarding its oversight of the troubled FHLBanks, including encouraging fiscally conservative dividend and investment practices, and closely monitoring them through examinations and ongoing communications.

However, FHFA-OIG also found that FHFA has not established policies, systems, and documentation standards that could strengthen its oversight. Specifically:

- FHFA has not established a written enforcement policy for troubled FHLBanks. Although FHFA examination guidance states that FHFA will take formal enforcement actions for FHLBanks that have supervisory concerns, officials said that the guidance does not constitute a specific Agency policy. Instead, FHFA officials have broad discretion in determining the circumstances under which formal actions against troubled FHLBanks will be initiated. FHFA-OIG believes that the absence of a consistent and transparent written FHFA enforcement policy for troubled FHLBanks: (1) results in a lack of clarity regarding the circumstances under which the Agency will initiate formal actions; (2) has contributed to instances in which FHFA has not acted proactively to hold troubled FHLBanks and their officers sufficiently accountable for failing to correct identified risks or for engaging in questionable risk-taking; and (3) impedes outside reviews of its oversight activities.
- FHFA does not have an automated management information system that provides ready access to current information about the deficiencies identified in its examinations and the status of efforts to address them. Instead, FHFA uses manual reporting processes that limit the Agency management's capacity to identify trends in examination findings and the progress made by particular FHLBanks in correcting identified deficiencies.
- FHFA does not consistently document substantive interactions with FHLBanks, including instances in which it has suggested that an FHLBank remove senior officers. The absence of a record is inconsistent with Agency policy and impedes oversight.

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ABBREVIATIONS

Fannie Mae..... Federal National Mortgage Association

FHFA .....Federal Housing Finance Agency

FHFB.....Federal Housing Finance Board

FHFA-OIG.....Federal Housing Finance Agency Office of Inspector General

FHLBanks.....Federal Home Loan Banks

Freddie Mac .....Federal Home Loan Mortgage Corporation

GSE.....Government-Sponsored Enterprise

HERA.....Housing and Economic Recovery Act of 2008

MBS .....Mortgage-Backed Securities

MRA .....Matter Requiring Attention

OFHEO ..... Office of Federal Housing Enterprise Oversight

OMB .....Office of Management and Budget

Federal Housing Finance Agency

Office of Inspector General

Washington, DC

PREFACE

FHFA-OIG was established by the Housing and Economic Recovery Act of 2008 (HERA),[1] which amended the Inspector General Act of 1978.[2] FHFA-OIG is authorized to conduct audits, investigations, and other activities of the programs and operations of FHFA; to recommend policies that promote economy and efficiency in the administration of such programs and operations; and to prevent and detect fraud and abuse in them. This evaluation is intended to assess FHFA's oversight of four troubled FHLBanks that have experienced significant losses and financial difficulties during at least the 2009 through 2010 examination cycles. FHFA has reported these 4 FHLBanks as having the most significant "supervisory concerns" among the 12 FHLBanks.[3]

The FHLBank System is a housing GSE that consists of 12 regionally-based FHLBanks.[4] The FHLBanks are chartered by the federal government, but owned in a cooperative structure by their respective member financial institutions. Member financial institutions, such as banks and thrifts, invest capital in their FHLBanks, and they may earn dividends on their investments. They also elect their respective FHLBanks' boards of directors which, in turn, appoint the FHLBanks' senior officers and managers.

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[1] Public Law No. 110-289.

[2] Public Law No. 95-452.

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[3] FHFA uses an internal system to classify the financial and operational soundness of the FHLBanks. Agency staff

[3] FHFA uses an internal system to classify the financial and operational soundness of the FHLBanks. Agency staff

said the internal system represents confidential supervisory information. In contrast, terminology used in this report (such as "supervisory concern") is consistent with the language that FHFA uses to describe the condition of FHLBanks in its publicly-disseminated annual reports to Congress. However, FHFA-OIG, not FHFA, developed the term "troubled FHLBanks" to describe FHLBanks classified as having supervisory concerns.

[4] Like the FHLBanks, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) are housing GSEs. Unlike Fannie Mae and Freddie Mac, however, FHLBanks do not issue publicly traded stock (rather their stock is issued exclusively to member financial institutions). Moreover, the FHLBanks carry out their housing mission by making collateralized loans, whereas Fannie Mae and Freddie Mac carry out their missions by purchasing and securitizing mortgages, and by guaranteeing mortgage-backed securities (MBS).

The FHLBank System's primary mission is to support housing finance. To carry out its mission, the FHLBank System issues debt in the capital markets generally at relatively favorable rates due to its GSE status. The proceeds of the debt are used by the FHLBanks to make secured "advances" (*i.e.*, loans) to member financial institutions to foster housing finance.[5] Traditionally, member institutions have secured advances by pledging single-family mortgages or investment-grade securities as collateral to their FHLBank.

FHLBanks may also have investment portfolios that contain mortgage assets, such as MBS. The four troubled FHLBanks are located in Boston, Chicago, Pittsburgh, and Seattle, and have experienced significant financial and operational deterioration primarily due to their investments in private-label MBS secured by non-traditional mortgages.

The troubled FHLBanks may have financial incentives to abuse their GSE status in ways that could increase their long-term risks. For instance, they conceivably can rely indefinitely on debt issued at favorable interest rates to finance their activities because of the implicit federal guarantee of the FHLBank System's debt.[6] Consequently, these FHLBanks could engage in higher-risk financial transactions to restore their profitability, but that could result in greater financial deterioration over time.[7]

As the FHLBank System's safety and soundness regulator, FHFA has a critical responsibility to monitor closely the troubled FHLBanks' financial activities, including the risks they take, and to help restore their financial and operational soundness. Without vigorous FHFA oversight, the potential exists that the troubled FHLBanks will engage in risky financial strategies that could further endanger their financial safety and soundness and the capacity to serve their housing missions.

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[5] Although the federal government does not explicitly guarantee the FHLBank System's debt obligations, creditors and other financial market participants have traditionally assumed that there is an "implied" federal guarantee. That is, creditors and other market participants have assumed that the federal government would provide financial assistance to the FHLBank System in an emergency and repay its debt obligations in full. Thus, creditors have traditionally loaned money to the FHLBank System on more favorable terms than to for-profit corporations without implicit guarantees, which are viewed as presenting a higher risk of defaulting on their debt. *See generally* Government Accountability Office, *Fannie Mae and Freddie Mac: Analysis of Options for Revising the Enterprises' Long-Term Structures*, GAO-09-782 (Sept. 10, 2009) (discussing the implicit guarantee in the context of other housing GSEs: Fannie Mae and Freddie Mac) available at www.gao.gov/new.items/d09782.pdf; and Federal Reserve Bank of Atlanta, *The Federal Home Loan Bank System: The "Other" Housing GSE*, M.J. Flannery and W.S. Frame, Economic Review, Federal Reserve Bank of Atlanta, Third Quarter 2006 available at www.frbatlanta.org/filelegacydocs/erq306_frame.pdf.

[6] In contrast, for-profit corporations with similar financial and operational challenges might face significantly higher debt costs or be shut out of debt and capital markets altogether.

[7] As discussed in this evaluation report, the evidence suggests that certain troubled FHLBanks engaged in investment strategies that ultimately resulted in further financial and operational deterioration and losses.

To that end, FHFA conducts annual examinations of each FHLBank and has the authority to take a formal enforcement action, such as a cease and desist order, against an FHLBank in order to remedy any safety and soundness concerns. In each of the examination reports it issues for the FHLBanks, FHFA guidance states that, in the case of a bank that is classified as having supervisory concerns, "The general policy is that a formal enforcement action will be taken to address identified deficiencies or weaknesses."[8]

But FHFA formal enforcement actions are outstanding against only two of the four troubled FHLBanks. FHFA initiated a formal action against the Seattle FHLBank in 2010, but it has not done so with respect to the Boston and Pittsburgh FHLBanks. FHFA's predecessor agency, the Federal Housing Finance Board (FHFB), initiated a formal enforcement action against the Chicago FHLBank in 2007 and it remains in effect.

FHFA-OIG initiated this evaluation to assess FHFA's oversight of the troubled FHLBanks during the 2008 through 2010 examination cycles. In so doing, FHFA-OIG identified several positive actions that the Agency has taken. These include: encouraging the troubled FHLBanks to restrict dividend payments to their members in order to rebuild their capital levels; communicating closely with the FHLBanks; and monitoring their finances and operations through annual examinations and ongoing discussions. However, FHFA-OIG also found that FHFA lacks policies, systems, and documentation standards that could strengthen its oversight. Specifically:

- **FHFA has not established a written enforcement policy for troubled FHLBanks.** Although FHFA examination guidance states that FHFA will take formal enforcement actions against FHLBanks that have supervisory concerns, officials said that the guidance does not constitute a specific Agency policy. Instead, FHFA officials exercise considerable discretion in determining the circumstances under which formal actions against troubled FHLBanks will be initiated. FHFA-OIG believes that FHFA's lack of a consistent and transparent written enforcement policy:
    - results in lack of clarity regarding the circumstances under which the Agency will initiate formal enforcement actions;
    - has contributed to instances in which FHFA has not held troubled FHLBanks and their officers sufficiently accountable for failing to correct identified deficiencies

[8] Similar language is included in FHFA's examination guidance for the FHLBanks. The language of the policy has been revised in this evaluation report to avoid the disclosure of confidential FHFA supervisory classifications for the FHLBanks.

or for engaging in questionable risk-taking that potentially further jeopardized their financial and operational conditions; and

  - impedes outside reviews of the Agency's troubled FHLBank oversight activities.

- **FHFA does not have an automated management information system that provides the Agency's managers with ready access to current information regarding the status of examination findings.** Instead, FHFA uses manual reporting processes that comparatively limit its ability to monitor and assess the extent to which individual FHLBanks are correcting identified deficiencies.

- **FHFA does not consistently document all key interactions with FHLBanks.** For example, although the boards of directors at certain troubled FHLBanks appear to have removed senior officers based on FHFA's assessments of their performance, the Agency does not document such interactions with them. The lack of a documentary record impedes efforts to review FHFA's oversight of FHLBanks.

FHFA-OIG believes that the recommendations in this report will result in more economical, effective, and efficient operations. FHFA-OIG appreciates the assistance of all those who contributed to the preparation of this report.

The FHFA-OIG evaluation team for this report included David Frost, Investigative Counsel; Stephen P. Learned, Investigative Counsel; Bruce McWilliams, Investigative Evaluator; and Wesley M. Phillips, Senior Policy Adviser. This evaluation report has been distributed to Congress, the Office of Management and Budget, and others and will be posted on FHFA-OIG's website, www.fhfaoig.gov.

George Grob
Deputy Inspector General for Evaluations

BACKGROUND

Overview of FHFA and the FHLBank System

FHFA

HERA established FHFA as the federal safety and soundness and mission regulator for the housing GSEs. Since September 2008, FHFA has also acted as the conservator for Fannie Mae and Freddie Mac. Prior to HERA's enactment, the FHFB was the safety and soundness and mission regulator for the FHLBank System and the Office of Federal Housing Enterprise Oversight (OFHEO) was the safety and soundness regulator for Fannie Mae and Freddie Mac.[9] FHFA carries out its GSE oversight and conservatorship responsibilities by conducting continuous supervision and targeted examinations and by issuing supervisory or enforcement orders.

The FHLBank System

a. Mission

The FHLBank System was created to reinvigorate a housing market devastated by the Great Depression of the 1930s. Specifically, the FHLBank System is intended to facilitate homeownership by increasing liquidity in the housing market.[10] Signing into law in 1932 the Federal Home Loan Bank Act,[11] which established the FHLBank System, President Hoover stated:

> the purpose of the system is both to meet the present emergency and to build up homeownership on more favorable terms than exist today. The immediate credit situation has … restricted the activities of … institutions making loans for home purposes, in such fashion that they are not only unable to extend credit for the

[9] The Department of Housing and Urban Development was Fannie Mae's and Freddie Mac's housing mission regulator.

[10] In addition to promoting liquidity in the mortgage markets, federal law and regulations require the FHLBanks to promote affordable housing and economic and community development initiatives. For example, under the Affordable Housing Program, each FHLBank is required to contribute 10% of its previous year's earnings to fund affordable housing. *See FHLBanks: Affordable Housing Program*, available at www.fhlbanks.com/programs_affordhousing.htm.

[11] Public Law No. 72-304.

acquirement of new homes, but in thousands of instances they have been unable to renew existing mortgages with resultant foreclosures and great hardships.[12]

To fulfill its mission, the FHLBank System issues debt on a combined basis through its Office of Finance. Due to its GSE status, the FHLBank System is able to issue debt at rates slightly higher than comparable U.S. Treasury Department debt but lower than private financial institutions.[13]

b. Assets

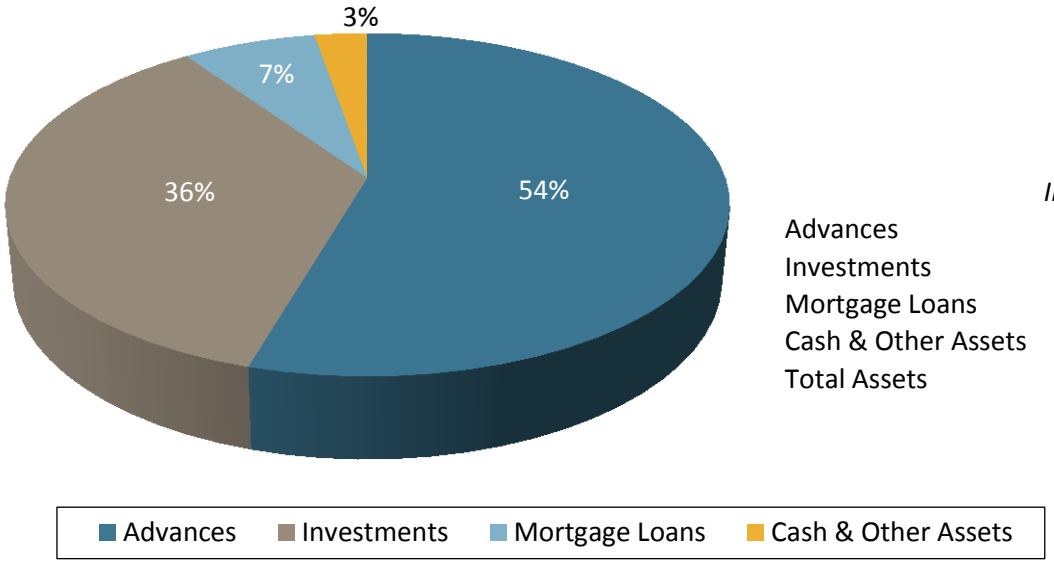
The individual FHLBanks use the proceeds from the FHLBank System's debt to make cash advances to members (the members pledge assets in return for the advances, as discussed below). The advances generate interest income for the FHLBanks and provide the members with the opportunity to issue additional mortgages and make other loans. Advances represented 54% of the FHLBank System's $878 billion in total assets at the end of 2010. The FHLBanks' investments, such as MBS, represented another 36% of total assets. FHLBanks make investments to generate interest income and to enhance liquidity. Additionally, some FHLBanks hold whole mortgages on their books, and such mortgages represent the FHLBank System's third largest asset class.[14] Finally, the FHLBanks hold cash and miscellaneous assets on their books. Figure 1 depicts the FHLBank System's asset holdings at the end of 2010.

[12] Herbert Hoover, *Statement About Signing the Federal Home Loan Bank Act*, July 22, 1932.

[13] The FHLBanks are jointly and severally liable for the FHLBank System's consolidated debt obligations. Thus, if an FHLBank encounters financial deterioration or fails, the other FHLBanks are responsible for satisfying its financial obligations and ensuring that the FHLBank System as a whole continues to honor its debt obligations.

[14] Some FHLBanks purchase whole mortgages directly from their members and hold such mortgages on their balance sheets. The FHLBanks generate interest income on these holdings.

Figure 1: FHLBank System Assets, Year-end 2010[15]



	In Billions
Advances	$479
Investments	314
Mortgage Loans	61
Cash & Other Assets	24
Total Assets	$878

c. The FHLBanks

The 12 FHLBanks are located in designated geographic regions (*see* Figure 2). Within these regions, financial institutions – such as commercial banks, thrifts, credit unions, and insurance companies – may elect to become members of the local FHLBank. Large financial services institutions with separately chartered subsidiaries may belong to more than one FHLBank. For example, Bank of America had memberships in 7 of the 12 FHLBank regions at the end of 2010.

[15] Source: FHFA (percentages have been rounded).

Figure 2: FHLBank System Regions[16]

Each of the 12 FHLBanks operates as a cooperative. That is, each FHLBank is owned by its member financial institutions, which elect the members of the board of directors. The board, in turn, appoints senior officers and managers to carry out FHLBank policy and run the FHLBank on a day-to-day basis. Although the 12 FHLBanks may coordinate their activities on selected issues, the FHLBank System itself does not have a unified management structure. There is no overall board of directors or other authority governing the FHLBank System as a whole.

FHFA regulations require member institutions to invest capital in their local FHLBank. These capital requirements, along with the requirement that members pledge collateral, such as single-family mortgages or investment grade securities to secure advances, are designed to protect the FHLBanks against the risk that members will default on their advances.[17]

[16] Source: FHLBank of Boston, available at www.fhlbboston.com/aboutus/thebank/08_01_04_fhlb_system.jsp.

[17] Reportedly, no FHLBank ever has suffered a credit loss on an advance. This is due, in part, to the collateral requirements.

Troubled FHLBanks Face Substantial Financial and Operational Challenges

Recent Losses and Their Cause

Since 2008, the troubled FHLBanks have experienced significant financial and operational challenges. Each of the four FHLBanks made substantial investments in private-label MBS collateralized by non-traditional mortgage assets that were originated during the housing boom years of 2005 through 2007. When the housing market collapsed, these FHLBanks suffered significant losses on their investments, and their investment portfolios continue to generate losses. Figure 3 shows that the troubled FHLBanks collectively recognized losses of nearly $2 billion on their investments in private-label MBS in 2009 and 2010. The FHLBank of Chicago recognized the largest amount of such losses – $600 million – followed by Boston, Seattle, and Pittsburgh.[18]

Private-Label MBS
MBS derived from mortgage loan pools assembled by entities other than GSEs or federal government agencies, such as private-sector financial services companies. Unlike Agency MBS issued by the GSEs, private-label MBS does not carry an explicit or implicit government guarantee.

[18] In addition to MBS losses, one of FHFA's larger concerns for the Chicago FHLBank has been managing the interest rate risks associated with the large portfolio of whole mortgages that the bank acquired from 1999 through 2007. Interest rate risk is the risk associated with fluctuations in interest rates. Whole mortgages are susceptible to interest rate risk because they are generally funded with short-term debt and pay a higher fixed rate of interest over an extended period, such as 15 or 30 years. But if short-term interest rates rise and exceed the fixed rate of interest paid by whole mortgages, then a financial institution that holds whole mortgages as investments may face significant financial challenges, which could lead to its eventual insolvency.

Figure 3: Troubled FHLBanks' Losses on Private-Label MBS Investments, 2009 and 2010 (Dollars in Millions)[19]

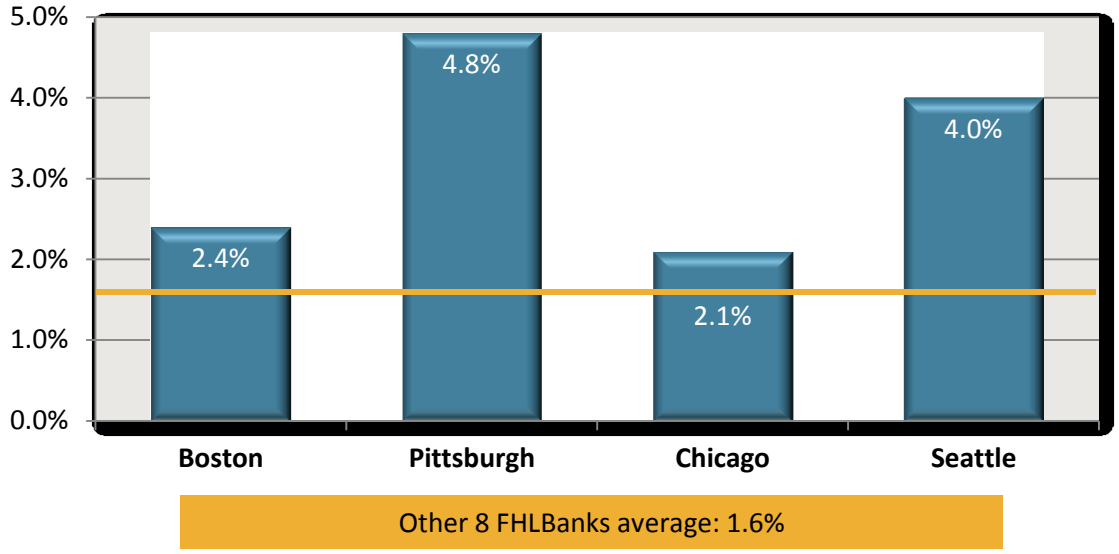
FHLBank	2009	2010	Total
Boston	$444	$85	$529
Pittsburgh	229	158	387
Chicago	437	163	600
Seattle	311	106	417
Total	$1,421	$512	$1,933

In addition to these reported losses, the troubled FHLBanks may face additional losses associated with the private-label MBS still in their investment portfolios. Figure 4, below, shows that the four FHLBanks hold higher levels of securities rated "below investment grade" than the other eight FHLBanks.[20] For example, at the FHLBanks of Pittsburgh and Seattle below investment grade investments represented more than 4% of total assets, which is more than twice the 1.6% average for the eight other FHLBanks that are classified as not having supervisory concerns.

[19] Source: FHFA.

[20] Below investment grade securities generally involve substantial risk, are of very poor quality, are at risk of imminent default, or are in default. *See* www.bonds.yahoo.com/safety.html.

Figure 4: Troubled FHLBanks' Below Investment Grade Investments Relative to Their Total Assets, Year-end 2010[21]



Senior officials at the troubled FHLBanks told FHFA-OIG that their private-label MBS investments remain financial and risk management challenges for their institutions. They explained that their FHLBanks continually monitor such investments and selectively sell MBS when it makes business sense to do so.

Other Notable Risks

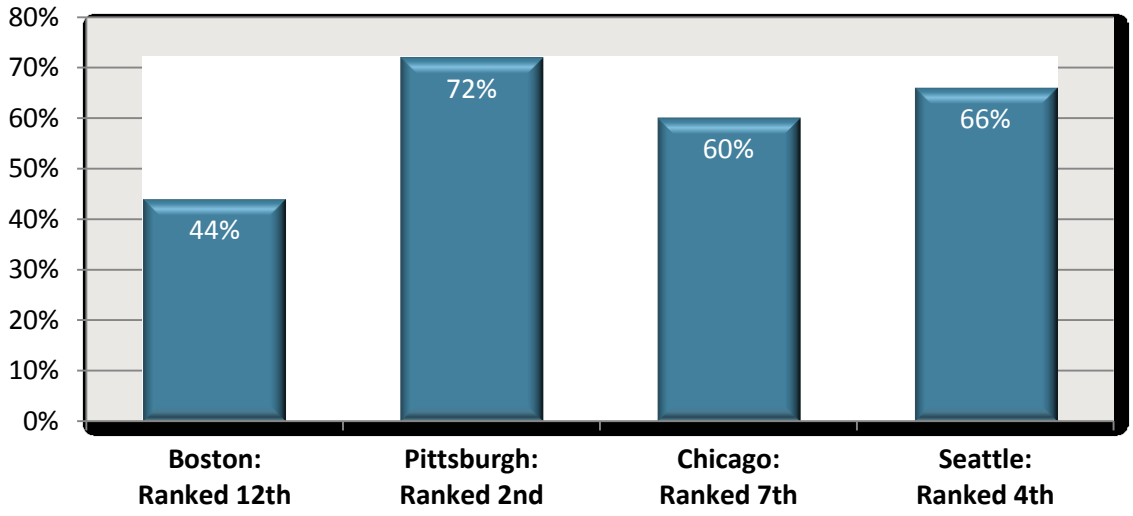
The troubled FHLBanks confront additional risks; the following risks affect two or more of the banks:

- **Concentration of member advances.** The FHLBanks of Pittsburgh and Seattle have significant member concentration risk, *i.e.*, a large percentage of advance business is confined to ten banks, a relatively small percentage of members (*see* Figure 5). (The FHLBank of Boston's low concentration of risk is the result of a recent substantial decline in advances to one of its largest members.) According to FHFA, these advance concentrations are a cause of concern because: (1) the withdrawal of one or more large members from a particular FHLBank could significantly reduce its net interest income; and (2) the failure of one or more such institutions could cause large

[21] Source: FHFA. The San Francisco FHLBank had the highest percentage at 5.4%.

losses to an FHLBank if its advances made to the failing institutions were not adequately collateralized or the collateral had declined substantially in value.

Figure 5: Troubled FHLBanks' Advances to Its Top Ten Members as Percentage of Their Total Advances, Year-end 2010[22]



- **Limited FHLBank advance demand.** FHFA and FHLBank officials told FHFA-OIG that some of the troubled FHLBanks are located in regions where the demand for advances (and, hence, for the FHLBanks' primary service/source of revenue) is limited.[23] The reasons for this limited demand include fewer eligible member financial institutions in the regions; relatively small member institutions (smaller financial institutions generate less demand for advances); and the overall state of the economy in the regions. For example, officials from the FHLBank of Pittsburgh said that the FHLBank has recruited as members most of the eligible financial institutions in its region and now is actively recruiting insurance companies in its region. FHFA officials said, however, that the Pittsburgh FHLBank's region (*i.e.*, Delaware, Pennsylvania, and West Virginia) has recently faced more significant economic challenges than other sections of the country. As a consequence, advances decreased to $30 billion in 2010. In 2006, advances had been $50 billion, and they were $62 billion in 2008.

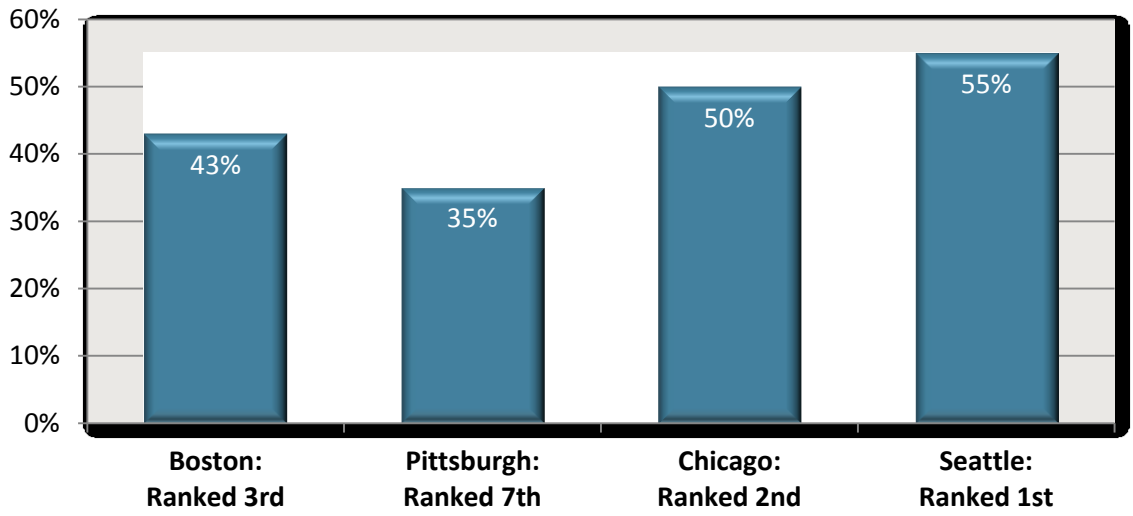
[22] Source: FHFA. The FHLBank of San Francisco had the highest percentage of advances to its top ten members at 86% at the end of 2010.

[23] FHFA-OIG recognizes that overall advances within the FHLBank System have declined substantially since 2008. There are various reasons for the decline, including the wide availability of relatively low cost deposits as funding sources for banks and thrifts. But certain troubled FHLBanks may face advance demand challenges that are more structural in nature, such as being located in regions that have relatively limited economic prospects or less diverse memberships than others.

In the Seattle FHLBank region several large members have either failed (*e.g.*, Washington Mutual) or withdrawn their membership in recent years.

- **High percentage of investments to total assets.** FHLBank investments include private-label MBS and MBS issued by Fannie Mae and Freddie Mac. As shown in Figure 6, three of the four troubled FHLBanks, (*i.e.*, Seattle, Chicago, and Boston), have the highest percentages of assets concentrated in investments within the FHLBank System.

Figure 6: Troubled FHLBank Investments as a Percentage of Their Total Assets, 2010[24]



In May 2011, FHFA's Acting Director stated that it "… is not a sustainable operating condition for an FHLBank" to have such large investment portfolios[25] because over the past 20 years investments have posed a greater risk to the FHLBanks than advances. In addition, he noted that a large investment portfolio is inconsistent with the FHLBanks' housing finance mission, and that the FHLBanks should meet their housing mission primarily by focusing on their advance business.[26]

- **Operational Risk.** FHFA examinations have also identified significant risk management and operational deficiencies at the troubled FHLBanks. These include,

[24] Source: FHFA.

[25] FHFA Acting Director Edward J. Demarco, *The Franchise Value of Federal Home Loan Banks*, 2011 Federal Home Loan Bank Directors Conference, Washington, DC, May 11, 2011, available at www.fhfa.gov/web-files/21197/FHLB51111Final.pdf.

[26] *See* footnote 4, above.

but are not limited to, poor collateral risk management, deficiencies in information technology systems, and weak corporate governance.

FHFA Supervisory Classifications Signify the Challenges Facing the Four FHLBanks

In its annual reports to Congress, FHFA uses a risk-based ranking system to classify the financial and operational soundness of the 12 FHLBanks. FHFA classifies:

- FHLBanks with the lowest risk as "satisfactory;"
- FHLBanks with higher risk but confined deficiencies as "limited supervisory concern;" and
- FHLBanks with the highest risk and widespread deficiencies as "supervisory concern."

Figure 7 shows that for at least two examination cycles between 2007 and 2010, FHFA (or its predecessor agency) assigned the four troubled FHLBanks a composite rating of supervisory concern. According to FHFA, FHLBanks with this rating are those having the most significant supervisory concerns among the 12 FHLBanks.

Figure 7: Supervisory Classification for the Troubled FHLBanks, 2007 Through 2010 Annual Examination Cycles[27]

	2007[28]	2008	2009	2010
Boston	Satisfactory	Satisfactory	Supervisory concern	Supervisory concern
Pittsburgh	Limited supervisory concern	Supervisory concern	Supervisory concern	Supervisory concern
Chicago	Supervisory concern	Supervisory concern	Supervisory concern	Supervisory concern
Seattle	Satisfactory	Limited supervisory concern	Supervisory concern	Supervisory concern

[27] Source: FHFA.

[28] FHFA's predecessor agency, FHFB, did not publicly report its FHLBank ratings in 2007. The 2007 classifications are consistent with the classifications FHFA used in its 2008 report to Congress and thereafter.

Troubled FHLBanks Potentially Have Greater Incentives to Engage in Higher Risk Business Strategies

Given that the four FHLBanks classified as having supervisory concerns confront significant financial and operational challenges, they may have greater incentives to address these challenges by undertaking higher risk activities in an effort to achieve higher returns. Thus, FHFA needs to monitor closely their activities and control actions that could potentially lead to greater financial and operational deterioration and cause greater long-term risks.

Indeed, a senior FHFA official advised FHFA-OIG that the weakened condition of some FHLBanks has led to increased risk-taking. Specifically, some FHLBanks have faced ongoing challenges in generating sufficient advance demand, and others have been challenged by weak economic conditions in their regions. They have reacted to this diminished business by investing heavily in higher-risk private-label MBS collateralized by non-traditional mortgages during the housing boom of 2005 to 2007. These investments subsequently resulted in significant losses when the housing market collapsed.

According to FHFA, these MBS investments were highly rated by credit rating agencies during the housing boom, and, thus, the risks that the FHLBanks were incurring were not fully appreciated by the FHLBanks or FHFB at the time. FHFA-OIG did not assess FHFB's oversight of the FHLBanks' investment practices during the housing boom and whether it could have taken additional steps to mitigate the risks associated with private-label MBS. Nonetheless, going forward, this experience emphasizes the importance of close FHFA oversight of troubled FHLBanks' investment practices and other business strategies and their potential for further losses.[29]

FHFA Has Taken Some Steps to Monitor and Control the Troubled FHLBanks

FHFA has taken several steps to monitor and control the four FHLBanks, including:

- Ensuring that they restrict the payment of dividends to preserve their retained earnings and capital;

[29] Fannie Mae and Freddie Mac also experienced significant losses based on investments during the housing boom. Both embarked on aggressive strategies from 2004 through 2007 to purchase risky, non-traditional mortgage assets such as private-label MBS collateralized by subprime and other mortgage assets. The Financial Crisis Inquiry Commission concluded that, although OFHEO noted an increase in the occurrence of the Enterprises' purchases of risky mortgage assets during that period, it did nothing to stop it. *See* Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report*, January 2011, available at www.gpoaccess.gov/fcic/fcic.pdf. When the housing market collapsed, the Enterprises suffered billions of dollars in losses on these investments, and FHFA placed them into conservatorships.

- Encouraging boards of directors to place limits on investment activities;
- Monitoring through annual examinations and regular communications; and
- Discussing with board members and managers the possibility of merging with healthier FHLBanks.

FHFA Does Not Regard Its Examination Guidance to Be a Policy Requiring the Initiation of Formal Enforcement Actions for Troubled FHLBanks

As discussed previously, FHFA's examination guidance states that the Agency generally will take formal enforcement actions when FHLBanks are classified as having supervisory concerns. However, the Agency has informed FHFA-OIG that the examination guidance does not constitute FHFA policy or require a particular course of action. Rather, under its discretion, FHFA has initiated formal enforcement actions on a case-by-case basis, and it believes it has acted appropriately.

FHFA-OIG disagrees. It views FHFA's lack of a consistent and transparent written enforcement policy as undermining the Agency's oversight of troubled FHLBanks.

FHFA's predecessor agency, FHFB, established the examination guidance that remains in effect. For FHLBanks classified as having supervisory concerns the guidance provides, "The general policy is that a formal enforcement action will be taken to address identified deficiencies or weaknesses." Formal enforcement actions include the termination of personnel (also known as "removal and prohibition" actions), the issuance of cease and desist orders, and the imposition of civil monetary penalties. FHFA may also enter into a Consent Order with an FHLBank under which the FHLBank must take specified corrective actions. For example, a Consent Order may require an FHLBank to submit and implement a plan to manage risks associated with its investment portfolio within a specified period.

As shown in Figure 8, despite the examination guidance, FHFA or its predecessor has initiated formal enforcement proceedings against only two of the four troubled FHLBanks: Seattle and Chicago. In 2010, FHFA issued a Consent Order against the Seattle FHLBank. The Chicago FHLBank is subject to a Consent Order initiated by FHFB in 2007.[30]

[30] FHFA-OIG found evidence that in some cases FHFA has taken action, albeit action short of formal enforcement proceedings as provided in its supervisory guidance. In particular, FHFA has expressed a lack of confidence in certain senior bank officers that led the boards of directors of the troubled FHLBanks to remove senior officers deemed to be responsible for their institutions' financial and operational deterioration. However, these actions were not conducted in accordance with 12 U.S.C. § 4636a, and, thus, it would be incorrect to characterize them as enforcement actions under the Federal Housing Enterprise Financial Safety and Soundness Act of 1992, as amended.

Figure 8: Troubled FHLBank Formal Enforcement Actions, Regulator, and Action Date[31]

FHLBank	Formal Action	Regulator	Date of Action
Boston	None	FHFA	N/A
Pittsburgh	None	FHFA	N/A
Chicago	Consent Order	FHFB	October 2007
Seattle	Consent Order	FHFA	October 2010

FHFA officials explained their rationale for the differing treatment of the four troubled FHLBanks. But FHFA-OIG has concerns about the lack of a consistent and transparent written enforcement policy. The following summarizes several of FHFA's rationales and FHFA-OIG's analysis of them:

- **The examination guidance does not constitute specific FHFA policy.** FHFA officials explained that FHFB developed the guidance, and FHFA interprets it as non-binding internal guidance, defining for examiners the significance of classifying an FHLBank as having supervisory concerns. The guidance is intended to create a presumption that financial and operational deficiencies are so serious that a formal action would typically follow from the classification, but such action is not necessarily mandated.

  FHFA-OIG believes the guidance's plain language is important and establishes expectations about Agency actions. If FHFA does not stand behind the language in its own examination guidance then clarification or amendment is necessary. Further, FHFA sends mixed messages to its examiners and the FHLBanks through its seemingly inconsistent interpretation and application of the guidance, particularly since the language is repeated in completed examination reports. In its current form, the guidance has limited to no practical value for examiners in determining whether to classify an FHLBank as having supervisory concerns.

- **There were significant differences between the FHLBank of Seattle (which is subject to an enforcement proceeding) and the Boston and Pittsburgh FHLBanks (which are not).**[32] FHFA believes that differences among FHLBanks

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Additionally, although the Boston and Pittsburgh FHLBank boards of directors agreed to adopt resolutions calling for improvements in their finances and operations, such board resolutions are not legally binding like enforcement actions.

[31] Source: FHFA.

[32] FHFB entered into a Consent Order with the Chicago FHLBank in 2007. The circumstances that surround FHFB's actions were outside of the scope of the evaluation.

may warrant establishing formal enforcement actions against some FHLBanks that are classified as supervisory concerns and not others. For example, many of the Seattle FHLBank's members had outstanding requests to "redeem" their capital investments in the institution; that was not the case in Boston and Pittsburgh.[33] According to FHFA, it was able to mandate that the Seattle Bank not redeem its members' redemption requests through the Consent Order.[34] Further, the Boston and Pittsburgh Banks had new management teams in place that appeared committed to developing and implementing reforms necessary to mitigate identified risks. Thus, FHFA officials believe that formal enforcement action was appropriate for the Seattle FHLBank but not for the Boston and Pittsburgh FHLBanks.

FHFA-OIG observes that FHFA has not established written criteria defining the exceptions to its guidance generally to initiate formal enforcement actions when FHLBanks are classified as supervisory concerns.[35] Nor did FHFA provide documentation for such exceptions. Without such written criteria and documentation: (1) FHFA officials appear to wield broad discretion in deciding whether to initiate formal enforcement actions; and (2) FHFA-OIG and other outside parties are not well positioned to assess the Agency's oversight activities.

FHFA-OIG also observes that a plain reading of FHFA's reports to Congress and internal documentation make it very difficult to distinguish any material differences surrounding the financial and operational conditions of the troubled FHLBanks. Each is classified similarly as a supervisory concern and faces profound challenges. Given the condition of FHLBanks classified as supervisory concerns, a consistent and transparent enforcement policy would be the best means to oversee their activities, monitor risk-taking, help restore their conditions, and assist public understanding.

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[33] FHLBank members have the authority to request redemptions of stock in their FHLBank under specified circumstances.

[34] FHFA stated that, in ordinary circumstances, an FHLBank must, at a member's request, redeem that member's stock at par value. An FHLBank can cease redemptions upon a determination that any redemption would lead to inadequate capital or unsafe and unsound conditions. FHFA states that its enforcement action prevented the Seattle FHLBank from redeeming its members' stock as they had requested. FHFA-OIG did not evaluate FHFA's argument, but notes that the Agency's assertions suggest that its decision to initiate the enforcement action appears to have been based on a narrow stock redemption issue rather than the Seattle FHLBank's overall financial and operational condition.

[35] According to Office of Management and Budget (OMB) standards, establishing and documenting management procedures is a key means to ensure that responsibilities are carried out and objectives attained.

FHFA Views Its Discretion-Based Oversight Strategy as Generally Successful, but the Troubled FHLBanks Continue to Face Considerable Challenges and Risks

In commenting on a draft of this report, an FHFA official emphasized the value of the Agency's discretion-based enforcement strategy for the troubled FHLBanks. Further, FHFA provided financial tables that tend to suggest that the FHLBanks' financial conditions have improved under the Agency's oversight approach over the past several years (*see* Appendix A). Specifically, FHFA stated that the FHLBanks have improved in terms of their capital ratios, retained earnings, market value, and earnings.

FHFA-OIG agrees that these measures indicate improvement and that it is likely that the Agency's supervisory actions contributed to those improvements. However, FHFA classified each of the four FHLBanks as having "supervisory concerns" through the 2010 examination cycle; this classification means that the banks represent the most significant supervisory concerns among the 12 FHLBanks. Further, the classification signifies that these four FHLBanks faced significant financial challenges throughout the relevant period (*see* Appendix B for additional discussion by FHFA-OIG).

Further, the improved financial position of the FHLBank of Chicago has largely occurred on the basis of its sizeable investment portfolio rather that its core advance business.[36] FHFA's Acting Director has stated that such large investment portfolios are neither "sustainable" nor consistent with the FHLBanks' housing missions. FHFA-OIG notes also that such portfolios represent considerable risks, such as the risk of loss associated with fluctuating interest rates.

As discussed below, FHFA-OIG does not believe that FHFA took sufficient steps to ensure that the FHLBank of Chicago mitigated these risks in a timely way as required by its 2007 Consent Order. FHFA-OIG also believes that the establishment of a specific enforcement policy that includes provisions designed to hold FHLBanks and their officers accountable for failing to comply with Consent Orders and other regulatory requirements would better ensure effective oversight of troubled FHLBanks.

[36] For example, the FHLBank of Chicago's securities filing for the third quarter of 2011 indicates that in the first nine months of 2011 its gross interest income derived from investments was more than four times higher than its gross interest income derived from advances ($932 million vs. $203 million). *See* http://www.sec.gov/Archives/edgar/data/1331451/000133145111000238/a2011093010q.pdf. Additionally, FHFA's 2010 Annual Report states that the FHLBank of Chicago's increasing interest income was "… due to lower funding costs and increased income from the FHLBank's large investment portfolio." *See* http://www.fhfa.gov/webfiles/21570/FHFA2010RepToCongress61311.pdf.

FINDINGS

FHFA-OIG finds that FHFA has taken several important actions, including restricting dividends and ongoing monitoring, to oversee the actions of the troubled FHLBanks. But FHFA-OIG also finds that:

1. FHFA Has Not Established a Clear, Consistent, and Transparent Written Enforcement Policy for Troubled FHLBanks

FHFA lacks a consistent and transparent written enforcement policy for troubled FHLBanks. Currently there is a conflict between FHFA's examination guidance for such FHLBanks and its stated enforcement policies and practices. This lack of clarity undermines FHFA's oversight of troubled FHLBanks and impedes oversight of the Agency's actions. Further, FHFA-OIG identified examples where FHFA arguably did not take proactive steps to hold troubled FHLBanks and their officers sufficiently accountable for failing to comply with the terms of a Consent Order or for engaging in what the Agency viewed as questionable risk-taking. In the absence of an enforcement policy that establishes consequences for such actions, the risks associated with FHLBanks may persist or increase over time.[37]

FHFA's examination guidance and its oversight policies and practices for troubled FHLBanks are in conflict. The examination guidance states that the Agency's policy is generally to initiate formal enforcement actions when an FHLBank is classified as a supervisory concern. Contrary to its guidance, however, FHFA officials stated that basing formal enforcement actions strictly on whether an FHLBank is classified as a supervisory concern would unduly restrict the Agency's supervisory discretion. Consistent with this discretion-based approach, FHFA initiated a formal action against the Seattle FHLBank but not the Boston and Pittsburgh FHLBanks.[38] FHFA-OIG views the conflict between FHFA's current guidance and its preferred discretion-based oversight approach as resulting in a lack of clarity for both its examination staff and the FHLBanks, neither of which have steady benchmarks against which to gauge their actions. From the perspective of effective management, FHFA has a responsibility to resolve the differences between its guidance and practices, preferably through the development of a written enforcement policy.

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[37] FHFA-OIG recognizes that to some extent the troubled FHLBanks' capacity to restore their financial and operational soundness is dependent upon the performance of the larger economy and the performance of their investment portfolios, and these factors are outside of FHFA's control through enforcement and supervisory actions.

[38] The Chicago FHLBank is subject to a Consent Order initiated by FHFB in 2007.

FHFA's lack of a written enforcement policy also undermines the ability of FHFA-OIG and other outside reviewers to assess the effectiveness of the Agency's oversight of troubled FHLBanks. Although discretion plays an important role in the supervisory process, FHFA-OIG views troubled FHLBanks as special risks given their GSE status, and therefore they merit a structured and consistent oversight approach. As such, FHFA-OIG views the current examination guidance calling for the Agency to generally initiate formal enforcement actions in such cases as a reasonable means to oversee their operations, minimize risk-taking, and help ensure their return to financial and operational soundness. The examination guidance also potentially provides a basis to assess FHFA's rationale for taking or not taking formal actions. Nonetheless, the establishment of the appropriate enforcement policy is within FHFA's discretion, but whatever policy it devises should be consistent and transparent.

FHFA-OIG also identified instances in which it believes FHFA arguably did not act proactively to address significant risks identified in its oversight of troubled FHLBanks. Specifically:

- FHFA did not enforce a key provision in the FHLBank of Chicago's Consent Order. Among other provisions, the Consent Order required the FHLBank to send revised policies and procedures to address its significant market risks to FHFB within 90 days of the date of the order (or early 2008). These market risks were primarily associated with the FHLBank's large holdings of whole mortgage loans. Despite the 90-day requirement, the FHLBank did not submit market risk policies and procedures that FHFA approved until mid-2010, or nearly three years after the Consent Order was established.[39] FHFA characterized the time it took the FHLBank to submit approved policies and procedures as "unacceptable" but did not take further enforcement actions based on its non-compliance.[40] Although the FHLBank submitted approved policies and procedures in 2010, FHFA's 2010 Annual Report said that it continued to face considerable market risks and its management of them was "weak." Thus, by

[39] The FHLBank's failure to comply with this provision of the Consent Order is discussed in FHFA's 2009 and 2010 reports to Congress.

[40] An FHFA official said that, on multiple occasions during the three years, the FHLBank submitted policies and procedures, but these were rejected by the Agency. The official also said that FHFA had "harsh" criticism for the FHLBank's failure to comply with the terms of the Consent Order relating to market risk and that the bank's executives were denied incentive compensation as a result. Further, Agency staff maintained an onsite presence at the FHLBank to ensure that it corrected identified deficiencies. The official believes that FHFA's oversight is a regulatory success story because the Agency held the FHLBank to high standards and the bank's finances and risk management have improved. FHFA-OIG recognizes the importance of these actions and the improvement in the FHLBank's conditions. However, improvement in its condition appears to be also attributable, in part, to income derived from its large investment portfolio. In addition, although FHFA-OIG credits FHFA for its ongoing oversight of the troubled FHLBanks, it is not clear that denying incentive compensation to a bank's executives holds them sufficiently accountable for failing to comply with a Consent Order. FHFA has more forceful authorities at its disposal that the Agency did not use to enforce compliance with the Order.

not ensuring that the FHLBank complied with the terms of the Consent Order on a timely basis, the FHLBank's market risks were not addressed for the first three years of the Consent Order and it remains to be seen how effectively these risks have been mitigated.

- FHFA did not take enforcement actions after it determined that the FHLBank of Boston had engaged in what the Agency viewed as questionable risk-taking.[41] FHFA first classified the FHLBank as a supervisory concern in 2009, but did not take a formal enforcement action at that point, purportedly because its new management team was viewed as receptive to taking necessary corrective actions. However, FHFA's 2010 Report to Congress subsequently described how the FHLBank increased its risks in 2010 through a "revenue generating strategy" that was "questionable" for a "weak" institution.[42] FHFA also stated that the FHLBank had engaged in this strategy without fully assessing the risks involved. FHFA officials said that the Agency's strategy was successful because it required the FHLBank to stop the investment strategy and it instituted a supervisory Matter Requiring Attention (MRA).[43] But FHFA-OIG notes that this approach lacks the strength and effect of using a formal enforcement action such as a cease and desist order or civil money penalty.

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[41] FHFA alleged that the FHLBank of Boston was using short-term debt to finance longer-term Enterprise debt in a revenue-generating strategy. FHFA also alleged that this initiative exposed the FHLBank to potential losses if interest rates increased substantially. *See* FHFA, *Report to Congress 2010* (June 13, 2011), available at www.fhfa.gov/webfiles/21570/FHFA-2010RepToCongress61311.pdf.

The FHLBank of Boston officials told FHFA-OIG that the investments were a legitimate strategy to hedge against a decline in advance interest income and that they fully apprised the Agency of it at the time. FHFA-OIG does not take a position on this dispute between FHFA and the FHLBank of Boston. Instead, FHFA-OIG assesses FHFA's actions based on its view of the risks involved with the FHLBank's strategy.

[42] Specifically, the report stated that:

> The board and management assumed additional … risk by embarking on a revenue-generating strategy …
>
> … Management increased the balance sheet by $4.7 billion at the end of the third quarter (of 2010) by purchasing agency (Fannie Mae or Freddie Mac) assets and funding them with debt maturing approximately one year shorter than these assets.
>
> In an increasing interest rate environment, this strategy increases the risk of a reduced market value of equity at a time when the FHLBank is overly exposed to credit risk. In a weak institution, using an increased interest rate risk strategy is questionable, particularly when the use of this strategy has not been subject to rigorous risk management.

Id.

[43] An MRA requires FHLBank management to take steps in a timely way to address the identified deficiency. Though a valuable supervisory tool, MRAs lack the legal effect of formal enforcement actions, such as Consent Orders.

FHFA-OIG believes that a written enforcement policy could better ensure FHFA oversight of troubled FHLBanks. Specifically, the policy could state that there would be specific enforcement actions, such as civil money penalties, for the failure to comply with Consent Order provisions. Similarly, the policy could also state that FHLBanks that are classified as supervisory concerns but are not initially subject to enforcement actions may be if they subsequently engage in questionable risk taking that FHFA views as material in nature.

FHFA-OIG also believes that a consistent and transparent enforcement policy needs to define exceptions to its general provisions to ensure FHFA sufficient flexibility in carrying out its oversight activities while at the same time allowing a basis for outside observers to assess its general oversight strategy.

FHFA officials agreed that the Agency should establish an enforcement policy. They also indicated that such a policy will be in effect by June 30, 2012. FHFA-OIG commends FHFA for its commitment to establish an enforcement policy by a specified date. FHFA-OIG will monitor FHFA's development of the policy and will assess the potential effectiveness of the final policy.

2. FHFA Has Not Established an Automated Management Information Reporting System to Track FHLBank Examination Findings

FHFA lacks an automated information system that provides ready access to current information needed by Agency managers.[44] Instead, FHFA uses manual processes. By relying on manual processes rather than an automated system, FHFA managers are comparatively limited in their ability to assess the extent to which individual FHLBanks, including those classified as having supervisory concerns, are correcting identified deficiencies. Further, the lack of such an automated information system impeded the ability of FHFA-OIG to assess efficiently the effectiveness of the Agency's oversight efforts.

FHFA examiners record their findings with respect to FHLBanks through several manual processes, none of which provides Agency managers or outside reviewers with the ability to obtain information rapidly or comprehensively compared to an automated system. For example, FHFA examiners document their findings, such as MRAs, in the examination reports themselves.[45] To determine whether a specific deficiency exists at a particular FHLBank, an

[44] OMB internal control guidance for the federal government states that: "Information should be communicated to relevant personnel at all levels within an organization. The information should be relevant, reliable, and timely …." OMB, *Circular A-123 – Management's Responsibility for Internal Control*, December 21, 2004.

[45] FHFA can take a variety of steps based on its examination findings to ensure that the GSEs correct deficiencies noted by the examiners. Among them is the creation of an MRA. MRAs are used to identify issues of supervisory concern that warrant special attention by the GSE to ensure that corrective action is appropriately planned and executed. An MRA will remain open until the Agency determines that the GSE has taken the action necessary to correct it.

Agency manager can retrieve and review an examination report. But the examination report predates action to resolve its findings and, thus, the report will not provide timely information about the status of efforts to respond to its findings. Because an FHLBank's examination report is a point-in-time document, it is not an ideal vehicle to track the status of corrective actions.

FHFA examiners also document their findings through the use of individual computer spreadsheets. These spreadsheets often facilitate the tracking of efforts to correct identified deficiencies. But FHFA-OIG found that different examiners use different spreadsheets – and the spreadsheets are not part of an overall reporting system that is readily accessible to Agency management. In addition, FHFA-OIG found instances in which information contained in a spreadsheet was inconsistent with information contained in relevant Agency examinations.

Certain FHLBanks, including Pittsburgh and Boston, have developed and implemented tracking systems that enable them to address matters brought to their attention by FHFA examiners.[46] For each issue raised by the Agency in an examination report, the FHLBanks' tracking systems reflect: the nature of the issue; the deadline for its resolution; the FHLBanks' progress in resolving the issue; and any other matters deemed noteworthy.

FHFA executives informed FHFA-OIG that the Agency is considering establishing an automated information system to better monitor and track FHLBank examination findings, as well as the particular bank's progress in resolving identified deficiencies. But FHFA officials said that the planned system is still in the development and early implementation stage.[47] Thus, it is not clear when FHFA managers will be in a better position to review the effectiveness of the Agency's and the FHLBanks' efforts to restore the FHLBanks' financial and operational soundness. Nor is it clear when outside parties will be in a better position to track the effectiveness of FHFA's FHLBank oversight.

3. FHFA Does Not Consistently Document Key Actions with Respect to Its Oversight of Troubled FHLBanks

FHFA does not consistently document significant oversight actions, including in some instances key personnel actions, which occur in the context of its oversight of troubled FHLBanks. Specifically, FHFA does not document instances in which it has implied that FHLBanks' boards of directors should remove certain senior officials who are viewed as being responsible for the institutions' financial and operational deterioration. FHFA-OIG is not in a position to assess the

[46] FHFA officials said the FHLBanks did so at the urging of the Agency, which FHFA-OIG believes reinforces this report's conclusion that FHFA should develop a similar system.

[47] FHFA-OIG has not audited or evaluated this system to determine whether its design would meet the standards for management information reporting contained in this report.

legitimacy of these implied recommendations because FHFA has not adequately documented its actions or the reasons for them.

FHFA officials said that the Agency has used its influence to cause – at least indirectly – boards of directors to remove FHLBank senior managers. For example, a senior FHFA official told FHFA-OIG that the Agency advised a troubled FHLBank board chairman that FHFA did not have confidence in the ability of a senior executive to carry out the executive's responsibilities, and the board reached a severance agreement with the executive that evening.

Officials from several troubled FHLBanks corroborated that FHFA managers have similarly influenced their boards to remove senior managers as part of overall efforts to restore their FHLBanks' financial and operational soundness.

But FHFA-OIG was unable to identify any FHFA record of these personnel actions even though Agency guidance establishes that such documentation shall be maintained. Specifically FHFA's records management policy states that:

> All FHFA employees and contractors are responsible for creating and managing the records necessary to document the Agency's official activities and actions in accordance with FHFA's recordkeeping requirements.[48]

FHFA officials told FHFA-OIG that they had not considered their interactions with FHLBanks regarding the removal of senior officials as necessitating documentation. Yet, they recognize that documentation is an internal control standard. FHFA is in the process of developing a new examination documentation framework that will be implemented during 2012. As part of the new framework, FHFA will consider documenting personnel interactions with the FHLBanks and other aspects of oversight that may not now be consistently documented.

[48] FHFA Records Management Policy, Policy No: 207 V.i. (January 9, 2009).

CONCLUSIONS

FHFA has taken several important steps to monitor closely and control the four troubled FHLBanks, which represent the most significant supervisory concerns among the 12 FHLBanks. These steps include restricting dividend payments, conducting regular examinations, and maintaining other ongoing regulatory contacts. On the other hand, FHFA lacks a clear, consistent, and transparent written enforcement policy. This shortcoming to some extent undermines the Agency's oversight of the troubled FHLBanks.

Additionally, FHFA's ability to supervise the FHLBanks, gauge their improvement or deterioration, and enforce the Agency's directives is impaired by the lack of an automated management information system. The lack of such a management reporting system, as well as FHFA's practice of not consistently documenting troubled FHLBank interactions (*i.e.*, recommending that FHLBank boards of directors remove certain senior officers), also impedes outside oversight of the Agency.

RECOMMENDATIONS

FHFA-OIG recommends that FHFA:

1. Develop and implement a clear, consistent, and transparent written enforcement policy that:

    - requires troubled FHLBanks (those classified as having supervisory concerns) to correct identified deficiencies within specified timeframes;
    - establishes consequences for their not doing so; and
    - defines exceptions to the policy.

2. Develop and implement a reporting system that permits Agency managers and outside reviewers to assess readily examination report findings, planned corrective actions and timeframes, and their status; and

3. Document consistently key activities, including recommendations to remove and replace senior officers and other personnel actions involving FHLBanks.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of this evaluation was to assess FHFA's oversight of four troubled FHLBanks: the FHLBanks of Boston, Chicago, Pittsburgh, and Seattle. FHFA has rated each of these FHLBanks as having "supervisory concerns" during two or more annual examination cycles.

To address its objective, FHFA-OIG interviewed senior FHFA officials who were responsible for monitoring and examining these FHLBanks. FHFA-OIG also interviewed officials of each of the four FHLBanks.

FHFA-OIG also reviewed FHFA's examination guidance "policy" for FHLBanks classified as having supervisory concerns, the Consent Orders for the Chicago and Seattle FHLBanks, FHFA's 2008 through 2010 examinations for each of the FHLBanks, and other supervisory materials. Further, FHFA-OIG reviewed FHFA financial data on the FHLBanks. FHFA-OIG appreciates the efforts of FHFA and FHLBank management and staff in providing information and access to necessary documents to accomplish this evaluation.

FHFA also reviewed OMB Circular A-123 provisions and requirements.

This evaluation was conducted under the authority of the Inspector General Act, and is in accordance with the *Quality Standards for Inspection and Evaluation* (January 2011), which was promulgated by the Council of Inspectors General on Integrity and Efficiency. These standards require FHFA-OIG to plan and perform an evaluation that obtains evidence sufficient to provide reasonable bases to support the findings and recommendations made herein. FHFA-OIG trusts that the findings and recommendations discussed in this report meet these standards.

The performance period for this evaluation was from May 2011 to November 2011.[49]

FHFA-OIG provided FHFA staff with briefings and presentations concerning the results of its fieldwork, and provided FHFA an opportunity to respond to a draft report of this evaluation. FHFA's Acting Chief Operating Officer provided FHFA's written comments, which are reprinted in Appendix A. FHFA agreed to implement the report's recommendations within specified timeframes, but FHFA disagreed with certain statements and analysis in the report.

FHFA-OIG commends FHFA for agreeing to implement the report's recommendations. FHFA-OIG also made several revisions to the report in response to FHFA's official comments as well

[49] The scope of this evaluation does not extend to subsequently released FHFA examinations of the troubled FHLBanks.

as technical comments that the Agency's staff provided separately. FHFA-OIG's responses to specific points raised in FHFA's comment letter are included in Appendix B to this report.

APPENDIX A: FHFA'S COMMENTS

Federal Housing Finance Agency

MEMORANDUM

DATE: November 18, 2011

TO: George Grob, Deputy Inspector General for Evaluations
FHFA Office of Inspector General

FROM: Stephen M. Cross
Deputy Director, Division of FHLBank Regulation

SUBJECT: FHFA Comments on FHFA-OIG Evaluation Report "FHFA's Oversight of Federal Home Loan Banks with Significant Financial Difficulties"

This memorandum transmits the Federal Housing Finance Agency's (FHFA) management responses for the findings and recommendations in the evaluation report "FHFA's Oversight of Federal Home Loan Banks with Significant Financial Difficulties" (Report) prepared by your staff. As stated in the Report, the purpose of the evaluation was to "assess FHFA's oversight of four FHLBanks that had experienced significant losses and financial deterioration since 2008."

Comments on the Report

Before discussing the report's specific findings and recommendations, I will address the report's stated purpose. The four FHLBanks in question were all identified by FHFA in 2009 or earlier as presenting supervisory concerns. The four FHLBanks each receive heightened supervisory attention and scrutiny as a result. The FHFA designated an examiner-in-charge (EIC) for each of these four FHLBanks. The EIC has focused his or her attention on the assigned FHLBank and has been on-site at the FHLBank frequently since 2008 or 2009. Each of the four FHLBanks has restricted dividend payments and capital repurchases, eliminated new investments in private-label mortgage-backed securities (PLMBS), and worked to remediate critical examination findings.

In each of the four FHLBanks, metrics measuring financial condition and performance – including capital ratios, retained earnings, market value, and income – have improved in 2010 and 2011. Therefore, FHFA disagrees with the statement in the report that these four FHLBanks have experienced significant financial deterioration since 2008. The following tables document the improvements in financial condition and performance between December 31, 2008 and September 30, 2011 at each of these FHLBanks.

Regulatory Capital/Total Assets (Percent)

Date	FHLB Boston	FHLB Pittsburgh	FHLB Chicago	FHLB Seattle
12/31/2008	4.6	4.6	4.5	4.6
12/31/2009	6.2	6.8	4.5	5.6
12/31/2010	6.8	8.3	5.2	6.1
9/30/2011	8.5	8.4	5.5	7.3

Retained Earnings/Total Assets (Percent)

Date	FHLB Boston	FHLB Pittsburgh	FHLB Chicago	FHLB Seattle
12/31/2008	0.0	0.2	0.6	-0.1
12/31/2009	0.2	0.6	0.8	0.1
12/31/2010	0.4	0.7	1.3	0.2
9/30/2011	0.7	0.9	1.8	0.4

Market Value of Equity/Par Value of Capital Stock (Percent)

Date	FHLB Boston	FHLB Pittsburgh	FHLB Chicago	FHLB Seattle
12/31/2008	48	24	-23	18
12/31/2009	78	74	73	52
12/31/2010	94	93	107	75
9/30/2011	95	96	122	76

Net Income ($ Millions)

Year	FHLB Boston	FHLB Pittsburgh	FHLB Chicago	FHLB Seattle
2008	-115.8	19.4	-118.7	-199.3
2009	-186.7	-37.5	-65.0	-161.6
2010	106.6	8.3	365.6	20.5
2011 (9/30/11)	94.9	27.1	207.8	70.7

Beginning with the FHLBank of Chicago in April 2008, each of the four FHLBanks has replaced its president and chief executive officer. However, the statement in the Report that "the lack of clear, consistent, and transparent enforcement could allow the risks associated with these FHLBanks to persist or increase over time" is not demonstrated or empirically supported. To the contrary, three of the four FHLBanks reported losses in 2008 and all four reported losses in 2009, but each has been profitable in 2010 and 2011. As shown in the tables above, capital ratios have increased; retained earnings have increased; and market value has improved. Condition and performance have improved irrespective of whether the particular FHLBank was subject to a formal enforcement action.

The FHFA also takes issue with certain other statements in the Report. For example, the Report criticizes the FHFA for not taking a formal enforcement action against one of these FHLBanks after identifying an investment strategy at the FHLBank that the FHFA deemed questionable in view of the FHLBank's circumstances at that time. The Report states this illustrates "the potentially adverse consequences" of the FHFA's approach to the oversight of these FHLBanks. On the contrary, that FHLBank's investment strategy ceased at the direction of the FHFA following a meeting between the EIC and the FHLBank's board of directors. A formal enforcement action was not necessary to achieve the remediation the FHFA desired.

In another instance, the Report states that the four FHLBanks that are the focus of the report "have greater incentives to engage in higher risk business strategies." One example cited is their purchase of "higher-risk" PLMBS in 2005-2007. However, at the time many of these securities were purchased, three of the FHLBanks were not "supervisory concerns," and the investments were not considered in the market as "high risk." Each of the investment securities was rated at the highest investment grade rating (e.g., AAA) by Nationally Recognized Statistical Rating Organizations.

In another example, the Report states, "FHLBanks may face additional losses associated with the [PLMBS] still in their investment portfolios." While that statement is true, it is also possible that losses realized will be less than the charges already taken against income. In fact, to date, FHLBanks have taken more than $4.4 billion in losses, but have experienced cumulative cash flow shortfalls of only $114 million – or less than 3 percent of the recognized losses. The recognized losses are generated by financial models that depend on assumptions, such as future house prices and default rates. While true that the FHLBanks "may face additional losses," it is also true that losses realized over time could turn out to be substantially less than the modeled estimates that have driven loss recognition in the FHLBank's financial statements.

FHFA Response to Report's Recommendations

While disagreeing with a number of statements, characterizations, or inferences in the Report, the FHFA generally agrees with the substance of the Report's recommendations. One core principle must be kept in mind, however. The FHFA does not believe it is prudent to mandate formal enforcement action simply because an FHLBank has been classified as a "supervisory concern." To do so would take away an important discretionary authority granted to the FHFA Director and other federal financial institution supervisors. There has been no demonstration of adverse effect in exercising that discretion to date. The FHFA Director should be able to decide whether a desired outcome can be best achieved with or without a formal enforcement action. It is not evident that a formal action should be taken if it is likely that the desired objective can be accomplished more effectively and efficiently without one.

The Report includes three recommendations. FHFA should:

1. Develop and implement a clear, consistent, and transparent enforcement policy that:
    a. Requires FHLBanks classified as a supervisory concern to correct identified deficiencies within specified timeframes;
    b. Establishes consequences for their not doing so; and
    c. Defines exceptions to the policy.

2. Develop and implement an automated reporting system that permits Agency managers and outside reviewers to assess readily examination report findings, planned corrective actions and timeframes, and their status.

3. Document consistently key activities, including recommendations to remove and replace senior officers and other personnel actions involving FHLBanks.

In response to those recommendations, FHFA will develop and implement a written enforcement policy by June 30, 2012. The FHFA will develop an automated information system for agency managers cataloguing examination findings, planned corrective actions, timeframes, and status, which we will introduce on a pilot basis by June 30, 2012 and target for full implementation by December 31, 2012. Finally, the FHFA will develop guidelines for documenting significant oral as well as written actions involving an FHLBank, including actions relating to the removal or replacement of senior officers. We will implement this policy as part of the enhancements to the management information system, which we target for full implementation by December 31, 2012.

APPENDIX B: FHFA-OIG'S RESPONSE TO FHFA'S COMMENTS

FHFA-OIG appreciates FHFA's agreement with the report's recommendations and establishment of timeframes for implementing them. FHFA-OIG notes, however, that FHFA also disagreed with some aspects of the draft report, such as the condition of the troubled FHLBanks, the impact of enforcement actions, and the appropriate quantum of decision-maker discretion.

Signs of Improvement. FHFA disagreed with text in the draft report stating that the troubled FHLBanks had experienced significant financial deterioration since 2008. FHFA states that each of the FHLBanks' financial conditions have improved over the past several years, and provided statistics supporting its assertion of improvement.

FHFA-OIG revised the draft report to reflect FHFA's comment that the four FHLBanks' financial condition has shown signs of improvement since 2008. FHFA-OIG also added text to the report body to reflect FHFA's view and noted that the Agency's oversight efforts likely contributed to these trends.

However, despite the improvements, FHFA classified these FHLBanks as having the most significant supervisory concerns among the 12 FHLBanks during the 2009 and 2010 examination cycles. For example, FHFA's 2010 Report to Congress describes significant financial and operational challenges facing these FHLBanks as shown in Figure 9.

Figure 9: Excerpts from FHFA's 2010 Report to Congress Regarding the Troubled FHLBanks[50]

FHLBank / Conditions of Concern	Examination Assessment
Boston FHFA found "significant weakness" in the FHLBank's private-label MBS portfolio. It noted that the FHLBank's financial condition and performance were both weak; retained earnings "still need to increase;" and "regulatory compliance is not adequate."	Level of risk: high for credit risk Quality of management: weak for market risk, operational risk, and corporate governance
Chicago FHFA reported that "key factors affecting Chicago's overall condition include continued weakness in corporate governance, market risk, credit risk, operational risk, and financial condition and performance." It listed a poor-quality portfolio of private-label MBS, a large proportion of "nonmission assets," and declining advance balances as among the factors influencing Chicago's financial condition and performance. Operations and controls are "deficient in key areas."	Level of risk: high for credit risk Quality of management: weak for market risk and corporate governance.
Pittsburgh FHFA reported that "continued weakness in private-label MBS portfolio and related credit risk position." It criticized retained earnings as "inadequate." As to risk management, the bank's performance "aligns more closely with its long-term plan's pessimistic scenario, which is characterized by ongoing recessionary trends on a sustained basis…." Pittsburgh's "return to a sound condition will take considerable time in the best of circumstances, and any new issues could be problematic."	Level of risk: high for credit and market risk Quality of management: weak for operational risk and corporate governance
Seattle FHFA reported that private-label MBS had occasioned "volatile credit losses." Other problems included inadequate retained earnings, a level of advances that had declined to its lowest point in over a decade, and a steep decline in 2009 and 2010 in the bank's "mission focus." FHFA also noted that credit risk "continues to be a major concern."	Level of risk: high for credit, market, and operational risk Quality of management: weak for credit risk and corporate governance

Further, FHFA-OIG believes that the establishment of a written enforcement policy would strengthen the Agency's actions by: (1) ensuring clarity as to the circumstances under which it will initiate formal enforcement actions; (2) ensuring that FHLBanks and their senior officers are held accountable for violating Consent Order terms or engaging in questionable risk-taking; and (3) facilitating independent reviews of FHFA's oversight activities.

Consequences of Current Enforcement Methods. FHFA also disagreed with FHFA-OIG's conclusion that the FHLBank of Boston's 2010 investment strategy illustrated the "potentially adverse consequences" of the Agency's approach to the oversight of FHLBanks. On the contrary, FHFA said that the FHLBank ceased the investment strategy after a meeting with the Examiner-in-Charge, and therefore, a formal enforcement action was unnecessary, as the desired supervisory outcome was achieved.

[50] FHFA, *Report to Congress 2010* (June 13, 2011), available at http://www.fhfa.gov/webfiles/21570/FHFA2010RepToCongress61311.pdf.

FHFA-OIG revised the report draft and added text reflecting FHFA's view that its oversight efforts in this case were appropriate and the reasons therefor. However, FHFA-OIG continues to view the example as illustrating the consequences of FHFA's not having developed a clear, consistent, and transparent enforcement policy. FHFA's apparent suggestion that the FHLBank cease the investment strategy and its issuance of the corresponding MRA took place after it had already incurred the risks associated with the strategy. Further, the MRA and the meeting with the Examiner-in-Charge lack the force of a formal enforcement action.

Flexibility. In developing an enforcement policy, FHFA believes it would not be prudent to mandate formal action simply because an FHLBank has been classified as having supervisory concerns. It believes that to do so would take away important discretionary authority granted to the FHFA Director and other federal financial institution regulators. FHFA also states that there has been no demonstration of an adverse effect resulting from its exercise of that discretion to date and that it is not evident that a formal action should be taken if it is likely that the desired objective can be accomplished more effectively and efficiently without one.

FHFA-OIG recognizes that discretion plays an important part in FHFA's supervisory and oversight processes. But FHFA-OIG also believes that the exercise of complete and undefined discretion with respect to troubled FHLBanks involves considerable risks as well. For example, as discussed above, FHFA-OIG believes that FHFA's oversight of the Chicago and Boston FHLBanks should have been more proactive in addressing the risks incurred.

Although it is within FHFA's purview to develop a new policy, FHFA-OIG suggests that the Agency consider its existing examination guidance as a starting point. The guidance states that FHFA generally will initiate formal actions when FHLBanks are classified as supervisory concerns. By defining the circumstances under which FHLBanks classified as supervisory concerns would be subject to enforcement actions through a written policy, FHFA would strengthen its oversight of such institutions. FHFA-OIG plans to monitor FHFA's development of the new enforcement policy and assess the final product's potential for meeting these objectives.

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