FHFA Sends Annual Report to Congress on GSEs, FHLBanks

By: Jann Swanson | Wed, Jun 13 2012, 3:29 PM

As required under the Housing and Economic Recovery Act (HERA), the director of The Federal Housing Finance Agency **(FHFA) submitted the agency's annual Report to Congress on the two government sponsored enterprises (GSEs)** for which it is responsible and for the Federal Home Loan Banking System (FHLBanks.) In addition to a lengthy recounting of the performance of the regulated entities during the course of 2011, FHFA also provided an assessment on their safety and soundness including information on any material deficiencies in their operations, their overall operational status, and an evaluation of their performance in carrying out their respective missions.

FHFA reported that it had conducted an examination of both GSEs as to their financial safety and soundness and overall risk management practices on a framework known as GSEER which stands for Governance, Solvency, Earnings, and Enterprise Risk which comprises credit, market, and operational risk management. The agency assigned rating of critical concern to both Fannie Mae and Freddie Mac in a number of areas and ratings of substantial concerns in others.

In the case of **Fannie Mae**, the report says that the GSE "exhibits **critical financial weaknesses** as evidenced by its poor performance and condition and prospects". Credit risk remains high but is somewhat mitigated by the higher quality of the single family book of business since 2009. Business operations are vulnerable to disruption, especially by human capital risk, and capital is wholly dependent on the support of the U.S. Treasury.

In the case of **Freddie Mac** FHFA says its credit risk remains high, the control structure is weak, human capital risk is elevated, and their capital is also wholly dependent on the Treasury.

The most significant risks facing Fannie Mae are credit risk, human capital risk, dependence on a legacy infrastructure that needs to be updated, and the need to execute the strategic plan for the conservator ships. Fannie Mae's management and its board were responsive throughout 2011 to FHFA findings and are taking appropriate steps to resolve issues the report says. However Fannie Mae must continue to identify and proactively reduce the risk and complexity of its business activities, focus on loss mitigation and foreclosure prevention, and maintain sound underwriting criteria for single family and multifamily portfolios.

FHFA assigns a limited concerns rating to Fannie Mae governance, an upgrade from the last examination and is working with the company to identify a new president and chief executive officer. This solvency or capital classification for ratings remains suspended as it has been since the beginning of conservatorship, but FHFA assigns earnings a critical concern rating. Fannie Mae's net losses increased in 2011 to $16.9 billion from $14 billion in 2010, driven primarily by high provisions for credit losses. New delinquencies along with further declining home prices resulted in a substantial increase in loan loss reserves. These reserves increased $10.6 billion to $76.9 billion in 2011. In addition a steep decline in long-term interest rates led to mark-to-market losses on derivatives used for hedging purposes.

Fannie Mae's credit risk also rates **a critical concern**. Although risk is high and the quality of risk management is adequate and the level of risk is decreasing the principal concerns are the credit characteristics of Fannie Mae's legacy 2005 to 2008 vintage single-family book of business, opportunity's to improve multifamily risk management, and continued weakness of its mortgage insurer counterparties.

FHFA assigns market risk a significant concern rating, an upgrade from 2010. Risk levels are high but the quality of risk management is adequate. The concerns are largely centered around increased balance sheet illiquidity because of the amount of distressed assets and whole loan portfolios resulting from loss mitigation activities, the need to strengthen attendant risk management practices, and the continued negative effects on earnings from the mark-to-market negative effects from derivative contracts. However liquidity and funding risks are low and the related risk management is adequate.

Operational risk is a significant concern, another upgrade from 2010. The level of risk is high and increasing but the quality of operational risk management is adequate although Fannie Mae needs to further strengthen project management. Its uncertain future, legacy information technology, manual processes that reduce its flexibility, and the requirement to implement the strategic plan keep operational and process risks at elevated levels. However the company improved risk management in 2011 by installing new operational risk leadership, implementing a risk management framework, centralizing the reporting structure and other innovations.

In conducting its examination of Freddie Mac, FHFA focused on matters previously identified as requiring attention and the board and management's response to deficiencies and weaknesses identified by internal and external audits.

Governance was considered a significant concern in the examination of Freddie Mac. The company's enterprise risk management structure continues to benefit from a recent redesign however management is finding it difficult to maintain an adequate control structure

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because of increased employee turnover and reliance on manual processes. The quality of information the Board of Directors receives has improved and FHFA is working with the board to identify a new CEO. The board should continue to focus on the key risks and issues facing Freddie Mac including the effect employee turnover has on its ability to manage its information technology.

Freddie Mac received a critical concerns rating on earnings. Total revenues increased slightly in 2011 and credit related expenses and mark-to-market losses on derivatives also increased. Derivative losses were offset partly by interest rate related gains on assets.

Credit risk was also considered a critical concern although it is decreasing and its risk management is considered adequate. As with Fannie Mae, the principal concerns center around the GSE's 2005 to 2008 vintage single family loans, coupled with underwriting and controls in the multifamily business line, weak mortgage insurer counterparties, and increased concentration of counterparty risk. FHFA said that the higher quality of Freddie's more recent single family business and management's success in loss mitigation is alleviating some concerns.

Market risk is considered a significant concern. The level is high relative to earnings and capital for the quality of risk management is adequate. The retained portfolio's growing proportion of illiquid assets is increasing risk because of the level of distressed assets and whole loan portfolios. These assets are less liquid, causing prepayment modeling difficulties and less reliable interest rate risk metrics. Human capital risk in the investment and capital markets group and continued negative effects from the mark-to-market derivative contracts are also a concern.

Operational risk is a critical concern as it is high and increasing and the quality of risk management needs improvement. Human capital risk and the dependence on legacy operational and information technology infrastructure are among the highest risks facing the GSEs.

Model risk is a significant concern but while the level is high it is stable. FHFA's concerns include the timeliness of model valuations and the efficacy of models in the current economic environment.

FHFA followed up a special review in October of 2011 with a directive requiring Freddie Mac to phase out its retained attorney network and to work with FHFA and Fannie Mae through the Servicing Alignment Initiative to develop and implement consistent requirements, policies, and processes for default and foreclosure-related legal services.

FHFA reported that as of the end of 2011, the FHLBanks exceeded the minimum leverage ratio by having at least 4 percent capital-to-assets. The weighted average regulatory capital to assets ratio for the system was 6.9 percent in 2011 compared to 6.5 percent in 2010. All FHLBanks were profitable for the year and the system's advance business continues to operate with no credit losses. However the quality of the FHLBanks' investments in private label mortgage backed securities (MBS) remains a significant concern. Exposure to such securities dropped by 20 percent during 2011 as did the credit charges associated with the securities.

During 2011 two FHLBanks were under consent orders because of their financial conditions. The FHLBank of Seattle saw deterioration in the value of its private label MBS starting in 2010 while Chicago had been operating under a cease and desist order since October 2007. Seattle remains under the enforcement action but Chicago's order was removed in early 2012.

The overall all scale of the FHL banks advance operations continued to decline in 2011 reaching $418 billion at year end compared to $479 billion at the end of 2010. Investments in private label MBS have adversely affected the overall operation of some banks reducing their ability to repurchase or redeem stock as the banks shrunk. FHFA has taken action where needed to address this problem.

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