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TO: Armando Falcon, Jr., Director, Office of Federal Housing Enterprise Oversight

/signed/

FROM: Ronald J. Hosking, Regional Inspector General for Audit, 7AGA

SUBJECT: The Office of Federal Housing Enterprise Oversight Exceeds Its 60 Percent
Statutory Requirement, But Has Weaknesses in Its Controls Over Allocating
Costs for that Requirement

HIGHLIGHTS

What We Audited and Why

We completed an audit of the Office of Federal Housing Enterprise Oversight (OFHEO). The Chairman of the Subcommittee on the Veterans Administration, U.S. Department of Housing and Urban Development, and Independent Agencies asked that we determine whether OFHEO was complying with a statutory requirement included in the Veterans Administration / U.S. Department of Housing and Urban Development Fiscal Year 2004 Appropriations Act. The Act requires OFHEO to use at least 60 percent of its total funds appropriated for fiscal year 2004 for the examination, supervision, and capital oversight of Fannie Mae and Freddie Mac, the Government Sponsored Enterprises.

We were also asked to determine whether OFHEO is using its funds to meet the 60 percent requirement in a manner consistent with other financial regulators of financial institutions, such as the Office of Thrift Supervision and the Federal Deposit Insurance Corporation. Further, the request asked us to determine whether the other regulators are using substantially more than 60 percent of their funding for the examination, supervision, and capital oversight of financial institutions.

What We Found

We concluded that OFHEO is exceeding the statutory requirement to use no less than 60 percent of its fiscal year 2004 appropriated funds for examination, supervision, and capital oversight of Fannie Mae and Freddie Mac. However, neither OFHEO nor HUD can be certain whether OFHEO has significantly exceeded the 60 percent requirement, as it has reported, because OFHEO cannot adequately support its method for allocating employee expenses, or the resulting use of funds reported in its annual reports and budget requests.

We further determined that OFHEO is allocating its funds using a method that is consistent with other financial regulators, including the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency. In addition, we concluded that OFHEO uses approximately the same percentage of its funds as these regulators for the purposes of examination, supervision, and capital oversight.

What We Recommend

We recommend that the Director, Office of Federal Housing Enterprise Oversight, ensure that his staff establishes and implements controls to ensure that OFHEO accurately allocates and reports its use of funding. These controls should include a reliable method of maintaining actual employee time spent on each strategic objective and a method of ensuring that actual expenses are reflected in its reporting of funds used.

For each recommendation without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-3. Please furnish us copies of any correspondence or directives issued because of the audit.

Auditee's Response

OFHEO generally agreed with our conclusions and recommendation. We provided the draft report to OFHEO on September 23, 2004, and OFHEO provided its written comments on September 28, 2004.

The complete text of OFHEO's response, along with our evaluation of that response, can be found in appendix A of this report.

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BACKGROUND AND OBJECTIVES

The Office of Federal Housing Enterprise Oversight (OFHEO) was established as an independent entity within the U.S. Department of Housing and Urban Development by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (Title 13 of Public Law 102-550). OFHEO is headed by a Director appointed by the President for a five-year term.

OFHEO's primary mission is to monitor Government Sponsored Entities, such as Fannie Mae and Freddie Mac. Fannie Mae and Freddie Mac are the nation's largest housing finance institutions. They buy mortgages from commercial banks, thrift institutions, mortgage banks, and other primary lenders, and either hold these mortgages in their own portfolios, or package them into mortgage-backed securities for resale to investors. These secondary mortgage market operations play a major role in creating a ready supply of mortgage funds for American homebuyers. Combined assets and off-balance sheet obligations of Fannie Mae and Freddie Mac were more than \$2.4 trillion at the end of 2000.

OFHEO's oversight responsibilities include:

- conducting broad-based examinations of Fannie Mae and Freddie Mac;
- developing a risk-based capital standard, using a "stress test" that simulates stressful interest rate and credit risk scenarios;
- making quarterly findings of capital adequacy based on minimum capital standards and a risk-based standard;
- prohibiting excessive executive compensation;
- issuing regulations concerning capital and enforcement standards; and
- taking necessary enforcement actions.

OFHEO is funded through assessments of Fannie Mae and Freddie Mac. OFHEO's operations represent no direct cost to the taxpayer. In its safety and soundness mission, OFHEO has regulatory authority similar to such other federal financial regulators as the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Board of Governors of the Federal Reserve System.

Our audit objective was to determine if OFHEO uses at least 60 percent of funding only for the examination, supervision, and capital oversight of Fannie Mae and Freddie Mac, including whether OFHEO can adequately support its allocation method, and whether the allocation is reasonable. Our sub-objectives were to determine if OFHEO calculates the percentage of funding used for examination, supervision, and capital oversight in a manner consistent with other federal financial regulatory agencies; and to determine whether other Federal financial regulators are using substantially more than 60 percent of their funding for the examination, supervision, and capital oversight of financial institutions.

RESULTS OF AUDIT

Finding 1: OFHEO Cannot Adequately Support its Method for Allocating Resources and Reporting its Use of Funds

OFHEO lacks adequate support for how it allocates employee expenses, and reports its use of funds in its annual reports and budget requests. Without reliable controls to ensure proper allocation of employee expenses, HUD and other interested parties cannot be certain that OFHEO is fully complying with the statutory requirement.

Inadequate Controls for Allocations and Reporting

According to OFHEO's current method of allocating its expenses to its strategic objectives, OFHEO is exceeding its requirement to use at least 60 percent of its funding for the purposes of examination, supervision, and capital oversight. However, OFHEO is not able to adequately demonstrate that its method for allocating employee expenses for those employees that work on more than one strategic objective accurately reflects the funds used to meet each of its strategic objectives.

OFHEO has three strategic objectives, one of which is directly related to examination, supervision, and capital oversight (Strategic Objective 1). Each fiscal year, OFHEO managers estimate the amount of funding needed by each of its 11 departments to accomplish each strategic objective. Of the 11 departments, OFHEO determined that five departments are nearly 100 percent dedicated to Strategic Objective 1, four departments have no direct responsibility for this objective, and two departments are partially responsible for meeting this objective. Within its departments, OFHEO has employees that perform functions on only one strategic objective, and has other employees that perform functions on more than one objective.

For expense allocation purposes, the Associate Directors (departmental heads) estimate the percentage of time they expect that each employee will incur on each strategic objective. As OFHEO incurs employee-related expenses, it allocates the expenses according to the Associate Directors' estimates. However, OFHEO has not implemented controls that would ensure that the estimates accurately reflect the employees' time and related expenses. Specifically, OFHEO's employees do not track their time in a time reporting system, nor has OFHEO conducted a time study to justify its percentage-of-time estimates. OFHEO employees simply prepare a limited report of the activities they accomplish each day, without indicating the amount of time spent on each activity, or the strategic objective the

activity met. Therefore, OFHEO cannot demonstrate that its allocation method for applying employee expenses to its use of funds is accurate and reasonable.

OFHEO uses a significant portion of its funds for employee compensation and related expenses. To determine the effect that employees performing functions on more than one strategic objective have on OFHEO's overall use of funds, we evaluated the staffing budgets and identified those employees with some estimated time spent on Strategic Objective 1, but less than 100 percent of their time estimated for this objective. We removed the budgeted expenses for these employees, and concluded that OFHEO would still meet its statutory requirement, even without including the efforts and expenses related to the percentage-of-time employees. Therefore, at this time, these employees do not affect OFHEO's ability to meet its requirement regarding use of funds for examination, supervision, and capital oversight.

Although the effect of percentage-of-time employees does not currently cause OFHEO to cease meeting its statutory requirement for use of its funds, OFHEO could be at risk if it encounters future changes in its organizational structure, or staffing assignments. It is feasible that future changes could cause OFHEO to no longer meet its statutory requirement if it does not implement adequate controls for allocating and reporting employee expenses.

Further, OFHEO reports its use of funds in its annual reports and budget requests. Because OFHEO cannot adequately support its allocation method for employee expenses, HUD and other interested parties cannot be assured that the reported use of funds is accurate.

OFHEO's Method is Comparable to Other Financial Regulators

OFHEO's method of allocating expenses to its three strategic objectives is comparable to the method used by other federal financial regulators, including OFHEO's method for allocating expenses related to its responsibilities for examination, supervision, and capital oversight.

OFHEO begins its yearly process by allocating its funds to each of its 11 departments, based on the line-item budgets prepared by the Associate Directors. Within each department, the Associate Directors develop departmental budgets that allocate expected expenses to each strategic objective. As OFHEO incurs direct expenses (costs that can be specifically attributed to a project or activity), OFHEO charges the direct expenses to the applicable department, and to the specific strategic objective related to each expense.

For indirect costs, OFHEO suspends these expenses until the end of the month, and then allocates the indirect costs, based on the percentage of direct costs applied to each strategic objective within each department. Therefore, OFHEO adjusts its budgets and actual expense information each month, and reports its percentages of use of funds at the end of the year, based on actual expenses incurred and applied to each strategic objective.

We compared OFHEO's allocation method to the method used by the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency. We concluded that OFHEO's allocation method is comparable to these agencies, as these agencies also adjust their percentages of use of funds, based on actual expenses, before reporting the percentages in their annual reports.

OFHEO's Usage Percentage is Comparable to Other Regulators

OFHEO's use of funds for examination, supervision, and capital oversight is comparable to other financial regulators, according to its reported percentages. For fiscal year 2003, OFHEO reported its use of funds for Strategic Objective 1 as 80.38 percent. For this same fiscal year, the Office of Thrift Supervision reported 83 percent, the Office of the Comptroller of the Currency reported 91.69 percent, and the Federal Deposit Insurance Corporation reported 63.3 percent. The Federal Deposit Insurance Corporation's percentage was lower primarily because it has two other substantial programs that it conducts.

For fiscal year 2004, OFHEO projects its percentage of use for Strategic Objective 1 to be 84 percent. As of June 30, 2004, OFHEO is reporting that it has used 74.38 percent of its funds for Strategic Objective 1. According to discussions with the other financial regulators that we considered, the Office of Thrift Supervision projects that it will use 87 percent, the Office of the Comptroller of the Currency projects that it will use 88.9 percent, and the Federal Deposit Insurance Corporation projects that it will use 59.8 percent of their funds for examination, supervision, and capital oversight.

As previously explained, because OFHEO lacks controls over the allocation of percentage-of-time employees, the 80.38 figure that OFHEO reported for fiscal year 2003 or its usage figure as of July 31, 2004 may not be accurate.

Conclusion

OFHEO is meeting the statutory requirement to use at least 60 percent of its funding for the purposes of examination, supervision, and capital oversight. However, HUD and other interested parties cannot be certain whether OFHEO has significantly exceeded the 60 percent requirement, as OFHEO has reported in its annual reports and budget requests. While OFHEO may currently be exceeding the requirement, any future changes in its organizational structure, or staffing assignments, may cause OFHEO to cease meeting the statutory requirement if it does not implement adequate controls over allocating its resources and reporting its use of funds. We recommend that OFHEO establishes and implements controls to ensure that OFHEO accurately allocates and reports its use of funding. This corrective action could include controls that would validate the numbers used to allocate funds, such as conducting time studies or requiring more detailed time reporting by employees.

Recommendation

We recommend that the Director, Office of Federal Housing Enterprise Oversight, ensure that his staff:

- 1A. Establishes and implements controls to ensure that OFHEO accurately allocates and reports its use of funding.

SCOPE AND METHODOLOGY

The audit covered OFHEO's fiscal year 2003, which began October 1, 2002, and fiscal year 2004 through July 31, 2004.

To determine whether OFHEO was complying with the statutory requirement to use at least 60 percent of its total funds appropriated for fiscal year 2004 for the examination, supervision, and capital oversight of Fannie Mae and Freddie Mac, we reviewed federal regulations and legislation, and OFHEO's policies and procedures. We also reviewed OFHEO's organizational charts and staffing information, descriptions of its departmental missions, and employee position descriptions within each department. In addition, we interviewed OFHEO staff in each department having examination, supervision, and capital oversight responsibilities. We also reviewed OFHEO's financial records, including budgets, financial statements, and reports of obligations and funds status.

To determine whether OFHEO is using its funds to meet the 60 percent requirement in a manner consistent with other financial regulators of financial institutions, we interviewed OFHEO staff; and reviewed its financial records, including budgets, financial statements, and reports of obligations and funds status. We also interviewed staff of other regulatory agencies, including the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the Federal Reserve Board. In addition, we obtained documentation of the method these federal financial regulators use to allocate their expenses.

To determine whether the other federal financial regulators are using substantially more than 60 percent of their funding for the examination, supervision, and capital oversight of financial institutions, we interviewed OFHEO staff, as well as staff from other regulatory agencies. We also reviewed the fiscal year 2003 annual reports for OFHEO, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision.

We performed audit work from June 15, 2004, through September 10, 2004. The audit was conducted in accordance with generally accepted government auditing standards.

INTERNAL CONTROLS

Internal Control is an integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved:

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

We determined the following internal controls were relevant to our audit objectives:

- Controls over the allocation of employee expenses.
- Controls over the reporting of usage of funds.

We assessed the relevant controls identified above.

A significant weakness exists if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet the organization's objectives.

Significant Weaknesses

We did not identify any significant weaknesses.

APPENDIX

Appendix A

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments



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September 28, 2004

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Dear Regional Inspector General Hosking;

On behalf of OFHEO, I am providing formal comments on the report The Office of Federal Housing Enterprise Oversight Exceeds Its 60 percent Statutory Requirement, But Has Weaknesses in its Controls Over Allocating Costs for that Requirement. Before commenting on your report, I would like to express our appreciation for the professionalism exhibited by your staff that performed the audit, and the opportunity to discuss issues with them during the exit conference on September 24. While our time frame for providing comments back to you was very short, we have made every effort to accommodate your desire to issue this report by September 30, 2004.

I am pleased that you have concluded that OFHEO is exceeding the statutory requirement to use no less than 60 percent of its fiscal year 2004 appropriated funds for examination, supervision, and capital oversight of Fannie Mac and Freddie Mac. We estimate that 84 percent of our resources will be used for these activities in FY 2004. We note that this minimum threshold spending and reporting requirement for OFHEO is unique among financial regulators.

Your report also concludes that OFHEO is allocating its funds using a method that is consistent with other financial regulators, and that we use approximately the same percentage of our funds as these regulators for purposes of examination, supervision, and capital oversight. We are pleased with these findings as they confirm our understanding of how other financial regulators utilize their funds for similar regulatory programs.

Comment 1

OFHEO estimates and reports its costs associated with each of its strategic goals. The costs associated with the examination, supervision, and capital oversight of the Enterprises is routinely captured as a part of this process (our first strategic goal). Since OFHEO is organized largely along functional lines, the majority of personnel costs are easily allocated to the examination, supervision, and capital oversight of the Enterprises. However, some OFHEO employees spend a portion of their time working on activities captured under other strategic goals. In this case, line managers estimate the amount of time each of these employees spend on other strategic goals.

Your report correctly points out that we do not have an employee time tracking system that would be capable of validating these estimates. We have concluded that such a system would be very expensive to develop and operate, and any resulting benefits would be small at best. Your suggestion that we conduct time studies to validate our estimates would be less burdensome. Therefore, we will design and conduct a time usage study at OFHEO to validate the estimates made by our line managers. In the absence of such validation, we continue to believe that these estimates are materially accurate.

Tracking the direct costs associated with examination, supervision, and capital oversight; unfortunately, does not describe the full range of important work that OFHEO undertakes as the safety and soundness regulator for these two Enterprises. OFHEO has chosen to describe our work as a safety and soundness regulator through the accomplishment of three strategic goals contained in our strategic plan (see WWW.OFHEO.GOV). These goals recognize that our work as a safety and soundness regulator has collateral benefits to the public and to the housing and housing finance markets and that these benefits are worthy of recognition and reporting. OFHEO's three strategic goals are:

1. Ensure the Enterprises comply with safety and soundness standards, are adequately capitalized, and comply with other legal requirements;
2. Enhance public understanding of the nation's housing finance system; and
3. Contribute to Federal efforts to promote efficient and effective financial markets and homeownership

As your report recognizes, our first strategic goal directly relates to the examination, supervision, and capital oversight of the Enterprises and this is where the bulk of the agency's resources are used. However, the activities that we capture under strategic goals two and three are intrinsically related to achieving strategic goal one in that they also support the agency's supervision and regulation of the Enterprises, but they are not counted in the total that we are required to report to Congress. Consequently, OFHEO could report the use of all of its resources under a single strategic goal encompassing financial safety and soundness standards, determining capital adequacy, and complying with all relevant legal requirements.

Ronald J. Hosking
September 28, 2004
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For example, activities supporting the achievement of strategic goal two include the production and distribution of OFHEO's Quarterly House Price Index (HPI) and annual report to Congress. OFHEO's research efforts, including the 2003 report "Systemic Risk: Fannie Mae, Freddie Mac, and the Role of OFHEO" are also captured under strategic goal two. The HPI is used as an input in determining risk-based capital requirements for the Enterprises, and we are required by law to report the results and conclusions of our annual examinations in our annual report to congress. Research is important because it helps to inform and improve the agency's supervisory and regulatory activities.

Activities captured under strategic goal three include the agency's interaction with other financial regulators on interagency task forces and meetings covering topics ranging from mortgage fraud to the capital treatment of specific assets and liabilities. In addition, the agency's efforts to ensure that the Enterprises have sufficient financial disclosure of information to the markets are also captured under this goal. Clearly these activities also have an impact on the agency's supervision and regulation of Fannie Mae and Freddie Mac.

I believe all of the agency's activities contribute to making OFHEO an effective safety and soundness regulator for Fannie Mae and Freddie Mac.

Sincerely,



Armando Falcon, Jr.
Director

OIG Evaluation of Auditee Comments

Comment 1 We commend OFHEO's commitment to design and conduct a time usage study. This type of effort would adequately address the concerns noted in this report.