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Report to the Chairman, Subcommittee on Capital Markets, Securities and Government-Sponsored Enterprises, Committee on Banking and Financial Services, House of Representatives

September 1998

FEDERAL HOUSING FINANCE BOARD

Actions Needed to Improve Regulatory Oversight

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The Honorable Richard H. Baker
Chairman, Subcommittee on Capital Markets,
Securities and Government-Sponsored Enterprises,
Committee on Banking and Financial Services
House of Representatives

Dear Mr. Chairman:

This report responds to your request that we review the Federal Housing Finance Board's (FHFB) safety and soundness and mission compliance oversight. Our objectives were to evaluate (1) FHFB's annual safety and soundness and mission compliance examinations of FHLBanks, (2) other aspects of FHFB's oversight, and (3) the status of FHFB's involvement in System business.

We are sending copies of this report to other appropriate congressional committees and executive branch agencies, including the Secretary of the Treasury, the Secretary of the Department of Housing and Urban Development, and the Acting Director of the Office of Federal Housing Enterprise Oversight. We will also make copies available to others on request.

This report was prepared under the direction of Richard J. Hillman, Associate Director, Financial Institutions and Markets Issues, who may be reached on (202) 512-8678 if you or your office has any questions. Major contributors are listed in appendix II.

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Executive Summary

Purpose

The Federal Housing Finance Board (FHFB) was established in 1989 as the regulator of the Federal Home Loan Bank System (System), a government-sponsored enterprise (GSE) whose mission is to support housing finance. The System raises funds through the issuance of consolidated debt obligations (primarily short-term), which exceeded $2 trillion during 1997. At year-end 1997, about $304 billion of consolidated debt remained outstanding. The System's assets at year-end 1997 totaled about $349 billion. FHFB's primary statutory duty is to ensure that the Federal Home Loan Banks (FHLBank) operate in a financially safe and sound manner. FHFB's safety and soundness oversight function is important to taxpayers because of the size of the financial obligation of the FHLBank System and the possibility, given the System's public purpose, that the federal government might provide assistance if the System became troubled.

In addition to responsibility for FHLBanks safety and soundness, the Federal Home Loan Bank Act (FHLB Act) assigns FHFB three other duties, "to the extent they are consistent with its primary duty." These are (1) supervise FHLBanks, (2) ensure that FHLBanks carry out their housing finance mission, and (3) ensure that FHLBanks remain adequately capitalized and able to raise funds in the capital markets.[1] In earlier work, GAO has consistently expressed concern that FHFB's involvement in corporate governance and System business functions may undermine FHFB's regulatory independence and objectivity.[2] FHFB has recognized the inherent conflict in the combined roles of regulation and governance and is devolving to the FHLBanks some System management and governance authorities. This report responds to a request from the Chairman of the Subcommittee on Capital Markets, Securities and GSEs, House Committee on Banking and Financial Services that GAO review FHFB's safety and soundness and mission-related oversight of the FHLBanks.

The specific objectives of this report are to evaluate (1) FHFB's annual safety and soundness and mission-compliance examinations of the FHLBanks; (2) other aspects of FHFB's oversight, including off-site monitoring and supervisory enforcement; and (3) the status of FHFB's involvement in System business.

[1] 12 U.S.C. § 1422a(3)(B).

[2] Government-Sponsored Enterprises: Framework for Limiting the Government's Exposure to Risks, (GAO/GGD-91-90, May 22, 1991) and Federal Home Loan Bank System: Reforms Needed to Promote Its Safety, Soundness, and Effectiveness (GAO/GGD-94-38, Dec. 8, 1993).

Background

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) created FHFB as an independent agency within the executive branch, with a five-member board of directors (Board). FHFB is organized into 10 offices; however, the functions of 3 offices are most relevant to this report. The primary responsibility of the Office of Supervision (OS) is to ensure the safety and soundness and mission-compliance of the FHLBanks; it conducts the federally mandated annual examinations of all FHLBanks. The Office of Policy (OP) and Office of General Counsel provide assistance to and share oversight responsibility with OS.

The System consists of 12 regional FHLBanks, each with its own board of directors and management, that are cooperatively owned and controlled by member institutions in their districts. However, each FHLBank is jointly and severally liable for the System's consolidated debt.[3] FHLBanks support housing finance by making loans, called advances, to owner-members and eligible nonmember mortgagees on the security of mortgages and other pledged collateral. In addition, FHLBanks make advances to smaller community lenders that lack diverse funding sources. At year-end 1997, advances accounted for 58 percent of System assets; investments accounted for 40 percent (the remainder was cash, buildings, etc.).

Like other financial institutions, FHLBanks face risks from their advances and investments. FHLBanks use a variety of techniques to manage these risks. The primary risks include losses from changes in interest rates, a borrower or counterparty failing to perform on an obligation, and poor internal controls. Also, FHFB and FHLBank officials have supported legislative initiatives that would expand the System's mission and eligible types of collateral which would result in additional business risk for the System.

In addition to the responsibilities discussed earlier, the FHLBank Act explicitly gives FHFB responsibility for a number of business or corporate-governance-type duties for the System, including issuing the System's consolidated obligations and approving FHLBank dividends, bylaws, the banks' initial selection of FHLBank presidents, and the appointment of six members of each FHLBank board including the chairs and vice chairs. In expressing concern that such involvement in System business compromises FHFB's regulatory objectivity, as discussed earlier, GAO has also said that if mission and safety and soundness oversight are combined in the same regulatory body, the regulator should not have a

[3]That is, should one or more FHLBank be unable to repay its participation in the consolidated obligations, each of the other FHLBanks could be called upon to repay a portion of such obligations.

role, other than oversight, in the governance or corporate affairs of the GSE. The central coordination of GSE activities should be carried out by the GSE, not by the regulator.[4]

The primary responsibility of FHFB's examination function is to assess the safety and soundness of the FHLBanks. After determining that FHFB's examination standards were comparable with those of other financial regulators, GAO compared FHFB's practices with its standards. To do that, GAO reviewed a judgmental sample of 1996 and 1997 examination reports and supporting work papers for six FHLBanks. FHLBanks in the sample accounted for about 60 percent of System assets as of year-end 1996. GAO also compared FHFB's enforcement policy and monitoring program with criteria previously articulated by GAO. Finally, GAO reviewed FHFB's effort to devolve its role in governance activities to FHLBanks and the extent of FHFB's ongoing involvement in System business.

Results in Brief

FHFB did not ensure that the annual examinations GAO reviewed met internal FHFB standards for assessing the safety and soundness of FHLBanks. While each of the 12 sampled examinations included reviews of FHLBank policies and procedures to mitigate interest-rate and credit risk, the examinations did not include assessments of those areas that FHFB and others have identified as vital in evaluating an institution's risk-management capabilities. Further, after identification of deficiencies in consecutive examinations of one FHLBank (inadequate segregation of duties), examinations were not expanded to investigate the extent of related potential problems, as required by FHFB standards. With regard to examining for mission compliance, the agency acknowledges having no examination policies or procedures outside of its reviews of the special affordable housing and community investment programs, to determine whether or to what extent FHLBanks were supporting housing finance. These special programs that were examined represented less than 1 percent of System assets at year-end 1997. Since 1997, FHFB has taken several steps to develop procedures and mechanisms to better ensure mission compliance.

Additional weaknesses existed in off-site monitoring and supervisory enforcement guidance. In 1997, OS suspended monthly off-site monitoring of FHLBank activities due to staffing constraints. Examiners primarily reviewed off-site information for each FHLBank's condition and activities

[4]GAO/GGD-91-90, GAO/GGD-94-38, and Government-Sponsored Enterprises: Advantages and Disadvantages of Creating a Single Housing GSE Regulator (GAO/GGD-97-139, July 9, 1997).

during their annual preexamination planning. Although OS and OP prepared several periodic reports that tracked specific bank activities, they did not coordinate their activities. FHFB lacked clear policies and procedures regarding corrective actions for specific FHLBank conditions and failed to specify what actions would be taken if certain conditions existed. In addition, FHFB's statutory enforcement authority is not clearly enumerated other than the authority to remove for cause a FHLBank director, officer, employee, or agent.

GAO found that FHFB has undertaken activities that further involve it in System business. In GAO's view, some of FHFB's activities may undermine FHFB's independence as a regulator. While FHFB began to devolve certain authorities, within limits, to FHLBanks in 1995, FHFB continues to promote and coordinate System activities. For example; (1) FHFB's strategic plan primarily focuses on and promotes changes to enhance FHLBanks' business performance with less emphasis on its role in providing safety and soundness oversight; (2) FHFB proposed a plan to involve itself in developing new services, products, and partnerships with housing advocates; and (3) the FHFB Chairman acts as a central coordinator and participates in Systemwide meetings with FHLBank chairs and vice chairs.

FHFB's involvement in promoting System programs and projects that it subsequently evaluates for mission compliance and safety and soundness could complicate FHFB's primary duty as safety and soundness regulator and may prompt questions about its objectivity. FHFB views these activities as consistent with its primary duty of ensuring the System's safety and soundness, as well as ensuring mission compliance. GAO maintains its position that regulation of the System could be done more effectively by an arm's-length regulator (preferably one for all the housing GSEs) that is not involved in System business.

Principal Findings

FHFB Did Not Ensure Examinations Met FHFB's Standards

FHFB, other financial regulators, and GAO have identified the following areas for review to be among those considered critical in evaluating an institution's risk-management capabilities: assessments of board of director and management oversight, assessments of internal control systems, and testing to determine the reliability of internal audits upon which examiners rely in conducting a review. While none of the

examinations GAO reviewed fully assessed more than one of the areas, all failed to assess board of director oversight. These critical areas should be reviewed during every annual examination.

OS officials said that because OS staff resources were inadequate to fully evaluate an FHLBank's system of internal controls, OS provided only limited assurance of the adequacy of internal control systems. Further, these officials said OS often does not formally assess oversight of boards of directors and managers or determine the reliability of internal audits because of time and resource constraints and the stability of the management and auditing functions of the FHLBanks. Rather, the examinations focus on specific problems that arise and then determine the role of the FHLBank board and management in relation to those problems.

In each of the examinations GAO reviewed, more than half of the areas of examination were not conducted in accordance with examination procedures in FHFB's examination manual (that is, examiners did not complete the examination program in the manual or use the manual's examination questionnaires, or both). FHFB examiners explained that they did not have time to complete the procedures described in the manual and that the manual's procedures often were not useful for certain parts of the examination. In addition, GAO found that examiners did not document the examination procedures or support for conclusions drawn from their work, as required by FHFB standards, for most areas covered in the examination.

In 11 of 12 examinations GAO reviewed, some planned examination procedures were not completed during the course of the examination. In each of the cases, examiners indicated in the work papers that those procedures were not completed due to time constraints. In two cases examiners curtailed the scope of examinations but provided no explanation for the change in scope in the work papers. OS officials said that limited examination staff resources often resulted in scope reductions, and that such reductions occurred in parts of the examination that examiners believed involved less risk.

Examiners also failed to expand the examination when potentially serious problems were found. Examiners found potentially serious internal control problems at consecutive examinations of a FHLBank but did not expand their review to determine whether there were additional problems. Both cases involved an inadequate segregation of duties in a FHLBank's

investment activities—an internal control problem that has allowed severe problems to cause losses at other financial institutions.

Although FHFB was established in 1989 and is responsible for ensuring FHLBank compliance with its housing mission, FHFB's examination program has not assessed FHLBank compliance with its housing finance mission. Rather, mission compliance oversight includes examiners reviewing FHLBanks' compliance with affordable housing program and community investment program requirements—two programs established by FIRREA that represented less than 1 percent of the System's total assets in 1997; and, beginning in 1997, annual reports from FHLBanks that describe new products, pricing, and investment partnerships. FHFB has taken several steps recently to better ensure mission compliance. For example, FHFB has (1) commissioned a study to, among other things, assist it in developing procedures to oversee FHLBank mission compliance; (2) tested draft examination procedures to ensure mission compliance; and (3) issued amended regulations for FHLBank member community support requirements as well as FHFB's oversight activities to ensure member compliance with those requirements.

Weaknesses Exist in Other Areas of FHFB's Regulatory Oversight Program

Recognizing the need for timely monitoring, OS developed a regulatory oversight and off-site monitoring system in 1996 that required monthly reviews of FHLBank data, including minutes from the board of directors meetings, internal audit reports, and financial data. In 1997, monthly monitoring was suspended due to staff constraints. GAO found that OS examiners primarily reviewed the periodic data submitted by the FHLBanks to FHFB as part of their preparation for annual FHLBank examinations. OS also prepared periodic reports on issues, such as financial management policy compliance and interest-rate risk exposures, financial trends, and debt-issuance activities. In addition to OS's reports, OP produced several periodic reports, such as the quarterly profile report that tracks FHLBank statistics including FHLBank membership, affordable housing program, unsecured credit, and individual FHLBank profiles. Both offices shared their reports with the Board but they did not coordinate their monitoring activities.

The statute authorizes FHFB to "promulgate and enforce regulations and orders," but only delineates one enforcement power for FHFB—the authority to remove or suspend for cause FHLBank directors, officers, employees, or agents. FHFB officials said they believe that the general provision in the statute enables the FHFB to take corrective action, if

necessary. Officials said they consider examination reports that include examination "findings" requiring corrective action, the equivalent of an enforcement order. GAO found that FHFB lacked clear policies and procedures regarding the use of corrective actions and failed to specify what actions would be taken if certain conditions existed. In addition, GAO believes, as it recommended in the past for any GSE regulator, that the statute should specifically give FHFB all enforcement authorities granted other regulators. Further, in past GSE work, GAO identified certain principles necessary for effective enforcement of rules and regulations.[5] Included in these principles are that certain enforcement actions should be mandatory when previously specified conditions are met and should be the result of a clear and reasonable process. FHFB needs a well-defined mechanism in place to address serious problems if they were to arise.

FHFB Remains Involved in System Business

Consistent with its 1993 report on the System, GAO continues to find that FHFB combines safety and soundness and System business functions.[6] In certain instances, the FHLBank Act provides for FHFB's involvement in System business. For example, under the FHLBank Act, FHFB is the legal issuer of the System's consolidated obligations. The act further requires that FHFB approve FHLBank dividends, bylaws, and selection of FHLBank presidents. In 1994, FHFB started a project to identify and devolve certain business or governance and management activities to the FHLBank boards. Since that time, numerous activities have been devolved to FHLBanks, within specified limits. Devolved activities include the authority to establish presidents' salaries and incentive plans, approve affordable housing program applications, determine the compensation of FHLBank directors, and set FHLBank performance targets. Activities identified by FHFB yet to be devolved include the authority to approve dividends, certain general administrative matters, and credit policies.

Also, as previously reported in 1993, GAO continues to find that FHFB is a promoter and coordinator for the System. That is, FHFB becomes involved beyond the business functions assigned to it in statute. Although the Chairman believes that this activity is consistent with his statutory responsibilities to ensure the System's safety and soundness and mission compliance, GAO continues to believe that such involvement in the System's business functions may inhibit FHFB's ability to independently assess System activities. Undertaking such activities may undermine FHFB's independence and lead to questions about its objectivity. FHLBanks

[5]GAO/GGD-91-90.

[6]GAO/GGD-94-38.

have established two groups with the potential to provide central coordination and promotion for the System. Nevertheless, FHFB officials view promotion as part of FHFB's role as a regulator. FHFB's 5-year strategic plan illustrates the prominence of the coordination and promotion roles in agency operations. Of the plan's nine objectives, one addresses the examination function; and five address changes FHFB advocates to enhance FHLBank performance, such as expanding the acceptable uses for advances and eligible collateral to include small business loans. Of the other three objectives, two address the devolution effort; and one deals with disseminating public information about the FHFB's performance.

GAO cited other examples of FHFB's promotion and coordination activities. For example, GAO identified the FHFB Chairman's actions in coordinating and participating in periodic meetings with FHLBank chairs and vice chairs including the coordination of congressional lobbying efforts to be inappropriate for a regulator. In particular, GAO noted that although other regulators consult with Congress about and testify on possible or pending legislation, the FHFB is in a strong position to influence the FHLBank chairs and vice chairs because it appoints them. GAO noted that FHFB should have regulatory authority over business functions to ensure safety and soundness and mission compliance but emphasized that having such regulatory authority differs from being a participant in System business on a regular basis and from promoting a particular program or activity over other mission-related activity. A regulator, according to GAO, must strike a balance between fostering mission compliance and promoting activities it prefers.

Single Housing Regulator Would Have Advantages Over FHFB

GAO noted in previous work that establishing a single, independent, arm's-length regulator for the System and the other two housing GSEs[7] would better ensure objective regulation of the System and create some economies, efficiencies, and valuable synergies among regulatory staff. GAO recommended combining safety and soundness oversight of the three housing GSEs in a 1993 report and, in a 1997 report, identified advantages to a single regulator—one that would also have mission oversight responsibility.[8] A single regulator would be more independent and objective than separate agencies because it would not be affiliated with

[7]The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) are regulated for safety and soundness by the Office of Federal Housing Enterprise Oversight (OFHEO), an independent regulator within the Department of Housing and Urban Development, which oversees the GSEs' mission compliance.

[8]GAO/GGD-94-38 and GAO/GGD-97-139.

one particular GSE, dependent on that GSE for its continued existence, and thus subject to its influence. A single regulator would be more prominent in government than FHFB is alone. This should further enhance a single regulator's independence and make it more competitive in attracting and retaining staff with appropriate expertise and experience.

Recommendations

To strengthen FHFB in its primary oversight role as the safety and soundness supervisor of the FHLBank System, GAO recommends that FHFB

(1) ensure that critical aspects of FHLBank operations are reviewed as part of every FHFB examination;

(2) ensure that examiners follow the guidance and complete the appropriate examination procedures described in the examination manual;

(3) adequately document the work performed and conclusions drawn during examinations; and

(4) more clearly articulate and document its current enforcement mechanisms, policies, and procedures.

Matters for Congressional Consideration

GAO continues to support its 1994 and 1997 positions that a single housing GSE regulator be created to oversee the safety and soundness and mission compliance oversight of the housing GSEs. While considering this action, Congress may want to consider taking interim action to redirect FHFB's attention to its primary role as the System's safety and soundness regulator by making FHFB an arm's-length regulator, as in the case of other GSE regulators. This could be achieved by ensuring that its statutory duties do not involve FHFB in any System business. In addition, Congress may want to consider giving FHFB specific enforcement authorities it has provided to other GSE regulators.

Agency Comments and Our Evaluation

GAO requested comments on a draft of this report from FHFB, which provided written comments that are discussed at the end of chapters 2 and 4. In addition, FHFB's comments are printed in appendix I, as well as GAO's response to specific comments. FHFB disagreed with GAO's assessment of FHFB's safety and soundness and mission oversight performance. Nevertheless, FHFB believed that the draft report had a number of useful suggestions for improving the quality of its examination process and said it

would evaluate and implement them where appropriate. FHFB framed its disagreements with the draft report around three major themes.

First, FHFB stated that the scope of GAO's work, focusing primarily on examination activities, was "very limited" and that GAO inappropriately drew "overly broad, inaccurate and unsubstantiated conclusions" about FHFB's performance. FHFB maintained that GAO assumed examinations were its "sole safety and soundness tool." Therefore, GAO's "work cannot support any conclusions regarding the overall effectiveness of the Finance Board's safety and soundness oversight."

GAO believes that its scope was appropriate and consistent with the objectives of its review. The congressional requester also agreed to the scope of work, which focussed not only on FHFB's examination activities but also its off-site monitoring efforts and supervisory enforcement program (see ch. 3). GAO believes that regular, comprehensive on-site examinations are the cornerstone of any financial institution regulator's oversight program. Without such periodic reviews of operations, a regulator cannot be assured that an institution has proper controls in place, is complying with relevant laws and regulations, or that its board and management are effectively managing risks and complying with safety and soundness and mission-related requirements.

GAO emphasized that off-site monitoring, fully integrated with the examination program, is also vital to effective oversight. Such monitoring should be timely, focus on previously identified problems, and identify potential problems. Off-site monitoring between annual examinations is especially important as the demographics of the System change, FHLBanks undertake new activities, and economic conditions change. GAO stated that clear policies and procedures for a regulatory enforcement program are essential to FHFB's ability to deal promptly and effectively with any serious problems that might arise. GAO's review identified weaknesses in FHFB's examination, off-site monitoring, and enforcement programs and recommended improvements. Thus, based on its review of all of these areas, GAO concluded that FHFB's oversight of the System needs to be strengthened to provide on-site assurance that FHLBanks are effectively managing risk and, thus, are operating in a safe and sound manner.

Second, FHFB said that in reaching its conclusions GAO did not consider the proper statutory and regulatory context that makes the System a conservative, low-risk, and well-capitalized GSE. FHFB emphasized that the safety and soundness prescribed for FHLBanks in statute, regulation, and

policy are conservative and result in a high credit rating for System obligations (without, according to FHFB, "reference to its implied government backing").

GAO does not disagree that the current standards are conservative and had already stated in its draft report that none of the FHLBanks had ever experienced a credit loss. GAO acknowledged that the System's financial policies, practices, and condition may result in a high credit rating. GAO had noted in the draft report, and in past reports, that the size of the System's obligations and its public purpose make regulatory oversight especially important because of the possibility the government might provide assistance, as it has done in the past for other GSEs, if the System became troubled. In addition, GAO noted that the government has afforded a priority lien status to FHLBank advances made to FDIC insured members. Aside from the need for FHFB to properly oversee compliance, as stated above, GAO noted that the environment within which the System operates can change due to such external factors as legislation, demand for System products, or membership. Although the FHLBanks may have a relatively low-risk profile today, conditions can change; and the System needs a well-equipped and vigilant regulator to ensure a continued low-risk profile.

GAO agrees with FHFB that corporate governance, annual independent audits, and internal audits are important elements in helping ensure the System's safety and soundness. However, GAO noted that these elements cannot substitute for judicious oversight in protecting the government's interest in a GSE. GAO emphasized that System capital, which is based on stock purchases required of members and is not risk based, is less suitable for absorbing losses than other forms of capital because it is redeemable by members, under certain circumstances.

Third, FHFB stated that GAO mistook its authorization of certain System activities and identification of ways for FHLBanks to fulfill their mission as intrusions into System business. GAO agrees that FHFB should have regulatory authority over business functions to ensure safety and soundness and mission compliance but emphasizes that having such regulatory authority differs from being a participant in System business. A regulator, GAO believes, must strike a balance between fostering mission compliance and promoting activities it prefers. In general, FHFB's comments reflect its general disagreement with GAO's view that a regulator's role of ensuring mission compliance should be limited to defining proper mission related activities in regulation and then ensuring—through a combination of on-site examinations, off-site

monitoring, and other oversight efforts—that the GSE is complying with the rules. FHFB characterized this as a "passive" view of its role as a mission regulator.

FHFB stated that its role by law is to actively foster what it sees as appropriate System activities. Because FHFB is ultimately responsible for regulating the projects and programs it has promoted, however, GAO is concerned that FHFB's strategy of "actively encouraging" the FHLBanks' development of mission-related assets raises questions about its independence and objectivity. GAO recognized the difficulty in developing a mission oversight mechanism and acknowledged steps FHFB took recently to develop such a regulatory mechanism. These matters are addressed in chapters 2 and 4 of this report.

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Abbreviations

AHP	Affordable Housing Program
CIP	Community Investment Program
DBIMS	District Bank Information Management System
FDIC	Federal Deposit Insurance Corporation
FHFB	Federal Housing Finance Board
FHLBank Act	Federal Home Loan Bank Act
FHLBank	Federal Home Loan Bank
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act
FMP	Financial Management Policy
FSLIC	Federal Savings and Loan Insurance Corporation
GARP	generally accepted risk principles
GSE	government-sponsored enterprise
HUD	Department of Housing and Urban Development
OF	Office of Finance
OFHEO	Office of Federal Housing Enterprise Oversight
OP	Office of Policy
OS	Office of Supervision
OTS	Office of Thrift Supervision
REFCorp	Resolution Funding Corporation
ROMS	Regulatory Offsite Monitoring System

Introduction

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) created the Federal Housing Finance Board (FHFB) as an independent agency within the executive branch with a combination of regulatory and management responsibilities for the 12 Federal Home Loan Banks (FHLBanks) that comprise the Federal Home Loan Bank System (System). FHFB's primary duty is to ensure that the FHLBanks operate in a financially safe and sound manner. The System is a government-sponsored enterprise (GSE) whose mission is to support housing finance.[1] The System provides funds to support housing finance through the issuance of consolidated debt obligations. This report responds to a request from the Chairman of the Subcommittee on Capital Markets, Securities and GSEs, House Committee on Banking and Financial Services that we review FHFB's safety and soundness and mission-related oversight. Our objectives are to evaluate (1) FHFB's annual safety and soundness and mission-compliance examinations of the FHLBanks; (2) other aspects of FHFB's oversight, including off-site monitoring and supervisory enforcement; and (3) the status of FHFB's involvement in System business.

Background

In 1989, Congress created FHFB following the thrift crisis in the 1980s. At the same time, Congress abolished the Federal Home Loan Bank Board (FHLBank Board), FHFB's predecessor, which was extensively involved in the business operations of the Federal Home Loan Banks (FHLBanks). Prior to FIRREA, FHLBanks were not only wholesale lenders to thrifts but also the regulator of thrifts. FIRREA maintained the FHLBanks' wholesale lender role and transferred the regulation of the thrift industry to the newly created Office of Thrift Supervision (OTS). It also abolished the FHLBank Board and transferred its other functions to FHFB, including a number of management functions and existing FHLBank Board policies. For example, FHFB has the authority to approve FHLBank dividends, appoint six directors to each of the FHLBank boards, and approve the selection of FHLBank presidents. Thus, FIRREA did not establish FHFB as an arm's-length regulator and FHFB remains the only GSE regulator that is not arm's-length from the GSE it regulates.

In 1989, FIRREA gave FHFB the responsibility to (1) supervise FHLBanks, (2) ensure that FHLBanks carry out their housing finance mission, (3) ensure that FHLBanks remain adequately capitalized and able to raise funds in the capital markets, and (4) ensure that FHLBanks operate in a safe and sound manner. In 1992, concerns about the safety and soundness of the housing

[1]GSEs are financial institutions chartered by Congress to achieve a public purpose, such as facilitating the flow of funds to housing and agriculture. In addition to the FHLBank System, these GSEs include the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Farm Credit System.

GSEs prompted Congress to raise the primacy of safety and soundness oversight by making it FHFB's primary duty. The 1992 amendment further specified that FHFB's other three duties were to be fulfilled, "to the extent they are consistent" with its primary duty.

FHFB Is an Independent Agency Led by a Board

FHFB is to be managed by a salaried five-member Board of Directors (Board). The Secretary of the Department of Housing and Urban Development (HUD) serves as an ex officio director. The remaining four full-time directors are appointed by the President with the advice and consent of the Senate for 7-year terms. Each of the four appointed members must have experience or training in housing finance or commitment to providing specialized housing credit. Not more than three of the five members can be from the same political party. At least one director must come from an organization with more than a 2-year history of representing consumer or community interests in banking services, credit needs, housing, or financial consumer protections. The President designates one of the four appointed directors to serve as chairman. Since 1990, the Board has operated under a resolution that delegated most Board functions to the chairman. According to the resolution, the Board's rationale for the delegation was "for ease of general operation."[2]

FHFB has not operated with a full five-member board since 1993. Until March 1998, FHFB had only one vacancy. However, in a letter dated March 9, 1998, the President terminated a board member who had served in a holdover capacity since February 28, 1995.[3] The term of one of the remaining three members expired February 28, 1997, but as of July 2, 1998, he continued to serve in a holdover capacity.

The costs of FHFB's operations are funded through assessments to the FHLBanks. In 1997, FHFB's assessments were about $16 million. As of May 31, 1998, FHFB's 114 staff members were organized into 10 offices, as

[2]FHFB Resolution 90-143 (Dec. 18, 1990) delegates to the FHFB chairman, "after consultation with the other members of the Board as appropriate, all authorities, powers and responsibilities of the Board necessary to effect the overall management, functioning and organization of the Board including, without limitation, the authority to execute documents on behalf of the Board, including regulations, resolutions or orders duly passed by the Board, and to appoint, remove, and direct FHFB personnel." This resolution was superseded by FHFB Resolution 93-92 on November 17, 1993, which reaffirmed the delegation to the chairman.

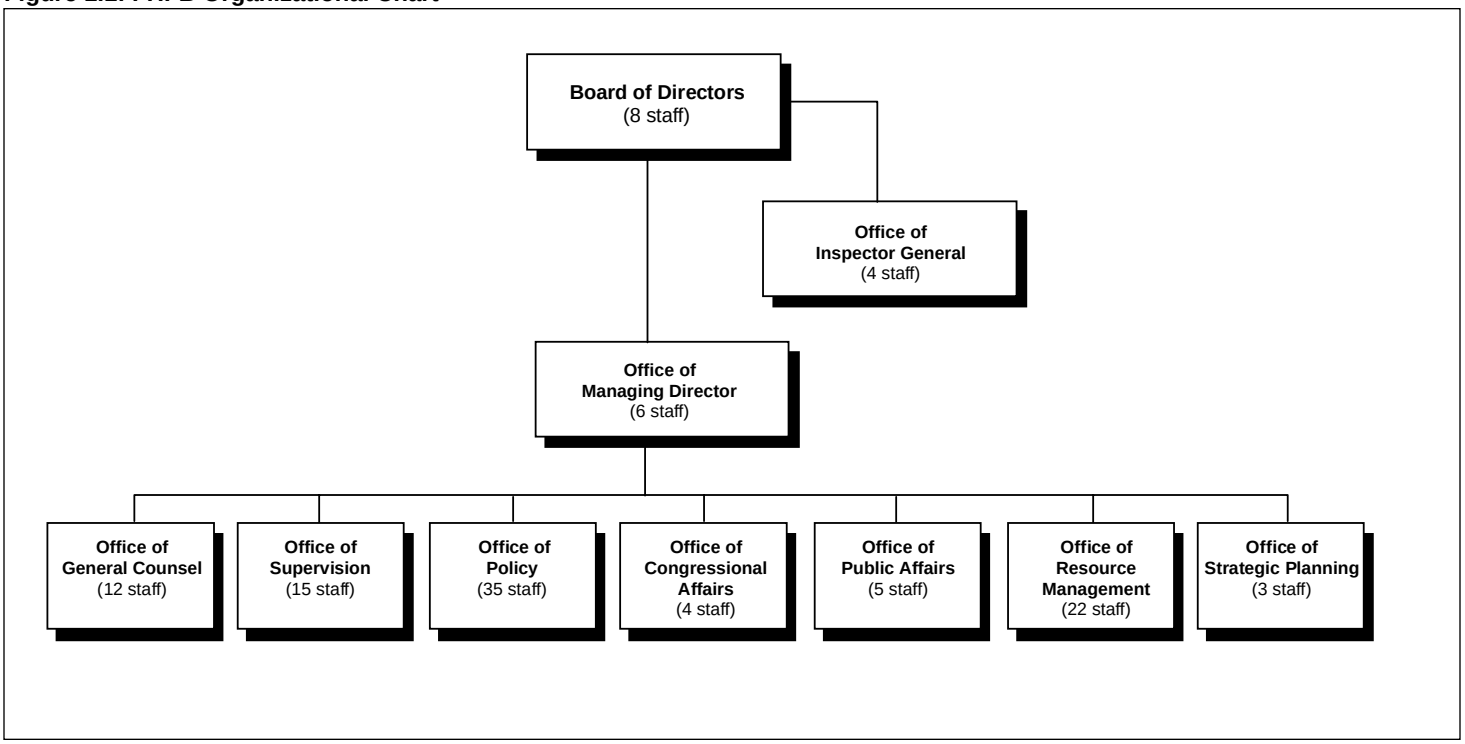
[3]The member's termination was effective March 23, 1998. On March 30, 1998, the member filed suit in U. S. District Court for the District of Columbia to override the termination. In July a federal judge upheld the termination.

illustrated in figure 1.1.[4] The number of staff assigned to each office is shown in parentheses. According to FHFB regulations and office descriptions,

- The Office of the Managing Director is responsible for the day-to-day management, functioning, and organization of FHFB.
- The Office of General Counsel is responsible for advising the Board, FHFB offices, and employees on legal interpretations.
- The Office of Supervision (OS) is responsible for conducting, at least annually, examinations of all 12 FHLBanks, the follow-up and resolution of outstanding examination issues, liaison with each FHLBank audit committee and the review and evaluation of the work of each FHLBank's internal audit staff, and the monitoring of FHLBanks and System interest rate risk, financial trends, and mission-related activities.
- The Office of Policy (OP) is responsible for coordinating policy development, providing policy advice and analyzing and reporting to the agency on various issues. Its responsibilities include, (1) analysis and modeling of the financial performance of the FHLBanks, (2) preparation of the System's annual combined financial reports and other periodic reports, (3) collection and analysis of data on the housing and community and economic development activities of the FHLBanks, (4) analysis of the FHLBank's performance under the affordable housing and community investment programs, (5) preparation of monthly survey of rates and terms and conforming loans limits for Fannie Mae and Freddie Mac purchases and guarantees, and (6) review of FHLBank's quarterly dividends recommendations.
- The Office of Congressional Affairs is responsible for ensuring effective coordination and communication between the agency, constituent groups, and Congress.
- The Office of Public Affairs is responsible for the dissemination of FHFB actions, policies, and press releases and ensuring effective coordination and communication between the agency and the media.
- The Office of Resource Management is responsible for human resources, payroll, contracting, procurement, support services, budget, accounting, finance, management, information systems, and general administrative functions in FHFB and is the chief advisor to FHFB on internal management and organization.
- The Office of Strategic Planning is responsible for the planning, analysis, development, and execution of the agency's strategic plan, both short and long term.

[4]The Office of the Board includes the board members, their assistants, and administrative staff. The Office of the Inspector General (staff of four) is not discussed in this report.

Figure 1.1: FHFB Organizational Chart



Note: Staff, as of May 31, 1998, shown in parentheses.

Source: FHFB.

According to FHFB regulation, OS oversees the FHLBanks, Office of Finance (OF) and the Financing Corporation[5] to ensure that they operate in a financially safe and sound manner, that the FHLBanks are carrying out their housing and community and economic development finance mission, and that they are in compliance with applicable statutes and regulations as well as FHFB policies and orders. OS responsibilities include annual examinations of FHLBanks, which are required by statute, and OF and the Financing Corporation examinations, which are required by regulation. The annual FHLBank examination focuses on safety and soundness but includes some mission-compliance oversight. According to FHFB's annual report, the purposes of the examinations are to review systems of internal

[5]OF is a joint office of the FHLBanks responsible for issuing the System's consolidated obligations. The Financing Corporation is a tax-exempt, mixed-ownership, government corporation that was established to issue bonds for the Federal Savings and Loan Insurance Corporation (FSLIC) and the FSLIC Resolution Fund for resolution activities.

control to ensure the integrity of operations; assess the degree to which assets are protected from loss; and review compliance with statutes, regulations, and policies. OP and the Office of General Counsel also provide technical support to OS in performing its duties.

FHFB's performance in its safety and soundness oversight role is important to taxpayers because of the size of the financial obligations of the FHLBank System and the possibility, given the System's public purpose, that the federal government might provide assistance if the System became troubled.[6] The importance of effective regulatory oversight becomes increasingly important as the System grows and FHLBanks undertake new activities that can pose new risks. As we discuss later in this chapter, both of these conditions exist.

System's Cooperative Structure Not Unique Among GSEs

The FHLBank System, established in 1932, is cooperatively owned by its members, who must buy stock in the System as a prerequisite for borrowing. This structure is not unique to the System: the Farm Credit System, a GSE created to increase the flow of funds to agriculture, is also cooperatively structured. At year-end 1997,[7] the System included a combination of voluntary and mandatory members. Voluntary members included state-chartered savings associations and savings banks and state-insured and uninsured thrifts, commercial banks, credit unions, and insurance companies. Mandatory members were federally chartered savings associations and savings banks regulated by OTS. Before FIRREA, membership was limited to thrifts, savings banks insured by the Federal Deposit Insurance Corporation (FDIC), and insurance companies. FIRREA expanded the System's voluntary membership to include commercial banks and credit unions. At year-end 1997, commercial banks dominated System membership with 69 percent of the members, thrifts were 27 percent; and the remaining 4 percent were credit unions and insurance companies (see table 1.1).

[6]The government has intervened in the past to strengthen the position of some troubled GSEs, although it has no legal obligation to do so. For example, the government intervened when the Farm Credit System faced severe financial stress in the 1980s. Congress authorized up to $4 billion in federal assistance despite the fact that the system's enabling legislation clearly states that its obligations are not guaranteed by the U.S. government as to principal or interest. The federal government provided less direct support to Fannie Mae in 1982 in the form of changes to its income tax treatment and regulatory forbearance of its troubled condition. See Farm Credit System: Repayment of Federal Assistance and Competitive Position (GAO/GGD-94-39, Mar. 10, 1994); and Government-Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks (GAO/GGD-91-90, May 22, 1991).

[7]Year-end means calendar year unless noted otherwise.

Table 1.1: Annual Federal Home Loan Bank System Membership, Year-End 1993 Through Year-End 1997

Institution	1993	1994	1995	1996	1997
Commercial banks	2,276[a]	3,133	3,641	4,072	4,514
Thrifts	2,177	2,067	1,969	1,874	1,742
Credit unions and insurance companies	[a]	106	165	200	248
Total	4,453	5,306	5,775	6,146	6,504

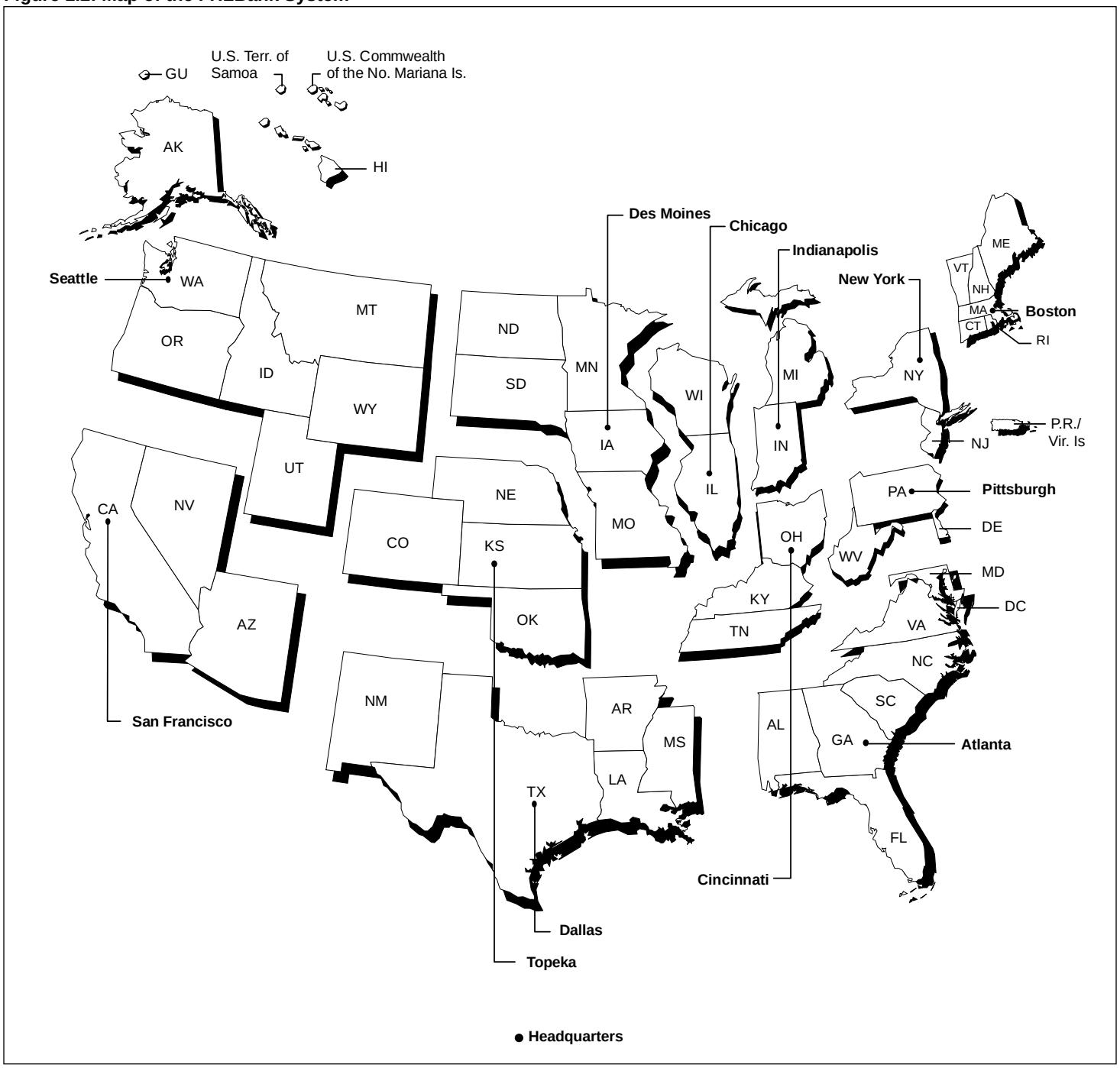
[a]In 1993, FHFB combined commercial banks, credit unions, and insurance companies.

Source: Federal Home Loan Bank System 1997 Financial Report, Federal Home Loan Bank System 1996 Financial Report, Federal Home Loan Bank System 1995 Financial Report.

By law, members must purchase stock in their FHLBank based on the level of their residential mortgage assets or total assets. The FHLBank Act also contains an advances-to-stock ratio subscription requirement. These stock purchases are the primary source of equity capital for FHLBanks. Member stock is not publicly traded. At year-end 1997, capital stock comprised 98 percent of the System's equity capital, the remaining 2 percent was from retained earnings.

The 12 FHLBanks are located in Boston, New York, Pittsburgh, Atlanta, Cincinnati, Indianapolis, Chicago, Des Moines, Dallas, Topeka, San Francisco, and Seattle and each serves a defined geographic region of the country (see fig. 1.2). At year-end 1997, the individual FHLBanks ranged in asset size from about $15 billion to over $61 billion. For purposes of comparison, as of year-end 1997, the 40 largest regional bank-holding companies in the United States ranged in asset size from about $14 billion to about $89 billion.

Figure 1.2: Map of the FHLBank System



Source: FHFB data.

Each FHLBank is governed by a board of at least 14 directors. Six directors are appointed by FHFB[8] and the remaining directors are elected by members. Appointed directors serve 4-year terms, and elected directors serve 2-year terms. The chair and vice chairs are designated by FHFB and serve a 1-year term. The chair is an appointed director, and the vice chair is an elected director. FHFB approves the bylaws and the initial appointment of the FHLBank presidents.

FHLBanks Provide Funding and Liquidity Through Advances

FHLBanks' primary mechanism to support housing finance is advances, which provide a funding source for mortgages. Advances are made to members and eligible nonmember mortgagees[9] on the security of mortgages and other pledged collateral. Advances generally are to support mortgage originations and provide term funding for portfolio lending. The System also serves as a source of liquidity for its members. While 57 percent of the System's over 6,500 members held advances as of December 31, 1997, 35 members held almost 50 percent of the System's total advances.

Like other GSEs, the System raises funds in the capital markets partially on the strength of its ties to the federal government. The primary source of funds for FHLBanks is the issuance of debt securities, known as consolidated obligations. Consolidated obligations, whether issued by a single FHLBank or collectively, are the "joint and several" obligations of FHLBanks.[10] The FHLBank Act authorizes FHFB to issue consolidated obligations, which FHFB delegated to OF, a joint office of the FHLBanks established by regulation. During 1997, the System's debt issuance exceeded $2 trillion. In the first quarter of 1998, the System's debt issuance continued to grow and the System replaced Treasury as the largest issuer of debt in the world. However, most of the debt issued consisted of short-term obligations to provide liquidity for members and for money-market investments. As a result, total consolidated obligations outstanding was about $304 billion at year-end 1997. The FHLBanks

[8]Of the six appointed directors, at least two must be chosen from organizations with more than a 2-year history of representing consumer or community interests on banking services, credit needs, housing, or financial consumer protections.

[9]The FHLBank Act authorizes FHLBanks to make advances to an entity that is not a member of the FHLBank if the FHLBank certifies the entity as a nonmember mortgagee. 12 U.S.C.§ 1430b. To be certified, an entity must meet certain criteria, including approval by HUD as a 'mortgagee' under the National Housing Act and being subject to the inspection and supervision of a governmental agency. Examples of eligible nonmember mortgagees are state housing finance agencies and tribally designated housing entities.

[10]With prior FHFB approval, a FHLBank may issue its own obligations. However, as of July 2, 1998, FHFB has not granted such approval, and no individual FHLBank obligations are outstanding.

collectively held about $349 billion in total assets at year-end 1997, making it the third largest GSE in the nation. See table 1.2 for a summary of FHLBank System financial data.

Table 1.2: Selected FHLBank System Summary Financial Data as of December 31, 1997, and December 31, 1993

Dollars in millions

Financial data	1997	1993
Advances to members	$202,265	$103,131
Investments	140,106	72,293
Total assets	348,575	178,897
Consolidated obligations	304,493	138,741
Capital stock	18,836	11,450
Retained earnings	342	317
Net income	1,492	884
Dividends paid	1,191	696
Return on average equity	8.33%	7.94%
Return on average assets	0.49%	0.54%

Source: Federal Home Loan Bank System 1997 Financial Report.

FHLBank System Faces a Number of Risks

The primary risks inherent in the FHLBank System activities are interest-rate risk, credit risk, and operations risk. Interest-rate risk is the potential for financial loss due to movements in interest rates. FHLBanks are exposed to interest-rate risk because they face possible losses and changes in the value of their portfolios resulting from changes in interest rates. Credit risk is the potential for financial loss from a borrower or counterparty failing to perform on an obligation. Finally, operations risk is the potential for unexpected financial loss arising from inadequate information systems, operational problems, breaches in internal controls, or fraud. FHLBanks use a variety of mechanisms to manage these risks, such as credit enhancements to manage credit risks and interest exchange agreements to manage interest-rate risk.[11] In addition, each FHLBank's financial statement is audited annually by an independent accounting firm.

None of the FHLBanks has ever experienced a credit loss on an advance. As we noted in an earlier report, this record reflects conservative credit standards and the use of collateral as a credit enhancement for advances.[12]

[11]The FHFB provides a framework for FHLBank's financial management strategies through its "Financial Management Policy."

[12]Federal Home Loan Bank System: Reforms Needed to Promote Its Safety, Soundness, and Effectiveness (GAO/GGD-94-38, Dec. 8, 1993).

In addition, the government has afforded a special lien status to FHLBank advances made to FDIC insured members. In the event of the failure of FDIC insured members (i.e., a bank or thrift), FHLBanks have priority in the assets of the failed institution over most other security interests, including insured deposits.[13] Advances represented 58 percent of total System assets at year-end 1997; the balance (less 2 percent for other fixed assets, such as accrued interest and bank premises and equipment) was in investments (discussed in greater detail later in this chapter). Among individual FHLBanks, advances as a percent of total assets ranged from 40 to over 80 percent.

Like other GSEs, the FHLBank System also faces business risk—the risk that factors largely beyond its control could lead to unexpected changes in earnings, growth, or capital. Examples of external factors that pose business risk include (1) changes in legislation or regulation governing their lines of business, (2) changes in demand for their products, and (3) changes in membership eligibility. For example, voluntary members, who can leave the System with 6 months' notice, can redeem their stock.[14] Due to legislative changes (as noted previously, only federally chartered savings associations and savings banks regulated by OTS are mandatory members) and thrift industry consolidation, the percentage of voluntary members has been increasing. At year-end 1997, voluntary members (who represented almost 85 percent of System membership) held about 55 percent of the System's capital stock. Mandatory members held the remaining 43 percent. As we reported in our past work, the nonpermanent nature of this capital stock makes it a less suitable buffer for absorbing losses than other forms of capital.[15]

FHLBank and System officials have supported legislation introduced into the 105th Congress that would, among other things, potentially expose the

[13]Another facet of FHLBanks' special lien status for advances is the risk it poses to FDIC. The priority of advances has the potential to result in increased costs to FDIC in resolving a possible bank or thrift failure. The FDIC Chairman expressed this opinion in a September 1995 correspondence with the Chairman of the Subcommittee on Capital Markets, Securities and Government Sponsored-Enterprises, Committee on Banking and Financial Services, House of Representatives. We concurred with the analysis and discussed the issue in comments on proposed legislation to expand the mission of the FHLBank System. See Enterprise Resource Bank Act (GAO/GGD-96-140R, June 27, 1996).

[14]FHFB may refuse to redeem stock at par value should the member's FHLBank be or likely be in financial difficulty.

[15]GAO/GGD-94-38, chapter 3.

System to additional risk.[16] The pending legislation would expand the collateral provisions for certain members to include certain small business loans and rural development loans. Such expansion of the System's mission increases its potential risk exposure. However, as of August 31 these provisions were still under consideration.

System's Activities Have Expanded

Although the System's charter contains no explicit statement of the System's purpose, the FHLBank Act identifies that purpose as supporting housing finance.[17] Historically, the System has achieved that purpose primarily by making loans (called advances) secured by home mortgages, to savings and loans, cooperative banks, and thrift institutions. Since 1989, the System's activities have expanded to include targeted lending, greater investments, pilot programs, and various other activities. In addition, pending legislation (discussed previously) would expand eligible types of activities even further.

FIRREA created special affordable housing requirements. Each FHLBank must maintain two low- and moderate-income housing programs—Affordable Housing Program (AHP) and Community Investment Program (CIP). These programs comprised less than 1 percent of System total assets at year-end 1997.

AHP, which began in 1990, requires the System to contribute the greater of $100 million or 10 percent of the preceding year's net income.[18] The funding is provided in the form of a direct subsidy. The FHLBank Act sets priorities for use among eligible projects. It also provides the grounds for FHFB to suspend an FHLBank's AHP obligations, if such payments are contributing to financial instability. In 1997, about $136 million was provided to AHP projects.

As part of CIP, the FHLBank Act requires that each FHLBank establish a program to make advances for members to finance the purchase or rehabilitation of housing for eligible households and to finance other

[16]H.R. 10 "Financial Modernization," which includes provisions relevant to the System) passed the House on May 13, 1998. S. 1423 "FHLBank System Modernization Act of 1997" was introduced Nov. 7, 1997.

[17]Section 1422a(3)(B), in part, charges FHFB with "[ensuring] that the Federal Home Loan Banks carry out their housing finance mission."

[18]FIRREA mandated that the systemwide AHP contributions would be 5 percent of net income, or not less than $50 million, between 1990 and 1993, increasing to 6 percent of net income or not less than $75 million in 1994. Since 1995, the systemwide contribution is the greater of 10 percent or $100 million. The contribution is calculated before affordable housing program charges but after paying Resolution Funding Corporation (REFCorp) bond obligations.

projects benefiting residents of low- and moderate-income neighborhoods at cost or at a special rate. The FHLBank Act did not specify a particular dollar goal but required these advances to be made at a discounted price. In 1997, over $3 billion in advances were made through CIP, including $152 million for economic or community development purposes.

Beginning in the early 1990s, significant changes occurred in the System's level of investment activities. According to FHFB officials, concerns about income pressures due to financial obligations relating to the thrift crisis and the new AHP requirements, among other concerns, led FHFB to expand FHLBanks' investment authority.[19] The primary investments of the FHLBanks are mortgage-backed securities, overnight and term federal funds sold, commercial paper, and U.S. government and agency securities. Between year-ends 1989 and 1997, the System's investments grew from about $34 billion to $140 billion, a 312 percent increase. Advances have also increased, though not as dramatically. Between year-ends 1989 and 1997, advances grew from about $142 billion to $202 billion, a 42 percent increase. Year-end 1989 investments represented almost 20 percent of System total assets, compared with almost 40 percent at year-end 1997. As we noted previously, the composition of assets among the individual FHLBanks varies. At year-end 1997, investments as a percentage of total assets at FHLBanks ranged from a low of 17 percent to a high of 58 percent.

According to testimony by the FHFB Chairman, FHFB began to follow a strategy ". . . to encourage the development of additional mission-related assets. . . " as an outgrowth of concerns about nonmission-related investments.[20] As of July 2, 1998, FHFB had approved four pilot programs that ranged in size from $25 million to $750 million. In general, the programs involve FHLBank funding or financing for home ownership in new ways. For example, in one program, the FHLBank purchases participation interests in affordable multifamily housing loans originated by a consortium of small banks that are mostly FHLBank members. Another program offers FHLBank members a new alternative to holding loans in their portfolios or selling them in the secondary market, for example to Fannie Mae or Freddie Mac. The FHLBank is to fund and retain in its portfolio the loans originated, serviced, and credit-enhanced by members. The risks are to be shared between the members and the FHLBank.

[19]FIRREA required the FHLBanks to transfer $2.5 billion in retained earnings to REFCorp to help pay for the cost of thrift resolutions and make a $300 million annual payment toward interest on the REFCorp bonds until the last bond matures in the year 2030.

[20]Statement of Bruce Morrison, Chairman of the Federal Housing Finance Board before the Subcommittee on Financial Institutions and Regulatory Relief of the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, September 24, 1997.

In April 1998, the Board approved a final rule to amend the definition of residential mortgages for the purposes of determining System membership and collateral requirements.[21] According to FHFB, this change should provide rural banks with greater access to the System both in terms of membership eligibility and borrowing power. Also in April 1998, FHFB issued a proposal that would expand existing targeted investment opportunities. Statute permits the FHLBanks to establish Community Investment Cash Advance programs in addition to AHP and CIP, which are required. Community investment cash advance programs are designed to target FHLBank advances to income-targeted households and specified economic development projects. The proposed rule would require each FHLBank to create a strategy for providing community investment program advances to support financing for projects that is not otherwise available or is available at less attractive terms.

Objectives, Scope, and Methodology

As agreed with our requester, the objectives of this report are to evaluate (1) FHFB's annual safety and soundness and mission-compliance examinations of the FHLBanks, (2) other aspects of FHFB's oversight, and (3) the status of FHFB's involvement in System business.

To evaluate FHFB's annual safety and soundness and mission-compliance review, we reviewed FHFB's examination program, including compliance with its policies and procedures. We reviewed FHFB's 1995 draft examination manual that was to be used during 1996 and 1997 examinations. We also reviewed its 1997 manual. We compared the topics covered by the draft and final manuals with those of other banking and GSE regulators, such as the Federal Reserve, OTS, Office of Federal Housing Enterprise Oversight (OFHEO), and the Farm Credit Administration. After determining that the topics to be reviewed by FHFB were comparable to other regulators, we compared FHFB's practices with its policies and procedures. However, we did not assess the depth or adequacy of FHFB's guidance.

We analyzed what the FHFB examiners did compared with FHFB's requirements along with standards stated in our previous reports, including standards related to management and board oversight, internal

[21]The law requires System members to have at least 10 percent of their total assets in residential mortgage loans. Previously, residential mortgages, which a member would use for collateral on advances, were defined as mortgages on residences whose value was at least 50 percent of the appraised value of the whole property. The change, which applies only to institutions with average total assets of $500 million or less, eliminated the 50 percent requirement and requires the residence to be an "integral part" of the property. According to FHFB, this change essentially eliminates the 50 percent test for business and farm property.

controls, and internal audits. Several of our studies on the regulation of banks, thrifts, and credit unions discussed the importance of appropriate standards and described typical deficiencies. We have stated in the past that the regulator should review the annual independent audit and consider the results in examining and monitoring the institution. We have also stated in previous work that an adequate system of internal controls is a vital part of assessing risk management. In addition, we stated that to determine the effectiveness of a bank's control systems, regulators need to assess the adequacy of control systems, specifically they need to identify critical control procedures, test the procedures, and evaluate the results of these tests.

We reviewed 1996 and 1997 examination reports for the 12 FHLBanks and OF. In addition, we reviewed the supporting examination work papers for 1996 and 1997 for a judgmentally selected sample of 6 of the 12 FHLBanks. In choosing our sample, we stratified FHLBanks into three tiers ranked according to year-end 1996 total assets to ensure that we reviewed FHLBanks of various sizes. The three tiers were less than $20 billion, between $20 and $29 billion, and over $29 billion. We selected two FHLBanks from each tier. In addition we reviewed the portfolio composition of the various FHLBanks to ensure that we included FHLBanks of various portfolio composition. The six FHLBanks selected comprised 60 percent of the System's year-end 1996 total assets.

We met with FHFB officials and examiners to discuss our findings and observations about the examinations reviewed. We also reviewed FHFB's annual examination plans and Advisory Bulletins. We documented the scope of the sampled examinations, the nature and extent of the problems identified, whether the identified problems were included as findings in the examination report and the types of findings. We also documented the extent to which examiners included supplemental information in the work papers, whether the work papers had been reviewed by a supervisor, whether examination questionnaires in the manual were completed, and whether the examiner followed the procedures specified in the exam manual.

To fulfill the second objective, we reviewed FHFB's monitoring and enforcement activities. Monitoring is an integral part of regulatory oversight. We reviewed existing FHFB documents, policies, procedures, and interviewed FHFB officials and staff from OS and OP to gain a better understanding of FHFB's monitoring activities. We also drew upon criteria for monitoring outlined in our previous work on GSEs, which, among other

things, states that monitoring should be timely, focus on previously identified problems, and enable examiners to identify potential problems. We reviewed relevant sections of the examination manual and other FHFB documents, including annual reports. We also reviewed one sample monitoring folder to determine the information typically reviewed and monitored. Because monthly monitoring was suspended in May 1997, we did not expand our sample.

To review FHFB's enforcement program, we reviewed the relevant sections of the FHLBank Act and compared them with the statutory authorities granted other GSE regulators, including the Farm Credit Administration and OFHEO. We compared FHFB's enforcement program to our existing principles for GSE oversight. For example, an enforcement program should have clear policies and procedures and specify conditions that would result in corrective actions being taken and what those actions would be. We reviewed FHFB's policies and procedures, including sections of the examination manual related to enforcement or corrective actions. In addition, we reviewed the examination reports and findings memos for all 12 FHLBanks and OF for 1996 and 1997 to determine what types of findings were included in the reports of examination. We met with various officials from OS and Office of General Counsel to discuss FHFB's enforcement authority. We also reviewed periodic reports FHFB uses to track the status of outstanding examination findings.

To fulfill our third objective of evaluating FHFB involvement in System business, we reviewed actions taken by FHFB to devolve managerial functions to FHLBanks and applied our previously articulated criteria. We applied criteria we developed in earlier work that a federal regulatory structure for GSEs would need to meet to carry out its oversight responsibilities effectively. They include independence and objectivity, prominence in government, economy and efficiency, separate regulation of primary and secondary markets, and consistency in regulation. We reviewed various FHFB activities considering these criteria. Specifically, we reviewed memorandums addressing the status of FHFB's effort to devolve certain business functions to FHLBanks, FHFB's analysis of devolution priorities, statutory provisions requiring FHFB involvement in System business, and FHFB regulations. We also reviewed FHFB's 5-year strategic plan and its 1998 annual plan. We reviewed agendas for meetings with FHLBank boards' chairs and vice chairs, testimonies and speeches of Board members, and various FHFB correspondence. In addition, we met with FHFB and System officials.

Our work was done in accordance with generally accepted government auditing standards. We did the work underlying this report between October 1997 and July 1998, primarily at FHFB in Washington, D.C.

We requested comments on a draft of this report from the Chairman of FHFB. The full text of FHFB's comments and our additional responses are included at the end of chapters 2 and 4 and in appendix I.

FHFB Examinations We Reviewed Did Not Fully Assess Safety and Soundness and Mission Compliance

We found several weaknesses that could limit the effectiveness of FHFB's examinations, particularly as it contemplates expanding the activities in which the FHLBanks may engage. While the examination manual is FHFB's primary source of examination policy and guidance, examiners routinely did not follow its procedures during examinations. Examiners did not always fully assess critical elements of bank operations, such as internal controls, that the FHFB examination manual, other financial industry regulators, and we have identified as vital to evaluate risk management. The planned scope of examinations was reduced and examination procedures were often not completed due to time constraints. We also found examples where the scope was not expanded when examiners found potentially significant deficiencies in bank operations. FHFB staff said limited examination staff resources often accounted for these conditions. FHFB has had a statutory obligation to ensure that FHLBanks carry out their mission to support housing finance since 1989. Since 1997, it has taken several steps to try to develop policies and procedures to assess mission compliance.

FHFB Procedures for On-Site Safety and Soundness Examinations of the FHLBanks

According to FHFB's examination manual, FHFB's examination process is to include an annual on-site examination and off-site monitoring performed by FHFB's OS. In 1996 and 1997, each FHLBank examination was allotted 120 staff days and lasted about 4 weeks. OS develops an annual plan for examinations each year that details planned examinations and issues to be reviewed at FHLBanks. FHFB's off-site monitoring activities are discussed in detail in chapter 3.

According to FHFB's examination manual, FHFB conducts three types of examinations: regular examinations, follow-up examinations, and special examinations. Regular examinations are scheduled in the annual plan and may include any aspect of bank operations but generally include credit operations, financial operations, operating performance, compliance issues, and housing finance mission. Follow-up examinations are designed to resolve important outstanding issues or to review the progress and sufficiency of corrective actions taken. The scope of follow-up examinations is limited to the unresolved issues or actions taken by a FHLBank under the direction of FHFB. Special examinations are to be conducted at the request of the Board. The scope of these examinations is usually to be limited to one issue or a narrow range of issues. In the last 2 years, FHFB has conducted each type of examination. In 1996 and 1997, FHFB has also conducted preimplementation examinations prior to the initiation of pilot programs.

The Examination Manual Contains Examination Programs for All Examination Areas and Questionnaires for Most

The FHFB examination manual describes FHFB's process for examining the FHLBanks. According to the manual, its purpose is to document examination objectives and procedures in order to provide guidance to examiners, FHLBanks, OF, and the Financing Corporation, and to promote an effective and efficient examination process. The manual states that it is intended to provide a framework for the examination process. Examiners are to assess an institution's operations and financial condition for safety and soundness and compliance with applicable statutes, regulations, and policies. Examiners are to report their findings regarding the sufficiency of control and compliance with law. Where needed, examiners are to direct that corrective actions be taken. The manual states that the examination process should identify existing weaknesses and cases of apparent noncompliance as well as potential problems and emerging issues. The manual states that examiners may recommend practical steps to correct such deficiencies.

The FHFB examination manual existed in draft form until April 8, 1998, but has been FHFB's primary source of examination guidance since 1994. The examination manual currently contains 29 examination programs covering different aspects of the FHLBanks' operations, such as internal control, collateral operations, and payment systems and funds transfer operations. For our review of 12 FHLBank examinations, we relied primarily on versions of the manual, compiled in 1995 and in 1997, that contained 31 programs. FHFB officials said this would be appropriate for our review and that FHFB examiners are expected to follow the examination manual when doing examinations. The two programs that were dropped in the final version of the manual, AHP and equal employment opportunity, are currently under revision and are to be added to the manual later.

The manual presents the examination programs in eight broad categories that include management, bank operations, financial management, community investment operations, compliance programs, OF and the Financing Corporation, asset review, and electronic data processing. In addition to an examination program, which includes the objectives and procedures for specific parts of FHFB examinations, there are also examination questionnaires, surveys, or worksheets (questionnaires) that accompany 16 of the 31 examination programs. Examination procedures contained in the manual instruct examiners to complete the questionnaires in areas where they are included.

Examiners Are to Determine Examination Scope Prior to Commencing the Examination

The scope of each examination is to be based on the annual examination plan and the preexamination analysis done by examiners before starting an examination. Examinations are defined according to several scope categories. At a minimum, all of the FHLBanks are to be subject to a limited scope examination each year. For regular examinations, this is generally to entail an off-site review, which may be combined with an on-site review of one or two risk factors or compliance issues. Most FHFB examinations have been moderate scope examinations. These examinations are to consist of an on-site review of several risk factors or compliance issues. OS may also perform comprehensive scope examinations, which may be requested by the Board and may entail an on-site examination of virtually all risk and compliance factors. Special examinations may be done as comprehensive scope examinations. FHFB did not conduct any comprehensive examinations during the period covered by our review.

Examination procedures are divided into two tiers. Tier 1 procedures represent the minimum review required to assess the adequacy of control and compliance systems in any given area of bank operations. Tier 1 procedures are to focus on review of internal control, audit reports, policies, and management compliance systems. Tier 2 procedures are to involve more in depth reviews, and include testing of management representations, procedures, and calculations or transactions. According to the examination manual, most reviews are a combination of Tier 1 and 2 procedures.

During the course of an examination, conditions at a FHLBank may convince examiners that the scope of an examination should be altered. Guidance in the FHFB examination manual states that to amend the examination scope, the examiner-in-charge should contact his or her supervisor to explain why the scope must be amended, obtain concurrence for amending the scope, and write a memo to the supervisor documenting the amended scope that is to be included in the examination work papers.

Examiners Are to Formulate Conclusions and Present Their Findings to FHLBank Management

Upon completing an examination, examiners are to develop their findings and present those that cause supervisory concern to FHLBank management in the form of findings memos. Findings are categorized according to the nature and seriousness of the issues presented in the finding. The categories include referral, recommendation, compliance matter, weakness, and violation. An additional unsafe and unsound category is used when intensive oversight and immediate corrective action is considered warranted. See table 2.1 for a description of each category.

Table 2.1: FHFB Report of Examination Findings Categories

Findings Category	Description
Referral	A novel or unsettled legal or policy issue requiring guidance from or development by other FHFB staff.
Recommendation	A practice or control that should be improved to meet best banking practices
Compliance matter	Compliance matter not warranting treatment as a violation. Examples: noncompliance with FHLBank internal policy, technical compliance matter resolved during or prior to the examination.
Weakness[a]	A deficient practice that may cause losses or a lack of sufficient internal control to ensure that deficient practices or violations will be timely detected.
Violation[a]	A violation of statute, regulations, or FHFB policy.
Unsafe and unsound practice or condition[b]	Practice or control deficiencies, or patterns of deficiencies in practices, or control that threaten or have caused substantial losses or impairment of capital.

[a]Finding category that requires corrective action.

[b]Finding category that requires immediate corrective action.

Source: FHFB Examination Manual.

FHLBank management is to be provided with the opportunity to respond to preliminary examination findings prior to completing the Report of Examination and presenting it to a FHLBank's board of directors.

OS Officials Said That Limited Examination Resources Have Affected Examinations

During the period covered by our review, OS employed 8 to 10 examiners who were responsible for completing the 14 required annual examinations of FHLBanks, OF, and the Financing Corporation as well as special, follow-up, and preimplementation examinations. The examiners were also responsible for other projects and activities, such as monitoring the FHLBanks between examinations, developing Advisory Bulletins for the FHLBanks, and revising the examination manual. In addition to the eight regular examiners, most of whom had some experience with other regulatory agencies, OS employed one special examiner for affordable housing and one for electronic data processing examinations. However, OS officials said that they have had difficulty retaining qualified examiners, particularly for electronic data-processing examinations.

During the period of our review, OS hired both affordable housing and electronic data processing examiners but also lost two senior examiners and one junior examiner. OS officials said that staffing constraints have hindered some of their supervisory oversight areas and that they have

plans to hire additional examiners in the near future to be better able to handle their examination workload. However, as discussed later, staff retention remains a problem.

Review of Examinations Revealed That Examiners Often Did Not Follow Guidance Provided in Examination Manual

In each of the examinations reviewed, we found that examiners often did not comply with examination procedures described in FHFB's examination manual. In most examination areas, we could not determine what procedures had been completed because the supporting examination work papers did not document what had been done. Examiners generally did not follow examination procedures in the examination manual nor did they complete the questionnaires designed to assist examiners in certain areas. In some instances, examiners documented examination procedures in a format other than that contained in the manual.

Examiners Generally Did Not Complete Examination Questionnaires

The examinations we reviewed included an average of 11 areas for which there were questionnaires that examiners were expected to complete. We found that examiners usually did not complete them. For example, examiners completed 3 or fewer questionnaires in 10 of the examinations reviewed, including 2 examinations in which examiners did not complete any questionnaires. In the remaining two examinations, examiners completed four questionnaires. According to an OS official, examiners often do not complete the questionnaires because they view them as being unnecessary documentation.

Examiners Generally Did Not Document Examination Procedures

In the 12 examinations we reviewed, we found that examiners often did not document their examination procedures. The examination manual states that work papers are to document the planning and execution of an examination and support and document the basis for the findings reached. We found that when examiners documented their examination procedures, they generally documented them in any of three ways; (1) they used the pages listing examination procedures from the examination manual (an average of 3 times per examination), (2) they used formats other than those that appear in the examination manual (an average of 3 times per examination), and (3) they used the examination questionnaires discussed previously (an average of 2 times per examination). Some examination procedures were documented through a combination of these techniques.

While each of the 12 examinations we reviewed covered an average of 24 examination programs, we found that an average of only 7 programs were documented using one or more of the three techniques. Because examination procedures were not documented for over two-thirds of examination programs, we could not determine with certainty what procedures were completed or how thoroughly some areas were reviewed. This sometimes resulted in inadequate documentation of conclusions drawn in the examination.

FHFB Examiners Said They Did Not Follow Manual Procedures Because of Time Constraints and Questions About the Usefulness of the Manual

FHFB examination staff said that they often did not follow the procedures in the examination manual or complete the questionnaires because they did not have time to complete the procedures described in the manual. Also, they said that in their opinions, the procedures were not often useful for certain parts of the examination. They explained that documentation of examination procedures and conclusions is often not completed because of staffing constraints. FHFB officials said that they expected that the manual would become more useful to examiners as it is revised over time and that they hope to hire additional examiners to help carry out the workload. However, the staff turnover discussed earlier in this chapter makes the documentation of examination procedures and conclusions all the more important to provide an audit trail and avoid the loss of institutional memory.

Examiners Did Not Always Fully Assess Critical Elements of FHLBank Operations in Examinations We Reviewed

Although all of the examinations we reviewed included reviews of FHLBank policies and procedures to mitigate interest rate and credit risk, examiners did not always fully assess critical elements of FHLBank operations that the examination manual, other financial industry regulators, and that we have identified as vital to evaluate risk management and that should be reviewed as part of every annual examination. These elements include internal controls, board of director oversight, management oversight, and the internal audit function. OS officials explained that they currently do not have adequate staff resources to fully evaluate a FHLBank's system of internal controls; and therefore, they provide only a limited assurance of the adequacy of the internal control system upon the completion of an examination. The officials explained that they often do not formally examine the other areas we identified because of time and staff resource constraints and the stability of the management and auditing functions of the FHLBanks.

FHFB Examiners Did Limited Reviews of FHLBank Internal Controls

During our review of 12 examination reports and their supporting work papers for the 6 FHLBanks sampled, we found that examiners generally did limited reviews of internal controls. As we have stated in earlier work, internal controls promote safety and soundness by preventing errors and irregularities from occurring, or by identifying them early enough for management to take corrective action before the bank's financial condition is significantly damaged. Reviewing internal controls during an examination is important because internal controls affect all major operational areas of banks. Periodic comprehensive evaluations of internal controls, including identification of significant controls and review of individual transactions and records to determine whether controls are functioning properly, help ensure that adequate systems are in place to enable banks to operate safely and soundly.[1]

Examiners did not perform comprehensive reviews of internal control systems at any FHLBanks reviewed in 1996 or 1997. Rather, examiners generally reviewed internal controls of selected areas of FHLBank operations, such as asset/liability management and wire transfers. We did not find evidence that examiners completed the internal controls procedures in the manual or questionnaires for any of the examinations we reviewed.

FHFB's assessment of the FHLBanks' internal controls is found only in the standardized language in the final reports of examination rather than in sections of the reports that describe each FHLBank's internal control system and the extent of examiners' review. In September 1996, FHFB began describing its review of internal controls in the report of examination by noting that examiners did a "limited" review. FHFB officials explained that this caveat was added because they do not do the type of review to merit an affirmative endorsement of a FHLBank's system of internal controls, and they changed the language in the report of examination to more accurately reflect the type of review OS examiners did. FHFB officials estimated that to do the work required to issue a definitive opinion of the FHLBank's internal controls would require that the entire FHFB examination staff work in a single FHLBank for 6 months.

FHFB officials explained that to compensate for their limited internal control assessments, they rely heavily on the work of FHLBank internal auditors. However, as we discuss later in this chapter, FHFB examiners generally do not assess the quality of the internal audit function before

[1]Bank Examination Quality: FDIC Examinations Do Not Fully Assess Bank Safety and Soundness (GAO/AFMD-93-12, Feb. 16, 1993).

relying on the work. We also found no evidence that examiners verified the internal control testing done by internal auditors or that examiners routinely tracked weaknesses identified by internal audit.

Because internal controls promote safety and soundness by preventing errors and irregularities from occurring, it is important that they operate effectively. FHFB examiners cannot verify, based on their reviews, that internal controls are operating effectively in FHLBanks and, therefore, that errors and irregularities are not occurring.

Examiners Often Did Not Routinely Assess FHLBanks' Internal Audit Function

During our review of the 12 examinations, we found that FHFB examiners did not routinely assess the internal audit function at the FHLBanks. The FHFB examination manual states that the examiner's review and evaluation of the internal audit function is a key element in determining the scope of the examination. The manual states that, based on the evaluation of relevant factors, the examiner should assess whether the work performed by the internal auditors is acceptable. According to the manual, there are three main objectives of the internal audit function: (1) the detection of financial irregularities; (2) the determination of compliance with a FHLBank's policies and procedures; and (3) the appraisal of the soundness and adequacy of accounting, operating, and administrative controls to ensure that those controls provide for the prompt and accurate recording of transactions and the proper safeguarding of assets. The manual states that examiners should consider several factors in reviewing and evaluating FHLBank internal audit functions. Principal among these factors are the competence and independence of the internal auditors and the adequacy and effectiveness of the audit program.

Although FHFB examiners rely heavily on the work of FHLBank internal auditors for their internal control assessments, we found that examiners evaluated the auditor's competence, independence, and audit program adequacy for only 2 of 12 examinations we reviewed. In both cases, a new internal auditor had been hired since the last examination. However, the examination procedures performed were not documented in a format found in the examination manual for either of the examinations. FHFB officials said that they generally do not do a full assessment of the internal audit function unless there has been a major change in some aspect of a FHLBank's audit function, such as hiring a new internal auditor. Generally, they said if there has not been a change of the internal auditor, FHFB examiners assume that the internal audit function is reliable.

In four other examinations, we found that examiners evaluated only the independence of the internal auditor. FHFB Advisory Bulletin 96-1, issued on February 29, 1996, emphasized the importance of maintaining the independence of the internal auditor and alerted the FHLBanks that compliance with FHFB policy guidelines regarding internal auditor independence would be included in the scope of all examinations conducted in 1996. FHFB did three of the four assessments of internal auditor independence in 1996. We did not find a completed Internal Audit Questionnaire or an examination program documenting examination steps for any of the examinations we reviewed.

The internal audit function is to detect financial irregularities and inaccuracies in financial reporting; determine compliance with laws, regulations, and FHFB and FHLBank policies and procedures; and appraise the adequacy of internal controls. Because FHFB examiners did not routinely review the audit function at FHLBanks we reviewed, they could not be certain that it was operating as it should and serving the purpose for which it is intended.

Examiners Did Not Review Board of Director or Management Oversight

We did not find documentation indicating that FHFB examiners had completely reviewed board of director or management oversight of overall FHLBank operations during any of the 12 examinations we reviewed. Board of director and management oversight are the essential elements of corporate governance of financial institutions. The FHFB examination manual states that the board of directors' collective responsibility is to ensure that the FHLBank operates in a financially safe and sound manner, that it is in compliance with law and policy, and that it supports housing finance and community investment. The manual states that management oversight is also important and that a major examination objective is the review of FHLBank management quality and effectiveness. The success of operations depends on the skill, abilities, and effectiveness of management. Operational weaknesses are often traceable to ineffective management.

Principles of risk management that have been developed by various financial industry and regulatory bodies stress the importance of board of director and management involvement in managing the risks undertaken

by financial institutions.[2] Under these principles, an organization's risk management strategy is to be based on a framework of responsibilities and functions driven by the board of directors down to operating levels, which cover all aspects of risk. The basis for this principle is the belief that unless the board of directors is fully integrated in the risk management approach, the organization's managers and employees will not be fully committed to risk management. To emphasize the importance of risk management, the principles state that a risk management group composed of senior managers is to be created. FHFB officials stated that their examinations are focused on risk management.

While reviewing examination work papers, we did not find a completed board of director oversight or management oversight questionnaire or examination program in any of the 12 examinations. Further, with the exception of one examination, we did not see board of director or management oversight explicitly discussed in any of the preexamination analysis, scope, assignment, or findings memos or the Report of Examination. In the one exception, a management oversight issue was discussed in a findings memo and in the report of examination, but there was little additional evidence in the work papers explaining how the area was reviewed.

One element of FHFB's review of board of director and management oversight is an assessment of the extent to which the FHLBank board and management are responsive to examination findings, which were raised during the prior year's examination and presented to the FHLBank board and management. OS is also required to monitor FHLBank responses to supervisory determinations (examination findings) as part of the FHFB's Disputed Supervisory Determinations process, which is discussed in chapter 3. In 6 of the examinations, we saw evidence to indicate that examiners had reviewed board of director responsiveness to examination findings while we found evidence that they assessed management's responsiveness to examination findings in each of the 12 examinations.

FHFB officials said that they did not approach board of director and management oversight in a top-down manner. Instead, they said that in cases where they identify problems in a FHLBank's operations, they would determine how board of director or management oversight may have

[2]Principles of risk management have been developed by various industry and regulatory bodies, including the Bank for International Settlements, the International Organization of Securities Commissions, Derivatives Policy Group, U.S. bank regulators, and a group assembled by Coopers & Lybrand. All of the risk management principles are broadly similar. The principles listed in the text are from Coopers & Lybrand, termed generally accepted risk principles or GARP.

contributed to the problem. However, they generally do not review board of director or management oversight during an examination unless a specific problem is uncovered that they believe warrants a review or if there have been significant changes in those areas since the last examination.

Board of director and management oversight are the primary factors in the management and operating strategy of FHLBanks. In omitting complete reviews of these two areas, FHFB examiners risk missing the opportunity to uncover, in a timely manner, the sources of certain operational weaknesses, which may or may not have manifested themselves in other aspects of FHLBank's operations.

Examinations We Reviewed Were Often Curtailed Due to Time or Other Unknown Constraints and Not Expanded When Potentially Serious Problems Were Found

In our review of the 12 examinations, we found that the planned examination scope or procedures were sometimes reduced due to time constraints or for reasons other than conditions identified at the FHLBank, while in other cases we found that the scope was not expanded when potentially serious problems were uncovered. In two examinations, we found that the planned examination scope was curtailed without explanation in the work papers. We also found that examiners failed to complete some planned examination procedures because of time constraints in 11 of the 12 examinations we reviewed.

Examiners Curtailed the Examination Scope in Two Examinations Without Explanation

In 2 of the 12 examinations we reviewed, we found that examiners did not complete the planned scope. The examination manual indicates that preexamination planning is important and provides an important control on the examination scope. The manual indicates that the scope of the examination is to be amended in response to conditions at the FHLBank. Reducing the planned examination scope for reasons other than the condition at a FHLBank is inconsistent with the guidance in the examination manual. Guidance in the FHFB examination manual also states that to amend the examination scope, the examiner-in-charge should contact his or her supervisor to explain why the scope must be amended, obtain concurrence for amending the scope, and write a memo to the supervisor documenting the amended scope that is to be included in the examination work papers.

In both of these cases the examination work papers contained no explanation of why the areas originally included in the examination scope

had been eliminated. OS officials said that limited examination staff resources often require that the planned scope of examinations be curtailed. In these instances, OS officials stated that examiners delete from the scope parts of the examination that they believe involve less risk. In the two cases where the scope was reduced without explanation, the deleted areas included the CIP, advances, and member applications. The FHLBanks' CIP are a major element of their compliance with their housing finance mission which, as we discuss later in this chapter, is an area in which FHFB is still working to develop examination policies and procedures. Therefore, in light of the importance of the areas that were dropped from the scope of the examinations, and because it is required by the examination manual, it would have been appropriate for examiners to have provided an explanation for deleting these areas from the planned scope.

Examiners Found Potentially Serious Internal Control Problems in Consecutive Examinations of a FHLBank but Did Not Expand the Scope to Look for Additional Problems

Examiners found potentially serious internal control problems during consecutive annual examinations of a FHLBank but did not expand the scope of either examination to determine whether additional problems resulted from those control deficiencies. As described earlier, the FHFB examination manual allows for the expansion of examination scope where conditions at a FHLBank indicate the need for enhanced review.

Both of the cases we identified involved an inadequate segregation of duties in the FHLBank's investment activities. A major internal control procedure within financial institutions is to segregate certain duties which, if done by the same person, could allow that person to perpetrate irregularities within the institution and to prevent their discovery by others. Inadequate segregation of duties is an internal control problem that has allowed large losses to occur at other financial institutions for an extended period of time without detection.

During a 1996 examination, examiners found that traders had the ability to process transactions and make changes to a counterparty's creditworthiness rating. They recommended in this case that management separate these two functions by restricting trader access levels on the unsecured credit system to reduce the risk of a trader engaging in unauthorized transactions. During the same examination, examiners noted that broker confirmation tickets for certain transactions were sent directly to the division responsible for conducting the trades rather than to the accounting division. Examiners recommended that management ensure that all broker confirmation tickets be sent to the accounting division to

reduce the risk of a trader engaging in unauthorized transactions. The finding memorandum describing this situation stated that examiner concern over this issue was mitigated by the fact that the tickets were sent to the traders' supervisor rather than directly to traders.

During the 1997 examination of the same bank, an examiner noted that so called "front and back office" operations were not sufficiently segregated in the investments area. Staff with trading functions (front office) were permitted to perform accounting functions (back office) in which they accounted for the market values of investments and off-balance sheet items. The examiner noted in the findings memo that if a significant difference were to arise between a securities dealer's valuation and the FHLBank's valuation, it might not come to the management's attention and that the reasons for any significant discrepancies might not be discovered if one individual is responsible for both duties. This was presented in the report of examination as a weakness that should be corrected.

Examiners did not expand the scope of either the 1996 or 1997 examination to determine whether the inadequate segregation of duties had resulted in damage to the FHLBank in the form of unauthorized transactions or inaccurate accounting data. In the first of the two cases, examiners presented the problem they had identified as a recommendation in the Report of Examination that the FHLBank correct the situation by strengthening internal controls. As indicated in table 2.1, a recommendation does not require that the FHLBank correct problems identified by FHFB examiners. In the other case, the problem was presented as a weakness, which is a category requiring mandatory corrective action.

An OS official said that OS did not expand the scope of the examinations in these instances to identify whether any irregularities had occurred because it believed that any problems would have been uncovered once the duties were segregated. The official also said that OS was not concerned that the problems had occurred at the same FHLBank in consecutive examinations because the FHLBank in question had traditionally been managed in a conservative manner. However, because examiners did not expand their review during either of these examinations, they could not be certain that other problems, such as undetected transactions or losses, had not occurred.

FHFB Is in the Process of Developing Mission Compliance Examination Program

Although FHFB was established in 1989, FHFB has not developed policies and procedures to ensure that FHLBanks fulfill their statutory mission. To ensure mission compliance, FHFB must have (1) a clearly defined mission, (2) well defined policies that delineate what constitutes mission compliance, and (3) methods to measure whether or not FHLBanks have fulfilled their mission. Without that type of structure, it is difficult to systematically ensure mission compliance. FHFB appears to have recognized the shortcomings in its existing structure and has taken several steps to develop a framework to ensure mission compliance.

Specifically, since 1997, FHFB has taken a number of actions to help ensure mission achievement. First, OS added a new mission-achievement reporting requirement. Second, OS tested examination procedures aimed at mission achievement oversight. Third, FHFB requested public input on mission achievement and measurement through an advance proposed rulemaking. Fourth, FHFB amended regulations for FHLBank member community support requirements and related FHFB monitoring activities to ensure compliance. Fifth, FHFB commissioned a study to, among other things, address how to measure and monitor the System's mission objectives. Finally, FHFB has been involved in reviewing System nonmission-related investments and considering whether regulations are needed to limit the FHLBanks' investment portfolios. FHFB has also encouraged alternative activities to increase mission-related investments.

Although FHFB has not developed examination procedures to assess nor ensure FHLBanks' compliance with the System's housing finance mission, examiners have traditionally reviewed some of the FHLBanks' activities to assess their consistency with specific regulations during the annual examination. These programs account for less than 1 percent of the System's total assets. Also in 1997, FHFB required that FHLBanks annually submit reports that describe new products, pricing, and partnerships. These reports are reviewed by OS during the annual examination, but examiners did not independently assess FHLBanks' overall mission compliance in the examination report. Instead examiners summarized FHLBanks' mission compliance reports.

FHFB also had begun to develop and test examination procedures that would be used during the annual examination to assess FHLBanks' compliance with mission. For example, draft procedures include evaluating FHLBank policies, existing and new products, and pricing to determine whether they are consistent with the System's housing finance mission. Draft procedures also include reviews of a FHLBank's degree of

market penetration and its marketing plans and tools to create awareness of its credit products. However, these procedures were not final as of July 1, 1998, nor have they been incorporated into the FHFB examination manual.

In April 1997, FHFB issued an advance notice of proposed rulemaking in the Federal Register to request public comment on ways the FHLBanks can further achieve their mission and ways the FHFB, as regulator, could measure and ensure that FHLBanks achieve their mission. According to the notice, FHFB believes the System's mission—to support and promote housing finance and community investment—is clear. The notice also requests comments on whether FHFB should define and measure mission fulfillment for FHLBanks through a regulation. In addition, it inquired about ways to measure mission achievement and how to relay that information to the public. As of July 1, 1998, no additional action had been taken on this matter.

In May 1997, FHFB amended its regulation on community support that establishes community support standards that FHLBank members must meet to maintain access to long-term FHLBank advances. The rule restates statutory criteria that FHFB would apply in evaluating a member's community support performance. The criteria includes a Community Reinvestment Act performance (based on its rating) and its lending record to first-time home buyers. The rule further specifies the FHFB's monitoring process, which includes selecting approximately one-eighth of the members in each FHLBank district for community support review each calendar quarter. Those members selected for the community support review are required to submit a community support statement to FHFB, which must act on the report within 75 calendar days once the statement is deemed complete. FHFB is required by statute to notify a member and the appropriate FHLBank in writing of its determination regarding the member's statement. The rule also states the conditions in which it would restrict a member's access to long-term advances.

In July 1997, FHFB commissioned a study to, among other things, assist it in developing procedures to oversee FHLBank mission compliance. Specifically, the study was to address "methodologies to measure performance against mission." FHFB officials said that the study results are expected to be incorporated into examination procedures for mission compliance. FHFB's 1998 annual performance plan included an objective to develop "a system for ensuring achievement of mission." Before the end of fiscal year 1999, FHFB expects to recommend a methodology for evaluating

the extent to which FHLBanks' assets support mission achievement and a process for monitoring mission achievement on an ongoing basis. As of July 1, 1998, the study had not been completed.

Finally, during 1998, FHFB engaged in an ongoing review of the System's investment practices and whether the System should be required to dedicate a greater portion of its assets to mission-related investments. Treasury has expressed concerns about the System's investment portfolio and a lack of its relationship to the GSE's public purpose. As noted in a Treasury letter dated July 27, 1998, "The System uses this portfolio to conduct extensive arbitrage—issuing debt securities at close to the Treasury rate and investing the proceeds in other, higher yielding securities."[3] Treasury added that most of the System's investments do nothing to support residential mortgage lending or otherwise advance the System's public purpose. At year-end 1997, Systemwide investments were almost 40 percent of total assets; individually, the percentage ranged from a low of 17 percent to a high of 58 percent. The FHFB review included development of a staff paper prepared by OP and a public hearing in which participants were asked to consider the System's investment practices and an approach for limiting certain nonmission related investments. As of July 1, 1998, FHFB's review was continuing and had not resulted in any concrete proposals. Also as part of FHFB's concerns about the level of nonmission-related investments, FHFB has encouraged pilot programs as a means to test alternative investment activities. According to FHFB's policy governing the approval process, among others, FHFB is to consider mission fulfillment as one of the criteria.

Agency Comments and Our Evaluation

FHFB had four primary comments about our findings on its safety and soundness and mission-compliance examinations. First, FHFB said that we failed to evaluate FHFB's examination program in the proper context given the stringent regulations, policies, and financial conditions that exists. We believe the FHFB's program should be evaluated in this context. In chapter 1 of the draft and final reports, we discuss the current financial condition of the System, the types of risks it faces, and how it manages these risks. We also reviewed the statutes and regulations with which FHLBanks are required to comply that affect these risks. We believe that regular, comprehensive on-site examinations are the cornerstone of any financial institution regulator's oversight program. Without such periodic reviews of operations, a regulator cannot be assured that an institution has proper

[3]Robert Rubin, Department of Treasury letter to Alfonse M. D'Amato, Chairman, Committee on Banking, Housing, and Urdan Affairs, U.S. Senate (July 27, 1998).

controls in place; is complying with laws, regulations, and policies; or that its board and management are effectively managing risks and complying with safety and soundness requirements. In addition, conditions can change and we believe changes to the mission of the System, and the environment within which FHLBanks operate, require FHFB to properly monitor FHLBanks and take any steps necessary to ensure they continue to operate in a safe and sound manner.

Second, FHFB said that we did not consider the extent to which examination findings addressed critical areas, most notably internal controls. We agree that many of the examination reports included findings on internal control problems. Our concern, however, is that FHFB's review of internal controls at the FHLBanks was limited to problems in areas that were routinely reviewed such as AHP, wire transfers, and financial operations. There was no overall assessment of the internal control systems of the FHLBanks. FHFB provided an analysis in its comment letter that indicated that 61 percent of its examination findings addressed internal control problems, which indicated to us that a broader review of overall control systems may be warranted.

Third, FHFB said we did not consider that these areas in which the examination scope was curtailed were relatively low-risk and that identified internal control problems did not merit an expansion of examination scope even though they recurred over time at the same FHLBank. Our concern that examination scope was curtailed is rooted in FHFB's own standards. Examination scope is determined through OS' preexamination analysis of each FHLBank and, according to FHFB's policy, the examiner-in-charge is to provide a written explanation subject to supervisory approval for any subsequent change in the planned scope.

We found the scope was curtailed in 2 of the 12 examinations reviewed, and examiners provided no explanation for the change in the work papers. Moreover, when we discussed these findings with OS officials, they said that limited staff resources and time constraints, in addition to the relative risk of the activities involved, sometimes required curtailing the planned examination scope. We believe that the two internal control problems examiners identified indicated a need to expand the scope of those examinations. Both of the cases involved an inadequate segregation of duties in consecutive annual examinations at the same FHLBank. Although the issues involved violations of fundamental principles of internal controls, FHFB felt that no additional review of the FHLBank's system of internal controls was warranted.

Finally, FHFB said that we had inappropriately based our conclusion about whether FHFB was ensuring mission compliance on the fact that it lacked policies and procedures. It said that its statutory duty is to work actively with the FHLBanks to ensure the housing finance mission is carried out. (We discuss this concern further in chapter 4.) While we considered whether FHFB had policies and procedures to ensure mission compliance, we did not limit our review to that alone. At the onset of this review, FHFB officials told us that they did not have a program in place to measure mission compliance but had begun to actively remedy that situation. In this chapter, we discuss numerous mission-related actions taken by FHFB. In addition, we note that FHFB's strategic plan indicates it is in the process of establishing its mission oversight program. One objective in FHFB's strategic plan is to establish "a system for ensuring mission compliance." As a result, we make no conclusions about whether or not FHFB is meeting its statutory duty. We recognize the difficulty in developing a mission oversight mechanism and acknowledge steps FHFB has taken recently to develop such a regulatory mechanism.

Programmatic Weaknesses May Limit the Effectiveness of FHFB's Regulatory Oversight

In addition to the weaknesses found in the sample of FHFB examinations we reviewed, we found two programmatic weaknesses that may limit the effectiveness of FHFB's regulatory oversight. First, FHFB's off-site monitoring consists of the preparation and review of several periodic reports prepared by OS and OP. However, FHFB lacked policies and procedures for off-site monitoring and there appeared to be no correlation between the FHLBank size or scope of activities and the level or type of off-site monitoring performed by these offices. Second, FHFB's supervisory enforcement program lacks clear policies and procedures for taking enforcement actions and does not specify what actions would be taken if certain conditions existed. In addition, the statute does not specifically enumerate FHFB's enforcement authority, except its authority to suspend or remove a director, officer, employee, or agent of the FHLBanks. These types of deficiencies raise concerns about FHFB's ability to compel timely corrective action should serious problems ever occur.

FHFB Off-Site Monitoring Needs Improvement

As stated in previous work on GSE regulation, monitoring between annual on-site examinations is an integral part of regulatory oversight.[1] We also stated that monitoring should be timely, focus on previously identified problems, and identify potential problems. We found FHFB monitoring activities consisted of several periodic reports that were not tailored to individual FHLBanks nor were they structured to identify potential problems. For example, an OS analyst prepared several periodic reports that tracked such activities as Financial Management Policy (FMP) compliance[2] and interest rate risk positions and trend data. Since 1996, FHFB has tracked the status of outstanding examination findings. Also in 1995 to 1996, OS established a "Regulatory Oversight Monitoring System" (ROMS). ROMS consisted of monthly reviews of various FHLBank information submitted to FHFB, including FHLBank board of director minutes, internal audit reports, and other FHLBank reports. We believe ROMS could also serve as a useful off-site monitoring tool between annual examinations. Monthly reviews under ROMS were suspended in May 1997, those reviews are now included as part of the annual preexamination planning.

OP, which is also involved in off-site monitoring activities, prepared periodic reports on various aspects of System operations. However,

[1]Farm Credit System: Farm Credit Administration Effectively Addresses Identified Problems (GAO/GGD-94-14, Jan. 7, 1994).

[2]The Financial Management Policy establishes guidelines for FHLBank funds not immediately required to fund credit programs or operations. It specifies allowable investments and contains certain limitations on others.

examiners generally reviewed these reports during preexamination planning, if at all, rather than throughout the year. OS and OP generally do not coordinate their activities. According to FHFB officials, the monitoring efforts of the two offices are viewed as serving different purposes.

Office of Supervision Off-Site Monitoring Activities

FHFB's regulations include off-site monitoring among the duties to be performed by OS.[3] As we have stated in our past work, "the level of monitoring must be sufficient to provide an adequate understanding of the GSE's operations, financial condition, and risk to the government. . . . Rapidly expanding business volume, entry into new activities, and issuing or purchasing new types of debt instruments should trigger increased regulatory monitoring."[4] Many of those conditions have existed in the System, as we noted in chapter 1. Regular monitoring between examinations is important because of the changing demographics of the System, its entry into new activities, and the issuance of new debt instruments. These factors reinforce the need for a fully-functioning monitoring program that is integrated with the examination program.

An OS analyst prepared four periodic reports for the Board. Examiners sometimes used these reports during annual preexamination planning. First, OS produced a quarterly "Regulatory and Financial Management Policy Compliance and Interest Rate Risk Positions Report." This report is compiled from reports FHLBanks are to submit monthly to FHFB about their compliance with FMP. During the course of our review, OS officials said they were also developing a way to independently verify FHLBank compliance with FMP. The report also provided the quarterly interest-rate positions of FHLBanks. Second, OS produced a quarterly monitoring and compliance review of System debt issuance activity based on information provided by OF. This report reviews several key areas OS identified as important including new developments, debt issuance activity, and compliance and disclosure. Third, OS produced a quarterly trend report that tracks various FHLBank financial data, such as income and balance sheet composition. This information is also included as an appendix to FHLBank examination reports. Fourth, since 1996, OS has prepared periodic reports that track the status of outstanding examination findings (that required management to take corrective action) between annual

[3]The regulation states that OS' responsibilities include, among others, monitoring of bank and System interest-rate risk, financial trends, and mission-related activities. C.F.R. § 900.14 (d).

[4]Government-Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks (GAO/GGD-91-90, May 22, 1991).

examinations. Finally, in 1998, OS began monitoring unsecured credit reports prepared by OF on a monthly basis.

These periodic reports cover many important aspects of FHLBank operations. However, other valuable information supplied by FHLBanks is not immediately reviewed by examiners when submitted to FHFB, although such reviews were performed under ROMS prior to May 1997. This information includes FHLBank board of directors minutes and bank internal audit reports. Minutes of board meetings can provide timely information about a bank's activities in addition to revealing directors' and managements' level of knowledge and participation in bank business. Internal audit reports can provide objective information on various facets of bank operations as well as management's response to any weaknesses the internal auditors identified. Currently, examiners review board minutes, internal audit reports, and other submitted information just prior to the annual on-site examination.

Office of Supervision Suspended Its Monthly Monitoring System Due to Staffing Constraints

As mentioned previously, OS suspended monthly monitoring under ROMS due to staff constraints in May 1997. According to FHFB documents, ROMS was originally established in 1995 to 1996 "to track the disposition of all examination issues and concerns, large and small." However, OS officials said that the purpose of ROMS was to save examiners time at the start of the annual on-site examination by reviewing and summarizing certain information that is periodically submitted to FHFB by the FHLBanks throughout the year on a monthly basis. FHFB officials said they did not consider ROMS a monitoring tool. However, we believe that ROMS has the added potential benefit of allowing examiners to monitor the activities of FHLBanks between annual examinations. Monthly monitoring through ROMS could enhance the standard Systemwide periodic reports prepared by OS.

As of July 1, 1998, monthly ROMS monitoring remained suspended and was to be completed as part of annual preexamination planning. Although FHLBanks are engaged in a fairly narrow range of activities, timely monitoring provides a useful way for the regulator to keep abreast of changes in activities between annual examinations. Given the recent and potential changes in the System, which we discussed in chapter 1, it will become more important for examiners to track the activities and condition of FHLBanks between annual examinations to ensure that the FHLBanks are adequately managing their risks. Unlike the other monitoring reports produced by OS, ROMS reviews could include a combination of historical and planned activities. For example, information addressed in board of

director minutes may include information about planned or proposed activities. This type of forward-looking information would be useful to augment the historical data captured in its monitoring reports.

OP Also Monitors FHLBank Operations; Coordination With OS Lacking

OP monitoring consists primarily of preparing various reports that range in frequency from monthly to annual. The reports are produced from information FHLBanks are required to submit periodically to FHFB and financial data that FHFB has access to through its District Bank Information Management System (DBIMS).[5] For example, each month, staff are to prepare a set of tables that track membership data, including the amount of advances, capital stock, and commitments that each member holds at the end of the month. In addition, OP is to annually reconcile AHP accounts to determine whether FHLBanks have committed all the AHP funds that the statute requires them to commit. Other reports may include quarterly reports on FHLBanks' advances to selected borrowers, such as state housing finance agencies and institutions owned or controlled by Native Americans; regular reports on AHP projects; special data tabulations for examiners during on-site examinations of AHP; reports on financial modeling, such as spread and growth estimates to generate income; and monthly financial reports. In addition, OP prepares a quarterly profile book that provides various types of comparative information, such as membership statistics and financial summaries, AHP data, and data on commercial bank versus thrift representation on boards of directors.

Most of these reports are generated for the Board, according to FHFB officials. These reports provide a systemwide rather than individual bank review. We found that examiners may use some of these reports during annual preexamination planning and preparation as part of their assessment of FHLBank operations rather than as a tool to monitor the FHLBanks' condition throughout the year. While both OP and OS monitor certain aspects of FHLBank activities, they generally do not coordinate their monitoring activities. Although officials said the purposes for their monitoring were different, we believe OS and OP could improve oversight of FHLBanks if their efforts were better coordinated. FHFB's regulations and the examination manual do not address the monitoring role performed by OP.

[5]DBIMS is the means by which the FHLBanks report their financial condition to FHFB on a monthly basis.

FHFB Enforcement Program Lacked Policies and Procedures

FHFB's enforcement program lacked clear policies and procedures. In our past work on GSE regulators and effective enforcement of rules and regulations, we outlined certain principles that we believed necessary for effective enforcement of GSE rules and regulations.[6] Those principles, among others, include that certain enforcement actions (1) should be mandatory when prespecified conditions are met, such as increasingly severe asset, earnings, or capital deterioration and (2) should be the result of a clear and reasonable process. The FHLBank Act does not enumerate specific enforcement authorities for FHFB, other than the authority to suspend or remove various parties, including any FHLBank director, employee, or officer. However, FHFB officials said that the statutory power to enforce orders allows the FHFB to issue and enforce orders requiring banks to take specified corrective actions. Given the lack of specificity in the statute, it is important that FHFB have a program in place to ensure that it has clear policies and procedures regarding what those specified actions would be. Currently, FHFB has no well-defined process to address serious problems if they should ever arise.

FHFB Lacked Clear Policies and Procedures for All Types of Enforcement Mechanisms

FHFB lacked clear policies and procedures regarding the use of enforcement actions and failed to specify what actions it would take if certain conditions existed. An FHFB official said that he does not believe it is necessary to produce detailed policies and procedures given the small size of the agency. He also said that enforcement decisions are made at the management level making written policies unnecessary. We believe that the broad statutory language makes policies and procedures more important. They would provide for consistency in regulation, continuity through changes in the Board and FHFB staff, and make FHLBanks fully aware of the repercussions of not taking corrective action.

We found that existing guidance, primarily the examination manual, stated that examiners have several "supervisory methods" to (1) encourage improved practices or to remedy violations of law, policy, or regulation and (2) correct weaknesses or unsafe and unsound practices or conditions. These methods include meetings with FHLBank management and boards, supervisory letters, follow-up examinations, requests for voluntary management changes or reorganizations, written voluntary agreements

[6]See GAO/GGD-91-90, May 1991.

with an FHLBank, and supervisory determinations[7]. While we found that FHFB used many of these methods, FHFB used supervisory determinations, which include certain categories of examination findings, most frequently. Officials said they view supervisory determinations as equivalent to an enforcement order because they require that a FHLBank take corrective action within a specified time period. See table 3.1 for a breakdown of examination findings for 1996 and 1997. FHLBank boards are required to respond to examination reports within 45 days and when warranted to include a remedial plan and timetable. According to FHFB records, FHLBanks were generally responsive to FHFB's examination findings.

Table 3.1: Examination Findings by Category for 1997 and 1996 Annual Examinations

Findings Category	1997	1996
Referral	2	2
Recommendation	41	61
Compliance matter	14	9
Weakness[a]	11	28
Violation[a]	10	19
Unsafe or unsound condition[b]	0	0

Note: Each finding category is defined in table 2.1.

[a]Denotes findings that require corrective action. These findings are also referred to in the chapter as supervisory determinations.

[b]Additional category used in infrequent circumstances requiring intensive regulatory oversight and corrective action, including measures to strengthen FHLBank management. Immediate corrective action is required.

Source: GAO analysis of 1997 and 1996 Reports of Examination for the 12 FHLBanks.

The examination manual does not provide examiners guidance that mandates the use of any type of action when a particular condition is determined, such as severe asset, earnings, or capital deterioration. The examination manual further states that if, in the examiner-in-charge's opinion, an FHLBank's response or planned action will not resolve the identified issue, the matter is to be referred to the OS director or deputy director for guidance. Once again, the manual does not indicate what additional actions would be taken by management or at what point the Board would become involved in enforcing supervisory determination.

[7]As defined in Finance Board Resolution 96-96 (Dec. 18, 1996), a supervisory determination is (1) a finding of OS requiring mandatory action (e.g., an unsafe and unsound practice or condition, weakness, or violation) set forth in a report of examination, order or directive; (2) an order or directive by the OS requiring mandatory action concerning safety and soundness or compliance matters; or (3) a failure by the OS, within 60 days of a Bank's written request, to acknowledge in writing that the OS will take no supervisory action with regard to an issue or set of circumstances presented by the institution.

According to one official, more specific details were not included in the examination manual because the manual is viewed as an examiner's tool and management would be responsible for any additional actions that would be taken, thus written guidelines were not considered necessary. We believe that FHFB could benefit from additional written guidance.

Beginning in 1996, we found that examiners tracked FHLBank responses to outstanding examination findings that required corrective action (i.e., weaknesses, violations, and unsafe or unsound conditions) and periodically prepared reports for the Board. Based on our review of those reports, it appears that the FHLBanks took corrective actions that satisfied the examiners and the Board. In addition, we identified only a few instances in FHFB records of weaknesses or violations that were carried forward into the subsequent year's examination and that resulted in the supervisory determinations being repeated. Examiners identified no unsafe or unsound conditions during the period of our review. The outstanding compliance issues generally related to CIP or AHP.

In July 1996, FHFB established a process for the FHLBanks to resolve examination findings that they dispute.[8] In general, FHFB encourages FHLBank staff to maintain cooperative communication to resolve disputes with OS staff informally. However, if an informal resolution is not possible, the FHLBank may file a petition with FHFB to have the matter considered by the Board. The FHFB's managing director is to review the filed petitions in consultation with OS and the chairman and promptly forward them to the Board. The managing director may also determine that additional information is needed before it is to be considered by the Board. According to FHFB documents, FHFB tries to resolve the dispute before it goes to the full Board and most disputes are expected to be resolved before a petition is filed. As of May 31, 1998, five FHLBanks had filed petitions disputing examination findings. Two of the petitions were closed or abandoned by FHLBanks prior to reaching the Board. FHFB withdrew the supervisory determination for one petition before it was considered by the full Board. In another petition, the Board approved a settlement agreement between OS and the FHLBank. The last petition, filed October 1997, is scheduled to be reviewed by the Board later this year.

[8]FHFB Resolution No. 96-60, dated July 30, 1996, "Procedures for the Review of Disputed Supervisory Determinations," was effective until Oct. 31, 1996. Resolution No. 96-74, dated Oct. 24, 1996 extended the effective date to Dec. 31, 1996. FHFB Resolution No. 96-96, "Revision and Adoption of Procedures for Review of Disputed Supervisory Determinations," Dec. 18, 1996.

Statute Does Not Specifically Enumerate FHFB's Enforcement Authority

Unlike other GSE regulators, FHFB's statutory enforcement authority is not specifically enumerated in the statute. The FHLBank Act authorizes FHFB to "promulgate and enforce"[9] regulations and orders; but, with one exception, it does not delineate enforcement authorities provided other GSE regulators, such as cease and desist orders and civil money penalties. These and other enforcement authorities are typically provided by law for other GSE regulators. The law does, however, specifically authorize FHFB to "suspend or remove for cause a director, officer, employee, or agent of any Federal Home Loan Bank or joint office."[10]

FHFB officials said that they believe that the general powers provision in the statute to enforce regulations and orders would enable them to issue and enforce orders requiring an FHLBank to take specific actions to address a safety and soundness problem if FHFB identified such a need. According to FHFB officials, they would seek court enforcement of the FHFB order if necessary. However, we believe that seeking this authority could take some time and thus preclude a prompt resolution of the problem. Further, because the statute does not enumerate specific authorities beyond FHFB's suspension and removal authority, an FHLBank may be inclined to legally challenge FHFB's authority. Therefore, having the specific statutory authorities that other regulators have would allow FHFB to avoid the potential for a dispute over its enforcement authority and to encourage timely corrective action, if a serious problem should ever arise. We believe, as we have stated in the past for any GSE regulator, that the statute should give FHFB enforcement authorities that are granted other regulators.[11]

[9]12 U.S.C. § b(a)(1)(1994).

[10]12 U.S.C. § b(a)(2)(1994).

[11]Formal enforcement actions, authorized by statute, available to other regulators include issuing cease and desist orders, assessing civil money penalties, and entering into formal written agreements with the institutions. Formal enforcement actions are legally enforceable tools that regulators can use to compel banks to take corrective actions to address supervisory concerns.

Statute and Practices Still Involve FHFB in System Business

FHFB has certain System business functions assigned to it in statute which complicate its primary duty as FHLBanks' safety and soundness regulator. Both FHFB and System officials agree that at least some of those business functions should be performed by FHLBanks. FHFB has devolved, within certain parameters, some of those functions to FHLBanks. In addition to its business functions based in statute, FHFB serves as a promoter and coordinator for the System to some extent. FHFB views these activities as consistent with its primary duty of ensuring the System's safety and soundness, as well as ensuring mission compliance. In our view some of FHFB's activities may undermine its independence as a regulator. For example, FHFB has adopted an initiative to stimulate development of new services and products. As the System's regulator, FHFB would be responsible for evaluating the new products it has previously advocated with respect to their safety and soundness. We continue to believe that Congress should shift FHFB's management functions to FHLBanks and their members so that the System manages itself, as other GSEs do.

In past work on the housing GSEs, we recommended that a single regulator be created to assume the duties of FHFB, OFHEO, and HUD. Our current work at FHFB and our recent work at OFHEO and HUD have strengthened our belief that oversight of the housing GSEs would be more effective if combined.

Like Its Predecessor, FHFB Remains Involved in System Business

When FHFB was established in 1989, the statute maintained many of the remnants of FHFB's predecessor agency, the FHLBank Board. The FHLBank Board was an integral part of the System and many of the System business functions it performed passed to the new FHFB. Thus, FHFB was not established as an arm's-length regulator as are other GSE regulators, such as the Farm Credit Administration that oversees the Farm Credit System. As recently as September 24, 1997, the FHFB Chairman testified before the Senate Subcommittee on Financial Institutions and Regulatory Relief of the Senate Committee on Banking, Housing, and Urban Affairs at the oversight hearing on FHFB that "One of the anachronisms from the days of the Federal Home Loan Bank Board is the degree to which the Finance Board, the regulator of the Banks, is required to approve day-to-day operational decisions of the Banks."[1] FHFB business functions include the authority to approve FHLBank dividends, bylaws, the appointment of presidents, employee benefits, the transfer of advances among FHLBanks, travel policies, cost-of-living adjustments for retirees, and other retirement

[1]Bruce Morrison, Chairman, FHFB, testimony before the Subcommittee on Financial Institutions and Regulatory Relief, Senate Committee on Banking, Housing, and Urban Affairs, Sept. 24, 1997.

policies. FHFB is reviewing these approval authorities for possible devolution.

FHFB also has statutory authority to issue consolidated obligations for the System. Generally, it is GSEs that have the authority to issue their own debt, rather than the regulator. The Farm Credit System, which is a cooperative system composed of banks and other entities, issues debt through a fiscal arm established in statute for that purpose. Although FHFB delegated its authority to issue System debt to OF through regulation, its statutory authority remains. FHFB has other ties to the office, such as appointing its three board members, approving the appointment of a director and the budget. This statutory link to debt issuance could potentially expose the federal government and ultimately taxpayers to legal risk.

Both FHFB and FHLBank officials have recognized the need for separation of the business and regulatory functions. FHFB stated in a 1993 report to Congress, "The dual role of the Finance Board is a weakness of the current Bank System structure. The roles of regulation and governance residing in one entity are not compatible and, indeed, represent a long-standing, well-understood inherent conflict when joined. A regulator needs the objectivity that 'distance' from decisionmaking provides; a manager cannot objectively self-audit."[2] According to its 1994 annual report, the FHFB had slated several of its regulations and policies for devolution. In response to recommendations made in a study by a committee of FHLBank stockholders,[3] the FHFB Chairman testified in September 1997 before a congressional committee that since 1993, FHFB had sought to devolve "as many purely management responsibilities as it could."[4] Thus, there has been general agreement for some time among top System officials and FHFB that business functions should be devolved to FHLBanks.

Others, including us, concur. Studies mandated by the Housing and Community Development Act of 1992 by the Departments of Treasury and HUD, FHFB, FHLBanks Stockholder Committee, and us said that the

[2]FHFB Report on the Structure and Role of the System, submitted by the FHFB to Congress Apr. 28, 1993.

[3]The Future Direction of the Federal Home Loan Bank System, report submitted to banking committees of the House and Senate, July 1993. The FHLBank Stockholder Study Committee was statutorily established by the Housing and Community Development Act of 1992 P.L. No. 102-550 § 1394, 106 stat. 3672, 4011 (1992). The Committee consisted of 24 members—two stockholders from each of the 12 FHLBanks—elected by their respective boards.

[4]Bruce Morrison, Chairman, FHFB, testimony before the Subcommittee on Financial Institutions and Regulatory Relief, Senate Committee on Banking, Housing, and Urban Affairs, Sept. 24, 1997.

management function should be separated from safety and soundness oversight of the System. In congressional testimony in 1994 and 1995, Treasury officials stated that the FHFB's "current responsibilities are in conflict."[5] In discussing an Administration bill to reform the System in 1995 Treasury explained that its proposal to devolve FHFB's managerial responsibilities to the FHLBanks would "remove the inherent conflicts between the Finance Board's regulatory and managerial responsibilities, while strengthening all members' stake in the System."[6] We also recommended in 1995 that all FHFB governance or management functions be devolved to the System. We expressed concern then, and continue to believe that combining the roles of oversight and management may undermine the independence necessary to be an effective safety and soundness regulator.[7]

FHFB Has Devolved Some System Business Functions to FHLBanks

As of July 1, 1998, FHFB had devolved several responsibilities to FHLBanks within specified limits. These responsibilities included the authority to (1) establish presidents' and other employees salaries and incentive payments, (2) approve AHP applications, (3) determine the appropriate level and structure of compensation for FHLBank directors, (4) establish FHLBank performance targets, (5) approve budgets and amendments, (6) approve membership applications for FHLBanks, (7) execute and administer the System's contract for an external audit, (8) approve charitable contributions and meetings outside of the FHLBank districts, and (9) approve applications for nonmember mortgagee eligibility.

FHFB, other GSEs, and bank regulators have regulatory authority over many aspects of the entities they regulate. Such authority is appropriate for ensuring that certain business decisions do not threaten financial soundness, that certain activities are consistent with mission, or as a tool for compelling a financial institution to correct safety and soundness deficiencies identified by a regulator. For example, FHFB and other regulators have authority, under certain conditions that could pose a threat to safety and soundness, to remove officers or directors of the institutions they regulate. However, FHFB also has the authority, following the selection by the FHLBank's board, to approve the appointment of each FHLBank's president—a function generally left to the boards of directors of

[5]Statement of Frank N. Newman, Under Secretary of the Treasury, Senate Committee on Banking, Housing, and Urban Affairs, June 15, 1994.

[6]Statement of Richard S. Carnell, Assistant Secretary of the Treasury, Subcommittee on Capital Markets, Securities, and Government-Sponsored Enterprises, House Committee on Banking and Financial Services, May 17, 1995.

[7]Federal Home Loan Bank System: Reforms Needed to Promote Its Safety, Soundness, and Effectiveness, (GAO/T-GGD-95-244, Sept. 27, 1995).

other GSEs. As part of its devolution project, FHFB authorized the FHLBank boards to determine the length of the FHLBank presidents' tenure, but retained its authority to approve the boards' initial appointment of the president.

FHFB explained its rationale for retaining authority to approve the initial appointment when it issued a final rule on this matter.[8] FHFB believes that FHLBank presidents are charged with representing and furthering not only a bank's stockholders' interest but also the interests of the public. Given its statutory duties, FHFB stated it believed that retaining its initial approval authority over a FHLBank's selection of its highest officer was necessary to carry out its duties. Although this approval authority may be useful to FHFB, we note that retaining this role could appear to give FHFB an interest in the individual's appointment and complicate FHFB's decision to remove a president if the need arose.

For most of the devolved activities, FHFB created guidelines and parameters within which FHLBanks are to exercise their authority. For example, in 1996, FHFB approved a final rule that authorized the FHLBank boards to establish reasonable salaries and incentive payments for employees, other than the president. The rule also transferred to FHLBanks the authority to establish presidents' salaries and incentive payments, within limits. The rule (1) required that FHFB set an annual base salary cap, (2) specified the standard criteria for incentive payments that the FHLBank boards must use for their presidents, and (3) limited the total incentive amount to a percentage of the annual base salary cap, published by FHFB. According to at least one FHLBank director, some of the incentive criteria created a conflict between the FHLBank board and FHFB because the board wanted to encourage certain types of mission-related activities and FHFB may want to encourage others. For example, one criterion FHFB specified that FHLBank boards must use to determine FHLBank presidents' incentives was the level of community investment programs activity. We acknowledge that it is appropriate for a GSE regulator, because of GSEs' special public purposes and close ties to the government, to have some regulatory authority over compensation levels. For example, other GSE regulators have the authority to ensure that compensation is not excessive.[9] However, it is less clear whether FHFB should be involved in

[8]Federal Register, Vol. 62, No. 1, Thursday, Jan. 2, 1997.

[9]OFHEO has authority to prohibit its GSEs from providing compensation to executive officers that is not reasonable and comparable with that of similar businesses. 12 U.S.C. § 4518 (1994). The Farm Credit Administration has authority to monitor Farm Credit System directors' compensation and ensure it does not exceed levels specified in law. 12 U.S.C. § 2209 (1994).

setting salary limits and specifying criteria that FHLBank boards should use to provide incentives for presidents. Those types of activities could be viewed as more managerial than regulatory.

System and FHFB officials generally agree that to completely make FHFB arm's-length would require legislative changes. FHFB's 1998 to 2002 strategic plan identifies the devolution of management issues "including compensation and dividends, with safety and soundness and mission oversight retained by the Finance Board" as part of legislation it wants to see enacted. In March 1998, the FHFB Chairman said in reference to its involvement in the day-to-day management of the FHLBanks, "Unfortunately, the Finance Board cannot extract itself from some of these matters under current law."[10] While the devolution process may offer some interim relief, several FHLBank officials said that they believe the devolution project is more form than substance. They said that most of the devolved items are administrative in nature and those that are not, have been devolved within such tight parameters that they leave little room for FHLBank board discretion. FHLBank officials also said that even with the devolution, legislation is required because the current devolution project could be suspended and the regulation reversed by a FHFB Board resolution. As stated in a previous report, other officials said they disagree with FHFB's interpretation of the statute on some issues and believe that the FHFB has the power to fully delegate these business functions to the banks and should do so.[11]

FHFB's Involvement in System Business Includes Promotion and Central Coordination

Although many of the activities that involve FHFB in System business are statutory or regulatory requirements, FHFB also continues to function as a promoter and coordinator for certain System activities and programs. The FHLBanks themselves have two groups to provide some coordination of System issues, and they have expanded their involvement in debt issuance. Nevertheless, the FHFB involves itself in promoting the System and coordinates communication among and congressional outreach by the FHLBank chairs and vice chairs. FHFB views these activities as consistent with ensuring the System's safety and soundness, as well as ensuring mission compliance. However, consistent with our previous work, we believe that aspects of such of participation in System business may be inappropriate for a regulator and undermine its independence.

[10]Statement for the record by Bruce Morrison, Chairman, FHFB, Committee on Banking, Housing, and Urban Affairs, U. S. Senate (Washington, D.C., Mar. 12, 1998).

[11]GAO/GGD-97-139, pp.10-11.

System Needs Central Coordination and Has Established Groups With the Potential to Fill This Role

The 12 FHLBanks are independently owned by their individual stockholders and governed by individual boards of directors. However, FHLBanks are interdependent in that they were established as GSEs under the same statute to fulfill the same mission, and they raise funds in the capital market through consolidated obligations for which they are joint and severally liable. As noted earlier, FHLBanks and FHFB acknowledged the need for central coordination, at least as early as 1993; and the System has made progress in trying to undertake this role.

Perhaps the most significant factor linking each FHLBank is the joint issuance of System obligations. Each FHLBank is jointly and severally liable for the System's debt. As noted in chapter 1, this means that if one or more FHLBanks are unable to repay its participation in the consolidated obligations, the other FHLBanks could be called upon to repay a portion of such obligations. This obligation makes it important for each bank to be aware of debt issuance activity, risk management, and in general the financial condition of the other banks in the System. In 1994 the FHLBanks took steps to improve the flow of information about debt issuance by creating a committee of bank presidents to work with the OF board. The OF board consists of two bank presidents and a private citizen, all appointed by FHFB. In addition, it was agreed that minutes of board meetings and related materials would be distributed to all FHLBank presidents.

In a 1993 report, FHLBanks, OF, and FHFB recognized several functions that need to be managed centrally for the System.[12] These included

- strategic planning,
- establishment of general credit policies,
- legislative coordination and lobbying,
- cultural leadership and image building, and
- data collection and financial modeling.

The existing mechanisms for managing these functions, include the Conference of Federal Home Loan Banks (President's Conference) and the newly established Council of the FHLBanks (Council). These mechanisms provide for the exchange of information and present the opportunity for the System to assume a larger role in coordinating Systemwide interest. The Presidents' Conference, consisting of the presidents of the 12 FHLBanks, meets at least bimonthly to "identify, define, and deliberate issues of strategic significance to the Federal Home Loan Bank System and to

[12]System 2000: A Strategic Framework for the Future of the Federal Home Loan Bank System, Aug. 1993.

provide a forum of the exchange of ideas and information related to improved service and performance of the Federal Home Loan Bank System." It works through five committees: steering; communication and general management; finance, research, and planning; housing and community development; and legislative. The steering committee develops a strategic issues agenda for the Conference and coordinates the study and discussion of the issues. For example, a task force on rural issues worked with FHFB, the Department of Agriculture, and five FHLBanks serving predominately rural areas in exploring increasing investments in targeted rural areas as part of the CIP. While the Presidents' Conference can make recommendations to the respective FHLBank boards, the positions and resolutions reached by the presidents are not binding.

In 1997, nine FHLBanks created a Council "to enhance the public's awareness and understanding of the Federal Home Loan Bank and to promote the role and purpose of the Federal Home Loan Banks." The Council has broader representation than the President's Conference because its representatives may include FHLBank board members and/or management; each member may appoint two representatives. A tenth bank joined the Council in 1998; as of July 1998, the FHLBanks of Chicago and New York had not joined. The Council is still in its formative stages, but it has established an office in Washington, D.C. and hired permanent staff including a lobbyist and executive vice president. The Council provides another opportunity for FHLBanks to come together in furthering the role of the System.

FHFB Still Serves as a System Promoter and Coordinator

Despite the existence of the President's Conference and the Council of FHLBanks, FHFB acts as a promoter and coordinator for the System in some respects. Although FHFB views these activities as consistent with its primary duty of ensuring the System's safety and soundness, we are concerned that these activities further involve FHFB in System business. Undertaking these activities may undermine FHFB's independence and lead to questions about its objectivity. We continue to support our 1991 position that the regulator's function "should not be to promote a GSE over other market participants nor should it include promotion of the economic sector served by the GSE." The following three examples illustrate FHFB's promotional and coordinating activities.

First, FHFB's strategic plan provides an overview of its promotional and coordinating activities as well as its safety and soundness function. Of the plan's nine objectives, one focuses on the examination function. Five

address changes FHFB advocates "for FHLBanks in order to enhance their performance." These changes include seeking structural and other reforms for the System through legislation, including expanding the acceptable uses for advances and eligible collateral to include, for example, small business loans. The plan also includes conducting an ongoing "cost-benefit" study regarding the value of the FHLBanks to provide information for "long-term decisions about ensuring mission achievement." Two objectives address the devolution effort; and one speaks to disseminating information about the goals, objectives, and achievements of the FHFB.

The plan, approved by the Board in September 1997, notes that it is an integral part of the budget planning process and that performance plans for FHFB divisions will be based on it. With so many of the plan's objectives focused on topics other than FHLBank safety and soundness, the official agency plan does not appear to place adequate emphasis on its primary responsibility—safety and soundness oversight. Further, the lack of significance FHFB places on the safety and soundness examination function is evident in its allocation of fulltime staff to the examination program—OS staff comprise 13 percent of FHFB staff resources as of May 31, 1998.

Second, in its strategic plan, FHFB identified what it believes is a need for a marketing clearinghouse function to collect information on marketing methods and the demand for new System services and products and to help the FHLBanks develop potential partnerships with housing advocates and others. FHFB officials acknowledged that this type of service typically would be performed by a trade association, but FHFB is proceeding to develop such a clearinghouse function. According to its 1998 annual performance plan, FHFB also will be involved in developing new services and products that are to fulfill housing finance needs. By fiscal year-end 1998, FHFB plans to develop a semiannual "best practices" report on innovative FHLBank products, services, and marketing methods. Although working with FHLBanks and others to identify and share such best practices is an appropriate undertaking for FHFB, it is less clear that developing new products or advocating that FHLBanks undertake specific activities are consistent with its duties as a regulator. As the System's regulator, FHFB would be responsible for examining any new products or programs thus raising questions about its objectivity in evaluating an activity it helped promote.

Third, FHFB plays a coordination role through the chairman's regular meetings with the FHLBank chairs and vice chairs. According to FHFB

documents, the meetings with the chairman were initiated by the chairs in 1996. In 1997, meetings were held quarterly; in 1998, they were to be held monthly. FHFB used these meetings to further its legislative agenda. For example, the chairman coordinates the congressional lobbying efforts of FHFB appointed FHLBank chairs and vice chairs through these monthly meetings. Agenda items addressed at meetings included "mobilizing for passage" and "getting Congress to adopt the legislation" that FHFB promoted. FHFB's involvement of chairs and vice chairs it appoints in lobbying for statutory changes illustrates the potential FHFB has for influence over those positions. Also, in June 1998, FHFB coordinated the annual conference for FHLBank directors planned by a committee of System officials with FHFB assistance. The purposes of the 1998 conference were to discuss the current status and strengths of the System and what should be changed to enhance the value of the System to its members. These activities illustrate concerns raised in our 1995 testimony about whether FHFB should be responsible for appointing directors to FHLBank boards because FHFB may nominate directors who support the regulator's views and may not reflect the views of the public.[13]

Single Housing Regulator Would Have Advantages Over Current Regulators

In past work on the housing GSEs, we recommended that a single regulator be created for the three housing GSEs that would assume the duties of (1) FHFB, (2) OFHEO, and (3) HUD, the regulators of Fannie Mae and Freddie Mac and discussed the advantages and disadvantages of such a regulatory scheme.[14] We have continued to monitor and evaluate the housing GSEs and their regulators. For example, we issued report on OFHEO in October 1997 and on HUD's mission oversight of Fannie Mae and Freddie Mac in July 1998.[15] We found that OFHEO had not fully completed two important duties: establishing risk-based capital standards and implementing a comprehensive and timely examination program.[16]

Our work at HUD raised a number of issues about its oversight of Fannie Mae and Freddie Mac, some of which would be eliminated or at least

[13]GAO/T-GGD-95-244.

[14]GAO/GGD-94-38 and GAO/GGD-97-139.

[15]The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 established OFHEO to oversee the safety and soundness of Fannie Mae and Freddie Mac. Other than safety and soundness and certain other matters that the 1992 Act specifies as exclusive to OFHEO, the 1992 Act gives general regulatory power over Fannie Mae and Freddie Mac to the Secretary of HUD.

[16]See Federal Housing Enterprises: OFHEO Faces Challenges In Implementing a Comprehensive Oversight Program (GAO/GGD-98-6, Oct. 22, 1997).

mitigated if there were a single regulator for the housing GSEs.[17] For example, HUD is required to establish goals for its purchase of mortgages serving targeted groups and also maintain the financial soundness because such purchases could increase credit risk. We found that HUD adopted a conservative approach to setting the goals that placed a high priority on maintaining the GSEs' financial soundness, but HUD did not consider the financial consequences of setting higher goals. In addition, we found that HUD has not implemented a process to ensure that the GSEs' financial activities are consistent with their housing mission. For example, HUD did not initiate efforts to determine whether the GSEs' nonmortgage investments were consistent with their housing mission until 1997. A single regulator would be better able to evaluate the trade-off between mission and safety and soundness as well as evaluate the financial aspects of new mortgage products and nonmortgage investments because it would combine expertise in housing and finance.

As a result of this work, we have found no evidence that would cause us to alter our previous positions. Rather, our current work at FHFB and the recent work at OFHEO and HUD have strengthened our belief that FHFB's, OFHEO's, and HUD's oversight of the housing GSEs would be more effective if combined.

A single regulator for the housing GSEs would have four important attributes that would facilitate improvements in the safety and soundness and mission oversight functions now mandated to FHFB. First, a single regulator would be more independent and objective than separate regulatory bodies can be. A single regulator would not be affiliated with one particular GSE, dependent on that GSE for its continued existence, and thus subject to their influence. Because the operations and interests of the System, Fannie Mae, and Freddie Mac do not align precisely, there should be a healthy tension in the oversight of the entities that could help prevent the regulator from being "captured" by the GSEs. In addition, a single regulator would not be inclined to promote any one particular segment of the GSE housing finance industry over another because its fate would not be tied to the existence of one particular GSE.

Second, a single regulator would be more prominent in government than FHFB, OFHEO, and HUD's GSE oversight function can be alone. This would not only afford the regulator more "clout" in overseeing the housing GSEs, but provide added weight to its opinions and findings when presented to

[17]Federal Housing Enterprises: HUD's Mission Oversight Needs to Be Strengthened (GAO/GGD-98-173, July 28, 1998).

Congress, the Department of the Treasury, GSE stockholders, and others in the public and private sectors.

Third, some economies and efficiencies would be created with a single regulator. Staff could share expertise in such areas as examinations, credit and interest-rate risk monitoring, financial analysis, and economic research. The examination staffing constraints we identified at FHFB and similar staffing concerns identified at OFHEO might be alleviated by combining FHFB, OFHEO, and HUD resources. Plus, an arm's-length regulator without responsibilities for any System business functions would have more resources to use in oversight. As we reported in chapter 2, OS was unable, due to staffing constraints, to perform all duties required by its own standards. FHFB officials acknowledged that lack of resources was also the reason the monthly off-site monitoring effort was suspended in 1997. A more prominent single regulator could help attract and retain staff with the special mix of expertise and experience needed to examine and monitor System and the other housing GSEs—three sophisticated financial institutions.

OFHEO's work in setting capital standards and developing a stress test for Fannie Mae and Freddie Mac could be useful in oversight of the System. We have recommended in past work that adequate capital standards be set for all the housing GSEs based on the risks they undertake. Bills now pending in the Senate and House propose that the FHLBank regulator set risk-based capital standards. The results of OFHEO's comprehensive financial modeling to determine how much capital its GSEs should hold may be helpful in evaluating the risks to the System and the adequacy of its capital.

Fourth, a single regulator would provide consistent regulation for the GSEs serving the same economic sector and sharing the public purpose of providing credit for housing. Although the System, Fannie Mae, and Freddie Mac do not directly compete in all of their activities, they are all participants in the residential mortgage market. Consolidating their regulation would enable a regulator to take into account the competitive effects that regulatory decisions made concerning Fannie Mae and Freddie Mac would have on the System and vice versa. For example, some pilot programs approved by FHFB and undertaken by some FHLBanks involve services Fannie Mae or Freddie Mac could or currently do provide. In one program, an FHLBank would fund and hold mortgages originated by its member institutions. FHFB found that this program would provide member institutions a way to move mortgages off their books without having to pay

fees associated with selling mortgages to Fannie Mae or Freddie Mac or to other secondary market participants. OFHEO officials said they independently assessed the competitive impact of the pilot programs on Fannie Mae and Freddie Mac. If a single regulator were responsible for all three housing GSEs, a single assessment could have combined consideration of all competitive effects and ensured regulatory consistency of oversight.

Agency Comments and Our Evaluation

FHFB generally disagreed with our analysis in this chapter, including our assessment of its allocation of staff resources, analysis of its strategic plan, and assessment of FHFB's coordination and mission promotion activities. FHFB stated that ensuring the safety and soundness and that FHLBanks "carry out their housing finance mission," are the primary duties of its entire staff. We evaluated the function and size of staff resources and overall responsibilities of staff offices on the basis of regulatory definitions and other published descriptions of FHFB operations. For example, FHFB's 1997 Annual Report states that

> "The Office of Supervision (OS) is responsible for the Finance Board's two most important functions: ensuring that the FHLBanks operate safely and soundly, and ensuring that public mission standards for the FHLBank System are being met. OS performs these functions through on-site examinations and off-site monitoring."

FHFB regulations support this description, and we note that none of the other offices have similar language in the regulations describing their responsibilities. Using full-time staff equivalents, as discussed in this chapter of the draft and final reports, we determined that OS, the office FHFB describes as "responsible for the Finance Board's two most important functions" comprised 13 percent of FHFB staff resources. In addition, FHFB officials' own statements to us that they curtailed some examination work, did not expand other examination work, and suspended some of their off-site monitoring performed between examinations, led us to question the adequacy of the resources allocated to the oversight of FHLBank safety and soundness, specifically OS. Although FHFB said that we failed to consider that "most of the goals listed in its strategic plan focus on safety and soundness and compliance issues," we reviewed and evaluated FHFB's strategic plan in the context of its regulatory mission. We found that most of the plan's objectives, in our opinion, did not have a "strong" safety and soundness and compliance component. Instead, we concluded that they focused on changes FHFB advocated to enhance their performance.

FHFB strongly disagreed with our conclusions about its approach to mission compliance oversight. FHFB also characterized our view of mission regulation as "passive" and "inconsistent with the plain language of the Bank Act." It also stated that FHFB's strategy of fulfilling its statutory mandate to ensure that the FHLBanks carry out their housing finance mission by "actively encouraging" the development of mission-related activities by the FHLBanks is entirely consistent with its statutory charge. We recognize and understand the difficulty in regulating mission compliance, as stated in this chapter and chapter 2. However, we make a distinction between mission regulation and mission promotion. Because FHFB is ultimately responsible for regulating the projects and programs it has promoted, we are concerned that FHFB's strategy of "actively encouraging" FHLBanks' development of mission-related assets could raise questions about its independence and objectivity. We believe an arm's-length regulator should have all the regulatory authority it needs to ensure mission compliance, but this should not include involvement in the day-to-day operations of the regulated entities.

Although FHFB contends that our conclusions about mission oversight are based on a "lack of understanding," we instead believe this represents a simple disagreement about what activities constitute mission regulation. FHFB considers its promotion activities to be a form of regulation. In chapter 2 of the draft and final reports, we discuss three elements that we consider essential to mission oversight: "(1) a clearly defined mission, (2) well defined policies that delineate what constitutes mission compliance, and (3) methods to measure whether or not FHLBanks have fulfilled their mission." In comparison, in its comments, FHFB cited three strategies a regulator should follow, (1) measure what is being accomplished, (2) authorize or refuse to authorize activities, subject to safety and soundness, but also (3) define public needs that FHLBanks should meet and mechanisms and procedures to achieve them. We agree with FHFB's first two strategies and view them as similar to ours. However, we believe Congress should define "public needs," not the regulator, as FHFB suggests.

Finally, we view the development of policies and procedures and a systematic way to view FHLBank activities as an active and appropriate means of ensuring that FHLBanks fulfill their public purposes. It is our view that a regulator's role is to ensure mission compliance by defining proper mission-related activities in regulation and then ensuring—through a combination of on-site examinations, off-site monitoring, and other oversight efforts—that the GSE is complying with the rules. Contrary to

FHFB's stated emphasis on laws, regulations, and policies for "ensuring" safety and soundness, FHFB does not subscribe to this approach for "ensuring" mission compliance. FHFB stated that its role is to actively foster what it sees as appropriate System activities. Instead, we would encourage FHFB to develop a regulatory framework for viewing FHLBank activities and ensure that FHLBanks comply with it.

Conclusions and Recommendations

In their 65 year history, no FHLBank has experienced a credit loss. However, the System of 1932 is not the System of today. In the last 10 years, the System has undergone substantial change. The System no longer makes advances only to thrifts for home mortgages. It provides funding and liquidity to new groups of members—commercial banks and credit unions—and to all members for more diverse purposes, such as community development and lending to targeted groups. FHFB has encouraged FHLBanks to create alternative mission-related investments in response to growing concerns about the System's large investment portfolio. In addition, Congress is considering whether System activities should be expanded further to accept additional types of collateral that could expose the System to additional risk.

Due to the System's expanding activities and changing business environment, FHFB's safety and soundness regulation is increasingly important to protect taxpayer interests. Recognizing the importance of safety and soundness, Congress made ensuring that the FHLBanks "operate in a financially safe and sound manner" FHFB's primary duty in 1992. FHFB has established quidelines for FHLBanks to follow in implementing financial management strategies through its "Financial Management Policy." However, FHFB's operations do not reflect the same prominence given its safety and soundness duty in statute. FHFB allocated 13 percent of its staff resources to OS. While it shares oversight responsibility with OP and the Office of General Counsel, OS has the sole responsibility for doing on-site examinations to ensure safety and soundness and mission compliance of the FHLBanks.

FHFB examiners focused on interest-rate and credit risk, which was generally appropriate, given the activities and risks of the FHLBanks. However, the 120 staff-day allocation per FHLBank was generally not sufficient for the staff assigned to conduct the planned analysis of the FHLBanks' operations. As a result, examiners often reduced the planned examination scope or eliminated examination procedures to finish examinations on time. Examiners also routinely excluded elements, such as oversight by board and management, internal control systems, and internal and external audits, which we, FHFB, and other regulators have deemed critical to evaluate risk management. Rather than evaluating FHLBanks' overall systems to review these critical areas, examiners looked for problems that had already occurred and tracked the sources of those problems. FHFB's "bottom-up" approach may be useful to track known problems, but it does not allow examiners to identify weaknesses in

control systems or other potential problems early enough for management to take corrective action.

FHFB's examiners generally did not follow examination procedures or document their examinations as required by FHFB's examination manual. FHFB officials explained that procedures are not followed and documented because examiners often do not have time to complete all of the procedures described in the manual or to adequately document their procedures or conclusions. In addition, they suggested that some of the examination programs contained in the manual are not well suited to their examinations. Especially given staff turnover, it is important that examiners have useful guidance and adequately document the work performed and conclusions reached during examinations.

Mission compliance is also part of FHFB's annual examination process. However, FHFB acknowledged having no examination policies or procedures outside of its reviews of the special affordable housing and community investment programs to determine whether or the extent to which FHLBanks were supporting housing finance. In 1997, FHFB began the process of determining whether it should promulgate regulations to define and measure mission fulfillment. Prior to 1997, mission compliance focused primarily on the AHP and CIP, two programs that account for less than 1 percent of the System's total assets. FHFB also relies on the percentage of advances outstanding to qualified thrift lenders as evidence of mission compliance. Other funds are invested. FHFB's efforts to establish parameters for nonmission investments could help ensure that a majority of System assets are dedicated to the System's mission. Currently, individual FHLBank investment portfolios (including mortgage-backed securities) ranged from 17 percent to 58 percent of total assets.

We recognize the difficulty in developing a mission compliance oversight mechanism because it is difficult to track how advances are used once the funds are dispersed to System members. FHFB has taken several steps to develop a regulatory mechanism that would provide procedures for determining the extent to which an FHLBank complies with the System's mission, including hiring a consultant to study the issue, requiring FHLBanks to self-report about their mission compliance activities, and issuing new community support regulations.

We identified additional weaknesses in FHFB monitoring and enforcement programs that raised concerns about FHFB's regulatory effectiveness. FHFB lacks a coordinated off-site monitoring system, which is an important part

of effective safety and soundness regulation because it can provide an early warning of potential problems. OS and OP produce a variety of reports that track many aspects of the FHLBanks. However, they do not coordinate their monitoring activities. Monitoring should be timely, focus on previously identified problems, and identify potential problems. ROMS was not viewed as a monitoring tool, which limited its potential benefit to examiners. Although OS' other periodic reports tracked useful information, OS could also benefit from the timely monitoring under ROMS, which could allow examiners to identify problems early. The periodic reports prepared by OS and OP provide some monitoring benefits; however, they are geared toward keeping the Board informed about FHLBanks rather than keeping examiners apprised of the condition and current activities of FHLBanks.

Another element of effective regulation is an adequate enforcement mechanism. Although FHFB believes that it has adequate authority under the statute, FHFB lacks policies and procedures that clearly delineate its program of corrective action. The examination manual lists several informal methods that FHFB can take to encourage corrective action, it primarily uses categories of examination findings to articulate whether the FHLBank needs to take corrective action. This type of approach may not be sufficient were a serious issue to develop at one of the FHLBanks. The statute governing FHFB gave it the authority to promulgate and enforce regulations and one specific enforcement authority, to remove or suspend FHLBank directors, officers, employees, or agents. FHFB officials said they believed the general provision would allow them to take any necessary action through the courts. However, we believe FHFB would be better prepared and assured of its ability to take forceful action if its statute enumerated the authorities granted other GSE regulators, such as cease and desist and civil money penalties.

Unlike other GSE regulators, FHFB does not function as an arm's-length regulator. In addition to its oversight responsibilities, FHFB has an ongoing role in the System's business. While many of its statutory and regulatory functions are administrative, they open the door for FHFB's involvement and participation in System business, which it has ultimate responsibility to oversee. FHFB has recognized this as inappropriate and begun to delegate several of these functions to FHLBanks. While we believe this is a positive step toward more arm's-length regulation of the System, achieving arm's-length regulation will require legislation to remove all governance functions assigned to FHFB in statute. Such a statutory change would not preclude FHFB's oversight of System business; rather, it would preclude FHFB's involvement in System business.

FHFB is also involved in the process of developing and promoting certain activities that it must ultimately regulate. FHFB views this role as consistent with ensuring the System's safety and soundness and its mission compliance. However, we believe that such involvement in System business raises concerns about FHFB's independence and objectivity because FHFB is ultimately responsible for regulating the projects and programs it has promoted. In addition, because it regulates only one GSE, FHFB may have a vested interest in the survival of the System which contributes to its willingness to act as an advocate of the System.

The deficiencies we identified in FHFB's examination and monitoring programs and FHFB officials' own acknowledgement of the lack of resources for these vital functions leads to our conclusion that FHFB's oversight of the System needs to be strengthened to provide on-site assurance that FHLBanks are effectively managing risk and, thus, are operating in a safe and sound manner. The quality, frequency, and coordination of off-site monitoring also needs to be improved so that problems can be detected sooner and on-site examinations can be carried out more effectively and efficiently. Since 1997, FHFB has taken a number of actions to help ensure mission achievement. However, FHFB is not yet in a position to ensure that the FHLBanks are carrying out their housing finance mission given that FHFB does not yet have policies or procedures, other than for special targeted-lending programs and self-reporting, to make such a judgment.

FHFB's limitations as a regulator need to be viewed against the backdrop of its continuing role, provided in statute, in System business, as well as its innovation and promotion of System programs. This lack of arm's-length status—unique among GSE regulators—raises additional questions about whether this regulatory agency is structured for effective oversight of the safety and soundness and mission compliance of the nation's third largest GSE.

As noted in previous reports, we continue to believe the best way to address many of our concerns would be to create an arm's-length regulator. A single regulator for the housing GSEs would help address many of the deficiencies we found at FHFB, HUD, and OFHEO. A single regulator would be more independent and objective, have more prominence than all agencies individually, create potential economies and efficiencies, and provide consistent regulation for the three largest GSEs.

Recommendation

To strengthen FHFB in its primary oversight role as the safety and soundness supervisor of the System, we recommend that FHFB

(1) ensure that critical aspects of FHLBank operations are reviewed as part of every FHFB examination;

(2) ensure that examiners follow the guidance and complete the appropriate examination procedures described in the examination manual;

(3) adequately document the work performed and conclusions drawn during examinations; and

(4) more clearly articulate and document its current enforcement mechanisms, policies, and procedures.

Matter for Congressional Consideration

GAO continues to support its 1994 and 1997 positions that a single housing GSE regulator be created to oversee the safety and soundness and mission compliance oversight of the housing GSEs. While considering this action, at a minimum, Congress may want to consider taking interim action to redirect FHFB's attention to its primary role as the System's safety and soundness regulator by making FHFB an arm's-length regulator, as in the case of other GSE regulators. This could be achieved by ensuring that its statutory duties do not involve FHFB in any System business. In addition, Congress may want to consider giving FHFB specific enforcement authorities it has provided to other GSE regulators.

Comments From FHFB

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

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September 8, 1998

Mr. James F. Hinchman
Acting Comptroller General
U. S. General Accounting Office
Washington, DC 20548

Re: Draft report of the United States General Accounting Office entitled "Federal Housing Finance Board -- Actions Needed to Improve Regulatory Oversight," prepared pursuant to the request of Richard Baker, Chairman, Subcommittee on Capital Markets, Securities and Government-Sponsored Enterprises, Committee on Banking and Financial Services, House of Representatives.

Dear Mr. Hinchman:

I appreciate the opportunity to provide comments on the above-referenced draft General Accounting Office (GAO) report.

The methodology chosen by the General Accounting Office focused primarily on the examination activities of the Finance Board, just one aspect of our regulatory activities. As a result, the draft report inappropriately extrapolates from the very limited scope of the audit performed to draw overly broad, inaccurate and unsubstantiated conclusions about the adequacy of the agency as both a safety and soundness and a mission regulator. I thus request that these written comments, including the enclosure, be included in their entirety in the final report to better ensure its accuracy and completeness.

See p. 11.

As the independent regulator of the Federal Home Loan Bank System, the Federal Housing Finance Board (Finance Board) is charged by statute with the primary duty of ensuring that the 12 Federal Home Loan Banks (FHLBanks) operate in a financially safe and sound manner. The Federal Home Loan Bank Act also requires that the Finance Board, consistent with its primary duty, supervise the FHLBanks and ensure that the FHLBanks carry out their housing finance mission and remain adequately capitalized and able to raise funds in the capital markets.

As required by law, safety and soundness is the primary consideration in everything the Finance Board does, from promulgating regulations, to developing policies and procedures, to authorizing pilot programs. The safety and soundness requirements prescribed for the FHLBanks in statute, regulation and policy are more stringent and conservative than those for

See pp. 11-12.

federally insured depository institutions or for other government-sponsored enterprises. This results in a System with a AAA-rating (without reference to its implied government backing), which has not experienced a credit loss since its inception in 1932. Because I do not see evidence that GAO considered this statutory and regulatory context in reaching conclusions as to the Finance Board's safety and soundness regulatory regime, the enclosure describes these requirements in detail.

See pp. 12-13.

The draft report mistakes the Finance Board's authorization of certain activities, and its identification for the FHLBanks of appropriate ways to fulfill their housing finance mission, for intrusion into the business of the FHLBanks. In fact, the Finance Board's strategy of actively encouraging the development by the FHLBanks of mission-related assets and reduction in holdings of non-mission related assets, also detailed in the enclosure, is entirely consistent with the Finance Board's statutory mandate to ensure that the FHLBanks carry out their housing finance mission.

Despite the methodological flaws and unsupported conclusions in the draft report, I believe it contains a number of useful suggestions that we will evaluate and implement, where appropriate, to improve the quality of the Finance Board's examination process.

Sincerely,

BRUCE A. MORRISON
Chairman

Enclosure

cc: Hon. Richard H. Baker
Hon. Paul E. Kanjorski

FEDERAL HOUSING FINANCE BOARD

Comments on GAO Draft Report
"Federal Housing Finance Board: Actions Needed to Improve Regulatory Oversight"

The Federal Housing Finance Board (Finance Board) has the primary statutory duty of ensuring that the 12 Federal Home Loan Banks (FHLBanks) operate in a financially safe and sound manner. The Federal Home Loan Bank Act (Bank Act) also requires that the Finance Board supervise the FHLBanks and ensure that the FHLBanks carry out their housing finance mission and remain adequately capitalized and able to raise funds in the capital markets.[1] The statutory charge to "ensure" requires the Finance Board to be results-oriented rather than process-oriented with respect to its two fundamental duties: (1) ensuring safety and soundness; and (2) ensuring that the FHLBanks carry out their housing finance mission. These duties are the primary responsibility of the entire 115-person agency.

I. Ensuring the safety and soundness of the FHLBank System.

A. *The safety and soundness policies prescribed for the FHLBanks by the Finance Board are more stringent and conservative than those that apply to federally insured depository institutions or to other government sponsored enterprises. The FHLBanks are AAA-rated (without regard to their implied government backing) and have not experienced a credit loss since their creation in 1932. Annual on-site examinations, together with comprehensive reporting and off-site monitoring, ensure regulatory compliance with these policies.*

See pp. 11-12 and 49-50.

The Finance Board fulfills its primary statutory duty to ensure the safety and soundness of the FHLBanks in a number of ways. Annual on-site examinations are only one of the Finance Board's safety and soundness tools. Safety and soundness also is critically dependent on the adequacy of: (1) the Bank Act, and the Finance Board's regulations and policies that limit the amount of risk that the FHLBanks can assume; (2) the corporate governance, risk management, auditing and disclosure policies and

[1] *See* 12 U.S.C.A. §§ 1422a(3)(A), (B).

See comment 1.

procedures that the FHLBanks are required to have in place to identify and manage their risks; and (3) the amount of capital that is available to absorb any losses that may occur at the FHLBanks.

1. Finance Board Regulations and Policies Tightly Control Risk.

The operations of the FHLBanks involve two major risks – credit risk and interest rate risk. Both types of risk are tightly controlled, either by the Bank Act, Finance Board regulations and policies, or both. These risks are also qualitatively different from, and inherently lower than, the risks facing federally insured depository institutions because of the FHLBanks' unique role of lending on a fully secured basis to their member institutions, who are themselves regulated for safety and soundness by federal and state regulators. Unlike many insured commercial banks, the FHLBanks also do not engage in trading operations.

Credit Risk Controls. The lending and investment activities of the FHLBanks that expose them to credit risk are prescribed by statute and further constrained by the regulations and policies of the Finance Board. Because the primary business of the FHLBanks is making loans (called advances) to their members and certain nonmember borrowers, advances represent the major asset held by the Banks. The Bank Act prescribes that advances must be fully secured by a very limited statutory list of eligible collateral, principally mortgage and other real estate related collateral, obtained from their members.[2] The FHLBanks also have a statutory lien on the stock of their borrowing members, and certain members must hold additional stock against advances.[3] The FHLBanks may also require additional collateral security for an advance whenever deemed necessary for their protection and have access to their members' safety and soundness examination reports.[4]

In addition to these statutory protections, the Finance Board imposes regulations and policies,[5] which further define eligible collateral, require the

[2] *Id.*, § 1430(a).

[3] *Id.*, § 1430(c), (e).

[4] *Id.*, §§ 1430(d), 1422.

[5] 12 C.F.R. Part 935.

FHLBanks to have appropriate policies on credit underwriting and advances and on monitoring the adequacy of collateral pledged for advances. They also impose safety and soundness considerations on the FHLBanks' pricing and on setting maturities of advances, among other things. Thus, the Bank Act, Finance Board regulations and policies, and the FHLBanks' own policies and procedures operate together in ensuring that the credit risk on FHLBank advances is extremely low. In fact, in the 65-year history of the FHLBank system, no FHLBank has ever experienced a credit loss on an advance.

While advances are the FHLBanks' primary assets, investments also represent a significant asset on their balance sheets.[6] As with advances, the credit risk of the FHLBanks' investments is tightly controlled by both the Bank Act and Finance Board regulations and policies. The Bank Act authorizes the FHLBanks to invest reserves and surplus funds in securities with relatively low credit risk, such as U.S. Treasury securities, securities issued by Freddie Mac, Fannie Mae or GNMA, and in such securities as fiduciary and trust funds may be invested in under the laws of the state in which the FHLBank is located.[7]

The FHLBanks' statutory investment authority is further restricted by the Finance Board's Financial Management Policy (FMP). The FMP sets forth specific, eligible investments for the FHLBanks and requires the FHLBanks to limit the credit exposure in their investments and to obtain collateral from all but the most creditworthy institutions. Investments in certain high-risk securities and the use of derivatives for speculative purposes are expressly prohibited. Generally, long-term investments are allowed only if the asset is issued or guaranteed by the U.S. government or a U.S. government sponsored agency, or if the asset is rated triple-A and secured. Mortgage backed securities (MBS) that meet these criteria are eligible investments. However, the FMP limits aggregate MBS investment by a FHLBank to three times the Bank's capital, and places restrictions on the types of MBS that a FHLBank may purchase to further reduce risk.

The FMP also requires that unsecured investments be short-term and be placed only with highly rated counterparties. The FMP also instructs the

[6] As of December 31, 1997, the FHLBanks had total assets of $348.5 billion, of which $202.3 billion were advances and $140 billion were investments.

[7] 12 U.S.C.A. §§ 1431(h), 1436(a).

3

FHLBanks to establish limits on credit risk exposure through swaps and other off-balance sheet agreements with counterparties and to obtain collateral when credit exposure exceeds established limits. As with advances, there has never been a known credit loss with any FHLBank investment.

Interest Rate Risk Controls. Like other financial institutions, the FHLBanks are exposed to interest rate risk whenever the cash flows associated with their assets and liabilities are not well matched over time. Unlike other federal financial regulators, the Finance Board has imposed strict limits on the amount of interest rate risk exposure that each FHLBank may assume. These limits include a stress test for sudden changes in interest rates, as well. The FMP requires each FHLBank to maintain its duration of equity – a commonly used measure of interest rate risk – at very conservative levels. The Finance Board monitors each FHLBank's duration of equity on a quarterly basis to assure compliance. By using a variety of risk management techniques – e.g. match funding advances and investments by issuing debt with similar structures, issuing callable debt, and using interest rate swaps and options to hedge their positions – the FHLBanks generally stay well within the conservative regulatory limits set by the Finance Board.

See pp. 11-12.

2. Corporate Governance, Risk Management, Auditing and Disclosure Requirements Help Ensure Safety and Soundness.

The senior management and boards of directors of the FHLBanks also play vital roles in ensuring safety and soundness, and the Finance Board uses this corporate governance structure to help fulfill its safety and soundness duty. Specifically, the Finance Board requires that the senior management of each FHLBank (1) establish internal control systems to ensure compliance with Finance Board policies and regulations and (2) report monthly to its board of directors and the Finance Board on regulatory compliance. The Finance Board also requires that the internal auditor of each FHLBank establish internal auditing programs that test for compliance with its safety and soundness policies.

Because the FHLBanks are subject to the Government Corporation Control Act, they are also required to have annual audits conducted by independent outside auditors in accordance with the Comptroller General's auditing standards. These standards, which are in addition to those for SEC registrants, require reviews, attestations, and public reporting on the results

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of internal control testing. Moreover, although the FHLBanks are exempt from SEC registration and reporting requirements, the Finance Board recently adopted a policy that requires the System's financial reports be prepared in a manner consistent with, to the greatest extent practicable, SEC disclosure requirements. Such extensive auditing and disclosure requirements provide additional safety and soundness protection.

See p. 12.

3. FHLBanks Are Required To Be Well-Capitalized.

Capital requirements, which ensure a buffer against loss, are a critical safety and soundness tool employed by financial regulators. The capital requirements of the FHLBanks are specified in the Bank Act.[8] These statutory capital requirements, together with the Finance Board's regulation limiting the System's debt to 20 times capital,[9] assure that the FHLBanks have capital-to-asset ratios which approximate the 5 percent ratio for well-capitalized depository institutions and are about twice the 2.5 percent capital-to-asset requirements for Fannie Mae and Freddie Mac.

On a risk-adjusted basis, the FHLBanks are even better capitalized. To be considered well-capitalized, depository institutions must have total risk based capital of 10 percent, and, as of year-end 1997, insured depository institutions held 12.65 percent risk-based capital on average. By comparison, the FHLBanks held over 22 percent risk-based capital at year-end 1997.

See comment 1.

4. Annual Examinations Assure Compliance with Safety and Soundness Standards.

The Bank Act mandates annual examinations of the FHLBanks.[10] During such examinations, critical risk areas, such as financial management, interest rate risk compliance and modeling, FMP compliance, and the integrity of internal controls over various banking operations, are routinely reviewed. Where operational issues suggest weaknesses in management or board oversight, such weaknesses are pursued. Examiners also routinely review board minutes and other materials.

[8] 12 U.S.C.A. § 1426. Members must purchase capital in their FHLBank equal to the greatest of 1 percent of their residential mortgage assets, 0.3 percent of total assets, or 5 percent of their outstanding balances. *See, also, id.*, § 1430(e).

[9] 12 C.F.R. § 910.1.

[10] 12 U.S.C.A. § 1440.

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Examiners review internal audit materials in the course of planning and executing each examination. Where review or testing in areas covered by internal audit materials suggests weaknesses in the scope or execution of the internal audit function, such weaknesses are pursued. For example, in reviewing interest rate risk modeling and pricing of MBS, examiners select a sample of such securities, check their prices and interest rate sensitivity against management and internal audit reports, and explore any discrepancies. Examiners have found that testing data at the operational level is an effective way to test the reliability of the audit function.

Substantial examination resources are devoted to reviewing the FHLBanks' financial modeling, which supports their monthly reporting to the Finance Board of compliance with the interest rate risk limits and other requirements of the FMP. The Office of Supervision prepares a quarterly report reviewing such compliance. This report provides a bank-by-bank discussion of key risk issues, including compliance with FMP limits on counterparty creditworthiness, credit concentrations, and interest rate risk sensitivity. The report also tracks the market value of FHLBank equity as compared to book value, as well as the sensitivity of that market value to 200 basis point interest rate shocks.

See comment 2.

Examination findings requiring mandatory corrective action generally are set forth in examination reports which constitute a "supervisory determination," to which FHLBank management and directors must respond in writing. FHLBanks may dispute examination findings requiring mandatory action in accordance with Finance Board procedures, but must comply with the determination unless it is stayed by the Board of Directors of the Finance Board. The Finance Board is empowered by the Bank Act to issue orders as necessary to effect enforcement[11] and to suspend or remove for cause a director, officer, employee or agent of any FHLBank.[12] The Finance Board also has statutory authority to liquidate, reorganize or merge any FHLBank upon finding that the efficient and economical accomplishment of the purposes of the Bank Act would be aided by such action.[13] There has never been an unimplemented directive from the Finance Board.

[11] *Id.*, § 1422b(a)(1).

[12] *Id.*, § 1422b(a)(2).

[13] *Id.*, § 1446.

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See p. 11.

B. *GAO incorrectly assumed that examinations are the Finance Board's sole safety and soundness tool, and limited its work to a narrow review of examination procedures. Therefore, its work cannot support any conclusions regarding the overall effectiveness of the Finance Board's safety and soundness oversight.*

In reviewing the examination function, GAO limited its work to a mechanical comparison of examination work papers against programs set forth in the Finance Board's examination manual (Manual). Congress requested that GAO review the *effectiveness* of the Finance Board's oversight efforts as safety, soundness and mission regulator of the FHLBank System. The narrow scope of GAO's audit and their audit methodology cannot support any conclusions regarding the "effectiveness" of the Finance Board's regulatory oversight. GAO's methodology overlooked critical matters necessary to any assessment of effectiveness:

See pp. 11-12 and 49-50.

♦ GAO did not assess the strong financial condition, performance, or low risk profile of the FHLBanks.

See pp. 11-12.

♦ GAO did not assess the critical role performed by conservative risk limits, set forth in the Bank Act, regulations, and financial management policies of the Finance Board and FHLBanks, in ensuring FHLBank safety and soundness.

See pp. 11-12.

♦ GAO did not assess how such regulatory risk limits, agency oversight, and the examination program function together to ensure safety and soundness.

See p. 50.

♦ GAO did not consider the extent to which actual examination output over the sample period – the reports and findings delivered to the FHLBanks -- effectively addressed the risks to be controlled at the FHLBanks. For example, GAO did not consider that 67 percent of the examination

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findings[14] made during its two-year sample period dealt with internal controls, management and board oversight, and internal audit -- areas GAO contends the Finance Board did not "always fully assess."

See comment 2.

♦ GAO did not uncover any evidence of actual difficulty in practice in achieving FHLBank compliance with examination findings, yet criticized the Finance Board's enforcement program as lacking clear policies and procedures.

See p. 71.

♦ GAO did not consider that the bulk of the Finance Board's staff, and most of the goals listed in its Strategic Plan, focus on safety and soundness and compliance issues.[15]

See p. 50.

GAO identified two instances where examination scope was curtailed without explanation, and two instances where examination scope was not expanded despite identified control weaknesses.

See p. 50.

The two scope curtailments were in low risk areas – regular and discount advances and member applications. To maximize examination efficiency, it is standard practice to de-emphasize low priority items in the field in favor of higher risk matters.

[14] GAO reviewed 26 examination reports from 1996 and 1997, containing 205 findings. Findings are generally labeled in reports by the operations area in which they are made. Here is a substantive breakdown of the findings by the critical areas identified by GAO – internal controls, internal audit, and management and board oversight:

Finding Type	Distribution (%)
Internal Controls (arising in financial management, information technology, departmental operations, affordable housing program, and other operations)	61.5
Internal Audit	3.4
Management and Board Oversight	2.5
Findings in GAO Critical Areas	67.4
Other findings	32.6
	100.0

[15] For example, with respect to the Strategic Plan, Goals/Objectives I (examination), IIA (legislation), IIE (FMP), IIIA (Devolution), and IIIB (compliance assistance), each have a strong safety and soundness or compliance component. GAO misread the Strategic Plan, incorrectly concluding from the fact that only one agency objective set forth therein deals with the examination function, that the Strategic Plan does not sufficiently emphasize safety and soundness.

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See p. 50.

Similarly, neither of the control weakness findings GAO identified involving segregation of duties warranted an expansion of examination scope. Correction of the weakness, as examiners recommended and the FHLBank implemented, was sufficient to satisfy the examination goal of assuring the integrity of internal controls to avoid material losses or capital impairment. The further search for "undetected transactions or losses" arising from the weakness, as recommended by GAO, would have been unnecessary and inefficient from an examination standpoint, since these procedures had been corrected and there was negligible risk of material loss.

Conclusion. Ensuring the safety and soundness of the FHLBanks is the top priority of the Finance Board, as reflected in and reinforced by statute, Finance Board regulations and policies, the Finance Board's strategic plan, the Finance Board's allocation of staff resources, and the Finance Board's examination process. GAO's reliance on comparing a sample of Finance Board exam reports to its Manual did not consider the many elements of the Finance Board's safety and soundness regime and misinterpreted the elements it did consider.

II. Ensuring that the FHLBanks carry out their housing finance mission.

See comment 3.

A. *In order to ensure that the FHLBanks carry out their housing finance mission, the Finance Board must actively foster the maximizing of public benefit from the activities of the FHLBanks.*

Housing finance[16] is the public purpose for which the FHLBank System was created. This public purpose is accomplished by the FHLBanks providing housing and community investment credit through member financial institutions. Just as the Finance Board has a statutory duty to ensure that the FHLBanks operate in a financially safe and sound manner, the Finance Board has a statutory duty to ensure that the FHLBanks carry out their housing finance mission consistent with their safe and sound operation. Both duties, of necessity, involve the agency to some degree in the FHLBank System's business.

[16] The Finance Board has long and consistently interpreted "housing finance" to include the statutorily mandated activities of "community investment" that were added to the Bank Act by FIRREA, *see Id.*, § 1430(j)(10); 12 CFR 935.1.

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As with safety and soundness, the primary tools for ensuring mission achievement are interpretations of the Bank Act, promulgation of regulations and policies, and the FHLBanks' own policies and programs. Once again, the Finance Board does not view examinations as its sole mission regulatory tool. The Finance Board looks primarily to the Bank Act and at the actual business and balance sheets of the FHLBanks to assess the mission performance of the FHLBanks. The Finance Board has also identified for the FHLBanks products and activities which would advance the public interest in housing finance.

See pp. 51 and 72-73.

The Bank Act specifies several specific products which support housing finance, such as the Community Investment Program,[17] the Community Support Program,[18] other Community Investment Cash Advance programs,[19] as well as advances generally. In addition, there is a requirement that the FHLBanks contribute 10 percent of their net income, but not less than $100 million annually, to an Affordable Housing Program (AHP),[20] to provide subsidies to members engaged in lending for long term low and moderate income owner occupied and affordable rental housing.

Currently, only about 1 percent of the FHLBanks' assets are comprised of AHP and CIP lending, and about 40 percent of the System's balance sheet is in assets that do not directly support the delivery of housing and community investment credit by the FHLBanks through their members. Assets that do not directly support the mission of the System, other than to provide arbitrage profits to enhance System earnings, should be transformed into assets that help members provide housing and community investment credit, as advances do. Therefore, the Finance Board has engaged in an affirmative strategy to actively encourage replacing these investment arbitrage assets with mission-related assets.

The Finance Board has promulgated regulatory initiatives, held hearings on changing the balance sheet of the FHLBanks, met with representatives of the FHLBanks and their members, set goals in its strategic plan, required the

[17] 12 U.S.C.A. § 1430 (i).

[18] *Id.*, § 1430 (g).

[19] *Id.*, § 1430 (j)(10).

[20] *Id.*, § 1430(j).

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FHLBanks to submit annual mission compliance reports as a part of the annual examination process, continued to develop pilot procedures, and approved four FHLBank pilot programs. Further, the Finance Board's primary emphasis on safety and soundness has assured that no initiatives are implemented until they have been assessed for risk, appropriate policies and procedures and risk management controls have been developed and put in place, and sufficient pre- and post-implementation examination and monitoring arrangements have been planned.[21]

The recent pilot programs are innovations in products developed through member institutions and FHLBanks. These pilots were not mandated by the regulator. Rather, the Finance Board encouraged members and the FHLBanks to "knock on the door" with creative programs to meet the System's mission, and they have responded to the call. The four authorized pilot programs also are the best examples of the Finance Board's primary emphasis on safety and soundness while ensuring mission achievement. Initial approval of each pilot was based on its providing credit support for housing or community investment not available on comparable terms in the private marketplace. Once approved, implementation of each FHLBank's pilot activities has required an extensive prior examination to verify that the FHLBank has put the needed policies, procedures and controls in place to assure that its pilot does not compromise that FHLBank's or the System's safe and sound operation. And, these pilots are subject to ongoing examination of their operations.

The Finance Board also has undertaken a number of regulatory initiatives aimed at clarifying mission, at measuring mission and at devolving governance to the Banks as the statute permits. For instance, in 1997, the Finance Board adopted comprehensive revisions to its regulations governing the AHP. In addition to devolving the administration of the AHP to the FHLBanks, the amended regulations were structured to increase the AHP's effectiveness, streamline the application process, clarify standards, reduce regulatory burden and strengthen the Finance Board's ability to enforce both the regulatory and statutory standards of the program.

The Finance Board has proposed regulations whereby the FHLBanks may target the use of letters of credit to mission-related activities, and whereby

[21] *See, i.e.*, "Pilot Procedures and Pilot Proposal Initial Submission Guidelines," Finance Board Resolution No. 97-70 (Nov. 12, 1997).

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the FHLBanks may establish "Community Investment Cash Advance Programs" authorized by the Bank Act.[22] Both of these proposed regulations contain standards for assuring that these mission-oriented activities will be conducted safely and soundly by requiring both activities to be fully secured by specified collateral and by requiring that the FHLBank develop appropriate policies and procedures concerning these activities. As always, safety and soundness remain the Finance Board's primary consideration.

The Finance Board has also established a Compliance Assistance Division in its Office of Policy to work with the FHLBanks and provide technical and other assistance in complying with statutory, regulatory and policy requirements. That office works closely with the Office of Supervision and the Office of General Counsel to address and resolve issues related to the AHP and the FMP, among others. In its role of ensuring that the FHLBanks carry out their housing finance mission, the Finance Board also has established a Market Research Division within the Office of Policy to work with the FHLBanks, their members, customers, and potential customers to assist in developing new mission-related assets for the FHLBanks.

See comment 4, pp. 12-13 and p. 51.

B. In reaching conclusions as to whether the Finance Board is meeting its statutory duty to ensure that the FHLBanks carry out their housing finance mission, GAO looked to whether the Finance Board has policies and procedures in place sufficient for the Finance Board to make that judgment. This passive view of the Finance Board's duty is inconsistent with the plain language of the Bank Act. The Finance Board's statutory duty is to ensure the housing finance mission is carried out consistent with the primary duty to ensure safety and soundness, not simply to form a judgment as to whether the mission of the FHLBanks is being carried out. In meeting this duty, the Finance Board actively works with the FHLBanks and carefully balances its combined mission and safety and soundness responsibilities.

[22] "Federal Home Loan Bank Standby Letters of Credit – Proposed Rule," (63 Fed. Reg. 25726 (May 8, 1998)); "Community Investment Cash Advance Programs – Proposed Rule," (63 Fed. Reg. 25718 (May 8, 1998)).

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See comment 5 and p. 72.

GAO's draft report demonstrates a total lack of understanding of what effective mission regulation entails. To read the report, one would think measuring what the FHLBanks do and saying "yes" or "no" to new initiatives is sufficient. Such an approach would not "ensure" any level of mission achievement. As GSEs, the FHLBanks have a special congressionally mandated duty to carry out their mission and the Finance Board is statutorily charged with defining what activities qualify and what activities do not. To "promote" the public interest is precisely what the Finance Board must do.

See p. 72.

A mission regulator actually must follow at least three different strategies to ensure mission performance: (1) it must measure what is being accomplished; (2) it must authorize or refuse to authorize activities as mission-consistent, subject to safety and soundness considerations; but also (3) it must define public needs which the regulated entities should be meeting and mechanisms and procedures to move them toward doing so. Who else but the public sector regulator is to have the final say on what the public interest is with respect to a GSE? Only Congress.

These are the standards by which the Finance Board seeks to ensure that the FHLBanks carry out their mission. In contrast, GAO established no criteria or standards in its draft report against which to measure or judge the success of the Finance Board as a mission regulator. GAO fails to assess the actual results of the agency's efforts to fulfill its responsibility to ensure that the FHLBanks carry out their housing finance mission, and instead confuses mission regulation with improper intrusion in the Banks' managerial affairs and corporate governance. In fact, as the draft report acknowledges, the Finance Board agrees that, to the extent possible within statutory parameters, it should devolve FHLBank managerial and administrative matters to the boards and management of the FHLBanks, and it has been doing so. The Finance Board has never sought to tell the FHLBanks how to conduct their businesses. Rather, the Finance Board is focused on what credit needs in housing finance and community investment should be addressed and for which segments of the population.

See comment 6.

Thus, it is impossible for an effective mission and safety and soundness regulator not to be involved with System business, as GAO suggests would be preferable. It is the proper role of a GSE regulator to set the parameters within which the regulated entities must operate to ensure that the government supplied subsidy is directed to the maximum extent possible to

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the achievement of the GSE's public purpose and that this is accomplished in a financially safe and sound manner.

The GAO draft report is critical of what it calls the "coordination" activities of the Finance Board Chairman in his meetings with the FHLBank chairs and vice chairs. The two items of concern identified are legislation and planning for an annual directors' conference. Throughout the draft report, GAO fails to analyze the connection of these subjects to the Finance Board's proper concerns and extrapolates them to suggest "coordination" of the management of the FHLBanks, which is never a part of these activities.

The legislation which the Finance Board Chairman has been promoting is that which GAO advocated in 1993.[23] It is essential to eliminating the Finance Board's statutory FHLBank management role, to establishing risk-based capital, to giving the Finance Board modern regulatory powers, and to ending the structural flaws which require substantial non-mission investments. Getting such legislation passed is essential to the future safe and sound and mission advancing operation of the FHLBanks. Legislation does not pass itself nor get passed over the opposition of the affected FHLBanks. A regulator that did not seek to coordinate success in this process would not be doing its job.

Similarly, the directors' conference was planned to assist the FHLBanks in understanding and planning for the Finance Board's initiative to reduce non-mission promoting investments.[24] Once again, facilitating success in this initiative is the Finance Board's job. The same is true of the other, limited items when "coordination" rather than providing information has been the subject of such meetings.

Part of the draft's confusion stems from failing to analyze specifically the inherent conflict between safety and soundness and mission accomplishment. But the Finance Board fully understands this issue. Consistent with its statutory responsibility, safety and soundness is the

See comment 7.

[23] U.S. GAO Report, "Federal Home Loan Bank System—Reforms Needed to Promote Its Safety, Soundness, and Effectiveness," Dec. 1993.

[24] *See*, "Notice – Hearing on FHLBank Investment Practices and an Approach for Limiting Certain Non-Housing-Related Investments," 63 Fed. Reg. 16505 (April 3, 1998); "Making the Best News Real: Leading the FHLBank System into the 21st Century," remarks of Chairman Bruce A. Morrison at FHLBank Directors' orientation, Jan. 27, 1998; "Maximizing the Value of the FHLBank System," remarks of Chairman Bruce A. Morrison at FHLBank Directors' Conference, June 2, 1998.

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overriding principle in everything the Finance Board does. As discussed in II.A. above, no initiatives are authorized by the Finance Board or implemented by the FHLBanks until the initiatives have been assessed for risk and until appropriate risk management controls have been put in place and pre- and post-examination arrangements have been planned.

See comment 8.

The fact that an agency authorizes an activity does not mean that the agency cannot then effectively examine and supervise the activity for safety and soundness. For instance, the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) charter financial institutions, yet have no difficulty regulating, examining and supervising those institutions for safety and soundness. All of the financial institution and GSE regulators approve applications whereby institutions in their regulated communities seek to engage in various activities; that does not hinder those agencies in their examination, supervision or regulation of the authorized activities.

Further, the fact that an agency exhorts its regulated entities to do what they are required to do by law or what would further their public mission does not prevent the agency from effectively examining and supervising the activity. For instance, the OCC and the OTS routinely "advocate" that their regulated entities fulfill their Community Reinvestment Act (CRA) requirements—having written regulations to guide and facilitate that compliance. GAO has not suggested that those agencies should not engage in that conduct or that those agencies cannot then conduct meaningful CRA examinations because of a conflict of interest. The same is true of the Finance Board's dual role.

Conclusion: The Finance Board's strategy of fulfilling its statutory mandate to ensure that the FHLBanks carry out their housing finance mission by actively encouraging the development of mission-related activities by the FHLBanks is entirely consistent with its statutory charge, and represents the regulator seeking to encourage maximization of the public benefit through the stimulation and authorization of financially safe and sound, innovative tools and products. This necessarily involves it in System business to an appropriate degree, while not governing the management of the FHLBanks.

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See pp. 10-11.

III. The Finance Board will review and consider several of GAO's suggestions to improve examination procedures.

In the course of its review, GAO compared the Finance Board's examination manual procedures to examination documentation to determine the extent to which the documentation evidenced compliance with the procedures. This method permitted GAO to make some useful procedural recommendations for greater consistency between written procedures and examination practices.

GAO found inconsistencies between Manual procedures and documented examination work. The need to ensure appropriate documentation of the examination process and consistency with examination standards must be balanced against the need to maintain flexibility and effectiveness in the field. The examination process differs from the audit process, in that it focuses on critical risks and controls that might materially affect the soundness of the institution, and correspondingly has more limited coverage. Adhering to fixed examination programs, irrespective of the need to redirect examination resources to particular areas based on the facts uncovered, would impair examination effectiveness.

In light of GAO's recommendations, the Finance Board plans to review the extent to which the balance between procedural regularity and necessary flexibility has been appropriately maintained in the examination process. Several options will be explored, including: (1) enhancing documentation of procedures conducted in the field, including conformity to those suggested in the Manual; (2) increasing examination staff to permit added attention to such documentation; and (3) better tailoring the Manual's examination programs to the operations and risk profiles of the FHLBanks and the actual experience of examiners in the field.

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GAO Comments

1. FHFB stated in its comment letter that during examinations it reviews critical risk areas such as financial management, interest-rate risk compliance and modeling, FMP compliance, and the integrity of internal controls over various banking operations. In addition, it stated that when operational issues suggest weaknesses in management or board oversight, such weaknesses are pursued. Our review of FHFB's examinations of the FHLBanks indicated that FHFB examiners routinely reviewed the elements of the FHLBank operations discussed in their comment letter. Thus, we noted in the draft that "all of the examinations we reviewed included reviews of FHLBank policies and procedures to mitigate interest rate and credit risk." However, we are concerned that OS examiners did not routinely assess other aspects of FHLBank operations that we and other financial industry regulators have identified as vital to evaluate risk management. That is, because of the growth in the size and complexity of the FHLBanks and the additional activities in which they have become involved, it has become increasingly important for FHFB to evaluate the overall oversight, management, and internal control systems of FHLBanks to assure that the institution's management has adequate, accurate information about their operations and that they use the information to manage the FHLBank in a safe and sound manner. Making such a determination can allow FHFB to anticipate problems that may emerge from an assessment of FHLBank management before problems develop and thereby lower its operations risk. We also noted in the draft that FHFB officials stated that although they do not assess board of director and management oversight in a top-down manner, they would attempt to determine how those functions contributed to any problems they identify during an examination.

In its comment letter, FHFB stated that examiners routinely review board minutes and other materials including internal audit materials in the course of planning and executing each examination. Our review of examination work papers indicated in some cases that OS examiners reviewed board of director minutes and internal audit reports. However, we did not see any indication, nor did we receive any from the OS officials we interviewed, that the review of these materials led to a conclusion on the part of OS examiners as to the role played by the board of directors in overseeing the institution or, with the exception of 2 of the 12 examinations we reviewed, of the overall quality or reliability of the internal audit function.

2. In its comment letter, FHFB described how examination findings constitute "supervisory determinations," with which FHLBank management must comply. FHFB also described its enforcement authorities and pointed

out that there has never been an unimplemented directive from the Board. We also noted in our draft that while we found no evidence of instances in which FHFB was unable to achieve FHLBank compliance with examination findings, we remained concerned that FHFB would not have procedures in place if serious problems ever were to occur.

We described two key principles that we believe are necessary for effective enforcement of GSE rules and regulations. First, certain enforcement actions should be mandatory when prespecified conditions are met. Second, such actions should be the result of a clear and reasonable process. We found that FHFB did not have policies or procedures consistent with the two key principles. We therefore believe that FHFB should more clearly articulate and document its current enforcement mechanisms, policies, and procedures.

3. FHFB commented that to ensure that FHLBanks fulfill their mission, it "must actively foster the maximizing of public benefit from the activities of the FHLBanks." We do not disagree that maximizing public benefit may be part of FHFB's role, but we also believe that regulation requires a regulatory framework. We do not consider "mission promotion" the same as "mission regulation." While a regulator must take certain actions to ensure mission compliance, we believe that unless FHFB develops regulations and policies to establish boundaries for what is and is not mission-related, it will be difficult to ensure whether a FHLBank is fulfilling the System's mission.

4. FHFB commented that examinations are not its sole mission compliance tool. We would agree that examinations are not the only tool available to ensure mission compliance, nor should they be. Further, we agree that statute, regulations, and policies should establish a framework for mission compliance. However, aside from AHP and community support requirements, we are unaware of other regulations that have been issued by FHFB on this issue. We address some of FHFB's proposed regulations and activities in chapters 1 and 2. We also discuss FHFB's involvement in the development of new products and services in chapter 4.

5. FHFB said that our report demonstrates a "total lack of understanding of what effective mission regulation entails." We believe that our differences in views are based on fundamental philosophical differences. As stated previously, we realize that active involvement by the regulator is needed. However, we view FHFB establising policies and procedures for oversight, measuring mission compliance, and taking action to ensure that FHLBanks fulfill their mission, as active appropriate involvement.

6. FHFB said that it is impossible for an effective mission and safety and soundness regulator not to be involved with System business. We believe that a regulator should be arm's-length from the institutions it regulates. In chapter 4 we discussed the statutory requirements that involve FHFB in System business and the fact that FHFB has devolved some of those requirements to FHLBank boards. However, we view some of FHFB's involvement in System business as beyond its statutory requirements and continue to believe that a regulator should not be involved in the business of its regulated entities, as discussed in chapter 4.

7. FHFB said that "Part of the draft's confusion stems from failing to analyze the inherent conflict between safety and soundness and mission accomplishment." We discuss the trade-off between mission and safety and soundness in chapter 4. We also cite previous work we performed that specifically focused on the advantages and disadvantages of having a single safety and soundness and mission-compliance regulator for the three housing-related GSEs, including the healthy tension created between mission and safety and soundness oversight.

8. FHFB said that the "fact that an agency authorizes an activity does not mean that the agency cannot then effectively examine and supervise the activity for safety and soundness." FHFB expressed its opinion that although the Office of the Comptroller of the Currency (OCC) and OTS charter financial institutions, they do not have difficulty regulating them. We have no reason to believe that chartering an institution would preclude regulatory objectivity. However, when a regulator is actively involved in the development and promotion of certain activities, as described by FHFB in its comments, at a minimum, it creates the appearance of a conflict of interest. We do not disagree that a regulator should "exhort" regulated entities to comply with statutory, regulatory, and policy requirements and that doing so does not preclude the agency from examining and supervising the regulated entity. We are also aware that OCC and OTS "advocate" Community Reinvestment Act compliance through "written regulations to guide and facilitate that compliance." We agree that we have not suggested that these agencies not engage in developing "written regulations to guide and facilitate" compliance. In fact, we encourage FHFB to do the same concerning FHLBanks' compliance with their housing finance mission.

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