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Watchdog Report Augurs More GSE Fights with Banks

Jeff Horwitz | September 17, 2012

There's an increasingly prominent third wheel in the relationship between the government-sponsored enterprises and their conservator.

The Federal Housing Finance Agency's inspector general released a "follow up" report Thursday detailing how it prodded the regulator and Freddie Mac into demanding that banks repurchase as much as $3.4 billion of government-guaranteed loans.

Aside from incrementally adding to banks' crisis-era mortgage losses, the report by the office of inspector general Steve Linick shows that the office is determined to maximize the government's bailout recoveries - even if that means pushing the GSEs into more fights with banks.

"We think there are going to be other reports out that are very critical of the GSEs in recovering money," says Paul Miller, an analyst for FBR Capital Markets. "Some of the stuff they're looking at is untested - like triple damages."

The inspector general's approach may conflict with the more mixed priorities of the FHFA, which has worked to broker a rapprochement after years of putback fights.

On Sept. 10, FHFA chairman Ed DeMarco promised attendees at the American Mortgage Conference in Raleigh that new guidelines for repurchase requests would provide "clarity" and "relief" from certain putback risks.

The history of the inspector general's review of Freddie Mac putbacks reinforces the prospect of greater conflict. Following the creation of the FHFA in mid-2008, the agency argued, to little effect, that the in-house watchdog's powers did not extend to the GSEs themselves.

"The OIG took a more expansive view of its authorities," recalls Mark Calabria, director of financial regulation studies at the Cato Institute.

The office's broader mandate put it in a position to review Freddie's putback settlement with Bank of America. Approved by the FHFA in late December of

2010, the deal aroused concerns among some in Congress and, eventually, FHFA staffers who told the inspector general's office that Freddie hadn't reviewed a large volume of bad loans for origination defects.

The inspector general's staff confirmed that certain Freddie Mac loans - such as those that had performed only during their teaser interest rate period - hadn't been reviewed. Freddie's "senior management" had ignored an audit calling for a more thorough review because they worried that the "loss of business from loan sellers" would offset the gains from putbacks, these executives told the inspector general's staff.

Separately, "former senior managers" had made repeated "overrides" to stop known flawed loans from being returned to banks, according to the inspector general report.

"The employees have all sorts of incentives that are not necessarily consistent with protecting the taxpayer," says Calabria, noting the GSEs' interest in survival and the relative frequency with which Fannie executives go to work for lenders.

The report does not identify the Freddie staffers who blocked loan testing and overrode planned putbacks.

Freddie's more expansive loan review is expected to force banks to take $800 million to $1.2 billion in losses. Those costs are likely already baked into lender financials - "everybody has adjusted their reserves and models for this," says Miller - but the inspector general report raises the prospect of additional fighting.

A series of recommendations at the end of the office's report expresses concern that the FHFA has been giving the GSEs too much deference to run themselves as they see fit. But while the FHFA ultimately concurred with broadening Freddie putbacks, the agency hasn't agreed to accept all of the inspector general's advice.

"Under the circumstances, FHFA-OIG said it would continue to monitor the issues discussed in the report and the actions that FHFA would be taking," the inspector general notes. Freddie, FHFA and the office of its inspector general declined to comment beyond the report itself.

The inspector general's discomfort with the latitude the FHFA gave Freddie on putbacks echoes other complaints by the office, such as those in its most recent semiannual report.

"OIG believes that FHFA needs to assume a more active role," the document broadly asserts, adding that the agency "is not proactive in its oversight and enforcement."

How hard the inspector general will be able to push is an open question, Miller says, given the office's limited enforcement powers.

"All they have is a bully pulpit," he says. "It's going to be very interesting."