adopting supervisory policies and standards by regulation, guidance, or other process.

(b) Preservation of existing authority. No action by OFHEO undertaken with reference to a policy guidance or this regulation will in any way limit the authority of the Director otherwise to address unsafe or unsound conditions or practices, or other violations of law, rule or regulation. Action with reference to a policy guidance or this regulation may be taken separate from, in conjunction with, or in addition to any other supervisory response, enforcement action, or agency-imposed requirements deemed appropriate by OFHEO. Nothing in this regulation or any guidance issued by OFHEO limits the authority of the Director pursuant to section 1313 of the Act (12 U.S.C. 4513) or any other provision of law, rule or regulation applicable to the Enterprises.

§ 1720.2 Safety and soundness standards.

Policy guidances as may be adopted from time to time by OFHEO, addressing safety and soundness standards, shall apply to the Enterprises. If OFHEO determines that an Enterprise does not meet a requirement set out in such policy guidance, it may require corrective or remedial actions by the Enterprise, and take such enforcement action as the Director deems to be appropriate.

APPENDIX A TO PART 1720—POLICY GUIDANCE; MINIMUM SAFETY AND SOUNDNESS REQUIREMENTS

A—BACKGROUND AND INTRODUCTION

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of a plan to achieve compliance with the particular requirement or standard without taking any other enforcement action.

II. Introduction. 1. Authority, purpose, and scope.

a. Authority. This Policy Guidance is issued by the Office of Federal Housing Enterprise Oversight (OFHEO) pursuant to sections 1313(a), 1313(b)(1), 1313(b)(5) and 1371 of the Federal Housing Enterprise Safety and Soundness Act (Act) (12 U.S.C. 4513(a), 4513(b)(1), 4513(b)(5) and 4531). These provisions of the Act authorize OFHEO to take any action deemed appropriate by the Director of OFHEO to ensure that the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (the Enterprises) are operated in a safe and sound manner, including by adopting supervisory policies and standards by regulation, guidance, or other process.

b. Purpose and scope. This Policy Guidance sets out certain minimum safety and soundness requirements for the business and operations of the Enterprises, and reiterates agency policies requiring the Enterprises to establish and implement policies and procedures that are sufficient to effectuate compliance with supervisory standards. If OFHEO determines that an Enterprise does not meet the requirements set forth herein, the Director may require the Enterprise to submit and carry out a plan to achieve compliance, or may take other corrective and remedial actions. The requirements enumerated herein are supervisory minimums. In order to satisfy an Enterprise's overarching obligation under the Act to conduct operations in a safe and sound manner, it may be necessary and appropriate for an Enterprise to take additional measures in these or other areas, as directed by OFHEO through regulation, guidance, order or otherwise as part of the supervisory process.

ii. Preservation of existing authority. Neither this Policy Guidance nor any action by OFHEO to enforce compliance of an Enterprise therewith in any way limits the authority of the Director otherwise to address unsafe or unsound conditions or practices, or other violations of law or other regulation. Action under this Policy Guidance may be taken separate from, in conjunction with, or in addition to any other enforcement action available to OFHEO. Compliance with the Policy Guidance in general would not preclude a finding by the agency that an Enterprise is otherwise engaged in a specific unsafe or unsound practice or is in an unsafe or unsound condition, or requiring corrective or remedial action with regard to such practice or condition. That is, supervisory action is not precluded against an Enterprise that has not been cited for a deficiency under the Policy Guidance. Conversely, an Enterprise's failure to comply with any of the supervisory requirements set forth in the Policy Guidance may not warrant a formal supervisory response from OFHEO, if the agency determines the matter may be otherwise addressed in a satisfactory manner. For example, OFHEO may require timely submission
B—OPERATIONAL AND MANAGERIAL REQUIREMENTS

I. Asset underwriting and credit quality. An Enterprise should establish and implement policies and procedures to adequately assess credit risks before they are assumed, and monitor such risks subsequently to ensure that they conform to the Enterprise’s credit risk standards on an individual and an aggregate basis. The Enterprise should:

i. For loans purchased and loans collateralizing securities guaranteed by the Enterprise, adopt and implement prudent underwriting standards and procedures commensurate with the type of loan or loans and the markets in which the loan or loans were made that include consideration of the borrower’s and any guarantor’s financial condition and ability to repay as well as the type and value of any collateral or credit enhancement;

ii. To the extent the Enterprise’s assets are serviced or administered by other entities or are covered by mortgage insurance or other credit enhancements or arrangements, the Enterprise’s policies and procedures should recognize the consequences and implications of such contractual arrangements for the Enterprise’s credit risk;

iii. Establish and implement policies and procedures to address declining credit quality and to require appropriate corrective action; to establish sufficient reserves; and to deal with defaulted assets so as to minimize losses;

iv. Establish and implement policies and procedures to select and price credit risk to ensure that the Enterprise is appropriately compensated commensurate with the credit risk it assumes and its statutory obligations;

v. Establish and implement policies and procedures that address the prudential selection, management and handling of counterparty credit exposure that arises from engaging in hedging activities and the use of derivative instruments; and

vi. Establish and implement policies and procedures to identify, monitor and evaluate its credit exposures on an aggregate basis so as to assess the implications and consequences of matters such as concentration exposure (including geographic as well as product concentrations), to identify and evaluate credit risk trends effectively, and to maintain and revise appropriately its systems and procedures for underwriting, servicing, and monitoring of such exposures and changes to those exposures.

II. Balance sheet growth and management. An Enterprise’s balance sheet growth should be prudent and consider:

i. The source, volatility, and use of funds that support balance sheet growth;

ii. Any changes in credit risk or interest rate risk resulting from balance sheet growth;

III. Market risk. An Enterprise should establish and implement policies and procedures that allow for the effective identification, measurement, monitoring, and management of market risk. The Enterprise should:

i. Establish and implement policies and procedures sufficient to quantify and monitor the interest rate risk of the Enterprise effectively and to model the effect of differing interest rate scenarios on the Enterprise’s financial condition and operations;

ii. Develop risk management strategies that respond appropriately to changes in interest rates;

iii. Establish and implement policies and procedures sufficient to quantify and monitor the Enterprise’s liquidity effectively, and to identify and anticipate various market environments and their effects on the Enterprise’s liquidity; and

iv. Establish and maintain an effective contingency plan for liquidity under varying scenarios.

IV. Information technology. An Enterprise should establish and implement policies and procedures to ensure that its computing resources, proprietary and nonpublic information and data are:

i. Protected from access by unauthorized users, and otherwise protected by appropriate security measures;

ii. Reliable, accurate and available at all times as needed for its business operations, including an ability to effect timely recovery and resume operations after a reasonably foreseeable adverse event; and

iii. Designed to ensure adequate support of business operations.

V. Internal controls. An Enterprise should maintain and implement internal controls appropriate to the nature, scope and risk of its business activities that, at a minimum, provide for:

i. An organizational structure and assignment of responsibility for management, employees, consultants and contractors, that provide for accountability and controls, including adherence to policies and procedures;

ii. A control framework commensurate with the Enterprise’s risks;

iii. Policies and procedures adequate to safeguard and to manage assets; and

iv. Compliance with applicable laws, regulations and policies.

VI. Audits. An Enterprise should establish and implement internal and external audit programs appropriate to the nature and scope of its business activities that, at minimum, provide for:

i. Adequate monitoring of internal controls through an audit function appropriate to the
Enterprise's size, structure and scope of operations;
ii. Independence of the audit function;
iii. Qualified professionals and management for the conduct and review of audit functions;
iv. Adequate testing and review of audited areas together with adequate documentation of findings and of any recommendations and corrective actions; and
v. Verification and review of measures and actions undertaken to address identified material weaknesses.

VII. Information reporting and documentation. An Enterprise should establish and implement policies and procedures for generating and retaining reports and documents that:

i. Enable the Enterprise's board of directors (including appropriate committees) to make informed decisions and to exercise its oversight function, by providing all such relevant information of an appropriate level of detail as necessary;

ii. Enable the Enterprise's managers to make informed business decisions and to assess risks for all aspects of the Enterprise's business on an ongoing basis, by providing sufficient relevant information of an appropriate level of detail as necessary;

iii. Ensure decision-makers have appropriate and necessary information about particular transactions and business operations;

iv. Enable the Enterprise to administer and supervise all assets, liabilities, commitments and other financial obligations appropriately;

v. Enable the Enterprise to enforce legal claims against borrowers, counterparties and other obligors; and

vi. Ensure timely and complete submissions of reports of financial condition and operations, as well as annual and other periodic reports and special reports to OFHEO whenever requested or required by OFHEO.

VIII. Board and management responsibilities and function. An Enterprise's board of directors shall ensure that the board (including appropriate committees) works with executive management to establish the Enterprise's strategies and goals in an informed manner, and that the Enterprise's executive managers and other managers, as appropriate, implement such strategies effectively, by ensuring at a minimum that:

i. The board (including appropriate committees) oversees the development of the Enterprise's strategies in key areas and exercises oversight necessary to ensure that management sets policies and controls to implement such strategies effectively;

ii. The board (including appropriate committees) hires qualified executive management, and exercises oversight to hold management accountable for meeting the Enterprise's goals and objectives;

iii. The board (including appropriate committees) is provided with accurate information about the operations and financial condition of the Enterprise in a timely fashion, and sufficient to enable the board to effect its oversight duties and responsibilities;

iv. Management of the Enterprise sets policies and controls to ensure the Enterprise's strategies are implemented effectively, and that the Enterprise's organization structure and assignment of responsibilities provide clear accountability and controls; and

v. Management of the Enterprise establishes and maintains an effective risk management framework, including review of such framework to monitor its effectiveness and taking appropriate action to correct any weaknesses.

IX. Format of policies and procedures. i. Generally, the policies of an Enterprise contemplated by this Policy Guidance should be in writing and in such form and detail as appropriate in light of their intended purpose, nature, and potential consequences for the operations and financial condition of the Enterprise, and approved by the board of directors (including appropriate committees) or such responsible officer or officers as designated by the board.

ii. The policies and procedures of an Enterprise contemplated by this Policy Guidance should be provided to OFHEO at such time and in such format as OFHEO directs.

C—COMPLIANCE PLANS

I. Notice; submission and review of compliance plans. i. Determination. The Director of OFHEO may, based upon a report of examination, or other supervisory information however acquired, determine that an Enterprise has failed or is likely to fail to satisfy the minimum supervisory requirements or standards set forth in part B of this appendix.

ii. Request for compliance plan. If the Director determines pursuant to paragraph C.I.1 of this appendix that an Enterprise has failed or is likely to fail to satisfy a supervisory requirement or standard, OFHEO may require the submission of a written compliance plan.

iii. Schedule for filing compliance plan. An Enterprise may be required to file a written compliance plan with OFHEO within thirty days of receiving a written request for a compliance plan pursuant to paragraph C.I.1i of this appendix.

iv. Contents of plan. A required compliance plan should include, subject to additional direction by OFHEO, a detailed description of the steps the Enterprise will take to correct a deficiency and any condition resulting therefrom and the time within which such steps will be undertaken and fully implemented.

v. Review of compliance plans. If the compliance plan submitted under this section is deemed to be inadequate or incomplete,
OPHEO may provide written notice of such inadequacy or deficiencies thereof to the Enterprise, OFHEO or seek additional information from the Enterprise regarding the plan. vi. Failure to submit acceptable plan or to comply with plan. An Enterprise that has filed a required compliance plan to which no objection has been raised by OFHEO may, after prior written notice to and approval by the Director, amend the plan to reflect changes in circumstance, policies and procedures.

II. Failure to submit acceptable plan or to comply with plan. If an Enterprise does not submit an adequate and complete plan as required by the agency within the time specified by OFHEO or does not implement such an adequate and complete plan, the Director may require the Enterprise to correct any deficiency and may require additional corrective or remedial actions by the Enterprise as deemed to be appropriate pursuant to the Act, including sections 1371 (12 U.S.C. 4631), 1372 (12 U.S.C. 4632), and 1376 (12 U.S.C. 4636).

APPENDIX B TO PART 1720—POLICY GUIDANCE; NON-MORTGAGE LIQUIDITY INVESTMENTS

A—Purpose

1. Fannie Mae and Freddie Mac (the Enterprises) were chartered by Congress as government-sponsored enterprises with public missions. They perform an important role in the United States mortgage market by gathering funds and purchasing mortgages from mortgage originators and guaranteeing mortgage-backed securities. In chartering the Enterprises, Congress charged the Enterprises with: (1) providing stability to mortgage markets; (2) responding to the changing capital markets; (3) assisting the secondary markets including the support of these markets for affordable housing; and (4) promoting access to credit throughout the country by increasing liquidity and improving distribution of investment capital for residential mortgage finance. These functions require the Enterprises, as principals in the secondary mortgage market, to serve as bedrock in providing liquidity to the U.S. housing finance system.

2. For the Enterprises effectively to perform their public purposes, they must be financially sound and liquid. As the Enterprises’ financial safety and soundness regulator, OFHEO conducts its regulatory programs to ensure these companies adhere to safety and soundness standards. In addition, OFHEO interprets this to include heightening the positive effect of market discipline on the Enterprises by encouraging quality disclosures, appropriate accounting standards, and state-of-the-art risk management further strengthens their safety and soundness. More specifically, OFHEO conducts comprehensive safety and soundness examinations and requires the Enterprises to adhere to regulatory capital requirements. In conducting its regulatory programs, OFHEO applies a series of safety and soundness standards to assess the Enterprises’ liquidity management, including their investments in non-mortgage liquidity assets. It is appropriate to issue initial guidance that addresses the safety and soundness standards OFHEO uses to evaluate Enterprise investment activities in non-mortgage liquidity assets.

3. Further, it should be noted that the Secretary of HUD, who has general regulatory power over the Enterprises and who is required to make such rules and regulations as necessary to ensure that the purposes of the GSE’s respective Charter Acts are accomplished, has issued an Advanced Notice of Proposed Rulemaking on possible substantive and/or procedural rules governing the GSEs’ non-mortgage investment activities. Accordingly, the GSEs may be subject to regulations in this area through future HUD actions, in addition to this initial guidance.

B—Activities Covered

1. The Enterprises must maintain sufficient liquidity to meet both known and unexpected payment demands on borrowings and mortgage securities, for operations and to purchase mortgage assets. Liquidity management is the process by which the Enterprises manage the use and availability of various funding sources to meet current and future needs. Liquidity must be closely managed on a daily basis.

2. The Enterprises manage liquidity through three primary channels: securitizations, issuance of debt and conversion of liquid assets into cash. It is through careful management within and among the three channels, that the Enterprises can effectively meet demands and remain safe and sound under all market conditions. This Guidance specifically addresses “non-mortgage liquidity investments” which are conducted within the liquidity channel whereby the Enterprises are able to convert their own assets into cash.

3. There are various types of investments that may be appropriate for non-mortgage liquidity holdings. Appropriate non-mortgage liquidity investments are characterized by both creditworthiness and low price volatility. Even though an investment may be creditworthy, if the holding is subject to undue price volatility (e.g. common stock), the investment is inappropriate for inclusion.