Federal Housing Finance Agency
Office of Inspector General

Management Alert: Need for Increased Oversight by FHFA, as Conservator of Fannie Mae, of the Projected Costs Associated with Fannie Mae's Headquarters Consolidation and Relocation Project

Management Alert • COM-2016-004 • June 16, 2016

OFFICE OF INSPECTOR GENERAL

Federal Housing Finance Agency

400 7th Street SW, Washington, DC 20219

June 9, 2016

TO: Melvin L. Watt, Director

FROM: Laura S. Wertheimer, Inspector General

SUBJECT: Management Alert—Need for Increased Oversight by FHFA, as Conservator of Fannie Mae, of the Projected Costs Associated with Fannie Mae's Headquarters Consolidation and Relocation Project

The Federal Housing Finance Agency (FHFA) Office of Inspector General (OIG) conducted a review of an anonymous hotline complaint alleging, among other things, excessive spending on Fannie Mae's relocation to new headquarters in downtown Washington, D.C. Based on facts learned during that review, we believe there are significant financial and reputational risks from the projected costs associated with Fannie Mae's relocation of its headquarters that warrant immediate, sustained, and comprehensive oversight from FHFA, the conservator of Fannie Mae.

Background

In 2012, Fannie Mae management faced a challenge in its workspace utilization in the District of Columbia and surrounding areas. Fannie Mae housed its thousands of employees among numerous locations in the metro D.C. area, some of which were owned by Fannie Mae and some of which were leased. The lease on its largest property (4000 Wisconsin) was set to expire in 2018, and that building required significant upgrades to meet Fannie Mae's operational needs. In early 2013, Fannie Mae launched an initiative to recommend a strategy for meeting future requirements for its D.C.-based workforce.

Fannie Mae management created a workplace strategy steering committee at the end of 2012 to develop a long-term solution to the Enterprise's workspace needs. An employee in FHFA's Division of Conservatorship (DOC) attended the steering committee meetings and had access to materials presented at those meetings.

One of the first decisions to be made was whether Fannie Mae should remain in its existing facilities and pay to upgrade them or vacate them and find suitable space elsewhere; this was called the "Go" or "Stay" decision. In 2013, Fannie Mae engaged a commercial real estate consultant to analyze options provided by management, including: relocating to facilities in Virginia, Maryland, and D.C.; remaining in the existing locations and incurring the cost

necessary to upgrade them; and consolidating operations into one facility. Fannie Mae's Board of Directors approved the "Go" strategy at its November 2013 meeting.

In 2014, Fannie Mae management engaged several subject matter experts to analyze various aspects of the "Go" strategy. Following the March 2014 Board meeting, Fannie Mae's management concluded that its best option would be to consolidate all operations in the Washington, D.C. area into a single facility in D.C. Fannie Mae documents reflect that the Board asked Fannie Mae management to explore the possibility of relocating to one of D.C.'s economic development zones as one of the relocation options. In May 2014, Fannie Mae's CEO briefed FHFA on Fannie Mae's workplace consolidation and its decision to consolidate its metro D.C. workforce into one location in downtown D.C.

Fannie Mae management narrowed down the universe of possible relocation options to three D.C. properties. At a meeting of the Fannie Mae Board on November 19, 2014, management presented a slide deck entitled "Future DC Workplace Strategy," which compared the cost to lease appropriate space in each of the three relocation options. One of those options involved consolidation and relocation to a new building, Midtown Center, to be built by Carr Properties on the former Washington Post site. To provide an empirically driven economic analysis of the three options, the consultant used a Net Present Value (NPV) measure for the comparison.[1] The slide deck provided to the Fannie Mae Board, and to a DOC employee who attended that board meeting, set forth the consultant's NPV comparisons of the three options, including the assumptions used to develop each NPV. The option to relocate to leased space in the Midtown Center building to be built on the site of the former Washington Post building had a projected 15-year NPV of $858,265,531.

In late December 2014, Carr Properties provided a revised offer to Fannie Mae, including a rental abatement early in the lease and a reduced rental rate. In January 2015, DTZ[2] reviewed the revised proposal and concluded that it lowered the NPV for Carr Properties' Midtown Center building from $858,265,531 to $770,481,598. DTZ's revised NPV was based on a number of assumptions that were identified in its analysis. These included: a 15-year lease for approximately 700,000 square feet at $48.15/square foot in rent (with annual increases of 2.5%); a 4% discount rate; rent abatements by Carr Properties; and build-out costs of $164.32/square foot to yield turnkey office space. This figure included the design costs, office configurations, and furniture, fixtures, and equipment. Of the $164.32/square foot, $120/square foot was to be paid for by Carr Properties through a tenant improvement allowance, and the remaining $44.32/square foot would be paid for by Fannie Mae.

[1] Net Present Values are used to measure the relative financial cost of different properties. NPVs consider future cash flows associated with leases, and the timing of the lease payments, over a specified period of time. The cash flows are discounted back to present value using a discount rate that reflects the lease period borrowing cost.

[2] In 2015, DTZ, which was formerly Cassidy Turley, merged with Cushman & Wakefield. For convenience, we will continue to refer to the organization as DTZ.

On January 22, 2015, the Fannie Mae Board approved the consolidation of Fannie Mae's Washington area offices into leased space in the Midtown Center building. The Board's decision was based primarily on the fact that Carr Properties' revised proposal had an estimated NPV of $111,025,282 lower than the competing relocation proposal.

Subsequent to that approval by the Fannie Mae Board, Fannie Mae submitted the same proposal to FHFA for its approval. Fannie Mae identified two options to lease approximately 700,000 square feet of space in one of two buildings in downtown Washington, D.C. in which it would consolidate its workforce in the metro D.C. area. For each of these options, Fannie Mae provided the projected NPV over the 15-year period of the proposed lease created by DTZ, but did not include the assumptions used by DTZ to develop the projected NPV estimates. Because the NPV of $770,481,598 for the Midtown Center building was lower than the NPV of $881,506,880 for the second option, Fannie Mae recommended approval of the first option to FHFA.

According to a DTZ employee responsible for developing the NPV estimates, all the NPVs projected for the final options over the full term of each lease were "all in" numbers: each NPV included all costs projected to consolidate the Fannie Mae metro D.C. area workforce into one location, in a turnkey building. That DTZ employee and the Fannie Mae executive charged with managing the relocation project separately reported to us that Fannie Mae understood that the NPVs provided for each of the final options were "all in" numbers so that Fannie Mae management, the Fannie Mae Board, and FHFA could compare the cost of each option head-to-head and determine which was the most cost-effective.

Review and Approval by FHFA

On January 26, 2015, DOC provided the FHFA Director with a staff analysis memorandum recommending approval of Fannie Mae's proposal to consolidate its separate metro D.C. area offices into approximately 700,000 square feet of space leased in the Midtown Center building to be constructed by Carr Properties on the site of the former Washington Post building. According to that memorandum, the estimated NPV of $770,481,598 over the term of the lease was less than the alternative relocation proposal of $881,506,880.[3]

On January 29, 2015, FHFA authorized Fannie Mae to proceed with the relocation project and execute the lease for space in the Midtown Center building pursuant to the terms of the DOC analysis memorandum.

[3] For comparative purposes, the staff analysis memorandum noted that the NPV of the "stay and renovate" option over the equivalent period was $1,103,686,643.

As of March 2016, Fannie Mae's Projected Build-out Costs Had Increased Significantly

During the course of our review, we were provided with a March 10, 2016, budget for the build-out of the building by the construction management firm, Hines, currently working for Fannie Mae on the project. According to this budget document, the projected cost to build-out the leased space at that time was $252.81/ square foot. Over a 14-month period from January 29, 2015, when FHFA approved Fannie Mae's proposal to relocate to 700,000 square feet in a new building on the former Washington Post site with a $770,481,598 NPV, to March 10, 2016, the projected build-out costs escalated from $164.32/square foot to $252.81/square foot, an increase of $88/square foot—or 53.35%.

That same budget document reported that the estimated square footage for the leased space had declined from 700,000 square feet to 679,000 square feet. With the reduced square footage, the increased cost for the build-out approached $56 million (from nearly $115 million to $171 million). Even though the total square footage in this budget declined by 3%, the NPV for Fannie Mae's consolidation remained at $770,481,598.

In separate interviews with a Hines representative and the senior Fannie Mae executive responsible for management of this relocation project, each reported that they are managing the overall relocation cost and lease within the FHFA-approved NPV of $770,481,598. According to the senior Fannie Mae executive, it will be a "challenge" for Fannie Mae to remain within that approved NPV.

Two Months Later, Fannie Mae's Projected Build-out Costs Decreased by $29.46/Square Foot

This senior Fannie Mae executive advised us that Hines revised the budget for the project in May 2016. The revised budget document, dated May 16, 2016, estimated the projected build-out costs at $223.35/square foot, $29.46/square foot lower than the March 10, 2016, estimate of $252.81/square foot. Assuming that the leased square footage remains constant at 679,000, the increased cost for the turnkey build-out from $164.32/square foot to $223.35/square foot would be roughly $36 million (from approximately $115 million to approximately $151 million). As Carr Properties first broke ground for Midtown Center in May 2016,[4] the square footage costs for the turnkey build-out of Fannie Mae's space have not been finalized by Fannie Mae or approved by FHFA.

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[4] Barbra Murray, *New Future for Former Washington Post Site*, Commercial Property Executive (May 16, 2016) (online at www.cpexecutive.com/post/new-future-for-former-washington-post-site/).

DOC's Oversight of Fannie Mae's Development of its Leased Space to Date

For the past seven years, Fannie Mae has operated in conservatorship, with FHFA as its conservator. Congress granted FHFA sweeping conservatorship authority over the Enterprises.[5] FHFA administers the conservatorships through: a combination of communications with the Enterprises' respective boards of directors and management; a multi-year strategic plan for the conservatorships that defines general goals and initiatives; annual conservatorship scorecards that focus the Enterprises on short-term objectives to further the conservator's strategic goals; and governance practices and organizational infrastructure that support these activities. The conservator can revoke delegated authority at any time and can intervene in any issue or matter at the direction of the FHFA Director.

On January 22 2015, FHFA rescinded authority previously delegated to Fannie Mae to decide whether and where to consolidate its metro D.C. area offices into one location and the money to be spent on any such relocation. FHFA's revocation was consistent with its revocation, in November 2012, of the Enterprises' budget approval authority to enable it to review and approve each annual operating budget "to ensure that the [Enterprises'] budgets [are] properly aligned with both FHFA's strategic direction and its safety and soundness priorities."[6] In both instances, FHFA determined that its review and approval of significant Enterprise expenditures was needed to protect the U.S. taxpayers' substantial investment in the Enterprises and to ensure their continued safety and soundness.

We spoke several times with the DOC employee identified by FHFA as responsible for FHFA's ongoing oversight of Fannie Mae's development of its new office space. The DOC employee said that he was not aware of anyone else within FHFA who is familiar with the lease and build-out costs and that the Agency had not been reviewing the finances of the project or related contracts.

This DOC employee insisted to us that Fannie Mae's build-out costs were capped at $120/square foot, all of which would be borne by Carr Properties, the owner of the building and the landlord. He reported to us that detailed budgetary oversight was unnecessary since Fannie Mae was operating within the $120/ square foot tenant improvement allowance. As he explained, he had numerous responsibilities competing for his time and "to ride shotgun" on Fannie Mae's development of its leased space was not a high priority. That employee also advised us that he is briefed regularly by a senior Fannie Mae official about Fannie Mae's evolving plans for its leased space. He maintained that he expected that the Fannie Mae official would inform him if

[5] For a discussion of these powers, see OIG, *The Continued Profitability of Fannie Mae and Freddie Mac is Not Assured* (Mar. 18, 2015) (WPR-2015-001) and OIG, *FHFA's Conservatorships of Fannie Mae and Freddie Mac: A Long and Complicated Journe*y (Mar. 25, 2015) (WPR-2015-002).

[6] *See* OIG, *FHFA's Exercise of its Conservatorship Powers to Review and Approve the Enterprises' Annual Operating Budgets Has Not Achieved FHFA's Stated Purpose* (Sept. 30, 2015) (EVL-2015-006).

the projected costs to customize the space were expected to exceed the $120/square foot tenant improvement allowance and that this official had never provided such information to him.

The Fannie Mae senior executive referenced earlier reported to us that, since January 29, 2015, when FHFA approved Fannie Mae's proposal, he has not briefed any FHFA employee on Fannie Mae's budget for developing its leased space. That senior executive advised us that he met with the Acting Deputy Director of DOC and offered to provide regular updates on the status of the project, but his offer was declined because the Acting Deputy Director explained that he received regular updates from DOC staff.

Based on the materials prepared by Fannie Mae and its consultant DTZ, we understood that the NPV for the total cost of Fannie Mae's relocation to the new Carr Properties building (Midtown Center) with a 15-year lease for roughly 700,000 square feet of space was estimated to be $770,481,598, which included an assumption of $164.32/square foot for build-out of the space. (Of that $164.32/square foot, $44.32/square foot would be borne by Fannie Mae.) When we brought these materials to the attention of this DOC employee to refresh his recollection, he acknowledged the materials showed that Fannie Mae would bear build-out costs beyond the $120/square foot tenant allowance to be borne by Carr Properties.

We advised this DOC employee that, as of March 2016, Hines had projected Fannie Mae's build-out costs had increased to $252.81/square foot. He responded that he had not received a copy of the March 2016 budget and was unaware of that estimate, but stated that Fannie Mae should have informed him of the change. From the materials we reviewed and the employees of Fannie Mae, Hines, and DOC whom we interviewed, it does not appear to us that anyone in DOC was aware of the projected 53% increase in estimated build-out costs for Fannie Mae's new office space.

When we learned that Fannie Mae's projected build-out costs were reduced from the March 2016 estimate of $252.81/square foot to the May 2016 estimate of $223.35/square foot, we reached out to this DOC employee to determine if he was aware of the revised budget. This employee reported to us that he had been told about the May 2016 revised budget but had not been provided with a copy of it.

FHFA Should Determine Whether the Proposed Features in Fannie Mae's Architectural and Engineering Plans Are Appropriate for an Entity in Conservatorship

In May 2016, Carr Properties broke ground on the Midtown Center building that will house the relocated offices of Fannie Mae. According to Oliver Carr III, the CEO of Carr Properties, "Midtown Center will be a new hub of activity in the center of the City that will offer a great

work environment and a tremendous street level dining experience."[7] Carr Properties anticipates that "Midtown Center will have a transformative impact upon the neighborhood and city."[8] Fannie Mae will be a tenant in the Midtown Center building.

Since FHFA approved the lease in January 2015, Fannie Mae has generated substantial construction documents and caused architectural and engineering plans to be drafted. As of May 2016, there are a number of architectural and other features in these plans, including:

- Three enclosed glass bridges to connect different parts of the buildings to be leased by Fannie Mae;
- "Town Centers" at the terminus of each bridge;
- Spiral staircases; and
- Rooftop viewing decks.

According to the Fannie Mae executive and a Hines representative, Fannie Mae has agreed to pay 70% of the costs to construct the glass bridges; the cost to Fannie Mae for these bridges, if they are built, will be about $15 million. We were not able to determine from Fannie Mae's budget documents whether Fannie Mae has agreed to pay all or part of the costs for any of the other proposed features listed above.

At this juncture, the future of Fannie Mae cannot be predicted. At our meeting on June 8, 2016, you represented to us that no plans for the build-out of Fannie Mae's space have been finalized and that plans will continue to evolve and change until Carr Properties begins work on the interior of the building. To the best of our knowledge, FHFA has not approved any of the proposed features in Fannie Mae's architectural and engineering plans nor has it reviewed or approved proposed expenditures by Fannie Mae for these features. We do not know—nor, we believe, does the Agency know—the extent to which proposed features in Fannie Mae's architectural and engineering plans can be altered, or what costs may be attendant upon the removal of proposed architectural features that FHFA does not approve.

Because Fannie Mae is an entity in the conservatorship of the U.S. government and is leasing space in a building owned by Carr Properties, FHFA, as conservator, will need to assess the anticipated efficiencies of specific proposed features against the estimated costs of those features and determine whether the efficiencies warrant the costs. FHFA will also need to determine whether the proposed features for leased space in a building that is not owned by Fannie Mae or the U.S. government are appropriate for an entity in conservatorship.

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[7] AZoBuild, *Carr Properties Begins Construction of LEED Gold Certified, Trophy Office Building in Northwest D.C* (May 13, 2016) (online at www.azobuild.com/news.aspx?newsID=21382).

[8] *Id.*

OIG Meeting with the FHFA Director

On May 26, 2016, we met with you to present our findings in this matter and our concerns with the Agency's oversight of this project, as well as the attendant financial and reputational risks to the Enterprise. You acknowledged the Agency's responsibility to monitor the amounts being spent on this project and agreed to look into the matter.

Conclusion

Since September 2008, Fannie Mae has operated in conservatorship, with FHFA as its conservator, and its continued operations were made possible by the $116.1 billion investment by U.S. taxpayers.

Pursuant to the terms of the Third Amendment to the Senior Preferred Stock Purchase Agreement, Fannie Mae's net worth less the amount of its capital reserve, is swept into the U.S. Treasury each quarter. Fannie Mae arguably has little incentive to cabin its costs for the build-out of its new headquarters because any positive net worth it does not spend on itself will be swept into the Treasury as a dividend. Excessive or unnecessary spending by Fannie Mae may be seen as monies that ought to have been swept to the U.S. Treasury as a dividend for the $116.1 billion investment by U.S. taxpayers.

For these reasons, we believe there are significant financial and reputational risks from the projected costs associated with Fannie Mae's relocation of its headquarters that warrant immediate, sustained comprehensive oversight from FHFA, the conservator of Fannie Mae.

Recommendations

For these reasons, we recommend that FHFA:

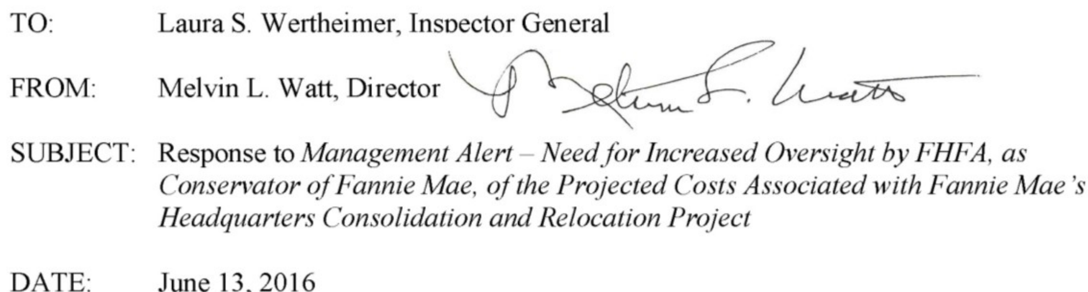
1. Ensure that FHFA has adequate internal staff, outside contractors, or both, who have the professional expertise and experience in commercial construction to oversee the build-out plans and associated budget(s), as Fannie Mae continues to revise and refine them.

2. Direct Fannie Mae to provide regular updates and formal budgetary reports to DOC for its review and for FHFA approval through the design and construction of Fannie Mae's leased space in Midtown Center.

FHFA's Response to OIG's Alert and Recommendations

Federal Housing Finance Agency

MEMORANDUM



TO: Laura S. Wertheimer, Inspector General

FROM: Melvin L. Watt, Director

SUBJECT: Response to *Management Alert – Need for Increased Oversight by FHFA, as Conservator of Fannie Mae, of the Projected Costs Associated with Fannie Mae's Headquarters Consolidation and Relocation Project*

DATE: June 13, 2016

Thank you for your Management Alert ("Alert") dated June 9, 2016 and for the Recommendations outlined on page 9 thereof. While FHFA agrees to and will certainly implement both of the constructive Recommendations you provided, I believe that it is important to provide the following responses and/or context related to several points made in the Alert:

1. I strongly disagree, as I have previously with respect to similar assertions about either Enterprise, with the OIG's assertion on page 8 of the Alert that "Fannie Mae arguably has little incentive to cabin its costs for the buildout of its new headquarters because any positive net worth it does not spend on itself will be swept into the Treasury as a dividend." This assertion is based on a faulty assumption, for which no substantiation has been provided, that the Enterprises lack motivation to control their expenses (or to maximize their income) because the terms of the Senior Preferred Stock Purchase Agreements require all profits to be swept to the taxpayers. In the two and a half years that I have served as Director of FHFA, I have observed absolutely nothing that would support that, or any similar, assumption. To the contrary, the members of the Boards and management teams of both Enterprises (almost all of whom were appointed to their positions after the Enterprises were placed into conservatorship) have demonstrated consistent commitments to their legal conservatorship obligations to "conserve and preserve" the assets of the Enterprises, as well as to their commitments under the law and under their Charters to both "operate in a safe and sound manner" and to "foster liquid, efficient, competitive, and resilient housing finance markets." These legal obligations, as well as personal commitments obtained from them when they were appointed, subsequent regular reminders from FHFA as conservator and others of the expectation of returns to the taxpayers and of the undesirability of another draw on the Treasury commitment, exposure to continuous public scrutiny, and numerous other factors, result in much more incentives to fiscal responsibility for the Enterprises than the incentives applicable to virtually any other corporate enterprise.

2. Any inference that may be drawn from the Alert, whether such inference was intended or not, that the decision to consolidate and relocate to the Midtown Center was anything other than a sound business decision or a decision not fully vetted, evaluated, and supported by FHFA would be unfounded. In fact:
    - The business case for the move, which was discussed at some length with leaders of FHFA's House and Senate oversight committees, involved, among other considerations, substantial downsizing of the new space to be occupied by Fannie Mae compared to the space currently occupied (a reduction of approximately 300,000 square feet), substantial cost savings projected from the "go" decision compared to the "stay" decision ($770 million versus $1.1 billion), and substantially more flexibility as a tenant than would be available to Fannie Mae as a property owner, with contractual rights to sublease or assign space at any time in the event a wind down of the business was mandated by Congress or to terminate the lease after 10 years. Additionally, the sale of the properties Fannie Mae currently owns and occupies will result in substantial additional financial benefits.
    - FHFA fully considered and vetted the decision and, as I advised in our May 26 conference on this issue, my personal involvement extended well beyond simply reviewing the staff analysis memorandum referenced on page 3 of the Alert. It involved extensive review, evaluation, and input about the lease and associated documents as the terms were being agreed upon prior to FHFA approval.

3. The Alert does not seem to take into account the reality that the cost of any construction project is inherently dynamic and that the cost of upfitting tenant space almost always involves tradeoffs between up-front costs and longer-term operating costs and efficiencies. To assume that these decisions, especially those involving tenant upfit features, are either final or necessarily made for purposes of extravagance without inquiry about what business objectives are being considered and balanced seems unwarranted. While spiral staircases may sound extravagant, they take up significantly less space than regular staircases and taking the stairs generally leads to better employee fitness and efficiency than taking elevators. Additionally, bridges that connect tenant spaces in different office towers facilitate employee collaboration by allowing employees to move efficiently throughout the space, and "Town Centers" are an essential part of the new "open-office" design concept that has proven to both save space and encourage employee collaboration and efficiency. In fact, there are numerous other options under consideration that will require difficult decisions that balance their up-front cost against their longer-term benefits. For example, upfitting space with more expensive LED lighting instead of less expensive fluorescent lighting would result in

significantly cheaper operating costs and decisions about more or less expensive window shades and mechanical systems will certainly impact heating and cooling costs significantly.

4. As I clearly indicated in our May 26 conference, it was never represented to me, nor was I ever under the impression, that the cost of upfitting this space would be capped at either the $120 per square foot tenant allowance provided by the developer or at the $164.32 per square foot figure discussed on page 6 of the Alert. Nor, for that matter, have I ever been under the impression that the overall NPV estimate of $770,481,598 was a dollar cap on the project instead of an analytical tool to be used in making choices among options and a benchmark that all parties would in good faith work to achieve. Based on my experience with construction projects, it would simply have been impracticable to expect that final design decisions could be made and costs determined so precisely at such an early stage of the project.

RESPONSE TO RECOMMENDATIONS

As conservator, we are well aware of the "significant financial and reputational risks" associated with this project. By providing the above responses and context to be included with the Alert, we seek respectfully to ensure that the Alert and inferences that may be drawn from it will not add to those inherent risks and that the Alert will serve the public purpose to which both the OIG and FHFA are fully committed. Despite these responses and context, FHFA believes that the Recommendations contained in the Alert are constructive and warranted, and that they suggest additional means and provide additional incentive for FHFA to provide more rigorous and appropriate oversight throughout the construction process. We accept them and will implement them to the extent that we are not already doing so.