

Federal Housing Finance Agency
Office of Inspector General



Compliance Review of FHFA's Suspended Counterparty Program



COM-2019-002

January 25,
2019

Executive Summary

Pursuant to the Housing and Economic Recovery Act of 2008 (HERA), the Federal Housing Finance Agency (FHFA/Agency) has regulatory and supervisory authority over Fannie Mae, Freddie Mac, and the Federal Home Loan Banks (the regulated entities). The regulated entities have adopted counterparty risk management programs designed to protect them from excessive financial loss caused by deterioration in a counterparty's financial condition.

In June 2012, FHFA promulgated a Suspended Counterparty Program (SCP) to augment the regulated entities' programs and provide them with additional protection from the financial and reputational risks posed by individuals and businesses with a history of engaging in fraudulent conduct. Under the SCP, each regulated entity must refer to FHFA a current or former counterparty or an affiliate that has been convicted of, or sanctioned administratively for, engaging in mortgage-related fraud or other financial misconduct within the last three years ("covered misconduct"). FHFA's Office of General Counsel (OGC) was tasked with reviewing each referral to determine whether to propose a suspension for the referred counterparty from conducting further business with the regulated entities. FHFA has delegated to its General Counsel the authority to suspend counterparties under the SCP. FHFA has issued guidelines for the terms of counterparty suspensions, which are published on its website.

In 2017, FHFA's Office of Inspector General (OIG or we) assessed OGC's administration of the SCP and determined whether the program had achieved its stated objective. OIG issued a report in July 2017 in which we identified deficiencies in OGC's administration of the SCP. Specifically, we found that, as of December 31, 2016, OGC had failed to resolve a backlog of 424 referrals it received from the regulated entities, OIG, and the Department of Housing and Urban Development (HUD). We further determined that the majority of these backlog referrals had been pending with OGC for a year or more. We also found several instances in which actual suspensions deviated from the suspension guidelines with no documented rationale in the record.

We recommended that OGC: (1) develop and implement a review plan containing a timeliness standard in order to eliminate the current backlog of referrals and prevent future backlogs; and (2) document its reasons for any departures from the suspension periods prescribed in the guidelines. In its management response letter, which we attached to the July 2017 report, FHFA agreed with our recommendations stating that, within six months, it would accelerate the clearance of referrals and provide additional information on suspension periods that may depart from the guidelines.



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OGC notified us, in a memorandum dated January 31, 2018, that, in response to our first recommendation it had developed timeliness standards for processing referrals, which it had implemented as of January 16, 2018. According to OGC, those standards required it 1) to send referrals to the regulated entities for preliminary review within 30 days of their receipt; and 2) to prepare a draft memorandum to the General Counsel recommending whether or not a suspension was warranted within 30 days of its receipt of the regulated entities' responses.

OGC also represented in its January 31, 2018 memorandum that it had cleared 86% of the referrals in the backlog, intended to assign an additional staff member to review referrals, and developed an information system to increase its ability to monitor SCP deadlines efficiently and effectively.

In response to our second recommendation, OGC reported that FHFA updated its written guidance: reviewers were required to document, in writing, any departures from the suspension periods specified in the guidelines. We closed both recommendations, based on those representations.

We initiated this compliance review in August 2018 to verify that OGC had implemented the agreed-upon corrective actions. Regarding the first recommendation, in October 2018, OGC informed us that it abandoned the two timeliness standards identified in its January 31, 2018, memorandum and that neither had been implemented.

OGC claimed that it abandoned the standards and adopted an unwritten process to prioritize the processing of aged referrals in its inventory, based on when the terms of the convictions or administrative sanctions will expire, and that it considered this process to be a "timeliness standard." While OGC's unwritten prioritization process may provide a reasonable means for prioritizing referrals, it does not ensure that referrals are disposed of on a timely basis, nor does it prevent future backlogs. In contrast, the timeliness standards OGC never implemented and has now abandoned would have prevented future backlogs because they established timelines for completing specific tasks associated with the disposition of all SCP referrals.

In December 2018, OGC reported to us that it eliminated the remaining backlog. While this is a salutary development, we note that it was OGC's lack of attention to the referrals created that backlog, and that the recommendations in our special report were designed to mitigate the risk of future backlogs. For that reason, we are reopening the first recommendation from our 2017 report, and it will remain open until OGC establishes and implements timeliness processing standards to avoid future backlogs.



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Regarding our second recommendation—that OGC document the basis for any departures from the guidelines, we did not identify any suspensions issued after January 2018 that departed from the Agency’s suspension guidelines. Accordingly, there was no record on which to test OGC’s compliance.

We provided FHFA with an opportunity to respond to a draft of this compliance review. FHFA provided technical comments on it, which we incorporated as appropriate. In its subsequent management response, which is reprinted in its entirety in the Appendix, FHFA stated that OGC is currently deploying new resources to assist in ongoing SCP reviews and it would determine, by July 31, 2019, whether additional timeliness standards are necessary to manage existing and incoming SCP referrals.

With this response, OGC has extended for another 18 months its implementation of a recommendation that it accepted in July 2017 and previously reported—inaccurately—that it had implemented in January 2018. When OGC notifies us of its determination on adoption of timeliness standards to manage existing and incoming SCP referrals, we will consider whether to close the recommendation.

This report was prepared by David P. Bloch, Senior Investigative Counsel, and Wesley M. Phillips, Senior Policy Advisor. We appreciate the cooperation of FHFA staff, as well as the assistance of all those who contributed to the preparation of this report.

This report has been distributed to Congress, the Office of Management and Budget, and others and will be posted on our website, www.fhfaog.gov.

David M. Frost
Acting Deputy Inspector General for Compliance & Special Projects

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ABBREVIATIONS

CFR	Code of Federal Regulations
Enterprises	Fannie Mae and Freddie Mac
FHFA or Agency	Federal Housing Finance Agency
FHLBanks	Federal Home Loan Banks
Guidelines	suspension guidelines
HERA	Housing and Economic Recovery Act of 2008
HUD	Department of Housing and Urban Development
OGC	FHFA Office of General Counsel
OIG	Federal Housing Finance Agency Office of Inspector General
Regulated Entities	Enterprises and the FHLBanks
SCP	Suspended Counterparty Program

BACKGROUND.....

The Agency has regulatory and supervisory authority over the regulated entities under HERA. The statute vests FHFA with the authority to supervise the regulated entities' risk management, including authority to supervise their management of the risks attendant to dealing with mortgage sellers and servicers and other counterparties.

In the course of their operations, the regulated entities transact business with individuals and third parties, referred to as counterparties.¹ The Enterprises' counterparties include mortgage sellers and servicers, and the FHLBanks' counterparties include financial institutions that obtain loans from them.

The Enterprises report in their annual securities filings that their counterparties may pose risks to their safe and sound operation should they fail to meet their contractual obligations or engage in fraud or other financial misconduct. The regulated entities have established counterparty risk management programs, the purpose of which are to manage counterparty risk through various means, including maintaining counterparty eligibility standards, evaluating counterparties' financial conditions, monitoring exposure to potential losses, and working with counterparties to limit realized losses. The Enterprises and FHLBanks may also cease doing business with counterparties that present unacceptable risks.²

In 2012, FHFA explained that it established the SCP to augment existing anti-fraud controls at the regulated entities by "ensur[ing] [they] are not exposed to unnecessary risk from doing business with individuals or businesses with a demonstrated history of fraudulent conduct."³ FHFA issued an interim rule for the SCP on October 23, 2013, and issued a final rule on December 23, 2015.

Under the SCP, the Agency may suspend counterparties or affiliates from doing business with the regulated entities that have been found, during the previous three years, by a court or

¹ See OIG, *FHFA Should Improve its Administration of the Suspended Counterparty Program* (July 31, 2017) (COM-2017-005) (online at www.fhfa.gov/Content/Files/SCP%20Final.pdf).

² FHFA, Advisory Bulletin 2013-01, *Contingency Planning for High-Risk or High-Volume Counterparties*, at 3 (Apr. 1, 2013) (online at www.fhfa.gov/SupervisionRegulation/AdvisoryBulletins/AdvisoryBulletinDocuments/20130401_AB_2013-01_Contingency-Planning-for-High-Risk-or-High-Volume-Counterparties_508.pdf).

See also OIG, *FHFA's Oversight of the Enterprises' Management of High-Risk Seller/Servicers* (Sep. 18, 2012) (AUD-2012-007) (online at www.fhfa.gov/Content/Files/AUD-2012-007.pdf).

³ News Release, FHFA Establishes Additional Anti-Fraud Measure for Fannie Mae, Freddie Mac and Federal Home Loan Banks (June 18, 2012) (online at www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Establishes-Additional-AntiFraud-Measure-for-Fannie-Mae-Freddie-Mac-and-Federal-Home-Loan-Banks.aspx).

administrative tribunal to have engaged in covered misconduct such as fraud, embezzlement, or similar offenses in connection with a mortgage, mortgage business, mortgage securities, or other lending product.⁴ The Agency also issued guidelines for the length of suspensions, determined by facts and circumstances of misconduct.

The SCP Process

Pursuant to both the interim and final rules, each regulated entity is required, as soon as it becomes aware of covered misconduct by a counterparty, to refer that counterparty to FHFA for possible suspension. OIG and HUD also make SCP referrals to FHFA.

OGC is responsible for reviewing SCP referrals and recommending resolutions. It has assigned an Associate General Counsel to serve as program manager for the SCP, with support from a paralegal. When a proposed or final decision is made to suspend a counterparty for covered misconduct, the FHFA Director, or an FHFA official with delegated authority (currently the General Counsel), must sign the proposed and final suspension orders and their accompanying notices. According to FHFA, the suspending official also signs every recommendation memorandum supporting a decision not to suspend a party referred to OGC under the SCP. See 12 CFR §§ 1227.2; 1227.5-1227.6.

OIG's 2017 Report and the Agency's Response

In our July 2017 report, we found that OGC was not processing referrals in a timely manner.⁵ OGC had adopted, in 2012, the Suspended Counterparty Program Enforcement Manual that set forth the standards and procedures for administering the SCP and provided a 126-day timeline under which OGC would resolve SCP referrals. OGC officials reported to us that OGC did not use the timeline in that Manual because the Manual no longer governed the administration of the SCP. We found, however, that OGC had not established another timeline or standard under which to resolve referrals. We found that, as of December 31, 2016, OGC had a backlog of 424 pending referrals, most of which had been pending for a year or more.⁶ We identified five instances in which OGC's significant delays in resolving SCP referrals deprived FHFA of the ability to determine whether to suspend counterparties

⁴ 12 CFR §§ 1227.2, 12 CFR pt. 1227. Since FHFA is limited under the regulation to suspending counterparties within three years of the date of the conviction or sanction imposed on the counterparty, OGC asserts that it may rely on its statutory authorities under HERA to effectuate suspensions in cases where this time bar has passed. See 122 STAT. 2654, Public Law 110-289 – Housing and Economic Recovery Act of 2008 (July 30, 2008). In this compliance review, we defer to FHFA's interpretation of its legal basis to issue suspensions.

⁵ See OIG, *FHFA Should Improve its Administration of the Suspended Counterparty Program* (July 31, 2017) (COM-2017-005).

⁶ Our 2017 report identified a backlog of 424 referrals, but this review removed one for technical reasons.

found guilty of fraud. Finally, we found three instances in which the lengths of suspensions were shorter than the suspensions set forth in the Agency's guidelines, with no written explanation for the divergence.

We recommended that FHFA: (1) develop and implement a review plan containing a timeliness standard in order to eliminate the current backlog of referrals and prevent future backlogs; and (2) document its reasons for any departures from the suspension periods prescribed in the guidelines. In its management response, which is attached to the report, OGC agreed with our recommendations. It stated that, within six months, it would take appropriate action to accelerate the clearance of referrals and provide additional information on suspension periods and mitigating factors relating to particular suspensions.

In its January 31, 2018, corrective action memorandum, OGC reported to us that it had taken actions to address our report recommendations, including, among other things:

- Developed standards for the timely processing of referrals and implemented those standards on January 16, 2018. Those standards required OGC staff to:
 - Transmit each referral to the regulated entities for comments or additional information within 30 days after FHFA's receipt of the referral; and
 - Prepare initial recommendation memoranda with proposed resolutions within 30 days after receiving comments or additional information from the regulated entity.
- Completed suspension recommendation memoranda for 366 (86%) of the 424 SCP referrals in the December 2016 backlog;⁷
- Arranged to have an FHFA detailed an employee to OGC (the detail to be effective as of February 5, 2018), to assist in tracking and processing referrals;
- Developed and implemented a referral information management system to increase the efficiency and effectiveness of FHFA's ability to monitor important deadlines regarding counterparties referred to the SCP;⁸ and
- Updated its suspension guidelines as of September 18, 2017, to, among other things, describe mitigating conditions that could result in suspensions greater or longer than

⁷ While OGC did not identify a timeline or plan for clearing the remaining 58 referrals from the backlog, it subsequently reported to us that, as of September 18, 2018, it had closed 410 of the 424 referrals in the backlog and closed the remaining referrals in the backlog by December 13, 2018. OGC also subsequently reported to us that it had processed 153 of the 176 new referrals received in 2017 and 2018.

⁸ For example, counterparties that have received a proposed suspension from FHFA have 30 days to respond to OGC. The system tracks the due date.

set forth in the guidelines, and created a recommendation memorandum template that, among other things, requires a written rationale for departures from these guidelines.

Based on OGC’s representations, we closed the recommendations from our July 2017 report in February 2018.

We initiated this compliance review to verify OGC’s implementation of these corrective actions.

FINDINGS

Our testing determined that:

1. OGC Never Implemented the Timeliness Standards for Processing SCP Referrals that it Represented Had Been Implemented in its January 31, 2018, Memorandum

In OGC’s January 31, 2018, corrective action memorandum, it represented to us that it had established standards for the timely processing of referrals and implemented them on January 16, 2018.

Notwithstanding that representation, OGC subsequently reported to us, in October 2018, that it never implemented these standards. Instead, it established an unwritten process to prioritize the processing of referrals in its inventory, based on the date of the covered misconduct. That is, OGC decided to ensure that it prioritized referrals that were close to running out of time for suspension, pursuant to its interim and final rules. OGC’s subsequent representation calls into question OGC’s candor in its January 31, 2018, corrective action memorandum in which it stated that it had already implemented the timeliness standards, which we find troubling.⁹

In its management response to this report, OGC asserted that it had adopted an unwritten process to prioritize referrals in its inventory, and that it considered this process to be a

⁹ In light of OGC’s October 2018 report that it had not implemented its timeliness standards, we sought to determine the time taken by OGC to process the 35 referrals it received from January 16, 2018, through September 18, 2018. OGC’s unimplemented first timeliness standard would have required OGC to send referrals to the regulated entities within 30 days of receipt for review and comment. OIG’s analysis of OGC’s records indicates that, for 26 of these 35 referrals (74%), OGC sent the referrals to the regulated entities more than 30 days after receipt. OGC’s second, unimplemented timeliness standard required OGC staff to prepare draft recommendation memorandum within 30 days after receipt of the regulated entities’ responses. We could not gauge whether OGC complied with this timetable because OGC did not track when draft recommendation memoranda were completed.

“timeliness standard.”¹⁰ According to OGC, it prioritizes the processing of referrals based on when the terms of the convictions or administrative sanctions will expire.¹¹

OGC’s unwritten prioritization process may provide a reasonable means for prioritizing referrals. However, it does not guarantee that referrals are disposed of on a timely basis, nor does it prevent future backlogs.

In contrast, the timeliness standards OGC never implemented and has now abandoned would have prevented future backlogs because they established timelines for completing specific tasks associated with the disposition of all SCP referrals.

2. OGC Followed its Suspension Guidelines

In its January 31, 2018, corrective action memorandum, OGC informed us that reviewers were to document the basis for any departures from the Agency’s suspension guidelines in their recommendation memoranda.

We identified a total of 42 proposed or final SCP suspensions from the date of OGC’s corrective action memorandum (January 31, 2018) to the close of our field work on September 18, 2018. Our analysis of OGC documentation concluded that OGC followed its suspension guidelines in each of these cases. Thus, we have no basis to test whether OGC reviewers adhered to the requirement outlined in its corrective action memoranda that it document the basis for any departures from those guidelines.

CONCLUSION.....

FHFA accepted the recommendations in our 2017 report and agreed to implement them. On January 31, 2018, OGC represented that it had implemented the remedial actions to eliminate

¹⁰ OGC also provided us with a document entitled “Draft: Suspended Counterparty Program Workflow, Updated November 2018,” which contains guidelines for referral processing timeliness. However, the Associate General Counsel reported to us that the draft document, which existed in different iterations since at least 2017, is a “work in progress” that is updated periodically, with no records kept of prior versions. Our testing indicates that OGC has not adhered to the timelines in this draft document and we do not consider the draft to be a substitute for the abandoned timeliness guidelines.

¹¹ In its technical comments, OGC took issue with our reading of its regulation regarding the deadline for issuing suspensions. OGC asserts that it does not interpret its regulation to require the issuance of a suspension within three years of a counterparty’s conviction or administrative sanction. Rather, OGC maintains that, so long as a referral is made to FHFA within three years of the conviction or sanction, OGC may issue a suspension at any time thereafter. This position directly contradicts the position taken by OGC previously and documented in our 2017 report: “FHFA’s suspending official, its General Counsel, likened the three-year period to a statute of limitations: he explained to us that FHFA cannot impose a suspension under the SCP for covered misconduct that falls outside of the three-year period (of the conviction or sanction date).”

its backlog and prevent future backlogs. Among these was the adoption and implementation of timeliness standards for processing referrals. We closed these recommendations in February 2018.

As we explained in our July 2017 report, the lack of timeliness standards increases the risk that SCP backlog referrals will recur. In this compliance review, we learned that, notwithstanding FHFA's representations, OGC abandoned, and never implemented, the timeliness standards it had developed. While the efforts made by OGC to eliminate its backlog are salutary, the backlog was created by its lack of attention to referrals. OGC has not adopted and implemented any standard or process that sets timelines for completing specific tasks associated with the disposition of all SCP referrals in order to prevent future backlogs. Accordingly, we are reopening the recommendation from our 2017 report and it will remain open until OGC implements timeliness standards, as it agreed to do in July 2017.

OBJECTIVE, SCOPE, AND METHODOLOGY

To conduct our work, we requested and reviewed OGC documentation on its corrective actions and the clearance of the backlog identified in our 2017 report and new referrals received in 2017 and 2018. Additionally, we reviewed documentation of OGC-issued suspensions in 2018 to assess their adherence to the Agency’s suspension guidelines and documentation standards. We also interviewed the General Counsel and OGC staff to conduct our work.

We conducted our compliance review from August 2018 to December 2018 under the authority of the Inspector General Act of 1978, as amended, and in accordance with the *Quality Standards for Inspection and Evaluation* (January 2012), which were promulgated by the Council of the Inspectors General on Integrity and Efficiency.

APPENDIX: FHFA MANAGEMENT RESPONSE.....



Federal Housing Finance Agency

MEMORANDUM

TO: David Frost, Acting Deputy Inspector General for Compliance and Special Projects

FROM: Alfred Pollard, General Counsel *JM or AMP*

SUBJECT: Draft Report: *Compliance Review of FHFA's Suspended Counterparty Program*

DATE: January 16, 2019

Thank you for the opportunity to respond to the Office of Inspector General (OIG) draft report: *Compliance Review of FHFA's Suspended Counterparty Program* (Report). Since the OIG's 2017 special project, the Office of General Counsel (OGC) implemented various process enhancements to the Suspended Counterparty Program (SCP) including timeliness standards, an automated referral information management system, and updated Suspension Guidelines.

Recommendation: *Develop and implement a review plan containing a timeliness standard in order to eliminate the current backlog of referrals and prevent future backlogs.*

Response: As noted in the report, OGC has implemented a timeliness standard based on the end dates of the Covered Misconduct. This standard allows the agency to consider each referral for suspension prior to the end of the Covered Misconduct.

OGC is currently deploying new resources to assist in ongoing SCP reviews. By July 31, 2019, OGC will evaluate whether this is the appropriate level of resources for the workload, and determine whether additional timeliness standards are necessary to manage existing and incoming referrals to the SCP.

ADDITIONAL INFORMATION AND COPIES.....

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