Federal Housing Finance Agency
Office of Inspector General

FHFA's Supervisory Standards for Communication of Serious Deficiencies to Enterprise Boards and for Board Oversight of Management's Remediation Efforts are Inadequate

Evaluation Report • EVL-2016-005 • March 31, 2016

EVL-2016-005

March 31, 2016

Executive Summary

As the federal regulator of Fannie Mae and Freddie Mac (collectively, the Enterprises) and of the Federal Home Loan Banks (FHLBanks), the Federal Housing Finance Agency (FHFA or Agency) is tasked by statute with ensuring that these entities operate safely and soundly so that they serve as a reliable source of liquidity and funding for housing finance and community investment. Critical to FHFA's supervision of the Enterprises and FHLBanks are on-site examinations, including ongoing monitoring and targeted examinations into strategically selected areas of high importance.

FHFA consistently maintains, based on the language of its authorizing statute, that its supervisory authority over the entities it regulates "is virtually identical to—and clearly modeled on—Federal bank regulators' supervision of banks." Like the Office of the Comptroller of the Currency (OCC) and the Board of Governors of the Federal Reserve System (Federal Reserve), FHFA conducts safety and soundness examinations, reports on examination findings, and, when necessary, issues findings identifying deficiencies. Supervisory guidance issued by FHFA, the OCC, and the Federal Reserve holds directors responsible for oversight of the affairs of a regulated entity and for its safety and soundness. These regulators require boards of directors of a regulated entity to ensure that the conditions and practices that gave rise to supervisory concerns and deficiencies are corrected by management in a timely manner.

In our recent evaluation, *FHFA's Examiners Did Not Meet Requirements and Guidance for Oversight of an Enterprise's Remediation of Serious Deficiencies*, we explained that FHFA, like the OCC and Federal Reserve, issues Matters Requiring Attention (MRA) for serious supervisory concerns or deficiencies that require prompt correction. Because each of these regulators charges directors of a regulated entity with responsiblility to ensure that the conditions and practices that gave rise to supervisory concerns and deficiencies are corrected by management, we compared the stringent requirements imposed on directors for oversight of MRA remediation by the OCC and the Federal Reserve to those imposed by FHFA's Division of Enterprise Regulation (DER) on Enterprise directors, and determined that requirements and guidance of FHFA and DER fall far short of peer federal financial regulators. Specifically, we found:

- The OCC and Federal Reserve require a board of directors to be notified, in writing, by the exam team when an MRA issues and the reasons for its issuance; FHFA examiners notify Enterprise management, not Enterprise directors, that an MRA has issued.

- The OCC and Federal Reserve require a board of directors to engage early in the MRA remediation process by reviewing or approving a

written remedial plan to correct the MRA deficiencies; FHFA places sole responsibility on Enterprise management to develop and submit a remedial plan to FHFA, without review by Enterprise directors.

- The OCC and Federal Reserve require a board of directors to oversee management's efforts to implement the proposed remedial measures on an ongoing basis and ensure that management's remediation is adequate and timely; FHFA does not.

- The OCC and Federal Reserve expect a board of directors to keep the regulator informed of the progress of the remediation; FHFA does not.

Under FHFA's supervisory guidance, an Enterprise board is responsible for ensuring timely and effective correction of significant supervisory deficiencies, but FHFA's supervisory practices significantly limit the ability of an Enterprise board to execute its responsibilities. DER does not communicate MRAs directly to an Enterprise board; rather, a board receives information concerning the most serious deficiencies through a management filter. An Enterprise board has no role in review or approval of a plan to remediate MRAs, which constrains the board's ability to effectively oversee management's remedial efforts.

FHFA acknowledged to us that it has no supervisory expectations for an Enterprise board to oversee management's efforts to remediate an MRA on an ongoing basis. According to FHFA, the responsibilities of an Enterprise board are limited to monitoring MRA remediation, not oversight: an Enterprise board is expected only to receive reports from management on the progress of its remedial actions. Under FHFA's current supervisory practices, there is a risk that an Enterprise board could become no more than a bystander to management's efforts to remediate MRAs, and FHFA risks prolonged or inadequate resolution of the most serious threats to the Enterprises' safety and soundness.

We make four recommendations to FHFA to remedy the shortcomings we found. FHFA agrees with three recommendations and partially agrees with one.

The report was prepared by Brian Stief and Brian Harris, Investigative Counsels. The report has been distributed to Congress, the Office of Management and Budget, and others and will be posted on our website, www.fhfaoig.gov. We appreciate the assistance of the officials from FHFA in completing this evaluation.

Angela Choy
Assistant Inspector General for Evaluations

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ABBREVIATIONS

Board	Board of Directors
Comptroller's Handbook	*Comptroller's Handbook for the Bank Supervision Process*
DBR	Division of Federal Home Loan Bank Regulation
DER	Division of Enterprise Regulation
Fannie Mae	Federal National Mortgage Association
Federal Reserve	Board of Governors of the Federal Reserve System
Federal Reserve Manual	*Commercial Bank Examination Manual*
FHFA or Agency	Federal Housing Finance Agency
FHLBank	Federal Home Loan Bank
Freddie Mac	Federal Home Loan Mortgage Corporation
HERA	Housing and Economic Recovery Act of 2008
MRA	Matter Requiring Attention
MRIA	Matter Requiring Immediate Attention
OCC	Office of the Comptroller of the Currency
OIG	Federal Housing Finance Agency Office of Inspector General
ROE	Report of Examination

BACKGROUND ....

Since July 2008, FHFA has operated as the regulator of the Enterprises to ensure that they operate safely and soundly so that they serve as a reliable source of liquidity and funding for housing finance and community investment.[1] FHFA, like other federal financial regulators, has adopted a risk-based approach for its supervisory activities. FHFA's Division of Enterprise Regulation (DER) conducts supervision activities for the Enterprises, including regular assessments to identify the risks posing the highest supervisory concerns, annual examinations of each Enterprise consisting of ongoing monitoring and targeted examinations into those strategically selected areas of high importance or risk, and regular communications with senior management of each Enterprise throughout the supervisory cycle.

MRAs: Their Role and Purpose for the Enterprises

> FHFA issues MRAs only for the most significant deficiencies that require prompt remediation by the regulated entity and timely follow-up by FHFA to check resolution consistent with a remediation plan.

During any supervisory activity, FHFA examiners may identify supervisory concerns or deficiencies. FHFA categorizes such supervisory concerns or deficiencies into one of three categories: (1) Recommendations, (2) Violations, or (3) Matters Requiring Attention (MRAs). According to FHFA, only "the most serious supervisory matters" are categorized as MRAs.[2] FHFA will issue MRAs for such matters as "non-compliance with laws or regulations that result or may result in significant risk of financial loss or damage," "repeat deficiencies that have escalated due to insufficient action or attention," "unsafe or unsound practices," "matters that have resulted, or are likely to result, in a regulated entity being in an unsafe or unsound condition," and "breakdowns in risk management, significant control weaknesses, or inappropriate risk-taking."[3] As of November

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[1] *See* Housing and Economic Recovery Act of 2008 (HERA), Pub. L. No. 110-289, § 1102, 122 Stat. 2654, 2663-64 (2008). HERA extensively amended the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, 12 U.S.C. § 4501 *et seq.* FHFA has also acted as the conservator of the Enterprises since 2008; however, this evaluation assesses only the Agency's role as regulator.

[2] FHFA, Advisory Bulletin 2012-01, *Categories for Examination Findings*, at 2 (Apr. 2, 2012) (online at www.fhfa.gov/SupervisionRegulation/AdvisoryBulletins/AdvisoryBulletinDocuments/2012_AB_2012-01_Categories_for_Examination_Findings_508.pdf). An FHFA Advisory Bulletin may be directed to FHFA employees, to the entities FHFA regulates, or to both. Advisory Bulletin 2012-01 is addressed to both.

[3] *Id.*

2015, the Enterprises, combined, had a total of 72 open MRAs, two-thirds of which were issued in 2013 or earlier.[4]

FHFA's Advisory Bulletin 2012-01, issued in April 2012,[5] and *Examination Manual*, issued in December 2013,[6] set forth FHFA's current requirements and guidance on MRA remediation and supervisory follow-up. These materials are supplemented by guidance issued by DER.[7]

While the Enterprises are not federally chartered banks, FHFA maintains, based on the language of its authorizing statute,[8] that its supervisory authority over the entities it regulates "is virtually identical to—and clearly modeled on—Federal bank regulators' supervision of banks."[9] Like the OCC and Federal Reserve, FHFA conducts safety and soundness examinations, prepares written reports of its examination findings, and issues findings identifying deficiencies. FHFA's governing statute also grants the FHFA Director authority to use the OCC and the Federal Reserve to conduct FHFA's supervisory activities and instructs the Director to set compensation levels for FHFA staff that are comparable to other federal financial regulators.[10] FHFA has successfully asserted the bank examination privilege, historically invoked by the OCC and Federal Reserve to shield from discovery materials relating to its supervision of the Enterprises.[11]

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[4] Since then, FHFA has informed us that it closed at least 12 of the 72 open MRAs.

[5] FHFA, Advisory Bulletin 2012-01, *Categories for Examination Findings*, *supra* note 2.

[6] FHFA, *FHFA Examination Manual* (Dec. 19, 2013) (online at www.fhfa.gov/SupervisionRegulation/Documents/ExaminationProgramOverview.pdf).

[7] Prior to December 2013, DER established MRA requirements and guidance for their examiners in its Supervisory Guide 2.0.

[8] *See* 12 U.S.C. §§ 4513(a)(3), 4517(e).

[9] Defendant's Response in Opposition to Plaintiffs' Motion to Compel Production of Certain Documents Withheld for Privilege, at 17, *Fairholme Funds, Inc. v. United States*, No. 13-465C (Fed. Cl. Feb. 19, 2016).

[10] *See* 12 U.S.C. §§ 4515(b), 4517(c).

[11] *See JPMorgan Chase & Co.*, 978 F. Supp. 2d at 280.

FACTS AND ANALYSIS ....

As a matter of law, the board of an organization—whether a publicly traded company, a bank regulated by the OCC or Federal Reserve, or a financial institution regulated by FHFA—is charged with the fiduciary responsibility to oversee the business and affairs of that organization. To discharge that fiduciary duty, directors set policies and objectives and oversee management's implementation of them, establish expectations for senior management and for the organization as a whole, and exercise appropriate oversight to ensure that those expectations are met.[12] For an entity subject to government regulation, the board is charged with the responsibility to ensure that management corrects deficiencies found by its regulator to bring the entity back into regulatory compliance.[13]

After FHFA placed the Enterprises into conservatorships in September 2008, it delegated to the board of each Enterprise responsibility for overseeing general corporate matters.[14] In its corporate governance regulation, FHFA has directed that the board of a regulated entity is responsible for having policies in place to assure oversight of the Enterprise's risk management program and of "[t]he responsiveness of executive officers…addressing all of FHFA's supervisory concerns in a timely and appropriate manner."[15] FHFA's *Examination*

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[12] *See* Mary Jo White, Chair, Securities and Exchange Commission, Remarks at Stanford University Rock Center for Corporate Governance (June 23, 2014) (online at www.sec.gov/News/Speech/Detail/Speech/1370542148863. *See also* Thomas J. Curry, Comptroller, OCC, Remarks at the Prudential Bank Regulation Conference in Washington, D.C. (June 9, 2015) (online at www.occ.treas.gov/news-issuances/speeches/2015/pub-speech-2015-82.pdf); *see also* Daniel K. Tarullo, Governor, Federal Reserve, Remarks Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Mar. 19, 2015) (online at www.federalreserve.gov/newsevents/testimony/tarullo20150319a.htm).

[13] *See, e.g.,* FHFA, Prudential Mgmt. and Operations Standards, 12 C.F.R. pt. 1236, App. (Standard 1, Princ. 1, 16) [hereinafter *FHFA PMOS*]; OCC, *Bank Supervision Process, Comptroller's Handbook,* at 105 (Dec. 2015) (online at www.occ.gov/publications/publications-by-type/comptrollers-handbook/pub-ch-ep-bsp.pdf) ("When discussing MRAs, examiners must be clear with management and the board of directors regarding our supervisory concerns and expectations. Examiners must impress upon the board its responsibility to ensure that management implements corrective actions within a reasonable period of time and to confirm that those actions are effective. Failure to do so could lead to enforcement actions."); Federal Reserve, *Commercial Bank Examination Manual*, Section 5000.1, at 5 (Oct. 2015) (online at www.federalreserve.gov/boarddocs/supmanual/cbem/cbem.pdf) ("Bank directors must ensure that management corrects deficiencies found in the bank. Instructions to do so may come from the Federal Reserve as a formal or informal supervisory action, depending on the severity of the problem.").

[14] Upon its appointment as conservator, FHFA succeeded to, among other things, all rights and powers of any director of the Enterprises. In November 2008, the FHFA Director delegated authority over general corporate matters back to the Enterprises' boards. For more information on FHFA's delegation of authority to the boards, *see* OIG, *FHFA's Conservatorships of Fannie Mae and Freddie Mac: A Long and Complicated Journey* (Mar. 25, 2015) (WPR-2015-002) (online at www.fhfaoig.gov/Content/Files/WPR-2015-002_0.pdf).

[15] *See* 12 C.F.R. § 1239.4(c)(1), (3).

Manual instructs that the board is ultimately responsible for ensuring that "the conditions and practices that gave rise to examination findings are corrected in a timely manner."[16]

In a recent OIG evaluation, we compared FHFA's definition of an MRA to the definitions adopted by the OCC and Federal Reserve and found the definitions to be substantially similar.[17] Because the OCC, Federal Reserve, and FHFA charge directors of a regulated entity with responsibility to ensure that management corrects supervisory deficiencies, we compared in this evaluation the stringent requirements imposed by the OCC and the Federal Reserve on directors for oversight of MRA remediation to those imposed by FHFA on Enterprise directors.

Supervisory Engagement with the Board of Directors of a Regulated Entity on MRA Issuance and Remediation

Format and Communication

In 2014 revisions to its *Comptroller's Handbook for the Bank Supervision Process* (*Comptroller's Handbook*), the OCC included new guidance on MRAs to focus a board's "attention on supervisory concerns that require their immediate acknowledgement and oversight."[18] According to the *Comptroller's Handbook*, examiners are required to meet with a board after an examination to discuss the examination results. The OCC directs its examiners to communicate, in writing, MRA deficiencies to the board "when discovered."[19] In that written communication, OCC examiners must:

- Describe the MRA;
- Identify contributing factors and the root cause(s) of the MRA;
- Describe potential consequences or effects on the bank from inaction;
- Describe expectations for corrective action; and

[16] FHFA, *FHFA Examination Manual*, *supra* note 6, at 23.

[17] *See* OIG, *FHFA's Examiners Did Not Meet Requirements and Guidance for Oversight of an Enterprise's Remediation of Serious Deficiencies* (Mar. 29, 2016) (EVL-2016-004) (online at www.fhfaoig.gov/Content/Files/EVL-2016-004.pdf). In this report, we found that the OCC and Federal Reserve have more stringent requirements with respect to MRA content than FHFA.

[18] OCC, *Bank Supervision Process, Comptroller's Handbook*, *supra* note 13, at 105.

[19] *Id*.

- Document the bank's commitment to corrective actions, including the time frame and the person(s) responsible for corrective action.

According to the *Comptroller's Handbook*, "examiners must be clear with management and the board of directors regarding [the OCC's] supervisory concerns and expectations" for an MRA.[20] Specifically, the OCC directs examiners to "impress upon the board its responsibility to *ensure* that management implements corrective actions within a reasonable period of time and to confirm that those actions are effective."[21] Where management is unable to provide a remedial plan to the OCC by the time the MRA issues, the OCC requires the board to review and approve management's remedial plan within 30 days of receipt of the MRA.

Similarly, the Federal Reserve imposes significant responsibilities on the board of a regulated entity subject to an MRA.[22] According to the Federal Reserve's *Commercial Bank Examination Manual* (*Federal Reserve Manual*), MRAs and Matters Requiring Immediate Attention (MRIAs)[23] resulting from supervisory activity "must [be] formally communicate[d]" in written reports to the entity's board of directors, or executive-level committee of the board.[24] After a board reviews an MRA, the Federal Reserve requires it "to provide a written response to the [Federal Reserve] regarding its plan, progress, and resolution of the MRA."[25] For an MRIA, where the Federal Reserve expects immediate corrective action, "the banking organization's board of directors is required to respond to the [Federal Reserve] in writing regarding corrective action taken or planned along with a commitment to corresponding time-frames."[26]

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[20] *Id.*

[21] *Id.* (emphasis added).

[22] The Federal Reserve Board of Governors establishes examination standards and requirements, and the Reserve Banks are responsible for supervising and regulating bank holding companies, Federal Reserve System member banks, foreign branches of member banks, and other related entities to ensure safe and sound banking practices and compliance with applicable laws and regulations. For purposes of this report, any reference to the "Federal Reserve" includes the Reserve Banks.

[23] The primary difference between an MRA and an MRIA is the degree of urgency to remediate the identified deficiency.

[24] Federal Reserve, *Commercial Bank Examination Manual*, *supra* note 13, Section 6000.1, at 2.

[25] *Id.* at 3.

[26] *Id.* For certain regulated entities, the Federal Reserve requires written reports to boards summarizing any MRAs. The guidance requires such reports for all entities with overall ratings below a specified level or entities that show signs of deterioration in condition or apparent violations of law. The summary reports must focus on identifying problems and presenting issues succinctly and clearly, and must include specific types of actions to be taken by the directors and management. According to Federal Reserve guidance, "summary reports should emphasize the responsibilities of the directors to ensure that corrective actions are taken to address all deficiencies" noted in the final report. The guidance also requires each director to read the

FHFA has inconsistent guidance with respect to notifying a board of directors of an MRA. FHFA requires its Division of Federal Home Loan Bank Regulation (DBR), which has supervisory authority over the FHLBanks, to identify an MRA issued to an FHLBank in its annual written Report of Examination (ROE), including a brief description and the date by which the MRA must be resolved if not resolved already. It is also DBR's practice to provide the ROE to the FHLBank's board of directors. DBR's internal guidance counsels DBR examiners to discuss an MRA with the affected FHLBank board and document those discussions in writing. However, FHFA does not require DER to notify an Enterprise board when an MRA has issued or the reasons for the MRA, even though FHFA only issues an MRA for "the most serious supervisory matters." FHFA also does not require that the written ROE include all outstanding MRAs.

FHFA's governance regulations and *Examination Manual* make clear that an Enterprise board is ultimately responsible for ensuring that the conditions and practices that gave rise to any supervisory concerns are corrected, ensuring that executive officers have been "responsive[]…in addressing all of FHFA's supervisory concerns in a timely and appropriate manner," and holding management accountable for remediating those conditions and practices.[27] These regulations and requirements make clear that Enterprise boards are charged with understanding the "serious deficiencies" in practices, policies, procedures, and controls adopted by management that gave rise to an MRA and overseeing management's efforts to correct these deficiencies in a timely and effective manner.

Notwithstanding the obligations imposed by FHFA on an Enterprise board, FHFA reported to us that DER's practice is to explain only to Enterprise management the control weaknesses that are the basis for an MRA. DER meets solely with Enterprise management at an exit meeting to discuss the supervisory concerns and findings, and communicates an MRA in a written conclusion letter sent only to the responsible business executive at the Enterprise, with copies to the heads of Enterprise internal audit and compliance.[28] According to FHFA,

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summary report, sign a statement confirming his or her review, and return the signed document to management to keep on file. *See* Federal Reserve, *Commercial Bank Examination Manual*, *supra* note 13, Section 5030.1, at 3-4.

[27] *See* FHFA, *FHFA Examination Manual*, *supra* note 6, at 23; 12 C.F.R. § 1239.4(c)(1), (3); FHFA, *FHFA PMOS*, *supra* note 13. For similar language from a peer regulator, *see also*, OCC, OCC Bulletin 2014-52, *Matters Requiring Attention* (Oct. 30, 2014) (online at www.occ.treas.gov/news-issuances/bulletins/2014/bulletin-2014-52.html) (bulletin directed to the chief executive officers of all national banks and federal savings associations and all examining personnel states that the OCC expects a bank's board of directors to hold management accountable for the deficient practices and to ensure the timely and effective correction of such practices).

[28] Although FHFA guidance vests the examiner-in-charge for each Enterprise with discretion whether to report an MRA to the Enterprise board or to management (*see* FHFA, Advisory Bulletin 2012-01, *Categories for Examination Findings*, *supra* note 2, at 2), FHFA informed us that the examiner-in-charge, in practice, reports MRA issuance to management.

DER's supervisory expectation is that Enterprise management will advise the Enterprise board of DER's supervisory concerns and findings (including MRAs) and that DER has no reason to believe that an Enterprise board was not aware of an MRA or the status of outstanding MRAs, based on its review of management presentations to the board.

While "serious deficiencies" in Enterprise management's practices, policies, procedures, and controls give rise to an MRA, DER defers to that same management team to report the MRA to the Enterprise's board. Although the OCC either requires that the remediation plan be part of the MRA or requires the board to submit a remediation plan within 30 days, and the Federal Reserve requires the board to submit the proposed remediation plan, FHFA leaves development and submission of a proposed remediation plan to Enterprise management without board review or approval. Nothing in FHFA's requirements or guidance contemplates board involvement in the development of a remediation plan or board approval of the plan before its submission to FHFA. FHFA acknowledged to us that it "is a management responsibility to develop and approve the design of MRA" remediation plans.

Follow-Up

OCC guidance outlines a board's responsibilities to monitor MRA remediation and to ensure MRA resolution. In Bulletin 2014-52, the OCC advises boards of its regulated entities that they are responsible for ensuring timely and effective correction of deficient practices identified in an MRA.[29] The bulletin sets forth specific board obligations, including:

- "[H]olding management accountable for the deficient practices";
- "[D]irecting management to develop and implement corrective actions";
- "[A]pproving the necessary changes to the bank's policies, processes, procedures, and controls"; and
- "[E]stablishing processes to monitor progress and verify and validate the effectiveness of management's corrective actions."[30]

The *Comptroller's Handbook* encourages frequent communication between the board and examiners throughout management's efforts to remediate an MRA.

The Federal Reserve also imposes oversight and reporting requirements on a board. The *Federal Reserve Manual* requires a board to report on management's plan to remediate the deficiencies identified in an MRA, on the status of remediation progress, and on resolution of

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[29] OCC, OCC Bulletin 2014-52, *Matters Requiring Attention*, *supra* note 27.

[30] *Id.*

all deficiencies. Additionally, for an MRIA, the board must make a written commitment to a remedial time frame.

Like the OCC and the Federal Reserve, FHFA maintains that an Enterprise board is ultimately responsible for ensuring that "the conditions and practices that gave rise to examination findings are corrected in a timely manner." DER officials informed us that they did not engage in ongoing communications directly with Enterprise boards about management's progress in remediating an MRA, and DER guidance does not contemplate regular communications between an Enterprise board and DER examiners during the remedial process.[31] FHFA acknowledged to us that it has no supervisory expectations for an Enterprise board to oversee management's efforts to remediate an MRA on an ongoing basis. According to FHFA, the responsibilities of an Enterprise board are limited to monitoring MRA remediation, not oversight:[32] an Enterprise board is expected only to receive reports from management on the progress of its efforts to remediate its practices that gave rise to the MRA issued by FHFA. As a consequence, Enterprise directors lack a reasonable basis on which to vigorously scrutinize efforts by the executive officers to address all of FHFA's supervisory concerns in a timely and appropriate manner.

Internal guidance promulgated by DER tasks the Internal Audit function of an Enterprise to determine, after management has completed its MRA remediation, the effectiveness of such corrective actions. Because the Internal Audit function of each Enterprise reports to the Audit Committee of an Enterprise board, FHFA suggested to us that the oversight duties of an Enterprise board would be satisfied by receipt of the Internal Audit report on its testing of the adequacy of MRA remediation. Such limited oversight by an Enterprise board of management's efforts to remediate an MRA creates the risk that an Enterprise board will be unable to satisfy FHFA's governance obligations.[33]

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[31] While FHFA requires an Enterprise board to respond in writing to the annual ROE, it does not require the ROE to identify existing MRAs.

[32] "[I]n order to be effective, a director must do more than simply monitor management's performance. Applicable standards require that a director must actively undertake vigorous scrutiny of the corporation's affairs, and must be unfailingly vigilant in requiring that management continuously provide an adequate and frequent flow of information concerning the goals, objectives, operations, and financial condition of the corporation." Office of Federal Housing Enterprise Oversight, *Report of the Special Examination of Fannie Mae*, at 280 (May 2006) (online at www.fhfa.gov/Media/PublicAffairs/PublicAffairsDocuments/20060517_SpecialExaminationFannieMae_N508.pdf).

[33] Those obligations include ensuring that the conditions and practices that gave rise to any supervisory concerns are corrected (FHFA, *FHFA Examination Manual*, *supra* note 6, at 23); ensuring that executive officers have been "responsive[]…in addressing all supervisory concerns of FHFA in a timely and appropriate manner" (12 C.F.R. § 1239.4(c)(1), (3)); and holding management accountable for remediating those conditions and practices (FHFA, *FHFA PMOS, supra* note 13).

FINDINGS

1. FHFA's acknowledgement that DER informs only Enterprise management of an MRA, and then relies on management to communicate that information to an Enterprise board, creates a significant risk that management will put its own spin on the deficiencies giving rise to the MRA or will filter the information it provides to the Board.

2. FHFA's determination that Enterprise management is solely responsible for development and submission of a proposed MRA remediation plan, without requiring any board review or approval, creates a significant likelihood that Enterprise directors lack a reasonable basis on which to affirm to FHFA that adequate and timely corrective actions have been taken or will be taken to resolve the MRA, as required by the *Examination Manual*.

3. Because FHFA acknowledged to us that it has no supervisory expectations for an Enterprise board to oversee management's efforts to remediate an MRA on an ongoing basis and maintained that the responsibilities of an Enterprise board are limited to monitoring MRA remediation based on reports from management, there is a risk that an Enterprise board could become no more than a bystander to management's efforts to remediate an MRA, and FHFA risks prolonged or inadequate resolution of the most serious threats to the Enterprises' safety and soundness.

CONCLUSION

FHFA consistently maintains, based on the language of its authorizing statute, that its supervisory authority over the institutions it regulates "is virtually identical to—and clearly modeled on—Federal bank regulators' supervision of banks." MRAs have long been used by federal banking regulators to identify and communicate significant deficiencies to regulated financial institutions, and, since 2008, FHFA has issued MRAs for the most serious supervisory matters requiring prompt correction. Like the OCC and the Federal Reserve, FHFA charges Enterprise directors with responsibility for ensuring that management corrects the conditions and practices that gave rise to an MRA in a timely manner.

For directors to be held responsible for ensuring that the conditions and practices giving rise to an MRA are effectively and timely corrected by management, they must be aware that an MRA has issued and the specific deficiencies identified in it, review or approve the plan to correct the deficiencies, oversee management's remedial efforts on an ongoing basis, confirm that the remedial actions are effective, and hold management accountable for the deficiencies. Requirements established by the OCC and Federal Reserve clarify the oversight responsibilities of a board of a regulated entity to ensure timely and effective correction of MRA deficiencies before they adversely affect the entity's safety and soundness. FHFA, however, has elected to communicate its supervisory findings solely to Enterprise management, to charge Enterprise management with responsibility to develop and submit a remediation plan without board review, and to be satisfied by a board's receipt of MRA remediation updates solely through the lens of management. Absent clear supervisory expectations from FHFA, there is a significant risk that an Enterprise board could become no more than a bystander to management's efforts to remediate MRAs, and FHFA risks prolonged or inadequate resolution of the most serious threats to the Enterprises' safety and soundness.

RECOMMENDATIONS

OIG recommends that FHFA:

1. Revise its supervision guidance to require DER to provide the Chair of the Audit Committee of an Enterprise Board with each conclusion letter setting forth an MRA;
2. Revise its supervision guidance to require DER to provide the Chair of the Audit Committee of an Enterprise Board with each plan submitted by Enterprise management to remediate an MRA with associated timetables and the response by DER;
3. Revise its supervision guidance to require DER to identify all open MRAs in the annual, written ROE and the expected timetable to complete outstanding remediation activities;
4. Include in this year's ROE, to be issued to each Enterprise for 2015 supervisory activities, all open MRAs and the expected timetable to complete outstanding remediation activities for each open MRA.

FHFA'S COMMENTS AND OUR RESPONSE

We provided FHFA an opportunity to respond to a draft report of this evaluation. FHFA provided technical comments on the draft report, which were incorporated as appropriate. In its management response, which is reprinted in its entirety in Appendix A, FHFA agreed with recommendations 1, 3, and 4. FHFA "partially agree[d]" with recommendation 2: it agreed to "send the chair of the board audit committee a copy of DER's written response to each MRA remediation plan" but refused to agree to provide the MRA remediation plan, which provides the basis for DER's written response, directly to the chair of the board audit committee. Instead, FHFA committed to communicate "to Enterprise management the supervisory expectation for clear, timely, detailed reporting to the boards of directors on open remediation plans and associated timetables" and its "expectations about circumstances in which remediation plans should be provided by management to the chair of the board audit committee."

As we demonstrate in this report, it is the responsibility of an Enterprise board to oversee management's efforts to correct all supervisory deficiencies identified by FHFA in a timely and appropriate manner and to hold management accountable. No board can exercise its oversight responsibilities if it lacks the approved remediation plans, which include the agreed upon deliverables and timetables for completion of remediation. Lacking the approved remediation plan with agreed upon deliverables and timetables, an Enterprise board is limited to monitoring management's remedial efforts, which falls far short of its oversight responsibilities under FHFA's governance principles and guidance.

OBJECTIVE, SCOPE, AND METHODOLOGY ....

The objective of this report was to evaluate what responsibilities FHFA imposes on an Enterprise's board of directors when an MRA issues, and to compare those responsibilities to those imposed by other federal financial regulators.

To achieve this objective, we reviewed publicly available documents, internal DER and DBR documents, and FHFA regulations. We also reviewed publicly available guidance published by the OCC and the Federal Reserve.

Our work was conducted under the authority of the Inspector General Act and in accordance with the Council of the Inspectors General on Integrity and Efficiency's *Quality Standards for Inspection and Evaluations* (January 2012). These standards require us to plan and perform an evaluation based upon evidence sufficient to provide reasonable bases to support its findings and recommendations. We believe that the findings and recommendations discussed in this report meet these standards.

The performance period for this evaluation was from October 2015 to February 2016.

APPENDIX A ....

FHFA's Comments on OIG's Findings and Recommendations

Federal Housing Finance Agency

MEMORANDUM

TO: Kyle D. Roberts, Deputy Inspector General - Evaluations

FROM: Nina A. Nichols, Deputy Director, Division of Enterprise Regulation naa

SUBJECT: Evaluation Report: *FHFA's Supervisory Standards for Communication of Serious Deficiencies to Enterprise Boards and for Board Oversight of Management's Remediation Efforts Are Inadequate*

DATE: March 28, 2016

This memorandum transmits the management response of the Federal Housing Finance Agency (FHFA) to the recommendations in the FHFA OIG draft evaluation report, *FHFA's Supervisory Standards for Communication of Serious Deficiencies to Enterprise Boards and for Board Oversight of Management's Remediation Efforts Are Inadequate* (Report).

The safety and soundness of Fannie Mae and Freddie Mac (Enterprises) is a statutory and strategic objective for FHFA. We utilize Agency regulations, guidance, and practices to further that objective, including what we believe are effective guidance and practices for communication of supervisory findings and expectations to the Enterprises' boards of directors (boards). FHFA disagrees with the Report's findings that the Enterprise boards may not have knowledge of supervisory concerns or corrective actions and may be constrained in their ability to oversee management effectively, and we do not believe the Report provides factual support for these findings. FHFA believes that the Enterprises' boards are informed of supervisory concerns appropriately and that existing reporting processes enable the boards to meet FHFA's expectations for oversight of corrective actions undertaken by Enterprise management.

FHFA management's responses to the OIG recommendations are below.

Recommendation 1:

OIG recommends that FHFA revise its supervision guidance to require DER to provide the Chair of the Audit Committee of an Enterprise Board with each conclusion letter setting forth an MRA.

<u>Management Response to Recommendation 1:</u>
FHFA agrees with this recommendation. Pursuant to existing guidance, DER issues a new MRA in a conclusion letter to the responsible Enterprise management official, with copies to the chief audit executive, the head of compliance, and the head of enterprise risk management. FHFA will amend its guidance to require that the chair of the board audit committee also receive a copy of any conclusion letter that includes an MRA. FHFA will complete this amendment to guidance by June 30, 2016.

<u>Recommendation 2</u>:
OIG recommends that FHFA revise its supervision guidance to require DER to provide the Chair of the Audit Committee of an Enterprise Board with each plan submitted by Enterprise management to remediate an MRA with associated timetables and the response by DER.

<u>Management Response to Recommendation 2:</u>
FHFA partially agrees with this recommendation. FHFA will revise its supervision guidance to require DER to send the chair of the board audit committee a copy of DER's written response to each MRA remediation plan. In addition, FHFA will communicate to Enterprise management the supervisory expectation for clear, timely, detailed reporting to the boards of directors on open remediation plans and associated timetables. FHFA will also communicate expectations about circumstances in which remediation plans should be provided by management to the chair of the board audit committee. FHFA will make these communications by October 14, 2016.

<u>Recommendation 3</u>:
OIG recommends that FHFA revise its supervision guidance to require DER to identify all open MRAs in the annual, written ROE and the expected timetable to complete outstanding remediation activities.

<u>Management Response to Recommendation 3:</u>
FHFA agrees with this recommendation. FHFA agrees that identifying all open MRAs in the annual, written Report of Examination (ROE) is a sound practice that FHFA has not consistently observed. DER will amend its examiner guidance to reflect current practice to require inclusion of a list of open MRAs and the expected timetable to complete outstanding remediation activities in the annual ROE for each Enterprise. This amendment to guidance will be effective for ROEs issued for 2016 and subsequently.

Recommendation 4:

OIG recommends that FHFA include in this year's ROE, to be issued to each Enterprise for 2015 supervisory activities, all open MRAs and the expected timetable to complete outstanding remediation activities for each open MRA.

Management Response to Recommendation 4:

FHFA agrees with this recommendation. FHFA has already included in this year's ROE, issued to each Enterprise for 2015 supervisory activities, all open MRAs and the expected timetable to complete outstanding remediation activities for each open MRA.

cc: John Major, Internal Controls and Audit Follow-up Manager

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