

REDACTED

Federal Housing Finance Agency
Office of Inspector General



**FHFA Requires the Enterprises’
Internal Audit Functions to Validate
Remediation of Serious Deficiencies
but Provides No Guidance and
Imposes No Preconditions on
Examiners’ Use of that
Validation Work**

This report contains redactions of information that is privileged or confidential.

Evaluation Report • EVL-2018-002 • March 28, 2018



EVL-2018-002

March 28, 2018

Executive Summary

FHFA is charged with ensuring that Fannie Mae and Freddie Mac (collectively, the Enterprises) operate in a safe and sound manner. Within FHFA, the Division of Enterprise Regulation (DER) is responsible for supervising the Enterprises. When DER conducts supervisory activities, it may identify significant deficiencies related to risk management, risk exposure, or violations of laws, regulations, or orders affecting the performance or condition of a regulated entity. Among these “adverse examination findings” are matters requiring attention (MRAs), which consist of either “critical supervisory matters (the highest priority) which pose substantial risk to the safety and soundness of the regulated entity” or “deficiencies,” which if not corrected, could “escalate and potentially negatively affect” the regulated entity.

FHFA expects the Enterprises to take corrective action to remediate MRAs, and DER is responsible for monitoring the remediation process. When Enterprise management determines that it has completed remediation of an MRA, FHFA expects the Enterprise’s internal audit (IA) functions to review the corrective action and “validate” that remediation has been fully implemented as intended. The Enterprise then submits a closure package to DER that contains documentation of IA’s validation work. Based on a review of the closure package, and any other follow-up examination work that DER may conduct, DER determines whether the MRA has been satisfactorily addressed and notifies the Enterprise of its determination.

In a previous evaluation, we found that some DER examiners appeared to have accepted MRA validation work conducted by the Enterprises’ IA functions without evidence of independent analysis. Following on that work, this evaluation reviews DER’s guidance and standards for reliance on the Enterprises’ IA functions when examiners assess the remediation of MRAs. A companion evaluation issued today reviews DER’s practices for a sample of 22 recent MRA closures. See *FHFA’s Adoption of Clear Guidance on the Review of the Enterprises’ Internal Audit Work When Assessing the Sufficiency of Remediation of Serious Deficiencies Would Assist FHFA Examiners*, EVL-2018-003, available online at www.fhfoig.gov/reports/auditsandevaluations.

To conduct this evaluation, we compared FHFA guidance (including DER’s guidance and standards) to guidance issued by the Office of the Comptroller of the Currency (OCC) and the Board of Governors of the Federal Reserve System (Federal Reserve), and interviewed DER officials and staff. Federal Reserve and OCC guidance direct their respective examiners to periodically assess and conclude on the overall effectiveness or strength of the IA



EVL-2018-002

March 28, 2018

functions at their regulated financial institutions. Federal Reserve guidance permits reliance on IA MRA follow-up only when the Federal Reserve has rated the institution's IA function as effective overall. We found, however, that FHFA has not concluded on the overall effectiveness of the Enterprises' IA functions and that DER has no present plans to do so. As a result, we concluded that DER examiners lack assurance of the overall quality, reliability, competency, and objectivity of the IA function when they use IA validation work.

In addition, we found that FHFA guidance does not address whether, or the circumstances under which, FHFA examiners may rely on, accept, or otherwise use information, analyses, or conclusions provided by an Enterprise's IA function when determining whether an Enterprise has satisfactorily remediated an MRA. Accordingly, DER examiners are given wide discretion to determine whether and to what extent to rely on, accept, or otherwise use IA validation work as a basis to close MRAs. In our view, such discretion to use IA validation work to close MRAs, without a predicate supervisory conclusion on the overall effectiveness of the IA function, creates the risk that DER's assessment of the adequacy of Enterprise remediation will be impaired.

We make three recommendations to FHFA to address these shortcomings. FHFA agreed with one recommendation and disagreed with two.

This report was prepared by Howard Klein, Attorney-Advisor, and Minh-Tu Greenburg, Investigative Counsel. 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.fhfa.org.

Angela Choy
Assistant Inspector General for Evaluations

TABLE OF CONTENTS

EXECUTIVE SUMMARY2

ABBREVIATIONS6

BACKGROUND7

 The Role of the Enterprises’ Internal Audit Functions.....8

FACTS AND ANALYSIS.....10

 FHFA Guidance and Policies Governing the Respective Roles of Enterprise IA and
 FHFA Examination Staff in Assessing Whether MRAs Have Been Satisfactorily
 Remediated10

 FHFA Prudential Management and Operations Standards.....10

 FHFA Examination Manual and the Internal and External Audit Module.....10

 FHFA Advisory Bulletin 2016-0511

 DER Operating Procedures Bulletin 2017-03.212

 Guidance of Other Federal Financial Regulatory Agencies Governing IA and the
 Assessment of MRA Remediation.....13

 Federal Reserve.....14

 OCC15

 Unlike the OCC and the Federal Reserve, Current FHFA Guidance Does Not
 Require FHFA Examiners to Conclude on the Overall Effectiveness or Strength of
 the Enterprises’ IA Function.....15

 According to DER Officials, DER Examiners “Leverage” the Validation Work of an
 Enterprise’s IA Function When Assessing the Adequacy Remediation17

FINDINGS18

 1. FHFA has not concluded on the overall effectiveness of the Enterprises’ IA
 functions.18

 2. FHFA guidance does not address whether, or the circumstances under which,
 FHFA examiners may rely on information, analyses, or conclusions provided by an
 Enterprise’s IA function when assessing the adequacy of MRA remediation.18

CONCLUSION.....19

RECOMMENDATIONS19

FHFA COMMENTS AND OIG RESPONSE20

OBJECTIVE, SCOPE, AND METHODOLOGY21

APPENDIX: FHFA MANAGEMENT RESPONSE22

ADDITIONAL INFORMATION AND COPIES24

ABBREVIATIONS

AB	Advisory Bulletin
Basel Committee	Basel Committee on Banking Supervision
DER	Division of Enterprise Regulation
EIC	Examiner-in-charge
Enterprises	Fannie Mae and Freddie Mac, collectively
Federal Reserve	Board of Governors of the Federal Reserve System and Reserve Banks
FHLBank	Federal Home Loan Bank
FHFA or Agency	Federal Housing Finance Agency
IA	Internal Audit
IIA	Institute of Internal Auditors
IIA Standards	International Standards for the Professional Practice of Internal Auditing
MRA	Matter Requiring Attention
OCC	Office of the Comptroller of the Currency
OIG	Federal Housing Finance Agency Office of Inspector General
OPB	Operating Procedures Bulletin

BACKGROUND.....

Since 2008, FHFA has operated as both regulator and conservator of the Enterprises and regulator of the Federal Home Loan Banks (FHLBanks). DER is responsible for supervising the Enterprises and does so through targeted examinations and ongoing monitoring activities. According to FHFA, targeted examinations enable examiners to conduct a deep or comprehensive assessment of selected areas of high importance or risk, while the purpose of ongoing monitoring is to analyze real-time information and to use those analyses to identify Enterprise practices and changes in an Enterprise’s risk profile that may warrant supervisory attention. DER also conducts ongoing monitoring or targeted examinations to assess the Enterprises’ remediation of serious deficiencies and the Enterprises’ adherence to supervisory guidance and conservatorship directives. At the end of each annual supervisory cycle, DER issues an annual report of examination to each Enterprise.¹

During an ongoing monitoring activity or a targeted examination, DER may identify significant deficiencies related to risk management, risk exposure, or violations of laws, regulations, or orders affecting the performance or condition of a regulated entity. These identified deficiencies are known as “adverse examination findings.” FHFA classifies adverse examination findings into one of three categories: (1) MRAs, (2) Violations, or (3) Recommendations. FHFA has two categories of MRAs: (a) “critical supervisory matters (the highest priority) which pose substantial risk to the safety and soundness of the regulated entity” and (b) “deficiencies,” which if not corrected, could “escalate and potentially negatively affect” the regulated entity.² The distinction between the two types of MRAs is the “nature and severity of the issues requiring corrective action’ and the priority that Enterprise management must give to remediation efforts.”

After FHFA issues an MRA to Fannie Mae or Freddie Mac, the Enterprise is expected to prepare and submit a written remediation plan to FHFA describing the proposed corrective actions. DER then reviews and analyzes the remediation plan, and notifies the Enterprise in writing of DER’s objection, nonobjection, or nonobjection with conditions to the plan. DER

¹ For more information on annual reports of examination, see *OIG, FHFA’s Failure to Consistently Identify Specific Deficiencies and Their Root Causes in Its Reports of Examination Constrains the Ability of the Enterprise Boards to Exercise Effective Oversight of Management’s Remediation of Supervisory Concerns* (July 14, 2016) (EVL-2016-008) (online at www.fhfa.gov/Content/Files/EVL-2016-008.pdf) and *OIG, FHFA Failed to Consistently Deliver Timely Reports of Examination to the Enterprise Boards and Obtain Written Responses from the Boards Regarding Remediation of Supervisory Concerns Identified in those Reports* (July 14, 2016) (EVL-2016-009) (online at www.fhfa.gov/Content/Files/EVL-2016-009.pdf).

² FHFA, *Advisory Bulletin 2017-01, Classifications of Adverse Examination Findings*, at 1-2 (Mar. 13, 2017) (online at www.fhfa.gov/SupervisionRegulation/AdvisoryBulletins/Pages/Classifications-of-Adverse-Examination-Findings.aspx).

examiners are expected to monitor the progress of remediation through ongoing monitoring or targeted examinations. When Enterprise management determines that it has completed remediation, the “Enterprise’s internal audit function or an independent third party reviews and validates that the remediation plan has been fully implemented as intended.”³ The Enterprise then submits a closure package to DER that contains documentation of validation work by its IA function. DER considers remediation of an MRA to be “validated” when the Enterprise’s IA function determines that the proposed remediation plan has been implemented and that the remedial actions are effective and sustainable.

After receipt of the closure package, DER examiners are expected to review its contents and the “follow-up examination work done to monitor progress of corrective actions.” Examiners are expected to document their assessments in an analysis memo, which is provided to the examiner-in-charge (EIC). Based on the examiner’s work, the EIC determines whether the MRA has been “satisfactorily addressed,” and communicates this determination in writing to the Enterprise. DER has previously characterized its oversight role as confirming IA’s validation.

The Role of the Enterprises’ Internal Audit Functions

The Enterprises manage risk using an industry standard “Three Lines of Defense” model.⁴ The third line of defense for each Enterprise is its IA function, which reports independently to the Audit Committee of the Board of Directors.⁵ Internal auditing is:

[A]n independent, objective assurance and consulting activity designed to add value and improve the organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to

³ This process began in 2013, when DER changed its practice for assessing remediation and closing MRAs. DER issued an operating procedures bulletin in April 2013 that called for an Enterprise’s IA function, or other independent third party, to validate that management’s MRA remediation was complete and consistent with the remediation plan. Under that operating procedure, DER examiners would assess the Enterprise’s remediation activities through ongoing monitoring, including reviewing IA’s validation work. The 2013 operating procedures bulletin was superseded in 2017, but the guidance governing the review and closure process did not change materially.

⁴ See Fannie Mae, *2016 Annual Report (Form 10-K)*, at 122 (online at www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2016/10k_2016.pdf); Freddie Mac, *2016 Annual Report (Form 10-K)*, at 92-93 (online at www.freddiemac.com/investors/financials/pdf/10k_021617.pdf).

⁵ The first line of defense is the business unit that generates a particular risk. The second line of defense includes groups, such as enterprise risk management, that are responsible for independent oversight and monitoring of risk management. The second line of defense reports directly to management.

evaluate and improve the effectiveness of risk management, control, and governance processes.

The charter for each Enterprise's IA function requires, and FHFA expects, that each Enterprise's IA function conform its practices to the Institute of Internal Auditors (IIA) International Standards for the Professional Practice of Internal Auditing (IIA Standards).⁶ The IIA Standards are principle-focused requirements that provide a framework for the professional practice of internal auditing. According to the IIA Standards, an "internal audit activity must be independent, and internal auditors must be objective in performing their work."⁷

FHFA's Internal and External Audit module (Audit Module), which is part of its *Examination Manual*, states that the "internal audit function generally reviews transactions and decisions after the fact, and therefore functions as a detective control to identify problems, weaknesses, or errors after they occur."⁸ FHFA's Audit Module further observes:

The internal audit function has a broad scope and assesses topics such as the effectiveness of the organization's operations, the reliability of financial reporting, fraud prevention and detection, safeguarding assets, and compliance with laws and regulations. The internal audit function should serve as a valuable resource for management, the board of directors, and the audit committee of the board of directors⁹

According to an FHFA advisory bulletin, the IA function is expected to "provide timely feedback to management and assurance to audit committees on the effectiveness of regulated entities' internal controls, risk management and governance. Timely and reliable information about elevated risks and internal control systems are important so that management can make prompt corrections." FHFA's Audit Module also provides that the IA function of each

⁶ The IIA is a global, authoritative source of guidance for the internal audit profession. See IIA, Standards & Guidance – International Professional Practices Framework (IPPF) (online at <https://na.theiia.org/standards-guidance/Pages/Standards-and-Guidance-IPPF.aspx>). According to the IIA, conformance with the standards "is essential in meeting the responsibilities of internal auditors and the internal audit activity."

⁷ Standard 1100 (Independence and Objectivity) of the IIA Standards. The IIA Standards devote a section to independence and objectivity, with individual standards for organizational independence, the chief audit executive's interaction with management, auditors' individual objectivity, and impairments to independence and objectivity.

⁸ FHFA, *FHFA Examination Manual*, Internal and External Audit, at 6 (Nov. 2013) (online at www.fhfa.gov/SupervisionRegulation/Documents/Internal_and_External_Audit_Module_Final_Version_1_0-508.pdf).

⁹ *Id.* at 1-2.

Enterprise is responsible for “determin[ing] whether corrective action has been effectively implemented” to remediate the deficiencies identified by FHFA, including MRAs.

FACTS AND ANALYSIS

FHFA Guidance and Policies Governing the Respective Roles of Enterprise IA and FHFA Examination Staff in Assessing Whether MRAs Have Been Satisfactorily Remediated

FHFA Prudential Management and Operations Standards

FHFA’s Prudential Management and Operations Standards establish performance standards for the Enterprises and the FHLBanks, and include a standard governing the IA function.¹⁰ Paragraph 10 of that standard directs that an “internal audit department should determine whether violations, findings, weaknesses, and other issues reported by regulators, external auditors, and others have been promptly addressed.”¹¹ Because the purpose of the Prudential Management and Operations Standards is to set forth standards for the Enterprises and the FHLBanks, they do not address whether, or the circumstances under which, FHFA examiners may rely on, accept, or otherwise use information, analyses, or conclusions provided by an Enterprise’s IA function to determine whether an Enterprise has satisfactorily remediated an MRA.

FHFA Examination Manual and the Internal and External Audit Module

The *FHFA Examination Manual*, a public document, is divided into two parts. Part I describes FHFA’s examination program and provides an overview of the Agency’s examination policies. Part II contains 26 individual examination “modules,” one of which is the Audit Module. Examination modules are detailed examination guidance for examiners pertaining to specific topics. The Audit Module contains detailed guidance and work steps for FHFA staff responsible for examining the IA functions. It also describes the roles and responsibilities of internal and external audit at the Enterprises and the FHLBanks.

FHFA’s Audit Module reflects the Agency’s expectation that the IA function of each regulated entity will play a role in assessing whether the entity has remediated an outstanding MRA and whether that remediation is effective. It states that the head of each IA function:

¹⁰ 12 C.F.R. § 1236 Appendix (Standard 2).

¹¹ 12 C.F.R. § 1236 Appendix (Standard 2, paragraph 10).

[M]ust establish a process to monitor and follow-up on the findings to determine whether corrective action has been effectively implemented In addition, the internal audit department should determine whether violations, findings, weaknesses, and other issues reported by regulators (including FHFA), external auditors, and others have been promptly addressed.

The Audit Module provides general guidance that FHFA “staff should understand the principles of sound internal and external audit *in order to assess to what extent they can rely on these functions* when examining operations of Fannie Mae, Freddie Mac, the Federal Home Loan Banks (FHLBanks), and the Office of Finance (OF)” (italics added). However, it identifies no conditions that must be met before examiners may rely on IA’s work, provides no specific guidelines on the extent of such reliance, and does not address the use of IA work to assist examiners in determining whether MRAs have been satisfactorily remediated.¹²

FHFA Advisory Bulletin 2016-05

Advisory Bulletin (AB) 2016-05, *Internal Audit Governance and Function*, which FHFA issued on October 7, 2016,¹³ communicates detailed supervisory expectations to the entities it regulates on the roles and responsibilities of their IA functions.¹⁴ The AB sets forth FHFA’s expectations that IA assess and validate management’s remediation of deficiencies, including MRAs:

IA should establish standards for performing timely and appropriately rigorous validation work once management asserts that remediation of significant audit issues (to include MRAs) has occurred. When management or the board indicates that they have performed the required remediation, IA should validate that revised processes and controls are in place, operating, and sustainable before closing the issue. The level of validation work that IA should perform to close an issue will vary based on the issue’s risk, complexity, and associated interdependencies. For higher-risk issues, IA should verify that sufficient testing is performed over an appropriate period of time to validate that the issue is sustainably resolved.

¹² FHFA’s Chief Accountant informed us that his office is working on a revision to the Audit Module that will omit any reference to reliance on IA.

¹³ AB 2016-05’s effective date was January 1, 2017.

¹⁴ AB 2016-05 supersedes three prior advisory bulletins on this subject.

DER Operating Procedures Bulletin 2017-03.2

In a 2016 evaluation, we assessed DER examiners' reliance on Enterprise IA validation of MRA remediation.¹⁵ In that evaluation, we identified some instances where DER examiners appeared to have accepted validation work from an Enterprise's IA function without documented evidence of independent review of the adequacy of remediation. We recommended that FHFA "[r]equire DER, when evaluating whether to close an MRA, to conduct and document . . . an independent analysis of . . . the adequacy of the Enterprise's internal audit validation work . . ." DER agreed with our recommendation and committed to "amend its internal guidance to provide that examiners should assess any . . . closure package, or internal audit validation of remediation activity and should include in the summary memorandum the results of that assessment."

From time to time, DER issues internal operating procedures bulletins (OPBs) to provide its examiners with guidance and instructions on supervisory issues. In response to our 2016 recommendation, DER issued OPB-2017-03.2, *Adverse Examination Findings Issuance and Follow-up*, on June 21, 2017, which superseded two prior DER OPBs, both of which concerned the role of internal audit in the issuance or remediation of MRAs. OPB-2017-03.2 updated DER's examination procedures for developing and issuing adverse findings, reviewing and acting on MRA remediation plans, monitoring the progress of remediation, and closing MRAs after remediation is completed:

Following Enterprise management's determination that planned remediation actions are complete, the Enterprise's internal audit function or an independent third party reviews and validates that the remediation plan has been fully implemented as intended. DER examination staff should direct the Enterprise to submit an MRA closure package that includes documentation of the independent validation work performed.

DER examiners should review the closure package, as well as follow-up examination work done to monitor progress of corrective actions. Examination staff should summarize and document their conclusions in an analysis memo. . . . Based on review of examiner work, the EIC determines whether the MRA has been satisfactorily addressed. The results of DER's assessment are communicated in a remediation letter . . . approved by the EIC and the DER Deputy Director.

¹⁵ See OIG, *FHFA's Inconsistent Practices in Assessing Enterprise Remediation of Serious Deficiencies and Weaknesses in its Tracking Systems Limit the Effectiveness of FHFA's Supervision of the Enterprises*, at 17-21 (July 14, 2016) (EVL-2016-007) (online at www.fhfa.gov/Content/Files/EVL-2016-007.pdf).

This OPB, which is the only current OPB issued by DER on MRA follow-up, does not provide guidance to examiners on what they must do, or the conditions that must exist, in order to rely on, accept, or otherwise use the data, analyses, or conclusions contained in IA’s validation work. When this OPB issued, we reminded DER officials that our recommendation, with which DER agreed, was that DER would require examiners to perform *independent* analyses of the Enterprises’ internal audit validation work, and we noted that the OPB did not contain such a provision. DER officials responded that provisions of FHFA’s *Examination Manual*, when read in conjunction with this OPB, require examiners to perform and document independent assessments of MRA closure packages.¹⁶

FHFA’s Chief Accountant, whose office is within DER, advised us that, in his view, this OPB does not provide clear guidance on whether DER examiners can rely on Enterprise IA validation of MRA remediation and suggested that DER should issue clarifying guidance on the subject in a supplemental technical practice or operating procedure bulletin.

An Associate Director of DER advised us that some DER examiners apprised him of their concerns regarding the clarity of DER guidance on the issue of reliance on the validation work of an Enterprise’s IA function. However, the Deputy Director of DER reported to us that she was unaware of such concerns. She acknowledged that the current OPB provided “sparse” guidance on the use of IA validation work by DER examiners. She stressed that the EIC, not individual DER examiners, determines whether an MRA has been satisfactorily remediated, based on review of the examiners’ workpapers. In the event that the workpapers lack evidence of examiner work to support closure of the MRA, the Deputy Director advised that she expects the EIC to send the closure request back to the examiner.

Guidance of Other Federal Financial Regulatory Agencies Governing IA and the Assessment of MRA Remediation

Because FHFA regularly asserts that its supervisory authority over its regulated entities “is virtually identical to—and clearly modeled on—Federal bank regulators’ supervision of banks,” we looked to the guidance and standards issued by these federal bank regulators regarding their use of IA work product to assess whether a regulated entity has fully remediated MRAs and their assessments of the overall adequacy of the IA function.

According to the Basel Committee on Banking Supervision (Basel Committee) (of which OCC and the Federal Reserve are members), “[b]ecause of the crucial role played by internal audit in assessing the effectiveness of a bank’s overall control systems and processes,

¹⁶ See FHFA, *FHFA Examination Manual*, Performing and Documenting Examination Activities, at 22 (Dec. 2013) (“Examiners support their conclusions through testing and independent analysis of Enterprise information, data, documents, and other materials obtained from management or other sources.”).

supervisors should assess the internal audit function. This will influence their overall assessment of the bank and enable them to determine the extent to which they will use the work of the internal audit function.” The Basel Committee is a global standard setter for the prudential regulation of banks.

Federal Reserve

The Board of Governors of the Federal Reserve System (Federal Reserve)¹⁷ provides the following guidance on the MRA follow-up process to its examiners:

The Reserve Bank must follow-up on MRAs to assess progress and verify satisfactory completion. The timeframe for follow-up should correspond with the timeframe during which actions are to be completed. . . . The means of supervisory follow-up may vary based upon the nature and severity of the matter for which corrective action is expected. Follow-up may take the form of a subsequent examination, targeted review, continuous monitoring, reliance on validation work conducted by an internal audit function, reliance on the results of examinations conducted by other supervisors, or any other supervisory activity deemed suitable for evaluating the issue at hand In all instances, examiners are expected to exercise judgment regarding the supervisory activities best suited for evaluating a particular issue. Once follow-up is complete, examiners are expected to clearly and fully document the rationale for their decision to close any issue.

Federal Reserve guidance permits Federal Reserve examiners to “rely on the work of internal audit” in following up on MRA remediation if the IA function has been rated “effective” in the most recent examination of IA. That guidance aligns with the principles issued by the Basel Committee. When relying on IA, the Federal Reserve guidance directs examiners “to review the relevant work papers and, when necessary, meet with internal audit staff who documented the resolution of the issue.” If an institution’s IA function is ineffective, examiners may not rely on it.

Because Federal Reserve examiners may rely on IA only when it is rated effective, we reviewed the Federal Reserve’s guidance and policies for examining and rating the IA function. According to Federal Reserve guidance, Federal Reserve examiners are required to make an “overall determination as to whether the internal audit function and its processes are

¹⁷ The Federal Reserve’s Board of Governors establishes examination standards, and the Reserve Banks are responsible for supervising 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.

effective or ineffective.” Federal Reserve examiners are expected to review certain “key elements” of the IA function annually, so as to obtain sufficient information to re-affirm the prior determination regarding the effectiveness of IA.

OCC

The Office of the Comptroller of the Currency (OCC) provides detailed guidance for its examiners on the issuance, follow-up, and closure of MRAs.¹⁸ With respect to remediation of MRAs, OCC expects its examiners to verify that banks implement the corrective actions and validate that the actions are both effective and sustainable.¹⁹

Like the Federal Reserve, OCC also expects its examiners to assess, conclude, rate, and report on the overall strength of the IA function of each regulated entity. During each supervisory cycle, OCC uses the following four categories to rate the overall strength of the IA function of a regulated entity: strong, satisfactory, insufficient, or weak. Each category is defined in OCC guidance.

Unlike the OCC and the Federal Reserve, Current FHFA Guidance Does Not Require FHFA Examiners to Conclude on the Overall Effectiveness or Strength of the Enterprises’ IA Function

As discussed, the Federal Reserve guidance permits Federal Reserve examiners to rely on MRA follow-up work performed by the IA function of a regulated entity, provided that prior examination work has rated the entity’s internal audit program as “effective.” FHFA guidance, however, imposes no comparable condition on DER examiners when they review IA validation work to assess MRA remediation. In fact, unlike the Federal Reserve and the OCC, FHFA does not require its examiners to reach conclusions on the overall strength or effectiveness of either Enterprise’s IA function. To be sure, FHFA’s Audit Module contains detailed work steps for examining the IA functions of the regulated entities, and requires examiners to prepare written memoranda containing conclusions regarding IA based on the examination work performed; however, the Audit Module imposes no expectation that examiners conclude on the overall strength, adequacy, or effectiveness of IA.²⁰ DER’s Deputy Director confirmed that DER does not require examiners to conclude on overall

¹⁸ OCC charters, regulates, and supervises all national banks, federal savings associations, and federal branches of foreign banks.

¹⁹ OCC has issued nonpublic, internal guidance addressing examiner use of IA MRA follow-up work.

²⁰ When conducting an examination of IA, examiners are not required to perform all of the work steps in the Audit Module.

effectiveness of the Enterprises' IA function. When we interviewed her in January 2018, she informed us that DER had no plan to do so.

FHFA's Office of Chief Accountant, which is part of DER, is charged with the primary responsibility for examining the Enterprise's IA functions. The Chief Accountant reported to us that he could not recall an instance in which FHFA concluded on the overall effectiveness of the Enterprises. While he advised us that he is not aware of any formal or informal FHFA policy that bars examiners from reaching such a conclusion, he observed that DER examiners have not conducted sufficient examination work to conclude on the overall effectiveness of the IA function for either Enterprise.²¹ Because DER has not concluded on the overall effectiveness or strength of either Enterprise's IA functions, its examiners may lack a sufficient basis "to determine the extent to which they will use the work of the internal audit function" in assessing the adequacy of MRA remediation by an Enterprise.

According to FHFA's Chief Accountant, a supervisory conclusion on the overall effectiveness of an IA function of an Enterprise, based on sufficient examination work, would be a worthy goal. He stressed, however, that the amount of examination work necessary to reach a conclusion of effectiveness would be "a high bar." He reported that FHFA is working to enhance its supervisory assessments of the Enterprises' IA functions, but the Agency is not yet in a position to conclude on the overall effectiveness of those functions. When we interviewed the Chief Accountant in November and December 2017, he reported to us that FHFA did not intend to conclude on the overall effectiveness of either Enterprise's IA function for the 2017 examination cycle.

The Chief Accountant and other FHFA officials have reported to us that the Agency intends to issue an updated Audit Module in 2018, and the updating effort is being led by the Chief Accountant's office. In December 2017, the Chief Accountant advised us that he expects the revised Audit Module to contain a work program sufficient to permit examiners to reach a conclusion as to the overall effectiveness of IA. He also anticipates that the revised Audit Module will not address whether examiners can rely on the validation work conducted by an IA function of a regulated entity.

Finally, the Chief Accountant explained to us that examiners, on an ad hoc basis, provide their feedback on the quality of the IA validation work for MRA remediation. We observe that FHFA's examination of the Enterprises' IA functions may benefit from formal feedback on

²¹ While DER's reports of examination for 2014, 2015, and 2016 for each of the Enterprises contain statements about the adequacy of IA's work, the Chief Accountant and the EIC of one of the Enterprises advised us that these statements did not constitute a determination about the overall effectiveness of their IA functions. Significantly, in each of the 2014, 2015, and 2016 Fannie Mae reports of examination, DER [REDACTED] department, and in 2015, DER [REDACTED]

the quality of IA validation work from all examiners engaged in MRA closure determinations.

According to DER Officials, DER Examiners “Leverage” the Validation Work of an Enterprise’s IA Function When Assessing the Adequacy Remediation

During our fieldwork for this evaluation, DER officials stated in writing that DER examiners “[g]enerally . . . [do] not accept or rely [on] IA’s assessments of MRA remediation without independent examiner work to support conclusions.” Most of the DER examination managers with whom we spoke reported that DER examiners are not permitted to – and do not – rely on the validation work performed by an Enterprise’s IA function. However, these same examination managers stated that DER examiners are permitted to – and do – “leverage” IA validation work, including IA validation testing, to assist DER in determining whether MRAs have been satisfactorily remediated.

When asked, the Chief Accountant and one examination manager defined reliance on IA work as the substitution of IA’s work for that of DER examiners and explained that leveraging IA work meant using that work as part of their examination activities. In a companion evaluation, we review DER’s practices related to the closure of a sample of 22 MRAs, including the extent to which examiners accepted, relied on, or otherwise used IA’s validation work in their assessment of the adequacy of MRA remediation and whether they conducted independent assessments of the adequacy of the remediation. We found that where DER examiners reported in their workpapers that testing was conducted for the MRAs in our sample, examiners generally relied on the validation testing conducted by the Enterprises’ IA functions instead of performing their own testing.

FINDINGS

1. FHFA has not concluded on the overall effectiveness of the Enterprises' IA functions.

Unlike the OCC and the Federal Reserve, FHFA does not expect its examiners to conclude on the overall effectiveness of the IA functions at the financial institutions it supervises. DER's Deputy Director confirmed that DER has not required its examiners to conclude on the overall effectiveness of the Enterprises' IA function and that DER has no plans to do so. FHFA's Chief Accountant, whose office is primarily responsible for examining the Enterprise's IA functions, advised us that FHFA has not concluded on the overall effectiveness of the IA function at Fannie Mae or Freddie Mac since 2008, when FHFA was established and assumed responsibility for their supervision.

2. FHFA guidance does not address whether, or the circumstances under which, FHFA examiners may rely on information, analyses, or conclusions provided by an Enterprise's IA function when assessing the adequacy of MRA remediation.

Although DER examiners are expected to "review" validation work conducted by the Enterprises' IA function when assessing whether MRAs have been adequately addressed, FHFA guidance does not address the extent to which – if at all – DER may rely on, accept, or otherwise use that IA work product. As a result, DER examiners have wide discretion to determine whether and to what extent to rely on, accept, or otherwise use IA validation work as a basis to close MRAs. In our view, such discretion to use IA validation work to close MRAs, without a predicate supervisory conclusion on the overall effectiveness of the IA function, creates the risk that DER's assessment of the adequacy of Enterprise remediation will be impaired.

CONCLUSION.....

Federal Reserve and OCC guidance direct their respective examiners to periodically assess and conclude on the overall effectiveness or strength of the IA functions at their regulated financial institutions. Federal Reserve guidance permits reliance on IA MRA follow-up only when the Federal Reserve has rated the institution’s IA function as effective overall. We found, however, that FHFA has not concluded on the overall effectiveness of the Enterprises’ IA functions and that DER has no present plans to do so. As a result, when using IA validation work, examiners lack assurance of the overall quality, reliability, competency, and objectivity of the IA function.

In addition, we found that FHFA guidance does not address whether, or the circumstances under which, FHFA examiners may rely on, accept, or otherwise use information, analyses, or conclusions provided by an Enterprise’s IA function when determining whether an Enterprise has satisfactorily remediated an MRA. Accordingly, DER examiners are given wide discretion to determine whether and to what extent to rely on, accept, or otherwise use IA validation work as a basis to close MRAs. In our view, such discretion to use IA validation work to close MRAs, without a predicate supervisory conclusion on the overall effectiveness of the IA function, creates the risk that DER’s assessment of the adequacy of Enterprise remediation will be impaired.

RECOMMENDATIONS.....

We recommend that FHFA:

1. Periodically conclude, based upon sufficient examination work, on the overall effectiveness of the IA functions at Fannie Mae and Freddie Mac.
2. Revise its guidance to provide clear direction to examiners on whether, or the circumstances under which, its examiners may rely on information, analyses, or conclusions provided by an Enterprise’s IA function when assessing the adequacy of MRA remediation.
3. Direct that examiners can use IA work to assess the adequacy of MRA remediation only if FHFA has concluded that the IA function is effective overall.

FHFA COMMENTS AND OIG RESPONSE.....

OIG provided FHFA an opportunity to respond to a draft report of this evaluation. FHFA provided technical comments that we incorporated into the report, as appropriate. On March 8, 2018, FHFA provided its formal response to our recommendations, which is attached in its entirety in the Appendix. In its response, FHFA agreed with recommendation 2 and disagreed with recommendations 1 and 3. As discussed below, OIG urges FHFA to reconsider its position and to fully implement our recommendations.

Recommendation 1 proposed that FHFA periodically conclude on the overall effectiveness of the Enterprises' IA functions. In recommendation 3, we proposed that FHFA condition examiners' use of IA work on a supervisory conclusion, after sufficient examination work, that the IA function is effective overall. FHFA rejected both recommendations in part because of concerns that examiners might rely exclusively on IA work in deciding whether to close an MRA where FHFA had reached a supervisory conclusion on the overall effectiveness or strength of the IA function. We did not recommend (and our recommendations should not be understood to imply) that FHFA should authorize its examiners to substitute IA validation work for independent assessments of the sufficiency of MRA remediation in the event that FHFA reached a supervisory conclusion of overall effectiveness of IA.

Adoption and implementation of these two recommendations would align FHFA's guidance and practice with that of the Federal Reserve and the OCC, which expect their respective examiners to periodically conclude on the overall effectiveness or strength of the IA functions at their regulated financial institutions. Notably, FHFA's Chief Accountant agreed that a conclusion on the overall effectiveness of the Enterprises' IA functions – the Enterprises' third line of defense – is a worthy goal and he informed us that a forthcoming revised Audit Module is expected to contain sufficient procedures to reach such a conclusion. In our view, examiners may lack a sufficient basis on which to determine whether, and how, they can leverage the IA work when FHFA has reached no conclusion on the overall effectiveness of the IA function.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of this report was to evaluate DER’s policies, guidance, and standards governing its acceptance of, reliance on, or use of work conducted by the Enterprises’ IA functions when DER assesses whether MRAs have been satisfactorily remediated. Based on information that came to our attention during this evaluation, we also sought to determine the extent to which DER concludes on the overall effectiveness of the Enterprises’ IA functions.

To achieve this objective, we requested and reviewed FHFA guidance pertaining to MRA remediation and IA. We also reviewed OCC and Federal Reserve guidance on MRA remediation and IA, as well as IIA standards and guidance issued by the Institute of Internal Auditors. Additional materials reviewed include prior OIG evaluation reports and supporting materials, IA charters of Fannie Mae and Freddie Mac, correspondence with DER, and reports of examination for Fannie Mae and Freddie Mac.

In addition to our document review, we interviewed the DER Deputy Director, FHFA’s Chief Accountant, the DER examiners-in-charge of Fannie Mae and Freddie Mac, and DER examination managers.

The field work for this report was completed between October 2017 and January 2018.

This evaluation 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 Evaluation* (January 2012). These standards require us to plan and perform an evaluation based upon evidence sufficient to provide a reasonable basis to support its findings and recommendations. We believe that the findings and recommendations discussed in this report meet those standards.

APPENDIX: FHFA MANAGEMENT RESPONSE.....



Federal Housing Finance Agency

MEMORANDUM

TO: Angela Choy, Assistant Inspector General for Evaluations

FROM: Nina A. Nichols, Deputy Director, Division of Enterprise Regulation (DER)^{NAN}

SUBJECT: Draft OIG Report: *FHFA Requires the Enterprises' Internal Audit Functions to Validate Remediation of Serious Deficiencies but Provides No Guidance and Imposes No Preconditions on Examiners' Use of that Validation Work*

DATE: March 8, 2018

This Memorandum transmits the management response of the Federal Housing Finance Agency (FHFA) to the FHFA Office of Inspector General's (OIG) draft report referenced above (Report).

As noted in the Report, FHFA guidance does not require examiners to conclude on the overall effectiveness of the Enterprises' Internal Audit (IA) functions. FHFA believes that existing examiner guidance effectively communicates that, while examiners may consider IA work when assessing an Enterprise's remediation of a Matter Requiring Attention (MRA), examiner conclusions should be based on independent examiner assessments. FHFA does not believe an assessment of the overall effectiveness of the Enterprises' IA functions is necessary to assess the remediation of specific MRAs.

FHFA management's response to the recommendations are below.

Recommendation 1:

OIG recommends that FHFA periodically conclude, based upon sufficient examination work, on the overall effectiveness of the IA functions at Fannie Mae and Freddie Mac.

Recommendation 3:

OIG recommends that FHFA direct that examiners can use IA work to assess the adequacy of MRA remediation only if FHFA has concluded that the IA function is effective overall.

Management Response to Recommendations 1 and 3:

FHFA disagrees with these recommendations. Through its various examination activities, FHFA has opportunities to identify and assess the weaknesses, deficiencies, and strengths of each Enterprise's IA function and to suggest ways to strengthen the IA function to make it a more valuable resource for the Enterprise board of directors and senior management, as well as for examiners in the MRA remediation context. However, FHFA does not believe that examiners should rely exclusively on the work of IA, regardless of the overall effectiveness of an Enterprise's IA function, in assessing MRA remediation.

Recommendation 2:

OIG recommends that FHFA revise its guidance to provide clear direction to examiners on whether, or the circumstances under which, its examiners may rely on information, analyses, or conclusions provided by an Enterprise's IA function when assessing the adequacy of MRA remediation.

Management Response to Recommendation 2:

FHFA agrees with this recommendation. When performing MRA remediation follow-up, DER examiners may review, but should not rely solely upon, the work of the Enterprise's IA function in assessing the adequacy of MRA remediation. By October 31, 2018, DER will issue more detailed examiner guidance regarding the use of IA work in assessment of Enterprise remediation of MRAs.

cc: John Major, Internal Controls and Audit Follow-up Manager
Larry Stauffer, Acting Chief Operating Officer

ADDITIONAL INFORMATION AND COPIES.....

For additional copies of this report:

- Call: 202-730-0880
- Fax: 202-318-0239
- Visit: www.fhfaoig.gov

To report potential fraud, waste, abuse, mismanagement, or any other kind of criminal or noncriminal misconduct relative to FHFA's programs or operations:

- Call: 1-800-793-7724
- Fax: 202-318-0358
- Visit: www.fhfaoig.gov/ReportFraud
- Write:

FHFA Office of Inspector General
Attn: Office of Investigations – Hotline
400 Seventh Street SW
Washington, DC 20219