

Federal Housing Finance Agency
Office of Inspector General



**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

March 28, 2018

Executive Summary

The Federal Housing Finance Agency (FHFA or Agency), through its Division of Enterprise Regulation (DER), is responsible for the supervision of Fannie Mae and Freddie Mac (collectively, the Enterprises). When conducting its supervisory responsibilities, DER may identify significant deficiencies regarding 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 requires 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 companion evaluation issued today, we reviewed DER’s guidance and standards for reliance on the Enterprises’ IA functions when examiners assess the remediation of MRAs. See *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*, EVL-2018-002, available online at www.fhfaog.gov/reports/auditsandevaluations. In this evaluation, we reviewed DER’s practices for closing MRAs in order to understand (1) 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 (2) whether they conducted independent assessments of the adequacy of the remediation. We reviewed key documentation for a sample of 22 out of 78 MRAs issued to Fannie Mae and Freddie Mac and closed by DER between January 2015 and October 2017. We also interviewed the examination managers and examiners who were responsible for closing these MRAs.

The examination managers and examiners we interviewed offered varying explanations of the difference between relying on and leveraging IA’s validation work, but provided no clear distinction between the two. They also



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expressed no uniform view on whether they were expected to conduct any testing as part of their assessment of MRA remediation. When DER examiners specifically reported that testing of the sufficiency of MRA remediation was conducted for the 22 MRAs in our sample, we found that the examiners generally relied on the validation testing conducted by the Enterprise's IA function. We determined, from our review of examiners' key workpapers for the 22 MRAs in our sample, that almost half (9 of 22) cited testing completed by the IA function and did not reflect that the examiners performed their own testing. For 11 of the 22 sampled MRAs, we found that the examiners' key workpapers reflected review of IA validation work, but did not specifically identify testing performed either by IA or by the examiners. For 2 of the 22 sampled MRAs, we found that the examiners performed their own testing; in one of these instances it appears the examiner conducted testing for a component of MRA remediation and relied on IA's testing for another component.

In the companion evaluation issuing today, we found that FHFA, unlike the Federal Reserve, does not require its examiners to conclude on the overall effectiveness of the Enterprises' IA functions as a predicate to use of IA work. As a result, its examiners may lack a sufficient basis to determine whether, or to what extent, to use IA's validation work, and FHFA has not issued guidance on the level of assurance of the competency, objectivity, reliability, and quality of IA's validation work needed before the IA work can be used.

Because FHFA only issues MRAs for the most significant deficiencies, determinations to close MRAs should be based on the examiners' independent assessments of the Enterprises' remedial actions. Current FHFA guidance directs examiners to independently review and assess the documents in the Enterprise's closure package, including some independent review or assessment of documentation provided by the Enterprise's business unit and/or IA. As FHFA does not identify the steps that examiners should undertake to assess the sufficiency of MRA remediation, we found that examination managers and examiners have broad discretion in determining the scope of their independent assessment of the adequacy of the remedial actions. We determined, from our review of key examiner workpapers for the 22 MRAs in our sample, that the workpapers reflected some independent assessment of the sufficiency of management's remediation activities and/or IA's validation work for nearly all of the 22 MRAs in our sample, although the scope of that assessment varied among examiners.

To promote consistency among examiners in determinations on MRA closures, we recommended, in our companion evaluation, that FHFA provide clear direction to examiners on whether, or the circumstances under which,



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they may rely on information, analyses, or conclusions from IA when assessing the sufficiency of MRA remediation. We recommend, based on our findings from this evaluation, that FHFA adopt guidance that identifies the work steps that should be included in examiners' independent assessments of IA's work when assessing the sufficiency of MRA remediation and specifies the conditions under which examiner testing is expected. FHFA agreed with our recommendation.

This report was prepared by Jacob Kennedy, Senior Investigative Evaluator, and Philip Noyovitz, Senior Auditor. 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.

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ABBREVIATIONS

AB	Advisory Bulletin
DER	Division of Enterprise Regulation
EIC	Examiner-in-charge
Enterprises	Fannie Mae and Freddie Mac, collectively
Fannie Mae	Federal National Mortgage Association
Federal Reserve	Board of Governors of the Federal Reserve System and Reserve Banks
FHFA or Agency	Federal Housing Finance Agency
Freddie Mac	Federal Home Loan Mortgage Corporation
IA	Internal Audit
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 Fannie Mae and Freddie Mac and regulator of the Federal Home Loan Banks. 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, such as MRAs, and the Enterprises’ adherence to supervisory guidance and conservatorship directives.

MRA Issuance and Follow-up Process

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 such 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.¹ After DER issues an MRA to an Enterprise, it requires the Enterprise to prepare and submit a written remediation plan to FHFA. DER reviews the remediation plan and determines whether the proposed corrective actions are sufficient to address the MRA. If DER considers the plan acceptable, the examiner-in-charge (EIC) notifies the Enterprise in writing of DER’s non-objection to the plan.² During the course of remediation, DER examiners are expected to monitor the Enterprise’s progress through ongoing monitoring or targeted examinations.

¹ FHFA, Advisory Bulletin (AB) 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). The MRAs reviewed for this evaluation were issued prior to the release of AB 2017-01. During the review period for this evaluation, AB 2012-01 was in force. Although there were changes to the definition of “MRA,” they are not material for purposes of this report.

² If the plan is not acceptable, the EIC issues an objection letter that identifies the concerns and requests a revised remediation plan. The EIC may also issue a non-objection with conditions letter that states that if certain conditions are met, the corrective actions proposed in the remediation plan, if implemented, would address the concerns that led to the finding.

When the Enterprise’s management determines that MRA remediation has been completed, the Enterprise’s IA function reviews and “validates” that the remediation plan was implemented as intended and that remediation is complete.³ The Enterprise is expected to prepare and submit a closure package to DER that includes the validation work performed by the IA function.

DER’s examiners are expected to review and assess the documents in the closure package along with any other follow-up work performed, and summarize and document their review and conclusions in the form of an analysis or summary memorandum. DER, in its response to a recommendation in OIG’s 2016 evaluation report, explained to us that it expects its examiners to independently analyze MRA closure packages, and referred to its *Examination Manual*, which states that “[e]xaminers support their conclusions through testing and independent analysis of Enterprise information, data, documents, and other materials obtained from management or other sources.”⁴ According to DER, this independent analysis would include some independent review or assessment of documentation provided by the Enterprise’s business unit and/or IA to support an examiner’s recommendation to close an MRA.

The EIC determines, based on the examiners’ work, whether the MRA has been “satisfactorily addressed.” Finally, the results of DER’s assessment are communicated in writing to the Enterprise.

In a companion evaluation issued today, we reviewed FHFA’s existing guidance governing the respective roles of the Enterprise’s IA⁵ and FHFA examination staff in assessing whether MRAs have been satisfactorily remediated.⁶ In that report, we observed that FHFA’s guidance sets forth its expectations that IA assess and validate management’s remediation of deficiencies, but does not address whether, or the circumstances under which, FHFA

³ DER adopted this process in 2013 when it 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. See DER, Operating Procedures Bulletin, *Matters Requiring Attention (MRA) Process* (Apr. 23, 2013) (2013-DER-OPB-01). The 2013 operating procedures bulletin was superseded in 2017, but the guidance governing the review and closure process did not change materially.

⁴ FHFA, *Examination Manual*, at 22 (Dec. 2013) (online at www.fhfa.gov/SupervisionRegulation/Documents/ExaminationProgramOverview.pdf).

⁵ FHFA, Advisory Bulletin 2016-05, *Internal Audit Governance and Function*, at 15 (Oct. 7, 2016) (online at www.fhfa.gov/SupervisionRegulation/AdvisoryBulletins/Pages/Internal-Audit-Governance-and-Function.aspx).

⁶ See OIG, *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* (Mar. 28, 2018) (EVL-2018-002) [hereinafter *EVL-2018-002*].

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 addressed an MRA.⁷

In this evaluation, we reviewed documentation for a sample of 22 out of 78 MRAs closed by DER between January 2015 and October 2017 that were issued to Fannie Mae and Freddie Mac,⁸ and interviewed the examination managers and examiners who were responsible for these MRAs.⁹ Our objective was to understand the extent to which (1) examiners accepted, relied on, or otherwise used IA's validation work in their assessment of the adequacy of MRA remediation and (2) whether they conducted independent assessments of the adequacy of the remediation.¹⁰

⁷ In its management response to our companion report, FHFA agreed with our recommendation to 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 and plans to issue the revised guidance by October 31, 2018.

⁸ The sample of 22 MRAs represents 28% of all MRAs closed between January 2015 and October 2017, our review period.

⁹ In a previous OIG evaluation, we reviewed DER's workpapers supporting closure of eight MRAs and identified three instances where DER examiners appeared to have accepted an Enterprise's IA work to close MRAs without documented evidence of independent review of the adequacy of remediation. We recommended that DER examiners conduct and document an independent analysis of the adequacy and sustainability of the Enterprise's remediation activity, or where appropriate, independently analyze the adequacy of the Enterprise's IA 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." 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.fhfaig.gov/Content/Files/EVL-2016-007.pdf).

¹⁰ In two separate audit reports issued today, OIG reviewed FHFA's closure of cybersecurity MRAs that were issued to the Enterprises. See OIG, *As Allowed by its Standard, FHFA Closed Three Fannie Mae Cybersecurity MRAs after Independently Determining the Enterprise Completed its Planned Remedial Actions* (Mar. 28, 2018) (AUD-2018-007) and OIG, *FHFA Failed to Ensure Freddie Mac's Remedial Plans for a Cybersecurity MRA Addressed All Deficiencies; as Allowed by its Standard, FHFA Closed the MRA after Independently Determining the Enterprise Completed its Planned Remedial Actions* (Mar. 28, 2018) (AUD-2018-008) (online at <https://www.fhfaig.gov/reports/auditsandevaluations>).

FACTS AND ANALYSIS

DER Expects its Examiners to Independently Analyze MRA Closure Packages but Provides No Guidance on the Elements of this Independent Analysis

Under FHFA’s Advisory Bulletin 2012-01, which was in effect when DER closed most of the MRAs in our sample,¹¹ examiners’ remediation follow-up “should include an assessment of materials provided by the [Enterprises], discussions with the responsible parties at the [Enterprises], and testing, if appropriate, to determine progress against a remediation plan.”¹² Also in effect at the time was guidance issued by DER, Operating Procedures Bulletin (OPB) 2013-DER-OPB-01, *Matters Requiring Attention (MRA) Process*, which directed:

[u]pon completion of the [remediation] plan and management’s determination that the respective Enterprise has remediated the MRAs, internal audit . . . will review and “validate” that the [remediation] plan was implemented as intended and that the remediation is complete.

That OPB further instructed: “FHFA will assess the remediation of the MRA through on-going monitoring or related targeted examination work. If additional reviews are needed, examiners will conduct the necessary reviews to validate the remediation.”¹³ Beyond these two guidance documents, FHFA did not specify the work steps examiners were expected to follow to assess the sufficiency of MRA remediation.

As discussed, DER represented to us that it expects its examiners to independently assess MRA closure packages. According to DER, this independent analysis would include some independent review or assessment of documentation provided by the Enterprise’s business unit and/or IA to support an examiner’s recommendation to close an MRA.

The Deputy Director of DER acknowledged to us that guidance in DER’s current OPB is “sparse” on examiners’ use of IA’s validation work. She stressed that the EIC, not individual DER examiners, determines whether an MRA has been satisfactorily addressed, based on review of the examiners’ workpapers. DER requires its EICs to review and approve certain workpapers prior to closing an MRA, including procedures documents and analysis or

¹¹ Three of the MRAs in our sample were closed after FHFA rescinded and replaced AB 2012-01 with AB 2017-01.

¹² When FHFA rescinded AB 2012-01, guidance related to remediation follow-up by examiners was moved to a 2017 DER OPB; however, the 2017 OPB does not mention testing as part of remediation follow-up.

¹³ DER does not define “assess” or “review” in the OPB and is silent on the examiner’s responsibilities with regard to IA’s validation work.

summary memoranda. The Deputy Director of DER advised us that, in the event that an EIC found no evidence of examiners' independent assessment in the review of workpapers prior to closing an MRA, she would expect the EIC to send back the closure recommendation to the examiners. In 2016, DER issued guidance that directs independent quality control reviews to be conducted of MRA remediation letters to provide reasonable assurance that examination work performed by examiners met DER standards and FHFA guidance. The Deputy Director of DER advised that she expects the closure recommendation to be sent back if it does not pass quality control review.¹⁴

Unlike Other Federal Financial Regulators, FHFA Has Not Concluded on the Overall Effectiveness or Strength of the IA Functions

As we discussed in our companion report,¹⁵ the Board of Governors of the Federal Reserve System (Federal Reserve) and the Office of the Comptroller of the Currency (OCC) require their examiners to reach conclusions on the overall effectiveness or strength of the IA function of a regulated entity. We explained that the Federal Reserve permits its 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 IA program as effective.

Unlike the Federal Reserve and the OCC, FHFA does not require its examiners to reach conclusions on the overall effectiveness or strength of either Enterprise's IA function. DER's Office of the Chief Accountant, which leads examinations of the IA functions of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, advised us that DER examiners have not conducted sufficient examination work to conclude on the overall effectiveness of the IA function for either Enterprise, and DER's Deputy Director informed us that DER had no plan to do so when we interviewed her in January 2018. Because DER has not reached conclusions on the overall effectiveness or strength of either Enterprise's IA functions, its examiners do not have that information to assist them when considering whether or to what extent to use an Enterprise's IA MRA validation work. However, FHFA, unlike the Federal Reserve, has imposed no limitations on the use of IA validation work by DER examiners in their assessments of MRA remediation.

The Chief Accountant and other FHFA officials reported to us that the Agency intends to issue an updated examination module on internal audit in 2018, and the Chief Accountant

¹⁴ DER issued guidance in 2016 for conducting independent quality control reviews "of certain supervisory written products [including MRA remediation letters] to provide reasonable assurance that examination work performed by examiners" met DER standards and FHFA guidance.

¹⁵ See *OIG, EVL-2018-002, supra* note 6, at 18.

advised that he expects the revised module to contain a work program sufficient to permit examiners to reach a conclusion as to the overall effectiveness of IA.

DER Expects its Examiners to Review the Validation Work Performed by an Enterprise’s IA but Provides No Guidance on the Use of the Validation Work by its Examiners

According to the Basel Committee on Banking Supervision (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, 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.”¹⁶ The Basel Committee on Banking Supervision is a global standard setter for the prudential regulation of banks.

In our companion report,¹⁷ we explained that DER officials represented in writing to us that DER examiners “[g]enerally . . . [do]not accept or rely [on] IA’s assessments of MRA remediation without independent examiner work to support conclusions.” As discussed in that report, FHFA provides no guidance to examiners on what they must do, or the conditions that must exist, to rely on, accept, leverage, or otherwise use the data, analyses, or conclusions contained in IA’s validation work. Accordingly, we asked examination managers and examiners whether they relied on or used IA’s validation work, including testing, to close MRAs.

Nearly all of the DER examination managers and examiners we interviewed reported that they did not rely on but rather “leverage[d]” the validation work of IA when assessing the adequacy of MRA remediation. Because DER had not concluded on the overall effectiveness or strength of the Enterprise’s IA functions, DER examiners lacked assurance of the competency, objectivity, reliability, and quality of the Enterprise IA functions in order to “leverage” IA’s work.

The examiners with whom we spoke did not cite any particular policy or guidance that provides a consistent process for them to use to gain assurance of the competency, objectivity, reliability, and quality of IA’s validation work. Similarly, none invoked policy or guidance that defined “leverage.” Several examination managers sought to explain the difference between leveraging and relying on IA’s validation work. One examination manager explained that reliance removes the examiner’s own independent judgment of IA’s validation

¹⁶ See Basel Committee on Banking Supervision, *The internal audit function in banks*, at 17 (June 2012) (online at www.bis.org/publ/bcbs223.pdf).

¹⁷ See OIG, *EVL-2018-002*, *supra* note 6, at 17.

work and implies that the examiners are taking IA's work and not performing their own assessment. "Leveraging," according to this manager, is "taking IA's work . . . within the course of [the examiner's] work." In the view of another examiner, leveraging enables examiners to assess the quality of IA's work and verify the work by the business units before using it.

Two examination managers explained that "reliance" on IA's work meant that an examiner, even after reviewing or assessing IA's work, did not exercise his or her own independent judgment. The same two examination managers and one other defined reliance to mean a substitution of their own work with IA's work. This third examination manager reported that, absent guidance, he and other examiners conduct their own independent assessments. In his view, examiners never used IA's work as part of their own review of the MRA remediation. Another examiner was not sure whether existing FHFA guidance permitted examiners to rely on IA's work.

These various explanations provide no clear distinction between reliance and leverage. As we now discuss, our review of the workpapers found that examiners, in many instances, relied solely on IA's testing instead of performing their own testing.

Where DER Examiners Reported in Their Workpapers that Testing Was Conducted for MRAs In Our Sample, Our Review Found that These Examiners Generally Relied on the Validation Testing Conducted by IA

As noted, DER has not issued guidance on the permissible use of IA validation work by its examiners in assessing MRA remediation. In its 2015 comments to a draft OIG report, however, FHFA stated that examiners "can leverage the work of internal audit but cannot rely on testing performed by [the Enterprise's] Internal Audit." Despite this position, the examiners with whom we spoke offered a wide range of opinions on whether to use IA's testing. While some examiners explained to us that testing was part of IA's validation work, others expressed the view that the nature of the MRA drove whether testing by IA would be appropriate. According to one examination manager, IA is expected to test in some form and IA's testing is considered to be validation. Some examination managers and examiners explained to us that certain conditions must be met to leverage IA's work, including IA's testing, to validate MRA remediation. For example, one examination manager said examiners "are permitted to accept" IA's testing if it makes sense and in many cases, they review IA's testing to determine its reasonableness before using IA's results. That examination manager also reported that DER examiners were not required to replicate IA's testing.¹⁸ Another examination manager stated that examiners can "agree with" IA testing only if there is

¹⁸ During an interview with OIG for a separate evaluation, FHFA's Chief Accountant explained that there is some expectation of independent performance or testing when relying on components of IA's work.

evidence that the examiner reviewed and is satisfied with IA's testing. One examiner said he would not replicate IA's testing but instead look at the reasonableness of IA's testing results. Another examiner said DER would conduct its own testing during review of remediation of an MRA for closure this year because, in that examiner's view, IA does not have the expertise to perform that testing.

We reviewed examiners' key workpapers for the 22 MRAs in our sample to determine the extent to which examiners conducted any testing when assessing remediation or relied on IA's testing of MRA remediation.¹⁹ Our review found:

- For 9 of the 22 sampled MRAs (41 percent), the examiners' workpapers cite IA's testing and do not reflect that the examiners performed their own testing.
- For 11 of 22 sampled MRAs (50 percent), the examiners' workpapers contain a review of IA's validation, but did not specifically identify testing performed either by examiners or IA; for 2 of the 11 MRAs within this group, the workpapers explicitly state that no testing was performed by either IA or the examiners.
- For 2 of 22 sampled MRAs (9 percent), the workpapers show that the examiners performed their own testing, and it appears that in one of these instances the examiner conducted testing for a component of MRA remediation and relied on IA's testing for another component of remediation.

In short, our review of the key DER workpapers for the 22 MRAs in our sample found that when the workpapers specifically documented that testing was performed, the workpapers reflected that the examiners generally relied on IA's testing as part of DER's assessment of MRA remediation instead of performing their own testing.

Review of Key Workpapers for the 22 MRAs in the Sample Found Evidence of Independent Assessments by DER Examiners of the Enterprise's Closure Packages for Nearly All of the Sampled MRAs

As discussed earlier, beyond FHFA's advisory bulletin and DER's OPB, neither FHFA nor DER has specified the work steps examiners were expected to follow to assess the sufficiency of MRA remediation. Based on the interviews and examiner workpapers, we concluded that DER examination managers and examiners had broad discretion in determining the scope of

¹⁹ DER requires its examiners to prepare two key workpapers for MRA remediation: (1) the procedures document, which provides the "decision path for the work performed to support the conclusions and examination findings" and (2) analysis memorandum or summary memorandum, which describe the examiners' work and conclusions. For almost all 22 sampled MRAs, the examiners prepared both required documents. DER did not prepare – and could not provide to OIG upon request – the procedures document for one MRA.

their independent assessment of the adequacy of the remedial actions. For example, one examination manager reported that some examiners perform two reviews – a review of IA’s work and then a review of the effectiveness of the completed remediation. Another stated that examiners should leverage the IA workpapers, look at deliverables, and assess what was received in comparison to what was required.

They expressed no uniform view on whether they were expected to conduct any testing as part of that assessment. For those examiners who explained that they conducted their own testing as part of the assessment, they offered different explanations about the meaning of testing to assess the adequacy of MRA remediation. One examination manager reported to us that testing is a broad term that could include getting people together to determine whether they are following a policy. Another examination manager noted that testing could include sampling and data analysis, or it could be a walk-through.

In a previous OIG report, we reviewed a fairly small sample of MRA closures and found that some DER examiners appeared to have accepted an Enterprise’s IA work to close MRAs without documented evidence of independent review of the adequacy of remediation. In this evaluation, we reviewed the workpapers for a larger sample of MRAs (22) for evidence that examiners independently assessed Enterprise management’s closure packages and/or IA’s validation work to support closure of the MRAs.²⁰ We observed variability in the work steps taken and variations in the level of detail provided in examiners’ workpapers for our sample of 22 MRAs, which is not surprising in light of the lack of guidance on the necessary work steps.

Although the scope of the examiners’ assessment of MRA remediation varied, our workpaper review found some evidence of independent assessment of the sufficiency of management’s remediation activities and/or IA’s validation work for nearly all of the 22 MRAs in our sample.²¹ We caution that the examiners’ broad discretion to determine the scope of their assessment work and the variability in the documentation in their workpapers constrained

²⁰ We used the same standards for this review as we did in our 2016 evaluation report. In that report, we reviewed “documentation made available to us by FHFA to determine whether DER examiners performed independent analyses or assessments, or merely recorded information that the Enterprises provided. Where we found no documentation, or where the documentation recited information from an Enterprise without any analysis, or where documentation reflected that DER agreed with an Enterprise’s assertions without any supporting analysis, we concluded that no independent analysis or assessment had been performed by DER examiners. Conversely, we credited DER with performing the independent assessment required by FHFA where the documentation reflected some independent analysis or assessment by the DER examiner, however limited.” 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.fhfaig.gov/Content/Files/EVL-2016-007.pdf).

²¹ We observed in one instance that the examiner documented IA’s work without evidence of independent assessment.

our assessment of whether the workpapers met expectations for an independent assessment required by FHFA examination guidance.

FINDINGS

1. When testing of the sufficiency of MRA remediation was conducted for the MRAs in our sample, DER examiners generally relied on the validation testing conducted by IA as part of their assessment of the Enterprises’ remedial actions.
2. FHFA has not issued guidance on the level of assurance of the competency, objectivity, reliability, and quality of IA’s validation work needed before the IA work can be used.
3. Because FHFA has not specified the work steps examiners are expected to follow to assess the sufficiency of MRA remediation, examiners have broad discretion in determining the scope of their independent assessment of the adequacy of the remedial actions, including whether to conduct any testing as part of that assessment.
4. For nearly all of the 22 MRAs in our sample, we found some evidence of independent assessment of the sufficiency of management’s remediation activities and/or IA’s validation work, although we found the scope of that assessment among examiners and the level of detail in the workpapers varied. The examiners’ broad discretion to determine the scope of their assessment work and the variability in the documentation in their workpapers constrained our assessment of whether the workpapers met expectations for an independent assessment required by FHFA examination guidance.

CONCLUSIONS

Current FHFA guidance directs its examiners to independently review and assess the documents in the Enterprise’s closure package, including some independent review or assessment of documentation provided by the Enterprise’s business unit and/or IA. As FHFA does not identify the steps that examiners should undertake to assess the sufficiency of MRA remediation, we found that DER examination managers and examiners have broad discretion in determining the scope of their independent assessment of the adequacy of the remedial actions. We determined, from our review of key examiner workpapers for the 22 MRAs in our sample, that the workpapers reflected some independent assessment of the sufficiency of management’s remediation activities and/or IA’s validation work for nearly all of the 22 MRAs in our sample, although the scope of that assessment varied among examiners.

When DER examiners specifically reported that testing of the sufficiency of MRA remediation was conducted for the 22 MRAs in our sample as part of their assessment of the Enterprises’ remedial actions, we found that the examiners generally relied on the validation testing conducted by the Enterprise’s IA function. We determined, from our review of examiners’ key workpapers for the 22 MRAs in our sample, that almost half (9 of 22) cited testing completed by the IA function and did not reflect that the examiners performed their own testing. For 11 of the 22 sampled MRAs, we found that the examiners’ key workpapers reflected a review of IA validation work, but did not specifically identify testing performed either by IA or by the examiners. For 2 of the 22 sampled MRAs, we found that the examiners performed their own testing; in one of these instances it appears the examiner conducted testing for a component of MRA remediation and relied on IA’s testing for another component.

In a companion evaluation issuing today, we found that FHFA, unlike the Federal Reserve, does not require its examiners to conclude on the overall effectiveness of the Enterprises’ IA functions as a predicate to use of IA work. As a result, its examiners may lack a sufficient basis to determine whether, or to what extent, to use IA’s validation work, and FHFA has not issued guidance on the level of assurance of the competency, objectivity, reliability, and quality of IA’s validation work needed before the IA work can be used.

RECOMMENDATION.....

We recommend that FHFA adopt clear guidance for examiners to follow when assessing the sufficiency of MRA remediation by the Enterprises that identifies the work steps that should be included in examiners’ independent assessments of IA’s work and specifies the conditions under which examiner testing is expected.

FHFA COMMENTS AND OIG RESPONSE.....

We provided FHFA an opportunity to respond to a draft report of this evaluation. FHFA provided technical comments on the draft report, which we incorporated as appropriate. In its management response, which is reprinted in its entirety in the Appendix, FHFA agreed with OIG’s recommendation.

OBJECTIVE, SCOPE, AND METHODOLOGY

We conducted this evaluation to assess DER’s follow-up practices for closing MRAs. Our objective was to understand the extent to which (1) examiners accepted, relied on, or otherwise used IA’s validation work in their assessment of the adequacy of MRA remediation and (2) whether they conducted independent assessments of the adequacy of the remediation.

To achieve this objective, we selected a sample of 22 MRAs from a population of 78 MRAs that were closed by DER between January 2015 and October 2017; 14 of these MRAs were issued to Fannie Mae and 8 to Freddie Mac. We reviewed key workpapers prepared by the examiners and Enterprise documents used by the examiners to assess remediation of the MRAs. We also reviewed FHFA guidance regarding MRA remediation in effect during the period in which our sample of MRAs were closed.

We also interviewed the Deputy Director of DER, FHFA’s Chief Accountant, and the examination managers and examiners for both the Fannie Mae and Freddie Mac examination teams responsible for closing the MRAs in our sample.

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 recommendation 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'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*

DATE: March 26, 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).

FHFA management's response to the recommendation is below.

Recommendation:

OIG recommends that FHFA adopt clear guidance for examiners to follow when assessing the sufficiency of MRA remediation by the Enterprises that identifies the work steps that should be included in examiners' independent assessments of IA's work and specifies the conditions under which examiner testing is expected.

Management Response to Recommendation:

FHFA agrees with this recommendation. By October 31, 2018, DER will provide more detailed guidance to examiners on procedures for conducting independent assessments of internal audit's work on Matters Requiring Attention (MRA) remediation and the conditions under which examiners are expected to perform testing to assess whether an MRA has been satisfactorily addressed.

ADDITIONAL INFORMATION AND COPIES.....

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