OFFICE OF INSPECTOR GENERAL
Federal Housing Finance Agency
400 7th Street SW, Washington, DC 20219

October 15, 2017

TO: Melvin L. Watt, Director

FROM: Laura S. Wertheimer, Inspector General

SUBJECT: Fiscal Year 2018 Management and Performance Challenges

We are pleased to provide you with this memorandum, issued pursuant to the Reports Consolidation Act of 2000 (P.L. 106-531), in which the Office of Inspector General (OIG) for the Federal Housing Finance Agency (FHFA or Agency) identifies serious management and performance challenges facing the Agency and its assessment of those challenges. We recognize that the ongoing uncertainty regarding the future role of Fannie Mae and Freddie Mac (collectively, the Enterprises) in the housing finance system creates an additional challenge.

Overview

FHFA was created in July 2008 by the Housing and Economic Recovery Act of 2008 (HERA) (P.L. 110-289) to serve as regulator of the Enterprises and the Federal Home Loan Banks (FHLBanks). As regulator, FHFA is charged with overseeing the safety and soundness and statutory missions of these entities. In September 2008, FHFA placed Fannie Mae and Freddie Mac into conservatorship "in response to a substantial deterioration in the housing markets that severely damaged Fannie Mae and Freddie [Mac's] financial condition and left them unable to fulfill their mission without government intervention."[1] Putting the Enterprises into conservatorships has proven to be far easier than ending them, and the conservatorships have now entered their tenth year.

Currently, FHFA serves in a unique role: it is both conservator of and regulator for the Enterprises and regulator for the FHLBanks. Its duties as conservator for the Enterprises, which together own or guarantee more than $5 trillion in mortgages, are fundamentally different from its responsibilities as the supervisor of these entities. FHFA's stakeholders—including the

[1] FHFA, *FHFA as Conservator of Fannie Mae and Freddie Mac* (online at www.fhfa.gov/Conservatorship/Pages/History-of-Fannie-Mae--Freddie-Conservatorships.aspx).

Congress, American taxpayers, and others—expect FHFA, as conservator, to ensure that both Enterprises are effectively governed and employ sound risk management practices; and expect FHFA, as a regulator, to exercise vigilant supervision of its regulated entities to ensure that they operate in a safe and sound manner.

FHFA-OIG believes that, for the foreseeable future, FHFA faces four serious management and performance challenges, described below, all of which carry over from prior years. We believe that these management and performance challenges, if not addressed, could adversely affect FHFA's accomplishment of its mission. Over the past few years, we have issued reports in which we assessed FHFA's progress in addressing elements of each of these challenges. Where we have identified shortcomings and/or weaknesses, we have proposed recommendations to address them. FHFA has accepted some of our recommendations and declined to accept others. For those recommendations FHFA has accepted, it has either implemented its proposed corrective actions or is in the process of developing and/or implementing them. Appendix B to each of our semiannual reports to Congress for the periods ending March 31 and September 30, 2017, sets forth our recommendations, by report, FHFA's response to each recommendation, and the status of each recommendation. For a listing of all our semiannual reports, see https://www.fhfaoig.gov/reports/semiannual. In addition, FHFA-OIG issues, on a regular basis, a Compendium of Open Recommendations, organized by the risks represented by the four serious management and performance challenges identified in this memorandum. See https://www.fhfaoig.gov/Content/Files/compendiumOctober2017.pdf. We do not repeat each of the shortcomings and/or weaknesses identified in our reports, or our recommendations to remediate them, here.

Challenge: Improve Oversight of Matters Delegated to the Enterprises and Strengthen Internal Review Processes for Non-Delegated Matters

As conservator of the Enterprises since September 2008, FHFA has expansive authority to oversee and direct operations of two large, complex financial institutions that dominate the secondary mortgage market and the mortgage securitization sector of the U.S. housing finance industry. Under HERA, FHFA possesses all rights and powers of any stockholder, officer, or director of the Enterprises; is vested with express authority to operate the Enterprises and conduct their business activities; may take actions necessary to put the Enterprises in a sound and solvent condition; and preserves and conserves their assets and property. Given the taxpayers' enormous investment in the Enterprises, the unknown duration of the conservatorships, the Enterprises' critical role in the secondary mortgage market, and their uncertain ability to sustain future profitability, FHFA's administration of the conservatorships remains a major risk.

As conservator of the Enterprises, FHFA owes duties to the U.S. taxpayers, the largest shareholders in the Enterprises, and is charged with ensuring that the Enterprises achieve their statutory purpose. Pursuant to its powers under HERA to take actions "necessary to put [Fannie Mae and Freddie Mac] in a sound and solvent condition" and "appropriate to carry on the business of [Fannie Mae and Freddie Mac]" and "preserve and conserve" their assets, FHFA has delegated authority for many matters, both large and small, to the Enterprises. The Enterprises acknowledge in their public securities filings that their directors serve on behalf of the conservator and exercise their authority as directed by and with the approval, when required, of the conservator. FHFA, as conservator, can revoke delegated authority at any time (and retains authority for certain significant decisions).

Our body of work over the past few years has found that FHFA has limited its oversight of delegated matters largely to attendance at Enterprise internal management and board meetings as an observer and to discussions with Enterprise managers and directors. Read together, our findings in these reports show that, for the most part, FHFA, as conservator, has not assessed the reasonableness of Enterprise actions pursuant to delegated authority, including actions taken by the Enterprises to implement conservatorship directives, or the adequacy of director oversight of management actions. FHFA also has not clearly defined the Agency's expectations of the Enterprises for delegated matters and has not established the accountability standard that it expects the Enterprises to meet for such matters. Our work has identified internal control systems at the Enterprises that fail to provide directors with accurate, timely, and sufficient information to enable them to exercise their oversight duties. Likewise, we have identified a lack of rigor by some directors in overseeing matters for which they are responsible. We have also identified instances in which corporate governance decisions generally reserved to a board of directors have been delegated to management.

As the Enterprises' conservator, FHFA is ultimately responsible for actions taken by the Enterprises pursuant to authority it has delegated to them. FHFA's challenge, therefore, is to improve the quality of its oversight of matters it has delegated to the Enterprises.

Related OIG Reports

- *Fannie Mae Dallas Regional Headquarters Project* (OIG-2017-002, December 15, 2016), online at https://www.fhfaoig.gov/Content/Files/OIG-2017-002.pdf
- *Update on the Status of the Development of the Common Securitization Platform* (COM-2017-001, December 9, 2016), online at https://www.fhfaoig.gov/Content/Files/COM-2017-001_0.pdf
- *Administrative Investigation of Hotline Complaints: Conflicts of Interest Issue* (OIG-2017-004, March 23, 2017), online at https://www.fhfaoig.gov/Content/Files/OIG-2017-004.pdf
- *NPL Sales: Additional Controls Would Increase Compliance with FHFA's Sales Requirements* (AUD-2017-006, July 24, 2017), online at https://www.fhfaoig.gov/Content/Files/AUD-2017-006%20NPL%20Sales%20Additional%20Controls%20Would%20Increase%20Compliance%20with%20FHFA%27s%20Sales%20Requirements.pdf
- *Management Alert: Need for Increased Oversight by FHFA, as Conservator, to Ensure that Freddie Mac's Policies and Procedures for Resolution of Executive Officer Conflicts of Interest Align with the Responsibilities of the Nominating and Governance Committee*

of the Freddie Mac Board of Directors (OIG-2017-005, September 27, 2017), online at https://www.fhfaoig.gov/Content/Files/OIG-2017-005%20%28Redacted%29.pdf

- *Special Report: Update on FHFA's Oversight of Fannie Mae's Build-Out of its Newly Leased Class A Office Space in Midtown Center* (COM-2017-007, September 28, 2017), online at https://www.fhfaoig.gov/Content/Files/pw%20DC%20Lease%20Update%209_%2028_2017.pdf
- *Management Alert: Need for Increased Oversight by FHFA, as Conservator of Fannie Mae, of the Projected Costs Associated with Fannie Mae's Headquarters Consolidation and Relocation Project*, (COM-2016-004, June 16, 2016), online at https://www.fhfaoig.gov/Content/Files/COM-2016-004_Revised%209_22_16.pdf

As conservator, FHFA can retain authority to decide specific issues and can, at any time, revoke previously delegated authority. Generally, FHFA has retained authority (or has revoked previously delegated authority) to resolve issues of significant monetary and/or reputational value. FHFA has established written internal review and approval processes for non-delegated matters to ensure that the Agency follows a consistent approach for analyzing and resolving such matters and that the decision-makers are apprised of all relevant facts and considerations. FHFA faces challenges in ensuring that its established processes are followed.

Related OIG Reports

- *Compliance Review of FHFA's Revised Process for Reviewing the Enterprises' Annual Operating Budgets* (COM-2017-006, September 19, 2017), online at https://www.fhfaoig.gov/Content/Files/COM-2017-006_Redacted.pdf
- *FHFA's Exercise of Its Conservatorship Powers to Review and Approve the Enterprises' Annual Operating Budgets Has Not Achieved FHFA's Stated Purpose* (EVL-2015-006, September 30, 2015), online at https://www.fhfaoig.gov/Content/Files/EVL-2015-006.pdf

Challenge: Upgrade Supervision of the Enterprises and Continue Robust Supervision of the FHLBanks

Created by HERA in 2008, FHFA assumed the supervisory responsibilities previously exercised by the Federal Housing Finance Board and the Office of Federal Housing Enterprise Oversight. As supervisor of the Enterprises and the FHLBanks, FHFA is tasked by statute to ensure 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. Examinations of its regulated entities are fundamental to FHFA's supervisory mission. Within FHFA, the Division of Federal Home Loan Bank Regulation (DBR) is responsible for supervision of the FHLBanks, and the Division of Enterprise Regulation (DER) is responsible for supervision of the Enterprises.

FHFA has long recognized that effective supervision of the entities it regulates is fundamental to ensuring their safety and soundness. In prior management and performance challenges statements, we identified FHFA's supervision of the Enterprises as a critical risk and believe that it continues to be such a risk.

Over the past few years, we have assessed critical elements of DER's supervision program for the Enterprises, including:

- DER's assessment of risks at the Enterprises and documentation of those risks in semiannual risk assessments;
- DER's plan for each annual supervisory cycle, based on the results of its risk assessments, and risk-related changes and updates to that plan;
- DER's planned examination procedures for its supervisory activities, which are designed to identify the objectives of the activity and describe the examination steps to be performed, including sampling and testing;
- DER's communication of its findings from its supervisory activities, including its supervisory concerns, to each Enterprise's board of directors;
- DER's follow-up on efforts by each Enterprise to correct identified deficiencies throughout the remediation period to ensure that remediation is timely and adequate; and
- DER's communication of its examination conclusions, findings, and composite/ component examination ratings after the end of each annual supervisory cycle to each Enterprise's board of directors in a written Report of Examination.

For each element that we assessed, we issued reports setting forth the facts, findings, conclusions, and recommendations on each of these critical elements. Each of these reports identified shortcomings and recommended remedial actions.

Based on our assessments of different elements of DER's supervision program, we identified four recurring themes, which were explained in a roll-up report issued during FY 2017. See OIG, *Safe and Sound Operation of the Enterprises Cannot Be Assumed Because of Significant Shortcomings in FHFA's Supervision Program for the Enterprises* (OIG-2017-003, December 15, 2016), online at www.fhfaoig.gov/Reports/AuditsAndEvaluations. Those themes are:

1. FHFA lacks adequate assurance that DER's supervisory resources are devoted to examining the highest risks of the Enterprises.
2. Many supervisory standards and guidance issued by FHFA and DER lack the rigor of those issued by other federal financial regulators.
3. The flexible and less prescriptive nature of many requirements and guidance promulgated by FHFA and DER has resulted in inconsistent supervisory practices.
4. Where clear requirements and guidance for specific elements of DER's supervisory program exist, DER examiners-in-charge and subordinate examiners have not consistently followed them.

In that roll-up report, we cautioned that "[w]ithout prompt and robust Agency attention to address the shortcomings we have identified," the "safe and sound operation of the Enterprises cannot be assumed from FHFA's current supervisory program." The findings from audits, evaluations, and compliance reports completed after issuance of this roll-up report highlight additional shortcomings of FHFA's supervision program for the Enterprises. FHFA must make a heightened and sustained effort to improve its supervision of the Enterprises.

We looked at similar elements of FHFA's supervision program for the FHLBanks and did not identify comparable weaknesses. Like any other federal financial regulator, FHFA faces challenges in appropriately tailoring and keeping current its supervisory approach to the FHLBanks.

Related OIG Reports

- *Safe and Sound Operation of the Enterprises Cannot Be Assumed Because of Significant Shortcomings in FHFA's Supervision Program for the Enterprises* (OIG-2017-003, December 15, 2016), online at https://www.fhfaoig.gov/Content/Files/OIG-2017-003.pdf
- *FHFA's Practice for Rotation of its Examiners Is Inconsistent between its Two Supervisory Divisions* (EVL-2017-004, March 28, 2017), online at https://www.fhfaoig.gov/Content/Files/EVL-2017-004.pdf
- *Update on FHFA's Implementation of its Housing Finance Examiner Commission Program* (COM-2017-003, March 22, 2017), online at https://www.fhfaoig.gov/Content/Files/Update%20on%20HFE%20Program-final.pdf
- *FHFA's 2015 Report of Examination to Fannie Mae Failed to Follow FHFA's Standards Because it Reported on an Incomplete Targeted Examination of the Enterprise's New Representation and Warranty Framework* (AUD-2017-008, September 22, 2017), online at https://www.fhfaoig.gov/Content/Files/AUD-2017-008%20FNM%20RWF%20Examinations%20%28redacted%29.pdf
- *The Gap in FHFA's Quality Control Review Program Increases the Risk of Inaccurate Conclusions in its Reports of Examination of Fannie Mae and Freddie Mac* (EVL-2017-006, August 17, 2017), online at https://www.fhfaoig.gov/Content/Files/EVL-2017-006.pdf
- *FHFA's Examination Program for the FHLBanks' Internal Audit Functions Was Adequately Designed and Executed* (AUD-2017-003, May 5, 2017), online at https://www.fhfaoig.gov/Content/Files/2017%2005%2005%20AUD-2017-003.pdf
- *DBR's Unwritten Procedures and Practices for Oversight of Efforts by Federal Home Loan Banks to Correct Deficiencies Underlying the Most Serious Supervisory Matters Are Inconsistent with the Written Oversight Requirements Promulgated by FHFA* (COM-2016-006, September 30, 2016), online at https://www.fhfaoig.gov/Content/Files/COM-2016-006.pdf

Challenge: Enhance Oversight of Cybersecurity at the Regulated Entities and Ensure an Effective Information Security Program at FHFA

Cybersecurity, as defined by the National Institute of Standards and Technology, is "the process of protecting information by preventing, detecting, and responding to attacks." In February 2016, President Obama stated that cybersecurity is one of the most important challenges facing the nation and in May 2017, President Trump issued an executive order to strengthen the cybersecurity of federal networks and critical infrastructure. The Financial Stability Oversight Council, of which FHFA is a member, has identified cybersecurity oversight as an emerging threat for increased regulatory attention. The Council reported that "cybersecurity-related incidents create significant operational risk, impacting critical services in the financial system, and ultimately affecting financial stability and economic health." Treasury Secretary Mnuchin recently testified that "cybersecurity is one of our biggest, biggest risks."

In its 2015 Performance and Accountability Report, FHFA represented that a "key objective of FHFA's supervisory work will continue to be the effective oversight of how each Enterprise manages cyber risks and addresses vulnerabilities." FHFA's program for the 2016 examination cycle for each Enterprise included a range of supervisory activities relating to their management of cybersecurity risks. FHFA completed none of these planned activities for one Enterprise, and did not complete one of its planned activities and deferred another activity to a later examination cycle, during 2016 for the other Enterprise.

As cyberthreats and attacks at financial institutions increase in number and sophistication, FHFA faces challenges in designing and implementing its examination activities for the entities it supervises. As the use of technology continues to become more sophisticated, hiring and training a sufficient number of employees with the expertise needed to conduct detailed examinations of information security systems presents a challenge. FHFA has advised us that it developed an examination module for cybersecurity examinations during 2016. FHFA will be challenged to ensure that: (1) the components in this newly developed examination module remain current; (2) it provides written guidance and training to examiners to aid them in their supervision of information technology issues; (3) it recruits and retains a sufficient complement of examiners with the experience and expertise needed to conduct detailed examinations of information security systems; and (4) completes the supervisory activities it has planned.

Related OIG Reports

- *FHFA Did Not Complete All Planned Supervisory Activities Related to Cybersecurity Risks at Freddie Mac for the 2016 Examination Cycle* (AUD-2017-011, September 27, 2017), online at https://www.fhfaoig.gov/Content/Files/AUD-2017-011%20FRE%20Cyber%20Examinations%20%28redacted%29.pdf
- *FHFA Failed to Complete Non-MRA Supervisory Activities Related to Cybersecurity Risks at Fannie Mae Planned for the 2016 Examination Cycle* (AUD-2017-010, September 27, 2017), online at https://www.fhfaoig.gov/Content/Files/AUD-2017-010%20FNM%20Cyber%20Examinations%20Redacted_Redacted.pdf.

FHFA is one of a number of federal agencies involved in a national effort to protect the critical infrastructure of the U.S. financial services sector. Computer networks maintained by federal government agencies have proven to be a tempting target for disgruntled employees, hackers, and other intruders. Over the past few years, cyber attacks against federal agencies have increased in frequency and severity. As cyber attacks continue to evolve and become more sophisticated and harder to detect, they pose an ongoing challenge for virtually every federal agency to fortify and safeguard its internal systems and operations.

As conservator of and supervisor for the Enterprises and supervisor for the FHLBanks, FHFA collects and manages sensitive information, including personally identifiable information, that it must safeguard from unauthorized access or disclosure. Equally important is the protection of its computer network operations that are part of the nation's critical financial infrastructure. FHFA is required to design information security programs to protect its computer networks. Our FISMA audits are intended to ensure FHFA's compliance with those standards and also to assist FHFA in strengthening protections over its network operations against those who would seek to attack its network.

For Fiscal Year (FY) 2016, an independent public accounting firm under contract with FHFA-OIG concluded that FHFA's information security program was compliant with FISMA and applicable OMB guidance and that sampled security controls demonstrated operating effectiveness. In coordination with the FY 2017 FISMA audit, the same independent public accounting firm under contract with FHFA-OIG also conducted a performance audit of FHFA's Privacy Program to address specific requirements in 42 U.S.C. § 2000ee-2. That performance audit tested FHFA's implementation of access controls for a sample of seven systems containing sensitive information, such as PII. The audit recommended that FHFA (1) enhance System Owner training to include FHFA access control policies, and (2) review all privileged user accounts, obtain authorizations for users where none are currently documented, and remove access for those not authorized. FHFA-OIG intends to follow up on the status of corrective actions as part of the FY 2018 FISMA audit. FHFA, like other federal agencies, faces challenges in enhancing its information security programs, ensuring that its internal and external online collaborative environments are restricted to those with a need to know, and ensuring that its third-party providers meet information security program requirements.

Related OIG Reports

- *FHFA's Processes for General Support System Component Inventory Need Improvement* (AUD-2017-005, May 25, 2017), online at https://www.fhfaoig.gov/Content/Files/AUD-2017-005%20FHFA%27s%20Processes%20for%20General%20Supp.pdf
- *Performance Audit of the Federal Housing Finance Agency's Privacy Program* (AUD-2017-007, August 30, 2017), online at https://www.fhfaoig.gov/Content/Files/FY2017%20Privacy%20Audit%20Report%20REVISED.pdf.

Other Reports

- *Annual Report to Congress for Fiscal Year 2016, Federal Information Security Modernization Act of 2014* (March 10, 2017 at page 63), online at www.whitehouse.gov/sites/whitehouse.gov/files/briefing-room/presidential-actions/related-omb-material/fy_2016_fisma_report%20to_congress_official_release_march_10_2017.pdf.

Challenge: Enhance Oversight of the Enterprises' Relationships with Counterparties and Third Parties

The Enterprises rely heavily on counterparties and third parties for a wide array of professional services, including mortgage origination and servicing. As the Enterprises and FHFA recognize, that reliance exposes the Enterprises to a number of risks, including the risk that a counterparty will not meet its contractual obligations, and the risk that a counterparty will engage in fraudulent conduct. FHFA has delegated to the Enterprises the management of their relationships with counterparties and reviews their management largely through its supervisory activities.

Our publicly reportable criminal investigations include alleged fraud by different types of counterparties, including real estate brokers and agents, builders and developers, loan officers and mortgage brokers, and title and escrow companies.

In light of the financial, governance, and reputational risks arising from the Enterprises' relationships with counterparties and third parties, FHFA is challenged to oversee the Enterprises' management of risks related to their counterparties.

Related OIG Reports

- *FHFA's Examinations Have Not Confirmed Compliance by One Enterprise with its Advisory Bulletins Regarding Risk Management of Nonbank Sellers and Servicers* (EVL-2017-002, December 21, 2016), online at https://www.fhfaoig.gov/Content/Files/EVL-2017-002.pdf
- *FHFA Should Improve its Administration of the Suspended Counterparty Program* (COM-2017-005, July 31, 2017), online at https://www.fhfaoig.gov/Content/Files/SCP%20Final.pdf
- *FHFA's 2015 Report of Examination to Fannie Mae Failed to Follow FHFA's Standards Because It Reported on an Incomplete Targeted Examination of the Enterprise's New Representation and Warranty Framework* (AUD-2017-008, September 22, 2017), online at https://www.fhfaoig.gov/Content/Files/AUD-2017-008%20FNM%20RWF%20Examinations%20%28redacted%29.pdf
- *FHFA's 2015 and 2016 Supervisory Activities, as Planned, Addressed Identified Risks with Freddie Mac's New Representation and Warranty Framework* (AUD-2017-009, September 22, 2017), online at https://www.fhfaoig.gov/Content/Files/AUD-2017-009%20FRE%20RWF%20Examinations%20%28redacted%29.pdf

*****

For the coming year, our audits, evaluations, compliance reviews, and other work will focus on the challenges highlighted in this memorandum. Included in these efforts are verification testing on closed recommendations to independently determine whether FHFA has implemented in full the corrective actions it represented to us that it intended to take and following up on open recommendations.

cc: Janell Byrd-Chichester, Chief of Staff
Lawrence Stauffer, Acting Chief Operating Officer
Mark Kinsey, Chief Financial Officer
Alfred Pollard, General Counsel
John Major, Internal Controls and Audit Follow-Up Manager