Federal Housing Finance Agency
Office of Inspector General

Safe and Sound Operation of the Enterprises Cannot Be Assumed Because of Significant Shortcomings in FHFA's Supervision Program for the Enterprises

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Executive Summary

The Federal Housing Finance Agency (FHFA or Agency) plays a unique role as both conservator and regulator for Fannie Mae and Freddie Mac (collectively, the Enterprises) and as regulator for the Federal Home Loan Banks (FHLBanks). As FHFA recognizes, effective supervision of the entities it regulates is fundamental to ensuring their safety and soundness. 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.

In the FHFA Office of Inspector General (OIG) 2015 and 2016 Audit and Evaluation Plans, we explained our intent to focus our resources on programs and operations that pose the greatest financial, governance, and reputational risk to FHFA, the Enterprises, and the FHLBanks. One of the areas of significant risk we identified was FHFA's rigor in its supervision of the Enterprises and the FHLBanks.

OIG published 12 evaluation, audit, and compliance review reports over the past 18 months in which we assessed different critical elements of DER's supervision program for the Enterprises. These elements included:

- 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 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 board of directors in a written Report of Examination (ROE).

For each element that we assessed, we found shortcomings and recommended actions to address these shortcomings and upgrade DER's supervisory activities. We published reports setting forth the facts, findings, conclusions, and recommendations on each of these critical elements. (A listing of these reports follows the Table of Contents.) A discussion of our findings, by element in DER's supervision program, can be found in the Management and Performance Challenges Memorandum we sent to FHFA on October 6, 2016. (*See* OIG, *Fiscal Year 2017 Management and Performance Challenges*, at 8-19 (Oct. 6, 2016) (online at www.fhfaoig.gov/Content/Files/FHFA%20management%20challenges%20FY2017.pdf).)

FHFA steadfastly maintains that its supervision of the Enterprises is effective and ensures their safe and sound operation. In our view, our evaluations, audits, and compliance review reports, when read together, call into question the effectiveness of FHFA's supervision program for the Enterprises. Among our findings was that FHFA had difficulty completing its planned targeted examinations over four supervisory cycles from 2012 through 2015 and that the number of targeted examinations planned and completed during each supervisory cycle has fallen since 2012 for Freddie Mac and has diminished significantly for Fannie Mae. We found that no targeted examinations of Fannie Mae planned for the 2015 supervisory cycle were completed before the annual ROE was issued.

Based on our assessments of different elements of DER's supervision program, we identified four recurring themes. In this roll-up of these 12 reports, we discuss each of the following themes:

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

Although FHFA asserted in its management responses that it was generally receptive toward our recommendations, it rejected a number of them and did

not propose alternative corrective actions for most of the recommendations it rejected. Given FHFA's disagreement with a number of our recommendations to correct shortcomings identified in our reports as well as its unwillingness to propose alternative corrective actions, it is our view that these elements of DER's supervisory program remain deficient. It remains to be seen whether the corrective actions that FHFA has agreed to take to address other shortcomings identified by us will, in fact, be implemented effectively.

Together, the Enterprises own or guarantee nearly $5 trillion in mortgages and are among the largest financial institutions in this country. Should either or both Enterprises sustain losses in the future that exceed their decreasing capital reserves, the U.S. Treasury—and the American taxpayers—will be on the hook for those losses. Pursuant to HERA, FHFA is charged with ensuring the safety and soundness of the Enterprises. Without prompt and robust Agency attention to address the shortcomings we have identified, we caution stakeholders that the safe and sound operation of the Enterprises cannot be assumed from FHFA's current supervisory program.

Other regulators have sought the assistance of independent third parties in assessing the effectiveness of their supervision programs. In 1997 and again in 2009, the Federal Reserve Bank of New York retained an outside independent expert to assess the effectiveness of its supervisory procedures and its internal processes to understand and foresee systemic problems and undertook internal initiatives to improve its practices and procedures. In 2013, the Office of the Comptroller of the Currency (OCC) asked a team of international regulators to provide an independent perspective on the OCC's approach to the supervision of large and midsize banks and thrifts and, based on that team's recommendations, the OCC reorganized its supervision programs and instituted practices designed to foster better communication and assessment of risks, among other things. FHFA has acknowledged that it considers the guidance and examination practices of its peer financial regulators when developing its own guidance and requirements. In view of FHFA's unwillingness to accept a number of OIG recommendations to address shortcomings in critical elements of DER's supervision program, we believe it would be prudent for FHFA to follow the lead of the Federal Reserve of New York and the OCC and engage independent external experts to review different critical elements of DER's supervision program.

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Inspector General for Compliance and Special Projects, with assistance from Jon Anders, Program Analyst. We appreciate the cooperation of FHFA staff, as well as the assistance of all those who contributed to the preparation of this report.

The audits summarized in this report were conducted in accordance with generally accepted government auditing standards. The evaluations and compliance review summarized in this report were conducted in accordance with the Council of the Inspectors General on Integrity and Efficiency's *Quality Standards for Inspection and Evaluations* (January 2012).

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

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FHFA's Targeted Examinations of Fannie Mae: Less than Half of the Targeted Examinations Planned for 2012 through 2015 Were Completed and No Examinations Planned for 2015 Were Completed Before the Report of Examination Issued (Sept. 30, 2016) (AUD-2016-006) (online at www.fhfaoig.gov/Content/Files/AUD-2016-006.pdf)

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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.fhfaoig.gov/Content/Files/EVL-2016-009.pdf)

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.fhfaoig.gov/Content/Files/EVL-2016-008.pdf)

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 (July 14, 2016) (EVL-2016-007) (online at www.fhfaoig.gov/Content/Files/EVL-2016-007.pdf)

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OIG's Compliance Review of FHFA's Implementation of Its Housing Finance Examiner Commission Program (July 29, 2015) (COM-2015-001) (online at www.fhfaoig.gov/Content/Files/COM-2015-001_1_0.pdf)

ABBREVIATIONS

AB	Advisory Bulletin
DBR	Division of Federal Home Loan Bank Regulation
DER	Division of Enterprise Regulation
Enterprises	Fannie Mae and Freddie Mac, collectively
FDIC	Federal Deposit Insurance Corporation
Federal Reserve	Board of Governors of the Federal Reserve System
FFIEC	Federal Financial Institutions Examination Council
FHFA	Federal Housing Finance Agency
FHLBank	Federal Home Loan Bank
HFE	Housing Finance Examiner
IMS	Information Management System
MRA	Matter Requiring Attention
NCUA	National Credit Union Administration
OCC	Office of the Comptroller of the Currency
OIG	FHFA Office of Inspector General
OPB	Operating Procedures Bulletin
OQA	Office of Quality Assurance
ROE	Report of Examination
SD	Supervision Directive

OVERVIEW

FHFA's appointment as conservator of the Enterprises did not suspend its statutory responsibilities to ensure that each Enterprise operates in a safe and sound manner so that they serve as a reliable source of liquidity and funding for housing finance and community investment.[1] Within FHFA, DER is charged with responsibility for supervision of the Enterprises.

The Enterprises' financial condition in September 2008 threatened their ability to perform their mission and prompted FHFA to place them into conservatorship. To date, the Enterprises have received $187.5 billion in financial support from U.S. taxpayers to enable them to fulfill their public mission and integral role in the secondary mortgage market.[2] The Enterprises are unable to accumulate a financial cushion to absorb future losses. Pursuant to the terms of their agreements with Treasury, the Enterprises are required to pay Treasury each quarter a dividend equal to the excess of their net worth over an applicable capital reserve amount, which will decrease to zero by January 1, 2018. If they sustain losses that lead them to report a negative net worth after that time, the Enterprises would be obligated to draw more taxpayer funds.[3] Therefore, their safe and sound operation is critical. Without timely and robust supervision by FHFA, stakeholders lack full assurance of the safe and sound operation of the Enterprises.

Over the past 18 months, we published a dozen evaluation, audit, and compliance review reports in which we assessed different elements of DER's supervisory program and found significant shortcomings. Based on our findings, we identified four recurrent themes, which we now discuss.[4]

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[1] 12 U.S.C. § 4513(a)(1)(A), (B)(i)-(ii). *See also* Melvin L. Watt, FHFA Director, Prepared Remarks at the Bipartisan Policy Center (Feb. 18, 2016) (discussing FHFA's fulfillment of its dual roles as conservator and regulator of the Enterprises) (online at www.fhfa.gov/Media/PublicAffairs/Pages/Prepared-Remarks-Melvin-Watt-at-BPC.aspx).

[2] Following payment of their expected fourth quarter dividends, the Enterprises will have paid a total of $255.8 billion in dividends to the U.S. Treasury.

[3] OIG, *The Continued Profitability of Fannie Mae and Freddie Mac Is Not Assured*, at 2, 3 (Mar. 18, 2015) (WPR-2015-001) (online at www.fhfaoig.gov/Content/Files/WPR-2015-001.pdf).

[4] In the Management and Performance Challenges memorandum we sent to FHFA on October 6, we discuss our findings by element. *See* OIG, *Fiscal Year 2017 Management and Performance Challenges*, at 8-19 (Oct. 6, 2016) (online at www.fhfaoig.gov/Content/Files/FHFA%20management%20challenges%20FY2017.pdf).

1. FHFA Lacks Adequate Assurance that Sufficient Supervisory Resources Are Devoted to Examining the Highest Risks of the Enterprises

Like other federal financial regulators, FHFA maintains that it uses a risk-based approach to carry out its supervisory activities. Supervision by risk requires a comprehensive, risk-focused view of each regulated entity so that supervisory activities can be tailored to the risks with the highest supervisory concerns. Based on the analysis in its risk assessments, DER is to prepare an annual supervisory strategy followed by a supervisory plan that schedules the specific supervisory activities it intends to conduct during the year. Those supervisory activities include targeted examinations and ongoing monitoring.

In a number of our reports, we found that DER has not carried out key elements of its supervisory responsibilities, which, in our view, calls into question whether DER has devoted sufficient supervisory resources to examining the Enterprises' highest risks.

Employing Risk Assessments in Supervisory Planning

According to FHFA's *Examination Manual*, risk assessments provide the critical foundation for developing annual supervisory plans for the entities it regulates. FHFA requires all risk assessments to be updated semiannually and "as significant changes to the risk profile occur." FHFA examiners are then able to leverage their resources by focusing their supervisory activities around the risks identified as posing the highest supervisory concerns in the risk assessments.

We found in an audit report entitled *FHFA's Supervisory Planning Process for the Enterprises: Roughly Half of FHFA's 2014 and 2015 High-Priority Planned Targeted Examinations Did Not Trace to Risk Assessments and Most High-Priority Planned Examinations Were Not Completed* that DER had not used the risk assessments completed by its examiners for their stated purpose.[5] Of the 61 high-priority targeted examinations planned for both Enterprises for the 2014 and 2015 supervisory cycles, we were able to trace only 32 to DER risk assessments and were unable to trace the remaining 29—almost half of the total. The EIC of supervision for each Enterprise acknowledged to us that these planned high-priority examinations were developed from information obtained by the EICs outside of the risk assessments.[6] Additionally, examiners did not revise the risk assessments, as required by

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[5] OIG, *FHFA's Supervisory Planning Process for the Enterprises: Roughly Half of FHFA's 2014 and 2015 High-Priority Planned Targeted Examinations Did Not Trace to Risk Assessments and Most High-Priority Planned Examinations Were Not Completed*, at 19 (Sept. 30, 2016) (AUD-2016-005) (online at www.fhfaoig.gov/Content/Files/AUD-2016-005.pdf).

[6] FHFA's examination teams for Fannie Mae and Freddie Mac are each led by an Examiner-in-Charge (EIC). According to the *Examination Manual*, the EIC is "responsible for the planning, execution, and documentation of each annual examination" and "must ensure that the activities that comprise the examination are consistent

FHFA to document the newly acquired information. For the 2014 and 2015 supervisory cycles, we found that DER risk assessments did not provide the critical foundation for almost half of the planned high-priority targeted examinations.

We also found that none of DER's risk assessments rated the severity of the identified risks. DER examiners lack guidance on prioritizing planned targeted examinations and are not required to document the basis for the prioritizations they assign to the planned targeted examinations. As a consequence, the risk assessments did not support, or link to, the priority level assigned to each planned targeted examination.[7]

Completion of Targeted Examinations Planned in Annual Approved Supervisory Plans

Based on the analysis in its risk assessments, DER is to prepare an annual supervisory strategy, and then a supervisory plan that schedules the specific supervisory activities that it intends to conduct during the year. The supervisory activities include ongoing monitoring and targeted examinations. 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. Because each of these supervisory activities has a separate purpose, they are not interchangeable.

Each supervisory activity must be carefully planned to ensure effective supervision and efficient use of FHFA resources. Because targeted examinations constitute a critical component of DER's supervisory activities, we examined whether DER examiners conducted and completed the targeted examinations identified in each supervisory plan for Fannie Mae and for Freddie Mac from 2012 through 2015. Based on the results of this review, we found that DER examiners completed less than half of the targeted examinations planned for Fannie Mae over a four-year period and a bit more than half of the targeted examinations planned for Freddie Mac over the same period.[8] We also found that no targeted examinations of Fannie

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with FHFA examination standards and support examination conclusions, findings (where applicable), and examination ratings." *See* FHFA, *FHFA Examination Manual*, Examination Program Overview, at 17 (Dec. 19, 2013).

[7] OIG, *FHFA's Supervisory Planning Process for the Enterprises: Roughly Half of FHFA's 2014 and 2015 High-Priority Planned Targeted Examinations Did Not Trace to Risk Assessments and Most High-Priority Planned Examinations Were Not Completed*, at 18-19, *supra* note 5. *See also* OIG, *Utility of FHFA's Semi-Annual Risk Assessments Would Be Enhanced Through Adoption of Clear Standards and Defined Measures of Risk Levels*, at 13 (Jan. 4, 2016) (EVL-2016-001) (online at www.fhfaoig.gov/Content/Files/EVL-2016-001.pdf).

[8] OIG, *FHFA's Targeted Examinations of Fannie Mae: Less than Half of the Targeted Examinations Planned for 2012 through 2015 Were Completed and No Examinations Planned for 2015 Were Completed Before the Report of Examination Issued*, at 14 (AUD-2016-006) (Sept. 30, 2016) (online at

Mae planned for the 2015 supervisory cycle were completed before the issuance of the 2015 ROE. As such, the 2015 Fannie Mae ROE could not and did not include the results and conclusions, findings, and supervisory concerns on these areas deemed by DER to be of the highest importance or risk for that supervisory cycle.[9]

For both Enterprises, we found that the number of targeted examinations planned and completed during an annual supervisory cycle decreased significantly during this four-year period. The reason repeatedly provided to us by DER officials for this decrease was resource constraints, notwithstanding the consistent position of DER leadership that DER has an adequate complement of examiners.[10]

Housing Finance Examiner Commission Program

As noted earlier, FHFA maintains that it uses a risk-based approach to carry out its supervisory activities like other federal financial regulators. Each of these regulators has concluded that a risk-focused approach to supervisory examinations demands enhanced knowledge and skills of examiners. To that end, each of these regulators offers a commissioning program for its examiners to provide training in the skills needed to employ successfully a risk-focused approach to examinations.

In a 2011 report, we found that two-thirds of FHFA's examiners were not commissioned—the examiners had not completed a structured process of classroom and on the job training that would provide them with technical competencies and practical examination experience necessary to lead major risk sections of examinations of the entities regulated by FHFA. We found, and FHFA agreed, that the efficiency and effectiveness of FHFA's oversight of its regulated entities would be strengthened by a sufficient corps of commissioned examiners.

In 2013, the Agency inaugurated its Housing Finance Examiner (HFE) commission program. Our compliance review, entitled *OIG's Compliance Review of FHFA's Implementation of Its Housing Finance Examiner Commission Program*, assessed Agency implementation of the HFE program during a 19-month period from August 2013 to March 2015 and found that the HFE program was not on track to meet its central objective. Only 1 of 66 enrolled examiners

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www.fhfaoig.gov/Content/Files/AUD-2016-006.pdf), and OIG, *FHFA's Targeted Examinations of Freddie Mac: Just Over Half of the Targeted Examinations Planned for 2012 through 2015 Were Completed*, at 14, (AUD-2016-007) (Sept. 30, 2016) (online at www.fhfaoig.gov/Content/Files/AUD-2016-007.pdf).

[9] OIG, *FHFA's Targeted Examinations of Fannie Mae: Less than Half of the Targeted Examinations Planned for 2012 through 2015 Were Completed and No Examinations Planned for 2015 Were Completed Before the Report of Examination Issued*, at 22-23, *supra* note 8.

[10] *Id*. at 23, 25 and OIG, *FHFA's Targeted Examinations of Freddie Mac: Just Over Half of the Targeted Examinations Planned for 2012 through 2015 Were Completed*, at 21-22, 24, *supra* note 8.

had submitted records reflecting completion of any of the 16 on the job training requirements. Given that many of the enrolled examiners failed to progress in meeting the HFE program requirements during its first 19 months of operation, we determined that their ability to earn HFE commissions within the projected timeframe of four years or less was at risk.[11]

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In reports published in 2011 and 2013, we found that FHFA lacked a sufficient number of examiners to ensure the efficiency and effectiveness of its supervisory program and FHFA committed to add examiners, which it has done.[12] In several recent reports, we found that DER has not carried out key elements of its supervisory program:

- Almost half of its planned high-priority targeted examinations for 2014 and 2015 could not be traced to underlying risk assessments, and none of the risk assessments supported the priority assigned to planned targeted examinations, which calls into question the utility of the risk assessments and the basis on which priorities are assigned to planned targeted examinations;

- It did not conduct more than half of the targeted examinations it planned for Fannie Mae between 2012 and 2015 and did not conduct slightly less than half of the targeted examinations it planned for Freddie Mac for that same period; and

- It failed to implement its commissioning program to develop a corps of commissioned examiners with the necessary technical competencies and practical examination experience to lead risk-based examinations.

In our view, these significant shortcomings in DER's execution of its supervisory responsibilities for the Enterprises lead us to conclude that FHFA lacks adequate assurance that sufficient supervisory resources are devoted to examining the highest risks of the Enterprises.

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[11] OIG, *OIG's Compliance Review of FHFA's Implementation of Its Housing Finance Examiner Commission Program*, at 3-4 (COM-2015-001) (July 29, 2015) (online at www.fhfaoig.gov/Content/Files/COM-2015-001_1_0.pdf).

[12] OIG, *Evaluation of Whether FHFA Has Sufficient Capacity to Examine the GSEs* (Sept. 23, 2011) (EVL-2011-005) (online at www.fhfaoig.gov/Content/Files/EVL-2011-005.pdf); OIG, *Update on FHFA's Efforts to Strengthen its Capacity to Examine the Enterprises* (Dec. 19, 2013) (EVL-2014-002) (online at www.fhfaoig.gov/Content/Files/EVL-2014-002.pdf). *See also* FHFA, *Fiscal Year 2015 Federal Housing Finance Agency Performance and Accountability Report*, at 106 (Nov. 16, 2015) (Memorandum to Director Watt from Inspector General Wertheimer re: Fiscal Year 2016 Management and Performance Challenges) (online at www.fhfa.gov/AboutUs/Reports/ReportDocuments/FHFA-2015-PAR.pdf).

2. Many Supervisory Standards and Guidance Issued by FHFA and DER Lack the Rigor of Those Issued by Other Federal Financial Regulators

FHFA is part of a network of federal financial regulators that are responsible for ensuring the safety and soundness of the regulated entities under their authority.[13] Other federal financial regulators include, but are not limited to, the OCC, the Board of Governors of the Federal Reserve System (Federal Reserve), the Federal Deposit Insurance Corporation (FDIC), and the National Credit Union Administration (NCUA). Each of these agencies conducts examinations and issues guidance and requirements that govern examinations conducted under their authority and updates those materials from time to time to reflect adjustments in supervisory practices.[14]

FHFA consistently maintains, based on the language of its authorizing statute, that its supervisory authority over its regulated entities "is virtually identical to—and clearly modeled on—Federal bank regulators' supervision of banks." FHFA's statutory obligations for supervision are similar to the obligations imposed on the OCC, Federal Reserve, and FDIC and FHFA has argued in court that it is entitled to certain privileges afforded to federal banking regulators.[15] FHFA acknowledges that it considers the examination guidance and policies of other federal financial regulators when developing its own guidance and requirements.

We compared the requirements and guidance issued by FHFA and DER for four critical elements of DER's supervision program to the requirements and guidance adopted by other federal financial regulators for the same elements. We found that current requirements and guidance of FHFA and DER are more limited and far less prescriptive than those adopted by other federal financial regulators for these elements. We now summarize those findings.

Standards for Preparation of Risk Assessments

The purpose of a risk assessment is to present a comprehensive view of each Enterprise, identify areas of supervisory concern, serve as a platform for developing a supervisory

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[13] The FHFA Director and the heads of the banking regulators serve as voting members of the Financial Stability Oversight Council, which is charged with identifying risks to the financial stability of the U.S., promoting market discipline, and responding to emerging risks to the financial system.

[14] The OCC, Federal Reserve, FDIC, and NCUA are members of the Federal Financial Institutions Examination Council (FFIEC), a formal interagency body created by Congress in 1979 to establish uniform principles, standards, and report forms for the federal examination of financial institutions and to make recommendations to promote uniformity in the supervision of financial institutions.

[15] FHFA has successfully asserted the bank examination privilege, which historically is invoked by the OCC and Federal Reserve to shield from discovery materials relating to its supervision of the Enterprises. *See JPMorgan Chase & Co.*, 978 F. Supp.2d at 280.

strategy, and identify areas for targeted examinations and ongoing monitoring. According to FHFA's *Examination Manual*, risk assessments provide the critical foundation for developing annual supervisory plans for the entities it regulates. FHFA examiners are then able to leverage their resources by focusing their supervisory activities around the risks identified as posing the highest supervisory concerns in the risk assessments.

In an evaluation report entitled *Utility of FHFA's Semi-Annual Risk Assessments Would Be Enhanced Through Adoption of Clear Standards and Defined Measures of Risk Levels*, we compared the standards for risk assessments promulgated by FHFA and DER to those issued by the OCC, the Federal Reserve, and NCUA and found that FHFA's flexible guidance fell far short of the requirements and clear guidance provided by the other regulators.[16] We showed that FHFA's "loosely defined parameters lack standardized measures of risks," "do not define the risk measures that examiners must use," and "do not require examiners to use a common format and common, defined measures of risk," which resulted in a lack of consistency in defining significant risks and identifying supervisory concerns in risk assessments for an Enterprise over a period of years.[17]

In a subsequent audit, we demonstrated that the deficiencies in DER's risk assessments for the 2014 and 2015 supervisory cycles created weaknesses in DER's annual supervisory plans. We were unable to trace almost half of the targeted examinations planned for those two cycles to specific risks described in the underlying risk assessments. The then-current EIC for each Enterprise reported that these exams were planned based on information received outside of the risk assessments, but neither EIC updated the risk assessments with this information, as required by FHFA.[18]

Standards for Communicating Supervisory Findings to an Enterprise Board of Directors and Prompt Remediation of Matters Requiring Attention

Through supervisory activities, FHFA examiners may identify supervisory concerns or deficiencies at a regulated entity. FHFA categorizes these examination findings into one of three categories: (1) Matters Requiring Attention (MRAs), (2) Violations, or (3) Recommendations. According to FHFA, the examiners categorize only "the most serious supervisory matters" as MRAs. FHFA, along with the OCC and Federal Reserve, charge the

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[16] OIG, *Utility of FHFA's Semi-Annual Risk Assessments Would Be Enhanced Through Adoption of Clear Standards and Defined Measures of Risk Levels*, at 13, *supra* note 7.

[17] In response to two of our recommendations, DER revised its internal guidance governing risk assessments in May 2016. OIG is reviewing DER's updated guidance to determine if it satisfies our recommendations, and FHFA has stated its intent to assess the effectiveness of its new process in the first quarter of 2017.

[18] OIG, *FHFA's Supervisory Planning Process for the Enterprises: Roughly Half of FHFA's 2014 and 2015 High-Priority Planned Targeted Examinations Did Not Trace to Risk Assessments and Most High-Priority Planned Examinations Were Not Completed*, at 17, *supra* note 5.

board of directors of a regulated entity with responsibility for ensuring that management corrects supervisory deficiencies.

For that reason, we compared FHFA's requirements and guidance for communicating an MRA to an Enterprise board of directors against the requirements and specific guidance of the OCC and Federal Reserve. We found that FHFA's standards fall far short in the evaluation report *FHFA's Supervisory Standards for Communication of Serious Deficiencies to Enterprise Boards and for Board Oversight of Management's Remediation Efforts are Inadequate*. While the OCC and Federal Reserve direct that supervisory findings must be communicated to the board of a regulated entity, we found that FHFA had no standards requiring examiners to communicate supervisory findings to Enterprise directors. As a matter of practice, we determined that DER examiners provided supervisory findings solely to Enterprise management and relied on Enterprise management to communicate information about those findings to the Enterprise board.[19]

In that same evaluation, we compared requirements imposed by the OCC and Federal Reserve on the boards of directors of regulated entities to review or approve a written plan to correct MRA deficiencies and to oversee management's remediation of those deficiencies to FHFA's requirements. We learned that the OCC and the Federal Reserve require directors of regulated entities to review or approve management's remediation plan, while FHFA places sole responsibility on Enterprise management to develop and submit a remedial plan to FHFA without review by Enterprise directors. We found that the OCC and Federal Reserve task boards of directors of regulated entities with responsibilities to oversee management's efforts to implement the proposed remedial measures on an ongoing basis and ensure that management's remediation is adequate and timely; FHFA does not.[20] In our view, FHFA's determination to engage with Enterprise management—typically those who are responsible for the actions or inactions which led to the MRA—on MRAs and MRA remediation, and not provide clear supervisory expectations to the boards, creates a significant risk that an Enterprise board could become no more than a bystander to management's efforts to remediate MRAs. As a result, FHFA risks prolonged or inadequate resolution of the most serious threats to the Enterprises' safety and soundness.[21]

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[19] OIG, *FHFA's Supervisory Standards for Communication of Serious Deficiencies to Enterprise Boards and for Board Oversight of Management's Remediation Efforts are Inadequate*, at 12 (Mar. 31, 2016) (EVL-2016-005) (online at www.fhfaoig.gov/Content/Files/EVL-2016-005.pdf).

[20] *Id*. at 13-14.

[21] In response to our recommendations, DER revised its internal guidance to direct its examiners-in-charge to provide to the chairs of the Enterprises' board audit committees copies of FHFA's conclusion letters that communicate results from targeted exams, supervisory letters that convey MRAs resulting from ongoing monitoring activities, responses to Enterprise remediation plans, and remediation letters that close MRAs.

Standards for the Content of Its Annual Reports of Examination

Federal financial regulators, including FHFA, use the annual ROE to communicate supervisory findings and examination ratings to the board of directors of each entity they regulate because the board of directors is ultimately responsible for ensuring the safety and soundness of the entity and management's correction of deficiencies. In 1993, the OCC, Federal Reserve, and FDIC created the uniform common core ROE, a format developed collaboratively to provide a common template and to set a minimum standard for the information provided in an ROE, such as mandatory pages for overall conclusions and examiner comments, matters requiring the board's attention, standardized financial condition assessments, and discussion of each examination rating area.[22] The uniformity of ROEs across regulatory agencies is intended to reduce regulatory burdens and promote consistency. In a July 2016 evaluation entitled *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*,[23] we found that neither FHFA nor DER has issued internal guidance that mirrors the requirements of these other federal financial regulators.[24]

However, the Agency disagreed with our recommendation that DER share the Enterprises' MRA remediation plans and associated timetables with the audit committee chairs.

[22] The common core ROE has been augmented with agency-specific templates and detailed instructions for bank examiners, including the requirement to clearly communicate and prioritize supervisory concerns and deficiencies to the boards of regulated financial institutions. Examiners are also expected to include corrective actions and record the board's and management's commitments to remediation in the ROE.

[23] 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*, at 13, 19 (July 14, 2016) (EVL-2016-008) (online at www.fhfaoig.gov/Content/Files/EVL-2016-008.pdf).

[24] We also found that FHFA's current limited guidance on the preparation of an ROE is a significant departure from—and relaxation of—prior DER guidance. From 2008 through 2013, DER provided instruction on specific elements included in each ROE in its *Supervision Handbook 2.1*. This guidance directed that ROEs include an overall condition statement, a core report section, separate sections addressing each of the six components covered by the examination rating system in place at that time, and the identification of all MRAs. DER's *Supervision Handbook 2.1* was superseded by FHFA's *Examination Manual*, issued in December 2013, but the *Examination Manual* did not incorporate these instructions. FHFA's resulting wholesale lack of requirements for ROE content and structure was at odds with the requirements of other federal financial regulators.

In a response to one of our recommendations, FHFA issued internal guidance to require that all open MRAs be included in ROEs.

Standards for Examiner Supervision of Enterprise Remediation of Serious Supervisory Matters

Once an MRA issues and a written remediation plan to correct the underlying deficiency is put into place, federal financial regulators, including FHFA, expect that the regulated entity will take the specific steps set forth in the plan to address the deficiency. We compared requirements issued by the OCC and Federal Reserve for examiner follow-up on an entity's progress in implementing the corrective actions to FHFA's requirements and found FHFA's requirements provide greater discretion to the EICs. For example, the OCC requires its examiners on a quarterly basis to: monitor board and management progress in implementing corrective actions; verify and validate the effectiveness of corrective actions; and perform timely verification after receipt of documentation. FHFA, however, has no such requirement for quarterly oversight. While FHFA directs its examiners to engage in ongoing monitoring "to determine the status of the Enterprise's compliance with [ ] MRAs," we found that the intervals at which examiners must "check and document progress" are "determined by the [examiner-in-charge] and guided by the remediation plan," rather than by FHFA requirements and guidance.[25] See *FHFA's Examiners Did Not Meet Requirements and Guidance for Oversight of an Enterprise's Remediation of Serious Deficiencies*.

Standards for Cyber Risk Management by Regulated Entities

In addition to the four elements of supervision described above, we compared the supervisory guidance issued by FHFA in May 2013 on cyber risk management to the cyber security guidance issued by the Federal Financial Institutions Examination Council (FFIEC) and its federal regulatory members. We found that FHFA's guidance was far less prescriptive and far more flexible than the guidance adopted by FFIEC and its federal regulatory members, particularly in the areas of security controls implementation and risk assessments. See *FHFA Should Map Its Supervisory Standards for Cyber Risk Management to Appropriate Elements of the NIST Framework.*[26]

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[25] We also found that DER eliminated two requirements directed to examiner oversight of Enterprise remediation of MRAs. Prior to December 2013, DER required its examiners to submit written reports, on a quarterly basis, detailing their assessment of an Enterprise's remediation efforts of MRAs, and limited approval of requests for extensions of MRA remediation deadlines to the Deputy Director of DER, upon a showing by the Enterprise of a "convincing case for extending the due date." FHFA's *Examination Manual*, issued in December 2013, did not include these requirements and DER did not promulgate subsequent internal guidance to reinstate them. *See* OIG, *FHFA's Examiners Did Not Meet Requirements and Guidance for Oversight of an Enterprise's Remediation of Serious Deficiencies*, at 16-17 (Mar. 29, 2016) (EVL-2016-004) (online at www.fhfaoig.gov/Content/Files/EVL-2016-004.pdf).

[26] OIG, *FHFA Should Map Its Supervisory Standards for Cyber Risk Management to Appropriate Elements of the NIST Framework*, at 13-14 (Mar. 28, 2016) (EVL-2016-003) (online at www.fhfaoig.gov/Content/Files/EVL-2016-003.pdf).

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FHFA is one of the links in the chain formed by federal financial regulators to oversee the nation's financial system. FHFA's statutory supervisory obligations are similar to the obligations imposed on the OCC, Federal Reserve, and FDIC, and FHFA has been afforded the same privileges as federal banking regulators. We found, however, that FHFA's requirements and guidance are less prescriptive and more flexible than the other federal financial regulators for a number of elements of DER's supervision program and FHFA has offered no reason its requirements and guidance should be less robust than those of its peer regulators. FHFA has consistently rejected our recommendations to revise its requirements and guidance to align them with those adopted by other federal financial regulators.

3. The More Flexible and Less Prescriptive Nature of Many Requirements and Guidance Promulgated by FHFA and DER Has Resulted in Inconsistent Supervisory Practices

In our assessments of four elements of DER's supervisory program, we found that the more flexible and less prescriptive nature of requirements and guidance issued by FHFA and DER vests significant discretion in each EIC and examination team, and the exercise of this discretion has led to a lack of consistent supervisory practices across DER.

ROE Structure and Content

For the five supervisory cycles we reviewed, we found that FHFA's requirements and guidance regarding the structure and content of the ROE consisted of four sentences in its *Examination Manual*:

> The report of examination identifies supervisory concerns and contains examination ratings that reflect FHFA's view of the regulated entity's financial safety and soundness and risk management practices. . . . The FHFA issues an ROE, signed by the EIC [Examiner-in-Charge]. . . . The ROE communicates substantive examination conclusions, findings (when applicable), and the composite and component ratings. The ROE must also contain analysis that supports the conclusions, findings, and ratings.

FHFA's *Examination Manual* contains no standardized ROE template or set of instructions to guide the examiners' preparation of an ROE. Beyond Advisory Bulletin (AB) 2012-03, which announced FHFA's adoption of the CAMELSO system, FHFA had issued no additional guidance to examiners to explain the basis on which each component rating should be determined or the basis on which a composite rating should be assigned. DER issued an

internal procedures bulletin for the preparation of an ROE that simply restates the brief guidance, quoted above, from the *Examination Manual*.

As a consequence, we found that each EIC exercised substantial discretion over the content and structure of the ROE. We determined that the content of the 10 ROEs issued by DER to the Enterprises during the five supervisory cycles in our review varied by Enterprise and across the five cycles. These ROEs did not consistently identify or describe specific supervisory concerns about management practices or the root causes of those concerns. We also found inconsistent practices in identifying open MRAs in ROEs. The five ROEs issued to Freddie Mac during the review period contained a list of open MRAs, but three of the five ROEs issued to Fannie Mae during this period did not.[27] None of the seven ROEs that identified open MRAs tied each open MRA to deficient practices that gave rise to it, which constrained the directors' ability to exercise effective oversight.[28]

Communication of Annual Reports of Examination

When FHFA adopted its *Examination Manual* in December 2013, it rescinded then-existing requirements for communicating directly with a board of directors of a regulated entity about the ROE results, conclusions, and supervisory concerns. The sole requirement in the *Examination Manual* for ROEs is that DER "issue" an annual ROE, signed by the EIC, to the board of directors of each Enterprise, a requirement that FHFA has imposed since 2013. Even this lone requirement was not followed: for the three supervisory cycles conducted under the *Examination Manual*, we determined that DER's practice, in general, was to send by email the final ROE to Enterprise management and leave to each Enterprise's management the decision of whether and when to provide the final ROEs to the Enterprise board. The elimination of other guidance on communications with a board of directors of a regulated entity about the ROE results, conclusions, and supervisory concerns has acted to vest the EIC and the individual examination teams to determine:

- Whether to present orally the ROE results, conclusions, and supervisory concerns to an Enterprise board;
- Whether this presentation occurs before or after the final ROE is issued to an Enterprise board of directors; and

[27] Since the issuance of the 2016 ROEs for 2015 examination activities, DER has promulgated internal guidance instructing the two examination teams to list in the ROEs all MRAs that were open as of the end of the examination year or that were closed during the examination year. DER revised its guidance in response to an OIG recommendation, *supra* note 24.

[28] 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*, at 15-16, *supra* note 23.

- Who will participate in any presentation.

Our review of DER's practices for ROE issuance in 2014, 2015, and 2016 found divergent practices between the Fannie Mae and Freddie Mac examination teams, and within the same examination team, which affected the ability of an Enterprise board to prepare for any discussion at the presentation. For example, DER examiners did not finalize the Fannie Mae ROEs, or provide the board with presentation materials, in advance of their presentation to the Fannie Mae board in two of the three years. See *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*.[29]

Risk Assessments

During our review period, the source of instructions and guidance to DER examiners on risk assessments was FHFA's *Examination Manual*, as supplemented by FHFA's Supervision Directive (SD) SD 2013-02, *Periodic Risk Assessments*, and DER's Operating Procedures Bulletin (OPB) 2013-DER-OPB-03.1, *Supervisory Planning Process*. While FHFA acknowledges the critical importance of risk assessments in planning its supervisory activities, its guidance, set forth in its *Examination Manual*, is approximately three-quarters of one page. FHFA's *Examination Manual* provides no definition of each risk level or the elements inherent in each risk level. DER's efforts to supplement FHFA's guidance, 2013-DER-OPB-03, a three-page list of "risk category components and evaluative factors" and detailed guidance on risk category components and evaluative factors, was revised five weeks later to one-half page, in 2013-DER-OPB-03.1, which simply restates the guidance in the *Examination Manual*.

FHFA and DER provided no additional requirements or other guidance as to the content of risk assessments. Neither defined the risk types or minimum risk measures and vested discretion with each EIC to consider a number of factors. Because FHFA did not require that risk assessments be prepared using a common format or template with a specific set of risk measures to analyze risk, each EIC determined which measures to use in assessing risks and which format to use to present their conclusions. As a result, there have been significant variations in the content and format of DER's risk assessments and those variations limited the utility of these risk assessments in the development of risk-based supervisory plans and as

[29] 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*, at 15-16 (July 14, 2016) (EVL-2016-009) (online at www.fhfaoig.gov/Content/Files/EVL-2016-009.pdf).

a tool to compare and contrast risk exposures between the Enterprises.[30] Even though both Enterprises have virtually identical federal charters, substantially comparable business models, and similar risk profiles, and FHFA prepares side-by-side comparison analyses of the Enterprises in its published financial performance reports, our efforts to compare the Enterprises' respective risk exposures and quality of risk management and to evaluate the level of consistency between the risk assessments were unsuccessful.

Examiner Review and Approval of Enterprise Remediation Plans to Address MRAs and Review of Completed Remediation Efforts by an Enterprise

FHFA's AB 2012-01, *Categories for Examination Findings*, sets forth limited requirements for examiner oversight of Enterprise remediation of supervisory concerns. According to AB 2012-01, MRAs are the "most serious supervisory matters" and it directs that the remediation process must begin with "written remediation plans, prepared by the regulated entity" that set forth corrective action(s) that are acceptable to FHFA. DER, in its internal operating procedures bulletin 2013-DER-OPB-1, requires its examiners to review each proposed remediation plan and determine "whether the plan is sufficiently detailed and appropriate to resolve the MRA." Neither AB 2012-01 nor 2013-DER-OPB-1 sets forth the steps, if any, examiners must take to determine whether the proposed remediation plan is "sufficiently detailed and appropriate to resolve the MRA." In a July 2016 evaluation report entitled *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*, we found significant inconsistency within DER with respect to examiner review of written Enterprise remediation plans: of the 18 MRAs in our sample, DER examiners conducted and documented an independent assessment of the sufficiency of 12 proposed written remediation plans before approving them but did not do so for the remaining 6.[31]

FHFA has issued no guidance on the specific steps that examiners should take before closing an MRA. According to DER, the Enterprises' internal audit departments are responsible for validating the effectiveness and sustainability of the remedial actions taken by the Enterprises and DER examiners are responsible to confirm validation. We evaluated the basis for DER's closure of eight MRAs in our sample and found that DER examiners independently assessed the sufficiency of internal audit's validation of Enterprise remediation of the deficiency

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[30] OIG, *Utility of FHFA's Semi-Annual Risk Assessments Would Be Enhanced Through Adoption of Clear Standards and Defined Measures of Risk Levels*, at 3, 13, *supra* note 7. As noted above, DER issued new guidance on the preparation of risk assessments in response to our recommendations, *supra* note 17.

[31] 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 21 (July 14, 2016) (EVL-2016-007) (online at www.fhfaoig.gov/Content/Files/EVL-2016-007.pdf).

underlying the MRA for five of the eight and accepted the results of the internal audit validation work for the remaining three.

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The determination by FHFA and DER to refrain from adoption of defined requirements and comprehensive standards for these elements of DER's supervisory program leaves the execution of these elements to the discretion of the EICs and examiners. We found that exercise of discretion has resulted in a lack of consistency in supervisory practices for each of these elements of DER's supervisory program.

4. Where Clear Requirements and Guidance for Specific Elements of DER's Supervisory Program Exist, DER Examiners-in-Charge and Examiners Have Not Consistently Followed Them

While FHFA and DER largely have issued guidance that is more flexible and less prescriptive than other federal financial regulators for the same elements of the supervisory program, we identified five areas where FHFA and/or DER have mandated specific requirements. We found, however, that DER EICs and examiners have not consistently followed those directives.

Changes to Approved Supervisory Plans for Non Risk-Related Reasons in Contravention of DER Requirements

Because supervisory planning is a continuous process, supervisory plans may need to be adjusted during each year to address newly emerging risks that require attention during the current supervisory cycle. Beginning with the 2014 supervisory cycle, DER requires that approved supervisory plans shall only be adjusted for risk-related reasons, must be approved by the EIC, and be fully documented in the examination work papers. For Fannie Mae, we found that 64 targeted examination were planned by DER for the 2014 and 2015 cycles and only 24 were either completed or commenced but not completed as of June 17, 2016. The remaining 40 (63%) were either not conducted or their dispositions were not documented. The documentation produced by DER explained the change in status for 33 of the 40, but reflected risk-related reasons for the change in status for only 11.[32] For Freddie Mac, we found that 54 targeted examinations were planned for the 2014 and 2015 cycles and only 26 were either completed or commenced but not completed as of the end of our field work. The remaining 28 (52%) were either not conducted or their dispositions were not documented.

[32] OIG, *FHFA's Targeted Examinations of Fannie Mae: Less than Half of the Targeted Examinations Planned for 2012 through 2015 Were Completed and No Examinations Planned for 2015 Were Completed Before the Report of Examination Issued*, at 19-20, *supra* note 8.

The documentation produced by DER explained the change in status for 21 of the 28, but reflected risk-related reasons for the change in status for only 4.[33]

Lack of Complete Supervisory Documentation in DER's Official System of Records in Contravention of FHFA Requirements

According to its operating procedures, DER must ensure that its supervisory planning and execution is documented and incorporated into official agency records. The Information Management System (IMS) is DER's official system of record. Our efforts to track through IMS whether each planned targeted examination was commenced and completed were not successful because IMS did not contain sufficient information to permit us to complete the tracking exercise. Despite repeated requests, DER was unable to provide any documentation for the disposition of a significant number of planned targeted examinations during four supervisory cycles.

We concluded that IMS was not complete and that DER lacked documentation to account for all of its supervisory activities. We also found that DER had no operating controls in place to ensure that supervisory documentation in IMS was complete and to accurately track the status of planned targeted examinations through disposition.[34]

We consider the lack of DER's documentation supporting its supervisory activities to create a significant risk exposure.

Failure to Ensure Issuance of the Annual ROEs to Enterprise Directors and Obtain Written Affirmations from Enterprise Directors that Supervisory Concerns Will Be Remediated in Contravention of FHFA Requirements

Since December 2013, guidance issued by FHFA has required DER examiners to "issue" the ROE to the board of directors of each Enterprise. For the 2014 and 2015 supervisory cycles, we found that DER sent the final ROE *to Enterprise management* by email and left to

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[33] OIG, *FHFA's Targeted Examinations of Freddie Mac: Just Over Half of the Targeted Examinations Planned for 2012 through 2015 Were Completed*, at 19, *supra* note 8.

[34] OIG, *FHFA's Targeted Examinations of Fannie Mae: Less than Half of the Targeted Examinations Planned for 2012 through 2015 Were Completed and No Examinations Planned for 2015 Were Completed Before the Report of Examination Issued*, at 23-24, *supra* note 8, and OIG, *FHFA's Targeted Examinations of Freddie Mac: Just Over Half of the Targeted Examinations Planned for 2012 through 2015 Were Completed*, at 22, *supra* note 8.

Enterprise management the decision of whether and when to provide the final ROEs to the Enterprise boards.[35]

Since 2013, FHFA has required each Enterprise board to respond in writing to the ROE, acknowledge review of the ROE, and affirm that corrective action is being taken, or will be taken, to resolve supervisory concerns. DER has issued internal guidance to underscore this requirement. Our review of the ROEs for the 2013 and 2014 supervisory cycles found that the Enterprises' boards of directors had not complied with this requirement and DER examiners failed to enforce compliance with it.[36] We learned that one Enterprise board was not even *aware* of the requirement, leading us to conclude that DER examiners had not effectively communicated it to Enterprise directors.

Failure to Oversee Enterprise Remediation of Serious Supervisory Matters in Disregard of FHFA Requirements

As noted above, FHFA's AB 2012-01 prescribes the process that must be followed by FHFA examiners to oversee a regulated entity's efforts to correct the deficiencies underlying an MRA. We reviewed a sample of open and closed MRAs issued to each Enterprise and found that examiners did not, on a consistent basis, follow the requirements set forth in AB 2012-01 or the internal guidance issued by DER to supplement these requirements.[37] Our reviews found that DER examiners infrequently conducted and documented independent assessments of the Enterprises' remediation activities during the remediation period.[38]

DER officials reported to us that they do not expect examiners to assess or document the Enterprises' remedial efforts until management reports that the remediation is completed and the Enterprise's internal audit has validated the sufficiency of the corrective actions,

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[35] 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*, at 15-16, *supra* note 29.

[36] After we requested board response documentation from FHFA, DER sought a response from the audit committee of the Fannie Mae board of directors to the 2015 ROE, and the chair of the board provided a written response. With respect to Freddie Mac, DER did not request a response to the 2015 ROE. When we inquired with Freddie Mac about board responses to DER's ROEs, a lawyer in its Office of General Counsel responded, "FHFA does not require a response, acknowledgement, or receipt from the Board that it has received and reviewed the ROE." *See Id*. at 18.

[37] OIG, *FHFA's Examiners Did Not Meet Requirements and Guidance for Oversight of an Enterprise's Remediation of Serious Deficiencies*, at 23-24, *supra* note 25; 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 21, *supra* note 31.

[38] We also determined that the systems DER uses to track open MRAs have substantial weaknesses that limit DER's ability to monitor the Enterprises' remediation efforts.

notwithstanding the clear instructions in AB 2012-01. DER's unwritten practices, in contravention of FHFA requirements, create the significant risk that inadequate or untimely remediation will not be quickly identified, significant deficiencies will not be promptly corrected, and Enterprise management will not be held accountable for such shortcomings.[39]

Intermittent Efforts Over Almost Four Years to Develop a Quality Control Review Process Deprived FHFA of the Assurance of the Adequacy and Quality of DER's Supervisory Activities

DER is responsible for ensuring that the targeted examinations it conducts comply with FHFA standards and policies, including supervision directives. FHFA established an Office of Quality Assurance (OQA) and charged it with reviewing the examination work of DER and DBR. OQA issued its first quality assurance report of DER on October 7, 2011, and recommended, among other things, that DER establish a comprehensive quality control review process to "help ensure the adequacy of the examination reports." In September 2012, DER committed, in writing, that it would develop an internal quality control program by December 31, 2012.

On March 25, 2013, FHFA issued SD 2013-01, *Quality Control Program for Examinations Conducted by the Division of Bank Regulation and Division of Enterprise Regulation*, for all examinations. In the directive, FHFA announced that, as a matter of FHFA policy, it is "particularly important that final examination findings and conclusions are subject to a quality control review before a report of examination or supervisory correspondence is communicated to the regulated entity…." Pursuant to this newly adopted policy, SD 2013-01 required DER and DBR to establish a quality control review program to "assess examination findings, conclusions, ratings, supporting workpapers, and related documents" and required that the quality control reviews meet specific identified standards. While DER made intermittent efforts to develop a quality control review process to implement this FHFA directive, it had not developed and implemented such a process as of July 1, 2015.

After our work was completed on an evaluation to assess the existence and efficacy of DER's quality control process, DER officials reported to us that DER adopted quality control

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[39] In a special project report issued on Sept. 30, 2016, we found that DBR acknowledges that AB 2012-1 applies to its oversight of FHLBank remediation of MRA deficiencies, but its unwritten procedures and practices, as reported to us by DBR officials and as found in our sampling of examiner documentation for remediation of 9 MRAs, are inconsistent with AB 2012-01. For example, DBR, not the affected FHLBank, prepared remediation plans for MRAs and those plans did not include specific interim milestones for remediation activities. *See* OIG, *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*, at 10-11, 13-14, 16 (Sept. 30, 2016) (COM-2016-006) (online at www.fhfaoig.gov/Content/Files/COM-2016-006.pdf).

procedures on July 28, 2015. DER's implementation began nearly four years after OQA recommended that it establish such a process and more than two years after FHFA issued a supervision directive requiring one—despite the Agency representing in its public disclosures that it had done so already. See our evaluation report, *Intermittent Efforts Over Almost Four Years to Develop a Quality Control Review Process Deprived FHFA of Assurance of the Adequacy and Quality of Enterprise Examinations.*[40]

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Our assessments found that DER EICs and examiners, in contravention of requirements issued by FHFA and DER: revised supervisory plans without risk-related reasons; failed to create and maintain complete supervisory documentation in the official system of records; failed to ensure issuance of the annual ROEs to Enterprise directors and obtain written affirmations that supervisory concerns will be addressed; and did not consistently conduct and document independent assessments of the Enterprises' remediation activities during the period of ongoing remediation. Further, DER did not establish a comprehensive quality control review process for examinations over a four-year period, including two years in which the Division was required to do so by Agency directive. Taken together, these practices demonstrate a lack of commitment to follow established requirements.

CONCLUDING OBSERVATIONS

In our 2015 and 2016 Audit and Evaluation Plans, we identified FHFA's supervision of the Enterprises and the FHLBanks as an area that posed significant risk. Over the past 18 months, we have published 12 evaluation, audit, and compliance review reports in which we assessed different critical elements of DER's supervision program for the Enterprises. We identified shortcomings in each of these elements and recommended specific actions to FHFA to address those shortcomings and upgrade DER's supervisory program. Although FHFA asserted, in its management responses, that it was generally receptive toward our recommendations, it rejected a number of them and did not propose alternative corrective actions.

Given FHFA's disagreement with a number of our recommendations to address the shortcomings we identified, as well as its unwillingness to propose alternative corrective actions for most of them, it is our view that these elements of DER's supervisory program remain deficient. It remains to be seen whether the corrective actions that FHFA has agreed

[40] OIG, *Intermittent Efforts Over Almost Four Years to Develop a Quality Control Review Process Deprived FHFA of Assurance of the Adequacy and Quality of Enterprise Examinations*, at 13 (EVL-2015-007) (Sept. 30, 2015) (online at www.fhfaoig.gov/Content/Files/EVL-2015-007.pdf).

to take to address other shortcomings identified by us will, in fact, be implemented effectively.

Together, the Enterprises own or guarantee nearly $5 trillion in mortgages and are among the largest financial institutions in this country. Should either or both Enterprises sustain losses in the future, the U.S. Treasury—and the American taxpayers—will be on the hook for those losses. Pursuant to HERA, FHFA is charged with ensuring the safety and soundness of the Enterprises. Without prompt and robust Agency attention to address the shortcomings we have identified, we caution stakeholders that the safe and sound operation of the Enterprises cannot be assumed from FHFA's current supervisory program.

Other regulators have sought the assistance of independent third parties in assessing the effectiveness of their supervision programs. In 1997 and again in 2009, the Federal Reserve Bank of New York retained an outside independent expert to assess the effectiveness of its supervisory procedures and its internal processes to understand and foresee systemic problems and undertook internal initiatives to improve its practices and procedures. In 2013, the OCC asked a team of international regulators to provide an independent perspective on the OCC's approach to the supervision of large and midsize banks and thrifts and, based on that team's recommendations, the OCC reorganized its supervision programs and instituted practices designed to foster better communication and assessment of risks, among other things. FHFA has acknowledged that it considers the guidance and examination practices of its peer financial regulators when developing its own guidance and requirements. In view of FHFA's unwillingness to accept a number of OIG recommendations to address shortcomings in critical elements of DER's supervision program, it would be prudent for FHFA to follow the lead of the Federal Reserve of New York and the OCC and engage independent external experts to review different critical elements of DER's supervision program.

FHFA COMMENTS AND OIG RESPONSE.....

OIG provided FHFA an opportunity to respond to a draft of this report. On December 12, 2016, FHFA provided its management comments, which are reprinted in their entirety in the Appendix. FHFA stated that no further response to this report was warranted because the report relied on statements, conclusions, and recommendations from previously published reports, to which it had previously responded. We note, by way of clarification, that FHFA, in its response, overstated the rate of its acceptance of recommendations in these reports. According to FHFA, it previously agreed to accept and implement 83 percent of the recommended corrective actions in the 12 referenced reports. Our review of FHFA's prior responses found that FHFA accepted only 64 percent of OIG's recommended remedial measures, partially agreed with 17 percent, and rejected outright 19 percent.

APPENDIX: FHFA COMMENTS TO OIG REPORT.....

Federal Housing Finance Agency

MEMORANDUM

TO: Kyle D. Roberts, Deputy Inspector General for Evaluations
Marla A. Freedman, Deputy Inspector General for Audits
Richard Parker, Deputy Inspector General for Compliance and Special Projects

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

SUBJECT: Draft OIG Report: *Safe and Sound Operation of the Enterprises Cannot Be Assumed Because of Significant Shortcomings in FHFA's Supervision Program for the Enterprises*

DATE: December 12, 2016

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

The Report states that it is a compilation of 12 evaluation, audit, and compliance review reports published by the OIG over the past 18 months, covering time periods over the past five years. FHFA OIG delivered the Report to FHFA on December 2, 2016, without prior notice that the Report was being prepared, and requested a response from FHFA in six business days.

FHFA has previously agreed to corrective actions for 83 percent of the OIG recommendations in the 12 referenced reports. With respect to various previous recommendations, FHFA's management responses set forth the reasons for our disagreement with the recommendations or with many of the findings, conclusions, and descriptions of FHFA's supervision program provided in the reports. Please see our prior responses. As this Report is based on no new findings or facts, but relies on statements, conclusions and recommendations to which FHFA has previously responded, we believe no further response is warranted. We will, however, continue

to both pursue the corrective actions to which we previously agreed and consider additional ways to make our supervision program more effective and efficient.

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

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