

Federal Housing Finance Agency
Office of Inspector General



**FHFA's Examination Program for
the FHLBanks' Internal Audit
Functions Was Adequately Designed
and Executed**



AUD-2017-003

May 5, 2017

Executive Summary

Created by Congress in 2008, the Federal Housing Finance Agency is charged by the Housing and Economic Recovery Act of 2008 with oversight of the housing related government-sponsored enterprises: the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Home Loan Bank System (FHLBank System) (collectively, the regulated entities).

FHFA conducts its supervision of the FHLBank System through its Division of Federal Home Loan Bank Regulation (DBR). One component of DBR examinations of the FHLBank System is review of the internal audit function. According to the Institute of Internal Auditors (IIA), “internal auditing is an independent, objective assurance and consulting activity” that uses “a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.”

In this audit, we assessed whether DBR’s examination program for internal audit functions within the FHLBank System has been adequately designed, if examination activities were executed and documented, and if supervisory determinations were supported. For this audit, we reviewed the DBR examinations of the internal audit functions of the 11 Federal Home Loan Banks (FHLBanks) and the Office of Finance for two examination cycles (review period). For 8 of the 11 FHLBanks and the Office of Finance, we reviewed DBR’s workpapers related to the examination of the internal audit functions in 2015 and 2016. For the other 3 FHLBanks, the 2016 examination was still ongoing as of October 2016 so we reviewed the 2014 and 2015 examinations for those banks. In total, we reviewed 22 DBR examinations of internal audit functions of the FHLBanks and the Office of Finance.

We found that the DBR examination program for internal audit functions within the FHLBank System was adequately designed and executed in a manner that provided adequate examination coverage during the review period. With two exceptions, we found that examination documentation supported DBR’s supervisory determinations with regard to FHLBanks’ internal audit functions during the review period. We determined the two exceptions were non-systemic; accordingly, we make no recommendations in this report.

This report was prepared by Bob Taylor, Assistant Inspector General for Audits; James Lisle, Audit Director; Terese Blanchard, Auditor; April Ellison, Auditor; and Brian Maloney, Auditor. We appreciate the cooperation of FHFA staff, as well as the assistance of all those who contributed to the preparation of this report.



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

Marla A. Freedman /s/
Deputy Inspector General for Audits

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ABBREVIATIONS

| | |
|----------------|--|
| AB | Advisory Bulletin |
| DBR | Division of Federal Home Loan Bank Regulation |
| DER | Division of Enterprise Regulation |
| EIC | Examiner-in-Charge |
| Fannie Mae | Federal National Mortgage Association |
| FHLBank System | Federal Home Loan Bank System |
| FHFA or Agency | Federal Housing Finance Agency |
| FHLBank | Federal Home Loan Bank |
| Freddie Mac | Federal Home Loan Mortgage Corporation |
| IIA | Institute of Internal Auditors |
| IMS | Information Management System |
| OCA | Office of the Chief Accountant |
| OIG | Federal Housing Finance Agency Office of Inspector General |
| OPB | Operating Procedure Bulletin |
| PMOS | Prudential Management and Operations Standards |
| ROE | Report of Examination |

BACKGROUND

Created by Congress in 2008, FHFA has been given the statutory authority and responsibility to examine the FHLBank System, Fannie Mae, and Freddie Mac.

Federal Home Loan Bank System

The FHLBank System consists of the 11 FHLBanks and the Office of Finance. As of September 30, 2016, the FHLBank System had combined total assets of \$1.036 trillion with total consolidated obligations of approximately \$969 billion.

The FHLBanks are organized under the authority of the Federal Home Loan Bank Act of 1932, as amended. Their mission is to provide reliable liquidity to member institutions to support housing finance and community investment. Although federally chartered, the FHLBanks are cooperatives that are privately and wholly owned by their members and former members. Each FHLBank operates as a separate entity within a defined geographic region of the country, known as its district, with its own board of directors, management, and employees. As a condition of membership, each member must purchase and maintain capital stock. Membership in an FHLBank is voluntary and is generally limited to federally insured depository institutions, insurance companies, and eligible community development financial institutions. As of September 30, 2016, the total number of members was 7,150.

To accomplish their mission, the FHLBanks provide financial products and services to their members, which include advances. These advances provide a readily available, low-cost source of funds that assist and enhance a member's financing of: (1) housing, including single-family and multi-family housing serving consumers at all income levels; and (2) community lending. In addition, certain of the FHLBanks provide members and housing associates with liquidity through programs under which the FHLBank purchases mortgage loans originated by the members. Through its Affordable Housing Program, the FHLBanks provide assistance in the purchase, construction, or rehabilitation of homes designed for seniors, the disabled, homeless families, first-time homeowners, and others with limited resources or special needs. The Office of Finance serves as the fiscal agent of the FHLBanks and was established to facilitate the issuance and servicing of FHLBank debt, known as consolidated obligations, and to prepare the quarterly and annual combined financial reports of the FHLBanks.

The Role of Internal Audit in the FHLBanks

One component of an FHLBank's or the Office of Finance's risk management framework is the internal audit function. IIA defines internal auditing as "an independent, objective assurance and consulting activity designed to add value and improve the organization's operations. It helps an organization accomplish its objectives by bringing a systematic,

disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.” IIA has promulgated standards for the professional practice of internal auditing. In addition, IIA requires an external quality assessment at least once every five years to assess an entity’s internal audit function’s conformance with IIA standards.

FHFA’s Prudential Management and Operations Standards (PMOS),¹ which establish standards relating to the management and operations of its regulated entities, direct that the internal audit function of each regulated entity should be independent, adequately staffed, and should report to the Audit Committee of the Board of Directors of the regulated entity.² Standard 2 of the PMOS instructs, among other things, that the internal audit system of each regulated entity should adequately test and review internal control and information systems; conduct risk-based audits; and determine whether violations, findings, weaknesses and other issues reported by regulators, external auditors, and others have been promptly addressed.

FHFA’s Division of Federal Home Loan Bank Regulation

FHFA has delegated to DBR the duties to supervise the FHLBanks and the Office of Finance. DBR has adopted and implemented a risk-based supervision program consisting of both on-site annual examinations and off-site monitoring of the FHLBanks and the Office of Finance. Under the leadership of the Deputy Director of DBR, DBR has three teams focused on safety and soundness examinations. As of December 5, 2016, DBR had 110 employees, including 46 safety and soundness examiners, and 2 examination specialists who performed examination quality control functions. A third examination specialist performed examination quality control functions on a temporary basis for part of 2016. In addition, FHFA’s Office of the Chief Accountant (OCA) provides resources to DBR to perform examinations of internal audit functions and internal controls over financial reporting within the FHLBank System.

DBR’s Examination Process

On an annual basis, the Examiner-in Charge (EIC) for each FHLBank and the Office of Finance develops a supervisory strategy that identifies key areas of risk and addresses the timeframe and the focus of the supervision for the next examination cycle.³ In planning the next examination, pre-examination analysis memoranda are prepared to support the EIC’s decision to include or exclude risk areas from the examination scope. The memoranda also describe how examiners will evaluate and test the quality and

¹ FHFA Prudential Management and Operations Standards, 12 C.F.R. pt. 1236, Appendix to Part 1236 (2016).

² The Office of Finance is not a regulated entity as the term is defined in the Federal Housing Enterprises Financial Safety and Soundness Act as amended. Accordingly, the PMOS do not apply to the Office of Finance.

³ The supervisory strategy is prepared at the end of each annual examination and lays out the examination strategy for the next examination cycle.

effectiveness of the FHLBanks’ or the Office of Finance’s policies, procedures, and internal controls related to the areas to be examined.

FHFA’s *Examination Manual* provides guidance and policies to DBR teams performing examinations within the FHLBank System. Specifically, Part I of the *Examination Manual* provides a description of the examination program, sets forth the processes examiners are to follow when conducting examination activities at a regulated entity, and describes the work products examiners are to produce during those examinations.⁴ Part II of the *Examination Manual* includes a general description of individual supplemental examination modules. Of the 26 supplemental examination modules with detailed examination guidance on specific risk areas, one relates to internal and external audit.

Supplementing the *Examination Manual* is DBR Operating Procedure Bulletin (OPB) 2012-DBR-OPB-03, *Work Program Minimum Frequency*, as updated February 7, 2014, which establishes how often (annually, biennially, triennially), at a minimum, examiners are to complete the various work programs in FHFA’s *Examination Manual* that cover the scope of operations for an FHLBank or the Office of Finance. According to the OPB, “core” FHLBank activities, such as advances funding, oversight and governance, and information technology, have higher inherent risk and should be examined annually. Activities that “support” core activities are deemed to have a lower inherent risk and the associated work programs are to be completed biennially or triennially, at a minimum.

DBR officials reported to us that DBR considers internal audit a low risk function and emphasized that they do not rely on testing performed by the internal auditors to reduce the scope of their own examination testing. As directed in 2012-DBR-OPB-03, the Internal and External Audit examination module of the *Examination Manual* should be completed at least every other year, which is consistent with DBR’s view that internal audit is considered a low risk function.

FACTS AND ANALYSIS

Examination Guidance for DBR’s Examinations of the Internal Audit Functions within the FHLBank System Was Adequately Designed

In November 2013, FHFA issued the Internal and External Audit examination module to its *Examination Manual*, which includes guidance to examiners on assessing internal audit functions of an FHFA-regulated entity. To evaluate the sufficiency of this guidance, we compared the illustrative work steps included in the module as well as illustrative work steps separately developed by OCA to: (1) the standards promulgated by the IIA and

⁴ Pursuant to FHFA’s *Examination Manual*, DBR examiners post completed examination workpapers to FHFA’s electronic recordkeeping system, called its Information Management System (IMS).

(2) the sections of FHFA’s PMOS Standard 2 covering the independence and adequacy of internal audit systems.⁵ We found that the illustrative work steps taken together with background information contained within the Internal and External Audit examination module addressed the IIA standards, and the Standard 2 sections related to the independence and adequacy of internal audit systems.

We also compared FHFA’s Internal and External Audit examination module to a similar manual⁶ used by another Federal financial regulator, the Office of the Comptroller of the Currency (OCC), and interviewed OCC officials responsible for examinations of internal audit functions at national banks and federal savings associations. We found that FHFA’s approach to the examination of internal audit functions was consistent with OCC’s approach.⁷

DBR’s Examinations of Internal Audit Functions within the Federal Home Loan Bank System Provided Adequate Examination Coverage

As explained earlier, examiners must follow the processes set forth in FHFA’s *Examination Manual* to plan, execute, and document examinations of FHLBanks. As the work steps are executed, examiners must document analysis, findings, and conclusions in the applicable work program. The results of this work are carried forward to the conclusion memorandum for the applicable individual component ratings. The conclusion memorandum is required to document the analysis used to arrive at the recommended component rating. The overall results and ratings are then summarized and included in the report of examination (ROE) issued to the FHLBank’s or the Office of Finance’s board of directors.

We reviewed workpapers documenting the examinations of FHLBank and Office of Finance System internal audit functions conducted within our review period and

⁵ In 2011, prior to the issuance of the Internal and External Audit examination module, an OCA accountant developed a checklist of work steps to assist examiners conducting exams of internal audit at Fannie Mae and Freddie Mac. Because we found that some work programs used by OCA accountants and DBR examiners to examine the internal audit functions of the FHLBanks during the two examination cycles sourced work program steps from this checklist, rather than from the Internal and External Audit examination module, we included the work steps in the Internal and External Audit examination module and the OCA-developed checklist in our assessment.

⁶ OCC, *Comptroller’s Handbook* booklet “Internal and External Audits” (Dec. 2016) (online at <https://www.occ.gov/publications/publications-by-type/comptrollers-handbook/pub-ch-m-iea.pdf>) (accessed May 1, 2017).

⁷ During fieldwork for this audit, FHFA issued Advisory Bulletin (AB) 2016-05, Internal Audit Governance and Function, in October 2016, which rescinded and replaced three prior advisory bulletins on the internal audit function. AB 2016-05 presents comprehensive guidance and supervisory expectations of the regulated entities regarding (1) audit committee oversight of the internal audit function, (2) internal audit independence and objectivity, and (3) internal audit attributes and operations. OCA officials told us that the rescinded ABs on internal and external audit were out of date and not being used. OCA officials also told us that, in connection with the issuance of this new AB, they plan to revise the Internal and External Audit examination module within the next year.

determined that the examination frequency requirement in 2012-DBR-OPB-03 was followed. For nine of the FHLBanks and the Office of Finance during the two examination cycles that we reviewed, the internal audit function was examined during both cycles, exceeding the biennial examination requirement in the 2012-DBR-OPB-03. Our analysis also found:

- DBR issued 10 Matters Requiring Attention (MRAs) and 9 Recommendations related to internal audit functions at 8 FHLBanks and the Office of Finance over the course of the examination cycles that we reviewed.⁸ These examination findings communicated concerns related to issues such as management of the internal audit function, internal audit planning and scoping of engagements, and the quality of the internal audit function’s audit committee reporting.
- Supervisory strategies were documented and internal audit pre-examination analysis memoranda were prepared for each of the 24 examinations included in our review period. The planned work program steps detailed in these pre-examination analysis memoranda addressed internal audit risk factors identified in the supervisory strategies. We noted that, for two of the examinations, internal audit work was “scoped out” (not performed), as allowed by 2012-DBR-OPB-03.
- Work programs were prepared and executed for 21 of the 22 internal audit examinations conducted during our review period. We found that the internal audit work programs for the FHLBanks and Office of Finance examinations, taken as a whole over the course of the two examinations in our review period, provided coverage of key aspects of internal audit as required by IIA standards and PMOS Standard 2. The one exception was the 2015 examination for the FHLBank of Chicago for which the internal audit examination work program was not completed before the ROE issued. The responsible OCA accountant unexpectedly had to take extended leave during the examination and did not upload a completed work program into IMS.
- The results of testing documented in the internal audit work programs supported the supervisory determinations included in the conclusion memorandum for the management component and ROE for 20 of 22 internal audit examinations conducted. For one examination (the 2015 examination of the FHLBank of Chicago discussed above), the supervisory determinations in the conclusion memorandum for the management component could not be validated because the work program was not completed before the ROE issued.

⁸ FHFA uses three categories of examination findings: (1) MRAs, (2) Violations, and (3) Recommendations. MRAs are the most serious supervisory matters. For a complete description of each category of examination findings, see OIG, *FHFA’s Failure to Consistently Identify Specific Deficiencies and Their Root Causes in Its Reports of Examination Constrains the Ability of the Enterprise Boards to Exercise Effective Oversight of Management’s Remediation of Supervisory Concerns* at 9 (Jul. 14, 2016) (EVL-2016-008) (online at www.fhfa.ig.gov/Content/Files/EVL-2016-008.pdf) (accessed May 1, 2017).

For the other examination, the 2015 examination of the Office of Finance, we found that a conclusion memorandum for the management component had not been prepared. The EIC for this examination reported to us that examiners had not followed DBR policy because the Office of Finance is only rated on two of the seven CAMELSO⁹ components – Management and Operational Risk – and that the final component ratings were determined by collaborative discussions among the examination team. This ad hoc, undocumented practice is contrary to the Office of Finance examination module in FHFA’s *Examination Manual*, which requires that the conclusions for all examination work performed be documented in a memorandum that “include[s] recommended component ratings for Management and Operational Risk[.]” We discussed the lack of a conclusion memorandum with a DBR official, who acknowledged that one should have been prepared. We found that a conclusion memorandum for the management component was completed for the 2016 examination of the Office of Finance, which was led by a different EIC.

CONCLUSION.....

We found that the DBR examination program for internal audit functions within the FHLBank System was adequately designed and executed in a manner that provided adequate examination coverage during the review period. With two exceptions, we found that examination documentation supported DBR’s supervisory determinations with respect to the FHLBank’s internal audit functions during the review period.

For one exception, we noted that the missing internal audit work program in the 2015 examination of the FHLBank of Chicago was attributable to an unusual circumstance: the OCA accountant unexpectedly needed to take extended leave. For the other exception, while the examiners did not prepare a conclusion memorandum for the management component in the 2015 Office of Finance examination, the examiners did prepare a conclusion memorandum in the 2016 examination for that office.

We considered these two documentation exceptions to be non-systemic. Accordingly, while we emphasize the importance of compliance with documentation requirements defined in FHFA’s *Examination Manual*, we make no recommendations in this report.

⁹ CAMELSO is a risk-focused rating system under which each FHLBank and the Office of Finance is assigned a composite rating based on an evaluation of various aspects of its operations. The individual components are Capital; Asset Quality; Management; Earnings; Liquidity; Sensitivity to Market Risk; and Operational Risk.

FHFA COMMENTS AND OIG RESPONSE.....

OIG provided FHFA an opportunity to respond to a draft report for this audit. In its management response, which is included as an appendix to this report, FHFA stated that they will continue to emphasize the importance of complete exam and adherence to FHFA documentation standards. FHFA also provided technical comments that we incorporated into the report, as appropriate.

OBJECTIVE, SCOPE, AND METHODOLOGY

We conducted this audit to determine whether FHFA’s DBR examination program for internal audit functions within the FHLBank System is adequately designed, executed, and sufficient to document examination activities and support supervisory determinations.

To accomplish our objective, we reviewed FHFA’s Internal and External Audit examination module (November 2013) contained within FHFA’s *Examination Manual* and examination documentation supporting DBR’s examinations of internal audit functions within the FHLBank System. Our review period covered DBR examinations of the FHLBanks’ and the Office of Finance’s internal audit functions for two examination cycles. For nine of these entities (8 FHLBanks and the Office of Finance), we reviewed DBR’s workpapers related to the examination of the internal audit functions in 2015 and 2016. For three entities (3 FHLBanks), the 2016 examination was still ongoing as of October 2016 so we reviewed the 2014 and 2015 examinations for those entities.

Specifically, we performed the following.

- Interviewed DBR and OCA management, EICs, examiners, and OCA accountants to gain an understanding of the examination approach used to evaluate internal audit functions within the FHLBank System.
- Reviewed FHFA’s *Examination Manual* and Internal and External Audit examination module. We evaluated the illustrative work steps contained within the Internal and External Audit examination module to determine if they provided coverage of the broad categories of IIA’s Internal Auditing Standards and FHFA’s PMOS – Standard 2 (12 C.F.R. Part 1236, Appendix).
- Compared the examination approach and work steps contained in FHFA’s Internal and External Audit examination module to those used by another Federal financial regulator, OCC. In this regard, we reviewed the *Comptroller’s Handbook* booklet “Internal and External Audits” (December 2016) and interviewed OCC officials responsible for examination of internal audit functions at national banks and federal savings associations.
- Reviewed the FHLBanks’ and the Office of Finance’s 2015 annual financial statements to identify factors in each entity that may impact the risks faced by the entity’s internal audit function.
- Reviewed workpapers for the 11 FHLBanks and Office of Finance for examinations within our review period to determine whether:
 - DBR complied with the internal audit examination frequency requirements defined in 2012-DBR-OPB-03;

- DBR's internal audit examination scopes were consistent with those planned in DBR's (1) prior year supervisory strategy and (2) internal audit pre-examination analysis memo;
 - Work steps contained in DBR's internal audit work programs provided adequate coverage of the FHLBank System's internal audit functions;
 - Results/conclusions documented in DBR's internal audit work program traced to (1) the findings memo(s) (if applicable), (2) the management conclusion memo, and (3) the ROE; and
 - DBR's supervisory strategy for the subsequent year was informed by the current examination's results and conclusions.
- Interviewed DBR's quality control review team and reviewed the results of reviews of internal audit examination workpapers completed within our review period.

We conducted this performance audit between October 2016 and May 2017 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for the findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

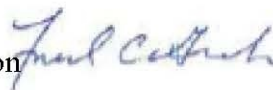
APPENDIX: FHFA COMMENTS TO OIG REPORT



Federal Housing Finance Agency

MEMORANDUM

TO: Marla A. Freedman, Deputy Inspector General for Audits

FROM: Fred Graham, Deputy Director, Division of FHLBank Regulation 

SUBJECT: OIG Audit Report *FHFA's Examination Program for the FHLBanks' Internal Audit Functions Was Adequately Designed and Executed*

DATE: April 28, 2017

Thank you for the opportunity to respond to the Office of Inspector General report titled *FHFA's Examination Program for the FHLBanks' Internal Audit Functions Was Adequately Designed and Executed*. The report assessed our examination program for internal audit at the FHLBanks, primarily for 2015 and 2016 examinations. The assessment included whether our program was adequately designed, whether our examination activities were executed and documented, and whether our supervisory determinations were supported.

Notwithstanding two exceptions identified by OIG, the report concludes our program provided adequate coverage in these areas. We will continue to emphasize the importance of complete exam documentation and adherence to FHFA documentation standards.

We appreciate the work and professionalism of the OIG Audit staff who worked with FHFA during this engagement. Please feel free to contact me with any questions or concerns.

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