AUDIT AND EVALUATION PLAN

February 2016

OVERVIEW

The Federal Housing Finance Agency (FHFA or Agency) Office of Inspector General (OIG) is pleased to present this Audit and Evaluation Plan for calendar year 2016. The plan describes FHFA's and OIG's roles and missions, explains our risk-based methodology for developing this plan, provides insight into particular risks within four areas, and generally discusses areas where we will focus our audit and evaluation resources during the 2016 calendar year.

BACKGROUND

Federal Housing Finance Agency

On July 30, 2008, FHFA was established by the Housing and Economic Recovery Act of 2008 (HERA).[1] Specifically, HERA abolished two existing Federal agencies, the Office of Federal Housing Enterprise Oversight and the Federal Housing Finance Board, and in their place created FHFA to regulate the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac) (together, the Enterprises), the Federal Home Loan Banks (FHLBanks), and the FHLBanks' fiscal agent, the Office of Finance (collectively, the regulated entities).[2] FHFA's mission is to "[e]nsure the regulated entities operate in a safe and sound manner so that they serve as a reliable source of liquidity and funding for housing finance and community investment."[3]

Since September 2008, FHFA also has been the conservator of the Enterprises. FHFA placed the Enterprises into conservatorships "in response to a substantial deterioration in the housing markets that severely damaged Fannie Mae and Freddie Mac's financial condition and left them unable to fulfill their mission without government intervention."[4] When then-Secretary of Treasury Henry Paulson announced the conservatorships in September 2008, he explained that the conservatorships were meant to be a "'time out' where we have stabilized the … [Enterprises, during which the] new Congress and the next Administration must decide what role government in general, and these entities in particular, should play in the housing market."[5] The current FHFA Director has echoed that view in recognizing that conservatorship "cannot and

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[1] Public Law No. 110-289.

[2] The Enterprises purchase mortgages from lenders and either package them into mortgage-backed securities that are sold to investors or hold them in their portfolios. By doing so, the Enterprises' actions promote liquidity in the housing finance system. The FHLBanks make secured loans known as advances to their members, such as banks or thrifts. Their members can use the advance proceeds to originate mortgages or support affordable housing or community development.

[3] FHFA, *FHFA Strategic Plan: Fiscal Years 2015–2019* (Nov. 21, 2014).

[4] FHFA, History of Fannie Mae & Freddie Mac Conservatorships (online at www.fhfa.gov/Conservatorship/Pages/History-of-Fannie-Mae--Freddie-Conservatorships.aspx).

[5] U.S. Department of the Treasury, Statement by Secretary Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers (Sept 7, 2008).

should not be a permanent state" for the Enterprises. However, putting the Enterprises into conservatorships has proven to be far easier than ending them, and the "time out" period for the conservatorships is now in its eighth year.

FHFA has administered two conservatorships of unprecedented scope and undeterminable duration over two entities that dominate the secondary mortgage market and the mortgage securitization sector in the United States and thus affect the entire mortgage finance industry. While in conservatorship, the Enterprises have required $187.5 billion in financial investment from the U.S. Treasury to avert their insolvency and, through December 2015, the Enterprises have paid to the Treasury approximately $241 billion in dividends on its investment. Despite their high leverage, lack of capital, conservatorship status, and uncertain future, the Enterprises have grown in size during conservatorship and, according to FHFA, their combined market share of newly issued mortgage backed securities is approximately 70%. The Enterprises' combined total assets are approximately $5.2 trillion and their combined debt exceeds $5 trillion.

The lack of consensus in Congress about the nation's future mortgage finance system and the role, if any, for the Enterprises may mean that the Enterprises will continue to operate under FHFA's conservatorship for a considerably longer period. Although market conditions have improved and the Enterprises have returned to profitability, their ability to sustain profitability in the future cannot be assured for a number of reasons: the winding down of their retained investment portfolios and reduction in net interest income; the level of guarantee fees they will be able to charge and keep; the future performance of their business segments; the elimination by 2018 of a capital cushion to buffer against losses; and the significant uncertainties involving key market drivers, such as mortgage rates, homes prices, and credit standards.

FHFA Office of Inspector General

HERA also established OIG with a mission to promote the economy, efficiency, and effectiveness of FHFA's programs, and protect it and its regulated entities against fraud, waste, and abuse.[6]

Our Vision

Our vision is to be an organization that promotes excellence and trust through exceptional service to FHFA, Congress, the stakeholders, and the American people.

OIG achieves this vision by being a first-rate independent oversight organization in the federal government that acts as a catalyst for effective management, accountability, and positive change in FHFA and brings enforcement actions against those, whether inside or outside of the federal

[6] Section 1105 of HERA amended the Inspector General Act of 1978, Public Law No. 95-452, to establish OIG.

government, who waste, steal, or abuse government funds in connection with the Agency, the Enterprises, or any of the FHLBanks.

Our Mission

OIG promotes economy, efficiency, and effectiveness and protects FHFA and the entities it regulates against fraud, waste, and abuse, contributing to the liquidity and stability of the nation's housing finance system. We accomplish this mission by:

- Providing independent, relevant, timely, and transparent oversight of the Agency in order to promote accountability, integrity, economy, and efficiency;
- Advising FHFA's Director, Congress, and the American people through audits, evaluations, compliance reports, and investigations; and
- Engaging in robust law enforcement efforts to detect and prevent fraud.

OIG Organization

OIG consists of the Inspector General, her senior staff, and eight offices. The Office of Audits, Office of Evaluations, Office of Investigations, and the Office of Compliance and Special Projects principally carry out OIG's substantive mission of promoting economy, efficiency, and effectiveness, and protecting against fraud, waste, and abuse. This Audit and Evaluation Plan most directly impacts the mission accomplishment of the Offices of Audits and Evaluations.[7] Additionally, OIG's Executive Office, which includes the Office of Chief Counsel, the Office of External Affairs, the Office of Communications, and the Equal Employment Opportunity Program Office, provides organization-wide supervision; and the Office of Risk Analysis, the Office of Administration, and the Office of Internal Controls and Facilities provide organization-wide support.

OIG Office of Audits

The Office of Audits is tasked with designing and conducting independent performance audits with respect to the Agency's programs and operations. It also undertakes projects to address statutory requirements and stakeholder requests. Through its performance audits and other projects, the Office of Audits seeks to promote economy, efficiency, and effectiveness in the administration of FHFA's programs; detect and deter fraud, waste, and abuse in its activities and operations; and ensure compliance with applicable laws and regulations.

[7] OIG does not publicly disclose our investigative plan due to the sensitive nature of investigations. The Office of Compliance and Special Projects' primary function is to follow up on the Agency's completion of management decisions arising from recommendations of OIG's audits and evaluations.

The Inspector General Act of 1978 (IG Act)[8] requires inspectors general to comply with the Government Accountability Office's *Government Auditing Standards* (Yellow Book). The Office of Audits performs its audits in accordance with the Yellow Book.

OIG Office of Evaluations

The Office of Evaluations reviews and analyzes FHFA's programmatic and operational activities, provides independent and objective reports to the Agency, and makes recommendations for improvement where applicable. The Inspector General Reform Act of 2008[9] requires inspectors general to adhere to the *Quality Standards for Inspection and Evaluation* (Blue Book), which was issued by the Council of the Inspectors General on Integrity and Efficiency. The Office of Evaluations performs its reviews and analyses in accordance with the Blue Book.

PLANNING

In order to meet the requirements of the IG Act, the Yellow Book, and the Blue Book, we have established an ongoing and dynamic planning process, which includes two types of periodic deliverables: strategic plans that seek to further FHFA's strategic goals for its programs (e.g., conservatorship, supervision, liquidity and access, etc.); and tactical audit and evaluation plans that flow from the strategic plans and focus on particular areas of greatest risk to FHFA and the entities it regulates within FHFA's larger program structure.

Strategic Plan

In February 2014, OIG issued *Strategic Plan: Fiscal Years 2015–2017*. The plan includes four high-level goals that serve as a blueprint for our oversight of FHFA. The goals are:

- Strategic Goal 1—Promote FHFA's Effective Oversight of the Safety and Soundness and Housing Missions of the entities it regulates.
- Strategic Goal 2—Promote FHFA's Effective Management and Conservatorship of the Enterprises.
- Strategic Goal 3—Promote Effective FHFA Internal Operations.
- Strategic Goal 4—Promote Effective OIG Internal Operations.

[8] Public Law No. 95-452.

[9] Public Law No. 110-409.

The Strategic Plan is available at www.fhfaoig.gov/Reports/StrategicPlan. OIG will continue to monitor events potentially impacting FHFA and housing finance, and make changes to the plan as circumstances warrant.

Audit and Evaluation Plan

OIG's Audit and Evaluation Plans[10] focus and implement the Strategic Plan's multi-year goals for a one-year or shorter period. We have identified four areas of significant risk facing FHFA, based on ongoing OIG work, OIG published reports, other publicly available information, and OIG's general knowledge of FHFA's operations and the external environment; discussions with FHFA and officials of the regulated entities, the public, Congress, and other government officials; reviews of relevant reports and documents prepared by FHFA and external parties; risk assessments performed in key areas related to FHFA's mission; and matters referred to OIG through its Hotline. For calendar year 2016, OIG will focus on four areas of risk:

- Conservatorship operations,
- Supervision of the regulated entities,
- Counterparties and third parties, and
- Information technology (IT) security.

Both FHFA and OIG have previously acknowledged the difficulties resulting from the ongoing uncertainty regarding the future role of the Enterprises in the housing finance system. In identifying and assessing these four serious management and performance challenges facing FHFA, OIG remains mindful of this uncertainty and recognizes that such ongoing uncertainty adds additional difficulties for FHFA as it seeks to address these challenges.

Conservatorship Operations

As conservator of the Enterprises since September 2008, FHFA has expansive authority to oversee and direct operations of two large, complex companies that dominate the secondary mortgage market and the mortgage securitization sector of the U.S. housing finance industry. Under HERA, FHFA possesses all rights and powers of any stockholder, officer, or director of the Enterprises; it may operate the Enterprises and conduct all of the Enterprises' business activities; it may take actions necessary to put the Enterprises in a sound and solvent condition;

[10] These plans are fluid; they are neither final nor all-inclusive. They do not include, for example, audits or evaluations that OIG may undertake pursuant to intervening requests from FHFA, Congress, and other stakeholders, or situations to which OIG's attention may be drawn as a result of our ongoing activities. They also do not include several statutorily required inquiries—such as the annual Federal Information Security Management Act security assessment (see 44 U.S.C. §§ 3535, 3545) and the improper payments audit (see 31 U.S.C. § 3321 note)—that OIG will conduct.

and it may take actions appropriate to carry on the Enterprises' business and preserve and conserve the Enterprises' assets and property.

As conservator of the Enterprises, FHFA exercises control over trillions of dollars in assets and billions of dollars in revenue, and makes business and policy decisions that influence and impact the entire mortgage finance industry. For reasons of efficiency, concordant goals with the Enterprises, and operational savings, FHFA has determined to delegate revocable authority for general corporate governance and day-to-day matters to the Enterprises' boards of directors and executive management. The Enterprises recognize that FHFA, as conservator, has succeeded to all rights, titles, powers, and privileges of the Enterprises and of any shareholder, officer, or director of the Enterprises, and that the directors of the Enterprises owe fiduciary duties only to FHFA. Under HERA, the Agency's actions as conservator are not subject to judicial review or intervention, nor are they subject to procedural safeguards that are ordinarily applicable to regulatory activities such as rulemaking.

Given the taxpayers' enormous investment in the Enterprises, the unknown duration of the conservatorships, the Enterprises' critical role in the secondary mortgage market, their unknown ability to sustain future profitability, and the unreviewability of FHFA's decisions by a court of law, OIG has determined that FHFA's administration of the conservatorships continues to be a critical risk.

Oversight of Delegated Matters

As conservator of the Enterprises, FHFA owes duties to the U.S. taxpayers, the largest shareholders in the Enterprises, and must ensure that the Enterprises achieve their statutory purpose. Pursuant to its powers under HERA to take actions "necessary to put [Fannie Mae and Freddie Mac] in a sound and solvent condition" and "appropriate to carry on the business of [Fannie Mae and Freddie Mac]" and "preserve and conserve" their assets, FHFA has delegated revocable authority for many matters, both large and small, to the Enterprises and, since 2008, has issued more than 231 conservatorship directives in which it instructs the Enterprises to take certain actions, most of which relate to delegated responsibilities.

FHFA Director Watt recently explained that, "[u]nder conservatorship, the Enterprises continue to operate as business corporations with boards of directors subject to corporate governance standards. The Enterprise boards are responsible – like boards of directors at other companies – for overseeing their business activities. They review budgets and set risk limits. They examine business plans and oversee senior management."[11] As conservator, FHFA is ultimately responsible for all decisions made and actions taken by the Enterprises.

Historically, FHFA's oversight of delegated matters, in its role as conservator, has largely been limited to attendance at Enterprise internal management and board meetings as observers and

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[11] FHFA, Prepared Remarks of Melvin L. Watt, Director of FHFA, at the Bipartisan Policy Center (Feb. 18, 2016).

discussions with Enterprise managers and directors. For the most part, FHFA, as conservator, has not assessed the reasonableness of Enterprise actions pursuant to delegated authority, including actions taken by the Enterprises to implement conservatorship directives. Recently, Director Watt reported that one element of FHFA's conservatorship model "is oversight and monitoring of Enterprise activities, and this is something that happens on an on-going basis – it's probably not an overstatement to say this takes place constantly. In addition to attending meetings of the management committees, FHFA staff members engage in regular dialogue with the management and operational teams at the Enterprises, regularly review information submitted by the Enterprises, and take action where appropriate."[12] In the coming year, we intend to look at a range of governance issues relating to FHFA's delegation of matters to the Enterprises, including its expectations of Enterprise directors for delegated matters and its assessments of actions of Enterprise directors for delegated matters, pursuant to its previously adopted standards.

Non-Delegated Matters

FHFA has retained authority to decide specific issues and can, at any time, revoke previously delegated authority. While FHFA has reported to OIG that it has made a number of enhancements to existing internal processes to improve the information flow to the FHFA Director, it has acknowledged, in response to a recent report from OIG, that additional improvements are warranted and have been put into place. In the next year, we intend to review the Agency's decision-making practices and processes to decide non-delegated matters.

Our efforts should assist FHFA in improving the effective management of the conservatorships.

Supervision

As noted earlier, FHFA plays a unique role, as both conservator and regulator for the Enterprises, and as regulator for the 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 is responsible for supervision of the FHLBanks and the Division of Enterprise Regulation is responsible for supervision of the Enterprises. FHFA's supervisory activities include designing a comprehensive, risk-based supervisory strategy (examination planning), conducting on-site examinations (examination execution), and monitoring remediation of deficiencies identified during examinations (oversight). FHFA has repeatedly stated that effective supervision of the FHLBanks and the Enterprises is critical to ensuring their safety and soundness, and we have determined that FHFA's administration of its supervision responsibilities continues to be a critical risk.

FHFA consistently maintains that its supervisory authority over its regulated entities "is virtually identical to – and clearly modeled on – Federal bank regulators' supervision of banks." According to FHFA, "Congress virtually duplicated the examination regime applicable to banks

[12] FHFA, Prepared Remarks of Melvin L. Watt, Director of FHFA, at the Bipartisan Policy Center (Feb. 18, 2016).

when it designed the examination regime" for the Enterprises and FHLBanks. FHFA must conduct annual examinations of the financial condition of the Enterprises and FHLBanks; the FHFA Director has substantially the same authority as the bank regulators; and FHFA examiners have the same authority as examiners employed by the Federal Reserve Banks.

Like the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board of Governors (FRB), and the Federal Deposit Insurance Corporation (FDIC), FHFA conducts safety and soundness examinations of its regulated entities, reports on the findings and conclusions of those examinations in annual reports of examinations, and, when necessary, issues findings identifying deficiencies. FHFA's governing statute, the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (as amended), grants the FHFA Director authority to use examiners from the OCC, FRB, or the FDIC to conduct FHFA's examinations and requires the Director to set compensation levels for FHFA staff that are comparable with other federal financial regulators.[13] A federal court acknowledged that Congress granted FHFA the exact same powers as bank regulators and observed that Congress intended FHFA's regulatory framework to mirror the banking regulatory framework.

In the next year, OIG intends to compare critical elements of FHFA's supervision program to the same elements used in the OCC and FRB supervision programs. We plan to assess whether FHFA's risk assessment and examination planning is carried through examination execution. We shall review whether FHFA examiners regularly follow FHFA standards and guidance in conducting examinations of the regulated entities and whether FHFA reports of examination adhere to established FHFA requirements.

As FHFA Director Watt recently observed, FHFA has been placed in an unprecedented role as conservator and regulator and, when it engages in supervisory activities, it does so "with a deliberate distance between FHFA and the Enterprises."[14] In our work for the coming year, we plan to assess how this "deliberate distance" has been created and is managed within FHFA.

Our efforts are intended to assist FHFA in determining whether its overall performance during recent examination cycles fulfilled its statutory duties and responsibilities and whether enhancements to existing requirements, standards, and guidance are warranted.

Counterparties and Third Parties

The Enterprises rely heavily on counterparties and third parties for a wide array of professional services, including mortgage origination and servicing. That reliance exposes the Enterprises to counterparty risk—that the counterparty will not meet its contractual obligations. FHFA has

[13] 12 U.S.C. §§ 4515(b), 4517(c).

[14] FHFA, Prepared Remarks of Melvin L. Watt, Director of FHFA, at the Bipartisan Policy Center (Feb. 18, 2016).

delegated to the Enterprises the management of their relationships with counterparties and reviews that management largely through its regulatory responsibilities.

There are numerous counterparty relationships with the Enterprises and each carries risk. One of the most significant counterparty risks is the risk posed by loan originators and servicers that are not depository institutions (also called non-banks). As participants in the mortgage market change, counterparties can affect the risks to be managed by Fannie Mae and Freddie Mac. In recent years, the Enterprises' businesses have changed dramatically in terms of the types of institutions originating and selling mortgages to them. Both Enterprises report that the share of Enterprise single-family loan purchases from depository institutions has fallen while the share of purchases from non-banks has risen. Based on OIG analysis of Enterprise data, from 2010 to 2014, Fannie Mae's share of purchases of single-family loans from non-depository institutions increased from 17% to 49% ($187 billion), while Freddie Mac's share increased from 10% to 38% ($97 billion).

Non-banks are not regulated by federal financial regulatory agencies and may not have the same financial strength, liquidity, or operational capacity needed to meet their obligations to the Enterprises as depository institutions. As a result, there is a risk that a non-bank seller that failed to honor its contractual obligations, such as by selling to an Enterprise loans that did not comply with the Enterprise's lending requirements, would not have sufficient capital or liquidity to honor repurchase demands by the Enterprises for non-compliant loans.

In light of the financial, governance, and reputational risks stemming from counterparties and third parties, OIG intends, in the coming year, to examine the guidance provided by FHFA to the Enterprises on this matter and how it oversees compliance with that guidance; review various facets of key controls in place to manage counterparty and third party risk; and assess FHFA's oversight of the Enterprises' management of risks related to counterparties.

This effort should help FHFA determine whether it and the Enterprises have sufficiently mitigated the risks posed by their counterparties.

Information Technology Security

With over 67,000 cyber incidents reported to US-CERT in fiscal year 2014, systems security continues to be a preeminent issue for businesses and individuals alike. The regulated entities, like most modern institutions, rely on numerous, complex IT systems to conduct almost every aspect of their work. These systems manage processes to guarantee and purchase loans, supporting more than $5 trillion in Fannie Mae and Freddie Mac mortgage assets. Both Enterprises and the FHLBanks have been the subject of cyber-attacks, although none caused significant harm.

All of the entities regulated by FHFA acknowledge that the substantial precautions put into place to protect their information systems may be vulnerable and penetration of their systems poses a material risk to their business operations. Further, the Enterprises are increasingly relying on third-party service providers, requiring the sharing of sensitive information between Enterprise and third-party systems. Consequently, the Enterprises face an increased risk in that an operational failure by a third party will adversely affect them.

In the coming year, OIG plans to assess FHFA's oversight of the regulated entities' compliance with its regulatory guidance and standards for cyber-risk management. We intend to examine FHFA's oversight of the regulated entities' efforts to identify and assess IT security risks and adequacy of existing controls. We seek to review FHFA oversight of Enterprise efforts to review evaluate counterparty compliance with contractual requirements for IT security and management of cyber-risk.

These efforts should assist FHFA in assessing the effectiveness of its oversight of cyber-risk management efforts by the regulated entities.

FEDERAL HOUSING FINANCE AGENCY
OFFICE OF INSPECTOR GENERAL

HOTLINE

To Report Suspected

FRAUD, WASTE, OR ABUSE

in FHFA Programs or Operations
(including mortgage fraud referrals involving FHFA, Fannie Mae, Freddie Mac, and Federal Home Loan Banks)

FEDERAL HOUSING FINANCE AGENCY
FHFA OIG
OFFICE OF INSPECTOR GENERAL

CALL

the OIG Hotline at
1–800–793–7724

ONLINE

www.fhfaoig.gov

FAX

202–318–0358

WRITE

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