FHFA's Supervisory Framework for Federal Home Loan Banks' Advances and Collateral Risk Management

AUDIT REPORT: AUD-2012-004 DATED: June 1, 2012

FEDERAL HOUSING FINANCE AGENCY
OFFICE OF INSPECTOR GENERAL

AT A GLANCE

FHFA's Supervisory Framework for the Federal Home Loan Banks' Advances and Collateral Risk Management

Why FHFA-OIG Did This Audit

The Federal Housing Finance Agency (FHFA or Agency) is the supervisor and regulator of the Federal Home Loan Bank system. The system is comprised of the 12 Federal Home Loan Banks (FHLBanks) and the Office of Finance. The FHLBanks are organized as regionally based cooperatives, comprised of member banks that are regulated by federal banking agencies (FBAs), such as the Federal Deposit Insurance Corporation (FDIC).

The FHLBanks extend loans, called advances, to member banks. Between September 2008 and September 2011, the FHLBank system's combined outstanding advances decreased from over $1 trillion to approximately $415 billion. The decrease was due in part to many member banks' financial deterioration and failure. FHLBank members with outstanding advances constituted many of the 800 problem and 399 failed banks that FDIC reported in September 2011.

Advances must be secured by collateral to protect the security interest of the lending FHLBank. FHLBanks have a claim on the collateral of failed member banks with outstanding advances and historically have not experienced losses on their advances. However, when a member bank fails, its chartering agency closes the institution and appoints FDIC as receiver to resolve the failure. This resolution process includes outstanding advances either being repaid or assumed by an acquirer of the failed member bank's assets, which effectively shields FHLBanks from losses on their advances to member banks that have FDIC insured deposits.

The FHFA Office of Inspector General (FHFA-OIG) initiated this audit to assess FHFA's supervisory framework related to FHLBanks' advances and collateral risk management practices for problem member banks.

What FHFA-OIG Recommends

FHFA-OIG recommends that FHFA implement its outstanding review recommendations, strengthen its supervisory framework, enhance its coordination with other FBAs, and improve its oversight of problem member banks. FHFA agreed with FHFA-OIG's recommendations.

What FHFA-OIG Found

Although FHFA has taken steps to mitigate risk at FHLBanks related to advances and collateral, it can strengthen its supervisory framework for the FHLBanks' risk management practices. FHFA's mitigation efforts include regular, onsite, annual examinations and the use of offsite monitoring. For example, in 2009, FHFA completed two reviews concerning collateral management practices. The first review, a horizontal (i.e., system-wide) review of FHLBanks, included recommendations to ensure that FHFA and FHLBanks implement corrective actions to address identified collateral management risks. The other review included a suggestion that FHLBanks reassess business plans that rely on troubled (otherwise referred to as problem) member banks for growth in advances.

FHFA-OIG believes that FHFA's recommendations and its suggestion merit consideration. However, as of December 2011, FHFA had implemented only one of seven recommendations from its horizontal review that concerned problem member banks. Six recommendations remain unimplemented. Also, the other review's suggestion remains unimplemented.

The sole recommendation that FHFA implemented is important and pertains to ensuring that FHLBanks take corrective actions regarding collateral management deficiencies that the Agency identifies during its examinations. In spite of the importance of the recommendation, however, FHFA does not adequately document its examination follow-up activities so that it can accurately assess FHLBanks' corrective actions.

The six recommendations that FHFA has not implemented are also important and include updating the Agency's examination guidance for collateral reviews; providing guidance to FHLBanks about effective collateral risk management; and offering relevant training to FHFA examiners. Agency officials acknowledged the importance of considering these recommendations for implementation, but, as of December 2011, FHFA had not approved an implementation plan or schedule for the outstanding recommendations.

FHFA-OIG also found that FHFA does not have access to data that could enable it to better assess advance and other risks posed to the FHLBanks. For example, FHFA does not avail itself of existing access agreements or request that FDIC and other FBAs provide it with copies of examination reports for problem member banks. Additionally, FHFA does not maintain a central listing of problem member banks identified by FHLBanks. FHFA would have greater insight into the risks posed to the FHLBanks by problem members through greater access to regulatory information.

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ACRONYMS/ABBREVIATIONS

CDFIs .... Community Development Financial Institutions

DBR .... Division of Federal Home Loan Bank Regulation

DIF .... Deposit Insurance Fund

Examination Manual .... *Federal Housing Finance Board Examination Manual* (April 2007)

FBAs .... Federal Banking Agencies

FDIC .... Federal Deposit Insurance Corporation

Bank Act .... Federal Home Loan Bank Act

FFIEC .... Federal Financial Institutions Examination Council

FHFA or Agency .... Federal Housing Finance Agency

FHFA-OIG .... Federal Housing Finance Agency, Office of Inspector General

FHFB .... Federal Housing Finance Board

FHLBank .... Federal Home Loan Bank

FHLBB .... Federal Home Loan Bank Board

HERA .... Housing and Economic Recovery Act of 2008

MOUs .... Memoranda of Understanding

OCC .... Office of the Comptroller of the Currency

PLMBS .... Private-Label Mortgage Backed Securities

ROE .... Report of Examination

Federal Housing Finance Agency

Office of Inspector General

Washington, D.C.

PREFACE

FHFA-OIG was established by the Housing and Economic Recovery Act (HERA),[1] which amended the Inspector General Act of 1978.[2] With respect to FHFA's programs and operations, FHFA-OIG is authorized to: conduct audits, investigations, and other activities; recommend policies that promote effective and efficient administration; and prevent and detect fraud and abuse.

The objective of this performance audit was to assess FHFA's supervisory framework related to FHLBanks' advances and collateral risk management practices for institutions that present heightened supervisory concern. The audit found that FHFA needs to improve its framework. Although FHFA conducted a system-wide horizontal review of secured credit at FHLBanks and an internal study that identified numerous significant risks, the Agency did not take sufficient steps to ensure that FHLBanks effectively managed risks posed by member banks that represented heightened supervisory concern.[3] Further, FHFA-OIG determined that the Agency should take additional steps to enhance its coordination with FBAs that are responsible for supervising and regulating FHLBanks' members.

FHFA-OIG believes that the recommendations contained in this report will help the Agency achieve more economical, effective, and efficient operations. FHFA-OIG appreciates the assistance of all those who contributed to the audit.

This audit was led by Laura Roberson, Audit Manager. Additionally, this report has been distributed to Congress, the Office of Management and Budget, and others, and will be posted on FHFA-OIG's website: http://www.fhfaoig.gov.

Russell A. Rau
Deputy Inspector General for Audits

[1] Public Law No. 110-289.

[2] Public Law No. 95-452.

[3] A horizontal review is a system-wide review FHFA conducts periodically that focuses on specific activities, functions, or programs. (See "Horizontal Review" section in the Background for more detail.)

BACKGROUND

Overview of the FHLBank System[4]

On July 30, 2008, HERA established FHFA as the supervisor and regulator of the FHLBank system. FHFA's mission is to promote FHLBanks' safety and soundness, support housing finance and affordable housing goals, and facilitate a stable and liquid mortgage market. Collectively, 12 FHLBanks[5] and the Office of Finance comprise the FHLBank system, which was established in 1932 by the Federal Home Loan Bank Act (Bank Act).[6] The system facilitates the extension of mortgage credit and the housing finance market.

FHLBanks are regionally based cooperatives, and member institutions are exclusively the owners and shareholders of their respective FHLBank. FHLBank membership is limited to regulated depository financial institutions (i.e., commercial banks, credit unions, and thrifts), insurance companies, and community development financial institutions (CDFI) that are engaged in housing finance in the United States.[7]

To carry out their mission and core business function, FHLBanks loan money to their members through secured transactions called advances (i.e., loans).[8] Advances are usually over-collateralized to protect the security interest of the lending FHLBank. Figure 1 below illustrates how FHLBanks and the Office of Finance support housing finance—from issuing debt to investors to originating home loans for homeowners.

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[4] For more information regarding the organization and functions of FHLBanks, see *FHFA's Oversight of Troubled Federal Home Loan Banks* (January 2012), available at: http://www.fhfaoig.gov/Content/Files/Troubled%20Banks%20EVL-2012-001.pdf.

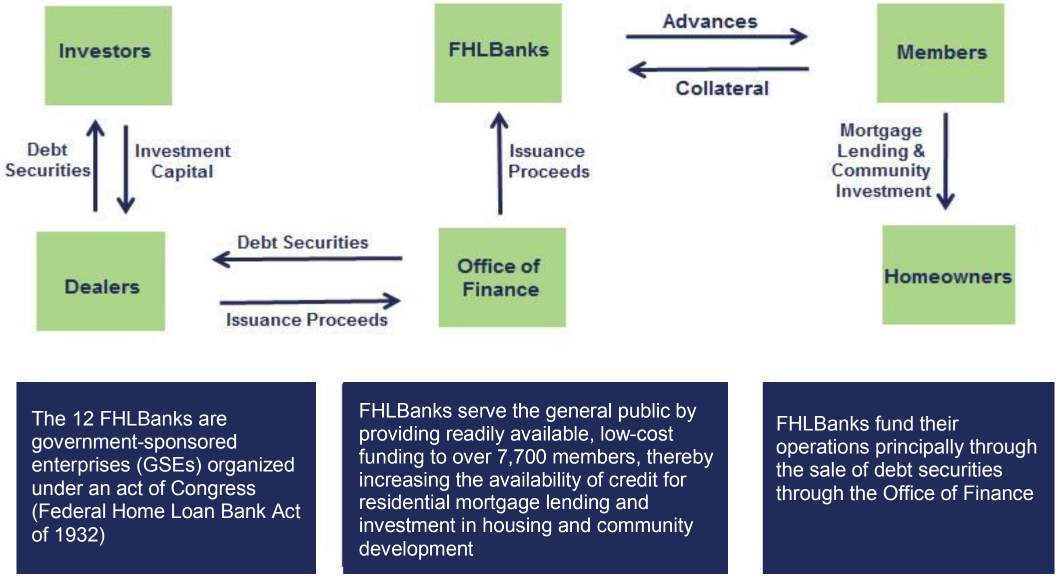
[5] The 12 FHLBanks are located in: San Francisco, CA; Atlanta, GA; New York, NY; Boston, MA; Pittsburgh, PA; Cincinnati, OH; Des Moines, IA; Dallas, TX; Topeka, KS; Chicago, IL; Indianapolis, IN; and Seattle, WA.

[6] Public Law No. 72-304.

[7] The Bank Act, as amended by HERA § 1206, expressly authorizes certified CDFIs to become members. On January 5, 2010, FHFA published a final rule that authorizes CDFIs to become members of FHLBanks.

[8] FHLBanks fund their lending operations primarily through the sale of debt securities, known as consolidated obligations, through the Office of Finance.

Figure 1: Advances & Collateral Process Flows for the FHLBank System[9]



According to the Office of Finance, advances are FHLBanks' largest category of assets. Between June 2005 and September 2008, FHLBanks' advances to members increased from $616 billion to over $1 trillion in response to the liquidity needs of members. However, as of September 2011, the amount of FHLBanks' advances had decreased to approximately $415 billion. This decline was due to the reduction in demand for advances because of the housing market's deterioration and member banks having lower cost funding options, particularly retail deposits. In addition, this substantial decrease was, in part, due to an increase in financial institution failures, voluntary or forced consolidations, and membership withdrawals. FHFA and one of its predecessors, the Federal Housing Finance Board (FHFB), expressed concerns about whether FHLBanks could manage rapid, substantial decreases in advances.

Overall, FHLBank membership has fluctuated but ultimately has declined from 8,113 members in December 2006 to 7,758 members in September 2011.[10] Commercial banks, thrifts, and credit unions represent the majority of the member institutions. Of the September 2011 membership, 4,775 had recent outstanding FHLBank advances as shown below in Figure 2.

[9] Source: material provided by the Office of Finance from its presentation at FHFA-OIG's Audit Conference on November 3, 2011.

[10] FHFA reports that 85% of banks and thrifts are members of FHLBanks, and that there is a strong correlation between the condition of U.S. banks and thrifts, generally, and the condition of FHLBank members.

Figure 2: FHLBank System Outstanding Advances by Member Type[11]

Member Type	December 2007 ($ Millions)		September 2011 ($ Millions)	
	Number	*Advances*	*Number*	*Advances*
Commercial Banks	4,232	$453,593	3,511	$200,911
Thrifts	941	339,424	768	92,462
Credit Unions	432	32,368	395	23,741
Insurance Companies	52	28,672	101	46,388
Totals	**5,657**	**$854,057**	**4,775**	**$363,502**

Credit Risk

In carrying out their core business function, FHLBanks assume various types and degrees of risk and implement risk management processes—including monitoring member banks—to mitigate those risks. Credit risk is the potential that a borrower or counterparty will fail to meet its obligations in accordance with agreed terms. This risk is mitigated by implementing controls such as: (1) establishing an appropriate credit risk management environment that includes credit strategies and credit and collateral policies and procedures; and/or (2) maintaining an effective credit administration process that includes continuous monitoring of counterparty member relationships.

According to FHFA's 2010 *Annual Report to Congress*, credit risk specifically associated with advances has increased because of financial stress at FHLBanks' member institutions.[12] For example, in 2009, the FHLBanks of San Francisco and Atlanta were ranked as "supervisory concerns" for credit risk and they had: (1) among the highest advance balances; and (2) were respectively ranked first and third for having the most members that present heightened supervisory concern.[13]

Advance growth and collateral quality are among several factors that affect credit risk. However, other factors may mask or distort the impact of collateral and advances on credit risk. For instance, FHLBanks have not incurred losses on advances and that is indicative of lower

[11] Source: data obtained from FHFA's membership listing tables but does not include information on CDFIs.

[12] Available at: http://www.fhfa.gov/webfiles/21572/FHFA2010_RepToCongress6%2013%2011.pdf.

[13] FHFA-OIG defines banks that present heightened supervisory concern as: (a) those that had adverse internal member ratings (typically a rating of 7 or higher on a scale of 10 representing the highest concern); regulatory banking agency ratings of 3 to 5 based on CAMELS, which measures a bank's overall condition (see "Glossary of Terms" for a more detailed definition); deteriorating financial condition, and/or formal enforcement actions; or high levels of advance concentrations; and (b) those that had been identified by an FHLBank or FHFA as being of supervisory concern. For reporting purposes, these banks are identified as problem or troubled.

credit risk. Yet, this condition is at least partly influenced by the manner in which FDIC resolves failed banks and incurs related losses.[14]

Collateral

Advances must be fully secured by eligible collateral. The Bank Act and FHFA regulations require each FHLBank to maintain a security interest in, or lien on, eligible collateral pledged by the member bank receiving an advance. These secured interests protect FHLBanks should member banks default or fail.[15] Because of the secured interests, if a member bank were to fail or default, the lending FHLBank would be able to liquidate the collateral and recover the amount of any outstanding advances.

The types of collateral accepted as security include, but are not limited to: cash deposits held by FHLBanks, residential mortgage loans, private-label mortgage backed securities (PLMBS), and U.S. Department of the Treasury securities. FHLBanks are also authorized to accept alternative forms of collateral, such as agricultural and small business loans.

To assist FHLBanks in managing the risks associated with collateral used for securing advances, their policies, procedures, and practices include a minimum of three designations of collateral status, as follows:

- **Blanket Lien**. Under this status, an individual FHLBank allows a member to keep eligible collateral pledged to the FHLBank, provided the member executes a written security agreement and agrees to hold the collateral for the FHLBank's benefit. The blanket lien status is typically accepted by FHLBanks only for loan collateral; most securities collateral must be physically delivered to the FHLBank (or a third-party custodian it approves) and pledged to the benefit of the applicable FHLBank.

- **Listing**. This category is generally for those institutions that have a higher risk profile than institutions with blanket lien collateral. Listing requires the member bank to provide more information to the FHLBank about its collateral. This category allows the FHLBank to assess more easily the type and quality of loans the member bank is pledging as collateral.

- **Delivery**. This status is the most stringent collateral status. Under it, FHLBanks require the member bank to deliver collateral to the FHLBank or to a third-party custodian. It allows the FHLBank to have full control of the collateral or to have the

[14] For example, in order to obtain clear title to a failed bank's collateral, FDIC may pay off the advances made to the bank in full regardless of the value of the collateral. Based on FHFA-OIG's inquiries of FDIC and FHLBanks, losses on collateral pledged in support of advances made to failed banks are not separately tracked.

[15] A bank fails when its chartering agency revokes its banking charter.

member bank secure the collateral in a vault. Delivery status is generally the highest-risk profile for member banks and allows FHFA to review loan files in order to assess the quality of underwriting and their compliance with FHLBank collateral requirements.

If a member's financial condition deteriorates, the collateral status normally becomes more stringent and increases from blanket lien to listing to delivery. However, according to FHFA, listing and delivery methods have been used to increase borrowing capacity for healthy members without the need to pledge additional collateral.

In addition, to assist FHLBanks in mitigating the heightened credit risk affecting advances and to protect their security interests, one option they have employed is to apply "haircuts" to the collateral (i.e., protective reductions in borrowing capacity relative to the value of the collateral). Collateral haircuts are generally adjusted depending on the quality of the pledged assets and the financial condition of a member. Depending on the member's credit status, an FHLBank will typically provide advances worth only a percentage of the value of the collateral pledged by the member bank; the discounted percentage is the "haircut." This results in advances being over-collateralized at the time they are made.

FHLBanks use information from member banks' FBAs to assess their financial condition and to make determinations regarding their credit risk profiles. This information includes examination results; financial information; CAMELS ratings, which measure a bank's overall condition; and formal and informal supervisory actions.[16] FHLBank determinations affect the member's borrowing capacity, collateral status, and internal member rating.[17] FHLBanks can also perform additional collateral verification, such as detailed loan reviews and collateral warehouse visits.[18]

FHFA's Oversight of the FHLBanks

Statutory and Regulatory Authorities

Effective July 30, 2008, HERA transferred supervisory and oversight responsibilities for the FHLBank system from FHFB to FHFA. The Division of Federal Home Loan Bank Regulation (DBR) is the principal organizational unit within FHFA responsible for supervising

[16] For a detailed definition of CAMELS rating, see "Glossary of Terms."

[17] In general, FHLBanks' internal member ratings range on a scale of increasing concern from 1 to 10. For member banks that are low risk (i.e., rated 1 to 3), their collateral is ordinarily carried under blanket lien status. As a member's financial condition deteriorates and credit risk increases, the institution is placed on a watch-list to be closely monitored to ensure that the collateral pledged against current and future advances is adequate. The collateral status for these members is adjusted to protect FHLBanks' security interest.

[18] A collateral warehouse is an FHLBank owned or approved third-party custodian that stores the collateral when it is delivered by a member bank.

and examining FHLBanks. DBR assesses FHLBanks through annual examinations; periodic visits; offsite monitoring; key financial data analysis; and review of other indicators, such as credit concentrations, member bank performance, and compliance with laws and regulations.[19]

FHFA is required by statute to examine FHLBanks annually to ensure their financial safety and soundness.[20] FHFA may also conduct other examinations, such as system-wide horizontal reviews, as it deems necessary. DBR develops supervisory plans to provide management oversight, direction, and support for all examination activity involving FHLBanks, including development of supervision findings and annual Reports of Examination (ROE) preparation.

FHFA also has the authority to impose formal enforcement actions and may take informal supervisory action to address concerns and to effect corrective actions by FHLBanks. The Federal Housing Enterprises Financial Safety and Soundness Act of 1992[21] provides guidance to FHFA regarding formal enforcement actions—specifically cease and desist orders, temporary cease and desist orders, civil money penalties, and removal authorities.[22] In addition, according to FHFA's Examination Manual, the Agency may also recommend or take informal action, including: (1) Board of Directors' resolutions; (2) memoranda of understanding; and (3) written agreements.[23]

FHFA is also required to establish prudential management and operational standards that address 10 separate areas relating to the management and operation of FHLBanks and the Enterprises. These standards must address the consequences if the regulated entities fail to comply with applicable guidance. Two of the standards, overall risk management processes and credit and

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[19] Under 12 CFR § 1263.27, the board of directors for each FHLBank can terminate the membership of any institution that: (1) fails to comply with any requirement of the Bank Act, any regulation adopted by FHFA, or any requirement of the Bank's capital plan; (2) becomes insolvent or otherwise subject to the appointment of a conservator, receiver, or other legal custodian under federal or state law; or (3) would jeopardize the safety or soundness of its FHLBank if it were to remain a member.

[20] 12 U.S.C. § 4517.

[21] Public Law No. 102-550.

[22] FHFA has prompt corrective action authority over FHLBanks so that specific mandatory or discretionary supervisory actions and restrictions under that statute would apply to any FHLBank that the Agency determines is undercapitalized, significantly undercapitalized, or critically undercapitalized. The general purpose for the prompt corrective action framework is to supplement FHFA's other regulatory and supervisory authority and to provide for timely and, in some situations, mandatory intervention by the regulator.

[23] According to the *Federal Housing Finance Board Examination Manual* (April 2007), if FHFA determines not to issue a supervisory or enforcement action against an FHLBank, it may issue a "No Action Letter," which states that FHFA will not recommend a supervisory or enforcement action for an FHLBank's failure to comply with a specific provision of the Bank Act or FHFB rule, regulation, policy, or order, provided that the FHLBank undertakes the proposed transaction or activity.

counterparty risk management practices, have specific applicability to advances and collateral risk management.[24]

Annual Examinations

Annual examinations are an integral part of a multi-step process that helps FHFA supervise FHLBanks. FHFA's examination regimen uses a risk-based approach that focuses on five key components: market risk; credit risk; operational risk; corporate governance; and financial performance. FHFA evaluates FHLBank advances and collateral management practices as part of the credit risk component. The Agency's *Examination Manual* outlines the actions that examiners should take to assess risks associated with secured credit, such as advances. The examination results are communicated to the FHLBank's management and boards of directors through ROEs and other means such as exit conferences and finding memoranda.

Beginning in 2007, widespread economic decline resulted in financial deterioration among many FHLBank members. This deterioration adversely impacted a majority of the FHLBanks and their examination results. Specifically, FHFA's examination results since 2007 have identified several weaknesses and risks related to advances, collateral, problem member banks, and investment decisions.[25] As a result, FHFA has reported significant declines to a majority of FHLBanks' credit risk component ratings over the last several years. One such declining component relates to advances and collateral management.

FHFA-OIG reviewed the results of FHFA's 2007 through 2010 examinations and offsite monitoring activities for two of the FHLBanks: Atlanta and San Francisco. FHFA-OIG determined that, through FHFA's supervisory efforts, the Agency and its predecessor, FHFB, identified risks over the last decade related to FHLBank advances and collateral risk management practices, and noted that an increasing number of their member banks presented heightened supervisory concern. In addition, examiners issued findings and recommendations requiring the two FHLBanks to address particular weaknesses. In one case, examiners recommended an informal enforcement action that addressed the weaknesses identified. The examiners also performed follow-up activities to determine whether: (1) FHLBanks had taken

[24] The other eight areas required to be addressed by prudential standards include: internal controls and information systems; internal audit systems; interest rate risk; market risk; liquidity and reserves; growth in assets and investment portfolio; and records that allow an accurate assessment of the institution's financial condition. FHFA published proposed rules on the prudential management and operations standards in the *Federal Register* on June 20, 2011. The official comment period closed on August 19, 2011. As of March 21, 2012, no final rule has been issued.

[25] In the mid-2000s, several FHLBanks also increased their PLMBS purchasing. For many FHLBanks, this investment strategy: (1) significantly increased their risk profiles by adversely influencing their secured credit component ratings; and (2) impacted other operations such as earnings and governance.

appropriate corrective action to address examiner recommendations; and (2) previously reported risks and findings still existed.[26]

As the financial crisis intensified in 2007 and 2008, the examination results documented in annual ROEs reflected additional focus on risks presented by the deteriorating financial condition of the members included on FHLBanks' watch-lists and large member bank advance concentrations.[27] This additional focus was particularly prevalent during the 2008 and 2009 examination cycles as discussed in the following section.

Horizontal Review

To supplement the annual examinations of each FHLBank, FHFA periodically conducts system-wide reviews that focus on specific activities, functions, or programs. The reviews are commonly referred to as horizontal reviews. In 2007, due to differences in FHLBanks' collateral valuation methodologies, FHFA's predecessor identified the need to conduct a horizontal review of secured credit, including advances and collateral risk management practices.

FHFA conducted the horizontal review during the 2008 and 2009 examination cycles, and examiners identified numerous significant findings regarding FHLBanks' policies, procedures, and practices relating to advances and collateral risk management. The examiners' findings were classified as unsafe or unsound practices, weaknesses, or recommendations.[28] Specifically, examiners reviewed six areas as follows.[29]

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[26] FHFA examiners recommended that the San Francisco FHLBank adopt a board resolution. Based on the examiners' follow-up activities in the 2011 examination, FHFA concluded that the bank had complied with this recommendation.

[27] Each FHLBank maintains a watch-list of member banks identified as presenting heightened supervisory concern. This list can include information about a member bank's collateral, advances, internal member ratings, and other information from the member's primary federal regulator.

[28] An **unsafe or unsound practice** is any action or inaction that is contrary to prudent operation and that has resulted in, or if continued could result in, abnormal loss or risk or damage to an FHLBank or the Office of Finance. Immediate corrective action is required for such practices. An FHLBank's condition need not deteriorate to the brink of insolvency before a practice or condition may be found to be unsafe or unsound. A **weakness** is an inadequate or otherwise unacceptable policy, procedure, or practice, or a lack of sufficient internal controls or risk management. Weaknesses require corrective action. A **recommendation** is a suggested change to a policy, procedure, practice, or control to improve performance or operations. See "Glossary of Terms."

[29] The horizontal review was conducted at 11 of 12 FHLBanks. According to FHFA officials, the Chicago FHLBank horizontal review results were not finalized due to unforeseen circumstances. In addition to the six areas discussed in this section, the horizontal review also included assessing risk limits. To control risks, FHLBanks employ limits on the volumes and types of collateral they will accept, or limits on the volume of advances they will provide to members. Examiners determined that of the 11 FHLBanks included in the horizontal review, only 1 had inadequate risk limits because it had not established limits on advances at the time of the review.

- **Member Bank Monitoring**. FHLBanks are entitled to monitor their member banks onsite and offsite. This requires FHLBanks to implement effective monitoring policies, procedures, and practices that assist them in identifying and addressing risks among their member institutions. In spite of these access rights, the horizontal review indicated that FHLBanks' monitoring activities were in need of significant improvement, such as monitoring members to assess their financial condition and their underwriting quality for collateral pledged to FHLBanks. Examiners issued 29 findings in this area, which were classified as 2 unsafe or unsound practices, 23 weaknesses, and 4 recommendations.

- **Member Bank Failure Plans**. The need for FHLBanks to develop and monitor adequate failure plans related to their members became apparent during the recent economic downturn as the number of bank failures escalated. As these events showed, member banks most often failed due to capital shortfalls although more sudden liquidity failures also occurred. In these cases, FHLBanks relied on FDIC or another receiver to pay or arrange for assumption of a member's advances at the time of failure. Although examiners expected FHLBanks to have well written, executable, and thoroughly tested member failure plans, they found that only one FHLBank had an adequate plan. The various deficiencies that examiners identified relative to the other 10 member failure plans included the lack of: (1) scenario analyses; (2) plan testing; (3) plan finalization; and (4) board of directors' approval. Several of these deficiencies had been noted in previous examinations. Examiners issued 10 findings in this area, which were classified as 6 weaknesses and 4 recommendations.

  Additionally, for institutions subject to FDIC resolution, FDIC can pay off their advances in order to obtain the secured collateral, or negotiate agreements with acquiring institutions to assume their advance debts; both of these actions can potentially result in losses to FDIC's Deposit Insurance Fund (DIF) if the value of an FHLBank's outstanding advances exceed the realized value of the pledged collateral.

- **Collateral Control**.[30] The Bank Act and FHFA regulations require each FHLBank to secure advances fully by maintaining security interests in eligible collateral. FHFA examiners concluded that FHLBanks could improve their risk management practices

[30] In addition to conducting the horizontal review, FHFA published two annual reports related to collateral securing advances at FHLBanks. The first report analyzed collateral data as of December 31, 2007, by type and FHLBank district. The second report provided collateral data as of December 31, 2008. The second report also studied the extent to which loans and securities used as collateral to support FHLBank advances were consistent with interagency guidance issued by FBAs on nontraditional mortgage products and subprime lending. This second report noted that each FHLBank had adopted policies, procedures, and practices requiring that mortgage loans and securities used as collateral be consistent with interagency guidance as well as policies addressing anti-predatory lending.

related to collateral control.[31] Among other concerns, FHFA found that four FHLBanks failed to identify third-party servicers and custodians used by members. In addition, examiners recommended that FHLBanks' security agreement include a material adverse change clause, which would require that the member notify its FHLBank of adverse events. Based on their review, examiners issued 20 findings in this area, which were classified as 11 weaknesses (4 of which were considered significant) and 9 recommendations.

- **Haircut Methodology and Valuation Models**.[32] When evaluating the effectiveness of FHLBanks' haircut methodologies, examiners assessed the basis for haircuts and the frequency with which the banks reviewed them. Because the value of the collateral pledged by member banks may fluctuate over time, it is important for FHLBanks to monitor the value of collateral to assure that member banks have pledged an appropriate amount. Generally, examiners expected FHLBanks to evaluate haircuts every six months to reflect changing market conditions and standards. Examiners also evaluated the frequency with which FHLBanks used valuation models to value members' collateral—a member's collateral should be valued quarterly with updated information provided by the member.

  The horizontal review determined controls related to haircuts and collateral valuation methodologies needed improvement. In addition, examiners found that, in some cases, FHLBanks had inadequate: (1) valuation models and methodologies; (2) processes for tracking member bank's collateral adjustments; and (3) staff to perform analysis and collateral valuation reviews. The most frequent finding in this area related to inadequate methodologies used by FHLBanks to support haircuts applied to collateral pledged by member banks. Examiners issued 15 findings in this area, which were classified as 1 unsafe or unsound practice, 13 weaknesses, and 1 recommendation.

- **Nontraditional Mortgage Products**.[33] When evaluating FHLBanks' compliance with FHFA guidance, examiners assessed the FHLBanks' processes to ensure that

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[31] When evaluating collateral control, some of the actions taken by examiners to assess the collateral status included: (1) determining the frequency that FHLBanks obtained loan portfolio information from their members and the source of this information; (2) reviewing the basis FHLBanks used to place member banks in the listing status; (3) reviewing the due diligence FHLBanks used when third-parties maintained collateral in the delivery status; and (4) conducting site visits for verification purposes.

[32] See "Glossary of Terms."

[33] Nontraditional residential mortgage loans are defined as mortgages that allow borrowers to defer payment of principal or interest. Such loans are also referred to as alternative or exotic mortgage loans and may be interest-only mortgages or payment-option mortgages. They may also have other features such as variable interest rates with below-market introductory rates and reduced documentation to support the borrower's repayment capacity.

they did not accept collateral for advances or purchase PLMBS that contain mortgages that had not been underwritten consistent with interagency guidance on nontraditional and subprime mortgage products.[34] On the basis of their findings, examiners criticized most of the FHLBanks for one or more of the following: (1) failing to assess and test loan collateral underwriting; (2) lacking adequate procedures to identify the volume of nontraditional and subprime mortgages pledged as collateral; and (3) not establishing risk limits on the volume of subprime and nontraditional residential mortgages accepted as collateral. Examiners issued 14 findings in this area, which were classified as 13 weaknesses and 1 recommendation.

- **Governance**.[35] Examiners' concerns regarding FHLBanks' governance were based on the weaknesses identified and the failure of boards of directors and management to ensure that controls for advances and collateral risk management practices were adequate. Specific concerns that influenced examiner decisions regarding governance related, but were not limited, to: (1) the overall credit risk structure including the lack of independence, insufficient staffing, and inadequate credit risk committee oversight at 7 of the 11 FHLBanks examined; (2) failure to implement a collateral system in a timely manner at 1 FHLBank; and (3) inadequate audit and risk assessment procedures at 2 FHLBanks. Examiners issued 17 findings in this area, which were classified as 1 unsafe or unsound practice, 13 weaknesses, and 3 recommendations.

In addition, examiners made recommendations for the improvement of FHFA's internal operations (see Figure 4, below, for a discussion of seven recommendations that are related to problem member banks; FHFA has implemented one of these internal recommendations).

Commercial Bank and Thrift Member Performance Study

In October 2009, FHFA conducted an internal study that included an analysis of the financial performance of member banks that presented heighted supervisory concern and the risks that they posed to the FHLBank system.[36] FHFA selected the member banks based on their

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Nontraditional residential mortgages may result in increased risk—particularly when the nontraditional mortgages are not appropriately underwritten. While FHLBanks do not originate loans, they have exposure to nontraditional and subprime mortgages because they are found in their holdings of mortgage-backed securities, purchased mortgage portfolios, and/or the collateral for advances to members.

[34] FHFB Advisory Bulletin: AB-07-01 (April 12, 2007); and Advisory Bulletin: AB-08-02 (July 1, 2008).

[35] Effective corporate governance at FHLBanks requires engaged, capable, and experienced directors and senior management; a coherent strategy and comprehensive business plan; effective and measureable risk limits and controls; and clearly defined lines of responsibility and accountability.

[36] FHFA, *Risk Monitoring Updates, Commercial Bank and Thrift Member Performance – Does Lending to Risky Members Pose Additional FHLBank Risks?* (October 2009).

composite CAMELS ratings, financial data obtained from FDIC's *Consolidated Reports of Condition and Income*, and FHLBank membership data. Based on the study's results, FHFA concluded that FHLBanks made 45% of their total advances to members characterized by relatively weakened financial conditions, and that FHLBanks might have over-extended lending to some members with higher levels of nonperforming assets.[37]

In addition, FHFA's internal study determined that the Atlanta and San Francisco FHLBanks had the highest percentages of total assets represented by member banks with CAMELS ratings of 3, 4, and 5—68% and 78% respectively. Further, FHFA-OIG determined that, between January 2007 and September 2011, many of these poorly rated institutions failed: 149 for the Atlanta FHLBank and 55 for the San Francisco FHLBank.

Further, the Agency expressed concern that excessive lending to members with a higher probability of failure could have a negative impact on FHLBanks' super lien protection. The super lien can improve the financial standing of FHLBanks—versus unsecured creditors—by giving them, in the context of an FDIC receivership or conservatorship, priority over unsecured creditors with respect to a failed member bank's unsecured assets.[38] Therefore, pursuant to super liens, FHLBank advances and associated prepayment fees will most likely be paid without the FHLBanks incurring losses, in the event of a member bank's failure and an eventual FDIC receivership or conservatorship.[39] However, if the value of an FHLBank's outstanding advances exceed the realized value of its pledged collateral, then other creditors, shareholders, and FDIC's DIF may incur losses.

FHFA also expressed concern that excessive lending to members with a higher probability of failure could result in a call for legislation to remove the preferred status of FHLBank advances. If the super lien protection was removed, FHLBanks would still be protected from losses by the collateral securing advances but could be at increased risk of loss because of the risk that the collateral's liquidation value is insufficient to cover the unpaid principal balance of the members' advances.

The study suggested that FHLBanks reassess their business plans that rely on troubled members for advance growth.[40] Nonetheless, the impact of the study is limited or at best unclear. FHFA

[37] This included member banks with composite CAMELS ratings of 3 to 5. About 90% of these advances were to banks that were rated as a 3.

[38] Public Law No. 100-86. The statute provides a priority claim only when a member grants a security interest in all of its assets to an FHLBank.

[39] Ordinarily, FHLBanks are required to include prepayment fees in the cost of advances to make the borrower "financially indifferent to [the] . . . decision to repay [an] advance prior to its maturity date" (12 CFR § 1266.6).

[40] Specifically, the study states that any FHLBanks with business plans that rely on members with high levels of nonperforming assets for growth may need to reassess these plans. Also, the study did not identify a role for FHFA in following up on business plans that rely on troubled banks for growth.

officials stated that the Agency distributed their findings to FHFA supervision staff, but could not provide information indicating when this was done or whether supervision staff used the report to enhance overall FHLBank supervision. Moreover, FHFA did not implement the report's suggestion or communicate the results of the study to FHLBanks.[41]

Oversight of FHLBanks' Member Banks

Generally

As of September 30, 2011, commercial banks, thrifts, and credit unions represented 7,511 of the 7,758 FHLBank members, or more than 96% of the membership.[42] However, FHFA does not have statutory supervisory authority over the financial institutions that comprise the FHLBanks' membership. Instead, they are supervised and regulated by FBAs, including FDIC, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System, and the National Credit Union Administration.[43] Among other things, these agencies conduct periodic examinations, issue regulations, establish capital standards, and may take supervisory enforcement actions to carry out their oversight responsibilities.

Each of these agencies is also a member of the Federal Financial Institutions Examination Council (FFIEC). FHFA is not a member of FFIEC, and so FHLBanks are not represented on this interagency council. This limits FHFA's capacity to coordinate its oversight activities with FBAs.[44]

[41] Many of the FHLBanks had business plans that assumed lending to members with composite CAMELS ratings of 3 to 5 would continue to sustain advance growth.

[42] Insurance companies and (to a much lesser extent) CDFIs represent the remaining 247 members of the FHLBank system, as of September 30, 2011, according to FHFA's membership data.

[43] Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, a fifth regulator, the Office of Thrift Supervision, closed as of July 21, 2011, and most of its functions were transferred to OCC.

[44] FFIEC was established on March 10, 1979, pursuant to Title X of the Financial Institutions Regulatory and Interest Rate Control Act of 1978, Public Law No. 95-630. Section 1002 of the authorizing legislation indicates that an early predecessor of FHFA, the Federal Home Loan Bank Board (FHLBB), was a member of FFIEC. Later legislative reorganizations of the FHLBanks' regulatory framework, including HERA, did not expressly include FHFA or its predecessor (and FHLBB's successor), FHFB, on FFIEC.

On June 3, 2009, former Director James B. Lockhart III testified that the supervision of "mortgage products, markets, and institutions" can be improved by making FHFA a member of FFIEC:

> A near term step would be for FHFA to have fuller participation in . . . FFIEC[]. In particular, designating FHFA as a liaison member to the FFIEC would facilitate sharing of information with FFIEC members. Because of the importance of mortgage holdings for banks, FHFA should be part of the FFIEC in terms of sharing information and providing input.

See www.fhfa.gov/webfiles/2707/FHFA_Director's_Testimony_Final.pdf.

FHFA's Coordination with the Federal Banking Agencies

According to FHFA officials, the extent of the Agency's coordination with FBAs includes periodic meetings and telephone calls that relate to large member banks and their potential failure. This coordination focuses on how FHLBanks that made advances to large member banks should address potential failure.

FBAs may share supervisory and examination information with FHFA but are not required by law to do so. FHFA has memoranda of understanding (MOUs) with the FBAs to facilitate coordination and information-sharing among the agencies. Pursuant to the MOUs, FHFA may request bank examination data directly from the FBAs on an as needed basis. However, FHFA officials advised that FHFA has not used the MOUs to request access to the member information necessary to oversee advances and collateral risks and potential losses to FHLBanks. FHFA needs to take the initiative and more actively pursue the respective information.

Additionally, in accordance with federal law, the FHLBanks have executed MOUs with the FBAs.[45] These MOUs provide FHLBanks with access to reports, records, and other information relating to the financial condition of any member bank with which an FHLBank is or is contemplating transacting business. However, FHFA is not a party to these MOUs and, therefore, is not afforded similar access to data regarding FHLBank member institutions.[46] When the MOUs were brought to the attention of FHFA officials, they advised that they had not been aware that FHLBanks had existing MOUs with FBAs.

Role of FDIC

FDIC has three main responsibilities relative to insured depository financial institutions, including FHLBank members. Specifically, FDIC acts as:

- Supervisor for most state-chartered banks and some thrifts;
- Insurer of most depository institutions through the DIF; and
- Receiver for failed financial institutions, when appointed by bank chartering agencies.

The roles of insurer and receiver require FDIC to play an active part in resolving failing and failed FHLBank members. When a member bank fails, its chartering agency closes the institution and appoints FDIC as receiver to resolve the failure. This resolution process includes determining how to handle FHLBank advances. Specifically, FDIC, as receiver, may recognize

[45] The Financial Institutions Reform, Recovery, and Enforcement Act of 1989, § 719.

[46] Further, the plain terms of the MOUs prevent sharing pertinent data with FHFA. The MOUs restrict the FHLBanks from sharing member bank information with FHFA, without prior approval from the respective FBAs.

the priority of any security interest granted to an FHLBank by any member bank, or develop a mutually agreeable plan for payment or assumption of any advances made by the FHLBank. The latter agreement could also provide for the servicing, including foreclosure upon and liquidation of the collateral securing any advances.[47]

Potential Impact on the DIF

When failed member banks have outstanding FHLBank advances, FDIC is responsible for determining how they will be treated. In connection with its secured advances, FHLBanks have a claim on pledged and delivered collateral of the failed bank. In addition and as discussed above, FHLBanks can possess a super lien on the failed members' unencumbered assets. To obtain clear title to the pledged, delivered, and unencumbered assets of the failed members, FDIC can repay the outstanding advances. Alternatively, institutions that acquire failed member banks may assume responsibility for the outstanding advances as part of an agreement with FDIC. In both of these cases, FDIC's DIF can incur losses to the extent that a failed member bank's secured collateral fails to satisfy the unpaid principal balance (and prepayment fee) of the FHLBank's advance.

Although FHFA asserts that FHLBanks have not suffered a loss associated with advances to member banks, losses may have been shifted to FDIC's DIF, which resolves obligations of failed financial institutions. FHFA-OIG was not able to quantify the estimated losses to the DIF explicitly associated with advances because definitive data were not available—neither FDIC nor FHFA tracks losses to the DIF that are specifically related to FHLBank advances. However, according to FDIC, secured advances can increase the resolution cost for a failed institution. The potential risk that advances can present to the DIF warrants that FHFA and FHLBanks take steps to ensure that the risk management practices for advances and collateral are appropriate. FHFA has in place a combination of onsite and offsite examination and related controls to address these risks although further enhancements should be considered.

Examples of FDIC Activities Affecting FHLBanks

FDIC's concerns regarding FHLBank advances are longstanding. Below are examples of FDIC's concerns related to and actions taken to address risks associated with FHLBank advances.

- **FDIC's Advisory Committee on Banking Policy**. In April 2003, FDIC's Advisory Committee on Banking Policy identified problems with the resolution process involving FHLBank advances, which included: (1) the preferred status that the resolution process provides to FHLBanks is not available to any other secured

[47] FDIC Rules and Regulations, *Resolution and Receivership Rules*, 12 CFR § 360.2.

creditor, including the Federal Reserve Banks; (2) the protection of FHLBanks from credit risk or any other investment risk through FDIC's payment of advances with principal and interest almost immediately at failure; and (3) the increased loss to uninsured depositors and the DIF associated with FHLBank advances prepayment fees. The committee also concluded that FHLBank advances have implications for both failed-bank resolutions and deposit insurance pricing.[48] FDIC has also recognized that banks that rely heavily on advances and non-core funding sources can increase a bank's liquidity risk profile, reduce a bank's franchise value, and increase FDIC's resolution costs in the event of failure.

- **FDIC Center for Financial Research**. In July 2005, FDIC's Center for Financial Research issued a working paper, *Should the FDIC Worry About the FHLB? The Impact of Federal Home Loan Bank Advances on the Bank Insurance Fund* (No. 2005-10). This paper discussed whether the growing reliance on FHLBank advances increased expected losses to the insurance fund, the insurance fund's moral hazard associated with the increased risk advances, and the lack of associated risk premiums to offset that risk. The paper concluded that FDIC should price FHLBank-related risk exposures to the DIF.

- **Consideration of Risks Associated with Advances in Assessments to the DIF**. In a final rule entitled "Assessments," effective April 2009, FDIC concluded that problem banks that use FHLBank advances and other secured liabilities to fund material growth strategies pose increased risk to the DIF.[49] To help mitigate potential losses to the DIF associated with FHLBank advances and other secured liabilities, such as brokered deposits, FDIC has taken steps to ensure that financial institutions pay risk-based assessments to the DIF.[50] Specifically, FDIC's final rule amended the manner in which it makes assessments to ensure that the risks that FHLBank advances present to the fund are considered in the assessment calculation.[51]

  Between 2007 and September 30, 2011, there were 399 financial institutions that failed. Most of them were FHLBank members. The proportion of failed member banks varied among the 12 FHLBank districts, with 204 (about 51%) occurring in the

[48] FDIC's Advisory Committee on Banking Policy, *Federal Home Loan Bank System Paper* (April 2003).

[49] 12 CFR § 327.

[50] FDIC defines a risk-based system as one based on an institution's probability of causing a loss to the DIF due to the composition and concentration of the institution's assets and liabilities, the amount of loss, and the revenue needs of the DIF.

[51] FHFA-OIG did not determine if the increase in assessment was sufficient to offset losses to FDIC's DIF resulting from FHLBank advances. Also, the payment of assessments does not reduce the need to focus on reducing losses resulting from bank failures.

Atlanta and San Francisco districts.[52] Many of the failed member banks had advances that were paid back by the DIF or assumed by the acquiring institutions.[53] Thus, losses were not incurred by FHLBanks, but, instead, were absorbed by FDIC's resolution process.

Role of FFIEC

FFIEC is an interagency council established to prescribe uniform principles and standards for examining financial institutions and recommending policies to promote uniformity in their supervision. FFIEC membership includes FBAs and state regulatory agencies. Together, these agencies have the authority to examine member banks and take enforcement actions as a result of: identified deficiencies; failure of banks to implement timely and effective corrective actions or comply with laws and regulations; or other supervisory concerns. Although FHFA is a federal agency that supervises and regulates FHLBanks, the Agency currently is neither a member of nor a participant in the full FFIEC.[54] However, as discussed above, FHFA has advocated for its inclusion in FFIEC and has sought legislation authorizing such inclusion.

FFIEC has recently addressed a number of issues related to residential mortgage lending that could be of particular interest to FHFA in fulfilling its substantial responsibilities in the secondary mortgage market. Examples of these issues include registration of mortgage loan originators, data on mortgage transactions, reverse mortgage lending, and mortgage interest rate risk.

Global Watch-lists of Problem Member Banks

FHLBanks and FDIC maintain lists of banks that they have identified as presenting heightened concern from a member bank's creditworthiness perspective (FHLBanks) or from a supervisory and/or regulatory perspective (FDIC). As the supervisor and regulator of the FHLBanks, the information FHFA maintains on problem member banks is not comparable to that maintained by

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[52] FHFA gathers information from FHLBanks on failed member banks and their amount of outstanding advances on a bi-weekly basis in its *Advances Reports* and in response to the Agency's *2009-03 Special Data Request*. However, FHFA does not maintain or report data on the cumulative amount of advances associated with member banks at the time of failure that were either paid by FDIC or assumed by the acquiring financial institutions.

[53] FHFA-OIG determined FDIC does not specifically track the estimated cost or loss to the DIF associated with FHLBank advances on the books of failed member banks. However, the impact that member banks and their associated outstanding advances present to the DIF and to the FHLBank system supports the need for FHFA to ensure FHLBanks have adequate controls over advances to member banks and that close coordination occurs between FHFA and the responsible FBAs.

[54] FHFA, however, is a member on FFIEC's Appraisal Subcommittee. The Appraisal Subcommittee's mission is to: (1) oversee the appraiser regulatory programs established by the states, territories, and the District of Columbia; (2) monitor the requirements addressing appraisal standards for federal financial institutions; (3) maintain the National Registry of State Certified and Licensed Appraisers; and (4) monitor and review operations of the Appraisal Foundation.

FHLBanks or FDIC. Having access to FHLBanks' and FDIC's lists of problem member banks can enhance supervision and allow for: (1) identifying, monitoring, and measuring systemic risks associated with advances, including those related to concentrations and market conditions; (2) increasing coordination with other FBAs; and (3) more effectively planning for potential failures and resolution activities.

FHLBanks' Watch-Lists. Each FHLBank maintains a watch-list consisting of member banks that present heightened supervisory concern. FHLBanks place member banks on their watch-lists to ensure that they closely monitor the problem institutions' overall and financial condition and that prospective advances made to them are considered more carefully. Being placed on a watch-list is a direct reflection of the member's creditworthiness. The specific criteria used to determine which member bank is placed on a watch-list varies from one FHLBank to another, but they commonly include declining financial condition, advance concentrations, adverse or downgrades in regulatory ratings, and formal enforcement actions.

FHFA does not obtain FHLBanks' watch-lists on a routine basis for use in system-wide oversight. Instead, FHFA examiners ordinarily obtain watch-lists during their pre-examination phase. The examiners use the lists to determine the appropriate scope and testing levels for the examination. The watch-lists, however, remain in the examination work papers and can be used for planning future examinations. The lists are not otherwise used by FHFA to enhance its supervisory mission related to the overall FHLBank system.

FHFA-OIG obtained the watch-lists for the Atlanta FHLBank and identified various indicators that should have been of interest to FHFA from a supervisory perspective. For example:

- Advances to watch-list members increased by approximately $8 billion (from $63 billion to $71 billion) in fiscal year 2008. This increased exposure to members that presented heightened supervisory concern.

- Advances to watch-list members decreased by approximately $49 billion (from $71 billion to $22 billion) in fiscal year 2009. This is partly due to failures of member banks. Sudden shifts in asset mix can present interest rate and other risks to an FHLBank.

- From the beginning of fiscal year 2008 to the end of fiscal year 2009, the number of institutions on the watch-list increased more than sevenfold (from 86 to 610 member banks). This indicates a significant increase in the Atlanta FHLBank's concerns regarding member banks' creditworthiness. Sharp increases in the watch-list can indicate increased credit risk and strain FHLBank and FHFA examination resources.

The FDIC's Problem Member Bank List. In an effort to identify insured financial institutions that FDIC deems to be of supervisory concern and potential risk to the DIF, FDIC maintains a list of problem banks. Many of the institutions on this list are FHLBank members.

From 2006 through September 30, 2011, the number of problem banks steadily increased, as did the number of bank failures. As of September 30, 2011, FDIC reported 844 financial institutions as problem banks. The majority of problem bank failures since 2006 occurred between 2009 and 2010, as indicated in Figure 3 below.

Figure 3: FDIC – Problem Banks and Bank Failures—2006 Through September 30, 2011[55]

Year	Number of Problem Banks	Number of Bank Failures
2006	50	0
2007	76	3
2008	252	25
2009	702	140
2010	884	157
2011	844	74
TOTAL	**n/a ***	**399**

* These values may not be summed, as a problem member bank can remain on the list for multiple periods.

FHFA officials advised FHFA-OIG that the Agency at one time had generated a report that listed distressed member banks, similar to FDIC's listing. However, FHFA-OIG determined that this report is no longer maintained although FHFA has stated that it collects certain member information, such as on capital, using public sources. FHFA-OIG believes the identification and monitoring of problem member banks on a systemic basis can aid FHFA in fulfilling its overall regulatory responsibilities and establishing system-wide supervisory priorities such as was evident in the horizontal review FHFA performed of advances and collateral. Additionally, the information can be used to monitor concentration risk for problem member banks doing business with multiple FHLBanks.

[55] Source: FDIC's annual: *Statistics At a Glance*, *Historical Trends*, and *Failed Bank List*.

FINDINGS

FHFA-OIG finds that:

1. FHFA Has Not Implemented Most of the Recommendations from Its Internal Reviews, and thus Has Not Fully Addressed Significant Risks Associated with FHLBank Advances and Collateral Risk Management

In 2008 and 2009, FHFA conducted two reviews related to FHLBanks' collateral management: a system-wide horizontal review of secured credit and an internal study on risky and troubled member banks. Both reviews identified significant internal risks associated with advances and collateral management practices, but FHFA did not ensure that most of the potential corrective actions recommended by the reviews were fully considered for implementation, or that the results of offsite monitoring analyses were made available to interested parties. FHFA could further enhance its supervisory responsibilities to mitigate risks associated with FHLBank advances and collateral risk management through cross-cutting reviews such as its horizontal review and internal study, but it cannot achieve the full potential of such reviews unless it thoroughly considers and, if appropriate, acts upon its review findings. In light of this, FHFA-OIG concludes that the Agency should take effective and timely action to address the significant risks it identified. Such actions include assessing the reviews' results and implementing their overall recommendations.

Horizontal Review

On February 19, 2010, FHFA examiners issued a consolidated report to DBR management that detailed the results of the horizontal review. The report concluded that the advances and collateral risk management practices of FHLBanks warranted increased supervision by FHFA. The report included internal recommendations to ensure that the FHLBanks and FHFA implement corrective actions—including enhanced Agency supervision—to address the identified risks.[56] FHFA-OIG determined that, as of December 2011, the Agency had implemented only one of seven recommendations related to problem banks, as listed in Figure 4, below. When asked about the six recommendations that have not been implemented, DBR management told FHFA-OIG that the Agency had no plans to implement those

[56] Examiners also identified weaknesses and deficiencies, and made recommendations to the 11 FHLBanks included in the review (individually) in their respective ROEs. FHFA-OIG reviewed the horizontal review recommendations made to the San Francisco and Atlanta FHLBanks. Based on FHFA's subsequent examinations of those two banks, FHFA-OIG determined that examiners concluded that both banks implemented corrective actions to address the horizontal review recommendations. The scope of this audit did not include verifying the implementation or assessing the effectiveness of corrective actions taken by FHLBanks.

recommendations, but DBR acknowledged the importance of them. As of December 2011, FHFA had no approved plans or schedule to implement the six recommendations.

Figure 4 outlines the details of some of the recommendations made to FHFA and the actions the Agency has taken to implement them.

Figure 4: Horizontal Review Recommendations Related to Problem Member Banks[57]

	Recommendations	Action Taken (Yes, No, or Ongoing)	Description of Action(s) Taken by FHFA
FOLLOW-UP			
1.	Conduct follow-up activities at subsequent examinations to assess corrective actions taken by FHLBanks to address deficiencies at the banks.	Ongoing	Examiners assessed actions taken by the FHLBanks to address horizontal review deficiencies during follow-up examinations conducted in 2009 and 2010.
2.	Conduct a follow-up horizontal review of the advances and collateral risk monitoring in 2014—five years after the completion of the 2008/2009 review.	No	FHFA conducted the horizontal review beginning in mid-2008 through mid-2009. Thus the five-year time period has not yet expired. However, planning for subsequent reviews has not started.
3.	Update the examination program for the horizontal review to reflect lessons-learned from the current in-depth review, the current economic crisis, and subsequent events that may affect advances and collateral risk management, including potential insurance company failures or new types of members such as CDFIs.	No	FHFA began updating the Examination Manual in early 2008. Although the horizontal review reinforced the need to update the manual, the Agency has not completed the revisions. Agency officials could not provide a specific completion date for the revised sections related to advances and collateral risk management.

[57] Sources: *Summary Results of In-Depth Review of Advances and Collateral Risk Management Practices at the FHLBanks* (February 19, 2010); FHFA-OIG analysis; and various other sources such as interviews and the annual ROEs.

	Recommendations	Action Taken (Yes, No, or Ongoing)	Description of Action(s) Taken by FHFA
GUIDANCE			
4.	Develop and issue additional supervisory guidance for advances and collateral risk management. The horizontal review concluded that FHFA's advisory bulletins for advances and collateral risk management that existed at the time of the horizontal review primarily focused on nontraditional and subprime mortgages and that guidance could be augmented for member bank monitoring, collateral control, haircut methodology, and valuation models.	No	FHFA periodically provides guidance to supervisory staff. Since the horizontal review began in June 2008, FHFA issued a total of 11 guidance bulletins, 6 of which included references to advances and collateral. None of this guidance addressed horizontal review recommendations. FHFA-OIG did not identify any other plans to provide advances and collateral-related guidance to address the horizontal review.
EXAMINER TRAINING			
5.	Provide periodic FHFA-sponsored training specific to advances and collateral risk management practices to staff and update training to reflect lessons-learned.	No	FHFA periodically provides training to supervisory staff. For instance, in June 2010, DBR held its regularly scheduled semi-annual training conference. However, FHFA-OIG did not identify any specific plans to provide advances and collateral-related training to address the horizontal review results.
6.	Because of the unique collateral practices at the FHLBanks, FHFA should develop its own training or use similar training procured by FHLBanks.	No	As of this audit, FHFA did not have specific plans to provide targeted training for advances and collateral risk management practices.
7.	Training can be organized into distinct modules covered by the horizontal review and into two categories: comprehensive and refresher training.	No	As of this audit, FHFA did not have specific plans to provide targeted training for advances and collateral risk management practices.

Recommendation 1

Preliminary information suggested that FHFA made progress in implementing Recommendation 1, which concerns following up to ensure that FHLBanks corrected deficiencies noted during the horizontal review. To confirm, FHFA-OIG reviewed subsequent ROEs and found that examiners reported they assessed corrective actions and concluded that the FHLBanks have made progress in implementing their respective horizontal review recommendations. However, FHFA-OIG determined that the examiners' documentation of the follow-up activities did not fully address the level and type of testing conducted to verify whether FHLBanks had adequately addressed prior examiner concerns.[58] For example, examiners did not complete standalone work-papers or summaries that document how they verified or tested FHLBank corrective actions taken in response to previously identified supervisory concerns. In addition, the findings tracker that FHFA uses to document follow-up activities did not always include references to follow-up testing procedures performed, actions taken by FHLBanks to implement examiner recommendations, or the basis of examiner conclusions that prior examiner recommendations had been implemented and closed.[59]

Nonetheless, it may be too early to assess FHFA's actions fully with respect to this recommendation until additional examination activity is completed.

Recommendations 2 through 7

As of December 2011, DBR management had no approved plans to implement the other six horizontal review recommendations. The Agency acknowledged, however, that the results should have been addressed in a timely manner.

FHFA-OIG has identified several risks posed by delayed action on the remaining recommendations.

- *Follow-up – Recommendations 2 and 3*. FHFA planning for subsequent horizontal reviews has not started. FHFA-OIG notes that the Agency took approximately three years to plan, perform, and report the results of the horizontal review. Therefore, in order to complete the next review by 2014, FHFA action is required in the near-term to plan the effort. Planning for the horizontal review should include an update of the review program related to advances and collateral risk management. Also, FHFA has

[58] As a result of an internal audit, FHFA's predecessor implemented a Findings Tracker to assist the Agency in ensuring that examination findings, including those related to advances and collateral risk management, are communicated to FHLBanks' management and boards of directors, and formally documented in ROEs. Additionally, the tracker was designed to document follow-up verification activities.

[59] FHFA-OIG determined that at least two Examiners-in-Charge have implemented steps to improve documentation of follow-up activities, including verifying corrective actions taken by their respective FHLBanks. However, actions to improve the documentation of follow-up activities are not completed Agency-wide.

not yet assessed lessons-learned from the 2008/2009 review to prepare for subsequent horizontal reviews. Specific examples of lessons-learned that need to be assessed by DBR management include work-paper review and non-bank member coverage, as discussed below.

According to the DBR Portfolio Manager who served as project leader for the horizontal review, the work-papers of results for each FHLBank review were not reviewed contemporaneously with their completion. Instead, the work-papers were reviewed up to one year afterwards, when the consolidated report preparation began. The project leader stated the delay in review of the results of each horizontal review for quality and consistency was a lesson-learned. Upon compiling the results of the review, FHFA concluded additional work related to one bank was necessary. As a result, the consolidated report of results was limited to 11 of the 12 FHLBanks.

Another lesson-learned relates to an emerging risk associated with insurance company FHLBank members. Because insurance companies are not depository institutions, they are not covered by the DIF and, therefore, are more likely to require collateral liquidation by FHLBanks in the event they fail. This risk should be more fully considered in subsequent horizontal reviews including by updating examination guidance to determine more accurately if FHLBanks' advances and collateral management practices are adequate for these non-bank members.

- *Guidance – Recommendation 4.* According to the *FHFA Strategic Plan 2009-2014*, concerns, deficiencies, and other matters identified during a horizontal review are often addressed in guidance bulletins issued by the Agency. FHFA-OIG determined that FHFA has not issued new guidance to FHLBanks or examiners to address the horizontal review results. FHFA-OIG concluded that since the horizontal review began in June 2008, FHFA issued a total of 11 guidance bulletins, 6 of which included references to advances and collateral. However, none of this guidance addressed the horizontal review recommendations.

  Further, FHFA-OIG noted that—separate and apart from the horizontal review—FHFA has initiated a number of guidance bulletins related to advances and collateral, but these bulletins were neither completed nor issued. Among these incomplete and unissued bulletins, FHFA-OIG identified four draft bulletins that could have mitigated numerous risks and findings identified during the horizontal review. It was determined that DBR management did not revisit these draft bulletins once the horizontal review was completed. FHFA-OIG concludes that without issuing updated and final guidance that seeks to mitigate identified risks, examiners have neither clear and consistent instruction nor knowledge of Agency expectations and standards to be applied consistently across the banks. The following three examples illustrate bulletins that have not been issued by the Agency that relate to risks identified in the horizontal review.

- The development of examination guidance on FHLBank risk management started in May 2009. The guidance would have provided criteria for examiners on the evaluation of the existence and adequacy of FHLBank risk management practices and the integration of risk management practices into decision making processes. The draft guidance highlights the importance of FHLBanks defining their risk tolerance as well as risk retention and transfer activities. In this regard, limits on member and geographic concentrations of advances and collateral valuation policies are examples of areas to which the guidance could be applied. The guidance was submitted to DBR's management for review in April 2011. The Agency concluded that the guidance would be better suited for integration into the Examination Manual, which also remains under development.

- Draft examination guidance on member advance concentration and business risk was completed in mid-2007, but it was not widely vetted or issued. This guidance would have provided a series of factors to be considered in the course of an FHLBank examination including governance of advance concentration risks. The factors specifically included regular reporting on concentration risk data relative to risk-based performance measures and analysis of members with large volumes of advances. According to DBR management, the review and issuance of this guidance was overtaken by other events.

- A project to update guidance or revise regulations on risk-based differential pricing of advances by FHLBanks was assigned to a staff member in 2007, and remained an active DBR project until December 2008.[60] The project was not completed due in part to efforts to establish FHFA in the summer and fall of 2008 and other priorities.

- *Training – Recommendations 5, 6, and 7*. The horizontal review's consolidated report notes, "the volume of findings from the onsite review reflects in part the absence of training in advances and collateral risk management prior to the in-depth review." Additionally, with regard to examiners with experience in this area, the roles and responsibilities within the examination team or the Agency may have changed over time so the examiners that have gained expertise may not be available

[60] In the pricing of advances, section 7(j) of the FHLBank Act authorizes an FHLBank to distinguish between members based on its assessment of the credit and other risks to the bank of lending to a particular member.

for subsequent horizontal reviews or follow-up verifications. Yet, FHFA has not provided specific training related to horizontal review issues concerning the examination of advances and collateral, and it does not have plans to provide such training in the immediate future. With additional training, examiners would be better prepared to conduct annual examinations and future horizontal reviews of secured credit, including advances and collateral risk management.

Commercial Bank and Thrift Member Performance Study

FHFA's offsite monitoring for 2009 included a study of the financial performance of member banks that presented heightened supervisory concerns and the risks posed by those members. The study relied on CAMELS ratings and financial data for 6,885 member banks, and focused on the credit risk presented by member banks with composite CAMELS ratings of 3 to 5. FHFA identified a number of significant risks to the FHLBank system. The most prominent risk that FHFA noted related to FHLBanks' lending practices related to poorly rated members or those with a high probability of failure. The study suggested that FHLBanks reassess business plans that rely on troubled members for advance growth.

FHFA-OIG concluded that DBR did not take action on the implementation of the study results regarding FHLBank review of business plans or adequately document its internal dissemination to examiners of the results of the study. Moreover, it is not clear that FHFA formally communicated the results of the review to the FHLBanks.

2. FHFA Can Take Additional Steps to Facilitate Its Capacity to Oversee FHLBanks Collateral Risk Management

FHFA-OIG found that FHFA can better oversee FHLBank collateral management by: (1) leveraging FHLBanks' access to FBA information; (2) exercising its rights under its MOUs with FBAs; (3) pursuing greater participation in FFIEC; and (4) maintaining a centralized list of FHLBank problem members.

Leveraging FHLBanks' Access to FBA Information. As discussed above, FHLBanks have MOUs that provide access to supervisory and regulatory information on their member banks. These MOUs do not authorize FHLBanks to share with FHFA the information concerning troubled member banks. FHFA needs to engage FHLBanks and FBAs to obtain amendments to the MOUs guaranteeing the Agency's access to FBA information regarding troubled member banks. This important information can materially assist FHFA's oversight capacity.

Exercising FHFA's Authority Under Its MOUs with FBAs. FHFA and its predecessor executed MOUs with FBAs that allow the Agency to request access to supervisory and examination information. However, FHFA has not used these MOUs to obtain bank examinations or otherwise enhance its FHLBank supervision.

By periodically requesting from FBAs the examinations relating to troubled member banks and reviewing them, FHFA would be better positioned to assess collateral management risks. For example, FHFA could periodically review the examinations of troubled financial institutions to better assess their overall financial condition and risk management. FHFA could also use such examinations to determine the extent to which individual FHLBanks are managing their advance exposure (e.g., whether FHLBanks have appropriately limited advances to problem institutions and ensured that advances are sufficiently collateralized).

Pursuing Greater Participation in FFIEC. FBAs that supervise and examine member banks are represented on FFIEC, but FHFA is not a member of or a participant in FFIEC. Although FHLBB—which was responsible for overseeing and regulating FHLBanks prior to the creation of FHFA and FHFB before it—was a member of FFIEC, unrelated legislation effectively eliminated FHFA's representation on the council.[61] As a result, FHFA and FHLBanks have limited access to sources with the greatest knowledge of issues that may impact the member banks. Coordinating with FFIEC is not prohibited by statute and could increase FHFA's and FHLBanks' awareness of issues that impact the safety and soundness of member banks. The Agency has pursued membership in FFIEC unsuccessfully. FHFA-OIG commends FHFA for attempting to become a member and believes the Agency should continue to pursue greater participation in some capacity.

Developing a Centralized Problem FHLBank Member Watch-List. FHFA has not established an effective, global method to identify and monitor member banks that are considered to present heightened supervisory concern. The FHLBanks maintain individual watch-lists of troubled member banks that are reviewed by FHFA examiners. FHFA, however, neither consolidates the listings of problem members nor collectively compiles information regarding the risk they pose to the FHLBank system.[62]

By maintaining centralized watch-lists of problem members, FHFA-OIG believes FHFA can identify: (1) increases in the number of problem member banks; (2) geographic concentrations of problem member banks; and (3) the impact of such increases on FHLBanks' ability to achieve their core mission of housing finance. FHFA would also be better positioned to ensure that FHLBanks are effectively managing associated risks.

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[61] FHLBB was also the chartering authority and regulator for federal savings and loan associations that supported its FFIEC membership.

[62] FHFA gathers information on the top ten borrowers within the FHLBank system and for each FHLBank district. However, the Agency does not gather and consolidate supervisory information on other member banks that are considered to be "problem" or that present risks to the FHLBank system.

CONCLUSION

FHFA has taken steps to mitigate risk related to advances and collateral at FHLBanks. These steps include regular, onsite, annual examinations and the use of offsite monitoring practices. However, FHFA can further strengthen its supervisory framework related to FHLBanks' advances and collateral risk management practices. FHFA has not implemented the majority of its examiners' recommendations to ensure effective advances and collateral risk management within the FHLBank system. Although preliminary evidence suggests that FHFA is implementing one recommendation from its horizontal review, its actions are not fully documented. Further, FHFA has not implemented important horizontal review recommendations pertaining to collateral risk guidance and examiner training. FHFA also has not implemented a suggestion from its 2009 internal study on advances management. Separately, FHFA-OIG has identified other steps that FHFA could take to obtain information necessary to enhance its collateral risk oversight and ensure that the FHLBanks are appropriately positioned to manage such risks.

RECOMMENDATIONS

FHFA-OIG recommends that FHFA:

1. Document fully its efforts to ensure that FHLBanks correct identified deficiencies in collateral risk management.

2. Implement and follow-up on the horizontal review recommendations related to the need for additional guidance and training and the need to conduct a follow-up horizontal review of secured credit.

3. Advise FHLBanks to reassess business plans periodically that rely on troubled members for advance growth.

4. Develop policies and procedures to ensure that offsite monitoring analyses that are relevant to supervisory issues, including those related to advances and collateral risk management, are distributed to examination staff and are used to enhance examinations.

5. Continue to enhance coordination with FBAs and FHLBanks, including the use of established MOUs or other written agreements, to obtain bank examinations and other supervisory information as warranted to ensure improved collateral risk management and to facilitate information-sharing related to member banks that present heightened supervisory concerns or that have advance concentrations.

6. Continue to pursue greater participation in FFIEC to enhance the Agency's coordination with FBAs and state regulatory authorities responsible for supervising and regulating FHLBank member banks.

7. Establish a consolidated global watch-list of member banks identified by FHLBanks or by FHFA that present heightened supervisory concern and use the global watch-list to enhance the Agency's supervision of FHLBanks.

SCOPE AND METHODOLOGY

The objective of this performance audit was to assess FHFA's supervisory framework for FHLBank advances and collateral risk management practices for member banks that present heightened supervisory concern. Specifically, FHFA-OIG sought to review FHFA's: (1) supervisory framework and controls related to advances and collateral risk management; and (2) annual examination results for the Atlanta and San Francisco FHLBanks and actions taken to address those results.

In April 2011, FHFA-OIG initiated a survey to assess FHFA's oversight of FHLBanks' controls with respect to underwriting standards and their compliance with such standards relative to their credit decisions. In May 2011, FHFA-OIG completed the survey and announced an audit with the modified objective set forth above. The scope of the audit was January 1, 2007, through September 30, 2011. The scope was lengthened from March 31, 2011, to encompass more recent information in relation to member bank failures and outstanding advances. FHFA-OIG notes that this timeframe includes events and actions that took place under FHFA's predecessor agency, FHFB. However, to understand the program area and to assess whether the Agency's supervisory framework and controls have improved, FHFA-OIG needed to establish benchmarks relative to the supervisory and banking industry environment at the height of the housing crisis.

FHFA-OIG performed fieldwork for this audit from June 8, 2011, to October 31, 2011. FHFA-OIG conducted its field work at FHFA's offices in Washington, DC. To achieve the objective, FHFA-OIG interviewed FHFA senior and middle management in DBR and the Office of General Counsel.[63] FHFA-OIG also interviewed Portfolio Managers, Examiners-in-Charge, and staff examiners within DBR's Office of Examination.[64, 65] As part of the examination staff interviews, FHFA-OIG issued a survey on various topics, such as policies and procedures, special working groups, and training.

Further, FHFA-OIG obtained, reviewed, and analyzed documents from FHFA and the Atlanta and San Francisco FHLBanks. This allowed FHFA-OIG to understand the program area and the

[63] DBR was formerly known as the Office of Supervision under FHFB.

[64] FHFA reorganized its structure in December 2010. Portfolio Managers are now referred to as Associate Directors. To cover the audit period, FHFA-OIG interviewed all current and former Portfolio Managers.

[65] FHFA-OIG selected six members of the examination staff, including Examiners-in-Charge and staff examiners who were on the examination teams for the two selected FHLBanks during the audit scope.

Agency's and FHLBanks' operations. To the extent possible, FHFA-OIG also reviewed source systems and documentation applicable to the audit period including:[66]

- ROEs;
- Internal studies related to advances and collateral, including the horizontal review of FHLBanks' credit risk;
- FHFA's Office of Management and Budget A-123 assessments;
- Prior audit reports, including those conducted by the U.S. Government Accountability Office and the former FHFA Office of Internal Audit;[67]
- Fiscal years 2007 through 2010 performance and accountability reports;
- Advisory and Examination Bulletins;
- Tracking systems and programs for core business functions and DBR projects; and
- DBR's quality assurance review reports.

FHFA-OIG selected two FHLBanks—Atlanta and San Francisco—for detailed testing and review based on the following criteria:

- Their locale in relation to the regions most impacted by the housing crisis;
- The number of member bank failures since 2007;
- The number of member banks with CAMELS ratings of 3 to 5; and
- FHFA's ratings of FHLBanks.

FHFA-OIG obtained and relied on computer-generated data from FHFA. Additionally, FHFA-OIG assessed the validity of the computerized data and found it to be generally accurate, but could not conclude on its completeness. FHFA-OIG reviewed data from the Call Report System, Membership Database, network drives, and numerous SharePoint sites, all of which are used by DBR to assist in the supervision of the FHLBanks.

FHFA-OIG also obtained computer-generated and hardcopy data from the two FHLBanks. After performing high-level analyses, FHFA-OIG determined that the data would not facilitate the detailed testing that was originally planned. As a result, minimal testing was performed on a judgmental sample of member banks to determine if FHLBanks' practices were consistent with those stated in their policies and procedures. Additionally, FHFA-OIG reviewed the supervisory strategies for FHLBanks to determine if advances and collateral deficiencies identified by FHFA were resolved in a timely manner.

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[66] For this audit, FHFA-OIG limited the scope and field work related to credit unions and insurance companies to obtaining source documentation and information on the numbers of those entities that are members of the FHLBank system, including the amount of outstanding advances attributable to those entities.

[67] Prior to the enactment of HERA, FHFB had an Office of Inspector General. Following HERA's enactment, FHFB's Office of Inspector General became FHFA's Office of Internal Audits, which was disbanded in 2010.

To understand the type and extent of coordination between FHLBanks and FHFA with some FBAs, FHFA-OIG coordinated general information sharing sessions with FDIC and OCC.[68] FHFA-OIG also obtained copies of MOUs from OCC and FHFA. In addition, FHFA-OIG reviewed FDIC data on the number of financial institution failures that occurred from January 1, 2006, through August 30, 2011. FHFA-OIG also reviewed information about FDIC's concerns and actions relating to the potential impact that FHLBank advances might have on the DIF.

FHFA-OIG assessed the internal controls related to the audit objective. Internal controls are an integral component of an organization's management that provide reasonable assurance that the following objectives are achieved: (1) effectiveness and efficiency of operations; (2) reliability of financial reports; and (3) compliance with applicable laws and regulations. Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives, and include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance. Based on the work completed on this performance audit, FHFA-OIG considers its findings on FHFA's supervisory framework related to FHLBanks' advances and collateral risk management practices to be significant deficiencies in internal control within the context of the audit objective. Additionally, FHFA-OIG identified other less significant matters that came to its attention during the audit. These matters will be communicated separately in writing to FHFA in an audit memorandum.

Internally, FHFA-OIG coordinated between its Office of Audits and its Office of Evaluations. The Office of Evaluations also had ongoing assignments related to FHLBanks. FHFA-OIG's goal was to avoid duplicating document requests, reported findings, and reportable conditions.

FHFA-OIG conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that audits be planned and performed to obtain sufficient, appropriate evidence to provide a reasonable basis for FHFA-OIG's findings and conclusions based on the audit objective. FHFA-OIG believes that the evidence obtained provides a reasonable basis for the findings and conclusions included herein, based on the audit objective.

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[68] As of September 30, 2011, credit unions and insurance companies represented 17% of FHLBanks' total membership and approximately 19% of total advances. Accordingly, FHFA-OIG excluded these institutions from the scope of the audit.

GLOSSARY OF TERMS

Term	Definition
Advances	An extension of credit from an FHLBank to a member or housing associate.
CAMELS Rating	Financial institution regulators and examiners use the Uniform Financial Institutions Rating System to evaluate a bank's performance in six components represented by the CAMELS acronym: Capital adequacy, Asset quality, Management practices, Earnings performance, Liquidity position, and Sensitivity to market risk. Each component and an overall composite score are assigned a rating of 1 through 5 from least to greatest regulatory concern.
Collateral	Assets pledged to an FHLBank to secure a member bank's indebtedness to the bank. Examples of assets pledged as collateral are: residential first lien mortgage loans; securities representing a whole interest in residential first lien mortgage loans; securities issued, insured, or guaranteed by the federal government or a federal agency; and mutual fund shares comprised of eligible securities, bank term deposits.
Community Development Financial Institutions	Private institutions that provide financial services dedicated to economic development and community revitalization in underserved markets
Component Rating	The individual rating assigned to each of the five components that FHFA examiners evaluate during an FHLBank examination. The rating ranges from lowest to highest degree of supervisory concern from 1 to 4.
Composite Rating	Overall rating of the bank that is based on an evaluation and rating of five key components: corporate governance, market risk, credit risk, operational risk, and financial condition and performance. The composite rating is not an arithmetic average of the component ratings, but the relative importance of each component is determined on a case-by-case basis and then a composite score is derived subjectively. The rating ranges from lowest to highest degree of supervisory concern from 1 to 4.
Credit Risk	The potential that a borrower or counterparty will fail to meet its obligations in accordance with agreed terms. FHLBanks are to establish controls to mitigate such risk.
Enforcement Action	Tools for resolving deficiencies identified within an FHLBank's operations. Tools range from informal to formal remedies. Formal remedies include cease-and-desist orders, temporary cease-and-desist orders, civil money penalties, and suspension or removal orders. Informal remedies include board of directors' resolutions adopted by the institution, memoranda of understanding, and written agreements.
Federal Housing Finance Board (FHFB)	FHFB was the predecessor agency to FHFA that was terminated by the Housing and Economic Recovery Act of 2008. It had supervisory oversight for FHLBanks from 1989 to 2008.

Term	Definition
Haircut	Haircut refers to actions taken by FHLBank management to reduce collateral value, which can impact the borrowing capacity of member banks.
Horizontal Review	A supervisory activity to assess an activity, function, or program across all 12 FHLBanks. These reviews lend themselves to timely comparison of the banks' operations, strategies, and policies. Through these reviews, FHFA can identify best practices and share them.
Matters Requiring Attention	Listing of examination findings evaluated by examination staff to require the attention of an FHLBank's Board of Directors to address and resolve.
Member Bank	Any financial institution that has been approved for membership at an FHLBank and has purchased stock in the bank.
Private-Label Mortgage Backed Securities (PLMBS)	Residential mortgage-backed securities in which the underlying loans or pools of loans are not guaranteed by federal agencies or the Enterprises.
Recommendation(s)	A suggested change to a policy, procedure, practice, or control to improve performance or operations.
Unsafe or Unsound Practice, or Condition	Any action or inaction that is contrary to prudent operation and that has resulted in, or if continued could result in, abnormal loss or risk or damage to the bank or the Office of Finance. Immediate corrective action is required. A bank's condition need not deteriorate to the brink of insolvency before a practice or condition may be found to be unsafe or unsound.
Weakness	An inadequate or otherwise unacceptable policy, procedure, or practice, or a lack of sufficient internal controls or risk management—requires corrective action.

APPENDIX A:

FHFA's Management Response to Findings and Recommendations

Federal Housing Finance Agency

MEMORANDUM

DATE: May 10, 2012

TO: Russell A. Rau, Deputy Inspector General for Audits
FHFA Office of Inspector General

FROM: Stephen M. Cross
Senior Deputy Director, FHFA Division of FHLBank Regulation

SUBJECT: FHFA Comments on FHFA-OIG Audit Report *FHFA's Supervisory Framework for the Federal Home Loan Banks' Advances and Collateral Risk Management* (Assignment No. AUD-2011-007)

This memorandum transmits the Federal Housing Finance Agency's (FHFA) management response to the findings and recommendations in the draft audit report FHFA's Supervisory Framework for the Federal Home Loan Banks' Advances and Collateral Risk Management (Report) prepared by your staff. The Report was transmitted to me initially on January 27, 2012 and in revised form on February 22, 2012. As stated in the Report, the FHFA Office of Inspector General (FHFA-OIG) "initiated this audit to assess FHFA's supervisory framework related to Federal Home Loan Banks' (FHLBanks') advances and collateral risk management practices."

FHFA considers the risks associated with advances and collateral to be generally low and also considers its supervision of FHLBank secured credit activity to be effective. As the Report notes, no FHLBank has ever incurred a credit loss on an advance to a member institution. All advances are secured by eligible collateral. As part of each exam, examiners review credit administration and are expected to check that the FHLBank under examination has policies, procedures, and practices that ensure collateral value exceeds the size of the associated advance and that collateral eligibility, control over the collateral, and the amount of "over-collateralization" reflect prudent underwriting standards. Examiners review the FHLBanks' standards for establishing a "watch list" of members facing financial uncertainties and the ways the FHLBank underwrites advances to members on the watch list. The FHLBanks' underwriting must take into account the borrowers' creditworthiness as well as pledged collateral.

Notwithstanding these conditions, FHFA's predecessor organization initiated, and FHFA completed, a comprehensive horizontal review of advances and collateral at all 12 FHLBanks as the housing and financial crisis was taking shape. The Report describes this initiative. According to the Report, "Examiners identified numerous significant findings regarding FHLBanks' policies, procedures, and practices relating to advances and collateral risk

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management." In the course of the horizontal review, FHFA examiners issued, in the aggregate, 104 findings requiring corrective actions or recommending improvements by an FHLBank. Findings related to monitoring of member institutions; plans for member failures; collateral control, valuation, and haircuts; nontraditional mortgage products; and governance. The findings were transmitted to the FHLBanks through their individual reports of examination. They were catalogued and tracked by examiners. FHFA required remediation of identified weaknesses.

These regulatory actions led to important enhancements at several FHLBanks and since then, despite the failure of more than 400 commercial banks, the FHLBanks did not experience any credit losses on advances. The FHFA-OIG's Report identifies no significant deficiencies in FHFA examination coverage or shortcomings in FHLBank risk management overlooked by FHFA examiners.

Despite an effective examination program and an empirical record of successfully supervising the FHLBanks, the Report asserts that "FHFA can further strengthen its supervisory framework" and offers seven recommendations. FHFA accepts that a nearly 80 year record of safe and sound advances lending is not enough to ensure future performance. Since advance lending is central to the business of the FHLBanks, and thus is central to ensuring the FHLBanks' safety and soundness, FHFA agrees that continued oversight of each FHLBank's advances and collateral program is a key element to our safety and soundness mission. Thus, we will review and implement the FHFA-OIG's recommendations as appropriate.

Below are our specific comments and planned actions in response to each FHFA-OIG recommendation.

1. *Document fully its efforts to ensure that FHLBanks correct identified deficiencies in collateral risk management.*

We agree with the recommendation. We would note that the Report asserts that examiners did not in every case "complete standalone work-papers or summaries that document how they verified or tested FHLBank corrective actions." However, the Report does not cite a single instance in which an FHFA examiner failed to identify a significant deficient collateral risk management practice at an FHLBank or seek remediation of any such deficiency. It is not possible from the Report, moreover, to know the nature or the extent of the alleged shortcomings in examiners' documentation. Nonetheless, because FHFA places a high value on work paper documentation of testing and verification of FHLBank remediation activities, the Agency agrees with this recommendation and will incorporate documentation of testing and verification into efforts already underway to develop an automated information system for Agency managers, which is targeted for implementation by December 31, 2012.

2. *Implement and followup on the horizontal review recommendations related to the need for additional guidance and training, and the need to conduct a follow-up horizontal review of secured credit.*

We agree that FHFA executive management will formally review each matter raised in the 2010 report and document our determinations regarding appropriate follow-up action. Until this review is completed, we believe it is premature to commit to implement these recommendations. We note that more than two years has passed since this work was completed. Our review will consider the appropriateness of these recommendations in light of developments since then, at FHFA, at the FHLBanks, and in the market. We plan to follow up on the horizontal review's recommendations by December 15, 2012.

3. *Advise FHLBanks to periodically reassess business plans that rely on troubled members for advance growth.*

We believe this is already routinely covered in our supervisory program but we agree to formally advise the FHLBanks of the need to assess their reliance on troubled members for advance growth. We plan to advise the FHLBanks to reassess business plans by June 30, 2012.

4. *Enhance policies and procedures to ensure that offsite monitoring analyses that are relevant to supervisory issues, including those related to advances and collateral risk management, are distributed to examination staff and are used to enhance examinations.*

We believe that the Division of Bank Regulation already has a robust offsite monitoring program and that this work is systematically shared with examination staff, but in view of this recommendation, we agree to consider further enhancements to our offsite monitoring programs. If warranted, we will update written policies and procedures to ensure appropriate offsite monitoring analyses are developed and shared with examination staff. We plan to review and enhance as needed our policies and procedures for offsite monitoring by November 15, 2012.

5. *Continue to enhance coordination with FBAs and FHLBanks, including the use of established MOUs or other written agreements, to obtain bank examinations and other supervisory information as warranted to ensure improved collateral risk management and to facilitate information-sharing related to member banks that present heightened supervisory concerns or that have advance concentrations.*

FHFA has already attempted to obtain bank examination reports or examination ratings from the FBAs. In view of this recommendation, we will re-engage with the FBAs to seek avenues for enhanced communication on troubled FHLBank members. Specifically, we will contact each FBA, alert them to the FHFA-OIG recommendation and our desire to engage in a dialogue to assess the current state of our information sharing, and discuss options for enhancements that serve our mutual needs and responsibilities. We will contact each FBA by September 30, 2012.

6. *Continue to pursue greater participation in FFIEC to enhance the Agency's coordination with FBAs and state regulatory authorities responsible for supervising and regulating FHLBank member banks.*

FHFA and at least one of its predecessor agencies have repeatedly sought legislative authorization to participate in an appropriate way on the FFIEC. Separately, the Dodd-Frank Act has required more instances of formal regulatory coordination between FHFA and other regulatory agencies. We will continue to seek appropriate opportunities to participate with the FFIEC consistent with our commitment in response to the previous recommendation. We will contact the Department of the Treasury and responsible Congressional Committees about FHFA inclusion in the FFIEC by September 30, 2012.

7. *Establish a consolidated global watch-list of member banks identified by FHLBanks or by FHFA that present heightened supervisory concern, and use the global watch-list to enhance the Agency's supervision of FHLBanks.*

We will formally evaluate the idea, in consultation with DBR's examiners-in-charge and supervision executives, DBR's managers responsible for off-site monitoring, and FHFA's Supervision Committee. Specifically, we will evaluate the merits of such a list, how it would be established, maintained and protected, and how it could be used to enhance supervision. Our evaluation will also consider alternatives to the same end. Our evaluation will be completed by March 15, 2013.

APPENDIX B:
FHFA-OIG's Response to FHFA's Comments

On May 10, 2012, FHFA provided comments to a draft of this report, agreeing with all of the recommendations and identifying FHFA actions to address them. FHFA-OIG considers the actions sufficient to resolve the recommendations, which will remain open until FHFA-OIG determines that agreed upon corrective actions are completed and responsive to the recommendations. FHFA-OIG has attached the Agency's full response (see Appendix A), which was considered in finalizing this report. Appendix C provides a summary of management's comments on the recommendations and the status of agreed-to corrective actions.

When agreeing to FHFA-OIG's recommendations, FHFA opined that it considers the risks associated with advances and collateral generally to be low, in part because no FHLBank has incurred a credit loss on an advance to a member institution. Nonetheless, FHFA concurs that "a nearly 80 year record of safe and sound advances lending is not enough to ensure future performance."

FHFA made two additional points in its comments that warrant clarification. First, FHFA stated that FHFA-OIG's report identifies no deficiencies in FHFA examination coverage or shortcomings in FHLBank risk management that were overlooked by FHFA examiners. Second, FHFA stated the FHFA-OIG report does not cite a single instance in which an FHFA examiner failed to identify a deficient collateral risk management practice at an FHLBank or seek remediation of any such deficiency. In contrast, the report addresses several enhancements to FHFA's supervisory framework including additional guidance, training, monitoring, access to information, and coordination with bank regulators that were either overlooked by examiners or not acted upon by management. Further, FHFA-OIG's audit objective was to assess the supervisory framework related to FHLBank advances and collateral risk management practices, not to fulfill FHFA's responsibility to perform examinations of the FHLBanks. Thus, FHFA-OIG focused on how FHFA processed over 100 deficiencies that were identified in the horizontal review and had not been previously identified by either the Agency's routine examinations or its supervisory framework.

APPENDIX C:
Summary of FHFA's Management Comments to the Recommendations

This table presents the management response to the recommendations in FHFA-OIG's report and the status of the recommendations as of the date of report issuance.

Rec.	Corrective Action: Taken or Planned	Expected Completion Date	Monetary Benefits	Resolved[a] Yes or No	Open or Closed[b]
1.	FHFA agreed with this recommendation and plans to incorporate documentation of testing and verification into efforts already under way to develop an automated information system. The Agency estimates implementation by December 31, 2012.	12/31/2012	$0	Yes	**Open**
2.	FHFA agreed with this recommendation. FHFA executive management will formally review each matter raised in the 2010 report and document the determinations regarding appropriate follow-up action. The review will consider the appropriateness of these recommendations in light of developments since then at FHFA, FHLBanks, and in the market. The Agency estimates implementation by December 15, 2012.	12/15/2012	$0	Yes	**Open**
3.	FHFA agreed with this recommendation. However, the Agency believes this is already routinely covered in its supervisory program but will formally advise FHLBanks of the need to assess their reliance on troubled members for advance growth. The Agency estimates implementation by June 30, 2012.	6/30/2012	$0	Yes	**Open**

Rec.	Corrective Action: Taken or Planned	Expected Completion Date	Monetary Benefits	Resolved[a] Yes or No	Open or Closed[b]
4.	FHFA agreed with this recommendation. Although the Agency believes it already has a robust offsite monitoring program and that this work is systematically shared with examination staff, due to this recommendation it will consider further enhancements to its offsite monitoring programs. If warranted, the Agency will update written policies and procedures to ensure appropriate offsite monitoring analyses are developed and shared with examination staff. The Agency estimates implementation by November 15, 2012.	11/15/2012	$0	Yes	**Open**
5.	FHFA agreed with this recommendation. FHFA will re-engage with FBAs to seek avenues for enhanced communication on troubled FHLBank members. Specifically, the Agency will contact each FBA, alert them to FHFA-OIG's recommendation and assess the current state of the Agency's information sharing, and discuss options for enhancements that serve the mutual needs and responsibilities. The Agency estimates implementation by September 30, 2012.	9/30/2012	$0	Yes	**Open**
6.	FHFA agreed with this recommendation. FHFA will continue to seek appropriate opportunities to participate with FFIEC consistent with its commitment in response to the previous recommendation. The Agency will contact the Department of the Treasury and relevant Congressional Committees about FHFA's inclusion in FFIEC. The Agency estimates implementation by	9/30/2012	$0	Yes	**Open**

Rec.	Corrective Action: Taken or Planned	Expected Completion Date	Monetary Benefits	Resolved[a] Yes or No	Open or Closed[b]
	September 30, 2012.				
7.	FHFA agreed with this recommendation. The Agency will formally evaluate the idea of a global watch-list in consultation with DBR's examiners-in-charge and supervision executives, DBR's managers responsible for offsite monitoring, and FHFA's Supervision Committee. Specifically, the Agency will evaluate the merits of such a list, how it would be established, maintained and protected, and how it could be used to enhance supervision. The Agency estimates implementation by March 15, 2013.	3/15/2013	$0	Yes	**Open**

a Resolved means: (1) Management concurs with the recommendation, and the planned, ongoing, and completed corrective action is consistent with the recommendation; (2) Management does not concur with the recommendation, but alternative action meets the intent of the recommendation; or (3) Management agrees to FHFA-OIG monetary benefits, a different amount, or no amount ($0). Monetary benefits are considered resolved as long as management provides an amount.

b Once FHFA-OIG determines that the agreed-upon corrective actions have been completed and are responsive to the recommendations, the recommendations can be closed.

ADDITIONAL INFORMATION AND COPIES

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Fax us the complaint directly: 202-318-0358

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Attn: Office of Investigation – Hotline
400 Seventh Street, S.W.
Washington, D.C. 20024