

Federal Housing Finance Agency
Office of Inspector General



FHFA Completed All of its Planned Ongoing Monitoring Activities for Freddie Mac for 2019

Audit Report • AUD-2020-012 • September 9, 2020



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September 9,
2020

Executive Summary

The Federal Housing Finance Agency (FHFA) is charged by the Housing and Economic Recovery Act of 2008 with the supervision of Fannie Mae and Freddie Mac (together, the Enterprises), any affiliate of the Enterprises, and the Federal Home Loan Banks (collectively, the regulated entities). Its mission as a federal financial regulator includes ensuring the safety and soundness of its regulated entities so that they serve as a reliable source of liquidity and funding for housing finance and community investment. Since 2008, FHFA has also served as conservator of the Enterprises.

FHFA maintains that it uses a risk-based approach to supervisory examinations, prioritizing examination activities based on the assessed risk of a given practice to a regulated entity's safe and sound operation or to its compliance with applicable laws and regulations. Within FHFA, the Division of Enterprise Regulation (DER) is responsible for supervision of the Enterprises. The Deputy Director, DER (Deputy Director), is responsible for providing management oversight, direction, and support for all examination activity involving the Enterprises, including the development of supervision findings and issuance of the annual reports of examination (ROE).

DER examiners engage in ongoing monitoring to analyze information and to identify Enterprise practices and changes in an Enterprise's risk profile that may warrant supervisory attention, as well as to determine the status of the Enterprise's compliance with supervisory guidance and conservatorship directives and remediation of Matters Requiring Attention (MRAs). Ongoing monitoring is one of the two types of supervisory activities conducted by DER; the other supervisory activities are targeted examinations.

In light of our prior work going back to 2016 that found DER failed to complete many targeted examinations or to complete them timely, we performed this audit to determine whether DER completed its planned ongoing monitoring activities for Freddie Mac for the 2019 examination cycle, and if it did not, whether it documented the deviations from its plans in accordance with its requirements.

We found that DER completed all 31 planned ongoing monitoring activities for Freddie Mac for the 2019 examination cycle before the 2019 ROE issued and we considered those to be timely. Accordingly, there were no changes to DER's planned ongoing monitoring activities for the 2019 examination cycle. As part of this test, we found two exceptions with documentation requirements; however, we consider these exceptions to be non-systemic.

We make no recommendations in this report.



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We are also issuing today, a second report, *FHFA Completed Most of its Planned Ongoing Monitoring Activities for Fannie Mae and CSS for 2019; However, FHFA Failed to Follow its Requirements When it Changed Examination Plans for Non-Risk-Based Reasons and Failed to Obtain Deputy Director Approval* (September 9, 2020) (AUD-2020-011), which undertakes the same assessment for DER's ongoing monitoring activities for Fannie Mae and Common Securitization Solutions.

This report was prepared by Tara Lewis, Audit Director; Terese Blanchard, Auditor-in-Charge; and Brian Maloney, Auditor; with assistance from Abdil Salah, Assistant Inspector General for Audits, and Bob Taylor, Senior Advisor. We appreciate the cooperation of FHFA staff, as well as the assistance of all those who contributed to the preparation of this report.

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

Marla A. Freedman, Senior Audit Executive /s/

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ABBREVIATIONS

DER	Division of Enterprise Regulation
Deputy Director	Deputy Director, Division of Enterprise Regulation
EIC	Examiner-in-Charge
Enterprises	Fannie Mae and Freddie Mac
FHFA	Federal Housing Finance Agency
MRA	Matter Requiring Attention
OIG	Federal Housing Finance Agency Office of Inspector General
OPB	Operating Procedures Bulletin
ROE	Report of Examination

BACKGROUND

Effective Supervision by FHFA Is Vital to Ensure Safety and Soundness of Freddie Mac

FHFA maintains that it uses a risk-based approach to supervisory examinations, prioritizing examination activities based on the risk a given practice poses to a regulated entity's safe and sound operation or to its compliance with applicable laws and regulations. Within FHFA, DER is responsible for supervision of the Enterprises. The Deputy Director is responsible for providing management oversight, direction, and support for all examination activity involving the Enterprises, including the development of supervision findings and issuance of the annual ROEs. Examination activity at each Enterprise is led by an examiner-in-charge (EIC), and conducted by a team of on-site examiners, in coordination with other subject matter experts. The EIC serves as the central point of contact for communication between DER and the Enterprises, and is responsible for the planning, execution, and documentation of examination activities.

FHFA's Examination Planning Process

According to FHFA's *Examination Manual*, December 2013,¹ risk assessments provide the foundation for determining the supervisory activities to be conducted. Using the risk assessments, a supervisory strategy is prepared for each Enterprise by the DER examination teams. Once the annual supervisory strategy is approved, the strategy is implemented through an annual examination plan, prepared by the EIC for each Enterprise and approved by the Deputy Director.

FHFA's annual examination plans identify the supervisory activities, both ongoing monitoring and targeted examinations, expected to be completed during that examination cycle. Examiners conduct ongoing monitoring to analyze information and to identify Enterprise practices and changes in an Enterprise's risk profile that may warrant supervisory attention. Ongoing monitoring is also used to determine the status of the Enterprise's compliance with supervisory guidance, remediation of MRAs,² and conservatorship

¹ In March 2020, DER issued the *Enterprise Examination Manual* for examiners performing supervisory activities at Fannie Mae, Freddie Mac, and their affiliates.

² Further, DER examiners may identify supervisory concerns or deficiencies occurring at an Enterprise as a result of ongoing monitoring or targeted examinations. MRAs are the most serious supervisory matters and fall into one of the following categories: (1) critical supervisory matters that pose substantial risk to the safety and soundness of the regulated entity, such as instances of noncompliance with laws or regulations of a serious nature or repeated criticisms that have escalated in importance because of insufficient attention or action; or (2) deficiencies that are supervisory concerns that FHFA believes could, if not corrected, escalate and potentially negatively affect the condition, financial performance, risk profile, operations, or reputation of the regulated entity.

directives. Targeted examinations complement ongoing monitoring: they enable examiners to conduct “a deep or comprehensive assessment” of the areas found to be of high importance or risk.

An operating procedures bulletin (OPB) issued by DER in 2019, *Examination Planning Process*, provides that the examination plan may be modified during the course of the year to reflect changes in Enterprise business operations or risk exposures (risk-based reasons).³ This OPB requires that any changes should be reflected in revisions to the plan, with documentation of the basis for the revisions. It instructs that any such revisions must be approved by the EIC and Deputy Director and approved as part of the mid-year planning process. The final examination plan is also approved as part of the year-end closeout process. Presumably, DER added the requirement for written Deputy Director approval to ensure that the Deputy Director, who is responsible for providing management oversight, direction, and support for all examination activity involving the Enterprises, properly executed these duties.

An OPB issued by DER in 2018, *Examination Processes and Documentation: Ongoing Monitoring*, directs that each ongoing monitoring activity is to be documented by an EIC-approved completed procedures document and analysis memorandum as of June 30 and as of December 31.⁴ Additionally, a conclusion letter is to be issued to the Enterprise to communicate any adverse examination findings identified during ongoing monitoring activities. Prior to the issuance of this OPB, an analysis memorandum was not required if the ongoing monitoring did not identify an adverse examination finding. Additionally, the prior guidance did not prescribe “as of” dates for preparing required documentation.

For the Enterprises, DER examiners summarize, in an annual ROE, examination results, conclusions, findings, and supervisory concerns from the supervisory activities completed during the annual examination cycle. For the 2019 examination cycle, DER issued its ROE for Freddie Mac on March 31, 2020.

Prior Audits and Evaluations Found that FHFA Failed to Complete Many Targeted Examinations and Other Targeted Examinations Were Not Completed During the Examination Cycle for Which They Were Planned

We have issued a series of reports on FHFA’s implementation of planned supervisory activities for Freddie Mac. In a 2016 audit we found that DER completed just over half of its planned targeted examinations of Freddie Mac for the 2012 through 2015 supervisory cycles

³ FHFA DER, OPB, *Examination Planning Process* (Apr. 1, 2019) (DER-OPB-2.5). DER’s prior guidance, *Supervisory Planning Process* (2013-DER-OPB-03.1, issued October 2013), also required that adjustments to the examination plans be based on risk.

⁴ The 2018 OPB states that the EIC may designate alternate time periods for this documentation, but time periods should not significantly exceed six months.

and could not account for all of its planned targeted examinations.⁵ In light of our findings in the 2016 audit, we performed a similar audit in 2019 to determine whether DER examiners completed the targeted examinations identified in each examination plan for Freddie Mac from 2016 through 2018, and compared the results to those of our 2016 audit. We found that timely completion of targeted examinations prior to issuance of the ROE improved, but continued to be an issue.⁶

In addition, we assessed DER’s implementation of supervisory activities in specific risk areas – cybersecurity and model risk – and found that DER fell short in completion of planned supervisory activities. In a 2017 audit related to Freddie Mac’s management of cybersecurity risk, we found that DER did not complete one of its planned 2016 targeted examinations until after the 2016 ROE issued; DER did, however, complete the three planned ongoing monitoring activities for that examination cycle relating to cybersecurity risk.⁷ We also looked at the Enterprises’ management of model risk in a 2020 evaluation and found that DER completed 20% of its targeted examinations (24 of 120 high-risk models) over six examination cycles. In that evaluation, we concluded that the failure to complete targeted examinations of high-risk models demonstrated the impact of a lack of workforce planning with respect to the qualifications of examiners, the appropriate number of model examiners, and the number of high-risk models to examine during each annual examination cycle.⁸

FACTS AND ANALYSIS

For the 2019 Examination Cycle, DER Completed All Planned Ongoing Monitoring Activities for Freddie Mac Before the ROE Issued; We Found Two Exceptions with Documentation Requirements

According to FHFA, DER examiners engage in ongoing monitoring to analyze information and to identify Enterprise practices and changes in an Enterprise’s risk profile that may warrant supervisory attention, as well as to determine the status of the Enterprise’s compliance with supervisory guidance and conservatorship directives and remediation of

⁵ See *OIG, FHFA’s Targeted Examinations of Freddie Mac: Just Over Half of the Targeted Examinations Planned for 2012 through 2015 Were Completed* (Sept. 30, 2016) (AUD-2016-007) (online [here](#)).

⁶ See *OIG, FHFA’s Completion of Planned Targeted Examinations of Freddie Mac Improved from 2016 through 2018, But Timeliness Remained an Issue* (Sept. 17, 2019) (AUD-2019-013) (online [here](#)).

⁷ See *OIG, FHFA Did Not Complete All Planned Supervisory Activities Related to Cybersecurity Risks at Freddie Mac for the 2016 Examination Cycle* (Sept. 27, 2017) (AUD-2017-011) (online [here](#)).

⁸ See *OIG, Despite FHFA’s Recognition of Significant Risks Associated with Fannie Mae’s and Freddie Mac’s High-Risk Models, its Examination of Those Models Over a Six Year Period Has Been Neither Rigorous nor Timely* (Mar. 25, 2020) (EVL-2020-001) (online [here](#)).

MRAs. Ongoing monitoring is one of the two types of supervisory activities conducted by DER to ensure the safety and soundness of the Enterprises' operations. In light of the findings in our prior work on DER's completion of planned supervisory activities, we performed this audit to analyze whether DER completed the ongoing monitoring activities identified in its 2019 examination plan (review period) for Freddie Mac.

Consistent with DER's guidance in OPB, *Examination Processes and Documentation: Ongoing Monitoring*, we considered an ongoing monitoring activity to be "commenced" when the initial procedures document for that activity was approved by the EIC.⁹ We considered an ongoing monitoring activity to be "completed" when the supporting documents were completed and approved (e.g., procedures documents, analysis memoranda, and conclusion letter, if issued).¹⁰ We considered an ongoing monitoring activity to be "not conducted" when DER documents showed the status of the activity as deferred or cancelled.

As described below, we performed tests to determine whether DER completed its planned ongoing monitoring activities for Freddie Mac during the 2019 examination cycle, and if it did not, whether it documented the deviations from its plans in accordance with its requirements and whether the documented reasons aligned with the OPB.

Testing to Determine Completion of Planned Ongoing Monitoring Activities

We tested whether DER completed its planned ongoing monitoring activities for Freddie Mac during the 2019 examination cycle. We developed a list of the Freddie Mac ongoing monitoring activities planned by DER for the 2019 examination cycle from annual examination plans obtained from FHFA's Information Management System, DER's system of record, and identified 31 planned ongoing monitoring activities.

Result of Test:

We determined that all 31 planned ongoing monitoring activities for the 2019 examination cycle were completed before the 2019 ROE issued and we considered those to be timely. As part of this test, we found two exceptions with documentation requirements, described below, which we consider to be non-systemic:

⁹ The initial procedures document states the objectives and scope of the activity and the specific work steps to meet the ongoing monitoring objective.

¹⁰ According to DER OPB, *Examination Processes and Documentation – Ongoing Monitoring*, supporting documentation for ongoing monitoring activities includes the following: (1) procedures document as of June 30 and/or December 31; (2) analysis memoranda as of June 30 and/or December 31; and (3) signed conclusion letter (if adverse examination findings were identified).

- DER officials did not prepare a procedures document and analysis memorandum as of June 30, 2019 (mid-year) for one ongoing monitoring activity. The EIC informed us that the examination team overlooked preparing these two documents at mid-year. We found that the required documents were prepared as of year-end, December 31, 2019.
- The EIC did not approve the initial procedures document for another ongoing monitoring activity, another exception that the EIC attributed to an oversight. The EIC approved the completed procedures document at year-end.

Testing to Determine Appropriate Documentation and Approvals of Changes to the Examination Plan

We set out to test whether DER documented a risk-based reason for not conducting the activities and whether those changes to the examination plans were approved in accordance with requirements.

Result of Test:

As previously discussed, all 31 planned ongoing monitoring activities were completed during the 2019 examination cycle. Accordingly, there were no changes to DER’s planned ongoing monitoring activities for the 2019 examination cycle.

CONCLUSION.....

DER completed all of its planned ongoing monitoring activities for Freddie Mac during the 2019 examination cycle. Specifically, we determined that all 31 planned ongoing monitoring activities for the 2019 examination cycle were completed before the 2019 ROE issued and, there were no changes to DER’s 2019 examination plan. As part of this test, we found two exceptions with DER documentation requirements; however, we considered the exceptions to be non-systemic.

FHFA COMMENTS AND OIG RESPONSE.....

We provided FHFA an opportunity to respond to a draft of this audit report. FHFA had no technical comments on the draft report. FHFA provided a management response, which is included in the Appendix of this report.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of the audit was to determine whether FHFA’s DER completed its planned ongoing monitoring activities for Freddie Mac for the 2019 examination cycle (review period) and, if it did not, whether it documented the deviations from its plans in accordance with its requirements.

To accomplish our objective, we:

- Reviewed FHFA’s guidance in effect during our review period, including FHFA’s *Examination Manual*; DER’s OPBs, *Examination Planning Process*; *Examination Processes and Documentation – Ongoing Monitoring*; *Examination Processes and Documentation – Targeted Examinations*; *Document Management Guidance*; *Reports of Examination*; *Enterprise Supervision Program*; and FHFA Advisory Bulletin 2017-01, *Classifications of Adverse Examination Findings*;
- Reviewed FHFA’s examination plans for 2019 for Freddie Mac to identify the universe of planned ongoing monitoring activities;
- Compared the planned ongoing monitoring activities for Freddie Mac – as described in FHFA’s examination planning documents – to the ongoing monitoring procedures documents, analysis memoranda, and other relevant documentation in order to determine whether FHFA completed its planned ongoing monitoring activities for the 2019 examination cycle, and if it did not, to identify the disposition of the ongoing monitoring activities;
- Assessed whether DER completed the planned ongoing monitoring activities for the 2019 examination cycle prior to the ROE issued;
- Reviewed FHFA’s changes to its 2019 examination plans for ongoing monitoring activities for Freddie Mac to determine if the changes were documented and approved in accordance with policies and procedures; and
- Interviewed FHFA officials regarding their implementation of the 2019 examination plans for ongoing monitoring activities for Freddie Mac.

We conducted this performance audit from March 2020 to September 2020 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence

obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

APPENDIX: FHFA MANAGEMENT RESPONSE



Federal Housing Finance Agency

MEMORANDUM

TO: Marla A. Freedman, Deputy Inspector General for Audits
FHFA Office of Inspector General (OIG)

FROM: Paul J. Miller, Deputy Director *PJM*
FHFA Division of Enterprise Regulation (DER)

SUBJECT: Draft Audit Report: *FHFA Completed All of its Planned Ongoing Monitoring Activities for Freddie Mac for the 2019 Examination Cycle*

DATE: August 31, 2020

Thank you for the opportunity to respond to the draft audit report titled, *FHFA Completed All of its Planned Ongoing Monitoring Activities for Freddie Mac for the 2019 Examination Cycle* (Report). The objective of the audit was to determine whether DER completed its planned ongoing monitoring activities for Freddie Mac for the 2019 examination cycle and whether deviations from the examination plan were documented in accordance with DER's requirements.

We are pleased that the audit found that DER completed all planned ongoing monitoring activities for the 2019 examination cycle before the 2019 Freddie Mac Report of Examination was issued.

We would like to thank the OIG staff that worked with the Agency during this audit. If you have any questions related to our response, please do not hesitate to contact Eric Wilson.

cc: Chris Bosland
Kate Fulton
Scott Valentin
Eric Wilson
John Major

ADDITIONAL INFORMATION AND COPIES.....

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