AUDIT, EVALUATION, AND COMPLIANCE PLAN

April 2020

OVERVIEW

The Federal Housing Finance Agency (FHFA or Agency) Office of Inspector General (OIG) is pleased to present this Audit, Evaluation, and Compliance Plan for calendar year 2020. The plan describes FHFA's and OIG's roles and missions, explains our risk-based methodology for developing this plan, provides insight into risks within five areas, and generally discusses where we will focus our audit, evaluation, and compliance resources during calendar year 2020.

As of this writing, we are mindful that measures are being taken to mitigate the impacts of the COVID-19 pandemic on U.S. citizens and financial system, including the FHFA-regulated entities. We will consider those impacts in scoping the oversight work we undertake in 2020.

BACKGROUND

Federal Housing Finance Agency

On July 30, 2008, Congress established FHFA with the Housing and Economic Recovery Act of 2008 (HERA)[1] to regulate Fannie Mae, Freddie Mac (together, the Enterprises), the Federal Home Loan Banks (FHLBanks) (collectively, the regulated entities), and the FHLBanks' fiscal agent, the Office of Finance.[2] FHFA's mission is to "[e]nsure that the regulated entities operate in a safe and sound manner so that they serve as a reliable source of liquidity and funding for housing finance and community investment."[3]

Since September 2008, FHFA also has been the Enterprises' conservator. FHFA placed the Enterprises into conservatorships "in response to a substantial deterioration in the housing markets that severely damaged each Enterprise's financial condition and left both of them unable to fulfill their mission without government intervention."[4] When then-Secretary of the Treasury Henry Paulson announced the conservatorships in September 2008, he explained that they were meant to be a "time out" during which the Enterprises would be stabilized, enabling the "new Congress and the next Administration [to] decide what role government in general, and these entities in particular, should play in the housing market."[5] However, putting the Enterprises into

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[1] Public Law No. 110-289.

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

[3] FHFA, *FHFA Strategic Plan: Fiscal Years 2018–2022* (Jan. 29, 2018).

[4] FHFA, History of Fannie Mae & Freddie Mac Conservatorships.

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

conservatorships has proven to be far easier than taking them out, and the "time out" period for the conservatorships is now in its 12th year.

FHFA's two conservatorships are of unprecedented scope and undetermined duration. The two entities dominate the United States' secondary mortgage market and the mortgage securitization sector and thus affect the entire mortgage finance industry. While in conservatorship, the Enterprises have required almost $191.5 billion in financial investment from the Treasury to avert their insolvency and, through December 2019, the Enterprises have paid to the Treasury more than $301 billion in dividends on its investment. Despite their high leverage, limited capital buffer, conservatorship status, and uncertain future, the Enterprises' guarantee portfolios have grown during conservatorship and, according to FHFA, their combined market share of newly issued mortgage backed securities is more than 60%. The Enterprises' combined total assets are more than $5.7 trillion and their combined debt exceeds $5 trillion.

Although market conditions improved prior to the United States' coronavirus-related economic downturn in 2020, and the Enterprises have paid dividends on Treasury's investments, the Enterprises' future profitability cannot be assured for these reasons: the wind down of their retained investment portfolios and associated reduction in net interest income; the level of guarantee fees they will be able to charge and keep; their business segments' future performance; and the significant uncertainties involving key market drivers, such as mortgage rates, home prices, credit standards, and unemployment.

FHFA Office of Inspector General

Congress established OIG with a mission to promote economy, efficiency, and effectiveness in the administration of FHFA's programs and operations, and to prevent and detect fraud, waste, and abuse in those programs and operations.[6] The FHFA Inspector General is presidentially appointed and Senate confirmed.

Our Vision

We seek to be an organization that promotes excellence and trust through exceptional service to FHFA, Congress, and the American people. OIG achieves this vision by being a first-rate independent oversight organization in the federal government that acts as a catalyst for effective management, accountability, and positive change in FHFA. In addition, we are committed to holding accountable those, whether inside or outside of the federal government, who waste, steal, or abuse funds in connection with the Agency, the Enterprises, or the FHLBanks.

Our Mission

OIG promotes economy, efficiency, and effectiveness and protects FHFA and the entities it regulates against fraud, waste, and abuse, contributing to the liquidity and stability of the

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

nation's housing finance system. We accomplish this mission by providing independent, relevant, timely, and transparent oversight of the Agency to promote accountability, integrity, economy, and efficiency. We also advance our mission by advising the Director of the Agency and Congress, informing the public, and engaging in robust law enforcement efforts to protect the interests of the American taxpayers.

Our Organization

OIG consists of the Inspector General, her senior staff, and operational and support offices within OIG. The operational offices include the Offices of Audits (OA), Evaluations, (OE) Investigations (OI), and Compliance and Special Projects (OCom). This Audit, Evaluation, and Compliance Plan most directly impacts OA, OE, and OCom. Supporting our mission is OIG's Office of Risk Analysis, which is tasked with identifying, analyzing, monitoring, and prioritizing emerging and ongoing risk to enable us to adjust our focus and deploy our assets to address them.

OIG Office of Audits

OA conducts independent performance audits with respect to the Agency's programs and operations. It also undertakes projects to address statutory requirements and stakeholder requests. As required by the Inspector General Act of 1978 (IG Act),[7] OA performs its audits in accordance with the audit standards promulgated by the Comptroller General of the United States. OA also oversees independent public accounting firms that perform certain audits of FHFA programs and operations.

OIG Office of Evaluations

OE conducts independent and objective reviews, assessments, studies, and analyses of FHFA's programs and operations. Under the Inspector General Reform Act of 2008,[8] inspectors general are required to adhere to the professional standards designated by the Council of the Inspectors General on Integrity and Efficiency (CIGIE). OE performs its evaluations in accordance with the standards CIGIE established for inspections and evaluations, which are known as the *Quality Standards for Inspection and Evaluation* (Blue Book).

OIG Office of Compliance and Special Projects

OCom is charged with several responsibilities. It is tasked with: tracking the status of all OIG recommendations, from issuance to closure to subsequent follow-up and testing; communicating with each office prior to closure of a recommendation to facilitate application of a single standard across the office for closing recommendations; and testing a sample of closed recommendations to verify independently whether FHFA has implemented in full the corrective

[7] Public Law No. 95-452.

[8] Public Law No. 110-409.

actions it represented to OIG that it intended to take and publishing its testing results as compliance reviews.

OCom also undertakes special projects, which include reviews and administrative inquiries of hotline complaints alleging non-criminal misconduct. It performs its compliance reviews and special projects in accordance with the Blue Book.

RISK ASSESSMENTS

OIG's broad oversight mission encompasses the full scope of the Agency's programs and operations, including its conservatorship of the Enterprises. To best leverage our resources to strengthen OIG's oversight, we focus our resources on programs and operations that pose the greatest financial, governance, and/or reputational risk to the Agency, the Enterprises, and the FHLBanks. We have established an ongoing and dynamic planning process to identify the most significant risks. This process includes two types of periodic deliverables. The first deliverable is composed of strategic plans that seek to further FHFA's strategic goals for its programs (i.e., ensure safe and sound regulated entities; ensure liquidity, stability, and access in housing finance, and manage the Enterprises' ongoing conservatorships); the second is composed of annual audit, evaluation, and compliance plans that flow from the strategic plans and focus on particular areas of greatest risk to FHFA and the entities it regulates.

Strategic Plan

In February 2018, OIG issued *Strategic Plan: Fiscal Years 2018–2022*. The plan sets forth four high-level goals, of which three serve as a blueprint for our oversight of FHFA.[9] These three goals are:

- Strategic Goal 1—Promote FHFA's effective supervision of the Enterprises and the FHLBanks to ensure their safety and soundness.
- Strategic Goal 2—Promote FHFA's effectiveness as conservator of the Enterprises.
- Strategic Goal 3—Prevent and detect fraud, waste, and abuse in the programs and operations of the Agency.

OIG will continue to monitor events potentially impacting FHFA and housing finance, including the COVID-19 pandemic, and make changes to the plan as circumstances warrant.[10]

[9] The plan also includes a fourth goal of promoting excellence and effectiveness in OIG internal operations.

[10] In response to the COVID-19 pandemic, FHFA has taken steps to support the secondary mortgage market and provide relief to borrowers, including authorizing the Enterprises to provide additional liquidity and loan processing flexibilities and directing them to suspend foreclosures and evictions for at least 60 days.

Audit, Evaluation, and Compliance Plan

OIG's Audit, Evaluation, and Compliance Plan[11] focuses on and implements these three high-level goals in the Strategic Plan for the upcoming year. We have identified four areas of significant risk facing FHFA and one area of management concern, based on ongoing OIG work, OIG's published reports, other publicly available information, and OIG's general knowledge of FHFA's operations and the external environment; discussions with FHFA and officials of the regulated entities, the public, Congress, and other government officials; reviews of relevant reports and documents prepared by FHFA and external parties; risk assessments performed in key areas related to FHFA's mission; and matters referred to OIG through its Hotline. For calendar year 2020, OIG will continue to focus on the four areas of significant risk, in addition to one area of management concern:

- Conservatorship operations,
- Supervision of the regulated entities,
- Cybersecurity at the regulated entities and information security at FHFA,
- Counterparties and third parties, and
- Internal controls over Agency and Enterprise operations (management concern).

Conservatorship Operations

As the Enterprises' conservator since September 2008, FHFA has expansive authority to oversee and direct operations of the two large, complex companies that dominate the secondary mortgage market and the mortgage securitization sector of the U.S. housing finance industry. Under HERA, FHFA, as conservator, possesses all rights and powers of any Enterprise stockholder, officer, or director, and is vested with express authority to operate them and conduct their business activities.

As the Enterprises' conservator, FHFA exercises control over trillions of dollars in assets and billions of dollars in revenue and makes business and policy decisions that impact the entire mortgage finance industry. For reasons of efficiency, concordant goals with the Enterprises, and operational savings, FHFA has determined to delegate revocable authority for general corporate

[11] These plans are fluid; they are neither final nor all-inclusive. They do not include, for example, audits, evaluations, compliance reviews, or special projects that OIG may undertake pursuant to requests from FHFA, Congress, and other stakeholders, or situations to which OIG's attention may be drawn as a result of our ongoing activities. They also do not include several statutorily required reviews—such as the annual independent evaluation pursuant to the Federal Information Security Modernization Act of 2014 of FHFA's information security program and practices (see 44 U.S.C. § 3555) and the improper payments audit (see 31 U.S.C. § 3321 note)—that OIG will conduct.

governance and day-to-day matters to the Enterprises' boards of directors and executive management.

The FHFA Director has announced that the Enterprises may emerge from conservatorship as early as 2021 but emphasized that the effort to build capital at the Enterprises is "process dependent, not calendar dependent."[12] He acknowledged that much work must be done before the conservatorships can end.

Given the taxpayers' enormous investment in the Enterprises, the unspecified timeline to end the conservatorships, the Enterprises' critical role in the secondary mortgage market, and their uncertain ability to sustain future profitability, FHFA's administration of the conservatorships remains a major risk.

Oversight of Delegated Matters and Management of Non-Delegated Matters

FHFA has delegated revocable authority for many matters, both large and small, to the Enterprises. The Enterprises acknowledge in their public securities filings that their directors serve on behalf of the conservator and exercise their authority as directed by and with the approval, when required, of the conservator. FHFA, as conservator, can revoke delegated authority at any time (and retains authority for certain significant decisions).

Our body of work over the last five years has found that FHFA has limited its oversight of delegated matters largely to attendance at Enterprise internal management and board meetings as an observer and to discussions with Enterprise managers and directors. For the most part, FHFA, as conservator, has not assessed the reasonableness of Enterprise actions taken pursuant to delegated authority, including the Enterprises' actions to implement conservatorship directives, or the adequacy of director oversight of management actions. FHFA also has not clearly defined its expectations of the Enterprises for delegated matters and has not established the accountability standard that it expects the Enterprises to meet for such matters. Our work has identified internal control systems at the Enterprises that fail to provide directors with accurate, timely, and sufficient information to enable them to exercise their oversight duties. Likewise, we have identified a lack of rigor by some directors in seeking information from management about the matters for which they are responsible. We also identified instances in which corporate governance decisions generally reserved to the board of directors have been delegated to management.

As the Enterprises' conservator, FHFA is ultimately responsible for actions taken by the Enterprises, pursuant to authority it has delegated to them. FHFA's challenge, therefore, is to improve the quality of its oversight of matters it has delegated to the Enterprises.

[12] *See* FHFA, *Prepared Remarks of Dr. Mark A. Calabria, Director of FHFA, at Credit Union National Association (CUNA) Government Affairs Conference* (Feb. 24, 2020).

Generally, FHFA has retained authority (or has revoked previously delegated authority) to resolve issues of significant monetary and/or reputational value. It has established written internal review and approval processes for non-delegated matters, designed to provide a consistent approach for tracking, analyzing, and resolving such matters and for providing decision-makers with all relevant facts and existing analyses. FHFA faces challenges in ensuring that its established processes are followed.

In the coming year, we intend to continue to look at governance issues relating to FHFA's delegation of matters to the Enterprises. We also will be assessing FHFA's oversight of the Enterprises' low down payment mortgage programs.

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

Supervision

As FHFA has recognized, effective supervision of the entities it regulates is fundamental to ensuring their safety and soundness. Within FHFA, the Division of Enterprise Regulation (DER) supervises the Enterprises and the Division of Federal Home Loan Bank Regulation supervises the FHLBanks. FHFA conducts safety and soundness examinations of its regulated entities, reports on the findings and conclusions of those examinations in annual reports of examinations, and, when necessary, issues findings identifying deficiencies. FHFA's supervisory activities include designing a comprehensive, risk-based supervisory strategy (examination planning), conducting on-site examinations (examination execution), and monitoring remediation of deficiencies identified during examinations (oversight). FHFA has repeatedly stated that effective supervision of the Enterprises and the FHLBanks is critical to ensuring their safety and soundness, and we have determined that FHFA's administration of its supervision responsibilities continues to be a critical risk.

In its *2019 Strategic Plan for the Conservatorships of Fannie Mae and Freddie Mac*, issued on October 28, 2019, FHFA stated that its capacity to supervise the Enterprises must be "on par with that of other independent federal financial regulators" before releasing them from conservatorship. In written Congressional testimony, the Director stated that the Enterprises must be "well-regulated" before they can "responsibly" be released from conservatorship. As he explained:

> All supervisory and oversight procedures and systems must ensure that FHFA's examination work is consistently rigorous, timely, and effective, and that additional resources are efficiently allocated to meet the needs of critical areas such as risk modeling and information technology.[13]

[13] House Committee on Financial Services, Testimony of Dr. Mark A. Calabria, Director, Federal Housing Finance Agency, "The Future of Affordable Housing in America Depends on Mortgage Finance Reform," at 4 (Oct. 22, 2019).

Since October 2014, we have issued more than 40 reports on FHFA's supervision program for the Enterprises. Many of these reports, taken collectively, detail chronic and pervasive deficiencies in the program itself, as well as in its execution. These deficiencies, organized into four programmatic elements, include: (1) examination guidance and execution; (2) adequately sized examiner workforce with necessary qualifications and training; (3) communication of supervisory findings; and (4) quality control.[14] We have reported that DER has struggled to complete remediation of chronic and pervasive deficiencies in a timely manner, or has abandoned, not fully completed, or completed in form and not substance actions it undertook to remediate these deficiencies.

Consequently, the challenge now facing FHFA is formidable. To remediate the deficiencies identified by us and by FHFA before the Enterprises are released from conservatorship, FHFA must accomplish a great deal in a relatively short period. We cautioned stakeholders that absent completion of meaningful remediation of deficiencies in its supervision program, FHFA may be unable to meet its statutory responsibilities to ensure the safe and sound operation of the Enterprises.

The magnitude of the risk posed by the Enterprises is significantly greater than the magnitude of the risk posed by the FHLBanks and the Office of Finance together because the asset size of the latter is a fraction of the asset size of the former. For that reason, the majority of OIG's work on supervision issues has focused on FHFA's supervision of the Enterprises. However, we also look at FHFA's supervision program for the FHLBanks. While we have found some shortcomings in that supervision program, we have not identified significant weaknesses. Like any other federal financial regulator, FHFA faces challenges in appropriately tailoring and keeping current its supervisory approach to the FHLBanks.

This year, we will continue to assess the rigor of some of the elements of FHFA's supervisory programs, to include assessments of its (1) execution of planned supervisory activities of the Enterprises; (2) oversight of the Enterprises' compliance with supervisory requirements and expectations; and (3) compliance with its established guidelines on examinations of the FHLBanks. We will also continue to review whether FHFA has implemented prior recommendations to strengthen its supervisory programs and assess the adequacy of those remedial measures and monitor FHFA's efforts to strengthen its Enterprise supervision program.

Our efforts are intended to assist FHFA in improving the effectiveness of its supervision of the Enterprises and the FHLBanks.

[14] OIG, *FHFA Faces a Formidable Challenge: Remediating the Chronic and Pervasive Deficiencies in its Supervision Program Prior to Ending the Conservatorships of Fannie Mae and Freddie Mac* (Mar. 30, 2020) (OIG-2020-002).

Cybersecurity at the Regulated Entities and Information Security at FHFA

Cybersecurity, as defined by the National Institute of Standards and Technology (NIST), is "the process of protecting information by preventing, detecting, and responding to attacks." In May 2017, President Trump issued an executive order to strengthen the cybersecurity of federal networks and critical infrastructure. The Financial Stability Oversight Council, of which FHFA is a member, has recognized that the potential for a destabilizing cybersecurity failure is a key financial stability vulnerability. According to the Council: "A cybersecurity event could threaten the stability of the U.S. financial system through at least three channels: [t]he event could disrupt a key financial service or utility for which there is little or no substitute . . .; [t]he event could cause a loss of confidence among a broad set of customers or market participants . . .; [t]he event could compromise the integrity of critical data."[15]

FHFA's regulated entities are central components of the U.S. financial system and are interconnected with other large financial institutions. As part of their processes to guarantee or purchase mortgage loans, the Enterprises receive, store, and transmit significant information about borrowers, including financial data and personally identifiable information. Further, the Enterprises increasingly rely on third-party service providers, requiring the sharing of sensitive information between Enterprise and third-party systems. Consequently, the Enterprises face an increased risk in that an operational failure by a third party will adversely affect them. Both the Enterprises and the FHLBanks have been the targets of cyberattacks. FHFA acknowledges that its regulated entities face significant cybersecurity risks, and the Agency understands its responsibility to provide effective oversight of the Enterprises' management of cybersecurity risks.

As cyberthreats and attacks at financial institutions increase in number and sophistication, FHFA faces challenges in designing and implementing its examination activities for the entities it supervises. These supervisory activities may be made increasingly difficult by FHFA's continuing need to attract and retain highly qualified technical personnel, with expertise and experience sufficient to handle rapid developments in technology.

Over the past few years, cyber attacks against federal agencies also have increased in frequency and severity. As cyber attacks continue to evolve and become more sophisticated and harder to detect, they pose an ongoing challenge for virtually every federal agency to fortify and safeguard its internal systems and operations.

Our oversight activities this year are intended to assess FHFA's IT security posture, including its use of cloud service providers. We will also continue to review whether FHFA has implemented prior recommendations to address gaps in its supervisory guidance to ensure that it adequately maps to the NIST *Framework for Improving Critical Infrastructure Cybersecurity*.

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[15] Financial Stability Oversight Council, *2019 Annual Report* at 115.

Our oversight is intended to assist FHFA in strengthening protections over its network operations and its supervision of cybersecurity risk management by the entities it regulates.

Counterparties and Third Parties

The Enterprises rely heavily on counterparties and third parties for a wide array of professional services, including mortgage origination and servicing. As the Enterprises and FHFA recognize, that reliance exposes the Enterprises to a number of risks, including the risk that a counterparty will not meet its contractual obligations, and the risk that a counterparty will engage in fraudulent conduct. FHFA has delegated to the Enterprises the management of their relationships with counterparties and reviews that management largely through its supervisory activities.

One of the most significant counterparty risks is the risk posed by loan originators and servicers that are not depository institutions (also called non-banks). As participants in the mortgage market change, counterparties can affect the risks to be managed by Fannie Mae and Freddie Mac. In recent years, the Enterprises' businesses have changed dramatically in terms of the types of institutions originating and selling mortgages to them. FHFA has acknowledged that "from a risk perspective there are some key differences between banks and non-banks that we need to address in a responsible way."[16]

In light of the financial, governance, and reputational risks arising from the Enterprises' relationships with counterparties and third parties, our efforts are intended to enhance FHFA's oversight of the Enterprises' management of risks related to their counterparties.

Sustain and Strengthen Internal Controls Over Agency and Enterprise Operations

FHFA's programs and operations are subject to legal and policy requirements common to federal agencies. Satisfying such requirements necessitates the development and implementation of, and compliance with, effective internal controls within the Agency.

Recently, we found that FHFA lacked adequate controls over electronic media targeted for disposal and needed to strengthen controls over its records management program. We also found that FHFA's disaster recovery procedures were missing certain required elements. Our work demonstrates that FHFA is challenged to ensure that its existing controls, including its written policies and procedures, are sufficiently robust, and its personnel are adequately trained on these internal controls and comply fully with them.

Our oversight will continue to include reviews of FHFA's internal operations that are important to achieving its mission.

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[16] FHFA, *Prepared Remarks of Dr. Mark A. Calabria, Director of FHFA, at 2019 Ginnie Mae Summit* (June 13, 2019).

FEDERAL HOUSING FINANCE AGENCY
OFFICE OF INSPECTOR GENERAL

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