AUDIT, EVALUATION, AND COMPLIANCE PLAN

March 2018

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 2018. The plan describes FHFA's and OIG's roles and missions, explains our risk-based methodology for developing this plan, provides insight into particular risks within four areas, and generally discusses areas where we will focus our audit, evaluation, and compliance resources during the 2018 calendar year.

BACKGROUND

Federal Housing Finance Agency

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

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

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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 (online at www.fhfa.gov/Conservatorship/Pages/History-of-Fannie-Mae--Freddie-Conservatorships.aspx).

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

has proven to be far easier than ending them, and the “time out” period for the conservatorships is now in its tenth year.

FHFA’s two conservatorships are of unprecedented scope and undetermined duration. The two entities dominate the secondary mortgage market and the mortgage securitization sector in the United States and thus affect the entire mortgage finance industry. While in conservatorship, the Enterprises have required almost $191.5 billion in financial investment from the Treasury to avert their insolvency and, through December 2017, the Enterprises have paid to the Treasury more than $278.8 billion in dividends on its investment. Despite their high leverage, diminished capital, conservatorship status, and uncertain future, the Enterprises have grown in size during conservatorship and, according to FHFA, their combined market share of newly issued mortgage backed securities is more than 60%. The Enterprises’ combined total assets are approximately $5.3 trillion and their combined debt exceeds $5 trillion.

Although market conditions have improved 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 reduction in net interest income; reduction in the value of the Enterprises’ deferred tax assets due to recent federal corporate tax reform (considered by FHFA to be a short-term consequence); the level of guarantee fees they will be able to charge and keep; the future performance of their business segments; and the significant uncertainties involving key market drivers, such as mortgage rates, homes prices, and credit standards.

FHFA Office of Inspector General

HERA also established OIG with a mission to promote the economy, efficiency, and effectiveness of FHFA’s programs and operations, and to prevent and detect fraud, waste, and abuse in those programs and operations.[6]

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

Our Vision

To be an organization that promotes excellence and trust through exceptional service to FHFA, Congress, stakeholders, and the American people. OIG achieves this vision by being a first-rate independent oversight organization in the federal government that acts a catalyst for effective management, accountability, and positive change in FHFA and 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 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; 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 are: the Office of Audits, the Office of Evaluations, the Office of Investigations, and the Office of Compliance and Special Projects. This Audit, Evaluation, and Compliance Plan most directly impacts OIG's Offices of Audits, Evaluations, and Compliance and Special Projects.

OIG Office of Audit

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

As required by the Inspector General Act of 1978 (IG Act),[7] the Office of Audits performs its audits in accordance with the standards promulgated by the Comptroller General of the United States, which are known as Generally Accepted Government Auditing Standards or GAGAS (Yellow Book).

[7] Public Law No. 95-452.

OIG Office of Evaluations

The Office of Evaluations conducts program and management assessments and makes recommendations for improvement where applicable. It provides independent and objective reviews, 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). The Office of Evaluations 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

The Office of Compliance and Special Projects is charged with several critical responsibilities. First, it consults with each division in the development of recommendations to ensure that such recommendations, if accepted and implemented, will be susceptible to follow-up and verification testing. Second, it tracks, in real time, the status of all OIG recommendations, from issuance to closure to subsequent follow-up and testing. Third, it consults with each division prior to closure of a recommendation to facilitate application of a single standard across the office for closing recommendations. Last, it conducts testing on closed recommendations to independently verify whether FHFA has implemented in full the corrective actions it represented to OIG that it intended to take. The results of that testing are published in compliance reviews.

The Office of Compliance and Special Projects also undertakes special projects, which include reviews and administrative investigations of hotline complaints alleging non-criminal misconduct and assessments of significant ongoing issues that, in OIG's view, require prompt attention. 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 determined to 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, which includes two types of periodic deliverables: strategic plans that seek to further FHFA's strategic goals for its programs (e.g., conservatorship, supervision, liquidity and access, etc.); and tactical audit, evaluation, and compliance plans that

[8] Public Law No. 110-409.

flow from the strategic plans and focus on particular areas of greatest risk to FHFA and the entities it regulates within FHFA's larger program structure.

Strategic Plan

In February 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.

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

Audit, Evaluation, and Compliance Plan

OIG's Audit, Evaluation, and Compliance Plan[10] 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, based on ongoing OIG work, OIG published reports, other publicly available information, and OIG's general knowledge of FHFA's operations and the external environment; discussions with FHFA and officials of the regulated entities, the public, Congress, and other government officials; reviews of relevant reports and documents prepared by FHFA and external parties; risk assessments performed in key areas related to FHFA's mission; and matters referred to OIG through its Hotline. For calendar year 2018, OIG will continue to focus on four areas of risk:

- Conservatorship operations,

- Supervision of the regulated entities,

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

[10] 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 intervening requests from FHFA, Congress, and other stakeholders, or situations to which OIG's attention may be drawn as a result of our ongoing activities. They also do not include several statutorily required reviews—such as the annual independent audit 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.

- Counterparties and third parties, and
- Cybersecurity at the regulated entities and information security at FHFA.

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

Conservatorship Operations

As conservator of the Enterprises since September 2008, FHFA has expansive authority to oversee and direct operations of two large, complex companies that dominate the secondary mortgage market and the mortgage securitization sector of the U.S. housing finance industry. Under HERA, FHFA possesses all rights and powers of any stockholder, officer, or director of the Enterprises, and is vested with express authority to operate them, conduct their business activities, and take those actions necessary to put them in a sound and solvent condition and preserve and conserve their assets and property.

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

As of this writing, the duration of the conservatorships is still unknown. In January 2018, Treasury Secretary Mnuchin identified housing finance reform as one of the priorities for the Administration this year. In a prepared statement to the Senate Committee on Banking, Housing, and Urban Affairs, Secretary Mnuchin stated that:

> …the current situation of indefinite conservatorship for Fannie Mae and Freddie Mac is neither sustainable nor a lasting solution. The Administration looks forward to working with Congress to reform America's housing finance system in a manner that helps consumers obtain the housing best suited to their own personal and financial situations while, at the same time, protecting taxpayers.

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

Oversight of Delegated Matters

As conservator of the Enterprises, FHFA has a responsibility to the U.S. taxpayers, the largest shareholders in the Enterprises, and is charged with ensuring that the Enterprises achieve their statutory purpose. FHFA has delegated revocable authority for many matters, both large and small, to the Enterprises pursuant to its powers under HERA to take actions "necessary to put [Fannie Mae and Freddie Mac] in a sound and solvent condition" and "appropriate to carry on the business of [Fannie Mae and Freddie Mac]" and "preserve and conserve" their assets. Since 2008, FHFA has issued more than 262 conservatorship directives, as of December 31, 2017, in which it instructs the Enterprises to take certain actions, most of which relate to delegated responsibilities.

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

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

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

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

relocation of workspace(s) and oversight of fraud reporting. We also intend to review FHFA's efforts to track and rate Enterprise performance against FHFA's annual scorecard.

Non-Delegated Matters

FHFA has retained authority to decide specific issues and can, at any time, revoke previously delegated authority. Generally, FHFA has retained authority (or has revoked previously delegated authority) to resolve issues of significant monetary and/or reputational value. FHFA has established written internal review and approval processes for non-delegated matters in an attempt to ensure that FHFA follows a consistent approach for analyzing and resolving such matters and that the decision-makers are apprised of all relevant facts and considerations. FHFA faces challenges in ensuring that its established processes are followed. In the next year, we intend to continue to review, as warranted, the Agency's decision-making for non-delegated matters.

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

Supervision

Director Watt has observed that FHFA has been placed in an unprecedented role as conservator and regulator and, when it engages in supervisory activities, it does so "with a deliberate distance between FHFA and the Enterprises." As FHFA recognizes, effective supervision of the entities it regulates is fundamental to ensuring their safety and soundness. Within FHFA, the Division of Federal Home Loan Bank Regulation is responsible for supervision of the FHLBanks and the Division of Enterprise Regulation is responsible for supervision of the Enterprises. FHFA's supervisory activities include designing a comprehensive, risk-based supervisory strategy (examination planning), conducting on-site examinations (examination execution), and monitoring remediation of deficiencies identified during examinations (oversight). FHFA has repeatedly stated that effective supervision of the FHLBanks and the Enterprises is critical to ensuring their safety and soundness, and we have determined that FHFA's administration of its supervision responsibilities continues to be a critical risk.

FHFA consistently maintains that its supervisory authority over its regulated entities "is virtually identical to – and clearly modeled on – Federal bank regulators' supervision of banks." According to FHFA, "Congress virtually duplicated the examination regime applicable to banks when it designed the examination regime" for the Enterprises and FHLBanks. FHFA must conduct annual examinations of the financial condition of the Enterprises and FHLBanks; the FHFA Director has substantially the same authority as the bank regulators; and FHFA examiners have the same authority as examiners employed by the Federal Reserve Banks.

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

Based on our assessments of different elements of DER's supervision program, we identified four recurring themes: (1) FHFA lacks adequate assurance that DER's supervisory resources are devoted to examining the highest risks of the Enterprises; (2) many supervisory standards and guidance issued by FHFA and DER lack the rigor of those issued by other federal financial regulators; (3) the flexible and less prescriptive nature of many requirements and guidance promulgated by FHFA and DER has resulted in inconsistent supervisory practices; and (4) where clear requirements and guidance for specific elements of DER's supervisory program exist, DER examiners-in-charge and examiners have not consistently followed them. Without prompt and robust Agency attention to address the shortcomings, we have cautioned that safe and sound operation of the Enterprises cannot be assumed from FHFA's current supervisory program. In the coming year, we will continue to assess the rigor of different elements of FHFA's supervisory programs. 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.

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

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.

Counterparty relationships with the Enterprises carry risk. One of the most significant counterparty risks is the risk posed by loan originators and servicers that are not depository institutions (also called non-banks). As participants in the mortgage market change, counterparties can affect the risks to be managed by Fannie Mae and Freddie Mac. In recent years, the Enterprises' businesses have changed dramatically in terms of the types of institutions originating and selling mortgages to them.

OIG intends in the coming year to assess FHFA's oversight of fraud reporting by the Enterprises.

[13] 12 U.S.C. §§ 4515(b), 4517(c).

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.

Cybersecurity at the Regulated Entities and Information Security at FHFA

Cybersecurity, as defined by the National Institute of Standards and Technology, is "the process of protecting information by preventing, detecting, and responding to attacks." In February 2016, President Obama stated that cybersecurity is one of the most important challenges facing the nation and 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 identified cybersecurity oversight as an emerging threat for increased regulatory attention. The Council reported that "cybersecurity-related incidents create significant operational risk, impacting critical services in the financial system, and ultimately affecting financial stability and economic health." Treasury Secretary Mnuchin recently testified that "cybersecurity is one of our biggest, biggest risks."

Systems security continues to be a preeminent issue for businesses and individuals alike. The regulated entities, like most modern institutions, rely on numerous, complex information technology (IT) systems to conduct almost every aspect of their work. These systems manage processes to guarantee and purchase loans, supporting more than $5 trillion in Fannie Mae and Freddie Mac mortgage assets. Both Enterprises and the FHLBanks have been the subjects of cyber attacks. All of the entities regulated by FHFA acknowledge that the substantial precautions put into place to protect their information systems may be vulnerable and penetration of their systems poses a material risk to their business operations. Further, the Enterprises are increasingly relying on third-party service providers, requiring the sharing of sensitive information between Enterprise and third-party systems. Consequently, the Enterprises face an increased risk in that an operational failure by a third party will adversely affect them.

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. As the use of technology continues to become more sophisticated, hiring and training a sufficient number of employees with the expertise needed to conduct detailed examinations of information security systems presents a challenge. Our oversight activities this year are intended to assess FHFA's IT security posture.

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.

FEDERAL HOUSING FINANCE AGENCY
OFFICE OF INSPECTOR GENERAL

HOTLINE

To Report Suspected

FRAUD, WASTE, OR ABUSE

in FHFA Programs or Operations

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

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the OIG Hotline at
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202–318–0358

WRITE

Federal Housing Finance Agency
Office of Inspector General
400 7th Street SW
Washington, DC 20219