

Federal Housing Finance Agency
Office of Inspector General



**Compliance Review of the
Content and Communication of the
Federal Housing Finance Agency’s
Reports of Examination to the
Enterprises’ Boards of Directors**



COM-2019-001

January 3, 2019

Executive Summary

The Federal Housing Finance Agency (FHFA or Agency) sends an annual report of examination (ROE) to each of its regulated entities—Freddie Mac and Fannie Mae (collectively, the Enterprises)—and the Federal Home Loan Banks. The purpose of an ROE is to communicate to the board of directors (board) of each entity the cumulative results of FHFA’s supervisory activities conducted during the annual examination cycle, supervisory concerns, and the composite and component ratings assigned in accordance with FHFA’s rating system. The boards can meet their oversight responsibilities only when they are informed in a timely manner of all deficient, unsafe, or unsound practices giving rise to supervisory concerns and findings.

The Agency’s Division of Enterprise Regulation (DER) is responsible for the supervision of the Enterprises. In two 2016 evaluation reports, we found multiple deficiencies both in the content of ROEs issued by DER and in how the ROEs were communicated to the Enterprises’ boards. We made six recommendations in those reports. The Agency agreed with one recommendation and partially agreed with three other recommendations.

In this compliance review, we tested whether the Agency complied with those portions of two recommendations concerning ROE content and communication with which it agreed, in the 2018 ROEs (which report on the 2017 supervisory cycle). In response to the 2016 evaluation reports, FHFA represented that it would:

- Adopt a standard ROE template and instructions for completing the template, and stated that the instructions would establish baseline elements that must be included in each ROE.
- Amend its internal guidance to provide that each Enterprise’s final ROE should be addressed to the respective board; each ROE should be issued and presented within established timeframes; the board, or a committee thereof, should confirm review of the ROE on a signature page appended to the ROE; and the examiners-in-charge (EICs) should request responses to ROEs from the Enterprise boards, with documentation of approval of such responses.

Our testing of DER’s compliance with the first recommendation found that DER adopted a standard ROE template and issued instructions for completing the template, which established the baseline elements that must be included in each ROE. Both of the 2018 ROEs included the mandatory sections in the template and followed the instructions for use of the template.



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Regarding the second recommendation, we found that DER amended its internal guidance and generally complied with the guidance regarding ROE issuance deadline and presentation to the boards. For one Enterprise, the ROE was issued and presented within the established timeframe; for the other Enterprise, the ROE was issued and presented one month later than its established timeline because of a change in the EIC as the ROE was being prepared. We also found that the boards responded in writing to the ROEs and confirmed their receipt and review of the ROEs within the established timeline.

We provided a draft of this report to FHFA, which declined to provide technical comments or a written management response.

This report was prepared by Patrice Wilson, Senior Investigative Evaluator, and Alisa Davis, Senior Policy 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.fhfa.org.

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ABBREVIATIONS

Board	Board of Directors
DBR	Division of Federal Home Loan Bank Regulation
DER	Division of Enterprise Regulation
EIC	Examiner-in-Charge
Enterprises	Fannie Mae and Freddie Mac, collectively
Fannie Mae	Federal National Mortgage Association
FHFA or Agency	Federal Housing Finance Agency
Freddie Mac	Federal Home Loan Mortgage Corporation
MRA	Matter Requiring Attention
OIG	Federal Housing Finance Agency Office of Inspector General
OPB	Operating Procedures Bulletin
ROE	Report of Examination

BACKGROUND.....

OIG Identified Deficiencies in Both the Content and Communication of DER’s ROEs to the Enterprises’ Boards of Directors

At the conclusion of each annual examination cycle, FHFA prepares and transmits an ROE to the board of each Enterprise. The annual ROE constitutes DER’s “primary work product that communicates . . . the cumulative results of [DER’s] supervisory activities conducted during the annual examination cycle.” The ROE rolls up the substantive examination results from DER’s targeted examinations and ongoing monitoring activities, supervisory concerns, and supervisory safety and soundness ratings for the previous calendar year.

In two 2016 evaluation reports,¹ we compared the guidance issued by DER on the structure and content of the annual Enterprise ROEs to the guidance issued by FHFA’s Division of Federal Home Loan Bank Regulation (DBR) and other federal financial regulators,² and found that it fell short, leading to inconsistent and incomplete ROEs. DER neither provided examiners with baseline standards for ROE structure and content, nor with a template. We found that the content of the ROEs varied by Enterprise and across supervisory cycles and that deficiencies in management practices and the root causes of supervisory deficiencies were not consistently reported in the ROEs. Finally, FHFA’s supervisory expectations for the corrective actions to be taken by management and overseen by the board for each supervisory concern or deficiency were not clearly communicated in the ROEs.³

Our review of the 2014-2016 ROEs for Fannie Mae revealed that DER examiners did not finalize the ROEs or provide the board with presentation materials in advance of their presentations to the board in two of the three years. DER consistently submitted final ROEs to Freddie Mac’s board during the same period, albeit less than a week in advance of examiners’ presentation of DER’s supervisory conclusions and ratings to the board.

¹ *OIG, FHFA’s Failure to Consistently Identify Specific Deficiencies and Their Root Causes in Its Reports of Examination Constrains the Ability of the Enterprise Boards to Exercise Effective Oversight of Management’s Remediation of Supervisory Concerns* (July 14, 2016) (EVL-2016-008) (online at www.fhfaog.gov/Content/Files/EVL-2016-008.pdf) [hereinafter EVL-2016-008] and *OIG, FHFA Failed to Consistently Deliver Timely Reports of Examination to the Enterprise Boards and Obtain Written Responses from the Boards Regarding Remediation of Supervisory Concerns Identified in those Reports* (July 14, 2016) (EVL-2016-009) (online at www.fhfaog.gov/Content/Files/EVL-2016-009.pdf) [hereinafter EVL-2016-009].

² The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation.

³ See EVL-2016-008, *supra* note 1, at 19.

Finally, we found that DER examiners failed to meet FHFA’s prior and current requirements for communication of the annual ROE. FHFA required the board of a regulated entity to provide the Agency “a written response to the ROE acknowledging [the board’s] review of the ROE and affirming that corrective action is being taken, or will be taken, to resolve supervisory concerns.”⁴ DER did not effectively communicate this requirement to the boards or enforce the boards’ compliance with it.

OIG Recommendations

The two 2016 evaluation reports contained a total of six recommendations aimed at correcting ROE deficiencies, many of which the Agency accepted, at least in part.⁵ In this compliance review, we tested whether the Agency complied with those portions of the two recommendations concerning ROE content and communication with which it agreed.⁶ Those portions of the recommendations required DER to:

1. Develop and adopt a standard template for Enterprise ROEs, issue instructions for completing that template, and promulgate guidance that establishes baseline elements that must be included in each ROE;⁷ and
2. Revise its *Examination Manual* to:
 - Require that each final ROE be addressed to the board of directors of an Enterprise by DER examiners;
 - Establish a timetable for submission of the final ROE to each Enterprise’s board and for DER’s presentation of the ROE results, conclusions, and supervisory concerns to each Enterprise board; and
 - Require each Enterprise board to reflect its review and approval of its written response to the ROE.⁸

⁴ See EVL-2016-009, *supra* note 1, at 17.

⁵ We list all six recommendations in full, together with Agency responses, in the appendix.

⁶ The Agency accepted another recommendation concerning the Enterprises’ review of the ROE, which is not the subject of this compliance review.

⁷ FHFA did not agree with the portion of our recommendation proposing that it promulgate guidance for the ROE to include “clear communication of deficient, unsafe, or unsound practices,” as well as an “explanation of how those practices gave rise to supervisory concerns and deficiencies.”

⁸ FHFA did not agree to require the boards to reflect their review of the ROEs in meeting minutes.

Based on FHFA’s Corrective Actions, OIG Closed the Recommendations

In response to our first recommendation, DER agreed to adopt a standard ROE template and instructions for completing the template and stated that the instructions would establish baseline elements that must be included in each ROE.⁹ On June 30, 2017, DER issued an operating procedures bulletin (OPB) containing guidance on ROE content and a template for the ROE; accordingly, we closed this recommendation.

In response to our second recommendation, FHFA agreed to amend its internal guidance to provide that: each Enterprise’s final ROE should be addressed to the respective board; each ROE should be issued and presented within established timeframes;¹⁰ the board, or a committee thereof, should confirm review of the ROE on a signature page appended to the ROE; and the EIC should request approved, written responses to the ROE from the respective board. FHFA issued the June 2017 OPB in response to our recommendation.

The Agency, however, refused to agree that it was required to deliver each ROE to the respective Enterprise board. We fail to understand why FHFA, as conservator and supervisor of the Enterprises, would not direct its examiners to deliver each annual ROE, with its summary of supervisory concerns, and supervisory safety and soundness ratings for the previous calendar year to each Enterprise board as it tasks each Enterprise board with responsibility for ensuring remediation of those supervisory concerns by Enterprise management. However, we recognized that FHFA agreed to require each Enterprise board to acknowledge receipt and review of the ROEs, an acknowledgement that could only be made if the ROE was delivered to the board. Accordingly, we also closed this recommendation.

⁹ In partially accepting this recommendation, the Agency declined to include a detailed discussion of all supervisory concerns in the ROEs. The Agency stated that, because it transmitted all matters requiring attention and supervisory letters directly to the boards, it did not need to duplicate every part of that information in the ROEs. While we accepted the Agency’s perspective, we found, in a recent compliance report, that the Agency had failed to communicate this important supervisory information directly to the boards and continued to rely on Enterprise management to transmit such concerns. *See* OIG, *Compliance Review of FHFA’s Communication of Serious Deficiencies to the Enterprises’ Boards of Directors* (Sept. 5, 2018) (COM-2018-005) (online at www.fhfa.ig.gov/Content/Files/Compliance%20Review%20of%20FHFAs%20Communication%20of%20Serious%20Deficiencies.pdf). This defect continues to be a matter of concern.

¹⁰ FHFA’s OPB requires that the DER Deputy Director and respective EIC meet with the board “within a reasonable timeframe following transmission of the ROE.”

FINDINGS

We initiated this compliance review in August 2018 to assess the Agency’s implementation of its new guidance on ROE content, timing, and communication of the 2018 ROEs (issued for the 2017 annual supervisory cycle).

1. DER Followed its Guidance for ROE Content

FHFA Followed its Template and Instructions for the 2018 ROEs

The OPB required each ROE to follow the format of a prescribed template and includes instructions to examiners on required ROE content. The template requires each ROE to contain the following sections: Enterprise Overview; Composite and Component Ratings; and Matters Requiring Attention (MRAs). The template and the instructions also specify certain required content for the ROE, such as a discussion of examiner authority, the examination rating system, and MRA issuance and closure.

We reviewed the content and structure of the 2018 ROEs issued by DER to the Enterprises and assessed whether they contained the prescribed elements in the template and followed the instructions that DER adopted in response to our recommendation. In both cases, we found that the ROE followed the prescribed template and instructions: the ROEs included all baseline content and specific text as required.

2. DER Largely Implemented its Corrective Actions Regarding Timetables for Issuance of, and Responses to, ROEs

DER Partially Complied with its Timetable for Issuance of the ROEs

The OPB directs the EICs to sign the ROE title page and coordinate transmission to the respective Enterprise by March 31 of each year. The ROE is to be accompanied by a transmittal letter to the chair of the Enterprise board that follows the template in the OPB. This template explains that the final ROE is enclosed and asks the board to respond in writing within 15 days after DER’s presentation of the ROE to the board.

We reviewed each transmittal letter sent to each Enterprise and the date on each ROE’s title page for compliance with the OPB. We found that the content of both transmittal letters to the Enterprises followed the template. We also found that the ROE issued to Fannie Mae was issued within the time parameters set in the OPB.

However, DER did not meet the March 31 deadline¹¹ established in the OPB for issuing the Freddie Mac ROE. Our testing found that the Freddie Mac ROE was finalized and issued more than a month after the March 31 deadline, primarily because of a change in the EIC as the ROE was being prepared. The EIC signed the ROE title page on May 2, 2018, and sought a response from the board within 15 days after the board meeting following DER’s presentation of the ROE to the board.

DER Complied with its Timetable for Presentation of the ROEs to the Enterprise Boards

The OPB directs the EICs and the DER Deputy Director to meet with the Enterprise boards within a “reasonable timeframe” following delivery of the ROE. DER does not define “reasonable timeframe” in its OPB.

We first reviewed the relevant board materials and minutes for evidence that DER met with the boards. We then compared the dates of the board meetings with the dates that DER issued the ROEs. Our testing found that the Fannie Mae EIC and the DER Deputy Director met with the board within 37 days following delivery of the ROE. Similarly, the Freddie Mac EIC and the DER Deputy Director met with the board 36 days following delivery of the ROE.

DER Obtained Written Responses from the Enterprise Boards Confirming Receipt and Review of the ROEs

The OPB sets forth that the boards should respond in writing to DER concerning the ROE within 15 days of the board meeting following DER’s presentation of the ROE. The boards’ responses should demonstrate their receipt, review, and approval (for example, by a resolution).

The Enterprises’ boards complied with DER’s request that it respond to the ROE within 15 days after the board meeting following DER’s presentation of the ROE to the board. We reviewed relevant board materials and minutes and assessed the content of the boards’ responses to DER concerning the 2018 ROEs. Also, we compared the dates on which DER presented the ROE to each board to the date that each board responded to DER concerning its review of the ROE.

Our testing found that FHFA received a written response from Fannie Mae’s board one day after DER’s presentation of the ROE to the board. The board’s written response acknowledged its receipt of the ROE, review by all directors, and approval in a resolution. The written response made a brief reference that the board posed questions about the ROE

¹¹ FHFA is not required by statute to issue an ROE to each Enterprise by March 31. According to a DER official, the March 31 date was selected by DER to allow reasonable time to conclude examination work conducted during the prior supervisory cycle and prepare a final ROE.

during DER’s presentation. Likewise, FHFA received the anticipated, approved resolution seven days after DER’s presentation of the ROE to the Freddie Mac board. We found that both the resolution and Freddie Mac board minutes reflected that discussions ensued between the board and DER concerning the ROE.

CONCLUSION.....

We found that the Agency generally followed its guidance for the issuance and transmittal of the 2018 ROEs to the Enterprise boards. Our review of the 2018 ROEs found that DER followed the template and instructions in its OPB and included all the requisite information required in the guidance it established in response to our recommendation.

We also found that DER partially complied with its timetable for issuance of the ROEs; the issuance of one ROE was delayed by a month primarily because of turnover in the EIC role. Finally, we found that DER complied with its timetable for presentation of the ROEs to the Enterprise boards and that the boards responded in writing, confirming their receipt and review of the ROEs within the established timelines.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of this review was to determine if FHFA complied with parts of two recommendations after implementing its OPB for 2018 ROEs. To accomplish our objective, we met with Agency officials involved with the content and communication of ROEs. We reviewed the 2018 ROEs, internal DER documents, and non-public information from FHFA that included materials of the boards of the directors from both Enterprises. We tested whether DER (1) followed the OPB template and instructions concerning baseline content for the five required sections; (2) signed and transmitted the ROEs to the Enterprises by the March 31 deadline; (3) met with the boards about the ROE within a reasonable time after delivery; and (4) obtained within 15 days of the board meeting a response that demonstrated the board’s receipt, review, and approval.

We conducted our compliance review from August 2018 to October 2018 under the authority of the Inspector General Act of 1978, as amended, and in accordance with the *Quality Standards for Inspection and Evaluation* (January 2012), which were promulgated by the Council of the Inspectors General on Integrity and Efficiency.

We provided a draft of this report to FHFA for its review and comment. On December 21, 2018, the Agency informed us that it did not intend to provide technical comments or a management response.

APPENDIX: 2016 RECOMMENDATIONS.....

Evaluation	Recommendation	Response
EVL-2016-008	1. Direct DER to develop and adopt a standard template for Enterprise ROEs, issue instructions for completing that template, and promulgate guidance that establishes baseline elements that must be included in each ROE, such as: clear communication of deficient, unsafe, or unsound practices; explanation of how those practices gave rise to supervisory concerns and deficiencies; and prioritization of remediation of supervisory concerns and deficiencies.	FHFA partially agreed with the recommendation. In response to the recommendation, FHFA indicated that supervisory concerns are communicated to the Enterprises as examination work is completed and, consequently, the ROE template will not enumerate all supervisory concerns.
	2. Direct DER to revise its guidance to require ROEs to focus the boards' attention on the most critical and time-sensitive supervisory concerns through (1) the prioritization of examination findings and conclusions and (2) identification of deficiencies and MRAs in the ROE and discussion of their root causes.	FHFA disagreed with the recommendation.
	3. Develop written procedures for the "fatal flaw" review of the ROE by Enterprise management that establish the purpose of the review, its duration, and a standard message for conveying this information to Enterprise management.	FHFA agreed with the recommendation. The recommendation is outside the scope of this review.

Evaluation	Recommendation	Response
EVL-2016-009	<p>1. Revise its <i>Examination Manual</i> to:</p> <ul style="list-style-type: none"> • Require that each final ROE be addressed and delivered to the board of directors of an Enterprise by DER examiners to eliminate any confusion over the meaning of the term “issue;” • Establish a timetable for the submission of the final ROE to each Enterprise’s board of directors and for DER’s presentation of the ROE results, conclusions, and supervisory concerns to each Enterprise board; • Require each Enterprise board to reflect its review of each annual ROE in meeting minutes; and • Require each Enterprise board to reflect its review and approval of its written response to the ROE in its meeting minutes. 	<p>FHFA partially agreed with the recommendation. FHFA disagreed that DER examiners must deliver the final ROE directly to the board of each Enterprise. FHFA also did not agree to require the boards to reflect their review of the ROEs in meeting minutes.</p>
	<p>2. Direct DER to develop detailed guidance and promulgate that guidance to each Enterprise’s board of directors that explains:</p> <ul style="list-style-type: none"> • The purpose for DER’s annual presentation to each Enterprise board of directors on the ROE results, conclusions, and supervisory concerns and the opportunity for directors to ask questions and discuss ROE examination conclusions and supervisory concerns at that presentation; and • The requirement that each Enterprise board of directors submit a written response to the annual ROE to DER and the expected level of detail regarding ongoing and contemplated remediation in that written response. 	<p>FHFA partially agreed with the recommendation. FHFA did not believe the Enterprise boards required additional guidance as to the purpose of discussion of the ROE with senior DER officials or directors’ opportunity to ask questions at that meeting.</p>
	<p>3. Direct the Enterprises’ boards to amend their charters to require review by each director of each annual ROE and review and approval of the written response to DER in response to each annual ROE.</p>	<p>FHFA disagreed with the recommendation.</p>

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