

Federal Housing Finance Agency
Office of Inspector General



Compliance Review of FHFA's Commitment to Evaluate Its Internal Quality Control Reviews Pertaining to Matters Requiring Attention



COM-2019-007

September 9,
2019

Executive Summary

In its examinations of Fannie Mae and Freddie Mac (the Enterprises) and the Federal Home Loan Banks (FHLBanks), the Federal Housing Finance Agency (FHFA) may issue findings regarding deficiencies. The most serious of these findings are Matters Requiring Attention (MRAs). FHFA mandates that examination workpapers, including those pertaining to MRAs, be subjected to quality control reviews intended to ensure their compliance with established examination standards and supervision policy.

In a March 2016 evaluation report, we found that Division of Enterprise Regulation (DER) examiners did not adhere to FHFA requirements and guidance in their supervisory oversight of an Enterprise's remediation of an MRA. Among other things, we recommended that FHFA evaluate the results of quality control reviews conducted by DER and the Division of Bank Regulation (DBR) to identify and address gaps and weaknesses pertaining to supervisory oversight of MRA remediation, but we did not specify the frequency of such evaluations. In response, DER and DBR ultimately agreed to prepare periodic reports for their respective managements consistent with our recommendation. We closed the recommendation in April 2017.

We initiated this compliance review in April 2019 to determine whether DER and DBR prepared periodic reports during our review period: May 2017 through 2018. We found that DBR complied with its commitment, but DER prepared no periodic reports during the review period, although it had drafted two such reports in 2016. DER stated that the draft reports were discontinued because they were time-consuming to produce and were not used. We identified no other DER actions addressing the recommendation during the review period.

In February 2019, DER prepared a report for management evaluating the results of multiple quality control reviews, including 17 reviews pertaining to MRAs. This February 2019 DER report, prepared outside of our review period, addresses our recommendation, but DER has not determined whether it will issue similar reports in the future.

In our view, a one-time assessment by DER to identify gaps and weaknesses in supervisory oversight of MRA remediation is not consistent with the spirit or letter of FHFA's commitment. For that reason, we are re-opening the recommendation to DER from our 2016 evaluation report.

In its written management response, DER agreed with the recommendation.



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This report was prepared by Wesley M. Phillips, Senior Policy Advisor, with assistance from staff from the Office of Compliance and Special Projects.

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

Brian Baker
Acting Deputy Inspector General for Compliance & Special Projects

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ABBREVIATIONS

DBR	Federal Housing Finance Agency Division of Bank Regulation
DER	Federal Housing Finance Agency Division of Enterprise Regulation
Enterprises	Fannie Mae and Freddie Mac
FHFA	Federal Housing Finance Agency
FHLBanks	Federal Home Loan Banks
MRA	Matter Requiring Attention
OIG	Federal Housing Finance Agency Office of Inspector General
OQA	Federal Housing Finance Agency Office of Quality Assurance

BACKGROUND.....

In examinations of the Enterprises and the FHLBanks, FHFA examiners may issue findings regarding deficiencies related to risk management, risk exposure, or violations of law, regulations, orders, or supervisory guidelines. Of these deficiencies, MRAs are reserved for the most serious supervisory matters, because they identify a serious deficiency, requiring prompt remediation.¹

Our March 2016 Evaluation Report Recommended that FHFA Evaluate the Results of Its Quality Control Reviews for MRAs

In a March 2016 evaluation report,² we found that DER examiners did not adhere to FHFA requirements and guidance in their supervisory oversight of an Enterprise’s remediation of an MRA.

One of our six recommendations³ proposed that FHFA evaluate the results of quality control reviews conducted by DER and DBR to identify and address gaps and weaknesses pertaining to supervisory oversight of MRA remediation, but it did not specify the frequency of such evaluations. In its management response to the March 2016 evaluation, FHFA agreed with this recommendation but did not commit to a timetable for its assessments.

FHFA represented that its Office of Quality Assurance (OQA)⁴ would evaluate the effectiveness of the quality control procedures of DBR and DER—the procedures used to perform the underlying quality control reviews—by September 15, 2016.⁵

¹ The two other deficiencies are referred to as “Violations” and “Recommendations.”

² OIG, *FHFA’s Examiners Did Not Meet Requirements and Guidance for Oversight of an Enterprise’s Remediation of Serious Deficiencies* (Mar. 29, 2016) (EVL-2016-004).

³ The report contained five other recommendations, none of which is within the scope of this compliance review.

⁴ OQA is tasked with conducting internal reviews of the divisions that perform the Agency’s statutory examination and regulatory functions.

⁵ FHFA noted that its implementation of the recommendation was consistent with the commitments it made in response to a recommendation in a previous Office of Inspector General (OIG) report: *Intermittent Efforts Over Almost Four Years to Develop a Quality Control Review Process Deprived FHFA of Assurance of the Adequacy and Quality of Enterprise Examinations* (Sept. 30, 2015) (EVL-2015-007), i.e., that OQA would issue a report evaluating DER’s quality control procedures within one year or during 2016.

Both DBR and DER Agreed to Prepare Periodic Assessments on Quality Control Reviews and Results, Including Those Related to Supervisory Oversight of MRA Remediation

OQA issued a report on September 29, 2016, addressed to both DBR and DER evaluating the effectiveness of their quality control procedures for supervisory oversight of MRA remediation.⁶ The OQA report recommended, among other things, that FHFA develop and provide regular written reports of MRA quality control review activity and results to senior management.⁷

In January 2017, DBR and DER officials met with us to present their plans for evaluating the results of quality control reviews for supervisory oversight of MRA remediation. At the meeting, a DBR official reported that DBR intended to prepare an annual report in which it identified common themes and issues from quality control reviews, beginning with reviews conducted during 2016. A DER official represented that DER intended to produce similar assessments on a monthly basis and had begun those assessments in July 2016.⁸

Subsequently, DBR provided a copy of its annual assessment of 2016 quality control reviews, dated April 12, 2017. The memorandum identified themes and common issues, including two issues related to documentation and workpapers of supervisory oversight of MRA remediation. DBR informed us that themes and common issues identified in the memo were being provided to DBR managers and examination staff.

DER provided two previously issued monthly quality control reports (dated July 29, 2016, and September 30, 2016) on February 6, 2017. Both DER reports included aggregate data

⁶ OQA, “*Quality Assurance Review of the quality control functions of DBR and DER surrounding Matters Requiring Attention*[.]”

⁷ OQA issued a separate report to DER in July 2016 focusing on its quality control related activities. The report contained a similar recommendation to the one included in the September 2016 report. In the July 2016 report to DER, OQA recommended that DER develop and provide regular reports of quality control review activity and results to DER management. In response to that recommendation, in August 2016 DER first committed to preparing periodic reports on completed quality control reviews and results.

⁸ In April 2017, FHFA issued Supervision Directive 2017-01 and required that examination workpapers, including those pertaining to MRAs, be subjected to quality control reviews. According to the directive, quality control reviews should “identify significant deviations from FHFA examination standards and supervision policy” and provide the examiners with the “opportunity to correct any deviations before final examination results are communicated...” to the Enterprises or FHLBanks or the Office of Finance. DER and DBR established units independent of their examination teams to conduct quality control reviews.

about the number of quality control reviews started and identified themes and common issues in the reviews.⁹

We notified FHFA on April 21, 2017, that we would close the recommendation based on information and materials the Agency provided.¹⁰ We initiated this compliance review in April 2019 to determine whether DBR and DER carried out these actions from May 2017 through year-end 2018.¹¹

FINDINGS

DBR Took Actions to Implement Our Recommendation for 2017

DBR issued an annual memorandum assessing its 2017 quality control activities, dated July 11, 2018. This memorandum aligns with DBR’s April 12, 2017, memorandum evaluating its 2016 quality control reviews, which DBR provided prior to the closure of the recommendation.¹² DBR sent this memorandum to DBR managers and examination staff and provided training to its examination staff on the themes and common issues identified in this memorandum during 2018.

The Deputy Director of DBR reported that he found the annual assessment memoranda to be informative with regard to DBR’s quality control function. A DBR quality control official explained to us that DBR intended that its annual assessment memo provide managers and examiners with an understanding “globally” of the issues identified in quality control reviews.¹³

DER Did Not Identify Gaps and Weaknesses Pertaining to MRAs Identified Through Quality Control Reviews from May 2017 Through Year-End 2018

The DER official responsible for oversight of quality control reports through the fall of 2018 reported to us that the two monthly reports from 2016 provided to us in 2017 were drafts and

⁹ The first report covered the period from January 1, 2016, to July 29, 2016, and the second from September 1, 2016, to September 30, 2016.

¹⁰ We recognized that the DBR and DER corrective actions were not specific to MRAs but included all quality control reviews related to supervision activities within the divisions.

¹¹ Because DBR provided a memorandum to us in April 2017 covering its 2016 quality control reviews, and that memo completed its corrective action for 2017, our testing of DBR corrective action in this compliance review focused on calendar year 2018.

¹² The annual quality control memoranda are required by DBR Operating Procedures Bulletin 2018-03.

¹³ On June 28, 2019, DBR issued its annual quality control review memo for its 2018 examination cycle.

that DER determined to discontinue preparation of such reports. According to this official, DER made that determination because the monthly reports were time-consuming to prepare and were not used by examination staff.

This same DER official advised us that DER decided to rely instead on an Agency automated document routing system, known as eWorkflow, to flag gaps and weaknesses identified in quality control reviews.¹⁴ This decision was memorialized in an April 2018 memorandum from OQA:

During our fieldwork, DER management stated that...eClearance [now called eWorkflow] provides managers and senior management with immediate results of the QC [quality control] reviews and on-going errors are addressed in ‘real time.’ As a result, DER determined that additional reporting would be repetitive and additional regular reports are unnecessary....¹⁵

However, DER acknowledged to us in writing that it does not view eWorkflow as a substitute for its assessment of completed quality control reviews to identify gaps and weaknesses, and that eWorkflow only routes supervisory documents for review and approval.

We were unable to find assessments by DER personnel of the gaps and weaknesses identified in underlying quality control reviews prepared from May 2017 through year-end 2018. The DER official who reviewed the quality control reports until the fall of 2018 advised us that her primary observations from that review were whether examiners were doing sufficient “independent analysis” of MRA finding memos and whether examiners were too reliant on the assessments by the Enterprises’ independent auditors with respect to closing MRAs. That

¹⁴ DER examination teams use the Agency’s eWorkflow system to route supervisory documents for review and approval by attaching conclusion letters, analysis memoranda, and procedures documents that contain links to supporting documentation. When the examination teams document via eWorkflow that their work is complete, the system notifies DER’s quality control team that the work is ready for review. The quality control team ensures that the work meets established supervisory standards, and it may request the examination staff make revisions or add supporting documentation as appropriate. When this process is completed, the quality control team attaches documentation of the completed review (referred to as the Quality Control Review Report) to the eWorkflow, which is routed to DER management, including the Deputy Director, for final review and approval.

¹⁵ The April 2018 OQA report followed up on the status of OQA’s recommendation to DBR and DER in its July 29, 2016, and September 29, 2016, reports, discussed above. In the April 2018 report, OQA closed the recommendation from its September 2016 report that FHFA develop and provide regular written reports of MRA quality control activity and results to senior management. OQA closed its recommendation based on DBR’s issuance of its April 2017 memorandum summarizing quality control results, and on the basis of DER’s statement that it relied on eWorkflow to provide managers immediate information about quality control reviews. An OQA official stated that DER has discretion to determine what type of reporting process is responsive to OQA’s recommendation.

official did not explain whether those primary observations were communicated to others in DER.

We asked DER to explain what, if anything, it did from May 2017 through September 2018 to address our recommendation that it evaluate the results of quality control reviews to identify gaps and weaknesses pertaining to supervisory oversight of MRA remediation. It responded by reiterating that it used the eWorkflow process to provide immediate feedback to examiners on quality control issues with documents, including oversight of MRA remediation. As noted, DER has acknowledged in writing that it does not view eWorkflow as a substitute for its assessment of completed quality control reviews to identify gaps and weaknesses. DER described no effort to identify gaps and weaknesses pertaining to supervisory oversight of MRA remediation through assessments of quality control reviews.

After the End of the Review Period, DER Prepared a Report that Addressed Our Recommendation, But DER Has Not Determined Whether it Will Produce Similar Reports in the Future

In February 2019, DER prepared a report for management evaluating the results of multiple quality control reviews, including 17 reviews pertaining to MRAs completed between October 1, 2018, through January 31, 2019.¹⁶ The report identified two of the same themes orally identified to us by the DER official.¹⁷ This February 2019 DER report, outside our review period, addresses our recommendation, but DER has stated that it has not determined whether it will issue similar reports in the future.¹⁸ In our view, a one-time assessment by DER to identify gaps and weaknesses in supervisory oversight of MRA remediation is not consistent with the spirit or letter of FHFA's commitment. For that reason, we are re-opening this recommendation.

In technical comments on a draft of this report, DER stated that its quality control staff provide immediate feedback to examiners and examination managers on significant deviations from DER standards through completed quality control checklists for supervisory

¹⁶ The report, entitled *Quality Control Observations and Program Enhancement Opportunities*, covered 43 quality control reviews conducted from October 1, 2018, to January 31, 2019, of which 26 covered targeted examinations or ongoing monitoring and 17 MRA remediation activities. According to the report, all examination branches showed examples of reliance on Enterprise sources without independent verification; of focusing on process descriptions rather than on process verification, assessment, or testing; and of misfiled supporting documentation. Half or more examination branches showed examples of examiner conclusions unsupported by documentation, failure to define the standard or criteria used in a review, and changing the scope of a review without approval or miscommunicating the scope to the Enterprise.

¹⁷ The scope of this compliance review did not include determining how DER plans to remediate the findings from its February 2019 report.

¹⁸ A DER official said the division is revising the operating procedures bulletin for its quality control function and has made no final decisions on its requirements.

correspondence pertaining to MRAs. DER further noted that the quality control reviewer is included on the workflow and attaches the completed checklist identifying any gaps or weaknesses in correspondence and supporting documentation.

We do not question DER’s assertion that it has developed processes through its checklists, eWorkflow, and other means to provide feedback to examiners and examination managers on the quality control review results for each individual MRA. The purpose of our 2016 recommendation and the corrective action that DER asserted it would implement in early 2017 involved the analysis of quality reviews pertaining to MRAs on an aggregated basis to identify themes and common issues in them that could be reported to DER management and examination staff.

CONCLUSIONS

We recommended in 2016 that FHFA evaluate the results of quality control reviews conducted by DER and DBR to identify and address gaps and weaknesses pertaining to supervisory oversight of MRA remediation, but we did not specify the frequency of such evaluations. In response, DER and DBR agreed that they would prepare periodic reports for their respective managements consistent with our recommendation. In this compliance review, we found that DBR complied with its commitment during the review period, but DER prepared no periodic reports and took no other steps to address our recommendation. In February 2019, DER prepared a report for its management that, while outside of our review period, addressed our recommendation, but DER has not determined whether it will issue similar reports in the future. Because a one-time assessment to identify gaps and weaknesses in supervisory oversight of MRA remediation is not consistent with the spirit or letter of FHFA’s commitment, we are re-opening the recommendation to DER from our 2016 evaluation report.

FHFA COMMENTS AND OIG RESPONSE.....

We provided FHFA an opportunity to respond to a draft of this compliance review. DER provided technical comments that were incorporated into the final report as appropriate. In its management response, which is reprinted in its entirety in the Appendix, DER agreed with OIG’s recommendation. DER stated that by January 31, 2020, it “will amend its internal guidance to provide that DER management will annually receive an updated report of QC observations, including gaps or weaknesses in supervisory correspondence and supporting documentation involving MRA issuance, review of MRA remediation plans, and MRA closure.”

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of this compliance review was to determine whether DBR and DER complied with the promised corrective actions from May 2017 through 2018; i.e., DBR prepared an annual memorandum summarizing quality control reviews and DER attached results of its quality reviews to periodic reports on quality control activity. To do so, we collected and reviewed relevant documentation from DER and DBR and interviewed quality control officials. We also reviewed information on DER’s use of the Agency’s eWorkflow system and a February 2019 DER report that summarized multiple quality control reviews.

We conducted our compliance review from April 2019 to July 2019 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.

APPENDIX: FHFA MANAGEMENT RESPONSE.....



Federal Housing Finance Agency

MEMORANDUM

TO: Brian W. Baker, Acting Deputy Inspector General, Compliance & Special Projects

FROM: Nina A. Nichols, Deputy Director, Division of Enterprise Regulation (DER)^{NAN}

SUBJECT: Draft OIG Report: *Compliance Review of FHFA's Commitment to Evaluate the Results of its Internal Quality Control Reviews Pertaining to Matters Requiring Attention*

DATE: September 5, 2019

Thank you for the opportunity to respond to the draft report referenced above (Report). We appreciate the Office of Inspector General's (OIG) acknowledgment that the February 2019 report evaluating the results of DER's quality control (QC) reviews addressed the OIG's recommendation, even though it was prepared after the OIG's review period.

As noted in the Report, the OIG is re-opening Recommendation 6 from EVL-2016-004, *FHFA's Examiners Did Not Meet Requirements and Guidance for Oversight of an Enterprise's Remediation of Serious Deficiencies* (March 29, 2016), as it relates to DER.

Recommendation: *OIG recommends that FHFA evaluate the results of quality control reviews conducted by DER and DBR to identify and address gaps and weaknesses involving MRA issuance, review and approval of proposed remediation plans, and oversight of MRA remediation.*

Management Response: FHFA agrees that it would be useful to regularly update the February 2019 qualitative review of DER's QC findings. By January 31, 2020, DER will amend its internal guidance to provide that DER management will annually receive an updated report of QC observations, including gaps or weaknesses in supervisory correspondence and supporting documentation involving MRA issuance, review of MRA remediation plans, and MRA closure.

cc: Chris Bosland
Larry Stauffer
John Major

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