

Federal Housing Finance Agency
Office of Inspector General



Compliance Review of DER's Assessments of Enterprise MRA Closure Packages



COM-2021-004

March 15, 2021

Executive Summary

FHFA is charged with ensuring that the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, the Enterprises) operate in a safe and sound manner. Within FHFA, the Division of Enterprise Regulation (DER) is responsible for supervising the Enterprises. When conducting safety and soundness examinations of the Enterprises, DER may identify Matters Requiring Attention (MRAs) which are “critical supervisory matters (the highest priority), which pose substantial risk to the safety and soundness of the [Enterprise]” or “deficiencies,” which if not corrected, could “escalate and potentially negatively affect” the regulated entity.

FHFA expects the Enterprises to take corrective action to remediate MRAs, and DER is responsible for monitoring the remediation process. When Enterprise management determines that it has completed remediation of an MRA, FHFA requires the Enterprise’s internal audit (IA) functions to review the corrective action and “validate” that remediation has been fully implemented as intended. The Enterprise then submits a closure package to DER to document IA’s validation work. Based on a review of the closure package and any other follow-up examination work that DER may conduct, DER determines whether the MRA has been addressed satisfactorily and notifies the Enterprise of its determination.

In 2018 evaluation reports, we found that FHFA guidance did not address whether, or the circumstances under which, FHFA examiners may rely on, accept, or otherwise use information, analyses, or conclusions provided by an Enterprise’s IA function when determining whether an Enterprise has remediated an MRA satisfactorily. Accordingly, DER examiners were given wide discretion to determine whether and to what extent to rely on, accept, or otherwise use IA validation work as a basis to close MRAs.

To address these deficiencies, we recommended that FHFA “[r]evise its guidance to provide clear direction to examiners on whether, or the circumstances under which, its examiners may rely on information, analyses, or conclusions provided by an Enterprise’s IA function when assessing the adequacy of MRA remediation.” We also recommended that “FHFA adopt clear guidance for examiners to follow when assessing the sufficiency of MRA remediation by the Enterprises that identifies the work steps that should be included in examiners’ independent assessments of IA’s work and specifies the conditions under which examiner testing is expected.”

FHFA agreed with these recommendations and committed to provide more detailed guidance to examiners on procedures for conducting independent



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assessments of IA's work on MRA remediation and the conditions under which examiners are expected to perform testing to assess whether an MRA has been addressed satisfactorily.

DER issued an Operating Procedures Bulletin (OPB) in which it instructed that "examiners should review and consider, but must not rely on, the validation performed by the Enterprise's internal audit division or an independent third party." It also required examiners to conduct an independent assessment whether the proposed corrective actions were completed and to document that assessment. Based on this direction, we closed the recommendations on September 13, 2019.

We initiated this compliance review to assess whether DER examiners adhered to these OPB requirements for a sample of 14 MRAs issued to the Enterprises and closed by DER between November 2018 and September 2020. For the first requirement, we found that DER examiners determined that all corrective actions described in each remediation plan were completed by the Enterprises in 14 of the 14 MRA closure packages (100%). For the second requirement, we found that DER examiners independently analyzed the sufficiency of 13 of the 14 MRA closure packages (93%).

We provided FHFA the opportunity to respond to a draft of this report.

This report was prepared by Karen E. Berry, Senior Investigative Counsel, and Patrice Wilson, Senior Investigative Evaluator. 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.fhfaog.gov.

/s/

Brian W. Baker
Deputy Chief Counsel

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ABBREVIATIONS

DER	Division of Enterprise Regulation
Enterprises	Fannie Mae and Freddie Mac
Fannie Mae	Federal National Mortgage Association
FHFA or Agency	Federal Housing Finance Agency
Freddie Mac	Federal Home Loan Mortgage Corporation
IA	Internal Audit function of each Enterprise
MRA	Matter Requiring Attention
MRA OPB	DER-OPB-2.4, <i>Examination Processes and Documentation: Issuance of Adverse Examination Findings and Assessment of MRA Remediation</i> (October 31, 2018)
OIG	Federal Housing Finance Agency Office of Inspector General
OPB	Operating Procedures Bulletin, issued by DER

BACKGROUND.....

FHFA is charged with ensuring that Fannie Mae and Freddie Mac operate in a safe and sound manner. Within FHFA, DER is responsible for supervising the Enterprises. DER conducts safety and soundness examinations of the Enterprises, reports on examination findings, and issues findings identifying deficiencies when necessary. At all times relevant to this matter, MRAs were defined as:

- Critical Supervisory Matters (the highest priority), which pose substantial risk to the safety and soundness of the [Enterprise]. They may involve instances of noncompliance with laws or regulations of a serious nature or may be repeat criticisms that have escalated in importance because of insufficient attention or action by the [Enterprise]; or
- Deficiencies, which are supervisory concerns that FHFA believes could, if not corrected, escalate and potentially negatively affect the condition, financial performance, risk profile, operations, or reputation of the [Enterprise].¹

FHFA expects the Enterprises to take corrective action to remediate MRAs, and DER is responsible for monitoring the remediation process. When Enterprise management determines that it has completed remediation of an MRA, FHFA requires the Enterprise’s IA functions to review the corrective action and “validate” that remediation has been fully implemented as intended. The Enterprise then submits a closure package to DER to document IA’s validation work. Based on a review of the closure package and any other follow-up examination work that DER may conduct, DER determines whether the MRA has been addressed satisfactorily and notifies the Enterprise of its determination.

In 2018, We Found that DER Examiners Accepted the Enterprises’ IA Validation of Remediation Efforts Without Independently Analyzing Those Efforts

We issued two evaluation reports on DER’s guidance and standards for reliance on the Enterprises’ IA functions when DER’s examiners assess the remediation of MRAs, and for application of these practices for closing MRAs.² We reviewed DER’s practices for closing a

¹ FHFA issued this definition in a March 13, 2017, Advisory Bulletin, *AB-2017-01-Classifications of Adverse Examination Findings*. DER then incorporated it by reference in its Operating Procedures Bulletin (OPB) DER-OPB-2.4, issued on October 31, 2018. The definition was in effect throughout our review period of November 1, 2018, to September 15, 2020. On December 31, 2020, DER issued a new OPB governing MRA remediation that uses this definition.

² *OIG, FHFA Requires the Enterprises’ Internal Audit Functions to Validate Remediation of Serious Deficiencies but Provides No Guidance and Imposes No Preconditions on Examiners’ Use of that Validation Work* (March 28,

sample of 22 MRAs in order to understand the extent to which examiners accepted, relied on, or otherwise used IA’s validation work in their assessment of the adequacy of MRA remediation, and whether they conducted independent assessments of the remediation’s adequacy.³

We found that FHFA guidance did not address whether, or the circumstances under which, FHFA examiners may rely on, accept, or otherwise use information, analyses, or conclusions provided by an Enterprise’s IA function when determining whether an Enterprise has remediated an MRA satisfactorily. Accordingly, DER examiners were given wide discretion to determine whether and to what extent to rely on, accept, or otherwise use IA validation work as a basis to close MRAs.

To address these deficiencies, we recommended that FHFA “[r]evis[e] its guidance to provide clear direction to examiners on whether, or the circumstances under which, its examiners may rely on information, analyses, or conclusions provided by an Enterprise’s IA function when assessing the adequacy of MRA remediation.” We also recommended that “FHFA adopt clear guidance for examiners to follow when assessing the sufficiency of MRA remediation by the Enterprises that identifies the work steps that should be included in examiners’ independent assessments of IA’s work and specifies the conditions under which examiner testing is expected.”⁴

FHFA agreed with these recommendations. The Agency said that by October 31, 2018, DER would provide more detailed guidance to examiners on procedures for conducting independent assessments of IA’s work on MRA remediation and the conditions under which examiners are expected to perform testing to assess whether an MRA has been satisfactorily addressed.

FHFA Issued Internal Guidance in 2018 and the Recommendations Were Closed

On October 31, 2018, FHFA issued Operating Procedures Bulletin (OPB) DER-OPB-2.4, *Examination Processes and Documentation: Issuance of Adverse Examination Findings and Assessment of MRA Remediation* (MRA OPB).⁵ The MRA OPB stated that “examiners should

2018) (EVL-2018-002); *FHFA’s Adoption of Clear Guidance on the Review of the Enterprises’ Internal Audit Work When Assessing the Sufficiency of Remediation of Serious Deficiencies Would Assist FHFA Examiners* (March 28, 2018) (EVL-2018-003).

³ The sampled MRAs were issued to Fannie Mae and Freddie Mac and closed by DER between January 2015 and October 2017.

⁴ While our evaluation reports made several other recommendations regarding DER’s guidance and standards for reliance on the Enterprises’ IA functions when examiners assess the remediation of MRAs and application of these practices for closing MRAs, this compliance review involves only those recommendations specified here.

⁵ DER “administratively reissued” this OPB “with no content changes” on February 24, 2020. The re-issued version was no longer numbered 2.4 but was substantively identical to the version in effect at all times relevant to this compliance review. For ease of reference, we refer to it herein as “MRA OPB.” On December 31, 2020, DER

review and consider, but must not rely on, the validation performed by the Enterprise’s internal audit division or an independent third party.” It also required examiners to: (1) “determine whether all correction actions described in the remediation plan were completed by the Enterprise;” and (2) “conduct independent examiner analysis of documentation from the Enterprise showing completion of the plan and the date of management’s determination that planned remediation actions are complete[.]”

Based on these commitments by FHFA, we closed the recommendations on September 13, 2019.

FINDINGS

We initiated this compliance review to assess whether DER examiners adhered to the following two requirements in the MRA OPB when reviewing MRA closure packages submitted by the Enterprises between November 1, 2018, and September 15, 2020 (the review period):

- The examiners must determine whether the Enterprise completed all corrective actions described in the remediation plan; and
- When doing so, the examiners must independently assess the Enterprise’s remediation efforts.⁶

According to DER records, 55 MRAs were closed by DER during the review period. From this population, we selected a random, nonstatistical sample of 14 MRA closure packages, which constitutes more than 20 percent of the overall testing population. For this sample, we reviewed key workpapers prepared by examiners and Enterprise documents used by examiners to assess the Enterprises’ remediation of MRAs. These documents included remediation plans, non-objection letters, and analysis memos for each MRA. We also reviewed the responses from the examiners-in-charge for the Fannie Mae and Freddie Mac examination teams to written questions that we asked regarding the closure of the MRAs in our sample.

As we now discuss, our testing found that DER examiners assessing MRA closure packages complied with the first requirement and were in substantial compliance with the second requirement.

further revised its examiner guidance for assessing MRA closure packages by issuing a new OPB that supersedes the MRA OPB. This OPB was issued after our review period closed.

⁶ The MRA OPB set forth additional requirements pertaining to examiners’ assessment of MRA closure packages received from the Enterprises, but this compliance review addresses only the two discussed above.

1. DER Determined that all Corrective Actions Described in the Remediation Plan were Completed by the Enterprises in 14 of the 14 MRA Closure Packages

The MRA OPB requires that the examiners determine whether all corrective actions described in the remediation plan were completed by the Enterprise. We reviewed the final remediation plans to identify the corrective actions, and we reviewed the analysis memoranda to verify whether the examiner determined that the Enterprise had completed each corrective action set forth in the remediation plan. We found that DER examiners made a determination that all corrective actions were completed by the Enterprises in 14 of 14 MRA closure packages (100%).

2. DER Conducted Independent Examiner Analysis of 13 of the 14 MRA Closure Packages

The MRA OPB requires that the examiner conduct an independent examiner analysis of documentation from the Enterprise showing completion of the remediation plan. In a prior compliance review, FHFA and DER told us that an independent examiner analysis should include:

- The results of the examiner’s independent assessment for each MRA in sufficient detail to provide a clear understanding to individuals reviewing that assessment;
- More than a recitation of the Enterprise’s proposed remediation to correct the MRA deficiency; and
- More than a bare conclusory statement that the remediation is, or appears to be, adequate.

We applied the above criteria when reviewing the analysis memoranda for our sample of 14 MRA closure packages. Our objective was to assess whether those documents reflected the examiner’s independent analysis of the adequacy of each Enterprise’s corrective actions.

In reviewing the analysis memoranda for our sample, we applied this standard and found that DER met all three of FHFA’s established independence criteria above – and therefore had conducted independent examiner analysis – for 13 of 14 MRA closure packages (93%). For the one remaining MRA closure package, DER asserted that independent examiner analysis was performed but the documentation they provided does not meet the standard of independent examiner analysis established above. The documentation for the one remaining MRA closure package merely provided a one-line statement asserting that the Enterprise submitted information to sufficiently address the supervisory concern of the MRA, but with no supporting detail. By itself, this statement does not provide a sufficient basis on which to conclude that the examiners conducted an independent analysis in accordance with the three criteria specified above for this one remaining MRA closure package.

CONCLUSIONS

Based on the sample of MRAs tested, we are reasonably assured that during our review period DER complied with the MRA OPB’s requirement that examiners determine whether the Enterprises completed all corrective actions described in the remediation plan. We are also reasonably assured that during this same period DER was in substantial compliance with the MRA OPB requirement that examiners perform independent assessments of the Enterprise’s remediation efforts.

OBJECTIVE, SCOPE, AND METHODOLOGY

We initiated this compliance review to assess whether DER adhered to the guidance set forth in the MRA OPB regarding assessing an MRA closure package. Our objective was to test DER’s compliance with the assessment procedures required by MRA OPB.

To achieve this objective, we selected a sample of 14 MRAs from a population of 55 MRAs that were closed by DER between November 1, 2018, and September 15, 2020. We reviewed key workpapers prepared by examiners and Enterprise documents used by examiners to assess the Enterprises’ remediation of MRAs, including remediation plans, non-objection letters, and analysis memos for each MRA. Finally, we also submitted written questions to the examiners-in-charge for the Fannie Mae and Freddie Mac examination teams regarding the closure of the MRAs in our sample and analyzed their written responses.

We conducted our compliance review from September 2020 to January 2021 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. We received a single technical comment from FHFA which did not necessitate revisions to this report.

APPENDIX: FHFA MANAGEMENT RESPONSE.....



Federal Housing Finance Agency

MEMORANDUM

TO: Brian W. Baker, Deputy Chief Counsel, Office of Inspector General (OIG)

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

SUBJECT: Draft OIG Report: *Compliance Review of DER's Assessments of Enterprise MRA Closure Packages*

DATE: March 12, 2021

Thank you for the opportunity to respond to the Office of Inspector General's (OIG) draft report referenced above. The objective of the OIG's compliance review was to assess whether DER adhered to the requirements set forth in its internal supervisory guidance for assessing Matters Requiring Attention (MRA) closure packages. To achieve this objective, the OIG selected a sample of 14 MRAs closed by DER.

We are pleased that the OIG concluded that DER complied with its internal supervisory guidance requirement that examiners determine whether the Enterprises completed all corrective actions described in the MRA remediation plan and DER substantially complied with the requirement that examiners perform independent assessments of the Enterprises' remediation efforts. We believe these results reflect our continuing efforts to enhance the efficiency and efficacy of our supervisory program.

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

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

ADDITIONAL INFORMATION AND COPIES.....

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