

Federal Housing Finance Agency
Office of Inspector General



**Compliance Review of
DBR's Quality Control for
Examination Work Performed by
Examiners-in-Charge**



COM-2021-007

August 25, 2021

Executive Summary

The Federal Housing Finance Agency (FHFA or Agency) regulates and supervises the Federal Home Loan Bank (FHLBank) System. The FHLBanks' mission is to provide reliable liquidity to member institutions to support housing finance and community investment.

To further this mission, FHFA's Division of Federal Home Loan Bank Regulation (DBR) conducts annual safety and soundness examinations of the FHLBanks and issues a Report of Examination (ROE) for each FHLBank. DBR conducts quality control (QC) reviews of its examinations to ensure that their findings and conclusions are adequately supported and that DBR's examinations are accurate, complete, and of uniform high quality.

In a 2019 audit, OIG found that DBR's QC process did not require a review of examination work directly performed by an examiner-in-charge (EIC). We recommended that FHFA revise DBR's QC procedures to ensure that examination workpapers directly prepared by an EIC be subjected to independent review by a person who had not participated in the examination. The Agency accepted the recommendation and revised its QC requirements accordingly.

We conducted this compliance review to determine whether DBR fully implemented its revised QC requirements. We found a mixed record of the 11 instances in which an EIC had personally conducted some portion of an examination. Of those 11, the required independent review did not occur in two instances. For the remaining nine, the required review was conducted on an incomplete record in four cases.

In total, we found that DBR did not implement its corrective action in more than half of the matters we reviewed. As a result, we are re-opening our recommendation. DBR has reviewed our findings and accepted our re-opened recommendation.

This report was prepared by David M. Frost, Assistant Inspector General, with assistance from 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.fhfaoig.gov.

/s/

Brian Baker
Deputy Chief Counsel

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ABBREVIATIONS

AD	Associate Director
Agency or FHFA	Federal Housing Finance Agency
DBR	FHFA Division of Federal Home Loan Bank Regulation
EIC	Examiner-in-Charge
FHLBank	Federal Home Loan Bank
OIG	FHFA Office of Inspector General
OPB	Operating Procedures Bulletin, issued by DBR. In this compliance review, the term “OPB” refers to DBR’s quality control OPB, 2018-DBR-OPB-03.
QC	Quality Control
Review Period	September 30, 2019 – March 31, 2021
ROE	Report of Examination
SE	Supervisory Examiner

BACKGROUND.....

Pursuant to the Housing and Economic Recovery Act of 2008, FHFA regulates and supervises the FHLBank System, which consists of the 11 FHLBanks and the Office of Finance, the FHLBanks’ fiscal agent. The FHLBanks’ mission is to provide reliable liquidity to member institutions to support housing finance and community investment.

To further this mission, DBR conducts an annual on-site safety and soundness examination of each FHLBank and the Office of Finance. DBR issues an annual ROE for each FHLBank.

In a 2019 Audit, We Found that DBR Did Not Subject to Quality Control Review the Examination Work Performed by Examiners-in-Charge

Federal financial regulators, including FHFA, have recognized that comprehensive QC reviews of examinations are a critical internal control. QC reviews are necessary to ensure that examination findings and conclusions are adequately supported and to assure the regulator that its examinations are accurate, complete, and of uniform high quality.

DBR maintains a QC process that requires the independent review of workproducts used to prepare ROEs. Our 2019 audit¹ found that this QC process had two prongs. First, the EIC for a particular examination was responsible for ensuring that documentation adequately evidences the work performed for that examination and that the documentation agrees with conclusions reached and ultimately expressed in the ROE. To meet this responsibility, an EIC was required to review a sufficient number of workpapers to have confidence in their adequacy or otherwise ensure that a combination of EIC reviews of such workpapers, when taken together with reviews by others, provides that confidence. Once this was completed, the second prong was that an independent DBR examination specialist who had not worked on the examination under review would conduct his or her own QC review of selected examination workproducts.

We found that DBR’s QC process did not require a review of examination work directly performed by an EIC, who, as indicated above, was responsible for the QC process’s first prong. Thus, we found that where an EIC did not merely supervise, but directly conducted, a portion of an examination, examination workpapers prepared by that EIC would not necessarily be subjected to either prong of DBR’s QC process. We found that some EIC-prepared workpapers were not subject to review prior to publication of one of the ROEs we assessed. We also found

¹ *OIG, FHFA Conducted BSA/AML Program Examinations of 10 of 11 Federal Home Loan Banks During 2016-2018 in Accordance with its Guidelines, But Failed to Support a Conclusion in the Report of Examination for the Other Bank*, AUD 2019-008 (July 10, 2019).

that DBR had relied upon these EIC-prepared, unreviewed workpapers to support an ROE conclusion that was not otherwise supported by adequate documentation.

We recommended that FHFA “[r]evise DBR’s quality control procedures to specifically require that all examination workpapers supporting examination findings, conclusions, and ratings directly prepared by the EIC be reviewed by an individual who did not participate in the examination.”² The Agency accepted the recommendation. On September 17, 2019, DBR revised its *Operating Procedure Bulletin on Quality Control*, 2018-DBR-OPB-03 (OPB) to include the following instruction:

All examination workpapers supporting examination findings, conclusions, and ratings directly prepared by the EIC must be reviewed by the EIC’s [Associate Director (AD)], or have that review delegated by the AD to the team’s [Supervisory Examiner (SE)] or to another EIC who did not participate on the examination.

Based on DBR’s corrective action, OIG closed the recommendation on October 2, 2019.

FINDINGS

We initiated this compliance review in April 2021 to assess whether DBR had complied fully with its corrective action – the revised OPB – by having all examination workpapers supporting examination findings, conclusions, and ratings that were directly prepared by the EIC reviewed by the EIC’s AD, the SE, or by another EIC who did not participate on the examination. To do so, we requested and obtained a list of all DBR examinations conducted from September 30, 2019 (after the corrective action had been implemented) through March 31, 2021 for which an EIC had been responsible for directly preparing any workpapers in support of the examination.

DBR identified a total of 11 instances during our review period where workpapers had been directly prepared by EICs. To determine for each of these 11 instances whether a DBR QC was performed in accordance with the OPB, we looked at the completed Peer Review form, which is a template reflecting the items to be reviewed pursuant to the OPB.

The template reflects the following items: Pre-exam Activity/Work Program Scope Memo; Workpaper Index; Exam Activity/Workprogram; Workpaper Supporting Documents; Activity and Conclusion Memos; and Finding/Closing Memos. The template’s categories cover all

² The 2019 audit report made a second recommendation that was narrowly tailored to an issue with a particular 2016 ROE, so it is not addressed here.

workpapers in the EIC’s workprogram, and completion of the form requires review of all of those workpapers, consistent with the OPB’s requirements.

DBR Did Not Fully Comply with the Revised OPB

We found that, in two out of those 11 examinations (18%), the EIC’s work was not subject to an independent review as required by the OPB.³

We reviewed the forms completed by the peer reviewers for each of the remaining nine examinations and found that the independent review required by the OPB took place in all cases. However, in four of those nine cases (44%), the EIC had not finished producing all workpapers until after the independent review had concluded. As a consequence, those peer reviews were conducted on an incomplete record.

In three of these four instances where the peer review was conducted on an incomplete record, the Peer Review form notes that the missing workpaper was the EIC’s conclusion memorandum;⁴ in the fourth instance, the peer reviewer noted that the activity memorandum had not been completed at the time of the peer review.

While the peer reviewer in each of the four cases noted the absence of the missing workpapers in each of these three peer reviews, he or she did not go back to review them once they were completed. As a result, DBR did not comply fully with all OPB requirements because the post-peer review workpapers were not seen by the peer reviewer.

DBR seeks to discount the lack of compliance with its OPB with the claim that the missing conclusion memoranda from these three examinations were subject to independent review. Specifically, DBR states that, because, as indicated above, conclusion memoranda are essentially recounted verbatim in the ROE and because the ROE “is reviewed by the team’s Associate Director, among many others,” these conclusion memoranda are functionally subject to review at a higher level, which, DBR states, is sufficient. We do not agree, because DBR’s OPB does not

³ In one case, the review was conducted by an examiner who had participated in the examination and therefore was not independent; the OPB requires that work performed by an EIC must be “reviewed by the EIC’s AD, or have that review delegated” to an appropriate independent examiner, so the review did not meet that standard. In the other case, the independent review mandated by the OPB did not take place at all (so no Peer Review form was prepared). DBR represents, and we confirmed, that, in both cases, the examinations were subject to review by DBR’s QC Branch (i.e., the second prong of DBR’s QC process). However, in neither case did DBR conform to the peer review requirements of the OPB.

⁴ DBR acknowledges that the information in the three missing conclusion memoranda was recounted—nearly verbatim—in ROEs. DBR points out that three of the missing memoranda identified by the peer reviewer were “Composite Conclusion memos and Management Conclusion memos” and, as such, “are typically synonymous with the Summary and Conclusions section and the Management section, respectively, of the Report of Examination.”

include an exemption for specific workpapers such as conclusion memoranda, nor does it provide that alternate forms of review are sufficient substitutes for the specified QC process.

DBR also reports that, in the instances where conclusion memoranda were missing at the time of the peer review, the examinations were subsequently subjected to review by DBR’s QC Branch after the peer review concluded (i.e., the second prong of the QC process). DBR’s workpapers reflect that this second internal control was performed.⁵ However, DBR, in adopting the OPB, contemplated that two quality control reviews would be performed. The record plainly demonstrates that this first control—the independent peer review—was not performed for these three conclusion memoranda, in disregard of the OPB requirement. In other words, both prongs are required to be performed and the OPB does not contemplate that successful performance of the second prong may remedy poor performance of the first one. Rather, the OPB refers to the subsequent review by the QC Branch as “an additional assurance of quality.”

As for the fourth examination, an activity memorandum was missing at the time of the peer review. According to DBR, the missing activity memorandum was subsequently completed, but it acknowledges that this memo was not subjected to QC by the peer reviewer nor by the QC Branch. This lapse is another failure to comply with the OPB.

Of the 11 examinations we reviewed, our testing found that independent peer review of all workpapers, in accordance with DBR’s OPB, was completed only 45% of the time (5 out of 11), with peer reviews of an incomplete record (missing a workpaper prepared by the EIC) having been conducted in another four instances. Of the six instances of non-compliance or partial compliance with the OPB, five were subsequently reviewed by DBR’s QC Branch. Nevertheless, neither our recommendation, nor DBR’s corrective action as stated in the OPB, contemplates the two prongs of the QC process as alternatives, but as separate requirements. As a result, we found that DBR complied fully with its own corrective action – the revised OPB – less than half of the time.

CONCLUSION.....

This compliance review assessed whether DBR implemented its corrective actions in response to an OIG recommendation for an independent quality control review of EIC examination work. Of the 11 instances where the EIC conducted some part of the examination, we found a mixed record of compliance with the independent reviews. More than half of the 11 lacked a QC

⁵ We obtained documents from DBR’s QC Branch reflecting its review of the three examinations from which the conclusion memoranda were missing at the time of the peer review. Based on our review of those documents and information provided by DBR, the missing documents had been completed and were subjected to the review.

review on the full record. Because we found that DBR did not fully implement its corrective action in more than half of the matters we reviewed, we are re-opening our recommendation.

FHFA COMMENTS.....

We provided a draft of this compliance review to the Agency for its review and comment. As detailed in its response below, the Agency has accepted our re-opened recommendation and commits to revise its QC process for the examination work directly performed by an EIC. DBR states that it will complete the QC process revisions by December 31, 2021.

OBJECTIVE, SCOPE, AND METHODOLOGY

We initiated this compliance review in April 2021 to determine whether DBR fully implemented its corrective action in response to our 2019 audit report. Specifically, we sought to determine whether workpapers created by an EIC were subject to QC review prior to the issuance of an ROE. To accomplish our objective, we requested and reviewed information and documents and conducted an interview of an EIC.

We conducted our compliance review from April 2021 through June 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.

APPENDIX: FHFA MANAGEMENT RESPONSE.....




Federal Housing Finance Agency

MEMORANDUM

TO: Brian W. Baker, Deputy Chief Counsel

FROM: Andre D. Galeano, Deputy Director, Division of FHLBank Regulation

 8/4/2021
Signed by ANDRE GALEANO

SUBJECT: Draft Compliance Report: *Compliance Review of DBR's Quality Control for Examination Work Performed by Examiners-in-Charge*

DATE: August 4, 2021

Thank you for the opportunity to respond to the Office of Inspector General's (OIG) draft report referenced above (Report). The objective of the OIG's compliance review was to determine if the Division of FHLBank Regulation (DBR) fully implemented the revised quality control requirements for the review of examination work directly performed by an examiner-in-charge (EIC).

The OIG has decided to reopen its 2019 audit recommendation:

Recommendation: *Revise DBR's quality control procedures to specifically require that all examination workpapers supporting examination findings, conclusions, and ratings directly prepared by the EIC be reviewed by an individual who did not participate in the examination.*

Management Response: Based on the results of the OIG's compliance testing, DBR has determined to revise the design of QC process for the examination work directly performed by the EIC. DBR will complete the QC process revisions by December 31, 2021.

I would like to acknowledge the dedicated and professional OIG staff that worked with DBR during the compliance review. I consistently find OIG's work informative that leads to more effective DBR operations. If you have any questions relating to our response, please do not hesitate to contact Rick Dalton.

cc: Edom Aweke

John Major
Richard Dalton

ADDITIONAL INFORMATION AND COPIES.....

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