Federal Housing Finance Agency
Office of Inspector General

Utility of FHFA's Semi-Annual Risk Assessments Would Be Enhanced Through Adoption of Clear Standards and Defined Measures of Risk Levels

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Executive Summary

The Federal Housing Finance Agency (FHFA) mission as a federal financial regulator is to ensure that Fannie Mae and Freddie Mac (the Enterprises) and the Federal Home Loan Banks operate safely and soundly so that they serve as a reliable source of liquidity and funding for housing finance and community investment. FHFA and other federal financial regulators for sophisticated financial institutions use a risk-based approach for their examination activities. Critical to the success of a risk-based approach are risk assessments for each regulated entity. A risk assessment presents a comprehensive, risk-focused view of the regulated entity so that examiners can focus their supervisory activities around the risks with the highest supervisory concerns: it identifies and evaluates the primary risks to the regulated entity; identifies cause(s) of unfavorable trends; and highlights the entity's strengths, vulnerabilities, and risks. A risk assessment is not a static document; revised regularly, pursuant to a schedule set by each financial regulator, the evolving risk assessment informs the development of the examination plan.

Pursuant to the Housing and Economic Recovery Act of 2008 (HERA), FHFA conducts annual on-site examinations, plans and executes targeted examinations of high risk areas, and engages in ongoing monitoring of the entities it regulates to determine their safety and soundness. FHFA has vested its Division of Enterprise Regulation (DER) with responsibility for performing these supervisory activities for the Enterprises. FHFA requires the examiner-in-charge for each Enterprise to prepare a risk assessment for that Enterprise and update it semi-annually.

As we announced in our Audit and Evaluation Plan, OIG uses a risk-based focus for its audit and examination activities and one area of that focus is FHFA's supervisory activities. Pursuant to our Plan, we conducted this evaluation to assess whether FHFA's requirements for its risk assessments of the Enterprises are sufficiently robust to produce risk assessments that achieve the purpose for which they are intended. We compared FHFA's broad guidance in its *Examination Manual* and in supplemental guidance issued by DER, for the preparation of risk assessments against the stringent requirements and specific guidance of other federal financial regulators. We found FHFA's loosely defined parameters lack standardized measures of risks (such as credit risk, sensitivity to market risk, liquidity risk, and operational risk), do not define the risk measures that examiners must use, or do not require examiners to use a common format and common, defined measures of risk. Over the past four years, DER has experienced high turnover in examination staff. FHFA's flexible guidance on preparation of risk assessments, combined with significant changes in examiner staffing, has produced risk assessments that

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are not readily susceptible to comparison year over year for one Enterprise. The lack of comparability limits the utility of risk assessments in planning risk-based supervision activity for that Enterprise.

The Enterprises have virtually identical federal charters, substantially comparable business models, and similar risk profiles, and FHFA uses side-by-side comparison analyses of the Enterprises in its published financial performance reports. However, the significant variations in risk assessments for each Enterprise limits the utility of these risk assessments as a tool to compare risk exposures between the Enterprises, even though the Enterprises share the same types of risk and those risks lend themselves to standardized measures.

Based on the deficiencies identified by OIG in this evaluation, we make three recommendations to FHFA to enhance its risk assessment framework for the Enterprises. FHFA agreed with our recommendations.

This report was prepared by Jacob Kennedy, Senior Investigative Evaluator, and Desiree Yang, Financial Analyst. 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.

Angela Choy
Assistant Inspector General for Evaluations

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ABBREVIATIONS

DER	Division of Enterprise Regulation
Enterprises	Fannie Mae and Freddie Mac
Federal Reserve	Federal Reserve Board of Governors
Fannie Mae	Federal National Mortgage Association
FHFA or Agency	Federal Housing Finance Agency
Freddie Mac	Federal Home Loan Mortgage Corporation
HERA	Housing and Economic Recovery Act of 2008
NCUA	National Credit Union Administration
OCC	Office of the Comptroller of the Currency
OIG	Federal Housing Finance Agency Office of Inspector General
OPB	Operating Procedures Bulletin

BACKGROUND

FHFA's Role as Regulator of the Enterprises

FHFA, which was created by Congress in 2008, is charged by the Housing and Economic Recovery Act of 2008 (HERA) with supervision of the Enterprises.[1] Its mission as a federal financial regulator is to ensure that the Enterprises operate safely and soundly so that they serve as a reliable source of liquidity and funding for housing finance and community investment.[2] It conducts annual on-site examinations, executes targeted examinations, and engages in ongoing monitoring of the Enterprises to determine the Enterprises' safety and soundness.[3] FHFA has vested DER with responsibility for these supervisory activities. DER has established a team of examiners to conduct such activities for each Enterprise, led by an examiner-in-charge.[4] The FHFA *Examination Manual* provides comprehensive guidance on the examination process, establishes standards, and communicates expectations to examiners.[5]

Risk Assessments: Their Role and Purpose

FHFA, like other federal financial regulators, has adopted a risk-based approach for its supervisory activities. According to FHFA, risk assessments provide the critical foundation for planning its annual supervisory strategies, targeted examinations, and ongoing monitoring. They identify and evaluate the primary risks; identify cause(s) of unfavorable trends; highlight the strengths, vulnerabilities, and risks of the regulated entity; and assess the adequacy of management systems used to measure, monitor, and control such risks. FHFA examiners are then able to leverage their resources by focusing their supervisory activities around the risks identified as posing the highest supervisory concerns in the risk assessments. Because of the critical importance of risk assessments, DER requires each examiner-in-charge to update the Enterprise's risk assessment semi-annually to reflect changes in the Enterprise's risk profile and FHFA's supervisory concerns.

We conducted this evaluation to assess whether FHFA's requirements for its risk assessments of the Enterprises are sufficiently robust to produce risk assessments that achieve the purpose

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[1] Pursuant to HERA, FHFA is also charged with supervisory authority for the Federal Home Loan Banks.

[2] *See* FHFA, About FHFA – Who We Are & What We Do (online at www.fhfa.gov/AboutUs).

[3] See 12 U.S.C. § 4517(a).

[4] DER's subject matter experts provide examination support and conduct other supervisory activities in the different risk areas.

[5] FHFA, *FHFA Examination Manual*, Version 1.0 (Dec. 2013) (online at www.fhfa.gov/SupervisionRegulation/Documents/ExaminationProgramOverview.pdf).

for which they are intended: namely, to identify and evaluate the critical risks to each Enterprise, using clearly defined terms, so that supervisory activities can focus on those risks.

FACTS AND ANALYSIS .....

FHFA maintains that its regulatory authority over the Enterprises mirrors the authority of federal bank examiners and has successfully asserted the bank examination privilege to shield from discovery materials relating to its regulation of the Enterprises.[6] Because FHFA is a relatively new federal financial regulator, it is useful to look to the risk assessment requirements and guidance from three mature federal financial regulators and compare them to FHFA's requirements and guidance for risk assessments of the Enterprises.

Risk Assessments: Requirements and Guidance of Other Federal Financial Regulators

Similar to FHFA, the Office of the Comptroller of the Currency (OCC), Federal Reserve Board of Governors (Federal Reserve), and National Credit Union Administration (NCUA) use risk assessments to ensure that appropriate examination resources will be focused on areas of elevated residual risk and not on those areas where inherent risk is well controlled and remaining risk is limited or low.

The OCC and Federal Reserve require their examiners to use standardized tools and apply common definitions for the risk assessments and to document and communicate judgments regarding their assessments of existing and emerging risks and the strengths and weaknesses of risk management on a risk template. Required use of these tools provides a repeatable, measurable, and consistent process to identify and measure the level of known and emerging risk associated with a regulated entity's products, services, and activities and the adequacy of management systems used to measure, monitor, and control such risks.

As a result, these regulators have reasonable assurance that their risk assessments enable them to measure and assess existing and emerging risks and the quality of controls in place to manage those risks, in the entities they regulate. Through a defined risk assessment process with clearly defined terms and required assessment tools, each regulator can assess the risks and the strengths and weaknesses of risk management across the entities that it regulates.

Examples of Specific Risk Assessment Requirements and Guidance

The OCC requires its examiners to assess specific factors used to measure risks and reach judgments about them. For example, examiners evaluating the quantity of credit risk must consider a number of factors, including underwriting, strategic, external, and credit quality factors. The level of credit risk is assessed using measures of specific delinquencies, nonperforming and problem assets, underwriting standards, and counterparty financial

[6] See *Fed. Hous. Fin. Agency v. JPMorgan Chase & Co.*, 978 F. Supp. 2d 267 (S.D.N.Y. 2013).

performance. Moreover, OCC identifies and defines exposure levels or ranges – high, moderate, or low – for each measure that must be used in each risk assessment. The OCC requires its examiners to use a standardized set of measures to assess the credit quality of its banks and a minimum set of factors that must be considered in reaching conclusions.[7] These standards do not preclude OCC examiners from using their professional discretion to assess credit or any other type of risks. The OCC's required elements of a risk assessment, using defined measures of risk, facilitates the consistent analysis of risk across the entities it regulates because OCC examiners use both a common language and defined standards to assess risk.

While the Federal Reserve does not require its examiners to consider specific factors like that of the OCC, it defines, in writing, high, moderate, and low composite risk, to "facilitate consistency" among its examiners in the assessment of risk. So, too, the Federal Reserve defines, in writing, the elements that constitute strong, acceptable, and weak risk management, which aids in reliable assessment of risk management across the entities it regulates.[8]

The NCUA has also developed standardized risk evaluation tools that its examiners use in their risk assessments. For example, one tool compares current financial and statistical data to prior years' data. This tool assists examiners to quickly identify significant changes and have their attention drawn to adverse or unusual trends. As with the OCC and Federal Reserve, NCUA examiners can add other risks to assess.

Both the OCC and the Federal Reserve require their examiners to complete a template for their risk assessments. Use of these templates provides examination teams with a standard format in which to document and communicate risk assessment conclusions.[9] By providing common definitions of risk, and requiring risk and quality of risk management to be measured using a well-defined method of evaluation, the basis for supervisory activities is consistent and clearly documented and communicated, regardless of the composition of the examination

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[7] *See* Office of the Comptroller of the Currency, "Large Bank Supervision," *Comptroller's Handbook* (January 2010, updated December 2015) (online at www.occ.gov/publications/publications-by-type/comptrollers-handbook/pub-ch-ep-lbs.pdf) (accessed Dec. 22, 2015).

[8] *See* Federal Reserve System, *Framework for Risk-Focused Supervision of Large Complex Institutions* (August 8, 1997) (online at www.federalreserve.gov/boarddocs/srletters/1997/sr9724a1.pdf) (accessed Dec. 22, 2015).

[9] While the NCUA does not require the use of a standard template, it directs that the risk assessment must be documented to demonstrate the extent of procedures and testing performed; reasons and factors considered in determining the areas and extent of review; analysis and assessment of risk areas; conclusions reached and recommendations made; and adequate support for conclusions and recommendations.

team, and facilitates comparison of quantity of risk and quality of risk management among regulated entities.

Risk Assessments: FHFA Requirements and Guidance

FHFA Flexible Standards

The source of instructions and guidance to DER examiners on risk assessments is FHFA's *Examination Manual*, as supplemented by FHFA's Supervision Directive 2013-02 and DER's Operating Procedures Bulletin 03.1. While FHFA acknowledges the critical importance of risk assessments in planning its supervisory activities, its guidance, set forth in its *Examination Manual*, is approximately ¾ of one page. The *Examination Manual* first affirms the central role that risk assessments play in focusing supervisory attention on high-risk matters and in developing an annual supervisory strategy to address FHFA's supervisory concerns. Then, it explains that the goal of a risk assessment is to "present a comprehensive view of the Enterprise" and directs that a risk assessment must be in writing. Last, it counsels that a risk assessment should include the following elements:

- An executive summary;
- Description of the types of risk (credit, market, liquidity, reputational, operational, model, legal) and direction (increasing, stable, decreasing);
- Assignment of a specific risk level of "high," "moderate," or "low" to each type of risk;
- Identification of all major functions, business lines, activities, and products from which significant risks emanate, as well as the key issues that could affect the risk profile; and
- Description of the Enterprise's risk management systems.

While we observed that these elements are included in the risk assessments, the factors or measures relied on varied and lacked common definition, resulting in inconsistent and incomparable assessments. FHFA's *Examination Manual* provides no definition of each of these risk levels or the elements inherent in each risk level. For example, with regard to credit risk, the *Examination Manual* provides no detail on whether the level of credit risk should be assessed using measures of serious delinquency, foreclosures, charge-offs, underwriting standards, early payment defaults, or changes in the loan loss allowance. Likewise, it does not identify exposure levels or ranges in these or other measures that would be high, moderate, or low. FHFA, with its Supervision Directive 2013-02, prescribes the timing of risk assessments.

On September 24, 2013, DER supplemented FHFA's guidance with Operating Procedures Bulletin (OPB) 03, which provided a three-page list of "risk category components and evaluative factors." Approximately one month later on October 29, 2013, DER revised OPB 03 with OPB 03.1. While DER affirmed, in OPB 03.1, that a risk assessment "helps the [examiners-in-charge] focus supervisory activities on areas of greatest risk to the Enterprises," DER eliminated the detailed guidance in OPB 03 on risk category components and evaluative factors. The risk assessment guidance in OPB 03.1 was reduced to ½ page and restates the guidance in the *Examination Manual*.

FHFA and DER provide no additional requirements or other guidance as to the content of risk assessments. None of these sources define the risk types or minimum risk measures, like those used by the OCC that examiners-in-charge must include in the risk assessments. Instead, they only set forth a number of factors for examiners-in-charge to "consider," including, for example: the overall risk environment; reliability of risk management and controls; and the adequacy of information technology systems.

Unlike other federal financial regulators, FHFA, through its *Examination Manual*, as supplemented by FHFA's Supervision Directive and DER's OPB, does not articulate the specific risks or measures of risk exposures that must be included in risk assessments, and provides no guidance to determine whether a given risk should be characterized as high, moderate, or low. Instead, each examiner-in-charge and examination team is free to develop its own factors to assess risk and quality of risk management. Because FHFA does not define the levels of risk, or require risk and quality of risk management to be measured with a well-defined method of evaluation, DER examination teams use different definitions to prepare their risk assessments. For example, we noted disparities between the two examination teams in the area of underwriting. The exam team for Fannie Mae assesses underwriting as a risk area but does not define what constitutes low, moderate, or high risk. Freddie Mac, on the other hand, considers underwriting in greater detail in the context of asset quality with specific quantifiable metrics.

FHFA Does Not Require that Risk Assessments Follow a Common Format

In light of the similarities in the Enterprises' federal charters, permissible activities, business limitations, business models, risk exposures, and current status in conservatorship, FHFA uses side-by-side and year-over-year analyses to compare the Enterprises' financial condition and performance in its public reports. Its quarterly performance reports compare key measures of the Enterprises' single-family credit guarantee business, such as income, credit losses, and loss reserves, and compare credit losses by state, product type, and vintage.

Because FHFA and DER provide no defined set of standard risk measures, no clear guidance, and no templates to document and communicate the risk assessments, each examiner-in-

charge and his or her examination manager is vested with discretion to develop its own approach and determine which measures to use in assessing risks and which format to use to present its conclusions. Since 2011, DER has experienced high turnover at all levels of staff: it has had three different deputy directors, three Fannie Mae examiners-in-charge, and complete turnover of Fannie Mae exam managers. As of August 2015, the DER examination managers for Fannie Mae had an average of slightly less than one year in their current positions and approximately two and a half years examining the Enterprise.

Because FHFA does not require that risk assessments be prepared using a common format or template using a specific set of risk measures to analyze risk, OIG's efforts to compare the Enterprises' respective risk exposures and quality of risk management and to evaluate the level of consistency between the two teams' determinations of whether risks were high, moderate, or low were unsuccessful. A senior DER official acknowledged to us that a consistent, standardized risk assessment approach, one that promotes efficiency and useful risk assessments, would be valuable but is not currently possible in light of the significant variances in the content and format of each risk assessment.

FINDINGS .....

1. The flexible guidance adopted by FHFA and DER for preparation of risk assessments falls far short of the requirements and clear guidance provided by other federal financial regulators that we reviewed.

Other federal financial regulators are clear in their guidance and definitions for risk assessments. As discussed above, the OCC requires its examiners to assess specific factors used to measure risks and reach judgments about them. Similarly, the Federal Reserve facilitates consistency with definitions of high, moderate, and low composite risk and what constitutes strong, acceptable, and weak risk management. Both the OCC and the Federal Reserve require their examiners to complete a template for their risk assessments. DER's standards lack defined requirements for risk assessments and fall short of the standards used by these other federal financial regulators.

2. Lack of minimum required standards limits the utility of DER's risk assessments.

The absence of minimum required standards for risk assessments combined with the broad discretion granted to examiners-in-charge and exam managers to select and define risk measures has resulted in a lack of consistency in defining significant risks and identifying supervisory concerns in risk assessments for an Enterprise over a period of years. The significant variability in risk assessments for an Enterprise limits their utility in development of a risk-based supervisory plan.

Because of the similarities in the Enterprises' federal charters, permissible activities, business limitations, business models, risk exposures, and current status in conservatorship, FHFA uses side-by-side and year-over-year analyses to compare the Enterprises' financial condition and performance in its public reports. A senior DER official acknowledged to OIG that a consistent, standardized risk assessment approach, one that promotes efficiency and useful risk assessments, would be valuable, but such comparisons are not currently possible because of the lack of clear guidance, defined terms, and standard risk matrix.

CONCLUSION

FHFA would benefit from upgrading its examination guidance and practices to more closely align with the more mature examination programs of the federal banking regulators. Detailed risk assessment standards, common risk measures and evaluative factors, standardized templates, and clear expectations for supporting documentation promote consistency over time while still allowing for reasonable examiner discretion and judgment. Standard templates and common measures of risk would facilitate comparisons between Enterprises and thereby increase the utility of risk assessments in planning examination activities and updating examination ratings.

Enhanced risk assessment requirements will also help mitigate the effects of high staff turnover within DER. Standard templates and clear instructions, accompanied by structured training, would promote common practice among examination staff new to FHFA and reduce the variability among DER's risk assessments. Common, stable practices over successive examination cycles also would promote continuity in institutional knowledge among DER examiners and would strengthen FHFA's examination program.

RECOMMENDATIONS

We recommend that FHFA implement detailed risk assessment guidance that provides:

1. Minimum requirements for risk assessments that facilitate comparable analyses for each Enterprise's risk positions, including common criteria for determining whether risk levels are high, medium, or low, year over year;

2. Standard requirements for format and the documentation necessary to support conclusions in order to facilitate comparisons between Enterprises and reduce variability among DER's risk assessments for each Enterprise and between the Enterprises.

And that FHFA:

3. Direct DER to train its examiners-in-charge and exam managers in the preparation of semi-annual risk assessments, using enhanced risk assessment guidance consistent with Recommendations 1 and 2.

OIG provided FHFA an opportunity to respond to a draft report of this evaluation. In its comments, which are reprinted in their entirety in Appendix A, FHFA agreed with the recommendations. FHFA also provided technical comments on the draft report, which were incorporated as appropriate.

OBJECTIVE, SCOPE, AND METHODOLOGY .....

The objective of this report was to evaluate DER's 2013 and 2014 processes for identifying high risk areas.

To achieve this objective, we interviewed FHFA personnel with examination responsibilities. We also reviewed publicly available documents, internal DER documents, and non-public information provided by FHFA.

Our work was conducted under the authority of the Inspector General Act and in accordance with the Council of the Inspectors General on Integrity and Efficiency's *Quality Standards for Inspection and Evaluation* (January 2012). These standards require us to plan and perform an evaluation based upon evidence sufficient to provide reasonable bases to support its findings and recommendations. We believe that the finding and recommendations discussed in this report meet these standards.

The performance period for this evaluation was between February and July 2015.

APPENDIX A .....

FHFA's Comments on OIG's Findings and Recommendations

Federal Housing Finance Agency

MEMORANDUM

TO: Angela Choy, Assistant Inspector General for Evaluations

FROM: Nina A. Nichols, Deputy Director, Division of Enterprise Regulation

SUBJECT: OIG Report: *Utility of FHFA's Semi-Annual Risk Assessments Would Be Enhanced Through Adoption of Clear Standards and Defined Measures of Risk Levels*

DATE: December 17, 2015

This memorandum transmits the management response of the Federal Housing Finance Agency (FHFA) to the recommendations in the draft evaluation report prepared by the FHFA Office of Inspector General (FHFA-OIG), *Utility of FHFA's Semi-Annual Risk Assessments Would Be Enhanced through Adoption of Clear Standards and Defined Measures of Risk Levels* (Report). The Report discusses the preparation and use of risk assessments by FHFA's Division of Enterprise Regulation (DER).

As noted in the Report, DER follows a risk-based approach in conducting supervision of Fannie Mae and Freddie Mac (together, the Enterprises). DER relies on the expertise of subject-matter experts on the examination teams and in other DER offices to ensure that examination activities are informed by an understanding of risks and risk management practices. Risk assessment is incorporated into examination activities at various stages, including a semi-annual risk assessment. The Report notes that lack of specificity in internal DER guidance on the performance of risk assessments results in considerable variation in the measures of risk exposure, the usage of terms to describe risk levels, and formats for the presentation of risk analysis.

DER agrees that risk assessment is an essential component of effective risk-based supervision. DER appreciates the FHFA-OIG's review and observations on how risk assessments are presented and will address the FHFA-OIG recommendations as described below.

Recommendations:

1. *FHFA-OIG recommends that FHFA implement detailed risk assessment guidance that provides minimum requirements for risk assessments that facilitate comparable analyses for each Enterprise's risk positions, including common criteria for determining whether risk levels are high, medium, or low, year over year.*

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DER agrees. By May 25, 2016 DER will amend its existing internal guidance on the performance of risk assessments to include definitions of key terms used in risk assessments and to specify measures for inclusion in risk assessments in the areas of credit, market, and operational risk.

2. *FHFA-OIG recommends that FHFA implement detailed risk assessment guidance that provides standard requirements for format and the documentation necessary to support conclusions in order to facilitate comparisons between Enterprises and reduce variability among DER's risk assessments for each Enterprise and between the Enterprises.*

   DER agrees. By May 25, 2016 DER will amend its existing internal guidance on the performance of risk assessments to include more specific guidance on the format for presentation of risk analysis and on supporting documentation needed for risk assessment conclusions.

3. *FHFA-OIG recommends that FHFA direct DER to train its examiners-in-charge and exam managers in the preparation of semi-annual risk assessments, using enhanced risk assessment guidance consistent with Recommendations 1 and 2.*

   DER agrees. By October 14, 2016 DER will (i) provide training to all DER program staff (including examiners-in-charge and examination managers) on the amendments to DER internal guidance discussed in 1 and 2 above, and (ii) ensure that the amendments to internal guidance are incorporated in the FHFA training module on examination practices for new examination staff.

cc: John Major, Internal Controls and Audit Follow-up Manager

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