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Federal Housing Finance Agency
Office of Inspector General

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

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Executive Summary

Since 2008, FHFA has operated as both regulator and conservator of Fannie Mae and Freddie Mac (the Enterprises) and regulator of the Federal Home Loan Banks (FHLBanks) to ensure that they operate safely and soundly so that they serve as a reliable source of liquidity and funding for housing finance and community investment. Like other federal financial regulators, FHFA has adopted a risk-based approach for supervision. FHFA's Division of Enterprise Regulation (DER) conducts supervision activities for the Enterprises. DER conducts ongoing monitoring and targeted examinations into strategically selected areas of high importance or risk at each Enterprise pursuant to a supervisory plan that is prepared annually and revised at mid-year. Supervision of the FHLBanks is the responsibility of FHFA's Division of Federal Home Loan Bank Regulation (DBR). DBR's supervisory activities include annual on-site examinations, periodic visits, special reviews, and off-site monitoring.

In its role as regulator of the Enterprises and the FHLBanks, FHFA produces written reports of examination (ROE) for each annual supervisory cycle, as do other federal financial regulators for their safety and soundness examinations of financial institutions they regulate. FHFA's governance regulations and *Examination Manual* charge a board of directors (board) of each of its regulated entities with oversight responsibilities to ensure that management corrects all deficient, unsafe, or unsound practices giving rise to supervisory concerns and findings in an ROE.

The purpose of an ROE is to communicate to the board of each regulated entity examination results and conclusions, findings, supervisory concerns, and the composite and component ratings assigned in accordance with FHFA's rating system. A board can only effectively satisfy its oversight responsibilities to ensure that such practices will be corrected when the ROE identifies all deficient, unsafe, or unsound practices giving rise to supervisory concerns and findings.

Given the central role the ROE serves in communicating FHFA's supervisory concerns, examination findings, and ratings to the board of directors of each of its regulated entities, we conducted this evaluation to compare FHFA's ROE requirements and guidance to the ROE requirements established by other federal financial regulators, and to assess whether ROEs issued by DER to the Enterprises over the past five years meet FHFA's established requirements and guidance. We also compared DER's ROE-related guidance and practices with those of DBR. Based on the information learned during this evaluation, we are issuing today two reports. In this report, we compare the requirements and guidance issued by other federal financial regulators regarding the minimum

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standard of information to be provided in each ROE to the requirements and guidance issued by FHFA. We then discuss the supplemental guidance issued by DBR for content of ROEs issued to FHLBanks and show that DER has no similar guidance. Last, we examine whether DER examiners have adhered to commitments made by DER for the preparation of ROEs over the past five years and we find that they have not.

The companion report (entitled *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*) assesses whether DER examiners have followed FHFA's limited requirements and guidance for delivery of the ROE and response by the regulated entity over the past five years. We show that, on a regular basis, DER examiners have failed to meet FHFA's requirements.

Read together, our reports show that FHFA's limited ROE requirements and guidance and DER's shortcomings in following those standards weaken the value of the ROE to Enterprise boards, create the risk that Enterprise boards may not be fully knowledgeable of matters addressed in the ROE, and constrain the boards' ability to oversee remediation of supervisory concerns. Given the lack of comprehensive guidance by FHFA and the inconsistent application of existing guidance by DER examiners, FHFA has little assurance that the ROE will focus the attention of an Enterprise board on excessive risks or deficient risk management practices and their root causes, consistent with the objectives of FHFA's supervisory activities.

We make three recommendations to remedy the shortcomings we found. FHFA has partially agreed with our first recommendation, disagreed with the second, and agreed with the third.

This report was prepared by Jon Anders, Program Analyst, and Timothy Callahan, Attorney 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.

Kyle D. Roberts
Deputy Inspector General for Evaluations

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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
FDIC	Federal Deposit Insurance Corporation
Federal Reserve	Board of Governors of the Federal Reserve System
FHFA or Agency	Federal Housing Finance Agency
FHLBank	Federal Home Loan Bank
MRA	Matter Requiring Attention
OCC	Office of the Comptroller of the Currency
OQA	Office of Quality Assurance
ROE	Report of Examination

BACKGROUND

Since 2008, FHFA has operated as both regulator and conservator of the Enterprises and regulator of the Federal Home Loan Bank system to ensure that these entities operate safely and soundly so that they serve as a reliable source of liquidity and funding for housing finance and community investment. FHFA recognizes that its relationship to the Enterprises in its role as conservator is quite different from its role as regulator. As conservator, "FHFA has the ultimate authority and control to make business, policy, and risk decisions for the Enterprises, and the Enterprises' boards know that their job is to meet [FHFA's] expectations."[1] According to Director Melvin L. Watt, "managing these Enterprises in conservatorship requires much more of a joint effort than would occur under a normal regulatory relationship." For example, employees from FHFA's "Division of Conservatorship team attend management and board meetings as part of [FHFA's] conservatorship functions, and [the FHFA Director] personally attend[s] and preside[s] at executive sessions of Enterprise board meetings."

As regulator of the Enterprises, FHFA's role is no different from its role as regulator of the FHLBanks or the role played by other federal financial regulators for the entities they regulate. FHFA, like other federal financial regulators, is tasked with ensuring that the regulated entities operate safely and soundly. FHFA meets these responsibilities through risk-based supervisory activities.

FHFA's DER is responsible for supervision of the Enterprises. DER conducts both ongoing monitoring and targeted examinations based on its supervisory strategy and plan. Through ongoing monitoring, DER examiners evaluate the Enterprises' operations and risk management by meeting with Enterprise management and reviewing management and board reports. Examiners may also conduct ongoing monitoring to determine the status of the Enterprises' compliance with supervisory guidance and conservatorship directives and remediation of Matters Requiring Attention (MRAs). Targeted examinations enable examiners to conduct a deep or comprehensive assessment of selected areas of high importance or risk. DER examiners conduct targeted examinations on an as needed basis, determined by risk. FHFA's DBR is responsible for supervision of the FHLBanks and the Office of Finance. DBR's supervisory activities include annual on-site examinations typically lasting several weeks, supplemented by periodic visits, special reviews, and off-site monitoring.

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[1] Melvin L. Watt, Director, FHFA, Prepared Remarks at the Bipartisan Policy Center (Feb. 18, 2016) (online at www.fhfa.gov/Media/PublicAffairs/Pages/Prepared-Remarks-Melvin-Watt-at-BPC.aspx). FHFA has delegated responsibility of day-to-day operations to the Enterprises' boards and senior management, with the exception of certain activities that require approval of the conservator.

Reports of Examination: Communicating Examination Findings, Supervisory Concerns, and Ratings

FHFA's governance regulations and *Examination Manual* make clear that the board of a regulated entity is ultimately responsible for: ensuring that the conditions and practices that gave rise to any supervisory concerns and findings are corrected and that executive officers have been responsive in addressing all of FHFA's supervisory concerns in a timely and appropriate manner;[2] and holding management accountable for remediating those conditions and practices. FHFA, like other federal financial regulators, produces an ROE in conjunction with its supervision of each regulated entity. According to FHFA, the ROE communicates to the board of directors of a regulated entity substantive examination results and conclusions. DER issues an ROE to each Enterprise at the end of each annual supervisory cycle, and DBR issues an ROE to each FHLBank after completing that bank's annual on-site examination.

As noted earlier, DER's supervisory activities during each annual supervisory cycle involve ongoing monitoring and targeted examinations. The results and conclusions from DER's ongoing monitoring activities are reported in the annual ROE. At the close of each targeted examination, DER issues a conclusion letter to Enterprise management, not the Enterprise board.[3] The ROE rolls up the substantive examination results from these targeted examinations and also reports on conclusions and any findings issued through ongoing monitoring. ROEs issued by DBR focus on results from its annual on-site examinations, any periodic visits, special reviews, and off-site monitoring.

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[2] FHFA's corporate governance regulation does not define the term "supervisory concerns," but imposes duties on a board of regulated entities to ensure that all supervisory concerns are addressed. *See* 12 C.F.R. § 1239.4(c)(3) (Duties and Responsibilities of Directors).

[3] Through discussions with management and formal correspondence such as "conclusion letters," DER communicates examination findings to Enterprise management as they are identified during the course of the examination cycle. Prior to March 2016, DER addressed conclusion letters to Enterprise management, not to the board of directors or a board committee of an Enterprise. In response to a recent OIG recommendation, FHFA will now require that any conclusion letter that includes an MRA be sent to the chair of the board Audit Committee of the affected Enterprise. *See* OIG, *FHFA's Supervisory Standards for Communication of Serious Deficiencies to Enterprise Boards and for Board Oversight of Management's Remediation Efforts are Inadequate*, at 20 (Mar. 31, 2016) (EVL-2016-005) (online at www.fhfaoig.gov/Content/Files/EVL-2016-005.pdf).

Each ROE includes **examination findings**, which FHFA defines as deficiencies related to: risk management; risk exposure; or violations of laws, regulations, or orders affecting the performance or condition of a regulated entity. The most serious examination findings are MRAs. The ROE also reports "supervisory concerns," a term of art commonly used among federal financial regulators to describe a practice or condition that, on its own, may not qualify as an MRA, but nevertheless requires remediation and resolution. Last, each ROE contains the component and composite ratings assigned in accordance with FHFA's examination rating system.[4]

FHFA's Examination Findings

Matter Requiring Attention: The most serious examination finding, issued for non-compliance with laws or regulations, repeat deficiencies, unsafe or unsound practices, significant control weaknesses, and inappropriate risk-taking.

Violation: A matter as to which there is reason to suspect non-compliance with laws, regulations, or orders. A violation with serious implications also may be classified as an MRA.

Recommendation: An advisory finding representing a suggested change to a policy, procedure, practice, or control to improve, or prevent deterioration in, condition, operations, or performance.

FHFA's Examination Rating System—An Overview

FHFA adopted the "CAMELSO" examination rating system in 2012.[5] CAMELSO is similar to the "CAMELS" rating system used by federal banking regulators for depository institutions.[6] The CAMELSO system has seven components (component ratings): **C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, **S**ensitivity to Market Risk, and **O**perational Risk. Under the CAMELSO system, FHFA assigns each component a rating (on a scale of 1 to 5), where a 1 rating represents the lowest level of supervisory concern and a 5 rating represents the highest level. After considering the examination findings and ratings for each of the components, FHFA assigns a rating for the overall condition of the regulated entity (composite rating).

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[4] FHFA published its examination findings categories and supervisory guidance in Advisory Bulletin 2012-01, which established a hierarchy of three findings categorized by the seriousness of the deficiency. *See* FHFA, Advisory Bulletin 2012-01, *Categories for Examination Findings*, at 2 (Apr. 2, 2012) (online at www.fhfa.gov/SupervisionRegulation/AdvisoryBulletins/AdvisoryBulletinDocuments/2012_AB_2012-01_Categories_for_Examination_Findings_508.pdf). An FHFA Advisory Bulletin may be directed to FHFA employees, to the entities FHFA regulates, or to both. Advisory Bulletin 2012-01 is addressed to both.

[5] *See* FHFA, Advisory Bulletin 2012-03, *FHFA Examination Rating System* (Dec. 19, 2012) (online at www.fhfa.gov/SupervisionRegulation/AdvisoryBulletins/Pages/AB-2012-03-FHFA-EXAMINATION-RATING-SYSTEM.aspx). The new rating system became effective January 1, 2013.

[6] *See* FHFA, *Examination Rating System,* 77 Fed. Reg. 67644 (Nov. 13, 2012) (online at 2012.11.13_FHFA_77FR67644-Examination-Rating-System).

The CAMELSO composite rating reflects FHFA's conclusions regarding the safety, soundness, and risk management practices of a regulated entity. According to FHFA, a composite rating of 1 or 2 reflects FHFA's conclusion that the regulated entity is generally sound; a composite rating of 3 reflects FHFA's determination that the entity has moderate to severe weaknesses and needs improvement; and a composite rating of 4 or 5 reflects the need for supervisory intervention.

Ramifications of CAMELSO Composite Ratings

FHFA may take enforcement action to address, among other things, examination findings, capital deficiencies, and unsafe or unsound practices or conditions. Enforcement actions can be informal or formal, and can take the form of a board resolution, written agreement, memorandum of understanding, prompt corrective action directive, consent order, or cease-and-desist order.

Under FHFA's Enforcement Policy, the CAMELSO composite rating is a significant factor in guiding FHFA's decision whether to take an enforcement action and the type of enforcement action that is appropriate. For a regulated entity with a composite rating of 1 or 2, FHFA's policy directs that examiners should address supervisory concerns identified in an ROE through commitments from management and the board to correct the problems. When a regulated entity receives a CAMELSO composite rating of 3, 4, or 5, FHFA's policy contemplates that a formal or informal enforcement action may be appropriate to ensure that management and the board correct the identified deficiencies within specified timeframes.[7]

Examination Ratings for Fannie Mae and Freddie Mac During the Conservatorships

For each year of FHFA's conservatorships of the Enterprises, FHFA has assigned examination ratings to each Enterprise. From 2008 through 2012, FHFA assigned ratings under its "GSEER" rating system;[8] after adopting the CAMELSO system, FHFA assigned ratings under it from 2013 to the present. FHFA assigned the worst possible GSEER rating—"Critical Concerns"—to each Enterprise until the Agency transitioned to the CAMELSO

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[7] *See* FHFA Advisory Bulletin 2013-03*, FHFA Enforcement Policy*, at 10-11 (May 31, 2013) (online at www.fhfa.gov/SupervisionRegulation/AdvisoryBulletins/AdvisoryBulletinDocuments/20130531_AB_2013-03_FHFA-Enforcement-Policy_508%20(2).pdf). Pursuant to 12 U.S.C. § 4631(b), the FHFA Director may bring an enforcement action against a regulated entity for unsafe and unsound practices if it receives a CAMELSO component rating of 3, 4, or 5 in any individual component for asset quality, management, earnings, or liquidity and fails to correct the deficiency that led to the rating.

[8] GSEER stands for **G**overnance, **S**olvency, **E**arnings, and **E**nterprise **R**isk (Enterprise Risk is comprised of Credit Risk, Market Risk, and Operational Risk). GSEER was a four-tiered system with ratings of "No or Minimal Concerns," "Limited Concerns," "Significant Concerns," and "Critical Concerns." A full description of the rating system is set forth in Chapter 3 of the DER *Supervision Handbook 2.1* (June 16, 2009). FHFA rescinded the *Supervision Handbook* after adopting the *Examination Manual* in December 2013.

system. FHFA publicly disclosed examination ratings in its annual reports to Congress from 2009 to 2012, but has not disclosed the Enterprises' composite or component ratings since its 2012 report. Perhaps because both Enterprises have been in conservatorship since September 2008, FHFA has not assigned either Enterprise a composite rating better than [redacted] during the conservatorships. FHFA has not brought any enforcement action against any Enterprise manager or director since placing the Enterprises into conservatorships in September 2008. According to FHFA's Advisory Bulletin 2013-03, the broad statutory powers granted to FHFA as conservator provide it with an effective means to remediate deficiencies at a regulated entity in its conservatorship, rendering traditional enforcement tools unnecessary.

FACTS AND ANALYSIS ....

Requirements of Other Federal Financial Regulators for Content of Reports of Examination

Like FHFA, other federal financial regulators such as the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Federal Reserve), and the Federal Deposit Insurance Corporation (FDIC), conduct safety and soundness examinations of, and issue periodic ROEs to, the financial institutions they supervise.[9] In 1993, the OCC, Federal Reserve, and FDIC adopted the uniform common core ROE, a format developed collaboratively to provide a common template and to set a minimum standard for the information provided in an ROE.[10] The uniform common core ROE template established baseline ROE elements such as mandatory pages for overall conclusions and examiner comments, matters requiring the board's attention, standardized financial condition assessments, and discussion of each examination rating area. The uniformity of ROEs across regulatory agencies is intended to reduce regulatory burdens and promote consistency. Consistency across ROEs within a regulatory agency allows the reports to guide and inform subsequent examination work.

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[9] FHFA maintains, based on the language of its authorizing statute, that its supervisory authority "is virtually identical to—and clearly modeled on—Federal bank regulators' supervision of banks." *See* Def's Resp. in Opp. to Pls' Mot. to Compel Prod. of Certain Documents Withheld for Privilege, at 17, *Fairholme Funds, Inc. v. United States*, No. 13-465C (Fed. Cl. Feb. 19, 2016).

[10] *See* OCC, FDIC, Federal Reserve, and Office of Thrift Supervision, *Interagency Policy Statement on the Uniform Common Core Report of Examination* (Oct. 1, 1993) (online at www.occ.gov/static/news-issuances/bulletins/pre-1994/examining-bulletins/eb-1993-7a.pdf).

The common core ROE has been augmented with agency-specific templates and detailed instructions for bank examiners,[11] including the requirement to clearly communicate and prioritize supervisory concerns and deficiencies to the boards of regulated financial institutions. Examiners are also expected to include corrective actions and record the board's and management's commitments to remediation in the ROE.

FHFA Requirements, Guidance, and Practice Regarding Reports of Examination

Requirements and Guidance on ROE Structure and Content

According to FHFA Director Watt, DER examiners produce ROEs and make findings as to whether the Enterprises need to make corrective actions in particular areas. During the review period,[12] FHFA's requirements and guidance regarding the structure and content of the ROE consisted of the following four sentences in its *Examination Manual*:

> The report of examination identifies supervisory concerns and contains examination ratings that reflect FHFA's view of the regulated entity's financial safety and soundness and risk management practices. . . . The FHFA issues an ROE, signed by the EIC [Examiner-in-Charge]. . . . The ROE communicates substantive examination conclusions, findings (when applicable), and the composite and component ratings. The ROE must also contain analysis that supports the conclusions, findings, and ratings.[13]

The *Examination Manual* contains no standardized ROE template or set of instructions to guide the examiners' preparation of an ROE.[14] Moreover, beyond Advisory Bulletin 2012-03, which announced FHFA's adoption of the CAMELSO system, FHFA has issued no

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[11] *See, e.g.*, OCC, *Bank Supervision Process, Comptroller's Handbook*, at 101-109 (Dec. 2015) (online at www.occ.gov/publications/publications-by-type/comptrollers-handbook/pub-ch-ep-bsp.pdf); Federal Reserve, *Commercial Bank Examination Manual*, Section 6000.1 (Apr. 2015) (online at www.federalreserve.gov/boarddocs/supmanual/cbem/cbem.pdf); and FDIC, *RMS Risk Management Manual of Examination Policies,* Section 16.1: Report of Examination Instructions (Apr. 2015) (online at www.fdic.gov/regulations/safety/manual/section16-1.pdf).

[12] On June 28, 2016, DER issued an internal bulletin that established a requirement for MRAs to be included in ROEs. DER issued this guidance in response to a March 2016 OIG report recommendation.

[13] *See* FHFA, *Examination Manual,* at 6, 16, 23. On May 25, 2016, DER issued internal procedures for performing risk assessments. The new procedures note that the ROE must be approved by the DER Deputy Director (in addition to the *Examination Manual*'s examiner-in-charge (EIC) signature requirement).

[14] A DER official responsible for examination standards informed us that his office developed a draft ROE template and shared it in 2016 with the EICs of Fannie Mae and Freddie Mac for informational purposes. The Deputy Director of DER has not reviewed or approved the template and, as such, it is not binding guidance.

additional guidance to examiners to explain the basis on which each component rating should be determined or the basis on which a composite rating should be assigned.

DER has issued an internal procedures bulletin for the preparation of an ROE that simply restates the brief guidance, quoted above, from the *Examination Manual*.[15] During the review period, neither FHFA nor DER issued requirements or guidance regarding identification and prioritization of MRAs or other supervisory concerns in the ROE, or the underlying deficiencies that gave rise to the MRA or supervisory concern. DER has not promulgated requirements or guidance regarding the reporting of specific deficiencies giving rise to supervisory concerns or MRAs. As a consequence, each EIC exercises substantial discretion over the content and structure of the ROE.

In contrast with DER, DBR has issued an ROE template to its examiners and internal guidance describing how to complete the ROE template for an FHLBank. DBR directs its examiners to include a principal findings table in the ROE consisting of a brief description of each examination finding and the date by which remediation is expected, and requires its examiners to identify all open "principal" findings from the prior examinations and findings resolved since the last examination.

FHFA's current ROE guidance on the preparation of an ROE is a significant departure from—and relaxation of—prior DER guidance.[16] From 2008 through 2013, DER guidance instructed that an ROE "should clearly, concisely, and effectively communicate FHFA's overall conclusions and issues," "convey[ ] FHFA's assessment of the overall condition of the Enterprise," and "discuss[ ] any unwarranted risks or significant deficiencies." To implement that instruction, DER established a number of specific requirements for ROE structure and content, which included:

- An overall condition statement providing the overall safety and soundness assessment and the composite rating (under the GSEER rating system);
- A core report section containing a narrative analysis of the Enterprise's condition;
- Separate sections addressing each of the six components covered by the examination rating system in place at that time (the GSEER rating system);and

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[15] *See* FHFA, DER Operating Procedures Bulletin 2014-DER-OPB-01, *Guidelines for Preparing Supervisory Products and Examination Workpapers* (Jan. 27, 2014).

[16] The prior examination guidance in place was DER *Supervision Handbook 2.1*, a revised version of the Office of Federal Housing Enterprise Oversight *Supervision Handbook* that existed when the Housing and Economic Recovery Act of 2008 combined the Office of Federal Housing Enterprise Oversight and the Federal Housing Finance Board to create FHFA.

- Identification of all MRAs, because the underlying deficiencies could have a major impact on an Enterprise's condition and an Enterprise board was responsible for ensuring that Enterprise management corrected such deficiencies.

From December 2013 through the end of our review period, none of these specific elements for ROE structure and content were required by FHFA or DER. In a previous evaluation concerning FHFA's semi-annual risk assessments, we found that the absence of standards within DER limits the utility of its work product.[17] A senior DER official acknowledged, in that context, the value of a consistent, standardized approach.

FHFA's wholesale lack of requirements for ROE content and structure is at odds with the requirements of other federal financial regulators. While DBR has issued internal guidance that mirrors the requirements of these regulators, DER has not, and committed the content and structure of the ROE solely to the discretion of the EIC.

Observed Practice

We reviewed the 10 ROEs issued by FHFA to the Enterprises during the review period (2012-16).[18] We found that these ROEs did not consistently identify or describe specific deficiencies in management practices or the root causes of those deficiencies. We also found that the content of the ROEs varied by Enterprise and across the five supervisory cycles under review.[19]

All 10 ROEs issued during the review period included an introductory section highlighting significant examination conclusions. However, the structure of these sections and their degree of specificity varied between DER's examination teams and over time. For example, the examination conclusions sections of both Enterprises' 2012 ROEs (issued for the 2011 supervisory cycle) identified specific areas of board and senior management focus and actions for the Enterprises to take to reduce risk. The following year, DER discontinued this practice

[17] *See* OIG, *Utility of FHFA's Semi-Annual Risk Assessments Would Be Enhanced Through Adoption of Clear Standards and Defined Measures of Risk Levels*, at 11-12 (Jan. 4, 2016) (EVL-2016-001) (online at www.fhfaoig.gov/Content/Files/EVL-2016-001.pdf).

[18] We examined the actual ROE practices of DER between 2012 and 2016 (corresponding to examination work conducted from 2011 to 2015) to assess whether DER met the requirements of FHFA's *Examination Manual*.

[19] *See* OIG, *Utility of FHFA's Semi-Annual Risk Assessments Would Be Enhanced Through Adoption of Clear Standards and Defined Measures of Risk Levels*, *supra* note 17, at 12, 14. These numerous differences may be attributed, in part, to the broad discretion over ROE form and content afforded to DER EICs. FHFA also has reported significant turnover in EICs and DER Deputy Directors during the review period. As we previously observed in the context of DER's preparation of semi-annual risk assessments for the Enterprises, detailed examination standards would reduce variability in content from year to year and mitigate the effects of high employee turnover within DER.

for the Fannie Mae 2013 ROE (for the 2012 supervisory cycle). DER continued the practice in the Freddie Mac 2013 ROE, but in the 2014 ROE shifted its discussion in these sections away from specific actions that needed to be taken by the Freddie Mac board and management and instead put an emphasis on FHFA's areas of planned supervision. DER discontinued its prior practice entirely in the Freddie Mac 2016 ROE.

While DER organized supervisory concerns and conclusions by each component rating in each of the 10 ROEs, our review found that DER did not expressly prioritize its supervisory concerns within each component rating area or among them.[20] For the most part, DER did not expressly link specific deficiencies and shortcomings in the narrative section for each component rating to outstanding MRAs, when they were identified in the ROEs. As a consequence, the ROE does not effectively communicate FHFA's supervisory expectations for the corrective actions to be taken by management and overseen by the board. In minutes from a 2014 Enterprise board meeting at which the EIC presented a summary of DER's supervisory findings and conclusions, directors voiced their concern about the lack of supervisory guidance from DER. The minutes report that, in relation to the EIC's presentation of DER's findings for the earnings component, directors pressed the EIC to focus the ROE narrative on shortcomings "within management's control" that gave rise to supervisory concerns, which could facilitate the board's oversight of management's efforts to address those matters.

Our review also identified inconsistent practices with respect to identification of open MRAs in the ROEs. As discussed earlier, FHFA's most serious examination findings are MRAs for which FHFA requires prompt remediation. The five ROEs issued to Freddie Mac during the review period contained a list of open MRAs, but three of the five ROEs issued to Fannie Mae during this period did not.[21] While FHFA insists upon prompt correction of the deficient practices giving rise to an MRA, none of the seven ROEs that identified open MRAs tied each open MRA to specific deficient practices that gave rise to it. In addition, none of these seven ROEs prioritized the order in which open MRAs should be remediated. As we explained in a recent evaluation, FHFA historically did not notify Enterprise directors when MRAs issued, nor did it provide them with approved remediation plans. By failing to identify open MRAs

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[20] As we highlighted earlier, other federal financial regulators require examiners to prioritize supervisory concerns and findings in an ROE to focus directors' attention on the most pressing supervisory concerns, including MRAs.

[21] DER's *Supervision Handbook 2.1*, in effect until FHFA published the *Examination Manual* in December 2013, required that the ROE include a section listing Matters Requiring Board Attention. The Fannie Mae 2012 ROE (for 2011 examination activities) contained a list of MRAs; the Fannie Mae 2013 ROE did not. In a recent evaluation, *FHFA's Supervisory Standards for Communication of Serious Deficiencies to Enterprise Boards and for Board Oversight of Management's Remediation Efforts Are Inadequate*, we recommended that the 2016 ROEs include "all open MRAs and the expected timetable to complete outstanding remediation activities for each open MRA." FHFA accepted, and has complied with, this recommendation.

in three of the last five ROEs issued to Fannie Mae, and by failing to explain the deficient practices giving rise to each of the open MRAs reported in the other seven ROEs, DER failed to provide in its ROEs critical information on its most serious examination findings to Enterprise directors, which necessarily constrained the directors' ability to exercise effective oversight.

Based on our review of a sample of ROEs issued by DBR to the 12 FHLBanks between 2012 and 2016, we found that DBR examiners used the division's ROE template and followed DBR's internal guidance. Among other things, we determined that these ROEs included a table of principal examination findings with remediation dates and identified all open principal findings from prior examinations.

DER's ROE Review Process Continues to Create the Appearance that the Enterprises Influence the Content of the Final ROEs

Unlike the "joint effort" used by FHFA to manage the Enterprises in conservatorship, FHFA's actions as the regulator of the Enterprises are, according to FHFA Director Watt, conducted "with a deliberate distance" to ensure that FHFA executes its safety and soundness supervision responsibilities. According to FHFA, its prudential supervision of the Enterprises should:

- Be at arm's length from the Enterprises to ensure objectivity;
- Be fair in that the same rules are applied consistently to both Enterprises;
- Report accurately and fully in each annual ROE the examination results and conclusions, findings, supervisory concerns, and composite and component ratings assigned in accordance with FHFA's rating system.

Only when an Enterprise board is presented by FHFA with sufficient information about the substantive examination results and conclusions, findings, and supervisory concerns can it effectively oversee management's efforts to correct the deficiencies giving rise to the findings.

In 2011, FHFA's internal Office of Quality Assurance (OQA)[22] reviewed the process used by DER to compile its ROE for 2010 examination activities for each Enterprise and identified "significant concerns" with DER's process. Those concerns included:

[22] OQA is an internal control established by FHFA to assist it in meeting its mission, goals, and objectives and minimizing risks associated with its programs and operations. Pursuant to its charter, OQA is responsible for evaluating the quality of work performed by DER, DBR, and the Division of Housing Mission and Goals.

- DER examiners shared draft ROEs with Enterprise employees without guidance in place that governed the scope of the Enterprises' review of draft ROEs;
- DER allowed the Enterprises to edit and even rewrite sections of draft ROEs, some of which changed the language and tone of the ROEs; and
- DER agreed to remove a number of findings from draft ROEs, without documenting the rationale for its decisions, after Enterprise officials reviewed the draft findings and raised objections.

OQA found that DER's process created the "appearance that the Enterprises have too much influence over the contents." In its September 2012 response to the OQA report, DER did not challenge any of OQA's findings. DER represented that it had revised its process to prepare ROEs to "significantly reduce the Enterprises' role in preparation of examination reports" and that its revised process limited Enterprise review of draft ROEs to the correction of factual errors. According to DER, the revised process would "reduce[] the Enterprises' input into supervisory written products, while improving the engagement" between DER and the Enterprises. DER also committed to increase training of examiners to strengthen their skill sets.

While the Enterprises' role in DER's process to prepare the annual ROE has been reduced from the role they played in 2011 (which gave rise to the OQA findings), we found that Enterprise management continued to offer proposed changes to draft ROEs in language and tone that were more favorable to the Enterprise than the language DER drafted. For each of the five annual supervisory cycles in the review period covered by our evaluation, DER provided draft ROEs to the management of each Enterprise for what DER called a "fatal flaw" review, supposedly limited to correction of factual errors. We found, in the sample we reviewed, that Enterprise management did not limit its comments to correcting factual errors. Enterprise management provided a range of comments to DER as part of its fatal flaw review: while some proposed edits involved factual corrections or clarifications, such as changing a figure or date for accuracy, others proposed changes in DER's examination narrative and conclusions that were more favorable to the Enterprises than those drafted by DER.

By way of example, DER transmitted by email earlier this year the draft ROEs for the 2015 supervisory cycle to the chief compliance officer or a regulatory affairs official at each Enterprise and requested "fatal flaw" comments or edits. While DER committed in 2012 that proposed changes by Enterprise management would be limited to factual corrections, we found that management at both Enterprises did not confine their comments to the correction of factual errors in the draft ROE. We observed, in the annotated draft ROEs returned to DER by management for each Enterprise, that management offered a number of line edits to DER which, in our view, affected the tone or reframed conclusions contained in the examination narrative.

We reviewed two sets of comments from Fannie Mae management on the draft ROE for 2015 examination activities. One assessed the accuracy of the draft ROE's financial information while the other, labeled "ROE Redline," included more substantial comments and edits. We found that the review of financial information primarily contained numeric factual corrections. In contrast, we found that a number of the edits and comments that Fannie Mae management provided in the ROE Redline attempted to reframe DER's language, tone, or conclusions beyond factual correction. DER rejected the majority of these suggested edits. However, it accepted two of them, in part, that went to DER's draft governance conclusions. While FHFA maintains that these edits conformed the conclusions to governing FHFA guidance, we believe, based on our review of these edits, that the edits softened the tone of the conclusions, beyond governing FHFA guidance. Similarly, Freddie Mac management provided comments and changes related to DER's draft of its ROE for the 2015 supervisory cycle, of which several sought to reframe or contest DER's language, tone, or conclusions beyond factual correction. DER accepted each of the several instances of these revisions. DER issued both revised ROEs in March 2016.

FINDINGS ....

1. Guidance issued by FHFA and DER on the structure and content of the annual ROE is incomplete compared to guidance issued by DBR and by three other federal financial regulators and has led to inconsistent and incomplete ROEs.

In contrast to three other federal financial regulators, neither FHFA nor DER provides examiners with baseline standards for ROE structure and content or a template. DBR, however, has issued internal guidance that mirrors the requirements of these three other federal financial regulators.

During the review period, DER issued no requirements or guidance regarding identification and prioritization of MRAs or other supervisory concerns in the ROE, or the underlying deficiencies that gave rise to the MRAs or supervisory concerns. Based on our review of ROEs issued for five annual supervisory cycles, we found: (1) that the content of the ROEs varied by Enterprise and across the five supervisory cycles; (2) specific deficiencies in management practices and the root causes of supervisory deficiencies were not consistently reported in the ROEs; and (3) 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.

2. ROEs issued to each Enterprise during the five annual supervisory cycles failed to consistently provide Enterprise directors with critical information on the most serious examination findings which necessarily constrained the directors' ability to exercise effective oversight.

According to FHFA, the annual ROE has provided the primary means to communicate to the board of each regulated entity FHFA's examination conclusions, findings, and supervisory concerns.[23] These directors can only satisfy their oversight responsibilities to ensure that the regulated entity is operating in a safe and sound manner and that executive officers have addressed all of FHFA's supervisory concerns when they are made aware of all deficient, unsafe, or unsound practices that led to supervisory concerns and/or deficiencies, including MRAs.

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[23] As noted above, prior to March 2016, DER only addressed the initial communication of examination findings, contained in conclusion letters, to Enterprise management. In response to a recent OIG recommendation, FHFA will now require that any conclusion letter that includes an MRA be sent to the chair of the board's Audit Committee.

We found no consistency among the 10 ROEs we reviewed regarding disclosure of specific deficiencies in management practices or the root causes of those deficiencies giving rise to an open MRA.[24] In those instances where the open MRAs were reported in an ROE, we found that the deficient, unsafe, or unsound practices identified in the narrative section for each component rating typically were not linked to specific open MRAs, constraining directors' ability to exercise effective oversight of management's remedial efforts.

3. DER's ROE review process continues to create the appearance that the Enterprises exert influence over ROE content.

In 2011, DER was criticized internally for allowing the Enterprises to edit and rewrite sections of draft ROEs, some of which changed the language and tone of the ROEs. DER committed that it had revised its processes to limit Enterprise input into draft ROEs to correction of factual errors. While the scope of comments by Enterprise management to draft ROEs has been reduced since 2011, we found that proposed line edits suggested by Enterprise management went beyond correction of factual errors to include changes to language, tone, or conclusions. Proposed edits and comments to the draft ROEs for the 2015 supervisory cycle by management of each Enterprise, and DER's willingness to accept some of the proposed changes to language and tone, call into question the "deliberate distance" with which FHFA conducts its safety and soundness supervision of the Enterprises.

CONCLUSION...

The annual report of examination has been the primary means by which FHFA communicates its supervisory findings from its targeted examinations and ongoing monitoring activities—including serious deficiencies and violations of laws and regulations—and its examination ratings. Consistent with the importance of these findings and ratings, FHFA directs that examiners issue the ROE to an Enterprise's board of directors, which is ultimately responsible for correcting deficiencies and ensuring the safety and soundness of the Enterprise.

Other federal financial regulators have adopted comprehensive standards and guidance for ROE structure and content and DBR has issued internal guidance that mirrors the requirements of these regulators. By comparison, the guidance issued by FHFA and DER is minimal and vests substantial discretion over the content and structure of the ROE to the EIC for each exam team. We found, based on our review of 10 ROEs issued for the past five annual supervisory cycles, that the content of the ROEs varied by Enterprise and across the

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[24] In accordance with a prior OIG recommendation, FHFA corrected this weakness in the 2016 ROEs by providing the boards of both Enterprises with similarly formatted MRA tables, which included MRA remediation timelines.

five supervisory cycles and that specific deficiencies in management practices and the root causes of supervisory deficiencies were not consistently reported in the ROEs. The lack of a consistent, standardized approach to preparation of ROEs weakens the value of the ROE to Enterprise boards, creates the risk that Enterprise boards may not be fully knowledgeable of matters addressed in the ROE, and constrains their ability to oversee remediation of supervisory concerns.

RECOMMENDATIONS

OIG recommends that FHFA:

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.

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; and

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 COMMENTS AND OIG RESPONSE..................................

We provided FHFA an opportunity to respond to a draft report of this evaluation. FHFA provided technical comments on the draft report, which we incorporated as appropriate. In its management response, which is reprinted in its entirety in Appendix B, FHFA partially agreed with recommendation 1, disagreed with recommendation 2, and agreed with recommendation 3.

FHFA "partially" agreed with recommendation 1. FHFA agreed to adopt a standard template and instructions for completing the template and stated that the instructions will establish baseline elements that must be included in each ROE. However, FHFA's response does not address whether its instructions will require clear communication of deficient, unsafe, or unsound practices; explain how those practices gave rise to supervisory concerns and deficiencies; or prioritize remediation of supervisory concerns and deficiencies. In this report, we found that ROEs issued by DER did not clearly communicate to Enterprise boards during the last five annual supervisory cycles all deficient, unsafe, or unsound practices and did not consistently explain how those practices gave rise to supervisory concerns and deficiencies. As a consequence, we found that the ROEs issued by DER failed to consistently provide Enterprise directors with critical information necessary for them to exercise their oversight responsibilities, as required by FHFA. Because FHFA has advised OIG that its template and accompanying instructions "will likely not require enumeration of all supervisory concerns," we do not consider FHFA's response as fully responsive to our recommendation. If FHFA does not intend to adopt this portion of our recommendation, we expect that FHFA will provide us with the remediation it intends to take to address the shortcomings sought to be corrected by this portion of the recommendation.

FHFA disagreed with recommendation 2. It stated that conclusion letters, which are issued from targeted examinations, along with ROEs and unnamed "other supervisory communications," are sufficient to enable board oversight to remediate MRAs and other supervisory concerns. FHFA's corporate governance regulation requires each Enterprise board to ensure that management addresses "all supervisory concerns of FHFA in a timely and appropriate manner." While FHFA requires conclusion letters to report all MRAs arising from the targeted examination, DER did not require examiners to provide those conclusion letters to Enterprise directors until June 2016, when FHFA only changed its guidance in response to an OIG recommendation in a report issued earlier this year. Neither FHFA nor DER require DER examiners to identify all supervisory concerns that do not rise to the level of an MRA in a conclusion letter. Consequently, Enterprise directors would not learn about any such supervisory concerns from conclusion letters. Following the publication of the *Examination Manual* in December 2013, DER was not required to identify all open MRAs in ROEs until June 2016, when, in response to the same OIG report issued in March 2016, DER adopted formal internal guidance requiring the inclusion of MRAs in ROEs. As we found in this report, only one of the three ROEs issued to Fannie Mae during that period identified open MRAs. DER's new guidance does not require supervisory concerns or the basis for those concerns to be identified in an ROE. FHFA has not identified the "supervisory communication" in which it communicates supervisory concerns to Enterprise directors, apart from the ROE and conclusion letters. As matters now stand, there is no clear foundation for FHFA's assertion that Enterprise directors will learn about supervisory concerns from conclusion letters, "other supervisory communications," or the ROE. In our recommendation, we sought to address a related shortcoming identified in this report: namely, to require DER to identify all supervisory concerns and deficiencies in each ROE and the root causes of such concerns and deficiencies to Enterprise directors to enable them to satisfy their governance obligations. We urge FHFA to reconsider its response to this recommendation.

FHFA agreed with recommendation 3. The Agency committed to issue internal guidance governing the process of the Enterprises' review of draft ROEs to "avoid the appearance of inappropriate influence."

OBJECTIVE, SCOPE, AND METHODOLOGY ....

We conducted this evaluation to compare ROEs issued by DER to the Enterprises between 2012 and 2016 to FHFA's established requirements and guidance, and to the ROE practices used by DBR. We also looked to the ROE requirements established by other federal financial regulators.

To achieve these objectives, we met with FHFA personnel involved with the creation and transmission of the ROEs. We conducted both an entrance conference and a follow-up document production clarification meeting with FHFA to better understand their processes and to obtain relevant documents. We also reviewed publicly available documents, internal DER and DBR documents, and non-public information provided by FHFA, which included official minutes and materials of the boards of directors from both Enterprises.

This evaluation 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 a reasonable basis to support its findings and recommendations. We believe that the findings and recommendations discussed in this report meet those standards.

The fieldwork for this report was completed between November 2015 and May 2016. The review period for this evaluation was between January 1, 2012, and March 31, 2016.

APPENDIX A ....

Examination Manuals and ROE Templates and Instructions of the OCC, Federal Reserve, and FDIC

OCC

Comptroller's Handbook (Dec. 2015)

- Safety and Soundness Booklets: *Bank Supervision Process* (last updated Sept. 2007) (online at www.occ.gov/publications/publications-by-type/comptrollers-handbook/pub-ch-ep-bsp.pdf)

Federal Reserve

Commercial Bank Examination Manual (Apr. 2016)

- *Section 1000: Examination Strategy and Risk-Focused Examinations* (online at www.federalreserve.gov/Boarddocs/SupManual/cbem/1000.pdf)
- *Section 5000: Assessment of the Bank* (last updated Apr. 2013) (online at www.federalreserve.gov/Boarddocs/SupManual/cbem/5000.pdf)
- *Section 6000: Federal Reserve Examinations* (last updated Oct. 2013) (online at www.federalreserve.gov/Boarddocs/SupManual/cbem/6000.pdf)

FDIC

Risk Management Manual of Examination Policies (Feb. 2016)

- *Section 1.1: Basic Examination Concepts and Guidelines* (online at www.fdic.gov/regulations/safety/manual/section1-1.pdf)
- *Section 16.1: Report of Examination Instructions* (last updated Apr. 2015) (online at www.fdic.gov/regulations/safety/manual/section16-1.pdf)
- *Section 17.1: Bank of Anytown – Report of Examinations* (last updated Apr. 2015) (online at www.fdic.gov/regulations/safety/manual/section17-1.pdf)

APPENDIX B...

FHFA's Comments on OIG's Findings and Recommendations

Federal Housing Finance Agency

MEMORANDUM

TO: Kyle D. Roberts, Deputy Inspector General - Evaluations

FROM: Nina A. Nichols, Deputy Director, Division of Enterprise Regulation (DER) nan
Fred C. Graham, Deputy Director, Division of Federal Home Loan Bank Regulation (DBR) FCG

SUBJECT: Evaluation Reports on FHFA Annual Reports of Examination

DATE: July 7, 2016

This memorandum transmits the management response of the Federal Housing Finance Agency (FHFA) to the recommendations in two OIG draft evaluation reports (Reports): *FHFA Guidance and Practice with Respect to the Content of Annual Reports of Examination (ROE Content Report)* and *FHFA Guidance and Practice with Respect to Communications with the Board of Directors Regarding Annual Reports of Examination (ROE Communications Report)*. The Reports discuss FHFA guidance and practice for preparing annual Reports of Examination (ROEs) for FHFA's regulated entities, the Federal Home Loan Banks (FHLBanks) and Fannie Mae and Freddie Mac (the Enterprises), and for communicating with the regulated entities' boards of directors about ROEs.

FHFA's responses to the six recommendations in the two Reports are below. While FHFA agrees with some of the recommendations, we do not agree with all the findings and conclusions in the Reports, particularly the following three points.

First, FHFA disagrees with OIG's suggestion that the Enterprises appear to unduly influence ROEs issued by FHFA. FHFA provides each FHLBank and Enterprise with the opportunity to review a draft version of the annual ROE and note any factual corrections. FHFA makes its own independent determination about what suggestions to incorporate. OIG states that DER was willing to accept certain edits that, in OIG's view, went beyond factual correction. FHFA disagrees with OIG's view. The record of Enterprise and DER communications demonstrates that each of the changes that DER made to the ROEs was purely factual in nature. FHFA believes that it followed "best practices" by appropriately permitting limited regulated entity review of ROEs.

Second, FHFA disagrees with the OIG's suggestion that the boards of directors of the Enterprises are not adequately informed about the ROEs and supervisory concerns. While the OIG has identified gaps in requirements for documentation of review by board members of ROEs and Enterprise responses, the OIG has not identified any instance in which board members were not aware of supervisory concerns covered in ROEs and did not satisfactorily fulfill their oversight responsibilities.

Third, the Reports correctly note that DER has less guidance on ROE format than other regulators. However, DER supervises just two institutions, much fewer than other regulators, and DER is in much more consistent contact with its supervised entities. While the ROE formats have not been identical, DER does not believe that ROE format variations reflect weaknesses in examination work or in the quality of supervisory communications about the safety and soundness of Enterprise operations.

FHFA management's responses to the recommendations are below.

I. ROE Content Report

Recommendation 1:

OIG recommends that FHFA 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 practice; explanation of how those practices gave rise to supervisory concerns and deficiencies; and prioritization of remediation of supervisory concerns and deficiencies.

Management Response to Recommendation 1:

FHFA partially agrees with this recommendation. DER is currently working on a draft template for Enterprise ROEs. DER will, by July 1, 2017, finalize its draft template and associated instructions for completing that template, which will include establishing baseline elements that must be included in each ROE.

As noted in the Reports, while DBR uses the ROE to communicate the results of its annual six-week on-site examination of each FHLBank, DER's on-site examination staff performs targeted examinations and ongoing monitoring continuously. DER communicates and explains supervisory concerns, including any unsafe or unsound practices and expectations for remedial action, as it completes examination work, rather than solely through the annual ROE. Consequently, the DER template will likely not require enumeration of all supervisory concerns.

Recommendation 2:

OIG recommends that FHFA 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.

Management Response to Recommendation 2:

FHFA disagrees with this recommendation. Critical supervisory concerns in the form of Matters Requiring Attention (MRAs) are brought to the attention of the board of directors through the course of the year, as copies of all Conclusion Letters are provided to the chair of the Enterprise's audit committee. FHFA believes that the ROEs as currently prepared, together with other supervisory communications, are sufficient to enable the boards of directors to satisfactorily perform their oversight function.

Recommendation 3:

OIG recommends that FHFA 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 message to Enterprise management.

Management Response to Recommendation 3:

FHFA agrees with this recommendation. By July 1, 2017, DER will issue internal guidance outlining the procedure for permitting Enterprise management a limited-time review of draft ROEs for factual inaccuracies to avoid the appearance of inappropriate influence.

II. ROE Communications Report

Recommendation 1:

OIG recommends that FHFA revise its Examination Manual to:

- *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 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.*

Management Response to Recommendation 1:

FHFA partially agrees with this recommendation.

- By July 1, 2017, DER will amend its internal guidance to provide that each Enterprise ROE should be addressed to the board of directors. FHFA does not believe that there is confusion over the meaning of the term "issue" and believes that Enterprise management can effectuate FHFA's required delivery of correspondence to the board.
- DER acknowledges that there have been instances in the past in which it did not complete the final ROE early enough to provide the board sufficient time to review it before DER's meeting with the board. By July 1, 2017, DER will amend its guidance to reflect existing timeframes for issuance and presentation of Enterprise ROEs.
- DER will, by July 1, 2017, amend its internal guidance to provide that the board of directors, or a committee thereof, should confirm review of the ROE on a signature page to be appended to the ROE.
- DER will, by July 1, 2017, amend its internal guidance to clarify that EICs should request responses to ROEs from Enterprise boards of directors, with documentation of approval of such responses.

Recommendation 2:

OIG recommends that FHFA direct DER to develop detailed guidance and promulgate that guidance to each Enterprise's board of directors that explains:

- *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.*

Management Response to Recommendation 2:

FHFA partially agrees with this recommendation.

- FHFA does not believe the Enterprise boards of directors require additional guidance as to the purpose of discussion of the ROE with senior DER officials or directors' opportunity to ask questions at that meeting.
- As noted in the response to Recommendation 1, DER will, by July 1, 2017, amend its internal guidance to clarify that EICs should request responses to ROEs from Enterprise boards of directors and the expected level of detail required.

Recommendation 3:

OIG recommends that FHFA direct the Enterprises' board 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.

Management Response to Recommendation 3:

FHFA disagrees with this recommendation. FHFA believes that management responses to the recommendations above are sufficient to address the issue of board review of and responses to ROEs, and amendments to board charters are unnecessary.

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

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