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Federal Housing Finance Agency
Office of Inspector General

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

Evaluation Report • EVL-2016-009 • July 14, 2016

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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. 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 Federal Home Loan Bank System 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.

Like other federal financial regulators, FHFA produces written reports of examination (ROEs) in conjunction with each annual supervisory cycle. The purpose of an ROE is to communicate the examination results and conclusions, findings, supervisory concerns, and the composite and component ratings assigned in accordance with FHFA's rating system to the board of directors of each regulated entity.

It is axiomatic that the board of an entity regulated by FHFA must receive from FHFA a clear articulation of examination findings and other supervisory concerns, such as deficient or unsafe and unsound practices and violations of laws or regulations, in order to satisfy its oversight responsibilities under FHFA's regulations and guidance. Without that clear articulation from FHFA, a board will be challenged to satisfy FHFA's expectation that the board submit a written response to the ROE and affirm that corrective action is being taken, or will be taken, to resolve supervisory concerns. To ensure that the board of directors of a regulated entity reviews the ROE and affirms its commitment to ensure that corrective action has been or will be taken to resolve deficiencies in risk management and supervisory concerns, FHFA guidance in place since December 2013 requires the boards to provide a written response to each ROE.

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, and the importance of diligent board oversight of corrective action by management, we conducted this evaluation to compare FHFA's ROE requirements and applicable requirements established by other federal financial regulators. We assessed whether DER and DBR followed FHFA requirements when issuing the ROEs, and whether they obtained written responses to the ROEs as required by FHFA policy. The scope of our

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evaluation for DER covered the five examination cycles from 2011 to 2015 and, for DBR, we reviewed the 2013-2015 cycles.

Based on the information learned during this evaluation, we are issuing today two reports. In a companion report (*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*), we compare the requirements and guidance issued by other federal financial regulators regarding the minimum standard of information to be provided in each ROE to FHFA's requirements and guidance; we discuss the supplemental guidance issued by DBR for content of ROEs issued to FHLBanks and show that DER has issued no similar guidance; and we evaluate whether DER examiners have complied with DER requirements for the preparation of the ROEs over the past five examination cycles.

In this report, we compare FHFA's requirements and guidance for the issuance of an ROE and response to it by the board of directors of the regulated entity to the requirements and guidance of other federal financial regulators. We found that FHFA's requirements and guidance are more limited than other federal financial regulators. We also assess whether DER and DBR examiners have followed FHFA's limited requirements and guidance. We found that DBR examiners have met these standards but DER examiners largely have not.

FHFA regulations and guidance establish that every board of directors of an entity regulated by FHFA is ultimately responsible for the safety and soundness of the entities. For a board to exercise its oversight responsibilities and ensure that management corrects all deficient, unsafe, or unsound practices giving rise to supervisory concerns and findings, it must, in the first instance, have notice from FHFA of all such practices. In our companion report issued today, we identified the shortcomings in ROEs issued by DER over the past five years that necessarily constrain the ability of the Enterprise boards to exercise effective oversight. For FHFA to obtain assurance that a board of directors is committed to ensure that all deficiencies are corrected in a timely manner, its examiners must issue the ROE to the board of directors, not to management, and must require a written response from the board that sets forth the corrective actions that have been or will be taken. In this report, we show that the practice by DER examiners for the past five years has fallen far short of the few requirements imposed by FHFA.

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

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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 it.

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
CCO	Chief Compliance Officer
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
OIG	Federal Housing Finance Agency Office of Inspector General
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's DER is responsible for supervision of the Enterprises. DER conducts both ongoing monitoring and targeted examinations based on its risk-based supervisory strategy and plan.[1] 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.

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

Like other federal financial regulators, FHFA produces an ROE in conjunction with its supervision of each regulated entity. 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. According to FHFA, the purpose of the ROE is to communicate to the board of directors of a regulated entity the substantive examination results and conclusions, examination findings, supervisory concerns, and the composite and component examination ratings assigned in accordance with FHFA's examination rating

[1] 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.

system.[2] The phrase “supervisory concern” is a term of art commonly used among federal financial regulators to describe a practice or condition that, on its own, may not qualify as a Matter Requiring Attention (MRA) but nevertheless requires remediation and resolution.[3] FHFA defines **examination findings** 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 finding is an MRA.[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.

Boards of Directors of Entities Regulated by FHFA are Charged by FHFA with Responsibility for Overseeing Management's Resolution of Examination Findings and Supervisory Concerns

FHFA regulations and guidance establish that boards of directors of entities regulated by FHFA are ultimately responsible for the safety and soundness

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[2] 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.

[3] FHFA's corporate governance regulation does not define the term “supervisory concerns,” but imposes duties on the boards 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).

[4] 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. Historically, DER has addressed conclusion letters to Enterprise management, not to the board of directors or a board committee. 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).

of those entities.[5] This responsibility includes ensuring that (1) the conditions and practices that gave rise to any supervisory concerns and examination findings raised in the ROE are corrected in a timely manner and (2) executive officers are "responsive[ ] in addressing all supervisory concerns of FHFA in a timely and appropriate manner."[6] Further, FHFA's prudential management and operations standards reinforce that the board of directors of a regulated entity is responsible for that entity's compliance with all applicable laws, regulations, and FHFA's supervisory guidance.[7]

FACTS AND ANALYSIS ....

Requirements of Other Federal Financial Regulators for Issuance of Reports of Examination, Response by Regulated Entity, and Follow-Up

As we explained in our companion report issued from this evaluation (*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*), FHFA, like 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), conducts safety and soundness examinations of, and issues periodic ROEs to, the financial institutions it supervises.[8]

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[5] *See* 12 C.F.R. § 1239.4(a) and the prior Office of Federal Housing Enterprise Oversight regulation at 12 C.F.R. § 1710.15(b). The Enterprises have been in conservatorships since September 2008; FHFA has delegated to the boards of directors responsibility for oversight of general corporate matters.

[6] 12 C.F.R. § 1239.4(c)(3). *See also* FHFA, *Examination Manual, Examination Program Overview*, at 23 (Dec. 19, 2013) (online at www.fhfa.gov/SupervisionRegulation/Documents/ExaminationProgramOverview.pdf); *see also* 12 C.F.R. § 1239.4(c)(1), (3) (Duties and Responsibilities of Directors).

[7] *See* FHFA Prudential Management and Operations Standards, Standard 1, Principle 16; 12 C.F.R. Part 1236, Appendix to Part 1236.

[8] 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* Defs. 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).

Issuance of the ROE and Required Meeting(s) with the Board of Directors

The OCC, Federal Reserve, and FDIC require that the ROE be issued to the board of directors of the regulated entity at least once during each supervisory cycle.[9] Implicit in this requirement is the recognition that the board of directors of the regulated entity is ultimately accountable for the safety and soundness of that entity.[10]

The OCC, Federal Reserve, and FDIC also expect that the examination team will meet with the board of directors of regulated entities to discuss the ROE. The OCC instructs that the examiner-in-charge (EIC) "will meet with the board of directors or an authorized committee that includes outside directors after the board or committee has reviewed the report of examination findings."[11] As needed, the OCC examiners are expected to use such meetings "to discuss how the board should respond to supervisory concerns and issues."[12]

When Federal Reserve examiners issue a composite "CAMELS" rating of 3 for an examination and determine that the bank's "condition appears to be deteriorating or has shown little improvement since a previous examination in which it received a 3 rating,"[13]

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[9] The OCC, in its *Comptroller's Handbook*, directs that "the OCC must provide a bank's board of directors a report of examination at least once each supervisory cycle (12 or 18 months)." *See* OCC, *Bank Supervision Process, Comptroller's Handbook*, at 36 (Dec. 2015) (online at www.occ.gov/publications/publications-by-type/comptrollers-handbook/pub-ch-ep-bsp.pdf).

[10] As the *Commercial Bank Examination Manual* for the Federal Reserve provides:

> While the board itself may not directly undertake the work to remediate supervisory findings as senior management is responsible for the organization's day-to-day operations, it is nevertheless important that the board be made aware of significant supervisory issues and ultimately be accountable for the safety and soundness and assurance of compliance with applicable laws and regulations of the organization.

The Federal Reserve requires that an ROE be sent "to the board of directors, or an executive-level committee of the board, as appropriate." Federal Reserve, *Commercial Bank Examination Manual*, Section 6000.1, at 1 (Oct. 2013) (online at www.federalreserve.gov/Boarddocs/SupManual/cbem/6000.pdf).

For its part, the FDIC requires that the boards of most large or lower rated banks regulated by it receive an ROE at least once during each 12-month period. *See* FDIC*, Basic Examination Concepts and Guidelines*, at 1.1-4, 1.1-6, and 1.1-16 (Feb. 2016) (online at www.fdic.gov/regulations/safety/manual/section1-1.pdf) and FDIC, *Report of Examination Instructions*, at 16.1-50 (Apr. 2015) (online at www.fdic.gov/regulations/safety/manual/section16-1.pdf).

[11] OCC, *Bank Supervision Process, Comptroller's Handbook*, *supra* note 9, at 37.

[12] *Id*.

[13] Federal Reserve, *Commercial Bank Examination Manual*, *supra* note 10, Section 5030.1, at 3. The Federal Reserve and other banking regulators employ "CAMELS" ratings to evaluate the soundness of financial institutions and identify those that require special attention or concerns. The ratings system is comprised of six component ratings (**C**apital Adequacy, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk) and a composite rating. Examiners assign CAMELS ratings on a numerical scale of 1 to 5, where a 1 rating represents the least degree of supervisory concern and a 5 rating represents the highest degree

they are required to meet with the board of directors after the ROE has been transmitted to the board. The purpose of such meetings is to explain the significant problems found during the examination and obtain a commitment to initiate and oversee appropriate corrective action.[14]

Like the Federal Reserve, FDIC guidance ties an annual meeting between FDIC examiners and a bank's board of directors to the bank's CAMELS rating. When a bank receives a composite CAMELS rating of 3, 4, or 5, the FDIC expects that the EIC will meet with the board of that bank to discuss the examination findings, enhance director awareness of FDIC supervision, and encourage director oversight of correction of deficiencies.[15]

Board Acknowledgement of and Written Response to the ROE

The OCC, Federal Reserve, and FDIC require each member of the board of the regulated entity to sign the ROE.[16] The signature serves to acknowledge that the director has read the entire ROE.[17]

In addition, guidance issued by the OCC, Federal Reserve, and FDIC contemplates that each board of directors will respond in writing to the ROE or that the ROE will reflect the board's commitment to corrective action. For example, the OCC's *Comptroller's Handbook* instructs that an ROE should include a summary of actions the institution should take in response to the OCC's supervisory findings and the commitment to those actions made by the board and management during the examination. OCC ROEs also should include a discussion of follow-up work, such as any request for a written board response and the timing and content of progress reports.[18] The Federal Reserve requires the board of directors of a regulated entity to

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of supervisory concern. FHFA has adopted a similar examination rating system, known as "CAMELSO," that incorporates a seventh component rating: Operational Risk.

[14] *See* Federal Reserve, *Commercial Bank Examination Manual*, Section 5030.1, *supra* note 10, at 1. Examiners are required to meet with the board of any bank that receives a composite CAMELS rating of 4 or 5 or if certain conditions, such as noncompliance with significant provisions of a supervisory action, are found during the examination. *Id.,* Section 5030.1, at 2-3.

[15] *See* FDIC, *Basic Examination Concepts and Guidelines*, *supra* note 10, at 1.1-15, -16. For any bank that receives a composite CAMELS ratings of 1 or 2, FDIC guidance recommends a meeting between FDIC examiners and the bank's board of directors every three years, unless the bank's management component rating, or a combination of component ratings, falls below 2 or any component rating falls below 3.

[16] The OCC, Federal Reserve, and FDIC allow members of a committee to sign the ROE, in lieu of the full board, if the committee includes outside directors and the full board has passed a resolution delegating review of the ROE to that committee.

[17] The directors must either return a copy of the signature page to the regulator (OCC) or retain it and make it available to the regulator upon request during subsequent examinations (Federal Reserve and FDIC).

[18] *See* OCC, *Bank Supervision Process, Comptroller's Handbook, supra* note 9, at 104.

provide a written response to each ROE with its plan, progress, and resolution of all MRAs identified in the ROE.[19] While the FDIC's *Report of Examination Instructions* does not expressly require a board response to the ROE, as noted above, the FDIC requires each director to sign the ROE acknowledging his or her review of the entire report, including any discussion of deficiencies. An FDIC supervision journal sheds light on examiners' practices; it counsels that examiners should request a response from a board of directors identifying corrective actions for an ROE that reports serious supervisory findings.[20]

FHFA Requirements and Guidance and DER Practice Regarding Issuance of Reports of Examination, Presentation of Findings, and Written Response

Issuance of the ROE and Presentation of Examination Findings to Boards of Directors

Current FHFA policy requires an ROE to be issued to the board of directors of each regulated entity for each annual examination. Notably, DER changed its guidance governing ROEs during the review period; as a consequence, the ROEs issued for the 2011-2012 examination cycles were subject to different requirements than the ROEs issued for the 2013-2015 examination cycles. DER guidance governing the 2011-2012 examination cycles (set forth in DER *Supervisory Guide 2.0*) directed each EIC to provide the board of directors with a final version of the ROE in advance of the meeting at which DER officials would discuss the examination findings and conclusions with the board. Specifically, DER guidance for these examinations required:

- Submission of the executed ROE to an Enterprise's board of directors at the end of the first week of March; and

- Presentation of the ROE results, conclusions, and supervisory concerns to an Enterprise board by the FHFA Director and DER Deputy Director during a subsequent board meeting in March or April to provide board members with the opportunity to ask questions and discuss examination conclusions and supervisory concerns.[21]

We assessed whether DER's practice for the 2012 and 2013 ROEs (for the 2011 and 2012 supervisory cycles) met the requirements of its *Supervisory Guide* and found that DER largely

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[19] *See* Federal Reserve, *Commercial Bank Examination Manual*, Section 6000.1, *supra* note 10, at 3.

[20] *See* Catherine H. Goñi et al., *Supervisory Trends: "Matters Requiring Board Attention" Highlight Evolving Risks in Banking*, Supervisory Insights, Vol. 11, Issue 1, at 8 (Summer 2014) (online at www.fdic.gov/regulations/examinations/supervisory/insights/sisum14/SIsummer2014.pdf).

[21] A concurrently applicable set of DER guidance (*DER Supervision Handbook 2.1)* provided for only the presence of the Deputy Director of DER (and not the FHFA Director) at these meetings.

failed to meet its own requirements for these two cycles.[22] Our review of DER materials showed that DER issued none of the final 2012 and 2013 ROEs to the board in advance of its annual presentations at Enterprise board meetings. Three of the four final ROEs were issued to Enterprise boards after DER's annual presentations. One of the final ROEs was provided by DER to the Enterprise board at the very board meeting at which DER presented the supervisory findings, conclusions, and concerns, providing those directors with no time to review the ROE in advance of DER's presentation.

More specifically, with respect to Freddie Mac, our review of documents provided to us by FHFA and Freddie Mac found that DER completed the 2012 ROE (for the 2011 supervisory cycle) after its March 2012 ROE presentation to the Freddie Mac board and addressed the cover letter to the Freddie Mac board but sent that final ROE by email to Freddie Mac management, which subsequently forwarded it to the board.[23] The following year, DER sent the final 2013 ROE (for the 2012 supervisory cycle) to Freddie Mac management by email two days prior to its March 2013 presentation to the board and distributed the final ROE to board members at the meeting.[24] At each presentation, DER provided board members with PowerPoint presentation slides and DER senior officials summarized examination ratings and examination conclusions.

With respect to Fannie Mae, DER did not meet the requirements in its Supervisory Guide for the 2012 and 2013 ROEs (for the 2011 and 2012 supervisory cycles), because DER did not complete the final ROEs in advance of its presentations.[25] Instead, DER senior officials provided Fannie Mae directors with PowerPoint presentation slides that contained provisional examination ratings and orally summarized DER's supervisory findings, conclusions, and

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[22] DER's *Supervisory Guide* mandated delivery of the final ROE to an Enterprise board of directors by the end of the first week of March, with a DER presentation of examination results at a subsequent board meeting. For purposes of our review, we treat delivery of the final ROE to an Enterprise board prior to DER's presentation to it as sufficient to satisfy the spirit of the *Supervisory Guide* requirements, even if that practice did not comply with the requirements. In contrast, we treat delivery of the final ROE to an Enterprise board at the meeting where DER presented the supervisory findings, conclusions, and concerns as falling far short of the spirit and meaning of the *Supervisory Guide* requirements as that Enterprise board would have no ability to review the ROE prior to the DER presentation.

[23] DER provided a draft 2012 ROE for the 2011 supervisory cycle to Freddie Mac management before its presentation to the board.

[24] The subject line of the March 2013 email from DER to Freddie Mac management included the phrase "Submission to the Board." In a prior email in that email chain, Freddie Mac management advised that it would distribute the final 2013 ROE to the Freddie Mac board with the board materials if DER transmitted that final ROE two days prior to the board meeting. Freddie Mac advised us that its directors received the 2013 ROE (for the 2012 supervisory cycle) at the meeting.

[25] In both years, DER sent a draft ROE by email to Fannie Mae regulatory affairs personnel two days before the DER board presentation. From the materials provided to us by FHFA and Fannie Mae, it does not appear that the Fannie Mae board received the draft ROEs for its review.

concerns during their presentation to directors. Several weeks after each DER presentation to Fannie Mae directors, DER completed the final 2012 and 2013 ROEs (for the 2011 and 2012 supervisory cycles) and sent the final ROEs to Fannie Mae management.[26]

FHFA adopted new rules in December 2013 (set forth in the FHFA *Examination Manual*) that applied to the ROEs finalized in 2014, 2015, and 2016 (for the 2013, 2014, and 2015 supervisory cycles). Those new rules eliminated the requirement to submit executed ROEs to the boards in advance of the presentations to the boards. The only requirement in the December 2013 *Examination Manual* is that DER "issue" the ROE, signed by the EIC, to the board of directors of the affected regulated entity. DER has not promulgated detailed guidance that defines the term "issue," governs ROE delivery to a board, or governs DER's presentation of ROE findings to a board.[27] As a result, all decisions on communications with a board of directors of a regulated entity about the ROE results, conclusions, and supervisory concerns are left to the discretion of DER, DBR, and the individual examination teams. For example, FHFA has no requirements or guidance respecting:

- Whether DER must transmit the final ROE directly to an Enterprise board of directors rather than to Enterprise management;
- Whether DER must or should present the ROE results, conclusions, and supervisory concerns to an Enterprise board;
- Whether the presentation of examination findings must or should occur before or after the final ROE is issued to the board of directors; and
- Which FHFA officials must or should participate in the meeting of the board of directors of the regulated entity when ROE conclusions, findings, and ratings are presented orally and discussed.

Our review of DER's practices for ROE issuance in 2014, 2015, and 2016 found that they were inconsistent from year to year. We observed divergence in practice between the Fannie Mae and Freddie Mac examination teams, and within the same examination team. Because

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[26] For the 2011 supervisory cycle, DER transmitted the final 2012 ROE to Fannie Mae management after the DER presentation to the board, even though DER's cover letter for that ROE was addressed to the Fannie Mae board. Fannie Mae management then distributed that final ROE to the board within days. For the 2012 supervisory cycle, DER finalized the 2013 ROE and transmitted it to Fannie Mae management after the DER presentation to the board, without any instructions regarding further distribution. Fannie Mae management, in turn, did not share the final 2013 ROE with the Fannie Mae board until more than a month after its receipt from DER.

[27] After the issuance of the 2016 ROEs, DER finalized internal procedures for performing risk assessments. These new procedures note that transmittal of the ROE to the Enterprise's board of directors occurs "in the first quarter following the calendar year [in which examination activities take place]." *See* DER, Operating Procedures Bulletin 2016-DER-OPB-01, *Enterprise Supervision: Mid-Year Risk Assessments* (May 25, 2016).

neither FHFA nor DER requires the EIC to submit or transmit the final ROE directly to an Enterprise board of directors (or to a committee of the board with delegated responsibility to review and respond to the ROE), we found that DER's practice, in general, was to send by email the final ROE to Enterprise management and leave to each Enterprise's management the decision of whether and when to provide the final ROEs to the Enterprise board.

With regard to Freddie Mac, DER sent by email the final 2014, 2015, and 2016 ROEs (for the 2013, 2014, and 2015 supervisory cycles) to Freddie Mac management, in advance of each of DER's annual presentations to the Freddie Mac, without instructions to provide the final ROEs to the Freddie Mac board. We found that in each of these three years, Freddie Mac management sent the final ROEs to the board, through a secure web portal, less than a week in advance of DER's presentation.[28] For each of these three years, DER appears to have followed its practice from the 2012 and 2013 ROE presentations: at each of its annual board presentations in 2014, 2015, and 2016, DER provided the board with a PowerPoint presentation that summarized examination findings, conclusions, and ratings.

With regard to Fannie Mae, DER did not deliver the final 2014 or 2015 ROEs (for the 2013 and 2014 supervisory cycles) in advance of, or at, the board presentation by DER officials of findings and conclusions of the examinations for each supervisory cycle. DER provided no written summary of examination results and conclusions to directors prior to or at its board presentations in 2014 and 2015. In advance of each of these DER presentations, Fannie Mae management prepared a summary of management's view of DER's expected examination conclusions, which it provided to the Fannie Mae board.[29] Several days after its board presentation in 2014 and several weeks afterwards in 2015, DER finalized the ROE. It sent the final 2014 and 2015 ROEs by email to Fannie Mae management and Fannie Mae management distributed both ROEs to the board. For the 2015 supervisory cycle, DER transmitted the final 2016 ROE to Fannie Mae management a week in advance of its presentation to the Fannie Mae board, and Fannie Mae management included the ROE in the board's materials for that meeting. It also provided directors with a copy of a PowerPoint presentation that summarized examination findings, conclusions, and ratings, apparently at its presentation.

[28] For the 2013 examination cycle, DER provided a hard copy of the final 2014 ROE to Freddie Mac directors the day before its presentation of findings, conclusions, and ratings to the Freddie Mac board. That same day, Freddie Mac management distributed the 2014 ROE to the board electronically.

[29] DER provided management with a draft ROE prior to the board meeting to discuss results from the 2013 examination. Management's expectations of examination results also appear to be based on discussions with the examination team.

Contrary to FHFA's Clear Requirements, DER Has Not Required the Enterprises' Boards of Directors to Provide a Written Response to the ROEs

FHFA's *Examination Manual,* adopted in December 2013, requires the board of a regulated entity to provide FHFA "a written response to the ROE acknowledging [the board's] review of the ROE and affirming that corrective action is being taken, or will be taken, to resolve supervisory concerns."[30] In its comments to a prior OIG report, FHFA maintained that its *Examination Manual* provides supervisory guidance to the entities it regulates and expects that each entity will follow such guidance. Subsequently, DER issued internal guidance underscoring the requirement of a written response by each Enterprise board to each ROE. Notwithstanding this clear requirement, DER has not taken effective action to communicate this requirement to the boards of directors or to enforce the boards' compliance with it. We found the Enterprises' boards of directors have not complied with this requirement and one Enterprise board is not *aware* of it.

DER's Examiner-in-Charge (EIC) requested written responses from Fannie Mae management, not from the Fannie Mae board or the board's Audit Committee,[31] to the 2014 and 2015 ROEs (for the 2013 and 2014 supervisory cycles).[32] In response to the EIC's requests, a member of Fannie Mae senior management—its Chief Compliance Officer (CCO)—submitted brief memoranda in 2014 and 2015. These memoranda demonstrate little more than that the board of directors and management reviewed the ROE. As such, they lack any detail regarding the specific corrective actions being taken, or to be taken, to resolve the supervisory concerns described in the ROE.

Because these memoranda purport to reflect the directors' review of each ROE, we reviewed board minutes in 2014 and 2015 for evidence of any discussion among directors about framing a response to the ROE, demonstration of director review of the CCO's draft memoranda, approval of the submission of the memoranda to FHFA, or authorizing the CCO to respond on the board's behalf. We found no such evidence in the board minutes in either year. We asked FHFA and Fannie Mae for documents evidencing review or approval by the Fannie Mae board of the CCO's draft responses or authorizing the CCO to submit a response on behalf of the board; we received none. We found no evidence that the Fannie Mae board was even made aware of the CCO's response to FHFA on its behalf.

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[30] FHFA, *Examination Manual*, *supra* note 6, at 16, 23.

[31] Fannie Mae's Audit Committee is responsible for "overseeing the corporation's response to any regulatory examination." Fannie Mae, *Audit Committee Charter*, section 4.xxix, at 5 (amended as of Nov. 20, 2014).

[32] In 2012, DER examiners requested a response from Fannie Mae's board to the ROE. We found no evidence that the Fannie Mae board responded to DER in 2012 or that DER followed up with the board for a response.

In March 2016, the EIC transmitted the final ROE to Fannie Mae's CCO, without requesting a response from the Fannie Mae board of directors or management. In early April 2016, two days after we sought all ROE-related communications between DER and the Enterprises' boards, the EIC for the Fannie Mae core team asked Fannie Mae's CCO to obtain a response to the ROE from the chair of the board's Audit Committee. Later that month, the Fannie Mae board chair provided a response to the ROE that was in line with the CCO's responses to prior ROEs.

With regard to Freddie Mac, DER's EIC did not request a response from Freddie Mac's board or management to the ROEs issued in 2014, 2015, or 2016.[33] Based on the materials received from Freddie Mac and FHFA, we found no evidence that the Freddie Mac board submitted any written response to any of these ROEs. It appears that Freddie Mac management is not aware of FHFA's requirement; in response to our request to Freddie Mac for board responses to DER's ROEs, a lawyer in its Office of General Counsel responded, "FHFA does not require a response, acknowledgement, or receipt from the Board that it has received and reviewed the ROE." While FHFA reported to us that the EIC for the Freddie Mac examination team never requested a response to any of the ROEs, the lack of such a request should not excuse the wholesale lack of response in light of the clear supervisory guidance in FHFA's *Examination Manual* discussed earlier.

DBR Guidance and Practice Governing ROEs Issued to FHLBanks

Unlike DER, DBR examiners follow FHFA's requirements, based on guidance in place since December 2013, for issuance of an ROE to the board of a regulated entity. We reviewed all ROEs prepared for FHLBanks for the review period and found that DBR examiners issued each final ROE to the FHLBank board chair. Similarly, we found that DBR examiners always sought a written response from each FHLBank to the ROE. In addition, DBR requires each FHLBank board to reflect its review and approval of its written response to the ROE in its meeting minutes. Our review of relevant documents for the ROEs issued for the 2014 supervisory cycle found that all FHLBank boards complied with the requirement that they provide a response.

For those FHLBanks with a composite rating of [redacted] or worse, DBR generally required, as a term in the ROE transmittal letter or through discussion in the ROE, that the FHLBank board adopt a board resolution or board commitment letter stating the planned remedial measures to

[33] In 2012, DER requested a response from the Freddie Mac board for the ROE, but FHFA produced no evidence to us that the Freddie Mac board provided the requested response or that DER followed up with the board when no response was received.

correct deficiencies identified in the ROE.[34] Our review found that the affected FHLBanks adopted board resolutions setting forth the board's commitment to oversee management's efforts to address specific supervisory concerns and management commitments to take specific remedial actions. In the following annual examination, DBR documented in the ROE that it evaluated whether the FHLBank fulfilled the terms of the resolution or letter.

DBR's practice is to meet with each FHLBank board at least twice each year concerning examination findings. Typically, DBR meets with each FHLBank board when the ROE is in draft form and meets again after the ROE is finalized and issued. Based on our review, we found that DBR consistently sent the final ROE to each FHLBank board in advance of its second presentation, often at least two weeks prior to the presentation.

[34] According to FHFA guidance, a request for a board resolution or commitment letter is a type of informal enforcement action.

FINDINGS ....

1. FHFA's current requirements and guidance on communication of the annual ROE are more limited than the requirements of other federal financial regulators and have led to divergent and inefficient practices among DER's examination teams.

FHFA and DER provide examiners with very limited guidance for communicating the ROE's findings, conclusions, and ratings to the board of directors of a regulated entity. In contrast, other federal financial regulators have issued detailed guidance on the timing and purpose of examiners' meetings with the board of directors and they establish the expectation for examiners to encourage board oversight of corrective actions.

During the review period, FHFA relaxed DER's prior guidance governing ROE delivery and the presentation of ROE findings to boards of directors. As a result, all decisions on communications with a board of directors of a regulated entity about the ROE are essentially left to the discretion of the EIC for each examination team. Our review of the 2014-2016 ROEs revealed that DER examiners did not finalize the Fannie Mae ROEs, or provide the board with presentation materials, in advance of their presentation to the Fannie Mae board in two of the three years, which necessarily affected directors' ability to prepare for the discussion. In contrast, examiners issued the final Freddie Mac ROE in advance of each of the three annual board presentations. We also found that DER's typical practice was to send by email the final ROE to Enterprise management and leave to management of each Enterprise the decision of whether and when to provide the final ROEs to the Enterprise board, in contravention of the FHFA requirement that ROEs must be issued to the board of directors of a regulated entity.

2. DER examiners failed to meet FHFA's prior and current requirements for communication of the annual ROE.

In December 2013, FHFA replaced DER's prior guidance on ROE issuance and presentations with the more limited guidance found in its *Examination Manual*. We found that DER examiners consistently failed to meet DER and FHFA requirements.

Under internal DER guidance in place at the time, DER examiners were required to issue the 2012 and 2013 ROEs at the end of the first week of March and present their findings to the board at a March or April board meeting. Examiners failed to adhere to the letter or spirit of this requirement as they did not issue any of the final 2012 and 2013 ROEs to the Enterprises' boards in advance of their board presentations.

FHFA, in its *Examination Manual,* established supervisory guidance that a board of directors of a regulated entity respond in writing to the ROE, which DER codified as a requirement. We found that DER has not effectively communicated this requirement to the boards of directors or enforced the boards' compliance with it. FHFA provided us with only a single response from an Enterprise board to 1 of the 10 ROEs issued during the review period. We also found no evidence of board approval of the three ROE responses DER received from Fannie Mae management, and the responses submitted by Fannie Mae management lacked detail regarding the specific corrective actions being taken, or to be taken, to resolve the supervisory concerns described in the ROE.

3. DBR examiners have met FHFA's current requirements for communication of the annual ROE.

In contrast to DER, we found that DBR examiners issued each final ROE to the FHLBank board chair and sought a written response from each FHLBank to the ROEs for the 2013-2015 review cycles. We also found that DBR requires, in its communications with FHLBank boards, that each FHLBank board reflect its review and approval of its written response to the ROE in its meeting minutes.

CONCLUSION...

The annual ROE has been the primary means by which FHFA communicates its supervisory findings—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 the board of directors of each entity it regulates because the board is ultimately responsible for ensuring the safety and soundness of the entity and management's correction of deficiencies. To ensure that the board of directors of a regulated entity reviews the ROE and affirms its commitment to ensure that corrective action has been or will be taken to resolve deficiencies in risk management and supervisory concerns, FHFA guidance in place since December 2013 requires the boards to provide a written response to each ROE.

Other federal financial regulators have adopted comprehensive standards and guidance for communicating the ROE to a regulated institution's board of directors and insisting that the board acknowledge and commit to addressing concerns identified in the ROE. FHFA's standards are weak in comparison. In addition, based on our review of DER's practices during the past five supervisory cycles, we found that DER examiners have fallen far short of the few requirements imposed by FHFA. For FHFA to obtain assurance that a board of directors is committed to ensure that all deficiencies are corrected in a timely manner, its examiners must issue the ROE directly to the board of directors and must require a detailed response from the board regarding corrective actions that have been or will be taken.

RECOMMENDATIONS...

OIG recommends that FHFA:

1. 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.

2. 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.

3. Direct the Enterprises' boards 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.

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 recommendations 1 and 2 and disagreed with recommendation 3.

FHFA "partially" agreed with recommendation 1. In response to recommendation 1, FHFA stated that DER will amend its internal guidance to: (1) provide that the ROE should be addressed to the board of directors; (2) reflect its existing timeframes for issuance and presentation of the ROE; (3) require the board, or a committee, to confirm its review of the ROE on a signature page; and (4) clarify that EICs should request responses to the ROEs from the Enterprise board, with documentation of board approval of the responses. FHFA disagreed with our recommendation that examiners should deliver the ROE directly to the board and it stated that Enterprise management can effectuate the delivery. Pursuant to FHFA's delegations of authority and corporate governance rule, each Enterprise board is responsible for day-to-day operations of that Enterprise and is charged with ensuring that management promptly addresses all supervisory concerns. FHFA's *Examination Manual* requires that each ROE "issue" to a board of directors of a regulated entity.

As informed by the guidance of the OCC and Federal Reserve, delivery of an ROE to the board of directors of a regulated entity is the best practice. FHFA offers no reasonable basis on which to reject our recommendation that it ensure that every ROE be delivered directly to Enterprise board members, rather than through Enterprise management, which typically is responsible for the actions or inactions criticized in the ROE.

Our recommendation sought to ensure that, going forward, FHFA delivers the ROE to every Enterprise director in a timely manner. FHFA's agreement to issue guidance on the timeframes for issuance and presentation of the ROE and to require Enterprise directors, or members of an appropriate board committee, to confirm review of the ROE on a signature page, if enforced, should achieve a satisfactory result.

FHFA has agreed to amend its guidance by July 1, 2017. Because time is of the essence, we encourage the Agency to amend its guidance prior to the issuance of its ROEs in March 2017 for the 2016 supervisory cycle.

FHFA "partially" agreed with recommendation 2. The Agency agreed to amend DER's internal guidance to "clarify that EICs should request responses to ROEs from Enterprise boards of directors and the expected level of detail required." FHFA declined to promulgate guidance to each Enterprise's board of directors explaining the requirement for each

Enterprise board to respond to each ROE and the expected level of detail. We found no definitive evidence that the board of directors of either Enterprise was aware of their obligation to respond in writing to the ROE. The record also shows that the EIC's have not enforced DER's requirement. There is no indication that FHFA has held Enterprise directors or the EICs accountable. In light of FHFA's refusal to issue supervisory guidance to Enterprise directors about their obligations, we intend to monitor closely those responses and assess whether they meet requirements imposed by FHFA and DER.

FHFA disagreed that the Enterprise boards needed "additional" guidance on the purpose of examiners' presentations of ROE results, conclusions, and supervisory concerns. As our report found, Enterprise directors often received the final ROEs either at the meeting with DER examiners or subsequently, and, as a consequence, lacked full opportunity to ask informed questions about the ROE findings. We hope that FHFA's agreement to require directors to confirm, in writing, their review of each ROE will encourage Enterprise directors to actively engage with DER examiners during the ROE presentations. We intend to closely monitor whether the shortcomings we have identified in this report are remediated in the next cycle.

Finally, FHFA rejected our recommendation 3 directing Enterprise boards 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. FHFA maintained that its agreement to require directors to confirm, in writing, their review of each ROE obviates the need for Enterprise boards to amend their charters. As this report found, the few requirements that FHFA has adopted with respect to ROEs have not been followed, either by the EICs or by Enterprise directors. One of the two Enterprise boards was not aware of its obligation to review each ROE and respond in writing to it. For those reasons, our recommendation sought to clarify, in the respective board of directors' charters, director responsibilities with respect to ROEs. FHFA, however, appears to be fully comfortable with the status quo.

We urge FHFA to reconsider its decision not to accept all of our recommendations.

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 that 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. <u>ROE Content Report</u>

<u>Recommendation 1:</u>

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.

<u>Management Response to Recommendation 1:</u>

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.*

<u>Management Response to Recommendation 2:</u>

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.

<u>Recommendation 3</u>:

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.

<u>Management Response to Recommendation 3:</u>

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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