REDACTED

Federal Housing Finance Agency
Office of Inspector General

FHFA Examiners' Lack of Assessment and Escalation of Shortcomings Identified by an Enterprise in its Servicer Fraud Risk Management Framework Limited the Agency's Supervisory Oversight

This report contains redactions of information that is privileged or confidential.

Evaluation Report • EVL-2020-002 • August 27, 2020

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Executive Summary

The Housing and Economic Recovery Act of 2008 created and charged the Federal Housing Finance Agency (FHFA or the Agency) with, among other things, the supervision of Fannie Mae and Freddie Mac (together, the Enterprises), the Federal Home Loan Banks, and the Federal Home Loan Banks' fiscal agent, the Office of Finance. Its statutory mission as a federal financial regulator includes ensuring the safety and soundness of its regulated entities. For the Enterprises, FHFA fulfills this statutory obligation through its Division of Enterprise Regulation (DER), which conducts targeted examinations and ongoing monitoring of the Enterprises. DER relies on these activities to conclude on the adequacy of the Enterprises' risk management policies, procedures, compliance, and internal controls. As supervisor of the Enterprises, DER conducts examinations to, among other things, assess whether the Enterprises' practices comport with the supervisory expectations set forth in FHFA's advisory bulletins (AB).

FHFA recognizes that effective fraud risk management is critical to the safe and sound operations of the Enterprises. Because the Enterprises have exposure to fraud risk associated with the activities of servicers and other counterparties, FHFA expects each Enterprise to maintain the safety and soundness of its operations by effectively managing counterparty risks and taking appropriate action to mitigate those risks or reduce the Enterprise's exposure. The Enterprises are responsible for appropriately managing the credit, operational, and reputational risks presented by their servicer counterparties and for maintaining a fraud risk management program. FHFA has issued supervisory guidance in the form of advisory bulletins to establish its supervisory expectations with respect to the Enterprises' oversight of seller/servicers.

FHFA requires each Enterprise to report fraud or possible fraud that may have a significant impact on that Enterprise within one calendar day of discovery. On December 22, 2017, Fannie Mae submitted an Immediate Notification Fraud Reporting Form (Immediate Notification) to FHFA based on the Enterprise's suspicion of a servicer's "[redacted]" of taxes and insurance (T&I) custodial funds and on a "[redacted]" to Fannie Mae by the servicer's chief executive officer. According to management's estimate, Fannie Mae could have lost up to [redacted] as a result of the servicer's misuse of T&I funds. This [redacted] constituted a breach of the servicer's contractual agreement with Fannie Mae.

After discovery of the potential fraud, Fannie Mae performed multiple internal reviews of its processes concerning and controls over servicers' custodial

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accounts. These included a "comprehensive post-mortem review" that was presented to a joint meeting of the Audit Committee and the Risk Policy and Capital Committee of Fannie Mae's Board of Directors (the Post-Mortem Report) and a review by Fannie Mae's Internal Audit (IA) function. These two reviews identified specific [redacted] and some [redacted] for the incident and [redacted].

We performed this evaluation to assess FHFA's supervisory responses to the Immediate Notification, the Post-Mortem Report, and the IA Report.

DER examiners serve as frontline fact gatherers in DER's supervision program. They obtain information from the Enterprises during the course of examinations and analyze that information to identify Enterprise practices, and changes in an Enterprise's risk profile, that warrant further supervisory attention and, if appropriate, recommend adverse examination findings. FHFA expects that its examiners will assess the Enterprises' compliance with statutory and regulatory standards. When an examiner identifies or otherwise learns of a potential deficiency that may warrant supervisory attention, it is incumbent on the examiner to bring the potential deficiency to the attention of the examiner's supervisor for consideration and a decision on how to proceed.

We identified three examination activities conducted during our review period—two ongoing monitoring activities and one targeted examination—as the most relevant to this evaluation. We found that the examiners responsible for these activities engaged in limited and siloed supervision activities and failed to assess whether the [redacted] in the Post-Mortem Report and IA Report were inconsistent with FHFA supervisory expectations. Further, we found no evidence in the workpapers that any of the examiners escalated the red flags in the Post-Mortem Report and the IA Report to his/her examination manager or the Examiner-in-Charge (EIC) for discussion or decision. As a consequence, the EIC and examination managers were deprived of critical information to assess whether additional supervisory activities were needed or adverse examination findings were warranted. DER management was left unaware whether Fannie Mae had sufficiently remediated the [redacted] it found in its oversight of custodial accounts and [redacted] or whether gaps still existed between Fannie Mae's practices and the Agency's supervisory expectations.

In its 2019 Report to Congress, FHFA stated that "Prior to ending the conservatorships, FHFA's supervision of the Enterprises must be strong and well executed. All supervisory and oversight procedures and systems must ensure that FHFA's examination work is consistently rigorous, timely, and

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effective . . ..” While we cannot conclude on the overall rigor and effectiveness of DER’s supervision program based on this case study, the issues that we observed, specifically, examiners’ failure to identify and raise [redacted] with DER management for discussion and decision, especially after those shortcomings were flagged by an Enterprise, would significantly impede the effectiveness of the supervision program if they were widespread.

We made three recommendations to address the shortcomings our evaluation identified. In a written management response, FHFA agreed with two of the recommendations and “partially” agreed with the third. We consider FHFA’s alternative management action for the third recommendation to be responsive to that recommendation.

This report was prepared by Jon Anders, Program Analyst, and Jason Ramserran, Program Analyst. We appreciate the cooperation of FHFA staff, as well as the assistance of all those who contributed to the preparation of this report.

This report has been distributed to Congress, the Office of Management and Budget, and others and will be posted on our website, www.fhfaoig.gov, and www.oversight.gov.

/s/

Kyle D. Roberts
Deputy Inspector General for Evaluations

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ABBREVIATIONS

AB	Advisory Bulletin
CMR	Cash Management Review
DER	Division of Enterprise Regulation
EIC	Examiner-in-Charge
Enterprises	Fannie Mae and Freddie Mac, collectively
FHFA or Agency	Federal Housing Finance Agency
IA	Internal Audit
T&I	Taxes and Insurance

BACKGROUND

DER's Supervision of the Enterprises

FHFA was established by the Housing and Economic Recovery Act of 2008 (P.L. 110-289) to serve as the supervisor and regulator of the Enterprises and the Federal Home Loan Bank system. By statute, FHFA must conduct annual onsite examinations of its regulated entities. DER is responsible for those examinations and for developing and implementing FHFA's supervision program for the Enterprises. According to FHFA's Examination Manual, DER examines risk management practices and the regulated entity's financial condition and safety and soundness relative to applicable laws, regulations, supervisory guidance, and prudent business practice. DER performs those examinations through ongoing monitoring activities and targeted examinations in accordance with a risk-based supervisory plan. DER relies on these activities to conclude on the adequacy of the Enterprises' risk management policies, procedures, compliance, and internal controls.

DER's Examination Function Relies on Examiners to Identify Practices at the Enterprises That May Warrant Supervisory Attention and Action

Examiners are DER's frontline fact gatherers. They obtain information from the Enterprises during the course of examinations and analyze that information to identify Enterprise practices, and changes in an Enterprise's risk profile, that warrant further supervisory attention and, if appropriate, recommend adverse examination findings. Adverse examination findings are typically "risk management deficiencies, increases in risk exposures, or violations of laws, regulations, or orders" that affect the performance or condition of an Enterprise.[1] DER may also issue adverse examination findings to address Enterprise practices that do not comport with supervisory guidance FHFA communicates through advisory bulletins.[2]

DER's examination program emphasizes the importance of collaboration among examiners and the flow of information from the examiners to the EIC. Examiners are expected to mine information and prepare analyses, but they do not issue adverse examination findings on their own. When an examiner identifies or otherwise learns of a potential deficiency that may warrant supervisory attention, it is incumbent on the examiner to bring the potential deficiency to the attention of the examiner's supervisor for consideration and a decision on

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[1] FHFA Advisory Bulletin 2017-01, *Classification of Adverse Examination Findings* (Mar. 13, 2017).

[2] Under FHFA's prudential management and operations standards, the Enterprises are expected to comply with supervisory guidance in addition to laws and regulations. *See, e.g.*, 12 C.F.R. Part 1236, Appendix to Part 1236, Standard 9 (Management of Credit and Counterparty Risk), Principle 10 ("A regulated entity should manage credit and counterparty risk in a way that complies with applicable laws, regulations, and supervisory guidance (e.g., advisory bulletins).").

how to proceed. The EIC ultimately decides the nature of a finding and the priority of its remediation, and does so based on a review of the examiners' work and recommendations.

The Enterprises Rely on Mortgage Servicers to Perform Many Important Functions

Servicers perform many important functions on the Enterprises' behalf. For example, they collect payments from borrowers; remit principal and interest to the Enterprises for securitized loans; perform collection, loss mitigation, and foreclosure activities with respect to delinquent borrowers pursuant to the terms of the guides; and pay property taxes and insurance premiums from escrowed funds. According to FHFA, "the business relationships between the Enterprises and Seller/Servicers are a fundamental component of the Enterprises' business models."[3] Those business relationships are defined through various contractual agreements, including the Enterprises' respective seller/servicer guides.

Servicers Must Maintain Property Tax and Insurance Premiums in Custodial Accounts

Fannie Mae's Servicing Guide requires servicers to maintain and manage separate custodial accounts to deposit monthly receipts of borrowers' principal and interest payments and tax and insurance escrowed funds. T&I funds remain in the custodial accounts until property tax and hazard insurance are paid by the servicer, with the T&I cycle repeating for the life of the loan. The Servicing Guide also states that funds in T&I custodial accounts must not be commingled with "the servicer's general corporate funds or with funds held by the servicer for other investors." Shortfalls in these accounts could result in losses to Fannie Mae to the extent the Enterprise funds the shortfall and is unable to recover those funds from the servicer or other means.

FHFA Recognizes the Importance of Effective Fraud Risk Management; Advisory Bulletins Establish Expectations for the Enterprises to Appropriately Manage Fraud Risk and Operational Risk

FHFA recognizes that effective fraud risk management is critical to the safe and sound operations of the Enterprises. According to FHFA, fraud may subject an Enterprise to financial, operational, legal, or reputational harm. Because the Enterprises have exposure to fraud risk associated with the activities of servicers and other counterparties, FHFA expects each Enterprise to maintain the safety and soundness of its operations by effectively managing counterparty risks and taking appropriate action to mitigate those risks or reduce the Enterprise's exposure.

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[3] *See* FHFA, Advisory Bulletin 2014-07, *Oversight of Single-Family Seller/Servicer Relationships*, at 1 (Dec. 1, 2014).

The Enterprises are responsible for appropriately managing the credit, operational, and reputational risks presented by their servicer counterparties and for maintaining a fraud risk management program. FHFA recognizes that it lacks statutory authority to examine servicers directly (and has requested such authority from Congress) and has issued supervisory guidance in the form of advisory bulletins to establish its supervisory expectations with respect to the Enterprises' oversight of seller/servicers.[4] Two of these advisory bulletins are:

- FHFA Advisory Bulletin 2014-07, *Oversight of Single-Family Seller/Servicer Relationships* (issued in December 2014). Established supervisory expectations for the Enterprises to assess operational, legal, compliance, and reputational risks associated with its single-family seller/servicer counterparties, to conduct risk-based ongoing monitoring of seller/servicers, and to take appropriate action to mitigate those risks or reduce the Enterprises' exposure.[5]

- FHFA Advisory Bulletin 2015-07, *Fraud Risk Management* (issued in September 2015). Established supervisory expectations that Enterprise management "develop and oversee the implementation of business unit policies and procedures to implement and support anti-fraud and regulatory reporting programs and controls consistent with the Enterprise's policies." AB 2015-07 explains: "[t]he Enterprise should provide for appropriate coordination across business lines and functions of fraud risk management activities and resources." It sets forth the expectation that the Enterprises will develop fraud risk management policies across their business lines and support coordination amongst those business lines to prevent fraud. In this bulletin, FHFA expressly identified a servicer's diversion of custodial funds as potential fraud that the Enterprises should guard against.

Fannie Mae Identified Potential Fraud by a Servicer, Notified FHFA, and Discovered [redacted]

FHFA requires each Enterprise to report fraud or possible fraud that may have a significant impact on that Enterprise within one calendar day of discovery.[6] On December 22, 2017,

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[4] FHFA currently does not have the authority to examine mortgage servicers. In its *2019 Report to Congress*, FHFA recommended that Congress authorize the Agency to "examine the records, operations, and facilities of each material service provider to a regulated entity for the limited purpose of identifying practices that could pose a safety and soundness risk to the regulated entity." FHFA, *2019 FHFA Report to Congress*, at 15 (June 15, 2020) (online at www.fhfa.gov/AboutUs/Reports/Pages/Annual-Report-to-Congress-2019.aspx).

[5] In addition, Advisory Bulletin 2018-08 established FHFA's supervisory expectations with respect to the Enterprises' management of third-party relationships and the need for them to continuously monitor the contractual relationship.

[6] In a prior report, we explained that the Enterprises face the risk of fraud throughout the mortgage life cycle. Fraud may be perpetrated by various participants in the mortgage market, including borrowers, loan

Fannie Mae submitted an Immediate Notification Fraud Reporting Form to FHFA based on the Enterprise's suspicion of a servicer's "[redacted]" of T&I custodial funds and on a "[redacted]" to Fannie Mae by the servicer's chief executive officer. This [redacted] constituted a breach of the servicer's contractual agreement with Fannie Mae.

On December 6, 2017, Fannie Mae learned from the purchaser of the servicer's servicing portfolio that there was a [redacted] shortfall in the servicer's T&I custodial accounts. Fannie Mae staff confirmed the shortfall after conducting an onsite "cash management review" (CMR) at the servicer between December 20-21, 2017.[7] Fannie Mae funded [redacted] of the shortfall. According to management's estimate, Fannie Mae could have lost up to [redacted] as a result of the servicer's misuse of T&I funds.

The Fannie Mae Compliance and Enterprise Risk Management Functions Investigated the Incident, Identified [redacted], and Presented the Results of this "Post-Mortem Review" to Committees of the Board of Directors on March 14, 2018

After discovery of the potential fraud, Fannie Mae's Chief Risk Officer and Chief Compliance and Ethics Officer oversaw an internal "comprehensive post-mortem review" and presented the results to a joint meeting of the Audit Committee and the Risk Policy and Capital Committee of Fannie Mae's Board of Directors on March 14, 2018. The Post-Mortem Report identified "[redacted]" on the part of Enterprise personnel in the Single-Family business unit. It also concluded that "[redacted]."

The Post-Mortem Report identified specific [redacted] and some [redacted] for the incident, including the following:

- Enterprise staff lacked "[redacted];"
- "[redacted];"

originators, mortgage brokers, loan sellers, attorneys, servicers, appraisers, property managers, and insiders. *See* OIG, *FHFA Should Address the Potential Disparity Between the Statutory Requirement for Fraud Reporting and its Implementing Regulation and Advisory Bulletin* (Mar. 23, 2018) (COM-2018-002) (online at www.fhfaoig.gov/Content/Files/2018_03_23%20Enterprise%20Fraud%20Reporting.FINAL_.pdf).

[7] Fannie Mae uses CMRs to assess the propriety of daily transactions within the servicer's principal and interest and T&I custodial accounts and support for those transactions.

- Enterprise staff's "[redacted];" and
- Enterprise staff's "[redacted]."[8]

Fannie Mae Internal Audit Performed a Review of Custodial Account Management and Made a "[redacted]" Finding that [redacted]

Roughly contemporaneously with the review that led to the Post-Mortem Report, Fannie Mae management asked the Enterprise's Internal Audit group (IA) to conduct a review of existing policies, processes, and controls related to custodial account oversight. On April 20, 2018, IA issued a memorandum that found, among other things, that the Single-Family business unit's "[redacted]." The IA Report also found that "[redacted]."[9] IA issued a "[redacted]" finding, the most [redacted] finding that IA can issue, and recommended that the Enterprise's [redacted].[10]

Fannie Mae took several actions in an effort to remediate these failures. The Enterprise updated its processes,[11] enhanced its controls for managing fraud risk oversight of servicers' custodial accounts,[12] and provided training for employees who regularly interacted with servicers. IA closed out the [redacted] finding in July 2019.

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[8] It also found that Enterprise staff exhibited "[redacted]" in cancelling a September 2017 CMR, which the Enterprise deemed necessary after discovering the servicer's improper use of borrower funds in May 2017, and not rescheduling it.

[9] The IA Report was limited in scope and did not include review of the [redacted] discussed in the Post-Mortem Report.

[10] Management responsible for correcting the problems identified in the IA Report agreed to develop and implement a detailed remediation plan.

[11] Fannie Mae developed and implemented a process to escalate potential servicing fraud issues identified through servicers' financial statements.

[12] Changes included enhancements to T&I review protocols for the largest servicers and revisions to its criteria for identifying servicers that require a CMR.

FACTS AND ANALYSIS ....

As supervisor of the Enterprises, DER conducts examinations to, among other things, assess whether the Enterprises' practices comport with the supervisory expectations set forth in FHFA's advisory bulletins. As we now show, however, DER examiners conducted limited and siloed supervisory activities with respect to the Immediate Notification and the findings in the Post-Mortem Report, and the IA Report. While both internal Enterprise reports found [redacted] in Fannie Mae's [redacted] and custodial account oversight, we found that none of the examiners assessed the severity of any of these weaknesses or their impact on Fannie Mae's [redacted] and servicer oversight during their respective examination activities. We determined that no examiners assessed whether these [redacted] were consistent with FHFA's supervisory expectations announced in its advisory bulletins, and none escalated any of these red flags to DER management for consideration of supervisory findings or additional supervisory attention.

DER Examiners Engaged in Limited and Siloed Supervisory Activities and Failed to Assess Whether the Findings of Control Failures and Root Causes in the Post-Mortem Report and IA Report Were Inconsistent with FHFA's Supervisory Expectations

In its *2019 Report to Congress*, FHFA explained that "to carry out its duties related to prudential oversight and safety and soundness," FHFA establishes or implements standards for the Enterprises and "examines them . . . *to assess their . . . compliance with statutory and regulatory requirements*."[13] As discussed earlier, FHFA has issued advisory bulletins that establish the Agency's supervisory expectations for fraud risk management and oversight of single-family seller/servicer relationships. FHFA conducts targeted examinations of the Enterprises that allow for "deep or comprehensive assessments" of the area under review and conducts ongoing monitoring activities "to analyze real-time information." FHFA expects that its examiners will, through their supervisory activities, assess the Enterprises' compliance with statutory and regulatory standards and identify practices that may warrant additional supervisory attention. DER's examination guidance calls for examiners to share relevant information with other examiners and to collaborate and communicate. That expectation was underscored by DER management, especially when issues cross multiple examination areas.

As we have discussed, both the Post-Mortem and IA Reports found [redacted] in Fannie Mae's [redacted], including a [redacted] by Enterprise staff responsible for overseeing servicers; [redacted]

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[13] FHFA, *2019 Report to Congress*, at 2 (June 15, 2020) (online at www.fhfa.gov/AboutUs/Reports/Pages/Annual-Report-to-Congress-2019.aspx) (emphasis added). The report also stated that "[p]rior to ending the conservatorships, FHFA's supervision of the Enterprises must be strong and well executed. All supervisory and oversight procedures and systems must ensure that FHFA's examination work is consistently rigorous, timely, and effective . . .."

[redacted] by Enterprise staff; and [redacted], particularly for T&I funds.

We identified three examination activities conducted during our review period—two ongoing monitoring activities and one targeted examination—as the most relevant to this evaluation. As we now discuss, each of the examiners responsible for these activities maintained that the scope of his/her examination activity did not include an independent assessment of whether risk management practices comported with FHFA's supervisory expectations in light of the [redacted] (together, shortcomings) identified in the Post-Mortem Report and IA Report. While two of the examiners maintained that the shortcomings were not systemic, we found no analysis to support that view. None of these examiners discussed with each other the potential implications of the shortcomings for fraud risk management, servicer oversight, and counterparty credit risk management. As a result, none of the DER personnel responsible for the oversight of fraud risk management reviewed Fannie Mae's practices against FHFA's supervisory standard in AB 2015-07 in light of the multiple [redacted] shortcomings.

Ongoing Monitoring Examination Activities: The two relevant 2018 ongoing monitoring examination activities for purposes of our evaluation covered the broad topics of fraud risk management and counterparty credit risk management. Both consisted primarily of reviewing management reports and conducting periodic meetings with management.

In 2018, a scheduled ongoing monitoring activity on fraud risk management was designed to apply the standards of FHFA's AB 2015-07 in the assessment of existing risk management practices. That advisory bulletin calls for the maintenance of "business unit policies and procedures to implement and support anti-fraud." The examination workpapers reflect that the fraud risk examiner assigned to this ongoing monitoring activity read the Post-Mortem Report and summarized the report's key findings. (The examiner also told us she reviewed the IA Report, although these workpapers do not show review of that report.) This examiner acknowledged to us that she did not seek additional information on the Post-Mortem Report's findings of specific [redacted]. The fraud risk examiner told us that in her view the findings in the Post-Mortem Report and IA Report related to business units outside of her area of responsibility.[14] The workpapers reflect no assessment by the examiner whether Fannie Mae's fraud risk management practices met FHFA's supervisory standard in AB

[14] We are not able to reconcile the examiner's assertion that the failures identified in the Post-Mortem Report and the IA Report fell outside the scope of the ongoing monitoring activity with the established examination procedures, which set AB 2015-07 as the applicable supervisory standard. In our view, the findings in the IA Report that Fannie Mae's [redacted] warranted an assessment of whether Fannie Mae's policies and procedures meet the standards in AB 2015-07.

2015-07 in light of the findings of multiple [redacted] in the Post-Mortem Report. Lacking any such assessment, the workpapers nevertheless conclude "[redacted]." No independent analysis appears in the workpapers to support this conclusory statement, contrary to required DER examination procedures.

The examiner acknowledged to us that the [redacted] identified in the Post-Mortem Report, which deviated from AB 2015-07, could have warranted an adverse examination finding. However, she contended that she had been told by multiple supervisors that DER did not issue adverse examination findings from ongoing monitoring activities, only from targeted examinations. We understood her to mean that she did not engage in additional fact gathering to support a proposed finding for that reason. Her understanding about the issuance of adverse findings is contrary to long-standing DER examination policy.

The other relevant ongoing monitoring examination activity we reviewed involved counterparty credit risk, described by FHFA as "the risk that the counterparty to a transaction could default on or before or deteriorate in creditworthiness before the final settlement of a transaction's cash flows." According to FHFA examination guidance, one of the Enterprises' primary exposures to counterparty risk arises from seller/servicers. While the lead examiner assigned to this ongoing monitoring activity recalled that he reviewed the IA Report and kept track of Fannie Mae's efforts to recover the shortages in the T&I custodial accounts, he maintained to us that the [redacted] found in the IA Report were an operational risk issue that fell outside the scope of this ongoing monitoring activity. He advised that his primary contact at Fannie Mae for this ongoing monitoring activity never discussed the Post-Mortem Report with him or provided him with a copy of it. He reported that he was unaware of this Post-Mortem Report until he received it from us in connection with his interview.

The examiners for both ongoing monitoring activities confirmed that they did not discuss the shortcomings found in either the Post-Mortem or IA Reports with each other.

Single-Family Servicing Oversight Targeted Examination: This targeted examination focused on the Enterprise's compliance with AB 2014-07 for its largest single-family mortgage servicers. Its lead examiner explained that he read the IA Report. Notwithstanding the IA Report's findings that the Single-Family business unit's "[redacted]" and that "[redacted]," this examiner reported that he considered the incident that was the subject of the report to be a "one-off situation" relating primarily to fraud risk and outside the scope of the targeted examination.[15] He asserted that he tracked the status of management's remediation of the [redacted] finding in the IA Report through his reviews of standard Enterprise management reports.

Although the examiner wrote in the workpapers that "[redacted]," he conducted no follow-up activities on the IA Report [redacted] audit finding, beyond keeping track of the status of remediation.

According to this examiner, the [redacted] audit finding was isolated to Fannie Mae's dealings with a small, rogue servicer and it related primarily to fraud. For that reason, he did not compare Fannie Mae's practices for managing relationships with servicers against FHFA's supervisory expectations in AB 2014-07 in view of the shortcomings identified by IA. He explained that he considered follow-up to be the fraud risk examiner's responsibility. However, he did not speak with either the fraud examiner or the examiner conducting the counterparty credit risk ongoing monitoring about the shortcomings identified in the IA Report.

Examiners Did Not Escalate the Red Flags in the Post-Mortem and IA Reports to the Examination Managers or the Examiner-in-Charge for Discussion and Decision

Under FHFA's supervision program, examiners are responsible, as the frontline fact gatherers, to identify potential concerns and escalate those concerns to examination managers and the EIC to determine whether any should be categorized as an examination finding. The EIC and the examination managers separately reported to us that each expected examiners to elevate control failures and shortcomings, such as those identified in the Post-Mortem Report and the IA Report.

As explained above, the Post-Mortem and IA Reports identified [redacted] around Fannie Mae's [redacted]. Senior Fannie Mae management, in the Post-Mortem Report, found that: Enterprise employees lacked "[redacted];" there was "[redacted];" and employees' prior history with the servicer "[redacted]." Fannie Mae's internal auditors, in the IA Report, identified [redacted]

[15] This examiner did not receive a copy of the Immediate Notification and speculated that he may have "glanced at" the Post-Mortem Report but could not recall whether he reviewed it during his examination activities.

[redacted] "[redacted]."

In performing supervisory activities, the examination team must look for and flag potential control weaknesses. Here, Fannie Mae's internal assessment and internal audit found [redacted] in custodial account oversight and [redacted] that went well beyond one rogue servicer, and those reports were available to the lead examiners for the two ongoing monitoring examination activities and the lead examiner for the targeted examination. However, we found no evidence in the workpapers that any of the examiners escalated these red flags to his/her examination manager or the EIC for discussion or decision.[16]

As a consequence, the EIC and examination managers were deprived of critical information to assess whether additional supervisory activities were needed or adverse examination findings were warranted. DER management was left unaware whether Fannie Mae had sufficiently remediated the [redacted] it found in its oversight of custodial accounts and [redacted] or whether gaps still existed between Fannie Mae's practices and the Agency's supervisory expectations.

FINDINGS ....

1. In performing supervisory activities, examination teams must look for and flag potential control weaknesses. Here, Fannie Mae's internal assessment and internal audit found [redacted] in custodial account oversight and [redacted] and [redacted] that went well beyond one rogue servicer, and those reports were available to the lead examiners for the two ongoing monitoring examination activities and the lead examiner for the targeted examination. Despite the red flags and [redacted] raised in the Enterprise's Post-Mortem Report and IA Report, DER examiners did not assess Fannie Mae's practices for the oversight of custodial accounts against FHFA's supervisory expectations set forth in its advisory bulletin on fraud risk management.

2. DER examiners did not communicate with each other regarding the shortcomings Fannie Mae identified in its Post-Mortem Report and IA Report or raise those

[16] During our interview, the fraud risk examiner asserted that she discussed the Post-Mortem Report with her former exam manager. However, neither the former nor current supervisory exam managers recalled seeing the Post-Mortem Report or discussing its findings with the fraud risk examiner. Any such discussion was not documented in the workpapers. Based on our interviews, we determined that the other two examiners did not discuss the IA report with their respective managers.

shortcomings to their management for discussion and decision, in contravention of DER examination guidance and expectations of DER management. As a consequence, the [redacted] identified by the Enterprise were not assessed during three supervisory activities, thereby limiting the effectiveness of DER's supervision.

3. Contrary to required DER examination procedures, a DER examiner reached the conclusion that the shortcomings described in the Enterprise's Post-Mortem Report did not present any "[redacted]" but failed to document any independent analysis supporting that conclusion.

4. Notwithstanding the [redacted] finding in the IA Report, another examiner discounted that finding as limited to a small, rogue servicer and outside the scope of his targeted examination. The examiner described the incident that was the subject of the report as a "one-off situation" and did not assess Fannie Mae's practices for managing relationships with servicers against FHFA's supervisory expectations in AB 2014-07.

CONCLUSIONS

Both the Post-Mortem and IA Reports found [redacted] in Fannie Mae's [redacted], including a [redacted] by Enterprise staff responsible for overseeing servicers; [redacted]; [redacted] by Enterprise staff; and [redacted], particularly for T&I funds. We found that none of the examiners assessed the severity of any of these weaknesses or their impact on Fannie Mae's [redacted] during their respective examination activities. We determined that no examiners assessed whether these [redacted] were consistent with FHFA's supervisory expectations announced in its advisory bulletins, and none escalated any of these red flags to DER management for consideration of supervisory findings or additional supervisory attention. As a result, DER management was left unaware whether Fannie Mae had sufficiently remediated the [redacted] it found in its oversight of custodial accounts and [redacted] or whether gaps still existed between Fannie Mae's practices and the Agency's supervisory expectations.

In its *2019 Report to Congress*, FHFA stated that "Prior to ending the conservatorships, FHFA's supervision of the Enterprises must be strong and well executed. All supervisory and oversight procedures and systems must ensure that FHFA's examination work is consistently rigorous, timely, and effective . . ..." While we cannot conclude on the overall rigor and effectiveness of DER's supervision program based on this case study, the issues that we observed, specifically, examiners' failure to identify and raise [redacted] with DER management for discussion and decision, especially after those shortcomings were flagged by an Enterprise, would significantly impede the effectiveness of the supervision program if they were widespread.

RECOMMENDATIONS

We recommend that FHFA:

1. Assess whether Fannie Mae's remediation of its [redacted] is sufficient.
2. Set clear expectations in supervisory guidance for prompt escalation within DER by examiners of information regarding deficient practices at an Enterprise for a determination of whether such practices warrant additional supervisory attention and/or should be the subject of an adverse examination finding.
3. Reinforce in examiner training and the annual performance appraisal process its expectations for collaboration among examiners, communication of potential deficient practices to DER managers, and documentation of support for conclusions.

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 the Appendix, FHFA agreed with our first and second recommendations and "partially" agreed with our third recommendation.

In response to the third recommendation, FHFA agreed to provide training to all examination staff on its expectations for "communicating potential safety and soundness concerns with other examiners, for the timely escalation of serious safety and soundness concerns to DER management, and documentation of examination conclusions." FHFA also committed to reinforce through this training its existing employee performance objective concerning compliance with internal supervisory guidance and employee performance competencies for collaboration and communication, instead of doing so through the annual performance process. OIG believes that such reinforcement is necessary given the shortcomings we observed, and we consider FHFA's alternative management action for the third recommendation to be responsive to that recommendation.

OBJECTIVE, SCOPE, AND METHODOLOGY ....

We conducted this evaluation to assess FHFA's supervisory responses to the Immediate Notification, Post-Mortem Report, and Internal Audit Report. To achieve this objective, we sought to determine whether the examination team's supervisory responses conducted during the 2018 and 2019 examination cycles were consistent with DER's expectations established in examination policy and guidance.

We reviewed DER's examination plans for 2018 and 2019 to identify relevant examination activities. From those relevant activities, we reviewed DER examination workpapers on fraud risk management and servicer oversight, including procedures documents, meeting notes, report notes, analysis memoranda, and quarterly status reports. We also interviewed the lead examiners and examination managers for those activities, as well as the EIC for Fannie Mae.

We reviewed applicable guidance and standards published by FHFA and DER in effect during our review period, including advisory bulletins, operating procedure bulletins, prudential management and operating standards, and the Examination Manual, as well as Fannie Mae's Servicing Guide. Additionally, we reviewed DER's examination policy and guidance pertaining to the handling of an immediate notification of potential fraud from the Enterprises.

The fieldwork for this report was completed between March 2020 and July 2020.

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.

APPENDIX: FHFA MANAGEMENT RESPONSE..........................

Federal Housing Finance Agency

MEMORANDUM

TO: Kyle D. Roberts, Deputy Inspector General for Evaluations
FHFA Office of Inspector General (OIG)

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

SUBJECT: Draft Evaluation Report: *FHFA Examiners' Lack of Assessment and Escalation of Shortcomings Identified by an Enterprise in Its Servicer Fraud Risk Management Framework Limited the Agency's Supervisory Oversight*

DATE: August 24, 2020

Thank you for the opportunity to respond to the draft report titled, *FHFA Examiners' Lack of Assessment and Escalation of Shortcomings Identified by an Enterprise in Its Servicer Fraud Risk Management Framework Limited the Agency's Supervisory Oversight* (Report). The draft Report makes three recommendations, which generally align with DER's current enhancements to the supervision program:

Recommendation 1: *OIG recommends that FHFA assess whether Fannie Mae's remediation of its* [redacted] *is sufficient.*

Management Response: FHFA agrees with this recommendation. In the 2021 examination cycle, DER will complete an examination activity that includes a review of Fannie Mae's remediation of the issues identified in the Internal Audit Report and Post-Mortem Report on [redacted] and [redacted].

Recommendation 2: *OIG recommends that FHFA set clear expectations in supervisory guidance for prompt escalation within DER by examiners of information regarding deficient practices at an Enterprise for a determination of whether such practices warrant additional supervisory attention and/or should be the subject of an adverse examination finding.*

Management Response: FHFA agrees with this recommendation. By July 30, 2021, DER will provide more detailed guidance to examiners on expectations for escalating serious safety and soundness concerns to DER management when conducting targeted examinations and ongoing monitoring activities.

Recommendation 3: *OIG recommends that FHFA reinforce in examiner training and the annual performance appraisal process its expectations for collaboration among examiners, communication of potential deficient practices to DER managers, and documentation of support for conclusions.*

Management Response: FHFA partially agrees with this recommendation. By May 31, 2021, DER will provide training to all examination staff (including Examiners-in-Charge and examination managers), which will cover expectations for communicating potential safety and soundness concerns with other examiners, for the timely escalation of serious safety and soundness concerns to DER management, and documentation of examination conclusions. This training will also reinforce the existing Job Performance Plan (JPP) objective that examiners are expected to follow internal supervisory guidance and current JPP competencies for collaboration and communication.

cc: Chris Bosland
Kate Fulton
Scott Valentin
John Major

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