OFFICE OF INSPECTOR GENERAL

Federal Housing Finance Agency

400 7th Street SW, Washington, DC 20219

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TO: Sandra L. Thompson, Director, FHFA

FROM: Brian M. Tomney, Inspector General /s/

SUBJECT: Fiscal Year 2024 Management and Performance Challenges

This memorandum, issued pursuant to the Reports Consolidation Act of 2000 (P.L. 106-531), provides OIG's identification of the most serious management and performance challenges facing the Agency.

The Housing and Economic Recovery Act of 2008 created FHFA, which is responsible for the effective supervision, regulation, and housing mission oversight of Fannie Mae and Freddie Mac, collectively the Enterprises, and the 11 Federal Home Loan Banks (FHLBanks) (collectively, the regulated entities).[1] In addition, since September 2008, FHFA has served as the Enterprises' conservator.

This memorandum is based on OIG work and a review of public and non-public FHFA and regulated entity sources, along with other public information. For fiscal year 2024, we have identified the following management and performance challenges facing FHFA:

- Continue Strengthening Supervision of the Regulated Entities
- Continue Stewardship of the Enterprise Conservatorships
- Respond to Market Volatility and Change
- Enhance Oversight of Cybersecurity at the Regulated Entities and Ensure an Effective Information Security Program at FHFA
- Ensure Oversight of Counterparty Risk, Third-party Risk, and Fourth-party Risk at the Regulated Entities
- Strengthen Oversight of the Regulated Entities' Model Risk

[1] The Office of Finance and Common Securitization Solutions, LLC (CSS) are not separate "regulated entities" as the term is defined by statute (see 12 U.S.C. 4502(20)). Rather, the Office of Finance is a part of the FHLBank System, and CSS is an affiliate of the Enterprises. However, for convenience, references to the "regulated entities" in this document should be read to also apply to the Office of Finance and CSS, unless otherwise noted.

- Oversee People Risk at the Regulated Entities and Enhance FHFA's Human Capital Management
- Ensure Resiliency at the Regulated Entities and at FHFA

Many of these challenges reiterate themes we identified in prior years. However, continued inclusion of a challenge area does not necessarily indicate a lack of progress by FHFA; rather, it indicates that a particular challenge persists. In some instances, for example, a challenge is simply inherent to the Agency's and the regulated entities' missions. This year, in addition to highlighting the persistent challenges facing FHFA, we highlight a new challenge: FHFA's response to market volatility and change.

We perform our mission primarily through audits, evaluations, compliance reviews, and investigative work. We use a risk-based approach, focusing our FHFA-OIG FY 2024 Annual Plan on the most significant risks facing the Agency. Specific information on our ongoing and anticipated oversight work is available in that plan.

Challenge: Continue Strengthening Supervision of the Regulated Entities

The regulated entities serve a vital function by providing liquidity and stability to the secondary mortgage market, and they manage trillions in assets. FHFA is charged with supervising them and ensuring they operate in a safe and sound manner. For these reasons, we have previously identified supervision as a longstanding and inherent challenge for FHFA.

In our prior work over numerous years, including in the FY2022 management and performance challenges memorandum, we identified several recurring challenges for the supervision program. For example, personnel challenges, both in terms of maintaining stable leadership and a sufficient cadre of skilled examiners, have been persistent. The Agency also faces continued challenges in supervising the Enterprises to ensure they meet regulatory capital requirements and in managing emerging risks associated with technology (addressed more fully in the cybersecurity and information technology challenge, below).

Our recent work has recognized FHFA's progress in strengthening its supervision program. For example, we saw that the Division of Enterprise Regulation (DER) implemented controls to ensure that the Enterprises and CSS remediate adverse examination findings within reasonable timeframes (as determined by FHFA). We also found that the Division of Federal Home Loan Bank Regulation (DBR) adhered to its work program minimum frequency guidelines for annual examinations and followed its guidance in performing annual examinations of each FHLBank's Affordable Housing Program (AHP).

We also identified areas for improvement. For example, we found certain areas of DBR's AHP examination planning process that, if not addressed, could increase the risk that issues with the FHLBanks' administration of their AHPs would not be identified and corrected in a timely manner. First, DBR did not plan or perform an in-depth review of a significant area within one of the higher risk AHP programs for more than 10 years. DBR officials told us that this in-depth review was delayed awaiting the amendment of an AHP regulation, which took longer than expected, and was not fully applied until 2021. Further, we determined that DBR had not performed an AHP workforce planning analysis since 2013 to assess current and future examination needs and determine the staffing levels required to provide adequate examination coverage. This was because DBR's planning process for AHP examinations does not require periodic workforce planning. Finally, DBR's publicly available AHP examination module is out of date. Internal updates to the module have not been subject to the level of structure, collaboration, and review required by FHFA policy due to a lack of needed collaboration between DBR offices. We also identified that the CSS examination module had not been updated since it was issued in 2016 and it is materially inaccurate. Instead of using that module for examination planning, the examiner-in-charge relied on another module focused on the Enterprises that made no mention of CSS specifically. FHFA agreed with our recommendations on these issues and is in the process of addressing these areas in need of improvement.

As noted above, maintaining consistent leadership is a persistent challenge in FHFA's supervisory role, and FHFA continues to experience leadership changes within its supervisory programs. Additionally, DER has not yet fully addressed our critical recommendations regarding workforce planning. Although FHFA has provided us with a high-level description of identified gaps and an action plan, the Agency has not provided the supporting analysis for the identified gaps or project plans or milestones for the workforce action plan. The Agency committed to develop project plans for a multi-year workforce strategy, and full implementation of such a strategy remains an important component of strengthening the supervision program.

Strong supervision is especially important for the Enterprises because they have a combined adjusted total risk-based capital shortfall of $421 billion. FHFA must supervise them to ensure that they work to meet regulatory capital requirements.

While FHFA has made progress in enhancing its supervision program, the longstanding nature and scope of the Agency's supervision challenge necessitates continued attention to these issues.

Select OIG Reports Issued During FY2023 on Supervision Matters:

DER Implemented Controls to Ensure that the Enterprises and CSS Remediated Adverse Examination Findings Within FHFA Determined Reasonable Timeframes, AUD-2023-007, September 6, 2023

FHFA Completed Examination Work Sufficient to Determine Whether the Enterprises' Credit Default Models Met Supervisory Expectations, EVL-2023-003, April 19, 2023

DBR Adhered to Its Work Program Minimum Frequency Guidelines for Annual Examinations, COM-2023-004, March 22, 2023

FHFA Examinations of CSS Include Review of the Board of Managers but Supervision Has a Key Person Dependency and Outdated Guidance, EVL-2023-002, March 20, 2023

The Division of Federal Home Loan Bank Regulation Followed Its Guidance in Performing Annual Examinations of Each Federal Home Loan Bank's Affordable Housing Program but the AHP Examination Planning Processes Require Improvement, AUD-2023-001, February 9, 2023

Challenge: Continue Stewardship of the Enterprise Conservatorships

As conservator, FHFA is vested with express authority under the Housing and Economic Recovery Act of 2008 to operate the Enterprises, which includes exercising broad authority over trillions of dollars in assets and billions of dollars in annual revenue. In this role, FHFA makes business and policy decisions that can influence the entire mortgage finance industry. Given the taxpayers' sizeable investment in the Enterprises, the conservatorships' unknown duration, the Enterprises' critical role in the secondary mortgage market, and the necessity to sustain their own future profitability, OIG determined that FHFA's administration of the conservatorships remains a critical challenge.

In its 2022 Scorecard, FHFA defined its first conservatorship goal as promoting sustainable and equitable access to affordable housing. In June 2022, the Enterprises released Equitable Housing Finance Plans for 2022-2024. According to FHFA, the plans are designed to promote the Enterprises' safety and soundness and to foster housing finance markets that provide equitable access to affordable and sustainable housing. They are also intended to identify and address barriers experienced by renters, aspiring homeowners, and current homeowners in underserved communities. While the activities are focused on addressing barriers and using technology to identify ways to responsibly serve more borrowers, FHFA must balance meeting program goals while simultaneously ensuring the Enterprises' safety and soundness.

To further this conservatorship goal, FHFA has directed the Enterprises to continue work related to the appraisal policy and process modernization initiative. That work includes engaging with industry stakeholders, such as appraisers, software providers, insurance companies, appraisal management companies, inspection companies, mortgage insurers, and industry trade groups. Considering input from multiple stakeholders and technologies can support FHFA in meeting its goals of improving data quality, reducing potential appraisal bias, and supporting effective risk management and process efficiency, yet accounting for the various viewpoints and information can also present challenges.

Another challenge for FHFA is providing sufficient oversight of the Enterprises' use of appraisals to ensure those appraisals do not improperly consider bases that are prohibited by federal fair lending law. FHFA's independent review of a sample of appraisal reports concluded that valuation bias persists in housing finance in America. In its review, the Agency identified several overt references to race, color, and other prohibited bases in appraisals. During our evaluation, FHFA told us they made 17 referrals to the U.S. Department of Housing and Urban Development and made appraisal information available to the U.S. Department of Justice. The Agency also told us it shared information with the Consumer Financial Protection Bureau. Although the Agency had not taken the additional step of filing complaints with the state licensing authorities responsible for investigating complaints against appraisers, in April 2023 it required the Enterprises to submit complaints to those authorities. Working to identify and address appraisal bias will continue to be an important challenge facing FHFA and the Enterprises.

Other recent OIG work indicates that while FHFA has undertaken initiatives to advance equity and support for underserved communities, its documentation processes could be improved. In our review, FHFA identified several relevant initiatives, and our review concluded that the four initiatives we studied generally complied with their stated purposes. However, we identified weaknesses in the Office of Fair Lending's fair lending assessment tracking and documentation processes and made recommendations for improvements.

We identified recommended improvements to documentation practices in other areas as well. For example, a recent audit concluded that while FHFA made conservatorship decisions in accordance with its conservatorship decision policy and procedures and performed conservatorship monitoring and surveillance, in some instances FHFA's document management and retention practices adversely impacted FHFA's ability to demonstrate its rationale for certain decisions. We also found that FHFA's current policies and procedures increase the risk that conservatorship decision activity would not be conducted in accordance with FHFA management's intentions.

Select OIG Reports Issued During FY2023 on Conservatorship Matters:

FHFA Performed Active Oversight and Made Efforts to Ensure Fannie Mae's Compliance with Its Directions to Improve Audit Committee Operations, COM-2023-007, September 6, 2023

FHFA Has Initiatives to Advance Equity and Support for Underserved Communities, but Tracking and Documentation Need Improvement, AUD-2023-005, July 26, 2023

FHFA Followed Its Guidance When Making Conservatorship Decisions But Needs to Improve Retention of Decision Documentation and Update the Conservatorship Decision Policy and Procedures, AUD-2023-003, March 29, 2023

FHFA Could Further Combat Appraisal Bias by Ensuring That Complaints Are Filed with State Authorities and Ensuring the Enterprises Use Appraisals That Comply with Federal Law, EVL-2023-001, December 20, 2022

Challenge: Respond to Market Volatility and Change

Over the past few years, the housing market has shifted significantly. High interest rates, limited home supply that continues to keep prices elevated, and high inflation pose challenges to the housing market. Considering this volatility, FHFA must continue to provide leadership in responding to today's market and preparing for the effects of future changes on the regulated entities.

High interest rates directly influence the regulated entities' mortgage acquisitions. The Enterprises' financial performance, as measured by earnings and mortgage purchase activities in 2022, was down year-over-year. Moreover, rising interest rates significantly altered the Enterprises' mortgage acquisitions from lower-risk refinance loans to purchase loans whose attributes, such as generally higher loan-to-value ratios and lower credit scores, are associated with higher credit risk. Temporary interest rate buydowns and other lender strategies to assist borrowers with purchasing homes in this high interest rate environment require the regulated entities to monitor those loans' characteristics to accurately assess risk.

Market changes – in addition to providing their own challenges – also make some of the other challenges identified in this memorandum more difficult. As just one example, both FHLBanks and the Enterprises rely on models to conduct their business and to make necessary decisions. When there are substantial changes in the market, existing models may rely on data generated in other economic environments, meaning they may not currently perform as expected. In this way, market volatility also contributes to challenges related to model risk.

Changes in the nation's economic situation can also have direct effects on the regulated entities. For example, when a major credit rating agency downgraded the nation's credit rating, it triggered a downgrade in certain Enterprise credit ratings.

FHFA must continue to adapt its oversight of the regulated entities to respond to market volatility and change. In recent work, we found that the Agency had done so; examiners adjusted their FHLBank examination planning in response to the heightened risk environment resulting from the March 2023 market disruption. In other work, we saw that the Enterprises offered forbearance in response to many homeowners' difficulties in paying their mortgages during the COVID-19 pandemic. We found that during a time of fluid circumstances and evolving data, the Agency measured, monitored, and identified ways to mitigate the Enterprises' forbearance-related costs.

FHFA must continue to ensure the regulated entities are well positioned to respond to market volatility and change. It is critical that the Agency, too, adjusts its oversight to address the effect of market factors on the regulated entities.

Select OIG Report Issued During FY2023 Related to Responding to Market Volatility and Change:

DBR Adapted the Scope of Its Federal Home Loan Bank Supervisory Activities in 2023 in Response to Market Disruptions, EVL-2023-004, September 21, 2023

Challenge: Enhance Oversight of Cybersecurity at the Regulated Entities and Ensure an Effective Information Security Program at FHFA

FHFA's regulated entities comprise central components of the U.S. financial system and electronically connect with other large financial institutions. As part of their business processes, they receive, store, and transmit highly sensitive private information about borrowers and businesses, including financial data and personally identifiable information. Protecting this information is critically important and reflects an ongoing challenge to FHFA and the regulated entities. Unfortunately, but perhaps not unexpectedly, both the Enterprises and the FHLBanks have been the targets of cyberattacks.

The threat landscape in this area is ever-changing, requiring constant vigilance and monitoring. FHFA has engaged in oversight of cybersecurity at the regulated entities and assessed that cybersecurity continues to be a top operational risk for the Enterprises and CSS. Similarly, the Agency assessed elevated risk at the FHLBanks because of ongoing information technology initiatives at many FHLBanks, and examiners identified areas that exhibited or could exhibit unacceptable operational risk in information security management.

FHFA's own assessment of cybersecurity risk is underscored by a recent report from the Financial Stability Oversight Council. It reported that a destabilizing cybersecurity incident could potentially threaten the stability of the U.S. financial system by disrupting a key financial service or utility, causing a loss of confidence among a broad set of customers or market participants, or compromising the integrity of critical data.[2] Considering the regulated entities' footprint and role in the financial markets, it is clear that managing this risk is critical for the regulated entities and important for FHFA to oversee.

Because FHFA's management of these cybersecurity-related challenges remains important, we regularly assess how FHFA oversees cybersecurity risk at the regulated entities. Previously, in a 2019 evaluation, we found that DER did not collect and review consistent cybersecurity information necessary to oversee risks to the Enterprises. Consequently, FHFA lacked useful data that could help it oversee the Enterprises' controls against cyberattacks and associated risks. Subsequently, the Agency issued an advisory bulletin regarding reporting and notification to FHFA of cybersecurity incidents. Recent reviews demonstrate that FHFA and the Enterprises have made progress in this area, finding that the Enterprises generally adhered to the reporting format and timeliness standards and CSS adhered to the standard for which it had reportable information.

In addition to FHFA's oversight of the regulated entities in this area, it must also ensure the effectiveness of its own information security program. As conservator of and supervisor for the Enterprises, and supervisor for the FHLBanks, FHFA collects and manages sensitive information, including personally identifiable information, which it must safeguard from unauthorized access or disclosure. An independent public accounting firm under contract with our office audited FHFA's 2023 privacy program and concluded that FHFA had generally implemented effective privacy and data protection policies and procedures in accordance with law, regulation, and policy. However, the Agency did not fully achieve implementation of certain privacy requirements.

In addition to the privacy audit, we perform an annual audit pursuant to the Federal Information Security Modernization Act of 2014 (FISMA) to ensure FHFA's compliance with information

[2] See Financial Stability Oversight Council's 2022 Annual Report. The FHFA Director is a member of the Council and voted in favor of the 2022 Annual Report.

security program standards and help FHFA strengthen its network protections. For FY 2023, an independent public accounting firm under contract with OIG determined that collectively the Agency's information security programs and practices were effective and complied with FISMA and related information security policies and procedures, standards, and guidelines. Although the Agency implemented effective information security programs and practices, a subset of selected controls was not fully effective.

Select OIG Reports Issued During FY2023 on Oversight of the Regulated Entities' Cybersecurity and FHFA's Internal Controls Over Security:

Audit of the Federal Housing Finance Agency's Privacy Program Fiscal Year 2023, AUD-2023-006, August 23, 2023

Audit of the Federal Housing Finance Agency's Information Security Programs and Practices Fiscal Year 2023, AUD-2023-004, July 26, 2023

FHFA Did Not Fully Implement Select Security Controls Over One of Its Cloud Systems as Required by NIST and FHFA Standards and Guidelines, AUD-2023-002, March 8, 2023

The Company That Issues and Administers the Enterprises' Mortgage-Backed Securities Adhered to FHFA's Cybersecurity Incident Reporting Standards, COM-2023-001, January 5, 2023

Challenge: Ensure Oversight of Counterparty Risk, Third-party Risk, and Fourth-party Risk at the Regulated Entities

The regulated entities rely on counterparties for business-critical matters. The Enterprises' counterparties include entities that carry out core functions, such as sellers, servicers, mortgage insurers, custodial depository institutions, and reinsurers. The FHLBanks' primary exposure to institutional counterparty credit risk stems from unsecured money market transactions with domestic and foreign counterparties, derivative counterparties, and mortgage servicers that service loans the FHLBanks purchased from members or housing associates.

This broad reliance on counterparties requires the regulated entities to identify and mitigate related risks. Counterparty credit risk is the risk that a counterparty either defaults on amounts owed or deteriorates in creditworthiness before a transaction settles, or both, and such risk can increase when a regulated entity engages with a limited number of counterparties. FHFA recognizes that counterparty credit risk is significant. Recent economic changes have increased stress on many counterparties, particularly nonbank seller/servicers, which do not necessarily have the same financial strength or operational capacity and regulatory oversight as traditional banks. In addition, reliance on nonbanks is increasing. According to FHFA, the Enterprises continue to monitor counterparty risks, particularly in light of declining earnings among many of their sellers and servicers throughout 2022. Nevertheless, FHFA continues to have supervisory concerns, and oversight of counterparty risk remains a challenge during this reporting cycle.

The regulated entities also rely on third parties to provide numerous products and services. For example, third parties provide critical operational support and information technology services. As with counterparties, this third-party reliance comes with risk, namely that the third party will not deliver the product or service as expected. The regulated entities' third parties rely, in turn, on their own third parties; these "third parties' third parties" are considered to be fourth parties to the regulated entities. As we discussed in a recent white paper, managing fourth-party risk can be challenging for a regulated entity due to limited direct oversight of the fourth parties. Typically, the regulated entities do not have contracts with their fourth parties. Instead, the third parties have the direct contractual relationship with the fourth parties.

Third-party relationships can pose risks to other areas. For example, two recent audits revealed information risk heightened by third-party related matters. In one, we found that FHFA did not fully implement select security controls over its third-party cloud computing system as required by National Institute of Standards and Technology and FHFA standards and guidelines. In another, we found that FHFA did not configure all its publicly accessible websites and web services with a secured connection, as required, because they were managed by a third-party vendor and not under the Agency's control. In public reporting FHFA indicates that, in addition to posing information security risks, third-party relationships can also pose risks related to resiliency and safety and soundness issues.

The regulated entities are exposed to fraud risk through the activities of third parties, including borrowers, loan originators, mortgage brokers, sellers, servicers, attorneys, appraisers, and others. OIG's publicly reportable criminal investigations include alleged fraud by different types of counterparties, reinforcing the need to ensure strong controls to prevent fraud.

Recently, FHFA has taken action in response to our prior counterparty-related work. For instance, FHFA made progress in addressing our recommendations on supervisory protocols for sharing critical information, such as counterparty performance issues.[3] The Agency issued new guidance and trained the relevant employees on how to appropriately share counterparty issues that affect the Enterprises.[4] As another example, we previously reported on challenges with FHFA's management of its suspended counterparty program, and FHFA has proposed amending its regulation.[5] Specifically, the Agency proposed to expand its categories of covered misconduct that serve as a basis for suspension under the program and eliminate the requirement that any final suspension order based on an administrative sanction be preceded by a proposed suspension order. The final rule has not yet been issued.

Ultimately, though, the Agency is challenged to oversee the regulated entities' counterparty and third-party risk management, because its oversight ability is limited. Unlike most other federal

[3] An examination team may identify supervisory concerns through examination activity or from information received from other internal [FHFA] or external sources relative to the performance or condition of a counterparty that transacts business with both Enterprises.

[4] The audit report identified that DBR already followed information-sharing practices.

[5] FHFA, Suspended Counterparty Program, 88 FR 47077 (July 21, 2023).

safety and soundness supervisors, FHFA lacks examination and enforcement authority for the counterparties and third parties.

Select FY2023 Results from OIG Criminal Investigations on Counterparty, Third-Party, and Fourth-Party Matters:

Nomura Securities International Agrees to Pay $35 Million Penalty Stemming from Its Participation in Securities Fraud Scheme, Press Release, August 22, 2023

UBS Agrees to Pay $1.435 Billion for Fraud in the Sale of Residential Mortgage-Backed Securities, Press Release, August 14, 2023

Pinellas County Man Sentenced for Wire and Bank Fraud Offenses, Press Release, July 17, 2023

Osceola County Mortgage Loan Officer Charged with Bank Fraud and Aggravated Identity Theft, Press Release, April 12, 2023

Challenge: Strengthen Oversight of the Regulated Entities' Model Risk

Models explain relationships by processing data into estimates. The Enterprises rely heavily on models to measure and monitor risk exposures and to inform and support business decisions. For example, they use models extensively for collateral valuation, home price forecasting, mortgage cash flow analysis, financial reporting, and stress testing, among other uses. The FHLBanks also use models in making business decisions and for financial reporting. They each make significant use of models to manage, measure, and monitor risks, as well as to determine the fair value of financial instruments when independent price quotations are not available.

The use of models naturally injects model risk, which FHFA defines as "the risk of loss resulting from model errors or the incorrect use or application of model output." FHFA has observed that although models are often essential, reliance on inaccurate or inappropriate models may lead to poor or costly decisions. For example, a model could be based on inappropriate methodology or data, or it might not receive necessary updates; users may lack understanding of model limitations; or adjustments, known as "overlays," could be inappropriately applied to model results. Further, many of the regulated entities' models interconnect, so a problem or error in one model can spread to other models. Because of the entities' heavy reliance on models and the potential results if they are inaccurate, they present a challenge for which FHFA oversight and management is crucial.

The Agency has identified model concerns at the regulated entities. FHFA examiners found that both Enterprises need to strengthen controls related to models. Examiners similarly identified areas for improvement in risk management practices at the FHLBanks, including related to modeling. Without adequate controls over complex models, errors might occur. For example, in 2023 Fannie Mae had to restate its required financial stress test results for multiple years after discovering modeling errors.

We recently assessed whether DER completed sufficient examination work to conclude whether certain Enterprise credit default models met FHFA's supervisory expectations. We found that FHFA examiners had completed work sufficient to make such a determination. DER identified practices that prompted it to issue adverse examination findings to Enterprise management, but it did not conclude that the criticized practices rose to the level of unsafe or unsound practices.

The Agency faces several challenges in adequately overseeing model risk at the regulated entities. Unprecedented events, such as the COVID-19 pandemic and changing economic conditions, challenge existing model assumptions and model performance. For instance, FHFA considers the Enterprises' model risk as elevated in part because many models rely on data generated in other economic environments.

In addition, model technology continues to evolve and increase in complexity. Advances in artificial intelligence and machine learning continue to expand how the Agency must oversee the regulated entities' models, including how such technology avoids unfair outcomes. Moreover, the Agency stated that it formerly considered the FHLBanks and the Office of Finance as "less complex" entities based on their use of models; however, FHFA notes that the FHLBanks' modeling activities have become more complex and pervasive in their operations. FHFA has recently taken steps to enhance its model-related guidance by releasing supplemental guidance to its model risk management guidance advisory bulletin. It is intended to address gaps in the advisory bulletin arising from changes in technology and model complexity.

To ensure it can supervise the regulated entities' high-risk models, FHFA must have a sufficient examination corps with the relevant modeling skills. The Agency's execution of our long-standing recommendation to implement a workforce plan that addresses the examiner capacity and competencies required to meet supervisory needs will further its efforts to ensure the regulated entities operate their models safely and soundly.

Select OIG Report Issued During FY2023 on FHFA Oversight of the Regulated Entities' Model Risk:

FHFA Completed Examination Work Sufficient to Determine Whether the Enterprises' Credit Default Models Met Supervisory Expectations, EVL-2023-003, April 19, 2023

Challenge: Oversee People Risk at the Regulated Entities and Enhance FHFA's Human Capital Management

To accomplish their missions, FHFA and the regulated entities must maintain a skilled workforce. People risk, or human capital risk, can occur when an organization is unable to attract, develop, and retain a highly qualified, diverse workforce with specialized skills. This risk can jeopardize the institution's ability to meet its business objectives. People risk manifests across a range of human capital related issues, such as an organization not planning for the effect of retirements or failing to address pervasive critical skill gaps.

FHFA's annual examination and rating for each regulated entity covers operational risk, which includes people risk. Examiners have noted concerns with people risk and flagged it as a heightened risk area with challenges.

Certain factors affecting human capital are outside of the regulated entities' direct control. Attrition at the regulated entities is largely correlated to general labor market conditions, and the regulated entities experienced high turnover during the pandemic's tight labor market. In addition, increasing competition from financial services and technology companies for information technology and modeling skills increased turnover, especially at the Enterprises. FHFA must ensure the regulated entities navigate these external forces while maintaining the human capital required to achieve their missions.

In addition to ensuring strong oversight of the regulated entities' people risk, FHFA must strengthen its own human capital management. We previously found that FHFA had multiple deficiencies in its hiring practices and its housing finance examiner commissioning program. Concerning its hiring, FHFA used incomplete and inaccurate monthly staffing plans and lacked sufficient policies, procedures, and training, among other issues. The Agency has addressed some aspects of our recommendations related to its hiring process, especially for mission critical occupations, such as examiners. For instance, FHFA documented and streamlined its hiring process, and it also implemented a tracking mechanism to report accurately on hiring timelines. With respect to the housing finance examiner commissioning program, the Agency issued a new internal guidance to identify training opportunities and monitor examiners' progress in completing the program.

Nevertheless, we have long-standing recommendations for the Agency to improve its human capital management. FHFA has not resolved its workforce planning deficiencies, particularly as they relate to its examination function. FHFA has initiated reviews into its examination resources and competencies; however, the Agency has not fully addressed identified gaps so it can implement a systematic workforce plan.

Select OIG Reports Issued During FY2023 on FHFA's Oversight of the Regulated Entities' People Risk and FHFA's Human Capital Management:

People Risk at FHFA's Regulated Entities, WPR-2023-003, September 21, 2023

FHFA Examinations of CSS Include Review of the Board of Managers but Supervision Has a Key Person Dependency and Outdated Guidance, EVL-2023-002, March 20, 2023

FHFA Adhered to Its Corrective Actions for Hiring Pathways Interns, COM-2023-002, January 26, 2023

Challenge: Ensure Resiliency at the Regulated Entities and at FHFA

As noted, the regulated entities perform important roles in providing a stable source of funding for housing finance. FHFA recognizes that "[u]ncontrolled events, such as natural disasters, pandemics, and cyberattacks, can threaten the regulated entities' ability to perform mission critical operations, such as providing liquidity and access to credit in the mortgage market." As FHFA officials have explained, should the Enterprises be unable to play their role, there could be a huge immediate impact on the mortgage finance industry and mortgage liquidity gridlock, with disruptions having widespread impacts on the financial services industry, homeowners, and investors.

FHFA defines business resiliency management to include the ability to minimize the impact of disruptions and maintain business operations at predefined levels. It includes the ability to withstand and recover from deliberate attacks, accidents, or naturally occurring threats or incidents. The regulated entities' resiliency is particularly vital given their critical mission and importance to financial markets.

Resiliency for the regulated entities is complex and multifaceted. They require planned responses for disruptions related to people, operations and processes, equipment and facilities, and information technology and data across a wide array of hazards and risk scenarios in multiple geographic locations. Additionally, their resiliency programs must assess and ensure the resiliency of critical third parties because they rely on thousands of third parties, including for key components of their business operations. As examples of reliance that must be considered, the Enterprises report that a failure in CSS' information systems could prevent the issuance of new mortgage-backed securities (MBS), inhibit payments to investors on existing securities, and ultimately adversely affect the value and liquidity of Enterprise MBS. Similarly, a failure or interruption of the Office of Finance's services, due to a system failure or cybersecurity incident, could disrupt the FHLBanks' access to funding. To help prepare the Enterprises to respond to such events and ensure the continuity of safe and sound operations, FHFA expects that each will have established, and will continue to maintain, a business resiliency program. However, FHFA has not always enforced that requirement. In 2021, we reported that for nine years, FHFA had not taken timely and decisive supervisory action to bring Fannie Mae into compliance with its prudential standard to ensure business resiliency. DER was aware that the Enterprise's deficient practices had not been corrected, but the Agency did not make a formal assessment against the relevant standard, instead allowing the Enterprise to set its own pace. More recently, examiners have noted progress in this area, while simultaneously noting heightened resiliency risks.

In addition to ensuring resiliency at the regulated entities, FHFA must ensure its own resiliency and has taken steps toward that end. For example, we examined contingency planning controls for two FHFA systems and found that FHFA developed a contingency plan for one, established an alternate storage location, and performed backups at the alternate storage location. However, FHFA did not review or test the systems' contingency plans. Further, FHFA's higher level contingency plan and annual plan testing did not include the second system. FHFA agreed with our recommendations and is further enhancing its contingency planning controls.

Select OIG Reports Issued on FHFA's Oversight of the Regulated Entities' Resiliency and FHFA's Resiliency Efforts:

FHFA Did Not Follow All of its Contingency Planning Requirements for the National Mortgage Database (NMDB) or its Correspondence Tracking System (CTS), AUD-2022-003, December 13, 2021

For Nine Years, FHFA Has Failed to Take Timely and Decisive Supervisory Action to Bring Fannie Mae into Compliance with its Prudential Standard to Ensure Business Resiliency, EVL-2021-002, March 22, 2021

Conclusion

Collectively, the challenges described above are significant and, thus, merit continued attention by the Agency. While we have identified areas of progress in several challenging areas, FHFA must continue to identify the elements of highest risk and, in turn, effectively supervise the regulated entities while they engage in these areas. OIG's risk-based work will remain grounded in these areas, and our audits, evaluations, and other projects will continue to identify findings and make appropriate recommendations to FHFA to strengthen its work.

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