OFFICE OF INSPECTOR GENERAL

Federal Housing Finance Agency

400 7th Street SW, Washington, DC 20219

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TO: Mark A. Calabria, Director

FROM: Laura S. Wertheimer, Inspector General

SUBJECT: Fiscal Year 2020 Management and Performance Challenges

We are pleased to provide you with this memorandum, issued pursuant to the Reports Consolidation Act of 2000 (P.L. 106-531).

On September 5, 2019, the Department of the Treasury (Treasury) released its Housing Reform Plan (Treasury Plan). The Treasury Plan outlined possible legislative and administrative actions intended to reform the housing finance system, including specific preconditions for ending the conservatorships of the Enterprises.[1] The Federal Housing Finance Agency (FHFA) has acknowledged that much work must be done before the conservatorships can end. As that work progresses, FHFA should address the four serious management and performance challenges and one management concern summarized below and identified previously by the FHFA Office of Inspector General (OIG).

Overview

FHFA was created in July 2008 by the Housing and Economic Recovery Act of 2008 (HERA) (P.L. 110-289) to serve as regulator of the Enterprises and the Federal Home Loan Banks (FHLBanks). As their regulator, FHFA is charged with overseeing the safety and soundness and statutory missions of these entities. In September 2008, FHFA placed Fannie Mae and Freddie Mac into conservatorships "in response to a substantial deterioration in the housing markets that severely damaged [Fannie Mae's and Freddie Mac's] financial condition and left them unable to fulfill their mission without government intervention."[2] For more than a decade, FHFA has

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[1] The Treasury Plan was developed in response to a March 27, 2019 Presidential Memorandum directing the Secretary of the Treasury to develop a plan for administrative and legislative reforms to achieve several housing reform goals.

[2] FHFA, *History of Fannie Mae and Freddie Mac Conservatorships*.

served as the Enterprises' conservator and supervisor. Putting the Enterprises into conservatorships has proven far easier than ending them. The conservatorships have now entered their 12th year.

The Treasury Plan identifies a number of administrative actions to reform the housing finance system but does not establish timelines for their implementation. FHFA has acknowledged that reforming the housing finance system will depend upon the development of:

> [A] responsible plan to end the conservatorships, with a clear road map and mile markers, and to adjust the Treasury share agreements accordingly. . . . And by January [2020], [the] hope and expectation is that [both Treasury and FHFA] will be on the path to a new regime where the [Enterprises] can start to build capital. At that point, the path out of the conservatorships will depend not on the calendar but on Fannie and Freddie meeting the mile markers set out for them.[3]

As their conservator, FHFA is ultimately responsible for all the Enterprises' business, policy, and risk decisions. To fulfill its responsibility, the Agency must ensure that both Enterprises are effectively governed and employ sound risk management practices. The stakes are high: with assets of more than $5.5 trillion as of June 30, 2019, the Enterprises' business and policy decisions both influence and affect the entire mortgage finance industry.

FHFA is also the supervisor for the Enterprises and for the FHLBanks, the latter of which collectively reported approximately $1.1 trillion in assets as of June 30, 2019. Under HERA, FHFA is responsible for conducting examinations of the Enterprises and the FHLBanks to ensure they operate safely and soundly and thereby serve as a reliable source of liquidity and funding for housing finance and community investment.

Based on our body of work, FHFA-OIG holds the view that, for the foreseeable future, FHFA faces four serious management and performance challenges and a management concern, all of which carry over from prior years. From our vantage point, these management and performance challenges, if not addressed, could adversely affect FHFA's accomplishment of its mission.

Since October 2014, FHFA-OIG has issued 139 reports in which we assessed FHFA's progress in addressing elements of each of these challenges. Where we have identified shortcomings and/or weaknesses, we proposed a total of 179 recommendations to address them. FHFA fully agreed to 150 of the 179, or 83.8%. For those recommendations FHFA has accepted, it has either implemented its proposed corrective actions or is in the process of developing and/or implementing them.

FHFA-OIG tracks FHFA's implementation of the recommendations to which it has agreed. FHFA-OIG regularly issues a Compendium of Open Recommendations that identifies both unimplemented and rejected recommendations, organized by the risks presented by the serious

[3] FHFA, *Prepared Remarks of Dr. Mark A. Calabria, Director of FHFA, at Mortgage Bankers Association National Secondary Market Conference & Expo 2019*.

management and performance challenges identified in this Memorandum. Our Semiannual Reports to the Congress (SARs), for the periods ending March 31 and September 30, 2019, also set forth our unimplemented open and rejected recommendations.

Below are the four significant challenges and the management concern identified by FHFA-OIG, along with our assessments of each.

Challenge: Improve Oversight of Matters Delegated to the Enterprises and Strengthen Internal Review Processes for Non-Delegated Matters

Under HERA, FHFA, as conservator, possesses all rights and powers of any stockholder, officer, or director of the Enterprises and is vested with express authority to operate the Enterprises and conduct their business activities. The Enterprises are large, complex financial institutions that dominate the secondary mortgage market and the mortgage securitization sector of the U.S. housing finance industry. Given the taxpayers' enormous investment in the Enterprises, the unspecified timeline to end the conservatorships, the Enterprises' critical role in the secondary mortgage market, and their uncertain ability to sustain future profitability, FHFA's administration of the conservatorships remains a major risk.

FHFA has delegated authority to the Enterprises for many matters, both large and small. The Enterprises acknowledge in their public securities filings that their directors serve on behalf of the conservator and exercise their authority as directed by and with the approval, when required, of the conservator. FHFA, as conservator, can revoke delegated authority at any time (and retains authority for certain significant decisions).

FHFA-OIG's body of work over the last five years has found that FHFA has limited its oversight of delegated matters largely to attendance at Enterprise internal management and board meetings as an observer and to discussions with Enterprise managers and directors. Read together, the findings in these reports demonstrate that, for the most part, FHFA, as conservator, has not assessed the reasonableness of Enterprise actions pursuant to delegated authority, including actions taken by the Enterprises to implement conservatorship directives, or the adequacy of director oversight of management actions.

FHFA also has not clearly defined its expectations of the Enterprises for delegated matters, nor has it established the accountability standard that it expects the Enterprises to meet for such matters. Our work identified that internal control systems at the Enterprises were ineffective: they failed to provide directors with accurate, timely, and sufficient information to enable them to exercise their oversight duties. Likewise, we identified a lack of rigor by some directors in seeking information from management about the matters for which they are responsible. We also identified instances in which corporate governance decisions generally reserved to the board of directors have been delegated to management.

Over the past five years, FHFA-OIG's work has found that FHFA has retained authority (or has revoked previously delegated authority) to resolve issues of significant monetary and/or reputational value. FHFA has established written internal review and approval processes for non-delegated matters, designed to provide a consistent approach for tracking, analyzing and resolving such matters and for providing decision-makers with all relevant facts and existing analyses. However, as our work during FY 2019 demonstrated, the former FHFA Director overrode those controls when considering both Enterprises' requests for approval of their respective succession plans. As we recognized, the FHFA Director was authorized, under HERA, to override the controls. However, we found that his override created an information vacuum within FHFA's Division of Conservatorship and rendered it unable to execute its responsibilities.

After the Agency received our reports and adopted our recommendations, it advised us that its system for maintaining and monitoring sensitive requests had been modified. Under the new record keeping process for sensitive requests, documents submitted by the Enterprises and internal FHFA records that are associated with such requests would be stored in a separate system with restricted access.

As the Enterprises' conservator, FHFA is ultimately responsible for actions taken by the Enterprises, pursuant to authority it has delegated to them. FHFA's challenge, therefore, is to improve the quality of its oversight of matters it has delegated to the Enterprises for the duration of the conservatorships and ensure that its established processes are followed for non-delegated matters to promote reasoned decision-making.

Select FHFA-OIG Report Issued During FY 2019 on Delegated Matters:

- *Special Report on the Common Securitization Platform: FHFA Lacked Transparency and Exercised Inadequate Oversight over a $2.13 Billion, Seven-Year Project* (OIG-2019-005, March 29, 2019).

Select FHFA-OIG Reports Issued During FY 2019 on Non-Delegated Matters:

- *FHFA's Approval of Senior Executive Succession Planning at Freddie Mac Acted to Circumvent the Congressionally Mandated Cap on CEO Compensation* (EVL-2019-002, March 26, 2019).
- *FHFA's Approval of Senior Executive Succession Planning at Fannie Mae Acted to Circumvent the Congressionally Mandated Cap on CEO Compensation* (EVL-2019-001, March 26, 2019).

Challenge: Upgrade Supervision of the Enterprises and Continue Supervision Efforts of the FHLBanks

As supervisor of the Enterprises and the FHLBanks, FHFA is tasked by HERA 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. Examinations of its regulated entities are fundamental to FHFA's supervisory mission. Within FHFA, the Division of Federal Home

Loan Bank Regulation (DBR) is responsible for supervision of the FHLBanks, and the Division of Enterprise Regulation (DER) is responsible for supervision of the Enterprises.

The Treasury Plan asserts:

> FHFA has relied primarily on its **conservatorship authorities** to oversee the safety and soundness of the GSEs over the last 11 years. With the end of the conservatorship, FHFA will instead rely on its supervisory and regulatory authorities, which include authorities to conduct examinations of the GSEs. FHFA could determine that it should specify conditions with respect to the hiring and training of examiners or other aspects of the buildout of its supervisory function. (Emphasis added.)

That assertion is at odds with representations made by FHFA in its annual Performance and Accountability Reports in which FHFA invoked its supervisory authority as its basis to ensure safe and sound operation of the Enterprises.[4] According to FHFA, its mission:

> [I]s to ensure that the regulated entities operate in a safe and sound manner so they serve as a reliable source of liquidity and funding for housing finance and community investment. FHFA uses its **supervisory program** to promote safe and sound operations. The supervisory program employs a risk-based approach to supervisory examinations, prioritizing examination activities based on the risk a given practice poses to a regulated entity's safe and sound operation or to its compliance with applicable laws and regulations. (Emphasis added.)

Until the issuance of the Treasury Plan, FHFA has consistently asserted in public statements that it relies on its supervisory authority, not its conservatorship powers, to ensure that the Enterprises operate in a safe and sound manner. During the course of our work, we have repeatedly noted that FHFA administers its supervision program of the Enterprises through DER.

The Treasury Plan contemplates that FHFA intends to "build out" FHFA's existing supervision program of the Enterprises. Further, FHFA has stated that its top priorities include "cement[ing] FHFA as a world-class regulator and [ ] restor[ing] Fannie Mae and Freddie Mac…to safe and sound condition by building capital to match their risk profiles." However, as demonstrated by many of our more than 40 related audits, evaluations, and compliance reports issued since October 2014, FHFA's existing supervision program for the Enterprises is materially deficient and its supervisory guidance falls short of the guidance issued by the Board of Governors of the Federal

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[4] FHFA, *FY2018 Performance and Accountability Report* at 10 (November 15, 2018); see also FHFA, *FY2017 Performance and Accountability Report* at 9 (Nov. 15, 2017), FHFA, *FY2016 Performance and Accountability Report* at 10 (Nov. 15, 2016), and FHFA, *FY2015 Performance and Accountability Report* at 55 (Nov. 16, 2015).

Reserve System, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation.

The shortcomings identified in these reports, coupled with the Agency's repeated failures to address previously identified shortcomings in a timely manner, suggests that significant efforts will be needed to cure previously identified deficiencies and develop and implement a comprehensive and effective supervision program for the Enterprises on par with FHFA's peer financial regulators. Only by undertaking these significant efforts will it be possible to succeed in turning FHFA into "a world-class regulator."

The magnitude of the risk posed by the Enterprises is significantly greater than the magnitude of the risk posed by the FHLBanks and the Office of Finance together because the asset size of the latter is a fraction of the asset size of the former. For that reason, the majority of FHFA-OIG's work on supervision issues has focused on FHFA's supervision of the Enterprises. However, we also looked at elements of FHFA's supervision program for the FHLBanks. While our reports of that work identified some shortcomings, they did not identify significant weaknesses. Like any other federal financial regulator, FHFA faces challenges in appropriately tailoring and keeping current its supervisory approach to the FHLBanks.

Select FHFA-OIG Reports Issued During FY 2019 on Supervision Matters:

- *FHFA's Completion of Planned Targeted Examinations of Freddie Mac Improved from 2016 through 2018, But Timeliness Remained an Issue* (AUD-2019-013, September 17, 2019).
- *FHFA's Completion of Planned Targeted Examinations of Fannie Mae Improved from 2016 through 2018, But Timeliness Remained an Issue; With the June 2019 Issuance of the Single Security, FHFA Should Reassess its Supervision Framework for CSS* (AUD-2019-012, September 17, 2019).
- *Five Years After Issuance, Many Examination Modules Remain in Field Test; FHFA Should Establish Timelines and Processes to Ensure Timely Revision of Examiner Guidance* (EVL-2019-003, September 10, 2019).
- *Compliance Review of FHFA's Commitment to Evaluate Its Internal Quality Control Reviews Pertaining to Matters Requiring Attention* (COM-2019-007, September 9, 2019).
- *FHFA Conducted BSA/AML Program Examinations of 10 of 11 Federal Home Loan Banks During 2016-2018 in Accordance with its Guidelines, But Failed to Support a Conclusion in the Report of Examination for the Other Bank* (AUD-2019-008, July 10, 2019).

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

Cybersecurity, as defined by the National Institute of Standards and Technology, is "the process of protecting information by preventing, detecting, and responding to attacks." In May 2017, President Trump issued an executive order to strengthen the cybersecurity of federal networks and critical infrastructure. The Financial Stability Oversight Council (FSOC), of which FHFA is a member, later reported:

> The financial system's increasing reliance on information technology, particularly across a broader array of interconnected platforms, increases the risk that a cybersecurity event could have severe negative consequences for the provision of financial services. . . . Sustained senior-level attention on cybersecurity risks and their potential systemic implications is necessary.[5]

FHFA's regulated entities are central components of the U.S. financial system and are interconnected with other large financial institutions. As part of their processes to guarantee or purchase mortgage loans, the Enterprises receive, store, and transmit significant information about borrowers, including financial data and personally identifiable information. Both the Enterprises and the FHLBanks have been the targets of cyberattacks. FHFA acknowledges that its regulated entities face significant cybersecurity risks, and the Agency understands its responsibility to provide effective oversight of the Enterprises' management of cybersecurity risks.

As cyberthreats and attacks at financial institutions increase in number and sophistication, FHFA faces challenges in designing and implementing its supervisory activities for the financial institutions it supervises. These supervisory activities may be made increasingly difficult by FHFA's continuing need to attract and retain highly-qualified technical personnel, with expertise and experience sufficient to handle rapid developments in technology.

FHFA issued an examination module for cybersecurity examinations for field testing in 2017, but never finalized it. The Agency advised us that this module continues to be revised. FHFA will be challenged to ensure that it: (1) completes its revised examination module and ensures that it reflects current challenges in the cybersecurity environment; (2) provides written guidance and training to examiners to aid them in their supervision of information technology and information security issues; (3) recruits and retains, or otherwise contracts for, a sufficient complement of examiners with the experience and expertise needed to conduct detailed examinations of information systems; (4) completes the planned supervisory activities in a timely matter; and (5) collects and analyzes sufficient data to understand the cybersecurity threats affecting its regulated entities.

Select FHFA-OIG Reports Issued During FY 2019 on Supervision of Cybersecurity Matters:

- *FHFA Should Enhance Supervision of its Regulated Entities' Cybersecurity Risk Management by Obtaining Consistent Cybersecurity Incident Data* (EVL-2019-004, September 23, 2019).

[5] FSOC, *2018 Annual Report* at 7 (Updated June 20, 2019).

- *Compliance Review of DBR's Examinations of Critical Cybersecurity Controls at the Federal Home Loan Banks* (COM-2019-004, May 7, 2019).

FHFA is one of a number of federal agencies involved in a national effort to protect the critical infrastructure of the U.S. financial services sector. Computer networks maintained by federal government agencies have been proven to be a tempting target for disgruntled employees, hackers, and other intruders. Over the past few years, cyber attacks against federal agencies have increased in frequency and severity. As cyber attacks continue to evolve and become more sophisticated and harder to detect, they pose an ongoing challenge for virtually every federal agency to fortify and safeguard its internal systems and operations.

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 2019 privacy program and concluded that FHFA had generally implemented effective privacy and data protection policies and procedures in accordance with law, regulation, and policy.

Equally important is the protection of its computer network operations that are part of the nation's critical financial infrastructure. FHFA is required to design information security programs to protect its computer networks. Our annual audits performed pursuant to the Federal Information Security Modernization Act of 2014 (FISMA) are intended to ensure FHFA's compliance with those standards and assist FHFA in strengthening protections over its network operations against those who would seek to attack its network. For Fiscal Year 2018, an independent public accounting firm under contract with FHFA-OIG determined that FHFA's information security program and practices were operating effectively, in compliance with FISMA, Office of Management and Budget guidance, and sampled security controls selected from National Institute of Standards and Technology Special Publication 800-53, Revision 4, *Security and Privacy Controls for Federal Information Systems and Organizations*.

The annual FISMA audit does not include penetration testing of FHFA's network and systems. So, during the past fiscal year, we performed internal and external penetration tests of FHFA's network and systems to determine whether FHFA's security controls were effective to protect its network and systems against internal and external threats. These audits identified a number of deficiencies. For example, without detection, we were able to access FHFA's internal network and run scans of its servers to search for vulnerabilities. We were also able to collect sensitive information, without detection. The deficiencies identified by these audits, if not remediated, pose serious risk to FHFA's network, systems, and information. FHFA management agreed to the recommendations we made to address the identified deficiencies, and has already taken corrective action on some, but continued management attention and action is required to ensure that FHFA's security controls protect its network and systems against internal and external threats.

FHFA, like other federal agencies, faces challenges in enhancing its information security programs, ensuring that its internal and external online collaborative environments are restricted to those with a need to know, and ensuring that its third-party providers meet information security program requirements.

Select FHFA-OIG Reports Issued During FY 2019 on FHFA's Internal Controls Over Information Technology:

- *2019 Internal Penetration Test of FHFA's Network and Systems* (AUD-2019-014, September 24, 2019).
- *Audit of the Federal Housing Finance Agency's 2019 Privacy Program* (AUD-2019-009, August 28, 2019).
- *External Penetration Test of FHFA's Network and Systems During 2018* (AUD-2019-003, February 11, 2019).
- *Performance Audit of the Federal Housing Finance Agency's Information Security Program Fiscal Year 2018* (AUD-2019-001, October 24, 2018).

Challenge: Enhance Oversight of the Enterprises' Relationships with Counterparties and Third Parties

The Enterprises rely heavily on counterparties and third parties to properly originate and service the mortgages the Enterprises purchase and third parties to provide operational support for a wide array of professional services. As the Enterprises and FHFA recognize, that reliance exposes the Enterprises to a number of risks, including the risk that a counterparty will not meet its contractual obligations, and the risk that a counterparty will engage in fraudulent conduct. As FSOC has cautioned:

> Reliance by financial institutions on third parties to provide important operational functions has increased over the past several years. With the adoption of fintech innovations and the proliferation of large data sets, some financial institutions have outsourced portions of certain operational functions and data gathering requirements. . . . They are also using outside cloud computing services to supplement existing technology infrastructures for data storage, redundancy, and computational capacity. These services have information and cost benefits, but relying on outside firms for critical data and services also creates risks.[6]

FHFA has delegated to the Enterprises the management of their relationships with counterparties and third parties, and reviews their management largely through its supervisory activities. FHFA has acknowledged that "from a risk perspective there are some key differences between banks and non-banks that we need to address in a responsible way."[7]

[6] *Id.* at 91.
[7] FHFA, *Prepared Remarks of Dr. Mark A. Calabria, Director of FHFA, at 2019 Ginnie Mae Summit.*

Our publicly reportable criminal investigations include inquiries into alleged fraud by a variety of counterparties, including real estate brokers and agents, builders and developers, loan officers and mortgage brokers, and title and escrow companies.

In light of the financial, governance, and reputational risks arising from the Enterprises' relationships with counterparties and third parties, FHFA is challenged to effectively oversee the Enterprises' management of risks related to their counterparties and third parties.

Select FHFA-OIG Reports Issued During FY 2019 on FHFA's Oversight of the Enterprises' Relationships with Counterparties and Third Parties:

- *Compliance Review of FHFA's Suspended Counterparty Program* (COM-2019-002, January 25, 2019).

Management Concern: Sustain and Strengthen Internal Controls Over Agency and Enterprise Operations

FHFA's programs and operations are subject to legal and policy requirements common to federal agencies. Satisfying such requirements necessitates the development and implementation of, and compliance with, effective internal controls within the Agency.

As described in the Government Accountability Office's *Standards for Internal Control in the Federal Government*, "change can often be overlooked or inadequately addressed in the normal course of operations…. Changes in conditions affecting the entity and its environment often require changes to the entity's internal control system, as existing controls may not be effective for meeting objectives or addressing risks under changed conditions…. Further, changing conditions often prompt new risks or changes to existing risks that need to be assessed."

Our work demonstrates that FHFA is challenged to ensure that its existing controls, including its written policies and procedures, are sufficiently robust, and its personnel are adequately trained on these internal controls and comply fully with them.

Both the Agency and the Enterprises have also undergone significant leadership changes. In January 2019, Director Watt ended his term as FHFA Director, and FHFA now has a new Director and a new senior leadership team. Both Enterprises have new Chief Executive Officers. In addition, the terms of a number of Enterprise directors expired by year end 2018; Fannie Mae and Freddie Mac each added three new directors in 2019.

Changes in leadership can lead to a shift in resources away from implementing internal controls to new initiatives.

Select FHFA-OIG Reports Issued During FY 2019 on FHFA's Internal Controls over Agency Operations:

- *FHFA Should Name an Ombudsman and Document the Office of the Ombudsman's Procedures* (AUD-2019-011, September 16, 2019).

- *FHFA Must Strengthen its Controls over the Hiring of Pathways Interns to Prevent the Improper Hiring of Relatives of Agency Employees* (OIG-2019-004, March 26, 2019).
- *FHFA's Offboarding Controls over Access Cards, Sensitive IT Assets, and Records Were Not Always Documented or Followed During 2016 and 2017* (AUD-2019-004, March 13, 2019).

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For the coming year, our audits, evaluations, compliance reviews, and other work will focus on the challenges highlighted in this memorandum. Included in these efforts will be verification testing on closed recommendations to independently determine whether FHFA has implemented in full the corrective actions it represented to us that it intended to take and following up on open recommendations.

cc: Christopher Bosland, Senior Advisor for Regulation
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