OFFICE OF INSPECTOR GENERAL
Federal Housing Finance Agency
400 7th Street SW, Washington, DC 20219

October 15, 2021

TO: Sandra L. Thompson, Acting Director

FROM: Phyllis K. Fong, Acting Inspector General

SUBJECT: Fiscal Year 2022 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), in which the Office of Inspector General (OIG) for the Federal Housing Finance Agency (FHFA or Agency) identifies the most serious management and performance challenges facing the Agency. We have identified four serious management and performance challenges, as well as one management concern, facing the Agency, representing what OIG believes to be the areas that, if not addressed, are most likely to hinder the Agency's accomplishment of its mission.

FHFA was created in July 2008 by the Housing and Economic Recovery Act of 2008 (HERA). HERA charged FHFA to serve as regulator and supervisor of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, Enterprises); Common Securitization Solutions, LLC (CSS), an affiliate of the Enterprises; the Federal Home Loan Banks (FHLBanks) (collectively, the regulated entities); and the FHLBanks' fiscal agent, the Office of Finance. HERA also granted the director of FHFA the discretionary authority to appoint the Agency as conservator of the regulated entities upon determining that any of the entities were in an unsafe or unsound condition or met other criteria. On September 6, 2008, the then-acting director of FHFA exercised this authority and placed Fannie Mae and Freddie Mac into conservatorships. Over 13 years later, both Enterprises remain in conservatorship.

The challenges identified in this memorandum are longstanding and remain unchanged from the last several years. FHFA's dual roles as supervisor for the Enterprises and the FHLBanks and as conservator of the Enterprises continue to present unique challenges. As supervisor, FHFA has a statutory duty to ensure that its regulated entities operate in a safe and sound manner. As conservator for the Enterprises, FHFA is directly involved in certain business and personnel decisions that are subject to supervisory oversight by FHFA and, if warranted, could be the subject of adverse examination findings. Additionally, as a supervisor of complex financial institutions, FHFA faces challenges in the areas of cybersecurity and counterparty and third-party risk. Over the last several years, FHFA also has not ensured that all of its existing controls are sufficiently robust or fully complied with by personnel.

Our audits, evaluations, and other reports continue to examine these areas. Where we have identified shortcomings or weaknesses, we have proposed recommendations to address them. Where we have confirmed that the Agency has adhered to the applicable criteria or implemented actions that satisfy our recommendations, we note that in our reports. FHFA has accepted some of our recommendations and rejected others. We issue on a regular basis a Compendium of Open Recommendations, organized by the specific risk to be mitigated. Therefore, this document does not repeat each of the findings and recommendations in our reports.

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

As HERA recognizes, FHFA's supervision of the Enterprises is of paramount importance to their safe and sound operation. History has shown that a precipitous decline in the Enterprises' safety and soundness contributed to a severe crisis in the national economy and required nearly $200 billion in taxpayer support to keep them afloat. For these reasons, we have deemed FHFA's supervision of the Enterprises – via the Agency's Division of Enterprise Regulation (DER) – to be one of four critical risks on which we have focused our oversight efforts. Since October 2014, we have issued more than 50 reports on FHFA's supervision program for the Enterprises, each of which was conducted in accordance with applicable professional standards. More than 40 of these reports, taken collectively, detailed chronic and pervasive deficiencies in the supervision program itself, as well as in its execution.

Based on our assessments of different elements of DER supervision program, in fiscal year (FY) 2017 we identified four themes among the weaknesses we observed and published them in a roll-up report. Almost five years later, our audits and evaluations conducted during FY 2021 continue to find deficiencies that fall under those themes, as well as additional shortcomings in FHFA's supervision program of the Enterprises. The four recurring themes are:

1. FHFA lacks adequate assurance that DER's supervisory resources are devoted to examining the Enterprises' highest risks.
2. FHFA and DER supervisory standards and guidance lack the rigor of those issued by other federal financial regulators.
3. FHFA and DER requirements and guidance result in inconsistent supervisory practices because they are more flexible and less prescriptive than those of other federal financial regulators.
4. DER examiners-in-charge and subordinate examiners did not follow requirements and guidance consistently for specific elements of DER's supervisory program where clear requirements and guidance did exist.

A new Deputy Director and Associate Director of DER were appointed in early 2020. We recognized in our March 2020 roll-up report that the new DER leadership, hired from outside

FHFA, would need to assess DER's supervision program and formulate and implement plans to meaningfully remediate the deficiencies we identified in its supervision program. However, our recent work established that there still remains much to do to address these issues. Further, DER's leadership recently changed again: effective September 20, 2021, FHFA appointed the Deputy Director of its Division of Bank Regulation as the new Deputy Director of DER and made other personnel changes within the division. Regardless of who leads DER, success remediating the weaknesses in DER's supervision program will require a sustained, disciplined, and robust effort on FHFA's part, led by an accountable senior executive. This will entail diligent project management, including the establishment of clear roles and responsibilities, work product deliverables, milestones, and specific timelines.

At the time of our FY 2017 roll-up report and the identification of the four themes listed above, we cautioned that "[w]ithout prompt and robust Agency attention to address the shortcomings we have identified," the "safe and sound operation of the Enterprises cannot be assumed from FHFA's current supervisory program." Given that our work continues to find these same shortcomings, we continue to believe that upgrading the Enterprise supervision program – and thereby addressing the identified deficiencies effectively – is a critical challenge facing the Agency.

Select OIG Reports Issued During FY 2021 on Supervision Matters:

FHFA's Use of its Enterprise Examination Manual, in Practice, Does Not Align with its Goal of Promoting a Consistent Examination Approach or Meet Management's Expectations, AUD-2021-013, September 28, 2021

FHFA's Failure to Use its Prudential Management and Operations Standards as Criteria for Supervision of the Enterprises Is Inconsistent with the FHFA Director's Statutory Duty to Ensure the Enterprises Comply with FHFA's Guidelines, OIG-2021-004, September 20, 2021

FHFA Must Resolve the Conflicts in its Guidance for Examinations of the Enterprises to Meet its Commitment to Develop and Maintain a World Class Supervision Program, OIG-2021-003, September 1, 2021

FHFA's Failure to Define and Clearly Communicate "Supervisory Concerns" Hinders the Enterprise Boards' Ability to Execute Their Oversight Obligations Under FHFA's Corporate Governance Regulation and Renders the Regulation Ineffective as a Supervisory Tool, EVL-2021-003, March 30, 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

Challenge: Improve Oversight of Conservator Operations

As conservator, FHFA is vested with express authority under HERA to operate the Enterprises, including expansive authority over trillions of dollars in assets and billions of dollars in revenue. FHFA also makes business and policy decisions that influence the entire mortgage finance industry. Given the taxpayers' enormous investment in the Enterprises, the conservatorships' unknown duration, the Enterprises' critical role in the secondary mortgage market, and their unknown ability to sustain future profitability, OIG determined that FHFA's administration of the conservatorships has been, and continues to be, a critical risk.

For reasons of efficiency, concordant goals with the Enterprises, and operational savings, FHFA has delegated authority for general corporate governance and day-to-day matters to the Enterprises' boards of directors and executive management. FHFA, as conservator, delegated to each Enterprise's board of directors a significant portion of day-to-day management and risk controls responsibilities. FHFA's regulations also authorize the boards to delegate execution of day-to-day operations to Enterprise employees. As conservator, FHFA has retained authority to decide specific issues and can, at any time, revoke previously delegated authority.

FHFA's governance regulations charge the Enterprises with establishing and administering "a written code of conduct and ethics that is reasonably designed to assure that its directors, officers, and employees discharge their duties and responsibilities in an objective and impartial manner." The foundation of corporate governance is the effort to recognize and mitigate conflicts of interest (COIs). Because both real and apparent COIs severely threaten the reputation and credibility of corporations, corporations impose structures and mechanisms that set forth the obligations of employees and directors to disclose situations that may present an actual or apparent COI and assign responsibility to resolve potential COIs to compliance officers and board committees.

Since 2017, we have published several reports on corporate governance which found various deficiencies relating to COIs, including but not limited to failures by a former Fannie Mae Chief Executive Officer (CEO) to timely and fully disclose potential COIs, as well as breakdowns in oversight by the Fannie Mae board and its committee tasked with resolving potential COIs. In an FY 2021 evaluation, we assessed whether Fannie Mae and its senior executive officers complied with certain governance documents related to COIs, and found a mixed record. Fannie Mae's CEO sometimes failed to make timely COI disclosures in contravention of an FHFA Directive and governance documents. Two other very senior Fannie Mae executive officers also failed to make timely disclosures in two instances, one involving a personal friendship with a contractor to whom Fannie Mae awarded approximately $25 million in contracts. We also found that sometimes Fannie Mae's ethics office substituted its own judgment for that of the Board committee tasked with resolving potential COIs. These findings lead us to continue to believe that the Agency's oversight of delegated functions remains a management challenge.

Unlike with COI matters, which have been delegated to the Enterprises to handle, the Agency has developed a process for reviewing and approving matters over which it has retained authority. One such area is the approval of compensation actions for Enterprise senior executive officers. In a 2019 evaluation, we found that a former FHFA Director overrode the Agency's internal control for approving conservator requests by reviewing and approving an Enterprise transition plan himself, without any staff analysis or recommendation, and found that FHFA's approval of the plan acted to circumvent the congressionally mandated cap on CEO compensation. We also found that the former FHFA Director's decision to approve the plan in a manner which violated established internal controls created an information vacuum within the particular FHFA office tasked with overseeing the conservatorship, and thereby rendered that office unable to execute its responsibilities. To address these deficiencies we made two recommendations, the second of which was to establish a process for maintaining and monitoring sensitive conservator requests in the Agency's conservator Status Tracking and Reporting System. An FY 2021 compliance review found that FHFA's corrective actions complied with our recommendation.

Select OIG Reports Issued in FY 2021 on Delegated Matters:

Corporate Governance: Fannie Mae Senior Executive Officers and Ethics Officials Again Failed to Follow Requirements for Disclosure and Resolution of Conflicts of Interest, Prompting the Need for FHFA Direction, EVL-2021-001, March 15, 2021

Select OIG Reports Issued in FY 2021 on Non-Delegated Matters:

Compliance Review of FHFA's Handling of Fannie Mae's Confidential Conservator Requests, COM-2021-006, July 21, 2021

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

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 highly sensitive private information about borrowers, including financial data and personally identifiable information. Both the Enterprises and the FHLBanks have been the targets of cyberattacks. FHFA has assessed that the Enterprises and their affiliated entity, CSS, have high inherent operational risk because of, among other things, continually evolving information security and cybersecurity risks, and recognizes that risks related to business resiliency and disaster recovery remain key management concerns for both Enterprises. Similarly, FHFA examiners identified areas that exhibited or could exhibit unacceptable operational risks in business resiliency and information security at some FHLBanks.

The Financial Stability Oversight Council (FSOC), of which FHFA is a member, has recognized the cybersecurity risk for its member agencies and recommends sustained, senior-level commitment to mitigate such risk and its potential systemic implications. According to FSOC, the COVID-19 pandemic may accelerate financial institutions' reliance on information technology through expanded use of teleworking systems and dual work locations, which may increase the risk that a cybersecurity incident may have severe consequences for those institutions.[1] FSOC has also recognized that a destabilizing cybersecurity incident could potentially threaten the U.S. financial system's stability in several ways, such as by disrupting a key financial service. FHFA officials have recognized this risk, explaining that if a cybersecurity

[1] FSOC, *2020 Annual Report* at 8-9.

incident hinders the Enterprises' ability to perform their essential functions, there could be not only a huge immediate impact on the mortgage finance industry and mortgage liquidity gridlock, but also severe consequences for the financial services industry, homeowners, and investors.

Our annual audits performed pursuant to the Federal Information Security Modernization Act of 2014 (FISMA) are intended to ensure FHFA's compliance with information security program standards and assist FHFA in strengthening protections over its network operations against those who would seek to attack its network. For FY 2021, an independent public accounting firm under contract with OIG determined that FHFA implemented an effective information security program and complied with FISMA and related information security policies and procedures, standards, and guidelines.

In addition to the annual FISMA audit, we audit the Agency's information security controls. During FY 2021, we performed an audit that found that FHFA had not recorded, tracked, or reported all security incidents to US-CERT. Specifically, we found that FHFA did not maintain complete records of incidents and lacked written procedures for recording, tracking, or reporting security incidents. We also assessed whether a sample of FHFA employees and contractors followed a requirement in the FHFA Information System Rules of Behavior to report an apparent data breach, and found that a significant percentage of them did not do so. In another audit, we found that an internal system was impacted by security control weaknesses.

Select OIG Reports Issued during FY 2021 on FHFA's Internal Controls Over Security:

Audit of the Federal Housing Finance Agency's Information Security Program, Fiscal Year 2021, AUD-2022-001, October 15, 2021

FHFA Did Not Record, Track, or Report All Security Incidents to US-CERT; 38% of Sampled FHFA Users Did Not Report a Suspicious Phone Call Made to Test User Awareness of its Rules of Behavior, AUD-2021-009, June 25, 2021

Audit of an FHFA Sensitive Employment-Related Case Tracking System: FHFA Followed its Access Control Standard, but its System is Adversely Impacted by Two Security Control Weaknesses, AUD-2021-006, March 29, 2021

Challenge: Enhance Oversight of the Enterprises' Management of Counterparty and Third-Party Risk

The Enterprises rely on institutional counterparties such as sellers and servicers, mortgage insurers, clearinghouses, and other counterparties to provide services that are critical to their business. By doing so, they must account for and mitigate potential counterparty credit risk, which is the risk associated with the inability or failure of a counterparty to meet its contractual obligations. The Enterprises and FHFA recognize that such risk is significant. If an institutional counterparty defaults on its obligations, it could negatively impact an Enterprise's ability to operate. Our publicly reportable criminal investigations include alleged fraud by different types of counterparties, including real estate brokers and agents, builders and developers, loan officers and mortgage brokers, and title and escrow companies. The Enterprises and FHFA also recognize that third parties that provide operational support for a wide array of professional services could also negatively impact an Enterprise's ability to operate.

According to Fannie Mae, the economic dislocation caused by the COVID-19 pandemic could lead one or more of its institutional counterparties to default on obligations to the Enterprise, which could result in significant financial losses. Fannie Mae also recognizes that if multiple single-family or multifamily servicers were to fail to meet their obligations, it could cause substantial disruption to the Enterprise's business, borrowers, and the mortgage industry.

FHFA lacks the statutory authority to directly examine the Enterprises' counterparties and third parties, so it has communicated to the Enterprises its expectations of their oversight of those entities. It also may examine the effectiveness of the Enterprises' oversight. However, an OIG audit this year found that FHFA did not complete any targeted examination of Fannie Mae's third-party risk management program over a seven-year period, notwithstanding the known significant operational risk associated with counterparties.

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

Select OIG Reports Issued During FY 2021 and FY 2021 Results from an OIG Criminal Investigation on Counterparty and Third-Party Matters:

FHFA's Division of Enterprise Regulation Did Not Follow or Train to its Procedures for Information Sharing of Enterprise Counterparty Performance Issues, AUD-2021-014, September 28, 2021

Despite FHFA's Acknowledgement that Enterprise Reliance on Third-Parties Represents a Significant Operational Risk, No Targeted Examinations of Fannie Mae's Third-Party Risk Management Program Were Completed Over a Seven-Year Period, AUD-2021-007, March 29, 2021

Compliance Review of FHFA's Suspended Counterparty Program, COM-2021-008, August 25, 2021

Update on Mortgage Insurers as Enterprise Counterparties, WPR-2021-001, March 8, 2021

Former President of First Mortgage Company Pleads Guilty to Bank Fraud, Money Laundering, and False Statements to a Financial Institution, Press Release, May 11, 2021

Management Concern: Sustain and Strengthen Internal Controls Over Agency Operations, Including Workforce Planning

FHFA's programs and operations are subject to legal and policy requirements common to federal agencies. Satisfying such requirements necessitates developing, implementing, and complying with effective internal control within the Agency. In our work over the last several years, OIG has found that the Agency has not ensured that all of its existing controls, including policies and procedures, are sufficiently robust, nor that its personnel comply fully with them. As examples, during the last year, an audit found that FHFA lacked documentation that showed it followed procedures to validate certain data used to produce an FHFA Housing Price Index used to set the conforming loan limit for the Enterprises. Another audit found exceptions related to (1) recommendation and approval requirements for monetary awards and (2) justifications for recruitment bonuses and retention allowances.

As a matter that affects both the Agency's supervision program and internal control, workforce planning is a process for identifying and addressing gaps between an organization's current staff and its future workforce needs. According to the Office of Personnel Management (OPM), workforce planning serves as the foundation for managing an organization's human capital.[2] Similarly, the Government Accountability Office recognizes, in its *Standards for Internal Control in the Federal Government* (also known as the Green Book), that "effective management of an entity's workforce, its human capital, is essential to achieving results and an important part of internal control. Only when the right personnel for the job are on board and are provided the right training, tools, structure, incentives, and responsibilities is operational success possible."

As discussed in our letter last year, in February 2020, OIG reported that FHFA had not engaged in a systematic workforce planning process for DER, notwithstanding its commitment to do so seven years earlier, and we made one recommendation to FHFA to address this shortcoming.[3] In response, FHFA described actions it was taking in conjunction with the realignment of the Agency's structure announced in January 2020. Specifically, FHFA engaged a contractor in May 2020 to prepare "an Organizational Optimization Blueprint, including a human capital management plan, to cement FHFA's position as a world-class regulatory agency and to ensure the agency has the optimal organizational framework to carry out its supervisory mission in a post-conservatorship environment." While FHFA has initiated actions that show promise to address the intent of the recommendation, those actions are in an early state, and we cannot yet determine whether these actions address all aspects of the OIG recommendation. Accordingly, the recommendation remains open. It is critical that FHFA address FHFA-wide organizational workforce issues to ensure the requirements of the Green Book are met.

Effective internal control requires effective leadership. We are mindful that FHFA has also undergone significant leadership changes in the past several years. Most recently, an Acting Director was appointed in June 2021, and several other key senior positions have been filled in an acting capacity. It is important for new leadership to demonstrate a commitment to effective internal control.

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[2] OPM has issued guidance and best practices that provide a framework for effective workforce planning. The OPM framework involves analyzing the mission, vision, and strategic plan for an organization; evaluating the current staff of the organization, including identification of current skills and competencies of the workforce (supply analysis); and forecasting the optimal headcount and competencies needed to meet the needs of the organization in the future (demand analysis). Any gap between supply and demand is evaluated to identify headcount or competency gaps.

[3] *Despite Prior Commitments, FHFA Has Not Implemented a Systematic Workforce Planning Process to Determine Whether Enough Qualified Examiners are Available to Assess the Safety and Soundness of Fannie Mae and Freddie Mac*, AUD-2020-004, Feb. 25, 2020.

Select OIG Reports Issued During FY 2021 on Internal Controls over Agency Operations:

FHFA Did Not Follow its Interim Directive on a Requirement to Use a FAR Clause Intended to Protect Whistleblower Rights of Contractor Employees, But Has Since Taken Corrective Action, AUD-2021-015, September 30, 2021

FHFA Lacked Documentation of its Validation of Data Used to Produce the Third Quarter 2020 Seasonally Adjusted, Expanded-Data FHFA HPI and Failed to Timely Review its Information Quality Guidelines, AUD-2021-010, July 7, 2021

FHFA Did Not Always Follow its Policies for Monetary Awards, Recruitment Bonuses, and Retention Allowances during Fiscal Years 2019 and 2020; FHFA's Excellence Awards Were Not Included in Agency Policy, AUD-2021-008, June 17, 2021

FHFA Followed OMB Guidance in Implementing its Enterprise Risk Management Program But its 2020 Risk Profile Failed to Identify a Significant Action Underway to Address Acknowledged Supervision Risk, AUD-2021-004, May 17, 2021

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