Federal Housing Finance Agency
Office of Inspector General

FHFA's Supervisory Planning Process for the Enterprises: Roughly Half of FHFA's 2014 and 2015 High-Priority Planned Targeted Examinations Did Not Trace to Risk Assessments and Most High-Priority Planned Examinations Were Not Completed

Audit Report • AUD-2016-005 • September 30, 2016

AUD-2016-005

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Executive Summary

The Federal Housing Finance Agency (FHFA or the Agency) is responsible for, among other things, ensuring that the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (together, the Enterprises) operate in a safe and sound manner.

Like other federal financial regulators, FHFA maintains that it uses a risk-based approach for its supervisory activities. Supervision by risk requires a comprehensive, risk-focused view of each regulated entity so that supervisory activities can be tailored to the risks with the highest supervisory concerns. According to FHFA's *Examination Manual*, risk assessments provide the critical foundation for developing annual supervisory plans for the entities it regulates. FHFA examiners are then able to leverage their resources by focusing their supervisory activities around the risks identified as posing the highest supervisory concerns in the risk assessments.

FHFA's Division of Enterprise Regulation (DER) is responsible for the supervision of the Enterprises. Led by an Examiner-in-Charge (EIC), a core team of DER examiners is assigned to conduct supervisory activities for each Enterprise. Each DER core team prepares a number of semiannual risk assessments for each Enterprise that, according to FHFA, should reflect an updated view of risk based upon supervisory activities conducted in the first half of the year and potentially other changes in risk caused by the external environment. Using these risk assessments, each DER core team should develop an annual supervisory plan for the respective Enterprise. The annual supervisory plan identifies all planned supervisory activities – ongoing monitoring and targeted examinations – of selected areas of high importance or risk.

The FHFA Office of Inspector General's (OIG) February 2016 Audit and Evaluation Plan identified FHFA's supervision of its regulated entities as a significant risk area. Earlier this year, we compared the risk assessment requirements and guidance from three mature federal financial regulators to FHFA's requirements and guidance and found that FHFA fell short of the standards used by other federal financial regulators. Among other things, we showed that FHFA's "loosely defined parameters lack standardized measures of risks," "do not define the risk measures that examiners must use," and "do not require examiners to use a common format and common, defined measures of risk." We further found:

> [t]he absence of minimum required standards for risk assessments combined with the broad discretion granted to examiners-in-charge and exam managers to select and define

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> risk measures has resulted in a lack of consistency in defining significant risks and identifying supervisory concerns in risk assessments for an Enterprise over a period of years. The significant variability in risk assessments for an Enterprise limits their utility in development of a risk-based supervisory plan.

In response to our recommendations to improve the preparation of risk assessments, DER issued internal guidance in May 2016 to improve consistency of definitions and use of key terms and risk measures and prescribed specific documentation and approval requirements to apply to mid-year risk assessments. Further, FHFA senior leadership recently explained to us that FHFA plans to assess the effectiveness of the enhanced risk assessment procedures in the first quarter of 2017 before mid-year risk assessments for 2017 are prepared.

Beginning in October 2015, significantly prior to the issuance of DER's internal guidance, we decided to build upon our evaluation work by conducting this audit to determine whether DER (1) supported its 2014 and 2015 high-priority planned targeted examinations identified in its annual supervisory plans with risk assessments and completed those planned high-priority examinations; (2) performed its planned targeted examinations for Fannie Mae from 2012 through 2015 and, if it did not, whether FHFA documented the deviations from its plan in accordance with policies and procedures; and (3) performed its planned targeted examinations for Freddie Mac from 2012 through 2015 and, if it did not, whether FHFA documented the deviations from its plan in accordance with policies and procedures. We are issuing three reports from this audit today.

This report, the first of three, analyzes whether the high-priority planned targeted examinations identified by DER in its annual supervisory plans for 2014 and 2015 for each Enterprise were supported by risk assessments and whether those planned high-priority targeted examinations were completed. We found that 61 high-priority targeted examinations were planned for the Enterprises for 2014 and 2015. Of these, we were able to trace 32 to different DER risk assessments but were unable to trace the remaining 29, almost half of the total, to specific risks described in the underlying risk assessments. We asked the then-current EIC for each Enterprise to explain the reason that each high-priority planned targeted examination identified in the annual supervisory plans could not be traced to an underlying risk assessment. The EICs reported that they relied on information received from other sources in DER, FHFA employees outside of DER, and sources outside of FHFA, in addition to risk assessments to develop the annual supervisory plan for the Enterprise; however, neither EIC updated the risk assessments, as required by FHFA.

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Of the 61 high-priority targeted examinations planned for the 2014 and 2015 supervisory cycles, DER examiners completed only 25 (41 percent) by June 17, 2016, when our fieldwork ended. Put another way, more than half of the planned high-priority examinations that FHFA identified as the highest risks to the Enterprises, were not completed. For the remaining 36 (59 percent) high-priority targeted examinations planned for those two years: 21 were not conducted (the examinations were either converted to ongoing monitoring, cancelled, or deferred), 8 were commenced but not completed, and DER did not provide any documentation for us to determine the disposition of the other 7.

Our review of DER's documentation found that, as of the end of our fieldwork, DER did not conduct, commenced but did not complete, or failed to provide documentation to show what, if anything, was done for 36 planned high-priority targeted examinations, while DER examiners completed 6 medium-priority planned targeted examinations (1 of the 6 targeted examinations was re-prioritized from medium- to high-priority during the supervisory cycle). In light of FHFA's commitment to risk-based supervision, it is incongruous that DER examiners completed medium-priority targeted examinations while not completing all planned high-priority examinations.

The second and third reports issued from this audit discuss our respective analyses of DER's performance with regard to planned targeted examinations of Fannie Mae and Freddie Mac from 2012 through 2015: *FHFA's Targeted Examinations of Fannie Mae: Less than Half of the Targeted Examinations Planned for 2012 through 2015 Were Completed and No Examinations Planned for 2015 Were Completed Before the Report of Examination Issued* (September 30, 2016) (AUD-2016-006), and *FHFA's Targeted Examinations of Freddie Mac: Just Over Half of the Targeted Examinations Planned for 2012 through 2015 Were Completed* (September 30, 2016) (AUD-2016-007).

Our audit work was hampered by the lack of DER's supervisory documentation, maintained in its official system of record. In our judgment, the lack of such documentation creates a significant risk exposure. This significant risk exposure, coupled with the other deficiencies identified in this audit, threatens FHFA's ability to fulfill its statutory mission to ensure that the Enterprises operate in a safe and sound manner.

We make five recommendations to address the findings identified in this report. In its written comments to our draft report, FHFA stated that it issued internal guidance in May 2016 that FHFA believes confirms its general agreement with four recommendations. FHFA disagreed with one recommendation. FHFA management's comments and our response are provided in the body of this report.

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Key contributors to this report were Robert Taylor, Assistant Inspector General for Audits; Tara Lewis, Audit Director; Terese Blanchard, Senior Auditor; Pamela L. Williams, Auditor; and Julio Santos, Lead Auditor. We appreciate the cooperation of FHFA staff, as well as the assistance of all those who contributed to the preparation of this report.

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

/s/

Marla A. Freedman
Deputy Inspector General for Audits

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ABBREVIATIONS

DER	Division of Enterprise Regulation
EIC	Examiner-in-Charge
Enterprises	Fannie Mae and Freddie Mac
Fannie Mae	Federal National Mortgage Association
FHFA or Agency	Federal Housing Finance Agency
Freddie Mac	Federal Home Loan Mortgage Corporation
IMS	Information Management System
OIG	Federal Housing Finance Agency Office of Inspector General
OPB	Operating Procedures Bulletin

BACKGROUND...

Effective Supervision by FHFA Is Vital to Ensure the Enterprises' Safety and Soundness

FHFA, created by Congress in 2008, is charged by the Housing and Economic Recovery Act of 2008 with, among other things, the supervision of the Enterprises and the Federal Home Loan Banks. Its mission as a federal financial regulator includes ensuring the safety and soundness of its regulated entities so that they serve as a reliable source of liquidity and funding for housing finance and community investment. FHFA's DER is responsible for supervision of the Enterprises. DER has established a core team of examiners for each Enterprise, led by an EIC.

To identify key risks facing the Enterprises, each DER core team prepares a number of semiannual risk assessments for each Enterprise that, according to FHFA's *Examination Manual,* provides the foundation for DER's annual supervisory plans and should reflect an updated view of risk based upon supervisory activities conducted in the first half of the year and potentially other changes in risk caused by the external environment. Using these risk assessments, each DER core team develops an annual supervisory plan for the respective Enterprise. The annual supervisory plan identifies all planned supervisory activities – ongoing monitoring and targeted examinations – of selected areas of high importance or risk. Ongoing monitoring activities are performed to analyze real-time information and to use those analyses to identify Enterprise practices and changes in an Enterprise's risk profile that may warrant supervisory attention. Ongoing monitoring is also "used to determine the status of the Enterprise's compliance with supervisory guidance, MRAs [Matters Requiring Attention], and conservatorship directives." Targeted examinations complement ongoing monitoring: they enable examiners to conduct "a deep or comprehensive assessment" of the areas found to be of high importance or risk.

In this report, we assess whether DER's 2014 and 2015 high-priority targeted examinations identified in the annual supervisory plans for each Enterprise were supported by risk assessments and whether those planned high-priority examinations were completed.

FACTS AND ANALYSIS ....

FHFA's Requirements for Supervisory Planning

FHFA's *Examination Manual,* adopted in December 2013, provides policies and guidance for the Agency's supervisory planning process. According to that *Examination Manual,* FHFA's supervisory activities are to be prioritized based on the risk a given practice poses to the regulated entity's safe and sound operations or its compliance with applicable laws and regulations. In a February 2016 speech, FHFA Director Watt underscored the risk-based focus of DER's supervisory activities:

> Like other federal financial regulators, FHFA conducts safety and soundness supervision with a deliberate distance between FHFA and the Enterprises. Members of our supervision staff, many of whom are located onsite at Fannie Mae and Freddie Mac, conduct examinations that focus on areas of highest risk to the Enterprises. They produce reports of examination and make findings as to whether the Enterprises need to make corrective actions in particular areas.[1]

Critical Role of Risk Assessments in Planning Supervisory Activities

FHFA's *Examination Manual* stresses the critical role of risk assessments in planning supervisory activities to focus supervisory attention on high-risk matters and develop an annual supervisory strategy to address FHFA's supervisory concerns. According to FHFA's *Examination Manual,* the goal of a risk assessment is to present "a comprehensive view of the Enterprise." As we discussed in our recent evaluation of FHFA's risk assessments, FHFA's *Examination Manual* directs that a risk assessment should include a number of elements, such as a description of the types of risk (credit, market, liquidity, reputational, operational, model, legal) and their level (high, moderate, low) and direction (increasing, stable, decreasing).[2]

FHFA directs that risk assessments should be prepared semiannually and reflect an updated view of risk based upon supervisory activities conducted in the first half of the year and

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[1] Melvin L. Watt, FHFA Director, Remarks before the Bipartisan Policy Center, Washington, D.C. (Feb. 18, 2016) (online at www.fhfa.gov/Media/PublicAffairs/Pages/Prepared-Remarks-Melvin-Watt-at-BPC.aspx) (accessed June 24, 2016).

[2] OIG, *Utility of FHFA's Semi-Annual Risk Assessments Would Be Enhanced Through Adoption of Clear Standards and Defined Measures of Risk Levels* (Jan. 4, 2016) (EVL-2016-001) (online at www.fhfaoig.gov/Content/Files/EVL-2016-001.pdf).

potentially other changes in risk caused by the external environment. On September 24, 2013, DER issued an Operating Procedures Bulletin (OPB), *Supervisory Planning Process* (2013-DER-OPB-03), which provided a three-page list of "risk category components and evaluative factors." That guidance was similar to guidance provided by the Office of the Comptroller of the Currency, another federal financial regulator that employs a risk-based approach to supervisory planning. Approximately one month after issuing 2013-DER-OPB-03, DER issued a revised OPB, *Supervisory Planning Process* (2013-DER-OPB-03.1). The revised OPB eliminated the detailed guidance on risk category components and evaluative factors that were included in the earlier OPB, without explanation.

In a recent evaluation report, we reviewed a number of DER risk assessments and found that the factors or measures cited in those risk assessments lacked common definition, resulting in inconsistent and incomparable risk assessments.[3] We noted that FHFA's guidance did not define each of the risk levels or the elements inherent in each risk level. In response to our recommendations, DER issued Operating Procedures Bulletin, *Enterprise Supervision: Mid-Year Risk Assessments* (DER-OPB-01) on May 25, 2016. DER-OPB-01 emphasized that DER's risk assessments are critical components of effective risk-based supervision of the Enterprises. Among other things, the procedures set forth in the new OPB are intended to improve consistency of definitions and use of key terms and risk measures. It also reiterated that assessment of risk by supervision staff is an ongoing process, and prescribed specific documentation and approval requirements to apply to mid-year risk assessments. According to FHFA senior leadership, DER requires its examination staff to participate in mandatory training on the new OPB. FHFA senior leadership further explained that FHFA plans to assess the effectiveness of the new procedures in the OPB during the first quarter of 2017, before the mid-year risk assessments for 2017 are prepared.

Review of DER Risk Assessments for 2014 and 2015 Found that None Categorized the Components of the Identified Risks by Degree of Severity

Given FHFA's recognition of the critical role of risk assessments in planning supervisory activities to focus supervisory attention on high-risk matters and in light of the information collected and analyzed by our Office of Evaluations for its report issued on January 4, 2016, we began planning for this audit in October 2015. We first identified and collected the risk assessments and supervisory plans prepared by DER for the 2014 and 2015 supervisory cycles, using information gathered by our Office of Evaluations and supplemented by our review of records maintained in FHFA's Information Management System (IMS), FHFA's

[3] OIG, *Utility of FHFA's Semi-Annual Risk Assessments Would Be Enhanced Through Adoption of Clear Standards and Defined Measures of Risk Levels* (Jan. 4, 2016) (EVL-2016-001) (online at www.fhfaoig.gov/Content/Files/EVL-2016-001.pdf)

official system of record for examination-related materials. The scope of our audit, which was set in December 2015, preceded the May 25, 2016, issuance of DER-OPB-01. Once we assembled information from those sources, we asked DER, starting in December 2015, to confirm on multiple occasions whether the information we had gathered was complete and accurate and to provide us with any missing documentation.

During this audit, we reviewed 52 DER risk assessments and found that while a rating of high, moderate, or low was assigned to the risk area, none identified the degree of severity of the component risks discussed within each risk area. By way of example, [redacted] since none of the components in this risk assessment were assigned a degree of risk severity, we found no basis in the underlying risk assessment to support the high-priority designations assigned to both planned targeted examinations.

DER's Risk Assessments Did Not Trace to High-Priority Targeted Examinations Included in FHFA's Supervisory Plans for 2014 and 2015

Using the semiannual risk assessments, each DER core team is tasked with developing an annual supervisory plan, revised at mid-year, for each Enterprise. The supervisory plan is supposed to identify all supervisory activities – ongoing monitoring and targeted examinations – expected to be conducted during the year and assign a priority designation[4] to each planned targeted examination. For 2014 and 2015, the supervisory plans for the Enterprises identified a total of 98 targeted examinations for those supervisory cycles.[5] DER

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[4] FHFA guidance uses the terminology of "high, *moderate*, and low" when referring to the risk level by the type of risk (e.g., market, operational, modeling, etc.). We found that DER, in practice, uses the terminology "high, *medium*, and low" when referring to a priority assigned to a planned targeted examination.

[5] Of the 98 planned targeted examinations initially identified in the supervisory plans, we determined, from documentation provided by DER that 31 were completed, 46 were not conducted, 11 were commenced but not completed, and no documentation was provided for us to determine the disposition of the remaining 10. DER guidance recognizes that supervisory planning is a continuous process. In this regard, during the 2014 and 2015 supervisory cycles, 20 targeted examinations were added to the supervisory plans. These 20 targeted examinations were not included in the scope of our analysis.

officials advised us that DER examiners on each core team are responsible for assigning a priority designation to each planned targeted examination.

We found that DER lacked written guidance or criteria for prioritizing planned targeted examinations as high, medium, or low and did not require examiners to document the basis for the prioritizations they assigned to the planned targeted examinations. Of the 98 planned targeted examinations identified on the supervisory plans for both Enterprises in 2014 and 2015, DER examiners designated 61 as high-priority and 36 as medium- or low-priority. One (1) planned targeted examination received no priority designation.

Given FHFA's acknowledgement of the critical importance of risk assessments in planning its supervisory activities, we then sought to determine whether the risks described in the risk assessments could be traced to the 98 targeted examinations in DER's supervisory plans for 2014 and 2015. However, we were not able to complete such tracing because the risk assessments did not provide enough information for us to make a direct linkage between the risks described in the risk assessment and all of the planned targeted examinations. Our inability to complete such tracing reinforced one of our findings in the January 2016 evaluation: "The significant variability in risk assessments for an Enterprise limits their utility in development of a risk-based supervisory plan."

Having found that the risk assessments contained insufficient information to permit us to determine whether the identified risks could be traced to the 98 planned targeted examinations, we sought to work backwards and trace whether the 61 planned targeted examinations designated as high-priority in the supervisory plans for 2014 and 2015 were supported by underlying risk assessments.

We conducted this tracing effort by comparing the title, objective, and/or subject matter of the planned targeted examination to the risk assessment narrative. Using this methodology, we were able to trace just over half, 32 (52 percent) of the 61 high-priority planned targeted examinations to the underlying risk assessments. By way of example, [redacted]

[redacted]

[redacted] We found that the link between the planned targeted examination and the underlying risk assessment in this instance was clear.

On the other hand, we found that 29 (48 percent) of the 61 high-priority planned targeted examinations could not be traced to specific risks described in the underlying risk assessments. For example, [redacted] Accordingly, we did not count this planned targeted examination as traceable to a risk assessment.

During our audit, we provided DER officials with a detailed list of 2014 and 2015 high-priority planned targeted examinations and identified the 29 high-priority planned targeted examinations that could not be traced to specific risks described in the underlying risk assessments. In response, these officials maintained that 27 of the 29 examinations were added to the supervisory plans, based on additional information that was received by the EICs from a number of different sources outside of the risk assessments.

FHFA directs that all risk assessments shall be updated semiannually as well as when "significant changes to the risk profile occur." Since each DER core team obtained information outside of the documented risk assessments that was used to develop the annual supervisory plans, FHFA required each core team to revise the existing risk assessments to reflect such information. We found that DER examiners did not follow this requirement.

Over Half of the 2014 and 2015 High-Priority Planned Targeted Examinations for the Enterprises Were Not Completed Even Though Lower Priority Planned Targeted Examinations Were Completed

As of June 17, 2016, we found that only 25 (41 percent) of the 61 high-priority targeted examinations planned for the 2014 and 2015 supervisory cycles were completed.[7] For the

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[7] For purposes of this audit, we considered a targeted examination to be "commenced" when DER issued a request letter. We considered a targeted examination to be "completed" when DER issued a conclusion letter to the Enterprises. We considered a targeted examination to be "not conducted" when FHFA documents

remaining 36 (59 percent) of the high-priority targeted examinations planned for those two years, our review of DER documentation found that 21 were not conducted (because the examinations were converted to ongoing monitoring, cancelled, or deferred) and 8 were commenced but not completed. DER did not provide any documentation for us to determine the disposition of the other 7 planned targeted high-priority examinations and our search of FHFA's IMS, its official system of record for examination-related materials, identified no documentation to assist us in determining the disposition of these 7.

Our review of DER's documentation found that, as of June 17, 2016, DER did not conduct, commenced but did not complete, or failed to provide documentation to show what, if anything, was done for 36 planned high-priority targeted examinations, while DER examiners completed 6 planned targeted examinations that were initially designed medium-priority – 3 for Fannie Mae and 3 for Freddie Mac.[8]

We sought to understand the reasons why medium-priority examinations were completed while high-priority examinations were not. Of the 3 medium-priority planned targeted examinations for Fannie Mae, DER officials reported to us that 1 identified on the annual supervisory plan as medium-priority was always considered by DER to be high-priority and was reprioritized to high-priority at the mid-year update to the supervisory plan. For the other 2, DER officials asserted that both were part of the operational risk area, and were performed because all of the high-priority examinations within that risk area had been completed or deferred. That assertion, however, is not supported by underlying DER documentation for the 2014 supervisory cycle. DER's records show that DER planned 5 high-priority targeted examinations for Fannie Mae in the operational risk area for 2014 and completed 3 examinations, did not complete 1 examination, and did not provide documentation regarding the disposition of the other planned examination.

For the 3 medium-priority examinations completed for Freddie Mac, DER officials offered separate explanations. For 1 of the 3, DER officials claimed that the attrition of two examiners caused certain planned examination activities to be deferred or to be limited in scope and that

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demonstrate that the status of that examination was changed to ongoing monitoring, cancelled, or deferred. We considered a targeted examination to be "commenced but not completed" based on DER's representation that the examination was in progress in one of three phases: fieldwork, management review, or quality review, absent any other conflicting documentation provided or discovered during our review of FHFA's records. We considered a targeted examination to be "disposition not documented" when DER did not provide any documentation regarding the disposition of the targeted examination in response to our requests.

[8] Because risk assessments play a critical role in effective supervisory planning, DER issued OPB, *Supervisory Planning Process* (2013-DER-OPB-03.1), effective January 1, 2014, which requires that any changes to the supervisory plan must be risk-based, approved by the EIC, and documented in the workpapers. In the two companion reports to this report, issued today, we assessed whether DER examiners provided risk-related reasons for changes to the supervisory plans.

the medium-priority examination performed "did not require the same level [of] technical expertise and so was more easily accomplished." For another, DER officials maintained that this examination should have been classified as a high-priority examination. Unlike the Fannie Mae core team who re-prioritized a medium-priority examination at the mid-year to a high-priority, the Freddie Mac core team did not re-prioritize this medium-priority examination to high-priority at the mid-year update to the supervisory plan. Further, we first learned of the May 2016 completion of the third medium-priority Freddie Mac targeted examination from FHFA's technical comments to this draft report on July 29, 2016, notwithstanding our prior data requests for such information. FHFA provided no explanation why DER examiners completed this medium-priority targeted examination in lieu of a high-priority targeted examination.

Figure 1 below presents summary totals for FHFA's planned targeted examinations for the 2014 and 2015 supervisory cycles, by priority, and the completion of those examinations as of June 17, 2016.

FIGURE 1. SUMMARY OF PLANNED TARGETED EXAMINATIONS FOR THE ENTERPRISES 2014 AND 2015. AS OF JUNE 17. 2016

	Fannie Mae		Freddie Mac		Total Enterprises	
	Planned	Completed	Planned	Completed	Planned	Completed
Total	**55**	**13**	**43**	**18**	**98**[a/]	**31**
Priority						
High	**36**	**10**	**25**	**15**	**61**	**25**
Medium	15	3[b/]	12	3	27	6[b/]
Low	4	0	5	0	9	0
Not Prioritized	0	0	1	0	1	0

[a/] As of June 17, 2016, 46 of the 98 targeted examinations identified in the 2014 and 2015 supervisory plans were not conducted (because the examinations were converted to ongoing monitoring, cancelled, or deferred); 11 were commenced but not completed; and DER did not provide any documentation for us to determine the disposition for 10 planned targeted examination.

[b/] DER officials reported to us that, while the supervisory plan identified 1 planned targeted examination of Fannie Mae to be medium-priority, they always considered this examination to be high-priority and it was re-prioritized to high-priority at the mid-year update to the supervisory plan.

FINDINGS ....

1. **DER's 2014 and 2015 high-priority planned targeted examinations identified in its annual supervisory plans did not trace to risk assessments.**

While our earlier evaluation report found that "significant variability in risk assessments for an Enterprise limits their utility in development of a risk-based supervisory plan," we made no effort in that evaluation to quantify these limitations. In this audit, we were able to trace only 32 of the 61 planned high-priority targeted examinations for the Enterprises for 2014 and 2015 to DER risk assessments and were unable to trace the remaining 29 – almost half of the total.

The then-current EIC for each Enterprise explained that our inability to trace 27 of the 29 planned high-priority examinations to the underlying risk assessments was driven by the use of information outside of the risk assessments when the annual supervisory plans were developed. Neither core team, however, revised the risk assessments at mid-year to reflect information learned from these other sources, as required by FHFA.

According to FHFA, risk assessments provide the critical foundation for developing annual supervisory plans for the Enterprises and FHFA requires all risk assessments to be updated semiannually and "as significant changes to the risk profile occur." FHFA contemplates that examiners can leverage resources by focusing supervisory activities around the risks identified in the risk assessments as posing the highest supervisory concerns to the Enterprises. Our tracing efforts, combined with the acknowledgements by each EIC that the supervisory plans were developed from information outside the risk assessments, demonstrate that DER risk assessments did not provide the critical foundation for high-priority targeted examinations planned for the 2014 and 2015 supervisory cycles.

2. **DER completed only 41 percent of the high-priority targeted examinations planned for the 2014 and 2015 supervisory cycles even though 6 lower priority planned targeted examinations were completed for the same cycles.**

We found that DER examiners completed only 25 (41 percent) of the 61 high-priority targeted examinations planned for the 2014 and 2015 supervisory cycles. Put another way, 36 (59 percent) of the planned high-priority examinations that FHFA identified as involving the highest risks to the Enterprises were not completed. Of these 36, our review of DER documentation found that 21 were not conducted (because the examinations were converted to ongoing monitoring, cancelled, or deferred) and 8 were commenced but not completed. DER provided no documentation for us to determine the disposition of the other 7.

For the same supervisory cycles, however, DER examiners completed 6 planned targeted examinations initially designated as medium-priority. While 1 of these 6 targeted examinations was later reprioritized as high-priority, the other 5 remained medium-priority and were completed. In light of FHFA's commitment to risk-based supervision, there is no sound basis for DER examiners to complete lesser priority targeted examinations while not completing high-priority examinations.

3. DER lacks written guidance for prioritizing planned targeted examinations, and DER examiners assign priorities to planned targeted examinations without identifying or explaining the degree of severity of the risks discussed in the underlying risk assessments.

DER lacks written guidance for prioritizing planned targeted examinations as high, medium, or low within each supervisory plan, and does not require examiners to document the basis for the prioritizations they assign to the planned targeted examinations. As discussed above, because DER's risk assessments are supposed to be the foundation for its supervisory plans, we attempted to determine whether the 61 high-priority planned targeted examinations identified by DER in its annual supervisory plans for 2014 and 2015 were supported by risk assessments. However, we found that none of FHFA's underlying risk assessments identified or explained the severity of the risks discussed within the risk assessments. As a consequence, the risk assessments did not support, or link to, the priority assigned to the planned targeted examinations.

4. DER's official system of record for its supervision of the Enterprises is not complete and could not be relied upon; DER lacked documentation to account for all of its targeted examinations, from planning through completion.

According to its operating procedures, DER is to ensure that the supervisory planning is documented and incorporated into official agency records. IMS is DER's official system of record for materials relating to its supervision of the Enterprises.

Our efforts to track the status of each of the 61 planned high-priority targeted examinations were hampered by the lack of supervisory documentation maintained in IMS. We needed to make multiple information requests to DER for documentation related to DER's execution of its supervisory plans because complete documentation was not retained in IMS. Although DER located some documentation outside IMS, it found no documentation to explain the disposition of 7 of the 61 high-priority targeted examinations planned for the 2014 and 2015 supervisory cycles (11 percent).

CONCLUSION

As the federal financial regulator for the Enterprises, FHFA asserts that it uses a risk-based approach to plan and execute its supervisory activities. Supervision by risk requires a comprehensive, risk-focused view of each regulated entity so that supervisory activities can be tailored to the risks with the highest supervisory concerns. DER has acknowledged that assessments of risk in key areas are fundamental to its examination planning process for the Enterprises. The risk assessments should highlight both the strengths and vulnerabilities of an Enterprise and provide a foundation for preparing the supervisory strategy and determining the supervisory activities to be conducted. In other words, risk assessments are supposed to present a comprehensive view of the Enterprises and drive supervisory activities toward the highest risks of the Enterprises.

We found, in this audit, that FHFA's risk assessments are not meeting their stated purpose. DER's risk assessments do not provide a sufficient foundation for planning DER's high-priority targeted examinations and the risk priorities assigned by DER examiners to targeted examinations bear no relation to the risk assessments. As a consequence, FHFA lacks sufficient assurance that DER's supervisory resources are devoted to examining the highest risks of the Enterprises.

Significant Risk Exposure Regarding the Quality of DER's Supervisory Records

We consider the lack of DER's documentation supporting its supervisory activities, as it relates to this audit, to create a significant risk exposure. This condition impacted the objectives of this report as well as those in its two companion reports, which were also issued today.[9]

According to DER's operating procedures, DER is to ensure that the supervisory planning is documented and incorporated into official agency records. IMS is DER's official system of record for documentation of its supervisory activities. Our efforts to track documentation of the planning and execution of DER's supervisory activities through IMS were not successful because a significant amount of documentation was not retained in IMS. During our audit, we needed to make multiple information requests to DER for basic documentation relating to supervisory plans and their execution because such documentation was not always found in

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[9] OIG, *FHFA's Targeted Examinations of Fannie Mae: Less than Half of the Targeted Examinations Planned for 2012 through 2015 Were Completed and No Examinations Planned for 2015 Were Completed Before the Report the Report of Examination Issued* (Sept. 30, 2016) (AUD-2016-006), and OIG, *FHFA's Targeted Examinations of Freddie Mac: Just Over Half of the Targeted Examinations Planned for 2012 through 2015 Were Completed* (Sept. 30, 2016) (AUD-2016-007).

DER's official system of record. Although DER located some documentation outside the official system of record, it was not able to find all requested documentation.

DER often relied on the recollections of the then-current EICs to explain the universe of planned targeted examinations and the disposition of those planned targeted examinations for the supervisory cycles within the review period of this audit (2012-2015), which, at times, were later found to be inaccurate. DER's inability to retrieve all supervisory documentation from its official system of record, its difficulty in finding documentation outside its official system of record, and its significant reliance on the imperfect individual recollections of personnel delayed us from the timely and efficient completion of our work.

DER officials maintained to us that a significant shift in DER's senior management and managers led to the lack of proper and complete documentation in IMS supporting its supervisory activities. That explanation surprises us. FHFA, which was created in 2008, took over the supervision of the Enterprises from its predecessor agency that had been operating since 1992, and it is not credible that a federal financial regulator, charged with supervision of the Enterprises, would be so impacted by a shift in senior management and managers.

That explanation, however, is the only one offered by DER. If it is taken at face value, DER's haphazard approach to creating and retaining complete documentation for its supervisory activities creates enormous risk. This risk, coupled with the other deficiencies identified in this audit, threatens FHFA's ability to fulfill its statutory mission.

In our judgment, deliberate urgency and resolute commitment by FHFA management to resolve these collective deficiencies, and to implement the recommendations in this report and its two companion reports, is required.

RECOMMENDATIONS ....

We make five recommendations to address the deficiencies identified in this report and ensure that FHFA's supervisory resources are used efficiently to examine the highest risks of the Enterprises.

Specifically, we recommend that FHFA:

1. Ensure that risk assessments support the supervisory plans in terms of the targeted examinations included in those supervisory plans and the priority assigned to those targeted examinations.

2. Reinforce and hold the EICs accountable to meet FHFA's requirement for risk assessments to be updated semiannually, and as additional information is learned that causes significant changes to the risk profile, such information, from whatever sources, should be factored into the risk assessment during the next update.

3. Direct DER to develop and implement controls to ensure that high-priority planned targeted examinations are completed before lower priority targeted examinations, unless the reason(s) for performing a lower priority targeted examination in lieu of a higher priority planned targeted examination is documented and risk based (e.g., change in process, delay in implementation).

4. Enhance DER guidance to provide a common definition for the priority assigned to targeted examinations and require examiners to document the basis of the priority assigned to targeted examinations.

5. Revise existing guidance to require examiners to prepare complete documentation of supervisory activities and maintain such documentation in the official system of record, and train DER examiners on this guidance.

FHFA COMMENTS AND OIG RESPONSE.................................

OIG provided FHFA an opportunity to respond to a draft report of this audit. FHFA provided technical comments that we incorporated into this final report, as appropriate. On September 22, 2016, FHFA provided its management response, which is provided in Appendix A. In its response, FHFA provided three general comments to our draft report. In addition, FHFA stated that it issued internal guidance that FHFA believed confirmed its general agreement with recommendations 1, 2, 3, and 4. FHFA disagreed with recommendation 5. FHFA's comments and our responses are below.

FHFA General Comment

We believe that the report and several of its recommendations are redundant in light of ongoing changes and commitments that FHFA has already made, and is in the process of implementing, in response to the OIG report dated January 4, 2016.[10] As the new report acknowledges, "DER issued internal guidance in May 2016 to improve the consistency of definitions and use of key terms and risk measures and prescribed specific documentation and approval requirements to apply to mid-year risk assessments." The report also does not appear to consider additional activities that DER conducts that assist in aligning risk assessments of the Enterprises with DER's schedule of targeted examinations: its mid-year and year-end planning meetings, discussions and documentation of examination work and risk assessments, and vetting of proposed changes to the examination plan for each Enterprise. Taken together, the revised guidance and these activities will result in an effective risk assessment and examination planning process that assures that supervisory resources focus on and conclude reviews of the highest risks at the Enterprises. Because the risk assessment changes were recently made in May 2016, there were no results to be reviewed in the OIG fieldwork for this Report.

<u>OIG Response to FHFA General Comment.</u> As stated in this report, beginning in October 2015, we decided to build upon our evaluation work by conducting this audit to determine whether high-priority planned targeted examinations were supported by risk assessments and whether those examinations were completed. That is not the same objective as our prior evaluation report, which evaluated DER's 2013 and 2014 processes for identifying high risk

[10] OIG, *Utility of FHFA's Semi-Annual Risk Assessments Would Be Enhanced Through Adoption of Clear Standards and Defined Measures of Risk Levels* (Jan. 4, 2016) (EVL-2016-001) (online at www.fhfaoig.gov/Content/Files/EVL-2016-001.pdf).

areas. The recommendations included in this report are a direct result of work performed during this audit and are not redundant.

FHFA General Comment

FHFA disagrees with the report's premise or implication that examination work may not be considered risk-based unless the title and objective of each examination can be traced to the language of a particular risk assessment. DER subject matter experts prepare risk assessments to record the focus and general objectives for review of Enterprise operations and risk management rather than to enable external reviewers to trace connections among supervision documents. DER believes that its risk assessments are useful in guiding examination work and that risk assessments, examination documentation, and communications to the Enterprises reflect a solid understanding and thoughtful analysis of relevant risks and risk management.

OIG Response to FHFA General Comment. FHFA's *Examination Manual* states that risk assessments provide the critical foundation for developing the annual supervisory plans for each Enterprise. Using the semiannual risk assessments, each DER core team is tasked with developing the annual supervisory plan. Given the critical role assigned by FHFA to risk assessments, there should be a logical link between the planned targeted examinations in the annual supervisory plan and the underlying risk assessments. Confronted with a lack of compliance by DER examiners with existing requirements, FHFA's response to this report – that risk assessments "record the focus and general objectives for review of Enterprise operations" – diminishes significantly the value of risk assessments from the foundational role described in its *Examination Manual*. As this report details, the then-current EICs recognized that our inability to trace 27 of the 61 high priority targeted examinations back to the risk assessments was caused by the simple fact that the information on which these examinations were planned was not included in the risk assessments, and that the risk assessments were not updated to reflect this newly obtained information, as required by FHFA.

FHFA General Comment

FHFA disagrees with the report's finding that DER's documentation of supervisory activities is lacking or of poor quality. While DER's documentation recording the basis for changes to examination plans has been inconsistent at times, the report's conclusions and recommendations are not limited to that type of documentation but refer generally to "supervisory documentation." FHFA specifically notes that FHFA OIG observed in a 2014 report that DER maintained complete examination documentation for 2013 targeted examinations.[11] That OIG report states "We reviewed DER's workpapers for 28 targeted examinations conducted by the Fannie Mae and Freddie Mac Core Teams (together, the Core Teams) in 2013. We found that in each of these cases DER staff complied with the Agency's recordkeeping policies and procedures." Since that report was issued, DER has put in place an enhanced quality control review function that will help to ensure that the official records of examination activities are complete and maintained appropriately.

<u>OIG Response to FHFA General Comment.</u> FHFA's reliance on our 2014 report is inapposite. There, we reviewed the examination workpapers for 28 completed targeted examinations and found that DER examiners complied with the Agency's recordkeeping policies and procedures. In this audit, other than to look for the presence of the request letter and conclusion letter, we did not review examination workpapers for completed targeted examinations and made no findings about the quality of those workpapers. While FHFA takes credit for DER's quality control process, we note: (1) that this process was only put into place in July 2015, after we completed fieldwork for an evaluation which found that DER had reneged on its commitments to put such a process into place for the prior four years;[12] and (2) that the quality control process only reviews documentation maintained for examination work products.

This audit had an entirely different focus: whether DER examiners created and maintained records to document the annual supervisory cycle, from planning through execution. As this audit found, DER was unable to provide any documentation for the disposition of 18 targeted examinations for both Enterprises – 10 for Fannie Mae and 8 for Freddie Mac – during the four supervisory cycles in our review period, notwithstanding our multiple requests.

Our 2014 report, on which FHFA relies in its comment, also states:

> …we also found that DER's recordkeeping practices have limitations that impede the efficient retrieval of these workpapers by FHFA examiners, other FHFA personnel, and outside oversight entities such as the OIG.

Almost two years later, these limitations have not been addressed by FHFA and hampered our work on this audit. FHFA's inability to provide documentation to show the disposition of

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[11] OIG, *Evaluation of the Division of Enterprise Regulation's 2013 Examination Records: Successes and Opportunities* (Oct. 6, 2014) (EVL-2015-001) (online at https://www.fhfaoig.gov/Content/Files/EVL-2015-001.pdf).

[12] OIG, *Intermittent Efforts Over Almost Four Years to Develop a Quality Control Review Process Deprived FHFA of Assurance of the Adequacy and Quality of Enterprise Examinations* (Sept. 30, 2015) (EVL-2015-007) (online at https://www.fhfaoig.gov/Content/Files/EVL-2015-007.pdf).

18 planned targeted examinations during the four supervisory cycles reviewed in this audit – roughly 10 percent of the total planned – creates a significant risk exposure.

FHFA Comments to Recommendations 1, 2, 3, and 4

On May 25, 2016, FHFA issued internal guidance that FHFA believes confirms its general agreement with these recommendations. During the first quarter of 2017 FHFA will assess the effectiveness of the enhanced risk assessment procedures outlined in the guidance and determine whether any revisions are needed before the mid-year risk assessment process commences in 2017. To the extent that recommendations 1 to 4 of the report contemplate steps other than those to which FHFA has previously agreed and is implementing in response to the OIG's January 4, 2016 report, we disagree with the recommendations at this time, but will consider them as part of our 2017 assessment.

OIG Response to FHFA Comments to Recommendations 1, 2, 3, and 4. Since FHFA is committed to implementing recommendations 1, 2, 3, and 4, either through its implementation of its May 25, 2016 internal guidance or as part of its 2017 assessment, we consider FHFA's response to these recommendations to be an agreement. After FHFA performs its 2017 planned mid-year assessment of the implementation of the May 2016 guidance, we plan to review the results of that assessment. To the extent that FHFA's assessment finds that OIG's recommendations 1, 2, 3, and 4 are not fully implemented by that guidance, we expect FHFA to take additional corrective actions.

FHFA Comments to Recommendation 5

FHFA disagrees with this recommendation. DER has sufficient guidance in place for documentation of supervisory activities. Moreover, in mid-2015, DER put in place an enhanced quality control function that provides an independent review of targeted examination work products to assess whether written communications to the Enterprises are supported by documentation of examination work that meets DER standards and applicable FHFA guidance for preparation of written products. DER believes that existing internal guidance and the quality control reviews now being performed are effective to ensure that the official records of examination activities are complete and maintained appropriately. To the extent that this recommendation refers to documentation of risk-based changes to examination plans, this issue will be addressed in the course of implementing the May 2016 guidance referenced above and in enhancements to DER's mechanisms for tracking changes to examination plans.

OIG Response to FHFA Comments to Recommendation 5. As discussed in this report as well as in two companion reports issued today, DER's operating procedures direct that supervisory planning is documented and incorporated into official agency records.[13] As we explained in detail, our efforts to track the planning and execution of DER's supervisory activities through documentation maintained in IMS were not successful because a significant amount of documentation was not retained in IMS.

FHFA's suggestion that DER's enhanced quality control reviews will remedy these problems is unfounded. In accordance with DER's quality control review process, put in place in July 2015, these reviews are focused on documentation for completed targeted examinations. This audit found lack of documentation supporting the planning and execution of supervisory activities. Of the 18 targeted examinations planned during the four supervisory cycles in our review for which DER provide no documentation to show their disposition, 3 were planned for the 2015 supervisory cycle, after the 2015 quality control reviews were put into place. DER's inability to produce documentation to show the disposition of 3 targeted examinations planned for the 2015 supervisory cycle demonstrates that DER's current quality control reviews are either not working as FHFA expected they would or working as intended but do not address this deficiency.

As we explained in the companion reports, DER has required, since January 1, 2014, that all changes to supervisory plans be risk-based, documented in writing, and approved. The reports issued today demonstrate widespread non-compliance with that requirement. Instead of addressing that deficiency, FHFA promises that documentation of risk-based changes to supervisory plans will be addressed in the course of implementing the May 2016 guidance and in enhancements to DER's mechanisms for tracking changes to supervisory plans but does not explain how it intends to change examiner behavior. Simply reiterating an existing requirement that has not been followed is unlikely to increase compliance.

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[13] OIG, *FHFA's Targeted Examinations of Fannie Mae: Less than Half of the Targeted Examinations Planned for 2012 through 2015 Were Completed and No Examinations Planned for 2015 Were Completed Before the Report the Report of Examination Issued* (Sept. 30, 2016) (AUD-2016-006), and OIG, *FHFA's Targeted Examinations of Freddie Mac: Just Over Half of the Targeted Examinations Planned for 2012 through 2015 Were Completed* (Sept. 30, 2016) (AUD-2016-007).

OBJECTIVE, SCOPE, AND METHODOLOGY ....

We conducted this audit to determine whether FHFA (1) supported its 2014 and 2015 high-priority planned targeted examinations with risk assessments and completed those planned high-priority examinations; (2) performed its planned targeted examinations for Fannie Mae from 2012 through 2015 and, if it did not, whether FHFA documented the deviations from its plan in accordance with policies and procedures; and (3) performed its planned targeted examinations for Freddie Mac from 2012 through 2015 and, if it did not, whether FHFA documented the deviations from its plan in accordance with policies and procedures.

This report addresses the first objective – tracing high-priority planned targeted examinations to risk assessments and determining whether those examinations were completed. We conducted this audit from December 2015 through June 2016 at FHFA's headquarters in Washington, D.C.

To accomplish the audit objective, we:

- Reviewed FHFA's *Examination Manual*; DER's OPB, *Supervisory Planning Process* (2013-DER-OPB-03.1); DER's OPB, *Supervisory Planning Process* (2013-DER-OPB-03); and DER's OPB, *Enterprise Supervision: Mid-Year Risk Assessment* (DER-OPB-01);

- Reviewed FHFA's supervisory plans for 2014 and 2015, as of the beginning of the year, and identified planned targeted examinations;

- Traced FHFA's high-priority planned targeted examinations for 2014 and 2015, as of the beginning of the year, to FHFA's risk assessments based on the title, objective, and/or subject matter of each examination;

- Compared the number of planned targeted examinations for the Enterprises included in the supervisory plans, as of the beginning of the year, to the targeted examination request letters, conclusion letters, and other relevant documentation in order to determine the disposition of the examinations;

- Reviewed FHFA's Information Management System in an effort to confirm and identify the universe of high-priority planned targeted examinations and their disposition;

- Reviewed FHFA's risk assessments for 2013 and 2014 for the categorization for component risks; and,

- Interviewed FHFA DER officials regarding their development of the 2014 and 2015 supervisory plans, as of the beginning of the year.

We held an exit conference with FHFA officials on September 12, 2016.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for the findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

APPENDIX A ....

FHFA's Comments on OIG's Findings and Recommendations

Federal Housing Finance Agency

MEMORANDUM

TO: Marla A. Freedman, Deputy Inspector General for Audits

FROM: Nina A. Nichols, Deputy Director, Division of Enterprise Regulation (DER) NAN

SUBJECT: Audit Report: *FHFA's Supervisory Planning Process for the Enterprises: Roughly Half of FHFA's 2014 and 2015 High-Priority Planned Targeted Examinations Did Not Trace to Risk Assessments and Most High-Priority Planned Examinations Were Not Completed*

DATE: September 22, 2016

This memorandum transmits the management response of the Federal Housing Finance Agency (FHFA) to the FHFA OIG draft audit report referenced above (Report).

FHFA agrees that effective risk assessment is a critical component of FHFA's supervision of the Enterprises, and we appreciate the FHFA OIG's attention to this area. FHFA is working to make improvements to our supervision protocols and processes to more effectively identify risks and to ensure that the risks identified are addressed in our examination activities, including targeted examinations. FHFA continues to improve our supervision program, taking into account FHFA OIG recommendations.

We specifically note that, in accordance with FHFA commitments made in response to a January 2016 OIG evaluation report,[1] in May 2016 DER issued internal guidance for conducting risk assessments to support risk-based supervision of the Enterprises. The guidance includes defined terms, measures, and formats for credit, market, and operational risk. As committed in the management response, DER has provided training to all Enterprise examination staff on the revised risk assessment procedures. As part of our ongoing evaluation process, in the first quarter of 2017 DER will assess the effectiveness of the new approach and determine if any revisions are needed before the mid-year risk assessment process commences in 2017.

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[1] *Utility of FHFA's Semi-Annual Risk Assessments Would Be Enhanced Through Adoption of Clear Standards and Defined Measures of Risk Levels* (EVL-2016-001), January 4, 2016.

We make the following general responses to the Report:

1) We believe that the Report and several of its recommendations are redundant in light of ongoing changes and commitments that FHFA has already made, and is in the process of implementing, in response to the OIG report dated January 4, 2016. As the new Report acknowledges, "DER issued internal guidance in May 2016 to improve the consistency of definitions and use of key terms and risk measures and prescribed specific documentation and approval requirements to apply to mid-year risk assessments." The Report also does not appear to consider additional activities that DER conducts that assist in aligning risk assessments of the Enterprises with DER's schedule of targeted examinations: its mid-year and year-end planning meetings, discussions and documentation of examination work and risk assessments, and vetting of proposed changes to the examination plan for each Enterprise. Taken together, the revised guidance and these activities will result in an effective risk assessment and examination planning process that assures that supervisory resources focus on and conclude reviews of the highest risks at the Enterprises. Because the risk assessment changes were recently made in May 2016, there were no results to be reviewed in the OIG fieldwork for this Report.

2) FHFA disagrees with the Report's premise or implication that examination work may not be considered risk-based unless the title and objective of each examination can be traced to the language of a particular risk assessment. DER subject matter experts prepare risk assessments to record the focus and general objectives for review of Enterprise operations and risk management rather than to enable external reviewers to trace connections among supervision documents. DER believes that its risk assessments are useful in guiding examination work and that risk assessments, examination documentation, and communications to the Enterprises reflect a solid understanding and thoughtful analysis of relevant risks and risk management.

3) FHFA disagrees with the Report's finding that DER's documentation of supervisory activities is lacking or of poor quality. While DER's documentation recording the basis for changes to examination plans has been inconsistent at times, the Report's conclusions and recommendations are not limited to that type of documentation but refer generally to "supervisory documentation." We specifically note that FHFA OIG observed in a 2014 report that DER maintained complete examination documentation for 2013 targeted examinations.[2] That OIG report states, "We reviewed DER's workpapers for 28 targeted examinations conducted by the Fannie Mae and Freddie Mac Core Teams (together, the Core Teams) in 2013. We found that in each of these cases DER staff complied with the

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[2] *Evaluation of the Division of Enterprise Regulation's 2013 Examination Records: Successes and Opportunities* (EVL-2015-001), October 6, 2014.

Agency's recordkeeping policies and procedures." Since that report was issued, DER has put in place an enhanced quality control review function that will help to ensure that the official records of examination activities are complete and maintained appropriately.

In light of the above, FHFA strongly disagrees that the Report justifies any conclusion or implication that any process or concern raised in the Report either "creates a significant risk exposure" or "threatens FHFA's ability to fulfill its statutory mission."

FHFA responds to Recommendations 1, 2, 3, and 4 as follows:

On May 25, 2016, FHFA issued internal guidance that FHFA believes confirms our general agreement with these recommendations. As we previously advised OIG staff, during the first quarter of 2017 FHFA will assess the effectiveness of the enhanced risk assessment procedures outlined in the guidance and determine whether any revisions are needed before the mid-year risk assessment process commences in 2017. To the extent that recommendations 1 – 4 of the Report contemplate steps other than those to which FHFA has previously agreed and is implementing in response to the OIG's January 4, 2016 report, we disagree with the recommendations at this time, but will consider them as part of our 2017 assessment.

Recommendation 5:

Revise existing guidance to require examiners to prepare complete documentation of supervisory activities and maintain such documentation in the official system of record, and train DER examiners on this guidance.

Management Response to Recommendation 5:

FHFA disagrees with this recommendation. DER has sufficient guidance in place for documentation of supervisory activities. Moreover, in mid-2015, DER put in place an enhanced quality control function that provides an independent review of targeted examination work products to assess whether written communications to the Enterprises are supported by documentation of examination work that meets DER standards and applicable FHFA guidance for preparation of written products. DER believes that existing internal guidance and the quality control reviews now being performed are effective to ensure that the official records of examination activities are complete and maintained appropriately. To the extent that this recommendation refers to documentation of risk-based changes to examination plans, this issue will be addressed in the course of implementing the May 2016 guidance referenced above and in enhancements to DER's mechanisms for tracking changes to examination plans.

cc: John Major, Internal Controls and Audit Follow-up Manager

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