REDACTED

Federal Housing Finance Agency
Office of Inspector General

# FHFA's 2015 Report of Examination to Fannie Mae Failed to Follow FHFA's Standards Because it Reported on an Incomplete Targeted Examination of the Enterprise's New Representation and Warranty Framework

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

Audit Report • AUD-2017-008 • September 22, 2017

## Executive Summary

The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (together, the Enterprises) provide liquidity to the U.S. housing finance system by supporting the secondary mortgage market. The Enterprises purchase residential mortgages from lenders and bundle the purchased mortgages into securities for which they guarantee principal and interest. In guaranteeing the securities, the Enterprises assume the credit risk from possible default of the underlying mortgages. To mitigate this risk, the Enterprises require lenders that sell the residential mortgages to make specific contractual representations and warranties in which they represent that the mortgages meet specific underwriting standards.

Historically, the Enterprises relied on the lenders' representations and warranties and conducted limited due diligence at the time the mortgages were purchased. When mortgages defaulted or the borrower missed payments, the Enterprises would review the loan files for evidence of breach of the representations and warranties and exercise their contractual rights to require lenders to repurchase, or buy back, non-compliant loans. The Enterprises' contractual rights to put back non-compliant loans at any point during the term of the loans enabled the Enterprises to reduce losses caused by underwriting defects.

In September 2012, the Federal Housing Finance Agency (FHFA) announced that the Enterprises would launch a new representation and warranty framework (new framework). The objective of the new framework was to enhance transparency and certainty for lenders by clarifying when a mortgage loan may be subject to repurchase. The new framework, designed by the Enterprises to meet FHFA's stated objective, shifted some risk of non-compliance with representations and warranties from the lenders to the Enterprises (and therefore to taxpayers). The new framework required operational changes at the Enterprises to mitigate the additional risk. FHFA recognized the need to test the adequacy of those operational changes, through its supervisory activities, to ensure that the risks had been mitigated.

FHFA is charged by the Housing and Economic Recovery Act with, among other things, ensuring that the Enterprises and the Federal Home Loan Banks operate in a safe and sound manner. Within FHFA, the Division of Enterprise Regulation (DER) is responsible for the supervision of the Enterprises. According to the *FHFA Examination Manual*, each year DER assesses the risks of Enterprise operations and plans its supervisory activities to assess the mitigation of those risks. DER summarizes and communicates the results of its

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supervisory activities in an annual report of examination (ROE) issued to each Enterprise.

We performed this audit to assess (1) whether DER's planned supervisory activities relating to Fannie Mae's implementation of the new framework for the 2015 and 2016 examination cycles could be tracked to its risk assessments and supervisory strategies and (2) whether DER executed these planned supervisory activities during the 2015 and 2016 examination cycles. As part of our work, we also assessed whether the objectives of the planned supervisory activities during the 2015 and 2016 examination cycles would provide for the testing of controls to mitigate the risks identified with the new framework.

For the 2015 examination cycle, the risks identified by DER with respect to Fannie Mae's implementation of the new framework focused on Fannie Mae's [redacted]. We found that DER planned a targeted examination of Fannie Mae's quality control function during the 2015 examination cycle and that the objectives of that planned targeted examination, if completed as stated, would provide for the testing of controls to mitigate the risks identified with the new framework.

At the conclusion of each annual examination cycle, FHFA prepares and transmits an ROE to the board of directors (Board) for each Enterprise. The annual ROE constitutes DER's "primary work product that communicates . . . the cumulative results of [DER's] supervisory activities conducted during the annual examination cycle." The ROE rolls up the substantive examination results from DER's targeted examinations and ongoing monitoring activities. In March 2013, FHFA issued Supervision Directive (SD) 2013-01 which directed DER and the Division of Federal Home Loan Bank Regulation (DBR) (which is responsible for supervision of the Federal Home Loan Banks) to perform independent quality control reviews of "examination findings, conclusions, ratings, supporting workpapers, and related documents" and of the ROEs, prior to finalizing and distributing the ROEs to the regulated entities. The then-Deputy Directors of DBR and DER provided input into the content of SD 2013-01 and formally approved it.

In a prior evaluation, we found the then-Deputy Director of DER had committed in writing to develop and implement a quality control review program by December 2012 and we catalogued the difficulties and delays over several years in establishing such a program within DER. In the summer of 2015 (and more than two years after SD 2013-01 issued), DER announced it was implementing a program for quality control reviews. We recommended that FHFA "[e]nsure that DER's recently adopted procedures for quality control reviews meet the requirements of [SD] 2013-01 and require DER to document in detail the results and findings of each quality control review in examination workpapers, including any shortcomings found during the quality control review." In its written response, FHFA "agree[d] with this recommendation," and acknowledged that "a process for independent quality control of examination documentation is important to the supervision of Fannie Mae and Freddie Mac."

In March 2016, DER issued an ROE to Fannie Mae for the 2015 examination cycle. Notwithstanding the requirements in SD 2013-01, that ROE was not subjected to an independent quality control review. A DER official reported to us that DER determined that quality control reviews of the ROEs were not needed because quality control reviews were conducted of all examination findings and conclusions *before* they were incorporated in the annual ROEs. This ROE for the 2015 supervisory cycle reported on DER's targeted examination of Fannie Mae's quality control function. Our audit of DER workpapers for this targeted examination found that no independent quality control review of this examination was conducted before the ROE issued, contrary to SD 2013-01 and the representations made to us by a DER official. Reporting examination findings in an ROE before they are vetted through a quality control process creates a risk that DER could provide misinformation to the Enterprise and its Board.

DER did not identify risks associated with the new framework as a specific supervisory focus for the Fannie Mae 2016 examination cycle and did not perform any new framework-related supervisory activities during 2016.

We make one recommendation to FHFA to address the shortcomings identified in this audit. In a written management response, FHFA stated that it disagreed with various statements in the report and the finding but agreed with our recommendation.

We are also issuing today the results of our audit of DER's execution and completion of planned supervisory activities for the 2015 and 2016 examination cycles to test the adequacy of Freddie Mac's implementation of the new framework. See *FHFA's 2015 and 2016 Supervisory Activities, as Planned, Addressed Identified Risks with Freddie Mac's New Representation and Warranty Framework*, AUD-2017-009, available online at www.fhfaoig.gov/reports/auditsandevaluations.

This report was prepared by James Lisle, Audit Director; Marco Uribe, Auditor-in-Charge; and Brian Maloney, Auditor; with the assistance of Bob Taylor, Assistant Inspector General for Audits. We appreciate the cooperation of FHFA staff, as well as the assistance of all those who contributed to the preparation of the report.

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

Marla A. Freedman, Deputy Inspector General for Audits /s/

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## ABBREVIATIONS .................................................................

| | |
|---|---|
| Board | Board of directors |
| DBR | Division of Federal Home Loan Bank Regulation |
| DER | Division of Enterprise Regulation |
| EIC | Examiner-in-Charge |
| Enterprises | Fannie Mae and Freddie Mac |
| Fannie Mae | Federal National Mortgage Association |
| FHFA | Federal Housing Finance Agency |
| Freddie Mac | Federal Home Loan Mortgage Corporation |
| LQC | Loan Quality Center |
| MRA | Matter Requiring Attention |
| New framework | Representation and Warranty Framework |
| OIG | Office of Inspector General |
| OPB | Operating Procedures Bulletin |
| PSPA | Preferred Stock Purchase Agreement |
| QC | Quality Control |
| ROE | Report of Examination |
| SD | Supervision Directive |
| Treasury | Department of the Treasury |
| UPB | Unpaid Principal Balance |

# BACKGROUND ................................................................

## DER Supervisory Process

Created by Congress in 2008, FHFA is charged by the Housing and Economic Recovery Act of 2008 with, among other things, the supervision of the Enterprises. Its mission as a federal financial regulator includes ensuring the safety and soundness of the Enterprises so that they serve as a reliable source of liquidity and funding for housing finance and community investment. FHFA exercises its supervision of the Enterprises through DER. Like other federal financial regulators, FHFA maintains that it uses a risk-based approach to carry out its supervisory activities.

In a number of recently issued reports, we have explained in detail the different elements of DER's supervision program for the Enterprises.[1] According to FHFA, DER's examinations of the Enterprises are risk-based and rely on an understanding of the Enterprise, risk assessments, the development of a supervisory strategy and supervisory plan, and examination procedures tailored to the Enterprise's risk profile. The specific elements of DER's supervisory program include:

- DER's written assessment of risks at the Enterprises, which serves as a platform for developing an annual supervisory strategy and supervisory plan;
- DER's annual supervisory strategy is intended to form a bridge between the risk assessment, which identifies significant risks and supervisory concerns, and the supervisory activities to be conducted. The supervisory strategy should include, among other things, the planned supervisory approach (extent of ongoing monitoring or targeted examination activity) and planned objectives that address the significant risks and the principal supervisory priorities for the year;
- DER's supervisory plan for each annual examination cycle sets forth the planned supervisory activities, prioritized based on level of risk identified in DER's risk assessments. Because supervisory planning is a continuous process, supervisory plans may need to be adjusted during each year to address newly emerging risks that require attention during the current examination cycle. Beginning with the 2014 examination cycle, DER requires that approved supervisory plans shall only be adjusted for risk-related reasons, must be approved by the examiner-in-charge (EIC), and be fully

[1] We have issued a number of reports addressing DER's supervisory process that are summarized in *Safe and Sound Operation of the Enterprises Cannot Be Assumed Because of Significant Shortcomings in FHFA's Supervision Program for the Enterprises* (OIG-2017-003) (Dec. 15, 2016) (online at https://www.fhfaoig.gov/Content/Files/OIG-2017-003.pdf).

documented in the examination workpapers. Planned supervisory activities in each plan can include ongoing monitoring and targeted examinations. According to FHFA, ongoing monitoring and targeted examinations serve complementary purposes. The purpose of ongoing monitoring is 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 increased supervisory attention. According to the *FHFA Examination Manual*, ongoing monitoring is also "used to determine the status of the Enterprise's compliance with supervisory guidance, MRAs [Matters Requiring Attention], and conservatorship directives[.]"[2] Targeted examinations complement ongoing monitoring; further, the *FHFA Examination Manual* notes that they enable examiners to conduct "a deep or comprehensive assessment" of the areas found to be of high importance or risk.

- DER's planned examination procedures for its supervisory activities, which are designed to identify the objectives of the activity and describe the examination steps to be performed, including sampling and testing;
- DER's quality control processes for its targeted examinations and for ongoing monitoring activities with findings that assess whether such activities comply with FHFA examination standards and procedural requirements in the *FHFA Examination Manual*, supplemental modules, supervision directives, and DER operating procedures bulletins (OPB), [3] which DER requires must be completed before DER communicates the results of such activities to an Enterprise;
- DER's communication of its findings from its supervisory activities, including its supervisory concerns, to each Enterprise;
- DER follow-up on efforts by each Enterprise to correct identified deficiencies throughout the remediation period to ensure that remediation is timely and adequate; and

[2] As discussed in AB-2017-01 *Classifications of Adverse Examination Findings*, MRAs are adverse examination findings that fall into one of the following categories: (1) critical supervisory matters (the highest priority) that pose substantial risk to the safety and soundness of the Enterprise and (2) deficiencies that are supervisory concerns, which FHFA believes could, if not corrected, escalate and potentially negatively affect the condition, financial performance, risk profile, operations, or reputation of the Enterprise.

[3] On June 23, 2016, DER issued DER-OPB-02, *Quality Control Reviews*. This OPB set forth the procedures for DER to follow in implementing SD 2013-01. Among other things, it required quality control reviews to be completed prior to the review and approval of supervisory letters by the Deputy Director of DER. It also provided that quality control reviews may only be waived by the Deputy Director of DER and that such waivers must be documented in the quality control review files.

- DER's communication of its examination conclusions, findings, and composite/component examination ratings after the end of each annual examination cycle to each Enterprise Board in an annual ROE to assist Enterprise directors in executing their oversight responsibilities.

## The New Framework Sought to Provide Greater Certainty to the Seller, Shifting Some Risk to the Enterprises

The Enterprises provide liquidity to the U.S. housing finance system by purchasing residential mortgages and bundling the purchased mortgages into securities for which they guarantee principal and interest. In guaranteeing the securities, the Enterprises assume the credit risk[4] from possible default of the underlying mortgages. To mitigate this risk, the Enterprises require lenders that sell the residential mortgages to make specific contractual representations and warranties in which they represent that their mortgages meet the specific underwriting standards set forth in Fannie Mae's *Selling Guide* or Freddie Mac's *Single-Family Seller/Servicer Guide*.

Historically, the Enterprises performed limited due diligence on the loans at the time of purchase. In the event of default, the affected Enterprise reviewed whether the defaulted loan complied with the lender's representations and warranties in the lender contract. If an Enterprise found that a defaulted loan breached these representations and warranties in any way, the Enterprise could exercise its contractual right to require the lender to repurchase the non-compliant loan, even if the loan defaulted years after it was made. This right to demand repurchase of defaulted loans that did not comply with the representations and warranties in the lender contract mitigated the risk of loss to the Enterprises from defaulted loans.

In September 2012, FHFA announced that the Enterprises would launch the new framework for conventional loans sold or delivered on or after January 1, 2013.[5] The objective of the new framework was to enhance transparency and certainty for lenders by clarifying when a mortgage loan may be subject to repurchase. The new framework provides relief for lenders from the requirement to remedy (e.g., repurchase) a loan due to breaches of certain underwriting and property valuation representations and warranties when a loan meets certain

[4] Credit risk is the potential that a borrower or counterparty will fail to meet its obligations in accordance with agreed terms.

[5] On September 10, 2012, then-acting FHFA Director DeMarco explained that "there has been much discussion that the uncertainty with representation and warranty exposure may be affecting the willingness of lenders to extend credit" and that this uncertainty warranted a change in the representation and warranty framework. Edward J. Demarco, FHFA Acting Director, Remarks as Delivered – American Mortgage Conference, Raleigh, NC (Sept. 10, 2012) (online at https://www.fhfa.gov/Media/PublicAffairs/Pages/Remarks-as-Delivered-Edward-J-DeMarco-Acting-Director-FHFA-American-Mortgage-Conference.aspx).

payment history requirements or the satisfactory conclusion of a quality control review by the Enterprise. [6] The new framework does not change the underlying representations and warranties the lender makes to the Enterprises when selling mortgages; it changes whether and how the Enterprises will enforce breaches of those representations.[7] As Director Watt testified to Congress in January 2015:

> FHFA's supervision function evaluates the safety and soundness of the Enterprises' operations. Safety and soundness is a top priority in meeting FHFA's statutory obligations, in execution of Enterprise strategic initiatives and in all business and control functions…. In updating and clarifying the Framework, FHFA's objectives are to continue to support safe and sound Enterprise operations, encourage lenders to reduce their credit overlays, and complement the agency's efforts to strengthen the Enterprises' quality control process.[8]

As Fannie Mae recognized in its March 31, 2017, Form 10-Q,[9] "Providing lenders with relief from repurchasing loans for breaches of certain representations and warranties on loans that meet specified eligibility requirements shifts some of the risk of non-compliance with our requirements back to us." The increased exposure under this new framework could pass through to the taxpayers, as the Enterprises continue to operate under FHFA's conservatorship.[10]

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[6] A quality control program defines the standards for loan quality, establishes processes designed to achieve those standards, and mitigates risks associated with the origination processes. A quality control program includes a documented quality control plan that outlines requirements for validating that loans are originated in accordance with the Enterprise's established policies and procedures.

[7] Lenders remain responsible for the life of the loan in the event of misstatements, misrepresentations and omissions, and certain other situations.

[8] Statement of Melvin L. Watt, before the U.S. House of Representatives Committee on Financial Services, "Sustainable Housing Finance: An Update from the Director of the Federal Housing Finance Agency (Jan. 27, 2015) (online at www.fhfa.gov/Media/PublicAffairs/Pages/Statement-of-Melvin-L-Watt-Director-FHFA-Before-the-US-House-of-Representatives-Committee-on-Financial-Services-1272015.aspx).

[9] Securities laws require publicly traded companies to disclose information on an ongoing basis. Form 10-Q includes unaudited financial statements and provides a continuing view of the company's financial position during each of the first three fiscal quarters of a company's fiscal year.

[10] Fannie Mae and Freddie Mac continue to operate under conservatorship, as they have since 2008. At the time the Enterprises were placed into conservatorship the Department of the Treasury (Treasury) and FHFA, as conservator of the Enterprises, executed senior preferred stock purchase agreements (PSPAs) to ensure that the Enterprises could continue to operate. The PSPAs, among other things, obligated Treasury to provide funds (subject to specified limits) to an Enterprise to restore it to positive net worth in any quarter in which the Enterprise's net worth becomes negative. Under these PSPAs, U.S. taxpayers, through Treasury, have invested a total of $187.5 billion into the Enterprises since 2008.

Fannie Mae reported that as of March 31, 2017, it has acquired more than 8 million loans, with an unpaid principal balance (UPB) of approximately $1.67 trillion, that are subject to the new framework. More than 3 million of those loans, with a UPB of approximately $543 billion, have demonstrated acceptable payment histories or passed Fannie Mae quality control review. Pursuant to the new framework, Fannie Mae will not exercise its remedies, including a demand to repurchase those loans except in limited situations. More than 5 million loans, with a UPB of nearly $1.11 trillion, have either not completed Fannie Mae quality control review or are still within the sunset period. Pursuant to the new framework, Fannie Mae can exercise its remedies, including a demand to repurchase those loans. More than 100,000 loans, with a UPB of nearly $19 billion, did not demonstrate acceptable payment histories within the sunset period or did not pass Fannie Mae quality control review. For those loans, Fannie Mae retains the right to exercise its remedies, including a demand to repurchase by the lender.

## Implementation of the New Framework Required Operational Changes at Fannie Mae

Implementation of the new framework shifted some risk of non-compliance with representations and warranties from the lenders to the Enterprises. As a result, the Enterprises' quality control programs became increasingly important to mitigate origination quality and credit risks since the Enterprises would no longer be able to seek repurchase from a lender for the life of the loan. For loans acquired under the new framework, both Enterprises represented that they would conduct most quality control reviews within 30 to 120 days after delivery of the loan to assess whether the specific representations and warranties were satisfied. According to the Enterprises, they would employ new technologies and data gathering tools to identify loans that are not originated in accordance with applicable underwriting and eligibility requirements.

# FACTS AND ANALYSIS ........................................................

## DER Planned and Executed Supervisory Activities for Fannie Mae to Address the Risks it Identified with the New Framework in the 2015 Examination Cycle

### *2015 Examination Cycle*

*Risk Assessment* – DER identified new framework-related risks in the risk assessment for the 2015 examination cycle. The Risk assessment noted that [redacted].[11] Specifically, the Risk assessment identified risk associated with actions taken [redacted]

*Supervisory Strategy* – Consistent with the identification of new framework-related risks with Fannie Mae's quality control function, DER's 2015 supervisory strategy included quality control as one of the focus areas in FHFA's supervision of Fannie Mae's credit risk.

*Supervisory Plan* – DER's 2015 supervisory plan included one supervisory activity related to the new framework, a targeted examination entitled Quality Control (QC). The planned objectives of this targeted examination were [redacted][12] We determined that the objectives of that planned targeted examination, if completed as stated, would provide for the testing of controls to mitigate the risks identified with the new framework.

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[11] The National Underwriting Center is the former name of what is now Fannie Mae's Loan Quality Center.

[12] This second objective was intended to address a recommendation in OIG, *FHFA's Representation and Warranty Framework*, AUD-2014-016 (Sept. 17, 2014), available online at www.fhfaoig.gov/Content/Files/AUD-2014-016.pdf. In this report, we concluded that neither Enterprise had implemented the processes, procedures, nor systems needed to operate within the new framework before it went into effect in 2013.

*Execution of Supervisory Activities* – Our review of DER's workpapers for the QC targeted examination found that DER examiners began that examination in September 2015[13] and completed the analysis memorandum on March 10, 2016. Those workpapers also showed that the independent quality control review for this targeted examination was completed on April 15, 2016, and that the conclusion letter was issued to Fannie Mae on April 27, 2016.

DER noted in its analysis memorandum that [redacted]. In the conclusion letter, DER reported that it:

> [redacted].

*DER's Quality Control Program* – In a 2015 evaluation, we reported that FHFA's Office of Quality Assurance recommended in 2011 that DER establish and implement formal quality control reviews for examinations and that the then-Deputy Director of DER committed in writing to develop and implement a quality control review program by December 2012. We explained that FHFA, in March 2013, issued SD 2013-01 in which it directed DER and DBR to perform quality control reviews of "examination findings, conclusions, ratings, supporting workpapers, and related documents" and of the ROEs, prior to finalizing them.[14]

Our evaluation catalogued the difficulties and delays in establishing a quality control program within DER. Shortly before we issued that evaluation, and more than two years after SD 2013-01 issued, DER announced it was implementing a program for quality control reviews. We recommended that FHFA "[e]nsure that DER's recently adopted procedures for quality control reviews meet the requirements of Supervision Directive 2013-01 and require DER to document in detail the results and findings of each quality control review in examination workpapers, including any shortcomings found during the quality control review." In its written response, FHFA "agree[d] with this recommendation," and acknowledged that "a process for independent quality control of examination documentation is important to the supervision of Fannie Mae and Freddie Mac." The formal written guidance issued by DER in June 2016, Operating Procedures

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[13] In the request letter and subsequent examination documentation and correspondence, the Quality Control (QC) targeted examination was referred to as Single-Family Loan Quality Center.

[14] DER documents show that the then-Deputy Directors of DBR and DER provided input into the content of SD 2013-01 and formally approved it.

Bulletin DER-OPB-02, *Quality Control Review*, fell short of the requirements of SD 2013-01 because it did not require quality control reviews of the ROEs.

In a recently issued evaluation,[15] we assessed, among other things, whether DER performed independent quality control reviews of the ROEs for the 2015 examination cycle before it issued the ROEs to the Enterprises. Notwithstanding the requirements in SD 2013-01 that an independent quality control review be conducted for every ROE before it issued, a senior DER official reported to us that DER determined that such reviews were not needed because DER conducted quality control reviews of all examination findings and conclusions *before* they were incorporated in the annual ROEs.

*Report of Examination for 2015 Supervisory Cycle* – We found that the ROE for the 2015 examination cycle, dated March 23, 2016, included a narrative consistent with the conclusions stated in DER's analysis memorandum for its QC targeted examination dated March 10, 2016. At that point in time, the findings and conclusions of that QC targeted examination had not been subjected to an internal independent quality control review. That review was completed on April 15, 2016, and a conclusion letter subsequently issued to Fannie Mae on April 27, 2016.

In its technical comments, FHFA sought to dismiss our finding that the conclusions from this targeted examination were included in the ROE before they were subjected to an independent quality control review on the grounds that a "substantive review" of the examination results by the EIC was an acceptable substitute. As mentioned previously, in March 2013, FHFA issued SD 2013-01, which required DER to conduct independent quality control reviews of its examinations and its ROEs. No provision of SD 2013-01 vested DER with authority to waive this requirement and determine that "substantive review" by the EIC was sufficient. DER failed to meet the requirements of SD 2013-01 when it included in the 2015 ROE conclusions from a targeted examination for which no independent quality control review had been conducted.

### *2016 Examination Cycle*

There were no specific risks identified or discussion included related to the new framework in DER's risk assessment for the 2016 examination cycle. The only mention of new framework-related risk in the risk assessment was a notation in the earnings (governance) risk area that the new framework [redacted]

Consistent with a lack of any risks identified in the risk assessment, the 2016 supervisory strategy did not identify the new framework as a focus of supervisory activities. We asked DER's EIC why the new framework was only mentioned in passing in the risk assessment for

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[15] For the full report, see *The Gap in FHFA's Quality Control Review Program Increases the Risk of Inaccurate Conclusions in its Reports of Examination of Fannie Mae and Freddie Mac* (Aug. 17, 2017) (EVL-2017-006) (online at https://www.fhfaoig.gov/Content/Files/EVL-2017-006.pdf).

the 2016 examination cycle and was not mentioned at all in the 2016 supervisory strategy. The EIC could not specifically recall but explained that the new framework received heightened attention in its earlier stages. The EIC commented that DER did not need to dedicate resources to a risk each year if they were comfortable with the examination results of the prior year related to that risk.

In line with the lack of any new framework-related risks identified in the 2016 risk assessment and supervisory strategy for Fannie Mae, no specific targeted examinations and ongoing monitoring activities regarding the new framework were planned and executed during the 2016 examination cycle. However, we found that workpapers supporting a DER 2016 ongoing monitoring activity, single-family credit risk, reflected that DER examiners looked at certain new framework- and LQC-related topics. For example, DER examiners [redacted] DER's summary memorandum for 2016 single-family credit risk ongoing monitoring did not summarize the results of new framework- or LQC-related monitoring. A DER official told us that this conclusion was reached because DER's 2016 ongoing monitoring on this issue did not change the conclusion that DER had reached in its 2015 QC targeted examination. DER did not include any discussion of the new framework in the ROE issued to Fannie Mae on March 3, 2017, for the 2016 examination cycle.

# FINDING

### DER Did Not Complete a 2015 Targeted Examination of Fannie Mae's Implementation of the New Framework before Reporting the Results in the 2015 ROE

DER reported to us that quality control reviews of ROEs are unnecessary because all examination findings and conclusions undergo a quality control review before they are incorporated in the annual ROEs.[16] Here, DER included the results of its QC targeted examination in the ROE issued on March 23, 2016, before that examination had been subjected to an internal quality control review. DER did not complete its quality control review for this targeted examination until April 15, 2016, or issue its conclusion letter to the Enterprise until April 27, 2016.[17] Reporting examination findings in an ROE before they are vetted through a quality control process creates a risk that DER could provide misinformation to the Enterprise and its Board.

# CONCLUSION

We found that DER's planned supervisory activities relating to Fannie Mae's implementation of the new framework for the 2015 examination cycle could be tracked to its risk assessments and supervisory strategies. We also found that DER executed the planned supervisory activities for the 2015 examination cycle. DER did not identify risks associated with the new framework as a specific supervisory focus for the Fannie Mae 2016 examination cycle and did not perform any new framework-related supervisory activities during 2016.

DER reported on a new framework-related targeted examination in the 2015 ROE. However, the targeted examination had not been subjected to an independent quality control review or communicated to Fannie Mae before the ROE issued, contrary to the requirements of SD 2013-01. The failure to perform timely quality control reviews on targeted examinations supporting conclusions communicated in the ROE creates the risk that DER could misinform the Enterprise and its Board on the condition of the Enterprise.

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[16] OIG, *The Gap in FHFA's Quality Control Review Program Increases the Risk of Inaccurate Conclusions in its Reports of Examination of Fannie Mae and Freddie Mac* (Aug. 17, 2017) (EVL-2017-006) (online at https://www.fhfaoig.gov/Content/Files/EVL-2017-006.pdf).

[17] With the issuance of DER-OPB-02, in June 2016, quality control reviews can be waived, but only by the Deputy Director, DER. Such waivers must be documented in the quality control review files.

## RECOMMENDATION........................................................

We recommend that FHFA reinforce the requirements of DER-OPB-02 and hold DER leadership accountable to ensure that targeted examination conclusions presented in the ROE are based on work that has either (1) undergone quality control review and been communicated in writing to the Enterprise, or (2) the required quality control review has been waived by the Deputy Director of DER and documented in writing.

We provided FHFA an opportunity to respond to a draft of this audit report. FHFA provided technical comments on the draft report, which we incorporated as appropriate. In its management response, which is included in the Appendix to this report, FHFA stated that while it disagreed with various statements in the report and the finding, it agreed with our recommendation.

## OBJECTIVE, SCOPE, AND METHODOLOGY ................................

We conducted this audit to assess (1) whether DER's planned supervisory activities relating to Fannie Mae's implementation of the new framework for the 2015 and 2016 examination cycles could be tracked back to its risk assessments and supervisory strategies and (2) whether DER executed and completed these planned supervisory activities during the 2015 and 2016 examination cycles.

To accomplish our objective, we reviewed the *FHFA Examination Manual* (December 2013) and the related Credit Risk Management examination module (July 2013); guidance issued by FHFA and DER related to supervisory planning, execution, and quality control; and supervisory planning and examination documentation supporting the supervisory activities conducted of Fannie Mae as related to the new framework.

Specifically, for Fannie Mae, we:

- Reviewed DER's risk assessments for the 2015 and 2016 examination cycles to identify risks related to the new framework.
- Reviewed DER's supervisory strategy documents for the 2015 and 2016 examination cycles to identify risks related to the new framework.
- Reviewed DER supervisory plan documents for the 2015 and 2016 examination cycles to identify whether planned supervisory activities addressed the risks related to the new framework DER identified in the risk assessments and supervisory strategies.
- Interviewed DER personnel to gain an understanding of the supervision process and examination approach used to supervise Fannie Mae's implementation of the new framework.
- Reviewed DER's workpapers for the targeted examinations and ongoing monitoring related to the new framework performed during the 2015 and 2016 examination cycles to determine whether:
  - Required documents for each type of examination performed were completed and included in examination documentation in accordance with FHFA guidelines, and
  - The scope and conclusions of each of the supervisory activities' conclusion documents addressed the associated supervisory activity objectives.

- Reviewed the 2015 and 2016 ROEs to determine whether the results and conclusions of the new framework-related supervisory activity were discussed.

We conducted this performance audit from March 2017 through September 2017 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: FHFA MANAGEMENT RESPONSE..........................

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: Draft OIG Report: *FHFA's 2015 Report of Examination to Fannie Mae Failed to Follow FHFA's Standards Because It Reported on an Incomplete Targeted Examination of the Enterprise's New Representation and Warranty Framework*

DATE: September 21, 2017

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

While we disagree with various statements in the Report and the finding, the Report's recommendation is reasonable, as we agree that independent quality control (QC) reviews provide an important internal control for supervision of the Enterprises. In accordance with Supervision Directive SD-2017-01, *Quality Control Program* (April 28, 2017), and DER-OPB-02, *Quality Control Reviews* (June 23, 2016), DER conducts independent QC reviews of documentation for examination conclusions, findings, and closures of Matters Requiring Attention before communicating these results in writing to the Enterprises. Internal DER guidance defines examination findings and closures; however, it does not define examination conclusions.

FHFA management's response to the recommendation is below.

**Recommendation:**

*OIG recommends that FHFA reinforce the requirements of DER-OPB-02 and hold DER leadership accountable to ensure that targeted examination conclusions presented in the ROE are based on work that has either (1) undergone quality control review and been communicated in writing to the Enterprise, or (2) the required quality control review has been waived by the Deputy Director, DER, and documented in writing.*

**Management Response to Recommendation:**

FHFA agrees with this recommendation. (i) DER's current internal guidance does not describe the distinction between factual observations and supervisory views on risk exposures. By September 1, 2018, DER will amend its existing internal guidance to define the term "examination conclusions" to clarify what language must go through a QC review before inclusion in the Report of Examination (ROE). (ii) By January 31, 2018, DER will provide training to all examination staff on the provisions of DER-OPB-02 with regard to what should be included in the 2017 ROEs.

cc: John Major, Internal Controls and Audit Follow-up Manager
Larry Stauffer, Acting Chief Operating Officer

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