

Federal Housing Finance Agency
Office of Inspector General



DBR's Safety and Soundness Quality Control Reviews Were Conducted in Compliance with FHFA's Standard During the 2017 Examination Cycle but DBR's Community Investment Quality Control Reviews Were Not



AUD-2018-010

August 17, 2018

Executive Summary

Created by Congress in 2008, the Federal Housing Finance Agency (FHFA) is charged by the Housing and Economic Recovery Act of 2008 (HERA) with oversight of Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System. The FHLBank System consists of the 11 Federal Home Loan Banks (FHLBanks) and the Office of Finance.

FHFA has delegated to its Division of Federal Home Loan Bank Regulation (DBR) the duty to supervise the FHLBanks and the Office of Finance. As such, DBR conducts both on-site annual examinations and off-site monitoring of the FHLBanks and the Office of Finance. In conjunction with this supervision program, FHFA's standard requires that DBR institute a quality control (QC) process to assess examination documentation and "identify significant deviations from FHFA examination standards and supervision policy and afford the examiner-in-charge an opportunity to correct any deviations before final findings, conclusions, and ratings are communicated to the regulated entity or Office of Finance." Additionally, FHFA's standard requires that individuals participating in a QC review be independent, i.e., they must not have participated in the examination activity under review.

In this audit, we sought to determine whether DBR guidance for independent QC activities followed FHFA's standard and to assess whether DBR's independent QC review activities for safety and soundness and for community investment examinations during the 2017 examination cycle met FHFA's standard.

We found that DBR guidance for safety and soundness QC reviews was consistent with FHFA's standard and determined that the safety and soundness QC reviews of examination work performed during the 2017 examination cycle were conducted in compliance with that guidance. However, we found that DBR guidance for community investment QC reviews was not consistent with the FHFA's standard regarding QC reviewer independence and that, in practice, the examination specialist who performed QC reviews for community investment examinations during the 2017 examination cycle was not independent of the examination process, as required by FHFA's standard.

We make two recommendations in this report. In a written management response, FHFA agreed with both recommendations. FHFA's planned corrective actions are responsive to our recommendations.

This report was prepared by James Lisle, Audit Director; April Ellison, Auditor-in-Charge; and Christopher Mattocks, Auditor, with assistance from



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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 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.

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

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ABBREVIATIONS

AHP	Affordable Housing Program
DBR	Division of Federal Home Loan Bank Regulation
DER	Division of Enterprise Regulation
EIC	Examiner-in-Charge
FHLBanks	Federal Home Loan Banks
FHFA or Agency	Federal Housing Finance Agency
OIG	Federal Housing Finance Agency Office of Inspector General
OMWI	Office of Minority and Women Inclusion
OPB	Operating Procedures Bulletin
QC	Quality Control
ROE	Report of Examination
SD	Supervision Directive

BACKGROUND.....

Created by Congress in 2008 the Federal Housing Finance Agency (FHFA or Agency) is charged by the Housing and Economic Recovery Act of 2008 (HERA) with oversight of Fannie Mae, Freddie Mac, and the Federal Home Loan Bank (FHLBank) System.

Federal Home Loan Bank System

The FHLBank System consists of the 11 FHLBanks and the Office of Finance. As of December 31, 2017, the FHLBank System had combined total assets of \$1.103 trillion with total consolidated obligations of approximately \$1.033 trillion.

The FHLBanks are organized under the authority of the Federal Home Loan Bank Act of 1932, as amended. Their mission is to provide reliable liquidity to member institutions (generally, federally insured depository institutions, insurance companies, and eligible community development financial institutions) to support housing finance and community investment. Although federally chartered, the FHLBanks are cooperatives that are privately and wholly owned by their members and former members. Each FHLBank operates as a separate entity within a defined geographic region of the country, known as its district, with its own board of directors, management, and employees. As of December 31, 2017, the total number of members was 6,989.

To accomplish their mission, FHLBanks provide financial products and services to their members, which include advances. These advances assist and enhance a member's financing of: (1) housing, including single-family and multi-family housing serving consumers at all income levels and (2) community lending. Through the Affordable Housing Program (AHP), FHLBanks provide assistance in the purchase, construction, or rehabilitation of homes designed for seniors, the disabled, homeless families, first-time homeowners, and others with limited resources or special needs.¹ The Office of Finance serves as the fiscal agent of the FHLBanks and was established to facilitate the issuance and servicing of FHLBank debt, known as consolidated obligations, and to prepare the quarterly and annual combined financial reports of the FHLBanks.

FHFA's Division of Federal Home Loan Bank Regulation

FHFA has delegated to DBR the duty to supervise the FHLBanks and the Office of Finance. DBR has adopted a supervision program that it maintains is risk-based and consists of both on-site annual examinations and off-site monitoring of the FHLBanks and the Office of Finance.

¹ The FHLBanks' AHPs are governed by section 10(j) of the Federal Home Loan Bank Act, as implemented by the FHFA's AHP regulation, 12 CFR Part 1291. On an annual basis, each of the 11 FHLBanks is required to contribute at least 10 percent of its previous year's net earnings to the AHP, subject to a minimum annual combined contribution by the 11 FHLBanks of \$100 million, in total.

Reporting to the Deputy Director of DBR (Deputy Director), DBR's Examinations Group conducts annual safety and soundness examinations of each FHLBank and the Office of Finance as well as community investment examinations of each FHLBank. DBR issues an annual report of examination (ROE) for each FHLBank and the Office of Finance. The ROEs communicate examination conclusions, findings (if any), and composite and component CAMELSO ratings for the entity.² The ROEs also communicate the results of examination work performed by examiners from FHFA's Office of Minority and Women Inclusion (OMWI); however, the OMWI examination function is not part of DBR.

FHFA's *Examination Manual* provides guidance to DBR teams performing examinations within the FHLBank System. Specifically, Part I of the *Examination Manual* provides a description of the examination program, sets forth the processes examiners are to follow when conducting examination activities at a regulated entity, and describes the work products examiners are to produce during those examinations. Part II of the *Examination Manual* includes a general description of individual supplemental examination modules. The modules provide examination instructions and work programs organized by risk category and line of business. The *Examination Manual* is supplemented by FHFA Advisory Bulletins,³ Supervision Directives,⁴ and Examiner Guidance Bulletins.⁵ DBR also issues Operating Procedures Bulletins (OPBs) that provide specific expectations of examiners who conduct examinations within the FHLBank System.

DBR Quality Control

In March 2013, FHFA issued Supervision Directive (SD) 2013-01, *Quality Control Program for Examinations Conducted by the Division of Bank Regulation and the Division of Enterprise Regulation*, directing the Division of Enterprise Regulation (DER) and DBR to "assess examination findings, conclusions, ratings, supporting workpapers, and related documents for quality control purposes." According to the directive, the assessments should "identify significant deviations from FHFA examination standards and supervision policy and afford the examiner-in-charge (EIC) an opportunity to correct any deviations before final findings, conclusions, and ratings are communicated to the regulated entity or Office of Finance." Additionally, the SD prescribed that participants in a quality control (QC) review must not have

² CAMELSO is a risk-focused rating system under which each FHLBank and the Office of Finance is assigned a composite rating based on an evaluation of various aspects of its operations. The components evaluated are Capital, Asset Quality, Management, Earnings, Liquidity, Sensitivity to Market Risk, and Operational Risk. Due to the nature of its activities, the Office of Finance is only rated on the Management and Operational Risk components.

³ Advisory Bulletins communicate guidance to FHFA supervision staff and the regulated entities on specific supervisory matters.

⁴ Supervision Directives establish guidance for the conduct of supervisory functions at FHFA.

⁵ Examiner Guidance Bulletins establish guidance that provides general procedures to examiners to ensure the consistent application of FHFA examination program requirements by the examination staff.

participated in the examination activity under review. DBR issued two OPBs⁶ to implement SD 2013-01⁷ and establish two QC processes – one for safety and soundness examinations and one for community investment examinations – to validate that: (1) examination work products are consistent with FHFA examination standards and supervision policy; (2) examination procedures are consistent with the examination scope; (3) workpapers evidence the work performed; and (4) workpapers support examination findings, conclusions, and ratings.

According to both OPBs, DBR’s QC process consists of two components: (1) QC reviews performed by the examination team that performed the work (not independent of the work being reviewed) and (2) QC reviews of workpapers⁸ performed by examination specialists whose primary duties are to perform such reviews (independent of the work being reviewed).

For the independent QC reviews, both OPBs state that the QC reviews should be completed before DBR transmits the final ROE to an FHLBank.

* * * * *

Our objectives for this audit were: (1) to determine whether DBR guidance for independent QC activities followed FHFA’s standard and (2) to assess whether DBR’s independent QC review activities for safety and soundness and for community investment examinations during the 2017 examination cycle met FHFA’s standard. We did not assess those pieces of the QC process that were either not an independent QC activity, or an examination function outside of DBR (i.e., OMWI).

⁶ 2014-DBR-OPB-003, *Safety and Soundness Examination Quality Control Program* (Dec. 24, 2014) provides guidance for QC reviews of safety and soundness examinations; 2014-DBR-OPB-004, *Community Investment Examination Quality Control Program* (Dec. 24, 2014) provides guidance for QC reviews of community investment examination work performed by Affordable Housing Program examiners.

⁷ During our audit period, FHFA rescinded and replaced SD 2013-01 with SD 2017-01, *Quality Control Program* (Apr. 28, 2017). (During our audit period, DBR did not revise either of its QC OPBs in response to FHFA’s issuance of SD 2017-01.)

As discussed in our August 2017 evaluation report on DER’s QC review program, FHFA SD 2017-01 eliminates two requirements found in SD 2013-01: pursuant to SD 2017-01, neither ROEs nor CAMELSO ratings are subject to a QC review. See 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 www.fhfa.ig.gov/reports/auditsandevaluations).

⁸ The independent QC review of an examination involves two steps: a “general” workpaper review and a “specific” workpaper review. The general workpaper review assesses the planning, summary results, and reporting of the overall examination by reviewing documents such as the supervisory strategy, examination scope memorandum, scope matrix, findings memorandums, etc. The specific workpaper review assesses supporting documentation for specific examination activities, i.e., those typically associated with an individual examination work program.

FACTS AND ANALYSIS

DBR Guidance for Safety and Soundness QC Reviews Were Consistent with FHFA’s Standard and Implemented in Practice

We found that 2014-DBR-OPB-003, which provides guidance for executing QC reviews of safety and soundness examinations, is consistent with SD 2013-01 with regard to the scope, timing, and documentation of QC reviews, as well as the competence and independence of individuals performing these reviews.

We also found that independent QC reviews were performed and documented in accordance with the guidance set forth in 2014-DBR-OPB-003 for each of the 12 annual safety and soundness examinations of the FHLBanks and the Office of Finance performed during the 2017 examination cycle. Our review of the workpapers documenting QC reviews of safety and soundness examinations found the following.

- General workpaper reviews were performed for all 12 safety and soundness examinations conducted during 2017.
- Specific workpaper reviews were performed on at least two work programs from each examination and met the guidance for work program selection in 2014-DBR-OPB-003. In total, specific reviews were performed on 25 (10 percent) of the 250 individual work programs completed by DBR safety and soundness examiners during the 2017 examination cycle.
- Examination specialists performing the QC reviews had not participated in the examination they reviewed and met competence requirements.
- QC reviews were completed, documented in the examination workpapers, and the findings identified were communicated to the examination team prior to the issuance of the ROE. We verified corrective action for a sample of 6 of 15 findings identified during the QC reviews that potentially impacted the ROE. In each case, the finding was addressed by the examination team before the ROE issued.

To test the examination specialists’ adherence to DBR guidance for QC reviews, we selected two general workpaper reviews and two specific workpaper reviews, and validated a sample of QC procedures performed by DBR examination specialists. For example, we reviewed certain examination workpapers to determine whether the QC results were supported as required by DBR guidance for QC reviews. We identified no exceptions to DBR guidance for QC reviews.

DBR Guidance and Practice for QC Reviews of Community Investment Examinations Were Not Consistent with the FHFA Standard Requiring Participant Independence from the Examination Work Under Review

SD 2013-01 and its successor, SD 2017-01, require that personnel performing a QC review “*must not have participated* in the examination activity under review.” (emphasis added) Both DBR and DER must follow SD 2017-01. However, DBR’s OPB governing QC reviews of community investment examinations, 2014-DBR-OPB-004, is at odds with SD 2013-01 and SD 2017-01 because both documents direct that an individual cannot independently review his or her own work. According to 2014-DBR-OPB-004, DBR considers the examination specialist conducting independent QC reviews for community investment examinations to be independent because “he or she *customarily does not participate* in DBR examination fieldwork.” (emphasis added) Accordingly, this OPB creates the risk that an examiner who participates in the community investment examination also conducts the QC review, which would run afoul of SD 2017-01.

We assessed 11 QC reviews of community investment examinations conducted during the 2017 examination cycle against the independence requirement in SD 2013-01 and SD 2017-01 and found that all failed to meet it. Each of these 11 QC reviews were conducted by an examination specialist who also participated in the fieldwork underlying the examination.

We asked the Associate Director, Office of Affordable Housing Programs, to explain the conflict between the independence requirement in SD 2013-01 and SD 2017-01 and the lack of independence of the AHP examination specialist. She explained that DBR never intended the role of the AHP examination specialist to be entirely independent, which it flagged by using the language “*customarily does not participate*” in 2014-DBR-OPB-004.

We raised the same question with the current Deputy Director.⁹ He explained that DBR leadership determined that the QC reviews of community investment examinations did not require a full-time dedicated examination specialist and assigned the same AHP examination specialist to perform the underlying community investment examinations: he reviewed his own work, in violation of the prohibitions in SD 2013-01 and SD 2017-01.

The Deputy Director acknowledged to us that the AHP examination specialist lacked independence for purpose of the QC review. He further reported that DBR’s organizational structure—in which all examination specialists report to Associate Directors, who are responsible for the examination work—was not ideal, and he sought to expand the QC function to other activities within DBR. He advised us that, as of January 2018, a separate QC branch within DBR was created to perform QC reviews of both the safety and soundness examinations and the community investments examinations. This new QC branch is headed by a QC manager who reports directly to the Deputy Director. Additionally, the QC manager

⁹ The current Deputy Director’s appointment to this position was effective August 18, 2017. The Deputy Director had previously served as an Associate Director within DBR.

told us that DBR plans to issue new OPBs for the QC function later this year, after DBR has gained experience under the revised QC process. (Implementation of this organizational restructure occurred outside our audit period.)

FINDING

Quality Control Reviews of Community Investment Examinations Did Not Meet FHFA’s Standard for Independence

QC reviews provide greater objectivity when performed by reviewers who do not have responsibility for the activities being evaluated. The AHP examination specialist who performed QC reviews for community investment examinations was not independent of the examination process as required by FHFA’s SD 2013-01 and its successor, SD 2017-01. Specifically, we found that DBR’s guidance, 2014-DBR-OPB-004, for QC reviews of community investment examination activities did not meet FHFA’s standard because it did not require examination specialists performing the QC reviews to be independent, and all 11 QC reviews of community investment examinations conducted during the 2017 examination cycle did not meet FHFA’s standard because they were conducted by an examination specialist who also participated in the underlying fieldwork.

The Deputy Director stated that a separate QC branch was established within DBR after our audit period that would, among other things, address the lack of independence with QC reviews of community investment examinations. The QC manager also stated that new DBR OPBs for the QC function are planned for later this year, after experience is gained with the revised QC process.

CONCLUSIONS

We found that DBR guidance for safety and soundness QC reviews was consistent with FHFA’s standard and that safety and soundness QC reviews of examination work performed during the 2017 examination cycle were conducted in compliance with that guidance. However, we also found that DBR guidance for community investment QC reviews was not consistent with FHFA’s standard regarding QC reviewer independence and, in practice, the AHP examination specialist who performed QC reviews for community investment examinations during the 2017 examination cycle was not independent of the examination process as required by FHFA’s standard.

RECOMMENDATIONS

We recommend that FHFA:

1. Ensure that examination specialists reviewing community investment examinations under DBR’s revised independent QC process did not participate in the examination activity under review.
2. Ensure the planned OPBs for independent QC reviews of DBR examinations are issued and conform to SD 2017-01, to include the requirement that personnel performing the QC review must not have participated in the examination activity under review.

FHFA COMMENTS AND OIG RESPONSE

We provided FHFA an opportunity to respond to a draft of this audit report. In its management response, which is included in the Appendix to this report, FHFA agreed with both recommendations. FHFA stated that in January 2018, DBR reorganized its quality control group as an independent function within DBR reporting directly to the Deputy Director. FHFA also stated that, by December 31, 2018, it will revise its QC procedures to articulate expectations of the independence of QC reviewers and consistency with SD-2017-01. In addition, FHFA stated that the new structure, combined with planned procedural changes, will ensure that examination specialists will not perform examination work that is subsequently subject to their QC review. We consider FHFA’s planned corrective actions responsive to our recommendations.

OBJECTIVE, SCOPE, AND METHODOLOGY

We conducted this audit (1) to determine whether DBR guidance for independent QC activities followed FHFA’s standard and (2) to assess whether DBR’s independent QC review activities for safety and soundness and for community investment examinations during the 2017 examination cycle met FHFA’s standard. We did not assess those pieces of the QC process that were either not an independent QC activity, or an examination function outside of DBR (i.e., OMWI).

To accomplish our objective, we performed the following.

- Reviewed the FHFA *Examination Manual* (December 2013) and the following QC program guidance.

- FHFA SD 2013-01, *Quality Control Program For Examinations Conducted By The Division of Bank Regulation And The Division of Enterprise Regulation* (March 25, 2013)
- FHFA SD 2017-01, *Quality Control Program* (April 28, 2017), which rescinded and replaced SD 2013-01
- 2014-DBR-OPB-003, *Safety and Soundness Examination Quality Control Program* (December 24, 2014)
- 2014-DBR-OPB-004, *Community Investment Examination Quality Control Program* (December 24, 2014)
- Compared DBR's QC OPBs to FHFA's standard, FHFA SD 2013-01 and FHFA SD 2017-01, to assess whether the OPBs were consistent with FHFA's standard.
- Interviewed DBR management and examination specialists to gain an understanding of the QC process, identify significant deviations between actual practice and written procedures, and identify the causes of those deviations.
- Assessed the coverage of independent QC reviews for the period under review by comparing the QC reviews performed to the population of work programs executed during each examination of an FHLBank and the Office of Finance during the 2017 examination cycle.
- Reviewed documentation for each general and specific QC review performed during 2017 to determine whether they were performed, documented, and communicated in accordance with DBR's QC OPBs.
- Selected a sample of two general and two specific QC reviews from the population of safety and soundness QC reviews performed during the 2017 examination cycle. The two general reviews and one of the specific reviews were randomly selected. The other specific review was selected based on an elevated number of findings identified by DBR in their QC review. We also randomly selected one community investment QC review. We used examination workpapers, QC review workpapers, and the listed examination guidance below to validate a sample of QC procedures performed by DBR examination specialists for each selected QC review.
- 2012-DBR-OPB-03, *Work Program Minimum Frequency* (December 19, 2012; updated February 7, 2014), which establishes minimum frequency expectations for the work programs DBR supervision staff use in an examination's onsite scope.

- 2016-DBR-OPB-01, *Federal Home Loan Bank Examination Workpaper Standards* (July 29, 2016), which establishes expectations for the standards and quality of examination support documentation, or workpapers.
- Advisory Bulletin 2017-01, *Classifications for Adverse Examination Findings* (March 13, 2017), which establishes classifications of adverse examination findings at Fannie Mae, Freddie Mac, the FHLBanks, and the Office of Finance.
- 2017-DBR-OPB-01, *Federal Home Loan Bank Examination Adverse Findings Processes* (April 19, 2017), which communicates various processes related to adverse examination findings at examinations of the FHLBanks and Office of Finance. It complements Advisory Bulletin 2017-01.
- FHFA Examination Practices Bulletin EPB 2014-01, *Sampling Practices in Examinations* (February 2014), which provides examiners with guidance on sampling practices to aid them in the performance of mandatory testing in accordance with FHFA examination work programs.

We conducted this performance audit from March 2018 through August 2018 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: Andre D. Galeano, Deputy Director, Division of FHLBank Regulation

SUBJECT: Draft Audit Report: *DBR's Safety and Soundness Quality Control Reviews Were Conducted in Compliance with FHFA's Standard during the 2017 Examination Cycle But DBR's Community Investment Quality Control Reviews Were Not*

DATE: August 14, 2018

Thank you for the opportunity to respond to the Office of Inspector General draft report titled *DBR's Safety and Soundness Quality Control Reviews Were Conducted in Compliance with FHFA's Standard during the 2017 Examination Cycle But DBR's Community Investment Quality Control Reviews Were Not*. The report found that parts of DBR's quality program were not fully independent during 2017 examinations. FHFA-OIG makes two recommendations, to which FHFA agrees.

OIG Recommendation 1: [OIG recommends that FHFA] Ensure that examination specialists reviewing community investment examinations under the DBR's revised independent QC process did not participate in the examination activity under review.

OIG Recommendation 2: [OIG recommends that FHFA] Ensure the planned OPBs for independent QC reviews of DBR examinations are issued and conform to SD 2017-01, to include the requirement that personnel performing the QC review must not have participated in the examination activity under review.

Management Response to Recommendations 1 & 2: FHFA agrees with both recommendations. In January of this year, DBR reorganized its quality control group as an independent function within DBR reporting directly to the Deputy Director. By December 31, 2018, we will revise our QC procedures to articulate expectations of the independence of QC reviewers and consistency with Supervisory Directive SD 2017-01. Our new structure,

combined with our planned procedural changes, will ensure that examination specialists will not perform examination work that is subsequently subject to their QC review.

We appreciate the work and professionalism of the OIG Audit staff who worked with FHFA during this engagement. Please feel free to contact me with any questions or concerns.

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

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