

Federal Housing Finance Agency
Office of Inspector General



Compliance Review of Federal Home Loan Bank Fraud Reporting to FHFA



COM-2017-002

January 24,
2017

Executive Summary

The Federal Housing Finance Agency (FHFA or the Agency) is responsible for ensuring the safety and soundness of its regulated entities, which include 11 regional Federal Home Loan Banks (FHLBanks). The FHLBanks loan funds to member financial institutions to finance housing, economic development, infrastructure, and jobs.

During the course of a criminal investigation in 2014, the FHFA Office of Inspector General's (OIG) Office of Investigations (OI) determined that one of the FHLBanks delayed reporting fraud and employee misconduct to FHFA. OI also found that FHFA's policy and related guidance in effect at that time did not explicitly require FHLBanks to notify the Agency of potential fraud and employee misconduct. Consequently, on June 27, 2014, OI recommended to FHFA that it amend its policy to require FHLBanks to report, among other things, fraud and employee misconduct to FHFA.

FHFA's Division of Federal Home Loan Bank Regulation (DBR) agreed with OI's written recommendation. In its management response dated July 28, 2014, the Deputy Director for DBR committed to align his division's standards for reporting employee misconduct or insider fraud with those of other federal financial regulators by January 15, 2015. On February 12, 2015, DBR issued Advisory Bulletin 2015-01, *FHLBank Fraud Reporting* (AB 2015-01). As set forth below, AB 2015-01 establishes the following guidelines and deadlines for the 11 FHLBanks:

- Notify DBR within one calendar day of fraud or possible fraud that is "significant," which AB 2015-01 defines as that "which may affect the integrity of or public confidence in the FHLBank or the U.S. Government."
- Notify DBR on the day of the filing of a Suspicious Activity Report (SAR) with the U.S. Department of Treasury's Financial Crimes Enforcement Network (FinCEN). A SAR provides information to FinCEN involving known or suspected criminal offenses or financial transactions of at least \$5,000 that financial institutions – such as FHLBanks – suspect involve money laundering or violate relevant statutes.
- Report fraudulent activity to DBR via the Cumulative Quarterly Status Report within 10 calendar days after quarter-end. The FHLBanks summarize previously submitted immediate notifications and SAR filings in this quarterly report.



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- Designate an employee as a fraud officer and submit an Annual Conformance Report by September 30 of the respective year. The annual report primarily describes an FHLBank's fraud policies, procedures, internal controls, and training, as well as the FHLBank's efforts to remediate serious fraud-related deficiencies identified during DBR examinations.

OIG's OI deemed DBR's actions to be responsive to its recommendation and considered the recommendation closed as of February 20, 2015.

The Deputy Director of DBR reported to us that our recommendation identified a weakness in prior guidance and that DBR's adoption of our recommendation strengthened the FHLBanks' fraud reporting and notified DBR of fraud that previously would have been unreported. In his view, this additional reporting has enhanced DBR's oversight of the FHLBanks.

In this compliance review, we tested the FHLBanks' compliance with three requirements in AB 2015-01 for the six-month period January 1, 2016, through June 30, 2016 (review period). We tested compliance with AB 2015-01's fourth requirement as of September 30, 2016. To do so, we reviewed documentation for the entire population of immediate notifications. We also selected a sample of SARs and all of the FHLBanks' Cumulative Quarterly Status Reports and Annual Conformance Reports issued during the review period to determine if the FHLBanks submitted those reports by the required deadlines. We studied the Annual Conformance Reports to determine whether they included the required content. Finally, we interviewed DBR personnel regarding the FHLBanks' fraud reporting.

Through our testing, we determined that the FHLBanks generally complied with the four requirements in AB 2015-01. We found that the FHLBanks submitted (with marginal exceptions) the immediate notifications, SAR filing notifications, quarterly reports, and annual reports by the required deadlines. We determined that each FHLBank designated an employee responsible for reporting fraud, and each described in its annual report fraud-related policies, procedures, training, and serious deficiency remediation efforts. Based on our compliance testing, we conclude that the FHLBanks successfully implemented AB 2015-01.

This report was prepared by Alisa Davis, Senior Policy Advisor, with assistance from Omolola Anderson, Senior Statistician, Timothy Callahan, Attorney Advisor, and Wesley M. Phillips, Senior Policy Advisor. We appreciate the cooperation of FHFA staff, as well as the assistance of all those who contributed to the preparation of this report.



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

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ABBREVIATIONS

AB 2015-01	Advisory Bulletin 2015-01, <i>FHLBank Fraud Reporting</i>
DBR	Division of Federal Home Loan Bank Regulation
FHFA or Agency	Federal Housing Finance Agency
FHLBank	Federal Home Loan Bank
FIFO	Financial Instrument Fraud Officer
FinCEN	U.S. Department of Treasury's Financial Crimes Enforcement Network
MRAs	Matters Requiring Attention
OI	Federal Housing Finance Agency Office of Inspector General's Office of Investigations
OIG	Federal Housing Finance Agency Office of Inspector General
SAR	Suspicious Activity Report

BACKGROUND.....

Like other financial institutions, the FHLBanks are susceptible to fraud perpetrated by their employees, counterparties, and other individuals and entities. For example, an FHLBank employee might initiate an unauthorized wire transfer of FHLBank funds to cover personal expenses or collude with an affordable housing developer to falsify documents to make it appear as though an affordable housing project is eligible for an FHLBank subsidy.¹

During the course of a criminal investigation in 2014, OI determined that an FHLBank delayed reporting fraud and employee misconduct to FHFA. OI also determined that FHFA's policy and related guidance did not expressly require the FHLBanks to notify the Agency of all potential fraud and employee misconduct.² Consequently, on June 27, 2014, OI recommended in writing to FHFA that the Agency "add to existing reporting policy that all types of fraud and employee misconduct are to be reported" to FHFA.

In DBR's written management response dated July 28, 2014, the Deputy Director of DBR agreed with the recommendation. The Deputy Director committed to prepare by January 15, 2015, guidance that would align DBR's fraud and employee misconduct reporting standards with those of other federal financial regulators. On February 12, 2015, DBR issued AB 2015-01³ in response to the recommendation.⁴

AB 2015-01 established the following reporting requirements⁵ for the FHLBanks to notify FHFA of possible and actual fraud (collectively, fraud), and relevant information regarding their anti-fraud programs to facilitate its supervisory oversight.

¹ The FHLBanks' Affordable Housing Programs support FHLBanks' housing finance mission by providing subsidies to its members, enabling them to make available owner-occupied or rental housing to individuals with very low-, low-, and moderate-incomes. Certain programmatic funds are allocated pursuant to an application process; the affected FHLBank evaluates applications for compliance with program requirements.

² The governing policy is set forth in 12 U.S.C. § 4642 and 12 C.F.R. Part 1233. Related guidance in effect at the time was contained in FHFA's Regulatory Policy Guidance (RPG-2011-001).

³ An advisory bulletin is an FHFA staff document that provides guidance to its regulated entities regarding particular supervisory issues. Although an advisory bulletin does not have the force of a regulation or an order, it does reflect the position of FHFA on a particular issue and is followed by supervisory staff.

⁴ See FHFA, Advisory Bulletin 2015-01, *FHLBank Fraud Reporting* (Feb. 12, 2015) (online at www.fhfa.gov/SupervisionRegulation/AdvisoryBulletins/AdvisoryBulletinDocuments/2015-AB-01_Bank_Fraud_Reporting_for_2-12-2015.pdf) (accessed Oct. 24, 2016).

⁵ AB 2015-01 uses the term "should" when describing the FHLBanks' notification and reporting responsibilities. According to the Deputy Director of DBR, FHFA expects the FHLBanks to comply with the term of this and all advisory bulletins.

Immediate Fraud Notification

AB 2015-01 requires an FHLBank to notify DBR within one calendar day of discovering fraud that may involve a “significant fiscal, financial, or reputational impact on the FHLBank, when a significant fraud or possible fraud involves a vendor, or when a fraud or possible fraud involves insider fraud, including employee misconduct.”⁶ Such notifications are termed “immediate notifications.” DBR developed a form on which an affected FHLBank must report an immediate notification. It captures information such as an estimated dollar amount of the fraud and contains a description of the fraud. An example of this form is in the Appendix. Each affected FHLBank is expected to submit the completed immediate notification form to a DBR website and to notify DBR by email that the form has been submitted.

SAR Filing Notification

The second reporting requirement in AB 2015-01 directed an affected FHLBank to notify DBR on the same day that it files a **SAR** with FinCEN.⁷ DBR also developed a form for affected FHLBanks to use for the SAR filing notifications, which includes fields such as the date the FHLBank filed the SAR, the discovery date, an estimated dollar amount of the fraud, and a description of the fraud. Similar to the process for submission of the immediate notification forms, the affected FHLBank submits the SAR notification form to a DBR website and notifies DBR by email that the form has been submitted.

SAR: Certain financial institutions are required to report to FinCEN known or suspected criminal offenses at specified thresholds, or transactions over \$5,000 that they suspect involve money laundering, or that violate the Financial Recordkeeping and Reporting of Currency and Foreign Transactions Act of 1970, also referred to as the Bank Secrecy Act.

Cumulative Quarterly Status Report

Third, the FHLBanks must submit quarterly summaries to DBR in which they report on all immediate notification and SAR notification forms previously submitted and any updates to the information on those forms.⁸ Again, DBR has created a template – the Cumulative

⁶ FHFA, Advisory Bulletin 2015-01, *FHLBank Fraud Reporting*, at 3 (Feb. 12, 2015) (online at www.fhfa.gov/SupervisionRegulation/AdvisoryBulletins/AdvisoryBulletinDocuments/2015-AB-01_Bank_Fraud_Reporting_for_2-12-2015.pdf).

⁷ The Bank Secrecy Act’s requirements for what must be reported in a SAR do not necessarily constitute “significant” fraud per AB 2015-01’s immediate notification requirement.

⁸ DBR also requires all FHLBanks to report on all SARs filed during the current year, even if outside the quarter, as well as SARs related to ongoing inquiries and any SARs closed or resolved during the past three years.

Quarterly Status Report – to be used by the FHLBanks for capturing that information. Each FHLBank is required to submit its completed Cumulative Quarterly Status Report within 10 calendar days after the end of the quarter, even if no reportable events occurred during the reporting period, through a DBR website.

Annual Conformance Report

Finally, each FHLBank is required to prepare and submit to its Board of Directors and DBR an Annual Conformance Report by September 30 of each calendar year. At a minimum, this report is expected to include the following information: a summary of the FHLBank’s fraud policies, procedures, and internal controls; anti-fraud training; other actions taken by the FHLBank to conform to the provisions of AB 2015-01; and the status of the FHLBank’s efforts to remediate fraud-related matters requiring attention (MRAs) identified as part of DBR examinations.⁹ In addition, DBR expects each FHLBank to designate a Financial Instrument Fraud Officer (FIFO) or the equivalent with overall responsibility for overseeing the fraud program, as well as fraud investigations and reporting. DBR allows each FHLBank to choose the annual reporting format. The FHLBanks submit their Annual Conformance Reports to DBR through the DBR website.

OI deemed DBR’s issuance of AB 2015-01 as responsive to its written recommendation and closed the recommendation as of February 20, 2015.

⁹ FHFA considers MRAs to be “the most serious supervisory matters,” and it issues them for non-compliance with laws or regulations that result, or may result, in significant risk of financial loss or damage, repeat deficiencies that have escalated due to insufficient action or attention, unsafe or unsound practices, and breakdowns in risk management, significant control weaknesses, or inappropriate risk-taking.

COMPLIANCE REVIEW RESULTS

We tested the FHLBanks' compliance with three of AB 2015-01's requirements for the period January 1, 2016, through June 30, 2016; we tested compliance with the fourth requirement as of September 30, 2016. Specifically, we tested whether the FHLBanks submitted to DBR: immediate notifications of fraud within one calendar day of discovery; SAR filing notifications the same day the FHLBanks submitted a SAR to FinCEN; Cumulative Quarterly Status Reports within 10 days of quarter-end; and Annual Conformance Reports by September 30, 2016, inclusive of the required content and designation of the FIFO.¹⁰ Our testing determined that the FHLBanks complied with all four AB 2015-01 requirements during the review period with a few marginal exceptions as described below.¹¹

1. DBR Documentation Indicates that FHLBanks Complied with the Immediate Fraud Notification Requirement.

AB 2015-01 requires the FHLBanks to notify DBR "immediately" of significant fraud, i.e., within one calendar day of discovering the fraud. During our review period, FHLBanks notified DBR of three significant frauds. Initially we were unable to verify that the FHLBanks complied with the immediate notification requirement from the form that DBR developed because that form does not include a field to record the date upon which the fraud was discovered.¹² However, the FHLBanks are required to report the date upon which frauds were discovered in their Cumulative Quarterly Status Reports. We reviewed the dates reported in the Cumulative Quarterly Status Reports against the information on the three immediate notifications and determined that the three significant frauds were reported within one calendar day of discovery.

2. The FHLBanks Complied with the SAR Filing Notification Deadlines.

We tested a sample of SAR notification forms to assess whether the FHLBanks complied with AB 2015-01's requirement to notify DBR the same day an FHLBank files a SAR with

¹⁰ The Annual Conformance Reports in our review period covered FHLBank activity from July 1, 2015 through June 30, 2016.

¹¹ Our review objective focused on FHLBank fraud reporting, because the underlying finding and corrective action addressed FHLBank failure to notify DBR of fraud. We did not test DBR's actions subsequent to receiving fraud notifications and reports.

¹² The FHLBanks' description of the fraud in the form sent to DBR did not explicitly identify a discovery date either.

FinCEN.¹³ To select the sample, we reviewed the FHLBanks' Cumulative Quarterly Status Reports provided by DBR, which contained an initial population of 70 SARs filed during the review period. We selected a random sample of 16 SARs, representing more than 20% of the volume of SARs filed during the review period.¹⁴

To test compliance, we reviewed copies of the 16 SAR notification forms that the FHLBanks submitted to DBR and the 16 accompanying emails against the date of the SAR reported in the Cumulative Quarterly Status Reports. From this review, we determined that, as required by AB 2015-01, the FHLBanks notified DBR the same day that they filed a SAR with FinCEN for the entire sample.

3. The FHLBanks Generally Complied with the Cumulative Quarterly Status Report Deadlines.

We also tested whether the FHLBanks complied with AB 2015-01's requirement to submit the Cumulative Quarterly Status Reports within ten days of quarter-end. To do so, we obtained from DBR all such reports from our review period, the associated emails from the FHLBanks to DBR containing those reports, and the automated email notifications that DBR receives from its centralized fraud reporting email address. We then compared the email dates to the respective quarterly deadlines (April 10, 2016, and July 10, 2016).

We determined that the FHLBanks submitted 20 of the 22 Cumulative Quarterly Status Reports by the reporting deadline. In the other two instances, the FHLBanks submitted the reports one and three days past the reporting deadline, respectively.

4. The FHLBanks Complied with the Annual Conformance Report Deadline and Content Requirements.

Last, we tested whether the FHLBanks complied with AB 2015-01's requirement to submit the Annual Conformance Report by September 30, 2016, whether the submitted reports contained the four required sections outlined in AB 2015-01,¹⁵ and whether each FHLBank disclosed the employee designated as the FIFO.

¹³ Our scope did not include testing FHFA's oversight of the FHLBanks' SAR processes. With respect to SARs, our scope was limited to AB 2015-01's requirement that the FHLBanks notify FHFA when they file a SAR.

¹⁴ See the Objective, Scope, and Methodology section of this report for additional information on the sampling methodology.

¹⁵ Those four sections include: fraud policies, procedures, and internal controls; anti-fraud training program; other actions regarding conformance to AB 2015-01; and the remediation status of fraud-related MRAs.

On September 30, 2016, DBR provided us with the Annual Conformance Reports submitted by the 11 FHLBanks. Accordingly, all FHLBanks met the deadline in AB 2015-01. Our review of the Annual Conformance Reports submitted by the 11 FHLBanks found that all contained the content required by AB 2015-01.

We spoke with the Deputy Director of DBR about the impact of our recommendation on FHLBank fraud reporting. The Deputy Director reported to us that our recommendation addressed a weakness in prior guidance and that DBR’s adoption of our recommendation strengthened the FHLBanks’ fraud reporting and notified DBR of fraud that previously would have been unreported. In his view, this additional reporting has enhanced DBR’s oversight of the FHLBanks.

CONCLUSION.....

We determined that the FHLBanks established fraud program fundamentals outlined in AB 2015-01 and generally complied with the notification and reporting requirements. Based on our compliance testing, we conclude that the FHLBanks successfully implemented AB 2015-01. Statements from the Deputy Director of DBR affirm that the Agency’s adoption of our recommendation strengthened the FHLBanks’ fraud reporting and DBR’s fraud oversight capacity.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of this compliance review was to test the 11 FHLBanks' compliance with key requirements in AB 2015-01 for reporting fraud.¹⁶ Specifically, we assessed during the period of January 1, 2016, to June 30, 2016, whether the FHLBanks: (1) notified DBR within one calendar day of discovering fraud covered by the immediate notification standard; (2) notified DBR the same day they filed a SAR with FinCEN; and (3) submitted the Cumulative Quarterly Status Report within ten days after quarter-end. Separately, we determined if the FHLBanks submitted the Annual Conformance Report by September 30, 2016, and included the required content.

To determine the FHLBanks' compliance with the immediate notification one calendar day deadline, we obtained the entire population of three immediate notifications from DBR. We compared the discovery date from the Cumulative Quarterly Status Report to the date the FHLBanks notified DBR of the fraud.

To assess the FHLBanks' compliance with the SAR filing notification requirement, we compiled a report of the population of 70 SARs based on the Cumulative Quarterly Status Reports from DBR. We selected a random sample of 16 notifications, which represents more than 20% of the population.¹⁷ Then, we compared the SAR filing date per the SAR filing notification to the date the FHLBanks emailed DBR about the SARs.

To determine if the FHLBanks complied with the Cumulative Quarterly Status Report submission deadline, we obtained all 22 reports that the FHLBanks submitted to DBR during the review period. We then compared the date the FHLBanks submitted the reports by email or via a DBR website to the quarterly deadlines of April 10, 2016, and July 10, 2016.

To ascertain the FHLBanks' compliance with the Annual Conformance Report submission deadline and report content, as well as designation of the FIFO and fraud training program, we obtained all 11 reports from DBR. We reviewed the content of the reports, including disclosure of the FIFO, policies and procedures, internal controls, training program, other actions, and remediation status of MRAs.

¹⁶ We did not test DBR's actions subsequent to receiving fraud notifications and reports.

¹⁷ The population of 70 SAR filing notifications is small. A statistical sample would require almost all 70 records to be tested. Accordingly, we tested a random, but non-statistical, sample. Although we cannot statistically project our test results to the population, the randomness and size of the sample allows for the collection of unbiased, evidential material for assessing the controls for the population. The 20% sample of the population exceeds the generally accepted level of 10% for testing small populations. See American Institute of Certified Public Accountants, *Audit Sampling Considerations of Circular A-133 Compliance Audits* (2009).

Finally, we interviewed DBR personnel, and we reviewed other public and internal DBR documents relating to fraud reporting.

We conducted our compliance review during the period September 2016 to November 2016 under the authority of the Inspector General Act of 1978, as amended, and in accordance with the Quality Standards for Inspection and Evaluation (January 2012), which were promulgated by the Council of the Inspectors General on Integrity and Efficiency.

We provided a draft of this report to FHFA for its review and comment. The Agency did not provide a management response letter or technical comments.

APPENDIX.....

Illustrative Immediate Notification Template

 SDR2015-01 Fraud Reporting		Federal Housing Finance Agency IMMEDIATE NOTIFICATION FRAUD REPORTING FORM	
FHFA Contact Info 		Bank Submitter Contact Info Name <input type="text"/> Title <input type="text"/> Phone <input type="text"/> Email <input type="text"/>	
FHLBank District Name <input type="text"/>	Form Filing Date <input type="text"/>	Estimate of Amount Involved <input type="text"/>	
Description of Fraud or Possible Fraud <div style="background-color: #e0e0ff; height: 150px;"></div>			
Type of Financial Instruments or Fraudulent Activity Involved <div style="background-color: #e0e0ff; height: 150px;"></div>			
Instructions for Completion and Submission <p>Within one calendar day of the discovery of a fraud that may have a significant impact, your Bank must:</p> <ul style="list-style-type: none"> • Fill out this form completely, save as a .PDF document, and email to FHLBankfraudnotification@fhfa.gov • Upload this file to your Bank's Data\Fraud Reporting\Immediate Notification Secure Bank Portal folder. • Email FHLBankfraudnotification@fhfa.gov to notify the FHFA of the filing and attach this form. • Call the FHFA contact listed on this form to notify the FHFA of the discovery and this confirm form submission. <p>Completion and submission of this form is required by 12 CFR §1233.3. For additional Fraud Reporting Requirements and for further instructions on how to submit this form, please see Advisory Bulletin AB2015-01 (FHLBank Fraud Reporting); SDR2015-01 (FHLBank Fraud Reporting) or call the FHFA contacts listed above.</p>			
<small>Form Effective 12/01/15</small>			

Source: FHFA.

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