Federal Housing Finance Agency
Office of Inspector General

Compliance Review of FHFA's Risk Assessments of the Enterprises

Compliance Review • COM-2019-006 • August 14, 2019

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Executive Summary

In the Housing and Economic Recovery Act of 2008, Congress charged the Federal Housing Finance Agency (FHFA) with, among other things, the supervision of Fannie Mae and Freddie Mac (the Enterprises) and the Federal Home Loan Bank System. In its role as supervisor, FHFA is tasked to ensure that these entities operate safely and soundly so that they serve as a reliable source of liquidity and funding for housing finance and community investment. FHFA's Division of Enterprise Regulation (DER) is responsible for conducting annual examinations of the Enterprises, which consist of targeted examinations and ongoing monitoring.

DER performs an annual risk assessment of each Enterprise that highlights both strengths and vulnerabilities. According to FHFA's *Examination Manual*, the risk assessment provides the foundation for preparing the supervisory strategy and determining the examination activities to be conducted in the annual supervisory plan (also called the annual examination plan) for each Enterprise. The annual examination plan identifies all targeted examinations and ongoing monitoring activities of selected areas of high importance or risk, as identified in the risk assessment. In this way, FHFA examiners are able to leverage their resources by focusing their activities around the risks identified as posing the highest supervisory concerns.

In September 2016, the FHFA Office of Inspector General (OIG) issued an audit report in which we found, among other things, that: (1) almost half of DER's high-priority targeted examinations for 2014 and 2015 did not trace to DER risk assessments; and (2) the risk assessments that DER prepared did not identify or explain the severity of the risks discussed within the risk assessment. We recommended that FHFA "[e]nsure that risk assessments support the supervisory plans in terms of the targeted examinations included in those supervisory plans and the priority assigned to those targeted examinations." The Agency generally agreed with the recommendation, committing to assess the effectiveness of its existing guidance and to consider OIG's recommendation as part of the assessment.

DER reviewed its risk assessment procedures and amended its guidance in September 2017, establishing revised procedures for the preparation, format, documentation, and approval of risk assessments. The revised guidance required that risk assessments adhere to a template, and it included instructions on required content. OIG concluded that, although DER's revised guidance did not align completely with the elements of recommendation, it satisfied the intent of the recommendation: that risk assessments support the examination plans. We closed the recommendation in October 2017.

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OIG initiated this review in April 2019 to assess FHFA's implementation of its revised risk assessment guidance. The scope of our review was limited to the risk assessments leading to the 2018 and 2019 annual examination plans for the Enterprises. We concluded that FHFA substantially implemented its revised guidance governing the content and approval of risk assessments. Where we noted departures from the guidance, we found that DER explained them sufficiently.

We provided a draft of this report to FHFA. The Agency provided a technical comment but no written management response.

This report was prepared by Patrice E. Wilson, Senior Investigative Evaluator, and Gregg M. Schwind, Attorney Advisor. 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.

Brian W. Baker
Acting Deputy Inspector General for Compliance & Special Projects

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ABBREVIATIONS

AML	Anti-Money Laundering
BSA	Bank Secrecy Act
DER	Division of Enterprise Regulation
EIC	Examiner-in-Charge
Enterprises	Fannie Mae and Freddie Mac
FHFA or Agency	Federal Housing Finance Agency
OFAC	Office of Foreign Assets Control
OIG	Federal Housing Finance Agency Office of Inspector General
OPB	Operating Procedures Bulletin

BACKGROUND

In the Housing and Economic Recovery Act of 2008, Congress charged FHFA with, among other things, the supervision of Fannie Mae and Freddie Mac (the Enterprises) and the Federal Home Loan Bank System. In its role as supervisor, FHFA is tasked to ensure that these entities operate safely and soundly so that they serve as a reliable source of liquidity and funding for housing finance and community investment. FHFA's Division of Enterprise Regulation (DER) is responsible for the supervision of the Enterprises.

DER's supervision includes annual examinations of the Enterprises, which consist of targeted examinations and ongoing monitoring. According to FHFA, examination activities 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.

DER has established a core team of examiners for each Enterprise, led by an Examiner-in-Charge (EIC), to conduct its supervisory activities. To focus examination activities on areas of greatest risk, DER performs an annual risk assessment of each Enterprise that highlights both strengths and vulnerabilities. According to FHFA's *Examination Manual*, the risk assessment provides the foundation for preparing the supervisory strategy and determining the examination activities to be conducted in the annual supervisory plan (also called the annual examination plan) for each Enterprise. The annual examination plan identifies all targeted examinations and ongoing monitoring activities of selected areas of high importance or risk, as identified in the risk assessment. In this way, FHFA examiners are able to leverage their resources by focusing their activities around the risks identified as posing the highest supervisory concerns.

OIG Identified Deficiencies in DER's Risk Assessments and Made Recommendations to Ensure that Supervisory Resources Are Used Efficiently to Examine Areas of High Risk to the Enterprises

In September 2016, OIG issued an audit report[1] in which we assessed whether targeted examinations identified as high-priority by DER in its annual examination plans for 2014 and 2015 for each Enterprise were based on risk assessments. We also assessed whether DER completed its planned targeted examinations. We found, among other things, that: (1) almost half of DER's high-priority targeted examinations for 2014 and 2015 did not trace to DER

[1] OIG, *FHFA's Supervisory Planning Process for the Enterprises: Roughly Half of FHFA's 2014 and 2015 High-Priority Planned Targeted Examinations Did Not Trace to Risk Assessments and Most High-Priority Planned Examinations Were Not Completed* (Sept. 30, 2016) (AUD-2016-005) (online at www.fhfaoig.gov/Content/Files/AUD-2016-005.pdf).

risk assessments; and (2) the risk assessments that DER prepared did not identify or explain the severity of the risks discussed within the risk assessment.

We made five recommendations to address the deficiencies identified in the report and to ensure that FHFA's supervisory resources are used efficiently to examine the highest risks of the Enterprises. The first recommendation was that FHFA "[e]nsure that risk assessments support the supervisory plans in terms of the targeted examinations included in those supervisory plans and the priority assigned to those targeted examinations." The Agency responded that DER's then-recently revised guidance from May 2016 confirmed a "general agreement" with the recommendation, but that it disagreed with the recommendation to the extent the recommendation went beyond this existing guidance. FHFA further stated that DER would assess the effectiveness of its existing guidance in the first quarter of 2017 and consider OIG's recommendation as part of the assessment.[2]

Based on FHFA's Corrective Action in 2017, OIG Closed the Recommendation

As it agreed, DER reviewed its risk assessment procedures in the first quarter of 2017. Its assessment led it to amend its internal risk assessment guidance. DER issued DER-OPB-01.2, *Enterprise Supervisory Risk Assessments* (OPB 1.2), on September 28, 2017, establishing revised procedures for the preparation, format, documentation, and approval of risk assessments.[3] The OPB included the following requirements:

- For each area of credit, market, and operational risk, the risk assessment must include assigned levels and supporting summaries for inherent risk, quality of risk management, residual risk, and direction of risk for specific components listed in an attached template.[4]

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[2] OIG made four other recommendations that are not within the scope of this compliance review: (1) that DER reinforce and hold EICs accountable to meet FHFA's requirement for risk assessments to be updated semiannually, and as additional information is learned that causes significant changes to the risk profile; (2) that DER develop and implement controls to ensure that high-priority planned targeted examinations are completed before lower priority targeted examinations; (3) that DER enhance guidance to provide a common definition for the priority assigned to targeted examinations and require examiners to document the basis of the priority assigned to targeted examinations; and (4) that DER revise existing guidance to require examiners to prepare complete documentation of supervisory activities and maintain such documentation in the official system of record and train DER examiners on this guidance.

[3] On January 25, 2019, DER administratively renumbered and reissued OPB 1.2 as OPB 1.1, with no content changes. For consistency, we refer to the OPB as OPB 1.2 throughout this report.

[4] Inherent risks are those to which an Enterprise is exposed, knowingly or unknowingly, as a result of its business activities. Quality of risk management refers to the risk management practices and controls implemented by an Enterprise to manage the specific risks identified. Residual risk is the risk remaining after risks have been managed. The direction of risk is a prospective assessment of the probable movement in residual risk.

- The risk assessment should be finalized and approved, together with the examination plan, by the EIC and DER Deputy Director no later than January 31.

Notably, the OPB did not require DER to assign a priority to targeted examinations, and DER confirmed that it had ended that practice.[5] OIG determined, nonetheless, that the enhanced requirements in OPB 1.2, if implemented as described, would ensure that risk assessments document the areas considered for inclusion in the annual examination plans for the Enterprises. OIG concluded that, although OPB 1.2 did not align completely with the elements of recommendation, DER's revised guidance satisfied the intent of the recommendation: that risk assessments support the examination plans. On October 30, 2017, OIG closed the recommendation.

FACTS AND ANALYSIS ....

We initiated this review in April 2019 to assess FHFA's implementation of its risk assessment guidance in OPB 1.2 – the corrective action that OIG concluded was sufficient to address the recommendation. The scope of our review was limited to the risk assessments leading to the 2018 and 2019 annual examination plans. We concluded that FHFA substantially implemented the guidance in OPB 1.2 governing the content and approval of Enterprise risk assessments for the 2018 and 2019 examination cycles.

DER's 2018 and 2019 Risk Assessments Included Assigned Risk Levels and Supporting Summaries

OPB 1.2 required that risk assessments adhere to a template, and it included instructions on required content. According to the template in the OPB, DER expected each risk assessment to address three general risk areas: credit risk, market risk, and operational risk. Each general risk area was broken down into subsidiary components. For example, within the general market risk area were the subsidiary components liquidity risk, interest rate risk, and market model risk. The OPB further stated that each risk assessment must include risk levels and supporting summaries for inherent risk, quality of risk management, residual risk, and direction of risk for each general risk area and for each subsidiary component.

We obtained the 2018 and 2019 annual DER risk assessments for each Enterprise. To test compliance with the OPB, we compared the content and structure of these risk assessments to the guidance and template in the OPB.

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[5] Because DER no longer prioritizes one targeted examination over another, the portion of the recommendation addressing prioritization is not addressed in this report.

We found that DER generally complied with the requirements in OPB 1.2. Although we noted four departures from the OPB template (see below), we found that DER explained sufficiently the departures. We also found that DER subsequently revised OPB 1.2 to incorporate the changes to the template in order to improve the risk assessment process.

1. Model Risk. OPB 1.2 required that model risk be assessed as a subsidiary component of credit risk and market risk. This was not done in the 2018 and 2019 risk assessments. Instead, DER assessed model risk more broadly in a free-standing model risk section. When asked to explain the reasons why the discussion of model risk did not follow the OPB, a DER official stated that model risk "cuts across everything" and should be assessed in a separate section.

2. Market Risk. In assessing each Enterprise's market risk, OPB 1.2 required an assessment of liquidity risk and interest rate risk, as well as a composite assessment of both. For 2019, a composite assessment was not performed. When questioned, a DER official stated that this was done to better align risk assessments to the CAMELSO rating system,[6] which separately rates sensitivity to market (interest rate) risk (the S in CAMELSO) and liquidity (the L in CAMELSO).

3. Business Process Risk. In assessing operational risk, OPB 1.2 required an assessment of an Enterprise's business process risk. In the 2019 risk assessments, however, DER split business process risk into three sub-components and assessed each separately: Single Family Business Process, Multi-Family Business Process, and Capital Markets Business Process. A DER official stated that this change was made to improve the assessment of the risk area.

4. Fraud Risk. OPB 1.2 required that fraud risk be assessed as a separate component of operational risk. In 2019, however, fraud risk was combined and assessed with another component, Bank Secrecy Act/Anti-Money Laundering (BSA/AML) and Office of Foreign Assets Control (OFAC) compliance. When questioned, a DER official explained that this was done because there is overlap between BSA/AML risk, OFAC risk, and fraud risk in that these matters all relate to financial crimes.

[6] The seven CAMELSO components are: **C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, **S**ensitivity to Market Risk, and **O**perational Risk. FHFA assigns ratings for each component area and a composite rating reflecting an overall assessment of the Enterprise's safety, soundness, and risk management practices.

Based on our review of and DER's explanations for the reasons that specific aspects of the 2018 and 2019 Enterprise risk assessments did not follow OPB 1.2, we were satisfied that the departures enhanced the effectiveness of these risk assessments.

After we concluded our fieldwork for this compliance review, DER formally revised its risk assessment guidance by issuing DER-OPB-1.1, *Enterprise Supervisory Risk Assessments*, dated June 17, 2019. The revised OPB incorporates the departures identified above in the 2018 and 2019 risk assessments.

The 2018 and 2019 DER Risk Assessments and Examination Plans Were Timely and Properly Approved

We also tested whether DER complied with the timeliness requirement in OPB 1.2 that risk assessments and examination plans be finalized and approved by the EIC and DER Deputy Director by January 31 of each annual examination cycle.

We obtained the approval documentation for the 2018 and 2019 risk assessments and annual examination plans. We found that DER completed and approved the 2018 and 2019 risk assessments and examination plans by January 31 each year.[7]

CONCLUSION ....

We found that the Agency generally adhered to the guidance in OPB 1.2, as a matter of content and timing, for both the 2018 and 2019 DER risk assessments. Our review found that where DER departed from the OPB, it did so in an effort to improve the risk assessment process. Moreover, the Agency has now formally updated its guidance to incorporate the improvements to its risk assessments. Accordingly, we conclude that the Agency implemented the corrective action taken in response to the OIG recommendation.

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[7] In April 2019, DER issued DER-OPB-2.5, *Examination Planning Process*, with revised timeframes for annual planning of examination activities at the Enterprises. Risk assessments now are to be completed by October 31 of the prior calendar year and the examination plans are to be approved no later than December 31 of the prior calendar year.

OBJECTIVE, SCOPE, AND METHODOLOGY ....

The objective of this review was to assess the Agency's implementation of its guidance in OPB 1.2 for Enterprise risk assessments and examination plans—guidance that, in part, addresses our 2016 recommendation. The scope of our review included the 2018 and 2019 examination cycles (that is, the risk assessments leading to the 2018 and 2019 examination plans).

Specifically, our review focused on comparing the content and structure of the 2018 and 2019 risk assessments to the guidance and template in OPB 1.2. We also tested whether the Agency complied with the timeliness requirement in OPB 1.2 that risk assessments and examination plans be finalized and approved by the EIC and DER Deputy Director by January 31. To accomplish our objective, we reviewed Agency guidance and analyzed risk assessments and approval documentation during our review period. In addition, we interviewed Agency personnel.

We conducted our compliance review from April 2019 through June 2019 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), 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. On August 13, 2019, the Agency provided a technical comment, which we incorporated, and informed us that it did not intend to provide a management response.

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