Compliance Review of FHFA's Communication of Serious Deficiencies to the Enterprises' Boards of Directors

Compliance Review • COM-2018-005 • September 5, 2018

COM-2018-005

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Executive Summary

Under the Federal Housing Finance Agency's (FHFA or Agency) supervisory guidance, an Enterprise board of directors is responsible for ensuring timely and effective correction of significant supervisory deficiencies. We found in a 2016 evaluation that FHFA failed to communicate the most serious safety and soundness deficiencies, called matters requiring attention (MRAs), to the Enterprises' boards. Instead, FHFA's Division of Enterprise Regulation (DER) informed only Enterprise management of an MRA and relied on management to determine whether to communicate the fact and content of each MRA to its board. We reported that FHFA did not require that its annual reports of examination (ROE) identify all outstanding MRAs. As a result, no mechanism existed to ensure that the boards were informed of all MRAs, creating a risk that an Enterprise board could become no more than a bystander to management's efforts to remediate an MRA, as well as prolonged or inadequate resolution of the most serious threats to the Enterprises' safety and soundness.

We made four recommendations, and FHFA fully agreed with three of them. Those three recommendations were:

- "Revise [FHFA's] supervision guidance to require DER to provide the Chair of the Audit Committee [Audit Committee Chair]of an Enterprise Board with each conclusion letter setting forth an MRA";
- "Revise its supervision guidance to require DER to identify all open MRAs in the annual, written ROE and the expected timetable to complete outstanding remediation activities"; and
- "Include in [the 2016] ROE, to be issued to each Enterprise for 2015 supervisory activities, all open MRAs and the expected timetable to complete outstanding remediation activities for each open MRA."

FHFA's 2016 ROEs included all open MRAs and the expected timetable for the remediation activities, and it revised its supervisory guidance. We closed these recommendations in late 2016.

In May 2018, we initiated this compliance review to test the Agency's implementation of its remedial actions in response to the first two agreed-upon recommendations, for the period October 13, 2016, through March 31, 2018 (review period), and for the 2017 and 2018 ROEs. For the first recommendation, DER issued supervisory guidance requiring all supervisory correspondence containing MRAs to be addressed to responsible Enterprise management official(s) and to the affected Audit Committee Chair. During our review period, DER issued supervisory correspondence containing 29 MRAs, each of which was addressed to Enterprise management and the affected Audit Committee Chair. However, our independent testing found that DER provided none of this supervisory correspondence to the Audit Committee Chairs, as it had committed to do when it agreed with the recommendation.

From our testing, we determined that Enterprise management subsequently distributed the supervisory correspondence containing MRAs to the affected Audit Committee Chair; DER, however, acknowledged to us that its examiners neither asked for, nor obtained, confirmation that the Audit Committee Chairs received the supervisory correspondence with the MRAs. Instead of implementing our recommendation, DER has preserved the status quo, which as we cautioned in our evaluation, "creates a significant risk that management will put its own spin on the deficiencies giving rise to the MRA or will filter the information it provides to the Board." Without an internal control requiring Enterprise management to provide written contemporaneous certification that it has promptly provided supervisory correspondence containing one or more MRAs to the Audit Committee Chair, DER's remediation does not implement the agreed-upon recommendation. DER currently lacks assurance that an Enterprise's Audit Committee has received timely notice of MRAs to enable it to monitor management's remediation of them.

Because DER's revised supervisory guidance, as implemented, fails to carry out the recommendation as agreed to by FHFA, we are re-opening that recommendation. We expect FHFA to direct DER either to amend its guidance to implement the recommendation, or to require that DER put into place an internal control to ensure that it receives contemporaneous, written certification from Enterprise management that each supervisory correspondence containing MRAs has been timely provided to the Audit Committee Chair of the affected Enterprise. In its Management Response, FHFA noted that DER would consider adoption of such an internal control.

Separately, we found that DER complied during our review period with our recommendation to list all open MRAs and the Enterprises' estimated remediation dates.

This report was prepared by Alisa Davis, Senior Policy Advisor, and Patrice Wilson, Senior Investigative Evaluator, with assistance from 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.fhfaoig.gov.

David M. Frost
Acting Deputy Inspector General for Compliance & Special Projects

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ABBREVIATIONS

Audit Committee Chair	Chair of the Audit Committee of an Enterprise board
Board	Board of Directors
DER	Division of Enterprise Regulation
Fannie Mae	Federal National Mortgage Association
FHFA or Agency	Federal Housing Finance Agency
Freddie Mac	Federal Home Loan Mortgage Corporation
MRA	Matter Requiring Attention
OIG	Federal Housing Finance Agency Office of Inspector General
OPB	Operating Procedures Bulletin
Review period	October 13, 2016, through March 31, 2018
ROE	Report of Examination

BACKGROUND..

OIG Identified Deficiencies in DER's Communication of Serious Deficiencies to the Enterprises' Boards

FHFA, like other federal financial regulators, issues MRAs for serious supervisory concerns or deficiencies that require prompt correction. In a 2016 evaluation report,[1] we found that DER failed to communicate MRAs, which contain the most serious safety and soundness deficiencies, directly to the Enterprises' boards and informed only Enterprise management. We found that DER's practice created "a significant risk that management will put its own spin on the deficiencies giving rise to the MRA or will filter the information it provides to the Board." In our evaluation report, we also found that FHFA did not require that its ROE include all outstanding MRAs.

To address these shortcomings, we recommended, and FHFA agreed, that: FHFA revise its supervision guidance to require DER to provide the Audit Committee Chair with supervisory correspondence[2] that contained one or more MRAs; and that it identify all open MRAs in the annual, written ROE, as well as the timetable for completion of outstanding remediation activities.[3]

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[1] OIG, *FHFA's Supervisory Standards for Communication of Serious Deficiencies to Enterprise Boards and for Board Oversight of Management's Remediation Efforts are Inadequate* (Mar. 31, 2016) (EVL-2016-005) (online at www.fhfaoig.gov/Content/Files/EVL-2016-005.pdf).

[2] We originally recommended that DER provide the Enterprises' Audit Committee Chairs with "each conclusion letter" setting forth MRAs. DER issued an OPB that was responsive to the recommendation, but we realized our recommendation might not be understood to include supervisory letters that might also set forth MRAs. Thus, we asked DER to include supervisory letters in its implementing guidance, and FHFA revised its OPB accordingly. In this report, we use the term "supervisory correspondence" to represent conclusion letters and supervisory letters that set forth MRAs.

[3] We made two other recommendations: (1) that DER provide the audit committee chairs with management's MRA remediation plans and DER's response to them; and (2) that DER include open MRAs and remediation timetables in its 2016 ROE for the 2015 examination cycle. DER partially agreed with the former recommendation and fully implemented the latter in its 2016 ROE.

FHFA Established Guidance to Implement Two Recommendations to which it Agreed

On June 28, 2016, DER issued an Operating Procedures Bulletin (OPB) governing examination documentation, which it later amended and re-issued on October 12, 2016.[4] The revised OPB, which was effective upon issuance, requires that:

- Examiners-in-charge address the supervisory correspondence that communicates MRAs to responsible Enterprise management official(s), with copies to the heads of each Enterprise's internal audit, compliance, and Enterprise risk management divisions, and the Audit Committee Chair; and
- Each Enterprise's ROE list all MRAs that were: (1) open as of December 31st and the expected completion dates for the corresponding remediation plans; or (2) closed during the calendar year covered by the ROE.

We closed these two recommendations on November 18, 2016, and September 20, 2016, respectively.

FINDINGS ....

1. DER's Supervisory Guidance Did Not Implement One of the Recommendations to which FHFA Agreed

As discussed, the OPB issued by DER required examiners-in-charge to address all supervisory correspondence containing MRAs to Enterprise management and to the Audit Committee Chair of the affected Enterprise. That OPB fails to implement our clear recommendation, with which FHFA agreed, "to require DER to **provide** the Chair of the Audit Committee of an Enterprise Board" with supervisory correspondence containing one or more MRAs. That recommendation flowed from our finding that DER acknowledged that it "informs only Enterprise management of an MRA, and then relies on management to communicate that information to an Enterprise board, [which] creates a significant risk that management will put its own spin on the deficiencies giving rise to the MRA or will filter the information it provides to the Board."

Instead, DER's supervisory guidance preserves the status quo. FHFA acknowledges in its Management Response that DER's supervisory guidance requires that the supervisory correspondence be *addressed* to the Audit Committee Chair, not provided to him or her. Our

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[4] DER, Operating Procedures Bulletin, *Examination Documentation and Report of Examination Guidance* (Oct. 12, 2016) (DER-OPB-03.1).

independent testing found that DER addressed all supervisory correspondence, containing a total of 29 MRAs issued during the review period, to Enterprise management and to the Audit Committee Chair of the affected Enterprise but provided **none** of this correspondence to the Audit Committee Chair of the affected Enterprise. While DER may consider its work-around to implement our agreed-upon recommendation, it does not: DER, not Enterprise management, agreed to provide supervisory correspondence containing MRAs to the Audit Committee Chair. As we found in the evaluation, this practice "creates a significant risk that management will put its own spin on the deficiencies giving rise to the MRA or will filter the information it provides to the Board."

2. DER's Work-Around is Insufficient Because DER Lacks any Internal Controls to Ensure that All Supervisory Correspondence Containing MRAs is Promptly Provided by Enterprise Management to the Audit Committee Chair

Our independent testing found that DER transmitted to Enterprise management, by email, the supervisory correspondence containing the 29 MRAs[5] issued during our review period and in that email, asked management to distribute the attached supervisory correspondence to appropriate parties, including the Audit Committee Chair. Effectively, DER continued to rely on Enterprise management to transmit its supervisory concerns to the Enterprises' boards, rather than to notify the boards directly, as it committed to do.

Our testing also found that Enterprise management forwarded all supervisory correspondence with MRAs on to the Audit Committee Chair within a week of receipt from DER. In its Management Response, FHFA asserts that DER's "revised process is effective in ensuring receipt of supervisory correspondence by the chairs of the board audit committees."

We disagree. DER acknowledged to us that its examiners neither asked for, nor obtained, confirmation from Enterprise management that the Audit Committee Chairs received the supervisory correspondence with the MRAs. Until DER obtained the results of our independent testing, it lacked any assurance that supervisory correspondence with MRAs had been received by the Audit Committee Chairs. Without an internal control requiring Enterprise management to provide written contemporaneous certification that it has promptly provided supervisory correspondence containing one or more MRAs to the Audit Committee Chair, DER's work-around does not implement the agreed-upon recommendation.

[5] DER may issue MRAs to the Enterprises based on targeted examinations, characterized as a "deep or comprehensive assessment" of a risk area, or ongoing monitoring, a supervisory approach allowing for analysis of "real-time information" to identify risk areas that may warrant further supervisory attention. DER issued 21 MRAs to Fannie Mae (14 from targeted examinations and 7 from ongoing monitoring activities) and issued 8 MRAs to Freddie Mac (2 from targeted examinations and 6 from ongoing monitoring activities) during our review period.

3. DER Complied with our Recommendation to List All Open MRAs and Their Estimated Remediation Dates

In our 2016 evaluation report, we recommended that the Agency "revise its supervision guidance to require DER to identify all open MRAs in the annual, written ROE and the expected timetable to complete outstanding remediation activities." DER's OPB requires that each ROE identify all MRAs that remain open as of December 31 of the supervisory cycle covered by the ROE or that were closed during that supervisory cycle. The OPB also requires the ROE to identify, for each open MRA, Enterprise management's expected date for completion of the remediation plan.

Consistent with our recommendation, DER listed in the 2017 and 2018 ROEs all MRAs that were open[6] at the end of the supervisory cycle[7] and the estimated date for completion of the remediation plan for each MRA, when available.[8] We compared all MRA descriptions and issuance dates in DER's supervisory communications to the list of open MRAs in the 2017 and 2018 ROEs and found only one minor date discrepancy

Based on our testing, we found that DER adopted and implemented supervisory guidance requiring all open MRAs and their estimated dates to complete remediation in these ROEs.

[6] There are 63 unique MRAs listed as open in the 2017 and 2018 Enterprise ROEs.

[7] DER included in the 2018 Freddie Mac ROE some MRAs issued after the end of the examination period, because, according to DER, the related examination work was "largely completed" by December 31, 2017.

[8] DER provides Enterprise management time to develop and submit to DER the expected remediation date and associated plan to remediate each MRA. In instances where DER communicated the MRA very late in the supervisory cycle, DER marked the estimated remediation date in the ROE as "TBD."

CONCLUSION

This compliance reviewed tested the Agency's implementation of its remedial actions in response to two agreed-upon recommendations, for the review period October 13, 2016, through March 31, 2018, from a 2016 evaluation involving communication of MRAs and their remediation timetable to the Audit Committees of the Enterprises' boards. Our independent testing found that DER's supervisory guidance, as implemented, failed to provide supervisory correspondence containing MRAs to the affected Audit Committee Chair, as FHFA agreed to do. Instead, DER addressed its supervisory correspondence containing 29 MRAs to Enterprise management and the affected Audit Committee Chair. However, our independent testing revealed that DER relied on Enterprise management to transmit that correspondence to the affected Audit Committee Chair. While we determined, from our testing, that Enterprise management subsequently distributed the supervisory correspondence containing MRAs to the affected Audit Committee Chair, DER acknowledged to us that its examiners neither asked for, nor obtained, confirmation that the Audit Committee Chairs received the supervisory correspondence with the MRAs. Instead of implementing our recommendation, DER has preserved the status quo, which as we cautioned in our evaluation, "creates a significant risk that management will put its own spin on the deficiencies giving rise to the MRA or will filter the information it provides to the Board."

Because DER's revised supervisory guidance, as implemented, fails to carry out the agreed-upon recommendation agreed to by FHFA, we are re-opening that recommendation. We expect FHFA to direct DER either to amend its guidance to implement the recommendation, or require that DER put into place an internal control to ensure that it receives contemporaneous, written certification from Enterprise management that each supervisory correspondence containing MRAs has been timely provided to the Audit Committee Chair of the affected Enterprise. In its Management Response, FHFA noted that DER would consider adoption of such an internal control.

When FHFA advises us that DER has either 1) amended its guidance to implement this agreed-upon recommendation or; 2) has put into place an adequate internal control, we will consider closing our recommendation.

In response to our other recommendation, DER complied with our recommendation by listing in the 2017 and 2018 ROEs those MRAs open as of the corresponding year-end, along with the respective estimated remediation dates.

OBJECTIVE, SCOPE, AND METHODOLOGY ....

Our objective was to determine if DER complied with two of our recommendations after implementing its OPB. Specifically, we tested whether DER provided the Enterprises' Audit Committee Chairs with issued MRAs for the period October 13, 2016, to March 31, 2018. We also tested whether the 2017 and 2018 ROEs, which cover the 2016 and 2017 examination periods, contained complete and accurate listings of MRAs and their expected remediation dates.

To test DER's communications with the Enterprises' Audit Committee Chairs, we reviewed DER emails issuing MRAs to the Enterprises during our review period and the supervisory correspondence attached to those emails.[9] We obtained the names of the Audit Committee Chairs during our review period from the Enterprises' 10-Ks issued in 2016–2018. We compared those names to both the email distribution list on each of DER's emails setting forth an MRA and emails from Enterprise management forwarding MRAs to the Audit Committee Chairs.

To test the completeness and accuracy of MRAs and their remediation status in the 2017 and 2018 ROEs, we first compared the 2016 and 2017 ROEs to determine if MRAs with an open status in the 2016 ROE were present and accurately classified in the 2017 ROE. We next examined DER emails to the Enterprises issuing and closing MRAs in 2017 and 2018 and the supervisory correspondence attached to those emails.[10] We compared the MRA number, when available, the MRA description, and the MRA status (open or closed) in the DER communications to that in the 2017 and 2018 ROEs.

Finally, we interviewed Agency officials and reviewed public Agency examination guidance.

We conducted our compliance review from May 2018 to July 2018 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.

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[9] We assessed neither DER communications objecting or not objecting to the Enterprises' remediation plans nor supervisory communications from which no MRA was issued or closed. We also excluded three MRAs that examiners in FHFA's Office of Women and Minority Inclusion issued, because that office is not the subject of this review.

[10] We extended our review of DER correspondence of MRAs with Freddie Mac to February 28, 2018, because DER issued MRAs arising from the 2017 examination cycle through that date.

APPENDIX: FHFA MANAGEMENT RESPONSE...........................

Federal Housing Finance Agency

MEMORANDUM

TO: David M. Frost, Acting Deputy Inspector General, Compliance & Special Projects

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

SUBJECT: Draft OIG Report: *Compliance Review of FHFA's Communication of Serious Deficiencies to the Enterprises' Board of Directors*

DATE: August 21, 2018

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

Following issuance of the OIG evaluation report, *FHFA's Supervisory Standards for Communication of Serious Deficiencies to Enterprise Boards and for Board Oversight of Management's Remediation Efforts are Inadequate* (EVL-2016-005) and the management commitment in response to that report, DER amended its process for addressing supervisory correspondence to Fannie Mae and Freddie Mac (the Enterprises). As a result of that amendment, DER includes the chairs of the Enterprises' board audit committees as cc's on all supervisory correspondence containing matters requiring attention (MRAs). DER sends all supervisory correspondence to the Enterprises' Regulatory Affairs departments for distribution to all recipients.

The OIG reviewed a sample of 29 MRAs, and found that Regulatory Affairs forwarded all supervisory correspondence to the chairs of the board audit committees within a week of receipt from FHFA. Therefore, DER believes the revised process is effective in ensuring receipt of supervisory correspondence by the chairs of the board audit committees. By December 31, 2018, DER will determine whether to augment supervisory monitoring by obtaining contemporaneous notification from Enterprise management that supervisory correspondence containing MRAs has been distributed to the chairs of the board audit committees.

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

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