Federal Housing Finance Agency
Office of Inspector General

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

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Executive Summary

Since 2008, FHFA has operated as both regulator and conservator of Fannie Mae and Freddie Mac (collectively, the Enterprises) and regulator of the Federal Home Loan Banks (FHLBanks) to ensure that they operate safely and soundly so that they serve as a reliable source of liquidity and funding for housing finance and community investment. FHFA's supervision program is carried out by two divisions: the Division of Enterprise Regulation (DER), which is responsible for supervising the Enterprises, and the Division of Federal Home Loan Bank Regulation (DBR), which is responsible for supervising the FHLBanks.

Each year, DER supervises the Enterprises through a series of targeted examinations and ongoing monitoring activities. Since 2014, DER has relied largely on its ongoing monitoring activities to examine the Enterprises. At the conclusion of each annual examination cycle, FHFA prepares and transmits a report of examination (ROE) to the board of directors (Board) for each Enterprise. The annual ROE constitutes DER's "primary work product that communicates . . . the cumulative results of [DER's] supervisory activities conducted during the annual examination cycle." Each ROE also contains numerical ratings that FHFA assigns for seven component areas, a rating system known as CAMELSO. In addition, FHFA assigns a composite rating for each Enterprise's overall safety, soundness, and risk management practices.

The FHFA Office of Inspector General (OIG) has identified FHFA's supervision program as a significant risk area and assessed the program in numerous audit and evaluation reports and compliance reviews. In this evaluation, we reviewed DER's processes for assigning CAMELSO ratings to the Enterprises and documenting the bases for those ratings. We found that DER examination managers prepare a draft ROE narrative that contains a proposed rating for each CAMELSO component within their purview. The examination managers then submit their draft narratives to the examiner-in-charge (EIC), who edits the narratives and compiles them into a draft ROE for the Deputy Director's approval. Based on a review of documentation for two CAMELSO ratings assigned to Fannie Mae and one CAMELSO rating assigned to Freddie Mac for the 2015 examination cycle, we determined that DER's ratings and the corresponding language in the 2015 ROEs were traceable to supporting DER examination workpapers.

During the course of our review of DER's processes for assigning CAMELSO ratings, we learned that, contrary to a 2013 FHFA supervision directive, DER's independent quality control review program—which is intended to confirm that examination findings and conclusions are adequately supported before DER communicates them to the Enterprises—does not review the

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ROEs or the CAMELSO ratings that DER assigns to the Enterprises. Instead, as a proxy, DER performs a quality control review of examination findings and conclusions that it sends to the Enterprises in certain supervisory correspondence throughout the year. According to a DER official, these reviews make it unnecessary to perform quality control reviews of the ROEs and the CAMELSO ratings because the pertinent information has been assessed in previous quality control reviews. However, ongoing monitoring activities—unlike targeted examinations—do not necessarily result in formal supervisory correspondence to the Enterprises that trigger a quality control review. Unless such correspondence is sent, DER does not perform a quality control review of the conclusions of the ongoing monitoring activity.

Had all findings and conclusions in ROEs issued by DER been subject to a quality control review, DER's position—that a quality control review of the ROE itself and the CAMELSO ratings would be redundant—would be reasonable. Based on our review of DER documents and discussions with DER officials, we determined that the ROEs issued for the 2015 supervisory cycle contained conclusions derived from ongoing monitoring activities that had not been previously communicated to the Enterprises in formal supervisory correspondence. As a result, those conclusions did not undergo a quality control review, revealing a gap in DER's quality control review program. This gap presents a risk that an ROE will assure an Enterprise's board of directors that management is meeting FHFA's supervisory expectations or making progress in addressing weaknesses, when it is not.

We make one recommendation to FHFA to address this shortcoming. FHFA agreed with our recommendation.

This report was prepared by Howard Klein, Attorney-Advisor; Minh-Tu Greenburg, Investigative Counsel; and Philip Noyovitz, Senior Auditor; with assistance from Jacob Kennedy, Senior Investigative Evaluator; and Shane Hammond, Investigative Counsel. 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.

Angela Choy
Assistant Inspector General for Evaluations

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ABBREVIATIONS

DBR	Division of Federal Home Loan Bank Regulation
DER	Division of Enterprise Regulation
EIC	Examiner-in-charge
Enterprises	Fannie Mae and Freddie Mac, collectively
FHFA or Agency	Federal Housing Finance Agency
FHLBanks	Federal Home Loan Banks
MRA	Matter Requiring Attention
OIG	Federal Housing Finance Agency Office of Inspector General
OQA	Office of Quality Assurance
OSAB	Oversight & Supervision Administration Branch
ROE	Report of Examination
SD	Supervision Directive

BACKGROUND

Created by Congress in 2008, the Federal Housing Finance Agency (FHFA) is charged by the Housing and Economic Recovery Act of 2008 with oversight of the Enterprises and the Federal Home Loan Bank System. Since September 2008, FHFA has also been the conservator of the Enterprises. FHFA's mission is to ensure that its regulated entities operate safely and soundly so that they serve as a reliable source of liquidity and funding for housing finance and community investment. FHFA strives to meet this responsibility, in part, through its supervision program. DBR is responsible for supervising the Federal Home Loan Banks and DER is responsible for supervising the Enterprises.

DER supervises the Enterprises through targeted examinations and ongoing monitoring activities. According to FHFA, targeted examinations enable examiners to conduct a deep or comprehensive assessment of selected areas of high importance or risk, while the purpose of ongoing monitoring is to analyze real-time information and to use those analyses to identify Enterprise practices and changes in an Enterprise's risk profile that may warrant supervisory attention. DER may conduct ongoing monitoring or targeted examinations to assess the Enterprises' remediation of serious deficiencies and the Enterprises' adherence to supervisory guidance and conservatorship directives.

During the course of an ongoing monitoring activity or a targeted examination, DER may identify significant deficiencies related to risk management, risk exposure, or violations of laws, regulations, or orders affecting the performance or condition of a regulated entity. These identified deficiencies are known as "adverse examination findings" (findings). FHFA uses three different types of findings: Matters Requiring Attention (MRAs), Violations, and Recommendations.

Throughout the annual examination cycle, DER communicates safety and soundness concerns to the Enterprises through supervisory correspondence. At the close of each targeted examination, DER issues a conclusion letter to Enterprise management, regardless of whether findings are made. At the conclusion of an ongoing monitoring activity that results in findings, DER issues a supervisory letter to Enterprise management.[1] When DER undertakes an ongoing monitoring activity to assess an Enterprise's efforts to remediate an MRA and

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[1] Prior to March 2016, DER addressed conclusion and supervisory letters to Enterprise management, not to the board of directors or a board committee of an Enterprise. In response to an OIG recommendation, FHFA now requires that any conclusion or supervisory letter that includes an MRA also be sent to the chair of the board's audit committee of the affected Enterprise. *See* OIG, *FHFA's Supervisory Standards for Communication of Serious Deficiencies to Enterprise Boards and for Board Oversight of Management's Remediation Efforts are Inadequate*, at 20 (Mar. 31, 2016) (EVL-2016-005) (online at www.fhfaoig.gov/Content/Files/EVL-2016-005.pdf).

determines that remediation satisfactorily addresses the deficiency identified in the MRA, it sends a remediation letter to the Enterprise.[2] DER may also identify supervisory concerns during ongoing monitoring that do not rise to the level of findings, or may conclude that an Enterprise has met supervisory expectations in a particular area. In those instances, however, DER is not required to, and generally does not, send a supervisory letter to the affected Enterprise.

At the conclusion of each annual examination cycle, FHFA prepares and transmits an ROE to the Board for each Enterprise. The annual ROE constitutes DER's "primary work product that communicates . . . the cumulative results of [DER's] supervisory activities conducted during the annual examination cycle." The ROE rolls up the substantive examination results from DER's targeted examinations and ongoing monitoring activities. In addition, the ROE contains numerical ratings that FHFA assigns to each Enterprise for seven component areas, a rating system known as CAMELSO,[3] and a composite rating reflecting FHFA's overall assessment of each Enterprise's safety, soundness, and risk management practices.[4]

FHFA has issued an Examination Manual to guide its examiners in conducting examinations. From time to time, it supplements its Manual with supervision directives that impose additional requirements on DER and DBR. In March 2013, FHFA issued Supervision Directive 2013-01 (SD 2013-01), directing DER and DBR to perform quality control reviews of "examination findings, conclusions, ratings, supporting workpapers, and related documents" and the ROEs, prior to finalizing ROEs.[5] The then-Deputy Directors of DBR and DER provided input into the content of SD 2013-01 and formally approved it. Previously, the then-Deputy Director of DER had committed in writing to develop and implement a quality control review program by December 2012.

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[2] In technical comments, DER stated that if it concludes that an Enterprise's efforts *do not* satisfactorily address an MRA, it will also send a remediation letter.

[3] 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 rates each component on a scale of 1 to 5. A rating of 1 represents the lowest level of supervisory concern and a rating of 5 represents the highest level. CAMELSO is similar to the "CAMELS" rating system used by federal banking regulators for depository institutions.

[4] A composite rating of 1 or 2 reflects FHFA's conclusion that the regulated entity is generally sound; a composite rating of 3 indicates that the entity has moderate to severe weaknesses and needs improvement; and a composite rating of 4 or 5 reflects the need for supervisory intervention. CAMELSO ratings constitute confidential supervisory information and are not publicly disclosed.

[5] FHFA, Supervisory Directive 2013-01, *Quality Control Program for Examinations Conducted by the Division of Bank Regulation and the Division of Enterprise Regulation* (Mar. 25, 2013), which was rescinded and replaced by Supervision Directive 2017-01, *Quality Control Program* (Apr. 28, 2017).

In a prior evaluation, we catalogued the difficulties and delays in establishing a quality control program within DER.[6] Shortly before we issued that evaluation, and more than two years after SD 2013-01 issued, DER announced it was implementing a program for quality control reviews. In December 2015, DER informed OIG that the scope of its quality control review program included quality control reviews of ongoing monitoring activities, regardless of whether they resulted in findings or conclusions.[7]

In our Audit and Evaluation Plans for 2015, 2016, and 2017, OIG identified FHFA's supervision of its regulated entities as a significant risk area. We have assessed FHFA's supervisory program in numerous audit and evaluation reports, and compliance reviews. We initiated this evaluation to review DER's policies and procedures for assigning CAMELSO ratings to the Enterprises. We also reviewed the extent to which DER conducted independent quality control reviews of ratings and certain conclusions in its ROEs for the 2015 examination cycle before it issued the ROEs to the Enterprises.

FACTS AND ANALYSIS ....

DER's Support for its CAMELSO Ratings of the Enterprises

To determine how DER assigned CAMELSO ratings to the Enterprises, we examined the documentation that DER examiners prepared to support their proposed CAMELSO ratings for the 2013, 2014, and 2015 ROEs. We also interviewed DER officials and reviewed applicable guidance. Under Advisory Bulletin 2012-03, *FHFA Examination Rating System*, examination managers are expected to consider certain enumerated factors for each rating component.

We learned that DER examination managers (or their designees) for each Enterprise prepare draft ROE narratives for each CAMELSO component within their purview. According to DER, the examination managers then submit those drafts, along with proposed ratings for the CAMELSO components for which they are responsible,[8] to the EIC. The EIC, in turn,

[6] *See* OIG, *Intermittent Efforts Over Almost Four Years to Develop a Quality Control Review Process Deprived FHFA of Assurance of the Adequacy and Quality of Enterprise Examinations*, at 13 (Sept. 30, 2015) (EVL-2015-007) (online at www.fhfaoig.gov/Content/Files/EVL-2015-007.pdf).

[7] DER has not defined the term "conclusions" in its guidance. DER officials advised us that "it is reasonable to consider [conclusions] as broader than findings," and that its use of the term "conclusion" includes both adverse findings and any determination that a particular condition or practice is adequate or meets supervisory expectations.

[8] The team of Freddie Mac examiners prepares risk assessments each quarter and its semiannual risk assessment, prepared for the quarter ending June 30, customarily contains a recommended rating for each CAMELSO component. Although Freddie Mac examiners usually rely on the third quarter risk assessments in preparing the draft ROE (since fourth quarter risk assessments are not typically completed until the first quarter of the following year), those assessments may or may not contain recommended CAMELSO ratings. The

compiles these narratives into one draft, revises the draft as needed, and submits the draft ROE for the DER Deputy Director's approval. Once approved, the ROE is issued to each Enterprise.

We sought to determine whether the CAMELSO ratings were supported by examination work during the 2015 examination cycle by testing whether three 2015 CAMELSO component ratings—the operational ratings for both Enterprises and the management rating for Fannie Mae—were traceable to DER's underlying examination work.[9] To perform our testing, we requested and reviewed the documents that DER relied on in assigning those three 2015 component ratings and interviewed the DER examination managers responsible for proposing those ratings. Based on that information, we concluded that these three component ratings and the corresponding examination language in the 2015 ROEs were traceable to supporting examination workpapers.[10]

Despite the Clear Requirements in Supervision Directive 2013-01, DER's Quality Control Review Program Did Not Include Review of CAMELSO Ratings and ROEs

In our prior evaluation, we reported that federal financial institution regulators, including FHFA, recognize that internal quality control reviews provide an important internal control for their examination programs.[11] These regulators require that independent internal quality control reviews be conducted prior to the issuance of examination reports to ensure that examinations adhere to the regulator's quality standards, are being performed with consistency, and include workpapers that support the findings and conclusions of the examination under review.[12]

Fannie Mae examination team prepared only one risk assessment per year: a detailed semiannual risk assessment as of July or August that customarily contains recommendations regarding CAMELSO component ratings.

[9] DER issued the ROE for the 2015 supervision cycle to Freddie Mac on March 11, 2016, and to Fannie Mae on March 23, 2016.

[10] Although the 2015 ratings we reviewed were traceable to supporting workpapers, we observed significant variability in the types of internal workpapers that Fannie Mae examiners relied on for these proposed ratings. Those workpapers included mid-year risk assessments, procedures documents, close-out memos, and memos to file. The Freddie Mac examination team showed less variability; the team relied primarily on quarterly risk assessments.

[11] *See* OIG, *Intermittent Efforts Over Almost Four Years to Develop a Quality Control Review Process Deprived FHFA of Assurance of the Adequacy and Quality of Enterprise Examinations*, at 13 (Sept. 30, 2015) (EVL-2015-007) (online at www.fhfaoig.gov/Content/Files/EVL-2015-007.pdf).

[12] DER's Operating Procedures Bulletin 2014-DER-OPB-01, *Guidelines for Preparing Supervisory Products and Examination Workpapers*, also identifies the "quality control memorandum" as a workpaper that documents the results of an independent quality control review, as referenced in SD 2013-01, and shows the evidence that final examination findings, conclusions, and *ratings* underwent a quality control review.

We found that, almost four years after FHFA's Office of Quality Assurance (OQA) issued its recommendation that DER establish and implement formal quality control reviews for examinations and more than two years after FHFA issued a supervision directive requiring such reviews, DER had not established and implemented a comprehensive internal quality control review program. We recommended that FHFA "[e]nsure that DER's recently adopted procedures for quality control reviews meet the requirements of Supervision Directive 2013-01 and require DER to document in detail the results and findings of each quality control review in examination workpapers, including any shortcomings found during the quality control review." In its written response, FHFA stated that it "agrees with this recommendation," and acknowledged that "a process for independent quality control of examination documentation is important to the supervision of Fannie Mae and Freddie Mac."

When we initiated this evaluation, FHFA's SD 2013-01 instructed both DER and DBR to implement a quality control review program to "assess examination findings, conclusions, ratings, supporting workpapers, and related documents" and "reports of examination."[13] During fieldwork for this evaluation, however, we learned that DER's quality control review program, implemented in July 2015 in response to SD 2013-01, did not include quality control reviews of the ROEs or CAMELSO ratings assigned to the Enterprises. Notwithstanding the plain requirements of SD 2013-01, a DER official reported to us that DER determined that quality control reviews of the ROEs were not needed because quality control reviews are conducted of all examination findings and conclusions *before* they are incorporated in the annual ROEs.

DER codified its practice in June 2016 with Operating Procedures Bulletin DER-OPB-02, *Quality Control Review*. DER-OPB-02 announced that quality control reviews of ROEs fall outside the scope of DER's quality control review program because an ROE "does not communicate conclusions, findings, or closures of MRAs, but reference [sic] prior communications to the Enterprises. . . ."[14] In addition, a DER official advised us that DER's CAMELSO ratings are not subject to a quality control review because the ratings are contained in the ROEs, and the ROEs are based, in part, on work previously assessed in quality control reviews.

In July 2016, OQA assessed the rigor of DER's year-old quality control program. (Quality control reviews for DER are performed by the Oversight & Supervision Administration Branch (OSAB), a group within DER.) As part of OQA's assessment, it examined whether

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[13] Specifically, SD 2013-01 directed that the quality control reviews include "the report of examination, findings memoranda, and conclusion letters."

[14] The OPB asserts that ROEs "are vetted through a separate process." According to DER's Deputy Director, all DER executives review the draft ROEs, and she explained that DER employees also review the ROEs for formatting. We found no evidence that either of these reviews constituted quality control reviews as contemplated by SD 2013-01.

DER-OPB-02 fully implemented the instructions in SD 2013-01. In its written report, OQA found that DER-OPB-02 failed to conform to SD 2013-01 in that it did not require quality control reviews of ROEs and CAMELSO ratings. OQA recommended that DER align the requirements of its OPB to those in SD 2013-01.

In response, DER reported that it had agreed with DBR to revise SD 2013-01 "to retain general QC requirements applicable to both DER and DBR" and "omit detailed references not applicable in the same way to both divisions." On April 28, 2017, shortly before the conclusion of our field work, FHFA rescinded and replaced SD-2013-01 with SD-2017-01, *Quality Control Program*. This new supervision directive eliminates two requirements that DER had not met: pursuant to SD 2017-01, neither ROEs nor CAMELSO ratings are subject to a quality control review.

In sum, DER provided input to FHFA for SD 2013-01 but did not comply with it for several years. FHFA agreed with our 2015 recommendation that FHFA "[e]nsure that DER's recently adopted procedures for quality control reviews meet the requirements of Supervision Directive 2013-01. . .." DER's Operating Procedures Bulletin DER-OPB-02, which it adopted in June 2016 (more than three years after FHFA issued SD 2013-01), did not fully implement the supervision directive's instructions. When alerted to this inconsistency, DER proposed to reduce the requirements in SD 2013-01 to mirror its OPB, rather than enhance its OPB to meet the requirements of SD 2013-01, and FHFA's other approving stakeholders concurred.

DER's Quality Control Program Does Not Review All Examination Conclusions from Ongoing Monitoring Activities

Had DER subjected all findings and conclusions in its ROEs to a quality control review, its position—that a quality control review of the ROE itself and the CAMELSO ratings would be redundant—would be reasonable. However, we found that ROEs issued by DER contained conclusions from ongoing monitoring activities which were not subject to a quality control review due to a gap in DER's quality control review program.

Ongoing monitoring activities have grown to comprise the majority of DER's supervisory work. In 2013, FHFA modified its supervisory strategy for the Enterprises, announcing that "2013 will be a transformative year for DER as it shifts it [sic] supervisory strategy to a more coordinated and effective ongoing monitoring approach." According to FHFA's 2013 supervisory strategy, DER's "comprehensive and structured ongoing monitoring program" would result in "fewer [targeted] examinations than in past years." That modification to FHFA's supervisory strategy was repeated in 2014. For 2015, 2016, and 2017, FHFA's supervisory strategies appeared to be more nuanced, stating that "DER will continue to augment targeted examinations with ongoing monitoring activities."[15]

Since 2014, ongoing monitoring activities have consistently comprised more than half of DER's planned supervisory activities.

- In 2014, 61.6% (85/138) of DER's planned supervisory activities and 54.7% of estimated examiner staff hours for Fannie Mae were designated as ongoing monitoring. For Freddie Mac, 62.8% (61/97) of planned supervisory activities and 73.7% of estimated examiner staff hours were designated as ongoing monitoring.

- In 2015, 92.2% (131/142) of the planned supervisory activities and 83.1% of estimated examiner staff hours for Fannie Mae were designated as ongoing monitoring. For Freddie Mac, 73.5% (50/68) of DER's planned supervisory activities and 70.2% of estimated examiner staff hours were designated as ongoing monitoring.

- In 2016, 79.3% (69/87) of DER's planned supervisory activities and 76% of estimated examiner staff hours for Fannie Mae were designated as ongoing monitoring. For Freddie Mac, 69.5% (41/59) of planned supervisory activities and 73.9% of estimated examiner staff hours were designated as ongoing monitoring.[16]

In December 2015, DER submitted documentation to FHFA's Acting Chief Operating Officer representing that DER had implemented the recommendations in our September 2015 evaluation. DER stated, in writing, that "the QC procedures DER has followed since July 2015 meet all requirements of SD 2013-01. . .." It also stated that the scope of its quality control program included a review of documentation of ongoing monitoring activities, regardless of whether they resulted in findings or conclusions.

Six months later, DER issued DER-OPB-02, which excluded from any quality control review the ROEs and CAMELSO ratings, as well as ongoing monitoring activities that did not result in either a finding or an MRA remediation letter. DER officials confirmed to us that DER-OPB-02 only requires a quality control review of examination work that results in written

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[15] In prior reports, OIG found a significant decrease in the number and percent of targeted examinations that DER completed from 2012 through 2015. *See* OIG, *FHFA's Targeted Examinations of Fannie Mae: Less than Half of the Targeted Examinations Planned for 2012 through 2015 Were Completed and No Examinations Planned for 2015 Were Completed Before the Report of Examination Issued*, at 3 and 14 (Sept. 30, 2016) (AUD-2016-006) (online at www.fhfaoig.gov/Content/Files/AUD-2016-006.pdf); and *FHFA's Targeted Examinations of Freddie Mac: Just Over Half of the Targeted Examinations Planned for 2012 through 2015 Were Completed*, at 3 and 14 (Sept. 30, 2016) (AUD-2016-007) (online at www.fhfaoig.gov/Content/Files/AUD-2016-007.pdf).

[16] DER was unable to provide us with a breakdown of actual examination staff hours devoted to ongoing monitoring and targeted examination for the 2013 through 2016 examination cycles.

findings and conclusions that are communicated to the Enterprises in certain supervisory correspondence.[17] Where ongoing monitoring activities do not result in either findings or remediation letters, DER is not required to communicate the conclusions of such ongoing monitoring activities in writing to the Enterprises. DER officials acknowledged to us that, absent such supervisory correspondence, DER's underlying examination work is not subject to a quality control review.

OQA's July 2016 report setting forth its assessment of DER's quality control review program also found that, contrary to DER's December 2015 written representation to OIG, the OPB did not require quality control reviews of ongoing monitoring activities that did not result in findings. The OQA report explained that, between August and December 2015, OSAB sought to perform quality control reviews of ongoing monitoring activities that did not result in findings, but determined that DER's standards and requirements for those activities were insufficient and thus discontinued the review.[18] According to an OSAB manager quoted in this report, DER's "standards and requirements . . . needed to be strengthened before a quality control process would be effective for [ongoing monitoring] examinations that did not result in findings or conclusions."[19] The OQA report recommended that DER reconcile the inconsistency between its OPB and its representation to OIG, and DER did so by informing us that it no longer performs quality control reviews of conclusions from ongoing monitoring activities unless they result in findings or remediation letters.

After the conclusion of our fieldwork, a DER official reported to us that DER now requires its examiners to draft summary memoranda documenting the results of all ongoing monitoring

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[17] The OPB provides that correspondence expressing either an objection or a non-objection to an MRA remediation plan is not subject to the quality control process, unless specifically directed by the DER Deputy Director. In technical comments and follow up communications, DER notified us that OSAB started performing a quality control review of these letters after October 12, 2016.

In technical comments, DER also stated that it performs a quality control review of correspondence notifying an Enterprise that it has *not* satisfactorily addressed an MRA. However, our review of OSAB's completed quality control reviews for 2015 and 2016 found no evidence that OSAB reviewed such letters, assuming any were sent.

[18] Our review of 2015 OSAB documents confirmed that OSAB unsuccessfully attempted to conduct substantive quality control reviews of ongoing monitoring activities that did not result in findings or remediation letters.

[19] DER has issued two operating procedures bulletins that discuss the expected workpapers for ongoing monitoring activities. DER's Operating Procedures Bulletin 2013-DER-OPB-04, *DER Supervisory Activities*, requires examiners to prepare a procedures document and at least one of the following in connection with all ongoing monitoring activities: a periodic status memorandum, an analysis memorandum, an input to the business profile, or an input to a periodic risk assessment memorandum. Its Operating Procedures Bulletin 2014-DER-OPB-01, *Guidelines for Preparing Supervisory Products and Examination Workpapers*, provides general guidance for preparing examination workpapers for ongoing monitoring and advises that a summary memorandum "may be used to report the results of . . . [o]ngoing monitoring on a periodic basis."

activities, regardless of whether findings are made,[20] and indicated that DER may, at some point in the future, update its guidance to reflect that requirement. We asked whether DER intended to conduct quality control reviews of these summary memoranda. In response, DER asserted that it does not intend to perform quality control reviews of the summary memoranda unless the specific ongoing monitoring activity results in formal supervisory correspondence to the affected Enterprise, such as a supervisory letter or an MRA remediation letter.[21]

DER's 2015 ROEs Communicated Examination Conclusions that Did Not Undergo Quality Control Reviews

The annual ROE issued to the Board of each Enterprise constitutes DER's "primary work product that communicates . . . the cumulative results of supervisory activities conducted during the annual examination cycle." The ROEs—and the CAMELSO ratings they report—are based on results from both targeted examinations and ongoing monitoring activities. ROEs identify those areas in which the Enterprises have and have not met supervisory expectations.

DER explained to us that quality control reviews of the ROEs and CAMELSO ratings were unnecessary because all the findings and conclusions on which they were based had been subject to quality control reviews. As we have shown, DER's supervision of the Enterprises since 2014 has relied, in significant part, on ongoing monitoring and DER has acknowledged that it does not conduct quality control reviews for ongoing monitoring activities that do not result in findings or remediation letters. We sought to determine whether conclusions from ongoing monitoring activities were reported in the 2015 ROEs without undergoing a quality control review.[22] Because DER first implemented its quality control review program in July 2015, our review was limited to conclusions from ongoing monitoring workpapers dated after July 2015.

We first identified a number of conclusions in the 2015 ROEs that appeared to be derived from ongoing monitoring activities that did not result in findings or remediation letters. We

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[20] On March 7, 2017, DER's associate director for the Office of Enterprise Supervision Operations sent an email to DER staff stating that all ongoing monitoring activities must be closed out with a summary memorandum. The email stated further that all 2016 ongoing monitoring activities should be closed by March 31, 2017, if practical.

[21] In the same written response, DER asserted that, notwithstanding its current position, this issue remains under review.

[22] In the course of another review, our Office of Audits identified conclusions from a targeted examination that did not undergo a quality control review before they were reported in an ROE for the 2015 supervisory cycle issued to an Enterprise on March 23, 2016. In that instance, DER initiated the targeted examination in September 2015, but did not complete it or conduct the quality control review prior to issuing the ROE. In this evaluation, we did not assess whether other conclusions from targeted examinations were also reported in the ROE without undergoing a quality control review.

traced those conclusions back to the available 2015 examination workpapers and determined that at least 10 ROE conclusions, contained in 7 different workpapers, had been derived from such ongoing monitoring activities. We found that, as a general matter, those conclusions reported that the affected Enterprise's practices or condition was acceptable, or that the affected Enterprise made significant progress to address a previously identified weakness but some supervisory concern remained. The Deputy Director of DER has taken the position that some of these conclusions are instead "statements of an Enterprise initiative" or "statements of fact."

We then compared 10 conclusions to the available 2015 OSAB documents and found no evidence that OSAB had performed a quality control review of any of them. Based on our comparison, we asked DER to confirm that OSAB did not perform a quality control review of these 10 conclusions. DER responded that it could not provide such confirmation without reviewing all documentation from 2015 targeted examinations and ongoing monitoring activities subject to OSAB's quality control review. However, DER acknowledged that, due to the structure of its quality control review program, conclusions from ongoing monitoring activities that did not result in findings or remediation letters could be reported in ROEs without undergoing a quality control review. Based on our review of the 2015 workpapers made available to us, we found that at least 10 conclusions from ongoing monitoring activities that did not result in findings or remediation letters were reported in the 2015 ROEs without undergoing a quality control review.

FINDINGS ....

1. **The three 2015 CAMELSO component ratings and corresponding ROE language that we reviewed were traceable to supporting examination workpapers.**

We tested three 2015 CAMELSO component ratings—the operational ratings for both Enterprises and the management rating for Fannie Mae—to determine whether they were traceable to DER's underlying examination work. After reviewing the documents that DER relied on in assigning those three 2015 component ratings and interviewing the DER examination managers responsible for proposing those ratings, we concluded that those component ratings and the corresponding examination language in the 2015 ROEs were traceable to supporting examination workpapers.

2. **A gap exists in the design of DER's quality control review process, resulting in an increased risk that an ROE may inaccurately report that an Enterprise is meeting supervisory expectations or making progress in addressing weaknesses.**

DER informed us that quality control reviews of ROEs are unnecessary because all examination findings and conclusions undergo a quality control review *before* they are incorporated in the annual ROEs. However, this assertion is inaccurate. Our review found that the 2015 ROEs communicated at least 10 examination conclusions from ongoing monitoring activities that did not undergo a quality control review. We traced those conclusions to workpapers from ongoing monitoring activities that did not result in findings or remediation letters. The lack of a quality control review of these ROE conclusions demonstrates a gap in the design of DER's quality control program.

This gap involves certain examination conclusions that are reported in the Enterprises' ROEs, but are not subject to a quality control review. These conclusions, derived from ongoing monitoring activities, generally consist of determinations that the affected Enterprise is meeting supervisory expectations or has made significant progress in addressing a previously identified weakness. DER's decision not to perform a quality control review of these conclusions has resulted in an increased risk that an ROE will assure an Enterprise's Board that management is meeting supervisory expectations or making significant progress, when it is not.

The magnitude of this risk depends, in part, on the extent to which the ROEs contain conclusions from ongoing monitoring activities that do not result in findings, such as conclusions that an Enterprise's practices are acceptable or that it has made significant progress in addressing previously identified weaknesses. As the number of those conclusions in the ROEs increases, so does the risk of inaccurate or unsupported statements due to a gap in the quality control program.

3. DER is aware of the gap in its quality control review program, but has not taken action to rectify it.

DER is aware of the gap in its quality control program. However, it has not strengthened its guidance or practices to include quality control reviews of ongoing monitoring activities that do not result in findings or remediation letters. DER has recently enhanced its documentation standards to require examiners to prepare a summary memorandum to close out each ongoing monitoring activity, and a quality control review of this workpaper (if it is timely prepared) could rectify the gap in the existing program. Nonetheless, DER informed us that it does not currently intend to require a quality control review of those memoranda, although the matter remains under consideration.

CONCLUSION

Although DER's annual ROEs constitute the "primary work product that communicates . . . the cumulative results of supervisory activities conducted during the annual examination cycle," DER does not perform a quality control review of the ROE or the CAMELSO ratings reported therein. Instead, as a proxy, DER performs a quality control review of examination findings and conclusions contained in certain supervisory correspondence that it sends to the Enterprises throughout the year. According to DER, these reviews make it unnecessary to perform quality control reviews of the ROEs and the CAMELSO ratings because the pertinent information has been assessed in previous quality control reviews. However, we determined in this evaluation that at least 10 conclusions from ongoing monitoring activities that did not result in findings or remediation letters were reported in the 2015 ROEs without undergoing a quality control review. Thus, a gap exists in the design of DER's quality control program. Until this gap is filled, there will be an increased risk that an FHFA ROE may assure an Enterprise's Board that management is meeting supervisory expectations, when it is not.

Filling this gap in the quality control program appears neither onerous nor impractical. For example, DER could conduct quality control reviews of the newly required summary memoranda that close out ongoing monitoring activities. By enhancing the design of its quality control review program, DER could better assure itself that conclusions communicated to the Enterprises in the ROEs are accurate and adequately supported.

RECOMMENDATION...

We recommend that:

> DER enhance its quality control review program so that examination conclusions from ongoing monitoring activities which do not result in findings or remediation letters are subject to a quality control review prior to being communicated to the Enterprises in ROEs.

We provided FHFA an opportunity to respond to a draft report of this evaluation. FHFA provided technical comments on the draft report, which we incorporated as appropriate. In its management response, which is reprinted in its entirety in the Appendix, FHFA agreed with OIG's recommendation.

OBJECTIVE, SCOPE AND METHODOLOGY ....

We conducted this evaluation to review DER's processes for assigning CAMELSO ratings to the Enterprises and documenting the bases for those ratings. Based on information that came to our attention during this evaluation, we also sought to determine the extent to which DER conducted independent quality control reviews of the CAMELSO ratings and certain conclusions in its ROEs for the 2015 examination cycle.

In reviewing DER's processes for assigning CAMELSO ratings to the Enterprises, we examined the documentation that DER examiners prepared to support their proposed CAMELSO ratings for the 2013, 2014, and 2015 ROEs, reviewed applicable guidance, and interviewed DER officials. We then tested whether three 2015 CAMELSO component ratings—the operational ratings for both Enterprises and the management rating for Fannie Mae—were traceable to DER's underlying examination work. For this testing, we requested and reviewed the documents upon which DER relied in assigning those three 2015 component ratings. We also interviewed the DER examination managers responsible for proposing those ratings.

With respect to DER's quality control process, we sought to determine whether conclusions from ongoing monitoring activities that did not result in findings or remediation letters were reported in the 2015 ROEs without being subject to a quality control review. Because DER implemented its quality control review program in July 2015, we limited our review to conclusions from ongoing monitoring workpapers dated after July 2015. We first identified a number of conclusions in the 2015 ROEs that appeared to be derived from ongoing monitoring activities that did not result in findings or remediation letters. We traced those conclusions back to the available 2015 examination workpapers and determined that at least 10 ROE conclusions, contained in at least 7 different workpapers, had been derived from such ongoing monitoring activities. We then compared 10 conclusions to the available 2015 OSAB documents to determine whether OSAB had performed a quality control review of any of them. After finding no evidence that those 10 conclusions had undergone a quality control review, we provided the list of 10 conclusions to DER for confirmation that they were not subject to quality control review.

The field work for this report was completed in two phases between May 2016 and June 2017.

This evaluation was conducted under the authority of the Inspector General Act and in accordance with the Council of the Inspectors General on Integrity and Efficiency's *Quality Standards for Inspection and Evaluation* (January 2012). These standards require us to plan and perform an evaluation based upon evidence sufficient to provide a reasonable basis to support its findings and recommendations. We believe that the findings and recommendation discussed in this report meet those standards.

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

Federal Housing Finance Agency

MEMORANDUM

TO: Angela Choy, Assistant Inspector General for Evaluations

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

SUBJECT: Draft OIG Report: *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*

DATE: August 16, 2017

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

We agree that internal quality control reviews provide an important internal control for supervision of the Enterprises. In line with Supervision Directive 2017-01, *Quality Control Program*, DER performs independent quality control reviews of supervisory correspondence that communicates examination conclusions and findings. Supervisory letters that communicate findings resulting from ongoing monitoring activities are also subject to independent quality control review. As noted in the Report, DER does not currently perform a quality control review of examination conclusions in circumstances where DER does not issue correspondence that notifies the affected Enterprise of the results of the ongoing monitoring activity.

FHFA management's response to the recommendation is below.

Recommendation:

OIG recommends that DER enhance its quality control review program so that examination conclusions from ongoing monitoring activities which do not result in findings or remediation letters are subject to a quality control review prior to being communicated to the Enterprises in ROEs.

Management Response to Recommendation:

FHFA agrees with this recommendation. By August 1, 2018, DER will amend 2016-DER-OPB-02, *Quality Control Reviews*, to include quality control reviews of ongoing monitoring activities that do not result in findings or remediation letters.

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

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