

Federal Housing Finance Agency
Office of Inspector General



**FHFA's Division of Enterprise
Regulation Did Not Follow or Train
to its Procedures for Information
Sharing of Enterprise Counterparty
Performance Issues**



AUD-2021-014

September 28,
2021

Executive Summary

The Federal Housing Finance Agency (FHFA or Agency) is charged by the Housing and Economic Recovery Act of 2008 with the supervision of Fannie Mae and Freddie Mac (together, the Enterprises); Common Securitization Solutions, LLC; the Federal Home Loan Banks (collectively, the regulated entities); and the Federal Home Loan Banks' fiscal agent, the Office of Finance. FHFA's mission is to ensure the safety and soundness of its regulated entities so that they serve as a reliable source of liquidity and funding for housing finance and community investment. FHFA has also served as conservator of the Enterprises since 2008.

In the course of their operations, the Enterprises rely on counterparties to provide services that are critical to their business such as mortgage servicing, mortgage insurance, single-family mortgage-backed security issuance and administration, and technology functions. Both FHFA and the Enterprises identified counterparties as a significant risk. FHFA, in its Report to Congress 2020, reported that counterparties pose risks related to the Enterprises' information security, business continuity, and other safety and soundness issues. Further, the Enterprises, in their respective 2020 public financial filings, reported that reliance on counterparties presents a significant risk that one or more of their institutional counterparties may fail to fulfill their contractual obligations.

We explain in our [Fiscal Year 2021 Management and Performance Challenges](#) letter that in light of the financial, governance, and reputational risks arising from the Enterprises' relationships with counterparties and third-parties, FHFA is challenged to effectively oversee the Enterprises' management of risks related to their counterparties and third-parties. This has been a long-standing management and performance challenge.

Within FHFA, the Division of Enterprise Regulation (DER) is responsible for supervision of the Enterprises. DER, in support of its supervisory activities, issued an operating procedures bulletin (OPB) in August 2013 titled *Information Sharing of Counterparty Performance Issues*; that same OPB was reissued in February 2020 without content change. This OPB sets forth the expectations and establishes the protocol to follow regarding when critical information about one Enterprise is to be shared, how it is to be shared, and what the responsibilities of the examination team(s) will be upon receipt of the information, including documentation requirements.

We conducted this audit to determine whether DER followed its guidance when a counterparty performance issue was identified at an Enterprise. The review period of the audit is January 2019 through January 2021 (review



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period). We found that DER examiners did not follow the procedures in the OPB on information sharing when they shared information on counterparty performance issues; in fact, DER officials told us while examiners had shared such information, they were unaware of the OPB and had not been trained to it. Further, adherence to the OPB and its reissuance in February 2020 was not subjected to DER's quality control process. We also found that FHFA's Office of General Counsel (OGC) is reviewing the OPB for possible recasting as an Agency-wide policy and procedures document for information sharing of counterparty performance issues.

We make two recommendations in this report. In a written management response, FHFA agreed with the recommendations.

This report was prepared by Tara Lewis, Audit Director; Terese Blanchard, Auditor-in-Charge; and Brian Maloney, Auditor; with assistance from Abdil Salah, Assistant Inspector General for Audits; James Hodge, Deputy Assistant Inspector General for Audits; and Bob Taylor, Senior 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.fhfaog.gov, and www.oversight.gov.

Marla A. Freedman, Senior Audit Executive /s/

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ABBREVIATIONS

DBR	Division of Federal Home Loan Bank Regulation
DER	Division of Enterprise Regulation
DHMG	Division of Housing Mission and Goals
Enterprises	Fannie Mae and Freddie Mac
FHFA or Agency	Federal Housing Finance Agency
OESO	Office of Enterprise Supervision Oversight
OGC	Office of General Counsel
OPB	Operating Procedures Bulletin
Regulated Entities	Fannie Mae; Freddie Mac; Common Securitization Solutions, LLC; and the Federal Home Loan Banks

BACKGROUND.....

Within FHFA, DER is responsible for supervision of the Enterprises. According to FHFA, DER's Office of Enterprise Supervision Oversight (OESO): (1) establishes, maintains, and administers DER's overall supervision program and supervision framework, and sets the standards via operating procedures bulletins; (2) monitors and reports on program execution, assesses adherence to DER standards, and utilizes the results from its oversight activities to inform continuous improvement; and (3) provides infrastructure support and conducts training for examiners on DER's supervision program.¹

FHFA and the Enterprises Identified Counterparties as a Significant Risk

FHFA, in its *Report to Congress 2020*, reported that counterparties pose risks related to the Enterprises' information security, business continuity, and other safety and soundness issues. For example, the Enterprises rely on non-bank servicers to collect payments from borrowers, advance some payments to investors in mortgage-backed securities, and perform loss mitigation on non-performing loans. FHFA expects each regulated entity to implement a program to manage these third-party risks.²

Further, the Enterprises, in their respective 2020 public financial filings, reported that reliance on counterparties presents a significant risk that one or more of their institutional counterparties may fail to fulfill their contractual obligations. For example, a counterparty may default on its obligations due to a reduction in liquidity, operational failures, or insolvency and in doing so, could negatively impact the Enterprises' ability to operate their business.

¹ OPB, *Independent Quality Control Process*, states that DER conducts independent quality control reviews of certain supervisory written products to provide reasonable assurance that examination work performed by examiners meets applicable DER examination standards and FHFA guidance for document preparation and management.

² FHFA's position is that it lacks statutory authority to examine counterparties. In FHFA's *Report to Congress 2020*, the then-Director stated, "... I reiterate my recommendation that Congress authorize FHFA to examine third parties that do business with the regulated entities. The Enterprises' exposure to non-bank seller/servicers has grown significantly since 2008. Non-banks, which operate outside the federal prudential regulatory system, are expected to service most of the Enterprises' portfolios in 2021. A limited and tailored grant of examination authority should position FHFA to achieve its statutory mandate to ensure the safe and sound operations of the regulated entities as housing finance continues to evolve."

DER Issued an Operating Procedures Bulletin that Established a Protocol for Information Sharing of Counterparty Performance Issues

DER, in support of its supervisory activities, issued an OPB in August 2013 titled *Information Sharing of Counterparty Performance Issues*. This OPB sets forth the expectations and establishes the protocol to follow regarding when critical information about one Enterprise is to be shared, how it is to be shared, and what the responsibilities of the examination team(s) will be upon receipt of the information, including documentation requirements. The OPB established the protocol for the sharing of counterparty performance issues obtained from the following three sources: (1) identified through examination activities; (2) referrals from other sources; and (3) immediate notification from the Enterprises.

The OPB notes:

A DER examination team may identify supervisory concerns through examination activity, or receive information from other internal [FHFA] or external sources relative to the performance or condition of a counterparty that transacts business with both Enterprises. The concerns may potentially increase the risk of financial, legal or reputational exposure to each Enterprise and, thus warrants focused examination attention at each Enterprise. The issue may also be sensitive in nature and could potentially subject the FHFA, the Enterprise, and the counterparty to legal liability or other negative criticism if not handled with the utmost care and consideration.

The OPB cautions, “[I]t is important that FHFA shares information with and amongst DER examination teams, without alerting the Enterprise of the concerns, while maintaining the security and confidentiality of the information regarding counterparties.”

Further, according to the OPB, FHFA encourages the dissemination and escalation of information pertaining to counterparty performance that could assist in the identification of emerging risks and potential supervisory concerns at one or both Enterprises. Communication and coordination of counterparty performance issues among divisions and offices is critical to ensure that FHFA takes appropriate and consistent supervisory action, when warranted. DER is the lead office responsible for coordinating the receipt and transfer of information and determining the appropriate level of supervisory concern for a particular counterparty when an emerging risk may involve one or more of the Enterprises. However, the principles of the OPB should be applied to any FHFA division and office that possesses information regarding a concern with a specific counterparty that needs to be shared with DER because it may warrant examination attention at one or both of the Enterprises.

The OPB also includes a non-exclusive list of counterparty performance issues that should trigger escalation and information sharing, including (1) suspicion or notice that the counterparty may have violated laws and regulations to include consumer protection laws, mortgage fraud, anti-money laundering, and privacy breaches; (2) performance issues such as egregious management, significant operational deficiencies, failure to meet contractual obligations, higher than normal significant delinquency ratios, and high employee turnover; (3) concentration risk; (4) counterparty risk such as financial capacity and eligibility; (5) trends in consumer complaints focused on a specific counterparty; and (6) reputational risk.

On February 24, 2020, DER administratively reissued the OPB without content change to remove the numbering structure and update outdated references.

FACTS AND ANALYSIS

We conducted this audit to determine whether DER followed its guidance when a counterparty performance issue was identified at an Enterprise. The review period of the audit is January 2019 through January 2021 (review period).

DER Did Not Use its OPB on Information Sharing of Counterparty Performance Issues

In performing this audit, to gain an understanding of the universe, we requested from FHFA a list of counterparty performance issues identified between August 2013 (when the OPB was originally issued) through December 2020. We were told “DER doesn’t maintain a list of when counterparty performance issues are escalated and shared as detailed in the OPB.”

We found that DER officials did not follow the procedures in the OPB on information sharing when they shared information on counterparty performance issues³ because they were unaware of the OPB.

Additionally, DER officials informed us that training was not provided on the OPB on information sharing of counterparty performance issues. Further, when we brought the OPB to their attention, DER officials told us that they considered the OPB to be flawed because it placed DER as the lead division within FHFA to handle counterparty performance issues when, in their view, multiple divisions and offices are involved with receiving and sharing counterparty performance information. DER officials identified the Division of Housing

³ Officials provided us with testimony of their sharing of counterparty performance issues, but stated that the OPB was not followed when sharing the information and documentation showing compliance with the OPB was not maintained.

Mission and Goals (DHMG), the Division of Federal Home Loan Bank Regulation (DBR), and OGC as other offices and divisions within FHFA that are involved with counterparty performance issues.

DHMG and DBR officials we met with stated that they do receive and share counterparty performance information through their senior management who in turn meet the Director and other offices. These officials also told us that their respective divisions did not have written guidance on the sharing of counterparty performance information.

We met with OGC officials and they stated that OGC advises other divisions and offices on how to share information on counterparty performance issues within FHFA. OGC also does not have written guidance on information sharing of counterparty performance issues.

OGC officials also informed us that, as a result of our audit, OGC is reviewing the DER OPB for possible recasting as an agency-wide policy and procedure document for information sharing of counterparty performance issues. In this regard, as of June 2021, OGC formed a working group to consult with other stakeholder offices and to scope the need for an agency-wide policy. OGC officials explained that once the issue is scoped, the group will proceed to recommend policy changes. As of June 2021, the OGC official could not provide an estimated date when a new policy will be finalized.

That DER Could Issue and Reissue an OPB that Was Not Used and Was Not Trained to, Is a Shortcoming in its Development and Implementation of Examiner Guidance

Federal standards for internal control state that management should implement control activities through policies. An attribute of this principle is that management periodically reviews policies, procedures, and related control activities for continued relevance and effectiveness in achieving the entity's objectives or addressing related risks.⁴

As discussed above, DER officials told us they were unaware of the OPB on sharing of counterparty performance issues until our audit. They also commented that training was not provided on this OPB. We found that DER's OESO had not performed any quality control reviews related to DER's adherence to the OPB sharing of counterparty performance issues.⁵ We also found that there was no documentation that DER performed a substantive review of

⁴ Government Accountability Office, *Standards for Internal Control in the Federal Government*, GAO-14-704G (Sept. 2014), Principle 12.

⁵ DER's OPB *Independent Quality Control Process* requires that OESO perform quality control reviews to confirm that certain DER examination standards and FHFA guidance are followed.

the OPB before it was administratively reissued in February 2020 to remove the numbering structure and update outdated references.⁶

We inquired of OESO how this situation could exist. An OESO official told us that the OPB on information sharing of counterparty performance issues is considered “administrative” in nature and therefore not subject to OESO quality control review. Officials informed us that they plan to differentiate between the two types of DER OPBs – administrative and supervisory – and that administrative OPBs will be reviewed on a periodic basis. As these statements are not currently in guidance, we do not credit them.⁷

FINDINGS

- DER did not use its OPB on information sharing of counterparty performance issues.
- OGC formed a working group to consult with other stakeholder offices and to scope the need for an agency-wide policy; once the issue is scoped, the group will proceed to recommend policy changes.
- DER issued and reissued an OPB that was not used and was not trained to, which is a shortcoming in its development and implementation of examiner guidance.

CONCLUSION

DER did not follow the procedures in the OPB on information sharing when its examiners shared information on counterparty performance issues. We also found that training was not provided on this OPB and that OESO had not performed any quality control reviews related to examiner adherence to the OPB sharing of counterparty performance issues. In addition, we

⁶ While DER stated that it reissued the OPB “without content change” on February 24, 2020, we found that the reissued OPB deleted a reference to an FHFA division that no longer exists but retained a reference to outdated fraud reporting guidance. Also, we asked for documentation if the reissued OPB was subject to the formal approval system (known as “eWorkflow”) and FHFA replied that “the administrative reissuance of the OPB was not approved through an eWorkflow, so [they had] no responsive documents to provide.”

⁷ In responding to a draft of this report, FHFA claimed that given the nature of the procedures established in the OPB on the sharing of counterparty performance issues, those procedures “could not” be subjected to OESO’s quality control process, which is focused on the examination workpapers and supervisory correspondence to the regulated entities. We note that the OPB states that examiners are to meet and share any and all information related to the counterparty that led to the supervisory concern and that work completed must be documented in the workpapers. In our view, the examiners’ documented work performed on information sharing of counterparty performance issues is supposed to be part of the examination workpapers and, as such, could and should be subject to quality control reviews.

found that there was no documentation that DER performed a substantive review of the OPB before it was reissued in February 2020. The fact that DER issued and reissued the OPB on information sharing that was not used and was not trained to is a shortcoming in DER’s development and implementation of examiner guidance. FHFA’s OGC is taking action to consult with other stakeholder offices and to scope the need for an agency-wide policy; once the issue is scoped, the group will proceed to recommend policy changes. We believe that this effort is prudent and should be completed in an expeditious manner.

RECOMMENDATIONS.....

We recommend that FHFA:

1. Complete, in an expeditious manner, the recasting of DER’s OPB on information sharing of counterparty performance issues as an Agency-wide policy and procedure document.
2. Once recommendation 1 is completed, ensure that the Agency-wide policy and procedure document on information sharing of counterparty performance issues is implemented and trained to.

FHFA COMMENTS AND OIG RESPONSE.....

We provided FHFA an opportunity to respond to a draft of this audit report. FHFA provided technical comments on the draft report and those comments were considered in finalizing this report. FHFA also provided a management response, which is included as the Appendix to this report. In its response, FHFA agreed with both of our recommendations and stated that DER would take the following corrective actions:

- By July 30, 2022, DER will recast its internal supervisory guidance on information sharing of counterparty performance issues by working with other key stakeholders on an agency-wide document.
- By August 31, 2022, DER will ensure that DER executives, management, and staff receive training on the agency-wide document on the information sharing of counterparty performance issues and will implement its use.

We consider FHFA’s planned corrective actions responsive to our recommendations.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of this audit was to determine whether DER followed its guidance when a counterparty performance issue was identified at an Enterprise. The review period of the audit is January 2019 through January 2021 (review period).

To accomplish our objective, we:

- Determined that three components of internal control were significant to our audit objective: (1) control environment; (2) control activities; and (3) information and communication.
 - With regard to control environment, and the underlying principle that management should establish an organizational structure, assign responsibility, and delegate authority to achieve the entity’s objectives, we interviewed officials from DER, DHMG, DBR, and OGC about their sharing of counterparty performance information. In addition, we discussed with DER officials whether the OPB on information sharing of counterparty performance issues established an organizational structure, assigned responsibility, and delegated authority to achieve the Agency’s objective of sharing counterparty performance issues.
 - With regard to control activities, and the underlying principles that management should (1) design control activities to achieve objectives and (2) implement control activities through policies, we reviewed DER’s documentation requirements included in DER’s OPBs *Information Sharing of Counterparty Performance Issues* and *Independent Quality Control Process*. In addition, we interviewed DER officials regarding DER’s documentation of counterparty performance issues to determine the extent to which DER implemented these activities consistent with internal control standards. We reviewed DER’s OPB *Independent Quality Control Process* and interviewed OESO officials regarding their assessments of DER’s adherence to OPBs and the administration of training on OPBs.
 - With regard to information and communication, and the underlying principles that management communicates quality information down and across reporting lines to enable personnel to perform key roles in achieving objectives, addressing risks, and supporting the internal control system, we conducted interviews with officials from DER, DHMG, DBR, and OGC regarding their sharing of counterparty performance information through their reporting lines.
- Reviewed laws and regulations related to FHFA sharing and following up on Enterprise counterparty performance issues including the Housing and Economic

Recovery Act and FHFA's Regulation on the Reporting of Fraudulent Financial Instruments (12 CFR § 1233);

- Reviewed the Enterprises' public financial filings, *FHFA's Report to Congress 2020*, and the *Enterprise Examination Manual*;
- Requested from FHFA a list of counterparty performance issues identified between August 2013 through December 2020 that would be subject to the requirements of the OPB on information sharing. As discussed in the body of this report, no such list was provided; and
- Conducted interviews with officials from the following divisions and offices:
 - DER regarding (1) controls in place and the process followed when sharing and following up on counterparty performance issues; (2) counterparty performance issues that were identified through examination activities, immediate notifications, and other sources; (3) examples of counterparty performance issues identified by DER; and (4) OESO's administration of DER's OPB on information sharing of counterparty performance issues.
 - DHMG regarding (1) guidance DHMG follows on information sharing of the Enterprises' counterparty performance issues; (2) how DHMG gathers, shares, tracks, documents, and uses the information it obtains on the Enterprises' counterparty performance issues; and (3) examples of counterparty performance issues identified by DHMG.
 - OGC on (1) guidance OGC follows on information sharing of the Enterprises' counterparty performance issues; (2) OGC's gathering, sharing, and tracking of the Enterprises' counterparty performance issues; (3) status of OGC's review of DER's OPB on information sharing of counterparty performance issues; (4) other divisions or offices involved in information sharing of counterparty performance issues; and (5) memorandums of understanding with other Federal agencies.
 - DBR regarding (1) guidance DBR follows regarding information sharing of the Federal Home Loan Banks' counterparty performance issues; (2) how DBR shares the Federal Home Loan Banks' counterparty performance issues within DBR and other divisions and offices within FHFA; and (3) examples of counterparty performance issues identified by DBR.

We conducted this performance audit from March 2021 to September 2021 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis

for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

APPENDIX: FHFA MANAGEMENT RESPONSE.....



Federal Housing Finance Agency

MEMORANDUM

TO: Marla A. Freedman, Senior Audit Executive, Office of Inspector General

FROM: Andre D. Galeano, Deputy Director, Division of Enterprise Regulation **ANDRE GALEANO** Digitally signed by ANDRE GALEANO
Date: 2021.09.24 16:22:40 -0400

SUBJECT: Draft Audit Report: *FHFA's Division of Enterprise Regulation Did Not Follow or Train to its Procedures for Information Sharing of Enterprise Counterparty Performance Issues*

DATE: September 24, 2021

Thank you for the opportunity to review the Office of Inspector General's (OIG) draft report referenced above (Report). The Report evaluates whether the Division of Enterprise Regulation (DER) followed its internal supervisory guidance when a counterparty performance issue was identified at Fannie Mae or Freddie Mac (the Enterprises). The Report found that DER did not follow its internal supervisory guidance on information sharing of counterparty performance issues and that training was not provided on this guidance, and makes two recommendations, to which we agree.

Recommendation 1: *Complete, in an expeditious manner, the recasting of DER's OPB on information sharing of counterparty performance issues as an Agency-wide policy and procedure document.*

Management Response: FHFA agrees with the recommendation. DER will recast its internal supervisory guidance on information sharing of counterparty performance issues by working with other key stakeholders on an agency-wide document to be completed by July 30, 2022.

Recommendation 2: *Once recommendation 1 is completed, ensure that the Agency-wide policy and procedure document on information sharing of counterparty performance issues is implemented and trained to.*

Management Response: FHFA agrees with the recommendation. By August 31, 2022, DER will ensure that DER executives, management, and staff receive training on the agency-wide document on the information sharing of counterparty performance issues and will implement its use.

I appreciate the professionalism and courtesy of the OIG staff who conducted this audit. I find the results valuable, and I believe they will lead to more effective and efficient operations in DER. If you have any questions related to our response, please do not hesitate to contact Eric Wilson.

cc: Diana Stebick
Eric Wilson
Edom Aweke
John Major

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