Federal Housing Finance Agency
Office of Inspector General

Compliance Review of FHFA's Quality Control Reviews of Enterprise Supervision Activities

Compliance Review • COM-2021-003 • February 12, 2021

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Executive Summary

The Federal Housing Finance Agency (FHFA or Agency) is charged by statute with supervising the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (together, the Enterprises). The Agency's mission as a federal financial regulator includes ensuring the Enterprises' safety and soundness so that they serve as a reliable source of liquidity and funding for housing finance and community investment. Within FHFA, the Division of Enterprise Regulation (DER) is responsible for supervision of the Enterprises. DER's supervisory activities include conducting targeted examinations of the Enterprises.

In 2015, we found that DER had not established a program to conduct comprehensive quality control (QC) reviews of its targeted examinations even though it committed to do so in 2012 and had issued a Supervision Directive (SD) in 2013 requiring that a QC program be established. Absent the important internal control of a QC program, FHFA lacked adequate assurance that targeted examinations were accurate, complete, and of uniform high quality, which put the credibility of DER's examination program at risk. We made two recommendations, the first of which was that FHFA ensure that DER's procedures for QC reviews met the SD's requirements and that FHFA require DER to document in examination workpapers each QC review's results and findings, including any shortcomings found during the QC review. FHFA agreed with the recommendation.

In 2017, FHFA replaced its SD on the QC program, and in 2018 DER issued a revised Operating Procedures Bulletin (OPB) requiring QC reviews of all supervisory correspondence (with supporting documentation) to the Enterprises communicating various types of information, including results of targeted examinations. DER also created checklists to document the results of its QC reviews of targeted examinations. We closed the recommendation on March 13, 2018.

This compliance review assessed whether, for a sample of 59 QC reviews conducted from January 1, 2019 through September 30, 2020, DER documented those QC reviews' results using the prescribed checklists. We found that DER did so.

This report was prepared by Alisa Davis, 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.

/s/

Brian Baker
Deputy Chief Counsel

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ABBREVIATIONS

DER	Division of Enterprise Regulation
Enterprises	Fannie Mae and Freddie Mac, collectively
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
OM	Ongoing Monitoring
OPB	Operating Procedures Bulletin, issued by DER
QC	Quality Control
Review Period	January 1, 2019 – September 30, 2020
SD	Supervision Directive

BACKGROUND

The Enterprises provide liquidity to the U.S. housing finance system by supporting the secondary mortgage market. They do so by purchasing residential mortgages from lenders and bundling them into securities for which they guarantee principal and interest. In guaranteeing the securities, the Enterprises assume the credit risk from possible default of the underlying mortgages. To mitigate this risk, the Enterprises require lenders that sell the residential mortgages to make specific contractual representations and warranties in which they represent that the mortgages meet specific underwriting standards.

The Housing and Economic Recovery Act of 2008 charges FHFA with the supervision of the regulated entities. Its mission as a federal financial regulator includes ensuring the regulated entities' safety and soundness so that they serve as a reliable source of liquidity and funding for housing finance and community investment. Within FHFA, DER is responsible for supervision of the Enterprises.

FHFA maintains that it uses a risk-based approach to supervisory examinations, prioritizing examination activities based on the risk a given practice poses to a regulated entity's safe and sound operation or to its compliance with applicable laws and regulations. DER conducts a variety of supervisory activities of the Enterprises during the annual examination cycle that are used to develop the annual reports of examination. Those supervisory activities include conducting targeted examinations[1] and ongoing monitoring (OM).[2] Based on these activities, DER may identify matters requiring attention (MRA),[3] which, in turn, requires the affected Enterprise to produce remediation plans with proposed corrective actions that must be

[1] As the review period commenced, FHFA characterized targeted examinations as "a critical component of supervision and will be undertaken, as needed, based on risk. The purpose of targeted examinations is to allow for a deep or comprehensive assessment of the area under review. Targeted examinations will be conducted in a manner consistent with examination workprograms [*sic*] and will be documented using the appropriate forms of examination documentation."

[2] According to DER internal guidance, "[e]xaminers conduct monitoring activities by meeting with Enterprise personnel, reviewing key board and management materials and reports, and reviewing and analyzing other documents and data to monitor key and emerging risks and changes in the Enterprise's risk profile. Although not required, monitoring activities may also include the testing of processes or controls."

[3] As a result of its supervisory activities, DER may issue adverse examination findings at an Enterprise. MRAs are the most serious supervisory matters, and DER categorizes MRAs as either "critical supervisory matters" or "deficiencies." According to FHFA, MRAs that are critical supervisory matters are "(the highest priority) which pose substantial risk to the safety and soundness of the regulated entity." FHFA defines deficiencies as "supervisory concerns that FHFA believes could, if not corrected, escalate and potentially negatively affect the condition, financial performance, risk profile, operations, or reputation of the regulated entity."

reviewed by DER, and a determination by DER whether the corrective actions adequately remediate the MRAs.

Our 2015 Evaluation Found that DER Had Not Established or Implemented a QC Program for its Examinations

Federal financial regulators, including FHFA, have long recognized that comprehensive internal QC reviews of examinations are a critical internal control to ensure that examination findings and conclusions are adequately supported and to assure the regulator that its examinations are accurate, complete, and of uniform high quality. In a 2015 evaluation, we found that DER had not established a QC program, although it had committed to do so in 2012. In 2013, the Agency had also issued internal guidance in the form of SD 2013-01, "Quality Control Program for Examinations Conducted by the Division of Bank Regulation and Division of Enterprise Regulation", requiring the establishment of a QC program. Absent the important control of a QC program, FHFA lacked adequate assurance that DER's targeted examinations were accurate, complete, and of uniform high quality, which put the credibility of its examination program at risk.

We made two recommendations,[4] the first of which was that FHFA ensure that DER's recently adopted procedures for QC reviews met the requirements of SD 2013-01 and require DER to document in detail the results and findings of each QC review in examination workpapers, including any shortcomings found during the QC review.[5] FHFA agreed with the recommendation.

In 2017, FHFA Issued Internal Guidance to Establish and Implement a QC Program, so We Closed Our Recommendation

On April 28, 2017, FHFA rescinded and replaced SD 2013-01 with SD 2017-01, entitled "Quality Control Program." Under SD 2017-01, "FHFA's correspondence that communicates examination conclusions and findings, together with supporting examination documentation, is subject to independent quality control review prior to issuance to the regulated entity[.]" On January 23, 2018, DER issued DER-OPB-04 to implement SD 2017-01. DER-OPB-04 instructs that DER shall conduct QC reviews of all supervisory correspondence (with supporting documentation) to the Enterprises communicating the following information:

[4] We made a second recommendation that FHFA evaluate the effectiveness of the new QC procedures, as implemented, one year after adoption. We verified that FHFA had done so in January 2017.

[5] FHFA advised OIG after completion of the fieldwork for the 2015 evaluation that DER finalized a QC review process on July 28, 2015 and had begun conducting QC reviews. As our evaluation noted, "[n]o comprehensive quality control review process was in place for FHFA's examinations of the Enterprises until July 28, 2015—after work on this evaluation was completed."

- Results of targeted examinations, which may or may not include adverse examination findings, and adverse examination findings identified through OM activities;[6]
- DER's nonobjection, nonobjection with conditions, or objection to Enterprise remediation plans submitted in response to MRAs; and
- DER determinations on whether to close adverse examination findings following review of remediation documentation.

DER created checklists to document the results of its QC reviews of targeted examinations and OM activities (including OM of MRA remediation). We obtained and reviewed copies of the completed checklists for nine QC reviews and confirmed that the required documentation of the results and findings for those nine QC reviews had been compiled as required. Based on the steps DER took to address the recommendation, we closed it on March 13, 2018.

On February 24, 2020, DER issued a revised version of DER-OPB-04. In it, OPB announced that DER had expanded its QC program to include reviews of initial planning documentation created in preparation for a targeted examination.[7]

FINDINGS

We initiated this compliance review in September 2020 to assess whether DER met its commitment to document the results of its QC reviews conducted from January 1, 2019 – September 30, 2020 (review period). To do so, we sought, obtained, and reviewed 59 QC checklists, which constituted a random sampling of QC reviews conducted during the review period. We found that DER met its commitment to document the results of its QC reviews, using prescribed checklists.

DER's guidance instructs those conducting QC reviews to focus on significant deviations from DER standards and other applicable guidance, such as FHFA's Examination Manual, supervision guidance and policies, FHFA's style guide, FHFA's records management policy, FHFA's information classification policy, and DER's approved file plan. The QC checklists contain the relevant criteria from those standards and applicable guidance, which the QC reviewer then uses to evaluate the examination documentation. We found that the QC

[6] OM activities that do not result in adverse findings are subjected to QC review on a judgmental sample basis and include reviews of procedures documents, analysis memoranda, and supporting workpapers.

[7] A DER official explained to us that this type of QC review was added because DER found that reviewing these initial documents after the team completed the examination work proved to be too late in the process to effect any improvement in the examination work.

reviewers used the checklists to capture in detail the results and findings of their assessment of examination documentation against those standards and applicable guidance.

We also found that DER's examiners responded to the shortcomings that were identified in the QC reviews. The QC reviewers considered the examiners' responses and found them to be sufficient to resolve the shortcomings (i.e., to "clear" the QC items).

1. We Selected a Sample of QC Reviews Completed During our Review Period

During our review period, DER completed 259 QC reviews. We tested a random sample of 59 QC reviews DER completed during our review period.

2. DER Documented its QC Results, and QC Reviewers Accepted the Examiners' Responses to Shortcomings Identified in the QC Reviews

DER's QC checklist states that a QC review's purpose is to "provide reasonable assurance that the examination work performed by examiners meets applicable DER examination standards and FHFA guidance for document preparation and management." DER's QC checklist includes the criteria for each aspect of the examination documentation the QC team reviewed, the detailed QC result, a detailed QC comment if a shortcoming were identified, and an examiner response to that shortcoming.

We tested each QC checklist in our sample for evidence of: (1) a QC result documented for each criterion reviewed; and (2) an examiner response to every shortcoming identified. Our compliance review assessed neither the quality of the examiner's response to the QC shortcoming nor the QC function's resolution of the shortcomings. We found that DER documented the results and findings in detail for all 59 of its QC reviews. DER's QC identified shortcomings in 52 (88%) of the 59 QC reviews we sampled. There were no shortcomings of any kind identified in the remaining seven QC reviews (12%) in our sample.

In 47 of the instances when a shortcoming was identified in the QC checklist, DER examiners responded to the shortcomings directly in the QC checklist. In all of those instances, the QC reviewers accepted the examiners' responses and cleared the QC items. In the remaining five instances where a shortcoming was identified but there was no apparent correlating examiner response, we requested documentation to determine whether the examiner addressed the shortcoming. For each of these five instances, DER provided documents to show the shortcoming was addressed by the examiner and the QC reviewer considered the examiner's actions to have been sufficient to correct the QC shortcomings.

CONCLUSION

Based upon our testing, we are reasonably assured that DER documented the results of the sampled QC reviews in accordance with its prescribed checklists.

FHFA COMMENTS AND OIG RESPONSE

We provided FHFA an opportunity to respond to a draft of this compliance review. DER provided technical comments that were incorporated into the final report as appropriate.

OBJECTIVE, SCOPE, AND METHODOLOGY .....

We initiated this compliance review in September 2020 to determine whether DER documented its findings, results, and any shortcomings when completing QC reviews of Enterprise supervisory activities.

To accomplish our objective, we reviewed a random sample of QC checklists completed from January 1, 2019, through September 30, 2020.[8] We examined the checklists to determine if there was a response from the QC function for each criterion on the checklist. We then assessed if the examiner responded to shortcomings, if any, identified in the checklists. We reviewed supporting documentation that DER provided in instances when the examiner's response was not readily apparent in the checklist.

We conducted our compliance review from September 2020 through December 2020 under the authority of the Inspector General Act of 1978, as amended, and in accordance with the *Quality Standards for Inspection and Evaluation* (January 2012), which were promulgated by the Council of the Inspectors General on Integrity and Efficiency.

We provided a draft of this report to FHFA for its review and comment.

[8] The populations of 2019 and 2020 QC reviews were each less than 250 items and, therefore, statistically small. A statistical sample would require almost all items to be selected for testing. Therefore, a random, nonstatistical sample of more than 20 percent of each population was selected. Although test results cannot be statistically projected to the population, the randomness of the sampling will provide unbiased material in using professional judgement to assess the population. A 20 percent sample exceeds the generally accepted level for testing small populations.

APPENDIX: FHFA MANAGEMENT RESPONSE.....

Federal Housing Finance Agency

MEMORANDUM

TO: Brian W. Baker, Deputy Chief Counsel, Office of Inspector General (OIG)

FROM: Paul J. Miller, Deputy Director, Division of Enterprise Regulation (DER)

SUBJECT: Draft OIG Report: *Compliance Review of FHFA's Quality Control Reviews of Enterprise Supervision Activities*

DATE: February 11, 2021

Thank you for the opportunity to respond to the Office of Inspector General's (OIG) draft report referenced above. The objective of the compliance review was to determine whether DER documented its findings, results, and any shortcomings when completing Quality Control (QC) reviews of Enterprise supervisory activities.

We are pleased that the compliance review found that DER documented the results of the 59 sampled QC reviews in accordance with its prescribed checklists. We believe these results reflect our continuing efforts to enhance the efficiency and efficacy of our supervisory program.

We would like to thank the OIG staff that worked with the Agency during this compliance review. If you have any questions related to our response, please do not hesitate to contact Eric Wilson.

cc: Chris Bosland
Kate Fulton
Scott Valentin
Eric Wilson
John Major

ADDITIONAL INFORMATION AND COPIES.....

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