REDACTED

Federal Housing Finance Agency
Office of Inspector General

FHFA's Failure to Define and Clearly Communicate "Supervisory Concerns" Hinders the Enterprise Boards' Ability to Execute Their Oversight Obligations Under FHFA's Corporate Governance Regulation and Renders the Regulation Ineffective as a Supervisory Tool

This report contains redactions of information that is privileged or otherwise protected from disclosure under applicable law.

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Executive Summary

FHFA is charged by the Housing and Economic Recovery Act of 2008 with supervision of Fannie Mae and Freddie Mac (collectively, the Enterprises). Its mission as a federal financial regulator is to ensure that the Enterprises operate safely and soundly so that they serve as a reliable source of liquidity and funding for housing finance and community investment.

By statute, FHFA must conduct annual onsite examinations of its regulated entities. The Division of Enterprise Regulation (DER) is responsible for developing and implementing FHFA's supervision program for the Enterprises and performs those examinations through ongoing monitoring activities and targeted examinations.

During an ongoing monitoring activity or a targeted examination, DER may identify deficiencies and may issue a Matter Requiring Attention (MRA) for those examination findings that "require the board of directors and/or management to take corrective action to address critical supervisory matters or deficiencies." Not every issue or deficiency identified by DER through its supervisory activities gives rise to an MRA. DER can draw attention to an issue or deficiency by characterizing it as a "supervisory concern." We found no formal definition of the term "supervisory concern" in FHFA's supervisory guidance or DER's examination guidance. Both examiners-in-charge (EICs) confirmed to us that the term supervisory concern is not defined but amounts to an issue or deficiency that typically does not warrant an MRA.

FHFA's corporate governance regulation directs that the Board of Directors of each Enterprise (Board) is responsible to oversee management in its remediation of "all supervisory concerns" in a timely and appropriate manner. FHFA maintained that Enterprise Boards "are informed of supervisory concerns appropriately." Both EICs separately explained that DER communicates its "supervisory concerns" in the annual written report of examination (ROE) issued to each Enterprise. In previous reports, we explained that the purpose of an ROE is to communicate examination results and conclusions, findings, supervisory concerns, and the Composite and Component ratings.

Recognizing that an Enterprise Board can only satisfy its oversight responsibilities under FHFA's governance regulation when DER clearly advises it of "supervisory concerns," we assessed whether each of 12 statements from the 2018 and 2019 ROEs was labeled as a "supervisory concern." Each of these 12 statements: (1) appeared to us to reflect a supervisory concern regarding an Enterprise's condition or risk management

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practices that had not appeared previously in a conclusion letter as a supervisory concern; (2) did not appear to us to relate to MRAs or the deficiencies underlying MRAs; and (3) was confirmed by DER to constitute a "supervisory concern."

We found that none of the 12 statements were specifically categorized as "supervisory concerns" in either the ROEs or the DER presentations to the Enterprise Boards. Not only were these 12 issues or deficiencies not categorized as supervisory concerns in the ROEs but DER did not explain the actions necessary to remediate them. Without clarity from DER, an Enterprise Board lacks a reasonable basis to understand that its obligations under FHFA's governance regulation have been triggered. DER potentially created further confusion when it used the term "supervisory concern" in ROEs for matters that did not trigger a Board's oversight under the regulation, such as in its discussion of an Enterprise's rating.

FHFA recognizes that it must clearly communicate supervisory concerns so that Enterprise management can remediate them, and the Board can oversee the remediation. Its Strategic Plan for 2021-24 announces that FHFA will produce examination and other supervisory reports that "clearly identify supervisory concerns." DER fell far short of that expectation. As a consequence, FHFA's ability to assess a Board's compliance with its governance regulation is impaired and the regulation is rendered ineffective as a supervisory tool.

We made two recommendations to address the shortcomings our evaluation identified. In its written management response, FHFA agreed with our recommendations.

This report was prepared by Adrienne Freeman, Investigative Counsel, and Philip Noyovitz, Investigative Evaluator, with assistance from Howard Klein, Attorney Advisor. We appreciate the cooperation of FHFA staff, as well as the assistance of all those who contributed to the preparation of this report.

This report has been distributed to Congress, the Office of Management and Budget, and others and will be posted on our website, www.fhfaoig.gov, and www.oversight.gov.

/s/

Kyle D. Roberts
Deputy Inspector General for Evaluations

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ABBREVIATIONS

Board	Board of Directors
DER	Division of Enterprise Regulation
EICs	Examiners-in-Charge
Enterprises	Fannie Mae and Freddie Mac
Federal Reserve	Board of Governors of the Federal Reserve System
FHFA	Federal Housing Finance Agency
MRA	Matter Requiring Attention
MRIA	Matter Requiring Immediate Attention
OCC	Office of the Comptroller of the Currency
ROE	Report of Examination

BACKGROUND...

FHFA, created by Congress in 2008, is charged by the Housing and Economic Recovery Act of 2008 with supervision of the Enterprises.[1] Its mission as a federal financial regulator is to ensure that the Enterprises operate safely and soundly so that they serve as a reliable source of liquidity and funding for housing finance and community investment.[2]

By statute, FHFA must conduct annual onsite examinations of its regulated entities. DER is responsible for examinations of the Enterprises. According to FHFA's *Examination Manual*, DER examines risk management practices and the regulated entity's financial condition and safety and soundness relative to applicable laws, regulations, supervisory guidance, and prudent business practice.[3] FHFA, through DER, satisfies its annual onsite examination requirements of the Enterprises by conducting ongoing monitoring activities and targeted examinations, in accordance with a risk-based supervisory plan.[4]

FHFA Charges Enterprise Boards of Directors with Responsibilities to Oversee Management in the Timely Remediation of Matters Requiring Attention and of Supervisory Concerns

During an examination activity, DER may identify issues or deficiencies related to risk management, risk exposure, or violations of laws, regulations, or orders affecting the performance or condition of a regulated entity and/or make examination findings. Some of these deficiencies may cause DER to issue an MRA. According to FHFA, MRAs "require the board of directors and/or management to take corrective action to address critical supervisory matters or deficiencies."[5]

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[1] 12 U.S.C. § 4513(a)(1)(A).

[2] 12 U.S.C. § 4513(a)(1)(B)(i-ii).

[3] FHFA's *Examination Manual* provides guidance on the examination process, establishes standards, and communicates expectations to examiners; DER operating procedures bulletins provide examiners more detailed instruction. *See generally*, FHFA, 2013 Examination Manual (version 1.0) (December 2013).

[4] 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. Targeted examinations complement ongoing monitoring and enable examiners to conduct "a deep or comprehensive assessment" of the areas found to be of high importance or risk.

[5] *See* FHFA, *2020 Performance and Accountability Report* (Nov. 16, 2020).

According to FHFA's supervisory guidance, FHFA divides MRAs into two categories based on the nature and severity of the deficiencies and the priority for remediation: (1) "Critical supervisory matters (the highest priority) which pose substantial risk to the safety and soundness of the regulated entity. . . ."; and

From time to time, DER may identify issues or deficiencies that do not warrant an MRA but give rise to a "supervisory concern." Under FHFA's corporate governance regulation, each Enterprise Board is responsible for oversight of management in its efforts to remediate "all supervisory concerns" of FHFA in a timely and appropriate manner.[6]

DER Formally Communicates Significant Deficiencies Identified During Examination Activities to Each Enterprise Board Through Conclusion Letters and Annual Reports of Examination

Communication of Matters Requiring Attention in Conclusion Letters

When an examination activity identifies significant deficiencies for which an MRA is imposed, DER formally communicates MRAs to the Enterprises through conclusion letters. According to FHFA's 2013 *Examination Manual*, conclusion letters should "describe[] … [examination] findings that require remediation with sufficient detail to enable management or the board of directors to … correct the problem." When preparing a conclusion letter, DER instructs examiners to "ensure that the tone of the [conclusion letter] reflects the seriousness of any adverse examination finding(s) and, to the extent feasible, provides a sense of the potential impact of the finding(s) if not satisfactorily addressed."

FHFA requires corrective action for all MRAs. For each MRA, the affected Enterprise must submit a remediation plan for DER's review and acceptance, and DER tracks remediation to ensure that the Enterprise corrects the identified deficiencies in accordance with the remediation plan. Remediation by Enterprise management is subject to oversight by the Enterprise's Board. Examiners monitor management's progress during the course of ongoing monitoring activities. Once DER determines that management has remediated the deficiencies in accordance with the remediation plan, DER closes the MRA and informs management and the Board of the closure through a remediation letter.

Communication of Supervisory Concerns in Annual Reports of Examination

As noted earlier, not every issue or deficiency identified by DER through its supervisory activities gives rise to an MRA. We found no formal definition of the term "supervisory concern" in FHFA's supervisory guidance or DER's examination guidance; both EICs confirmed to us that the term is not defined but typically amounts to an issue or deficiency

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(2) "Deficiencies which are 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. . . ." Violations and Recommendations are two other classifications of adverse examination findings. *See* FHFA, Advisory Bulletin 2017-01, *Classifications of Adverse Examination Findings* (Mar. 13, 2017).

[6] 12 C.F.R. § 1239.4(c)(3) (Duties and Responsibilities of Directors).

that does not warrant an MRA.[7] Both EICs advised that a "supervisory concern" should focus attention of the Board and management on the issues or deficiencies giving rise to it because remediation is required. By way of example, both EICs explained that DER has a "supervisory concern," but will not issue an MRA, when management of an Enterprise self-identifies an issue or deficiency and commits to take reasonable corrective action.[8] According to one EIC, a supervisory concern could be considered a warning to the Enterprise Board and its management.

While FHFA previously maintained to us "that the Enterprises' boards are informed of supervisory concerns appropriately," it did not identify the forum in which those concerns are communicated. Both EICs separately explained that DER communicates its "supervisory concerns" in the annual ROE issued to each Enterprise. (DER also meets with each Enterprise Board to present and discuss the results and conclusions in each ROE.) For purposes of this evaluation, we relied on the EIC's representations that they include supervisory concerns that must be remediated by the Enterprises in annual ROEs.

In previous reports, we have explained that the purpose of an ROE is to communicate to the Board examination results and conclusions, findings, supervisory concerns, and the Composite and Component ratings.[9] Each annual ROE issued by DER follows a standard format. Each ROE first summarizes FHFA's statutory examination authority and examination rating system, and explains how the numerical ratings reflect the Agency's level of "supervisory concern."[10] The next section contains an Enterprise Overview of, among other

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[7] In a technical comment to a draft of this report, FHFA "disagree[d] with the characterization of the interviews with the EICs that the term 'supervisory concern' 'amounts to an issue short of warranting an MRA' " because it has no "classification of examination findings that falls below adverse examination findings. We either issue an MRA or not."

This evaluation focuses on those issues and deficiencies described in ROEs for which MRAs are not issued but that are considered "supervisory concerns" by DER and for which remediation is required under FHFA's governance regulation.

[8] However, if the issue or deficiency identified by management constitutes a violation of law or regulation, both EICs told us that they would expect the issuance of a violation or an MRA.

[9] *See* OIG, *FHFA's Failure to Consistently Identify Specific Deficiencies and Their Root Causes in Its Reports of Examination Constrains the Ability of the Enterprise Boards to Exercise Effective Oversight of Management's Remediation of Supervisory Concerns* (EVL-2016-008, July 14, 2016); and *FHFA Failed to Consistently Deliver Timely Reports of Examination to the Enterprise Boards and Obtain Written Responses from the Boards Regarding Remediation of Supervisory Concerns Identified in those Reports* (EVL-2016-009, July 14, 2016).

[10] Under FHFA's examination rating system, DER assigns a Composite rating based on its assessment of seven components (Capital, Asset Quality, Management, Earnings, Liquidity, Sensitivity to Market Risk, and Operational Risk). DER assigns numerical ratings to the Composite rating and to the individual Component ratings as well. Each ROE explains that the Composite and Component ratings are on a scale from "1" to "5," with a "1" rating indicating the lowest degree of supervisory concern and a "5" the highest.

things, emerging risks and changes in the Enterprise's operations, structure, and business activities. The following sections contain the Composite rating and Component ratings that, according to DER guidance, should reference and describe relevant "examination results."[11] The final section addresses MRAs; it identifies open MRAs and contains summary descriptions of each MRA.[12]

Beyond the brief description of the numerical ratings, DER's examination guidance for ROE preparation does not use the term "supervisory concerns." Consequently, there is no examination guidance addressing whether those issues or deficiencies that DER considers to be "supervisory concerns" should be characterized as "supervisory concerns" in the ROE to alert a Board that its oversight obligations under FHFA's corporate governance regulation have been triggered. Unlike its practice with respect to MRAs, DER ***does not***: insert a section in each ROE that sets forth, in one place, all issues and deficiencies that it considers to be supervisory concerns; require an Enterprise to submit a remediation plan to correct the issues and deficiencies underlying each "supervisory concern" for DER's review and acceptance; formally track an Enterprise's remediation efforts; and report in an ROE that a supervisory concern has been closed.

Absent adequate remediation by an Enterprise, DER can issue an MRA for the unaddressed supervisory concern.

FHFA Recognizes That Enterprise Boards of Directors Must Have Notice of Supervisory Concerns in Order to Execute Their Responsibilities to Oversee Management's Timely Remediation

As explained, FHFA's corporate governance regulation requires each Enterprise Board to have adequate policies to assure its oversight of the responsiveness of executive officers in addressing "all supervisory concerns" of FHFA in a timely and appropriate manner.[13] In prior reports, we explained that FHFA's governance regulation requires each Board to receive from FHFA an articulation of examination findings and other supervisory concerns in order to

[11] In practice, the ROE highlights issues and deficiencies chosen by the EIC and describes the focus of DER's concern and the actions that management has taken to address the issue.

[12] The MRA list contains a description of the MRA, when the MRA was issued, and management's estimated remediation date. The ROE also identifies MRAs that DER closed during the examination cycle.

[13] 12 C.F.R. § 1239.4(c)(3) (Duties and Responsibilities of Directors).

satisfy its oversight responsibilities under FHFA's regulations and guidance; FHFA has concurred with that explanation.[14]

To ensure that the issues and deficiencies that give rise to supervisory concerns are adequately remediated, FHFA recognizes that it must clearly communicate such supervisory concerns. That recognition is announced in its Strategic Plan for 2021-24: FHFA will produce examination and other supervisory reports that "clearly identify supervisory concerns."

FACTS & ANALYSIS ....

DER's Guidance on Communication of Supervisory Concerns Is Far Less Rigorous Than the Guidance of Other Federal Financial Regulators

Guidance of the OCC and Federal Reserve

Like FHFA, the Office of the Comptroller of the Currency (OCC) is a federal financial regulator and uses MRAs to communicate concerns about a bank's deficient practices. Pursuant to OCC guidance, an MRA will issue for a "Concern" which the OCC identifies as a deficient bank practice. The MRA will explain how the identified "Concern" "deviates from sound governance, internal control, or risk management principles, or results in substantive noncompliance with laws or regulations, enforcement actions, or conditions imposed in writing." [15] According to the OCC guidance, "Examiners must communicate such concerns to management and the board when the concerns are discovered and must not defer issuing MRAs pending bank management's efforts to address the concerns." OCC guidance does not permit a "graduated process" where examiners first communicate the OCC's concern with the deficient practice as a recommendation and then, "if the deficient practice is not addressed, . . . an MRA."[16]

With respect to ROEs, the OCC provides extensive guidance on disclosure of concerns. Among other things, it requires that major examination conclusions and significant concerns be highlighted in a separate section of the ROE, prioritized and summarized, and that the ROE

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[14] *See* OIG, *FHFA Failed to Consistently Deliver Timely Reports of Examination to the Enterprise Boards and Obtain Written Responses from the Boards Regarding Remediation of Supervisory Concerns Identified in those Reports* (EVL-2016-009, July 14, 2016).

[15] OCC Bank Supervision Process Handbook (BSP Handbook), at 46. The OCC notes that an MRA can consist of multiple "concerns."

[16] OCC BSP Handbook, at 46.

"provide the board with a concise, unambiguous assessment of the bank's condition and focus the board's attention on any deficiencies or excessive risks."[17]

Similarly, the Board of Governors of the Federal Reserve System (Federal Reserve) does not use a graduated approach for issues that do not amount to an MRA or "Matter Requiring Immediate Attention (MRIA)." When examiners expect a regulated entity *to take action* to remediate issues in a particular area or business function, "examiners should treat these matters as MRIAs or MRAs."[18] Federal Reserve guidance requires every MRIA and MRA to follow a common format and state that "[t]he board of directors (or executive-level committee of the board), or banking organization is required to" address the identified deficiency within a timeframe provided for that remediation. Pursuant to Federal Reserve guidance, all MRIAs and MRAs must be included in the ROEs. For regulated entities rated a 3, 4, or 5 (or a 1 or 2 rated entity that shows signs of significant deterioration in condition or apparent violations of law), the Federal Reserve requires a supplemental report that "focus[es] on identified problems" and "present[s] the bank's deficiencies succinctly and clearly" and the "types of actions directors and management should take to address identified problems should be specifically stated."[19]

FHFA Communication of Supervisory Concerns

In contrast with the OCC and the Federal Reserve, DER's written guidance does not require an MRA to be issued for "supervisory concerns." DER's Deputy Director and Senior Associate Director acknowledged that DER does not use the term "supervisory concern" in the same manner as other federal financial regulators.

Neither FHFA nor DER define the term "supervisory concern." According to the EICs, DER purportedly includes an issue or deficiency that it considers to be a "supervisory concern," but does not warrant an MRA, in an ROE to alert the Board and management of the need for corrective action.[20] This practice contrasts with the guidance from the OCC and Federal Reserve. Unlike the OCC and the Federal Reserve, FHFA uses a graduated process for

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[17] *Id.* at 61.

[18] *See* Federal Reserve, SR 13-13 *Supervisory Considerations for the Communication of Supervisory Findings*, at 1 (June 17, 2013) (emphasis added).

[19] According to FHFA, its CAMELSO examination rating system is similar to the ''CAMELS'' rating system used by the federal banking regulators for depository institutions. *See* 77 Fed. Reg. 67644 (November 13, 2012).

[20] DER may repeat those "supervisory concerns" in subsequent ROEs until the issue or deficiency is ultimately resolved. In the event a supervisory concern is not adequately addressed, DER may issue an MRA.

adverse examination findings: some issues and deficiencies give rise to MRAs while others are considered supervisory concerns.[21]

Our review of the 2018 and 2019 ROEs found that each was roughly 30 pages long, not including the section discussing open and closed MRAs. In contrast to the clear instructions from the OCC and Federal Reserve, FHFA and DER provide no guidance on whether the ROE should clearly flag, for the reader, those issues and deficiencies that DER considers to be "supervisory concerns" [22] and summarize the expected remediation, for purposes of FHFA's corporate governance regulation.

DER Does Not Clearly Articulate in the ROEs Each "Supervisory Concern" Nor Does It Set Forth the Proposed Remediation and Timetable to Facilitate Board Oversight

Because DER holds the view that "supervisory concerns" may not rise to the level of MRAs but FHFA's governance regulation demands remediation of such concerns, it is incumbent on DER to make clear which issues and deficiencies fall into the category of "supervisory concerns."

For this evaluation, we selected twelve statements from the 2018 and 2019 ROEs issued to the Enterprises that appeared to reflect DER's supervisory concerns regarding an Enterprise's condition or risk management practices. We chose statements that did not appear to relate to MRAs or the deficiencies underlying the MRAs and had not appeared previously in conclusion letters as supervisory concerns. DER confirmed to us that: (1) it identified each of the 12 statements as reflecting an issue or deficiency during ongoing monitoring activities but did not issue an MRA; and (2) each of the 12 statements in our sample constituted a "supervisory concern" and required remediation.[23] Because DER acknowledged that each of

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[21] In its technical comments to a draft of this report, DER asserted that its process is not graduated because its use of the term "supervisory concern" applies only to adverse examination findings, not preliminary views.

By using the term "graduated," we do not suggest that "supervisory concerns" are preliminary opinions for which additional examination work is required before a determination can be made. As the EICs explained to us, a supervisory concern is an issue or deficiency identified by examiners that does not warrant imposition of an MRA but must be corrected. To the same end, FHFA's governance regulation makes clear that all supervisory concerns must be remediated. Absent remediation, an MRA may be imposed. As the term is described by the EICs and used in FHFA's governance process, that term reflects that FHFA uses a graduated process to address issues and deficiencies.

[22] DER's practice is also incongruous with the approach it has adopted for handling matters that examiners identify during a targeted examination that are not directly relevant to the objectives and scope of that examination. Under its revised Operating Procedures Bulletin on targeted examinations, DER instructs examiners to document these matters in examination workpapers as "matters requiring further attention" and monitor them until a final conclusion is reached.

[23] These 12 statements in the ROEs are:

these 12 statements constitutes a supervisory concern requiring remediation, we considered them to fall within the meaning of FHFA's governance regulation.

DER Failed to Communicate That Any of the 12 Issues or Deficiencies Constituted Supervisory Concerns That Required Remediation Under Its Corporate Governance Regulation

As FHFA recognizes, a Board can only execute its responsibilities to oversee management's timely and appropriate remediation of supervisory concerns when those concerns are clearly identified. Accordingly, we first sought to determine whether DER described each of the 12 identified statements as a "supervisory concern" consistent with FHFA's stated goal to produce examination and other supervisory reports that "clearly identify supervisory concerns." We reviewed the annual ROEs for 2018 and 2019, presentations by DER to the Boards that highlighted the discussion in each ROE, and minutes from the Board meetings at which DER presented each ROE that the Board discussed.

For the 12 statements in our sample that DER confirmed to be supervisory concerns, we found that none were specifically categorized as "supervisory concerns" in either the ROEs or the DER presentations to the Enterprise Boards. While these communications discuss a range of problems around these 12 statements, they do not use the term "supervisory concern," the

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1. "[redacted] and the Enterprise's "[redacted]."
2. "[redacted]."
3. DER is concerned that the [redacted]."
4. DER and management "[redacted]"
5. "Fannie Mae also [redacted], including [redacted]"
6. "Fannie Mae's [redacted]."
7. "[redacted]."
8. The Enterprise "[redacted]."
9. "[redacted] Freddie Mac's [redacted]."
10. Despite substantial progress, "[redacted]."
11. [redacted]."
12. "[redacted]"

term used in 12 C.F.R. § 1239.4(c)(3) to signal to an Enterprise Board that its obligations to oversee management's timely and appropriate remediation are initiated.

With regard to Board meeting minutes arising out of DER's ROE presentations, we found no discussion in the minutes that reflected (1) either the Board understood that any of these 12 statements constituted specific "supervisory concerns" for purposes of FHFA's governance regulation, or (2) required specific action or oversight by it. We also found no acknowledgement that either Board recognized that its obligations to oversee management's remedial efforts of the issues or deficiencies captured in any of these statements were required.

While DER failed to use the term "supervisory concern" to categorize any of the 12 issues or deficiencies, we found that DER notified the Board that it "must increase oversight" of management remediation for one issue. In that instance, DER advised the Board of a four-year delay in management's implementation of an initiative and that "critical elements [of the program] remain incomplete." DER directed the Board to increase oversight so that the program would be "universally accepted and supported by the business lines" and "not derailed by competing priorities and lack of resources." In our view, advising a Board that it "must increase oversight," without more, is not sufficient to put the Board on notice that this issue is a "supervisory concern" within the meaning of the governance regulation.[24]

Even assuming that reasonable minds could differ over whether DER's instruction to the Board was sufficient to alert the Board that the delayed initiative amounted to a "supervisory concern," DER's lack of clear communication of supervisory concerns for 91.7% of statements in our sample amounts to a failure of its duty to "clearly identify supervisory concerns." Our review underscores the finding of a July 2019, third-party review of FHFA's supervision program in which the reviewers determined that FHFA's [redacted]

Failure to clearly categorize any of these issues or deficiencies as a "supervisory concern" means that Board members lack a reasonable basis to know that their obligations to oversee remediation of a particular supervisory concern have been triggered. As a consequence, FHFA's ability to assess a Board's compliance with the governance regulation is impaired and the regulation is rendered ineffective as a supervisory tool.

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[24] We traced the follow-up work performed by DER on the issues flagged in this statement, which included both ongoing monitoring and a targeted examination, and found that DER examiners reached no adverse examination findings or identified safety and soundness concerns. Workpapers from the 2020 follow-up examination work recorded the same delays and deficiencies recited in the ROE, but the examiners had no findings and never proposed an MRA. For those reasons, we cannot determine the reasons that FHFA characterized this statement as a "supervisory concern."

DER's Different Uses of the Term "Supervisory Concern" in the ROEs for Other Matters Further Muddies Communication to the Board to Trigger Its Obligations Under FHFA's Governance Regulation

While DER did not categorize any of the 12 issues or deficiencies in our sample as a "supervisory concern" in the four ROEs we reviewed (or the explanatory presentation DER provided to the Boards), we found that DER used the term "supervisory concern" 20 times in these ROEs, with different meanings within the same ROE. For example, the term "supervisory concern" is used in each ROE to describe FHFA's CAMELSO examination rating system: a CAMELSO rating of "1" reflects low supervisory concern, a rating of "5" reflects the highest level of supervisory concern. Plainly, use of this term in connection with a CAMELSO rating cannot provide notice to a Board of a specific issue or deficiency for which it must oversee management's remediation, pursuant to FHFA's governance regulation.

DER also used the term "supervisory concern" to express discomfort over an entire risk area covered in its examination rating system; for example, it identified "market risk" and "operational risk" as "supervisory concerns." Use of the term "supervisory concerns" in these contexts does not reconcile with a Board's responsibilities pursuant to FHFA's corporate governance regulation to oversee management's remediation of "all supervisory concerns" in a timely and appropriate manner.

DER Failed to Articulate Its Supervisory Expectations for Remediation of Supervisory Concerns for Which Board Oversight Is Required

An Enterprise Board can only effectively satisfy its oversight responsibilities under FHFA's governance regulation when DER identifies all supervisory concerns and the deficient, unsafe, or unsound practices giving rise to such concerns, and sets forth the remediation expected to address those concerns.[25] Even though DER failed to categorize in the ROEs any of the 12 issues or deficiencies in our sample as a "supervisory concern," clear articulation by DER of its expectations for remediation of each issue or deficiency and the timetable for that remediation could potentially put a Board on notice of its oversight obligations. For that reason, we sought to determine from the descriptions in the ROEs (and DER's presentations to the Board) whether DER identified how it expected management to address these issues in a timely and appropriate manner.

Again, DER failed to provide the Boards with sufficient information to enable them to execute their responsibilities. Of the 12 issues or deficiencies in our sample, we identified

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[25] *See* OIG, *FHFA's Failure to Consistently Identify Specific Deficiencies and Their Root Causes in Its Reports of Examination Constrains the Ability of the Enterprise Boards to Exercise Effective Oversight of Management's Remediation of Supervisory Concerns* (EVL-2016-008, July 14, 2016).

one where DER described its expectations regarding management's actions to address the underlying issue or deficiency and expressly opined on whether DER considered the actions already taken by management to be timely and appropriate.

For 11 of the 12 issues or deficiencies, we found that DER recited the remedial actions taken by management during the prior examination cycle and/or management's planned remedial actions. These recitations were presented as a narrative in the Composite Rating section of the ROE and/or the Component Rating sections, and organized by the applicable CAMELSO component (e.g., Asset Quality, Management, Operational Risk) and relevant subtopic. For five issues or deficiencies, DER provided no commentary on the timeliness or appropriateness of management's remediation activities to date to the Board.

For 6 of the 12 issues or deficiencies, we found that DER provided commentary on management's ongoing efforts to remediate. The commentary for these six issues did not express supervisory views on the appropriateness of the remedial actions taken and the projected timetable:

- "Significant work remains";
- "Further work is necessary";
- "Management continues to address control weaknesses";
- Management is "coordinating to address these issues";
- "[I]t is too early to determine whether management action will have the desired effect"; and
- "This should continue to be a priority until this issue is fully resolved."

Although the 12 statements in our sample may reflect implicit supervisory criticisms of management's remedial efforts to date, DER did not issue MRAs to address the underlying issues or deficiencies nor did it set forth its expectation that the Board oversee management's corrective actions as "supervisory concerns," pursuant to the governance regulation. Had DER intended that the issues or deficiencies described in the 12 statements required prompt corrective action by Enterprise management, overseen by an Enterprise Board, as contemplated by FHFA's corporate governance regulation, DER's commentary did not clearly communicate that intent.[26]

[26] 12 C.F.R. 1239.4(c)(3) requires the board to have processes in place to ensure management addresses FHFA's "supervisory concerns" in a timely and appropriate manner.

FINDINGS

1. FHFA's corporate governance regulation requires the Enterprises' Boards to have adequate policies to assure oversight of management's remediation of "all supervisory concerns" in a timely and appropriate manner. FHFA and DER guidance do not define "supervisory concern" for purposes of this regulation. According to the EICs, a "supervisory concern" is undefined but amounts to an issue or deficiency found during an examination activity that must be corrected, but does not warrant an MRA. In contrast, the OCC and the Federal Reserve call for an MRA to be issued when a "supervisory concern" is identified and management is expected to take action.

2. DER examination guidance does not address how supervisory concerns, that require remediation within the meaning of FHFA's corporate governance regulation (12 C.F.R. § 1239.4(c)(3)), must be communicated in the ROEs. DER does not: (a) insert a section in the ROE that identifies all issues and deficiencies characterized as supervisory concerns, or (b) summarize the expected remediation to be undertaken by management and overseen by the Board. In contrast, DER has established guidance for discussion of MRAs in the ROE, where remediation is also required by management and overseen by the Board.

3. DER did not categorize any of the 12 statements in our sample as "supervisory concerns" in the 2018 and 2019 ROEs. We found no discussions in Board minutes that reflected the Board's understanding that any of these statements constituted "supervisory concerns" or required Board-overseen remediation within the meaning of the corporate governance regulation. We found no acknowledgement by the Boards that they recognized their respective obligations to oversee management's remedial efforts of the issues or deficiencies captured in these statements.

CONCLUSIONS

FHFA's corporate governance regulation states that the Board of each Enterprise is responsible for having adequate policies in place to assure its oversight of the responsiveness of executive officers in addressing "all supervisory concerns" of FHFA in a timely and appropriate manner. According to the two EICs, DER communicates supervisory concerns to the Enterprises through the annual ROE. However, FHFA does not define the term, and DER provides no instructions regarding communication of supervisory concerns in the ROE. Because FHFA's governance regulation demands remediation of supervisory concerns, it is incumbent on DER to clearly categorize the issues and deficiencies that it deems to be "supervisory concerns" in the ROE. Otherwise, an Enterprise Board lacks a reasonable basis to know its obligations to oversee management's efforts to address all supervisory concerns in a timely and appropriate manner have been triggered. Because DER failed to identify supervisory concerns in all of the 12 statements in our sample, FHFA's ability to assess a Board's compliance with its governance regulation is impaired and the regulation is rendered ineffective as a supervisory tool.

RECOMMENDATIONS

We recommend that FHFA:

1. Define the term "supervisory concern" as it is used in FHFA's corporate governance regulation; and

2. Develop examination guidance that explains how supervisory concerns should be described and categorized in the ROEs, establishes DER's expectations for timely and appropriate remediation for each such concern, and prescribes how such concerns should be monitored until they are fully remediated.

FHFA COMMENTS AND OIG RESPONSE

We provided FHFA an opportunity to respond to a draft of this evaluation. FHFA provided technical comments on the draft report, which were considered in finalizing this report. FHFA also provided a management response, which is reprinted in its entirety in the Appendix. We based our characterization of a supervisory concern on our interviews with the EICs. In FHFA's management response, it committed to enhance its internal supervision program guidance and clarify that "supervisory concern" should be interpreted to refer to adverse examination findings. FHFA agreed with both our recommendations.

OBJECTIVE, SCOPE, AND METHODOLOGY ....

We conducted this evaluation to determine if supervisory concerns that appeared in FHFA's annual ROEs, but not related to MRAs, were communicated to the Enterprises in such a manner that their respective Board directors could perform their responsibilities to oversee management's remediation of supervisory concerns in a timely and appropriate manner, in accordance with FHFA's corporate governance regulation (12 C.F.R. § 1239.4(c)(3)).

To meet this objective, we selected a sample of 12 statements from the 2018 and 2019 ROEs and received confirmation from DER that each of the sample statements was an issue or deficiency supported by an ongoing monitoring activity, was not related to an MRA but required corrective action, and was considered a supervisory concern. We reviewed publicly available guidance issued by the OCC and the Federal Reserve. We reviewed applicable FHFA and DER guidance in effect during our review period, DER examination records related to the 12 statements in our sample, and Enterprise Board materials and minutes. We also conducted interviews of DER's senior leadership.

The fieldwork for this report was conducted between October 2020 and January 2021. The review period for this evaluation was January 1, 2018, through March 31, 2020.

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 recommendations discussed in this report meet those standards.

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

Federal Housing Finance Agency

MEMORANDUM

TO: Kyle D. Roberts, Deputy Inspector General for Evaluations, Office of Inspector General

FROM: Paul J. Miller, Deputy Director, Division of Enterprise Regulation PJM

SUBJECT: Draft Evaluation Report: *FHFA's Failure to Define and Clearly Communicate "Supervisory Concerns" Hinders the Enterprise Boards' Ability to Execute Their Oversight Obligations Under FHFA's Corporate Governance Regulation and Renders the Regulation Ineffective as a Supervisory Tool*

DATE: March 25, 2021

Thank you for the opportunity to respond to the Office of Inspector General's (OIG) draft report referenced above (Report). FHFA disagrees with the premise of the Report that a supervisory concern "…amounts to an issue or deficiency found during an examination activity that must be corrected, but does not warrant an MRA." That said, as discussed below, FHFA acknowledges that it is important that statements made in the annual Reports of Examination (ROEs) appropriately reflect conclusions reached based upon supervisory work performed and the status of this work.

The draft Report makes two recommendations:

Recommendation 1: *OIG recommends that FHFA define the term "supervisory concern" as it is used in FHFA's corporate governance regulation.*

Management Response: FHFA agrees with the OIG's recommendation. FHFA agrees that it would be appropriate to clarify how the term "supervisory concern" is used in the FHFA's corporate governance regulation when describing the responsibility of the board to oversee the responsiveness of executive officers in addressing FHFA's supervisory concerns in a timely and appropriate manner. In this context, it is FHFA's intent that the term "supervisory concern" be interpreted to refer to adverse examination findings, as outlined in DER's internal supervision program guidance on Matters Requiring Attention remediation. By December 31, 2021, FHFA will clarify this term in its internal supervision program guidance on the ROEs.

Recommendation 2: *OIG recommends that FHFA develop examination guidance that explains how supervisory concerns should be described and categorized in the ROEs, establishes DER's expectations for timely and appropriate remediation for each such concern, and prescribes how such concerns should be monitored until they are fully remediated.*

Management Response: By December 31, 2021, FHFA agrees to issue enhanced internal supervision program guidance for use when developing the ROEs. This enhanced guidance will emphasize the importance of ensuring that statements made in the ROEs appropriately reflect conclusions reached based upon supervisory work performed and the status of this work (i.e., that potential concerns that require further follow-up should not be discussed as "supervisory concerns" without making it clear that DER has not yet reached a definitive conclusion on the concerns). As described in the response to Recommendation 1, "supervisory concerns" will refer to adverse examination findings that have been communicated to the Enterprise through supervisory correspondence and require remediation by the Enterprise.

DER feels strongly that it must have flexibility to include information in the ROEs that originates from various sources in order to deliver clear and unambiguous messages to the board and senior management regarding its assessment of the current state of the Enterprise's financial condition and risk management and control systems in its ROEs, including: 1) messages that summarize concerns in an area based upon adverse examination findings that have been identified and issued in formal conclusion letters to the Enterprise; 2) statements of fact that are supported by supervisory work performed; and/or 3) observations that are based upon information obtained from various sources including public filings, Enterprise managements' self-identified issues, reports from outside consultants, or the Enterprise's Internal Audit function.

We would like to thank the OIG staff that worked with the Agency during this evaluation. 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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