OFFICE OF INSPECTOR GENERAL
Federal Housing Finance Agency
400 7th Street SW, Washington, DC 20219

October 6, 2022

**TO:** Sandra L. Thompson, Director, FHFA

**FROM:** Brian M. Tomney, Inspector General

**SUBJECT:** Fiscal Year 2023 Management and Performance Challenges

This memorandum, issued pursuant to the Reports Consolidation Act of 2000 (P.L. 106-531), provides the Federal Housing Finance Agency (FHFA or Agency) Office of Inspector General's (OIG) identification of the most serious management and performance challenges facing the Agency.

The Housing and Economic Recovery Act of 2008 created FHFA, which is responsible for the effective supervision, regulation, and housing mission oversight of its regulated entities: Fannie Mae and Freddie Mac (collectively, the Enterprises); Common Securitization Solutions, LLC (CSS), an affiliate of each Enterprise; and the 11 Federal Home Loan Banks (FHLBanks) and their fiscal agent, the Office of Finance (collectively, the FHLBank System). In addition, since September 2008, FHFA has served as conservator of the Enterprises.

For fiscal year 2023, we have identified the following management and performance challenges facing FHFA:

- Effective supervision of the regulated entities
- Stewardship of the Enterprise conservatorships
- Oversight of information risk for the regulated entities
- Oversight of counterparty risk, third-party risk, and fourth-party risk for the regulated entities
- Oversight of model risk for the regulated entities
- Oversight of people risk for the regulated entities
- Oversight of resiliency risk for the regulated entities

The first four challenges reiterate themes we identified in prior years. At the outset, it is important to note that continued inclusion of a challenge area does not necessarily indicate a lack of progress by FHFA; rather, it indicates that a particular area remains a challenge. This year we also highlight FHFA's oversight of key operational risks at the regulated entities, including model risk, people risk, and resiliency risk, as discussed below.

Importantly, these challenges naturally are interconnected. FHFA's functions as supervisor for the regulated entities, as well as conservator for the Enterprises, encompass its oversight of all the operational risk challenge areas. Further, the operational risk areas themselves overlap. For example, a regulated entity might contract with a third-party for cloud services, which may impact information, third-party, people, and resiliency risks. In addition to overseeing the regulated entities, FHFA must also manage risks, such as information, people, and resiliency risk, in its own operations.

We conduct our oversight work primarily through audits, evaluations, compliance reviews, and investigative work. We use a risk-based approach, focusing our FHFA OIG FY 2023 Annual Plan on the top management and performance challenges. Information on specific ongoing and planned oversight work is available in that plan.

## Challenge: Effective Supervision of the Regulated Entities

FHFA is charged with supervising the regulated entities, and effective supervision remains critical to their safe and sound operation. The regulated entities serve a vital function by providing liquidity and stability to the secondary mortgage market, and they manage more than $8 trillion of assets. Beginning in 2008, a precipitous decline in the Enterprises' safety and soundness required nearly $200 billion in taxpayer support to keep them afloat. For these reasons, we have deemed FHFA's supervision of the regulated entities a top management challenge.

Challenges associated with FHFA's supervision of the regulated entities arise in various ways. For example, FHFA has undergone considerable personnel changes and struggled, at times, to maintain stable Enterprise supervision leadership and a sufficient corps of commissioned examiners. FHFA changed its Division of Enterprise Regulation (DER) leadership in 2020, with another DER leadership change in September 2021. Similarly, FHFA announced a new Deputy Director for its Division of Federal Home Loan Bank Regulation in August 2022, following on the heels of a September 2021 personnel change in that division. The Agency is also challenged to maintain the skilled workforce necessary to supervise the Enterprises. Other federal financial regulators have commissioning programs through which they instruct and train staff to become commissioned examiners. FHFA established a program in 2013 but has struggled to produce and retain commissioned examiners.

In overseeing the Enterprises' capital, the Agency possesses the dual challenge to consider both its supervisory obligation to ensure safety and soundness and its conservator role to position the Enterprises to potentially exit conservatorship. Historical transfers of excess capital to the U.S. Treasury Department (Treasury Department) limited the Enterprises' ability to retain capital and become adequately capitalized. However, as a result of changes in the Senior Preferred Stock Purchase Agreements (PSPAs) between FHFA and the Treasury Department, the Enterprises now retain more of their earnings and are again building capital. These PSPA changes, along with strong income, have increased the Enterprises' net worth. Fannie Mae's capital reserves increased from $14.6 billion at year-end 2019 to $51.8 billion by March 31, 2022. In the same period, Freddie Mac's capital reserves increased from $9.1 billion to $31.7 billion. FHFA must continue to supervise the Enterprises to ensure that they work to meet regulatory capital requirements.[1]

The Agency also must ensure its supervision of the regulated entities includes due consideration of a myriad of emerging risks. In particular, there has been increased consumer demand for technology in traditional processes, such as buying a home. Rapid technological advances create uncertainty, which in turn, can increase risk at the regulated entities.

Recognizing many of these challenges to effective supervision of the regulated entities, the Agency has implemented certain policy and organizational changes.[2] FHFA amended the Enterprises' regulatory capital framework and modified the capital treatment for retained credit risk transfer exposure to encourage the use of credit risk transfer without increasing safety and soundness risks posed by some transactions. The Agency also established an Office of Financial Technology in July 2022. In doing so, it solicited public input on the role of technology in housing finance and on how FHFA can most constructively interact with other stakeholders to facilitate responsible innovation. It is important for FHFA to continue monitoring the risks related to its supervision of the regulated entities, especially in light of the intersection of its supervision and conservator responsibilities for the Enterprises.

### Challenge: Stewardship of the Enterprise Conservatorships

As noted above, FHFA's role as both supervisor and conservator for the Enterprises continues to present unique challenges. As supervisor, FHFA has a statutory duty to ensure that its regulated entities operate in a safe and sound manner. As conservator, FHFA has broad authority over the Enterprises and is directly involved in certain business decisions subject to the Agency's supervisory oversight. Considering the taxpayers' sizeable investment in the Enterprises, the unknown duration of the conservatorships, the Enterprises' central role in the secondary mortgage market, and their unknown ability to sustain future profitability, OIG determined that FHFA's administration of the conservatorships has been, and continues to be, a management challenge.

To be sure, uncertainty with regard to the duration of the conservatorships exacerbates this challenge. As you have said in congressional testimony, FHFA can take certain actions to address the conservatorships of the Enterprises, but the Agency defers to Congress to act to resolve the conservatorships. There have been proposals from Congress regarding the Enterprise

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[1] The Housing and Economic Recovery Act of 2008 requires FHFA to establish, by regulation, risk-based capital requirements for Fannie Mae and Freddie Mac to maintain sufficient capital and reserves to support the risks that arise in the operations and management of the Enterprises. The Agency's Enterprise Regulatory Capital Framework, as amended, establishes and governs these requirements. *See* FHFA, *Final Rule to Amend the Enterprise Regulatory Capital Framework* (Feb. 25, 2022).

[2] OIG has no position on the effectiveness of any policy or organizational change unless or until we conduct oversight work in a particular area.

conservatorships, but no proposed legislation resolving the conservatorships has become law. Thus, the Enterprises have remained in conservatorship for 14 years.

In its role as conservator, the Agency is also required to maintain liquidity for the Enterprises' mortgage-backed securities (MBS). In 2014, FHFA directed the Enterprises to build infrastructure that would facilitate issuance of the Uniform Mortgage-Backed Security (UMBS) to establish and maintain a single liquid market for Fannie Mae and Freddie Mac MBS.[3] Subsequent to the launch of the UMBS, the Enterprises also started issuing securities that allow commingling of Fannie Mae and Freddie Mac collateral. After FHFA, as conservator, approved the Enterprises' announcement of a new fee for the commingled securities effective July 1, 2022, market participants expressed concerns to the Agency about the potential fee's effects on the UMBS market.

Here, as with other areas, FHFA has taken some steps to address the challenges noted. Similar to rules issued by the other federal financial regulators requiring plans for the orderly bankruptcy resolution of a firm in the event of material financial distress or failure, FHFA established a rule in 2021 that the Enterprises must provide resolution plans to the Agency by April 2023. According to FHFA, those plans are in progress, but the Enterprises will have to continue to work to complete the plans by the established deadline. In response to market feedback on the potential fee for commingled Enterprise securities, the Agency stated it would explore alternatives to ensure the long-term viability of the UMBS. As FHFA continues in its role as conservator, the Agency will need to ensure that it exercises appropriate engagement as conservator, while also recognizing that those decisions are subject to supervisory oversight by FHFA.

## Challenge: Oversight of Information Risk for the Regulated Entities

FHFA's regulated entities comprise central components of the U.S. financial system and interconnect with other large financial institutions. They receive, store, and transmit highly sensitive private information about borrowers and businesses, including financial data and personally identifiable information. Because FHFA and the regulated entities rely on copious amounts of information, the risk of incomplete, inaccurate, unprotected, or inappropriately managed information negatively impacting the regulated entities and housing finance sector is significant. The large volume of information, along with the interconnectedness of several other operational risk areas, leaves FHFA challenged to comprehensively oversee information risk at the regulated entities. This includes risks related to data management, information access, cybersecurity, information physical security, and privacy.

The Financial Stability Oversight Council reported that a destabilizing cybersecurity incident could potentially threaten the stability of the U.S. financial system by disrupting a key financial service or utility, causing a loss of confidence among a broad set of customers or market

[3] UMBS is a security issued either by Fannie Mae or Freddie Mac and backed by that Enterprise's single-family fixed-rate mortgages.

participants, or compromising the integrity of critical data.[4] This risk becomes even more critical for the regulated entities to manage and for FHFA to oversee considering the regulated entities' footprint and role in the financial markets.

According to FHFA, while both Enterprises employ information security programs, operational risks remain elevated given increased exposure to cybersecurity threats.[5] Similarly, the Agency assessed an elevated risk to information at the FHLBanks because of continued remote operations, expanded telework related to the COVID-19 pandemic, and ongoing information technology initiatives at many FHLBanks. In the current environment of ever-increasing cybersecurity attacks and data breaches, it remains imperative that FHFA continues to oversee information risk for its regulated entities.

### Challenge: Oversight of Counterparty Risk, Third-Party Risk, and Fourth-Party Risk for the Regulated Entities

The regulated entities rely on institutional counterparties for matters that are critical to their business. Reliance on counterparties is not unusual in today's business environment, but it requires the regulated entities to account for and mitigate related risks. For example, counterparty credit risk, which is the risk associated with the inability or failure of a counterparty to meet its contractual obligations, is a heightened risk and must be considered and mitigated. The Enterprises' counterparties include entities, such as sellers, servicers, mortgage insurers, custodial depository institutions, and reinsurers. The FHLBanks' primary exposures to institutional counterparty credit risk stem from unsecured money market transactions with domestic and foreign counterparties, derivative counterparties, and mortgage servicers that service loans the FHLBanks purchased from members or housing associates.

Counterparty credit risk can arise due to concentration among a limited number of counterparties, defaults, or inadequate or ineffective oversight. FHFA recognizes that such risk is significant. If an institutional counterparty defaults on its obligations, it could negatively impact an entity's ability to operate. Moreover, as our criminal investigations and prosecutions continue to demonstrate, fraud perpetrated by different types of counterparties, including real estate brokers and agents, builders and developers, loan officers and mortgage brokers, and title and escrow companies, is persistent. Additionally, prolonged periods of financial stress, as seen during the pandemic, might cause adverse financial outcomes such as counterparty financial difficulties and failures. Of note, non-depository counterparties to the regulated entities might pose greater risk because they do not have the same financial strength or operational capacity, nor are they subject to the same level of regulatory oversight, as depository institutions.

The regulated entities also rely on third-parties to provide numerous products and services. For example, third-parties provide critical operational support and information technology services

[4] See Financial Stability Oversight Council's 2021 Annual Report.

[5] See FHFA's 2021 Report to Congress.

supporting the regulated entities. As with counterparties, this third-party reliance comes with risk, namely that the third-party will not deliver the product or service as expected. The Enterprises, in particular, have risk from CSS, which administers their portfolios of MBS and issues UMBS.[6] CSS's underlying platform stores, processes, and transmits large volumes of data.

Third-parties to the regulated entities rely on their own third-parties, which are fourth-parties to the regulated entities. Like third-parties, fourth-parties pose risk that must be managed. Managing fourth-party risk can be challenging due to limited direct oversight of fourth-parties. Typically, the entities do not have contracts with their fourth-parties. Instead, the third-parties have the direct contractual relationship with the fourth-parties. Demonstrating the interconnected nature of the risks, the regulated entities must consider information security issues related to their third- and fourth-parties.

The regulated entities rely on counter-, third-, and fourth-parties for their businesses, and thus, are reliant on them to meet their mission. As explained above, these relationships involve a number of risks. FHFA is challenged to oversee those risks, especially when considering the multiple ways they can present.

## Challenge: Oversight of Model Risk for the Regulated Entities

The Enterprises rely heavily on models to measure and monitor risk exposures and make business decisions. They use models extensively for mortgage underwriting, collateral valuation, home price forecasting, mortgage cash flow analysis, financial reporting, risk management, risk measurement, stress testing, portfolio management, hedging, financial instrument valuation, measuring compliance with internal risk limits, and capital reserves measurement. The FHLBanks also use models in making business decisions and for financial reporting. According to the FHLBank Combined Financial Report for 2021, each FHLBank makes significant use of models for managing, measuring, and monitoring risks. They also use models to determine the fair value of financial instruments when independent price quotations are not available.

Models explain relationships by processing data into estimates. Model risk can arise due to a model error or the incorrect use of model output and includes risk stemming from how models are developed, implemented, monitored, and used. For example, a model could be based on inappropriate methodology or data, or it might not receive necessary updates; users may lack understanding of model limitations; or adjustments, known as "overlays," could be inappropriately applied to model results.

FHFA and the regulated entities have recognized the risk presented by models. The Agency warns that misuse of models may lead to poor or costly decisions. The Enterprises classify their

[6] CSS is an affiliate of each Enterprise that acts as agent for them to facilitate issuance of single-family mortgage securities and related disclosures, as well as administer the securities post-issuance. FHFA considers CSS to be an independent service provider to the Enterprises.

models according to the level of risk, and together, they had more than 50 models in their respective highest risk categories during the third quarter of 2021. FHFA's 2021 Report to Congress also identified examination concerns related to models for several FHLBanks.

Although the Agency issued guidance on model risk to its regulated entities, FHFA has been challenged to continue supervising the regulated entities' use of models. As recently as 2020, we found that the Agency had not assessed whether it had sufficient staff with the skills and competencies to examine the Enterprises' high-risk models. The complexity and sophistication of models require the Agency to have the appropriate examination resources to ensure the safety and soundness of its regulated entities. Further, Enterprise use of artificial intelligence and machine learning (AI/ML) in models, such as for automated property valuation, continues to grow and evolve.[7] This modeling technology requires the Agency to supervise fairness and equity concerns as poorly designed models developed using AI/ML may produce outcomes that benefit or harm some individuals, groups, or communities.[8] FHFA issued an advisory bulletin in February 2022 to provide the Enterprises with guidance on managing risks associated with the use of AI/ML, including model risk.

FHFA's oversight of this area becomes more challenging because of the uncertainty and shifting nature of the current economy. In a rapidly changing economic environment, a regulated entity may use more management judgment to adjust or "overlay" their models. At the outset of the pandemic, for example, both Enterprises made model adjustments that increased their estimates of their single-family credit losses. As another example, with interest rates as an important component in several of the regulated entities' financial models, the rapidly changing interest rate environment in 2022 increases the uncertainty of the assumptions and expectations in models. The introduction of more change and uncertainty may hinder the accuracy of the regulated entities' models. As both the economy and modeling techniques continue to evolve, it is crucial for FHFA to keep abreast of model risk and take appropriate action to address that risk.

## Challenge: Oversight of People Risk for the Regulated Entities

To accomplish their missions, FHFA and the regulated entities must attract, develop, and retain a highly qualified, diverse workforce with specialized skills. An inability to do so can jeopardize mission accomplishment. People risk can manifest across a range of human capital related issues. It encompasses scenarios such as an organization not planning and assessing the effect of retirements or the loss of institutional knowledge. People risk also includes pervasive critical skill gaps and individuals making decisions adverse to the institution.

The last two years have posed significant changes and challenges to the American workforce. In 2021, according to the U.S. Bureau of Labor Statistics, over 47 million Americans voluntarily quit their jobs – a phenomena now commonly called the "great resignation." The Enterprises

[7] *See* OIG, *Enterprise Use of Artificial Intelligence and Machine Learning* (Sept. 19, 2022) (WPR-2022-02).

[8] *See* FHFA, *Office of Minority and Women Inclusion Supervisory Letter on Artificial Intelligence and Machine Learning* (Feb. 10, 2022).

have not been immune to turnover. The regulated entities require people with specialized, highly in-demand skills, for example, information security and technology-related skills. The rise of remote work has further exacerbated competition for employees, as the regulated entities must now compete with companies across the country and world to attract and retain top tier talent. In addition to the typical recruitment needs, recent workforce pressures can translate to thinned ranks, requiring the regulated entities to rebuild depth amidst already difficult recruitment and retention circumstances.

Further, several key senior executives departed recently, including both Enterprises' chief executive officers. The FHLBanks and CSS also lost key executives. Such leadership and key executive changes require FHFA's oversight to ensure the regulated entities continue managing risks and executing their mission during transitional times.

In addition to overseeing this risk at the regulated entities, FHFA must manage its own people risk. As with other challenges highlighted in this memorandum, change and uncertainty also affects FHFA's people risk. From June 2020 to December 2021, 281 employees, contractors, and other persons departed the Agency, including the former Director and other senior employees. As context, the Agency employed nearly 700 employees as of December 31, 2021. Some departures were long-time employees, with FHFA losing their years of institutional knowledge. Changes in FHFA leadership brought accompanying shifts in strategic direction and approach. These executive changes reinforce the need to manage people risk and attract and retain a workforce with the requisite skills and competencies to oversee its regulated entities. We have previously reported concerns about the lack of systematic workforce planning in segments of FHFA.[9] Although FHFA has taken steps to address those concerns, that work remains ongoing, and FHFA awaits work product from an external partner to determine the appropriate path forward. The Agency should continue its efforts to manage its people risk so it can execute its oversight responsibilities.

## Challenge: Oversight of Resiliency Risk for the Regulated Entities

As noted, the regulated entities perform important roles in providing a stable source of funding for housing finance. Events such as a wide-scale power outage, natural disaster, or cyber-attack can jeopardize their ability to perform mission critical operations.

According to the Federal Financial Institutions Examination Council, resilience is "the ability to prepare for and adapt to changing conditions and withstand and recover rapidly from disruptions. Resilience includes the ability to withstand and recover from deliberate attacks, accidents, or naturally occurring threats or incidents." Resiliency risk describes the risk of loss from the inability to adapt to disruptions and maintain business operations. It can stem from risks related

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[9] *See* OIG, *Despite FHFA's Recognition of Significant Risks Associated with Fannie Mae's and Freddie Mac's High-Risk Models, its Examination of Those Models Over a Six Year Period Has Been Neither Rigorous nor Timely* (Mar. 25, 2020) (EVL-2020-001) and *Despite Prior Commitments, FHFA Has Not Implemented a Systematic Workforce Planning Process to Determine Whether Enough Qualified Examiners are Available to Assess the Safety and Soundness of Fannie Mae and Freddie Mac* (Feb. 25, 2020) (AUD-2020-004).

to crisis management, business continuity, disaster recovery, or incident response. The regulated entities' resiliency is particularly vital given their critical mission and importance to the financial markets.

Recent events, such as the COVID-19 pandemic and the spike in interest rates, underscore the role of resiliency at the regulated entities, and FHFA is challenged to ensure regulated entity resiliency when a disruption occurs. During the pandemic, more than 6% of Enterprise loans went into forbearance.[10] While FHFA reports that 96% of the homeowners that relied on forbearance have successfully exited the program, the situation underscores that an external event can cause uncertainty and payment problems. The pandemic also affected the regulated entities' operations, because they had to adopt strategies to accommodate remote workforces while still meeting their missions. In addition to operational complexities, refinances, which accounted for 65% of Freddie Mac's single-family acquisitions in 2021, have precipitously declined amid higher interest rates in 2022. Both Enterprises forecast a slowdown in home sales and expect mortgage originations to be almost $2 billion lower in 2022 than in 2021, which will affect their acquisition volume.

Meanwhile, the FHLBanks have seen significant fluctuations in advances resulting from the pandemic and subsequent government policy decisions. FHLBank members sought advances at the start of the COVID-19 pandemic in 2020, but the government's monetary policy provided relief, causing FHLBank members to retreat from advances. As of September 30, 2021, the FHLBanks had the lowest quarter-end level of advances since 2001; advance balances have increased since that time.

As large, complex organizations, the regulated entities require planned responses for disruptions related to people, operations and processes, equipment and facilities, and information technology and data across a wide array of hazards and risk scenarios in multiple geographic locations. Additionally, their resiliency programs must assess and ensure the resiliency of critical third-parties because they rely on thousands of third-parties, including for key components of their business operations. FHFA must continue to oversee the regulated entities' resiliency to ensure they are able to deliver on their mission.

## Conclusion

Collectively, the risks posed by the areas described above are significant and, thus, merit continued attention by the Agency. The challenge for FHFA is to identify the facets of highest risk, effectively supervise the regulated entities while they engage in these areas, and remain nimble with their focus as matters continuously evolve. OIG's risk-based work will remain

[10] A November 2021 OIG administrative inquiry reported that FHFA has determined that the Enterprises can absorb the full cost of pandemic-related mortgage forbearance. *See* OIG, *Report of Administrative Inquiry: FHFA Has Determined that the Enterprises Can Absorb the Full Cost of CARES Act Mortgage Forbearance* (Nov. 3, 2021) (OIG-2022-001).

grounded in these areas, and our audits, evaluations, and other projects will continue to identify findings and make appropriate recommendations to FHFA to strengthen its work.

cc: Edom Aweke, Associate Director
Katrina D. Jones, Chief Operating Officer
Clinton Jones, General Counsel
John Major, Internal Controls and Audit Follow-Up Manager