Federal Housing Finance Agency
Office of Inspector General

FHFA's Failure to Use its Prudential Management and Operations Standards as Criteria for Supervision of the Enterprises Is Inconsistent with the FHFA Director's Statutory Duty to Ensure the Enterprises Comply with FHFA's Guidelines

This management advisory was removed and reposted on May 11, 2022, to include an Addendum to the original report. In its August 6, 2021, management response to this report, FHFA stated that it deferred its response to our first recommendation due to the level of effort and stakeholder input needed to make a decision. The Addendum provides FHFA's March 16, 2022, response. In summary, FHFA's planned approach to our recommendation meets the intent of the recommendation.

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

September 20, 2021

TO: Sandra L. Thompson, Acting Director, Federal Housing Finance Agency

FROM: Kyle D. Roberts, Deputy Inspector General for Evaluations /s/

SUBJECT: Management Advisory: FHFA's Failure to Use its Prudential Management and Operations Standards as Criteria for Supervision of the Enterprises Is Inconsistent with the FHFA Director's Statutory Duty to Ensure the Enterprises Comply with FHFA's Guidelines

Summary

In February 2021, we received an anonymous hotline complaint alleging that "the [Division of Enterprise Regulation's] quality control function, residing in the Office of Enterprise Supervision Operations, does not allow for [the prudential management and operations standards] as criteria for examination findings ([Matters Requiring Attention])." We conducted an administrative inquiry into this allegation and this Management Advisory reports on the results of our inquiry.

The Housing and Economic Recovery Act of 2008 (HERA), Pub. L. No. 110-289, 122 Stat. 2654, established the Federal Housing Finance Agency (FHFA). Among other things, HERA required FHFA to establish prudential standards that address 10 specific areas relating to the management and operations of the regulated entities under FHFA's authority. Pursuant to Section 1108 of HERA, FHFA issued its prudential management and operations standards (PMOS or Standards) in June 2012, effective August 7, 2012. These Standards were adopted by regulation, after public notice and comment, and published in Part 1236 of Title 12 of the Code of Federal Regulations. The PMOS set FHFA's minimum standards for the risk management practices of Fannie Mae and Freddie Mac (together, the Enterprises), as well as the Federal Home Loan Banks. The FHFA Director has a statutory duty to ensure that each regulated entity complies with the PMOS.

FHFA is a member of a network of other federal financial regulators, and is responsible for the safety and soundness of its regulated entities. Like FHFA, each of these federal financial regulators has adopted standards, pursuant to its statutory authority and through a notice and

comment process, and published those standards in the Code of Federal Regulations. These agencies have also adopted supervisory guidance, as has FHFA. FHFA's peer regulators recently adopted final rules clarifying that non-compliance with their safety and soundness standards can create a basis for supervisory action, but that supervisory guidance is unenforceable. FHFA has not taken comparable action.

FHFA is out of step with these peer regulators in this regard. Moreover, the Division of Enterprise Regulation (DER), the division responsible for supervision of the Enterprises, does not assess the Enterprises' practices against FHFA's PMOS. Instead, DER asserts that "[i]t is our supervisory determination that examining to specific criteria, such as Advisory Bulletins . . . , is more effective than the general standards in PMOS" and that such criteria go well beyond the general standards outlined in the PMOS. In taking this position, DER has supplanted the binding, legally enforceable PMOS with unenforceable statements of policy set forth in its supervisory guidance. Further, FHFA has not adopted any written policy or guidance explaining the interplay between the application of the PMOS, which are enforceable, and supervisory guidance, which is not, during examinations. Senior FHFA officials informed us that DER examiners do not determine whether a significant deficiency or collection of significant deficiencies, identified during examination activities, fail to meet the relevant PMOS, and DER does not issue Matters Requiring Attention based on an Enterprise's failure to meet a PMOS. Under DER's current examination practice, FHFA is not positioned to ensure that the Enterprises comply with FHFA's PMOS because it is not assessing their practices to determine whether those practices fail to meet the PMOS.

We are issuing this Management Advisory to alert the Acting FHFA Director to the tension between DER's examination practice and FHFA's authorizing act, and the importance of clarifying FHFA's position regarding the use of the PMOS in its examinations of the Enterprises. We made three recommendations to address FHFA's failure to use PMOS as criteria in its supervision of the Enterprises. In a written management response, FHFA agreed with our second recommendation and disagreed with our third recommendation, which we consider closed as rejected. FHFA advised that it has deferred its response to our first recommendation to within 120 days of issuance of this Management Advisory due to the level of effort and stakeholder input needed to make a decision on whether revisions to PMOS are necessary.

Background

Congress Directed FHFA to Establish Prudential Management and Operations Standards

HERA amended the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (Safety and Soundness Act). Among other things, HERA required FHFA to establish prudential standards that address 10 specific areas relating to the management and operations of the

regulated entities under FHFA's authority.[1] Pursuant to Section 1108 of HERA, FHFA issued its PMOS in June 2012, effective August 7, 2012. These standards were adopted by regulation, after public notice and comment, and published in Part 1236 of Title 12 of the Code of Federal Regulations.[2] The PMOS set FHFA's minimum standards for the risk management practices of the Enterprises, as well as the Federal Home Loan Banks. The FHFA Director has a statutory duty under the Safety and Soundness Act to ensure that each regulated entity complies with the PMOS.[3]

FHFA is part of a network of federal financial regulators that are responsible for ensuring the safety and soundness of the regulated entities under their authority.[4] Other federal financial regulators include, but are not limited to, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Federal Reserve), and the Federal Deposit Insurance Corporation (FDIC). Nearly thirty years ago, Congress was concerned by the regulators' failure to take timely and forceful action to address the banking and thrift crisis[5] and

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[1] 12 U.S.C. § 4513b(a)(1)-(10); the 10 areas are: (1) adequacy of internal controls and information systems; (2) independence and adequacy of internal audit systems; (3) management of interest rate risk exposure; (4) management of market risk; (5) adequacy and maintenance of liquidity and reserves; (6) management of asset and investment portfolio growth; (7) investments and acquisitions of assets; (8) overall risk management processes; (9) management of credit and counterparty risk; and (10) maintenance of adequate records. 12 U.S.C. § 4502(20) defines regulated entity to mean Fannie Mae, Freddie Mac, and every Federal Home Loan Bank.

The FHFA Director has statutory authority to establish other operational and management standards as the Director determines to be appropriate. 12 U.S.C. § 4513b(a)(11).

[2] *See* 12 C.F.R. Part 1236, Appendix to Part 1236; and 77 Fed. Reg. 33,950 (June 8, 2012). Congress gave FHFA the option of issuing the PMOS as guidelines or regulations, and FHFA chose to issue them as guidelines. *See* 12 U.S.C. § 4513b(a); 12 C.F.R. § 1236.3(b).

[3] *See* 12 U.S.C. § 4513(a)(1)(B)(iii). Pursuant to this section, one of the FHFA Director's principal duties is to "ensure that . . . each regulated entity *complies with* [Chapter 46, Title 12] and the rules, regulations, *guidelines*, and orders issued under this chapter and the authorizing statutes." (emphasis added). The PMOS, adopted by FHFA as guidelines, fall within this section.

[4] In FHFA's management response to a draft of this Management Advisory, the Agency stated that it does not participate in any such network. Contrary to FHFA's assertion, as we noted in a 2016 report, the FHFA Director and the heads of the other financial regulators serve as voting members of the Financial Stability Oversight Council (FSOC), which is charged with identifying risks to the financial stability of the U.S., promoting market discipline, and responding to emerging threats to the U.S. financial system. *See* OIG, *Safe and Sound Operation of the Enterprises Cannot Be Assumed Because of Significant Shortcomings in FHFA's Supervision Program for the Enterprises*, at 16 n.13 (OIG-2017-003, Dec. 15, 2016). According to its website, the FSOC has a statutory duty to, among other things, "facilitate information sharing and *coordination among the member agencies* regarding domestic financial services policy development, *rulemaking, examinations*, reporting requirements, and enforcement actions. Through this role, the Council will help reduce gaps and weaknesses within the regulatory structure, to promote a safer and more stable system." (emphasis added).

[5] *See* GAO, *Deposit Insurance – Assessment of Regulators' Use of Prompt Corrective Action Provisions of FDIC's New Deposit Insurance System*, GAO-07-242, at 1 (Feb. 15, 2007). GAO reported that "In response to the federal banking regulators' failure to take appropriate action, Congress passed the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), implementing significant changes to the way banking regulators supervise the nation's depository institutions." According to GAO, at the time FDICIA was enacted, these regulators were

sought to address the regulators' collective lack of action. It designed a supervisory structure that requires each of these federal financial regulators to establish standards for risk management and the regulated entities to comply with those standards.[6] Each such regulator issues guidance and requirements that govern examinations conducted under its authority and updates those materials from time to time to reflect adjustments in supervisory practices. Each conducts examinations pursuant to its guidance and requirements. Congress also required these regulators to take prompt corrective action in order to address weak risk management practices.

During the course of examining a regulated entity, a federal financial regulator may determine that the entity's risk management practices are deficient because they fail to meet one or more of the safety and soundness standards.[7] In that event, the regulator could require a plan from its affected regulated entity to correct the underlying deficiency. Should the affected entity fail to submit a corrective plan or fail to implement a plan that was accepted by the federal financial regulator, the regulator must issue an order to correct the underlying deficiency.

FHFA's PMOS framework shares this basic statutory design, and FHFA has underscored that its PMOS authorities provide a means to set and enforce standards for risk management. In 2013, shortly after FHFA adopted its Standards, its then-General Counsel testified before Congress on the subject of "Powers and Structure of a Strong Regulator" and highlighted that, under HERA, FHFA had enhanced supervisory tools, including "explicit authority to impose and enforce prudential standards."[8] He explained that FHFA carries forward "prudential standards set forth in regulation to meet [its] responsibilities relating to safety and soundness and compliance with laws and regulations."[9]

The supervisory determination of whether a significant deficiency, or combination of significant deficiencies, identified at a regulated entity is severe enough to constitute a failure to meet a PMOS is a key inflection point in FHFA's statutory PMOS framework. In the event FHFA

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criticized for failing to take timely and forceful action to address the causes of the large number of failures of banks and thrift institutions and prevent losses to the deposit insurance fund and taxpayers.

[6] Like FHFA, the other federal financial regulators issued their standards as guidelines. In the introduction to the *Interagency Guidelines Establishing Standards for Safety and Soundness*, the regulators explained that "[t]hese standards are designed to identify potential safety and soundness concerns and ensure that action is taken to address those concerns before they pose a risk to the deposit insurance funds." *See* Federal Reserve, 12 C.F.R. App'x D-1 to Part 208 (I.vi.); OCC, 12 C.F.R. App'x A to Part 30 (I.vi.); and FDIC, 12 C.F.R. App'x A to Part 364 (I.vi.).

[7] In FHFA's case, the determination may be based upon "an examination, inspection or any other information." *See* 12 C.F.R. § 1236.4(a).

[8] U.S. Senate Committee on Banking, Housing, and Urban Affairs, Testimony of Alfred M. Pollard, General Counsel, FHFA, "Housing Finance Reform: Powers and Structure of a Strong Regulator" (Nov. 21, 2013).

[9] *Id.* Additionally, in a 2015 final rule, FHFA repealed a provision of the regulations of its predecessor agency that "established certain safety and soundness standards for the Enterprises[] because many of the matters addressed by those regulations are also addressed by the Prudential Standards or by the proposed rule." Responsibilities of Boards of Directors, Corporate Practices and Corporate Governance Matters, 80 Fed. Reg. 72,327, 72,328 (Nov. 19, 2015).

determines that a regulated entity fails to meet a PMOS, it can either proceed under the PMOS statutory framework, or select an alternative supervisory action as a means to require the subject regulated entity to correct the deficiency.

Should FHFA elect to use its enforcement authorities under the PMOS framework, it issues a "written notice" to the regulated entity and directs the regulated entity to submit a "corrective plan" for review and approval.[10] If a regulated entity fails to submit an acceptable plan, or fails to materially implement a plan approved by FHFA, then FHFA must issue an order that requires the entity to correct the deficiency.[11] Such an order constitutes a formal enforcement action under FHFA's Enforcement Policy.[12]

Alternatively, FHFA could issue a Matter Requiring Attention (MRA) as a means to address the deficiency. Under FHFA policy, an MRA is an adverse examination finding that falls under one of two categories depending on the nature and severity of the issues identified that require remediation: (1) "Critical supervisory matters (the highest priority) which pose substantial risk to the safety and soundness of the regulated entity . . ."; and (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 . . . ."[13] Should FHFA issue an MRA for failure to meet a PMOS, then, as with all MRAs, the regulated entity must submit a proposed remediation plan for approval and implement this plan, and DER is responsible for monitoring the remediation process. MRAs are not considered enforcement actions under FHFA's Enforcement Policy.

In March 2021, OIG Reported That the Division of Enterprise Regulation Did Not Determine Whether Deficient Enterprise Practices Failed to Meet the Agency's Statutorily Mandated Standards

Within FHFA, DER is responsible for the supervision and examination of the Enterprises. In a March 2021 evaluation,[14] we found that DER did not examine against FHFA's statutorily mandated PMOS to determine whether certain deficient practices—practices that FHFA had

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[10] *See* 12 U.S.C. § 4513b(b)(1)(A)(ii); 12 C.F.R. §§ 1236.4(b), (e).

[11] 12 U.S.C. § 4513b(b)(2)(A); 12. C.F.R. § 1236.5(a). The PMOS regulation also states a failure to meet a standard may constitute an "unsafe and unsound practice" for purposes of FHFA's enforcement authorities. 12 C.F.R. § 1236.3(d).

[12] FHFA, Advisory Bulletin 2013-03, *FHFA Enforcement Policy*, at Section II.B., p.4 (May 31, 2013) (FHFA Enforcement Policy). Enforcement actions are a mechanism through which FHFA communicates supervisory expectations and requirements to the regulated entities regarding corrective action to address problems and weaknesses that remain unaddressed through supervisory processes. *See* FHFA Enforcement Policy, Section I, p.3.

[13] *See* FHFA, Advisory Bulletin 2017-01, *Classifications of Adverse Examination Findings* (Mar. 13, 2017).

[14] *See For Nine Years, FHFA Has Failed to Take Timely and Decisive Supervisory Action to Bring Fannie Mae into Compliance with its Prudential Standard to Ensure Business Resiliency* (EVL-2021-002, Mar. 22, 2021).

repeatedly criticized in multiple, successive reports of examination—failed to meet the applicable Standard.

We reported that DER examination supervisors acknowledged to us that, in their view, the Enterprise's deficient practices did not meet the applicable Standard, but no such finding was made during any examination activity. Accordingly, we recommended that DER assess those practices against the applicable Standard during the 2021 examination cycle and reach a finding on whether the practices met that Standard.

FHFA did not agree with our recommendation but offered an alternative. It proposed to assess the Enterprise's business resiliency practices against criteria set forth in supervisory guidance contained in an Advisory Bulletin, rather than the criteria in the PMOS. DER's Advisory Bulletins provide guidance on selected topics; however, Advisory Bulletins do not go through the public notice-and-comment process, do not create obligations for the Enterprises, and are not legally binding. The failure to follow them, without more, provides no basis for an enforcement action to correct the deficient practices FHFA identified.

FHFA asserted that "[i]t is our supervisory determination that examining to specific criteria, such as Advisory Bulletins . . . , is more effective than the general standards in PMOS" and that such criteria go well beyond the general standards outlined in the PMOS. We did not accept FHFA's proposed alternative. We explained that "[a]ssessing an Enterprise's practices against an unenforceable supervisory policy guidance, [an Advisory Bulletin], is not an acceptable alternative to assessing those practices against the Agency's PMOS, which are enforceable and are required by Congress. . . . [T]hat guidance is no substitute for law, regulation, or the applicable PMOS." We further highlighted that FHFA "has long held the position that its supervisory guidance is not enforceable." We emphasized that "FHFA is obligated to adhere to the PMOS framework required by Congress and its rejection of our recommendation is inconsistent with its statutory obligation." We closed the recommendation as rejected.

An Anonymous Hotline Complaint Alleged That DER Examiners Are Barred from Using FHFA's PMOS as Criteria for Issuing MRAs

In February 2021, we received an anonymous hotline complaint alleging that "DER's quality control function, residing in the Office of Enterprise Supervision Operations, does not allow for PMOS as criteria for examination findings (MRAs)." We launched an administrative inquiry into that allegation, and this Management Advisory reports on the results of our inquiry.

Discussion

We were unable to substantiate the hotline allegation that DER's quality control function "does not allow" examiners to use PMOS as criteria for MRAs. However, our inquiry into that allegation found that FHFA fails to use its PMOS as criteria in its supervision of Fannie Mae and Freddie Mac, in contravention of the FHFA Director's statutory duty to ensure that the Enterprises comply with the Agency's Standards.

DER's Practice to Rely on Supervisory Guidance Instead of Standards Is Out of Step with FHFA's Peer Federal Financial Regulators

As discussed, the FHFA Director has a duty under the Safety and Soundness Act to ensure that FHFA's regulated entities comply with its PMOS. Standards adopted in accordance with statutory authority by FHFA and its peer federal financial regulators, and published in the Federal Register and Code of Federal Regulations after public notice and comment, create enforceable obligations on the entities they regulate.

FHFA's statutory obligations for supervision are similar to the obligations imposed on its peer federal financial regulators. FHFA has consistently maintained, based on the language of its authorizing statute, that its supervisory authority over its regulated entities "is virtually identical to—and clearly modeled on—Federal bank regulators' supervision of banks." FHFA acknowledges that it considers the examination guidance and policies of other federal financial regulators when developing its own guidance and requirements.

In 2021, FHFA's peer federal financial regulators issued final rules codifying their position that their statutorily mandated safety and soundness standards provide a source of law that may serve as a basis for MRAs[15] but non-compliance with supervisory guidance cannot.[16] Historically, FHFA has taken the same position: for example, it advised Congress in 2018 that its supervisory guidance, like its Advisory Bulletins, which do not go through the public notice-and-comment process, are not legally binding, and failure to follow that guidance provides no basis for enforcement actions.[17]

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[15] *See* OCC (Role of Supervisory Guidance, 86 Fed. Reg. 9,253, 9,255, n.10 (Feb. 12, 2021)); Federal Reserve (Role of Supervisory Guidance, 86 Fed. Reg. 18,173, 18,174, n.10 (Apr. 8, 2021)); FDIC (Role of Supervisory Guidance, 86 Fed. Reg. 12,079, 12,080, n.10 (Mar. 2, 2021)). In September 2018, the regulators adopted the *Interagency Statement Clarifying the Role of Supervisory Guidance*, which confirmed that, among other things, "[e]xaminers will not criticize a supervised financial institution for a 'violation' of supervisory guidance." In response to the Interagency Statement, the Bank Policy Institute and the American Bankers Association petitioned for rulemaking to codify the Statement and bind the agencies to it. *See* BPI-ABA Joint Petition for Rulemaking on the Role of Supervisory Guidance (Nov. 5, 2018). That petition for rulemaking ultimately led to the regulators' final rules on the Role of Supervisory Guidance. *See* OCC (86 Fed. Reg. at 9,254); Federal Reserve (86 Fed. Reg. at 18,173–74); FDIC (86 Fed. Reg. at 12,080).

[16] OCC (86 Fed. Reg. at 9,255 n.11, 9,260 App'x A (2)(ii)); Federal Reserve (86 Fed. Reg. at 18,174 n.11, 18,179 App'x A); FDIC (86 Fed. Reg. at 12,080 n.11, 12,086, App'x A).

[17] Letter from FHFA Director Melvin L. Watt to Hons. Blaine Luetkemeyer and J. French Hill, U.S. House of Representatives (Aug. 16, 2018) ("FHFA has consistently made clear that, in general, supervisory guidance, which does not go through the public notice-and-comment process of the Administrative Procedure Act (APA), is not legally binding and that failure to follow it cannot by itself be the basis for an enforcement action.").

Two years earlier, DER advised us, in its technical comments to a draft 2016 OIG report, that supervisory guidance does not have the power of law or regulation and is not binding. To support its statement, DER cited two decisions of the U.S. Court of Appeals for the District of Columbia Circuit, *Ass'n of Flight Attendants v. Huerta*, 785 F.3d 710 (D.C. Cir. 2015) (policy statements are not binding on the public or an agency and the agency retains the right to change its position; such policies apprise the regulated community of the agency's intentions and informs the

The position taken by FHFA's peer federal financial regulators and by FHFA in the past aligns with court decisions recognizing a critical distinction between supervisory guidance and enforceable standards required by statute. For example, in a 2014 federal district court opinion, the court assessed whether supervisory guidance issued by the Federal Reserve had the effect of a substantive, enforceable rule or was a nonbinding statement of policy or guidance.[18] To make this determination, the court considered three factors: whether the statement purported to create new, substantive obligations; whether the pronouncement was subject to notice and comment; and whether the statement had been published in the Code of Federal Regulations.[19]

In March 2021, FHFA advised us that, in effect, it has shifted away from its 2013 position. It informed us that "[i]t is our supervisory determination that examining to specific criteria, such as Advisory Bulletins . . . is more effective than the general standards in PMOS" and that such criteria go well beyond the general standards outlined in the PMOS. This shift in FHFA's supervisory posture is not set forth in written Agency policy, but is reflected in 2020 training materials provided to DER examiners that instruct an Enterprise's "failure to comply" with an Advisory Bulletin may provide the grounds for issuing an MRA.[20]

FHFA's reliance on criteria set forth in non-binding supervisory guidance, rather than its PMOS, is out of step with other federal financial regulators. According to FHFA's peer regulators, supervisory guidance may be helpful in articulating general supervisory views but creates no enforceable legal obligations. Similarly, federal courts have made clear that, as a matter of administrative law, supervisory guidance cannot be treated as interchangeable with legally

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exercise of discretion by agents and officers in the field), and *Nat'l Mining Ass'n v. McCarthy*, 758 F.3d 243 (D.C. Cir. 2014) (guidance does not tell regulated parties what they must do or may not do in order to avoid liability; guidance may not be the basis for an enforcement action; it may signal further actions which may be challenged and an agency may not rely on guidance to defend such challenges).

[18] *Segarra v. Federal Reserve Bank of N.Y.*, 17 F. Supp. 3d 304, 310–11 (S.D.N.Y. 2014), *aff'd* 802 F.3d 409 (2d Cir. 2015) (per curiam).

[19] *Segarra*, 17 F. Supp. 3d at 313 (citing *Brock v. Cathedral Bluffs Shale Oil Co.*, 796 F.2d 533, 538 (D.C. Cir. 1986) (whether the statement creates new substantive obligations; and whether the statement was published in the Code of Federal Regulations), and *N.Y.C. Emps.' Ret. Sys. v. S.E.C.*, 45 F.3d 7, 11–12 (2d Cir. 1995) (whether the statement was subject to notice and comment)); *cf. Segarra*, 17 F. Supp. 3d at 311 (recognizing " 'central distinction' in administrative law . . . between those agency pronouncements that amount to 'substantive rules' and those that are merely 'interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice' " (quoting *Chrysler Corp. v. Brown*, 441 U.S. 281, 301 (1979)); *Nat. Res. Def. Council v. Wheeler*, 955 F.3d 68, 83 (D.C. Cir. 2020) ("A 'legislative rule' is one that has 'legal effect' or, alternately, one that an agency promulgates with the 'intent to exercise' its 'delegated legislative power' by speaking with the force of law. An 'interpretive rule,' meanwhile, is one that 'derive[s] a proposition from an existing document,' such as a statute, regulation, or judicial decision, 'whose meaning compels or logically justifies the proposition.' " (citations omitted)); *Perez v. Mortg. Bankers Ass'n*, 575 U.S. 92, 97 (2015) ("Interpretive rules do not have the force and effect of law and are not accorded that weight in the adjudicatory process." (quotation marks omitted) (citation omitted)), *cited in Kisor v. Wilkie*, 588 U.S. __ (2019) (slip op., at 22 (plurality opinion)).

[20] DER Examination Practices Course, Session 1, Slide 40 & notes (2020).

binding regulations.[21] As we have shown, the Safety and Soundness Act *requires* the FHFA Director to ensure each regulated entity complies with the PMOS.

FHFA Lacks Formal Agency Guidance on the Use of PMOS in Examination Activities

FHFA's PMOS have been in place for almost a decade. Except for redesignating the introductory section on general board and management responsibilities as an additional Standard,[22] FHFA has made no changes to them. FHFA has the statutory authority to revise its PMOS as necessary. When it adopted the PMOS, FHFA stressed that the Standards were issued as guidelines so it could revise them in a timely manner.

DER's existing examination guidance does not address whether, or how, the Standards should be applied as criteria during FHFA's examinations of the Enterprises. For example, DER's Operating Procedures Bulletin (OPB) on targeted examinations instructs that the Examiner-In-Charge (EIC) determines the course of action appropriate to address "a serious safety and soundness concern" and "whether to recommend to senior DER stakeholders that [examination findings] be communicated to the Enterprise as a critical supervisory matter, deficiency, or violation, or whether the matter is not an adverse examination finding." However, this OPB does not mention use of the Standards when assessing the adequacy of an Enterprise practice. Similarly, DER's OPB on monitoring contains no references to the application of the Standards during the course of monitoring activities. Although DER updated much of its examination guidance during 2020, that guidance does not clarify when and how the PMOS should be applied. Thus, FHFA lacks specific guidance in OPBs on the use of PMOS in examination activities.

According to senior FHFA officials, FHFA's PMOS are too general to provide effective criteria for examinations. They confirmed that, for that and other reasons, in practice, DER examiners do not determine whether a given significant deficiency or collection of significant deficiencies, identified during examination activities, fail to meet the relevant PMOS.[23] They also advised us that they do not issue MRAs based on an Enterprise's failure to meet a PMOS.

Notably, FHFA expressed no concern regarding the generality of the PMOS during the notice and comment period or when it promulgated the final rule. Its then-General Counsel

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[21] *See, e.g.*, *Segarra*, 17 F. Supp. 3d at 311 (citing *Chrysler*, 441 U.S. at 301); *id.* at 313 (citing *Brock*, 796 F.2d at 538).

[22] Responsibilities of Boards of Directors, Corporate Practices and Corporate Governance Matters, 80 Fed. Reg. 72,327, 72,336 (Nov. 19, 2015).

[23] We do not suggest that DER must determine, for purposes of the statute, whether every significant deficiency its examiners identify constitutes a failure to meet a PMOS. In our March 2021 evaluation, we learned that DER identified significant deficiencies in an Enterprise's practices and repeatedly criticized those deficiencies in multiple, successive reports of examination. DER examination supervisors acknowledged to us that, in their view, the Enterprise's deficient practices did not meet the applicable PMOS. However, DER made no determination whether these significant deficiencies failed to meet the applicable PMOS.

subsequently testified to Congress that FHFA has authority to "enforce [its] prudential standards" in order to "meet [its] responsibilities relating to safety and soundness and compliance with laws and regulations."

To the extent FHFA has refrained from examining against the PMOS for the past eight years because it views these Standards as too general to provide an effective standard for supervision, only FHFA has the authority to modify any such Standards. We found no evidence of any initiative underway within FHFA to update and refine the PMOS to provide more effective criteria for examination activities. Instead, FHFA appears to have decided to supplant these Standards, which were required by Congress and are analogous to the standards for safety and soundness adopted by other federal financial regulators, in favor of non-binding supervisory guidance.

Findings

1. Congress required FHFA to establish the PMOS and imposed a duty on the FHFA Director to ensure each Enterprise complies with the Safety and Soundness Act and FHFA's regulations and guidelines. FHFA adopted the PMOS, after notice and comment, in 2012.

2. FHFA's peer federal financial regulators recognize that their standards for safety and soundness (adopted as guidelines), which are analogous to the PMOS, are binding, legally enforceable, and can provide a basis for MRAs while non-compliance with their non-binding supervisory guidance cannot. Historically, FHFA's position aligned with its peer regulators.

3. By opting to rely on criteria set forth in discretionary, non-binding supervisory guidance rather than its PMOS, FHFA has shifted away from its 2013 position that its authority to "impose and enforce prudential standards" is among an "enhanced array of supervisory tools" and that the Agency "carr[ies] forward prudential standards . . . to meet FHFA's responsibilities relating to safety and soundness."

4. To the extent that FHFA has refrained from examining against the PMOS for the past eight years because it views these Standards as too general to provide effective criteria for supervision, only FHFA has the authority to modify the Standards. We found no evidence of any initiative underway within FHFA to update and refine the PMOS to provide more effective criteria for examination activities.

5. DER's current practice is inconsistent with the statutory duty imposed on the FHFA Director. FHFA is also out of step with its peer federal financial regulators.

6. FHFA lacks specific guidance on the application of the PMOS as criteria during its examinations of the Enterprises.

Conclusion

HERA required FHFA to establish prudential standards that address 10 specific areas relating to the management and operations of the regulated entities under FHFA's authority. Pursuant to Section 1108 of HERA, FHFA issued its PMOS in June 2012, effective August 7, 2012. These standards were adopted by regulation, after public notice and comment, and published in Part 1236 of Title 12 of the Code of Federal Regulations. The PMOS set FHFA's minimum standards for the risk management practices of the Enterprises, as well as the Federal Home Loan Banks. The FHFA Director has a statutory duty under the Safety and Soundness Act to ensure that each regulated entity complies with the PMOS.

FHFA, through DER, has now determined to examine the Enterprises against its unenforceable supervisory guidance, set forth in Advisory Bulletins, rather than against the PMOS. That position is out of step with its peer federal financial regulators. These regulators have adopted final rules clarifying that non-compliance with their standards can create a basis for supervisory action, but that supervisory guidance is unenforceable.

DER, the division within FHFA responsible for supervision of the Enterprises, does not assess the Enterprises' practices against FHFA's PMOS. Instead, DER asserts that its examinations are conducted against the criteria in supervisory guidance, rather than against the PMOS. In taking this position, DER has supplanted the binding, legally enforceable PMOS with unenforceable statements of policy set forth in its supervisory guidance. Further, FHFA has not adopted any written policy or guidance explaining the interplay between the application of the PMOS, which are enforceable, and supervisory guidance, which is not, during examinations. As a result, under DER's current examination practice, FHFA is not positioned to ensure that the Enterprises comply with FHFA's PMOS because it is not assessing their practices to determine whether those practices fail to meet the PMOS.

We make three recommendations to address FHFA's failure to use PMOS as criteria in its supervision of the Enterprises.

Recommendations

We recommend that FHFA:

1. Revise the PMOS, to the extent necessary, to establish criteria to be used in examinations of the regulated entities;

2. Issue clear internal guidance to examination personnel on the use of the PMOS as criteria in supervisory activities; and

3. Issue a formal position on the use of non-binding supervisory guidance as criteria for supervisory activities.

FHFA Comments and OIG's Response

We provided a draft of this Management Advisory to FHFA and received a written management response. In its management response, which is included in the Appendix to this Management Advisory, FHFA agreed with our second recommendation and disagreed with our third recommendation. FHFA advised that it has deferred its response to our first recommendation to within 120 days of issuance of this Management Advisory due to the level of effort and stakeholder input needed to make a decision on whether revisions to PMOS are necessary.

FHFA made a number of assertions in its response that warrant comment from OIG. FHFA disagreed with our conclusion that DER "does not assess the Enterprises practices against FHFA's PMOS" and supported that assertion by pointing to "multiple" MRAs "that cite the [PMOS] as criteria in the respective conclusion letters to the Enterprises." OIG acknowledges that certain conclusion letters DER has issued to the Enterprises to communicate MRAs refer to one or more PMOS. However, we give substantial weight to statements made by the Examiner-in-Charge who signed several of the conclusion letters (the other EIC retired from FHFA) that DER does not assess Enterprise practices against the PMOS to determine whether those practices meet, or do not meet, the PMOS.

FHFA asserts that its practice "with respect to supervisory guidance and prudential standards is comparable to that of the bank regulatory agencies."[24] (Footnote omitted). As we have pointed out in this report, FHFA's position is not comparable to the position those agencies have memorialized in recently issued final rules. Whereas the other agencies uniformly acknowledge that noncompliance with their prudential standards can support a supervisory criticism, DER has advised us that it does not issue MRAs based on an Enterprise's failure to meet a PMOS, and it instead examines the Enterprises against its supervisory guidance. Additionally, according to one senior official, the PMOS can be treated as any other supervisory guidance, and FHFA further asserts in its management response that the PMOS "are not legally binding, in the sense that FHFA would not be able to bring an enforcement action for their violation as it could for the violation of a statute or regulation requiring that the regulated entity cease and desist or pay a money penalty." On the latter point, we direct FHFA's attention to 12 C.F.R. § 1236.3(d), which states: "Failure to meet any Standard may constitute an unsafe and unsound practice for purposes of the enforcement provisions of 12 U.S.C., chapter 46, subchapter III." Thus, the PMOS regulation expressly contemplates that FHFA could determine that a deficient practice fails to meet a PMOS *and* constitutes an unsafe and unsound practice under the Agency's enforcement provisions.

[24] FHFA also asserted that the Agency's "authority to issue supervisory guidance is explicit in its statute, 12 U.S.C. 4526(a)." For accuracy, we note that the cited statutory language does not use the term "supervisory guidance." It uses the term "guidelines." It states: "The Director shall issue any regulations, *guidelines*, or orders necessary to carry out the duties of the Director under this chapter or the authorizing statutes, and to ensure that the purposes of this chapter and the authorizing statutes are accomplished." (emphasis added)

FHFA disagreed with our third recommendation that "FHFA issue a formal position on the role of non-binding supervisory guidance as criteria for supervisory activities" and asserted that "the status of supervisory guidance . . . is well understood and does not require the issuance of a formal statement." During our discussion with FHFA legal counsel on this topic, counsel acknowledged that FHFA's position and rationale for treating the PMOS as supervisory guidance is not documented in formal legal memoranda or written guidance. During our inquiry it became clear that different individuals within DER and FHFA hold different views of the role of the PMOS. Accordingly, we disagree with FHFA's management decision on our third recommendation and consider it closed as rejected.

Appendix: FHFA's Response to OIG's Advisory and Recommendations

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
Clinton C. Jones III, General Counsel, Office of General Counsel

Miller, Paul Digitally signed by Miller, Paul Date: 2021.08.06 12:10:11 -04'00'

CLINTON JONES Digitally signed by CLINTON JONES Date: 2021.08.06 10:16:41 -04'00'

SUBJECT: Draft Management Advisory: *FHFA's Failure to Use Its Prudential Management and Operations Standards as Criteria for Its Supervision of the Enterprises Is Inconsistent with the FHFA Director's Statutory Duty to Ensure the Enterprises Comply with FHFA's Guidelines*

DATE: August 6, 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 Report's conclusion that the Division of Enterprise Regulation (DER) "does not assess the Enterprises practices against FHFA's PMOS," as DER has issued multiple Matters Requiring Attention that cite the Prudential Management and Operations Standards (PMOS) as criteria in the respective conclusion letters to the Enterprises.

FHFA believes that its practice with respect to supervisory guidance and prudential standards is comparable to that of the bank regulatory agencies.[1] Like them, FHFA has prudential standards and other supervisory guidance. As with the banking agencies, FHFA's supervisory guidance is much more numerous and detailed than its prudential standards. As with the banking agencies, much more of FHFA's examination and supervision practice revolves around the supervisory guidance than the prudential standards. The banking agencies bring few formal enforcement actions under their prudential standards. Most supervisory findings are resolved through voluntary remediation by the regulated entities, as is the case with FHFA. In FHFA's case, the agency's broad authority to issue supervisory guidance is explicit in its statute, 12 U.S.C. 4526(a). That authority is not limited to

[1] The Report refers to FHFA as a "part of" and a "member of" a "network" of financial regulators. In fact, despite similarities between FHFA and other regulators, FHFA does not participate in any such network. FHFA is independent from the so-called "peer" regulators to which the report frequently refers as exhibiting practices that FHFA does not share. FHFA is not bound by law, regulation, or agreement to mirror the practices of other agencies if FHFA does not consider the practice wise in its regulation of its regulated entities. Some of the other federal financial regulators are members of the Federal Financial Institutions Advisory Council, 12 U.S.C. 3303(a), but FHFA is not.

prudential standards issued under 12 U.S.C. 4513b, but is as broad as the purposes of the Safety and Soundness Act and the "authorizing statutes" (the Enterprises' charter acts and the Federal Home Loan Bank Act).[2] Like the banking agencies, FHFA, as authorized by the Safety and Soundness Act,[3] adopted the prudential standards at 12 CFR part 1236 as guidelines rather than regulations. This means that they are not legally binding, in the sense that FHFA would not be able to bring an enforcement action for their violations as it could for the violation of a statute or regulation, requiring that the regulated entity cease and desist, or pay a money penalty. The enforcement framework available for the prudential standards is instead a framework that requires remedial plans, similar to the type of plans that FHFA expects in response to its MRAs. In recognition that the prudential standards could be adopted as guidelines, rather than as regulations, the statute does not speak of "violations" of them. Instead, like the banking agencies' statute, the Safety and Soundness Act speaks of "failure to meet" the standards.

Similarly, when the standards are adopted as guidelines rather than regulations, then, like other supervisory guidance, they permit flexibility in how regulated entities meet them, as well as in how the regulator responds to failures to meet them. Failure to meet a standard that is a guideline does not require the regulator to demand a corrective plan from the regulated entity. Such flexibility in how the regulated entity meets a standard adopted as a guideline was noted by the banking agencies when they adopted their prudential standards,[4] and the flexibility available to the regulator in whether to require a corrective plan or not was a key factor in the banking agencies adopting the standards as guidelines, rather than as regulations.[5]

Recently, regulators have preferred not to speak of regulated entities being required to "comply" with supervisory guidance, in order to avoid a suggestion that such guidance is binding, in the way that laws and regulations are binding. The banking regulators have adopted an interagency statement expressing that preference.[6] That usage is not universal, and did not appear in an earlier version of the same interagency statement.[7] The Safety and Soundness Act itself expresses that a regulated entity

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[2] The banking agencies have general rule-writing authority comparable to FHFA's, but unlike FHFA's authority in 12 USC 4526(a), the banking agencies' statutory authorizing provisions do not specifically authorize the use of supervisory guidance. See 12 USC 93a (OCC), 12 USC 1819(a)(Tenth) (FDIC), 12 USC 1844(b) (Federal Reserve Board, with respect to the Bank Holding Company Act), 12 USC 1766(a) (NCUA), 12 USC 2252(a)(9) (Farm Credit Administration), 12 USC 2277a-7(a) (Farm Credit System Insurance Corporation). This difference in explicit statutory authorizations may be a factor in the banking agencies' restrained approach toward guidance in their interagency statement on supervisory guidance, notes 6 and 7 below.

[3] 12 USC 4513b(a).

[4] See 60 FR 35674, 35675 (July 10, 1995) (the guidelines would satisfy commenters' desire that the standards should be "general and flexible in nature").

[5] See *id.*

[6] See 12 CFR Part 262 App. A.

[7] Interagency Statement Clarifying the Role of Supervisory Guidance (Sept. 11, 2018).

"complies" with guidelines, as well as with laws and regulations,[8] but that usage is not sufficient to override the Administrative Procedure Act (APA) requirement that binding requirements for the regulated entities must be adopted through notice-and-comment rulemaking, see 5 U.S.C. 559.

With that background in mind, FHFA turns to the OIG's recommendations.

Recommendation 1: *OIG recommends that FHFA revise the PMOS, to the extent necessary, to establish criteria to be used in examinations of the regulated entities.*

Management Response: Based on the level of effort and stakeholder input needed to make a decision on whether or not revisions to the PMOS are necessary, FHFA will need additional time to make a decision. Accordingly, FHFA will assess this recommendation and provide a response to the OIG within 120 days of issuance of the Report.

Recommendation 2: *OIG recommends that FHFA issue clear internal guidance to examination personnel on the use of the PMOS as criteria in supervisory activities.*

Management Response: FHFA agrees with this recommendation. By April 29, 2022, DER will issue guidance to its examiners on the use of the PMOS in conducting examination activities of the Enterprises.

Recommendation 3: *OIG recommends that FHFA issue a formal position on the role of non-binding supervisory guidance as criteria for supervisory activities.*

Management Response: FHFA disagrees with this recommendation. As noted in the Report, FHFA stated in its response to Representatives Luetkemeyer and Hill that, "in general, supervisory guidance, which does not go through the public notice-and-comment process of the Administrative Procedure Act (APA), is not legally binding and that failure to follow it cannot by itself be the basis for an enforcement action." (The exception to that proposition, and the reason FHFA couched the proposition as "in general," is that prudential standards are enforceable through the statutory mechanism of requiring corrective plans. Prudential standards adopted as guidelines, however, like other supervisory guidance, are not enforceable through the statutory mechanism for obtaining a cease and desist order or civil money penalties for legal violations.) FHFA believes that the status of supervisory guidance, as stated above, is well understood and does not require the issuance of a formal statement. Supervisory guidance sets out FHFA's supervisory expectations and is used in the examination process, and that usage is clearly stated at the end of every Advisory Bulletin (AB) that FHFA issues, most recently AB-2021-01: *Board Diversity Data Collection,* March 17, 2021.

[8] 12 USC 4513(a)(1)(B)(iii).

If you have any questions related to our response, please do not hesitate to contact Mark Laponsky or Eric Wilson.

cc: Chris Curtis
Mark Laponsky
Scott Valentin
Eric Wilson
Edom Aweke
John Major

Addendum to OIG-2021-004

In FHFA's August 6, 2021, management response to a draft of this management advisory, which is included in the Appendix on pages 15-18, FHFA deferred its management decision to OIG's first recommendation, stating that "[b]ased on the level of effort and stakeholder input needed to make a decision on whether or not revisions to the PMOS are necessary, FHFA will need additional time to make a decision." FHFA submitted its March 16, 2022, management decision to OIG on March 17, 2022.

In its March 16, 2022, management response (Appendix to this Addendum), FHFA stated that it "agrees that criteria to be used in examinations of the regulated entities should be established but does not believe such criteria should be located in Standards that FHFA has established or will establish as PMOS or in FHFA's Regulation at 12 C.F.R. Part 1236." FHFA also stated that it "believes its response to Recommendation No. 2 will also be responsive to Recommendation No. 1."

We met with FHFA officials on April 22, 2022, to discuss FHFA's management response to our recommendation. We explained that, for purposes of the first recommendation, "criteria to be used in examinations" refers to FHFA's prudential standards and not to guidance to examiners, such as the guidance contained in operating procedures bulletins. We asked whether FHFA had assessed the PMOS and determined that the Standards do not need to be revised. The Deputy Director of DER and the Acting Deputy Director of Division of Federal Home Loan Bank Regulation acknowledged the distinction between PMOS and examiner guidance and responded that they consider the PMOS, as written, to be sufficient for application in examination activities of the regulated entities.

The FHFA Director appointed a new Deputy Director of DER on September 20, 2021, the same date that we issued this management advisory. On his first day as Deputy Director of DER, he sent an email to all DER staff communicating interim guidance on when and how to apply the PMOS during the course of examination activities. At our April 22, 2022, meeting, the Deputy Director confirmed that DER will incorporate that interim guidance into an operating procedures bulletin by August 31, 2022.

Based on our discussion with FHFA, we determined that the Agency's planned approach to the first recommendation meets the intent of our recommendation.

Addendum Appendix: FHFA Management Decision to the First Recommendation in OIG-2021-004 Dated March 16, 2022

CONTROLLED

Federal Housing Finance Agency

MEMORANDUM

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

FROM: Clinton C. Jones, General Counsel CLINTON JONES Digitally signed by CLINTON JONES Date: 2022.03.16 08:06:11 -04'00'
Andre D. Galeano, Deputy Director, Division of Enterprise Regulation ANDRE GALEANO
Louis Scalza, Acting Deputy Director, Division of FHLBank Regulation LOUIS SCALZA

SUBJECT: Management Advisory: *FHFA's Failure to Use Its Prudential Management and Operations Standards as Criteria for Its Supervision of the Enterprises Is Inconsistent with the FHFA Director's Statutory Duty to Ensure the Enterprises Comply with FHFA's Guidelines* (OIG-2021-004)

DATE: March 16, 2022

The purpose of this memo is to provide the Office of Inspector General (OIG) with an update on the actions that the Federal Housing Finance Agency (FHFA) will take to address Recommendation No. 1.

FHFA met with the OIG on February 7, 2022, to provide an update on progress and planned actions related to Recommendation No. 1. Based on the meeting, FHFA's planned actions address the concerns raised in the Report and are responsive to the Recommendation No. 1.

Recommendation No. 1: *OIG recommends that FHFA revise the PMOS, to the extent necessary, to establish criteria to be used in examinations of the regulated entities.*

Management Response to the Draft Report: *Based on the level of effort and stakeholder input needed to make a decision on whether or not revisions to the PMOS are necessary, FHFA will need additional time to make a decision. Accordingly, FHFA will assess this recommendation and provide a response to the OIG within 120 days of issuance of the Report.*

Updated Management Response: After review, FHFA agrees that criteria to be used in examinations of the regulated entities should be established but does not believe that such criteria

should be located in Standards that FHFA has established or will establish as PMOS or in FHFA's PMOS regulation at 12 C.F.R. Part 1236. The Standards themselves address supervisory expectations for FHFA's regulated entities while the regulation generally sets forth a procedural framework for corrective plans and orders that may be undertaken if FHFA determines that a regulated entity has failed to meet a Standard. FHFA has not previously used those issuances to establish or communicate examination criteria, and views direct guidance to FHFA examination staff as a more effective approach in this case. Utilizing that approach, FHFA believes its response to Recommendation No. 2 will also be responsive to Recommendation No. 1.

In reaching the conclusion not to incorporate examination criteria in revised Standards or a revised PMOS rule, FHFA examination staff engaged with FHFA's Office of General Counsel (OGC) on a project OGC has initiated to consider revisions to the PMOS regulation adopted by FHFA in 2012. OGC is in the initial stages of the project and is engaging Agency stakeholders to determine the types of revisions desired. OGC anticipates the following revisions to the PMOS rule from this project:

- Revise the PMOS rule to expressly address Standards established as regulations, in addition to Standards established as guidelines, to reflect the full extent of authority provided to FHFA at 12 U.S.C. 4513b.

- Create a mechanism to identify current or future supervisory guidance (e.g., Advisory Bulletins) as Standards.

To amend its PMOS rule, FHFA is required to follow Administrative Procedure Act provisions including publishing a proposed rule for public notice and comment, 5 U.S.C. 553. FHFA anticipates publishing a Notice of Proposed Rulemaking in 2022 (late Q2 or Q3) and a final rule in late 2022 or early 2023.

In addition, the Division of Enterprise Regulation (DER) plans to issue guidance in the form of an Operating Procedures Bulletin (OPB) to examiners on the use of the PMOS in conducting examination activities of the Enterprises and CSS. This guidance will serve as a bridge between the examination of the regulated entities and the application of the binding and legally enforceable PMOS standards. This action is anticipated to address Recommendation No. 2 and will be completed by August 31, 2022.

The Division of FHLBank Regulation (DBR) also anticipates issuing guidance, in the form of an OPB, on the use of PMOS in the FHLBank examination process. DBR plans to complete its guidance by August 31, 2022.

Let us know if you have any questions.