Federal Housing Finance Agency
Office of Inspector General

Fannie Mae and Freddie Mac Fourth-Party Risk

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Executive Summary

Fannie Mae and Freddie Mac (the Enterprises) rely on numerous third parties to originate and service mortgages and to provide a wide array of services essential to their business operations. Third parties to the Enterprises rely on their own third parties, which are fourth parties to the Enterprises. Like third parties, fourth parties pose risk to the Enterprises that must be managed.

In its 2020 Report to Congress, the Federal Housing Finance Agency (FHFA or Agency) said that fourth-party risks will have to be a point of emphasis for the Enterprises. Officials from FHFA, Fannie Mae, and Freddie Mac each told us that fourth-party risk is an increasing focus.

FHFA and the Enterprises described to us challenges the Enterprises face in managing fourth-party risk, particularly related to the Enterprises' limited direct oversight of fourth parties. Typically, the Enterprises do not have contracts with their fourth parties. Instead, the third parties have the direct contractual relationship with the fourth parties. As the Enterprises explained, they oversee their third parties' management of third-party (Enterprise fourth-party) risk rather than overseeing fourth parties directly.

FHFA told us that it is increasing its oversight of Enterprise fourth-party risk management and described actions it intends to take in 2022.

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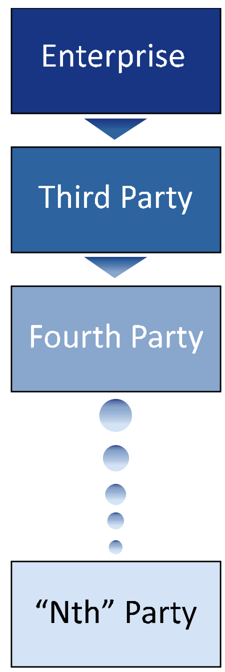
ABBREVIATIONS

Enterprises	Fannie Mae and Freddie Mac
FHFA or Agency	Federal Housing Finance Agency
OIG	Federal Housing Finance Agency Office of Inspector General

BACKGROUND

Fannie Mae and Freddie Mac rely on numerous third parties to originate and service mortgages and to provide a wide array of services essential to their business operations.[1] Third parties to the Enterprises rely on their own third parties, which are fourth parties to the Enterprises. Fourth parties may themselves have third parties, and so on, referred to as "nth" parties. (Figure 1 depicts the contractual relationship between an Enterprise and its third party, between the third party and a fourth party, etc.) For example, the Enterprises have third parties deemed critical that provide information technology services, such as data management, cloud computing, and cybersecurity. These third parties, in turn, often are supported by fourth parties.

FIGURE 1. ILLUSTRATION OF ENTERPRISE THIRD, FOURTH, AND NTH PARTIES



Like third parties, fourth parties pose risk to the Enterprises that must be managed. According to FHFA's guidance to its examiners, having many vendors outsourcing work to fourth parties raises concerns about the ability of fourth parties to effectively and appropriately carry out the contracted services. A fourth party could fail to meet its obligations to the third party, which could in turn fail to meet its obligations to the Enterprise.

An FHFA official told us that fourth-party risk is not new; it is expected when there are third parties. However, fourth-party risk is getting more attention, according to FHFA and the Enterprises. FHFA told us, for example, that the pandemic demonstrated the fragility of the supply chain and raised awareness of fourth-party risk. Supply chain incidents, such as the SolarWinds compromise, and large-scale cybersecurity breaches also have increased the visibility of fourth-party risk.[2] In its Form 10-Q for the first

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[1] The FHFA Office of Inspector General (OIG) has previously reported on Enterprise third-party risk, such as OIG, *Despite FHFA's Acknowledgement that Enterprise Reliance on Third-Parties Represents a Significant Operational Risk, No Targeted Examinations of Fannie Mae's Third-Party Risk Management Program Were Completed Over a Seven-Year Period* (Mar. 29, 2021) (AUD-2021-007) (online at www.fhfaoig.gov/sites/default/files/AUD-2021-007 FNM Third Party public.pdf) and OIG, *Enterprise Third-Party Relationships: Risk Assessment and Due Diligence in Vendor Selection* (Mar. 12, 2020) (WPR-2020-003) (online at www.fhfaoig.gov/sites/default/files/WPR-2020-003.pdf).

[2] The Government Accountability Office reported that, as early as January 2019, a foreign threat actor breached the computing networks of SolarWinds, a U.S.-based company. In 2020, the threat actor injected malicious code into a file that later was included in updates of SolarWinds' Orion products. SolarWinds unwittingly released the compromised updates to its customers. *See* Government Accountability Office,

quarter of 2021, Fannie Mae said that the SolarWinds breach and a 2021 Microsoft Exchange cyberattack suggest that the risk of damaging cyberattacks affecting it or its third parties is increasing.

The Enterprises told us that they have experienced loss events linked to fourth parties. However, Fannie Mae and Freddie Mac officials characterized losses in 2021 from these events as very low or minimal. As Freddie Mac stated in a 2021 internal document, while impacts to the Enterprise have been low, the increase in the number of fourth-party events highlights potential risk exposure.

FHFA Advisory Bulletin

FHFA issued an advisory bulletin in 2018 providing guidance to the Enterprises about their oversight of third-party provider relationships.[3] The advisory bulletin lists types of risk that third-party relationships can pose to the Enterprises: financial, operational, legal, compliance, and reputational risk. FHFA and the Enterprises told us that these are the same types of risk that fourth-party relationships can pose. They also described concentration risk associated with fourth parties. FHFA explained that Enterprise third parties often rely on a select number of technology vendors, creating fourth-party concentration risk. FHFA and the Enterprises used the example of Amazon Web Services, which is a third party to the Enterprises and to many of their third parties.

In addition, an FHFA official told us that the third-party advisory bulletin incorporates its guidance to the Enterprises to date about fourth-party risk management. The advisory bulletin describes phases of the third-party provider relationship lifecycle. For example, in the risk assessment phase, the Enterprises assess the risks associated with engaging a third party to supply a product or service.

The advisory bulletin includes guidance pertaining to subcontractors (or fourth parties) for various phases of the third-party lifecycle:[4]

Cybersecurity: Federal Response to SolarWinds and Microsoft Exchange Incidents (Jan. 2022) (GAO-22-104746) (online at www.gao.gov/assets/gao-22-104746.pdf).

OIG surveyed the impact of the SolarWinds Orion supply chain compromise on FHFA and its regulated entities. The March 2021 OIG report was not released publicly because information in it could be used to circumvent internal controls at FHFA and its regulated entities. Fannie Mae reported in its Form 10-Q for the first quarter of 2021 that it had not experienced any material impacts from the SolarWinds Orion cyberbreach.

[3] FHFA, Advisory Bulletin 2018-08, *Oversight of Third-Party Provider Relationships* (Sept. 28, 2018) (online at www.fhfa.gov/SupervisionRegulation/AdvisoryBulletins/Pages/Oversight-of-Third-Party-Provider-Relationships.aspx).

[4] The advisory bulletin uses the term subcontractor, which FHFA told us would also be considered a fourth party. In some contexts, subcontractors are distinguished from other fourth parties, as noted below.

- *Risk assessment*: Each Enterprise should have a process to assess risks that may include the potential that a third party will use subcontractors.

- *Due diligence in third-party provider selection*: Each Enterprise should consider concentration risks that may arise from the third party's reliance on subcontractors, the extent to which the third party relies on subcontractors to perform its obligations, the controls the subcontractor has in place, and the third party's processes to oversee subcontractors directly involved in the outsourced product or service.

- *Contract negotiation*: If contracts allow for subcontracting, the Enterprise generally should seek to ensure that the third party remains responsible for the performance of its subcontractors in accordance with the terms of the primary contract, and the Enterprises should be notified of the identity of material subcontractors, when appropriate.

- *Ongoing monitoring*: Each Enterprise should consider whether the third party is monitoring and evaluating subcontractor controls relevant to the contract work.

ENTERPRISE FOURTH-PARTY RISK..

Fannie Mae and Freddie Mac each have identified fourth parties as a risk facing the Enterprise. For instance, in a September 2021 internal Fannie Mae document, the Enterprise included third- and fourth-party reliance among a number of its key risk themes. When we asked Fannie Mae how it would characterize its fourth-party risk, the Enterprise told us that fourth-party risk currently is not part of its ten top risks, but fourth-party risk has been an important component of its third-party risk management program. Freddie Mac told us that it would characterize fourth-party risk as a key risk within third-party risk, which is a top risk to the Enterprise. Officials from FHFA, Fannie Mae, and Freddie Mac each said that fourth-party risk is an increasing focus.

Challenges of Managing Fourth-Party Risk

FHFA and the Enterprises described to us challenges the Enterprises face in managing fourth-party risk compared to managing third-party risk. In particular, they noted challenges related to the Enterprises' limited direct oversight of fourth parties.

Typically, the Enterprises do not have contracts with their fourth parties. Instead, the third parties have the direct contractual relationship with the fourth parties. (In some cases, fourth parties also are direct third parties of the Enterprises and, therefore, the Enterprises would have a contract. For example, cloud service providers such as Amazon Web Services are both third and fourth parties to the Enterprises.)

Without a direct contract, as Fannie Mae explained, the Enterprise will not have the same access to information or understanding of the controls in place for fourth parties as it would have for third parties. FHFA also told us that the Enterprises will have less information about fourth parties. The Enterprises might not have insight into where a fourth party is located, its controls, or its oversight by the third-party provider, according to FHFA guidance to its examiners. Fannie Mae told us that, without a direct relationship with the fourth party, the challenge is relying on what the third party communicates. Similarly, Freddie Mac said that it relies on third parties to have appropriate mechanisms in place to oversee fourth parties.

FHFA noted the additional challenge that the number of fourth parties is vastly larger than the number of third parties. FHFA also told us that other financial service firms are having similar challenges and are focused on maturing their fourth-party risk management programs as well.

Regarding nth parties, FHFA and the Enterprises agreed that the further an nth party is from the Enterprise, the greater the challenges. As FHFA explained, the Enterprises' contractual relationship directly with a third party provides them with some insight into fourth parties. The further down the nth-party list, the less information the Enterprise will have. Both Enterprises told us that they are aware of nth-party risk; however, they said their current focus is on fourth-party risk.

Enterprise Fourth-Party Risk Management

This section describes some ways the Enterprises intend to mitigate fourth-party risk. We did not evaluate the adequacy or implementation of the risk mitigants.

Oversight of Third Parties

The Enterprises have limited direct oversight of fourth parties.[5] Instead, as the Enterprises explained, they oversee their third parties' management of third-party (Enterprise fourth-party) risk. For example, in the contract negotiation phase of the third-party lifecycle, the Enterprises may include provisions in their contracts with third parties specifying expectations for the third party's oversight of subcontractors. In the due diligence and third-party selection and ongoing monitoring phases, the Enterprises may assess the third-party risk management programs of their third parties.

[5] Again, unless the fourth party also is a third party.

FHFA told us that Fannie Mae mitigates fourth-party risk through its third-party risk management standard. That standard includes minimum contractual requirements for third parties, including provisions related to subcontractors. It also specifies some minimum requirements for Enterprise due diligence and monitoring based on the level of risk. For example, the Enterprise should determine that the third party has policies and procedures in place to evidence appropriate oversight of fourth parties to the extent that fourth parties are identified as accessing certain highly confidential Enterprise information. Freddie Mac has internal fourth-party framework guidance that lists requirements for phases of the third-party lifecycle. Freddie Mac told us that it is developing additional implementation guidance to build out its processes.

In some cases, Enterprise third parties must get the Enterprise's approval before engaging a fourth party. Fannie Mae told us that when its standard contract is used, third parties are required to inform the Enterprise of any new subcontractors. (Fannie Mae considers a fourth party to be a subcontractor when the third party outsources direct support for services specified in the third party's contract with Fannie Mae.) Fannie Mae may elect to use its authority to review new subcontractors, but Enterprise approval is not required for other types of fourth parties. Freddie Mac told us that when its standard contract is used the Enterprise reserves the right to approve subcontractors and material fourth parties. The Enterprise added that it requires third parties to notify it about material fourth parties, but in general it does not seek to approve fourth parties. Even if an Enterprise approves a fourth party upfront, this approval is not the same as the Enterprise having an ongoing contract with the fourth party. As a result, the Enterprise still would have the challenges of limited direct oversight and limited information about the fourth party.

Focus on Higher-Risk Fourth Parties

Both Enterprises explained that they focus on fourth parties that pose higher risk. Fannie Mae said that it has an inventory of what it calls key fourth parties. Freddie Mac said that it is developing an inventory of what it calls material fourth parties. Although the Enterprises do not use identical definitions, both Enterprises include, for example, fourth parties that have access to confidential information. As Freddie Mac explained, when material fourth parties are identified, the third parties associated with those fourth parties would get more oversight. Freddie Mac reported in its 2021 10-K that the Enterprise is working to strengthen its processes related to identifying material subcontractors and service providers of the third parties with which it does business and managing the associated risk.

A subservicer performs mortgage servicing activity on behalf of a seller/servicer for the benefit of an Enterprise. According to Fannie Mae, large subservicers are a category of higher-risk fourth parties. However, subservicers for Enterprise loans must be approved by the Enterprises and have direct contractual relationships with the Enterprises. Fannie Mae explained that it has the ability to conduct risk assessments and ongoing monitoring of subservicers in the same way as for its servicers.

FHFA PLANS TO INCREASE ITS OVERSIGHT OF ENTERPRISE FOURTH-PARTY RISK

FHFA told us that Enterprise fourth-party risk is increasing. The Agency cited factors including increased use of subcontractors in the supply chain generally and increased interconnectivity, such as a cloud provider of the Enterprises also being a cloud provider of their third parties. Cybersecurity threats are also increasing fourth-party risk, according to the Agency. FHFA said in its 2020 Report to Congress that fourth-party risks will have to be a point of emphasis for the Enterprises. Reporting on its assessment of Enterprise operational risk, the Agency explained that third-party risk management remains a significant challenge for both Enterprises, as demonstrated by supply chain issues such as the SolarWinds cyberattack and several data breaches affecting third- and fourth-party vendors.

FHFA has conducted ongoing monitoring of Enterprise third-party risk management, including the management of fourth-party risk. In addition, the Agency told us that it is increasing its oversight of Enterprise fourth-party risk management. In 2022, FHFA intends to monitor trends in fourth-party risk management to inform its supervision of the Enterprises and evaluate Fannie Mae and Freddie Mac exposure to fourth parties. FHFA also said that it would consider enhancing its guidance to the Enterprises addressing fourth-party risk.

CONCLUSION

Managing fourth-party risk poses challenges to the Enterprises and other financial services firms. As reported by FHFA, fourth-party risk will have to be a point of emphasis for the Enterprises. Officials from FHFA, Fannie Mae, and Freddie Mac each told us that fourth-party risk is an increasing focus. In addition, FHFA said that it is increasing its oversight of Enterprise fourth-party risk management and described actions it intends to take in 2022. We believe this risk area merits the Agency's attention.

OBJECTIVE, SCOPE, AND METHODOLOGY ....

The objective of this white paper was to provide background information on fourth-party risk for the Enterprises, FHFA and Enterprise views of this risk, and Enterprise actions taken to mitigate this risk. We did not evaluate the adequacy or implementation of the risk mitigants. To achieve this objective, we reviewed internal FHFA and Enterprise documents as well as publicly available documents. We also interviewed FHFA and Enterprise officials.

We provided FHFA with the opportunity to respond to a draft of this white paper. We appreciate the cooperation of FHFA staff, as well as the assistance of all those who contributed to the preparation of this white paper.

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