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

October 15, 2018

TO: Melvin L. Watt, Director

FROM: Laura S. Wertheimer, Inspector General

SUBJECT: Fiscal Year 2019 Management and Performance Challenges

We are pleased to provide you with this memorandum, issued pursuant to the Reports Consolidation Act of 2000 (P.L. 106-531), in which the Office of Inspector General (FHFA-OIG) for the Federal Housing Finance Agency (FHFA or Agency) identifies four serious management and performance challenges facing the Agency for Fiscal Year (FY) 2019 and a management concern, and its assessment of those challenges and concern. Both FHFA and FHFA-OIG have acknowledged the difficulties resulting from the ongoing uncertainty regarding the future role of Fannie Mae and Freddie Mac (collectively, the Enterprises) in the housing finance system.

Overview

FHFA was created in July 2008 by the Housing and Economic Recovery Act of 2008 (HERA) (P.L. 110-289) to serve as regulator of the Enterprises and the Federal Home Loan Banks (FHLBanks). As regulator, FHFA is charged with overseeing the safety and soundness and statutory missions of these entities. In September 2008, FHFA placed Fannie Mae and Freddie Mac into conservatorship "in response to a substantial deterioration in the housing markets that severely damaged each Enterprise's financial condition and left both of them unable to fulfill their missions without government intervention."[1] For the past ten years, FHFA has served as both conservator and supervisor, a dual role that Director Watt has called "extraordinary." Putting the Enterprises into conservatorships has proven to be far easier than ending them, and the conservatorships have now entered their 11th year.

[1] FHFA, *History of Fannie Mae and Freddie Mac Conservatorships* (online at www.fhfa.gov/Conservatorship/Pages/History-of-Fannie-Mae--Freddie-Conservatorships.aspx).

As conservator of the Enterprises, which together reported assets of approximately $5.4 trillion as of December 31, 2017, FHFA has the ultimate authority and responsibility for all business, policy, and risk decisions. These business and policy decisions influence and affect the entire mortgage finance industry. As conservator, FHFA must ensure that both Enterprises are effectively governed and employ sound risk management practices.

FHFA is also the supervisor for the Enterprises and for the FHLBanks, which collectively reported roughly $1.1 trillion in assets as of December 31, 2017. FHFA is responsible for conducting examinations of the Enterprises and the FHLBanks to ensure that they operate safely and soundly so that they serve as a reliable source of liquidity and funding for housing finance and community investment.

Based on our body of work, FHFA-OIG holds the view that, for the foreseeable future, FHFA faces four serious management and performance challenges, all of which carry over from prior years, and a management concern. From our vantage point, these management and performance challenges, if not addressed, could adversely affect FHFA's accomplishment of its mission.

During my tenure as Inspector General, FHFA-OIG has issued 103 reports in which we assessed FHFA's progress in addressing elements of each of these challenges. Where we have identified shortcomings and/or weaknesses, we have proposed recommendations to address them. These 103 reports included 131 recommendations to address identified shortcomings, of which FHFA fully agreed to 105, or 80%. For those recommendations FHFA has accepted, it has either implemented its proposed corrective actions or is in the process of developing and/or implementing them. Appendix B to each of our Semiannual Reports to the Congress (SARs) for the periods ending March 31 and September 30, 2018, sets forth our recommendations, by report, FHFA's response to each recommendation, and the status of each recommendation. For a listing of all our SARs, see www.fhfaoig.gov/reports/semiannual. In addition, FHFA-OIG issues, on a regular basis, a Compendium of Open Recommendations, organized by the risks represented by the serious management and performance challenges identified in this memorandum. See www.fhfaoig.gov/reports/compendium_of_recommendations.

Set forth below are the four significant challenges and the management concern we have identified, together with our assessments of those challenges and concern.

Challenge: Improve Oversight of Matters Delegated to the Enterprises and Strengthen Internal Review Processes for Non-Delegated Matters

As conservator of the Enterprises since September 2008, FHFA has expansive authority to oversee and direct operations of two large, complex financial institutions that dominate the secondary mortgage market and the mortgage securitization sector of the U.S. housing finance industry. Under HERA, FHFA, as conservator, possesses all rights and powers of any stockholder, officer, or director of the Enterprises and is vested with express authority to operate the Enterprises and conduct their business activities. FHFA Director Watt has acknowledged that his statutory responsibilities are to "preserve and conserve" the assets and property of the

Enterprises while operating them in a manner consonant with the public interest. Given the taxpayers' enormous investment in the Enterprises, the unknown duration of the conservatorships, the Enterprises' critical role in the secondary mortgage market, and their uncertain ability to sustain future profitability, FHFA's administration of the conservatorships remains a major risk.

FHFA has delegated authority for many matters, both large and small, to the Enterprises. The Enterprises acknowledge in their public securities filings that their directors serve on behalf of the conservator and exercise their authority as directed by and with the approval, when required, of the conservator. FHFA, as conservator, can revoke delegated authority at any time (and retains authority for certain significant decisions).

During my tenure as Inspector General, FHFA-OIG's body of work has found that FHFA has limited its oversight of delegated matters largely to attendance at Enterprise internal management and board meetings as an observer and to discussions with Enterprise managers and directors. Read together, our findings in these reports show that, for the most part, FHFA, as conservator, has not assessed the reasonableness of Enterprise actions pursuant to delegated authority, including actions taken by the Enterprises to implement conservatorship directives, or the adequacy of director oversight of management actions. FHFA also has not clearly defined the Agency's expectations of the Enterprises for delegated matters and has not established the accountability standard that it expects the Enterprises to meet for such matters. Our work has identified internal control systems at the Enterprises that fail to provide directors with accurate, timely, and sufficient information to enable them to exercise their oversight duties. Likewise, we have identified a lack of rigor by some directors in seeking information from management about the matters for which they are responsible. We have also identified instances in which corporate governance decisions generally reserved to the board of directors have been delegated to management.

As the Enterprises' conservator, FHFA is ultimately responsible for actions taken by the Enterprises, pursuant to authority it has delegated to them. FHFA's challenge, therefore, is to improve the quality of its oversight of matters it has delegated to the Enterprises.

Select FHFA-OIG Reports Issued During FY 2018 on Delegated Matters:

- *Corporate Governance: Review and Resolution of Conflicts of Interest Involving Fannie Mae's Senior Executive Officers Highlight the Need for Closer Attention to Governance Issues by FHFA* (EVL-2018-001, January 31, 2018).
- *Administrative Review of a Potential Conflict of Interest Matter Involving a Senior Executive Officer at an Enterprise* (OIG-2018-001, July 26, 2018).
- *Consolidation and Relocation of Fannie Mae's Northern Virginia Workforce* (OIG-2018-004, September 6, 2018).

Generally, FHFA has retained authority (or has revoked previously delegated authority) to resolve issues of significant monetary and/or reputational value. FHFA has established written internal review and approval processes for non-delegated matters, designed to provide a consistent approach for analyzing and resolving such matters and for providing decision-makers with all relevant facts and existing analyses. FHFA faces challenges in ensuring that its established processes are followed.

Select FHFA-OIG Reports Issued During FY 2018 on Non-Delegated Matters:

- *Audit of FHFA's Oversight of the Enterprises' Affordable Housing Set-Asides and Allocations* (AUD-2018-012, September 24, 2018).
- *Consolidation and Relocation of Fannie Mae's Northern Virginia Workforce* (OIG-2018-004, September 6, 2018).
- *Compliance Review of FHFA's Process for Making Changes to Conservatorship Scorecard Targets* (COM-2018-004, June 20, 2018).

Challenge: Upgrade Supervision of the Enterprises and Continue Robust Supervision of the FHLBanks

As supervisor of the Enterprises and the FHLBanks, FHFA is tasked by statute to ensure that these entities operate safely and soundly so that they serve as a reliable source of liquidity and funding for housing finance and community investment. Examinations of its regulated entities are fundamental to FHFA's supervisory mission. Within FHFA, the Division of Federal Home Loan Bank Regulation (DBR) is responsible for supervision of the FHLBanks, and the Division of Enterprise Regulation (DER) is responsible for supervision of the Enterprises.

As FHFA Director Watt has observed, Fannie Mae and Freddie Mac would be Systemically Important Financial Institutions (SIFIs), but for the conservatorships, and are subject to the heightened supervision requirements for SIFIs, except that they are supervised by FHFA, not the Federal Reserve. Because the asset size of the FHLBanks and Office of Finance, together, is a fraction of the asset size of the Enterprises and because the Enterprises are in conservatorship, we determined that the magnitude of risk is significantly greater for the Enterprises. During my tenure at FHFA-OIG, the majority of our work on supervision issues has focused on FHFA's supervision of the Enterprises. In prior management and performance challenges statements, we identified FHFA's supervision of the Enterprises as a critical risk and believe that it continues to be such a risk.

Over the past few years, we have assessed critical elements of DER's supervision program for the Enterprises. For each element that we assessed, we issued reports setting forth the facts, findings, conclusions, and recommendations on each of these critical elements. Each of these reports identified shortcomings and recommended remedial actions.

Based on our assessments of different elements of DER's supervision program, we identified four recurring themes, which were explained in a roll-up report issued during FY 2017. See FHFA-OIG, *Safe and Sound Operation of the Enterprises Cannot Be Assumed Because of*

Significant Shortcomings in FHFA's Supervision Program for the Enterprises (OIG-2017-003, December 15, 2016). Those themes are:

1. FHFA lacks adequate assurance that DER's supervisory resources are devoted to examining the highest risks of the Enterprises.
2. Many supervisory standards and guidance issued by FHFA and DER lack the rigor of those issued by other federal financial regulators.
3. The flexible and less prescriptive nature of many requirements and guidance promulgated by FHFA and DER has resulted in inconsistent supervisory practices.
4. Where clear requirements and guidance for specific elements of DER's supervisory program exist, DER examiners-in-charge and subordinate examiners have not consistently followed them.

In that roll-up report, we cautioned that "[w]ithout prompt and robust Agency attention to address the shortcomings we have identified," the "safe and sound operation of the Enterprises cannot be assumed from FHFA's current supervisory program." The findings from subsequent audits, evaluations, and compliance reports regarding FHFA's supervision program for the Enterprises identified additional shortcomings. In light of Director Watt's recognition that the Enterprises would be SIFIs, but for the conservatorships, and are subject to the heightened supervision requirements for SIFIs, FHFA must make a heightened and sustained effort to improve its supervision of the Enterprises.

We also looked at elements of FHFA's supervision program for the FHLBanks. While our reports of that work identified some shortcomings, they did not identify significant weaknesses. Like any other federal financial regulator, FHFA faces challenges in appropriately tailoring and keeping current its supervisory approach to the FHLBanks.

Select FHFA-OIG Reports Issued During FY 2018 on Supervision Matters:

- *FHFA Completed its Planned Procedures for a 2016 Representation and Warranty Framework Targeted Examination at Freddie Mac, but the Supporting Workpapers Did Not Sufficiently Document the Examination Work* (AUD-2018-006, March 13, 2018).
- *FHFA Requires the Enterprises' Internal Audit Functions to Validate Remediation of Serious Deficiencies but Provides No Guidance and Imposes No Preconditions on Examiners' Use of that Validation Work* (EVL-2018-002, March 28, 2018).
- *FHFA's Adoption of Clear Guidance on the Review of the Enterprises' Internal Audit Work When Assessing the Sufficiency of Remediation of Serious Deficiencies Would Assist FHFA Examiners* (EVL-2018-003, March 28, 2018).
- *DBR's Safety and Soundness Quality Control Reviews Were Conducted in Compliance with FHFA's Standard During the 2017 Examination Cycle but DBR's Community Investment Quality Control Reviews Were Not* (AUD-2018-010, August 17, 2018).

- *Compliance Review of FHFA's Communication of Serious Deficiencies to the Enterprises' Boards of Directors* (COM-2018-005, September 5, 2018).
- *FHFA's Housing Finance Examiner Commissioning Program: $7.7 Million and Four Years into the Program, the Agency has Fewer Commissioned Examiners* (COM-2018-006, September 6, 2018).

Challenge: Enhance Oversight of Cybersecurity at the Regulated Entities and Ensure an Effective Information Security Program at FHFA

Cybersecurity, as defined by the National Institute of Standards and Technology, is "the process of protecting information by preventing, detecting, and responding to attacks." In May 2017, President Trump issued an executive order to strengthen the cybersecurity of federal networks and critical infrastructure. The Financial Stability Oversight Council, of which FHFA is a member, has identified cybersecurity oversight as an emerging threat for increased regulatory attention. The Council reported that "cybersecurity-related incidents create significant operational risk, impacting critical services in the financial system, and ultimately affecting financial stability and economic health." Treasury Secretary Mnuchin has testified that "cybersecurity is one of our biggest, biggest risks."

As cyberthreats and attacks at financial institutions increase in number and sophistication, FHFA faces challenges in designing and implementing its supervisory activities for the financial institutions it supervises. These supervisory activities may be made increasingly difficult by FHFA's continuing need to attract and retain highly-qualified technical personnel, with expertise and experience sufficient to handle rapid developments in technology.

FHFA advised us that it developed an examination module for cybersecurity examinations during 2016. FHFA will be challenged to ensure that it: (1) fully implements its newly developed examination module; (2) updates the elements of this module, as needed, to reflect any changes in the cybersecurity environment; (3) provides written guidance and training to examiners to aid them in their supervision of information technology issues; (4) recruits and retains, or otherwise contracts for, a sufficient complement of examiners with the experience and expertise needed to conduct detailed examinations of information security systems; and (5) completes the supervisory activities it has planned.

Select FHFA-OIG Reports Issued During FY 2018 on Supervision of Cybersecurity Matters:

- *As Allowed by Its Standard, FHFA Closed Three Fannie Mae Cybersecurity MRAs after Independently Determining the Enterprise Completed its Planned Remedial Actions* (AUD-2018-007, March 28, 2018).
- *FHFA Failed to Ensure Freddie Mac's Remedial Plans for a Cybersecurity MRA Addressed All Deficiencies; as Allowed by its Standard, FHFA Closed the MRA after Independently Determining the Enterprise Completed its Planned Remedial Actions* (AUD-2018-008, March 28, 2018).

FHFA is one of a number of federal agencies involved in a national effort to protect the critical infrastructure of the U.S. financial services sector. Computer networks maintained by federal government agencies have proven to be a tempting target for disgruntled employees, hackers, and other intruders. Over the past few years, cyber attacks against federal agencies have increased in frequency and severity. As cyber attacks continue to evolve and become more sophisticated and harder to detect, they pose an ongoing challenge for virtually every federal agency to fortify and safeguard its internal systems and operations.

As conservator of and supervisor for the Enterprises and supervisor for the FHLBanks, FHFA collects and manages sensitive information, including personally identifiable information, that it must safeguard from unauthorized access or disclosure. Equally important is the protection of its computer network operations that are part of the nation's critical financial infrastructure. FHFA is required to design information security programs to protect its computer networks. Our annual audits performed pursuant to the Federal Information Security Modernization Act of 2014 (FISMA) are intended to ensure FHFA's compliance with those standards and assist FHFA in strengthening protections over its network operations against those who would seek to attack its network.

For Fiscal Year 2017, an independent public accounting firm under contract with FHFA-OIG determined that FHFA's information security program complied with FISMA and with applicable Office of Management and Budget guidance and that sampled security controls demonstrated operating effectiveness. FHFA, like other federal agencies, faces challenges in enhancing its information security programs, ensuring that its internal and external online collaborative environments are restricted to those with a need to know, and ensuring that its third-party providers meet information security program requirements.

Select FHFA-OIG Report Issued During FY 2018 on FHFA's Internal Controls Over Information Technology:

- *Performance Audit of the Federal Housing Finance Agency's Information Security Program Fiscal Year 2017* (AUD-2018-001, October 17, 2017).

Challenge: Enhance Oversight of the Enterprises' Relationships with Counterparties and Third Parties

The Enterprises rely heavily on counterparties and third parties for a wide array of professional services, including mortgage origination and servicing. As the Enterprises and FHFA recognize, that reliance exposes the Enterprises to a number of risks, including the risk that a counterparty will not meet its contractual obligations, and the risk that a counterparty will engage in fraudulent conduct. FHFA has delegated to the Enterprises the management of their relationships with counterparties and reviews their management largely through its supervisory activities.

Our publicly reportable criminal investigations include inquiries into alleged fraud by different types of counterparties, including real estate brokers and agents, builders and developers, loan officers and mortgage brokers, and title and escrow companies.

In light of the financial, governance, and reputational risks arising from the Enterprises' relationships with counterparties and third parties, FHFA is challenged to effectively oversee the Enterprises' management of risks related to their counterparties.

Select FHFA-OIG Reports Issued During FY 2018 on FHFA's Oversight of the Enterprises' Relationships with Counterparties and Third Parties:

- *Fannie Mae and Freddie Mac Purchases of Adjustable-Rate Mortgages* (WPR-2018-001, January 4, 2018).
- *Enterprise Counterparties: Mortgage Insurers* (WPR-2018-002, February 16, 2018).
- *Enterprise Counterparties: Custodial Depository Institutions* (WPR-2018-003, March 27, 2018).
- *FHFA Should Address the Potential Disparity Between the Statutory Requirement for Fraud Reporting and its Implementing Regulation and Advisory Bulletin* (COM-2018-002, March 23, 2018).
- *FHFA Should Re-evaluate and Revise Fraud Reporting by the Enterprises to Enhance its Utility* (EVL-2018-004, September 24, 2018).

Management Concern: Sustain and Strengthen Internal Controls Over Agency and Enterprise Operations

FHFA's programs and operations are subject to legal and policy requirements common to federal agencies. Satisfying such requirements necessitates the development and implementation of, and compliance with, effective internal controls within the Agency.

In January 2019, there will be a leadership change upon the expiration of Director Watt's term. Key senior positions within FHFA have been filled on an acting capacity for a long period of time (e.g., Chief Operating Officer, Deputy Director of the Division of Conservatorship). Two senior agency officials were found to have violated FHFA's policies regarding leave and work schedules. Our work demonstrates that FHFA is challenged to ensure that its existing controls, including its written policies and procedures, are sufficiently robust, and its personnel are adequately trained on these internal controls and comply fully with them.

Both Enterprises have also announced significant leadership changes. Fannie Mae has stated that its Chief Executive Officer (CEO) will leave Fannie Mae by October 15, 2018, and Freddie Mac has stated that its CEO will depart during 2019. In addition, the terms of a number of Enterprise directors are set to expire by year end 2018.

Changes in leadership can lead to lack of attention to internal controls.

Select FHFA-OIG Reports Issued During FY 2018 on FHFA's Internal Controls over Agency Operations:

- *Audit of FHFA's Fiscal Year 2017 Government Purchase Card Program Found Several Deficiencies with Leased Holiday Decorations, and the Need for Greater Attention by Cardholders and Approving Officials to Program Requirements* (AUD-2018-011, September 6, 2018).
- *Summary of Administrative Inquiry: The Office of Inspector General's Review of Alleged Time and Attendance Fraud by Two Senior Agency Officials* (OIG-2018-005, September 24, 2018).
- *FHFA Needs to Strengthen Controls Over Its Employee Transportation Benefits Programs* (AUD-2018-013, September 25, 2018).
- *Audit of FHFA's Fiscal Year 2017 Government Travel Card Program: FHFA Needs to Emphasize Certain Program Requirements to Travelers and Approving Officials* (AUD-2018-014, September 25, 2018).

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For the coming year, our audits, evaluations, compliance reviews, and other work will focus on the challenges highlighted in this memorandum. Included in these efforts are verification testing on closed recommendations to independently determine whether FHFA has implemented in full the corrective actions it represented to us that it intended to take and following up on open recommendations.

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