FEDERAL HOUSING FINANCE AGENCY
OFFICE OF INSPECTOR GENERAL

Evaluation of FHFA's Oversight of Fannie Mae's Management of Operational Risk

Evaluation Report: EVL-2011-004

Dated: September 23, 2011

AT A GLANCE

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Why FHFA-OIG Did This Evaluation

The Federal Housing Finance Agency (FHFA or the Agency) is required to oversee the prudential operations of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively the Enterprises), and – through examinations – determine whether they operate in a safe and sound manner. Additionally, in September 2008, FHFA placed the Enterprises into conservatorships to preserve their assets and minimize taxpayer losses.

FHFA views operational risk management as an important financial safety and soundness challenge facing the Enterprises. The Agency defines operational risk as the risk of loss resulting from failed people, processes, or systems, or from external events (such as foreclosure abuses). In September 2008, FHFA issued guidance requiring the Enterprises to develop and implement programs to identify, report, and remedy operational risks. Effective operational risk management programs can assist FHFA's safety and soundness examiners to identify trends in such risks and focus their examinations accordingly.

FHFA has reported that Fannie Mae has not taken acceptable steps to establish an operational risk management program. FHFA's Office of Inspector General (FHFA-OIG) initiated this evaluation to assess FHFA's oversight of Fannie Mae's efforts to establish an acceptable operational risk management program.

What FHFA-OIG Recommends

FHFA-OIG recommends that FHFA closely monitor Fannie Mae's implementation of its operational risk management program; exercise its broad conservatorship or enforcement authority to compel Fannie Mae to establish an operational risk program, if the Enterprise fails to do so by the end of first quarter 2012; and ensure that Fannie Mae has qualified personnel to implement its plan.

What FHFA-OIG Found

Between 2006 and early 2011, FHFA and its predecessor agency repeatedly found that Fannie Mae had not established an acceptable and effective operational risk management program despite outstanding requirements to do so. Nonetheless, FHFA has not taken decisive action to compel Fannie Mae to create and administer an operational risk management program. As Fannie Mae's regulator and conservator, FHFA's authority over the Enterprises is broad and includes the ability to discipline or remove Enterprise personnel to ensure compliance with Agency mandates. But to date, FHFA has not exercised this or other authorities. Instead, FHFA has pursued the matter principally through less forceful supervisory means, such as conducting ongoing operational risk examinations and issuing Matters Requiring Attention, which were ineffective during the period.

Fannie Mae's lack of an acceptable and effective operational risk management program may have resulted in missed opportunities to strengthen the oversight of law firms it contracts with to process foreclosures. For example, in a May 2006 internal report, Fannie Mae learned that attorneys acting on its behalf in Florida and elsewhere had filed false documents in foreclosure proceedings. The report further stated that Fannie Mae did not oversee the quality of these attorneys' representation or the legal positions taken in their pleadings. Nonetheless, in a 2011 preliminary report FHFA concluded that Fannie Mae still had not acted on the recommendations to improve its attorney oversight contained in the 2006 report.

According to FHFA, Fannie Mae has recently made improvements in its operational risk program, and the Agency expects that the Enterprise will have an acceptable program in place no later than the first quarter of 2012. Given Fannie Mae's history of non-compliance, FHFA-OIG believes that the Agency must exercise maximum diligence and take forceful action to ensure that Fannie Mae meets the Agency's expectations in this regard. Otherwise, FHFA's safety and soundness examination program, as well as its delegated approach to conservatorship management, may be adversely affected.

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ABBREVIATIONS

CRO .... Chief Risk Officer

Fannie Mae.. Federal National Mortgage Association

FHFA .... Federal Housing Finance Agency

FHFA-OIG..................................... Federal Housing Finance Agency Office of Inspector General

Freddie Mac .... Federal Home Loan Mortgage Corporation

HERA.. Housing and Economic Recovery Act of 2008

MBS .... Mortgage-Backed Securities

MRA .... Matter Requiring Attention

OFHEO .... Office of Federal Housing Enterprise Oversight

Treasury .... U.S. Department of the Treasury

Federal Housing Finance Agency

Office of Inspector General

Washington, DC

PREFACE

FHFA-OIG was established by the Housing and Economic Recovery Act of 2008 (HERA), which amended the Inspector General Act of 1978. FHFA-OIG is authorized to conduct audits, investigations, and other studies of the programs and operations of FHFA; to recommend policies that promote economy and efficiency in the administration of such programs and operations; and to prevent and detect fraud and abuse in them. This evaluation is one in a series of audits, evaluations, and special reports published as part of FHFA-OIG's oversight responsibilities. It is intended to assess FHFA's oversight of Fannie Mae's development and implementation of an operational risk management program.

Fannie Mae and Freddie Mac are government-sponsored enterprises that support the nation's housing finance system. They do so by purchasing mortgages from loan sellers; in turn, the sales proceeds may be used to originate additional mortgages.

FHFA is required to oversee the prudential operations of the Enterprises and – through examinations – determine whether they operate in a safe and sound manner; maintain adequate capital and internal controls; foster liquid, efficient, competitive, and resilient housing finance markets; and operate in a manner consistent with the public interest. Additionally, in September 2008, FHFA placed the Enterprises into conservatorships to preserve and conserve their assets and minimize taxpayer losses.

According to an FHFA official, operational risk presents a considerable financial safety and soundness concern for the Enterprises. FHFA defines operational risk as "…exposure to loss from inadequate or failed internal processes, people, and systems, or from external events (including legal events)."[1] For example, an operational risk would include allegations reported in the summer of 2010 that: (1) Fannie Mae and Freddie Mac had failed to oversee adequately

[1] Enterprise Guidance on Operational Risk Management, September 2008.

their networks of law firms that process foreclosures on their behalf; and (2) some of those firms filed false documents in judicial foreclosure proceedings.[2]

The failure to effectively manage this operational risk has come at a cost to FHFA and the Enterprises. FHFA initiated targeted examinations of the Enterprises' oversight of their attorney networks, and the Enterprises have incurred legal costs associated with their alleged failure to manage the risks associated with them.

FHFA policy requires the Enterprises to develop programs to manage operational risks by identifying them, reporting them to their respective boards of directors and FHFA, and mitigating them. Moreover, FHFA safety and soundness examiners may use Enterprise operational risk reports and other materials to identify trends in operational risks and focus their examinations accordingly. The importance that FHFA places upon Enterprise operational risk management programs is highlighted by the fact that the Agency warned the Enterprises that their failure to establish such programs could subject them and their officers to supervisory enforcement actions, including civil monetary penalties and removal.

In its 2009 report to Congress, FHFA stated that Fannie Mae's program represented a "Critical Concern;"[3] this is the most serious regulatory classification of financial, non-financial, operational, and compliance weaknesses. FHFA further noted that Fannie Mae was not in compliance with a 2006 Consent Order – issued by FHFA's predecessor, the Office of Federal Housing Enterprise Oversight (OFHEO) – under which it was required to establish an operational risk management program by 2009. Specifically, FHFA stated that, "[w]eaknesses continued in the overall effectiveness of governance and oversight, risk reporting, program design, and program implementation, as evidenced by significant, high-profile operational events during the year."[4]

Levels of Concern
(in ascending order)
None or Minimal
Limited
Significant
Critical

Given the importance of Enterprise operational risk management to FHFA's examination program and to its delegated approach to managing the conservatorships,[5] FHFA-OIG initiated

[2] *Fannie and Freddie's Foreclosure Barons*, Mother Jones, August 4, 2010. FHFA officials said that the issues raised in the article and subsequent Agency examinations constitute operational risks.

[3] According to FHFA's *Division of Enterprise Regulation Handbook* dated June 16, 2009, "Enterprises with critical safety and soundness concerns exhibit severe financial, non-financial, operational, or compliance weaknesses."

[4] FHFA, *Report to Congress 2009*, May 25, 2010. *See* www.fhfa.gov/webfiles/15784/FHFA-RepToCongress52510.pdf. FHFA's 2008 report to Congress similarly stated that Fannie Mae had significant work to do to develop and implement a robust operational risk function.

[5] FHFA's philosophy is to delegate day-to-day operations to the Enterprises. On November 24, 2008, FHFA clarified its role as conservator by identifying Enterprise activities that require its approval in advance. These include, among others, reasonably foreseeable material increases in operational risk, actions deemed likely to cause significant reputational risk, and legal settlements with a value of $50 million or more. FHFA's Acting Director has

this evaluation to assess the Agency's oversight of Fannie Mae's efforts to develop an acceptable operational risk program.[6] FHFA-OIG found that:

- For the five-year period from 2006 until early 2011, FHFA repeatedly found that Fannie Mae had missed regulator-established deadlines for it to create and implement an acceptable and effective operational risk management program. Despite these repeated findings, FHFA has not taken decisive action to compel Fannie Mae to implement an acceptable and effective operational risk management program.

- Fannie Mae's lack of an acceptable and effective operational risk management program may have resulted in missed opportunities to correct weaknesses in the Enterprise's oversight of law firms that process foreclosures on its behalf. Some of those law firms allegedly engaged in fraudulent practices, such as filing false documents in foreclosure proceedings.

- FHFA officials claimed that, due to the Agency's oversight efforts, Fannie Mae has made recent improvements to its operational risk management program, and FHFA expects the Enterprise to have an approved program established by the end of the first quarter of 2012. However, given Fannie Mae's poor track record in developing and implementing such a program since at least 2006, FHFA-OIG believes that the Agency must exercise its broad conservatorship or enforcement authority to compel Fannie Mae to establish an acceptable and effective operational risk program if the Enterprise fails to do so by the end of first quarter 2012.

FHFA-OIG believes that the recommendations in this report will result in more economical, effective, and efficient operations. FHFA-OIG appreciates the assistance of all those who contributed to the preparation of this report.

This evaluation was led by Investigative Counsel Joseph Capone and Senior Policy Advisor Wesley Phillips.

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stated that, beyond these specified activities, the Enterprises are generally responsible for their daily operations and business activities despite their having been placed into conservatorships. Thus, FHFA will not use its sweeping powers under HERA to manage every aspect of the Enterprises' operations.

[6] This evaluation began as a survey of FHFA's oversight of the Enterprises' internal controls of their mortgage loan servicers' foreclosure prevention and loss mitigation efforts. Facts developed during the survey resulted in a more specific evaluation of FHFA's oversight of Fannie Mae's management of operational risk.

This evaluation report has been distributed to Congress, the Office of Management and Budget, and others and will be posted on FHFA-OIG's website, www.fhfaoig.gov.

Richard Parker
Acting Deputy Inspector General for Evaluations

BACKGROUND

Overview of the Enterprises and FHFA

Fannie Mae and Freddie Mac developed and support what is commonly known as the secondary mortgage market to fulfill their charter and legislative obligations to provide liquidity to, and support for, the national mortgage finance system. In the secondary mortgage market the Enterprises purchase mortgages that meet their underwriting criteria from loan sellers, such as banks and other mortgage originators. The loan sellers can then use the proceeds from these sales to originate additional mortgages. The Enterprises may hold the mortgages they purchase in their investment portfolios or securitize and sell them to investors as Mortgage-Backed Securities (MBS). In exchange for a fee, the Enterprises guarantee that the MBS investors will receive timely payment of principal and interest on their investments.

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 established risk-based and minimum capital standards for Fannie Mae and Freddie Mac. It also established housing goals for financing affordable housing in underserved areas. Additionally, it created OFHEO as a new regulator of the Enterprises with the responsibility to conduct examinations of them and to determine their capital levels.[7]

OFHEO required the Enterprises to develop operational risk management programs.[8] As envisioned by OFHEO, the Enterprises' operational risk management programs would feed data to its examiners who, in turn, would use the data to identify the level of – and trends in – operational risk at the Enterprises. OFHEO expected that both Enterprises would develop standardized programs to supply OFHEO with comparable information from which it could determine, for example, the relative effectiveness of each Enterprise's risk management and internal controls. Further, OFHEO planned to use Enterprise-generated operational risk data "in its continuous supervision program, to scope targeted exams, and as input for quarterly risk assessments and the determination of overall capital adequacy."[9]

On July 30, 2008, HERA abolished OFHEO[10] and established FHFA[11] in its place. Pursuant to HERA, FHFA is required to oversee the prudential operations of the Enterprises and – through

[7] *See* Public Law No. 102-550 § 1313.

[8] "These requirements [to collect operational event data and report it to OFHEO] are consistent with the safety and soundness responsibilities of OFHEO under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992." Letter to Richard F. Syron from Director, OFHEO, dated August 10, 2007.

[9] Id.

[10] *See* Public Law No. 110-343 § 1301. The completion of OFHEO's abolishment was envisioned to take 12 months, beginning with the enactment of HERA.

[11] *See* id. at § 1101.

examinations – to determine whether they operate in a safe and sound manner; maintain adequate capital and internal controls; foster liquid, efficient, competitive, and resilient housing finance markets; and operate consistent with the public interest.

On September 6, 2008, due to the Enterprises' mounting mortgage-related losses, FHFA determined that they were "critically undercapitalized" and, as provided for under HERA, placed them into conservatorships. As the Enterprises' conservator, FHFA assumed responsibility for preserving and conserving their assets. To fulfill its responsibility, HERA provides FHFA with all the powers of the Enterprises' shareholders, directors, and officers.[12]

On September 23, 2008, OFHEO/FHFA issued its *Enterprise Guidance on Operational Risk Management* (Guidance), noting that "the effective management of operational risk is required to support Enterprise safety and soundness."[13] The Guidance is based on special examinations of Fannie Mae and Freddie Mac initiated in 2003 and 2004, respectively. Those examinations revealed serious deficiencies in the way that the Enterprises managed their operational risk and categorized them as a "critical supervisory concern." Additionally, the Guidance formally requires the Enterprises to develop and implement operational risk programs.

FHFA's Examination Program is the Primary Means by Which the Agency Monitors the Enterprises' Financial Safety and Soundness

FHFA's safety and soundness examination program is the primary means by which the Agency monitors the Enterprises' financial conditions and operations. Pursuant to this program, FHFA conducts periodic examinations of the Enterprises to assess, among other things, their credit, market, and operational risk management programs and practices.[14] FHFA can take a variety of steps based on its examination findings to ensure that the Enterprises correct deficiencies noted by the examiners. Among them is the designation of a risk as a Matter Requiring Attention (MRA).

MRAs are used to identify issues of supervisory concern that warrant special attention by the Enterprise to ensure that corrective action is appropriately planned and executed. FHFA policy is to follow-up on MRAs to ensure that the Enterprise's response is appropriate, timely, and effective. Further, FHFA has regulatory authority to initiate formal enforcement actions, such as

[12] *See id*. at § 1145.

[13] *Enterprise Guidance on Operational Risk Management* (PG-08-002) at pp. 1-4.

[14] Credit risk is the risk that borrowers will default on their obligations such as mortgage loans. Market risk, which includes interest rate risk, arises from the adverse effects of changes in interest rates or foreign exchange rates. FHFA guidance states that market risk can also cause liquidity risk which arises when an Enterprise is unable to: (1) liquidate assets or obtain adequate funding in order to meet obligations when they come due; or (2) easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or large market disruptions.

the issuance of cease and desist orders and the imposition of civil monetary penalties, to compel the Enterprises to correct deficiencies identified in examinations or through other means. FHFA also has conservatorship authority to control and direct the Enterprises' operations, including the power to remove or replace personnel.

Definition of Operational Risk and the Key Components of an Effective Enterprise Risk Management Program

FHFA's definition of operational risk is broad and applies to the full range of the Enterprises' business activities. Operational risk is defined as, "…exposure to loss resulting from inadequate or failed internal processes, people, and systems, or from external events (including legal events)."[15]

Specific examples of Enterprise operational risk include:[16]

- <u>Outdated information technology systems.</u> Related deficiencies include system complexity, poor system integration, inadequate data management, and multiple interfaces that create the need for manual workarounds and multiple data reconciliation efforts. Inflexible, proprietary technology often necessitates the use of inefficient and poorly controlled end-user computers for long periods. FHFA has stated that such deficiencies have impeded the Enterprises' ability to close monthly financial statements, as well as convert certain mortgages into MBS.

- <u>Inadequate internal controls.</u> This deficiency involves the failure to manage and control a variety of operations and processes. For example, FHFA has stated that the Enterprises have not been able to consistently demonstrate robust and effective mortgage servicer performance management. Such oversight is essential because mortgage servicers perform a variety of functions on behalf of the Enterprises, including modifying delinquent mortgages and conducting foreclosures. Recently, the Enterprises have been subject to intense Congressional, public, and regulatory criticism for failing to oversee adequately the law firms they retained to conduct foreclosures, which is also an operational risk. As discussed later in this evaluation report, FHFA-OIG believes that Fannie Mae's failure to establish an acceptable and effective operational risk management program represents a potential missed opportunity to identify and correct abusive foreclosure practices at an earlier point in time.

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[15] Enterprise Guidance on Operational Risk Management (PG-008-002), September 23, 2008.

[16] The examples in this section are derived from FHFA's *Report to Congress 2010* (June 13, 2011). *See* http://www.fhfa.gov/webfiles/21570/FHFA2010RepToCongress61311.pdf.

The Guidance issued by OFHEO/FHFA on September 30, 2008, specified OFHEO/FHFA's expectations for the Enterprises' operational risk management programs and identified four key features for such programs:

a. Operational risk identification and assessment: Each Enterprise's board of directors should review and approve a definition of operational risk, and management is responsible for communicating it throughout the organization. Each Enterprise should also develop processes and mechanisms for identifying operational risks. These processes and mechanisms should include an operational event reporting system that is closely tied to a system by which to assess promptly the causes of such events. The Enterprises should also collect meaningful data to support cause and effect analyses and routinely validate and test its processes.

b. Measurement and modeling: Each Enterprise should develop models to provide management with accurate assessments of the magnitude and direction of identified operational risks. The models should be: (1) consistently applied throughout each Enterprise; (2) derived from valid data from adequate data systems; (3) tested for sensitivity to changes in data or assumptions; and (4) periodically validated by an independent party. The system should also be able to assess the potential financial losses associated with operational risks and events.

c. Reporting: Each Enterprise should develop a system under which operational risks are reported to management and the boards of directors to inform their assessments of the operational risks and permit them to identify corrective actions. Separate regulatory guidance dating from 2007, which remains in effect, requires the Enterprises to report operational events to FHFA.[17]

d. Risk management decision-making: Each Enterprise should select strategies by which to manage its operational risks including, among others, avoidance, transfer, mitigation, and monitoring. The selection of risk management strategies should be informed by the employment of one or more decision frameworks, such as cost benefit analysis. Further, the Enterprises should apply the decision frameworks consistently across their organizations.

[17] OFHEO established this policy in August 2007.

Operational Risk Management Program Requirements Offer Important Benefits for FHFA's Examination Program and Its Delegated Approach to Managing the Conservatorships

The requirement that the Enterprises establish effective operational risk management programs is intended, in part, to assist safety and soundness examiners to carry out their responsibilities. For example, an effective operational risk management program should enable FHFA examiners to identify the highest operational risks within an Enterprise; assess its internal controls in those areas; and evaluate its plans to mitigate identified risks. The effective management of operational risk is integral to support Enterprise safety and soundness.

FHFA-OIG also observes that the establishment of effective Enterprise operational risk management programs is critical given FHFA's limited examination resources. As stated in a previous FHFA-OIG report, FHFA faces significant examination staffing and capacity shortfalls.[18] These shortfalls, which tend to limit FHFA's capacity to carry out its safety and soundness regulatory responsibilities, may be mitigated by the Enterprises' ability to self-identify, report, and correct key operational risks.

Further, FHFA-OIG believes that the establishment of effective operational risk management programs is important to the success of FHFA's delegated approach to managing the Enterprises' conservatorships. As their conservator, FHFA largely relies on the Enterprises to effectively manage their own day-to-day operations and normal business activities.[19]

FHFA Repeatedly Found that Fannie Mae Did Not Establish an Acceptable and Effective Operational Risk Management Program

FHFA repeatedly concluded from 2006 through early 2011 that Fannie Mae did not establish an acceptable and effective operational risk management program. Despite the importance of such a program, FHFA did not take adequate steps to compel Fannie Mae to establish an acceptable and effective program during that period.

FHFA's predecessor agency, OFHEO, completed a special examination of Fannie Mae in 2006. It identified significant concerns about Fannie Mae's risk management, financial reporting, internal controls, and corporate governance. OFHEO found that Fannie Mae management placed a higher priority on meeting specific earnings goals than it did on ensuring proper accounting, risk management, internal controls, and complete and accurate financial reporting. Further,

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[18] *See* FHFA-OIG, *Federal Housing Finance Agency's Exit Strategy and Planning Process for Enterprises' Structural Reform* (EVL-2011-001, March 31, 2011).

[19] The scope of this evaluation does not include assessing merits or results of FHFA's delegated approach to managing the Enterprises' conservatorships, and FHFA-OIG makes no conclusions on such approach in this report.

OFHEO concluded that Fannie Mae avoided making the investments needed to develop systems and policies by which to ensure compliance with applicable accounting standards.

To address Fannie Mae's operational weaknesses and other deficiencies noted in the special examination report, OFHEO and the Enterprise entered into a Consent Order in May 2006. With respect to operational risk management, the Consent Order required that:

> ***Consent Order***
> *is a type of formal agreement intended to ensure that appropriate corrective action is taken*

- Fannie Mae shall maintain a Chief Risk Officer (CRO). The CRO shall direct a risk management organization with responsibility for overseeing risk management for financial and operational risk throughout Fannie Mae. The CRO shall report directly to the Chief Financial Officer and independently to the Risk Policy and Capital Committee of the Board; and

- Fannie Mae shall provide to OFHEO within 180 days of the Consent Order a plan for the build out of the Enterprise's operational risk oversight function over the succeeding three years. Fannie Mae shall move expeditiously to implement the plan.

Fannie Mae submitted to OFHEO an operational risk management program in November 2006, but the Enterprise did not implement the plan.

On May 6, 2008, OFHEO terminated the 2006 Consent Order; however, Fannie Mae's obligation to establish and implement an operational risk management plan remained in place and was unaffected by the termination. Specifically, OFHEO's letter stated that it would continue to assess the implementation of Fannie Mae's operational risk management program over the succeeding two years in accordance with the requirements set forth in the Consent Order. OFHEO added that Fannie Mae's operational risk management program would receive heightened focus via the examination process. In response, Fannie Mae acknowledged its continuing obligation to create and administer such a plan.

Nonetheless, throughout the years that followed Fannie Mae did not create an acceptable and effective plan and neither OFHEO nor FHFA used their considerable enforcement powers (nor did FHFA use its broad conservatorship authority) to compel Fannie Mae to do so. FHFA documented Fannie Mae's non-compliance, as follows:

(a) FHFA's September 2008 Letter to Fannie Mae Identifying Deficiencies in Its Operational Risk Management Program

On September 4, 2008, two days before placing Fannie Mae into conservatorship, FHFA sent Fannie Mae a letter criticizing many aspects of its operations. FHFA stated that Fannie Mae's infrastructure, including its information technology systems, were inadequate, and that the Enterprise lacked the controls necessary to manage new products and their associated risks. FHFA also noted that Fannie Mae's operational risk management framework was not fully established.

(b) FHFA's 2008 Examination of Fannie Mae – Operational Risk Management Findings

In its 2008 Report of Examination, FHFA rated Fannie Mae's operational risk management oversight as a "significant concern." According to FHFA guidance, a "significant concern" means that Fannie Mae's operational risk management program exhibited "more than moderate … weaknesses." FHFA also found that it would take Fannie Mae a "significant" amount of work to create an acceptable program. Finally, FHFA cited changes in Fannie Mae's operational risk management leadership as a factor contributing to delays in improving compliance in this area.

(c) FHFA's May 2009 Review of Fannie Mae and the Opening of Three MRAs Pertaining to Operational Risk Management Deficiencies

In a May 2009 letter to Fannie Mae, FHFA again rated Fannie Mae's operational risk management program a "significant concern" and noted a number of weaknesses in it that undermined the Enterprise's capacity to identify and correct operational risks. FHFA further noted that the board of directors and Enterprise senior management did not exercise effective oversight of the program, the establishment of which was well behind the three-year schedule set forth in the 2006 Consent Order.

On the basis of the 2009 review, FHFA opened three MRAs concerning Fannie Mae's operational risk management program. The first MRA required Fannie Mae to strengthen its operational risk management governance and oversight, the second required it to develop an operational risk management program, and the third required it to implement the program.[20]

FHFA also opened a fourth MRA pertaining to the frequency of operational reporting in a July 2009 letter to Fannie Mae. FHFA officials said that they closed this MRA in December 2010 because Fannie Mae was "technically" in compliance with it. Specifically, FHFA said that Fannie Mae had increased the reporting of operational risks to its board of directors, but that the quality of its reporting required improvement.

[20] FHFA policy states that MRAs are issues of supervisory concern that warrant special attention by the Enterprise to ensure that corrective action is appropriately planned and executed. FHFA policy also states that the Agency will follow-up on MRAs to ensure that the Enterprises' responses are appropriate, timely, and effective.

(d) FHFA's Fourth Quarter 2009 Analysis of Fannie Mae's Operational Risk Oversight Deficiencies

On December 15, 2009, FHFA issued its fourth quarter 2009 analysis of Fannie Mae's operational risk oversight, which resulted in the Agency increasing its level of concern from "significant" to "critical" – the most severe rating. FHFA concluded that Fannie Mae had failed to develop an operational risk management program within three years as required by the 2006 Consent Order. The Agency also identified a number of weaknesses in Fannie Mae's operational risk governance and design, and it noted that Fannie Mae's management had been slow to recognize these weaknesses. Consequently, FHFA determined that Fannie Mae was not in compliance with the three MRAs pertaining to operational risk deficiencies.

(e) FHFA's 2009 Report of Examination of Fannie Mae Identifying Ongoing Operational Risk Management Deficiencies

In its 2009 Report of Examination, FHFA again rated Fannie Mae's operational risk oversight as a "Critical Concern." The examiners determined that Fannie Mae still had not established an acceptable and effective operational risk management program. Specifically, the examiners found that the Enterprise's efforts to improve its operational risk management were only in the early stages of development.[21]

(f) FHFA's September 8, 2010, Non-Compliance Letter Regarding the Three 2009 MRAs Pertaining to Operational Risk

On September 8, 2010, FHFA issued a non-compliance letter to Fannie Mae advising that the three operational risk MRAs issued after the Agency's May 2009 review remained open. Further, FHFA concluded that the third MRA (Operational Risk Management Program Implementation) "will remain open until Fannie Mae effectively demonstrates that the operational risk management tools are influencing and affecting the behavior of Fannie Mae managers and employees."

(g) FHFA's 2010 Report of Examination of Fannie Mae Again Rating Operational Risk as a "Critical Concern" and Noting the Enterprise's Non-Compliance with OFHEO's 2006 Consent Order

FHFA's 2010 Report of Examination issued on April 1, 2011, again rated Fannie Mae's operational risk oversight as a "Critical Concern." The report found, among other things, that Fannie Mae had not developed an acceptable operational risk management program as required by the 2006 Consent Order and the three MRAs. FHFA concluded that Fannie Mae had not

[21] Fannie Mae responded to the examiners that it expected to have its operational risk management program in place by the end of 2010, but it ultimately failed to meet this deadline.

demonstrated the ability to comply with Agency guidance on developing an operational risk management program.

(h) FHFA Stating that Fannie Mae Has Made Recent Improvements in Developing an Operational Risk Management Program, but the Program's Full Implementation Is Not Expected Until the End of the First Quarter of 2012

Although a first quarter 2011 FHFA analysis continued to rate Fannie Mae's operational risk management program as a "Critical Concern,"[22] Agency officials stated that the Enterprise has recently taken steps toward developing an acceptable program. These steps involve developing a basic framework that includes executive leadership, an operational risk reporting framework, and dedicated resources. FHFA officials also stated that Fannie Mae reports operational incidents on a quarterly basis pursuant to established requirements.[23]

FHFA officials also said that the Agency has taken steps to ensure that Fannie Mae has improved its development and implementation of an operational risk management program. In particular, FHFA officials said that they have kept open the three MRAs pertaining to Fannie Mae's operational risk management program as a means to persuade Fannie Mae's board of directors and senior managers to develop and implement an acceptable and effective operational risk management program. FHFA officials added that they have held meetings with Fannie Mae to stress the importance of an acceptable and effective operational risk management program. FHFA-OIG, however, does not believe that FHFA's supervisory strategy of maintaining open MRAs, which have been unresolved for years, has been demonstrated to be an effective means to ensure Fannie Mae's implementation of an acceptable and effective operational risk program.

FHFA officials added that they will continue to monitor closely Fannie Mae's implementation of its risk management program and expect it to be completed no later than the first quarter of 2012. FHFA officials also said that, given the importance of Enterprise operational risk management programs, the Agency and Fannie Mae will act decisively if the Enterprise fails to implement its program on schedule.

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[22] FHFA officials also said that Fannie Mae "had not developed all the fundamentals of a successful, mature operational risk program" and, as a result, the Enterprise did not "provide senior management and the Board of Directors with actionable information on the operational risks facing [it]." *See* Division of Enterprise Regulation Memorandum to File, dated March 31, 2011.

[23] Moreover, FHFA officials said that Fannie Mae had made significant improvements with respect to mitigating operational risks associated with information security, data management, information technology infrastructure, and related operational incidents.

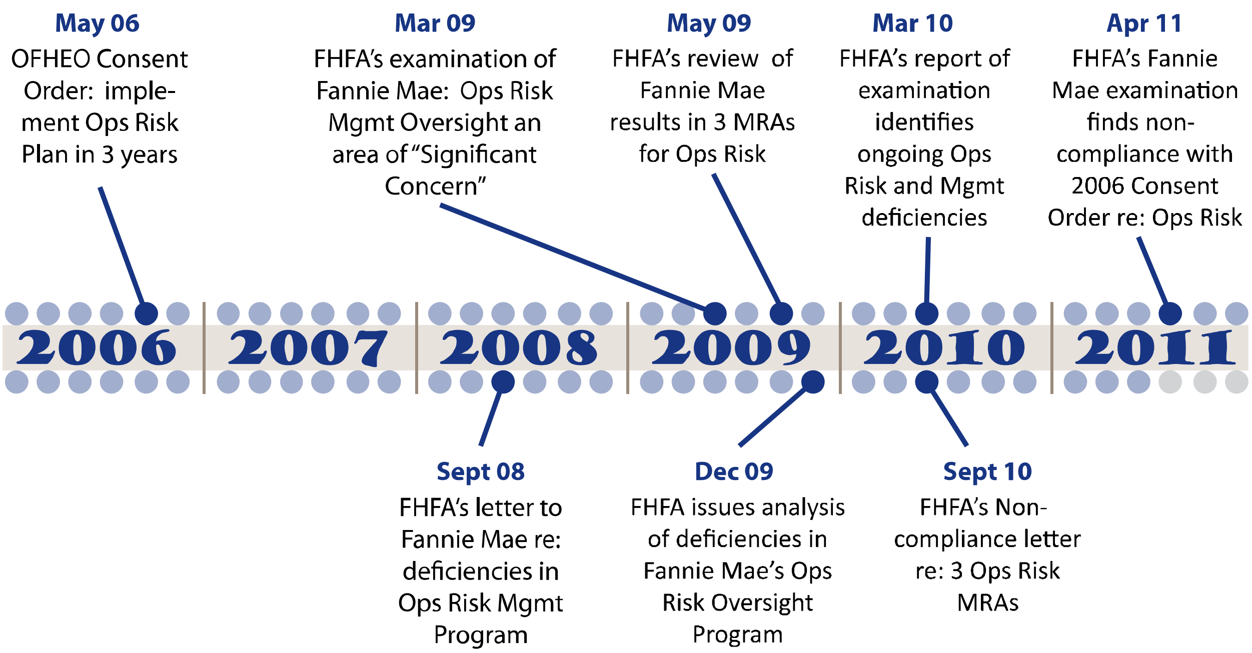
FINDINGS

FHFA-OIG finds that:

1. FHFA Repeatedly Found that Fannie Mae Had Not Developed an Acceptable and Effective Operational Risk Management Program, but FHFA Did Not Take Decisive Steps to Ensure Compliance by the Enterprise

From 2006 through early 2011, FHFA – and its predecessor, OFHEO – repeatedly found that Fannie Mae had not established an acceptable and effective operational risk management program, despite outstanding requirements to do so as reflected in the timeline contained in Figure 1, below.

Figure 1: Timeline Regarding FHFA's Identification of Operational Risk Management Deficiencies at Fannie Mae



Despite these ongoing findings over a five year period, neither FHFA nor OFHEO took decisive steps to ensure compliance. For instance, as the Enterprises' conservator, FHFA has broad authority to control and direct the Enterprises' operations, including removing and replacing personnel. As regulator, FHFA may issue cease and desist orders and levy fines to ensure compliance with Agency mandates. To date, however, the Agency has not exercised any of these authorities.[24] Rather, FHFA relied upon less forceful supervisory measures, such as issuing MRAs, which have not proven to be effective.

2. Foreclosure Processing Abuses in Florida and Elsewhere Illustrate the Potential Negative Consequences of Fannie Mae's Failure to Establish an Effective Operational Risk Management Program

Fannie Mae's lack of an acceptable and effective operational risk management program may have resulted in missed opportunities to identify and correct timely weaknesses in the Enterprise's oversight of law firms in its Retained Attorney Network. Some of these law firms allegedly filed false documents and engaged in other foreclosure processing abuses in Florida and elsewhere. For example, in 2005, Fannie Mae hired an outside law firm to investigate a variety of allegations referred by one of its investors regarding purported foreclosure processing abuses and other matters. In May 2006, the law firm issued a report of investigation in which it found that certain law firms that represented Fannie Mae in foreclosures filed false documents in foreclosure proceedings in Florida and elsewhere. The report referred to such practices as "unlawful" and stated that they were unauthorized by Fannie Mae and should be stopped.

Further, the report observed that Fannie Mae did not take steps to ensure the quality of its foreclosure attorneys' conduct, the legal positions taken in the attorneys' pleadings, or the manner in which the attorneys processed foreclosures on the Enterprise's behalf.

The report noted that Fannie Mae was developing a computer system to improve communication within its attorney network and more effectively monitor the conduct of its counsel.[25] But the report also noted that the development and implementation of the computer system was not expected to be completed in the near-term.

Operational Risk
is exposure to loss resulting from inadequate or failed internal processes, people, and systems, or from external events (including legal events)

[24] FHFA officials advised FHFA-OIG that FHFA is not inclined to issue cease and desist orders and levy fines when the Enterprises are in conservatorship.

[25] Fannie Mae officials told FHFA-OIG that they had initiated other corrective actions in response to the internal report's conclusions, including initiating teleconferences with law firm officials on appropriate foreclosure processing steps and conducting relevant training at mortgage industry trade shows.

In late 2010, FHFA initiated a special review of Fannie Mae's oversight of its attorney network; and in early 2011 preliminarily concluded that the Enterprise's controls over the network were inadequate. FHFA specifically noted that Fannie Mae was alerted in May 2006 by the internal report that some of its foreclosure attorneys were sacrificing accuracy for speed, *i.e.*, filing false documents in foreclosure proceedings. FHFA also stated that it had found no evidence that Fannie Mae's receipt of this information caused the Enterprise to make any improvements in its oversight of its law firms. Further, FHFA found that Fannie Mae never developed and implemented the computer system that was identified in the 2006 internal report as a potential means to improve its oversight of the law firms. Consequently, this evidence from FHFA's review suggests that Fannie Mae did not take sufficient steps in response to the 2006 report to mitigate the operational risks associated with its foreclosure processing attorney network.

FHFA-OIG cannot establish whether Fannie Mac complied with another key requirement of an operational risk management program: notifying its regulator of the 2006 report or submitting it to the regulator. Fannie Mae officials claim that they informed an OFHEO senior official of the report during a telephone conversation in 2006, but they have no record of the communication. The OFHEO official, who now works for FHFA, has no records or recollection of the conversation. In any event, neither Fannie Mae nor its regulator acted on the 2006 report, and FHFA examination officials informed FHFA-OIG that they did not learn of the 2006 report until after it was disclosed in a March 2011 newspaper article.

In summary, FHFA-OIG views the circumstances surrounding Fannie Mae's 2006 report on foreclosure processing abuses as a missed opportunity to address an important operational risk at an early stage. Per FHFA's guidance, one of the essential elements of an operational risk program is the Enterprise's development of strategies to correct identified operational risks. FHFA's preliminary 2011 examination findings indicate that, after learning of its attorneys' misconduct in 2006, Fannie Mae did not develop and implement a strategy to improve its oversight of this portion of its operation. FHFA further concluded that Fannie Mae did not deploy the computer system that was intended to enhance its attorney oversight. Moreover, if OFHEO or FHFA had received Fannie Mae's 2006 report, as would be consistent with operational risk guidance, then the regulators might have been in a position to assess the risks involved, determine whether Freddie Mac's attorneys engaged in similar practices (as turned out to be the case), and ensured that the Enterprises took actions to better oversee their attorneys and possibly prevent foreclosure processing abuses.

3. FHFA Must Ensure that Fannie Mae Fully Implements Its Operational Risk Management Program

A first quarter 2011 FHFA review of Fannie Mae's operational risk management program continued to classify it as a "critical concern." However, FHFA officials told FHFA-OIG that Fannie Mae has taken positive steps in 2011 to implement an acceptable program. The FHFA officials said that Fannie Mae has new senior officers responsible for operational risk management and that they have developed a new management program. FHFA officials also said that FHFA has closely monitored Fannie Mae's progress and that under Fannie Mae's schedule its program should be in place no later than the end of the first quarter of 2012.

Further, FHFA officials also said that, given the importance of Enterprise operational risk management programs, the Agency will act in a decisive fashion if Fannie Mae fails to implement its program on schedule.[26] FHFA-OIG believes that, as Fannie Mae's conservator and regulator, FHFA must closely monitor Fannie Mae's progress and take decisive action if necessary. Given Fannie Mae's five-year history of noncompliance, there is good reason to question whether Fannie Mae will meet its first quarter 2012 deadline. If it fails to do so, FHFA should penalize Fannie Mae and its officers for their nonfeasance.

[26] FHFA's General Counsel said that if Fannie Mae does not implement its program, the Agency could employ its conservatorship authorities under HERA to control and direct Fannie Mae's operations, as opposed to its formal regulatory enforcement authorities, such as civil money penalties. The General Counsel noted that as Fannie Mae's conservator FHFA could remove and replace culpable risk officials, or more likely direct Fannie Mae's board of directors to do so.

CONCLUSION

FHFA and its predecessor have tolerated five years of delay by Fannie Mae, which has been under directives to establish and implement an acceptable and effective operational risk management program. FHFA possesses the authority through a variety of mechanisms to enforce its directives. However, to date, FHFA has not taken decisive action to compel the Enterprise's compliance. Fannie Mae's lack of such a program creates potentially significant risks for Fannie Mae and FHFA.

RECOMMENDATIONS

FHFA-OIG recommends that FHFA:

- Closely monitor Fannie Mae's implementation of its operational risk management program;
- Take decisive and timely actions to ensure the implementation of the program if Fannie Mae fails to establish an acceptable and effective operational risk program by the end of the first quarter 2012; and
- Ensure that Fannie Mae has qualified personnel in place to ensure continuing compliance with its operational risk management program.

SCOPE AND METHODOLOGY

The objective of this evaluation was to assess FHFA's oversight of Fannie Mae's efforts to develop an acceptable operational risk management program.

To address these objectives, FHFA-OIG staff reviewed FHFA and OFHEO Guidance pertaining to the development of operational risk management programs as well as a May 2006 Consent Order between Fannie Mae and OFHEO. Further, FHFA-OIG reviewed FHFA examination reports and other related documentation for the period covered in the evaluation.

Additionally, FHFA-OIG staff interviewed senior officials within FHFA responsible for monitoring and examining Fannie Mae's operational risk program. FHFA-OIG officials also spoke with senior Fannie Mae officials regarding a 2006 report prepared for the Enterprise on its oversight of attorneys who conduct foreclosures on its behalf and foreclosure processing practices in Florida and elsewhere. FHFA-OIG staff analyzed the extent to which Fannie Mae's failure to establish an operational risk management program was illustrated by the circumstances surrounding the Enterprise's 2006 internal report.

This evaluation was conducted under the authority of the Inspector General Act and in accordance with the Quality Standards for Inspection and Evaluation (January 2011), which was promulgated by the Council of Inspectors General on Integrity and Efficiency. These standards require FHFA-OIG to plan and perform an evaluation that obtains evidence sufficient to provide reasonable bases to support the findings and recommendations made herein. FHFA-OIG trusts that the findings and recommendations discussed in this report meet these standards.

The performance period for this evaluation was from February 2011 to September 2011.

FHFA-OIG provided FHFA staff with briefings and presentations concerning the results of its fieldwork and provided FHFA an opportunity to respond to a draft report of this evaluation. FHFA's comments on FHFA-OIG's draft report are reprinted in their entirety at Appendix A.

FHFA-OIG appreciates the efforts of FHFA and Fannie Mae management and staff in providing information and access to necessary documents to accomplish this evaluation.

APPENDIX A

FHFA'S Comments on Findings and Recommendation

Federal Housing Finance Agency

MEMORANDUM

TO: Richard Parker, Deputy Inspector General for Evaluations (Acting)

FROM: Elizabeth Scholz, Associate Director
Office of Examination Support, Operational Risk

SUBJECT: FHFA Comments on "Evaluation of FHFA's Oversight of Fannie Mae's Management of Operational Risk" Report

Thank you for the opportunity to provide formal agency comments on this report.

While we generally agree with the recommendations in the report which are consistent with our supervisory actions and plans, we do not believe that the characterization of FHFA's oversight and the characterization of the status of the Fannie Mae operational risk program fully reflect all facts and context. Further, FHFA would not agree with the finding that implies foreclosure abuses may have been prevented if Fannie Mae established an effective operational risk program. We will limit our formal response to the findings and the recommendations in the report, given that FHFA provided more detailed feedback directly to OIG for consideration.

OIG Findings

The OIG presents three findings in the report.

Finding 1: *FHFA repeatedly found that Fannie Mae had not developed an acceptable and effective operational risk program, but FHFA did not take decisive steps to ensure compliance on the part of the enterprise.*

FHFA took a series of supervisory actions to force Fannie Mae to create a more mature and effective operational risk oversight program. This included a series of progressive actions, including a factor in the Conservatorship actions in 2008, and subsequent formal Matters Requiring Attention (MRAs), proactive and continuous supervision, management escalations and Board discussion. These actions result in management decisions regarding assignments, evaluations and compensation. In fact, in early 2011 a new executive team was installed to lead Operational Risk Oversight at Fannie Mae. FHFA is closely supervising the transition and progress in this area.

FHFA, under conservatorship, has extensive authorities. FHFA does not believe the cease and desist actions or fines, as suggested in the report, would produce better results.

Finding 2: *Foreclosure abuses in Florida and elsewhere illustrate the potential negative consequences of Fannie Mae's failure to establish an effective operational risk program.*

FHFA shares the OIG's concerns regarding industry foreclosure abuses. However, this finding implies that the abuses that took place in Florida and elsewhere might not have occurred had Fannie Mae established an effective operational risk program. Unfortunately, the primary issue with foreclosure abuses was that servicers and attorneys did not honor their respective obligations. Servicers and attorneys were obligated under contractual agreements to comply with applicable laws, regulations, and rules. Moreover, attorneys are subject to ethical rules imposed by state licensing bodies, and local court rules that prohibit the filing of fraudulent pleadings. Clearly, there were breakdowns in a number of areas within the industry that contributed to the well-publicized foreclosure abuses. An effective operational risk program would not have *prevented* servicing personnel and licensed attorneys from engaging in improper, unethical or fraudulent practices.

Finding 3: *FHFA must ensure that Fannie Mae fully implement its operational risk management program*

FHFA required Fannie Mae to develop a more effective operational risk oversight program through its supervisory actions. We believe, through our supervisory actions, Fannie Mae is achieving progress in this area. Improvements to the program are the primary focus of our supervisory efforts.

FHFA is concerned that some parts of the OIG report might lead the reader to believe Fannie Mae did not have any program for years. That would be incorrect, Fannie Mae has an Operational Risk Oversight Office in place, with executive leadership, extensive reporting, dedicated resources, and dedicated infrastructure that includes Committee structures, Board reporting, Risk and Control Self Assessments, and reporting on key risks with formal remediation plans.

OIG Recommendations

The OIG makes three recommendations in the report.

Recommendation 1: *Closely monitor Fannie Mae's implementation of its operational risk management program.*

FHFA agrees that Fannie Mae needs to continue to improve the existing program. This is consistent with our past and current supervisory activities. We will continue to closely monitor Fannie Mae's progress through the MRA remediation process and ongoing exam activities. As new executives were installed at the beginning of 2011, a plan for improvements and key deliverables are being closely monitored by FHFA.

Recommendation 2: *Take decisive and timely actions to ensure the implementation of the program if Fannie Mae fails to establish an acceptable level and effective operational risk program by the end of the first quarter 2012.*

FHFA will continue to take actions as appropriate to monitor Fannie Mae's progress and effectiveness in the operational risk oversight program. FHFA continues to engage with executives and the Board to improve its operational risk program, and FHFA will continue to take formal and informal actions as necessary.

Recommendation 3: *Ensure that Fannie Mae has qualified personnel in place to ensure continuing compliance with its operational risk management program.*

FHFA agrees with the recommendation. A newly installed (early 2011) executive team is under close supervision, we continue to closely supervise progress in training, reporting and controls surrounding the operational risk oversight program.

APPENDIX B

FHFA-OIG'S Response to FHFA'S Comments

FHFA-OIG is pleased that FHFA generally agrees with the report's recommendations to:

- Closely monitor Fannie Mae's implementation of its operational risk management program;
- Take decisive and timely actions to ensure the implementation of the program if Fannie Mae fails to establish an acceptable and effective operational risk management program by the end of the first quarter of 2012; and
- Ensure that Fannie Mae has qualified personnel in place to ensure continuing compliance with its operational risk management program.

But FHFA states that the draft report's characterization of the Agency's oversight efforts and Fannie Mae's operational risk management program do not fully reflect all the facts and the context.

1. FHFA disputes FHFA-OIG's finding that FHFA did not take decisive steps to ensure that Fannie Mae established an acceptable and effective operational risk management program. Further, FHFA states that it has extensive conservatorship authorities and that it does not believe that cease and desist orders or fines, as suggested in the report, would produce better results.

   FHFA-OIG revised the draft report to reflect some of FHFA's concerns, but stands behind its assertions that the Agency did not take decisive action to compel Fannie Mae to establish an acceptable and effective operations risk program. By May 2009, Fannie Mae was in substantial non-compliance with the May 2006 OFHEO Consent Order under which it was required to establish an operational risk management program within three years. Rather than use its extensive conservatorship or regulatory powers at that point (for example, FHFA could have directed Fannie Mae to discipline or remove employees for non-compliance), FHFA chose a less forceful supervisory approach, which included opening MRAs and using them as a means to "compel" Fannie Mae to develop an acceptable and effective program. Nevertheless, more than two years later, Fannie Mae has yet to comply. Further, it remains to be seen whether Fannie Mae will meet FHFA's expectations of having an acceptable and effective operational risk management program in place by the end of the first quarter of 2012 – six years after FHFA's predecessor commenced efforts to gain Fannie Mae's compliance.

2. FHFA disagrees with FHFA-OIG's finding that foreclosure abuses in Florida and elsewhere illustrate the potential negative consequences of Fannie Mae's failure to establish an acceptable and effective operational risk management program.

   FHFA-OIG revised the draft report text to state that Fannie Mae's lack of an acceptable and effective operational risk management program may have resulted in missed opportunities to correct the Enterprise's weak oversight of its Retained Attorney Network. In this regard, FHFA-OIG reiterates that FHFA's special review of Fannie Mae's oversight of the attorney network concluded that Fannie Mae did not act on information contained in its 2006 internal report, which found that law firms in Florida and elsewhere were sacrificing accuracy for speed (*i.e.*, filing false documents in foreclosure proceedings) and that its oversight of the firms' litigation practices were weak. FHFA-OIG contends that strengthened law firm oversight by Fannie Mae could have detected – if not prevented – these abuses by attorneys.

3. FHFA disputes FHFA-OIG's finding that it must ensure that Fannie Mae implement an operational risk management program. FHFA states the draft report could lead readers to conclude that Fannie Mae did not have an operational risk program in place for years when, in fact, executive leadership, extensive reporting, and dedicated resources were in place.

   FHFA-OIG added the phrase "acceptable and effective" before "operational risk program" throughout the report, as appropriate.

ADDITIONAL INFORMATION AND COPIES

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