

## **CHAPTER 2**

# **OFHEO'S COMPREHENSIVE, ANNUAL, RISK-BASED EXAMINATION PROGRAM**

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OFHEO reached a new milestone for its safety and soundness examinations of the Enterprises in January 1998. Beginning in January, OFHEO transitioned from its initial cycle of core examinations covering discrete areas of risk at the Enterprises to its comprehensive, annual, risk-based examination program.

This chapter first describes in detail OFHEO's *comprehensive, annual, and risk-based* examination program. The chapter then describes the process OFHEO examiners use to conduct examinations in this program.

## OFHEO's Examination Program

OFHEO's approach to examinations recognizes that the Enterprises must accept risks in order to meet their public purposes of providing a secondary mortgage market for conforming mortgages.<sup>1</sup> OFHEO determines whether the risks assumed by the Enterprises are warranted. As a key part of making this judgment, examiners evaluate whether the Enterprises knowingly accept risks and have the capacity to identify, measure, monitor, and control or alter risks on an ongoing basis. An Enterprise that, in OFHEO's opinion, appropriately identifies, measures, monitors, and controls or alters its risks and effectively prices those risks would be considered to operate in a safe and sound manner. If OFHEO were to conclude that an Enterprise was not operating in a safe and sound manner, OFHEO would take appropriate action to ensure the Enterprise's continued operation was not jeopardized.

### Comprehensive

OFHEO's *comprehensive*, annual, risk-based examination program is designed to capture all areas of risk and risk management in the Enterprises. As described in detail later in this chapter, OFHEO has segmented the sources of risk into 10 program areas that roll up into four categories of risk and risk management. OFHEO will render the following judgments on each of the 10 program areas:

- The appropriateness of the levels of risk;
- The appropriateness of Board of Directors and Executive Management governance;
- The adequacy of the policies, procedures, and limits intended to mitigate risk;
- The appropriateness of the risk selection, measurement, and reporting mechanisms;
- The adequacy of the framework for internal controls;
- The quality of issue resolution; and
- The effectiveness of risk-taking and risk management initiatives.

### Annual

OFHEO's comprehensive, *annual*, risk-based examination program is designed so that an examination cycle corresponds to one calendar year. Between January 1 and December 31, OFHEO will assess risk and risk management of both Enterprises in the 10 program areas covering all areas of risk. This will enable OFHEO to assess, every year, all areas of risk on a timely basis and communicate its findings to each Enterprise.

## **Risk-Based**

OFHEO's examination program has always been *risk-based* and will continue to be so. Largely through its initial set of core risk examinations, OFHEO gained a thorough understanding of the risks, business strategies, organizational structures, and cultures at the two Enterprises. A risk-based examination approach promotes the effective use of OFHEO resources by focusing on areas of relatively high risk in each Enterprise. Examiners pay particular attention to those risks that represent a current or potential threat to the stable operations of an Enterprise.

As described below, OFHEO's examiners assess all areas of risk in the Enterprises. The risk-based focus allocates more OFHEO resources to the highest areas of risk in each Enterprise. This facilitates OFHEO's ability to take corrective action before issues pose a financial threat to an Enterprise, thus furthering the goal of protecting the United States taxpayer.

OFHEO's risk-based examination approach is flexible and allows OFHEO to adjust its oversight focus as conditions change in the Enterprise, industry, or economy. Finally, this approach allows examiners to evaluate Enterprise actions and initiatives against established standards and to determine whether an Enterprise engages in an activity in a safe and sound manner.

## **OFHEO's Examination Principles**

OFHEO has adopted six examination principles to implement its comprehensive, annual, risk-based examination program. These principles add transparency to the examination process. The six principles, which are set out below, guide the implementation of OFHEO's examination program and its assessment of risk and risk management at the Enterprises.

1. Effective examination (which incorporates all examination-related activities) evaluates the existing financial condition and state of risk management and attempts to anticipate the onset of potential issues or problems that have the capacity to adversely impact the financial health of an Enterprise.
2. Effective examination requires each Enterprise's management to exercise a degree of oversight and control that is commensurate with the risks at that Enterprise.
3. Effective examination focuses examination resources on those areas where errors are pervasive, result from intentional disregard, or could impair the financial health of an Enterprise.
4. Effective examination incorporates the opportunity to share with each Enterprise the regulator's unique perspective on best practices and emerging issues, promoting operations and performance enhancements through sharing knowledge.
5. Effective examination is goal- and results-oriented and does not rigidly prescribe the means by which an Enterprise achieves the desired goals or results.
6. Effective examination uses the regulator's resources efficiently and does not impose unwarranted costs on an Enterprise.

## **A Quality Examination Force**

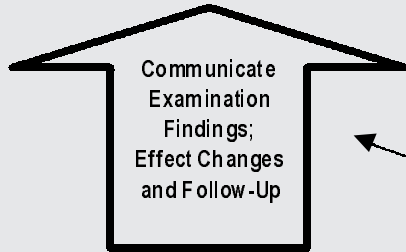
Achieving OFHEO's examination program goals critically depends on OFHEO's continued ability to be staffed by talented individuals who have the ability to render judgments on complex safety and soundness issues. OFHEO is committed to maintaining a high quality examination force that has the capacity to assess risks and risk management in the increasingly sophisticated Enterprises.

## **The Examination Process**

The manner in which OFHEO conducts its comprehensive, annual, risk-based examinations is depicted on the chart on the next page and in the discussion that follows. The description starts with the bottom of the chart and concludes with the arrow at the top.



**OFHEO'S COMPREHENSIVE, ANNUAL, RISK-BASED EXAMINATION PROGRAM**



Continuous communications and follow-up

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EXAMINATION OBJECTIVES
ASSESSMENT FACTORS
EVALUATION CRITERIA

Basis for evaluating the quantitative and qualitative features of risk and risk management

- remain constant

4

CREDIT	MARKET	OPERATIONS	CORPORATE GOVERNANCE
Credit Risk	Interest Rate Risk Liquidity Management	Information Technology Business Process Controls Internal Controls	Board Governance Management Processes Audits Management Information

Categories of risk and risk management

- remain constant

3

Program areas for risk-based examinations

- remain constant

<p><b>EXAMINATION STRATEGIES</b></p> <ul style="list-style-type: none"> <li>• Strategy Tailored for Fannie Mae</li> <li>• Strategy Tailored for Freddie Mac</li> </ul>
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Annual risk-based examination plan

- review and update quarterly

2

FANNIE MAE Risk Profile	FREDDIE MAC Risk Profile
<ul style="list-style-type: none"> <li>• On- and Off-Balance-Sheet Items</li> <li>• Strategy</li> <li>• Business Initiatives</li> <li>• Management of Risks</li> </ul>	<ul style="list-style-type: none"> <li>• On- and Off-Balance-Sheet Items</li> <li>• Strategy</li> <li>• Business Initiatives</li> <li>• Management of Risks</li> </ul>

OFHEO's risk profile for each Enterprise

- review and update quarterly
- change routinely

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## **Risk Profiles** ①

OFHEO begins the examination process by assessing the quantity of risk and quality of risk management at each Enterprise. OFHEO reviews each Enterprise's risk profile at least quarterly, and revises its views if, for example, the Enterprise has planned or undertaken significant new business initiatives or the Enterprise has substantially changed the manner in which it manages risks.

## **Examination Strategies** ②

In the next step of the examination process, OFHEO develops detailed examination strategies to provide effective, efficient oversight of each Enterprise. Written examination strategies are dynamic; they are reviewed and updated quarterly based on Enterprise, industry, and economic developments. Each strategy is tailored to the Enterprise and is based on OFHEO's knowledge of a variety of factors: the Enterprise's management, strengths, weaknesses, past performance, and markets; the applicable economic conditions and their actual or potential impact on the Enterprise; OFHEO's guidelines, standards, and priorities; and examination requirements. Each strategy is designed to evaluate the continued effectiveness of the Enterprise's risk management processes, enhancements management has made, and, if applicable, actions management has taken in response to previously identified issues. Examination activities identified in the strategy correlate to the level of risk in the Enterprise or in a particular current or proposed activity. Part of the oversight activity detailed in the strategy is the communication plan, including the means and frequency of communication with the Enterprises.

In conjunction with the strategies, OFHEO creates work plans that describe how the strategies will be achieved. The work plans outline the scope, timing, and resources needed to meet the objectives and examination activities set forth in the strategies.

## **Program Areas for Risk-Based Examinations and Categories of Risk and Risk Management** ③

Once OFHEO has strategies and work plans in place, examiners implement strategies by completing examination work in each of the 10 program areas for risk-based examinations. These 10 program areas capture all areas of risk and risk management in the Enterprises, and each program area focuses on specific sources of risk or risk management. In order to complete examinations and allocate resources efficiently, OFHEO has grouped the 10 program areas into four categories of risk and risk management and aligned its examiner force into four teams that correspond to the categories of risk and risk management.

The 10 program areas, grouped by risk category, are:

### *Credit*

1. **Credit Risk** - the risk that borrowers and counterparties will fail to meet their contractual or other obligations to an Enterprise.

### *Market*

2. **Interest Rate Risk** - the risk to earnings and capital from movements in interest rates, including changes in the level of interest rates, the shape of the yield curve, the level of volatility, and the relationships or spreads among various yield curves or indices.
3. **Liquidity Management** - the risk to earnings and capital arising from an Enterprise's inability to meet its obligations as they come due and to transact the next incremental dollar of business cost-effectively.

## Operations

- 4 **Information Technology** - the infrastructure, or the general controls, needed to safeguard data, protect computer application programs, prevent system software from unauthorized access, and ensure continued computer operations in case of unexpected interruptions.
- 5 **Business Process Controls** - the controls related to the data inputs, files, programs, and outputs of a specific computer application that ensure transactions are valid, properly authorized, and completely and accurately processed and reported.
- 6 **Internal Controls** - the plan of organization, methods, and procedures adopted by management to ensure that goals and objectives are met; resource use is consistent with laws, regulations, and policies; resources are safeguarded against waste, loss, and misuse; and reliable data are obtained, maintained, and fairly disclosed in reports.

## Corporate Governance

- 7 **Board Governance** - the manner in which the board of an Enterprise discharges its duties and responsibilities.
- 8 **Management Processes** - the processes used to drive behaviors to support an Enterprise's defined corporate goals, standards, and risk tolerances.
- 9 **Audits** - the possibility that a board's or management's reliance on internal or external audits is misplaced.
10. **Management Information** - the possibility that management will make decisions based on ineffective, inaccurate, or incomplete information or reports.

## Examination Objectives, Assessment Factors, and Evaluation Criteria "

OFHEO conducts examination work in each of the 10 program areas by using examination objectives, assessment factors, and evaluation criteria. The examination objectives are broad in scope, the assessment factors are more narrowly focused, and the evaluation criteria are narrower still.

For each program area, there are four or five examination objectives. These are broad statements of what OFHEO's examiners will determine through their work in each of the 10 program areas. For example, one of the examination objectives for the credit risk program area is to *identify and evaluate the change in the level of credit risk and the potential impact on the Enterprise*.

The assessment factors, in conjunction with the examination objectives, form the basis for OFHEO's evaluating the qualitative and quantitative features of risk and risk management in the Enterprises. The assessment factors link directly to one or more of the examination objectives for each of the 10 program areas. There are between 10 and 15 assessment factors for each program area. Sources for the assessment factors include industry standards and benchmarks, best practices, and examiner expertise. In order to make a determination on an examination objective, OFHEO's examiners are required to opine on each of the supporting assessment factors. An example of one of the assessment factors that supports the credit risk examination objective set forth above is to *determine the degree and trend of diversification in the credit portfolio*.

The evaluation criteria detail items that examiners routinely consider when making decisions about the assessment factors. The evaluation criteria are designed to assist the examiners by ensuring that the examination work performed throughout the Enterprises is consistent. For example, when

making a decision about the assessment factor on diversification in the credit portfolio, examiners would refer to evaluative criteria that directed them to consider, among other things, the following methods of diversifying a portfolio: *by product, by origination channel, by geography, and by counterparty.*

The work performed in an examination cycle that results in decisions on all assessment factors and renders judgments on the examination objectives constitutes a comprehensive examination. Consistent with the examination cycle, comprehensive examinations will be completed annually.

### **Communicate Examination Findings... ..**

Throughout the course of an examination, OFHEO communicates with Enterprise personnel not only to gather information, but also to share findings and discuss observations. The types of communication run the gamut from a hallway discussion with a technical expert to clarify a point, to a letter addressed to executive management or the board. Regardless of the format, OFHEO has the same goal for all communications: that the free flow of information furthers the objective of ensuring the safe and sound operations of the Enterprises. OFHEO is committed to continuous, effective communication with the Enterprises.

Communications are tailored to the individual structure and dynamics of the Enterprise, and the timing of the communication depends on the situation being addressed. OFHEO keeps executive management and the board appropriately informed and communicates with them as often as required by the Enterprise's condition and the findings from examination activities. OFHEO brings those issues to the immediate attention of the board and executive management that either: introduce an exposure to the stable operation of

the Enterprise, fall under the normal duties and responsibilities of the board, or otherwise warrant immediate attention. Technical issues and matters relating to a single line of business or activity will generally be brought to the attention of the technical and operating managers, with the board and executive management kept appropriately informed. This communication plan reinforces the risk-based examination concept and permits timely corrective action to be effected at the appropriate level.

One special form of communication that will be delivered annually to each Enterprise is the written Report of Examination (ROE). The ROEs will have an open date of January 1 and a close date of December 31. The ROEs will be delivered to the Enterprises no later than 60 days after the close date.

The ROE will describe the focus of the examination activities at each Enterprise, reflect the cumulative conclusions made throughout the yearlong examination process, and address each Enterprise's safety and soundness on an ongoing basis. Thus, while the same examination standards are applied at both Enterprises, the same issues may not be addressed in both ROEs. While all 10 program areas will be addressed, the emphasis and level of detail in the ROE will vary between Enterprises and from year to year.

### **...Effect Changes and Follow-Up**

A primary goal of the examination process is to effect needed changes in the Enterprises to enhance their financial safety and soundness. Both the degree of specificity OFHEO provides to the Enterprises about items to be changed and the level of OFHEO follow-up with the Enterprises relate directly to the risk presented by an issue. If, for example, in the course of an examination, OFHEO identifies a significant issue in risk management systems or an undesirable risk level, OFHEO will

require management to develop and execute a corrective action plan and will ensure that the board holds management accountable for executing the action plan. OFHEO will review the action plan to ensure that it identifies the steps or methods management expects will cure the root causes of significant deficiencies and to determine whether the plan is likely to resolve the significant issues within an appropriate timeframe. As part of the follow-up, OFHEO will verify that the action plan has been executed and evaluate its success. OFHEO will consider the responsiveness of the Enterprise in recognizing the issue and formulating an effective solution when determining if OFHEO needs to take further action. If an Enterprise is unresponsive or unable to effect resolution of significant issues, OFHEO will take more formal steps to ensure deficiencies are corrected.

## The End . . . or Starting Over?

While “effect changes and follow-up” is designated as the final step in OFHEO’s comprehensive, annual, risk-based examination process, that is not really the case. In practice, the final steps start the entire examination cycle anew. The examination findings, including items for follow-up, affect OFHEO’s assessment of the Enterprise’s risk profile. That, in turn, drives the examination strategy and begins the examination cycle once again.

<sup>1</sup> The sizes of mortgage loans that the Enterprises are permitted to buy are limited by their Charter Acts. These limits are usually referred to as “conforming loan limits.” For example, the maximum original principal amount of a single-family mortgage that the Enterprises can currently buy is \$227,150. In addition to loan size, conforming loans must also meet the Enterprises’ underwriting guidelines. Non-conforming loans are loans that either exceed the conforming loan limits or do not meet the Enterprises’ underwriting guidelines. Non-conforming loans that exceed the current limit of \$227,150 are often called “jumbo” loans.