

CHAPTER 3

OFHEO'S REGULATORY ACTIVITIES

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OFHEO's Office of Examination and Oversight (OEO) conducts a comprehensive, annual, risk-based program of examination activities to determine the condition of Fannie Mae and Freddie Mac for the purpose of ensuring their financial safety and soundness. These activities include on-site examinations and off-site financial analysis and supervisory monitoring, as well as ongoing communication with the Board of Directors and management of each Enterprise. OEO's examination program complements OFHEO's quarterly capital classification of the Enterprises and provides comprehensive oversight of the financial safety and soundness of each Enterprise.

Preparing for Transition

OFHEO completed its initial cycle of core examinations, which focused on corporate governance, credit risk, interest rate risk, business risk, information systems and technology risk, and internal audit/operations risk. OFHEO's 1997 Annual Report explained OFHEO's strategy to complete these core examinations and proceed into a continuous examination program. Chapter 2 of this report describes OFHEO's transition into the comprehensive, annual, risk-based examination program that began in January 1998. This chapter describes the activities, which focused on information technology and internal audit/operations risk, that completed the initial cycle of examinations. In addition, this chapter describes OFHEO's ongoing examination of the Year 2000 "challenge," the Enterprises' compliance with applicable flood insurance requirements, OFHEO's capital classifications of the Enterprises and minimum capital, and OFHEO's executive compensation authority.

Through the initial cycle of examinations, OFHEO developed a knowledge base of the Enterprises' respective organizational structures, programs, processes, tools, policies, practices, and business strategies. From this knowledge base, OFHEO formulated a business and risk profile for each Enterprise, and refined examination objectives and assessment factors to be used in examining the Enterprises. As explained in the preceding chapter, the risk profiles are given form in the examination strategies OFHEO prepares each year, and on which OFHEO bases its annual examination activities. The knowledge gained during the course of the initial examinations is crucial to OFHEO's effective oversight and positions OFHEO to effectively deploy its risk-based examination program.

The Information Systems and Technology (IT) Examinations

IT Exposure

The secondary mortgage market increasingly relies on information technology. The Enterprises have been among the leaders in the development and implementation of technological innovations. In recognition of this increased reliance, OFHEO conducted examinations to assess each Enterprise's exposures to risks presented by the management and use of information technology. For purposes of the IT examinations, OFHEO defined IT risk to mean the potential that an event or action may impair an Enterprise's ability to process transactions and information in a timely and accurate manner.

Objective of the IT Examination

The primary objective of the IT examination was to assess whether management at each Enterprise effectively governs its proprietary risk management framework and tools. This included assessing management's ability to identify and resolve IT issues. Based upon these examinations, OFHEO reached a conclusion on whether management effectively oversees the IT area and the risks associated with the use of technology.

Sources of IT Exposure

When evaluating the quality of IT management and the risks associated with technology use, OFHEO must consider the numerous paths by which risk can be introduced. For example, OFHEO must consider such aspects as management's degree of reliance on IT to meet the needs of the business; management's success in integrating the IT strategies with the organization's business needs; and management's success in obtaining and retaining the expertise and staffing to implement and maintain the technology to effectively operate the business. Additional considerations include the dependence placed on external resources; the quality and reliability of vendors and service providers; the reliability and effectiveness of the Enterprise's existing technology platforms; and the quality of change management to ensure there is the capacity to evolve with the technological environment.

Examination Scope

OFHEO considered the sources of IT risk when developing the examination plan, and structured its work to assess seven control areas: (1) program management, (2) systems development, (3) program monitoring, (4) change management, (5) data security, (6) business continuity planning, and (7) facilities management. OFHEO's IT examination scope was to:

- Determine the extent of IT usage in the business processes;

- Identify the existing IT controls;
- Assess IT strengths and weaknesses;
- Evaluate the strategic thinking associated with IT;
- Evaluate the adequacy of the risk management framework as it relates to IT; and
- Conclude on the effectiveness of the overall management of IT.

Examination Results and Conclusions— Fannie Mae

Based upon our review, OFHEO concluded that Fannie Mae's risk management of the IT area is satisfactory.¹ This designation signifies that the risk management of Fannie Mae's automated environment adheres to appropriate safety and soundness standards. While some issues OFHEO identified warrant the attention of the Board of Directors and senior management, none pose safety and soundness concerns.

OFHEO identified various strengths in Fannie Mae's IT risk management framework and concluded that the use of this framework provides effective management of the risks associated with using IT. The key strengths of IT risk management include:

1. Direct, quality involvement by the Board of Directors and senior management in IT risk management;
2. Effective utilization of information technology to address the Enterprise's business needs;
3. Timely and sound IT-related decisions; and
4. Competent and capable IT staff.

There were no findings which presented OFHEO with safety and soundness concerns; however, OFHEO directed the attention of the Board of Directors and senior management to certain areas of the IT management framework. OFHEO also brought a number of other observations and suggestions to the attention of the appropriate level of operating management. OFHEO's recommendations and suggestions to the board and senior

management pertained primarily to documentation enhancements for certain aspects of the risk management framework, especially end-user computing policies and procedures. Fannie Mae has addressed, or is addressing, OFHEO's recommendations, and examiners are monitoring the Enterprise's progress.

Examination Results and Conclusions— Freddie Mac

Based upon its review, OFHEO concluded that Freddie Mac's risk management of the IT area is satisfactory.² This designation signifies that the risk management of Freddie Mac's automated environment adheres to appropriate safety and soundness standards. While some issues warrant the attention of the Board of Directors and senior management, none pose safety and soundness concerns.

OFHEO identified various strengths in Freddie Mac's IT risk management framework and concluded that the use of this framework provides effective management of the risks associated with using IT. The key strengths of IT risk management include:

1. A comprehensive risk assessment framework;
2. Comprehensive management reporting;
3. Effective monitoring for resolution of significant issues and concerns; and
4. Competent and capable IT staff.

While there were no findings that presented safety and soundness concerns, OFHEO directed the attention of the Board of Directors and senior management to certain aspects of the IT management framework. OFHEO also brought a number of other observations and suggestions to the attention of the appropriate level of operating management. OFHEO's recommendations and suggestions to the board and senior management pertained primarily to enhancing the formal oversight of cross-cutting IT-related issues; continuing management's efforts to strengthen the control environment for data security; enhancing end-user computing standards and procedures; and enhanc-

ing business recovery testing. Freddie Mac has addressed, or is addressing, OFHEO's recommendations, and examiners are monitoring the Enterprise's progress.

The Internal Audit/Operations Risk Examinations

The Role of Internal Audit

Internal audit is a fundamental instrument for the discharge of corporate governance to ensure that operating controls are effective and appropriate to minimize risks. The primary objective of the internal audit function is to serve the Board of Directors in the effective discharge of its responsibilities. The work performed by internal auditors plays a vital role in evaluating the effectiveness of the risk management program, the sound operation of internal controls, and the reliability of records and data. A flawed internal audit program might not detect breaches in controls which are intended to mitigate financial exposure and maintain or improve an Enterprise's quality standards.

Objective of the Internal Audit/ Operations Risk Examinations

The primary objective of the examinations was to evaluate the structure, scope of authority, activities, policies, and procedures for the internal audit programs. By evaluating the work of each Enterprise's internal audit department, which focuses on, among other things, the development of and adherence to an effective internal control program, OFHEO was able to assess the degree to which the Enterprises manage their exposure to operations risk.

Examination Scope

OFHEO considers the work performed by the internal auditing departments at each Enterprise when discharging its examination authority. Leveraging off the work of internal audit contributes to OFHEO's effective use of its examination re-

sources. OFHEO's ability to rely upon internal audit requires routine testing and evaluation of the audit programs to ensure that the work within each department meets OFHEO's standards and the appropriate professional standards. The examination activities evaluated aspects of the auditing function to re-validate the reliability of internal audit's work. Under OFHEO's risk-based examination program, OFHEO will assess more comprehensively the quality of the internal audit program on an annual basis.

OFHEO structured its work to:

1. Test a sample of audit workpapers to determine whether the work supported the department's conclusions and whether the workpapers were consistent with internal standards and applicable professional standards;
2. Review adherence to the policies and procedures;
3. Review the role of audits in management's internal control risk assessment programs;
4. Review the department's risk assessment activities; and
5. Review the tracking and reporting of control issues.

Examination Results and Conclusions— Fannie Mae

OFHEO concluded that Fannie Mae's internal audit work products are high quality and that audit activities and results generally are well documented. Particular attention was given during the examination to the Office of Auditing's transition to a continuous-presence audit approach. The continuous audit approach allows the department to maintain ongoing contact with business activities and personnel, and to rapidly adjust audit activities to address issues and concerns as they emerge.

OFHEO identified various strengths in Fannie Mae's internal audit program. These strengths include:

1. A written charter that establishes, among other things, the department's scope of authority;
2. Comprehensive written policies and procedures to guide audit personnel;
3. An internal quality control program;
4. A formal tracking and reporting system to communicate weaknesses to management and the Audit Committee of the Board of Directors;
5. A formal risk assessment process to analyze business developments and allocate resources appropriately; and
6. An active role in management's internal control self-assessment program.

OFHEO did not identify any safety and soundness concerns; however, it suggested a number of enhancements to the internal audit program. These recommendations relate to the auditing department's implementation of its quality assurance program and to documentation in certain areas impacted by the department's shift to a continuous-presence audit program. With respect to documentation, OFHEO recommended that management update internal policies and consolidate guidance related to the department's risk assessment activities, and also that it review its process for ensuring that internal control verifications are documented in a manner that complies with Enterprise policy. In addition, OFHEO encouraged the Enterprise to adopt written guidance with respect to management's internal control self-assessment program.

OFHEO has shared with senior management its suggestions and recommendations on areas which would benefit from enhancement. Fannie Mae has addressed, or is addressing, those recommendations, and examiners are monitoring the Enterprise's progress. As part of OFHEO's risk-based examination program, examiners will continue monitoring the internal audit program throughout the year, and OFHEO will produce annual conclusions on the quality of the internal audit program.

Examination Results and Conclusions— Freddie Mac

OFHEO concluded that Freddie Mac's internal audit work products are high quality and that audit activities and results are well documented. The audit program was found to meet the prescribed professional standards, and various aspects were found to substantially exceed those standards.

OFHEO identified various strengths in Freddie Mac's internal audit function. These strengths include:

1. A written charter that establishes, among other things, the department's scope of authority;
2. A key role in management's risk assessment process;
3. Sophisticated risk assessment tools to identify and prioritize risks and allocate resources;
4. A quality assurance program which exceeds prescriptive professional standards; and
5. An automated audit program which enhances management's capability to actively oversee audit scheduling, findings, status, and follow-up.

OFHEO did not identify any safety and soundness concerns, nor did it identify aspects of the internal audit program that require the board's or senior management's involvement or follow-up. As part of OFHEO's risk-based examination program, examiners will continue monitoring the internal audit program throughout the year, and OFHEO will produce annual conclusions on the quality of the internal audit program.

The Year 2000 Challenge and Examination Activities

What Is the Year 2000 Challenge?

The Year 2000 "challenge" arises because computer systems have typically used two digits, rather than four, to represent the year—for example, "98" represents the year 1998. The problem with a two-

digit date field is that computer systems may identify "00" as the year 1900, rather than 2000. This error would lead to errors in performing date-sensitive tasks, including calculations to determine payment amounts, payment dates, payoff balances, interest payments, investor payouts, and other mortgage-related payment information. Failure to address this problem also may lead to errors in annual financial reporting to investors, shareholders, and federal regulatory agencies; reporting related to mortgage-backed and debt securities and derivative financial instruments; portfolio rebalancing; mortgage commitments and purchases; and the issuance of securities.

OFHEO's role as the Enterprises' financial safety and soundness regulator requires it to evaluate management's efforts to resolve the problem as it may impact the Enterprises' internal systems. OFHEO also is evaluating management's efforts to safeguard against circumstances where an Enterprise's key business partners (such as sellers, servicers, vendors, and service providers) have not corrected the problem in their own systems.

How Does OFHEO Evaluate the Enterprises' Efforts to Achieve Year 2000 Compliance?

Year 2000 compliance efforts were an important focus of OFHEO's examination effort during 1997 and will remain an examination priority into the new millennium. OFHEO follows the principles and framework laid out in the General Accounting Office's guide entitled *Year 2000 Computing Crisis: An Assessment Guide* to evaluate the Enterprises' efforts to address the problem. Additionally, OFHEO has been participating in the Federal Financial Institutions Examination Council's Year 2000 efforts and the Working Group on Year 2000 to ensure consistent standards and treatment with the other financial regulators.

The complexity of the effort to achieve Year 2000 compliance is not in the solution to the actual problem, but in the size and scope of the project itself. Given that this is essentially a project management

issue, OFHEO has examined, and will continue to examine, the Enterprises' timely and successful management of this critical project.

The Year 2000 Evaluative Framework

The framework used to achieve Year 2000 compliance follows a five-phase approach. This five-phase approach progresses in the following sequence:

1. **Awareness Phase** - define the Year 2000 problem, make personnel aware of the issue, establish a Year 2000 program team, and develop an overall compliance strategy.
2. **Assessment Phase** - assess the Year 2000 impact on the organization, identify core business areas and processes, analyze the systems supporting the core business areas, and prioritize conversion and/or replacement of those critical systems.
3. **Renovation Phase** - perform the conversions, replacement, or elimination of critical platforms, applications, databases, and utilities, and modify interfaces.
4. **Validation Phase** - test, verify, and validate the converted or replacement platforms, applications, databases, and utilities to ensure that they meet the organization's needs.
5. **Implementation Phase** - implement the converted and replacement platforms, applications, databases, utilities, and interfaces while maintaining appropriate back-up.

The Enterprises' Year 2000 Efforts Are Appropriate

In addition to examining the Enterprises' efforts to achieve Year 2000 compliance with their systems, OFHEO also assesses the Enterprises' efforts to ensure that their critical business partners achieve timely Year 2000 compliance. Because technology is a cornerstone of the Enterprises' business, Year 2000 compliance is critical for business continuity.

OFHEO's Year 2000 priority with respect to the Enterprises is to safeguard the orderly operation of the secondary mortgage market by ensuring that the Enterprises are able to process transactions and information at the new millennium. OFHEO will continue to treat the Year 2000 challenge as a priority during 1998 and 1999 (and thereafter as appropriate) and will monitor the Enterprises' efforts to lead, and ultimately require, their business partners to be Year 2000 compliant.

OFHEO is able to report that each Enterprise is proceeding with an acceptable plan, and the implementation of these plans is on schedule. Year 2000 ranks among the top priorities at each Enterprise and receives the attention of senior management and substantial resource investment (both human and financial). The Enterprises recognize the significance of the Year 2000 challenge, and each organization has designated working groups to address the numerous business and technology issues. The implementation plans for correcting the problem are comprehensive, and these plans are also being enhanced as the body of knowledge for Year 2000 issues evolves. Each Enterprise has begun internal testing and is following a schedule that will allow comprehensive testing (including testing with business partners) to begin early in 1999. Overall, OFHEO continues to view each Enterprise's Year 2000 compliance plans and related timetables as reasonable.

Because OFHEO believes the Year 2000 challenge is a crucial operating issue for the Enterprises, it believes that the Board of Directors and senior management of each company should be actively involved. OFHEO has determined that the Boards of Directors are being appropriately and routinely briefed on the progress toward Year 2000 compliance, including the meeting of pertinent timetables. Senior executives at both Enterprises are actively engaged and routinely receive status updates. In addition to frequent dialogue with appropriate Enterprise representatives, OFHEO has been testing, and will continue to test and verify, each Enterprise's performance against its respective plan and evaluate its contingency plans. In

the event there are adverse deviations from the plans or timetables, OFHEO will immediately determine the appropriate regulatory response.

Flood Insurance Compliance Activities

Background

Federal legislation requires the Enterprises to implement procedures designed to ensure that adequate flood insurance is in place over the term of loans that the Enterprises purchased after September 28, 1995, and that are secured by properties located in certain designated flood hazard areas. OFHEO is responsible for assessing whether the Enterprises have adopted, and are adhering to, such procedures and is also responsible for including that assessment in our annual reports to Congress for 1996, 1998, and 2000.

In its 1996 Annual Report, OFHEO reported that Freddie Mac had established adequate flood insurance policies and procedures and was complying with them. OFHEO further reported that Freddie Mac had established appropriate internal controls to provide reasonable assurance of compliance with applicable flood insurance requirements and had adopted quality control procedures that would allow the Enterprise to verify sufficient flood insurance coverage on applicable loans.

OFHEO's 1996 Annual Report also reported that Fannie Mae had established an appropriate flood insurance compliance framework and adequate procedures to ensure the Enterprise's compliance with the applicable flood insurance requirements. OFHEO further reported that the Enterprise was developing internal controls to ensure adequate flood insurance is in place on applicable loans, and that OFHEO would monitor the Enterprise's implementation of the compliance program.

Results of Flood Insurance Review

In 1997, OFHEO again reviewed the flood insurance procedures and controls at each Enterprise. These reviews included on-site evaluations of applicable procedures and meetings with responsible management. The reviews also included the evaluation of each Enterprise's efforts to test and validate the internal controls established to ensure compliance with applicable statutory requirements. Based on these reviews, OFHEO concluded that each Enterprise has implemented, and is adhering to, adequate flood insurance procedures.

Capital Classification and Minimum Capital

The 1992 Act requires OFHEO to determine the capital classifications of Fannie Mae and Freddie Mac for purposes of financial safety and soundness. The Act requires that these determinations be made "not less than quarterly." The classifications are "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized." The Act gives the OFHEO Director "prompt corrective action" enforcement authorities if an Enterprise is classified other than adequately capitalized.

To qualify as adequately capitalized, an Enterprise must meet both minimum and risk-based capital standards. However, only the minimum capital standard applies currently. During this period, an Enterprise is considered adequately capitalized if its core capital - common stock, preferred stock, paid-in capital and retained earnings - equals or exceeds its minimum capital requirement.

The minimum capital requirement is designed to establish an essential amount of capital that an Enterprise must hold as a cushion against losses from broad business categories. It is computed on the basis of leverage ratios applied to all assets (2.50 percent) and off-balance sheet obligations (0.45 percent), with more complex rules applied to in-

terest rate and foreign exchange contracts. OFHEO implemented the minimum capital provision of the 1992 Act by publishing a proposed minimum capital regulation for public notice and comment on June 8, 1995. After considering the comments received, OFHEO published the final regulation on July 8, 1996. Based on the minimum capital requirement, OFHEO has classified Fannie Mae and Freddie Mac adequately capitalized in each quarter since June 30, 1993.

Executive Compensation Authority

OFHEO's enabling statute and the Enterprises' Charter Acts give the Director of OFHEO oversight responsibility in the area of executive compensation. OFHEO's statute requires the Director to prohibit the Enterprises from providing excessive compensation to any executive officer. Specifically, the statute provides that compensation must be reasonable and comparable with compensation paid by other similar businesses to executives having similar duties and responsibilities. "Similar businesses" include publicly held financial institutions or major financial services companies. Additionally, the Enterprises' Charter Acts require the Enterprises to obtain the prior approval of OFHEO's Director before entering into or changing termination agreements with their executive officers. The Charter Acts provide that the Director of OFHEO may not approve any such agreement unless the Director determines that the benefits provided under the agreement are comparable to benefits provided under such agreements for officers of other public and private entities involved in financial services and housing interests who have comparable duties and responsibilities.

During the past 12 months, OFHEO has approved two termination agreements submitted by the Enterprises: one termination agreement for an executive officer and one amendment for another executive officer.

¹ OFHEO has substituted the term "satisfactory" for the term "adequate" to characterize practices that adhere to safety and soundness standards. OFHEO uses the term "strong" to characterize practices that substantially exceed safety and soundness standards.

² Ibid.