Introduction

All areas of a regulated entity's operations are the responsibility of its board of directors (board) and senior management. As a result, the board and senior management must understand the interrelationships among the regulated entity's activities and business lines and the resulting potential risks. The board of directors and senior management must also be familiar with the external environment and how factors outside the regulated entity may affect the operations and performance of the institution. This module applies to examinations of Fannie Mae and Freddie Mac (the Enterprises), the Federal Home Loan Banks (FHLBanks), and the Office of Finance (OF). Although the Office of Finance is not a "regulated entity" as the term is defined in the Safety and Soundness Act (see the section in this module on *Regulatory Environment*), for purposes of convenience, this module includes the Office of Finance when referring to the regulated entities collectively, unless otherwise noted.

Sound corporate governance begins with engaged, capable, and experienced directors and senior management, a coherent strategy and business plan, and clear lines of responsibility and accountability. The board of directors oversees the development of the overall business strategy for the regulated entity and the decisions made by senior management in the pursuit of strategic objectives. The board of directors is responsible for both the appropriateness of the strategy and decisions and risks undertaken to achieve it. Senior management, with input and approval by the board of directors, develops the business strategy, makes significant decisions to implement that strategy, and oversees day-to-day decisions and actions by subordinate staff to ensure that these decisions support and achieve the long-term objectives and policies as determined by the board of directors.

Strategic and operational objectives must be supported by the development and maintenance of a system of strong internal controls and effective risk management. Such a system is essential to provide assurance that assets are adequately safeguarded; information and data are relevant, reliable and timely; and resources are utilized in an effective and efficient manner, as well as to evaluate compliance with management policies, standards, laws, regulations, supervisory guidance, and fiduciary responsibilities.

Examiners should evaluate the quality of corporate governance by a board of directors and senior management throughout the examination process. While the board of directors and senior management are collectively responsible for management of the regulated entity, it is important to recognize the differences between the duties and responsibilities of the board of directors from those of senior management. These differences are particularly important in evaluating the various processes and systems established to direct and control a regulated entity's operations. A summary of the key responsibilities of the board of directors and senior management is set forth below.

Board of Directors Responsibilities

The board of directors determines the strategic direction for the regulated entity. It also approves certain policies and limits, and oversees the actions of senior management. The board's duties include advancing the regulated entity's mission and other regulatory requirements. The board of directors may delegate some responsibilities to senior management, but cannot delegate its fiduciary duty to oversee the institution's affairs nor its responsibility for the consequences of unsound or imprudent policies and practices. In the case of the Enterprises, the board is responsible for obtaining regulatory approvals under FHFA's Letter of Instruction to the Enterprises, dated November 15, 2012.

In making an overall assessment of the adequacy of oversight by a regulated entity's board of directors, examiners should evaluate the competence of the board of directors and its effectiveness in directing the regulated entity's affairs. The key responsibilities of a board of directors include the following:

1) *Hire and retain competent senior management*

    The board of directors' primary responsibility is to hire a qualified chief executive officer (CEO), and to ensure that the CEO engages senior management with the necessary skills, knowledge, and experience to manage the institution's affairs in a sound and responsible manner. Selection criteria should include technical competence, character, education, and experience in fields relevant to the operations of the Enterprises, the FHLBanks, or the OF, as appropriate.

    Ongoing evaluation of the CEO and senior management by the board of directors is critical to the success of the regulated entity. Assessment of a CEO's performance should be measured against clearly defined duties and responsibilities, as well as standards of performance and measurable performance targets. Performance standards and targets should be linked to the regulated entity's success in implementing its strategic and operational plans, including the achievement of both long- and short-term financial performance goals, maintenance of a safe and sound condition, and the carrying out of its housing finance and community lending mission. All significant areas of a regulated entity's operations including loans, investments, asset and liability management, profitability, strategic planning, and risk management should be considered when evaluating the performance of the senior management team.

    A regulated entity's board of directors is responsible for taking disciplinary action, including dismissal, against the CEO or other members of senior management who prove unable to meet the performance standards and targets or who commit violations of law, breaches of fiduciary duty, or otherwise place the regulated entity or its reputation at undue risk. Failure by the board of directors to act when the need arises may constitute a breach of the board's fiduciary responsibilities.

The board of directors must also have a formal management succession plan to ensure that the regulated entity can continue operations without disruption in the event of the loss of the CEO or other key senior officers. The succession plan should provide for the transition in leadership by identifying individuals who have the qualifications to successfully fill top management roles on an interim and long-term basis. Once potential candidates are identified the management succession plan should provide for training opportunities to develop the candidate's skills to effectively fulfill their new responsibilities at the time of transition.

2) *Establish a risk management framework*

The risk management process is intended to identify a regulated entity's exposure to risks and determine whether risks are appropriately managed, monitored, controlled, and reported to ensure they are consistent with the desired risk profile established for the regulated entity by the board of directors and senior management.

The risk management process has three components: (i) risk identification, reporting, and analysis; (ii) risk control; and (iii) risk treatment. Risk identification, reporting, and analysis requires a review of all aspects of a regulated entity's current and future operations to determine where there is potential exposure to loss and reporting of identified risks to management and the board of directors. Risk control is a function of the strength of the regulated entity's internal controls, policies, and procedures. Risk treatment is the selection of appropriate measures or methods to manage a particular risk, such as a hedge.

To effectively identify potential risk, a board of directors must have a fundamental understanding of the regulated entity's business activities and associated risks. While a given director may not be considered expert in all of the risks associated with all of a regulated entity's activities, the board must collectively ensure that such expertise is available to it and that the risk management framework is reviewed by qualified professionals.

The board of directors is responsible for taking reasonable steps to ensure that management has established a management information system (MIS) to accurately identify, measure, monitor, and control risks. The system should:

a) Facilitate the assessment and management of risks within the regulated entity, including the identification, monitoring, measurement, and limitation of risks;
b) Provide management with an adequate decision support system by providing information that is timely, accurate, complete, and consistent;

c) Deliver complex or technical information to multiple users throughout the regulated entity;
d) Provide a means to monitor the achievement of the regulated entity's goals and objectives;
e) Reduce expenses related to labor-intensive manual activities; and
f) Allow for communication with employees and customers.

The board of directors has primary responsibility for establishing and maintaining a robust risk management framework. The regulated entity's safe and sound operation is dependent upon identification and management of its risk exposures. Examples of specific risk management responsibilities of the board of directors include:

a) Establishing a sound risk management culture and overall risk tolerances for the regulated entity;
b) Reviewing and approving policies, standards, and procedures that clearly quantify acceptable risk and that define responsibility and authority;
c) Evaluating and approving policies and controls to mitigate risks;
d) Reviewing variances and exceptions that exceed established risk standards and limits;
e) Reviewing current and potential litigation and other legal claims initiated or asserted by the regulated entity, or by third parties against the regulated entity, including an evaluation of the potential effect;
f) Requiring independent audits of the key risks and internal controls, policies, and procedures;
g) Ensuring that corrective action is taken to remediate material weaknesses, significant deficiencies, and critical and major (however characterized) audit findings reported by the regulated entity's external or internal auditors;
h) Ensuring that corrective action is taken to remediate FHFA examination findings;
i) Reviewing and approving of the regulated entity's strategic and operational plans;
j) Formally delegating to management the authority to formulate and implement the regulated entity's strategic and operational plans;
k) Specifying content and frequency of reports provided to the board of directors;
l) Ensuring sound staffing and compensation practices, as well as a positive working environment that emphasizes the importance of compliance with regulatory and internal requirements;
m) Performing an annual performance evaluation of the CEO;
n) Evaluating the degree and consistency of the regulated entity's compliance with applicable laws and regulations; and
o) Taking reasonable steps to ensure that the regulated entity's financial statements are accurate and comply with applicable laws and regulations.

3) *Develop and maintain an understanding of the regulated entity's operations and business environment*

Directors should have an understanding of the regulated entity's business environment and the legal and regulatory framework within which it operates. Directors should be familiar with applicable laws and regulations so that they may determine that the regulated entity has appropriate policies and procedures in place to maintain compliance with them. Moreover, each director should have a working knowledge of basic finance and accounting policies, including the regulated entity's financial statements and the ability to monitor management and the internal and external auditors.

An effective tool to assist new board members in the discharge of their duties is an orientation program. That program should explain the operation of the regulated entity and the business environment and legal and regulatory framework in which it operates. The orientation program should clearly emphasize the responsibilities of board members both individually and as a group as well as provide ethics training for new directors.

The board of directors should conduct a survey of director skills to assist in the development of programs that enable any director that does not have a working familiarity with basic finance and accounting to gain such knowledge within a reasonable time after being elected or appointed to the board. Educational programs covering regulated entity activities, risks, hedging, modeling, emerging issues, and legal/regulatory updates should be provided regularly.

4) *Establish an effective board of directors structure and reporting protocol to oversee the activities of the regulated entity*

The key responsibilities of directors include the establishment of an effective organizational structure that ensures that appropriate information concerning the regulated entity's activities is brought to its attention, consistent with applicable laws, rules, and regulations. These responsibilities include the authorization of committees to perform specific tasks and oversee certain aspects of the regulated entity's operations. All committees should have written charters that clearly address their mission, authority, responsibility, and duration. Standing committees address continuing areas of responsibility, such as a loan committee or an audit committee, while *ad hoc* committees may be established to accomplish special projects, allowing in-depth consideration of one-time issues.

Each board committee must keep minutes of its meetings documenting the discussions of each item considered at the meeting and, if applicable, procedures should be established to address issues or concerns without the presence of senior management, including the convening of executive sessions. Committees must report regularly to the full board of directors. The board may rely upon information provided to it by committees, but the full board retains responsibility for all decisions.

12 CFR 1261.24 of the FHFA regulations requires FHLBank boards of directors to hold a minimum of six in-person meetings per year and 12 CFR 1710.11 of the Office of Federal Housing Enterprise Oversight's (OFHEO) regulations requires the Enterprises' boards of directors to meet at least eight times per year. Boards of directors should meet as frequently as the business and affairs of the regulated entity require. Board meeting packages should focus directors' attention on important issues or concerns. Priorities should be clear and requested board action identified. Explanatory materials should accompany data and information.

The board of directors should identify the type and frequency of reports necessary to oversee the regulated entity's financial performance and activities. Information technology should be aligned with the board's expectations and requirements and be able to provide accurate and useful reports in a timely manner. Key performance reports enable the board to evaluate the regulated entity's financial performance in accordance with its strategic goals and mission, financial trends, risk profile, compliance with established risk tolerances and standards, and the adequacy of its risk management processes.

The board of directors should ensure that an accurate record of its actions is maintained in the form of minutes of each board and committee meeting, including any executive sessions and any telephonic meetings, and fully executed forms of director consent for any actions taken by unanimous written consent in lieu of meeting. Minutes should document the board's review and discussion of all agenda items. The minutes also should record the attendance/absence of each director and abstentions by any director from any vote.

Examiners should review the minutes of board of directors and committee meetings, as well as typical packages sent to board members in preparation for the meeting, to determine if directors are receiving appropriate information to make informed decisions. Examiners also should assess whether board meeting frequency is consistent with regulations and appropriate to oversee the regulated entity's activities.

Management Responsibilities

Senior management must have the expertise necessary to manage the day-to-day operations of the regulated entity in carrying out the strategic objectives of the board. Members of the senior management team, including the CEO, should possess certain fundamental qualities and qualifications: integrity, financial and management experience, technical competence, and character. Effective senior management must also possess and demonstrate the leadership qualities necessary to coordinate and organize resources and guide and motivate personnel to achieve the organizational objectives.

As part of its responsibilities, senior management advises the board of directors about the regulated entity's activities and corresponding risks to ensure that directors are fully informed. Senior management is also responsible for implementing corrective actions specified by the board of directors. This includes management's willingness and ability to take timely corrective action in response to audit, review, and examination findings and recommendations. Procedures should be established to ensure continuing compliance with applicable laws, regulations, and FHFA policy, including conservatorship directives for Fannie Mae and Freddie Mac, as well as internal policies of the regulated entity. Corrective action must be responsive to the cited criticism, and implementation of appropriate action must be timely and effective.

Examples of specific senior management responsibilities include, but are not limited to, the following:

1) Develop strategic and operational plans and risk management policies for approval by the board of directors;
2) Implement strategic and operational plans and risk management policies following approval by the board of directors;
3) Assess and implement an effective internal control framework and risk management process to address and monitor critical processes and mission activities of the regulated entity;
4) Establish procedures and controls to address compliance with key laws and regulations applicable to the regulated entity;
5) Develop and implement management information systems that adequately address the regulated entity's business environment and risk profile;
6) Develop written policies, procedures, and standards to address critical processes and mission activities and controls of the regulated entity;
7) Establish procedures to identify, report, assess, and correct deviations from key standards, risk tolerances, and controls in a timely manner;
8) Implement timely corrective action on significant control deficiencies and issues that were reported by the external or internal auditors, and governmental authorities; and
9) Implement timely corrective action on FHFA examination findings.

Senior management must ensure that all functions are carried out in accordance with policies established by the board of directors and that the regulated entity has adequate systems in place to effectively monitor and manage risks. In addition, senior management must ensure that the regulated entity maintains internal risk controls appropriate for its size, activities, and business and that information and reporting systems produce information that is timely, accurate, and complete.

The responsibilities of senior management also include maintaining an organizational structure that clearly assigns responsibility, authority, and relationships; establishing adequate performance incentives and personnel management systems; and hiring middle managers with appropriate professional skills, experience, and integrity.

In making an overall assessment of senior management, examiners should evaluate whether senior management has provided adequate guidance in the critical activities of the institution and has established adequate processes to manage, monitor, and control key risks. Examiners should consider management's qualifications, its fulfillment of its duties and responsibilities, and its performance related to strategic goals and objectives. In addition, examiners should assess whether management has established satisfactory risk controls over operations and business lines, and complied with applicable laws, regulations, and supervisory guidance.

Operational Processes

Examiners must assess the effectiveness of the board of directors' and senior management's practices relating to the management of the regulated entity and evaluate the quality of their decision-making processes. In making such an assessment, examiners should evaluate the processes established by the board of directors and senior management to manage the regulated entity. Those processes include, for example, strategic planning, policies and procedures, internal control systems, MIS, and human resource management. The examiner's review should focus on the level of involvement of directors and senior management in these processes.

<u>Strategic and Operational Planning</u>

Strategic and operational planning is an organized and continuous process ensuring that projections of the future operating environment influence current decisions. In its simplest terms, strategic and operational planning is the process of determining where the regulated entity is, where the board of directors and senior management believe it should be, and how the board and senior management plan to get there. Planning can be divided into two components: strategic planning, which is an ongoing process that focuses on long-term deployment of resources to achieve goals, and operational planning, which concentrates on short-term actions that flow logically from the strategic plan and are revised periodically, and includes an annual operating budget.

Well-developed and well-executed strategic business plans represent projections about the future of the regulated entity. In order to be effective, planning must be dynamic and well-supported. Projections must be revised periodically as circumstances change and new strategies must be devised to meet stated objectives. The board of directors' and senior management's attention to this area and the extent to which plan objectives are met are two of the best indicators of board and management capability. The most important factor in an effective planning process is the commitment and involvement of the board of directors and senior management to this process. For additional guidance, refer to the Strategic Planning module of the Examination Manual.

The quality of the strategic business plan is dependent on the effectiveness of the planning process. While the planning process is continuous, it begins with the formulation of the board of directors' overall philosophy and vision for the regulated entity's future. Planning that is integrated into the management process can assist managers in accomplishing their work and benefit the entire institution. Frequently, deficiencies noted in the plan are the result of flaws in the planning process. Attention to details in the design and implementation of the plan should reduce the risk of failure. The following elements enhance planning and should be incorporated into the planning process:

1) Endorsement from both senior management and the board of directors;
2) Full participation at the board of directors and all management levels; the planning process should identify who should be involved, determine the appropriate form and timing of the involvement, provide an opportunity for participation, and ensure that participation occurs;
3) A planning policy that is formally documented and outlines the steps for completing the planning process;
4) Assigned responsibilities for developing and implementing the plan;
5) Effective communication of expectations and planned actions to those responsible;
6) An adequate information system that provides management and the board of directors with timely, accurate, consistent, and appropriate information needed to allow for monitoring performance in accordance with the strategic business plan;
7) Measurable goals, objectives, strategies, and action plans;
8) Contingency plans that identify probable emergency or contingency conditions and their expected effect;
9) Flexibility to reflect changes to the institution's operational environment;
10) Review and follow-up to determine completeness, consistency, and accuracy; the board should review and approve the final plan;
11) Effective implementation, including prudent decision-making, commitments of resources, and consistent and clearly stated performance standards based on planned goals and objectives; and
12) Formalized monitoring and control systems that evaluate progress against the plan and identify weaknesses in the implementation of the plan.

The success of business planning is dependent on strategic planning for all significant areas of the regulated entity's operations, and includes effective planning and utilization of human resources and MIS.

Policies and Procedures

Comprehensive policies and procedures are essential in the oversight and management of a regulated entity. The FHLBank Act, as well as, OFHEO and FHFA regulations require the regulated entities to adopt policies and procedures for all critical activities of the institution. The extensiveness of a regulated entity's policies and procedures governing any function or activity should depend upon the significance of the function or activity, and the degree of risk its presents, as well as the organization of the regulated entity.

Evaluating the regulated entity's policy-making process involves assessing policies and procedures of the regulated entity as a whole, as well as policies and procedures of specific activities and operations. The review of the policy-making process should be closely coordinated with the examiners' reviews of other areas of examination interest. Significant deficiencies in specific policies or procedures may result in adverse financial or other conditions and generally indicate weaknesses in the policy-making process.

Policies are guides for achieving the established objectives and strategies of the institution. Procedures are the steps taken to implement policies. Both policies and procedures are necessary to ensure sound business practices. The board of directors is responsible for formulating sound policies. The board must ensure that policies and procedures are appropriate for the regulated entity and consistent with strategic goals, objectives, and risk tolerances. Senior management is responsible for implementing the board's policies through the development of appropriate procedures.

Although the board of directors usually delegates the day-to-day conduct of the regulated entity's business to senior management, the board is ultimately accountable for the consequences of unsound or imprudent policies and the lack of policy guidance.

The purpose of policy-making is to provide guidance to staff in making decisions and taking actions. Policies prescribe a course of action that is expected to achieve a particular goal. The anticipated effects of those goals on the organizational structure, financial condition and performance, product and service offerings, and marketing, as well as consistency with the regulated entity's strategic direction and risk tolerance limits, should be considered in policy development.

Policies provide for future planning, taking into account the unique characteristics of the regulated entity and the board of director's goals and objectives. Policies must establish responsibility for managerial decisions and provide a mechanism for the necessary coordination between different departments within the institution. The board of directors must provide a clear framework of policies within which executive management must operate and administer the regulated entity's activities. Policies should be stated in broad terms to allow for varying situations, and periodically reevaluated and modified when necessary.

Policies generally should incorporate the following six principal elements:

1) The purpose of the policy should be clearly defined. The policy should also define the objectives that are to be accomplished.
2) The policy should specify the operating policy parameters within which management and staff are expected to operate. The parameters should be consistent with FHFA regulations, federal and state law, and professional standards, for example Generally Accepted Accounting Principles. The parameters should also ensure the safety and soundness of the regulated entity, adequately control risk, and be compatible with the regulated entity's risk profile.
3) The authorities delegated to management should be clearly defined, consistent with the risk profile of the regulated entity, and within the operating parameters, regulations, and laws.
4) Authorities not delegated to senior management and retained for board of directors approval or action should be clearly stated in the policy.
5) The policy should provide a clearly defined process to address exceptions to the operating parameters.
6) The policy should describe reporting requirements, such as what is to be reported to the board of directors, the frequency and content of the reports, and the individual responsibilities for preparing the reports.

Procedures detailing the planned implementation of policies should be developed and include steps for obtaining appropriate board approval for exceptions. Procedures should be reevaluated and modified when necessary. Procedures should be consistent with adopted policies and generally establish the following:

1) Purpose and objective;
2) Tasks to be performed;
3) Responsibilities of positions involved;
4) Appropriate departmental interactions;
5) A clear sequence of actions or steps to be taken to accomplish the objectives of the procedures and provide adequate controls; and
6) Sufficient detail to provide adequate direction to intended users.

The board of directors and senior management are responsible for ensuring that policies and procedures are thoroughly understood at all levels of the regulated entity. Without adequate communication, policies and procedures may not be properly implemented.

<u>Internal Controls</u>

Internal controls are measures taken by senior management to enhance the likelihood that established objectives and goals will be achieved. Senior management should ensure that it plans, organizes, directs, and controls a sufficient number of actions to reasonably assure that the institution's goals and objectives will be achieved. Internal controls may be preventive (to deter undesirable events from occurring), detective (to detect and correct undesirable events which have occurred), or directive (to cause or encourage a desirable event to occur).

Senior management is responsible for the identification and evaluation of the institution's risk exposures and the establishment of an effective and efficient internal control environment that promotes the following:

1) Reliability and integrity of financial and operational information;
2) Effectiveness and efficiency of operations;
3) Safeguarding of assets; and
4) Compliance with laws, regulations, and contracts.

The internal control environment represents the collective effect of various factors that establish or enhance the effectiveness of, or mitigate risk in, specific management processes. The evaluation of the internal controls provides the examiner a basis for assessing senior management's effectiveness in overseeing the activities of the institution.

The evaluation of the internal control environment is a key factor in assessing a board of directors' and senior management's administration of the regulated entity's activities. Examiners should consider the following factors when performing this assessment:

1) *Management philosophy and operating style.* Management's philosophy and operating style encompass a broad range of characteristics applicable to both the board of directors and senior management which could affect the internal control environment. Specific examples include the approach to taking and monitoring the regulated entity's risk exposures, attitudes, and actions with respect to financial reporting; adequacy of and compliance with policies and procedures; and emphasis on planning, budget, earnings, housing finance and community investment activities, and other financial and operating goals.

2) *Organizational structure.* Organizational structure provides the overall framework for the internal controls needed to ensure effective planning, organizing, directing, and controlling of the regulated entity's activities. The institution's size, diversity, and complexity of operations affect the level of control required. An organizational structure also includes consideration of the form and nature of a regulated entity's major business units and related management functions and reporting relationships. In addition, an organizational structure should provide the framework for the assignment of responsibility for risk taking and risk monitoring within the regulated entity in an appropriate manner.

3) *Methods of assigning authority and responsibility.* Methods of assigning responsibility affect the understanding of reporting relationships and responsibilities established within the regulated entity. Specific methods of assigning responsibility include consideration of:

   a) Policies regarding such matters as acceptable business practices, conflicts of interest, and codes of conduct;
   b) Assignment of responsibility and delegation to address matters that relate to organizational goals and objectives, operating functions, and regulatory requirements;
   c) Employee job descriptions delineating specific duties, reporting relationships, and constraints;
   d) Performance standards; and
   e) Computer systems documentation indicating the procedures for authorizing transactions and approving system changes.

   In assessing the methods of assigning authorities and responsibilities, consideration should be given to how certain duties are assigned. Generally, no one person should have the authority to perform or approve all aspects of a particular function. For example, the duties associated with the requisition, approval, recording, and reconciliation of a particular transaction should not be assigned to the same employee. Also, duties should be periodically rotated and/or performed by other employees during leave of absences. Limiting and rotating duties can control the ability of one person to make significant errors or perpetrate significant irregularities without timely detection.

   Directors must structure their dealings with the regulated entity to comply with legal requirements and avoid the appearance of a conflict of interest. Likewise, they must administer the affairs of the regulated entity fairly and impartially, without discrimination in favor of or against any member or counterparty. In addition, directors must take reasonable action to prevent employees from abusing their positions with the regulated entity. The board of directors should adopt a written code of conduct including ethical conduct applicable to directors, management, and subordinate employees, including provisions setting forth requirements for confidentiality of information, employee treatment and safety, and conflicts of interest. 12 CFR Part 1261 of the FHFA regulations establishes specific requirements for the FHLBank's conflicts of interest policy. 12 CFR 1710.14 of OFHEO's regulations established requirements for code of conduct and ethics for the Enterprises.

4) *Human resources management (HRM).* HRM focuses on effective personnel management and involves placing and employing personnel in an institution's structure through selection, appraisal, compensation, and development programs.

HRM is not an isolated element of organizational management and it is integral to other corporate processes such as planning, organizing, directing, and controlling. An effective HRM program should include the following:

a) Board of directors-approved personnel policies and practices that address the regulated entity's ability to employ competent personnel to accomplish its goals and objectives. Personnel policies and practices should address compliance with laws and regulations, hiring, evaluating, training, promoting, compensating, and retaining employees, as well as providing the necessary resources to enable them to properly discharge their responsibilities.

   A regulated entity should have a board of directors-approved equal employment opportunity (EEO) policy that addresses the following practices:

   i. Hiring and disciplinary action;
   ii. Compensation, assignment, or classification of employees;
   iii. Transfer, promotion, layoff, or recall;
   iv. Job advertising and recruitment;
   v. Testing;
   vi. Use of company facilities;
   vii. Training and apprenticeship programs;
   viii. Fringe benefits;
   ix. Pay, retirement plans, and disability leave; and
   x. Other terms and conditions of employment.

   Examiners should verify that compliance with the regulated entity's EEO policy and operating practices are evaluated by the internal auditors and periodic reports are made to the board of directors as to the status of policy compliance. Examiners should be alert to any current or potential litigation or other claims challenging the regulated entity's EEO policy that may indicate weaknesses in the institution's risk management, governance, and internal control structure.

b) Employee performance accountability that requires management to evaluate and review job performance, usually through a performance evaluation system. Evaluating and reviewing performance provides an internal control to promote, monitor, and evaluate adherence to policies, procedures, laws, and regulations. The process also allows for the detection and correction of weaknesses in operating systems and records and provides management with a means of establishing and maintaining control over delegated duties.

c) Executive and Non-Executive compensation (including incentive compensation) policies that are structured to avoid potential incentives for excessive risk taking. Compensation policies should align with performance, risk, and the regulated entity's long-term financial condition. Compensation programs that do not properly account for risk could encourage risk-taking actions that may be detrimental to the regulated entity's performance and reputation.

5) *External influences.* External influences are influences established and exercised by parties outside the regulated entity that affect the institution's operations and practices. These influences include FHFA and external auditors. While external influences are outside the regulated entity's authority, such influences can heighten senior management's consciousness of, and attitude toward, the conduct and reporting of the regulated entity's activities. They may also affect management's attitude toward compliance with law, regulation, and policy. Outside parties may also prompt management to establish specific internal control structure policies or procedures.

   External influences also can adversely affect the effectiveness of internal controls. For example, competitive pressures may result in lending staff relaxing or even circumventing certain credit standards. Additionally, key officers or employees may take inappropriate actions when their personal financial interests (bonuses, performance awards) depend unduly upon short-term operating results or the financial condition of the regulated entity. Examiners should be alert to circumstances outside the regulated entity that may lead employees, officers, and even directors, to pursue activities and actions that could adversely affect the interests of the regulated entity.

6) *Management Information Systems (MIS).* MIS comprises the system(s) that the regulated entity uses to obtain, generate, and report information needed to make decisions, plan, monitor, and oversee the institution's risk exposures and activities effectively. MIS incorporates both automated and manually operated systems, as well as the manner in which information flows through the institution and is reported to the board of directors and management.

   The board of directors is responsible for determining the information needs and the most effective means of fulfilling them. Consequently, the board should communicate its expectations for the reporting of information to management through formal written policies. The policies should identify what information is to be reported, with what frequency, and when. In addition, sufficient policy direction should be in place to ensure that the information is accurate, complete, and presented in a usable format. Policies also should address the extent to which automation and integration of the various information sources and systems should be employed to enhance reliability, usability, and efficiency.

   Direction by the board of directors should specifically address the information needed to monitor and oversee the regulated entity's risk exposures and activities. Monitoring and oversight is required to ensure that the regulated entity is progressing toward stated objectives and that failure to comply with or weaknesses in operating standards and risk tolerances are identified and corrected. The board should periodically assess the adequacy of MIS in meeting these objectives. The review should determine whether MIS provides sufficient information to:

a) Review and assess performance relative to the strategic business plan and policy objectives;
b) Evaluate compliance with the operating policies, delegated authorities, and reporting requirements outlined in policies;
c) Assess compliance with laws, regulations, and sound business practices;
d) Determine the financial condition and performance of the institution;
e) Determine the condition of the loan portfolio, other major assets, as well as liabilities;
f) Identify and evaluate operational deficiencies that increase the risk of loss or reduce efficiencies; and
g) Evaluate the status of corrective actions to address previously identified weaknesses.

Examiners should evaluate the specific information needs and reporting requirements for each area of the regulated entity. The amount of information and frequency of reporting should be dependent upon the risk exposures and overall effect on the safety and soundness of the regulated entity.

7) *Litigation and other legal matters.* Current or threatened litigation, or other legal claims, can pose significant costs to the regulated entity. Whether legal issues give rise to unenforceable contracts, lawsuits, adverse judgments, forgone business opportunities, loss of mission/strategic focus, or diminished reputation, they can disrupt the operations, possibly reducing earnings and capital and damaging the regulated entity’s image in the marketplace. Boards of directors and senior management must properly assess and manage the risks associated with litigation and other legal matters.

   Examiners should assess the potential effect of current or threatened litigation or other legal claims upon the financial condition, performance, and reputation of the regulated entity, as well as determine whether the issues indicate weaknesses with the regulated entity’s risk profile, governance, and internal control structure.

8) *External and internal audit programs.* External and internal audit programs are integral components of the internal control environment. Internal audit is an independent function that contributes to the effectiveness and improvement of risk management, control, and governance systems. The objective of internal auditing is the evaluation of the adequacy and effectiveness of the internal control structure. These evaluations are used by management at all levels in the effective discharge of their responsibilities.

The role of the internal audit function is to assist management in attaining the regulated entity's goals by providing an independent and objective assurance and consulting service designed to add value and improve operations through independently reviewing and evaluating the effectiveness of operations and controls and by providing objective analyses and constructive recommendations. Management retains full control over the implementation of these recommendations.

The responsibility of the internal audit function extends beyond that of external auditors with respect to the reliability and integrity of information. External auditors are primarily concerned with the internal control structure relevant to a financial statement audit, which includes an evaluation of the regulated entity's ability to record, process, summarize, and report financial data consistent with the assertions in the financial statements, while the internal audit function is also concerned with controls over the effectiveness, economy, and efficiency of management decision-making processes that do not relate to a financial statement audit.

Regulatory Environment

The primary authorities governing, or relevant to, the structure, duties, and responsibilities of the regulated entities' boards of directors and senior management are set forth below. The examiner should ensure that the application of such authorities to a regulated entity has been considered by the regulated entity and its legal counsel.

1) Federal Home Loan Bank Act

Section 7 of the FHLBank Act states that "…the management of each FHLBank shall be vested in its board of directors," and that "the board of directors shall administer the affairs of the [FHLB]ank fairly and impartially without discrimination in favor or against any member borrower...." Section 7 also addresses the size and composition of the board of directors, the selection of directors, directors' terms, and director compensation. *(See* discussion of Section 7 in the FHLBank Environment section below.)

2) Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the Safety and Soundness Act)

The Safety and Soundness Act provides FHFA regulatory authority over Fannie Mae, Freddie Mac, the FHLBanks, and the Office of Finance. The act also establishes, among other things, FHFA's examination authorities, conservatorship authorities, and enforcement authorities.

3) Fannie Mae Charter Act and Freddie Mac Charter Act

12 USC 1716 and 12 USC 1451 – Define and limit the activities of Fannie Mae and Freddie Mac.

4) Rules and Regulations of the Federal Housing Finance Agency

12 CFR Part 1236 of the FHFA regulations establishes Prudential Management and Operations Standards (PMOS), and requires the regulated entities to adopt effective policies and procedures to address:

i. Internal Controls and Information Systems;
ii. Independence and Adequacy of Internal Audit Systems;
iii. Management of Market Risk Exposure;
iv. Management of Market Risk – Measurement Systems, Risk Limits, Stress Testing, and Monitoring and Reporting;
v. Adequacy and Maintenance of Liquidity and Reserves;
vi. Management of Asset and Investment Portfolio Growth;
vii. Investments and Acquisitions of Assets;
viii. Overall Risk Management Processes;
ix. Management of Credit and Counterparty Risk; and
x. Maintenance of Adequate Records.

5) Rules and Regulations of the Federal Housing Finance Agency and its predecessor, the Federal Housing Finance Board (Finance Board), which include the following parts and sections relevant to board of directors and senior management for the FHLBanks:

12 CFR Part 917 of the Finance Board regulations addresses the powers, responsibilities, and accountability of FHLBank boards of directors and senior management by prescribing standards for a corporate governance framework.

12 CFR Part 933 of the Finance Board regulations requires each FHLBank board of directors to submit a capital structure plan to the FHFA that complies with 12 CFR Parts 931 and 932.

12 CFR Part 1261 of the FHFA regulations sets forth the responsibilities of the FHLBanks and FHFA in the election and appointment of FHLBank directors as well as director eligibility requirements. 12 CFR Part 1261 of the FHFA regulations also requires each FHLBank to annually adopt a written compensation policy that adheres to standards prescribed in the regulation.

12 CFR Section 1270.10(b)(1) of the FHFA regulations requires, among other things, written quarterly certifications from the president of each FHLBank as to compliance with the liquidity requirements set forth in Section 11(g) of the FHLBank Act any other FHFA regulation and will remain capable of making full and timely payment of all of its current obligations, including direct obligations, coming due during the next quarter. (see 12 CFR 932.8).

12 CFR Part 1272 of the FHFA regulations requires the FHLBanks not undertake any new business activities, as defined in the regulation, except in accordance with the procedures set forth in 12 CFR 1272.3 of the FHFA regulations.

12 CFR 1273.7 of the FHFA regulations addresses the structure of the OF board of directors and establishes requirements for membership; terms; election of Chairperson, Vice-chair, and Independent Directors; by-laws and committees; compensation; corporate governance and indemnification; election and designation of body of law; delegation; and outside staff and consultants.

12 CFR 1273.8 of the FHFA regulations addresses the general duties of the OF board of directors and establishes director’s duties and requirements for meetings and quorum.

12 CFR 1273.9 of the FHFA regulations addresses the audit committee of the board of directors of the OF, including committee composition; committee responsibilities; charter; and delegation matters.

12 CFR Part 1274 of the FHFA regulations establishes audit and related requirements applicable to financial statements of the FHLBanks, the OF, and the Financing Corporation.

12 CFR Part 1291 of the FHFA regulations requires, among other things, the board of directors of each FHLBank to adopt a written affordable housing program (AHP) implementation plan that contains the information specified in 12 CFR 1291.3.

6) Rules and Regulations of the Federal Housing Finance Agency and its predecessor, the Office of Federal Housing Enterprise Oversight, which include the following parts and sections relevant to board of directors and senior management for the Enterprises:

12 CFR Part 1710 of the OFHEO regulations addresses powers and responsibilities of the boards of directors for Fannie Mae and Freddie Mac. In particular, 12 CFR 1710.15(1) requires the boards of directors of the Enterprises to adopt corporate strategies, major plans of action, and risk policies and programs, including prudent

plans for growth and allocation of adequate resources to manage operations risk.

12 CFR Part 1720 of the OFHEO regulations addresses safety and soundness; in particular, 12 CFR 1720.2, Appendix A, sections B.II.(i),(ii), and (iii) require balance sheet growth to be prudent with consideration given to volatility of funding, changes in credit or interest rate risk, and capital adequacy.

7) ***Advisory Bulletins of the Federal Housing Finance Board that provide supervisory guidance relating to the topic of oversight by the board of directors and senior management are the following:***

Advisory Bulletin 01-4, dated February 14, 2001, provides guidance on the avoidance by FHLBank boards of directors and staff of conflicts of interests. In addition to the FHFA regulations, FHLBanks should consider authoritative industry guidance and guidance provided by other bank regulators.

Advisory Bulletin 01-8, dated October 4, 2001, provides guidance regarding asset review, classification, and reporting.

Advisory Bulletin 02-3, dated February 13, 2002, and Advisory Bulletin 03-02, dated February 10, 2003, provides guidance on the considerations that FHLBank boards of directors should address in the formulation of their business continuity plans.

Advisory Bulletin 02-5, dated April 8, 2002, provides guidance on the role of the internal auditor in an FHLBank's development of its annual risk assessment.

Advisory Bulletin 02-7, dated August 27, 2002, provides guidance on unsecured credit reporting requirements by the FHLBanks.

Advisory Bulletin 02-8, dated October 7, 2002, provides guidance on the manner in which an FHLBank should respond to the placement by a Nationally Recognized Statistical Rating Organization (NRSRO) of an unsecured credit counterparty on "credit watch" for a potential rating downgrade.

Advisory Bulletin 03-03, dated March 6, 2003, provides guidance to the FHLBanks that permits expanded disclosure in their financial statements under certain circumstances.

Advisory Bulletin 03-4, dated March 18, 2003, provides guidance on what FHLBanks should include in capital plan amendment submissions for FHFA approval. The Advisory Bulletin also explains the amount of time that will likely be necessary to complete a review of the FHLBank's submission.

Advisory Bulletin 03-5, dated April 16, 2003, provides guidance on annual risk assessments required by 12 CFR 917.3(c).

Advisory Bulletin 03-08, dated August 18, 2003, provides guidance regarding capital management and retained earnings. Among other things, the Advisory Bulletin requires the board of directors of each FHLBank to maintain a complying formal retained earnings policy and to annually assess the adequacy of its retained earnings in the manner described therein.

Advisory Bulletin 03-9, dated October 3, 2003, provides FHLBanks with a uniform methodology for calculations of duration-of-equity in "designated low-rate environments," as defined in the Advisory Bulletin.

Advisory Bulletin 03-13, dated December 1, 2003, provides guidance to the FHLBanks on providing financial information to the OF for inclusion in the FHLBank System combined financial reports the OF prepares.

Advisory Bulletin 04-01, dated March 10, 2004, provides guidance on FHLBank use of service organizations to perform critical activities for the FHLBank's operations, particularly AMA programs.

Advisory Bulletin 04-2, dated May 13, 2004, establishes a minimum standard for minutes of board of directors and board committee meetings, including all general and executive sessions and board committee meetings.

Advisory Bulletin 04-5, dated September 29, 2004, provides guidance on interest rate risk management. Among other things, the Advisory Bulletin describes the policies, procedures, and internal controls, as well as risk measurement monitoring and reporting systems, that an FHLBank should maintain to measure and manage its interest rate risk exposure.

Advisory Bulletin 05-04, dated April 21, 2005, provides guidance related to regulatory reporting and AHP assessment calculations in connection with the adoption of Statement of Accounting Standards Number 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity."

Advisory Bulletin 05-05, dated May 18, 2005, provides guidance as to the risk management oversight responsibilities of the board of directors and senior management.

Advisory Bulletin 05-06, dated June 10, 2005, provides guidance on the process through which an FHLBank may obtain approval to make changes to a previously approved internal market risk model.

Advisory Bulletin 05-08, dated August 25, 2005, provides guidance concerning the FHFA's assessment of required FHLBank anti-predatory lending mortgage purchase and advance policies. The Advisory Bulletin sets out required contents for such policies and processes for their establishment and dissemination to members.

Advisory Bulletin 06-03, dated July 18, 2006, provides guidance on the circumstances under which an FHLBank may disclose "unpublished information," as defined in Part 911, in Securities and Exchange Commission (SEC) filings.

Advisory Bulletin 09-03, dated December 15, 2009, requires the validation and documentation of models and related controls on internal processes. Each FHLBank and the Office of Finance should have policies and procedures to ensure that its various models are appropriately documented and validated.

8) ***Regulatory Interpretations of the Federal Housing Finance Board are the following:***

2000-RI-6, Accounting Issues: Independent Auditor's Review of Quarterly Financial Information, dated June 23, 2000, is an interpretation of 12 CFR 1273.6(b)(1) that, among other things, requires each FHLBank and the combined FHLBanks to comply with an SEC rule requiring quarterly reviews by independent auditors of financial information the FHLBanks provide to the preparer of the FHLBank System's combined quarterly financial reports, as well as of the resulting financial reports.

2000-RI-24, Accounting Issues: Audit Committee Disclosures, dated September 19, 2000, notes adoption of an SEC rule requiring companies' inclusion in their proxy statements of audit committee reports and certain disclosures set forth in the rule. The Regulatory Interpretation requires FHLBanks to include in their annual reports the report of their audit committees and certain disclosures set forth in the Regulatory Interpretation.

9) ***Sarbanes-Oxley Act of 2002 (SARBOX) and regulations and interpretations of the Securities and Exchange Commission thereunder.***

The statute was enacted in response to various corporate scandals, and addresses various corporate governance requirements that relate to the responsibilities of corporate boards of directors, the external and internal audit function, the quality of a corporation's internal controls, and the accuracy of its financial reporting.

10) ***Foreign Corrupt Practices Act of 1977*** addresses concerns with illegal bribes to foreign officials and requires specific internal control standards and requirements that pertain to financial reporting.

11) ***Reports and other issuances of the Basel Committee on Banking Supervision (Basel Committee).***

    The Basel Committee is a committee of banking supervisory authorities established by the central bank Governors of the Group of Ten countries in 1974. It includes senior representatives of banking supervisory authorities and provides guidance and recommendations on sound supervisory standards worldwide, including those related to capital standards, risk management, internal controls, internal audit, corporate governance, and other areas central to the safe and sound operation of banks and other financial institutions.

12) ***Financial Accounting Standards Board ("FASB") Codification*** establishes standards of financial accounting and reporting governing the preparation of financial reports that are officially recognized as authoritative by the SEC and the American Institute of Certified Public Accountants (AICPA).

13) ***Regulations and interpretations of the Securities and Exchange Commission.*** The SEC is the federal agency that is principally responsible for enforcing the federal securities laws and regulating the U.S. securities markets. The federal securities laws require issuers of securities to disclose meaningful information about their business and financial condition.

14) ***Professional standards adopted by the American Institute of Certified Public Accountants.*** The AICPA is the national professional organization for certified public accountants. Its mission is to provide members with the resources, information, and leadership that enable them to provide professional services to benefit the public as well as employers and clients. In fulfilling its mission, the AICPA works with state certified public accountant organizations and gives priority to those areas where public reliance on certified public accountant skills is most significant.

15) ***Government Auditing Standards*** provides standards for audits of government organizations. The standards pertain to auditors' professional qualifications, the quality of the audit effort, and the characteristics of professional and meaningful audit reports.

16) ***Reports and other issuances of Committee of Sponsoring Organizations of the Treadway Commission***. The Treadway Commission is a private sector initiative established in 1985 to provide guidance on improving the quality of financial reporting by focusing on corporate governance, ethical practices, and internal control.

17) ***Professional standards adopted by the Institute of Internal Auditors.*** The Institute of Internal Auditors (IIA) was organized in 1941 to develop and promote the

professional status of internal auditing. The organization provides certification, education, research, and technological guidance for the profession. The IIA serves as the profession's resource on significant auditing issues worldwide.

Issues Specific to the Regulated Entities

Prudential Management and Operations Standards

Section 1108 of the Housing and Economic Recovery Act of 2008 (HERA) required the FHFA to establish prudential management and operations standards (PMOS) relating to the management and operations of the regulated entities. Under 12 CFR Part 1236 of the FHFA regulations, FHFA has ten PMOS standards, adopted in the form of guidelines, and enforcement actions to address the failure of a regulated entity to meet the prudential standards. A summary of each of the PMOS standards follows:

1) *Internal Controls and Information Systems.* The board of directors and senior management should ensure that the regulated entity has an effective internal control system that defines controls at every business level. In addition, a regulated entity should have information systems that provide relevant, accurate, and timely information and data.

2) *Independence and Adequacy of Internal Audit Systems* - The internal audit system for each regulated entity should adequately monitor the institution's system of internal controls, including information systems. These standards establish reporting requirements directly to the audit committee of the board of directors which is ultimately responsible for monitoring and evaluating the effectiveness of the internal audit function and ensuring that corrective action is appropriate to address concerns identified. The standard includes ensuring the audit function conducts risk-based audits and the audit function is properly staffed.

3) *Management of Market Risk Exposure.* A regulated entity should have a clearly defined and well-documented strategy for managing market risk.

4) *Management of Market Risk: Measurement Systems, Risk Limits, Stress Testing, and Monitoring and Reporting.* A regulated entity should have a risk measurement system that captures all material sources of market risk and provides meaningful and timely measures of risk exposure.

5) *Adequacy and Maintenance of Liquidity and Reserves.* A regulated entity should establish a liquidity management framework that ensures it maintains sufficient liquidity to withstand a range of stressful events. In addition, a regulated entity should set a liquidity risk tolerance that is appropriate for its business strategy and its mission goals and objectives. Further, a regulated entity should have a sound process

for identifying, measuring, monitoring, controlling, and reporting its liquidity position and its liquidity risk exposures.

6) *Management of Asset and Investment Portfolio Growth.* A regulated entity should manage asset growth and investment growth in a manner that is consistent with the regulated entity's business strategy, board-approved policies, risk tolerances, and safe and sound operations.

7) *Investments and Acquisitions of Assets.* A regulated entity should have an investment policy that establishes the regulated entity's investment objectives, risk tolerances, investment constraints, and procedures for selecting investments. The regulated entity should also have a policy that establishes guidelines for asset acquisitions that are appropriate for the regulated entity's mission and objectives.

8) *Overall Risk Management Processes.* The board of directors should ensure that the requisite processes are in place to identify, manage, monitor, and control the regulated entity's risk exposures on a business unit and an enterprise-wide basis.

9) *Management of Credit and Counterparty Risk.* A regulated entity should have credit risk management policies, procedures, and systems that are appropriate for its business model and that cover all aspects of credit administration including credit pricing, underwriting, credit limits, collateral standards, and collateral valuation. The policies should also cover the use of derivatives.

10) *Maintenance of Adequate Record.* A regulate should maintain financial records in compliance with Generally Accepted Accounting Principles (GAAP), FHFA guidelines, and applicable laws and regulations.

Prudential Management and Operations Standards

Std	Description	Examination Guidance
1	Internal Controls and Information Systems	**Exam Module** – Board and Senior Management, Information Technology Risk Management, and Business Continuity Planning
2	Independence and Adequacy of Internal Audit Systems	**Exam Module** – Internal and External Audit
3	Management of Market Risk Exposure	**Exam Module** – Interest Rate Risk Management, Derivatives, Securitizations
4	Management of Market Risk – Measurement Systems, Risk Limits, Stress Testing, and Monitoring and Reporting	**Exam Module** – Interest Rate Risk Management, Derivatives, Risk Modeling
5	Adequacy and Maintenance of Liquidity and Reserves	**Exam Module -** Liquidity
6	Management of Asset and Investment Portfolio Growth	**Exam Module** – Investment Portfolio Management, Acquired Member Assets, and Advances and Collateral
7	Investments and Acquisitions of Assets	**Exam Module** – Investment Portfolio Management and Acquired Member Assets
8	Overall Risk Management Processes	**Exam Module** – Enterprise Wide Risk Management
9	Management of Credit and Counterparty Risk	**Exam Module** – Advances and Collateral, Acquired Member Assets, FHLBank Membership, Credit Risk Management
10	Maintenance of Adequate Records	**Exam Module** – Financial Reporting

Issues Specific to the FHLBanks

The FHLBank Act provides for the management of each FHLBank to be vested in the FHLBank's board of directors and states that each FHLBank is a corporate entity. In addition to authorizing certain enumerated corporate and banking powers, the FHLBank Act grants each FHLBank all such incidental powers as are consistent with the provisions of the FHLBank Act and customary and usual in corporations generally. Attendant to the exercise of customary and usual corporate powers, FHLBank boards of directors are subject to the same general fiduciary duties of care and loyalty to which the board of directors of a state-chartered business or banking corporation would be subject.

The duties and responsibilities of an FHLBank director derive from a source different from that of a director of a state-chartered business or banking corporation. Each FHLBank is created in accordance with federal law to further public policy, and its statutory powers and purposes are not subject to change except by the Congress. An FHLBank's board of directors has neither the right nor the duty to alter the purpose of the FHLBank, whereas an ordinary corporate board of directors may approve mergers, consolidations, and changes in the corporate charter that could alter the objectives and nature of the business of the corporation. The directors of an FHLBank are responsible for ensuring that the FHLBank achieves the statutorily-mandated mission of promoting housing finance and community lending, and meeting the FHLBank's statutory obligations of making contributions to its affordable housing program (AHP). The board of directors is also expected to ensure that the FHLBank operates in a financially safe and sound manner that is in compliance with law and policy.

In addition to establishing a distinct mission for the FHLBanks and a federally-derived source of duties and responsibilities for each FHLBank director, the FHLBank Act contains other provisions that may distinguish certain features of corporate governance at the FHLBanks from those encountered at a state-chartered business or banking corporation. For example, Section 7 of the FHLBank Act governs the size and composition of FHLBank boards of directors, the manner of selection of board members, and the terms and compensation of directors. While such differences may influence the manner in which the principles of sound corporate governance, described previously, apply at the FHLBanks, they do not reduce the continuing application of these principles to the FHLBanks.

12 CFR 917.7 of the Finance Board's regulations requires the board of directors of each FHLBank to establish an audit committee of the board. The audit committee is responsible for monitoring, overseeing, and evaluating the extent to which an FHLBank's management, internal audit function, and the external auditors successfully carry out their duties and responsibilities to maintain the FHLBank's processes for controlling its operations; ensure the reliability and integrity of the organization's accounting, financial

reporting and disclosure practices; and ensure that all issues reported by the institution's internal audit function, external auditor, and other outside auditors have been satisfactorily resolved.

Issues Specific to the Enterprises

The Enterprises have been operating under the conservatorship of, and with the financial support of, the federal government since September 2008. FHFA acts as conservator, and the Department of Treasury provides financial support through Senior Preferred Stock Purchase Agreements (PSPA). As conservator, FHFA has the statutory responsibility to preserve and conserve assets of the Enterprises and to take necessary action to put them in a safe and sound condition. When exercising conservator authority, FHFA seeks to:

1) Maximize net present value;
2) Minimize losses to the Enterprise; and
3) Ensure competition and fair and consistent treatment of offers.

FHFA, as conservator of Fannie Mae and Freddie Mac, succeeded to all "rights, titles, powers, and privileges" and assets of each company, and all "rights, titles, powers, and privileges" of any director, officer, or stockholder of either company. In exercising these authorities, in November 2008, FHFA issued an order delegating general management responsibility back to the boards of each company. At the same time, FHFA provided letters of instructions to the boards of directors that made exceptions to the order and expressly required conservator review or approval of specific items. On November 15, 2012, FHFA revised and replaced the 2008 letters of instruction to the boards of directors to provide greater specificity on the respective roles and responsibilities of FHFA, the boards, and management in relation to the conservatorship. The 2012 letters of instruction include specific instruction regarding matters not delegated by the conservator to the board. These non-delegated actions include actions requiring approval of or consultation with the U.S. Treasury under the terms of the PSPA (Part A), actions requiring approval of the conservator (Part B), and actions requiring notice to the conservator (Part C).

The letters require that the board confirm that management has established appropriate policies and procedures to coordinate with FHFA with respect to matters not delegated. Additionally, the policies and procedures should include management's responsibility to communicate with appropriate FHFA personnel to assure the agency is made aware of on an ongoing and current basis significant pending, contemplated, or actual plans regarding matters requiring conservator approval.

Specifically, the board of directors should oversee that management consult with or obtain the written approval of the Conservator before taking action in the following areas (Parts A and B)

Actions Requiring Approval under the PSPA (Part A)

1) The declaration or payment of dividends or making any other distribution with respect to capital stock, or the redemption, purchase, retirement, or other acquisition of capital stock.
2) The sale or issuance of capital stock, other than as contemplated under the PSPA.
3) Any reorganization or recapitalization involving the Enterprise's common stock.
4) Incurring indebtedness in excess of limits set forth in the PSPA.
5) Issuance of any subordinated debt.
6) Entering into a merger or consolidation with another entity, or the purchase or acquisition of all or substantially all of the assets of another entity or any division, unit, or business of another entity.
7) Engaging in any transaction with an affiliate of the Enterprise, unless such transaction is on terms no less favorable to the Enterprise than would be obtained in a comparable arm's length transaction or in the ordinary course of business or pursuant to an obligation predating the PSPA.
8) Any sale, transfer, or other disposition of assets, unless the disposition is for fair market value and (a) of assets or properties in the ordinary course of business, consistent with past practice; (b) of assets or properties have fair market value individually or in aggregated less than $250,000,000; (c) of cash or cash equivalents for cash or cash equivalents; or (d) necessary to comply with the PSPA's limits on ownership of Mortgage Assets.
9) Entering into new compensation arrangements or increasing amounts or benefits payable under existing compensation arrangements of officers of the Enterprise who are Named Executive Officers.

Actions Requiring Approval of the Conservator (Part B)

1) Engaging in redemptions or repurchases of subordinated debt issued by the Enterprises, except as requiring U.S. Treasury approval under the PSPA.
2) Increases in Board risk limits, material changes in accounting policy, and reasonably foreseeable material increases in operational risk.
3) Matters that relate to the Conservator's powers, the status of the Enterprises in conservatorship, or the legal effect of the conservatorship on contracts.
4) Retention or termination of external auditors and law firms serving as consultants to the Board.
5) Agreements relating to litigation, claims, regulatory proceedings, or tax related matters where the value of the claim is in excess of $50 million, including related matters aggregating to more than $50 million. Such agreements do not include loan workouts, which are conducted in the ordinary course of business.
6) Alterations or changes to the terms of the master agreement between an Enterprise and one of its top five single family sellers or top five single family servicers that

are otherwise not mandated by FHFA and that will alter, in a material way, the business relationship between the parties.

7) The termination of a contract between an Enterprise and one of its top five single family sellers or top five single family servicers.
8) Actions that in the reasonable business judgment of the management of an Enterprise, at the time that the action is taken, are likely to cause significant reputational risk to the Enterprise or result in substantial negative publicity.
9) Creation of any subsidiary or affiliate, or entering into a substantial transaction with a subsidiary or affiliate, except for the creation of, or transaction with, a subsidiary or affiliate undertaken in the normal course of business.
10) Setting or increasing the compensation or benefits payable to the members of the Board of Directors of an Enterprise.
11) Entering into new compensation arrangements or increasing amounts or benefits payable under existing compensation arrangements of executives in addition to those covered under Section A including SVPs and above and other executives as FHFA may deem necessary to successfully execute its role as Conservator.
12) Any establishment or modification by an Enterprise of performance management processes for SEC Section 16 officers and executives, including the establishment or modification of a Conservator scorecard.
13) Any assessment by an Enterprise of the performance of the Enterprise against a Conservator scorecard.
14) Establishing the annual operating budget.

Actions Requiring Notice to the Conservator (Part C)

Part C of the letters of instruction notifies the Enterprises that FHFA requires timely notice from both Enterprises of any planned changes in business processes or operations, including changes to Enterprise single- and multi-family credit policies and loss mitigation strategies that management has determined in its reasonable business judgment to be significant. The Enterprises are required to have processes in place to notify FHFA promptly in order that FHFA may participate in decision-making as FHFA determines appropriate. The letters of instruction cite examples that would fall under this category including:

- Proposed changes in the business processes, policies, or operations of the Enterprises that management anticipates to be significant.
- Proposed plans that management has determined would alter, in a material way, the services provided, products offered, or external business practices of the Enterprises.
- Proposed transactions, regardless of size, that in the business judgment of Enterprise management are not in the ordinary course of business, are not consistent with past practices, and involve material risk.

- Actions that in the reasonable business judgment of Enterprise management, at the time the action is to be taken, are likely to cause heightened reputational risk to the Enterprise.
- Significant changes in customer policies or business strategies of the Enterprises that could materially adversely impact, as a group, customers of the Enterprises.
- Any significant reorganization, anticipated layoffs, or material changes in employee compensation that could materially impact the employees of the Enterprises.
- Any significant changes in the approved operating budget that will impact draws from or dividends to the U.S. Treasury.
- The commencement of contractual negotiations between an Enterprise and a third party, where the contract, if executed, would have a significant financial or operational impact on the Enterprise, as determined in the reasonable business judgment by Enterprise management.
- Any activities required by FHFA's "External Communications Standards for Enterprises in Conservatorship," which details specific notification requirements when the Enterprises engage in external communication with Congressional or Administration contacts, the media, and trade groups.

Additionally, the Enterprises are prohibited from engaging in political activity, including lobbying. Contacts with federal, state, and local officials need to be coordinated with FHFA in advance to ensure that advocacy of particular public policy outcomes is avoided and communication involves exclusively transactional business, factual, technical, or educational matters.

Notwithstanding any delegation of functions, FHFA retains its right and authority to review and approve or to require review and approval of any transaction or activity at any time.

FHFA examiners are not directly involved in the review of proposals, initiatives, or decisions for the conservator. Rather, examiners are responsible for ongoing reviews of various governance practices and control mechanisms within the Enterprise to ensure these practices and controls are functioning without safety and soundness concerns. Division of Enterprise Regulation (DER) examiners may be asked to provide technical assistance on an item for conservatorship action, but other FHFA resources should be utilized to the extent feasible to ensure examinations remain the examiners' high priority. Where appropriate, DER examiners, and perhaps with technical assistance from DSPS, may include within the scope of their examination work on the Enterprises' implementation of conservatorship decisions.

12 CFR 1710 and 1720 of the OFHEO regulations provide requirements specific to the Enterprises with respect to corporate governance and safety and soundness, respectively. The following areas are addressed in these regulations:

1) Committees of board of directors;
2) Compensation of board members, executive officers, and employees;
3) Code of conduct and ethics;
4) Conduct and responsibilities of board of directors;
5) Prohibition of extensions of credit to board members and executive officers;
6) Certification of disclosures by the CEO and the chief financial officer;
7) Change of audit partner;
8) Compliance and risk management programs; compliance with other laws;
9) Asset underwriting and credit quality;
10) Balance sheet growth and management;
11) Market risk;
12) Information technology;
13) Internal controls;
14) Audits;
15) Information reporting and documentation;
16) Board and management responsibilities and function;
17) Format of policies and procedures;
18) Compliance plans;
19) Non-mortgage liquidity investment activities; and
20) Information security programs.

Examination Guidance

The workprogram for the Board of Directors and Senior Management examination module is detailed below. If this module is included in the examination scope, the examiner must perform worksteps sufficient in coverage to document the basis for conclusions on the quantity of risk and quality of risk management pertaining to this area. Transaction testing is mandatory and the examiner must document sufficient worksteps from Section 4, *Testing*, to support the findings and conclusions from this examination module.

In determining the extent of review and testing to be conducted in completing each examination, the examiner should take into account any applicable FHFA off-site monitoring or analysis reports, such as analysis of the quality and effectiveness of corporate governance practices, financial condition and performance, economic and housing industry conditions, internal controls, and audit coverage.

NOTE: Text in (*italics*) referenced in a workstep represents illustrative guidance that serves as suggestions for specific inquiry.

1. Scope of Examination Work Performed

1) Review past reports of examination for outstanding issues or previous problems related to the board and senior management.

2) Review FHFA off-site monitoring or analysis reports, and workpapers produced as part of on-going monitoring, related to the board and senior management.

3) Assess the status of outstanding Matters Requiring Attention and violations pertaining to the board and senior management.

4) Review internal audit reports for outstanding issues relating to the board and senior management.

5) Review minutes of meetings of the board of directors and relevant board and management committees for any issues regarding the board and senior management.

6) Review past reports for outstanding issues or previous problems. Evaluate the adequacy of the regulated entity's responses. Consider the following:

a) Prior examination workpapers with respect to: (1) governance; (2) strategic planning; and (3) operating performance.
b) Prior quarterly reviews and correspondence.
c) External audit reports.
d) Current year strategic plan and budget.
e) Actual versus budget from prior business plans.
f) For the Enterprises, effectiveness of analyses of past business practice and their use in formulating future business plans.

6) Evaluate work completed by other offices within FHFA related to the regulated entity's efforts to achieve stated goals.

Summarize the work performed in the examination of the regulated entity's board and senior management. To the extent there were modifications to the originally planned scope based on concerns identified during the examination, document those changes and the reasons for such changes.

2. Description of Risks

1) For FHLBanks, evaluate the effectiveness of the annual risk assessment and determine if it reasonably identifies and evaluates all material risks as noted in 12 CFR 917.3(c). Investigate any action plans arising from the assessment and check corrective actions for effectiveness.

2) Conclude on the effectiveness of the board of directors and senior management's efforts to identify all risks facing the institution.

3. Risk Management

Risk Identification Process

1) Evaluate the processes to identify the regulated entity's exposure to risk. *(Does the board have a fundamental understanding of the regulated entity's business activities and the associated risks?)*

2) Evaluate the analysis conducted that provides the basis for the regulated entity's chosen risk profile. *(Does the analysis support the board's business decisions? Is the analysis timely, complete, and relevant?)*

Organizational Structure

1) Evaluate the composition and role of board and management committees. *(Do the committees operate under formal charters? Are minutes kept at each committee meeting? Do committee members have sufficient expertise for the role of the committee?)*

2) Evaluate the appropriateness of the frequency of the board of directors' meetings. *(Are special meetings convened to address changing economic conditions?)*

3) Determine if the regulated entity has an orientation program for new directors that explains their duties.

4) Evaluate the process for hiring the FHLBank's CEO, as well as plans for management succession. *(What did the selection criteria include?)* (FHFA, as conservator, approves the hiring of the CEO for Fannie Mae and Freddie Mac.)

5) Evaluate the management succession plan. (*Did the process include an evaluation of individual's current and potential management skills? Does the plan address developing the necessary skills needed for new responsibilities?)*

6) Evaluate the board of directors' process for assessing senior management performance. *(Does the board hold management accountable for achieving desired results?)*

7) Assess and conclude on the adequacy of the regulated entity's organization structure. (*Are duties appropriately segregated to keep risk taking activities separate from risk mitigation? Are roles clearly defined?*)

Policy and Procedure Development

1) Determine if the board of directors has established a comprehensive set of operational policies that sufficiently address all risks, as well as regulatory requirements.

2) Evaluate operational and risk management practices that are established to implement board-approved policies. *(Are all critical activities addressed?)*

3) Determine if the board has established a process to review and oversee third-party relationships.

4) Evaluate the board of directors' role in establishing enterprise-wide risk management policies and procedures. Consult with the examiner responsible for completing the Enterprise Risk Management workprogram.

5) Evaluate management's controls implemented to ensure adherence to board-approved policies. *(How are exceptions to policy documented, reported, and approved? Have the controls been effective in helping the regulated entity achieve established goals and objectives?)*

6) Evaluate the methods to manage the identified and accepted risks. *(Have the risks been effectively mitigated?)*

7) Evaluate the board policies established to promote ethical conduct by directors, management, and staff.

Risk Metrics

1) Evaluate the process for establishing risk limits. *(Do risk limits appropriately reflect the risk appetite established by the board of directors?)*

2) Review and assess any deviations from the established risk limits. *(Is there a board policy that allows exceptions to the established risk limits? What is the approval process for exceptions?)*

3) Review and conclude on the appropriateness of compensation (including incentive compensation) policies and programs. (*Do incentive compensation programs encourage excessive risk taking? Are long-term financial objectives included?)*

Reporting

1) Determine if the board of directors is appropriately informed of the financial condition and operations of the regulated entity (including market and credit risk positions), and receives the necessary reports to evaluate operational results. *(Does the board receive information from outside sources, such as management consultants, in addition to internal reporting? Do reports show progress toward achieving long and short-term goals?)*

2) Determine if information reported to the board of directors is supplied with meaningful context. *(Are results presented along with strategic plan benchmarks? Do reports include trend analysis?)*

Internal/External Audit

1) Evaluate the promptness and effectiveness of corrective actions taken to address internal control weaknesses identified by internal or external audit. Consult with the examiner responsible for completing the Internal and External Audit workprogram.

2) Determine if the internal audit function is free from management influence. (*Does the internal audit function report directly to the audit committee of the board of directors? Does the board meet with internal audit in executive sessions?)*

Information Technology

1) Evaluate any information technology project initiatives. *(Is the project supported by an adequate feasibility analysis that was presented to the board for approval? Is the board kept apprised of progress?)*

2) Evaluate the sufficiency of the budget allocated to maintain an MIS to identify, measure, and monitor risks.

3) Determine if management conducts periodic assessments of its information systems. If so, review any identified weaknesses and determine if subsequent corrective actions were timely and effective. Consult with the examiner responsible for completing the Information Technology workprogram.

Compliance

1) Assess and conclude on the regulatory entity's efforts to comply with PMOS standards in 12 CFR Part 1236. Consult with the examiners responsible for completing other workprograms included in the scope of the examination.

2) For the FHLBanks, assess compliance with 12 CFR Part 917.5.

3) For the Enterprises, assess compliance with 12 CFR Part 1710 Corporate Governance and 12 CFR Part 1720 Safety and Soundness Standards.

4) For the Enterprises, assess compliance with Conservator decisions and directives. (*Does the board have effective processes for identifying matters that require the Conservator's approval, and for implementing the Conservator's decisions? Do board minutes reflect that matters requiring the Conservator's approval are sent to the Conservator in a timely fashion?)*

4. Testing

1) Review a sample of information packages provided to the board of directors prior to regularly scheduled board meetings. *(Do the information packages contain ad hoc reports in addition to standard reports? Are the information packages complete with sufficient disclosure to be understandable to the members of the board?)*

2) Review and assess the most recent performance evaluation of the CEO.

3) Assess adherence to the board-approved compensation policy for the senior management team. *(Does the compensation policy consider the financial condition, operating performance, and risk profile of the regulated entity?)*

5. Conclusions

1) Summarize conclusions for all examination work performed, including work performed by other FHFA staff, as it relates to the regulated entity's board and senior management. Develop a memorandum describing the risks to the institution resulting from weaknesses identified in the regulated entity's board and senior management practices. The memorandum should clearly describe the basis of conclusions reached and summarize the analysis completed. Within the memorandum, discuss the types of risk the regulated entity is exposed to (e.g., market, credit, operational); the level of risk exposure; the direction of risk (stable, decreasing, increasing); and the quality of risk management practices (strong, adequate, weak). A memorandum must be prepared irrespective of whether the examiner's assessment is positive or negative.

2) Conclude on the responsiveness to previous examination findings. Evaluate the adequacy of the regulated entity's response to previous examination findings and concerns.

3) Develop findings and prepare findings memorandums, as appropriate. Based on examination work performed, develop findings communicating concerns identified during the examination. Findings should identify the most significant risks to the institution and the potential effect to the regulated entity resulting from the concerns identified. Such documents should describe a remediation plan specifying the appropriate corrective action to address examination concerns and establish a reasonable deadline for the regulated entity to remediate the finding. Communicate

preliminary findings to the EIC. Discuss findings with regulated entity personnel to ensure that findings and analysis are free of factual errors.

4) Develop a list of follow-up items to evaluate during the next annual examination. In addition to findings developed in the steps above, include concerns noted during the examination that do not rise to the level of a finding. Potential concerns include issues the regulated entity is in the process of addressing, but require follow-up work to ensure actions are completed appropriately. In addition, potential concerns should include anticipated changes to the regulated entity's practices or anticipated external changes that could affect the regulated entity's future governance practices.

Workprogram

1. Scope of Examination Work Performed

Workpapers must document the examination activities undertaken to evaluate potential risks related to the board of directors and senior management function.

2. Description of Risks

- Identify areas of concern in the board of directors and senior management area
- Assess current risks and trends in the risk to the organization emanating from the board of directors and senior management function
- Evaluate changes within the organization or industry affecting risk
- Evaluate the entity's own risk-identification practices and conclude on their adequacy

3. Risk Management

- Assess and conclude on the adequacy of the organization's risk identification process
- Assess and conclude on the overall adequacy of internal controls, including an evaluation of:
  - The regulated entity's organizational structure
  - Policy and procedure development for this area
  - Appropriateness of risk metrics established in this area
  - Reporting by management and the board
- Assess and conclude on the internal and external audit of risks
- Assess and conclude on the adequacy of information technology and controls related to board of directors and senior management
- Assess and conclude on the adequacy of the organization's efforts to ensure:
  - Compliance with laws, regulations and other supervisory guidance
  - Compliance with the organization's policies and procedures

4. Testing

- Complete testing, as appropriate, to assess adherence with examination standards

5. Conclusions

- Summarize conclusions for all examination work performed related to the board of directors and senior management function
  - Conclude on the level of risk to the organization
  - Include an assessment of the adequacy of an organization's monitoring of risk and establishment of internal controls to mitigate risk
- Conclude on responsiveness to examination findings from previous examinations
- Develop findings and Matters Requiring Attention, as appropriate
- Identify areas requiring follow-up examination activities or monitoring