

# FHFA Examination Manual





December 19, 2013

The Examination Manual (the Manual) is a guide to the Federal Housing Finance Agency (FHFA)'s examination program for the Federal Home Loan Banks (FHLBanks), the Office of Finance, the Federal National Mortgage Association (Fannie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac). For convenience, the Manual refers to these institutions collectively as "the regulated entities," or "the institutions" unless it is necessary to clarify differences in examination practice or regulatory requirements.

Part I of the Manual provides a description of the examination program and a policy overview, including FHFA's mission and examination authorities. The description includes basic examination concepts, including risk-based examination fundamentals, FHFA's examination ratings system (CAMELSO), examination findings categories, FHFA's enforcement policy, examination documentation and records management requirements, the FHFA Style Guide, and quality control and quality assurance. Part I also sets forth the processes examiners follow when conducting examination activities at the FHLBanks and Office of Finance; and describes the work products examiners produce during those examinations. Further, Part I sets forth the processes examiners follow when conducting examination activities at Fannie Mae and Freddie Mac, and describes the work products examiners produce during those activities. Finally, Part I provides an overview of the regulated entities and a description of their primary business activities. Part II includes a general description of individual examination modules and provides hyperlinks to those modules. The modules provide examination instructions and workprograms organized by risk category and line of business. The Manual groups them under the CAMELSO examination ratings component to which they generally pertain; however, examiners should understand that examination work performed in conjunction with a workprogram may be relevant to more than one CAMELSO component. FHFA will update the Manual from time to time to reflect evolving examination practices, supervisory expectations, and regulated entity operations, as well as changes in regulatory requirements.

The Manual integrates and harmonizes examination policies and practices previously adopted by FHFA's predecessor agencies, the Federal Housing Finance Board (FHFB) (for the FHLBanks and the Office of Finance) and the Office of Federal Housing Enterprise Oversight (OFHEO) (for Fannie Mae and Freddie Mac). During the process of developing the Manual, FHFA considered differences between the FHLBanks and the Enterprises in accordance with the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, as amended. FHFA will also consider these differences during the development of additional examination policies and practices in the future.

A dynamic supervision and examination program depends on continual enhancement. FHFA welcomes feedback and suggestions for improvements to this Manual. Suggestions for enhancement may be sent to [SupervisionPolicy@fhfa.gov](mailto:SupervisionPolicy@fhfa.gov).

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## **PART I**

### **A. THE FEDERAL HOUSING FINANCE AGENCY EXAMINATION PROGRAM OVERVIEW**

FHFA's mission is to ensure that each FHLBank, Fannie Mae, and Freddie Mac operate in a safe and sound manner so that they serve as a reliable source of liquidity and funding for housing finance and community investment.

FHFA also supervises the Office of Finance (OF), a joint office of the FHLBanks and the fiscal agent for the Federal Home Loan Bank System (the FHLBank System). The OF offers, issues, and services consolidated obligations of the FHLBanks and prepares and issues combined financial statements for the FHLBank System. The OF is also responsible for managing the day-to-day activities of the Finance Corporation. The Financing Corporation was established to recapitalize the Federal Savings and Loan Insurance Corporation, and its sole purpose is to function as a financing vehicle for the Federal Savings and Loan Insurance Corporation Resolution Fund. FHFA also oversees and examines the Financing Corporation. References in the Manual to the OF also include the Financing Corporation.

FHFA has the statutory authority and responsibility to examine the regulated entities under the Federal Home Loan Bank Act (The FHLBank Act) and the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, as amended (the Safety and Soundness Act). FHFA conducts at least annual on-site examinations to determine the condition of, and evaluate the risk management practices of, each regulated entity.

### **B. FHFA EXAMINATIONS**

#### *1. Purpose of the Examination Manual*

The Manual provides examiners a resource for FHFA examination guidelines and requirements. The Manual provides examiners with necessary foundational information, and directs examiners to other relevant guidance.

The Manual applies to all FHFA examination activities. FHFA examiners may be assigned to examinations of any of the regulated entities, and should apply examination modules as appropriate based on the institution being examined. The FHFA examination program allows for flexibility in examination practices that reflect the nature, size, and complexity of the regulated entity under examination. Examiners should seek guidance from the examiner-in-charge (EIC) and/or the Division of Supervision Policy & Support's Office of Supervision Policy when they have questions about FHFA examination requirements.

FHFA provides detailed examination guidance to examiners through the examination modules. The examination modules pertain to specific topics (for example, credit risk management, operational risk management, liquidity risk management), and each includes an introduction with background information about regulated entity operations, a description of

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the regulatory environment (applicable laws, regulations, and regulatory guidance), examination guidance, and a workprogram for examiners to follow. FHFA also issues supplemental examination modules that focus on specific business lines, products, or discrete topics that complement the modules of the Manual.

FHFA will revise the Manual from time to time to reflect changes in the agency's examination program. FHFA will also issue additional examination instruction to address emerging issues and provide procedural updates. Revisions to the Manual will be publicly available, and other materials will generally be available to examiners through the FHFA Intranet site.

FHFA may provide guidance using the following types of documents:

- Public documents that communicate FHFA supervisory expectations to FHFA supervision staff and to the regulated entities on specific supervisory matters and topics. A regulated entity's failure to implement such guidance may be subject to examiner criticism. FHFA may seek public comment on these policy documents; however, they do not constitute rulemaking and are not subject to formal notice and comment requirements. This form of guidance includes FHFA advisory bulletins.
- FHFA internal guidance that notifies supervision staff of supervisory policy positions or internal process. This form of guidance includes supervision directives.
- FHFA internal guidance that provides general procedures to examiners to ensure the consistent application of FHFA examination program requirements by the examination staff. This form of guidance includes examiner guidance bulletins and examiner bulletins.
- FHFA internal guidance that provides detailed division-level procedures to examiners. This form of guidance includes division operating procedure bulletins.
- FHFA may issue supervisory and examination guidance in other forms as circumstances warrant.

## *2. Risk-based Examination Fundamentals*

FHFA conducts risk-based examinations. The supervision divisions in FHFA (the Division of Federal Home Loan Bank Regulation and the Division of Enterprise Regulation) prioritize examination activities based on the risk a given practice poses to a regulated entity's safe and sound operation or its compliance with applicable laws and regulations. Examinations focus on a regulated entity's process for managing risks associated with its strategies or activities that could, for example, impair earnings; deplete capital; compromise internal controls and operations; violate laws, regulations, or fail to conform with regulatory guidelines; or expose the regulated entity to undue reputational risk. New programs or products may also be determined to be a priority for supervisory purposes.

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Using a risk-based examination approach, FHFA determines whether the risks a regulated entity is exposed to as a result of its business activities and operations are reasonable and well-managed. The regulated entity should have sufficient capital relative to its risk exposures, and should be able to withstand business fluctuations and adverse changes in the economic environment. Examination modules contain workprograms that help examiners assess the types of risk the regulated entity is exposed to, the level of risk exposure, the direction of risk, and the quality of risk management practices. Each workprogram provides illustrative examples of worksteps and lines of inquiry the examiner could consider when completing the analysis required in the workprogram. Examiners should determine the specific worksteps and procedures to apply based upon the scope and objectives of the examination work.

FHFA examines risk management practices and the regulated entity's financial condition and safety and soundness relative to applicable laws, regulations, supervisory guidance, and prudent business practice. The report of examination identifies supervisory concerns and contains examination ratings that reflect FHFA's view of the regulated entity's financial safety and soundness and risk management practices. FHFA's supervisory engagement with its regulated entities may include ongoing monitoring and target examinations, as well as communication in various formats. Where there is a significant supervisory concern or violation of law or regulation, FHFA may issue a Matter Requiring Attention (MRA) that requires the board of directors and/or management to take corrective action to address deficiencies and violations (see *Examination Findings* section below). Those actions may include, for example, reducing risk exposures; increasing capital; and strengthening risk management processes, internal controls, and operational capabilities.

### 3. *FHFA Examination Rating System*

FHFA uses an examination rating system known as CAMELSO to assign a risk rating for: (1) the overall condition of each regulated entity (the composite rating), and (2) individual components of financial condition and risk management (the component ratings, described in more detail below). Examiners are expected to be knowledgeable of the details of FHFA's examination rating system and governing principles, which can be found in FHFA [Advisory Bulletin 2012-03 \(FHFA Examination Rating System\)](#) and in the final notice describing CAMELSO that FHFA published in the Federal Register on November 13, 2012<sup>1</sup>.

The individual component ratings are for **Capital**, **Asset quality**, **Management**, **Earnings**, **Liquidity**, **Sensitivity to market risk**, and **Operational risk**. For the Office of Finance, FHFA assigns ratings only to the Management and the Operational Risk components. The following descriptions summarize the discussion contained in Advisory Bulletin 2012-03.

*Capital* When rating a regulated entity's capital, examiners determine whether the regulated entity has sufficient capital relative to the entity's risk profile.

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<sup>1</sup> 77, No. 219 *Federal Register* 67644 (November 13, 2013).

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*Asset quality* When rating a regulated entity's asset quality, examiners determine the quantity of existing and potential credit risk associated with the loan and investment portfolios, advances, real estate owned, and other assets, as well as off-balance sheet transactions, and management's ability to identify, measure, monitor, and control credit risk.

*Management* When rating a regulated entity's management, examiners determine the capability and willingness of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of the regulated entity's activities and to ensure that the regulated entity's safe, sound, and efficient operations are in compliance with applicable laws and regulations.

*Earnings* When rating a regulated entity's earnings, examiners determine the quantity, trend, sustainability, and quality of earnings.

*Liquidity* When rating a regulated entity's liquidity, examiners determine the current level and prospective sources of liquidity compared to funding needs, as well as the adequacy of funds management practices relative to the regulated entity's size, complexity, and risk profile.

*Sensitivity to market risk* When rating a regulated entity's sensitivity to market risk, examiners determine the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect the regulated entity's earnings or economic capital.

*Operational risk* When rating a regulated entity's operational risk, examiners determine the exposure to loss from inadequate or failed internal processes, people, and systems, including internal controls and information technology, or from external events, including all direct and indirect economic losses related to legal liability, reputational setbacks, and compliance and remediation costs to the extent such costs are consequences of operational events.

Using the principles developed for CAMELSO, FHFA rates each individual component on a scale of "1" to "5." A "1" rating indicates the lowest level of supervisory concern; a "5" rating indicates the highest level of supervisory concern. FHFA also assigns each FHLBank, Enterprise, and the OF a numerical composite rating from "1" to "5."

The composite rating is derived from the ratings of the individual components. The composite rating of the OF is based primarily on an evaluation of Management and Operational risk components. When determining the composite rating, FHFA considers the relative importance of each component on a case-by-case basis. The composite rating is not an arithmetic average of the component ratings. Further, the component rating is not determined solely on the basis of the number and nature of specific examination findings FHFA issues to a regulated entity. MRAs and Violations (or examination findings issued under prior agency policy that required corrective action) identify specific supervisory

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concerns; however, they may not necessarily represent an exhaustive list of weaknesses at the regulated entity.

#### 4. *Examination Findings*

Examination findings include deficiencies related to, for example, risk management, risk exposure, or violations of laws, regulations, orders, or supervisory guidelines that affect, or may affect the future performance or condition of a regulated entity. FHFA uses three categories of examination findings: (1) Matters Requiring Attention, (2) Violations, and (3) Recommendations. MRAs are the most serious supervisory matters. Violations require action by the regulated entity to correct findings, if possible, of non-compliance with requirements and to change a program or practice to prevent recurrence. Recommendations identify policies, procedures, or practices that could be improved. FHFA [Advisory Bulletin 2012-01 \(Categories for Examination Findings\)](#) provides detailed instruction on examination findings, including definitions, remediation requirements, and FHFA follow-up activities.

#### 5. *FHFA Enforcement Policy*

FHFA has authority to pursue several types of enforcement action to address conditions and identified weaknesses at a regulated entity or the Office of Finance. Some actions are formal in nature, such as cease-and-desist orders, written agreements, removal and prohibition of officers and directors, the imposition of civil money penalties, capital directives, orders to enforce housing goals, prompt corrective action directives, and orders to address a failure to meet FHFA's prudential management and operations standards (the Office of Finance is not subject to FHFA's prudential management and operations standards). Other actions are informal, and include written commitments from a regulated entity's board of directors to take specific actions to resolve supervisory concerns. FHFA determines whether an enforcement action is necessary based on the specific circumstances of a given condition or weakness, including the statutory grounds provided for each form of action and the board and management's ability and willingness to take corrective action. Examiners should refer to FHFA [Advisory Bulletin 2013-03 \(FHFA Enforcement Policy\)](#) for additional detail.

When an examiner identifies conditions or weaknesses at a regulated entity that he or she believes are serious enough to warrant formal or informal enforcement action, the examiner must escalate the issue through appropriate senior supervision officials for determination of the appropriate course and supervisory response. FHFA [Advisory Bulletin 2012-01 \(Categories for Examination Findings\)](#) provides instruction regarding examination findings that constitute MRAs and Violations.

#### 6. *Examination Documentation and Records Management*

##### a. *Examination Documentation*

Examination documentation is the written record of examination activity and must support examination results, conclusions, findings, and ratings. Examination documentation facilitates the planning, performance, and supervision of examination

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activities, and is the basis for the review of the quality of the work under FHFA's quality control requirements. This documentation includes, for example, materials that evidence the planning of the examination work, the procedures performed, information obtained from the regulated entity under examination, and the examiner's analysis and conclusions. The FHFA Comprehensive Records Schedule, as implemented by the Divisions, contains additional detail on specific documents that are included in examination documentation. Examiners should refer to Appendix A of this Manual for a list of authorized work product and workpaper forms and use the corresponding FHFA templates when documenting examination work. Examiners should note that divisional operating procedures may provide more detailed documentation requirements and file management policies and comply with those requirements.

i. *Workpapers*

Examination workpapers include request and alert letters, planning documents, meeting notes, evaluation and analyses, research, conclusion letters, supervisory letters, workprograms and procedures, and other documents or data created or collected by examiners that support examination results, conclusions, findings, and ratings. Workpapers must be prepared in sufficient detail to provide a clear understanding of the examination work performed. They must also be objective and concise.

Examiners should ensure that they properly document communications of substantive information to the regulated entities. Substantive information includes, for example, agency decisions or official responses to requests from the regulated entities for specific FHFA action and for interpretations of agency policies. Workpapers should include e-mails and voicemails if they meet the definition of an FHFA "record." On this point, examiners should review and follow applicable FHFA policies such as *RM-At-A-Glance What are My Responsibilities for Managing [Emails](#) or [Voicemails that are Records?](#)*

Examiners must cross-reference documents provided by a regulated entity or other documents created by FHFA staff in their workpapers when necessary to support examination work. Unless otherwise authorized by the EIC, examiners should use hyperlinks to cross-reference other documents, and hyperlinks should use the unique object ID number for the referenced document. Examiners should consult with personnel from the FHFA Office of Technology and Information Management as necessary to ensure hyperlinks are completed properly and to reduce the chance of broken links in workpapers.

b. *Records Management*

Certain documents prepared during the course of examination activities will meet the definition of a "record" for purposes of the Federal Records Act, and are governed by FHFA records management policy; specifically, examiners are expected to review and comply with [FHFA Policy No. 207 \(Records Management Policy\)](#). As noted in the

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preceding section, examiners should be aware that FHFA records may be released to the public in response to FOIA requests and litigation. They also may be subject to review by the U.S. Government Accountability Office (GAO) and the FHFA Office of Inspector General (OIG).

i. *FHFA Electronic Recordkeeping System*

Examiners must post workpapers to the designated folder(s) in the FHFA electronic recordkeeping system that the EIC has authorized for examination documentation. Examination documentation described above are agency records and FHFA examination staff must follow FHFA's records management policy and complete all required FHFA records management training.

ii. *Confidentiality and Information Security*

Unauthorized disclosure of non-public information is prohibited and subject to civil and criminal penalties. In general, no FHFA employee in possession or control of non-public information may disclose or permit the use or disclosure of such information in any manner or for any purpose. Examiners are authorized to disclose non-public information only to other FHFA examiners, employees, and authorized contractors who have a need to know in conjunction with the performance of their official duties. Examiners should review FHFA regulations on disclosure of non-public information and confidential supervisory information at 12 CFR 1214, and also review [FHFA Policy No. 221 \(Federal Housing Finance Agency Information Classification Policy\)](#) and [FHFA Procedures for Policy No. 221 \(FHFA Information Classification and Handling Procedures\)](#) for additional information. Examiners must also complete mandatory FHFA training in information security and privacy awareness and strictly adhere to information security requirements.

FHFA examiners are responsible for maintaining adequate security over electronic and printed non-public information in their possession or control, particularly, confidential supervisory information as defined in FHFA regulations. FHFA staff must pay particular attention to securing information stored in FHFA-issued laptop computers, FHFA-issued flash drives or similar devices, and, if working in a VPN or Citrix environment, the computer in use at the time.

Examiners must immediately report any confirmed or suspected security breaches to the EIC and otherwise follow the reporting requirements in FHFA's Information Classification Policy and procedure. FHFA policy requires immediate reporting to the FHFA Help Desk at (202) 649-3990 during regular business hours (between 7:00 a.m. and 7:00 p.m.) or by email to [HelpDesk@fhfa.gov](mailto:HelpDesk@fhfa.gov) and to FHFA Information Security at [!OTIMSecurityTeam@fhfa.gov](mailto:OTIMSecurityTeam@fhfa.gov). The EIC must, in turn, notify his or her supervisor.

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iii. *Personally Identifiable Information*

Personally identifiable information (PII) is information in electronic or printed format that can be used to distinguish or trace an individual's identity either alone or when combined with other personal or identifying information that is linked or linkable to a specific individual. Sensitive PII is a subset of PII that if released would pose a higher risk of subsequent identity theft or personal harm. Examiners must follow FHFA policies related to PII, particularly requirements for reporting breaches of security involving PII. Examiners must report any known or suspected breached involving PII to the FHFA Chief Privacy Officer within one hour of becoming aware of it, and, if the breach involved a FHFA computer, FHFA information technology systems, or data, the examiner must also report the breach to the FHFA Help Desk at (202) 649-3990 during regular business hours (between 7:00 a.m. and 7:00 p.m.) or by email to [HelpDesk@fhfa.gov](mailto:HelpDesk@fhfa.gov). Examiners should refer to [FHFA Policy No. 301 \(Use and Protection of Personally Identifiable Information Policy\)](#) and the [FHFA Policy No. 601 \(Federal Housing Finance Agency \(FHFA\) Breach Notification Policy and Plan\)](#) for further guidance.

Generally, examiners should refrain from collecting source documents containing PII unless necessary to accomplish a specified examination objective. Examiners must not transmit PII, especially sensitive PII, using unencrypted email. Examiners must require a regulated entity to redact PII from requested documents. Staff must omit all unnecessary PII when entering information into spreadsheets, lists, or other summary documents. Staff must protect all PII that is under their control, including storing documents containing PII in a locked cabinet or room, saving electronic files in folders with restricted access, and ensuring that documents are not left unsecured on copiers, printers, or fax machines. See Examiner Guidance Bulletin 2009-EGB-01 (*Examination Information, Workpapers, and Personally Identifiable Information*).

7. *FHFA Style Guide*

When preparing examination documentation, examiners should use plain language that is easy to understand. Examiners should also follow the style standards and abbreviations in the FHFA Style Guide. The Style Guide is contained in the [FHFA Policy No. 801 \(Official Documents Policy\)](#). The FHFA Style Guide establishes FHFA-specific style standards and serves as a brief reference guide for examiners and other FHFA personnel. FHFA has adopted the *Chicago Manual of Style* as the source of guidance for grammar, capitalization, punctuation, and citing source materials. Examiners may access an electronic version of the *Chicago Manual of Style* through a link on the FHFA Intranet site.

8. *Quality Control*

Quality control ensures that examination activities comply with FHFA examination standards and procedural requirements, which are included in the FHFA examination manual, supplemental modules, supervision directives, and division operating procedures bulletins. Effective quality control ensures that examination conclusions, findings, and ratings are

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adequately supported and documented in accordance with FHFA standards and any significant deficiencies are identified and resolved prior to their communication to the regulated entities. FHFA's quality control program is described in a supervisory directive ([Supervision Directive 2013-01 \(Quality Control Program for Examinations Conducted by the Division of Bank Regulation and the Division of Enterprise Regulation\)](#)) and is designed to provide the EIC with actionable information regarding significant deviations from FHFA policy/procedure in a manner that allows the EIC to take appropriate corrective action.

Generally, quality control reviews should evaluate whether: (1) workpapers support examination findings, conclusions, and ratings; (2) examination work products are consistent with FHFA examination standards and supervision policy; and (3) examination procedures were consistent with the examination scope. Quality control reviews will be conducted by FHFA personnel who have experience with, and are knowledgeable of, FHFA examination requirements, but have not participated in the examination activity under review.

## **C. DIVISION OF FEDERAL HOME LOAN BANK REGULATION EXAMINATION PROCESS**

### *1. Introduction*

The Division of Federal Home Loan Bank Regulation's (DBR) examination and supervisory activities include an annual examination, periodic visitations, special reviews, and offsite monitoring. DBR relies on these activities to reach conclusions on the overall condition and the adequacy of risk management policies, procedures, compliance, and control systems at the FHLBanks, the Office of Finance, and the Financing Corporation (references in this section to the FHLBanks include the Office of Finance and the Financing Corporation, unless otherwise noted). DBR also evaluates the FHLBanks' affordable housing and community investment activities relative to statutory requirements and effectiveness. FHFA issues an annual report of examination for each FHLBank, the OF, and the Financing Corporation that contains examination conclusions, findings (when applicable), and a composite and component ratings (in the case of the OF, only the Management and Operational Risk components are rated).

DBR's examination activities are risk-based and are tailored to each institution's risk profile. Examiners evaluate, for example, corporate governance, risk management, internal controls, and other practices in order to assign examination ratings. Examiners also evaluate significant strategic or operational changes that have taken place since the prior examination or are planned for the future. FHFA's supervisory program emphasizes that each FHLBank's board of directors and management are the principal source for detecting and deterring unsafe and unsound practices through adequate internal controls and operating procedures.

### *2. Examination Basics*

The EIC is the central point of contact for communication between DBR and an FHLBank

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and is responsible for the planning, execution, and documentation of each annual examination. The EIC, in coordination with other FHFA offices, is responsible for monitoring the institution and apprising DBR senior management of developments that have a bearing on supervisory matters. The EIC must ensure that the activities that comprise the annual examination are consistent with FHFA policy and support examination findings (when applicable), conclusions, and ratings. The remainder of this section describes the examination activities and the corresponding documentation requirements.

a. *Supervisory Strategy*

At the conclusion of an examination, the EIC develops a supervisory strategy that identifies key areas of risk and addresses the timeframe and the focus of the supervision for the next year. The supervisory strategy should demonstrate that both the supervisory concerns and the deficiencies noted in the previous examination are being or will be addressed. The supervisory strategy provides specifics as to how the strategy will be addressed in the coming year. Consideration should be given to:

- Prioritizing supervisory resources on areas of higher risk;
- Including steps to determine compliance with supervisory action;
- Balancing mandated requirements with the objectives of the strategy; and
- Providing general logistical information (for example, a timetable of supervisory activities).

The EIC should develop the supervisory strategy within 30 days after the issuance of each report of examination, and update the strategy during the year when necessary; for example, based on significant changes in a FHLBank's financial performance, results of offsite monitoring, or other factors. When preparing the supervisory strategy, the EIC should consider the work and input of FHFA personnel, including financial analysts, risk modelers, accountants, affordable housing specialists, and attorneys. The EIC will benefit from the perspectives of other FHFA personnel and an enhanced understanding of risk-related issues and projects that may intersect with examination work.

Each supervisory strategy should include an institution overview. The institution overview should contain a concise executive summary that describes the institution's present condition and its current and prospective risk profile, and highlights key emerging issues, changes in business activities, and past examination findings. Information that may be valuable to include in the overview includes:

- A brief description of the institution's organizational structure;
- A summary of the institution's current and future business strategies;
- Key issues for the institution, either from external or internal factors;
- An overview of management;
- A summary of the FHLBank's financial condition and trends; and
- A description of the internal and external audit functions.

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b. *Pre-examination Analysis Memoranda*

Pre-examination analysis memoranda are prepared to support the EIC's decision to include or exclude areas from the examination scope. The memoranda describe how examiners will evaluate and test the quality and effectiveness of the FHLBank's policies, procedures, and internal controls related to the areas to be examined. For transaction testing, the sampling choices may take into account the effectiveness of the institution's internal controls and risk management programs. Sample size may be adjusted based on FHFA's conclusions on the effectiveness of those internal controls and programs. Pre-examination memoranda should be developed in accordance with examination guidance.

c. *The Examination Scope Memorandum*

The EIC documents the examination plan using an examination scope memorandum. The examination scope memorandum includes an institution overview, an analysis of the institution's risks, and a schedule of examination work including detail regarding staff responsibilities for specific examination activities. The examination scope memorandum should summarize and update, as necessary, the institution overview section of the supervisory strategy.

To focus supervisory activities on areas of greatest risk to the FHLBanks or OF, the EIC should perform a risk analysis and document it in the examination scope memorandum to support the EIC's determination of the examination's scope. The risk analysis should highlight both the strengths and vulnerabilities of the institution and provide a foundation for determining the supervisory activities to be conducted.

When preparing the scope memorandum, the EIC must consider the institution's overall risk environment, earnings and capital, prior examination ratings, the quality of risk management, the adequacy of its information technology systems, and the risks associated with each of its significant business activities. Input provided by other FHFA divisions, offices, and branches should be considered to ensure that the assessment of risks is appropriately comprehensive. The examination scope memorandum should:

- Include an introduction and summary;
- Describe the primary risks to the institution (such as information technology, corporate governance, credit, earnings, capital, market, liquidity, operational, model, legal);
- Identify major functions, activities, and products from which significant risks emanate, as well as the key issues that could affect the risk profile; and
- Describe the institution's risk management program.

The examination scope memorandum should also incorporate the following logistical elements:

- A schedule of activities, timing, and resource estimates for planned activities;

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- An identification of FHFA personnel conducting and participating in the supervisory activity; and
  - The need for special examiner skills and the extent of participation of individuals from specialty functions (for example, the FHLBank Risk Modeling Branch, the Office of Bank Analysis, the Office of the Chief Accountant, and the Office of Risk Analysis).

d. *Annual Examination Cycle*

The EIC has primary responsibility for supervising examination planning activities, and for making periodic updates to the supervisory strategy and the examination scope. The planning process will typically begin several weeks prior to scheduled commencement of the examination. Prior to the beginning of on-site work, the EIC submits a letter to the FHLBank, known as an alert letter. The alert letter notifies the FHLBank of the upcoming examination and requests relevant documents and information and the completion of several questionnaires. The examination team and specialists from other DBR and FHFA offices analyze the documents and information provided by the FHLBank in response to the alert letter. The examination team then prepares the pre-examination memoranda, and the EIC completes the examination scope memorandum.

3. *Examination Execution—General*

a. *Examination Activities*

Examiners conduct their work under the supervision of the EIC in accordance with the workprograms contained in applicable examination guidance in order to assess the level of risk and quality of risk management for the area under examination. Examiners support their conclusions with independent analysis of FHLBank information, data, documents, and other materials. Examiners must document their analysis, findings, and conclusions in the applicable workprogram. Appendix A of this Manual contains a table of authorized work product and workpaper forms available to examiners.

b. *On-Site Visitations*

The EIC and other DBR examination personnel conduct on-site visitations to meet with executive management and FHLBank personnel and review, for example, the FHLBank's financial performance, emerging issues and strategies, and the status of corrective actions to resolve examination findings. The on-site visitation is an important step in the supervisory process. These visits enable the EIC and DBR examination staff to monitor developments at the FHLBank and develop information that may be used to amend the supervisory strategy, and check progress on the remediation of examination findings.

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c. *Findings Memoranda*

Examiners document examination findings in memoranda that describe the nature of the finding, the basis and analysis supporting the finding, any recommended remediation efforts, and discussions of the finding with the institution's management. The findings memoranda should be succinct and contain only the information needed to explain the underlying deficiency. When developing examination findings, the examiner should review and follow FHFA [Advisory Bulletin 2012-01 \(Categories for Examination Findings\)](#). As noted in the *Examination Findings* section of this Manual, Advisory Bulletin 2012-01 provides detailed instruction on examination findings, including definitions, remediation requirements, and follow-up activities.

d. *Conclusions Memoranda*

There must be a conclusion memorandum for the composite rating and for each of the individual component ratings. The conclusion memorandum documents the analysis used to arrive at the recommended rating, and should clearly convey matters of import, both positive and negative, with respect to the condition and practices of the FHLBank and how those considerations were factored into the recommended rating. The analysis and recommended ratings should be based on the guidance provided in the CAMELSO examination rating system and describe the evaluative factors used to develop the ratings recommendation.

e. *Report of Examination*

The FHFA issues a report of examination (ROE), signed by the EIC, to the FHLBank's board of directors for each annual examination. The ROE communicates substantive examination conclusions, findings (when applicable), and the composite and component ratings. The ROE must also contain analysis that supports the conclusions, findings, and ratings. The board of directors is expected to provide FHFA a written response to the ROE acknowledging their review of the ROE and affirming that corrective action will be taken to resolve FHFA's supervisory concerns. The board of directors is ultimately responsible for ensuring that the conditions and practices that gave rise to the examination findings are addressed in a timely manner.

## **D. DIVISION OF ENTERPRISE REGULATION EXAMINATION PROCESS**

### *1. Introduction*

The Division of Enterprise Regulation's (DER) examinations of Fannie Mae and Freddie Mac (the Enterprises) are risk-based and rely on an understanding of the Enterprise, risk assessments, the development of a supervisory strategy and supervisory plan, and examination procedures tailored to the Enterprise's risk profile. FHFA's supervisory program emphasizes that each Enterprise's board of directors and management are the principal source for detecting and deterring unsafe and unsound practices through adequate

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internal controls and operating procedures.

DER supervisory activities include an annual examination, which consists of ongoing monitoring and targeted examinations conducted in accordance with a supervisory plan prepared by the EIC and approved by the DER Deputy Director. The supervisory plan implements a supervisory strategy that is based on a risk assessment. DER relies on these activities and related analyses to reach conclusions on the adequacy of the Enterprises' risk management policies, procedures, compliance, and internal control systems. FHFA issues an annual report of examination, signed by the EIC, to each Enterprise's board of directors that communicates supervisory concerns and contains examination ratings that reflect FHFA's view of the Enterprise's financial safety and soundness and risk management practices.

## 2. *The Conservatorships*

FHFA placed Fannie Mae and Freddie Mac in conservatorship in September 2008, due to inadequate capital levels and pervasive weaknesses that created an unsafe and unsound condition. FHFA, as conservator (the Conservator), succeeded to all rights, titles, powers, and privileges of the companies and of any shareholder, officer, or director of the companies with respect to the companies and their assets; and succeeded to the title to the books, records, and assets of any other legal custodian of the companies. The Conservator also exercises authority over the appointment of directors and the chief executive officers; compensation practices; strategic planning; and corporate objectives and initiatives. The Conservator delegated to the boards of directors and management the authority to conduct day-to-day operations, subject to the direction of the Conservator, and they are responsible for maintaining appropriate controls and risk management practices.

Although the Conservator plays a significant role in determining the strategic direction of the Enterprises and in many other aspects of the Enterprises' activities, DER's supervisory activities, including examination conclusions and ratings, are independent of the two conservatorships.

## 3. *Examination Basics*

The EIC is the central point of contact for communication between DER and the Enterprise and is responsible for the planning, execution, and documentation of each annual examination. The EIC is responsible for monitoring the Enterprise and apprising DER senior management of developments that have a bearing on supervisory matters. Although the EIC may receive input and work product from a variety of FHFA personnel during the course of the examination cycle, the EIC must ensure that the activities that comprise the examination are consistent with FHFA examination standards and support examination conclusions, findings (where applicable), and examination ratings. The remainder of this section describes the activities and corresponding documentation requirements that comprise the annual examination.

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a. *The Supervisory Strategy*

The supervisory strategy forms a bridge between the risk assessment, which identifies significant risks and supervisory concerns, and the supervisory activities to be conducted.

i. *Preparing the Supervisory Strategy*

A comprehensive supervisory strategy for each Enterprise must be developed annually. The supervisory strategy identifies the supervisory objectives and priorities for the next year. The supervision strategy should demonstrate that both the supervisory concerns identified through the risk assessment and the deficiencies noted in the previous examination are being or will be addressed. The supervisory strategy provides specifics as to how the strategy will be addressed in the coming year.

Consideration should be given to:

- Prioritizing supervisory resources on areas of higher risk;
- Determining compliance with, or potential for, supervisory action;
- Balancing mandated requirements with the objectives of the strategy;
- Providing general logistical information (for example, a timetable of supervisory activities, the participants, and expected resource requirements); and
- Assessing the extent to which internal and external audit, compliance, and other risk management systems will be tested and relied upon.

Generally, the planning horizon to be covered by the supervisory strategy should be 18 months. The overall supervisory objectives for the coming examination cycle need to be outlined by early fourth quarter. The supervisory strategy should be finalized by the end of the year for execution in the following year. Input provided by other FHFA divisions, offices, and branches should be considered to ensure that the risk assessment is appropriately comprehensive. When completed, the supervisory strategy must be maintained in the FHFA electronic recordkeeping system.

b. *The Business Profile*

A current business profile should be developed for each Enterprise. The business profile should contain a concise executive summary that (1) demonstrates an understanding of the Enterprise's present condition and its current and prospective risk profile, and (2) highlights key emerging issues, changes in business activities, and past examination findings. Business profiles may address specific lines of business to provide additional detail. When appropriate to aid in understanding the Enterprise's activities, business profiles may describe the Enterprise's statutory mission, permissible activities, and restrictions on business practices, including provisions in the Enterprises' respective charters, Conservator orders and directives, the Senior Preferred Stock Purchase

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Agreements, and FHFA regulations. General types of information that may be valuable to present in the business profile include:

- A description of the Enterprise's organizational structure;
- A summary of the Enterprise's business strategies and changes in key business lines; corporate goals and objectives, including those established by the Conservator through a Conservator Scorecard or other means; and high-priority initiatives;
- Key issues for the Enterprise, either from external or internal factors;
- An overview of management;
- A summary of the Enterprise's financial condition and trends; and
- A description of the internal and external audit functions.

c. *Risk Assessment*

To focus supervisory activities on areas of greatest risk to the Enterprises, the EIC should perform a risk assessment. The risk assessment highlights both the strengths and vulnerabilities of an Enterprise and provides a foundation for preparing the supervisory strategy and determining the supervisory activities to be conducted. When preparing the risk assessment, consideration must be given to the Enterprise's overall risk environment, the reliability of its internal risk management and controls, the adequacy of its information technology systems, and the risks associated with each of its significant business activities (for example, single-family, multifamily, and capital markets).

The starting point in the risk assessment process is an evaluation of the Enterprise's risk tolerance and of FHFA's evaluation of, and supervisory conclusions regarding, the Enterprise's strengths and weaknesses. This evaluation should be based on discussions with management as appropriate, and a review of the Enterprise's strategic plan, corporate objectives, and the Enterprise's key internal scorecards and measures of performance.

i. *Preparing the Risk Assessment*

A written risk assessment is used as an internal supervisory planning tool. The goal is to develop a document that presents a comprehensive view of the Enterprise, identifying areas of supervisory concern, and serving as a platform for developing the supervisory strategy and identifying areas for targeted examinations and ongoing monitoring. The risk assessment reflects the dynamics of the Enterprise; therefore, it should consider the Enterprise's evolving business strategies and be amended as significant changes to the risk profile occur. Input provided by other FHFA divisions, offices, and branches should be considered to ensure that the risk assessment is appropriately comprehensive. The risk assessment should:

- Include an executive summary;
- Describe the types of risk (credit, market, liquidity, reputational, operational,

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model, legal) and their level (high, moderate, low) and direction (increasing, stable, decreasing);

- Identify all major functions, business lines, activities, and products from which significant risks emanate, as well as the key issues that could affect the risk profile; and
- Describe the Enterprise's risk management systems.

The Enterprises' internal risk assessments performed by internal auditors, external auditors, and business and support units should be considered, as should the Enterprise's ability to take on and manage risk prospectively. The EIC should attempt to identify the cause of unfavorable trends, not just report the symptoms. The risk assessment should reflect a thorough analysis that leads to conclusions about the Enterprise's risk profile, rather than just repeating facts.

d. *The Supervisory Plan*

The supervisory plan should provide a schedule of supervisory activities and aid in the communication of responsibilities for supervisory activities. The supervisory plan generally incorporates the following logistical elements:

- A schedule of activities, period, and resource estimates for planned activities;
- An identification of staffing requirements for conducting and participating in the supervisory activity;
- The need, if any, for special examiner skills and the extent of participation of individuals from specialty functions (for example, the Enterprise Risk Modeling Branch, the Office of the Chief Accountant, and the Office of Risk Analysis); and
- The planned product for communicating or documenting findings (indicate the expected work product).

e. *Examination Procedures*

After the areas to be reviewed have been identified in the supervisory strategy and supervisory plan, the procedures document should be prepared that reflect the specific objectives for the scheduled activity and identify the level of transaction testing to be completed. Procedures should be developed in accordance with examination modules, supplemental guidance, and divisional operating procedures. Examiners should include in the examination procedures:

- A statement of the objectives of the supervisory activity that reflects the scope of the activity;
- An overview of the activities and risks to be evaluated; and
- A description of the procedures to be performed, including the sampling methodology to be used and the expected level of transaction testing.

Examination procedures should be tailored to the practices of each Enterprise and should

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focus on developing appropriate documentation to adequately assess management's ability to identify, measure, monitor, and control risks. Procedures should generally comport with the worksteps and workprograms found in applicable FHFA examination modules and supplemental guidance. They should be completed to the degree necessary to determine whether the Enterprise's management understands and adequately controls the levels and types of risks that are assumed. For transaction testing, sampling choices may take into account the effectiveness of the Enterprise's internal controls and risk management programs. Sample size may be adjusted based on FHFA's conclusions on the effectiveness of those controls and programs.

f. *Annual Supervisory Planning Cycle*

The EIC is primarily responsible for overseeing supervisory planning activities, including the preparation of the supervisory strategy, the business profile, the risk assessment, and the supervisory plan. Supervisory planning will typically take place early in the fourth quarter. The supervisory strategy and accompanying documents should be finalized by the end of the year for execution in the following year. Division operating procedures may provide additional instruction regarding the planning cycle, required documentation, and schedules.

4. *Examination Execution—General*

a. *Ongoing Monitoring*

DER's supervisory program emphasizes ongoing monitoring, which allows for timely adjustments to the supervisory plan as conditions change within the Enterprise and the mortgage industry. The purpose of ongoing monitoring is to analyze real-time information and to use those analyses to identify Enterprise practices and changes in an Enterprise's risk profile that may warrant supervisory attention. This approach allows staff to monitor and evaluate the Enterprise's operations and assess risk management. Onsite examiners engage frequently with management by holding periodic meetings to discuss relevant issues and developments and by reviewing key board and management reports. Ongoing monitoring is also used to determine the status of the Enterprise's compliance with supervisory guidance, MRAs, and conservatorship directives, and may result in targeted examinations. The results of ongoing monitoring will be taken into account when determining an Enterprise's composite and component ratings.

Examiners performing ongoing monitoring must document their activities, findings, and conclusions using the appropriate form of documentation (for example, procedures documents, meeting notes, report notes, and summary analysis memoranda). The guiding principle is that the results of these activities must be reflected in a workproduct—or workproducts—in a manner that provides the EIC with the basis to take action of some kind. Appendix A of this Manual contains a table of authorized workpaper forms available to examiners. Division operating procedures may provide additional instruction regarding ongoing monitoring and required documentation.

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b. *Targeted Examinations*

Targeted examinations are a critical component of supervision and will be undertaken, as needed, based on risk. The purpose of targeted examinations is to allow for a deep or comprehensive assessment of the area under review. Targeted examinations will be conducted in a manner consistent with examination workprograms and will be documented using the appropriate forms of examination documentation.

The EIC initiates each targeted examination by sending a request letter to the Enterprise. The request letter describes the purpose and scope of the targeted examination and includes a preliminary document request. The request letter also includes request(s) for meetings with Enterprise management. The EIC and examiners will coordinate requests for additional meetings and documents with Enterprise personnel.

c. *Performing and Documenting Examination Activities*

Examiners conduct their work in accordance with the workprograms contained in the applicable examination modules. They complete the workprograms and corresponding procedures documents in order to assess the level of risk and quality of risk management for the area under examination. Workprograms must be adapted to the scope and objectives of the examination activity, and the examination procedures must reflect the scope and objectives of the activity. Examiners support their conclusions through testing and independent analysis of Enterprise information, data, documents, and other materials obtained from management or other sources. Examiners must document their analysis, conclusions, and findings in analysis memoranda or other workproducts. Final workproducts must be maintained in the appropriate examination folder in the FHFA electronic recordkeeping system.

d. *Conclusion and Supervisory Letters*

Conclusion letters formally communicate final conclusions of targeted examination activities and, when applicable, examination findings to the Enterprise. All targeted examinations result in the issuance of a conclusion letter. Supervisory letters communicate findings that were identified through ongoing monitoring activities. The EIC signs the conclusion or supervisory letter and issues the letter in a timely manner after the completion of the examination work, and, if selected for a quality control review, after the review is completed as provided in [Supervision Directive 2013-01 \(Quality Control Program for Examinations Conducted by the Division of Bank Regulation and the Division of Enterprise Regulation\)](#). The conclusion letter describes the examination scope and objectives, and conclusions and findings that require remediation with sufficient detail to enable management or the board of directors to prepare a remediation plan and correct the problem. Similarly, the supervisory letter describes the ongoing examination activity and examination findings with sufficient detail for management or the board of directors. As noted in the *Examination Findings* section of this Manual, FHFA [Advisory Bulletin 2012-01 \(Categories for Examination Findings\)](#) provides detailed instruction on examination findings, including definitions,

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remediation requirements, and follow-up activities.

e. *Report of Examination*

The FHFA issues a ROE, signed by the EIC, to the Enterprise's board of directors for each annual examination. The ROE communicates substantive examination conclusions, findings (when applicable), and the composite and component ratings. The ROE must also contain analysis that supports the conclusions, findings, and ratings. The Enterprise's board of directors is expected to provide FHFA a written response to the ROE acknowledging their review of the ROE and affirming that corrective action is being taken, or will be taken, to resolve supervisory concerns. The board of directors is ultimately responsible for ensuring that the conditions and practices that gave rise to examination findings are corrected in a timely manner.

## **E. THE REGULATED ENTITIES**

### 1. *The Federal Home Loan Banks and Office of Finance*

#### a. *Overview*

The Federal Home Loan Bank Act of 1932 (the Bank Act) created the FHLBank System (the System) as a government-sponsored enterprise to support mortgage lending and related community investment. The System is composed of 12 FHLBanks and the System's fiscal agent, the Office of Finance. Each FHLBank is a separately chartered entity with its own board of directors, management, and employees; and is a cooperative owned by member institutions located within a defined geographic district. All members are required to purchase capital stock in the FHLBank as a condition of membership.

The primary business of the FHLBanks is to provide liquidity for their members, primarily in the form of collateralized loans known as advances. FHLBanks can also participate in programs that enable members to sell mortgage loans to an FHLBank called Acquired Member Assets (AMA) programs. FHLBanks provide other services to members, including safekeeping, wire transfers, and depository and settlement services. In addition, all FHLBanks are required by statute to establish Affordable Housing Programs.

#### b. *Boards of Directors*

An FHLBank board of directors must consist of at least 13 directors, each of whom is elected for a four-year term unless otherwise adjusted by the Director of FHFA. Terms are staggered so that approximately one-fourth of the directors' terms expire each year with directors serving no more than three consecutive full terms.

There are two categories of directors: (1) member directors, who are required to be directors or executive officers of a member institution; and (2) non-member independent

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directors. Both types of directorships are filled by a vote of the members. According to the Bank Act, member directorships must always make up a majority of the board of directors' seats, and the independent directorships must comprise at least forty percent of the entire board of directors. In addition, two of the independent directors must be public interest directors who have more than four years of experience in representing consumer or community interests in banking services, credit needs, housing, or consumer financial protections. No individual who is employed as part of an FHLBank's management may serve as a director of that FHLBank.

The Office of Finance's board of directors consists of seventeen members, including the twelve FHLBank presidents, *ex officio*, and five independent directors. Each independent director serves a five-year term, and terms are staggered so that no more than one independent director seat is vacant in any one year. The independent director is elected by majority vote, subject to the approval and non-objection of FHFA.

Additional information on this topic can be found in Section 7 of the Bank Act<sup>2</sup>, which governs the qualifications and elections of directorships, and in the examination module on [Board of Directors and Senior Management Oversight](#).

*c. Membership*

All federally-insured depository institutions, insured credit unions, insurance companies, and community development financial institutions engaged in residential housing finance can apply for membership in the FHLBank in their district. Membership is voluntary for eligible institutions. Only members and non-member housing associates may access FHLBank credit and mortgage finance products. Members that withdraw from membership must wait at least five years after their membership was terminated and all of their capital stock was redeemed or repurchased before requesting readmission for membership in any FHLBank.

Eligible financial institutions may be a member of one FHLBank only, and generally may purchase capital stock only in the FHLBank whose district includes the state where the member's principal place of business is located. However, some holding companies may have more than one subsidiary, each of which may be a member of the same or a different FHLBank than the other affiliated member.

Additional information on membership can be found in the examination module on [Federal Home Loan Bank Membership](#).

*d. Capital Structure*

Every member must purchase capital stock in an FHLBank to become a member (membership stock). Members may also be required to purchase additional capital stock in proportion to their activities with an FHLBank, such as borrowing activity (activity

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<sup>2</sup> Section 7 of the Bank Act can be accessed on the FHFA intranet site under the drop down menu for Laws/Regs.

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stock). FHLBank stock is not publicly-traded. Members buy and sell capital stock at the par value of \$100 per share. There are two classes of stock – Class A with a six-month redemption period and Class B with a five-year redemption period. Excess stock is a member’s capital stock investment in the FHLBank that exceeds the amount of stock it must hold to meet the FHLBank’s membership and activity stock requirements. Some FHLBanks repurchase excess capital stock when a member’s activity declines. For those FHLBanks, capital tends to expand and contract with the size of the FHLBank’s balance sheet.

The FHLBank must hold regulatory capital (GAAP capital stock, retained earnings, and mandatorily redeemable capital stock) greater than three separate requirements: First, total capital must be at least 4 percent of assets. Second, permanent capital (Class B capital stock and retained earnings) when weighted by 1.5 must exceed 5 percent of assets. Third, permanent capital must exceed required total risk-based capital, which is the sum of credit risk, market risk, and operations risk capital requirements.

The level of retained earnings is critically important; it is the cushion to absorb losses in order to retain the par value of the capital stock. If losses exceed the level of retained earnings, the ability of the FHLBank to buy and sell stock at par may be impaired.

The FHFA determines each FHLBank's capital classification on at least a quarterly basis, as required by the Prompt Corrective Action regulation. If FHFA determines that an FHLBank is other than adequately capitalized, that FHLBank becomes subject to supervisory actions.

Additional information on capital can be found in the examination module on [Capital](#).

e. *Funding*

The primary source of funds for FHLBanks is the sale of their debt securities, known as consolidated obligations, in the U.S. and global capital markets. Consolidated obligations are the joint and several obligations of the FHLBanks, backed only by the financial resources of the 12 FHLBanks. No FHLBank issues bonds or discount notes in its own name; all bond and discount notes are issued in the name of all the FHLBanks. For most consolidated obligations, a single FHLBank receives all the proceeds and is thus the “primary obligor.” In contrast, more than one FHLBank receives the proceeds of discount notes, global bond issues, and other large bond transactions. In addition to being liable for the portion of the consolidated obligations issued on its behalf, each FHLBank is jointly and severally liable with the other FHLBanks for the payment of principal and interest on the consolidated obligations of all FHLBanks. The Office of Finance issues and services all consolidated obligations.

Other sources of funds include member deposits and the issuance of capital stock.

Additional information on funding can be found in the examination modules on [Liquidity](#) and the [Office of Finance](#).

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f. *Business Activities*

i. *Advances and Standby Letters of Credit*

The FHLBanks provide liquidity to the housing finance market through advances, which are secured loans to members and non-member housing associates. Advances are the primary business of the FHLBanks. Advances are available as short- and long-term loans with adjustable-variable and fixed-rate features. The FHLBanks also provide standby letters of credit to their members and non-member housing associates, which guarantee payment between the member and a third party. Members and non-member housing associates are required to pledge collateral to secure their advances and standby letters of credit. The Bank Act requires FHLBanks to maintain a security interest in eligible collateral, which includes mortgage loans, U.S. Treasury and agency securities, mortgage-backed securities (MBS), cash, and certain other real estate-related collateral. The collateral protects the FHLBank's interest should the member or non-member housing associate default or fail. FHLBanks have a statutory lien priority with respect to certain member assets pledged as collateral under the Bank Act, as well as a claim on FHLBank capital stock held by members.

Advances are subject to a prepayment fee if terminated prior to their stated maturity or outside of a predetermined call or put date. The fees charged are priced to make the FHLBanks financially indifferent to the prepayment of the advance.

Additional information on this topic can be found in section 10 of the Bank Act and in the examination module on [Advances and Collateral](#).

ii. *Acquired Member Assets (AMA)*

The FHLBanks are permitted to acquire certain assets from or through their members under the AMA programs. The intent of the programs is the purchase of single-family residential mortgages from the member institutions by the FHLBanks for purposes of investment. The criteria of the AMA programs may differ, but FHLBanks primarily invest in qualifying 15-year to 30-year conventional and government-guaranteed, fixed-rate mortgage loans and participations in pools of these mortgage loans, secured by one-to-four family residential properties.

Additional information on the AMA programs can be found in the examination module on [Acquired Member Assets](#).

iii. *Investments*

FHLBanks maintain investment portfolios for earnings and liquidity purposes. Short-term investment portfolios provide funds to meet members' borrowing needs and satisfy FHLBank liquidity requirements. Short-term investments may include, but are not limited to, interest-bearing deposits, Federal funds sold, securities purchased

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under agreements to resell, negotiable certificates of deposit, U.S. Treasury obligations, government-sponsored enterprises (GSE) obligations, and commercial paper.

The FHLBanks also maintain long-term investment portfolios to enhance earnings and cover operating expenses. Long-term investments may include, but are not limited to, MBS, state or local housing agency obligations, other U.S. Treasury obligations, Temporary Liquidity Guarantee Program (TLGP) debentures, and taxable municipal bonds.

Additional information can be found in the examination modules on [Investment Portfolio Management](#) and [Liquidity](#).

#### *iv. Affordable Housing Program*

Each FHLBank is required to establish an Affordable Housing Program (AHP) and a Community Investment Program. The AHP provides subsidies for the purchase, construction, or rehabilitation of low-income housing. Each FHLBank must set aside annually 10 percent of the preceding year's net income (as defined by regulation) for the AHP. If the aggregate amounts set aside by all of the FHLBanks is less than \$100 million, then each FHLBank must set aside its *pro rata* share of whatever amount is necessary to ensure that the aggregate AHP contributions from all the FHLBanks for that year is not less than \$100 million.

The Community Investment Program, Rural Development Advance, and Urban Development Advance are community-lending programs that provide support to members in their affordable housing and economic development lending activities.

Additional information on the AHP can be found in the examination module on the [Affordable Housing Program](#).

## *2. The Enterprises*

### *a. Overview*

Fannie Mae and Freddie Mac are government-sponsored enterprises, chartered by Congress to support liquidity, stability, and affordability in the secondary mortgage market. The Enterprises are permitted to purchase, service, sell, lend on the security of, and otherwise deal in certain mortgage loans; and issue debt obligations and mortgage-related securities. The Enterprises are prohibited from participating in the primary mortgage market (they cannot originate mortgage loans).

### *b. Conservatorships*

FHFA placed Fannie Mae and Freddie Mac in conservatorship in September 2008, due to inadequate capital levels and pervasive weaknesses that created an unsafe and unsound

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condition in each company. FHFA, as Conservator, succeeded to all rights, titles, powers, and privileges of the companies and of any shareholder, officer, or director of the companies with respect to the companies and their assets; and succeeded to the title to the books, records, and assets of any other legal custodian of the companies. The Conservator also exercises authority over, among other things, the appointment of directors and the chief executive officers; compensation practices; strategic planning; and corporate objectives and initiatives. The Conservator delegated to the boards of directors and management the authority to conduct day-to-day operations, subject to the direction of the Conservator, and they are responsible for maintaining appropriate controls and risk management practices.

The Enterprises receive financial support from the U.S. Treasury under the terms of Senior Preferred Stock Purchase Agreements. They continue to be obligated to fulfill their statutory mission to support the secondary mortgage market. The terms of the Senior Preferred Stock Purchase Agreements are structured to enable each Enterprise to maintain positive net worth during the conservatorship. These agreements were executed when FHFA placed the Enterprises into conservatorship, and are amended periodically.

*c. Board of Directors*

As noted above, the Conservator also exercises authority over the appointment of directors. The directors serve on behalf of the Conservator and exercise their authority as directed by and with the approval of the Conservator (where required). The directors have no duties to any person or entity other than the Conservator. Pursuant to the Conservator's delegation, the board of directors is responsible for carrying out normal board functions, but is required to obtain the Conservator's review and approval before taking action in certain areas specified in the delegation document (for example, actions involving capital stock, dividends, increases in risk limits, material changes in accounting policy, and increases in operational risk).

Additional information on the boards of directors can be found in the examination module on [Board of Directors and Senior Management Oversight](#).

*d. Funding*

The primary source of funds for the Enterprises is the sale of debt securities in the U.S. and global capital markets. Debt securities include short-, medium-, and long-term maturities.

Additional information on funding can be found in the examination module on [Liquidity](#).

*e. Business Activities*

The Enterprises provide market liquidity by purchasing or securitizing single-family and multifamily mortgage loans originated in the primary mortgage market. The Enterprises may purchase mortgage loans and mortgage-related securities and hold them in portfolio

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(the retained portfolio); however, the retained portfolios are subject to statutory and contractual limits that (1) impose a portfolio cap on the size of the portfolio and (2) require the retained portfolios to be reduced in accordance with prescribed terms.

For purposes of corporate organization and financial reporting, the Enterprises established three business segments: Single-family Business, Multifamily Business, and Capital Markets. The business segments are supported by other organizational units within the companies, such as legal, human capital, and information technology and operations. The following descriptions provide a general outline of the Enterprises' organization and aid the examiner's understanding of their structure; however, Enterprise management may change the organizational structure from time to time. When conducting examinations, examiners should familiarize themselves with the current organizational structure.

i. *Single-Family Business*

The single-family business comprises the activities involved in the purchase of mortgages backed by single-family properties, and the guarantee of Enterprise-issued securities that are backed by such mortgages. Those activities include the setting of underwriting standards; pricing; establishing terms of business with various counterparties (for example, seller/servicers and mortgage insurers); portfolio management (including delinquency management, loss mitigation, foreclosure, and foreclosed property management); customer relationship management; operations; and model development and management.

Additional information on the single-family business can be found in the examination modules and related supplemental guidance on [Credit Risk Management](#), [Enterprise Wide Risk Management](#), [IT Risk Management](#), [Investment Portfolio Management](#), [Operational Risk Management](#), [Risk Modeling](#), [Securitizations](#), and [Strategic Planning](#).

ii. *Multifamily Business*

The multifamily business comprises the activities involved in the purchase of mortgages backed by multifamily properties, the guarantee of Enterprise-issued securities that are backed by such mortgages, and the purchase of commercial mortgage-backed securities. The multifamily business is a primary channel through which the Enterprises meet their statutory mission to provide liquidity for housing for low- and moderate-income families. Multifamily mortgage loans are secured by properties with five or more residential units. These properties include apartments, cooperatives, mixed-use, and manufactured housing. The multifamily business differs from the single-family business in a number of ways, for example, the nature of the borrower (typically the multifamily borrower is a partnership, joint venture, or other legal structure rather than an individual), the terms and maturity of the loan (multifamily loans tend to be shorter term and to have balloon payments), and the reliance on the property securing the loan to service the mortgage debt (rather than on

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the creditworthiness of the borrower). In addition, the Enterprises' multifamily businesses may involve loss sharing arrangements whereby the originating lender absorbs a portion of any losses.

Additional information on the multifamily business can be found in the examination modules and related supplemental guidance on [Credit Risk Management](#), [Enterprise Wide Risk Management](#), [IT Risk Management](#), [Investment Portfolio Management](#), [Operational Risk Management](#), [Risk Modeling](#), [Securitizations](#), and [Strategic Planning](#).

iii. *Capital Markets*

The capital markets groups are responsible for the activities involved in funding, asset/liability management, and hedging. The Enterprises' business exposes them to interest rate risk, and the capital markets groups are responsible for managing this risk. This includes the use of derivatives of various forms for hedging purposes.

Additional information pertinent to capital markets can be found in the examination modules and supplemental guidance on [Derivatives](#), [Interest Rate Risk Management](#), [Liquidity](#), [Operational Risk Management](#), [Risk Modeling](#), [Securitizations](#), and [Strategic Planning](#).

## F. LAWS, REGULATIONS, AND REGULATORY GUIDANCE

The regulated entities are subject to a variety of laws, FHFA regulations, and guidance. Examiners must review and understand the legal, supervisory, and regulatory requirements listed in the *Regulatory Environment* section of each examination module before commencing examination work. Examiners can access these materials on the FHFA intranet site (<http://intranet.fhfa.gov/>) under the *Laws/Regs* drop-down menu and the *Supervision Information* drop-down menu.

Because laws, regulations, and supervisory guidance may be amended, repealed, and revised from time to time, examiners should ensure that examination planning includes a review of laws, regulations, and guidance applicable to their assigned examination activity. FHFA's Office of Supervision Policy may be consulted on questions of the application of supervisory guidance. FHFA's Office of General Counsel may be a helpful resource in assessing compliance with laws and regulations. FHFA's Office of Conservatorship Operations and Division of Housing Mission and Goals may be consulted about questions regarding conservatorship decisions, including conservatorship directives.

**APPENDIX A**

**FHFA Authorized Forms for Examination Documentation**

<b><u>Purpose</u></b>	<b><u>DBR</u></b>	<b><u>DER</u></b>
<b>Pre-Examination Activities</b>		
Describe expected strategy to address weaknesses at the regulated entity.	Supervisory Strategy	Supervisory Strategy
Document a comprehensive view of the regulated entity to identify areas of supervisory concern and support the supervisory strategy.	N/A	Risk Assessment
Notify the regulated entity of upcoming examination activity.	Alert Letter	Request Letter
Summarize offsite work activity to frame the scope of the examination.	Pre-Examination Analysis Memorandum	N/A
Describe the scope of examination activity and estimated resources.	Examination Scope Memorandum	Supervisory Plan
Assign examination responsibilities to individual team members.	Scope Matrix	N/A
<b>Examination Activities – Examination Staff</b>		
Document work performed during an onsite examination.	Workprogram	Procedures Document
Summarize examination meetings with personnel from the regulated entity.	Workprogram	Meeting Note
Summarize results of the review of key reports.	Workprogram	Report Note
Summarize support for examination findings.	Workprogram Findings Memorandum	Analysis Memorandum
Summarize conclusions of an individual workprogram.	Activity Memorandum	Analysis Memorandum Summary Memorandum
Recommend examination ratings to EIC.	Conclusions Memorandum	N/A
<b>Examination Activities – Examiner-in-Charge</b>		
Communicate examination findings to the regulated entity.	Findings Memorandum Report of Examination	Conclusion Letter Report of Examination
Communicate examination conclusions and findings from targeted examinations and ongoing monitoring activities.	N/A	Conclusion Letter Supervisory Letter
Document conclusions, findings, and examination ratings from the annual examination.	Report of Examination	Report of Examination
<b>Non-Examination Activities</b>		
Communicate with the regulated entity on matters other than examination conclusions/findings.	As determined by EIC or Associate Director	As determined by EIC

## **PART II**

### **A. SUBJECT MATTER EXAMINATION MODULES and WORKPROGRAMS**

Examination modules provide instruction to examiners on how to assess specific topics, business lines, and risk areas. They contain workprograms that help examiners assess the types of risk the regulated entity is exposed to, the level of risk exposure, the direction of risk, and the quality of risk management practices. The workprograms provide *illustrative* examples of lines of inquiry that the examiner could consider when completing the analysis required in a workprogram. Examiners should determine the specific worksteps and procedures to apply based on the scope and objectives of the examination work they are performing.

FHFA will revise existing examination modules and add new modules and supplemental guidance as needed to reflect enhancements to examination practice. FHFA also encourages examiners to provide feedback on the modules to ensure they address examiner needs and evolving professional practice. Examiners may send feedback to [supervisionpolicy@fhfa.gov](mailto:supervisionpolicy@fhfa.gov).

The examination modules appear below under a CAMELSO component to which they generally pertain. Modules typically cover more than one CAMELSO component, however, and examiners should be aware that a given module may have relevance for several ratings components. In addition, examiners should refer to the Supervision Information drop-down menu of the FHFA intranet site and the Examination Manuals section to identify supplemental examination guidance that may provide additional detail for specific examination topics. Examiners may also refer to the M drive for examination modules and supplemental examination guidance at M:\Examination Manual and Supplemental Guidance.

#### **CAPITAL**

[Capital](#)

#### **ASSET QUALITY**

[Acquired Member Assets](#)  
[Advances and Collateral](#)  
[Credit Risk Management](#)  
[Investment Portfolio Management](#)

#### **MANAGEMENT**

[Affordable Housing Program](#)  
[Board of Directors and Senior Management Oversight](#)  
[Enterprise-Wide Risk Management](#)  
[Internal and External Audit](#)  
[Office of Finance](#)

[Strategic Planning](#)

EARNINGS

[Earnings](#)

LIQUIDITY

[Liquidity](#)

SENSITIVITY TO MARKET RISK

[Derivatives](#)

[Interest Rate Risk Management](#)

OPERATIONAL RISK

[Business Continuity and Planning](#)

[Federal Home Loan Bank Membership](#)

[Financial Reporting](#)

[Information Technology Risk Management Program](#)

[Insurance Management](#)

[Office of Finance](#)

[Operational Risk Management Program](#)

[Payment Systems](#)

[Risk Modeling](#)

[Securities Safekeeping Operations](#)

[Securitizations](#)