Division of Enterprise Regulation

Supervision Handbook 2.1

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Federal Housing Finance Agency

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What's New

This 2009 update reflects the new agency created by the Housing and Economic Recovery Act of 2008 (HERA). The Federal Housing Finance Agency (FHFA) was formed by combining the former Federal Housing Finance Board, the Office of Federal Housing Enterprise Oversight (OFHEO), and the housing mission staff from the Department of Housing and Urban Development. This *Supervision Handbook* of the former OFHEO incorporates those organizational changes.

This handbook is applicable to the supervision of the Enterprises (Fannie Mae and Freddie Mac) by the FHFA Division of Enterprise Regulation, the former OFHEO Office of Supervision. All references in this handbook to the supervision program of the FHFA apply only to the supervision of the Enterprises. The FHFA Division of Federal Home Loan Bank Regulation, has separately published an *Examination Manual* applicable to the supervision of the Federal Home Loan Banks. The supervision programs of the FHFA Division of Enterprise Regulation and Division of Federal Home Loan Bank Regulation, although similar, reflect the unique characteristics of the regulated entities.

On September 7, 2008, Fannie Mae and Freddie Mac were placed in conservatorship by the FHFA. As noted in the statement of Director James Lockhart, pervasive weakness in the financial condition and operations of the Enterprises were compounded by adverse market conditions. The Director made the determination that the Enterprises could not continue to operate in a safe and sound manner and fulfill their critical public mission without government intervention.

The restoration of the Enterprises to a safe and sound condition is one of the critical objectives of the conservatorship. The supervision program of the FHFA Division of Enterprise Regulation continues to identify and address safety and soundness issues with the board and management of the Enterprises. This *Supervision Handbook* describes the framework for the supervision program of the FHFA Division of Enterprise Regulation.

Background

The principal duties of the Director of the FHFA established by the Housing and Economic Recovery Act of 2008 (HERA) are to oversee the prudential operations of each regulated entity and to ensure that each regulated entity operates in a safe and sound manner, including:

- maintenance of adequate capital and internal controls;
- the operations and activities of each regulated entity foster liquid, efficient, competitive, and resilient national housing finance markets (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities);
- each regulated entity complies with this title and the rules, regulations, guidelines, and orders issued under this title and the authorizing statutes;
- each regulated entity carries out its statutory mission only through activities that are authorized under and consistent with this title and the authorizing statutes; and

- the activities of each regulated entity and the manner in which such regulated entity is operated are consistent with the public interest.

FHFA's Director has implemented this statutory authority as it relates to the Division of Enterprise Regulation by establishing a comprehensive supervisory program to examine the overall safety and soundness of the Enterprises.

FHFA has committed, through its 2006 – 2011 Strategic Plan, to strengthen its regulatory infrastructure to enhance the supervision of the Enterprises. FHFA is providing this handbook to improve the transparency of supervision processes, apply uniform standards to both Enterprises, and clarify FHFA's expectations of them. Publishing this updated handbook also facilitates the establishment of an internal quality assurance function to maintain consistent application of the supervisory standards and examination practices across Enterprises and to ensure that appropriate policies are followed.

This handbook explains the philosophy and methods used by the FHFA Division of Enterprise Regulation in carrying out its mission. The first version was published in January 2007 and updated July 2008. The handbook will continue to be amended over time to improve the oversight provided to the Enterprises and to ensure that FHFA continues to meet its statutory mission.

Supervision Principles

FHFA has identified principles for ensuring the safety and soundness of the Enterprises. The core supervision principles are the basis for FHFA's supervision program described throughout this handbook.

1. FHFA applies uniform supervision standards to ensure conclusions about the Enterprises are derived from logical and consistent processes.

2. FHFA uses resources efficiently by focusing on those areas of highest risk to the Enterprises.

3. FHFA relies upon the collaborative work of dedicated staff with specialized skills, knowledge, and experience.

4. FHFA employees rely upon regular interaction with Enterprise management and staff to complete their work.

5. FHFA considers new information and evolving risks on an ongoing basis.

6. FHFA verifies that the Enterprises have established risk limits and have implemented risk management systems appropriate to their level of risk.

7. FHFA attempts to anticipate issues that could exacerbate the condition of the Enterprises.

8. FHFA uses regular written communication with the Enterprises to promote a common understanding of supervisory issues and the transparency of the supervision program.

Chapter 1 – Division of Enterprise Regulation Supervisory Regime

The Housing and Economic Recovery Act of 2008 established FHFA as an independent entity (Pub.L. 110-289). FHFA's primary mission is ensuring the prudential operational of the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the twelve Federal Home Loan Banks. FHFA issues regulations to implement HERA and carry out its mission regarding Fannie Mae and Freddie Mac. Regulations covering topics such as corporate governance, executive compensation, risk-based capital, and safety and soundness can be found on the FHFA web site www.fhfa.gov.

FHFA also issues guidances that provide additional detail on supervision of specific areas of the Enterprises and these can also be found on the web site.

The supervisory guidances issued by OFHEO and remaining under FHFA include:

- December 1, 2000 Non-mortgage Liquidity Investments
- December 19, 2000 Minimum Safety and Soundness Requirements
- April 2, 2001 Regulatory Review
- December 19, 2001 Safety and Soundness Standards for Information
- February 20, 2004 Conforming Loan Limit Calculations
- February 22, 2005 Reportable Legal Proceedings
- November 8, 2006 Examination for Corporate Governance
- November 8, 2006 Examination for Compensation Practices
- November 8, 2006 Examination for Accounting Practices
- September 12, 2007 Standards for Capital Management Practices
- October 22, 2007 Revised Proposed Guidance on Conforming Loan Limit Calculations
- January 10, 2008 Examination of Mortgage Fraud Programs
- March 26, 2008 Conforming Loan Limit Calculations
- April 21, 2008 Standards for Enterprise Use of the Fair Value Option

Supervision Program Functions

FHFA's risk-based safety and soundness Enterprise supervision program is the responsibility of the Division of Enterprise Regulation. The Deputy Director of the Division of Enterprise Regulation provides oversight and ensures coordination among all of the FHFA mission-critical Enterprise supervisory functions. These functions include accounting and disclosure, capital adequacy, compliance, examination, financial analysis, policy research, and supervision infrastructure. Each of these functions contributes to a comprehensive assessment of the capital adequacy and safety and soundness of the Enterprises.

Accounting and Disclosure

The accounting and disclosure function advises the FHFA staff on all accounting-related matters. This function develops policies for accounting and financial disclosure and monitors the accounting standards that affect the Enterprises. The work is coordinated with the other supervision functions to provide an overall view of the Enterprise.

Capital Adequacy

The capital adequacy function assesses capital using various quantitative measures and evaluates how well the Enterprises measure and manage their capital. Capital adequacy evaluations include whether the Enterprises meet statutory and any additional FHFA capital requirements. Through the examination process, FHFA determines whether capital is maintained and managed commensurate with the Enterprises' risk profiles.

Examination

The examination function plans and conducts examinations of the Enterprises, prepares and issues reports of examination summarizing the financial condition and management practices of each Enterprise, and seeks preventative and corrective actions as appropriate. The examination function complements its on-site examination activities with off-site financial safety and soundness monitoring. Special reviews are conducted to focus on specific issues of concern in coordination with other supervision functions at the request of the Director. Examiners monitor and report on compliance with enforcement actions.

Financial Analysis

This function provides FHFA senior management with quantitative and comparative financial analysis and reports about the Enterprises, some of which FHFA may disclose publicly. This function monitors, analyzes, and reports on the Enterprises' historical and projected financial performance. Current and emerging risks to the Enterprises' financial performance are identified in reports to FHFA management. Measures of financial performance include historical and projected earnings, retained earnings, stockholders' equity, and fair value of net assets as defined in accordance with Generally Accepted Accounting Principles (GAAP), non-GAAP measures of financial performance related to the Enterprises' fair value, and financial measures of business risk. Analysis is based on public and non-public information and management reports. This function also provides ad-hoc analysis of emerging issues as requested by FHFA management.

Supervision Infrastructure

This function serves to develop, formalize, and issue the policies and procedures for the Division of Enterprise Regulation. It coordinates a quality assurance program to ensure the work of the Division of Enterprise Regulation complies with policies, guidelines, and standards and is conducted effectively and efficiently. This function also develops and maintains Examiner Workstation (xWorks), the automated records management, document storage, and workflow system used within the Division of Enterprise Regulation to capture Enterprise submissions, supervision work products, and other authoritative literature.

Chapter 2 - The Risk-Oriented Supervisory Approach

FHFA recognizes that the Enterprises are in the business of taking risks in order to earn a reasonable rate of return. Under a risk-oriented supervisory approach, FHFA does not attempt to prevent risk-taking, but rather determines if the risks are reasonable and well managed. This includes review of how well the Enterprises identify, measure, understand, and control risks. When any of these elements of risk management is deficient, FHFA directs Enterprise management to take corrective action. In all cases, FHFA's primary concerns are that the Enterprises operate in a safe and sound manner, maintain adequate capital, and obtain adequate compensation for the risks taken.

From a supervisory perspective, risk is defined as the potential for loss. The absolute level of risk in any area is not necessarily a concern, so long as that level of risk is managed effectively. To put risks in perspective, FHFA decides whether the risks an Enterprise undertakes are warranted. Generally, a risk is warranted when it is identified, measured, monitored, controlled, and backed by adequate capital. It should be within the Enterprise's capacity to withstand the financial distress that such risk could cause. When risks are unwarranted (e.g., not identified, measured, monitored, controlled, or backed by adequate capital), FHFA communicates to the Enterprise's management and the board of directors the need to mitigate or eliminate the unwarranted risks. Appropriate Enterprise actions may include reducing exposures, increasing capital, and strengthening risk management processes.

Risk Management

Risk management is a program to identify, measure, monitor, and control risk. Each Enterprise must tailor its risk management system to its needs and circumstances. Key elements of a sound risk management system include:

- *Identifying Risk*: It is important to understand both existing risks and risks that may arise from new or potential business initiatives. Risk identification should be a continuing process, and should occur at the transaction, portfolio, business line, and Enterprise level. Proper identification is critical to ensure that risks are appropriately addressed.
- *Measuring Risk*: Accurate and timely measurement of risk is essential to effective risk management systems. A risk measurement system is critical to an Enterprise's ability to control and monitor risk levels. Complex risks require more sophisticated tools to accurately measure and quantify risk. Enterprises should periodically test to make sure that the measurement tools it uses are accurate. Risk measurement systems should assess the risks of both individual transactions and portfolios. The Enterprises must ensure that risks are appropriately measured across the entire entity.
- *Monitoring Risk*: Enterprises should monitor risk levels to ensure timely review of risk positions, limits, and exceptions. Monitoring is essential to ensure that management's decisions are informed and are appropriately implemented across the Enterprise.

Monitoring reports should be frequent, timely, accurate, informative, and appropriately distributed.

- *Controlling Risk:* The Enterprise should establish and communicate risk limits and tolerances through policies, standards, and procedures that clearly define responsibility and authority. Strong risk controls should cover all product lines and services. The board of directors should approve operational standards (including limits) and hold management accountable for operating within them. The board and management should maintain a strong system of internal controls. The Enterprise should manage risk through prompt and accurate decision making, and conduct reviews to ensure the effectiveness of decisions.

Chapter 3 - GSE Enterprise Risk Ratings

FHFA has implemented a unique safety and soundness rating system to evaluate the condition of the Enterprises. The rating system reflects the statutory mission of FHFA as it relates to regulation of the Enterprises. This rating system is known as the **GSE Enterprise Risk** rating. GSE stands for **G**overnance, **S**olvency, and **E**arnings. The term **Enterprise Risk** includes credit risk, market risk, and operational risk. There is also an overall composite summary rating.

The ratings are highly interdependent. Ratings are assigned based on the collaborative work of all functions and offices within the Division of Enterprise Regulation. Ratings are approved by the Director of FHFA. The GSE Enterprise Risk ratings provide for additional focus on financial performance and a new broader measure of capital adequacy not limited to the consideration of statutory requirements. The ratings scheme is streamlined to provide a more direct stratification of the condition of the Enterprises.

The *Composite* rating considers all of the factors affecting the condition of the Enterprise. In addition, individual ratings evaluate the following components:

- *Governance* – comprises accounting, board, compensation, compliance, enterprise wide risk management, external audit, internal audit, management, model processes, reputation, and strategy

- *Solvency* – a rating that incorporates the quantitative measurements of available capital in relation to the risks facing the Enterprise, the sufficiency of the capital planning, and other capital management tools in light of the risks and future capital requirements

- *Earnings* – comprises all aspects of earnings and financial analysis including the soundness of the business model, adequacy of earnings to build and maintain capital, and the quality of earnings

Enterprise Risk

- *Credit Risk* – comprises accounting, counterparty, credit models, multifamily, portfolio credit, and single family

- *Market Risk* – comprises accounting, interest rate, liquidity, and market models

- *Operational Risk* – comprises accounting, financial reporting, information technology, internal controls, and operational models

The Office of Policy Analysis and Research will also issue an annual *Systemic Risk* white paper. This white paper will be a review of the Enterprises and the mortgage markets including consideration of:

- Areas of rapid growth;
- New products;
- Changes in underwriting standards and practices;
- Changes in market share; and
- Changes in the macro-economy that could influence the housing and mortgage markets.

FHFA will not issue a rating for systemic risk.

Safety and Soundness Ratings

The new risk structure uses a single streamlined set of ratings that includes the evaluation of both the quantity of risk and quality of risk management. The same ratings are used for the risk assessments and in conclusions letters issued at the conclusion of a supervisory activity such as a targeted examination. For each rating category, FHFA will assign one of the following *Safety and Soundness Ratings*:

- No or Minimal Concerns
- Limited Concerns
- Significant Concerns
- Critical Concerns

The safety and soundness rating is FHFA's judgment about the condition of the Enterprise. Even if many elements of risk are acceptable and well managed, FHFA may assign a significant or critical concern rating due to the serious nature of the risk in just one sub-area or product. Assigning the safety and soundness ratings requires the application of supervisory judgment and is not a mathematical or statistical exercise. In addition, while ratings may be downgraded by FHFA based on potential for problems or concerns, ratings are upgraded only based on sustained, demonstrated performance. Plans for improvement alone would not support a rating upgrade. Only fully institutionalized corrective actions provide sufficient support for improved ratings. Processes are institutionalized when they are implemented consistently across the Enterprise and are supported by infrastructure and feedback mechanisms that support continuous improvement and compliance.

The following table illustrates how the FHFA Division of Enterprise Regulation considers its supervisory findings, and management's response to those findings, when assigning safety and soundness ratings to the Enterprises. The same ratings are used for the high-level GSE Enterprise Risk ratings and for individual area conclusion letters. The last column indicates the potential FHFA supervisory response to a particular rating and is not an indication that FHFA must make any particular supervisory response.

FHFA Assessment of			**Results in Rating**	**FHFA Response**
Scope Of Deficiencies	**Vulnerability & Business Operation**	**Management Response to Deficiencies**		
None	• Risk is low and well managed • Business operation is fundamentally sound	N/A	**No or Minimal Concerns**	Normal Supervision
Correctable in the normal course of business	• Risk is low or well managed • Business operation has minor deficiencies	• Units self-identify and correct weaknesses	**Limited Concerns**	Continuous Monitoring
Require significant remediation efforts	• Risk is moderate or inadequately managed • Business operation may be vulnerable to disruptions • Potential for losses	• Uncertain willingness or ability to correct deficiencies • May not self-identify weaknesses	**Significant Concerns**	Heighten Supervision or Consider an Enforcement Action
Require immediate attention	• Risk is high or poorly managed • Business operations are disrupted or vulnerable • Capital may be impaired	• Scale and complexity of deficiencies may impede correction	**Critical Concerns**	Prompt Corrective Action or Enforcement Action

Note this table is provided only to illustrate certain distinctions between ratings and is not a comprehensive rating guide.

Composite Rating

The assigned composite GSE Enterprise Risk rating summarizes FHFA's view of the condition of the Enterprises. This composite rating incorporates the underlying component ratings into an overall assessment.

No or Minimal Concerns Composite Rating

Enterprises with this rating are sound in every respect; any findings or comments are of a minimal nature and are handled in a routine manner by Enterprise management. Such Enterprises are likely to withstand external economic and financial disturbances or uncertain business conditions. As a result, such Enterprises give no cause for supervisory concern. The overall strength and financial capacity of the Enterprise are unquestioned.

Limited Concerns Composite Rating

Enterprises with this rating have moderate weaknesses correctable in the normal course of business. The Enterprise generally self-identifies any problems or areas of concern. The nature and severity of deficiencies are not considered material and such Enterprises are stable and able to withstand business fluctuations quite well. While areas of weakness could develop into conditions of greater concern, the supervisory response is limited to the extent that minor adjustments are resolved in the normal course and operations continue to be satisfactory.

Significant Concerns Composite Rating

Enterprises with significant concerns exhibit a combination of more than moderate financial, non-financial, operational or compliance weaknesses. The Enterprise may not have initially recognized these weaknesses. Adverse market conditions combined with uncertainty as to the effect of continued adverse conditions on an Enterprise's safety and soundness may result in significant supervisory concerns. When weaknesses relate to financial condition, such Enterprises may be vulnerable to adverse business conditions and could easily deteriorate if concerted action is not effective in correcting the areas of weakness. When weakness relates to an elevated level of risk, the Enterprise must address that level as well as the risk management practices. An Enterprise that is in non-compliance with laws and regulations may also be accorded this rating. Generally, these Enterprises give cause for supervisory concern, because the weaknesses require more than normal supervision to ensure that deficiencies are addressed in a timely manner. FHFA may enter into a consent order or formal agreement with the Enterprise to ensure the Enterprise takes the appropriate corrective action.

Critical Concerns Composite Rating

Enterprises with critical safety and soundness concerns exhibit severe financial, non-financial, operational or compliance weaknesses. For example, the Enterprise may not be a timely filer of financial statements, or may require a significant restatement of previous financial statements. When weaknesses relate to financial condition the Enterprise is vulnerable to adverse business conditions that could result in further deterioration. An Enterprise that is in non-compliance with laws, regulations, or regulatory enforcement actions may also be assigned this rating. Enterprises with this rating require more than normal supervision to ensure deficiencies are addressed (e.g., prompt corrective action or formal enforcement action). Enterprise management may be unwilling or unable to implement all necessary corrective actions. FHFA will typically pursue a consent order or formal agreement with the Enterprise to ensure appropriate corrective action is taken. The Enterprise may be classified as critically undercapitalized. The unsafe and unsound conditions may be so critical as to require recapitalization or other financial restructuring. In the absence of immediate corrective measures, these situations could result in government action such as conservatorship.

Governance Rating

The Governance rating comprises the following areas:

Accounting – The risk that accounting policies related to financial and regulatory reporting processes and internal control over financial reporting may not prevent or detect errors or misstatements. If effective, an Enterprise's process over financial reporting utilizes policies that provide reasonable assurance that financial statements fairly present, in all material respects, financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.

Board - Board risk is the exposure arising from deficiencies in leadership or effectiveness exhibited by the board. This risk is demonstrated by the adequacy of the Enterprise's limits, policies, processes, personnel, and reports. The adequacy of board supervision of independent oversight functions, including internal and external audit, enterprise wide risk management, and compliance are also considered in assessing overall board supervision.

Compensation – The general compensation scheme used in the Enterprise as well as the specifics of compensation packages provided to senior executives. The alignment of compensation incentives with good governance practices is also considered.

Compliance – The risk arises from violations of, or nonconformance with, laws, regulations, or ethical standards. It also includes the risk arising from the potential that unenforceable contracts, lawsuits, or adverse judgments can disrupt or otherwise negatively affect operations. Compliance risk can result in exposure to fines, penalties, or punitive damages resulting from supervisory actions as well as private litigation.

Enterprise-wide risk management – A process that enables the board and management to effectively deal with uncertainty, opportunity, and associated risk including:

- Ensuring the Enterprise's risk appetite and strategies are consistent with its capital and quality of risk management,
- enhancing the rigor of the Enterprise's risk-response decisions,
- reducing the frequency and severity of unanticipated operational events and losses,
- identifying and managing multiple and cross-enterprise risks, and
- improving the effectiveness of the Enterprise's capital deployment.

External audit – The risk that the audit does not provide an independent and objective view of the reliability of an Enterprise's financial statements. The external auditor's objective in an audit of financial statements is to form an opinion on the financial statements taken as a whole. When planning and performing the audit, the external auditor considers the financial institution's internal controls over financial reporting. Generally, the external auditor communicates any identified deficiencies in internal control to management and communicates significant deficiencies to management and the audit committee, which enables management and the Board to take appropriate corrective action. The examiner's determination of whether the external auditor was independent and objective in forming an opinion about the Enterprise's financial statements helps to assess overall quality of risk management. For an Enterprise registered with the SEC, the external auditor must provide an opinion on the effectiveness of Enterprise's internal control over financial reporting as well as an opinion on management's assessment of internal control over financial reporting

Internal audit - An accurate assessment of audit is crucial to the proper supervision of the Enterprise. The examiner's determination influences whether the overall audit program can be used to leverage FHFA resources, guide the setting of the work plans for the Enterprise, and help to assess the overall quality of risk management. The Examiner's assessment of internal control will include determining the scope and appropriateness of the external auditor's ability to leverage off of the work of internal audit.

Management - Management risk is the exposure arising from deficiencies in leadership or effectiveness exhibited by management. This risk may be evident in the adequacy of the Enterprise's policies, processes, personnel, and reports. The adequacy of independent oversight functions, including internal and external audit, enterprise-wide risk management, and compliance are considered in assessing overall management risk.

Model processes – This is an assessment of the process used to validate the models and periodically review all elements of the modeling process, including assumptions and risk measurement techniques. The internal models must be audited, validated, and free from the undue influence of a particular individual or division. Models should be reconciled to source data to ensure data integrity and validity of principal assumptions. The board and senior management should review parameters used in the model periodically. The workings of and the assumptions used in the internal models must be adequately documented.

Reputation - Risk arises from the potential that an Enterprise's business practices generate adverse public reaction that cause a decline in the franchise value, expose the Enterprise to costly litigation, or otherwise adversely affect revenue, expenses, or capital.

Strategy - Risk arises from poor business decisions or improper implementation of business decisions. This risk is a function of understanding of the external environment and the strengths and weaknesses of the Enterprise in relations to that environment, the compatibility of the strategic goals, the business strategies developed to achieve the goals, the resources deployed against the goals, the quality of implementation, and monitoring the results of the strategy.

FHFA considers the following when assessing Governance for the purpose of assigning a safety and soundness rating. FHFA weighs the significance and scope of supervisory findings when making the assessment.

- Understanding of, and management of, risks inherent in the Enterprise's activities
- Board approval of business strategies, limits, and significant policies
- Board oversight of management's actions to implement strategies, limits, and policies
- Board review of decisions to ensure they are producing the desired results
- Enterprise compliance with laws, regulations, standards, and FHFA directives
- Management response when the business strategy or environment changes
- Independence of the risk management oversight functions (including audit, compliance, and ethics)
- Policies, limits, and exception reporting
- Documentation, review, and validation of models

- Infrastructure review and feedback mechanisms to support continual improvement in processes and procedures across the organization
- Any other relevant information that has come to FHFA's attention

Solvency Rating

The Solvency rating incorporates a quantitative measurement of available capital in relation to the risks facing the Enterprise, as well as an assessment of the sufficiency of the Enterprise's capital planning processes and other capital management resources available to the Enterprise in light of risks, exposures, and future capital obligations.

Background - Maintaining the solvency of the Enterprises is essential to assure public confidence in their ability to meet the market needs for which they were chartered.

FHFA expects the Enterprises to maintain capital commensurate with the nature and extent of risk to their portfolios and their ability to identify, measure, monitor and control these risks. The effect of all risk exposures on the Enterprise's financial condition should be considered when evaluating the adequacy of capital and the solvency exposure of the Enterprise. The types and quantity of risk inherent in an Enterprise's activities, as well as their ability to manage these risks, will determine the extent to which it may be necessary to maintain capital at levels above required statutory minimums to properly reflect the potential adverse consequences that these risks may have on the Enterprise's capital. The supervisory process continually assesses whether the Enterprise's level of capital is sufficient to permit it to operate as a viable institution.

Definitions of Capital - The definitions of Enterprise capital (core capital and total capital) and the methodology to determine the capital requirements are stated in statute. Both a minimum leverage ratio and a risk-based stress test are statutorily required. The Director of FHFA may also use discretionary authority to increase the required capital levels above the statutory requirements when risks warrant. When the discretionary authority is used, the additional capital requirements are communicated in writing to the Enterprises. FHFA may also evaluate other measures of available and needed capital, such as fair value of equity and economic capital, to supplement the statutory requirements. To the extent these other measures are used in determining capital adequacy, FHFA communicates to the Enterprise the rationale and support for the determination.

Assessment of Solvency - The assessment of solvency risk at the Enterprises is multi-faceted. FHFA assesses solvency using both a quantitative perspective using various measures and a qualitative perspective, which uses examination techniques to understand how the Enterprises measure and manage their capital position. More specifically, FHFA assesses capital as follows:

- By statute (12 USC 4614), FHFA is required to classify the enterprises on a quarterly basis as: adequately capitalized, undercapitalized, significantly undercapitalized, or critically undercapitalized. These classification categories are defined in statute based upon the relationship of the required level of statutory minimum, statutory risk-based capital, or other FHFA-mandated capital requirements compared to the existing capital on their books. The classification is made public on a quarterly basis.

- By examination, FHFA determines whether capital is maintained and managed commensurate with the Enterprise's risk profile from both a current and prospective view. The supervisory processes involve both a quantitative and qualitative assessment of capital and results in a rating for Solvency.

FHFA considers the following when assessing Solvency for the purpose of assigning a safety and soundness rating to an Enterprise. FHFA weighs the significance and scope of supervisory findings when making this assessment.

- Capital cushions are sufficient to ensure that losses projected under a reasonable range of stress scenarios will not jeopardize the Enterprise's ability to meet statutory, regulatory, and internal capital requirements
- Enterprise projections of future available capital levels are appropriately sophisticated, fully integrated with business and economic plans/analysis, and reflect the ongoing ability of the Enterprise to meet capital measures/requirements under all likely scenarios over a reasonable (two-year) horizon
- Strategies for capital deployment and returning capital to shareholders are clearly articulated, incorporate a long-range versus short-term capital adequacy assessment, are supported by well-defined analysis, and are consistent with meeting anticipated statutory, regulatory, and internal capital requirements
- Capital planning and projections are supported by multiple fully integrated models and stress scenarios
- Sources of additional capital, as well as flexibility in managing the balance sheet, provide the ongoing ability to respond and react quickly to changing risks and market conditions without unduly jeopardizing future capital options
- Any other relevant information that has come to FHFA's attention

Public Disclosure of Capital Position and Classification - On a quarterly basis, FHFA is required by statute to classify the Enterprises capital adequacy and disclose those classifications. As required by statute, FHFA communicates to the Enterprises a proposed classification and a final classification. FHFA also sends appropriate notice of the final classification to appropriate U.S. Senate and House of Representative members. A public disclosure of the quantitative positions, as well as the capital adequacy conclusion, is also made. FHFA provides a historical history of the capital positions on its web site for public reference.

Suspension of Capital Classifications During Conservatorship

The Director has determined that it is prudent and in the best interests of the market to suspend capital classifications of Fannie Mae and Freddie Mac during the conservatorship, in

light of the United States Treasury's Senior Preferred Stock Purchase Agreement. FHFA will continue to closely monitor capital levels, but the existing statutory and FHFA-directed regulatory capital requirements will not be binding during the conservatorship. For more information see the October 9, 2008 news release at www.fhfa.gov.

The Solvency rating of the Enterprise is disclosed and discussed within the annual Report of Examination. FHFA does not include proprietary information in its capital classification related public disclosures.

Earnings Rating

Evaluation of earnings includes assessment of the level of earnings, trends and stability, the quality and sources of earnings, and the ability to provide for adequate capital through retained earnings. Consideration is also given to the level of expenses in relation to operations, the adequacy of the budgeting systems, forecasting processes, and management information systems in general. The level of exposure due to credit, market, and operational risk is also a factor in the analysis of earnings.

FHFA considers the following when assessing Earnings for the purpose of assigning a safety and soundness rating. FHFA weighs the significance and scope of supervisory findings when making this assessment.

- The level of earnings, including trends and stability
- Earnings exposure to credit and market risk factors
- The level of expenses in relation to operations
- The quality and sources of earnings and the role of assumptions and accounting policies
- The ability to provide for adequate capital through retained earnings
- Any other relevant information that has come to FHFA's attention

Enterprise Risk Rating Components

The GSE Enterprise Risk ratings assigned for Credit Risk, Market Risk, and Operational Risk incorporate consideration of both the quantity of risk in the Enterprise and the quality of risk management.

Quantity of Risk

Quantity of risk is an assessment of the risk inherent in the current activities of and external environment faced by the Enterprise. For example, the quantity of risk associated with a given activity may be indicated by the volume of on- and off-balance sheet items that the activity represents, or by the portion of revenue for which the activity accounts, or by the fair value of the assets and obligations related to that activity. Activities that are new to an Enterprise or for which exposure is not readily quantified may also represent high risks that should be evaluated.

A number of analytical techniques and metrics may be used to estimate the quantity of risk exposure. For example, to assess the quantity of credit risk in loans and commitments, the level of past-due loans, internally classified or watch list loans, nonperforming loans, and concentrations of credit should be considered. In addition, as part of the assessment of credit risk, the adequacy of the overall loan loss allowance can be evaluated by considering trends in past due, problem, and nonperforming loans; historic charge-off levels; and the coverage of nonperforming loans by the loan loss allowance. The measurement of the quantity of market risk involves proprietary interest rate process models and prepayment models that may be applied, for example, to evaluate value-or earnings-at-risk. Measurement of the quantity of operational risk may include consideration of the volume of transactions, complexity of operations, the state of systems development, planned conversions, and use of emerging products and technology.

Quality of Risk Management

Quality of risk management includes how well risks are identified, measured, monitored, and controlled. Assessment of the quality of risk management will reflect judgment of how well Enterprise management:

- Recognizes and understands existing and emerging risks
- Produces accurate and timely measurement of risk
- Employs appropriate methods to monitor risk levels
- Manages the risk through prompt and accurate decisions
- Reviews decisions made to ensure that they were effective

- Establishes risk limits that are appropriate to the Enterprise's risk exposure, capital, and the capabilities of its risk analytics
- Establishes and communicates risk limits through policies and processes that define responsibility and authority

When examiners assess risk management systems, they consider the Enterprise's policies, processes and controls, personnel, reports, and independent oversight. If any one of these component areas is deficient, the Enterprise's risk management exhibits signs of safety and soundness concerns.

Policies are statements of an Enterprise's commitment to pursue certain results and set their risk tolerance. Policies set standards and recommend courses of action. Policies include the Enterprise's interpretations of GAAP. Policies should advance the Enterprise's underlying mission, values, risk tolerance, and principles. Policies must be reviewed and updated regularly, including when an Enterprise's activities or risk tolerances change.

Processes and Controls are the procedures, programs, and practices that the Enterprise uses day-to-day to carry out its policies. Processes implement policies and define how activities are carried out. Effective processes are consistent with the underlying policies, are efficient, and are governed by controls. Controls include the tools and information systems that Enterprise managers use to measure performance, make decisions about risk, and assess the effectiveness of processes. These processes should provide timely, accurate, and pertinent feedback.

Personnel are the staff and managers who execute or oversee processes. Good staff and managers are qualified, competent, and perform all their job functions as expected. They understand the Enterprise's mission, values, policies, and processes. The compensation programs should be designed to attract, develop, and retain qualified personnel as well as reward contributions to effective risk management. There should be a sufficient number and balance of staff and managers with appropriate depth and expertise to ensure effective and sound operation of business activities.

Reports provide the information needed to manage the organization effectively. They should be informative, timely, accurate, and received by the people in positions to use the information to make appropriate decisions. Reports should enhance communication among staff and between staff and management, deliver information throughout the Enterprise, provide an objective system for reporting and aggregating information, and support the Enterprise's strategic goals and direction. The board of directors must receive timely and appropriate reports to allow them to perform their duties.

Independent Oversight functions provide the board and management an Enterprise-wide view of the business activities and risks independent of the business units. Independent oversight functions consist of internal and external audit, compliance, and Enterprise risk management. External Audit focuses on the accuracy of financial statements. Internal Audit evaluates processes, reporting, controls, and functions throughout the company. Enterprise risk management evaluates credit risk, market risk, and operational risk taken by the company by reviewing both limit breaches and the inherent risk in activities. Compliance provides background information and training for the rest of the Enterprise.

Credit Risk Rating

Credit Risk arises from an obligor's failure to meet the term of any financial contract with the Enterprise or other failure to fulfill a financial commitment. Credit risk is found in activities where success depends on counterparty, issuer, or borrower performance. The risk arises any time Enterprise funds are extended, committed, invested, or otherwise exposed through actual or implied contractual agreements.

FHFA considers the following when assessing Credit Risk for the purpose of assigning a safety and soundness rating. FHFA weighs the significance and scope of supervisory findings when making this assessment.

- The maintenance of an appropriate balance between risk and reward; e.g., appropriate pricing of risk
- Changes in underwriting standards including, but not limited to, credit score, leverage, policies, price, tenor, collateral, guarantor support, covenants, and structure
- The borrower's ability to service debt based on debt service coverage, debt/income ratios, and credit history
- The volume and extent of exceptions and overrides
- The impact of strategic factors including the target market, the portfolio and product mix, acquisitions, diversification of repayment sources, new products and delivery channels, third-party originations, concentrations, and securitizations
- The impact of external factors including, but not limited to, economic, industry, competitive, and market conditions; legislative and regulatory changes; and technological advancement
- The levels and trends of delinquencies, nonperforming and problem assets, losses, weighted average risk ratings, and reserves
- Trends in the growth and volume of fee-based credit activities, including off-balance-sheet, investment, payment, settlement, and clearing activities
- The ability of counterparties—including mortgage insurers and seller/servicers—to meet their obligations, and the effectiveness of Enterprise monitoring and management of their counterparty risk exposure
- Trends identified in loan pricing methods, portfolio analytics, loss forecasting, and stress testing methods
- Trends in summary ratings assigned by the Enterprise's loan review and internal audit
- The consistency of the credit policy with the Enterprise's overall strategic direction and tolerance limits
- The appropriate balance of the credit culture between credit and marketing
- The structure of the credit operation and whether responsibility and accountability are assigned at every level

- The reasonableness of definitions that guide policy, underwriting, and documentation exceptions and of guidelines for approving policy exceptions
- The appropriateness of credit policies that establish risk limits or positions and whether the Enterprise periodically reevaluates those limits
- The approval of the credit policy by the board or an appropriate committee
- The adequacy of processes that communicate policies and expectations to appropriate personnel
- The production of timely, accurate, complete and relevant management information
- The adequacy of processes and systems to approve, monitor, and report on compliance with policy and risk limits
- The appropriateness of the approval and escalation process for policy exceptions
- Model techniques and assumptions used are consistent with financial industry best practices
- Users of model results understand the models and use their results appropriately
- The adequacy of internal control including, but not limited to, segregation of duties, dual control, authority commensurate with duties
- The capabilities of the front- and back-office systems to support current and projected credit operations
- The appropriateness of the approval process, marketing campaigns, and delivery channels
- The thoroughness of the underwriting analysis, including a sensitivity analysis of borrower projections
- The sufficiency and reliability of methods used to analyze the creditworthiness of counterparties and debt issuers to ensure repayment capacity, including the review of trends in counterparty financial performance.
- The sufficiency and effectiveness of the credit analysis of private label securities, and the ongoing monitoring of their credit performance.
- The quality of analytical resources, such as pricing models, scoring systems and portfolio models, the adequacy of their periodic revalidation, and their predictive accuracy
- The adequacy of portfolio management, including the ability to identify, measure, and monitor risk relating to credit structure and concentrations
- The adequacy of portfolio stress testing, rescoring, and behavioral scoring practices
- The adequacy of credit analysis, including financial assessment and comparison of projections to actual performance
- The frequency and reliability of verifying compliance with covenants, and the extent to which an Enterprise enforces covenants
- The accuracy and integrity of internal risk rating processes

- The development and execution of action plans and collection strategies to facilitate timely repayment
- The timely involvement of a specialized collection unit
- The method of evaluating and maintaining the allowance for loan losses
- Compliance with regulatory and accounting guidelines
- The depth of technical and managerial expertise
- The appropriateness of performance management and compensation programs
- The appropriateness of management's response to deficiencies identified in policies, processes, personnel and control systems
- The level of turnover of critical staff
- The adequacy of training
- The ability of managers to implement new products, services, and systems in response to changing business, economic, or competitive conditions
- The understanding of and adherence to the Enterprise's strategic direction and risk tolerance as defined by senior management and the board
- The timeliness, accuracy, completeness, and relevance of management information systems, reports, monitoring, and control functions
- The scope, frequency, and independence of the risk review, quality assurance, and internal/external audit functions
- The effectiveness of quality assurance and audit functions in identifying deficiencies in policy, processes, personnel and internal control
- The independent use and validation of measurement controls
- The effectiveness of exception monitoring systems that identify, measure, and track incremental risk exposure by how much (in frequency and amount) the exceptions deviate from policy and established limits, and the adequacy of corrective actions
- Any other relevant information that has come to FHFA's attention

Market Risk Rating

Market risk arises from the adverse effects of changes in interest rates or foreign exchange rates. Types of interest rate risk include: duration risk, convexity risk, yield curve risk, volatility risk, and basis risk. The market risk category also includes liquidity risk. Liquidity risk arises from the Enterprise's inability either to:

(1) liquidate assets or obtain adequate funding (referred to as funding liquidity risk) in order to meet its obligations as they come due

(2) easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or large market disruptions (market liquidity risk).

FHFA considers the following when assessing Market Risk for the purpose of assigning a safety and soundness rating. FHFA weighs the significance and scope of supervisory findings when making this assessment.

- Impact of market risk on earnings and capital
- Ability to measure exposure to duration, yield curve, convexity, volatility, basis, and liquidity risks
- Ability to attribute fair value profit and loss against duration, convexity, volatility, and basis risks
- Exposure from repricing, basis, yield curve, liquidity, or options risk
- Correlation of positions used to manage market risk exposure to underlying risks
- Presence of significant mismatches in the durations and convexity of assets versus liabilities
- Sensitivity of current and future earnings and capital to changes in interest rates or the exercise of options
- The impact of market changes on the Enterprise's earnings and capital
- Policies for accountability, limits, and reporting consistent with the Enterprise's overall strategic direction and risk tolerance
- Processes to communicate expectations, monitor, and report on compliance with policy to senior management and the board
- Adequacy, timeliness, and relevance of management information
- Risk measurement systems capture of positions and the net risk inherent in those positions
- Management's responses to changes in market conditions
- Adequacy of the front-, middle-, and back-office systems for the current and projected future operations
- Management's technical and managerial expertise

- Performance management and compensation programs
- Business line understanding of and adherence to the Enterprise's strategic direction and risk tolerance
- Use of model techniques and assumptions
- Business unit understanding and use of model results
- Control systems prevention or mitigation of internal control deficiencies
- Independence of the risk-monitoring and control functions from the risk taking functions
- Quality of the independent review of market risks
- Improved processes and procedures are consistently implemented across the organization
- Infrastructure and feedback mechanisms support continual improvement in processes and procedures
- Impact of the Enterprise's funding strategy including debt composition, and stability of funding sources
- Ability of the liquidity programs to meet 1) cash needs, 2) short term excess capital deployment
- Ability to maintain positive net cash in overnight funds for a minimum number of days
- Size and composition of a portfolio of highly liquid assets
- Calculation of net cash needs
- Capacity/capability to convert unencumbered assets into liquidity
- Placement of an appropriate amount of agency collateral with a repurchase counterparty to allow for immediate execution
- Ability to cover 90 days cash needs
- Immediacy of liquidity reporting (e.g., daily pricing of liquid assets)
- Quality of Liquidity event triggers
- Appropriateness of haircuts
- Capability for stress testing and contingency planning
- Any other information or matters that have come to FHFA's attention

Operational Risk

Operational risk is the exposure to loss from inadequate or failed internal processes, people, and systems, or from external events. Operational losses include all direct and indirect economic losses including those related to legal liability, reputational setbacks, and compliance and remediation costs to the extent that such costs are consequences of operational events. FHFA's consideration of operational risk includes both internal controls and information technology.

Well planned and structured internal controls are essential to properly manage risk and help maintain a safe and sound operating environment at the Enterprises. The system of internal controls should reasonably be expected to help prevent or detect inaccurate, incomplete or unauthorized transactions, unreliable financial and regulatory reporting, violation of law or regulations or deviations from the Enterprise's internal policies and procedures. Many of the Enterprises business decisions are dependent on information systems and their reliability.

The Enterprises' information technology has two major purposes: processing business transactions and providing reports and information to management and the board. FHFA considers how well the Enterprises perform these two purposes. Management decisions made on ineffective, inaccurate or incomplete information may increase risks in all areas at the Enterprises. Reliable information technology is necessary for the Enterprises to maintain basic control over financial recordkeeping and achieve their long term business objectives and goals.

The operational risk rating is broad in nature and encompasses the following activities and functions – accounting, financial reporting, information technology, internal controls and models. An array of systems, techniques, procedures and processes are taken into account when evaluating operational risk at the Enterprises. In addition, automated, manual, preventative and detective controls are also considered when FHFA assesses operational risk.

FHFA considers the following when assessing Operational Risk for the purpose of assigning a safety and soundness rating. FHFA weighs the significance and scope of supervisory findings when making this assessment.

Operational Risk – Internal Controls and Financial Reporting

- Efficiency and effectiveness of Enterprise operations
- Threats posed to operations by external factors including economic, industry, competitive, legislative, regulatory, and technology
- The organizational structure including lines of authority and responsibility for monitoring adherence to prescribed policies
- Procedures and processes to implement accounting policies
- Accurate recording of transactions
- Timely and accurate financial reporting
- Public and regulatory financial reports comply with generally accepted accounting principles

- Compliance with Sarbanes-Oxley
- Controls limit authorities; safeguard access to and use of Enterprise records and assets; separate and rotate duties; include reviews and testing; and include management-self assessments and monitoring
- Control systems detect errors
- Independent testing of processes ensures ongoing reliability and integrity of Enterprise records and detects possible operational, administrative, and accounting control exceptions and potential losses from fraud or operating errors
- Control processes and procedures are consistently improved across the organization
- New product and systems development is well controlled
- Any other relevant information that has come to FHFA's attention

Operational Risk - Information Systems

- Information systems processing of transactions given the volume, type, and complexity
- Information systems support for existing and new business opportunities
- Information systems monitoring of capacity and performance
- Information systems data collection and editing, results summarization, and error correction
- Editing, balancing and internal control reviews of Enterprise information
- Production of effective, accurate and complete management reports
- Business continuity planning including the ability to restore key systems such as data centers, file servers, PCs, networks, service providers, and business units
- Policies, procedures and controls to ensure that data systems have safeguards to adequately protect data and not be subject to unauthorized changes
- Processes ensure the reliability and retention of information (e.g., data creation, processing, storage, and delivery); the integrity and security of systems; and the independence of operating staff
- Monitoring of and controls over service providers
- Collection and reporting of data
- Management of system changes, integrations, and conversions
- Any other relevant information that has come to FHFA's attention

Operational Risk - Models

- Systems to measure and analyze operational risk given the size and type of business transacted by the Enterprises
- Use of model techniques and assumptions consistent with financial industry best practices

- Business unit understanding and use of model results
- Integration of risk measurement systems into the decision-making process
- Identification, measurement, and tracking of incremental risk exposure arising from policy deviations
- Any other relevant information that has come to FHFA's attention

Systemic Risk White Paper

The Office of Policy Analysis and Research prepares an annual Systemic Risk white paper. This white paper provides a review of the Enterprises and the mortgage markets. Topics covered in the paper include:

- Areas of rapid growth
- New products
- Changes in underwriting standards and practices
- Changes in market share
- Changes in the macro-economy that could influence the housing and mortgage markets

The Division of Enterprise Regulation will use the annual systemic risk white paper as a resource for determining emerging areas of risk within the operations of the Enterprises. No safety and soundness rating is issued for systemic risk.

Chapter 4 - The Supervision Process and Products

FHFA's Enterprise supervision program assesses the risks of the Enterprises and the quality of their risk management systems in the context of their capital structure. The supervisory program focuses most on those business activities that pose the greatest risk. The review of risk management determines how effectively risk is identified, measured, monitored, and controlled. The supervision workplans are revised as new information is received during targeted examination work, continuous supervision activities, or supervisory analyses. Given that the two Enterprises operate the same basic businesses and face the same exogenous risks, supervision of the Enterprises is coordinated to ensure consistent application of supervisory standards.

As described in the table below, the Enterprise supervision methodology is comprised of five key steps, each of which uses specific products to facilitate communication and coordination.

SUPERVISORY PROCESS STEP	SUPERVISION PRODUCT
Understanding the Enterprise	Business Profile
Planning	Supervision Workplan
Performing Supervisory Activities	Continuous Supervision Targeted Examination Supervisory Analysis Remediation Activities
Communicating	Midyear Letter Conclusion Letter Matters Requiring Attention Supervisory Letter Report of Examination Report to Congress
Assigning Ratings	Risk Assessment

Understanding the Enterprise

The starting point for risk-focused supervision is developing and maintaining an ongoing understanding of the Enterprise. Understanding the institution includes developing the business

profile to document the Enterprise's organizational structure, culture, risk tolerance, and other internal and external factors. This step is critical to tailoring the supervision program to meet the characteristics of the organization and adjusting that program as circumstances change. Each Enterprise is unique and may quickly change its business approach. In order to deliver effective supervision, the Enterprise supervision process incorporates a risk-based approach that tailors supervisory activities to the business profile of the Enterprise. By identifying and then concentrating on an Enterprise's major risk areas, FHFA can achieve an in-depth understanding of the Enterprise's condition.

Planning

Planning is essential to effective supervision by helping examiners develop detailed strategies to effectively and efficiently supervise each Enterprise. Planning for the supervision of the Enterprises is carefully coordinated to maximize FHFA effectiveness and insights, and to ensure consistent application of supervisory standards. Workplans outline a comprehensive strategy of supervisory activities to be conducted at the Enterprise over the planning horizon. Managers develop workplans that are dynamic documents, reviewed and updated as necessary based on Enterprise business profiles, risk assessments, and external factors such as industry, economic, legislative, and regulatory developments. The workplan is a link between the overall risk assessment, which identifies and analyzes significant risks and supervisory concerns, and the supervisory activities to be conducted. The workplan should cover a twelve month period, be reviewed during the risk assessment process, and be updated as necessary.

Planning also requires effective and periodic communication with Enterprise management. Examiners will discuss workplans with Enterprise management as the plans are made and when plans are modified. Workplans are approved by the Director of FHFA.

Performing Supervisory Activities

The Enterprise supervision process is designed to determine the condition of the Enterprise, identify areas in need of corrective action, and monitor ongoing activities. Examiners determine the overall condition of the Enterprise and prepare a comprehensive risk assessment. Supervisory activities are conducted through a continuous cycle of risk assessment and planning. Whenever possible and appropriate, supervisory activities focusing on similar areas at the two Enterprises are coordinated to maximize efficiency, share insights, and analyze consistently. Supervisory activities focus on three principal functions discussed below.

***Discovery**:* Through discovery, FHFA gains a fundamental understanding of the condition of the Enterprise, the quality of management, and the effectiveness of the risk management systems. This understanding helps focus supervision on the areas of greatest concern. In discovery, FHFA:

- Evaluates the Enterprise's condition;
- Identifies significant risks;
- Quantifies the risk;

- Evaluates management's and the board's awareness and understanding of the significant risks facing the institution;
- Assesses the quality and integrity of risk management systems; and
- Identifies unacceptable levels of risk, deficiencies in risk management systems, and the underlying causes of the deficiencies.

FHFA's judgments and evaluations form the foundation for future supervisory activities. Supervision is a continuous process that enables examiners periodically to confirm and update their assessments to reflect current and emerging risks.

***Correction**:* In correction, FHFA directs the Enterprises to address identified deficiencies in risk management systems or unacceptable risk levels. The objective is to verify that management's corrective actions have been successful and timely. In this process, FHFA:

- Reviews Enterprise-prepared action plans to resolve each significant deficiency, including the appropriateness of time frames for corrective action;
- Verifies that the Enterprise is executing the plans;
- Evaluates whether actions the Enterprise has taken or plans to take adequately address deficiencies; and
- Resolves continuing supervisory issues through informal or formal actions.

Management's efforts to correct deficiencies should address *root causes* rather than symptoms. Management is responsible for developing and executing action plans. The board is expected to hold management accountable for executing action plans. Action plans should:

- Address the underlying root cause of significant deficiencies.
- Specify action to correct deficiencies.
- Set realistic time frames for completion.
- Establish benchmarks to measure progress toward completion.
- Identify the person(s) in the Enterprise who will be responsible for correction.
- Detail how the management (and the board if necessary) will monitor and ensure effective execution of the plan.

FHFA's supervision of the deficient areas focuses on verifying adequacy and execution of the action plan and validating its success. When determining whether to take further action, FHFA considers the responsiveness of the Enterprise in recognizing the problem and formulating an effective solution. When the Enterprise is unresponsive or unable to effect resolution, FHFA may take more formal steps to enforce correction.

***Monitoring**:* Ongoing monitoring allows FHFA to respond in a timely manner to risks facing the individual Enterprise or the industry as a whole. The dynamic nature of the Enterprises makes this an important part of effective supervision. In monitoring, FHFA:

- Identifies current and prospective issues that affect the Enterprise's business profile or overall condition;
- Formulates future supervisory strategies;
- Measures the Enterprise's progress toward correcting identified deficiencies; and
- Communicates with management regarding areas of concern.

Monitoring activities are focused on assessing the Enterprise's risks, including any potential material risks, and their progress in executing plans and correcting deficiencies as needed.

Types of Supervisory Activities

FHFA's Enterprise supervision program consists of four types of activities: targeted examinations, continuous supervision activities, supervisory analyses, and remediation activities. Each of these supervisory activities contributes to developing risk assessments of the Enterprises. A combination of activity types may be used to meet the overall supervisory objectives. Each type of activity is discussed below.

Targeted Examinations are in-depth, focused evaluations of a specific risk or risk management system. They focus on a single business line or parts of a business line, a functional area, a specific risk or program area, a business process, or an issue of supervisory concern. Examination procedures are tailored to the overall supervisory objective and can involve assessing safety and soundness, performing an in-depth assessment of a risk exposure or risk management, or reviewing corrective action taken in response to previously cited deficiencies.

Continuous Supervision encompasses a wide range of ongoing activities designed to monitor and analyze the overall business profile including any trends or associated emerging risks. Examples of continuous supervision activities include periodic analysis of Enterprise prepared management or board reports, discussions with management regarding a risk exposure or risk management system, or assessing economic or industry trends or other external environment risks or emerging issues.

Supervisory Analyses are initiatives conducted to enhance FHFA's assessment of the risks to, and risk management programs of, the Enterprises. Supervisory Analysis often involves detailed research activities that bear on and contribute directly to an improved understanding of one or both Enterprises utilizing cross-functional teams of examiners and analysts.

Remediation Activities are how FHFA assesses Enterprise progress in correcting identified deficiencies. Remediation activities may follow up on previously identified matters requiring attention, supervisory letters, or enforcement actions. Documentation of remediation activities includes the information submitted by the Enterprise as well as internal memoranda describing FHFA's assessment of those submissions. FHFA notifies the Enterprise of its conclusions regarding the success of Enterprise remediation activities through formal correspondence known as a correction letter.

Communicating

Communication is essential to high-quality supervision. FHFA is committed to continual, effective communication with the Enterprises. Communication includes formal and informal conversations and meetings, risk assessment letters, conclusion letters, and other written materials. All FHFA communications must be professional, objective, clear, and informative. Open communication should continue throughout the supervision process.

Written communication must:

- Convey FHFA's conclusions about the condition of the Enterprise;
- Discuss concerns FHFA has about quantity of risk or risk management;
- Have a tone consistent with any discussions held with the Enterprise on the topic;
- Be addressed to the appropriate audience at the Enterprise;
- Summarize the actions and commitments that FHFA will require the Enterprise to take to correct deficiencies;
- Be concise to ensure that the issues are clear; and
- Be reviewed and approved by the Deputy Director of the Division of Enterprise Regulation, the Deputy Director, and the Director of FHFA before being sent to the Enterprise.

Assigning Ratings

A risk assessment is a process of developing a comprehensive, risk-focused view of the Enterprise. The objective of performing a risk assessment is to formulate and articulate a current understanding of the Enterprise's existing and emerging risk characteristics. This view of existing and emerging risk serves as a blueprint for planning future supervisory activities. The written risk assessment identifies all key drivers supporting the conclusion. FHFA forms judgments about the root cause, impact, and significance of identified issues. Supervisory concern could surface through continuous supervision activities, targeted examinations, or supervisory analyses. Determining the significance of identified issues includes considering the relationship between the probability of an adverse event and its potential resultant impact on the Enterprise. The risk assessment process also facilitates discussions with Enterprise management regarding existing and emerging risks.

Conclusion Letter

A Conclusion Letter is integral to the supervision-by-risk process. A Conclusion Letter is used to concisely document and communicate FHFA's conclusions for a supervisory activity. Conclusion letters are routinely prepared when targeted examinations are completed and, if appropriate or applicable, for continuous supervision activities or supervisory analyses. Conclusion Letters are addressed to the responsible party at the Enterprise, to senior management, or to the board of directors depending upon the area reviewed and the significance of the findings.

The content of a Conclusion Letter should provide sufficient information to communicate and support all findings, conclusions, and the assigned supervisory rating. The amount of detail included should correspond to the nature and complexity of the findings relative to the scope of the supervisory activity.

FHFA will conduct an exit meeting prior to formally issuing the Conclusion Letter to discuss the rationale for conclusions and findings. Through discussion of significant weaknesses or unwarranted risks, business line managers will have an opportunity to understand FHFA's position. The Conclusion Letter will request a written response from the responsible party, including the timeframe for Enterprise correction of any matters requiring attention cited in the letter. The Conclusion Letter should be consistent in tone and content with the exit meeting discussions.

Conclusion Letters must be reviewed and approved by the Deputy Director of the Division of Enterprise Regulation, Deputy Director, and the Director of FHFA before they are sent to the Enterprise. The approval process ensures consistent application of FHFA policies and helps to maintain uniform application of those policies to the Enterprises.

Conclusion Letter Components

The following components generally are included in each Conclusion Letter: supervisory rating; description of objectives and scope; overall conclusion statement(s); and Matters Requiring Attention (when applicable).

Supervisory rating: The Supervisory rating reported in the Conclusion Letter use the same adjectives as the GSE Enterprise Risk ratings: No or Minimal Concerns, Limited Concerns, Significant Concerns, and Critical Concerns. These ratings describe how well risks are identified, measured, monitored, controlled, and managed. Ratings are defined as:

No or Minimal Concerns - No (or only very minor) weaknesses or criticisms that impact the Enterprise's safety and soundness were identified during the activity. The area reviewed is well managed and controlled. Problems are self-identified and corrective action is undertaken without FHFA intervention.

Limited Concerns - Some weaknesses or criticisms were noted during the examination, but they were self-identified by management and are being corrected in the normal course of business. Management generally recognizes the weaknesses and will take appropriate corrective action

without any regulatory prompting. Management has effective controls in place and takes appropriate corrective action when issues arise.

Significant Concerns - During the review FHFA found more than moderate weaknesses or criticisms that need to be addressed by management. Management may not be taking appropriate and timely steps to identify or address deficiencies. Issues may not be self-identified by management or corrective action proposed by management may be ineffective or not timely. Reporting or escalation of issues may not be adequate. FHFA may enter into a consent order or formal agreement with the Enterprise to ensure the Enterprise takes the appropriate corrective action.

Critical Concerns - Management is unable to supervise the area meaning that in some respect they are not properly identifying, measuring, monitoring or controlling risk. Corrective actions require immediate fundamental changes in policies, processes, personnel, or control systems. Enterprise management may be unwilling or unable to implement corrective action. FHFA will typically pursue a consent order or formal agreement with the Enterprise to ensure appropriate corrective action is taken.

Scope: This section briefly defines the specific objectives of the supervisory activity and should include an overview of activities or risks that were evaluated and a description of the supervisory activity's scope or span of review.

Conclusion Statement(s): The Conclusion Statement section provides succinct statements of the overall conclusions and findings for the supervisory activity. It is important for the Conclusion Statement(s) to be written effectively in a concise manner to ensure that conclusions are understandable and clear. The amount of supporting facts or analysis presented depends on the nature and complexity of the area reviewed.

Matters Requiring Attention: Matters Requiring Attention are issues of supervisory concern that warrant special attention by the Enterprise to ensure that corrective action is appropriately planned and executed. The Conclusion Letter may not include any Matters Requiring Attention if none are being cited. This section should include a title and succinct description of each Matter Requiring Attention. FHFA will follow-up on Matters Requiring Attention to ensure that the Enterprise's response is appropriate, timely, and effective. The Conclusion Letter will ask the Enterprise responsible party to provide a formal written response to the Matter Requiring Attention.

Matter Requiring Attention Correction Letters

When the Enterprise has taken the appropriate corrective action regarding a Matter Requiring Attention, and the corrective action has been verified by FHFA, a Matter Requiring Attention Correction Letter is sent to communicate those findings. The subject line of the letter refers to either the individual matter requiring attention title (if only one matter is addressed) or to the title of the original Conclusion Letter (if several matters are addressed). The Matter Requiring Attention Correction Letter should indicate a summary of the verification procedures that were performed by FHFA.

Enforcement Actions

The formal supervisory tools available to FHFA under the Federal Housing Enterprises Financial Safety and Soundness Act (12 U.S.C. 4501 *et seq.*) include, but are not limited to:

- Issuing guidance or directives (12 U.S.C. 4513),
- Requiring reports (12 U.S.C. 4514),
- Conducting other examinations (12 U.S.C. 4517),
- Issuing discretionary reclassification (12 U.S.C. 4614),
- Initiating discretionary action (12 U.S.C. 4616(b)),
- Appointing a conservator (12 U.S.C. 4619(a)), or
- Initiating administrative enforcement action (12 U.S.C. 4631, 4632 and 4636).

Cease and Desist - FHFA's enforcement regime, addressing the scope of these authorities and the applicable rules of practice and procedure, is set forth in part 1780 of FHFA's regulations. 12 CFR part 1780; *see* 66 FR 18040 (April 5, 2001).

Temporary Cease and Desist - Under sections 1372(a) and (b) of the 1992 Act, if the Director determines that any conduct or violation or threatened conduct or violation described in the notice of charges in cease and desist proceedings described under § 1780.20 is likely to cause insolvency, to cause significant depletion of core capital, or to cause other irreparable harm to an Enterprise before proceedings described in this part will be completed, the Director may issue a temporary cease and desist order. Such order may direct the Enterprise, executive officer or director thereof to refrain from the conduct or violation, and to take whatever affirmative action the Director determines to be appropriate to prevent or remedy such insolvency, depletion, or harm pending completion of such cease and desist proceedings.

Civil Money Penalty - Section 1736 of the 1992 Act authorizes the Director to assess civil money penalties against an Enterprise for violations of the 1992 Act, violations of any final order or formal written agreement, or for conduct that causes or is likely to cause a loss to the Enterprise. Three tiers of penalties are available, depending on factors such as gravity of the violations and history of previous violations.

Conservatorship – Under 12 USC 4619 the Director of FHFA may appoint a conservator for an Enterprise upon a determination in writing (1) that alternative remedies available to the Director under this chapter are not satisfactory and (2) that the Enterprise is not likely to pay its obligations in the normal course of business; the Enterprise has incurred or is reasonably likely to incur losses that would deplete substantially all of its core capital and it is unlikely that the Enterprise will replenish its core capital within a reasonable period; the Enterprise has concealed or is concealing books, papers, records, or assets of the Enterprise that are material to the discharge of the Director's responsibilities under this subchapter, or has refused or is refusing to submit such books, papers, records, or information regarding the affairs of the enterprise for inspection to the Director upon request; or the Enterprise has willfully violated, or is willfully violating, a final cease-and-desist order.

Prompt Supervisory Response - Under 12 CFR § 1777.11(a), FHFA will issue a supervisory letter commencing the prompt supervisory response review, but the content of the letter will depend entirely on the "particular circumstances and the nature of the development." There are then three additional levels of available supervisory responses under § 1777.11(b) through (d),

but FHFA's decision as to which, if any, of the levels to use will be based on the Enterprise's "response to the supervisory letter and other appropriate factors." 12 CFR § 1777.11

The supervisory letter shall notify the Enterprise that, pursuant to this subpart, FHFA is commencing review of a potentially adverse development. As is appropriate under the particular circumstances and the nature of the potentially adverse development, the letter may direct the Enterprise to undertake one or more of the following actions, as of such time as FHFA directs:

1) Provide FHFA with any relevant information known to the Enterprise about the potentially adverse development, in such format as FHFA directs;

2) Respond to specific questions and concerns that FHFA poses about the potentially adverse development.

Risk Assessments

The Division of Enterprise Regulation prepares quarterly risk assessments. The associate director for each risk area prepares the risk assessment in consultation with other offices. Risk assessments are prepared the first week of each quarter for each risk area. The information in the risk assessments is used to prepare the Interim Supervisory Assessment Letter. The Interim Supervisory Assessment Letter provides the chief executive officer with FHFA's view of the condition of the Enterprise midway through the examination cycle. The Deputy Director of the Division of Enterprise Regulation signs the Interim Supervisory Assessment Letter after review and approval by the FHFA Director and Deputy Director.

The Interim Supervisory Assessment Letter provides an overview of issues and concerns that have been identified by FHFA to bring them to the attention of the chief executive office and the board of directors. Topics in the Interim Supervisory Assessment Letter include examination matters, safety and soundness observations or conclusions, risk assessment issues, outstanding matters requiring attention, executive compensation, earnings and financial performance, capital, communications, or any other issue of concern to FHFA.

Report of Examination

Section 1317 of The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 requires the Director of FHFA to annually conduct an on-site examination of each Enterprise to determine the condition of the Enterprise for the purpose of ensuring its safety and soundness. FHFA annually prepares a comprehensive Report of Examination for each Enterprise. The annual Report of Examination reflects the cumulative supervisory activities conducted throughout the supervision process. More frequent written communications are initiated if supervisory concerns warrant.

The Report of Examination (ROE) is written for the board of directors and should clearly, concisely, and effectively communicate FHFA's overall conclusions and issues. The ROE conveys FHFA's assessment of the overall condition of the Enterprise and discusses any unwarranted risks or significant deficiencies. FHFA will provide a high quality and informative Report of Examination to the board of directors.

The Deputy Director of the Division of Enterprise Regulation, Deputy Director, and the Director of FHFA must approve the Report of Examination before it is sent to the Enterprise. The approval process ensures consistent application of FHFA policies to the Enterprises.

Report of Examination Components

The following components are generally included in each Report of Examination: Overall Condition Statement; Matters Requiring Board Attention; and Core Report Section. The level of detail provided in the Report of Examination likely will vary between the Enterprises and from year to year consistent with differences and changes in the Enterprises' business profiles and risk.

Overall Condition Statement: The Overall Condition Statement provides the Composite safety and soundness assessment of the Enterprise including the composite GSE Enterprise Risk rating. The composite rating serves to incorporate all factors that bear significantly on the overall condition and soundness of the Enterprise.

Matters Requiring Board Attention: Matters Requiring Board Attention listed in the Report of Examination inform the board of problems that could have a major impact on the Enterprise's condition. Matters Requiring Board Attention are those issues the board must acknowledge and oversee. This section provides the board with an effective tool for monitoring management's progress in correcting these problems.

Core Report Section: The Core Report Section includes information to support the Overall Condition Statement. Although performance metrics can be helpful in drawing conclusions about an Enterprise's condition, the most important information in the Report of Examination is the narrative analysis of the Enterprise's condition. The narrative analysis comments and performance metrics or comparisons to industry averages contained in the Report of Examination should clearly and succinctly support the conclusions.

The Deputy Director of the Division of Enterprise Regulation has the discretion to include additional sections as necessary, but the following sections are always included:

- Governance Assessment
- Solvency Assessment
- Earnings Assessment
- Credit Risk Assessment
- Market Risk Assessment
- Operational Risk Assessment

The rating associated with each area is also included in this section of the Report of Examination.

Responsibility for the Report of Examination

The Report of Examination is the responsibility of the Deputy Director of the Division of Enterprise Regulation, with input provided by all the offices within the Division of Enterprise Regulation. The Deputy Director of the Division of Enterprise Regulation meets with the boards of directors following the completion of the Report of Examination. The meeting provides an opportunity for board members to make comments and ask questions. At the meeting, the Deputy Director of the Division of Enterprise Regulation will discuss:

- The objectives of FHFA's supervision of the Enterprises and how FHFA pursues those objectives;
- Examination results and conclusions; and
- Supervisory concerns or issues.

Report to Congress

Section 1319B of The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (1992 Act) requires the Director of FHFA to submit a written report to the Committee on Financial Services of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate by June 15 of each year. In part, this report includes a description of the financial safety and soundness of each Enterprise including the results and conclusions of the annual examinations conducted under Section 1317 of the 1992 Act. While the Report to Congress is the responsibility of the Director of FHFA, it is the responsibility of each office within the Division of Enterprise Regulation to provide input for the safety and soundness portion of the Report to Congress.

Report to Congress Components

The components of the safety and soundness portion of the Report to Congress closely mirror the Report of Examination as described in the previous section of this handbook. The following components are generally included in the safety and soundness section of the Report to Congress: Overall Condition Statement and Core Report Section. The level of detail provided in the Report to Congress will vary for each Enterprise and from year to year consistent with differences and changes in the Enterprises' business profiles and risk.

Overall Condition Statement

The Overall Condition Statement provides the Composite safety and soundness assessment of the Enterprise including the composite GSE Enterprise Risk rating. The composite rating incorporates all factors that bear significantly on the overall condition and soundness of the Enterprise.

Core Report Section

The Core Report Section includes information to support the Overall Condition Statement. Although performance metrics can be helpful in drawing conclusions about an Enterprise's condition, the most important information in the Report to Congress is the narrative analysis of the Enterprise's condition. The narrative analysis comments and performance metrics or comparisons to industry averages contained in the Report to Congress should clearly and succinctly support the conclusions. The following sections are generally included:

- Governance Assessment
- Solvency Assessment
- Earnings Assessment
- Credit Risk Assessment
- Market Risk Assessment
- Operational Risk Assessment

Responsibility for the Report to Congress

While the Report to Congress is the responsibility of FHFA's Director, the Deputy Director of the Division of Enterprise Regulation and the associate directors within the Division of Enterprise Regulation will provide input into the final written report

Chapter 5 - Supervision Infrastructure

Supervision policy is set by the Deputy Director of the Division of Enterprise Regulation with the approval of the Director of FHFA. Supervision policies issuances include this *Supervision Handbook* and *Policy Bulletins*. This *Supervision Handbook* is the second edition in what will be a series that formalizes FHFA's policies for supervision of the Enterprises. The original *Supervision Handbook* was published in January 2007. The handbooks will be updated and republished at www.fhfa.gov. The supervision infrastructure function also issues internal guides, standards, and procedures to for Division of Enterprise Regulation employees.

Division of Enterprise Regulation Issuances

Division of enterprise regulation issuances include documents created, approved or maintained by an office within the Division of Enterprise Regulation. The Division of Enterprise Regulation will define each type of issuance, articulate the purposes for each type of issuance, establish standards issuances, and establish procedures for approval, maintenance, revision and cancellation for all Division of Enterprise Regulation issuances.

Quality Management

The quality management program of the Division of Enterprise Regulation will:

1. Ensure the integrity of the supervision program.
2. Verify that supervision work complies with policies and procedures and is accurate, comprehensive, effective, efficient, and timely.
3. Ensure that documentation standards promote reliable and timely support for supervisory conclusions and management decisions.

The Division of Enterprise Regulation's quality management program is not a reexamination of a regulated entity; rather, it seeks to ensure that the conclusions reached and conveyed to the regulated entity comply with policy and are accurate, reasonable under the circumstances, and supported by the information available. Quality management covers all aspects of supervision including the development of strategies; targeted examinations; continuous supervision activities; remediation activities; communication with regulated entity management and directors; and an assessment of the actions required of the regulated entity.

In addition, the quality management program provides the basis for establishing, assessing, correcting, and reporting on the internal controls within the supervision program as required by OMB Circular No. A-123. Circular No. A-123 defines management's responsibility for internal control in federal agencies and notes that management is responsible for establishing and maintaining internal control to achieve the objectives of effective and efficient operations within agencies. Management must provide annual assurances on internal control in its Performance and Accountability Report. The quality management program work will be an input into that report through the Executive Committee on Internal Controls.