Federal Housing Finance Agency
Office of Inspector General

FHFA Could Enhance Its Supervision of the Federal Home Loan Banks by Incorporating Lessons Learned from the Spring 2023 Bank Failures

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EXECUTIVE SUMMARY

PURPOSE

The Federal Housing Finance Agency (FHFA or the Agency) increased its scrutiny of the Federal Home Loan Bank (FHLBank) System's lending and credit risk management practices when four bank members collapsed in the Spring of 2023 after relying on FHLBank funding prior to their failure.

We conducted this evaluation to determine the extent to which FHFA examined the adequacy of the FHLBanks' assessment of their bank members' credit risk and took appropriate action to address any deficient practices they identified.

RESULTS

We reviewed examination activities performed between January 1, 2021, and September 30, 2023, at four FHLBanks. In the 2021 and 2022 examination cycles, prior to the member bank failures, FHFA examiners reached generally positive conclusions regarding credit risk management policies and practices. In 2023, they shifted their supervisory focus to address shortcomings in those policies and practices that were exposed by the member failures. Examiners found weaknesses in the FHLBanks' lending philosophies (certain FHLBanks over relied on collateral and did not give adequate attention to the members' creditworthiness), advances terms and limits in their credit policies, bank credit risk assessments and ratings, and credit risk modeling, among other areas. In September 2023, FHFA communicated with each FHLBank directly and reinforced FHFA's supervisory expectations and plans to issue supplemental guidance by September 30, 2024.

We found that:

1. FHFA has not issued written guidance on FHLBank practices with respect to subordinating their security interests in members' collateral when necessary to allow the members to access the Federal Reserve System's discount window;
2. FHFA did not have internal written guidance to inform coordination with other regulators during member failures;
3. FHFA has not revised relevant examination guidance since 2014, and the current guidance does not address the risks that resulted in the members' failure; and
4. FHFA management acknowledged that the Agency lacks a practical approach for ensuring all topics covered by examination guidance are reviewed by

examiners; as a result, management cannot know if risks are being overlooked.

RECOMMENDATIONS

We made four recommendations to address our findings. In a written response, FHFA agreed with our recommendations.

This report was prepared by Jon Anders, Lead Program Analyst; Joseph Colon, Program Analyst; Philip Noyovitz, Senior Investigative Evaluator; Jason Ramserran, Program Analyst; and Reginald Warren, Program Analyst. We appreciate the cooperation of FHFA staff, as well as the assistance of all those who contributed to the preparation of this report. This report has been distributed to Congress, the Office of Management and Budget, and others and will be posted on our website, www.fhfaoig.gov, and www.oversight.gov.

Kyle D. Roberts
Deputy Inspector General for Evaluations /s/

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ABBREVIATIONS

DBR	Division of Federal Home Loan Bank Regulation
Deputy Director	Deputy Director of the Division of Federal Home Loan Bank Regulation
FDIC	Federal Deposit Insurance Corporation
Federal Reserve	Board of Governors of the Federal Reserve System
FHFA or Agency	Federal Housing Finance Agency
FHLBank	Federal Home Loan Bank
FHLBank System	The 11 FHLBanks and the Office of Finance, collectively
Senior Associate Director	Senior Associate Director for Safety and Soundness Examinations and Quality Control
Supervisory Letter	The Deputy Director's Sept. 20, 2023, letter to the Presidents and Chief Executive Officers of the FHLBanks, entitled "Member Credit Assessments and Federal Home Loan Bank Extensions of Credit"

BACKGROUND

The Federal Home Loan Bank System consists of 11 FHLBanks and the Office of Finance (the FHLBank System). The FHLBanks are cooperatively owned by more than 6,500 members. The FHLBank System plays a key role in housing and community development by providing liquidity to financial institutions. The FHLBanks provide this liquidity primarily by making secured loans, known as advances, to their members. In most cases, advances with a term of more than five years must be used for residential housing finance. Advances for terms of five years or less may be used for any business purpose. Federal law and FHFA regulations require members to pledge assets as collateral for all advances.

Within FHFA, the Division of Federal Home Loan Bank Regulation (DBR) is responsible for supervising the FHLBanks and the Office of Finance to ensure their safe and sound operation. DBR's examination and supervisory activities include an annual examination, periodic visits, special reviews, and offsite monitoring. According to DBR, the annual examination includes, among other things, assessment of the credit, market, and operational risks in the FHLBank's operations and evaluation of the FHLBank's earnings, liquidity, capital adequacy, and corporate governance.

FHFA Requires the FHLBanks to Manage the Credit Risk Associated with Members and Advances

Member credit risk is the potential that an FHLBank member will fail to meet its obligations to the FHLBank, such as repayment of advances, in accordance with agreed upon terms. While advances generally have low credit risk because they are secured in full by collateral, the Agency considers them to be among the largest sources of credit risk to the FHLBanks. The FHLBanks recognize this risk and acknowledged in their 2023 combined financial report that "[d]efaults by borrowers with significant obligations to the FHLBanks could result in significant financial losses, which would adversely affect the FHLBanks' results of operations and financial condition."[1]

Agency regulations require the FHLBanks to manage the credit risk associated with members and advances. To that end, FHFA requires the FHLBanks to have a board-approved risk

[1] Federal Home Loan Banks, *Combined Financial Report for the Year Ended December 31, 2023*, at 107 (Mar. 22, 2024).

management program that addresses credit risk.[2] In addition, the Agency's Prudential Management and Operations Standards state that the FHLBanks should:

- Have policies, procedures, and systems for evaluating credit risk that will enable them to make informed credit decisions;
- Regularly assess and monitor risk exposures;
- Establish and adhere to well-defined risk limits; and
- Ensure the completeness and timeliness of risk-related information.[3]

The FHLBanks have discretion to limit or deny advances to a member based on, among other things, the FHLBank's determination that the member has "financial or managerial deficiencies" that "bear upon the member's creditworthiness."[4] According to Agency examination guidance, FHFA expects the FHLBanks' procedures to ensure that they enact appropriate risk mitigation controls in a timely manner for higher risk members, such as restrictions on advances amounts or terms.[5]

DBR Has Issued Guidance on the Examination of the FHLBanks' Credit Risk Management and Advances and Collateral Activities

FHFA's Examination Manual contains modules that provide instruction to examiners on how to assess specific topics, business lines, and risk areas.[6] Each module includes a work program that provides a framework for the examination of a topic or risk area and the development of examination conclusions and ratings. The work program includes illustrative examination work steps that examiners could apply during an examination activity. DBR does not require examiners to complete all of the illustrative work steps in each module's work program. Instead, DBR requires examiners to "evidence sufficient risk-based work steps to support the findings and conclusions" and perform work steps to "sufficiently meet the [examination] scope

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[2] 12 C.F.R. § 1239.11. The regulation states, "Each regulated entity's board of directors shall approve, have in effect at all times, and periodically review an enterprise-wide risk management program that establishes the regulated entity's risk appetite, aligns the risk appetite with the regulated entity's strategies and objectives, addresses the regulated entity's exposure to credit risk, market risk, liquidity risk, business risk and operational risk . . .."

[3] Prudential Management and Operations Standards 8 and 9 (Appendix to 12 C.F.R. Part 1236).

[4] 12 C.F.R. § 1266.4(a)(iv).

[5] FHFA, *FHFA Examination Manual, Part II: Advances and Collateral Module*, at 13 (revised Oct. 2014).

[6] FHFA's Examination Manual is publicly available. See FHFA, FHFA Examination Manual webpage (accessed June 6, 2024).

objectives," and examiners are expected to select sample work steps or develop their own work steps on a risk-adjusted basis.

The Manual includes modules for examining FHLBanks' credit risk management and advances and collateral activities. Under its internal guidance, DBR requires examiners to perform the Advances and Collateral work program annually and the Credit Risk Management work program every other year.

During the Spring of 2023, Three Member Banks Failed, and Another Voluntarily Liquidated, in the Largest U.S. Bank Failures Since the 2008 Financial Crisis

As FHFA has reported, four member banks encountered significant headwinds from a combination of rising interest rates, the corresponding decline in asset values, and deposit withdrawals following the bankruptcy of a large cryptocurrency exchange operator toward the end of 2022.[7] Matters came to a head during March 2023 when three of the four member banks experienced rapid deposit withdrawals that led to their collapse within days of each other. The events exposed the vulnerabilities of member banks that relied heavily on uninsured deposits and failed to manage liquidity risk. Seven weeks later, the fourth member bank failed for similar reasons. We refer to these member banks collectively as the "failed members."

When Faced with the Urgent Need for Liquidity, the Failed Members Sought and Obtained Funding from the FHLBanks

FHFA reported that the failed members substantially increased their advances to offset deposit withdrawals in the months before their failure. The FHLBanks continued to lend to two of the members until shortly before they failed in March 2023.[8] FHFA records show:

- One FHLBank provided a member bank with $5 billion in advances on the last business day before its failure and treated the bank as a member in high standing.
- Another FHLBank lent a member $10 billion during the month of March and continued to rate it highly until the day before it failed.

Both member banks unsuccessfully attempted to borrow an additional $20 billion in advances in the days before their failure. The failures caused a loss of confidence in large regional banks,

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[7] *See* FHFA, *FHLBank System at 100: Focusing on the Future*, at 103 (Nov. 7, 2023).

[8] For more information on the FHLBanks' lending to the failed member banks, see Government Accountability Office, *Federal Home Loan Banks: Actions Related to the Spring 2023 Bank Failures*, GAO-24-106957 (Mar. 8, 2024).

and the FHLBank System provided record levels of advances in the week following the March 2023 failures as members sought liquidity to offset falling deposits.

OBJECTIVE AND SCOPE

We conducted this evaluation to determine the extent to which DBR examined the adequacy of the FHLBanks' assessment of their member banks' credit risk and took appropriate action to address any deficient practices it identified. We assessed DBR's examination activities related to member credit risk management for banks between January 1, 2021, and September 30, 2023—the two examination cycles before the Spring 2023 member failures and during the 2023 examination cycle. Our review covered a sample of four FHLBanks. See Appendix I for a description of our evaluation methodology.

RESULTS

DBR examiners shifted their supervisory focus in 2023 to address the shortcomings in the FHLBanks' credit risk management policies and practices that were exposed by the member failures. There remain areas for improvement where DBR can apply lessons learned from that experience.

We found that DBR did not convey FHFA's expectations to the FHLBanks about subordinating collateral to the Board of Governors of the Federal Reserve System (Federal Reserve) or have guidance in place to inform coordination with other regulators during member failures. In addition, FHFA has not revised its examination modules for Credit Risk Management or Advances and Collateral since 2013 and 2014, respectively, and FHFA management acknowledged that the Agency lacks a practical approach for ensuring all topics covered by examination guidance are reviewed by examiners.

DBR Shifted Its Supervisory Focus and Took Supervisory Actions in Response to the Spring 2023 Bank Failures

FHFA has acknowledged that the particular causes of the Spring 2023 bank failures demonstrated that some of DBR's assumptions on FHLBank member credit risk management were insufficient or inaccurate.[9] The highly stressed, rapidly deteriorating environment of March 2023, and FHLBank management's responses to the spike in advances requests from failing members, exposed weaknesses in member credit risk management at certain FHLBanks.

[9] *See* FHFA, *FHLBank System at 100: Focusing on the Future*, at 107-108 (Nov. 7, 2023).

As a result, while the supervisory conclusions DBR reached on member credit risk management during the 2021 and 2022 examination cycles were generally favorable,[10] DBR criticized FHLBank policies and practices based on its 2023 examination work.

Following the March 2023 member failures, DBR examiners reviewed member credit risk management in each of the examinations it undertook. In a departure from the generally favorable reviews in 2021 and 2022, DBR issued adverse examination findings to each of the FHLBanks in our sample and took informal enforcement actions against two of them to correct identified weaknesses in existing practices. Examiners found weaknesses in the FHLBanks':

- Lending philosophies (that is, the FHLBanks' overreliance on collateral and inadequate attention given to the members' creditworthiness),[11]
- Advances terms and limits in their credit policies,
- Bank credit risk assessments and ratings, and
- Credit risk modeling, among other areas.

DBR's 2023 adverse examination findings included recommendations and matters requiring attention pertaining to collateral centric lending philosophies, insufficient member credit assessments and modeling, and failures by FHLBank management to restrict advances terms and limits to members experiencing rapid deterioration in their financial condition.

In its informal enforcement action for one FHLBank, DBR observed that the FHLBank failed three of FHFA's Prudential Management and Operations Standards and violated FHFA's regulations. In the other informal enforcement action, DBR noted an FHLBank did not adequately monitor the credit risk of its failed members or timely curtail lending to those members despite their rapidly declining financial and liquidity conditions.

DBR Officials Explained Their Shift in Supervisory Posture Between 2023 and the Prior Two Examination Cycles

DBR officials told us several reasons why secured advances to banks was not an area of supervisory concern prior to March 2023, including: there were no emerging issues or member failures, the advances were overcollateralized, and credit risk management for banks was viewed as more mature compared to other member types. In the 2021 and 2022 examination cycles,

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[10] DBR recommended in 2021 that one FHLBank in our sample should establish minimum credit review frequency standards and triggers for expedited credit reviews.

[11] FHFA considers member creditworthiness as the member's ability to repay advances and the Agency emphasizes the importance of capturing all appropriate dimensions of risk when assessing creditworthiness.

examiners focused on collateral adequacy and issues pertaining to insurance company members because DBR considered these areas to be higher risk.

Lending Philosophy

Our review of a sample of DBR's work programs and summary workpapers found that there were no examiner conclusions or adverse examination findings related to the FHLBanks' lending philosophy in the 2021 and 2022 examination cycles. DBR officials generally told us that lending philosophy was not an examination focus prior to the Spring 2023 bank failures because there were no apparent problems and examiners were focused on other areas. However, these officials maintained a consistent view that collateral adequacy should not be the sole basis for lending.

The Deputy Director of DBR (Deputy Director) told us that DBR and the FHLBanks have long focused on collateral management and protecting the FHLBanks' collateral positions. In his view, during the 2021 and 2022 examination cycles, DBR focused on the FHLBanks' practices with respect to collateral, rather than on whether the FHLBanks should be lending to a member in the first place.

FHLBank Credit Policies

Regarding DBR's findings on the FHLBanks' credit policies, the DBR Senior Associate Director for Safety and Soundness Examinations and Quality Control (Senior Associate Director) told us that in bad times, "stressors" may call attention to weaknesses in policies and procedures that are not obvious in good times. We understood this official to mean that these policy weaknesses did not attract the same degree of examiner attention or criticism in 2021 or 2022 that they attracted in 2023 because market conditions were more benign. The Deputy Director explained that DBR's supervisory standards regarding credit risk management policies changed following the bank failures.

Credit Risk Assessments, Ratings, and Modeling

DBR officials also indicated that the FHLBanks' actual, inappropriate practices were not obvious until the failures unfolded. An examination manager for one of the FHLBanks most affected by the bank failures told us that because there were no problems with members at the time of the 2022 examination, DBR did not have any indications that the FHLBank's member risk rating system was inadequate. The Deputy Director described the bank failures as an earthquake that exposed clearly and quickly the flaws in DBR's thinking.

In Addition to Its Examination Findings and Enforcement Actions, DBR Issued a Supervisory Letter to the FHLBank System with Its Expectations for Member Credit Risk Management

In response to the deficient practices that examiners found among several FHLBanks during the 2023 examinations, the Deputy Director issued a letter to the presidents and chief executive officers of the FHLBanks on September 20, 2023 (Supervisory Letter). The Supervisory Letter reemphasized FHFA's expectations for a sound credit risk management framework to support an FHLBank's credit decisions. FHFA expects FHLBanks to, among other things:

- Base their advances on an assessment of members' creditworthiness, including "first and foremost the member's ability to repay," and not solely on the collateral;
- Incorporate relevant and timely information in their credit risk management frameworks; and
- Revise their credit assessments to account for the member's business profile and other qualitative factors.

The Supervisory Letter advised that FHFA plans to issue an advisory bulletin related to member credit assessments that would set forth DBR's basic expectations on member credit risk management and expand upon the specific expectations outlined in the Supervisory Letter. DBR officials informed us that they expect to issue the advisory bulletin by the end of the third quarter of 2024.[12]

DBR examiners and officials shifted their supervisory focus in 2023 to address the shortcomings in the FHLBanks' credit risk management policies and practices. However, in reviewing DBR's examination record over the past three cycles, we found several areas related to its guidance in which DBR could improve.

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[12] FHFA also announced in its Unified Agenda that it would propose a rule on FHLBank member creditworthiness evaluation in October 2024. The proposed rule would amend FHFA's regulation on advances to state that "each FHLBank's primary method of credit risk mitigation must be robust credit underwriting, as opposed to over-reliance on collateral." *See* Office of Management and Budget, *Federal Home Loan Bank Member Creditworthiness Evaluation*, RIN 2590-AB42 (Spring 2024).

Finding 1: DBR Did Not Have Written Guidance in Place that Communicated FHFA's Supervisory Expectations for the FHLBanks' Subordination of Collateral to the Federal Reserve

The Federal Reserve acts as an insured bank's lender of last resort through its discount window.[13] According to FHFA, the FHLBanks are not designed or equipped to take on that function. DBR officials expect member banks exhibiting signs of failure to seek emergency liquidity funding from the Federal Reserve's discount window rather than relying solely on advances from the FHLBanks. Like the FHLBanks, the Federal Reserve requires collateral that meets its specifications.

When a member needs emergency funding from the discount window but lacks sufficient collateral, an FHLBank may reach an agreement with the relevant Federal Reserve Bank to subordinate the FHLBank's interest in excess collateral previously pledged by the member; that is, the FHLBank agrees to provide the Federal Reserve with a higher priority claim to the collateral in the event of the member's failure. This subordination is possible because member banks typically pledge an amount of collateral to the FHLBanks that exceeds their borrowing needs. It permits the member to pledge that excess collateral to the Federal Reserve in order to secure funding from the discount window.

DBR Examiners Criticized an FHLBank's Collateral Subordination Practices

As the events of March 2023 occurred, one FHLBank entered into new agreements, and revised existing ones, with the local Federal Reserve Bank to subordinate collateral for three weaker members. DBR documents indicate that when the FHLBank subordinated its interest in the collateral to the Federal Reserve, it subordinated entire loan portfolios of two of the banks because it did not have enough information about the collateral to avoid pledging of the same collateral to both entities. For the third member bank, the FHLBank subordinated much of its collateral without receiving a reduction in the amount of outstanding advances.

Examiners commented that while subordinating collateral gives member banks access to the Federal Reserve discount window, it also reduces the FHLBank's total collateral position. The subordination of excess collateral could be an issue if the market value of the remaining collateral falls, which could occur during periods of volatility or rising rates. The danger is that an FHLBank could be undercollateralized should the pledged assets lose significant value and the FHLBank was not able to obtain additional collateral to offset the reduction in value. That said, examiners informed us that subordination did not cause the FHLBank in question to be undercollateralized with respect to the members' outstanding advances.

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[13] For more information, see Federal Reserve, Discount Window Lending (updated June 28, 2024).

Examiners also criticized subordination practices that did not serve the financial interests of the FHLBank. One criticism was that the FHLBank subordinated collateral without receiving a paydown of advances in return. The Senior Associate Director told us that the FHLBanks should receive a paydown of advances if they sign over the member's "best" collateral. We note, however, that this supervisory expectation is not documented in FHFA regulation or supervisory guidance.

Finally, according to DBR documents and officials, the FHLBank did not provide examiners with notes and summaries from the discussions management had with representatives from the Federal Deposit Insurance Corporation or the Federal Reserve Bank, or its own internal discussions, about the subordination decisions.[14] Without documented evidence of management discussions in making its subordination decisions or its conversations with the other regulators, that is, appropriate reasoning and support from management, an examiner described subordination detrimental to an FHLBank's overall collateral position as an "unsafe and unsound practice." DBR executives did not agree that the scenario rose to the level of an unsafe and unsound practice, which demonstrates the need for more examination guidance on collateral subordination practices.

Following the Spring 2023 Bank Failures, FHFA Advised the FHLBanks to Prepare for Eligible Members to Borrow from the Federal Reserve

According to DBR, during the Spring 2023 bank failures, the FHLBanks discovered that some large member banks did not have agreements in place or collateral positioned to allow for borrowing from the discount window. As a result, those members were overly reliant on the FHLBanks for emergency funding.

In its Supervisory Letter, DBR emphasized its expectation that FHLBanks reach agreements with Federal Reserve district banks to facilitate collateral subordination and to test their procedures for subordination. However, the Supervisory Letter did not give further guidance on subordination practices, and FHFA has not provided formal written guidance elsewhere.[15]

[14] FHFA made several requests for these materials, but they were never fulfilled by the FHLBank. According to a DBR official, examiners accepted other documentation of communications received from the FHLBank as a technical fulfillment of the requests. The Deputy Director informed us that he suspected the FHLBank did not draft meeting notes and summaries for the discussions covered by the requests.

[15] FHFA previously issued guidance on subordination to the FHLBanks in 1999. DBR had attempted to enact standard subordination agreements with the Federal Reserve System. However, the negotiations failed and DBR advised the FHLBanks through an advisory bulletin to not subordinate secured loans, with some exceptions. The Agency rescinded the advisory bulletin in 2013 but did not replace it with other guidance on subordination practices.

Recommendation

We recommend that DBR:

1. Issue written guidance on the FHLBanks' collateral subordination practices.

Finding 2: DBR Did Not Have Internal Written Protocols that Would Have Facilitated Coordination with the Members' Prudential Regulators

DBR officials responded to the rapid financial deterioration of several FHLBank members by, among other things, strengthening oversight of lending by the FHLBank to certain of those members and engaging with relevant financial regulators at the state and federal level to establish communication channels and working relationships while the failures unfolded.[16] Although DBR undertook these actions, it lacked internal written protocols to inform and facilitate its inter-agency communications and supervisory response to the failures.

Protocols would provide a structured framework and reference source for FHFA's future supervisory actions during such events, such as engaging in enhanced oversight of lending and coordinating agreements with the FHLBank and the member's prudential regulator on the appropriate path forward. Guidance institutionalizes processes so that they are repeatable and not dependent on personal relationships between FHFA officials and points of contact at other regulators. In addition, guidance helps to ensure continuity in FHFA's approach, and ensures connectivity between FHFA and the appropriate points of contact at the relevant prudential regulators for FHLBank members.[17]

DBR Examiners Engaged in Heightened Oversight of the FHLBanks' Management of Several Bank Members that Failed in the Spring of 2023

DBR regularly met with the management of an FHLBank to discuss the FHLBank's relationships with two of the failed member banks, and the members' financial condition, before their failures. Meeting notes show that DBR took the additional step of requiring the FHLBank

[16] The primary federal regulators of the failed members included the Federal Deposit Insurance Corporation and the Federal Reserve Bank of San Francisco. DBR also interacted with the California Department of Financial Protection and Innovation regarding one failed member bank that was a state-chartered bank domiciled in California.

[17] FHFA developed a Cyber Incident Response Plan that provides a framework to Fannie Mae, Freddie Mac, and Common Securitization Solutions, LLC, for reporting information security incidents, business disruption events, and the sharing of critical threat information. Its Information Security and Business Incident Reporting Procedures provide more detailed guidance to FHFA staff. Similar to the response plan procedures, a member failure playbook could, for example, identify the points of contact at the respective agencies with which the FHLBank and FHFA would need to coordinate, the level of information that should be shared, and the process for information sharing.

to provide notice of all future lending to those members.[18] The Deputy Director told us that this extraordinary level of oversight was caused by a "lack of faith" in FHLBank management, rather than by specific triggers or red flags.

The Deputy Director explained to us that the prior notice gives DBR time to engage with the stressed member's prudential regulator before the FHLBank lends to it to better understand the member's condition. He said that the other regulators are willing to share more information with DBR than they are with the FHLBanks and DBR can then calibrate its guidance to the FHLBank that is making the lending decision. He informed us that DBR has engaged in heightened oversight of lending to stressed members since the Spring of 2023.

While DBR's requests for prior notice of lending were intended to allow for increased supervisory scrutiny, and not involvement in lending decisions, the Deputy Director said that he would step in and inform the FHLBank not to make the advances if the lending presented a safety and soundness situation. Another senior official told us that DBR wants to ensure that advances to a stressed member are being used toward a solution of the member's issues—either to ensure a more orderly resolution of the member's pending failure or toward the member's recovery.

DBR Had to Establish Additional Working Relationships with Counterparts at the Federal Deposit Insurance Corporation and Federal Reserve as the Members' Condition Deteriorated

Before the March 2023 events, DBR regularly met with other regulators to discuss general supervisory issues. In addition, senior leaders at DBR had relationships with their colleagues at the other federal regulators. However, the Deputy Director told us that once the bank failures began to unfold, the situation among FHFA and other financial regulators became complex, reactive, and disorderly.

The Deputy Director stated that the greatest challenge was that he, and key individuals at other regulators, were relatively new to their positions and could not rely on pre-established personal relationships to facilitate communication among them. He also recounted a situation from the Spring of 2023 where officials at an FHLBank and the regional Federal Reserve Bank did not have each other's contact information and needed to coordinate through him. DBR did not have internal written guidance that identified and facilitated contact points among regulators to address stressed and failing members.

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[18] DBR senior managers told us that the other two members failed too quickly for DBR to engage in that level of oversight of the FHLBanks' lending to those members.

The Deputy Director acknowledged that DBR would benefit from internal written guidance to facilitate coordination with other regulators when a member is failing, and that the roles among the regulators need to be clarified. He told us that DBR currently has the correct first points of contact at the other regulators, but lacks awareness of the responsible individuals at the field office or regional level, and could formalize its processes for reaching those officials during a crisis.

We observed indications that information sharing between the regulators was a challenge during the bank failures. For example, FHFA did not obtain a recovery plan that the Federal Deposit Insurance Corporation (FDIC) received from one of the failed members. That recovery plan included expectations of future advances lending to the failing member at longer terms. DBR's records reflect that FHFA executives met with representatives of the FDIC and Federal Reserve about an FHLBank's lending to the member. The Deputy Director noted that neither FHFA nor the FHLBank had seen the plan and he expressed discomfort with the FHLBank lending to the member.[19] We confirmed with the Deputy Director that FHFA never received a copy of it.

FHFA Plans to Establish Protocols on Coordination with Other Regulators

FHFA described its desired role in coordinating with the FHLBanks and members' prudential regulators in the *FHLBank System at 100: Focusing on the Future* report. FHFA stated, in pertinent part, "an FHLBank may need to diverge from standard lending procedures in consultation with FHFA and a member's primary regulator to address broader risk mitigation concerns" and that "*all appropriate officials… must agree on the course of action when necessary and properly document that agreement*." (emphasis added)

DBR has established initiatives to help implement its vision of the future of the FHLBank System described in the *FHLBank System at 100: Focusing on the Future* report. One of these initiatives identified actions that would facilitate Agency and FHLBank coordination with other regulators to ensure the timely exchange of information on stressed members. These actions include:

- Creating a phone tree of relevant contacts at each regulator;
- Establishing protocols for repayment of advances made to members placed into receivership;

[19] FHFA-OIG expects to conduct further work on the topic of the effectiveness of communications among FHFA, the primary prudential regulator of each failed member, and state regulators during the period of the 2023 bank failures.

- Establishing protocols for member borrowing through the Federal Reserve's discount window; and

- Determining communication protocols based on a review of troubled member cases.

Recommendation

We recommend that DBR:

2. Complete the development and implementation of protocols for DBR personnel to follow in times of member distress and failure, including heightened oversight of the FHLBanks and coordination of communication and actions with the appropriate federal and state regulators.

Finding 3: DBR's Examination Guidance for Advances and Collateral, and Credit Risk Management Has Not Been Updated and Does Not Reflect FHFA's Lessons Learned During 2023 Examination Activities

As described above, following the examination work prompted by the Spring 2023 bank failures, DBR issued its Supervisory Letter to the FHLBanks to communicate its expectations for member credit risk management. However, FHFA has not updated its Examination Manual guidance to examiners for assessing credit risk management practices to reflect the recent developments. The Advances and Collateral module and Credit Risk Management module have not been updated since October 2014 and July 2013, respectively.

The Spring 2023 bank failures occurred due to many factors, including heavy reliance on unstable uninsured deposits, inadequate liquidity risk management, and poor interest rate risk management. Examiners and DBR senior officials told us that the failures occurred much more rapidly than prior failures. The Deputy Director noted that the FHLBanks' models missed members' risks from uninsured deposit concentrations.

The current versions of the Credit Risk Management module and the Advances and Collateral module do not address key issues and lessons FHFA learned from its 2023 examination work, such as heavy reliance on uninsured deposits and liquidity management during stress periods. FHFA's Examination Manual states that its modules will be revised from time to time to reflect changes in the Agency's examination program. The Deputy Director acknowledged that the modules should be updated, however, efforts to do so had been delayed. DBR plans to update examination modules by the end of 2024.

Recommendation

We recommend that FHFA:

3. Update the Examination Manual's Credit Risk Management module and Advances and Collateral module to include guidance on the review of topics and issues related to the Spring 2023 bank failures and otherwise incorporate lessons learned from the 2023 examinations of member credit risk management.

Finding 4: FHFA Lacks a Practical Approach for Ensuring All Topics Covered by Examination Guidance are Reviewed by Examiners

DBR established minimum frequencies for the completion of work programs found in the Examination Manual modules. DBR expects examiners to perform the work programs every one to four examination cycles, based on the "volume or complexity of an activity or function, as well as [its] relevance in developing examination conclusions and assigning examination ratings." Under this guidance, examiners must perform the Advances and Collateral work program annually and the Credit Risk Management work program every other year.[20]

DBR relies on examiner judgment to outline the scope of reviews. Examination workpaper standards state that the Examination Manual's suggested work steps are optional and should be selected on a "risk-adjusted basis considering the risk profile of the area, and work steps completed during prior examinations." The examiners' breadth of discretion in selecting work steps could result in topics within the examination modules not being reviewed at all.

The Deputy Director Acknowledged the Need for DBR to Enhance Its Examination Program to Ensure Examination Topics Within the Work Programs Are Reviewed at a Regular Frequency

The Deputy Director said that DBR's current program needs more structure to ensure frequency of review and that DBR needs to make sure it is looking through all the review areas within work programs with a "cadence," which we understood to mean a set frequency. Currently, there is no practical approach for DBR management to ensure all examination topics are reviewed under current guidance. As a result, management cannot know if risks are being overlooked. The

[20] If examiners do not complete the Credit Risk Management work program, DBR's guidance advises them to "ensure that the scope of the examination includes sufficient work to assign the Asset Quality component rating."

Deputy Director said that if examiners only review the highest risk topics, there is the possibility that examiners may miss issues that arise in lower risk areas.[21]

This scenario occurred during the two examination cycles prior to the Spring 2023 bank failures. We found that DBR examiners did not perform testing work steps that involved classifying the member's exposure to the FHLBank, including an evaluation of the member's ability to repay advances, and assessing the FHLBank's ongoing communications with federal regulators regarding weaker members. One of the examination teams informed us that it opted to forego a review of members' ability to repay in 2021 and 2022 as the result of a risk-based selection process.

Recommendation

We recommend that DBR:

4. Adopt a process to ensure the appropriate examination coverage of all topics within its Examination Manual guidance.

OTHER MATTERS FOR CONSIDERATION.................................

While assessing the supervisory actions DBR examiners took regarding the FHLBanks, we identified several areas of apparent noncompliance with examination workpaper standards. These issues were not prevalent enough to rise to the level of an evaluation finding. We describe them below for DBR's consideration and response as appropriate.

DBR Examiners Did Not Comply with Guidance for Examination Workpaper Standards in Certain Instances

During our review of DBR's supervision regarding FHLBank member credit risk management from 2021-2023, we identified occasional, yet notable, instances where, in our view, DBR did not comply with applicable workpaper documentation standards.

Our team reviewed the planning, scoping, work program, and conclusion documents for four examination areas each year of our review period, for each of the four FHLBanks we reviewed. However, we did not conduct a comprehensive review of documentation issues in DBR's

[21] FHFA's Division of Enterprise Regulation employs a Supervisory Taxonomy to develop supervision planning and identify a minimum frequency for supervision activities. The Deputy Director advised us that he plans to incorporate a similar risk taxonomy program in DBR.

examination workpapers and do not offer an opinion on the extent to which these issues may be found in other workpapers.

Some Conclusions Were Unsupported or Absent

We identified several instances across multiple examinations where examiners did not adequately support and explain their conclusions, sometimes providing only one-sentence responses to work steps that were directly related to the Spring 2023 bank failures. Per the examination workpaper standards, examiners must explain the logic, observations, facts, and examples used to support conclusions. FHFA's Examination Manual also states that workpapers "must be prepared in sufficient detail to provide a clear understanding of the examination work performed."

We identified several instances in which examination scope objectives lacked corresponding examiner conclusions. DBR guidance requires examiners to "clearly state [their] conclusions" and "make definitive assessments or conclusions." During our fieldwork, certain DBR examiners described an exceptions-based approach to documentation where they documented their analysis of certain areas only if an issue arose. We concluded that this type of approach is not supported by the Examination Manual or DBR's internal examination guidance and is inconsistent with our understanding of the Deputy Director's expectations.

Several Objective and Work Step Responses Were Incomplete or Missing

We identified various examples of incomplete work step responses. On several occasions, examiners did not address the core or italicized sections of work steps as written in the work programs. An examiner-in-charge at the time confirmed that, while the Manual's work steps are optional, all parts of a work step that are included in an examination work program should be completed. DBR's internal guidance states that "[i]n every case, examiners need to perform [work steps] to sufficiently meet the scope objectives . . .."

We also identified instances where examiners established a scope objective for the examination, but it was not addressed in the work program documentation. An examiner we interviewed explained that he performed the work related to the objectives and did not have an issue with the FHLBank's practices. He noted, however, that the scope objectives could have been better documented.

DBR Did Not Document Meetings with an FHLBank

During a 2023 special credit review, DBR did not document substantive communications with an FHLBank's management and staff. DBR management explained that the expedited nature of the special credit review made it difficult to memorialize meetings. DBR's internal guidance states that FHFA supervision staff must document "any significant matter or supervisory concern discussed with any decision maker (e.g., senior management or a member of the board of directors) of an FHLBank." The special credit review resulted in an informal enforcement action, which underscores the significant supervisory context of these meetings.

FHFA COMMENTS AND OIG EVALUATION................................

We provided FHFA an opportunity to respond to a draft of this evaluation report. FHFA management provided technical comments, which we considered in finalizing this report. FHFA management also provided a written response, which we included in Appendix II. In its management response, FHFA agreed with our recommendations and committed to:

1. Issue written guidance on the FHLBanks' collateral subordination practices by June 30, 2025;

2. Complete and implement protocols for DBR personnel to follow in times of member distress and failure by June 30, 2025;

3. Update its Examination Manual's Credit Risk Management module and Advances and Collateral module by September 15, 2025; and

4. Adopt a process to ensure the appropriate examination coverage of all topics within its Examination Manual guidance by June 30, 2025.

We consider FHFA's planned corrective actions responsive to our recommendations. The recommendations will remain open until we confirm that corrective actions have been implemented.

APPENDIX I: METHODOLOGY...

We conducted this evaluation to determine the extent to which DBR had examined the adequacy of the FHLBanks' assessment of their members' credit risk and taken appropriate action to address deficient practices they may have identified. We reviewed examination activities performed between January 1, 2021, and September 30, 2023 (review period), at four FHLBanks.

To meet this objective, we reviewed the provisions of the Federal Home Loan Bank Act, FHFA regulations, and Federal Deposit Insurance Corporation regulations applicable to FHLBank advances and their repayment and the FHLBanks' credit risk management. We also reviewed FHFA and DBR guidance and standards in effect during our review period that were relevant to the examination of member credit risk. These included:

- *FHFA Examination Manual*, Part 1: Examination Program Overview, Dec. 19, 2013;
- *FHFA Examination Manual*, Part 2: Credit Risk Management Module, July 2013;
- *FHFA Examination Manual*, Part 2: Advances and Collateral Module, Oct. 2014;
- Federal Home Loan Bank Examination Workpaper Standards, 2016-DBR-OPB-01, updated Sep. 9, 2020;
- *Work Program Minimum Frequency Guidelines*, 2012-DBR-OPB-03, Updated Oct. 1, 2020; and
- *Documentation of Contacts with FHLBanks*, 2012-DBR-OPB-02, Updated July 26, 2019.

Finally, we read Government Accountability Office, FHFA, OIG, and other reports related to the Spring 2023 bank failures.

We obtained and reviewed examination files from the 2021-2023 examination cycles for a sample of four FHLBanks. We selected FHLBanks where examination activities began after the March 2023 bank failures and were scheduled to conclude before the end of our review period. For this sample, we reviewed the examination workpapers, work programs, activity memoranda, and conclusion memoranda most relevant to member credit risk management. That review included the work programs and workpapers for the Advances and Collateral, Credit Risk Management, Credit and Collateral Risk Modeling, and Board and Senior Management work programs and the conclusion memoranda for the Asset Quality and Management examination ratings components. We also reviewed examination findings and reports of examination from our review period for the sample.

The goal of our review was to better understand what aspects of member credit risk management that examiners reviewed in the two cycles before the Spring 2023 bank failures, including what issues they found and what conclusions they reached. The aspects of member credit risk management for which we searched included:

- Lending philosophy and underwriting based on a member's ability to repay,
- Member credit quality reviews and assessments,
- Watchlist practices,
- Credit risk modeling for depository members, and
- Credit risk management policies and procedures, among other aspects.

We also sought to understand what changes in examination practices and scope occurred in 2023 that allowed examiners to identify the extensive deficiencies in the FHLBanks' member credit risk management.

In addition, we obtained information on DBR officials' oversight of the FHLBanks most affected by the bank failures. This included meeting summaries, notes, and email correspondence about their meetings with FHLBank management and other regulators regarding the failed member banks.

To supplement our review of the Agency's written record, we interviewed DBR officials, including the Deputy Director, Senior Associate Director, Associate Directors, and several examiners-in-charge and senior examiners. Finally, we provided FHFA with a draft of this report for its review and comment.

This evaluation was conducted between October 2023 and May 2024 under the authority of the Inspector General Act and in accordance with the Council of the Inspectors General on Integrity and Efficiency's *Quality Standards for Inspection and Evaluation* (December 2020).

APPENDIX II: FHFA MANAGEMENT RESPONSE.........................

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Federal Housing Finance Agency

MEMORANDUM

TO: Kyle D. Roberts, Deputy Inspector General for Evaluations

FROM: Joshua Stallings, Deputy Director, Division of FHLBank Regulation

JOSHUA STALLINGS

Digitally signed by JOSHUA STALLINGS
Date: 2024.08.09 13:08:42 -04'00'

SUBJECT: Draft Audit Report: *FHFA Could Enhance Its Supervision of the Federal Home Loan Banks by Incorporating Lessons Learned from the Spring 2023 Bank Failures* (*EVL-2024-01)*

DATE: August 9, 2024

Thank you for the opportunity to respond to the Office of Inspector General's (OIG) evaluation report. The objective of OIG's evaluation was to determine whether the Division of FHLBank Regulation (DBR) examined the adequacy of the FHLBanks' assessment of their member banks' credit risk and took appropriate action to address any deficient practices it identified.

The report identified four areas for improvement and offered four corresponding recommendations. As outlined below, FHFA agrees with the recommendations. Notably, the recommendations primarily relate to items identified in the *FHLBank System at 100: Focusing on the Future* public report, for which work is underway.

Recommendation 1: *Issue written guidance on the FHLBanks' collateral subordination practices*.

Management Response 1: FHFA agrees with the recommendation. DBR will issue written guidance on the FHLBanks' collateral subordination practices by June 30, 2025.

Recommendation 2: *Complete the development and implementation of protocols for DBR personnel to follow in times of member distress and failure, including heightened oversight of the FHLBanks and coordination of communication and actions with the appropriate federal and state regulators.*

Management Response 2: FHFA agrees with the recommendation. DBR will complete and implement protocols for DBR personnel to follow in times of member distress and failure by June 30, 2025.

Recommendation 3: *Update the Examination Manual's Credit Risk Management module and Advances and Collateral module to include guidance on the review of topics and issues related to the Spring 2023 bank failures and otherwise incorporate lessons learned from the 2023 examinations of member credit risk management.*

Management Response 3: FHFA agrees with the recommendation. DBR will update its Credit Risk Management and Advances and Collateral Examination Manual Modules to include guidance on the review of topics and issues related to the Spring 2023 bank failures and incorporate lessons learned from the 2023 examinations of member credit risk management. DBR will complete these updates by September 15, 2025.

Recommendation 4: *Adopt a process to ensure the appropriate examination coverage of all topics within its Examination Manual guidance.* (OIG cited DBR's Credit Risk Management and Advances and Collateral Examination Manual Modules related to this recommendation in the evaluation report's corresponding Finding 4).

Management Response 4: FHFA agrees with the recommendation. DBR will adopt a process to ensure the appropriate examination coverage of all topics within its Examination Manual guidance, including its Credit Risk Management and Advances and Collateral Examination Manual Modules. DBR will complete adoption of this process by June 30, 2025.

I would like to acknowledge the dedication and professionalism by the OIG staff who conducted this audit. I find the report and its conclusions valuable as the Agency continues to enhance its supervisory program. If you have any questions relating to this response, please contact Ed Stolle.

cc: Edom Aweke
John Major
Mark David
Ed Stolle

Federal Housing Finance Agency
Office of Inspector General

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