OFFICE OF INSPECTOR GENERAL

Federal Housing Finance Agency

400 7th Street SW, Washington, DC 20219

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TO: Sandra L. Thompson, Director, FHFA

FROM: Brian M. Tomney, Inspector General /s/

SUBJECT: Fiscal Year 2025 Management and Performance Challenges

In accordance with the Reports Consolidation Act of 2000 (P.L. 106-531), this memorandum identifies the most serious management and performance challenges facing the Federal Housing Finance Agency (FHFA or the Agency). This memorandum is based on OIG work and a review of public and non-public information, including data obtained from Fannie Mae and Freddie Mac (collectively, the Enterprises), and the 11 Federal Home Loan Banks (FHLBanks) (collectively, the regulated entities).[1] It includes risk areas discussed in prior years that continue to constitute serious management and performance challenges, as well as identifying two new risk areas that merit attention.

OIG has identified challenges in the following areas as the most serious facing FHFA for Fiscal Year (FY) 2025:

1. Managing risk in the Enterprises' multifamily lines of business (this is a new area);
2. Supervising the regulated entities' model risk management;
3. Managing vulnerability within FHFA's information security programs and at the regulated entities;
4. Addressing people risk at FHFA and at the regulated entities;
5. Overseeing the regulated entities' reliance on counterparties and third parties; and
6. Achieving certain supervisory goals for the FHLBank System and member credit risk management (this is a new area).

We identified these challenges based upon the severity of potential impact they may pose to FHFA's mission and stakeholders.

[1] The Office of Finance and Common Securitization Solutions, LLC (CSS) are not separate "regulated entities" as the term is defined by statute (see 12 U.S.C. § 4502(20)). Rather, the Office of Finance is a part of the FHLBank System, which includes the 11 FHLBanks, and CSS is an affiliate of the Enterprises. However, for convenience, references to the "regulated entities" in this document should be read to also apply to the Office of Finance and CSS, unless otherwise noted.

Certain challenges are inherent to FHFA's mission, such as the Agency's continual need to provide effective supervision of the regulated entities. Rather than simply describing those inherent challenges, this year's memorandum focuses on more specific challenges FHFA faces within these areas. We also describe FHFA's progress in addressing the identified challenges.

Challenge 1: Managing Risk in the Enterprises' Multifamily Lines of Business (New)

The Enterprises' multifamily businesses provide liquidity to the mortgage market and contribute to the achievement of FHFA's affordable housing goals and conservatorship objectives. According to FHFA's 2023 annual report to Congress, the Enterprises' combined multifamily business volumes for the years 2022-23 exceeded $243 billion. As of June 30, 2024, the combined multifamily portfolios exceed $925 billion. FHFA stated in its 2023 annual report that "both Enterprises lacked adequate capital to support the risks associated with their business models" at the end of 2023. It also acknowledged "recent stress" in the commercial real estate sector overall and "challenges" for the multifamily industry in particular.

In FY2024, our Office of Investigations, working with other law enforcement partners, successfully prosecuted several significant cases involving loans purchased by the Enterprises to finance multifamily properties. The cases include schemes such as real estate investors conspiring to deceive lenders into issuing multifamily and commercial mortgage loans, and a real estate company conspiring to submit false and fictitious information on loan applications to obtain mortgages on multifamily and single-family properties. Simultaneous with this uptick in investigative activity, FHFA has acknowledged that fraud involving multifamily loans has increased.

The FHFA Director has a statutory duty to ensure that the Enterprises' multifamily businesses operate in a safe and sound manner and comply with FHFA's regulations and prudential management and operations standards. FHFA reported in June 2024 that governance at the board and senior management levels of Fannie Mae and Freddie Mac "needs further improvement" and "needs improvement," respectively, and that multifamily credit risk exposure management at each Enterprise "needs improvement." These are meaningful downgrades, given that FHFA reported in 2023 that multifamily risk management at the Enterprises was "generally satisfactory[.]"

Why This is a Challenge

The Enterprises are doing billions of dollars of multifamily business during a period of challenging market conditions, at a time when FHFA considers their risk management practices less than satisfactory and capital is inadequate to support the risk. This environment presents a serious challenge to FHFA's ability to ensure that the Enterprises operate in a safe and sound manner.

FHFA's Progress in Addressing This Challenge

FHFA has increased examination activity to assess the Enterprises' respective risk profiles more accurately and more closely monitor the conditions that led to the downgrade in multifamily risk management, but it acknowledges that more work is necessary.

Over recent supervisory cycles (2021 to present), the Division of Enterprise Regulation (DER) has examined various aspects of the multifamily businesses, issued adverse examination findings, and monitored management's remediation of those findings. In addition, although this was not the case in 2023, the risks associated with the Enterprises' multifamily businesses are a supervisory priority for the 2024 supervisory cycle, and the 2024 Conservatorship Scorecard calls for the Enterprises to "strengthen" multifamily asset management. In accordance with its 2024 supervisory plans, DER has scheduled additional examination work that includes the areas of seller/servicer oversight, asset management, and market risk.

Select OIG Report Issued During FY2024 Related to the Enterprises' Multifamily Businesses

Infographic on Multifamily Seniors Housing – May 13, 2024

Select OIG Results from Criminal Investigations During FY2024 Related to Multifamily Fraud

Real Estate Investor Pleads Guilty to $54.7M Mortgage Fraud Conspiracy – Press Release, June 17, 2024

Real Estate Investor Pleads Guilty to $165M Mortgage Fraud Conspiracy – Press Release, Dec. 14, 2023

Challenge 2: Supervising the Regulated Entities' Model Risk Management

The Enterprises rely heavily on models to measure and monitor risk exposures and to inform and support business decisions. They use models for collateral valuation, home price forecasting, mortgage cash flow analysis, financial reporting, and stress testing, for example. The FHLBanks also rely on models in making business decisions and for financial reporting. They each make significant use of models to manage, measure, and monitor risks, as well as to determine the fair value of financial instruments when independent price quotations are not available.

The use of models exposes the regulated entities to model risk, which FHFA defines as "the risk of loss resulting from model errors or the incorrect use or application of model output." As FHFA has observed, reliance on inaccurate or inappropriate models may lead to poor management decisions. Further, many of the regulated entities' models provide input for other models, so a problem or error in one model can impair the reliability of another.

In June 2024, FHFA reported that governance in the area of model risk by the boards of directors and senior management at Fannie Mae and Freddie Mac "needs further improvement" and "needs improvement," respectively. The Agency also reported that examiners identified several model-related areas of improvement at multiple FHLBanks, including model risk management, member credit model performance monitoring, and model benchmarking. Following the Spring 2023 failures of several FHLBank System members, examiners found that the credit risk modeling of several FHLBanks understated the liquidity risk that contributed to the bank failures.

Why This Is a Challenge

The improvements needed in the Enterprises' model risk management, and limitations on DER's model examination resources, present a serious challenge to FHFA's ability to effectively examine and supervise model risk. The challenge is more severe when shifts in market conditions are significant enough to render previous model assumptions and methodologies unreasonable.

DER has identified a competency gap in the area of model risk examination, but, as of May 2024, had not started action to close that gap. This is a long-standing challenge. In 2020, we recommended that DER implement a workforce planning process specifically to ensure that the Agency has sufficient examination capacity to conduct supervisory activities of the Enterprises' high-risk models.[2] Among other things, we recommended that the process include identifying the appropriate number of Enterprise high-risk models to examine each year and forecasting the optimal staffing levels and examiner competencies necessary to complete those examinations. FHFA did not agree to implement the recommendation.

FHFA's Progress in Addressing This Challenge

Model risk remains a supervisory priority for the 2024 supervisory cycle. In accordance with its 2024 supervisory plans, DER has scheduled examination work in various areas of model risk management, including model overlays and model risk management frameworks, and monitoring of remediation of numerous adverse examination findings. Remediation of certain significant findings is expected in 2026.

Although DER did not agree to implement our recommendation to address any competency gaps specifically in model risk examination, DER developed and implemented a systematic workforce planning process in response to a recommendation in our 2020 audit report.[3] That was a positive step, however, we cautioned that without appropriate milestones, DER may be challenged with implementing the workforce plan timely.

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[2] OIG, *Despite FHFA's Recognition of Significant Risks Associated with Fannie Mae's and Freddie Mac's High-Risk Models, its Examination of Those Models Over a Six Year Period Has Been Neither Rigorous nor Timely* (EVL-2020-001, Mar. 25, 2020).

[3] OIG, *Despite Prior Commitments, FHFA Has Not Implemented a Systematic Workforce Planning Process to Determine Whether Enough Qualified Examiners are Available to Assess the Safety and Soundness of Fannie Mae and Freddie Mac* (AUD-2020-004, Feb. 25, 2020).

Select OIG Reports Issued During FY2023 and FY2024 Related to FHFA's Oversight of Model Risk Management

FHFA Could Enhance Its Supervision of the Federal Home Loan Banks by Incorporating Lessons Learned from the Spring 2023 Bank Failures, EVL-2024-003, August 19, 2024

FHFA Completed Examination Work Sufficient to Determine Whether the Enterprises' Credit Default Models Met Supervisory Expectations, EVL-2023-003, April 19, 2023

Challenge 3: Managing Vulnerability within FHFA's Information Security Program and at the Regulated Entities

FHFA's regulated entities comprise central components of the U.S. financial system and electronically connect with other large financial institutions. As part of their business processes, the regulated entities receive, store, and transmit highly sensitive private information about borrowers and businesses, including financial data and personally identifiable information (PII). Protecting this information is critically important and reflects an ongoing challenge to FHFA and the regulated entities. Unfortunately, but perhaps not unexpectedly, the regulated entities have been the targets of cyberattacks.

The threat landscape in this area is ever-changing, requiring constant vigilance and monitoring. FHFA has engaged in oversight of cybersecurity at the regulated entities and assessed that cybersecurity continues to be a top operational risk. Similarly, the Agency assessed elevated risk at the FHLBanks because of ongoing information technology initiatives, and examiners identified areas that exhibited or posed unacceptable operational risk in information security management.

In addition to FHFA's oversight of the regulated entities' cybersecurity posture, FHFA must also ensure the effectiveness of its own information security program. In this regard, FHFA collects and manages sensitive information, including PII, which FHFA must safeguard from unauthorized access or disclosure.

Vulnerability management is an essential component of information security programs that includes both regular vulnerability assessments and the timely remediation of vulnerabilities that exceed an entity's risk appetite. Without consistent and adequate vulnerability management, hackers could exploit vulnerabilities to take control of systems at FHFA and the regulated entities. Hackers could cause a denial-of-service attack or allow unauthorized access and malicious modification to systems and data. Vulnerabilities that remain un-remediated over an extended period of time increase exposure and the likelihood that the confidentiality, integrity, and availability of systems and data can be compromised.

Why This Is a Challenge

Regulated Entities

While both Enterprises employ information security programs, operational risks remain elevated given increased exposure to cybersecurity threats. In FHFA's 2023 Report to Congress, the Agency reported that Fannie Mae's exposure to information security risk persists because of both elevated levels of cyber threats and notable opportunities for improvement in information security risk management. At Freddie Mac, work continues on matters related to information security and data management. In addition to the Enterprises, FHFA stated that the FHLBanks continued to face elevated cyber and information security risk from cyberattacks such as spoofing[4] and ransomware.[5] FHFA examiners identified areas that exhibited or could exhibit unacceptable operational risks in vulnerability management, among other cybersecurity areas.

FHFA

Pursuant to the Federal Information Security Modernization Act of 2014 (FISMA),[6] OIG contracted with an independent public accountant (IPA) to conduct an independent evaluation of FHFA's FY2023 information security programs and practices. The IPA identified a weakness in vulnerability management. Specifically, the IPA found that FHFA did not fix 1,716 of 2,820 vulnerabilities (60 percent) identified within 14 days of discovery, as required by the Cybersecurity and Infrastructure Security Agency and FHFA's Office of Technology and Information Management's Vulnerability Management Process. Additionally, the IPA's finding reflects FHFA's own concerns regarding hardware lifecycle.[7] Systems may be vulnerable to attacks if technology can no longer be upgraded or supported.

FHFA's and the Regulated Entities' Progress in Addressing This Challenge

Regulated Entities

FHFA worked with the Enterprises to ensure that their business resiliency, information technology operations, data management, and information security programs adequately address safety and soundness concerns. The Enterprises each continued to implement technology solutions to protect the security and confidentiality of sensitive information and to respond

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[4] According to the National Institute of Standards and Technology, spoofing is the deliberate inducement of a user or resource to take incorrect action, such as impersonating, masquerading, piggybacking, and mimicking, in order to gain illegal entry into a secure system.

[5] According to the National Institute of Standards and Technology, ransomware is a type of malware that attempts to deny access to a user's data, usually by encrypting the data with a key known only to the hacker who deployed the malware, until a ransom is paid.

[6] FISMA requires agencies to develop, implement, and document an agency-wide information security program and practices. The Act also requires Inspectors General to conduct an annual independent evaluation of their agencies' information security programs and practices.

[7] According to the Federal Housing Finance Agency Information Resources Management Strategic Plan for Fiscal Years 2024-2026, some elements of FHFA's IT infrastructure are reaching their end of life and may no longer be supportable. As a result, FHFA is at risk of security vulnerabilities and an inability to access data.

to emerging cybersecurity threats. FHFA required the Enterprises to focus on ensuring that remediation programs were adequately funded and that they timely addressed any gaps or identified control weaknesses. Several FHLBanks continued to evolve their information security and cybersecurity controls to address existing and potential risks by improving software security patching, hardening access, enhancing user access management, and increasing staff awareness and training related to increasingly sophisticated social engineering tactics.

FHFA

In response to the vulnerability management deficiencies identified in the FY2023 FISMA audit report, FHFA management stated that they will remediate past due exploitable vulnerabilities and develop Plans of Action and Milestones. However, in the following year's FISMA audit report, the IPA found that those corrective actions had not yet been completed and that vulnerabilities remain.

Select OIG Reports Issued During FY2023 and FY2024 Related to Vulnerability Management within FHFA's Information Security Program

Audit of the Federal Housing Finance Agency's Information Security Programs and Practices Fiscal Year 2024, AUD-2024-006, July 30, 2024

Audit of the Federal Housing Finance Agency's Information Security Programs and Practices Fiscal Year 2023, AUD-2023-004, July 26, 2023

Challenge 4: Addressing People Risk at FHFA and at the Regulated Entities

To accomplish their missions, FHFA and the regulated entities must maintain a skilled workforce. People risk, or human capital risk, can occur when an organization is unable to attract, develop, and retain a highly qualified, diverse workforce with specialized skills. This risk can jeopardize the institution's ability to meet its business objectives. Given their ongoing need for skilled personnel, FHFA and the regulated entities confront people risk continually.

Why This Is a Challenge

Regulated Entities

FHFA's annual examination and rating for each regulated entity covers operational risk, which includes people risk. Examiners have noted concerns with people risk and flagged it as a heightened risk area with challenges. Certain factors affecting human capital are outside of the regulated entities' direct control. For example, attrition at the regulated entities is largely correlated to general labor market conditions, and the regulated entities experienced high turnover during the pandemic's tight labor market. In addition, increasing competition from financial services and technology companies for information technology and modeling skills increased turnover, especially at the Enterprises. FHFA must ensure the regulated entities navigate these external forces while maintaining the human capital required to achieve their missions. In the past year, FHFA has noted human capital related concerns at some regulated entities. Furthermore, several regulated entities have undergone changes in leadership that could increase people risk by impacting employee morale, productivity, retention, and overall organizational culture.

FHFA

FHFA acknowledges that its people risk challenges include strategic and integrated workforce planning and communication, information and knowledge management, and time to hire, among others. In prior years, we have reported on related issues, such as:

- Needed improvements to FHFA's workforce planning, particularly related to its examination function,[8] and

- Instances in which FHFA may not have the human capital needed to discharge certain statutory responsibilities. [9]

FHFA must also deal effectively with changing conditions such as the "aging" of its workforce. As of February 2024, FHFA employees aged 55 and over represented 32 percent of the organization. Related to this, a number of FHFA divisions and offices have undergone leadership changes in the past year and "acting" leaders remain in several key roles. Further, in December 2023, 43 employees took a voluntary early retirement opportunity, which could potentially impact the experience, institutional knowledge, and expertise of its workforce.

Without effective workforce planning, FHFA will face challenges across a range of human capital related issues ranging from organizational planning to dealing with pervasive critical skill gaps to manage the effects of retirements.

FHFA's Progress in Addressing This Challenge

FHFA has noted improvements in the Enterprises' people risk metrics and taken supervisory action to address human capital related concerns at some regulated entities.

[8] See OIG reports: *Despite Prior Commitments, FHFA Has Not Implemented a Systematic Workforce Planning Process to Determine Whether Enough Qualified Examiners are Available to Assess the Safety and Soundness of Fannie Mae and Freddie Mac* (AUD-2020-004, Feb. 25, 2020); *Despite FHFA's Recognition of Significant Risks Associated with Fannie Mae's and Freddie Mac's High-Risk Models, its Examination of Those Models Over a Six Year Period Has Been Neither Rigorous nor Timely* (EVL-2020-001, Mar. 25, 2020); and *The Division of Federal Home Loan Bank Regulation Followed Its Guidance in Performing Annual Examinations of Each Federal Home Loan Bank's Affordable Housing Program but the AHP Examination Planning Processes Require Improvement* (AUD-2023-001, Feb. 9, 2023). In each of these reports, we identified weaknesses in workforce planning for the examination functions and made recommendations to address these weaknesses.

[9] *See* *FHFA Could Enhance the Efficiency of the Agency's Oversight of Enterprise Executive Compensation by Ensuring Sufficient Human Capital Resources and Updating Procedures* (EVL-2022-003, Sept. 27, 2022). In this report we determined that FHFA had not determined the staffing needed to ensure the execution of its statutory responsibility for the oversight of Enterprise executive compensation and made a recommendation to address this weakness.

According to FHFA management, actions to improve workforce planning are in process. FHFA has initiated actions designed to improve its own workforce planning and completed actions to address its hiring issues. In September 2023, FHFA issued a Workforce Planning Policy, which established a process to ensure strategic alignment, identify workforce gaps, and develop and implement strategies to recruit, hire, develop, engage, and retain high quality, diverse talent. According to the policy, FHFA divisions and offices should have begun workforce planning by March 2024 and must complete their initial workforce plans by the end of March 2025. It is intended that these workforce plans will evolve and mature over time.

Select OIG Reports Issued During FY2023 and FY2024 Related to FHFA's Oversight of the Regulated Entities' People Risk and FHFA's Human Capital Management

FHFA Regularly Analyzed Agency Workforce Data and Assessed Trends in Hiring, Awards, And Promotions, COM-2024-004, March 14, 2024

People Risk at FHFA's Regulated Entities, WPR-2023-003, September 21, 2023

FHFA Examinations of CSS Include Review of the Board of Managers but Supervision Has a Key Person Dependency and Outdated Guidance, EVL-2023-002, March 20, 2023

FHFA Adhered to Its Corrective Actions for Hiring Pathways Interns, COM-2023-002, January 26, 2023

Challenge 5: Overseeing the Regulated Entities' Reliance on Counterparties and Third Parties

As we have reported in prior years, FHFA is challenged by the regulated entities' reliance upon counterparties. The regulated entities rely on counterparties for business-critical matters. Among the Enterprises' counterparties are entities that perform core functions, such as sellers, servicers, mortgage insurers, custodial depository institutions, and reinsurers. The FHLBanks' counterparties may include derivative counterparties as well as mortgage servicers that service loans the FHLBanks purchase from their members or from housing associates.

Why This Is a Challenge

The regulated entities' reliance on counterparties exposes them to counterparty credit risk, which is the risk that a counterparty defaults on amounts owed, deteriorates in creditworthiness before a transaction settles, or both. If an institutional counterparty defaults on its obligations, it could negatively impact a regulated entity's ability to operate. Such risk can arise when a regulated entity engages with a limited number of counterparties or due to inadequate or ineffective oversight. According to FHFA, the Enterprises continue to monitor counterparty risks, particularly in light of declining earnings throughout 2023 among many sellers and servicers of Enterprise-backed loans.

As we have also reported in prior years, FHFA is challenged by the regulated entities' reliance on third parties. The regulated entities rely on third parties to provide numerous products and services. For example, third parties provide critical operational support and information technology services. As with counterparties, this third-party reliance comes with risk, namely that the third party will not deliver the product or service as expected. FHFA has also reported that the regulated entities' third-party relationships can pose risks related to mortgage origination and servicing, information security, and business continuity. Further, OIG's recent publicly reportable criminal investigations include alleged fraud by various counterparties and third parties, reinforcing the need to ensure strong controls to prevent fraud.

The regulated entities' continued reliance upon counterparties and third parties presents a persistent challenge to FHFA because the Agency lacks statutory authority to supervise those parties directly. FHFA may oversee the regulated entities themselves, including but not limited to their risk management, but they have no regulatory authority over counterparties and third parties and therefore lack visibility into their operations. As a result, FHFA has only a limited ability to oversee risks to the regulated entities arising from their reliance upon counterparties and third parties.

FHFA's Progress in Addressing This Challenge

FHFA took steps in FY2024 to address risks to the regulated entities posed by their reliance on counterparties and third parties. A key step was the Agency's use of its Suspended Counterparty Program, which FHFA established to help protect the regulated entities from individuals and entities with a history of fraud or other financial misconduct. Pursuant to the Suspended Counterparty Program, FHFA may issue orders suspending an individual or entity from doing business with the regulated entities. FHFA reports having issued 24 suspension orders in FY2024 so far, which is half of the number of suspension orders it reported having issued in FY2023. In 2023, FHFA proposed to amend the existing Suspended Counterparty Program regulation. Following the close of the comment period on that proposed rule, in September 2024, FHFA re-proposed the rule with changes. That rulemaking remains pending.

Select OIG Reports Issued During FY2024 Related to Counterparty or Third-Party Issues

DBR Conducted Effective Oversight of the FHLBanks' Management of Third-Party Provider Risks But Did Not Fully Document Sampling in Examination Workpapers, AUD-2024-004, March 28, 2024

DER Provided Effective Oversight of the Enterprises' Nonbank Seller-Servicers Risk Management But Needs to Develop Policies and Procedures for Two Supervisory Activities, AUD-2024-003, March 28, 2024

Inspection: FHFA's Oversight of Enterprise Fraud Risk Management, COM-2024-005, March 28, 2024

DER Effectively Followed Its Risk-Based Approach in Its Oversight of Fannie Mae's IT Investment Management, AUD-2024-002, November 7, 2023

Select OIG Results from Criminal Investigations During FY2023 and FY2024 Related to Counterparty and Third-Party Matters

Real Estate Executive Pleads Guilty to Multi-Year Conspiracy to Falsify Financial Statements – Press Release, September 29, 2023

Asheville Man Convicted of Bank Fraud Involving the Purchase of Short-Term Rental Properties and Illegal Firearm Possession Is Sentenced to More than Seven Years in Prison – Press Release, December 14, 2023

Real Estate Company Owner Pleads Guilty in Mortgage Fraud Scheme – Semiannual Report page 34, October 1, 2023, through March 31, 2024

Challenge 6: Achieving Certain Supervisory Goals for the FHLBank System and Member Credit Risk Management (New)

In the Spring of 2023, several federally insured banks failed that were members of the Federal Home Loan Bank System (FHLBank System). FHFA stated in *FHLBank System at 100: Focusing on the Future* that communication channels between the FHLBanks and their members' primary federal regulators are longstanding and well-developed. FHLBanks use these channels to ask those regulators questions about risk trends at their members. Those channels become increasingly important when a bank experiences rapid deterioration in its financial condition and begins to exhibit signs of potential failure.

The federal regulators are required by law to make available to an FHLBank reports, records, and other information relating to the condition of a member bank with which the FHLBank is transacting business.[10] FHLBanks generally obtain reports of examination from primary federal regulators only upon request. According to FHFA, the member banks' reports of examination are not directly available to the Agency.

FHFA reported that one of the lessons learned from the 2023 market disruption and bank failures is that coordination among FHLBanks, the members' primary federal regulators, and the Federal Reserve discount window is critical to ensure the FHLBanks "are fully apprised of members' financial standing" and that all liquidity needs can be met during times of market stress. FHFA pointed out that this is especially the case when a member bank's failure is imminent, and emphasized its efforts to strengthen the FHLBanks' review of member creditworthiness.

Why This is a Challenge

From a supervisory perspective, FHFA has stressed the need for the FHLBanks to strengthen their review of member creditworthiness, especially when a member may be on the brink of failure. The Agency's message is that FHLBanks are neither designed nor equipped to be the lender of last resort.

[10] 12 U.S.C. § 1442(a)(1).

An FHFA regulation addresses an FHLBank's discretion to limit or deny a member's request for an advance, and it lists several bases on which an FHLBank could make such a decision.[11] An FHLBank may limit or deny an advance if, *in the FHLBank's judgment*, the member "is engaging or has engaged in any unsafe or unsound banking practices." However, according to FHFA, the information may lag behind as the "FHLBanks may receive reports of examination long after problems are identified." The potential lack of timely information presents a serious challenge to FHFA's efforts to get the FHLBanks to strengthen their review of creditworthiness, particularly during periods of market stress.

An FHLBank may also deny or limit a request for an advance when, in the FHLBank's judgment, the member "[h]as financial *or managerial deficiencies*, as determined by the [FHLBank], that bear upon the member's creditworthiness."[12] As noted above, in the absence of the primary regulator's views on a given member's managerial deficiencies, an FHLBank lacks information pertinent to the member's creditworthiness, and this presents a serious challenge to FHFA's supervisory efforts.

FHFA's Progress

In response to the member bank failures, FHFA increased its examination focus on the FHLBanks' member credit risk management during FY2023. It also issued a letter to the presidents and chief executive officers of the FHLBanks in September 2023 that reemphasized FHFA's expectations for a sound credit risk management framework to support an FHLBank's credit decisions. To supplement the supervisory letter, the Agency began drafting an advisory bulletin on member credit assessments that it intends to release by the third quarter of 2024. In addition, FHFA recently announced that it would amend its 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."

Select OIG Report Issued During FY2024 Related to FHFA's Supervision and Regulation of the FHLBank System

FHFA Could Enhance Its Supervision of the Federal Home Loan Banks by Incorporating Lessons Learned from the Spring 2023 Bank Failures, EVL-2024-003, August 19, 2024

Conclusion

The challenges described above are serious and merit the Agency's continued attention. While we have identified progress related to several of these challenges, FHFA must remain diligent in identifying potential risks and effectively supervising the regulated entities to mitigate those

[11] *See* 12 C.F.R. § 1226.4(a)(1)(i)-(v). FHFA regulations state that an FHLBank may make advances and renewals "only if the [FHLBank] determines that it may safely make such advance or renewal to the member[.]" 12 C.F.R. § 1226.4(a)(2).

[12] *See* 12 C.F.R. § 1226.4(a)(1)(iv) (emphasis added).

risks. OIG's own work will continue to be risk-based, and our audits, evaluations, and other projects will report all findings and make appropriate recommendations to FHFA to strengthen its work.