

# Annual Report of the Council of Inspectors General on Financial Oversight



JULY 2016



## Message from the Chair

In keeping with its mission, the Council of Inspectors General on Financial Oversight (CIGFO), which is authorized to oversee Financial Stability Oversight Council (FSOC) operations, continued its work by sharing financial oversight information which enhanced Inspectors General knowledge and insight about specific issues related to members' current and future work. For example, during its quarterly meeting sessions CIGFO discussed the Board of Governors of the Federal Reserve System's oversight of large bank holding companies and FSOC-designated nonbank financial companies. Also, members shared findings regarding their latest computer network intrusion detection and prevention work.

In addition to the CIGFO's oversight and monitoring activities, it has, since 2011, established working groups that are comprised of staff from the CIGFO member Inspector General offices to conduct audits of FSOC operations--CIGFO relies on these working groups to fulfill its mission.

In 2015, the CIGFO approved a working group proposal to review FSOC's promotion of market discipline in order to eliminate expectations on the part of shareholders, creditors, and counterparties of large bank holding companies or nonbank financial companies that the Government will shield them from future losses in the event of failure. That group is in the process of completing that audit in the near future.

CIGFO has also approved working groups to conduct a follow-up review of the 2013 CIGFO Audit of FSOC's Financial Market Utility Designation Process and a review of FSOC's evaluation of emerging threats posed by operational risk management, such as emergency preparedness and cybersecurity. Both efforts are expected to be completed in 2017.

/s/

Eric M. Thorson

Chair, Council of Inspectors General on Financial Oversight

Inspector General, Department of the Treasury

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# **The Council of Inspectors General on Financial Oversight**

The Council of Inspectors General on Financial Oversight (CIGFO) was established by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and meets on a quarterly basis to facilitate the sharing of information among Inspectors General. The CIGFO members discuss the ongoing work of each Inspector General who is a member of the Council, with a focus on concerns that may apply to the broader financial sector, and talk about ways to improve financial oversight. The CIGFO publishes an annual report that includes separate sections within the exclusive editorial control of each Inspector General. Those sections describe the concerns and recommendations of each Inspector General and a discussion of ongoing and completed work.

During the course of the year, the CIGFO continued to monitor coordination efforts among and between Financial Stability Oversight Council (FSOC) members. Specifically, CIGFO members discussed the following:

- FSOC's implementation of CIGFO audit recommendations
- Designated nonbank financial companies' supervisory requirements
- Office of Financial Research's role in the collection and dissemination of financial statistics
- HUD -1 Settlement Statement form modifications and mortgage fraud

The CIGFO recognizes that it has been 6 years since the Dodd-Frank Act was enacted and agency implementation of different provisions of the Act continues. The CIGFO encourages FSOC to continually assess its processes and procedures to ensure the Act is applied in a fair, consistent, and transparent manner, and that the processes and procedures appropriately reflect related case law as that case law evolves.

## **The Council of Inspectors General on Financial Oversight Audits**

The Dodd-Frank Act authorizes the CIGFO to convene a working group, by a majority vote, for the purpose of evaluating the effectiveness and internal operations of the FSOC.

To date, CIGFO has conducted four audits—

- 2012- Audit of the Financial Stability Oversight Council's Controls over Non-public Information
- 2013- Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities
- 2014- Audit of the Financial Stability Oversight Council's Compliance with Its Transparency Policy
- 2015- Audit of the Financial Stability Oversight Council's Monitoring of Interest Rate Risk to the Financial System

The corrective actions described by FSOC met the intent of our recommendations, and may be subject to verification in future CIGFO working group reviews.



# Office of Inspector General

## Board of Governors of the Federal Reserve System and Consumer Financial Protection Bureau

*The Office of Inspector General provides independent oversight by conducting audits, investigations, and other reviews of the programs and operations of the Board of Governors of the Federal Reserve System and the Consumer Financial Protection Bureau and demonstrates leadership by making recommendations to improve economy, efficiency, and effectiveness, and by preventing and detecting fraud, waste, and abuse.*

### I. Background

Congress established the Office of Inspector General (OIG) as an independent oversight authority for the Board of Governors of the Federal Reserve System (Board), the government agency component of the broader Federal Reserve System, and the Consumer Financial Protection Bureau (CFPB).

Under the authority of the Inspector General Act of 1978, as amended (IG Act), the OIG conducts independent and objective audits, inspections, evaluations, investigations, and other reviews related to the programs and operations of the Board and the CFPB.

- We make recommendations to improve economy, efficiency, and effectiveness and prevent and detect fraud, waste, and abuse.
- We share our findings and made corrective action recommendations to the Board and the CFPB, but we do not have the authority to manage agency programs or implement changes.
- We keep the Board's Chair, the CFPB's Director, and Congress fully informed of our findings and corrective action recommendations, as well as the agencies' progress in implementing corrective action.

In addition to the duties set forth in the IG Act, Congress has mandated additional responsibilities for the OIG. Section 38(k) of the Federal Deposit Insurance Act (FDI Act) requires that the OIG review failed financial institutions supervised by the Board that result in a material loss to the Deposit Insurance Fund (DIF) and produce a report within six months. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) amended section 38(k) of the FDI Act by raising the materiality threshold and requiring the OIG to report on the results of any nonmaterial losses to the DIF that exhibit unusual circumstances warranting an in-depth review.

Section 211(f) of the Dodd-Frank Act also requires the OIG to review the Board's supervision of any covered financial company that is placed into receivership under title II of the act and produce a report that evaluates the effectiveness of the Board's supervision, identifies any acts or omissions by the Board that contributed to or could have prevented the company's receivership status, and recommends appropriate administrative or legislative action.

The Federal Information Security Management Act of 2002 (FISMA), as amended by the Federal Information Security Modernization Act of 2014, established a legislative mandate for ensuring the effectiveness of information security controls over resources that support federal operations and assets. In a manner consistent with FISMA requirements, we perform annual independent reviews of the Board's and the CFPB's information security programs and practices, including the effectiveness of security controls and techniques for selected information systems.

## **II. OIG Reports and Other Products Related to the Broader Financial Sector**

In accordance with section 989E(A)(2)(B) of the Dodd-Frank Act, the following highlights the completed and ongoing work of our office, with a focus on issues that may apply to the broader financial sector.

### ***Completed Work***

#### **Major Management Challenges for the Board and the CFPB**

Although not required by statute, the OIG annually reports on the major management challenges facing the Board and the CFPB. These challenges identify the areas that, if not addressed, are most likely to hamper the Board's and the CFPB's accomplishment of their strategic objectives.

We identified six major management challenges for the Board this year. The challenge titled Enhancing Oversight of Cybersecurity at Supervised Financial Institutions was added in recognition of the difficult challenges the Board faces in continuing to promote the safety and soundness of financial institutions in an environment in which cyberthreats are increasing and becoming more sophisticated. The 2015 major management challenges for the Board are

- Enhancing Oversight of Cybersecurity at Supervised Financial Institutions
- Ensuring an Effective Information Security Program
- Continuing to Implement a Financial Stability Regulatory and Supervisory Framework
- Building and Sustaining a High-Performing and Diverse Workforce
- Improving Collaboration and Governance
- Maintaining Physical Infrastructure

We identified four major management challenges for the CFPB this year. We removed a challenge listed last year, Improving the Operational Efficiency of Supervision, because the CFPB has done significant work to reduce the backlog of examination reports and improve the examination process. The 2015 major management challenges for the CFPB are

- Ensuring an Effective Information Security Program
- Building and Sustaining a High-Performing and Diverse Workforce
- Strengthening Controls Over Management Operations
- Maintaining Physical Infrastructure

### **The Board Should Strengthen Controls to Safeguard Embargoed Sensitive Economic Information Provided to News Organizations, OIG Report 2016-MO-B-006, April 15, 2016**

Our audit objective was to assess the Board's controls to protect sensitive economic information from unauthorized disclosure when it is provided under embargo to news organizations either (1) through a press lockup room located at the Board or (2) via the Board's embargo application, which enables news participants to remotely access information made available by the Board.

The OIG's audit covered the period April 2014 through March 2015 and included the Federal Open Market Committee (FOMC) statements and Summaries of Economic Projections, the FOMC minutes, the *Summary of Commentary on Current Economic Conditions by Federal Reserve District* (also known as the Beige Book), and the four principal federal economic indicators (as designated by the Office of Management and Budget). We also conducted live observations of the press lockup room on June 17, 2015, and March 2, 2016.

During the course of this audit, we discovered issues that warranted the Board's immediate attention. We issued a restricted early alert memorandum to the Board on July 16, 2015, that outlined these concerns and included recommendations. On August 19, 2015, a news organization broke the embargo of the FOMC meeting minutes that had been provided through the embargo application. On August 21, 2015, the Board ceased using the embargo application to provide news organizations embargoed access to FOMC-related information and other market-moving economic publications within the scope of our audit. Separately, the Board relocated its press lockup room in September 2015, a move that had already been planned prior to the start of our audit.

We identified opportunities for the Board to (1) more strictly adhere to controls already established in policies, procedures, and agreements with participating news organizations and (2) establish new controls to more effectively safeguard embargoed economic information. We also identified risks to providing information under embargo through the embargo application.

Our report contains recommendations designed to strengthen the Board's controls to safeguard sensitive economic information provided to news organizations under embargo and includes actions taken by the Board in response to the early alert memorandum.

The Board generally concurs with our recommendations. The Board notes that substantial improvements were planned before we began our review and that many were implemented during our review.

### **The Board Identified Areas of Improvement for Its Supervisory Stress Testing Model Validation Activities, and Opportunities Exist for Further Enhancement, OIG Report 2015-SR-B-018, October 29, 2015**

This evaluation assessed the extent to which the Board's model risk management practices in support of supervisory stress testing are consistent with model risk management guidance applicable to supervised financial institutions. We focused on stress testing model validation but also evaluated broader governance, policies, and controls.

The Dodd-Frank Act mandated that the Federal Reserve conduct annual stress tests of all bank holding companies with \$50 billion or more in total consolidated assets. In late 2010, the Federal Reserve initiated the annual Comprehensive Capital Analysis and Review exercise, which includes quantitative stress tests and a qualitative assessment of the largest bank holding companies' capital planning practices. The Comprehensive Capital Analysis and Review has developed into the cornerstone of the Federal Reserve System's supervisory program for the largest bank holding companies.

Overall, we found that the Board has demonstrated its commitment to continuous improvement by identifying enhancements to supervisory stress testing model validation and governance. For example, in 2014, the Board completed three reviews assessing its performance and that of the broader supervisory stress testing program, and it identified several areas for improvement, including transitioning to a new staffing approach.

Although the reviews and the subsequent actions taken by the Board demonstrate its focus on continuous improvement, we identified (1) certain risks associated with validation staffing and performance management that may not be mitigated by the new staffing approach, (2) controls around changes to models that occur late in the supervisory stress testing cycle that need to be enhanced, (3) several components that should be included in the supervisory stress testing model inventory, and (4) limitations encountered by reviewers during model validation that were not documented in validation reports submitted to Board management.

Our report contains recommendations designed to strengthen supervisory stress testing model validation and governance practices. The Board generally agreed with our recommendations and noted that it is already implementing or has completed a number of our recommended actions.

### **Coordination of Responsibilities Among the Consumer Financial Protection Bureau and the Prudential Regulators—Limited Scope Review, OIG Report 2015-SR-X-009 June 1, 2015**

During a March 20, 2013, hearing held by the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Financial Services, a concern was raised regarding potential regulatory overlap between the CFPB and the Federal Deposit Insurance Corporation (FDIC). In subsequent conversations, the FDIC OIG notified the subcommittee that it planned to coordinate with the OIGs of the other prudential regulators to assess whether there are overlaps in how the CFPB and the prudential regulators are carrying

out their regulatory responsibilities. As such, the FDIC OIG and the OIGs for the Board and the CFPB, the U.S. Department of the Treasury, and the National Credit Union Administration conducted a joint review. The objective of our review was to assess the extent to which the CFPB and the prudential regulators were coordinating their supervisory activities and avoiding duplication of regulatory oversight responsibilities.

At the time of our review, the U.S. Government Accountability Office had completed, ongoing, and planned assignments that evaluated agency coordination efforts, among other matters. In addition, our office issued an evaluation report on the CFPB's supervisory program in March 2014; this evaluation addressed coordination activities between the CFPB and the prudential regulators, among other matters. Accordingly, we tailored our review to complement, but not duplicate, prior work. The OIGs agreed that the objectives of this review could be addressed with a limited-scope review rather than an audit or evaluation. This limited-scope review was not conducted under government audit or evaluation standards, and the OIGs determined that formal recommendations would not be made.

We found that the CFPB and the prudential regulators were generally coordinating their regulatory oversight activities for federal consumer financial laws, consistent with the Dodd-Frank Act and the provisions of a memorandum of understanding governing coordination activities. Nonetheless, we determined that there are opportunities for enhanced coordination, such as developing a standard CFPB process for notifying the prudential regulators of federal consumer financial law violations by institutions with assets of \$10 billion or less and timely notifying the prudential regulators of CFPB information requests made to their regulated institutions. We separately reported our finding and recommendation related to enhanced coordination (see the below summary of OIG Report 2015-SR-C-010, *The CFPB Can Enhance Its Process for Notifying Prudential Regulators of Potential Material Violations*). We did not identify any regulatory duplication of oversight responsibilities.

### **The CFPB Can Enhance Its Process for Notifying Prudential Regulators of Potential Material Violations, 2015-SR-C-010, June 29, 2015**

In a joint review conducted by the OIGs for the prudential regulators (see the above summary of OIG Report, 2015-SR-X-009, *Coordination of Responsibilities Among the Consumer Financial Protection Bureau and the Prudential Regulators—Limited Scope Review*), the OIGs identified opportunities for enhanced coordination, including an opportunity for the CFPB to develop a standard process for notifying the prudential regulators of federal consumer financial law violations by institutions with \$10 billion or less in total assets.

We conducted a review to address the issue of written notifications to the prudential regulators. During our review, we were unable to determine the frequency with which the CFPB identified potential material violations and shared them with prudential regulators and whether the CFPB consistently acted in accordance with section 1026(d) of the Dodd-Frank Act. Further, because the CFPB did not track written notifications and recommendations, we were not able to assess whether the relevant prudential regulator responded within 60 days of the recommendation as required by the Dodd-Frank Act.

We recommended that the CFPB implement a policy that outlines the process for assessing the materiality of a violation, provides guidance on determining whether a written notification or recommendation is necessary, and requires the tracking of written notifications and recommendations to the prudential

regulators and the corresponding written responses received from them. The CFPB concurred with our recommendations.

### **Security Control Review of the Board's Statistics and Reserves System (STAR), OIG Report 2015-IT-B-021, December 17, 2015**

STAR is a web-based application that collects and edits over 75 periodic statistical reports that are received from financial institutions. In addition, the system manages financial institutions' reserve requirements and term deposits.

We performed this audit in accordance with FISMA requirements. Specifically, we evaluated the adequacy of selected information security controls for protecting Board data in STAR from unauthorized access, modification, destruction, or disclosure, as well as the system's compliance with FISMA and the Board's information security policies, procedures, standards, and guidelines.

Overall, we found that the Board's Division of Monetary Affairs and its Division of Information Technology have taken several steps to implement information security controls for STAR, in accordance with FISMA and the Board Information Security Program. However, we found that improvements are needed in the Board's security governance of STAR to ensure that information security controls are adequately implemented, assessed, authorized, and monitored.

Our report includes recommendations that focus on strengthening information security controls related to planning, security assessment and authorization, contingency planning, auditing, access control, risk assessment, and system and information integrity. The Board agreed with our recommendations and outlined actions that have been or will be taken to address them.

### **Opportunities Exist to Enhance Management Controls Over the CFPB's Consumer Complaint Database, OIG Report 2015-FMIC-C-016, September 10, 2015**

Our audit objective was to assess the effectiveness of the CFPB's controls over the accuracy and completeness of its public-facing Consumer Complaint Database.

We determined that the CFPB's Office of Consumer Response has implemented controls to monitor the accuracy of complaint data in the internal case management system, but it has not established separate management controls to ensure the accuracy of the Consumer Complaint Database. We also found that Consumer Response does not (1) review all company closing responses, including verifying whether the company-selected response is consistent with the definition, and (2) consistently publish untimely company closing responses in the Consumer Complaint Database. In addition, consumers are not consistently offered the opportunity to dispute untimely company responses. Finally, although the Consumer Complaint Database website asserts that complaint data are refreshed daily, we found that Consumer Response did not consistently notify the public when the database was not updated.

Because the DT Complaint Database plays a role in the daily update process, our findings should be considered in conjunction with the security control deficiencies associated with the DT Complaint Database that were identified in OIG Report 2015-IT-C-011, *Security Control Review of the CFPB's Data Team Complaint Database*.

Our report includes recommendations designed to improve the CFPB's controls over the accuracy and completeness of the Consumer Complaint Database. The CFPB concurred with our recommendations.

**Security Control Review of the CFPB's Data Team Complaint Database, OIG Report 2015-IT-C-011, July 23, 2015**

Our audit objective was to evaluate the adequacy of selected security controls for protecting the CFPB's DT Complaint Database from unauthorized access, modification, destruction, or disclosure, as well as the system's compliance with FISMA and the information security policies, procedures, standards, and guidelines of the CFPB. The DT Complaint Database supports the CFPB's Consumer Response System and is the source of consumer complaint information published on the CFPB's public website.

While the CFPB had taken steps to secure the DT Complaint Database in accordance with FISMA, we identified several control deficiencies related to configuration management, access control, and audit logging and review.

Our report includes recommendations to strengthen controls for the DT Complaint Database. The CFPB concurred with our recommendations.

**Security Control Review of the Board's Consolidated Supervision Comparative Analysis, Planning and Execution System, OIG Report 2015-IT-B-015, September 2, 2015**

We completed our security control review of the Board's Consolidated Supervision Comparative Analysis, Planning and Execution System (C-SCAPE). C-SCAPE is intended to provide supervisory teams throughout the Federal Reserve System with tools and methods to plan and execute supervisory events, manage issues, and enhance decisionmaking around the examination planning process. Our audit objective was to evaluate the adequacy of selected security controls implemented by the Board to protect C-SCAPE from unauthorized access, modification, destruction, or disclosure. We also evaluated C-SCAPE's compliance with FISMA and the information security policies, procedures, standards, and guidelines of the Board.

Overall, we found that the Board has taken steps to secure the C-SCAPE application in accordance with FISMA and the Board's information security program. However, during vulnerability scanning of the databases supporting C-SCAPE, we found vulnerabilities that require the attention of the C-SCAPE application owner and the Board's Division of Information Technology. Additionally, we noted that the C-SCAPE application audit logs do not record certain database activity on financial institution information.

Our report includes recommendations to address C-SCAPE database vulnerabilities. We also identified items for management's consideration that are already being addressed by management. The Chief Information Officer and the Director of the Division of Banking Supervision and Regulation agreed with our recommendations.

### **Congressional Request Related to the In-Scope Borrower Population of the Independent Foreclosure Review and the Subsequent Payment Agreement, September 30, 2015**

We completed our review to address the five questions raised via a congressional request related to the group of borrowers, referred to as the in-scope borrower population, included in the IFR and the subsequent payment agreement established by the Board and the Office of the Comptroller of the Currency with the relevant mortgage servicers. The IFR process allowed borrowers who felt harmed by unsafe and unsound mortgage practices to submit a request to have their mortgage file reviewed. To address the questions within our jurisdiction, we reviewed the results of our prior and current work related to the Board's efforts to validate the in-scope borrower population and all IFR complaints received by the Board from January 2011 through June 2015. Overall, we concluded that the Board used an inclusive approach that involved adding borrowers to the in-scope population throughout the IFR process, using appropriate discretion. This inclusive approach was apparent during the Board's supervision of the servicers' identification of the in-scope population and the Board's approach to resolving complaints related to the IFR and the payment agreement.

### **The CFPB's Civil Penalty Fund Victim Identification Process Is Generally Effective but Can Be Enhanced, OIG Report 2016-FMIC-C-001, January 19, 2016**

The Civil Penalty Fund victim identification process includes collecting victim-related data, sorting and validating this data, and developing a final list of victims eligible to receive compensation. Our audit assessed the efficiency and effectiveness of the CFPB's process for identifying victims eligible to receive compensation from the Consumer Financial Civil Penalty Fund. Overall, we found that the process is generally effective and efficient, but we noted that the Office of the Chief Financial Officer has not documented the roles and responsibilities of the Office of Technology and Innovation in identifying victims. Victim identification depends on data and, in some instances, requires the Office of Technology and Innovation to produce preliminary lists of those who are eligible for compensation. We suggested that the Chief Financial Officer, in coordination with the Office of Technology and Innovation, update the Office of the Chief Financial Officer's procedures to document its roles and responsibilities in identifying victims eligible for compensation. The CFPB agreed with our suggestion.

### **Review of the Failure of NBRS Financial, OIG Report 2016-SR-B-005, March 31, 2016**

NBRS Financial, in Rising Sun, Maryland, operated as a national bank serving local communities for more than 120 years before transitioning from a national to a state charter in 2002. The bank was supervised by FRB Richmond and the Maryland Office of the Commissioner of Financial Regulation. On October 17, 2014, the Maryland Office of the Commissioner of Financial Regulation closed NBRS Financial and appointed the FDIC as receiver. Consistent with the requirements of section 38(k) of the Federal Deposit Insurance Act, as amended by the Dodd-Frank Act, we conducted an in-depth review of the failure of NBRS Financial due to unusual circumstances. NBRS Financial failed for several reasons. The bank consolidated authority in an individual who served as the President, CEO, and Chairman of the board of directors. This individual's dominant influence on the bank's operations limited the institution's ability to overcome its deteriorating financial condition. In addition, the board of directors approved a strategic plan that relied heavily on a perceived economic opportunity for the local economy that never materialized, and it also failed to adapt

to changing market conditions in a timely manner. Further, the bank developed high concentrations in commercial real estate and extended large loans to single borrowers, which exacerbated the bank's concentration risk and resulted in numerous regulatory violations. NBRF Financial's board of directors and management also failed to establish adequate credit risk management practices and internal controls commensurate with the risks within the bank's loan portfolio. These concentrations and poor credit risk management practices, along with a deteriorating real estate market, resulted in asset quality deteriorations, significant losses, and an erosion of capital.

With respect to supervision, FRB Richmond complied with examination frequency guidelines, conducted regular offsite monitoring, and implemented prompt corrective action provisions during the time frame under review—2006 through 2014. FRB Richmond's supervisory activity during this period included formal enforcement actions in the form of a written agreement and a prompt corrective action directive. FRB Richmond took strong supervisory action in 2009 and even stronger supervisory action in 2012. Our review did not reveal any opportunities for the Reserve Bank to have taken stronger supervisory action sooner but did result in one finding related to the potential fraud and insider abuse risks that dominant management officials can present. We have reported on this theme in prior failed bank reviews.

Our report recommends that the Board develop guidance or training related to highlighting indicators of internal abuse or heightened fraud risk in situations involving dominant officials. The Board agreed with our recommendation and outlined planned corrective actions to address the recommendation.

## **Ongoing Work**

### **Evaluation of the Federal Reserve System's Practices for Addressing Divergent Views and Making Supervisory Decisions for Large Banking Holding Companies**

In response to a request from the Board, the OIG is conducting an evaluation of the Federal Reserve System's practices for addressing divergent views and making supervisory decisions regarding large bank holding companies with total assets in excess of \$50 billion, known as Large Institution Supervision Coordinating Committee (LISCC) firms, and large banking organizations (LBOs).

Our objectives are to (1) assess the methods for Federal Reserve System decisionmakers to obtain material information necessary to ensure that decisions and conclusions resulting from supervisory activities at LISCC firms and LBOs are appropriate, supported by the record, and consistent with applicable policies and (2) determine whether there are adequate channels for Federal Reserve System decisionmakers to be aware of supervision staff's divergent views about material issues regarding LISCC firms and LBOs. As a part of our project, we also plan to evaluate the effectiveness of continuous monitoring as a supervisory tool for LISCC firms and LBOs.

This project is an evaluation conducted pursuant to the Council of the Inspectors General on Integrity and Efficiency's Quality Standards for Inspection and Evaluation and is not a criminal, civil, or administrative investigation. Unlike investigations conducted by law enforcement officials that may assess the actions of individual employees, auditors conduct evaluations that assess the effectiveness and efficiency of agency programs and operations. Our evaluations typically result in reports issued to Board officials that often

include recommendations designed to improve the efficiency and effectiveness of the agency's operations, programs, and policies.

### **Evaluation of the Effectiveness of the CFPB's Examination Workpaper Documentation**

The CFPB's Supervision and Examination Manual (version 2.0) summarizes the agency's expectations for workpaper documentation to support the results of its examination activity. The manual describes the following three principal purposes for workpaper documentation: (1) providing a record of the work performed that supports examination results, (2) maintaining the evidence necessary to support supervisory agreements or formal enforcement actions, and (3) facilitating internal quality control reviews. This evaluation will assess the CFPB's policies and procedures for documenting examination results, the training programs and materials used to implement workpaper documentation expectations, and the extent to which each of the CFPB's regions meets those expectations.

### **Evaluation of the CFPB Enforcement Office's Processes for Protecting Confidential Information**

The Enforcement office within the Division of Supervision, Enforcement, and Fair Lending routinely possesses confidential information as a result of the agency exercising its enforcement powers under title X, subtitle E, of the Dodd-Frank Act. For example, the CFPB can issue civil investigative demands to compel document production when the CFPB has reason to believe that a violation of federal consumer financial law has occurred. This evaluation is assessing the Enforcement office's regulations, policies, and procedures for safeguarding confidential information and the effectiveness of its controls designed to maintain the confidentiality of such information.

### **Evaluation of the Examination Approach Used to Assess Office of Foreign Assets Control (OFAC) Compliance**

In the past few years, there have been high-profile instances of foreign banking organizations (FBOs) operating in the United States that were facilitating payments to prohibited entities on OFAC's list of specially designated nationals. The Federal Financial Institutions Examination Council's Bank Secrecy Act/Anti-Money Laundering Examination Manual contains specific examination procedures for assessing OFAC compliance programs. This evaluation seeks to assess the effectiveness of the Board's and the Federal Reserve Banks' approach to examining the OFAC compliance programs for FBOs operating in the United States. This evaluation will assess the extent to which the current examination approach to OFAC compliance should be updated based on (1) lessons learned from these incidents or (2) evolving expectations for OFAC compliance programs based on recent updates to the sanctions list.



# Office of Inspector General

## Commodity Futures Trading Commission

*The CFTC OIG acts as an independent Office within the CFTC that conducts audits, investigations, reviews, inspections, and other activities designed to identify fraud, waste, and abuse in connection with CFTC programs and operations, and makes recommendations and referrals as appropriate.*

### Background

The CFTC OIG was created in 1989 in accordance with the 1988 amendments to the Inspector General Act of 1978 (P.L. 95-452). OIG was established as an independent unit to:

- Promote economy, efficiency and effectiveness in the administration of CFTC programs and operations and detect and prevent fraud, waste and abuse in such programs and operations;
- Conduct and supervise audits and, where necessary, investigations relating to the administration of CFTC programs and operations;
- Review existing and proposed legislation, regulations and exchange rules and make recommendations concerning their impact on the economy and efficiency of CFTC programs and operations or the prevention and detection of fraud and abuse;
- Recommend policies for, and conduct, supervise, or coordinate other activities carried out or financed by such establishment for the purpose of promoting economy and efficiency in the administration of, or preventing and detecting fraud and abuse in, its programs and operations; and
- Keep the Commission and Congress fully informed about any problems or deficiencies in the administration of CFTC programs and operations and provide recommendations for correction of these problems or deficiencies.

CFTC OIG operates independently of the Agency and has not experienced any interference from the CFTC Chairman in connection with the conduct of any investigation, inspection, evaluation, review, or audit, and our investigations have been pursued regardless of the rank or party affiliation of the target<sup>1</sup>.

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<sup>1</sup> The Inspector General Act of 1978, as amended, states: "Neither the head of the establishment nor the officer next in rank below such head shall prevent or prohibit the Inspector General from initiating, carrying out, or completing any audit or investigation..." 5 U.S.C. App. 3 sec. 3(a).

The CFTC OIG consists of the Inspector General, the Deputy Inspector General/Chief Counsel, the Assistant Inspector General for Auditing, three Attorney-Advisors (one part-time), two Auditors, one Senior Program Analyst, and an Audit Management Analyst. The CFTC OIG obtains additional audit, investigative, and administrative assistance through contracts and agreements.

## Role in Financial Oversight

The CFTC OIG has no direct statutory duties related to oversight of the futures, swaps and derivatives markets; rather, the CFTC OIG acts as an independent Office within the CFTC that conducts audits, investigations, reviews, inspections, and other activities designed to identify fraud, waste, and abuse in connection with CFTC programs and operations, and makes recommendations and referrals as appropriate. The CFTC's yearly financial statement and Customer Protection Fund audits are conducted by an independent public accounting firm, with OIG oversight.

### **Recent, Current or Ongoing Work in Financial Oversight**

In addition to our work on CIGFO projects described elsewhere in this report, CFTC OIG worked on the following projects during the past year:

In addition to our work on CIGFO projects described elsewhere in this report, CFTC OIG worked on the following projects during the past year:

- Performance Audit of CFTC's Rule Enforcement Reviews of Designated Contract Markets – FY2011 through FY2014

As stated in its current strategic plan, "CFTC conducts regular Rule Enforcement Reviews (RERs) and System Safeguard Examinations (SSEs) to assess ongoing compliance by the exchanges with core principles through the self-regulatory programs operated by exchanges. This function represents a significant part of the regulatory oversight structure and serves to assess the soundness of the self-regulation program of the derivatives industry."<sup>2</sup> The objective of this audit was to review DMO Market Compliance Section's performance in conducting RERs during the period FY2011 through FY2014. This was the first audit performed by OIG in this program area, and CFTC OIG contracted an independent public accounting firm to conduct the audit.

The audit noted the Division of Market Oversight (DMO) is not conducting rule enforcement reviews of all core principles. When 16 of 23 core principles are not reviewed, it may hamper DMO's ability to meet CFTC's strategic goal of promoting market integrity and transparency. In addition, procedures for selecting designated contract markets (DCM) for a RER needs to be improved. When 9 of 20 DCMs are not reviewed, there is a risk of noncompliance with the Commodity Exchange Act. Further, follow-up procedures on

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2 CFTC, Strategic Plan FY 2014-2018 (Oct. 16, 2014) (<http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/2018strategicplan.pdf>).

concerns and recommendations made in prior RER reports need to be enhanced. Without robust follow-up, there is the risk that DCMs will not address reported concerns and recommendations timely. Lastly, inadequate staffing leads to lengthy RER completion time.

When completion time averages 591 days, DMO risks that it will not effectively fulfill its business objective of market oversight.

Recommendations were made to the DMO Market Compliance Branch to (1) implement operating procedures that ensure DCMs comply with all Core Principles; (2) enhance documentation of its procedures for selecting DCMs to be reviewed; (3) strengthen procedures for following up promptly on all concerns and recommendations issued to a DCM; and (4) take steps to reduce average time between rule enforcement reviews.

Management generally concurred with the findings and recommendations and noted budget constraints for staffing limitations.

- Evaluation of Market Cybersecurity

Recent information technology (IT) breaches at commercial and federal entities curb confidence in networks used to facilitate financial transactions. As the vast majority of derivatives transactions are conducted electronically, it is of greater importance that CFTC management focus on protecting registrants' information. OIG contracted Brown and Company LLC to evaluate the CFTC's performance in monitoring information technology system safeguards in place at entities subject to CFTC regulatory oversight.

- Evaluation of CFTC Oversight of NFA

The CFTC relies on the National Futures Association (NFA), a self-regulatory organization for the U.S. futures and derivatives industry, to perform a number of delegated tasks. These delegated tasks enable CFTC to better focus its oversight responsibilities and resources on the derivatives markets. CFTC management performs periodic reviews of NFA's delivery of delegated services. OIG initiated a review to examine CFTC oversight activities of the NFA. Specifically, OIG is assessing the nature of reviews performed by the CFTC, frequency of reviews, and effectiveness of CFTC management in achieving its desired outcomes from the NFA.



## Office of Inspector General Federal Deposit Insurance Corporation

*The Office of Inspector General (OIG) promotes the economy, efficiency, and effectiveness of FDIC programs and operations, and protects against fraud, waste, and abuse. In doing so, the OIG assists and augments the FDIC's contribution to stability and public confidence in the nation's financial system.*

### Background

The Federal Deposit Insurance Corporation (FDIC) was created by the Congress in 1933 as an independent agency to maintain stability and public confidence in the nation's banking system by insuring deposits and independently regulating state-chartered, non-member banks. Federal deposit insurance protects depositors from losses due to failures of insured commercial banks and thrifts. According to most recent data, the FDIC insures approximately \$6.5 trillion in deposits at 6,182 banks and savings associations, and promotes the safety and soundness of these institutions by identifying, monitoring, and addressing risks to which they are exposed. The FDIC is the primary federal regulator for 3,947 of the insured institutions. An equally important role for the FDIC is as receiver for failed institutions—that is, upon closure of an institution by its chartering authority—the state for state-chartered institutions, and the Office of the Comptroller of the Currency for national banks and federal savings associations—the FDIC is responsible for resolving the institution and managing and disposing of its remaining assets.

The FDIC Office of Inspector General (OIG) is an independent and objective unit established under the Inspector General (IG) Act of 1978, as amended. The FDIC OIG mission is to promote the economy, efficiency, and effectiveness of FDIC programs and operations, and protect against fraud, waste, and abuse. In doing so, we can assist and augment the FDIC's contribution to stability and public confidence in the nation's financial system. We have continued to undertake work in support of that mission since issuance of the last CIGFO annual report, as discussed in more detail below. This discussion highlights OIG efforts that contribute broadly to stability in the financial sector, in line with CIGFO's mission.

Since issuance of last year's annual report, we completed a case study of the FDIC's response to institutions with elevated interest rate risk. With respect to failed bank work, we conduct material loss reviews in cases where losses to the Deposit Insurance Fund meet the threshold outlined in Section 38(k) of the Federal Deposit Insurance Act (FDI Act), as amended, and we perform failed bank reviews of all failures of FDIC-supervised institutions to determine whether unusual circumstances exist that would warrant an in-depth review of the failure. We issued three material loss reviews, focusing in each on the causes for the institution's failure and the FDIC's supervisory activities involving each institution. We also completed six failed bank reviews and determined that none warranted further in-depth review. We have continued an on-going risk

assessment and monitoring of the FDIC's activities related to implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and initiated several new assignments as a result of that assessment.

We continued to coordinate with our financial IG counterparts on issues of mutual interest. Of special note, we collaborated in the conduct of a review of coordination efforts among the Consumer Financial Protection Bureau (CFPB) and prudential regulators. As a member of CIGFO, the FDIC OIG also participated in the joint project related to the Financial Stability Oversight Council's efforts to promote market discipline.

In addition to audit and evaluation work, we sustained strong investigative efforts to combat financial institution fraud at both open and closed institutions. We have also stepped up efforts to remain vigilant with regard to cybersecurity and threats to the FDIC and the financial services industry as a whole. Further discussion of selected FDIC OIG work in these areas since issuance of the last CIGFO report follows.

## **The FDIC Addresses Institutions with Elevated Interest Rate Risk Profiles**

The FDIC has been concerned that certain institutions are not sufficiently prepared or positioned for sustained increases in, or volatility of, interest rates because rates have been exceptionally low for a prolonged period. To address its concerns, the FDIC's Division of Risk Management Supervision (RMS) has undertaken a number of initiatives, including reiterating supervisory expectations and enhancing its offsite review program to help identify institutions that have potential exposure warranting additional review.

We conducted an evaluation to study RMS' response to institutions with elevated interest rate risk (IRR) profiles. The scope of this study focused on well-rated institutions identified by the FDIC's analysis of Call Report data as of June 30, 2013 as having above average IRR exposure. In total, 98 FDIC-supervised institutions met our study criteria. In our view, focusing on this particular group provided a reasonable way to isolate our attention on the FDIC's supervisory response to IRR. Additionally, studying institutions meeting these criteria was of interest because, historically, regulators have been challenged dealing with ostensibly healthy institutions engaging in risky behavior. Forward-looking supervision is aimed at addressing this issue, thus, our evaluation approach enabled us to assess one application of this initiative.

Our observations, while limited to the group studied, illustrate RMS' application of forward-looking supervision. Employing lessons learned from the financial crisis, RMS has taken a series of steps aimed at emphasizing the importance of having effective risk management practices in place to mitigate the effects of adverse movements in interest rates before they happen. The FDIC's response included reiterating supervisory expectations; enhancing its offsite review program to better identify institutions with above-average IRR exposure; and following up by applying risk-focused examination procedures to further understand institution-specific risks. Further, the FDIC's process encourages examiners to consider the fact that even well-rated institutions can experience financial stress in cases where risks are not properly monitored, measured, and managed. Accordingly, as warranted, we observed that examiners are taking proactive supervisory action and progressive action to encourage banks to take preemptive measures to address risk exposures before their profitability and viability is impacted. For the most part, institutions are

responding to examiners' concerns. Importantly, management's responsiveness to supervisory concerns was a key differentiating factor between banks that failed and those that remained viable during the financial crisis.

In responding to the draft report, the Director of RMS stated that RMS intends to continue its vigilant supervision of IRR, and that professional development efforts will remain a priority to ensure that staff have the knowledge and resources to prudently supervise rate sensitivity issues.

## Reviews of Failed Banks

Although the number of institution failures has decreased dramatically since the height of the financial crisis, we continue work related to failed banks, as required by Section 38(k) of the FDI Act, as amended. These reviews of failed banks provide valuable insights on causes of failure and provide us an opportunity to make recommendations to improve supervisory activities to help ensure safety and soundness. A brief discussion of the three MLRs that we completed during the past year follows.

### Doral Material Loss Review

The Office of the Commissioner of Financial Institutions of Puerto Rico (OCFIPR) closed Doral Bank (Doral), San Juan, Puerto Rico, on February 27, 2015, and named the FDIC receiver. On March 6, 2015, the FDIC notified the OIG that total assets at closing were \$5.6 billion and that the loss to the DIF was \$748.9 million. As of July 31, 2015, the estimated loss had decreased to \$698.4 million. We conducted a material loss review, the scope of which covered examinations performed and supervisory actions taken from 2005 until Doral failed in 2015.

**Cause of Failure:** Poor asset quality was the underlying cause of Doral's failure. Puerto Rico's severe and prolonged economic decline coupled with weak underwriting and risk management practices were significant factors in the deterioration of Doral's loan portfolio. Management's strategies for handling its troubled loan portfolio were based on overly optimistic assumptions in light of actual economic conditions and proved to be ineffective over time. In addition, Doral's flawed allowance for loan and lease losses methodology masked the extent of deterioration in its loan portfolio. Further, the Board's oversight of management was inadequate, given the bank's size, financial condition, and challenges.

Negative earnings resulting from losses associated with the loan portfolio progressively eroded capital. Doral's holding company served as a source of strength for a period of time, but the amount and quality of Doral Financial Corporation's capital proved to be insufficient. In addition, in 2014, the FDIC determined that the \$286 million in prepaid tax assets on Doral's books, much of which had been down streamed by DFC to the bank, should not have been included in regulatory capital until collected by the bank from the Secretary of the Department of Treasury of Puerto Rico, also known as the Hacienda. As a result, the bank did not comply with capital requirements under an existing formal enforcement action with the FDIC. Further, Doral was no longer statutorily able to enhance liquidity by accepting, renewing, or rolling over any brokered deposits. Because Doral was not in a sound financial condition to continue operations, OCFIPR closed Doral and appointed the FDIC as receiver on February 27, 2015.

We made two recommendations in the report. The first was intended to enhance the effectiveness of supervisory controls for ensuring the FDIC's compliance with the FDI Act examination frequency requirements when a bank is on a targeted examination schedule. The second recommendation involved issuing or revising policy guidance to document the requirements and responsibilities of Regional Accountants related to conducting analysis for complex and/or unique accounting transactions, including when such matters should be escalated within RMS. FDIC management concurred and its proposed actions were responsive to the recommendations.

## **Capitol City Bank Material Loss Review**

On February 13, 2015, the Georgia Department of Banking and Finance (DBF) closed Capitol City Bank & Trust Company, Atlanta, Georgia (CCB), and the FDIC was appointed receiver. The FDIC's Division of Finance notified the FDIC's OIG on March 6, 2015, that the estimated loss to the DIF for the failure was \$88.9 million. We engaged KPMG LLP to conduct a material loss review of CCB.

CCB was a state nonmember minority depository institution that was chartered and became insured in 1994. Its Board of Directors and management historically pursued a traditional community banking model focused on serving the African American community in the Atlanta, Georgia, metropolitan area.

**Cause of Failure:** We determined that CCB failed primarily because its Board and management did not properly manage the risks associated with the bank's growth strategy that was centered on higher-risk commercial real estate (CRE) loans, which included acquisition, development, and construction, church and religious organizations, and gas and convenience store loans. Specifically, CCB's Board and management did not establish appropriate risk management practices, such as applying prudent credit underwriting and administration practices, ensuring adequate internal controls were in place, and maintaining key personnel and proper staffing levels as the bank grew. The president and chief executive officer (CEO) served as a dominant official, exerting significant authority over the lending function as well as the Board. Under the leadership of the CEO, the bank significantly increased its CRE portfolio and did not adequately respond to examiners' repeat recommendations to improve the bank's overall condition, particularly in the lending area.

Deficient loan underwriting and credit administration practices, such as over-reliance on collateral, lack of borrower financial information, and continued loan renewals negatively impacted the CRE loan portfolio.

Additionally, the bank's appraisal practices were less than ideal since the bank did not often obtain updated appraisals, and the bank's appraisal reviews did not identify concerns noted by examiners.

Such practices resulted in inaccurate calculations of the Allowance for Loan and Lease Losses and had the effect of delaying the timely recognition of loan exposure and losses as well as overstating earnings and capital. As a result, when economic and real estate market conditions deteriorated during the financial crisis, beginning in late 2007, CCB's loan portfolio was heavily impacted. We made no recommendations in this report.

## Valley Bank Material Loss Review

On June 20, 2014, the Illinois Department of Financial and Professional Regulation closed Valley Bank, Moline, Illinois (VBI), and the FDIC was appointed receiver. The FDIC's Division of Finance notified the FDIC OIG on July 9, 2014 that the estimated loss to the DIF was \$51.4 million. We engaged KPMG LLP to conduct a material loss review.

VBI was a state-chartered nonmember bank that was established on January 31, 2002 when the State Bank of Latham, Latham, Illinois, merged with the Valley State Bank, Eldridge, Iowa. The combined institution adopted a new name—Valley Bank. VBI's assets were centered in its loan portfolio, which contained significant concentrations of CRE loans, including acquisition, development, and construction loans. In the years preceding its failure, VBI also developed a considerable exposure to troubled businesses in the media sector, including television and broadcast operations. In addition, the bank maintained an investment portfolio consisting of mortgage-backed securities, collateralized mortgage obligations, municipal securities, and other investments. At the time of its failure, VBI maintained 15 offices, all of which were located in Iowa, except for the bank's main office, which was located in Moline, Illinois.

**Cause of Failure:** VBI failed primarily because of lax oversight by its Board and a dominant CEO that implemented a risky business strategy. Under the leadership of the CEO, VBI pursued an aggressive growth strategy centered in CRE loans, including speculative acquisition, development, and construction loans that made the bank vulnerable to a sustained downturn in the real estate market. In 2008, after deterioration in VBI's CRE portfolio had been identified, the bank acquired a failing thrift institution that had a considerable amount of distressed CRE loans. Adding to VBI's exposure to the real estate market was a significant investment in Private Label Mortgage Backed Securities that the bank acquired without conducting a proper pre-purchase analysis. Although these securities had an investment grade at the time of their purchase, they had risky characteristics and lost significant value when the real estate market deteriorated.

As losses associated with VBI's CRE and acquisition, development, and construction loans and Private Label Mortgage Backed Securities increased, VBI's CEO made a number of poor business decisions in an attempt to return the bank to profitability. For example, the CEO continued to extend credit to certain business customers after they were unable to repay their existing obligations, which had the effect of masking the true financial condition of VBI's loan portfolio, and ultimately increased the losses incurred by the bank. Weak internal controls, particularly in the lending function, also contributed to VBI's problems. Specifically, examiners identified numerous errors in VBI's financial books and records, inappropriate insider transactions, conflicts of interest involving certain directors and officers, and repeat apparent violations of laws and regulations and contraventions of policy. Notably, VBI's Board did not effectively challenge the CEO regarding the bank's risky business strategy and lending practices or hold the CEO accountable for the bank's weak internal controls and unsatisfactory financial performance.

Between 2010 and the first quarter of 2014, VBI reported combined net losses of approximately \$51.3 million and provision expenses for loan and lease losses of approximately \$70.4 million. These losses and provision expenses eliminated the bank's earnings and impaired its capital. The Illinois Department of Financial and Professional Regulation closed VBI on June 20, 2014 because the bank did not have sufficient capital to continue safe and sound operations and had no viable means of raising additional capital.

We made three recommendations that were intended to enhance the effectiveness of the FDIC's supervisory controls for ensuring bank compliance with the prohibitions of Section 19 of the FDI Act, addressing risks associated with dominant bank officials, and ensuring information pertaining to key supervisory decisions is recorded in systems of record. Management concurred with those recommendations and described responsive actions.

## **FDIC OIG Dodd-Frank Act Risk Assessment and Related Assignments**

The OIG continued an initiative to keep current with the FDIC's efforts associated with implementation of risk management, monitoring, and resolution authorities emanating from the Dodd–Frank Act. Our purpose in doing so is to understand and analyze operational issues and emerging risks impacting the FDIC, the financial community, and internal OIG operations and plans. This continuous and focused assessment of risk and monitoring enhances our more traditional, periodic OIG risk assessment and planning efforts and assists with the OIG's internal preparation efforts in the event a systemically important financial institution should fail. The assessment and monitoring to date has provided an informal, efficient means of making FDIC and OIG management aware of issues and risks warranting attention—it has not been conducted as an audit or evaluation.

Over the past year, we continued to observe the FDIC's Complex Financial Institutions Coordination Group meetings, monitored Dodd-Frank Act issues and media coverage, and briefed the FDIC Chairman and Vice Chairman to share our perspectives and hear their views on areas where the OIG can add the most value going forward. As part of our planning for FY 2016, we identified potential assignments, several of which are ongoing. Those include an audit of the FDIC's controls for safeguarding sensitive information in resolution plans, an evaluation of the FDIC's resolution plan review process, and an evaluation of the FDIC's monitoring of systemically important financial institutions.

## **Coordination of Responsibilities Among the Consumer Financial Protection Bureau and the Prudential Regulators—Limited Scope Review**

During a March 20, 2013, hearing held by the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Financial Services, a concern was raised regarding potential regulatory overlap between the CFPB and the FDIC. In subsequent conversations, the FDIC OIG notified the Subcommittee that it planned to coordinate with the OIGs of the other prudential regulators (Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (OCC), and the National Credit Union Administration) to assess whether there are overlaps in how the CFPB and prudential regulators are carrying out their regulatory responsibilities. As such, the FDIC OIG and OIGs for the FRB and the CFPB, Department of the Treasury, and the National Credit Union Administration conducted a joint review.

The objective of our review was to assess the extent to which the CFPB and prudential regulators were coordinating their supervisory activities and avoiding duplication of regulatory oversight responsibilities.

We found that the CFPB and prudential regulators were generally coordinating their regulatory oversight activities for federal consumer financial laws, consistent with the Dodd-Frank Act and the provisions of

a memorandum of understanding governing coordination activities. Nonetheless, we determined that there are opportunities for enhanced coordination. We did not identify regulatory duplication of oversight responsibilities. Officials from the CFPB and prudential regulators reported that they were generally satisfied with the level of communication and coordination occurring, which has continued to improve since the inception of the CFPB. These officials also identified challenges to coordinating certain supervisory activities and stated that they continue to discuss opportunities for improved coordination. None of the officials interviewed identified any instances where institutions received duplicative or conflicting supervisory guidance from the CFPB and a prudential regulator.

In accordance with the Dodd-Frank Act, the CFPB assumed exclusive responsibility for examining Very Large institutions for compliance with Federal consumer financial laws. Officials from the prudential regulators confirmed that their agencies were continuing to examine Very Large institutions for laws or areas of law for which they retained responsibility under the Dodd-Frank Act. The CFPB and prudential regulators entered into a memorandum of understanding in May 2012 which governs the CFPB and prudential regulators' coordination and information-sharing activities pertaining to Very Large institutions. The CFPB and prudential regulators shared examination schedules, conducted a limited number of simultaneous examinations,<sup>3</sup> and shared draft examination reports for comment and other appropriate supervisory materials.

Based on our interviews, we concluded that the prudential regulators retained responsibility for examining other institutions for compliance with federal consumer financial laws, and the CFPB does not examine these institutions. Consistent with the framework established by the Dodd-Frank Act, the CFPB exercises limited oversight of these institutions.

We also found that the CFPB requested information from Very Large and Other institutions in support of its consumer protection and enforcement activities, as allowed by the Dodd-Frank Act. CFPB officials usually notified the prudential regulator in advance of such information requests. None of the officials interviewed were aware of any significant complaints from financial institutions pertaining to these requests. As an example of the feedback provided, officials at prudential regulators reported that some institutions questioned the CFPB's information requests because those institutions did not fully understand the CFPB's role and authority to collect such information. The OCC noted several examples where other institutions received information requests from the CFPB and erroneously believed they would be examined by the CFPB.

We concluded that there were opportunities for improved coordination between the CFPB and prudential regulators. These opportunities included conducting additional simultaneous examinations, better communicating matters identified in draft supervisory letters among the regulators, establishing a framework to address the potential for conflicting supervisory determinations, developing a standard CFPB process for notifying the prudential regulators of federal consumer financial law violations by Other institutions, and timely notifying the prudential regulators of CFPB information requests to their regulated institutions. The CFPB and prudential regulators meet periodically to discuss these and other matters.

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<sup>3</sup> A simultaneous examination generally is one where material portions of the examinations by the prudential regulator and CFPB are conducted during a concurrent time period to facilitate coordination and information-sharing. Examination activities may be carried out on- or off-site by either regulator.

## **FDIC OIG Investigations Target Financial Institution Fraud**

FDIC OIG investigative work at both open and closed banks over the past months continued to complement our audit and evaluation work. Our criminal investigations provide additional insights into the control weaknesses that allowed perpetrators of fraud to commit illegal acts. We are particularly concerned when individuals inside the bank—officers, directors, and others—conspire to circumvent controls and commit crimes that harm their banks and cause losses to the DIF, thus undermining the integrity of the banking system as a whole.

Our office is committed to partnerships with other OIGs, the Department of Justice, the Federal Bureau of Investigation, and other state and local law enforcement agencies in pursuing criminal acts in open and closed banks and helping to deter fraud, waste, and abuse. The OIG also actively participates on numerous mortgage fraud and other financial fraud working groups nationwide to keep current with new threats and fraudulent schemes that can undermine the integrity of the FDIC's operations and the financial services industry as a whole.

These include the Bank Fraud Working Group, Mortgage Fraud Working Group, and Financial Fraud Enforcement Task Force, all spearheaded by the Department of Justice.

The OIG is also a member of the National Cyber Investigative Joint Task Force, the focal point for all government agencies to coordinate, integrate, and share information related to all domestic cyber-threat investigations, and is an active participant in the Federal Bureau of Investigation's Washington Field Office Cyber Task Force.

Our caseload as of March 31, 2016 included 274 active investigations. Of these, 167 relate to open bank matters and 63 to closed bank matters. These cases involve fraud and other misconduct on the part of senior bank officials, and include mortgage and commercial loan fraud exposed by turmoil in the housing, commercial real estate, and lending industries. The perpetrators of such crimes can be those very individuals entrusted with governance responsibilities at the institutions—directors and bank officers. In other cases, parties providing professional services to the banks and customers, others working inside the bank, and customers themselves are principals in fraudulent schemes. Some investigations involve money laundering or Bank Secrecy Act-related matters. Other current investigations include cases involving misrepresentations of FDIC insurance or affiliation, concealment of assets, and computer crimes. We are coordinating closely with the FDIC to ensure the continued safety and soundness, and integrity of the nation's banks and to preserve public confidence in the banking system.

A priority initiative for our office continues to involve enhanced coordination with the FDIC Legal Division, Division of Risk Management Supervision, and Division of Resolutions and Receiverships on matters related to enforcement actions. Specifically, we have established an on-going program to share information to ensure that the OIG's investigative results are available to FDIC management in its consideration of civil and administrative enforcement activities, and that information developed by the FDIC is effectively communicated to OIG criminal investigators, when warranted.

FDIC OIG investigative results over the 12 months ending March 31, 2016 include the following: 100 indictments; 46 arrests; 91 convictions; potential monetary recoveries (fines, restitution, and asset forfeitures) of more than \$1.5 billion; and 84 referrals to the Department of Justice.

## **FDIC OIG Addresses Cybersecurity and Threats to Financial Stability**

Our office has taken steps to enhance our understanding and involvement in the IT security and cyber arena on multiple fronts. Our efforts include assigning a senior manager to serve as a senior cyber security liaison officer, responsible for proactively monitoring and disseminating information on cyber risks both internal and external to the FDIC; establishing an OIG Cyber Threat Working Group; increasing our involvement with the FBI's Cyber Task Force in Washington DC; and assigning one of our agents to serve as our representative on the National Cyber Investigative Joint Task Force, a group focusing on cyber threat investigations across the federal, state, local, and international law enforcement, intelligence, counterintelligence, and military communities. We are also conducting audits and evaluations involving information security on an on-going basis to address current and emerging cyber risks. Our goal is to leverage the expertise and experience of our own staff, subject matter experts in other parts of the FDIC, and investigative entities external to the Corporation to more fully understand cyber threats, respond as needed, and share information as we seek to protect the FDIC's and the nation's critical infrastructure. We will continue to be vigilant and to actively participate in such working groups, given the significance of cyber threats and the vital importance of information sharing in government-wide efforts to effectively thwart such threats.

Additional information on the work of the FDIC OIG may be found at [www.fdicig.gov](http://www.fdicig.gov).



# Office of Inspector General

## Federal Housing Finance Agency

*The Federal Housing Finance Agency Office of Inspector General (FHFA OIG) conducts, supervises, and coordinates audits, evaluations, investigations, and other activities relating to the programs and operations of the Federal Housing Finance Agency (FHFA or the Agency), which regulates and supervises (1) the housing-related government-sponsored enterprises, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, the Enterprises), and (2) the Federal Home Loan Banks (FHLBanks). Since September 2008, FHFA has also served as conservator for Fannie Mae and Freddie Mac.*

### Introduction

FHFA OIG promotes economy, efficiency, and effectiveness and protects FHFA and the entities it regulates against fraud, waste, and abuse, thereby contributing to the liquidity and stability of the nation's housing finance system, and protecting the interests of the American taxpayers. We accomplish this mission by providing independent, relevant, timely, and transparent oversight of the Agency to promote accountability, integrity, economy, and efficiency; advising the Director of the Agency and Congress; and informing the public.

### Background

Created by statute in July 2008, FHFA is charged with serving as regulator of the Enterprises and the FHLBanks. Once the Enterprises were placed in conservatorship in September 2008 and FHFA was appointed conservator of them, it was placed in the extraordinary dual role of supervisor and conservator. Now in their eighth year, FHFA's conservatorships of the Enterprises are of unprecedented scope, scale, and complexity.

While in conservatorship, the Enterprises have required \$187.5 billion in financial investment from the Department of the Treasury (Treasury) to avert insolvency, and, through December 2015, the Enterprises have paid to Treasury approximately \$241 billion in dividends. Despite their high leverage, lack of capital, conservatorship status, and uncertain future, the Enterprises have grown in size during conservatorship and, according to FHFA, their combined market share of newly issued mortgage-backed securities is approximately 70 percent. The Enterprises' combined total assets are approximately \$5.2 trillion and their combined debt exceeds \$5 trillion. Although market conditions have improved and the Enterprises have returned to profitability, their ability to sustain profitability in the future cannot be assured for a number of reasons: the winding down of their investment portfolios and reduction in net interest income; the level of guarantee fees they will be able to charge; the future performance of their business segments; the elimination by 2018 of a capital cushion to buffer against losses; and the significant uncertainties involving key market drivers such as mortgage rates, homes prices, and credit standards.

Given the taxpayers' enormous investment in the Enterprises, the unknown duration of the conservatorships, the Enterprises' critical role in the secondary mortgage market, and their unknown ability to sustain future profitability, FHFA's administration of the conservatorships has been, and continues to be, a critical risk.

## **Examples of FHFA OIG's Oversight Accomplishments: Audit, Evaluation, and Compliance Activities**

### ***Compliance Review of FHFA's Implementation of Its Procedures for Overseeing the Enterprises' Single-Family Mortgage Underwriting Standards and Variances (COM-2016-001; issued December 17, 2015)***

In a 2012 audit report, *FHFA's Oversight of Fannie Mae's Single-Family Underwriting Standards* (AUD-2012-003), FHFA OIG reported that the Agency lacked a formal process to review Fannie Mae's and Freddie Mac's single-family mortgage purchase underwriting standards and variances to those standards. We recommended that FHFA establish a policy for reviewing Enterprise underwriting standards and variances, including escalation of unresolved issues reflecting potential lack of agreement. The Agency accepted the recommendation and, in January 2013, implemented a process called the "Single-Family Policy Review and Escalation Process" (the Process).

As a follow-up to this prior audit, FHFA OIG reviewed the Agency's implementation of this Process. Testing found that the Agency did not implement two of the Process' three key requirements. The Agency advised FHFA OIG that, in late 2014, it had begun to "reevaluate and reengineer" those two requirements but, as of the date of our review, the Agency had not established any timeline for completing its work on the Process. Regarding the third requirement, we found that, while one Enterprise routinely submitted all proposed revisions to its single-family credit policies for the Agency's review, the other Enterprise submitted far fewer proposed revisions to its policies. As a result, the Agency had reduced "visibility" into the latter Enterprise's single-family credit policies and underwriting standards.

Based on the compliance review results, FHFA OIG reopened the recommendation, and plans to keep it open until FHFA fulfills its commitment to establish and fully implement a formal process for reviewing the Enterprises' underwriting standards and variances to those standards. FHFA agreed with the recommendation.

### ***FHFA's Oversight of the Enterprises' Implementation of and Compliance with Conservatorship Directives during an 18-Month Period (ESR-2016-002; issued March 28, 2016)***

FHFA issues conservatorship directives to set forth significant policy determinations and initiatives and provide specific directions to the Enterprises for which compliance is required. As of October 2015, FHFA had issued 231 conservatorship directives of differing scope and purpose.

In December 2011 and in April 2013, the Inspector General testified before Congress that FHFA had not proactively overseen Enterprise compliance with its conservatorship directives to ensure that their purposes were achieved. FHFA OIG conducted an evaluation survey to assess whether FHFA had significantly enhanced its oversight of the Enterprises' implementation of and compliance with two conservatorship directives for an 18-month period, from January 2013 through June 2014 (the review period), and learned that little had changed.

We found that, in large measure, FHFA exercised little oversight of the Enterprises' compliance with these two conservatorship directives and relied on the Enterprises to self-report concerns, questions, and operational issues with implementation and compliance. We found that one Enterprise provided FHFA with compliance reports every quarter on the implementation status of directives, but its reports were of limited value because of their inaccuracies and incomplete information. The other Enterprise provided no written directive compliance reports to FHFA and, at the end of the review period, had not completed its formal compliance program and had not tested compliance with conservatorship directives. FHFA OIG found that FHFA's heavy reliance on the Enterprises to self-report compliance issues with conservatorship directives during the review period significantly limited FHFA's ability, as conservator, to determine whether the policies and initiatives announced in its conservatorship directives had been fully implemented.

During this evaluation survey, we were advised that Enterprise reporting on the implementation of and compliance with conservatorship directives changed in 2014. We intend to monitor FHFA's oversight of Enterprise implementation of and compliance with conservatorship directives, and will subsequently test whether additional reporting from the Enterprises has enhanced FHFA's oversight of conservatorship directives.

***Review of FHFA's Tracking and Rating of the 2013 Scorecard Objective for the New Representation and Warranty Framework Reveals Opportunities to Strengthen the Process (AUD-2016-002; issued March 28, 2016)***

Historically, the Enterprises relied on the sellers' representations and warranties when purchasing loans from sellers. In the event of default of a purchased loan, the affected Enterprise reviewed the loan file for possible breach by the seller of its contractual representations and warranties. When a breach was identified, the affected Enterprise could exercise its contractual rights to require the seller to repurchase the loan, mitigating losses caused by underwriting defects. After placed into conservatorship, FHFA directed the Enterprises to review defaulted loans for evidence of breach of sellers' representations and warranties. The Enterprises subsequently demanded repurchase of many such loans from the lenders. Sellers complained that the Enterprises' open-ended ability to demand loan repurchases was unfair and unpredictable, and caused them to tighten lending standards beyond what the Enterprises required to protect themselves from future exposure from loan repurchases. Concerned by the limitations on the availability of mortgage credit, FHFA directed the Enterprises in 2012 to develop and implement a new representations and warranties framework (new Framework) to provide sellers with greater certainty about their potential future repurchase exposure.

In February 2012, FHFA identified its strategic goals for the Enterprises in a strategic plan; in 2013 and in each subsequent year, FHFA has issued a Scorecard in which it set objectives for each of its three strategic

goals and set specific targets for each objective. FHFA tracks and rates Enterprise performance against the Scorecard on a quarterly basis and awards an overall annual Scorecard performance for each Enterprise, which is factored into Enterprise executive compensation for the following year. Tracking Enterprise performance against the annual Scorecard is a valuable internal control to keep Enterprise activities aligned with conservatorship strategic goals and to keep Enterprise executives accountable for the Enterprises' performance.

FHFA's 2013 Scorecard, issued on April 1, 2013, and revised on May 1, 2013 (2013 Scorecard), identified 11 objectives with specific targets for the Enterprises to work toward meeting FHFA's strategic goals. One of those 11 objectives was implementation of the new Framework. That objective contained two quarterly targets for both Enterprises. The first target required development of a plan to conduct upfront quality control reviews. The second target required an assessment of the Enterprises' execution of the new model and use of tools to identify defective loans, and an assessment of the effectiveness of the upfront quality control reviews.

FHFA OIG audited the effectiveness of FHFA's efforts to track and rate Enterprise performance on this objective regarding implementation of the new Framework. With respect to this one objective, we found that the rating for the first target for an Enterprise was inconsistent with the underlying written assessment. We also found that the rating for the second target of this objective for both Enterprises, where each Enterprise was found to have met the target, was inconsistent with documentation created after the quarter reporting that the target had been suspended due to insufficient data. While FHFA advised that the second target was suspended near the end of the fourth quarter in 2013, it did not revise its 2013 Scorecard target. FHFA reported that it advised each Enterprise orally that the target had been suspended during that quarter, but FHFA OIG was not able to confirm whether FHFA provided the same advice to both Enterprises.

FHFA OIG found that these inconsistencies and gaps, if not confined to this one instance, have the potential to create the misimpression that Scorecard objectives have been met when, in fact, they were suspended or modified by FHFA employees. Because of the importance of FHFA's Scorecard tracking and rating process, we recommended that FHFA: (1) establish standards requiring that modifications or suspensions of Scorecard targets must be documented in writing; (2) require that FHFA comments and ratings on quarterly rating sheets be dated; and (3) establish standards to address missed or partially missed quarterly targets, including requiring that every quarterly rating sheet record when any target was missed and the reset target date. FHFA agreed with all OIG recommendations and identified actions that it believed addressed each recommendation.

### ***FHFA's Oversight of Governance Risks Associated with Fannie Mae's Selection and Appointment of a New Chief Audit Executive (EVL-2015-004; issued March 11, 2015)***

FHFA OIG assessed the process used by Fannie Mae's Audit Committee of its Board of Directors to fulfill its delegated responsibility to select a Chief Audit Executive (CAE)—the senior executive who heads Internal Audit—which is a critical element of Fannie Mae's risk management controls. We found that the Audit Committee's process was haphazard, at best: the Committee waited several months after it learned that the CAE position would soon become vacant before it began a search for possible CAE candidates; ignored a

Succession Plan for senior executive positions that concluded that no internal candidate across Fannie Mae was “ready now” for the CAE position and a permanent successor would require an “external” candidate; limited its search to internal candidates; relied on Fannie Mae’s Chief Human Resources Officer to identify qualified internal candidates even though he and others in senior management concluded, 2 months earlier, that there was no internal candidate for the CAE position; and selected the Chief Credit Officer of Fannie Mae’s largest business unit, the Single-Family Business Group, even though he had not been identified as a candidate for the position in senior management’s Succession Plan, lacked the professional audit experience deemed “preferable” in the CAE Position Description, and was burdened by significant conflicts because of his management responsibilities in the Single-Family Business Group. We also found that the Audit Committee did not develop a plan and comprehensive controls to address the candidate’s conflicts of interest.

As a consequence, Fannie Mae hired a candidate who was burdened by conflicts without controls in place to mitigate them, and FHFA exercised no oversight of Fannie Mae’s delegated responsibility. Even after FHFA, acting in its capacity as regulator, directed the Audit Committee to assess the candidate’s conflicts and put compensating controls in place, the Committee declined to complete the requested assessment and adopt controls in a timely manner. For more than a year after the conflicted CAE began work, Fannie Mae’s Internal Audit was not in full conformance with governing standards, yet FHFA failed to impose any consequences on either the individual Audit Committee directors or on Fannie Mae.

FHFA OIG made five recommendations to address these shortcomings and improve FHFA’s oversight of corporate governance at the Enterprises, with which FHFA agreed. FHFA:

- Reviewed and revised internal FHFA procedures to ensure that the FHFA Director is informed of significant issues and concerns by FHFA staff on all conservatorship and supervisory matters that require the Director’s decision;
- Communicated in writing to Fannie Mae its expectations of enhancements to Audit Committee processes; and
- Directed Fannie Mae to retain an independent third-party consultant to conduct an assessment of the Audit Committee’s effectiveness and identify recommendations for improvements, and this assessment is underway.

### **Compliance Review of FHFA’s Oversight of Enterprise Executive Compensation Based on Corporate Scorecard Performance (COM-2016-002; issued March 17, 2016)**

In a 2011 report, *Evaluation of Federal Housing Finance Agency’s Oversight of Fannie Mae’s and Freddie Mac’s Executive Compensation Programs* (EVL-2011-002), FHFA OIG reported that the Enterprises had paid their top six executives more than \$35 million in compensation in 2009 and 2010, of which a substantial portion was “at risk” because it was tied to individual performance and could be reduced if the performance was inadequate. OIG found that the Agency’s oversight of the Enterprises’ compensation process was insufficiently robust: FHFA largely accepted and approved the Enterprises’ annual at-risk compensation proposals rather than verifying and testing the accuracy of the reported information and conclusions. OIG recommended that the

Agency strengthen its process to review the at-risk compensation proposals for Enterprise executives by, among other things, testing and verifying the Enterprises' proposals. FHFA agreed with this recommendation. At year-end 2011, the Agency provided OIG with newly adopted testing and verification procedures. After review, OIG closed the recommendation.

OIG reviewed FHFA's implementation of these testing and verification procedures. OIG learned that in March 2012, FHFA discontinued the implementation of its testing and verification procedures upon adoption of a new structure for Enterprise executive compensation that reduced the percentage of at-risk compensation from roughly 70 percent to 30 percent. According to FHFA, this new compensation structure rendered its testing and verification procedures obsolete. While FHFA acted within its discretion in establishing the new executive compensation structure, its decision to abandon any effort to test or verify the Enterprise proposals for at-risk executive compensation payments limited its ability to review the Enterprises' proposals before approving them. The total individual at-risk compensation payments amounted to \$11.7 million for 85 executives in 2014. Our review found several instances where the Enterprises proposed, and the Agency approved, payment of all at-risk compensation for executives even though the Enterprises were not on track to meet some of the performance goals for which the executives were responsible. In these cases, the Agency did not follow up with the Enterprises to gather basic information about their compensation proposals, much less challenge any of them.

OIG recommended that: (1) the Agency develop controls to test and verify Enterprise proposals for at-risk compensation based on executive performance prior to its approval of them; and (2) FHFA notify OIG when it does not fully implement, substantially alters, or abandons controls or corrective actions implemented in response to OIG recommendations. The Agency rejected both recommendations.

***FHFA's Exercise of Its Conservatorship Powers to Review and Approve the Enterprises' Annual Operating Budgets Has Not Achieved FHFA's Stated Purpose (EVL-2015-006; issued September 30, 2015)***

FHFA OIG assessed the effectiveness of FHFA's budget review and approval process for the Enterprises' annual operating budgets, which had increased about \$1.2 billion, or 31 percent, between 2012 and 2015. We found budget submissions by the Enterprises after the fiscal year had begun, combined with cursory level analysis by FHFA's Division of Conservatorship and inadequate resources within that Division to assess the reasonableness of the proposed budgets, prevented FHFA from exercising effective control over Enterprise spending, both in amount and direction, and FHFA's approval of the budgets created the risk that it endorsed Enterprise spending that was not well understood by FHFA.

OIG recommended that FHFA: (1) direct each Enterprise to submit its proposed operating budget and supporting materials for the next fiscal year so that FHFA has sufficient time before the fiscal year begins to adequately analyze the proposals; (2) revise the existing budget review process and staff the review process with employees who have the qualifications and experience needed for critical financial assessments of the proposed Enterprise budgets to permit FHFA to determine whether each Enterprise's budget aligns with FHFA's strategic direction and its safety and soundness priorities; (3) set a date certain during the first quarter of 2016 by which FHFA will take final action on each proposed annual operating budget for 2016 and approve

the budget by that date; and (4) set a date certain, prior to January 31 of each subsequent fiscal year, by which FHFA will take final action on each proposed annual operating budget and approve the budget by that date. FHFA agreed with recommendations 1, 2, and 3, and “generally agreed” to recommendation 4.

***FHFA’s Examiners Did Not Meet Requirements and Guidance for Oversight of an Enterprise’s Remediation of Serious Deficiencies (EVL-2016-004, March 29, 2016)***

On-site examinations of the Enterprises by FHFA’s Division of Enterprise Regulation (DER) are fundamental to FHFA’s supervisory mission. Through its supervisory activities, DER may identify a concern or deficiency, the most significant of which is labeled by FHFA as a Matter Requiring Attention (MRA). FHFA requires an Enterprise to promptly remediate an MRA. According to FHFA, a key component of effective supervision is close oversight of an Enterprise’s efforts to timely and effectively remediate MRAs.

Because MRAs are only issued by DER for the most serious supervisory deficiency, FHFA OIG assessed whether DER examiners followed FHFA’s requirements and supplemental guidance for supervision of an Enterprise’s efforts to remediate MRAs. OIG first compared FHFA’s requirements against the requirements imposed by other prudential Federal financial regulators and found that, in certain instances, FHFA’s standards fell short. OIG then reviewed whether DER examiners followed existing FHFA requirements and guidance in their oversight of a previously issued MRA and found that they did not. Specifically, the evidence showed: DER accepted the Enterprise’s proposed remediation plan, even though the plan failed to address all of the deficiencies identified in the MRA; and DER examiners did not assess the adequacy and timeliness of the Enterprise’s efforts to remediate the MRA beyond attending meetings with Enterprise personnel and receiving written presentations.

OIG recommended that FHFA: (1) review its existing requirements, guidance, and processes regarding MRAs against those adopted by other federal financial regulators; (2) assess whether any should be enhanced, and to make such enhancements; (3) compare the processes followed by DER and Division of FHLBank Regulation (DBR) for the form, content, and issuance of an MRA, approval authority for a proposed remediation plan, and real-time assessments at regular intervals of MRA remediation efforts; (4) assess whether the guidance issued and processes followed should be enhanced, and make such enhancements; (5) provide mandatory training for all FHFA examiners on MRA-related guidance; and (6) utilize the results of its quality control reviews to identify MRA-related gaps and weaknesses. FHFA disagreed with recommendations 1 and 2 and agreed with the remaining four recommendations.

***FHFA’s Supervisory Standards for Communication of Serious Deficiencies to Enterprise Boards and for Board Oversight of Management’s Remediation Efforts are Inadequate (EVL-2016-005, issued March 31, 2016)***

Under FHFA’s supervisory guidance, an Enterprise board is responsible for ensuring timely and effective correction of significant supervisory deficiencies. In order to perform such oversight, an Enterprise board must know that an MRA has issued, the practices giving rise to the MRA, and the remedial plan and timetables proposed by Enterprise management. The board would also benefit from specific supervisory expectations on its oversight responsibilities for MRA remediation. Because FHFA consistently maintains, based on the language of its authorizing statute, that its supervisory authority over the entities it regulates “is virtually

identical to—and clearly modeled on—Federal bank regulators’ supervision of banks,” FHFA OIG compared the stringent requirements imposed on directors for oversight of MRA remediation by the Office of the Comptroller of the Currency (OCC) and the Board of Governors of the Federal Reserve System (FRB) to those imposed by FHFA on Enterprise directors.

OIG found that FHFA’s requirements, guidance, and practices fell short of peer federal financial regulators. Specifically:

- OCC and FRB require a board of directors to be notified, in writing, by the exam team when an MRA issues and the reasons for its issuance; FHFA examiners notify Enterprise management, not Enterprise directors, that an MRA has issued. An Enterprise board receives information that an MRA has issued and the basis for its issuance from management, even though actions or inactions by management typically give rise to the MRA.
- OCC and FRB require a board of directors to engage early in the MRA remediation process by reviewing or approving a written remedial plan to correct the MRA deficiencies; FHFA places sole responsibility on Enterprise management to develop and submit a remedial plan to FHFA, without review by Enterprise directors, and there is no supervisory expectation that an Enterprise board receive a copy of the remediation plan, either before it is submitted for FHFA approval or after FHFA has approved it.
- OCC and FRB require a board of directors to oversee management’s efforts to implement the proposed remedial measures on an ongoing basis and ensure that management’s remediation is adequate and timely; FHFA does not.
- OCC and FRB expect a board of directors to keep the regulator informed of the progress of the remediation; FHFA does not.

OIG recommended that FHFA: (1) revise its supervision guidance to require DER to provide the Chair of the Audit Committee of an Enterprise Board with each conclusion letter setting forth an MRA; (2) revise its supervision guidance to require DER to provide the Chair of the Audit Committee of an Enterprise Board with each plan submitted by Enterprise management to remediate an MRA with associated timetables and the response by DER; (3) revise its supervision guidance to require DER to identify all open MRAs in the annual, written Report of Examination (ROE) and the expected timetable to complete outstanding remediation activities; and (4) include in this year’s ROE, to be issued to each Enterprise for 2015 supervisory activities, all open MRAs and the expected timetable to complete outstanding remediation activities for each open MRA.

FHFA agreed with recommendations (1), (3), and (4). FHFA “partially agree[d]” with recommendation (2): it agreed to “send the chair of the board audit committee a copy of DER’s written response to each MRA remediation plan” but refused to agree to provide the MRA remediation plan, which provides the basis for DER’s written response, directly to the chair of the board audit committee. Instead, FHFA committed to communicate “to Enterprise management the supervisory expectation for clear, timely, detailed reporting to the boards of directors on open remediation plans and associated timetables” and its “expectations about

circumstances in which remediation plans should be provided by management to the chair of the board audit committee.”

***FHFA Should Improve its Examinations of the Effectiveness of the Federal Home Loan Banks’ Cyber Risk Management Programs by Including an Assessment of the Design of Critical Internal Controls (AUD-2016-001; issued February 29, 2016)***

FHFA OIG assessed whether DBR’s examination of the effectiveness of the FHLBanks’ cyber risk management programs included review of the design of their vulnerability scanning and penetration testing efforts. We found that in 14 of 15 of DBR’s Information Technology (IT) examinations performed between 2013 and 2014 that included vulnerability scanning and/or penetration testing, DBR did not assess the design of those tests performed by contractors at the Banks’ direction. Some DBR examiners determined that such an assessment was outside of the scope of the examination plan, and all 14 of the work programs lacked steps to perform the assessment. Absent any examination of the design of vulnerability scans or penetration tests, FHFA lacks reasonable assurance that such testing can accomplish its intended purpose. OIG determined that failure to assess the design of key IT internal controls, such as vulnerability scanning and penetration tests, as part of FHFA’s examination of operational effectiveness of those controls, creates significant risks to FHFA’s DBR examination program because vulnerabilities may not be detected and the findings may not be reliable or accurate.

OIG recommended that FHFA: (1) update its IT Risk Management Program Module to direct examiners to assess the design of the Banks’ vulnerability scans and penetration tests when assessing the operational effectiveness of such controls; and (2) require examiners to document their assessment of the design of the Banks’ vulnerability scans and penetration tests as part of their assessment of the operational effectiveness of such controls. The Agency agreed with our recommendations.

***Corporate Governance: Cyber Risk Oversight by the Fannie Mae Board of Directors Highlights the Need for FHFA’s Closer Attention to Governance Issues (EVL-2016-006, issued March 31, 2016)***

In an evaluation, FHFA OIG assessed the execution of cyber risk management responsibilities by Fannie Mae’s Board of Directors (Board). Although the Board had made progress, we determined that much more remained to be done by the Board to satisfy the cyber risk management responsibilities delegated to it by FHFA. OIG found that the Board’s three foundational cyber risk management policies did not meet FHFA’s supervisory expectations announced in the Agency’s advisory bulletin. Additionally, Fannie Mae management presented to the Board plan after plan to enhance Fannie Mae’s cyber risk management program without explaining the reasons for the numerous plans or the integration of one plan with another, and offered timeline upon timeline, but provided little evidence of concrete progress in remediating conditions that gave rise to FHFA’s supervisory concerns. The Board largely received these presentations without challenging management’s changing timelines or multiple plans, questioning the integration of one plan with prior plans still in effect, or pressing management to provide a comprehensive master plan with clear timelines and milestones to remediate legacy technology issues and implement current cyber security initiatives.

OIG recommended that FHFA direct the Fannie Mae Board to enhance its cyber risk management policies, establish and communicate a desired target state of cyber risk management for Fannie Mae that identifies and prioritizes which risks to avoid, accept, mitigate, or transfer through insurance, and oversee management's efforts to leverage industry standards. FHFA agreed with OIG's recommendations, but asserted that our report did not sufficiently recognize the Board's recent activities and offered work performed by three third-party experts who evaluated Fannie Mae's cyber risk management efforts. We noted that two of the third-party reports were not completed until January and March 2016, after our field work concluded, and the findings of those reports would not be shared with the Board until its May 2016 meeting. The third report, issued in the second half of 2015, recommended that the Board place extremely high priority on implementation of the National Institute of Standards and Technology Framework for Improving Critical Infrastructure Cybersecurity (NIST Framework), a task that management reported to the Board had been completed in March 2015.

***FHFA Should Map Its Supervisory Standards for Cyber Risk Management to Appropriate Elements of the NIST Framework (EVL-2016-003, issued March 28, 2016)***

The FHFA Director, along with the heads of other Federal financial regulators, is a voting member of the Financial Stability Oversight Council (FSOC). In 2015, FSOC recommended that Federal financial institutions use the NIST Framework and that financial regulators map their existing regulatory guidance to appropriate elements of the NIST Framework and encourage consistent cyber security standards. Five of these federal financial regulators, exclusive of FHFA, are members of the Federal Financial Institutions Examination Council (FFIEC), an organization that promotes uniformity in the supervision of financial institutions. FFIEC developed supervisory guidance on cyber security risk management, which its five federal regulators follow. Although FHFA is not a member of FFIEC, FHFA has maintained that its respective regulatory responsibilities are similar. FHFA OIG conducted an evaluation to assess whether FHFA had mapped its regulatory guidance to the NIST Framework and whether its supervisory guidance on the development of a cyber security framework is substantially similar to the guidance adopted by FFIEC. OIG found that FHFA had not mapped its supervisory guidance to appropriate elements of the NIST Framework. OIG also found that FHFA's guidance is far less prescriptive and far more flexible than the guidance adopted by FFIEC and its Federal regulatory members.

OIG recommended that FHFA implement FSOC's 2015 recommendations to map its existing regulatory guidance to appropriate elements of the NIST Framework, identify gaps, and determine whether to revise its existing guidance to address those gaps. FHFA accepted our recommendations.

**Examples of FHFA OIG's Investigative Accomplishments**

FHFA OIG is vested with statutory law enforcement authority, which is exercised by the Office of Investigations (OI). OI is staffed by highly trained law enforcement officers, investigative counsels (ICs), forensic auditors, and support staff who conduct investigations related to programs overseen by FHFA. Depending on the type of misconduct uncovered during OIG investigations, the investigations may result in criminal charges, civil complaints, and/or administrative sanctions and decisions. Criminal charges filed against individuals or entities may result in plea agreements or trials, incarceration, restitution, fines, and penalties. Civil claims can lead to settlements or verdicts with restitution, fines, penalties, forfeitures, assessments, and

exclusion of individuals or entities from participation in federal programs. ICs in OI have been appointed as Special Assistant U.S. Attorneys (SAUSAs) in several judicial districts throughout the country. They have been assigned criminal matters arising from OI's investigations in the districts where they have been appointed and have pursued these investigations through to conviction and sentencing.

## **Civil Cases**

OI continued to participate in the Residential Mortgage-Backed Securities (RMBS) Working Group. Established by the President in 2012 to investigate individuals and entities responsible for misconduct involving the pooling of mortgage loans and sale of RMBS, the Working Group is a collaborative effort of dozens of Federal and state law enforcement agencies. OI Special Agents work closely with U.S. Attorneys' offices around the country and with State attorneys general to investigate allegations of fraud committed by financial institutions and individuals in connection with RMBS. OI has reviewed evidence produced by various parties for members of the Working Group, assisted with witness interviews, provided strategic litigation advice, and briefed other law enforcement agencies on the operations of the RMBS market. Since the inception of the RMBS Working Group, the Department of Justice has negotiated civil settlements worth over \$34 billion.

During this reporting period, Morgan Stanley agreed to pay a \$2.6 billion penalty to resolve claims related to its marketing, sale, and issuance of RMBS. In a detailed statement of facts that is part of the agreement, Morgan Stanley acknowledged that it failed to disclose critical information to prospective investors about the quality of the mortgage loans underlying its RMBS and about its due diligence practices. Investors, including Federally insured financial institutions, suffered billions of dollars in losses from investing in RMBS issued by the bank in 2006 and 2007. Morgan Stanley made representations to investors that it did not securitize underwater loans (loans that exceeded the value of the property). The bank did not, however, disclose that in April 2006 it had expanded its "risk tolerance" in evaluating loans to purchase and securitize "everything possible." The expansion resulted in Morgan Stanley ignoring information indicating that thousands of securitized loans were, in fact, underwater. As part of the agreement, the bank acknowledged that it did securitize nearly 9,000 underwater loans from January 2006 through mid-2007. Morgan Stanley also made representations to investors that it did not securitize loans that failed to meet the originators' guidelines unless those loans had compensating factors. However, the bank acknowledged that it "did not disclose to securitization investors that employees of Morgan Stanley received information that, in certain instances, loans that did not comply with underwriting guidelines and lacked adequate compensating factors were included in the RMBS sold and marketed to investors."

## **Criminal Cases**

### **Four Convicted at Trial for Mortgage Fraud, Virginia**

FHFA OIG ICs are appointed as SAUSAs in districts throughout the country to help investigate and prosecute criminal cases involving fraud that adversely affects the Enterprises, the FHLBanks, and its members. As an example where FHFA OIG IC designated as an SAUSA successfully tried a case through verdict, in February 2016 a Federal jury convicted Mohsin Raza, Humaira Iqbal, Farukh Iqbal, and Mohammad Haider on charges of conspiracy to commit wire fraud affecting a financial institution and wire fraud affecting a financial institution. According to evidence presented in court, from May 2006 through January 2007, the defendants,

all former employees of SunTrust Mortgage, conspired to defraud SunTrust by preparing false mortgage loan applications for prospective borrowers for 13 properties. These fictitious loan applications contained false material information such as inflated incomes, inflated assets, reduced liabilities, and statements that the borrowers intended to use the houses as their primary residences. To support these false loan applications, defendants prepared false documents, created fraudulent wage-and-earning statements for the prospective borrowers, and generated false letters from certified public accountants. They submitted the fraudulent loan applications and supporting documents to SunTrust Mortgage offices to obtain approvals for the loans sought by the prospective borrowers and some of the loans, in turn, were sold to Fannie Mae.

### **Conviction of Former Chief Executive Officer (CEO) of Cay Clubs Resorts, Florida**

In December 2015, Fred Davis “Dave” Clark Jr., former CEO of Cay Clubs Resorts and Marinas, was convicted after a 5-week jury trial on charges of bank fraud, making false statements to a financial institution, and obstruction of the Securities and Exchange Commission (SEC). Approximately 1,400 investors, Federal Deposit Insurance Corporation (FDIC) -insured banks, and the Enterprises were defrauded in this \$300 million Ponzi scheme involving the sale of Cay Clubs vacation rental units. In February 2016, Clark was sentenced to 40 years in federal prison, followed by 5 years of supervised release, ordered forfeiture of \$303.8 million, and ordered to pay \$3.3 million for obstructing an SEC investigation. Additionally, Clark was ordered to forfeit \$2.6 million in overseas assets.

Clark was the CEO of Cay Clubs, which operated from 2004 through 2008 from offices in Florida. Cay Clubs marketed vacation rental units for 17 locations in Florida, Las Vegas, and the Caribbean and raised more than \$300 million from investors by promising to develop dilapidated properties into luxury resorts. Evidence at trial showed that these properties were never developed. Clark further incentivized investors by promising an upfront “leaseback” payment of 15-20 percent of the unit sales price at the time of closing. Clark concealed these incentives from lenders and the Enterprises.

Clark deceived lenders and the Enterprises by conducting insider sales transactions of the units, artificially inflating values. Clark directed his administrative assistant and his bookkeeper to forge signatures on loan documents and falsely notarize mortgage paperwork to make it appear that straw buyers, including family members, were executing the documents when in reality Clark was providing the deposits and down payments and using the proceeds of the transactions to fund Cay Club’s operations and for his own personal benefit. Clark engaged in a series of fraudulent mortgage transactions, which resulted in more than \$20 million in bank loans. After the collapse of Cay Clubs, the SEC began an investigation into alleged securities fraud at Cay Clubs. In March 2013, after the SEC filed a civil fraud action against him, Clark transferred more than \$2 million to a corporate account he controlled in Honduras. After this transfer, U.S. law enforcement and authorities in Honduras were able to obtain a court order freezing these funds. The fraud scheme caused losses to Fannie Mae and Freddie Mac in excess of \$11 million.

In related cases, in October 2015, former Cay Clubs executives Barry J. Graham and Ricky Lynn Stokes were ordered to pay restitution of \$163,530,377. Previously, Graham and Stokes were each sentenced to 5 years in prison.

### **Five Indicted on Money Laundering Charges at a Member Bank of the FHLBank of Topeka**

In October 2015, three former employees of the Plains State Bank (PSB), President J. Kirk Friend, Matthew Thomas, loan officer, and Kathy Shelman, bank cashier, were charged by a superseding indictment along with business owners and PSB customers George and Agatha Enns for an alleged conspiracy to launder money through PSB, a member bank with more than \$76 million in advances from the FHLBank in Topeka, Kansas. From 2011 to 2014, deposits into a PSB bank account controlled by the two indicted business owners totaled more than \$6.8 million, which included more than \$1.6 million in cash. The PSB bank employees failed to file Treasury reports, as required, based upon the amount and type of cash and monetary instruments deposited into the PSB account.

### **Short Sale Fraud Conviction and Sentencing Involving an FHLBank Member Bank, Virginia**

In November 2015, Michelle M. Borzillo, former senior attorney at the FDIC, pled guilty to bank fraud relating to a short sale of her home to her live-in boyfriend. According to court documents, Borzillo purchased a home for \$850,000 with mortgages totaling \$807,500 from Wells Fargo Bank, a member of an FHLBank. In 2013, she engineered the short sale of her home to her boyfriend, who had been living with her at the property for several years. Borzillo induced Wells Fargo Bank to approve the short sale by falsely representing that the sale was an arm's length transaction to someone with whom she had no close personal relationship. Borzillo also falsely certified that she was moving out of the property and claimed she was suffering a financial hardship due to a Federal pay freeze. In reality, despite her representation to her lender and her acceptance of \$3,000 in relocation assistance in connection with a Federal program designed to assist financially distressed short sellers, Borzillo admitted that she had no intention of moving out of the property. As a senior FDIC employee, Borzillo had not been subject to the Federal pay freeze, and, at the time of the short sale, her base annual salary steadily increased. As a result of her misrepresentations, the mortgage lender approved the short sale and Borzillo benefitted from a \$290,000 reduction in her mortgage while continuing to live in the home after the sale. As a result of the fraudulent short sale transaction, Wells Fargo Bank was required to write off nearly \$300,000 in losses. In February 2016, Borzillo was sentenced to 12 months and one day in prison, followed by 2 years of supervised release. She was also ordered to pay \$288,497 in restitution and to forfeit the proceeds of her offense.

### **Real Estate Broker and Investor Charged in a Buy-and-Bail Scheme, Michigan**

In December 2015, William Elias, owner and a licensed real estate broker for Elias Realty, and Kimberly Doren, an Elias Realty employee and owner of KLD Consulting, were charged by information for their roles in a short sale fraud scheme. According to the information, Elias executed a buy-and-bail scheme through Elias Realty. Through extensive advertising, Elias reached out and promised homeowners whose homes were underwater that he could help them sell their existing homes, eliminate their debt, and buy new homes. To accomplish this, Elias instructed his clients to apply for a mortgage and buy a second home. Allegedly, the mortgage applications falsely inflated the values of the first homes and misrepresented that the borrowers intended to keep their existing homes as rental properties. In reality the homes were worth significantly less than stated, and the homeowners had no intention of renting their homes; rather, they intended to sell them by short

sale. To convince the second loan originator that the existing home was being retained for a rental property, Elias Realty manipulated the Multiple Listing Service (MLS) to make it appear as though the existing property was not being short sold. The false MLS information corroborated the false and fraudulent information on the loan applications. Once the second homes were purchased, Elias purportedly instructed the homeowners to stop making mortgage payments on the first homes and to apply for approval with their lenders to conduct short sales on their original properties given the financial hardships due to having two active mortgages. Many homeowners were permitted to conduct short sales and lenders forgave the difference between the short sale prices and the outstanding amount of the loans. In some instances, however, the financial institutions did not agree to the short sales and the mortgages were foreclosed. In addition, according to the information, in December 2013, Doren allegedly caused KLD Consulting to act as a straw buyer on behalf of William Elias. Prior to the sale, Doren and the seller allegedly signed an affidavit that falsely stated the short sale was an arm's length transaction between the parties. The Enterprises suffered losses in excess of \$5.1 million involving nearly 100 homes.

### **Sentencings in Complex Short Sale Fraud Scheme, California**

An FHFA OIG investigation found evidence of a wide-ranging conspiracy in which numerous conspirators engaged in several schemes to fraudulently obtain money, including: a “flopping” scheme where banks were convinced to accept short sale prices that were lower than a legitimate buyer would be willing to pay, recording false second and third liens, tricking distressed homeowners into signing their properties over to the conspirators, and renting distressed properties while simultaneously stalling foreclosure through the use of fraudulent documents. Mortgages on at least eight of the properties were owned by the Enterprises, causing losses to date of \$300,000. In December 2015, the following individuals received sentences ranging from 6 years in prison to 80 days in custody with 5 years of probation: James Styring, Joseph Jaime, Deanna Bashara, and Delia Wolfe. Varying amounts of restitution from \$50,000 to \$596,232 were also ordered.

### **Five Pled and Two Sentenced in Loan Modification Scheme, California**

In November 2015, Roscoe Umali, Joshua Johnson, Isaac Perez, Raymund Dacanay, Jefferson Maniscan, and Hanh (Jennifer) Seko were arrested for allegedly participating in a nationwide loan modification scheme. During March 2016, five of the co-defendants pled guilty to conspiracy to commit wire fraud. According to statements of facts filed with their plea agreements, Umali, Johnson, Perez, Dacanay, Mansican, and others made a series of misrepresentations to struggling homeowners in order to induce the homeowners to make payments of thousands of dollars in exchange for supposed home loan modification assistance. The defendants allegedly convinced struggling homeowners to make several “trial mortgage payments” directly to the conspirators rather than to the homeowners’ mortgage lenders. The defendants then did nothing to help modify any mortgages, no services were provided, and the defendants allegedly used the money they received for their own benefit. The scheme victimized over 400 individuals and families and resulted in overall losses estimated at \$3.8 million, with approximately \$1.1 million in potential losses to the Enterprises. Seko did not plead guilty and is awaiting trial. Two other schemers, Joshua Sanchez and Kristen Ayala, were sentenced in October 2015 after pleading guilty to conspiracy to commit wire fraud. Sanchez was sentenced to 151 months in prison and 3 years of supervised release. Ayala was sentenced to 135 months in prison and 3 years of supervised release.

## **Sentencings in Fraudulent Deed Scheme, California**

In February 2016, Shara Surabi, Panik Karikorian, and Juan Velasquez were sentenced for their roles in a foreclosure rescue scheme. All three defendants were sentenced to 4 months in prison, followed by 5 years of probation. The sentencings occurred shortly after no contest pleas to conspiracy were entered by defendants Surabi and Velasquez in late December 2015, along with Karikorian's plea of no contest to being an accessory after the fact during the same time period. In February 2016, Eugene Fulmer, a fourth co-conspirator, pled guilty to his role in this foreclosure rescue scheme. According to court documents, from early 2011 to early 2014, Surabi, Karikorian, Velasquez, and co-conspirators collected more than \$2 million in proceeds from their foreclosure-delay/eviction-delay scheme involving hundreds of fraudulent bankruptcies and deeds of trust. The schemers worked for and operated Trustee Sale Stoppers, Property Assistance, Asset Help, as well as other businesses out of Los Angeles, California. Surabi and Karikorian contacted homeowners who were in foreclosure and facing a trustee's sale and promised that they would delay the trustee's sale for up to 36 months for an initial payment of \$750 to over \$1,000, and a \$750 per month fee thereafter. To accomplish the delays, Karikorian and Surabi caused a series of fraudulent bankruptcies to be filed, mostly in the Northern and Central Judicial Districts of California. They would also file backdated "short form Deed of Trust and assignment of rent" forms against the clients' homes, which included several d/b/a companies as well as Velasquez and others as beneficiaries. At least 60 fraudulent deeds of trust were recorded at the direction of Surabi and Karikorian. At least 11 of the properties involved were Freddie Mac-owned, resulting in a credit loss of approximately \$817,955; the overall exposure on these properties is approximately \$4.4 million.

## **Guilty Plea in REO/Deed Theft Scheme, California**

In January 2016, former real estate agent Mazen Alzoubi pled guilty to conspiracy to commit mail and wire fraud, mail fraud, aggravated identity theft, money laundering conspiracy, and criminal forfeiture associated with his role in a REO/deed theft scheme. Alzoubi and his co-defendants, Daniel Deaibes and Mohamad Daoud, operated a scheme to steal properties from the Enterprises and others by forging grant deeds granting the underlying properties to shell companies they created and filing the deeds in the county recorder's office. By recording these fraudulent deeds, the defendants made the transfers appear legitimate. The stolen properties were then marketed and sold, using a legitimate title and escrow company, to unwitting investors. Once the sale proceeds were wired to the defendants' bank accounts, the money was either wired overseas or transferred numerous times in an attempt to launder the money. As investigators closed in on the defendants and successfully stopped the sale of stolen properties, the defendants changed tactics and fraudulently assumed control over an LLC that owned many investment properties. The defendants, while acting as owners of the stolen LLC, attempted to obtain hard money loans using the properties owned by the LLC as collateral. By the time the defendants were indicted and arrested, they had either sold or attempted to sell 15 properties worth more than \$3.6 million. On at least 10 occasions, the defendants were successful and earned nearly \$2.2 million in illicit proceeds. At least 10 of the properties stolen by the defendants were owned by the Enterprises, valued at over \$2.5 million.



## Office of Inspector General U.S. Department of Housing and Urban Development

*The U.S. Department of Housing and Urban Development (HUD) Inspector General is one of the original 12 Inspectors General authorized under the Inspector General Act of 1978. The HUD Office of Inspector General (OIG) strives to make a difference in HUD's performance and accountability. HUD OIG has a strong commitment to its statutory mission of detecting and preventing fraud, waste, and abuse and promoting the effectiveness and efficiency of government operations..*

While organizationally located within HUD, HUD OIG operates independently with separate budget authority. Its independence allows for clear and objective reporting to HUD's Secretary and Congress. HUD's primary mission is to improve housing and expand opportunities for families seeking to improve their quality of life. HUD does this through a variety of housing and community development programs aimed at helping Americans nationwide obtain affordable housing. These programs are funded through a \$45 billion annual congressional budget.

Also, within HUD are the Federal Housing Administration (FHA) and Government National Mortgage Association (Ginnie Mae). FHA provides mortgage insurance for single-family and multifamily properties, nursing homes, and hospitals. FHA is self-funded through mortgage insurance premiums and receives limited congressional funding. FHA generated more than a trillion dollars in insured loans in fiscal year 2015, and Ginnie Mae securitized almost \$1.7 trillion in mortgage-backed securities. The majority of the mortgage-backed securities are FHA mortgages.

Ginnie Mae guarantees the timely payment of principal and interest on mortgage-backed securities to institutional investors worldwide. These securities, or "pools" of mortgage loans, are used as collateral for the issuance of securities. Mortgage-backed securities are commonly referred to as "pass-through" certificates because the principal and interest of the underlying loans are passed through to investors. Ginnie Mae guarantees only securities backed by mortgage loans insured by government agencies, including FHA, the U.S. Department of Veterans Affairs, HUD's Office of Public and Indian Housing, and the U.S. Department of Agriculture's Rural Development. Ginnie Mae offers the only mortgage-backed securities carrying the full faith and credit guaranty of the United States Government, which means that its investors are guaranteed payment of principal and interest in full and on time.

While there are other HUD programs that are vulnerable to fraud and abuse, HUD OIG spends considerable time on the FHA program because of the mortgage crisis and an increased reliance on HUD to resolve foreclosure matters.

The degree of FHA predominance in the market is unparalleled. In recent testimony to Congress, OIG stated that it continues to have concerns regarding the ability of FHA's systems and infrastructure to adequately meet its requirements and perform its services.

These concerns were also expressed by OIG to FHA through audits and comments on proposed rule changes. Some of these are longstanding issues that were highlighted in our work products from as far back as the early to mid-1990s.

As an example, the FHA Mutual Mortgage Insurance (MMI) fund barely met the statutorily required minimum capital ratio of 2 percent in fiscal year 2015. The capital ratio is defined as the ratio of capital to unamortized insurance in force. After being below the mark for 6 years, FHA met the statutory requirement.

OIG continues to have concerns that an increase in demand on the FHA program will have collateral implications for the integrity of the Ginnie Mae mortgage-backed securities program, including the potential for increases in fraud in that program. Ginnie Mae securities are the only mortgage-backed securities to carry the full faith and credit guaranty of the United States. In addition, if an issuer fails to make the required pass-through payment of principal and interest to mortgage-backed securities investors, Ginnie Mae is required to assume responsibility for it by defaulting the issuers and assuming control of the issuers' mortgage-backed securities pools. Like FHA, Ginnie Mae has seen an increase in its market share.

A significant problem facing FHA and the lenders it works with was decreasing home values. This condition increased the risk of default, abandonment, and foreclosure and made it difficult for FHA to resell the properties. Although FHA endorsement levels meet or exceed previous peaks in its program history, defaulted mortgages continue to be an issue. These issues reinforce the importance for FHA-approved lenders to maintain solid underwriting standards and quality control processes to withstand severe adverse economic conditions.

Over the years, HUD OIG has continued to report on the mediocre underwriting efforts and quality control processes of some FHA-approved lenders. Based on the results of the mortgage loan origination and underwriting initiative, HUD OIG again partnered with the U.S. Department of Justice's Civil Division, as well as a number of U.S. Attorneys' Offices and HUD's Office of General Counsel, to investigate FHA-approved lenders for potential fraud and to facilitate litigation under the False Claims Act and other statutes when warranted. Our reviews focused on FHA's mortgage lenders that posed the greatest risk regarding their compliance with FHA's underwriting requirements and their quality control processes. HUD OIG staff will continue assisting in these efforts into fiscal year 2017.

This year, HUD OIG is highlighting three areas of concern related to the financial market as follows:

1. For the second year, OIG issued a disclaimer of opinion on the Ginnie Mae's fiscal year 2014-2015 financial statements.

Again, OIG was unable to obtain sufficient evidence to express an opinion on the fairness of the \$6.6 billion in nonpooled loan assets from Ginnie Mae's defaulted issuers' portfolio. In addition, Ginnie Mae continued to improperly account for FHA's reimbursable costs as an expense instead of capitalizing the costs as an asset. This error resulted in the misstatement of the asset and net income.

Overall, the issues cited in the report were tied to problems associated with the acquisition and management of a multi-billion-dollar defaulted issuers' portfolio, which is a noncore segment of Ginnie Mae's business. Due to the scope limitation in our audit work and the effects of material weaknesses in internal control, we continue being unable to obtain sufficient evidence to provide a basis for an audit opinion on Ginnie Mae's fiscal year 2015 financial statements. Accordingly, we did not express an opinion. In addition, we identified four material weaknesses and one significant deficiency. Ginnie Mae's inadequate monitoring, oversight, and governance of its accounting and reporting functions by the executive management team; the loss of several key Office of the Chief Financial Officer personnel; and the inability to track accounting transactions and events at a loan level due to system limitations were all factors contributing to these issues.

2. OIG's fiscal year 2015 joint civil fraud investigations with the Department of Housing and Urban Development and the U.S. Department of Justice and U.S. Attorney's Offices resulted in multiple settlements with mortgage lenders, two of which are highlighted.

### **First Tennessee Bank, June 1, 2015, \$212.5 Million Civil Settlement**

FHA's MMI fund received approximately \$142 million from this settlement. Our office investigated the FHA loan origination and underwriting practices of First Tennessee Bank as a joint investigation with the U.S. Department of Justice and the U.S. Attorney's Office for the Northern District of Georgia. As an FHA-approved direct endorsement lender, First Tennessee Bank was authorized by HUD to originate and underwrite mortgage loans on HUD's behalf, including determining a borrower's creditworthiness and whether the proposed loan met all applicable requirements. When borrowers default on an FHA-insured loan, the lender can submit an insurance claim to HUD to compensate the lender for losses sustained as a result of the default. The Government contended that First Tennessee Bank approved loans for FHA insurance that were not eligible for insurance and as a result, FHA paid claims and the insurance fund incurred significant losses when borrowers defaulted. First Tennessee Bank entered into a settlement agreement to resolve the case. As part of the settlement, the lender agreed that although it had certified certain loans for FHA insurance, these loans did not meet certain HUD requirements and, therefore, were not eligible for FHA insurance.

As a result, HUD insured hundreds of ineligible loans and incurred substantial losses when it paid insurance claims on the loans covered by the settlement agreement.

### **Franklin American Mortgage Company, December 2, 2015, \$70 Million Civil Settlement**

FHA's MMI fund was to receive approximately \$70 million from this settlement. The U.S. Department of Justice, the U.S. Attorney's Office for the District of Colorado, and our office investigated the FHA loan

origination and underwriting practices of Franklin American. The Government contended that Franklin American originated, underwrote, and approved certain loans for FHA insurance, certifying to the eligibility of the loans for FHA insurance coverage. However, these loans were not eligible and should not have been insured. As part of the settlement, Franklin American agreed that it had not followed certain HUD loan requirements when certifying to HUD that certain loans were eligible for FHA insurance. It also agreed that its conduct caused HUD to insure hundreds of loans that were not eligible for FHA mortgage insurance and to incur substantial losses when HUD paid insurance claims on these loans.

3. Below is a sample of HUD OIG's criminal mortgage fraud cases closed in fiscal year 2015.

### **Loan Origination Fraud:**

#### **Owner of Mortgage Company Sentenced to 11 Years Incarceration**

The owner and operator of a former FHA mortgage lender in Miami, FL, was sentenced in U.S. District Court to 135 months incarceration and 60 months of supervised release and agreed to forfeit \$8 million following his conviction of conspiracy to commit wire fraud affecting a financial institution. From at least 2006 through September 2008, the owner and other conspirators specialized in approving FHA loans primarily for buyers of condominiums at complexes where he had an ownership interest. As part of the scheme, the conspirators provided false information on loan documents to qualify borrowers and in some cases, also paid inducements to borrowers to purchase the condominium units. Many of the loans defaulted, causing losses to FHA and financial institutions. In total, 25 individuals were charged, pled guilty, and were sentenced, including the owner, 3 partner developers, and 20 former employees of the mortgage lender. Losses to FHA exceeded \$64 million. This investigation was conducted by HUD OIG.

#### **Branch Manager to Serve 41 Months in Prison for Conspiracy**

The former branch manager for Phoenix Housing Group, a manufactured housing retailer, was sentenced in U.S. District Court to 41 months incarceration and 3 years of supervised release and ordered to pay \$4.17 million in restitution to FHA, jointly and severally among five other defendants. The former branch manager was also required to pay a separate money judgment of \$500,000 to the United States. The sentencing was related to her earlier guilty plea to conspiracy related to her involvement in a scheme to provide false documents for the purpose of assisting potential borrowers in obtaining FHA-insured mortgages.

HUD OIG, the U.S. Department of Agriculture-OIG, the North Carolina State Bureau of Investigation, the North Carolina Office of the Commissioner of Banks, and the North Carolina Attorney General's Office conducted this investigation.

#### **Real Estate Speculator Sentenced to 5 years in Prison**

A real estate speculator was sentenced in U.S. District Court to 61 months incarceration, followed by 5 years of supervised release, and ordered to pay \$3.36 million in restitution to the U.S. Treasury following his conviction of conspiracy to commit wire fraud, wire fraud, and aggravated identity theft. From September 2009 through November 2010, the speculator enticed straw borrowers to purchase properties in Baltimore, MD, and told them they would not need to provide money toward the closing costs or make the mortgage

payments. The speculator paid the straw borrowers \$5,000 to \$8,000 for their role in the transaction. Further, the speculator told the straw borrowers that in 3 years, he would sell the houses and they would receive between 20 to 80 percent of the sales proceeds. The investigation identified 35 FHA-insured mortgages affected by the scheme, which caused Cardinal Financial Company to lend approximately \$3.8 million in mortgage loans. To date, FHA has paid a claim on 15 of the 35 properties, totaling more than \$1.6 million. HUD OIG, the Federal Housing Finance Agency (FHFA) OIG, the Federal Deposit Insurance Corporation, and the Federal Bureau of Investigation conducted this investigation.

## **Rescue of Foreclosure Fraud:**

### **Mortgage Broker Sentenced in Loan Modification**

A former mortgage broker and owner of a mortgage company was sentenced in U.S. District Court to 24 months incarceration and ordered to pay \$997,712 in restitution related to his conviction of making false statements. From January 2010 through April 2015, the mortgage broker assisted 40 distressed homeowners in obtaining extensions and renewals of their mortgage loans while charging illegal fees for his loan modification services. The mortgage broker also received mortgage payments from the borrowers but did not forward the payments to the lenders. This investigation was conducted by HUD OIG and FHFA OIG.

### **Mortgage Company Owner Sentenced to Prison for Loan Modification**

The owner of two mortgage companies was sentenced in U.S. District Court to 12 months incarceration and ordered to pay \$1.4 million in restitution to the affected homeowners following his May 2015 conviction of wire fraud and money laundering. The investigation determined that the company made inaccurate and false claims to victims, leading them to believe that U.S. Mortgage Bailout would be able to achieve a loan modification for them in exchange for an upfront fee. The investigation identified more than 1,100 victims from various locations across the country and confirmed at least 64 victims with FHA-insured mortgages, including 28 with claims paid by FHA, which totaled \$4.99 million. HUD OIG and the Internal Revenue Service, Criminal Investigations conducted this investigation.

The tasks before HUD OIG continue to be daunting. Challenges remaining include:

- Addressing the elements of fraud that were involved in the collapse of the mortgage market and monitoring the rollout of new FHA loan products to reduce exploitation of program vulnerabilities;
- Combating perpetrators of fraud, including those who have migrated from the subprime markets, who seek to exploit FHA loan programs; and
- The emergence of certain aspects of seller-funded downpayment assistance by nonprofits and State housing finance agencies.

The consequences of the mortgage crisis, its worldwide economic implications, and the resulting pressures placed on HUD and OIG come at a time when HUD has had significant new leadership responsibilities. Over the last 7 years, HUD has also been focused on rebuilding communities devastated by disasters, such as Lower Manhattan post-September 11 and Hurricanes Katrina, Rita, and Wilma, which have added tens

of billions of dollars in new program funds, requiring quick distribution and keen oversight. In addition, in the last few years, Congress has appropriated \$16 billion to assist States and people affected by Superstorm Sandy, and HUD OIG continues to work closely with the Department as it implements the funding for recovery from this natural disaster.



# Office of Inspector General

## National Credit Union Administration

*The NCUA OIG promotes the economy, efficiency, and effectiveness of NCUA programs and operations, and detects and deters fraud, waste and abuse, thereby supporting the NCUA's mission of providing, through regulation and supervision, a safe and sound credit union system which promotes confidence in the national system of cooperative credit.*

### Agency Overview

The National Credit Union Administration (NCUA) is responsible for chartering, insuring, and supervising Federal credit unions and administering the National Credit Union Share Insurance Fund (NCUSIF). The NCUA also manages the Operating Fund (OF), the Temporary Corporate Credit Union Stabilization Fund (TCCUSF), the Community Development Revolving Loan Fund (CDRLF), and the Central Liquidity Facility (CLF).

Credit unions are member-owned, not-for-profit cooperative financial institutions formed to permit members to save, borrow, and obtain related financial services. NCUA charters and supervises federal credit unions, and insures accounts in federal and most state-chartered credit unions across the country through the NCUSIF, a federal fund backed by the full faith and credit of the United States government.

The NCUA's mission is to provide through regulation and supervision, a safe and sound credit union system that promotes confidence in the national system of cooperative credit. The agency also has a vision to protect consumer rights and member deposits. Finally, the NCUA is further dedicated to upholding the integrity, objectivity, and independence of credit union oversight. NCUA continually implements initiatives designed to continue meeting these goals.

### Major NCUA Programs

#### **Supervision**

NCUA's supervision program ensures the safety and soundness of the credit union system. Identifying and resolving risk concerns such as credit risk, concentration risk, and strategic risk continue to be the primary focus of the agency's supervision program. NCUA supervises natural person credit unions through annual examinations, regulatory enforcement, providing guidance in regulations and Letters to Credit Unions, and taking supervisory and administrative actions as necessary to manage credit union risk.

On January 1, 2013, the NCUA established the Office of National Examinations and Supervision (ONES) to oversee the unique examination and supervision issues related to consumer credit unions with assets greater than \$10 billion and all corporate credit unions. Large consumer credit unions pose unique challenges in

light of their size in comparison to the NCUSIF. Corporate credit unions touch the operations of thousands of consumer credit unions through the critical services they provide. ONES staff includes examiners, lending specialists, capital markets specialists, information systems specialists, and payment systems specialists to focus on key areas of potential risk. ONES is positioned to adapt its examination and supervision process and procedures to keep pace with a changing financial and operational environment.

## **Insurance**

The NCUA administers the NCUSIF, which provides insurance for deposits held at federally insured natural person and corporate credit unions nationwide. The fund is capitalized by credit unions. NCUA manages the fund to ensure members' deposits are insured. In 2010, Congress permanently increased the insurance limit from \$100,000 to \$250,000 per depositor.

## **Small Credit Union Initiatives**

Through its Office of Small Credit Union Initiatives (OSCU), NCUA fosters credit union development, particularly the expansion of services provided by small credit unions to eligible consumers. NCUA fulfills this goal through training, partnerships, and assistance. A major source of assistance is the CDRLF, which provides loans and grants to credit unions which serve low-income customers. CDRLF assistance enables these credit unions to provide basic financial services and stimulate economic activities in their communities. NCUA's OSCU is also responsible for assisting the agency's risk mitigation program.

## **Consumer Protection**

NCUA protects credit union members through effective enforcement of consumer protection regulations and requirements. NCUA's Office of Consumer Protection (OCP), created in 2010, is responsible for consumer protection in the areas of fair lending examinations, member complaints, and financial literacy. OCP consults closely with the Consumer Financial Protection Bureau (CFPB). CFPB has direct supervisory authority over credit unions with assets of \$10 billion or more, but can request to accompany NCUA on examinations of other credit unions. In addition to consolidating consumer protection examination functions within NCUA, OCP responds to inquiries from credit unions, their members, and consumers involving consumer protection and share insurance matters. Additionally, OCP processes member complaints filed against federal credit unions.

## **Asset Management**

The NCUA's Asset Management and Assistance Center (AMAC) conducts credit union liquidations and performs management and recovery of assets. AMAC assists NCUA regional offices with the review of large, complex loan portfolios and actual or potential bond claims. AMAC also participates extensively in the operational phases of conservatorships and records reconstruction. AMAC's purpose is to minimize costs to the NCUSIF and to credit union members.

## Office of Minority and Women Inclusion

NCUA formed the Office of Minority and Women Inclusion (OMWI) in January 2011, in response to the “Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010” (Dodd-Frank). OMWI is responsible for all matters relating to measuring, monitoring and establishing policies for diversity in the agency’s management, employment and business activities. OMWI is also responsible for measuring, monitoring, and providing guidance about diversity for NCUA’s regulated entities, excluding the enforcement of statutes, regulations and executive orders pertaining to civil rights.

## The NCUA Office of Inspector General

The 1988 amendments to the Inspector General Act of 1978 (IG Act), 5 U.S.C. App. 3, established IGs in 33 designated Federal entities (DFEs), including the NCUA. The NCUA Office of Inspector General (OIG) was established in 1989. The NCUA IG is appointed by, reports to, and is under the general supervision of, a three-member presidentially-appointed Board. The OIG staff consists of ten (10) FTEs: the IG, the Deputy IG/Assistant IG for Audit, the Counsel to the IG/Assistant IG for Investigations, the Director of Investigations, three (3) senior auditors, two (2) auditors, and an office manager. The OIG promotes the economy, efficiency, and effectiveness of NCUA programs and operations, and detects and deters fraud, waste, and abuse, thereby supporting the NCUA’s mission of facilitating the availability of credit union services to all eligible consumers through a regulatory environment that fosters a safe and sound credit union system. The OIG supports this mission by conducting independent audits, investigations, and other activities, and by keeping the NCUA Board and the Congress fully and currently informed of its work.

## Role in Joint Financial Oversight Working Groups

### ***Audit of the FSOC’s Efforts to Promote Market Discipline***

NCUA OIG continues to coordinate with our financial IG counterparts in CIGFO on issues of mutual interest. In September 2015, CIGFO members approved a proposal to convene a working group to assess FSOC’s efforts to promote market discipline by eliminating expectations on the part of shareholders, creditors, and counterparties of large bank holding companies or nonbank financial companies that the Government will shield them from losses in the event of failure. The Department of the Treasury’s OIG is leading the working group with participation from other CIGFO members, including NCUA OIG. NCUA OIG has begun eliciting NCUA’s responses to a questionnaire the working group designed to gather information about member agencies’ participation in FSOC’s efforts. CIGFO will incorporate the working group’s results into a consolidated report to FSOC. The audit could result in recommendations for FSOC to improve its efforts to promote market discipline.

## Recent, Current, and Projected Oversight Work

In accordance with section 989(a)(2)(B) of Dodd-Frank, the following highlights the completed, ongoing, and projected work of our office, with a focus on issues particular to NCUA as well as those that may apply to the broader financial sector.

## **Review of NCUA's Interest Rate Risk Program**

In the previous reporting period, NCUA OIG self-initiated an audit to determine whether NCUA's interest rate risk (IRR) policy and procedures helped to effectively reduce IRR, and what action NCUA had taken or planned to take to identify and address credit unions with IRR concerns. NCUA OIG issued a final report dated November 13, 2015.

The results of the audit determined that NCUA had taken steps to identify and address credit unions with interest rate risk concerns through such means as relying on Regional Capital Market Specialists to identify credit unions with elevated IRR, the use of multiple methods to assess and monitor IRR concerns, and the establishment of an IRR working group to develop examination-based IRR assessment tools and IRR supervisory guidance. However, NCUA OIG was unable to evaluate the effect of these efforts, because NCUA was refining their overall IRR process. The audit report noted that NCUA OIG would revisit this objective at a later date.

The results of the audit also determined that NCUA may not be effectively capturing IRR when assigning a composite CAMEL rating to a credit union. The report noted that NCUA currently assesses sensitivity to market risk under the "L" or Liquidity rating in its CAMEL rating system. However, with the addition of an "S" rating to its CAMEL rating system to capture and separately assess a credit union's Sensitivity to market risk, the report concluded that NCUA would improve its ability to accurately measure and monitor IRR.

The report made two recommendations. First, it recommended that NCUA management modify its current CAMEL rating system by adding an "S" for market risk sensitivity. Second, it recommended revising the "L" rating to reflect only liquidity factors. NCUA management agreed with NCUA OIG's recommendations.

## **NCUA's Breach Notification Policies and Procedures**

In October 2014, an NCUA examiner lost an unencrypted flash drive provided by a credit union manager in connection with an examination. The flash drive contained the names, addresses, social security numbers, and account numbers belonging to approximately 1,600 credit union members. The flash drive did not include passwords or PINS. Moreover, there was no indication of any unauthorized access to members' accounts or attempts to gain improper access as a result of the incident.

Because of our ongoing oversight of the agency's progress in monitoring its own and credit unions' efforts to assess and mitigate cybersecurity threats, NCUA OIG conducted an audit to determine whether NCUA has adequate controls in place to protect the security, confidentiality, and integrity of electronic sensitive, confidential, and personally identifiable credit union information during the examination process. NCUA OIG issued a final report on June 8, 2015.

The audit determined that NCUA has provided examiners with appropriate tools with which to securely receive electronic information from credit unions during the examination process.

However, NCUA OIG also determined:

1. NCUA did not require credit unions to provide sensitive, confidential, and personally identifiable credit union member information to NCUA staff in a protected manner;

2. NCUA needed to improve its policies, procedures, and training to help ensure NCUA staff take appropriate measures to protect sensitive, confidential, and personally identifiable electronic credit union member information during examinations; and
3. NCUA needed to improve its guidance to require NCUA staff to use specific tools to transfer sensitive, confidential, and personally identifiable electronic credit union member information during examinations.

The report made seven recommendations to NCUA management to help increase staff awareness regarding the importance of protecting sensitive credit union member information and to ultimately strengthen the agency's efforts to protect this information in its electronic format. NCUA management agreed to all recommendations and provided planned corrective actions.

### ***Review of NCUA's Supervisory Oversight of Credit Union Cybersecurity Programs***

Cybersecurity is the practice of defending computers and servers, mobile devices, electronic systems, networks, and data from cyberattacks. Cyberattacks use malicious code to alter computer code, logic, or data, resulting in disruptive consequences that can compromise data and lead to cybercrimes. NCUA indicates that credit unions rely on applications to ensure accurate, timely, and confidential processing of data. Vulnerabilities, particularly those associated with web-based applications, are increasingly the focus of attacks from external and internal sources for the purpose of committing fraud and identity theft.

NCUA OIG is currently conducting a review of NCUA's Information Systems and Technology (IS&T) Examination Program to determine whether it provides adequate oversight of credit union cybersecurity programs, and to assess whether credit unions are taking sufficient and appropriate measures to protect the confidentiality, availability, and integrity of credit union assets and sensitive credit union information against cyber-attacks. The audit could result in recommendations to NCUA management to improve its IS&T Examination Program going forward.



## Office of Inspector General U. S. Securities and Exchange Commission

*The U.S. Securities and Exchange Commission (SEC or agency) Office of Inspector General (OIG) promotes the integrity, efficiency, and effectiveness of the critical programs and operations of the SEC and operates independently of the agency to help prevent and detect fraud, waste, and abuse in those programs and operations, through audits, evaluations, investigations, and other reviews.*

### Background

The mission of the SEC is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. The SEC strives to promote a market environment that is worthy of the public's trust and characterized by transparency and effective oversight. Its core values are integrity, effectiveness, fairness, accountability, teamwork, and excellence. The SEC's strategic goals are to establish and maintain an effective regulatory environment; foster and enforce compliance with the Federal securities laws; facilitate access to the information investors need to make informed investment decisions; and enhance the SEC's performance by effectively aligning and managing human resources, information, and financial capital.

The SEC is charged with overseeing about 27,000 market participants, including nearly 12,000 investment advisers, almost 11,000 mutual funds and exchange-traded funds, more than 4,000 broker-dealers, and more than 400 transfer agents. The agency also oversees 18 national securities exchanges, 10 credit rating agencies, 6 active registered clearing agencies, as well as the Public Company Accounting Oversight Board, the Financial Industry Regulatory Authority, the Municipal Securities Rulemaking Board, the Securities Investor Protection Corporation, and the Financial Accounting Standards Board. In addition, the SEC is responsible for reviewing the disclosures and financial statements of more than 9,100 reporting companies.

In recent years, the SEC's responsibilities have increased, with new or expanded jurisdiction over securities-based derivatives, hedge fund and other private fund advisers, credit rating agencies, municipal advisors, and clearing agencies. The SEC has also been required to implement and oversee a new regime for crowdfunding offerings. The SEC has reported that it has proposed or adopted nearly all the mandatory rulemakings required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and the Jumpstart Our Business Startups Act, in addition to advancing other key rules in mission critical areas. As the SEC's jurisdiction has expanded, the size and complexity of the markets and entities it oversees have grown significantly.

The SEC OIG was established as an independent office within the SEC in 1989 under the Inspector General Act of 1978, as amended (IG Act). The SEC OIG's mission is to promote the integrity, efficiency, and effectiveness of the SEC's critical programs and operations. The SEC OIG prevents and detects fraud, waste, and abuse through audits, evaluations, investigations, and other reviews related to SEC programs and operations.

The SEC OIG Office of Audits conducts, coordinates, and supervises independent audits and evaluations of the SEC's programs and operations at its headquarters and 11 regional offices. These audits and evaluations are based on risk and materiality, known or perceived vulnerabilities and inefficiencies, and information received from the Congress, SEC staff, the U.S. Government Accountability Office (GAO), and the public.

The SEC OIG Office of Investigations performs investigations into allegations of criminal, civil, and administrative violations involving SEC programs and operations by SEC employees, contractors, and outside entities. These investigations may result in criminal prosecutions, fines, civil penalties, administrative sanctions, and personnel actions. The Office of Investigations also identifies vulnerabilities, deficiencies, and wrongdoing that could negatively impact the SEC's program and operations.

In addition to the responsibilities set forth in the IG Act, Section 966 of the Dodd-Frank Act required the SEC OIG to establish a suggestion program for SEC employees. The SEC OIG established its SEC Employee Suggestion Program in September 2010. Under this program, the OIG receives, reviews, and processes suggestions from agency employees for improvements in the SEC's work efficiency, effectiveness, and productivity, and use of its resources, as well as allegations by employees of waste, abuse, misconduct, or mismanagement within the SEC.

## **SEC OIG Work Related to the Broader Financial Sector**

In accordance with Section 989E(a)(2)(B)(i) of the Dodd-Frank Act, below is a discussion of the SEC OIG's completed and ongoing work, focusing on issues that may apply to the broader financial sector.

### ***Completed Work***

#### **Final Management Letter: Evaluation of the SEC's Use of the Reserve Fund, July 6, 2015**

Section 991e(i) of the Dodd-Frank Act established the SEC Reserve Fund to be used as the SEC "determines is necessary to carry out the functions of the Commission." This section authorized the SEC to deposit into the Reserve Fund up to \$50 million per year from registration fees collected from SEC registrants, with a Reserve Fund balance limit of \$100 million. Given its discretion under the Dodd-Frank Act, the SEC determined that for fiscal years (FYs) 2012, 2013, and 2014, it would use the Fund for information technology (IT) modernization efforts. The SEC generally defines "IT modernization" as "large-scale, enterprise-wide, multi-year efforts broad in scope," and the SEC chose eight IT modernization program areas to receive funding. Additionally, the Dodd-Frank Act requires the SEC to notify Congress of the date, amount, and purpose of Fund obligations no later than 10 days after the date of each Reserve Fund obligation.

The SEC OIG completed an evaluation of the SEC's use of the Reserve Fund for FY 2012 to FY 2014 and, on July 6, 2015, issued a management letter summarizing the results of the evaluation. The SEC OIG found the following:

- The SEC had authority to use the Reserve Fund for IT modernization efforts and did not exceed its authority in making this decision.
- The SEC obligated the Reserve Fund to the eight IT modernization program areas with increasing efficiency between FY 2012 and FY 2014.
- The SEC established a process to request, grant, use, and track the money in the Reserve Fund.
- The SEC reported to Congress all Reserve Fund obligations, as required, and the reports were generally accurate, complete, and timely.
- The SEC did not concurrently report to the Office of Management and Budget obligations as required by agency policy.
- The availability of the Reserve Fund directly affects SEC's IT modernization efforts and the absence of the Reserve Fund would adversely affect those efforts and the Office of Information Technology's ability to provide services.

The SEC OIG did not make any recommendations in the management letter. However, the SEC OIG noted that the SEC routinely prioritizes IT modernization projects during the planning process and suggested that the agency could use this process to decide on project funding if the Reserve Fund was unavailable.

***Improvements Needed in the Division of Enforcement's Oversight of Fund Administrators, Report No. 531, September 30, 2015***

Protecting investors is a critical mission of the SEC. To meet this mission, the SEC collects disgorgement and penalty amounts from securities law violators and returns monies to harmed investors. In some instances, the SEC uses third party fund administrators to distribute the monies collected. As of July 2015, 9 fund administrators were administering 77 distribution matters totaling more than \$6.5 billion ordered. If internal controls over the collection and distribution process are not well designed or are not operating effectively, harmed investors may not receive the monies owed to them or may not receive the monies in a timely manner.

The SEC OIG performed this audit to assess the SEC Division of Enforcement's Office of Collections' (OC) and Office of Distributions' (OD) controls over collections and distributions to harmed investors, including oversight of fund administrators used in the distribution process. The SEC OIG did not identify concerns related to OC's controls over its collection efforts and found that, in 2010, the SEC initiated a Fund Administrator Project to improve the efficiency and timelines of the appointment of fund administrators. However, the SEC OIG determined that OD's oversight of fund administrators could be improved to more fully align with the Standards for Internal Control in the Federal Government.

Specifically, the SEC OIG determined that some distribution plans attached to court orders stated that fund administrators provide payment files for SEC staff's review and authorization or approval before distributing funds. Division of Enforcement officials stated that controls are in place to ensure that fund administrators are responsible for submitting accurate payment files. However, the OD did not clearly document in its policies and procedures (1) the steps it takes to review and accept payment files submitted by fund administrators, and (2) its responsibilities for fund administrator oversight generally. Policies and procedures should address risks identified and, based on those risks, establish controls designed to ensure Federal requirements and the agency's goals and objectives are met. OD officials identified a limited number of instances, some of which occurred before FY 2010, in which fund administrators submitted and the OD accepted inaccurate payment files and at least one case where a fund administrator made inaccurate payments. According to OD officials, corrective payments were made to the underpaid investors in that case. However, the SEC's oversight of fund administrators could be improved by fully assessing and documenting the risks involved when using fund administrators and updating policies and procedures for fund administrator oversight.

Additionally, in some instances where the SEC designed internal controls for oversight of fund administrators, the SEC did not implement the internal controls. For example, fund administrators collect on the SEC's behalf harmed investors' personally identifiable information (PII). Despite Federal and agency requirements to assess fund administrators' information security controls, the agency did not complete required assessments of fund administrators' information technology environments before relying on the fund administrators. As a result, the agency lacks assurance that fund administrators adequately protect the investors' PII collected and maintained on the SEC's behalf. The SEC Office of Information Technology stated that it planned to complete the required assessments by December 31, 2015, and these assessments have been performed.

The SEC OIG issued its final report on September 30, 2015, and made three recommendations to improve oversight of fund administrators, comply with applicable laws and agency policy and requirements, and ensure that goals and objectives are met. Management concurred with all the recommendations, which are closed for reporting purposes.

***Allegations of Bias on the Part of Administrative Law Judges, Case No. 15-ALJ-0482-I, January 21, 2016***

The SEC OIG investigated allegations of bias on the part of the Administrative Law Judges (ALJs) in the SEC's administrative proceedings that were attributed to a former ALJ. Specifically, the SEC OIG investigated allegations that (1) there was improper influence on ALJs to favor the SEC, (2) the SEC Chief ALJ criticized the former ALJ and questioned the former ALJ's loyalty to the SEC, and (3) ALJ personnel were pressured to shift the burden of proof to respondents.

Furthermore, the SEC OIG's investigation of the allegations of improper influence focused on any instructions, directives, or orders on how to rule on motions, decide questions of facts or law, or make other dispositions of any particular administrative proceeding that the Chief ALJ may have given to the other ALJs, without regard to the evidence or applicable legal authority.

The SEC OIG did not develop any evidence to support allegations of improper influence on ALJs to favor the SEC. Current and former staff of the Office of the ALJs stated that ALJ decisions were made independently and free from the Chief ALJ's influence. Several individuals interviewed during the investigation indicated that the Chief ALJ emphasized the Office's fairness and independence, and some noted only systemic factors, such as Commission precedent and the rules of practice, that impacted complete adjudicative independence.

With the exception of the former ALJ's allegations, the SEC OIG investigation found that the Chief ALJ's criticisms of ALJs related to the timeliness of their decisions and/or the procedural quality of their work, rather than to the substance of their decisions. The SEC OIG identified only a possible reference to loyalty by the Chief ALJ, but the reported emphasis was loyalty to the quality of the ALJ process and not loyalty to the SEC Division of Enforcement.

Finally, the SEC OIG investigation did not develop any evidence to support the allegation that ALJ personnel were pressured to shift the burden of proof to respondents.

***Office of Compliance Inspections and Examinations' Management of Investment Adviser Examination Coverage Goals, Report No. 533, March 10, 2016***

The SEC Office of Compliance Inspections and Examinations (OCIE) coordinates the national examination program for more than 27,000 market participants over which the SEC has regulatory authority. OCIE's largest program area is the Office of Investment Adviser/Investment Company (IA/IC) Examinations. In April 2014 Congressional testimony, the SEC Chair stated that the SEC was in a position to examine only 9 percent of registered IAs in FY 2013 and that more coverage was plainly needed.

OCIE's risk-based examinations of registered entities, including IAs, are central to the SEC's strategic goal of fostering compliance with Federal securities laws. The GAO has established Standards for Internal Control in the Federal Government for ensuring that Federal agencies, including the SEC, achieve stated objectives and allocate resources efficiently and effectively to meet those objectives. Additionally, the GAO has established a risk-management framework to help managers make decisions about allocating finite resources and take action under conditions of uncertainty.

The SEC OIG initiated this evaluation to assess OCIE's human resources management to ensure it efficiently and effectively addresses mission priorities and long-term goals, particularly for IA examinations. The SEC OIG's specific objectives were to determine: (1) the methodology and evidence supporting OCIE's budget requests and the allocation of personnel to OCIE programs, including examinations of IAs and ICs; (2) how OCIE identifies and monitors examination targets (number and types) by program area; and how OCIE adjusted its examination targets or resource allocations based on the SEC FY 2015 budget approved by Congress.

The SEC OIG found that OCIE has worked to increase its examination coverage of IAs, including creating an Office of Risk Analysis and Surveillance and enhancing its use of advanced quantitative techniques, and continues to seek new ways to increase its efficiency. In fact, the almost 2,000 formal examinations OCIE conducted in FY 2015 was an increase over each of the previous four fiscal years.

However, improvements are needed to assess OCIE's progress toward meeting strategic objectives and long-term IA examination coverage goals. Specifically, the SEC OIG found that: (1) OCIE's performance measure – percentage of IAs examined each year – may not provide meaningful information because of varying regional office environments; and (2) the IA/IC program may benefit from adopting the GAO risk-management framework.

OCIE's management of IA examination goals and performance metrics can be more consistent with Federal internal control and risk management standards. Doing so will help ensure that examinations conducted support OCIE's examination priorities, as well as OCIE's long-term goal and the SEC's strategic plan. In addition, management should ensure that OCIE's performance metrics allow management to assess performance and ensure efficient and effective use of OCIE's limited resources across regional offices. In September 2015, OCIE hired a consultant to help identify ways for OCIE to use its resources more efficiently. Management expects the consultant to report its findings and recommendations, if any, by March 2017.

The SEC OIG issued its final report on March 10, 2016, and made two recommendations to improve OCIE's management of the IA/IC program. The recommendations relate to (1) results of the ongoing efficiency study, and recommendations made by an internal working group, and (2) GAO's risk-management framework. Management concurred with these recommendations. The recommendations will be closed upon completion and verification of corrective action.

## **Ongoing Work**

### **Audit of the SEC's Process for Reviewing Self-Regulatory Organizations' Proposed Rule Changes**

Self-regulatory organizations (SROs) are nongovernmental entities that have the power to create and enforce industry regulations and standards. SROs establish rules that govern member activities, ensure market integrity and investor protection, and allow for disciplining members for improper conduct. The SEC—specifically, its Division of Trading and Markets and Office of Municipal Securities—is responsible for reviewing SROs' proposed rule changes. These proposed rule changes include new rules, changes to rules, and additions to or deletions from existing rules.

The purpose of the SEC's review is to ensure that proposed rule changes submitted by SROs are consistent with the Securities Exchange Act of 1934 and applicable rules and regulations established to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. In 2010, Section 916 of the Dodd-Frank Act streamlined the process for reviewing SROs' proposed rule changes and defined specific timeframes for the SEC to review and publish proposed rule changes for public comment.

On September 30, 2015, the SEC OIG initiated an audit of the SEC's process for reviewing proposed rule changes submitted by SROs. The objective of the audit is to assess the SEC's compliance with applicable laws, regulations, policies, and procedures for reviewing SROs' proposed rule changes, including requirements for communicating with SROs and other external stakeholders when the agency initiates proceedings to determine whether to disapprove an SRO's proposed rule change. In addition, the SEC OIG is evaluating the information security controls for the related filing and tracking systems. Finally, to the extent that prior

recommendations are relevant and applicable, the SEC OIG is following up on corrective actions to address recommendations from the OIG's previous audit of the SRO rule filing process. The SEC OIG expects to issue a report summarizing its findings during 2016.

### **Evaluation of the SEC Division of Enforcement's Coordination Related to a Federal Court Civil Action**

A Federal court in a civil action filed by the SEC issued an opinion and order that discussed a perceived lack of coordination of cases with overlapping factual circumstances. The court stated that a self-examination may be appropriate and could lead to a review and effective implementation of procedures in the SEC Division of Enforcement, as well as related operational offices, to ensure that investigations are coordinated and scarce resources are deployed efficiently.

On January 8, 2016, the SEC OIG initiated an evaluation to determine whether the SEC has processes and systems for ensuring that enforcement investigations are coordinated internally and, when appropriate, across SEC divisions and offices. The SEC OIG expects to issue a management letter summarizing its findings during 2016.



# Special Inspector General for the Troubled Asset Relief Program

*The Special Inspector General for the Troubled Asset Relief Program has the duty, among other things, to conduct, supervise, and coordinate audits and investigations of the purchase, management, and sale of assets under the Troubled Asset Relief Program (“TARP”) or as deemed appropriate by the Special Inspector General.*

## Background

The Special Inspector General for TARP (“SIGTARP”) was created by Section 121 of the Emergency Economic Stabilization Act of 2008 (“EESA”). Under EESA, as amended by the Special Inspector General Act of 2009, SIGTARP has the responsibility, among other things, to conduct, supervise, and coordinate audits and investigations of the purchase, management, and sale of assets under the Troubled Asset Relief Program (“TARP”) or as deemed appropriate by the Special Inspector General. SIGTARP’s oversight through audits continues to bring transparency and address fraud, waste, and abuse in remaining TARP programs. SIGTARP is required to report quarterly to Congress to describe SIGTARP’s activities and to provide certain information about TARP over that preceding quarter. EESA, as amended, also gives SIGTARP the authorities listed in Section 6 of the Inspector General Act of 1978, including the power to obtain documents and other information from Federal agencies and to subpoena reports, documents, and other information from persons or entities outside the Government. SIGTARP’s oversight through audits continues to bring transparency and address fraud, waste, and abuse in remaining TARP programs.

## Investigations

SIGTARP is a white-collar law enforcement agency. SIGTARP takes its law enforcement mandate seriously, working hard with our partners to deliver the accountability the American people demand and deserve.

As of May 2016, SIGTARP’s investigations have delivered substantial results, including:

- criminal charges against 354 individuals,
- criminal convictions of 248 defendants,
- prison sentences for 148 defendants (others are awaiting sentencing),
- civil cases and other actions against 161 individuals and entities (in some instances an individual will face both criminal and civil charges),

- orders of restitution and forfeiture and civil judgments and other orders entered for \$16.3 billion. This includes restitution orders entered for \$4.4 billion, forfeiture orders entered for \$271 million, and civil judgments and other orders entered for \$11.7 billion. Although the ultimate recovery of these amounts is ongoing, to date SIGTARP has already returned \$10.2 billion to the government and other victims as a result of SIGTARP investigations. These orders happen only after conviction and sentencing or civil resolution and many SIGTARP cases have not yet reached that stage; accordingly, any recoveries that may come in these cases would serve to increase the amount returned, and
- savings of \$553 million in TARP funds that SIGTARP prevented from going to at least one bank – the now-failed Colonial Bank.

SIGTARP's investigations concern a wide range of possible wrong-doing, and result in charges including: bank fraud, TARP fraud, conspiracy to commit fraud or to defraud the United States, wire fraud, mail fraud, making false statements to the Government (including to SIGTARP agents), securities fraud, money laundering, and bankruptcy fraud, among others.

### **SIGTARP Enforcement Against TARP Bankers**

SIGTARP's investigations resulted in significant criminal prosecutions and civil fraud enforcement actions against bankers. Highlighted enforcement actions against bankers this quarter include: the first indictment of a TARP institution by the Department of Justice, SIGTARP's arrest of the former CEO of a bank still in TARP, the guilty plea of a TARP bank CEO, the conviction by a jury of a TARP bank chairman, the conviction by a jury of a bank CEO for fraud involving a TARP application, the sentencing to prison of a TARP bank officer, the sentencing to prison of a bank CEO for fraud involving a TARP application, and the Securities and Exchange Commission's filing of fraud charges against 11 officers/directors of a failed TARP bank.

Already, 100 bankers investigated by SIGTARP have been the subject of a government criminal prosecution or civil fraud enforcement action. Of these bankers, 80 have been criminally charged (50 who were at TARP banks). These charges related to bankers' conduct leading up to and during the financial crisis.

Already, 35 bankers investigated by SIGTARP have been sentenced to prison, including 11 at banks that received TARP, and 23 officials at banks that applied unsuccessfully for TARP using fraudulent bank books.

The conduct that SIGTARP investigates in many cases occurred at institutions of significant size and importance to the nation's financial system and economy, including:

- One of the largest auto manufacturers (General Motors) (deferred prosecution criminal conduct);
- The 17th largest bank in the nation and its subsidiary mortgage servicer participating in the HAMP program (SunTrust Banks, Inc. and SunTrust Mortgage Inc.) (DOJ non-prosecution agreement for criminal conduct);
- One of the largest mortgage lenders in the nation (Taylor, Bean & Whitaker) (criminal prosecution);

- Three global securities and investment companies/broker-dealers (Jefferies LLC, RBS Securities, Inc., Nomura Securities International) (criminal prosecution);
- One of the 25 largest banks in the nation, and the 3rd largest bank failure since the financial crisis with \$25 billion in assets at the time of its failure (Colonial Bank) (criminal prosecution);
- The largest national bank (JP Morgan Chase) related to its mortgage servicing (DOJ civil fraud);
- The second largest national bank (Bank of America)—(1) NYAG civil action against the bank, then-CEO and CFO related to the bank's merger with Merrill Lynch and additional TARP payments; (2) DOJ civil fraud action resolved by DOJ;
- A bank with nearly \$11 billion in assets & branches in 6 countries (Wilmington Trust) (criminal prosecution);
- A bank with more than \$10 billion in assets when it failed with branches in the US, China and Taiwan—the 8th largest bank failure since the financial crisis (United Commercial Bank) (criminal prosecution); and
- The 21st largest bank in the nation serving 15 regions (Fifth Third Bancorp) (SEC & DOJ civil).

### **SIGTARP Role on President Obama's Financial Fraud Enforcement Task Force**

President Obama established the Financial Fraud Enforcement Task Force in November 2009 to wage aggressive and coordinated investigations and prosecutions of financial frauds. Its objective is to maximize both the recovery of ill-gotten proceeds from fraud and obtain just and effective punishment of those who commit them. In addition to co-chairing the Rescue Fraud Working Group, SIGTARP conducts collaborative investigations alongside its law enforcement partners in the Residential Mortgage-Backed Securities (RMBS) Working Group. The RMBS Working Group has recovered tens of billions of dollars on behalf of American consumers and investors for claims against large financial institutions arising from misconduct related to the financial crisis.

### **SIGTARP Contributes to Investigative Efforts Leading to Goldman Sachs Agreeing to Pay More Than \$5 Billion in Connection with Its Sale of RMBS.**

SIGTARP, along with its partners on the RMBS Working Group, secured a \$5.06 billion settlement with Goldman Sachs related to Goldman's conduct in the packaging, securitization, marketing, sale, and issuance of RMBS between 2005 and 2007. Investors, including federally-insured financial institutions, suffered billions of dollars in losses from investing in RMBS issued and underwritten by Goldman between 2005 and 2007.

The settlement includes a statement of facts, to which Goldman agreed, that describes how Goldman made false and misleading representations to prospective investors about the characteristics of the loans it securitized and the ways in which Goldman would protect investors in its RMBS from harm (the quotes in the following paragraphs are from that agreed-upon statement of facts, unless otherwise noted):

- Goldman told investors in offering documents that “[l]oans in the securitized pools were originated generally in accordance with the loan originator’s underwriting guidelines,” other than possible situations where “when the originator identified ‘compensating factors’ at the time of origination.” But Goldman has today acknowledged that, “Goldman received information indicating that, for certain loan pools, significant percentages of the loans reviewed did not conform to the representations made to investors about the pools of loans to be securitized.”
- Goldman made detailed representations to investors about its “counterparty qualification process” for vetting loan originators, and told investors and one rating agency that Goldman would engage in ongoing monitoring of loan sellers. Goldman has now acknowledged, however, that it “received certain negative information regarding the originators’ business practices” and that much of this information was not disclosed to investors.
- Goldman was aware in early-mid 2006 of certain issues with Countrywide Financial Corporation’s origination process, including a pattern of non-responsiveness and inability to provide sufficient staff to handle the numerous loan pools Countrywide was selling. In April 2006, while Goldman was preparing an RMBS backed by Countrywide loans for securitization, a Goldman mortgage department manager circulated a “very bullish” equity research report that recommended the purchase of Countrywide stock. Goldman’s head of due diligence, who had just overseen the due diligence on six Countrywide pools, responded “If they only knew . . . . .”
- Meanwhile, as Goldman has acknowledged in this statement of facts, “[Around the end of 2006], Goldman employees observed signs of uncertainty in the residential mortgage market [and] by March 2007, Goldman had largely halted new purchases of subprime loan pools.”

The resolution requires Goldman to pay \$2.385 billion in a civil penalty under the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) and also requires the bank to provide \$1.8 billion in other relief, including relief to underwater homeowners, distressed borrowers, and affected communities, in the form of loan forgiveness and financing for affordable housing. FIRREA authorizes the federal government to impose civil penalties against financial institutions that violate various predicate offenses, including wire and mail fraud. The settlement expressly preserves the government’s ability to bring criminal charges against Goldman, and does not release any individuals from potential criminal or civil liability. In addition, as part of the settlement, Goldman agreed to fully cooperate with any ongoing investigations related to the conduct covered by the agreement.

### **SIGTARP Contributes to Investigative Efforts Leading to Morgan Stanley Agreeing to \$2.6 Billion Penalty in Connection with the Sale of RMBS.**

Based on a multi-agency law enforcement investigation, including SIGTARP, Morgan Stanley agreed to pay a \$2.6 billion penalty to resolve claims related to Morgan Stanley’s marketing, sale and issuance of RMBS. As part of the agreement, Morgan Stanley acknowledged in writing that it failed to disclose critical information to prospective investors about the quality of the mortgage loans underlying its RMBS and about its due diligence practices. Investors, including federally insured financial institutions, suffered billions of dollars in losses from investing in RMBS issued by Morgan Stanley in 2006 and 2007.

As acknowledged by Morgan Stanley in a detailed statement of facts that is a part of this agreement (and is quoted below), the company made representations to prospective investors about the characteristics of the subprime mortgage loans underlying its RMBS – representations with which it did not comply:

- In particular, Morgan Stanley told investors that it did not securitize underwater loans (loans that exceeded the value of the property). However, Morgan Stanley did not disclose to investors that in April 2006 it had expanded its “risk tolerance” in evaluating loans in order to purchase and securitize “everything possible.” As Morgan Stanley’s manager of valuation due diligence told an employee in 2006, “please do not mention the ‘slightly higher risk tolerance’ in these communications. We are running under the radar and do not want to document these types of things.” As a result, Morgan Stanley ignored information – including broker’s price opinions (BPOs), which are estimates of a property’s value from an independent real estate broker – indicating that thousands of securitized loans were underwater, with combined-loan-to-value ratios over 100 percent. From January 2006 through mid-2007, Morgan Stanley acknowledged that “Morgan Stanley securitized nearly 9,000 loans with BPO values resulting in [combined loan to value] ratios over 100 percent.”
- Morgan Stanley also told investors that it did not securitize loans that failed to meet originators’ guidelines unless those loans had compensating factors. Morgan Stanley’s offering documents “represented that ‘[the mortgage loans originated or acquired by [the originator]] were done so in accordance with the underwriting guidelines established by [the originator]’ but that ‘on a case-by-case-basis, exceptions to the [underwriting guidelines] are made where compensating factors exist.’” Morgan Stanley has now acknowledged, however, that “Morgan Stanley did not disclose to securitization investors that employees of Morgan Stanley received information that, in certain instances, loans that did not comply with underwriting guidelines and lacked adequate compensating factors . . . were included in the RMBS sold and marketed to investors.” So, in fact, “Morgan Stanley . . . securitized certain loans that neither comported with the originators’ underwriting guidelines nor had adequate compensating factors.”
- Through these undisclosed practices, Morgan Stanley increased the percentage of mortgage loans it purchased for its RMBS, notwithstanding its awareness about “deteriorating appraisal quality” and “sloppy underwriting” by the sellers of these loans.

The bank has now acknowledged that “Morgan Stanley was aware of problematic lending practices of the subprime originators from which it purchased mortgage loans.” However, it “did not increase its credit-and-compliance due diligence samples, in part, because it did not want to harm its relationship with its largest subprime originators.” Indeed, Morgan Stanley’s manager of credit-and-compliance due diligence was admonished to “stop fighting and begin recognizing the point that we need monthly volume from our biggest trading partners and that . . . the client [an originator] does not have to sell to Morgan Stanley.”

The \$2.6 billion civil monetary penalty resolves claims under FIRREA. The settlement expressly preserves the government’s ability to bring criminal charges against Morgan Stanley, and likewise does not release any individuals from potential criminal or civil liability. In addition, as part of the settlement, Morgan Stanley promised to cooperate fully with any ongoing investigations related to the conduct covered by the agreement.

**Former CEO of \$3 Billion TierOne Bank Sentenced to 11 Years in Prison for Orchestrating Scheme to Hide More Than \$100 Million in Losses from Shareholders and Regulators – the Bank Applied for \$86 Million from TARP Before Collapsing.**

On March 23, 2016, Gilbert G. Lundstrom, the former CEO of TierOne Bank, a –now failed– \$3 billion publicly-traded commercial bank, was sentenced to 132 months in prison and ordered to pay a \$1.2 million fine following his conviction after a jury trial for orchestrating a scheme to defraud TierOne’s shareholders and misleading regulators by concealing more than \$100 million in losses. Additionally, on March 25, 2016, James Laphen, TierOne’s former President and Chief Operating Officer, and Don Langford, TierOne’s former Chief Credit Officer, were sentenced to 34 months and 21 months, respectively, after pleading guilty in 2014, for their roles in the scheme. Laphen was also fined \$200,000.

According to the trial evidence, Lundstrom designed an aggressive strategy to expand TierOne’s portfolio beyond traditional lending in Nebraska to riskier areas, including commercial real estate in Las Vegas, which decimated the bank once the financial crisis hit. Lundstrom then covered up what he referred to as the bank’s “death spiral” due to these bad loans, in a conspiracy which included applying for \$86 million in TARP with false bank books because, as Lundstrom wrote, the bank would be “dead without TARP.” Lundstrom presented one picture of the bank’s health to regulators and for the TARP application, when executives had, in actuality, tallied \$60 million to \$70 million in hidden loan losses written on a napkin.

Additionally, Lundstrom lied to shareholders saying that the bank decided against applying for TARP, when, in reality, the bank’s regulator did not support the TARP application. In June 2010, following TierOne’s ultimate disclosure of \$120 million in loan losses and its subsequent delisting from the NASDAQ exchange, TierOne was shut down by the FDIC. The FDIC estimated its loss at \$298 million. At the time of the closure, TierOne had more than 750 employees working at its headquarters in Lincoln and its 69 branch offices located in Nebraska, Iowa and Kansas. SIGTARP and the FBI investigated the case, which was prosecuted by the DOJ Criminal Division’s, Fraud Section.

**Former TARP Bank CEO Sentenced to 84 Months in Federal Prison and \$3.9 Million Restitution for Hiding Past Due Loans from Regulators and Shareholders.**

On February 25, 2016, Gary Patton Hall Jr., the former President and CEO of TARP recipient, Tifton Bank Corporation (“TBC”) was sentenced in the United States District Court for the Middle District of Georgia to 84 months in prison having pleaded guilty in December 2015 to conspiracy to commit bank fraud and conspiracy to commit fraud against the United States. Hall was also ordered to pay restitution of \$3,931,018.

Between 2005 and 2010, Hall engaged in a scheme to cover up past due loans to mask the bank’s poor financial condition from the FDIC and the bank’s loan committee, eventually resulting in millions of dollars of losses to the bank and others. Hall also concealed his personal and business interest in loans to which he exercised approval authority, including funding an unsecured loan to a borrower who purchased Hall’s condominium in Panama City, Florida, and who later declared bankruptcy, resulting in a loss of more than \$400,000 to TBC. In 2009, TBC obtained \$3.8 million in TARP funds, all of which was lost (together with over \$50 thousand in missed dividends) when the bank failed in 2010.

The case was investigated by SIGTARP and its law enforcement partners. TBC was closed by the Georgia Department of Banking and Finance in November 2010 due to its poor financial condition. At that time, TBC had not repaid the \$3.8 million it received from the Department of Treasury's Troubled Asset Relief Program.

**RBS Supervisor Pleads Guilty to Conspiracy to Commit Multimillion Dollar Securities Fraud – TARP Recipients were Impacted by Fraudulent Deals.**

On December 22, 2015, Adam Siegel, the co-head of asset-and mortgage-backed trading at the global trading firm RBS Securities, waived his right to indictment and pleaded guilty in federal court to participating in a multimillion dollar securities fraud scheme. Siegel also entered into an agreement to cooperate with the government's ongoing investigation.

In pleading guilty, Siegel admitted that he and others conspired to increase RBS's profits on collateralized loan obligations (CLO) and RMBS bond trades at the expense of customers. As part of the scheme, Siegel and his co-conspirators made misrepresentations to induce buying customers to pay inflated prices and selling customers to accept deflated prices for bonds, all to benefit RBS. The investigation revealed numerous fraudulent transactions by Siegel and other members of the conspiracy that cost at least 35 victim customers, including firms affiliated with recipients of federal bailout funds through TARP, millions of dollars.

On March 11, 2015, Matthew Katke, a registered broker-dealer and managing director at RBS Securities Inc., pleaded guilty to the same charge and also is cooperating with the government.

**Former Nomura RMBS Traders Charged with Multiple Fraud and Conspiracy Offenses – TARP Public-Private Investment Program (PPIP) Securities were Involved in Alleged Overcharging.**

As alleged in the indictment, the three co-conspirators supervised the RMBS Desk at Nomura Securities International ("Nomura") in New York. One was the Managing Director who oversaw all of Nomura's trading in RMBS, another was the Executive Director of the RMBS Desk and principally oversaw Nomura's trading of bonds composed of sub-prime and option ARM loans, and the third was the senior-most Vice President of the RMBS Desk and focused primarily on Nomura's trading of bonds composed of prime and alt-A loans.

The indictment alleges that the three co-conspirators engaged in a conspiracy to defraud customers of Nomura by fraudulently inflating the purchase price at which Nomura could buy a RMBS bond to induce their victim-customers to pay a higher price for the bond, and by fraudulently deflating the price at which Nomura could sell a RMBS bond to induce their victim-customers to sell bonds at cheaper prices, causing Nomura and the three defendants to profit illegally.

According to the indictment, the three co-conspirators trained their subordinates to lie to customers, provided them with the language to use in deceiving customers, and encouraged them to engage in the practice. In one instance, one of the defendants' subordinate traders told a salesperson that he "lied" about the price of bond and "marked up 2 pts," to which the salesperson responded "haha sick . . . well played."

The defendants are also alleged to have created fictitious third parties in an effort to increase their profits, and colluded with at least one outside client to deceptively broker trades on their behalf. In one instance, an investment advisor for another firm concocted a false story with one of the defendants to tell to customers. According to the indictment, he wrote to a defendant asking, “when did I buy [the bond] and at what price.”

The victims of this scheme include funds from around the world, retirement plan providers, and a TARP fund manager.



# Office of Inspector General Department of the Treasury

*The Department of the Treasury Inspector General performs independent, objective reviews of specific Treasury programs and operations with oversight responsibility for one federal banking agency – the Office of the Comptroller of the Currency. That federal banking agency supervises approximately 1,500 financial institutions.*

## Introduction

The Department of the Treasury Office of Inspector General (OIG) was established pursuant to the 1988 amendments to the Inspector General Act of 1978. The Treasury Inspector General is appointed by the President, with the advice and consent of the Senate. Treasury OIG performs independent, objective reviews of Treasury programs and operations, except for those of the Internal Revenue Service (IRS) and the Troubled Asset Relief Program (TARP), and keeps the Secretary of the Treasury and Congress fully informed. Treasury OIG is comprised of four divisions: (1) Office of Audit, (2) Office of Investigations, (3) Office of Counsel, and (4) Office of Management. Treasury OIG is headquartered in Washington, DC, and has an audit office in Boston, MA.

Treasury OIG has oversight responsibility for the Office of the Comptroller of the Currency (OCC). OCC is responsible for approximately 1,071 national banks, 415 federal savings associations, and 49 federal branches of foreign banks. The total assets under supervision are \$11.1 trillion, making up 68 percent of the total U.S. commercial banking assets. Treasury OIG also oversees four offices created by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) which are (1) the Office of Financial Research (OFR), (2) the Federal Insurance Office, and (3) the Offices of Minority and Women Inclusion within Treasury's Departmental Offices (DO) and OCC. Additionally, Treasury OIG oversees Treasury's role related to the financial solvency of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) under the Housing and Economic Recovery Act of 2008 (HERA), to include Treasury's Senior Preferred Stock Purchase Agreements established for the purpose of maintaining the positive net worth of both entities. As of March 2016, the funding capacity available to the two entities is \$258 billion covering future net worth deficiencies.

## Treasury Management and Performance Challenges Related to Financial Regulation and Economic Recovery

In accordance with the Reports Consolidation Act of 2000, the Treasury Inspector General annually provides the Secretary of the Treasury with his perspective on the most serious management and performance challenges facing the Department. In a memorandum to the Secretary dated October 30, 2015, the Inspector General reported three management and performance challenges that were directed towards financial

regulation and economic recovery. Those challenges are: Cyber Threats, Management of Treasury's Authorities Intended to Support and Improve the Economy, and Anti-Money Laundering and Terrorist Financing/Bank Secrecy Act Enforcement.<sup>4</sup>

### **Cyber Threats**

Cybersecurity represents one of the most serious challenges facing the Nation today. A reliable critical infrastructure, including information systems and networks, is vital to our national security and economic stability. Cyber threats are a persistent concern as Treasury's information systems are critical to the core functions of Government and the Nation's financial infrastructure. As cyber threats continue to evolve and become more sophisticated and subtle, they pose an ongoing challenge for Treasury to fortify and safeguard its internal systems and operations and the financial sector it oversees.

Cyber attacks on financial institutions continue to evolve at an accelerated rate, and include distributed denial of service attacks, phishing attacks, and fraudulent wire payments. Organized hacking groups leverage published and unpublished vulnerabilities and vary their methods to make attacks hard to detect and even harder to prevent. Criminal groups and nation-states are constantly seeking to steal information; commit fraud; and disrupt, degrade, or deny access to information systems.

Effective public-private coordination continues to be required to address the cyber threat against the Nation's critical infrastructure. In this regard, Treasury is looked upon to provide effective leadership to financial institutions in particular, and the financial sector in general, to strengthen awareness and preparedness against cyber threats.

### **Management of Treasury's Authorities Intended to Support and Improve the Economy**

This challenge focuses on the administration of broad authorities given to Treasury by the Congress to address the financial crisis under HERA and the Emergency Economic Stabilization Act of 2008 (EESA), among others. Another focus of the challenge is on the responsibilities of Treasury and the Secretary under Dodd-Frank. To a large extent Treasury's program administration under these acts has matured, but challenges remain in managing Treasury's programs and its outstanding investments as well as ensuring financial reform under Dodd-Frank.

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4 The Treasury Inspector General's memorandum included two other challenges not directly related to financial regulation and economic recovery: Efforts to Promote Spending Transparency and to Prevent and Detect Improper Payments and Gulf Coast Restoration Trust Fund Administration. The memorandum also discussed concerns about two matters: currency and coin production and documenting key activities and decisions.

Among other things, Dodd-Frank established the Financial Stability Oversight Council (FSOC). FSOC's mission is to identify risks to financial stability that could arise from the activities of large, interconnected financial companies; promote market discipline; and respond to any emerging threats to the financial system. The intention of Dodd-Frank is most notably to prevent, or at least minimize, the impact of a future financial sector crisis on the U.S. economy. To accomplish this, Dodd-Frank placed great responsibility with Treasury. This management challenge from our perspective is to maintain an effective FSOC process<sup>5</sup> that timely identifies and appropriately responds to emerging risks, particularly in times of economic growth when government action to curtail risky behavior in marketplaces can be unpopular and seen as unnecessary.

Through several HERA and EESA programs, Treasury injected capital into financial institutions and businesses. Under HERA, Treasury supports the financial solvency of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), which continue to operate under the conservatorship of the Federal Housing Finance Agency. To maintain the positive net worth of these two government sponsored enterprises (GSE), Treasury has invested approximately \$187 billion in senior preferred stock in the two enterprises. While the GSEs have not required additional support since fiscal year 2012, their futures remain uncertain and further assistance may be required. If such support is needed, the current funding capacity available to Fannie Mae is \$117.6 billion and available to Freddie Mac is \$140.5 billion. Treasury must also continue to monitor the underlying assets of its \$7.8 billion investment in the GSEs under the Housing Finance Agency Initiative, which supports State and local housing finance agencies.

Until a solution to address housing finance reform is reached, it is difficult to predict what lies ahead for winding down the Fannie Mae and Freddie Mac investments.

### **Anti-Money Laundering and Terrorist Financing/Bank Secrecy Act Enforcement**

Preventing criminals and terrorists from using U.S. financial networks to sustain their operations and/or launch attacks against the U.S. continues to be a challenge. Treasury's Office of Terrorism and Financial Intelligence (TFI) is dedicated to disrupting the ability of terrorist organizations to fund their operations. TFI brings together intelligence gathering and analysis, economic sanctions, international cooperation, and private-sector cooperation to identify donors, financiers, and facilitators supporting terrorist organizations, and disrupt their ability to fund such organizations. Enhancing the transparency of the financial system is one of the cornerstones of this effort. Treasury carries out its responsibilities to enhance financial transparency through the laws collectively known as the Bank Secrecy Act (BSA). The Financial Crimes Enforcement Network (FinCEN) is the Treasury bureau responsible for administering BSA, while Treasury's Office of Foreign Assets Control (OFAC) administers U.S. foreign sanction programs.

With respect to FinCEN, it faces continuing challenges to enhance financial transparency as a way to strengthen efforts to combat financial crime and collect, analyze, and report data on national threats.

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5 FSOC is supported by the Office of Financial Research and the Federal Insurance Office; both are offices within Treasury.

FinCEN has focused on enhancing its enforcement efforts to promote compliance with the BSA in partnership with Federal banking regulators and law enforcement. Other matters of concern on the horizon include the increasing use of (1) mobile devices for banking, internet banking, internet gaming, and peer-to-peer transactions; and (2) virtual currencies. FinCEN and other regulatory agencies will need to make sure that providers of these services who are covered by BSA understand their obligations under the statute. Given the criticality of this challenge to the Department's mission, and notwithstanding the efforts described above, we continue to consider anti-money laundering and combating terrorist financing programs and operations as inherently high-risk.

## **Completed and In-Progress Work on Financial Oversight**

### **OCC Financial Institution Assessment Process**

From March 2009 through March 2013, OCC under-assessed fees to five financial institutions by a total of approximately \$4.9 million. In September 2013, OCC under-assessed six institutions (including the five previously mentioned) by a total of approximately \$860,000. During these periods, the institutions were assessed as commercial banks instead of independent trust banks. Independent trust banks are supposed to be assessed a surcharge above the commercial bank assessment. OCC subsequently waived the assessment and collection of the \$4.9 million and collected the September 2013 under-assessment \$860,000 in October 2013. We initiated an audit to evaluate (1) OCC's authority and decision-making process for waiving the under-assessments and (2) the actions taken by OCC to identify and correct internal control deficiencies in the financial institution assessment process.

We reported that OCC had the requisite authority to waive the collection of fees. However, the waiver of the fees effectively resulted in the inconsistent treatment of banks subject to the fees and a windfall for a few banks. We noted that OCC did not have a documented process to address the handling of this type of event. We also concluded that OCC did strengthen its internal control over the assessment process for banks.

We recommended that OCC (1) reevaluate the decision to waive the approximately \$4.9 million in under-assessments from the March 2009 through March 2013 period and as appropriate, take action to collect the under-assessments; and (2) implement policies and procedures to govern the waiver of under-assessed fees.

### **OCC Oversight of Amended Foreclosure Consent Orders**

In April 2011, OCC, the former Office of Thrift Supervision, and the Board of Governors of the Federal Reserve System issued foreclosure-related consent orders against 14 major mortgage servicers for unsafe and unsound practices in residential mortgage servicing and foreclosure processing. These unsafe and unsound practices, including such things as the "robo-signing" of documents, were identified during a horizontal review performed in 2010. Pursuant to the orders, the servicers engaged independent consultants to perform independent foreclosure reviews to identify and remediate financial injury to borrowers who were in the foreclosure process during 2009 and 2010. These reviews were performed in 2011 and 2012. In late 2012, OCC officials concluded that the independent foreclosure review process was taking longer than anticipated and delaying the compensation to harmed borrowers. In January 2013, OCC negotiated a change to the terms of the consent orders for the mortgage servicers. As we reported last year, OCC pursued the amendment of the

original foreclosure consent orders to facilitate more timely relief to borrowers potentially harmed during the foreclosure process in the form of cash payments totaling \$3.4 billion and foreclosure prevention totaling \$5.3 billion.

We have two audits in-progress related to the foreclosure consent orders.

### **Oversight of Servicers' Operational Improvement and Foreclosure Prevention Activities (In Progress)**

We initiated an audit of the OCC's oversight of mortgage servicers' operational improvements and foreclosure prevention actions that were required by the 2011 Foreclosure-Related Consent Orders. Our objective is to assess OCC's oversight of actions taken by servicers to (1) address those articles of the foreclosure consent orders designed to correct the unsafe and unsound operational practices identified in the 2010 horizontal review of servicers' foreclosure practices and (2) provide a range of foreclosure prevention actions.

### **Oversight of Servicers' Determination of In-Scope Borrowers Under the Amended Consent Orders (In Progress)**

Expressing concern that one servicer under an amended foreclosure consent order failed to identify and send payments to 24,000 borrowers until after a private citizen contacted OCC, the Ranking Member of the House Committee on Financial Services asked the Treasury Inspector General and the Board of Governors of the Federal Reserve System/Consumer Financial Protection Bureau Inspector General to look into the matter. In response, we initiated an audit of OCC's oversight of the determination of the population of in-scope borrowers related to the amended foreclosure consent orders. Our objectives, consistent with the request, are to determine: (1) the facts and circumstances surrounding the increase in the population of the one servicer's in-scope borrowers; (2) the methodology used and procedures performed by OCC to test and validate the universe of in-scope borrowers and whether such borrowers were appropriately sent checks for the five servicers not covered in prior Treasury OIG reviews; (3) OCC's process for vetting any individual questions, complaints, or requests for appeal related to the in-scope population from borrowers; (4) any direction that OCC has provided to servicers outlining how the servicer should process questions, complaints, or request to appeal the determination of the in-scope population that they receive from borrowers; and (5) what data gaps existed within servicers' systems that made it difficult to identify in-scope borrowers and whether such data gaps or system integration issues have been fixed.

### **OCC's Supervision of Banks' Use of Independent Consultants Under Enforcement Actions (In Progress)**

We initiated an audit of OCC's use of OCC Bulletin No. 2013-33, Use and Review of Independent Consultants in Enforcement Actions. Our objective is to evaluate OCC's supervision when requiring banks to employ independent consultants as part of enforcement actions to address significant violations of law, fraud, or harm to customers.

### **OCC's Supervision of Financial Institutions' Student Loan Lending Activities (In Progress)**

We initiated an audit of OCC's supervision of banks' student loan lending activities. The objective of this audit is to assess the adequacy and effectiveness of OCC's supervision over financial institutions' risk management controls and practices in place to mitigate losses in their student loan portfolios.

### **OCC's Supervision of Federal Branches of Foreign Banks (In Progress)**

We initiated an audit of OCC's supervision of federal branches of foreign banks. The objective of this audit is to assess OCC's supervision of federal branches and agencies of foreign banking organizations operating in the U.S.

### **Treasury's Departmental Offices' Office of Minority and Women Inclusion (In Progress)**

We initiated an audit of Treasury's establishment of an Office of Minority and Women Inclusion (OMWI) with its Departmental Offices. The objective of this audit is to determine whether OMWI was established and carrying out its functions consistent with Section 342 of the Dodd-Frank Act.

### **OFR's Performance Measures (In Progress)**

We initiated an audit of OFR's performance measures. The objective of this audit is to assess the design and implementation of the performance measures by OFR.

### **OFR's Procurement Activities (In Progress)**

We initiated an audit of OFR's procurement activities. The objectives of this audit are to determine if (1) OFR's procurement activities ensure that OFR effectively and efficiently acquire the goods and services needed to accomplish its mission; and (2) these acquisitions are made in compliance with applicable procurement regulations.

## **Failed Bank Reviews**

In 1991, Congress enacted the Federal Deposit Insurance Corporation Improvement Act (FDICIA) amending the Federal Deposit Insurance Act (FDIA). The amendments require that banking regulators take specified supervisory actions when they identify unsafe or unsound practices or conditions. Also added was a requirement that the Inspector General for the primary federal regulator of a failed financial institution conduct a material loss review when the estimated loss to the Deposit Insurance Fund is "material." FDICIA defines the loss threshold amount to the Deposit Insurance Fund triggering a material loss review to a loss that exceeds \$50 million for 2014 and thereafter (with a provision to temporarily raise the threshold to \$75 million in certain circumstances). The act also requires a review of all bank failures with losses under these threshold amounts for the purposes of (1) ascertaining the grounds identified by OCC for appointing FDIC as receiver and (2) determining whether any unusual circumstances exist that might warrant a more in-depth review of the loss. As part of the material loss review, OIG auditors determine the causes of the failure and assess the supervision of the institution, including the implementation of the prompt corrective action

provisions of the act.<sup>6</sup> As appropriate, Treasury OIG also makes recommendations for preventing any such loss in the future.

From the beginning of the current economic crisis in 2007 through May 2016, FDIC and other banking regulators closed 518 banks and federal savings associations. One hundred and forty (140) of these were Treasury-regulated financial institutions; in total, the estimated loss to FDIC's Deposit Insurance Fund for these failures was \$36.2 billion. Of the 140 failures, 56 resulted in a material loss to the Deposit Insurance Fund, and our office performed the required reviews of the failures. During the period covered by this annual report, we did not perform a material loss review. We completed a review of one bank failure with a loss under the material loss review threshold, Hometown National Bank, whose failure in October 2015 resulted in an estimated \$1.6 million loss to the Deposit Insurance Fund. We determined there were no unusual circumstances warranting an in-depth review of the failure.

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6 Prompt corrective action is a framework of supervisory actions for insured institutions that are not adequately capitalized. It was intended to ensure that action is taken when an institution becomes financially troubled in order to prevent a failure or minimize the resulting losses. These actions become increasingly severe as the institution falls into lower capital categories. The capital categories are well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized.

