

Annual Report of the Council of Inspectors General on Financial Oversight



JULY 2017

Message from the Chair

In keeping with its mission, the Council of Inspectors General on Financial Oversight (CIGFO), which is authorized to oversee the 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 meetings, members discussed agencies' implementation of the Cybersecurity Information Sharing Act, FSOC's review of the asset management industry, as well as FSOC's revised Freedom of Information Act rules. In addition, members discussed ongoing investigative work related to federal waste, fraud, and abuse.

In 2015, CIGFO established a Working Group to Audit FSOC's Efforts to Promote Market Discipline—one of FSOC's statutory mandates, requiring regulators to end "too big to fail." After extensive field work, CIGFO issued its audit conclusions in February 2017. The audit found that FSOC has made progress in promoting market discipline, yet the wide range of views that still exist on the issue of "too big to fail" indicate that there is a lack of consensus regarding whether FSOC has eliminated expectations on the part of shareholders, creditors, and counterparties of large bank holding companies or nonbank financial companies that the federal government will shield them from losses in the event of failure.

In May, CIGFO issued its Corrective Action Verification on the July 2013 Audit of FSOC's Designation of Financial Market Utilities, which found FSOC had taken corrective actions responsive to each of the Audit recommendations. In the future, CIGFO members will continue to work together to share information that could enhance Inspector General oversight.

/s/

Eric M. Thorson
Chair, Council of Inspectors General on Financial Oversight
Inspector General, Department of the Treasury

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Council of Inspectors General on Financial Oversight

The Council of Inspectors General on Financial Oversight (CIGFO) was established by the 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:

- Agency cybersecurity measures
- FSOC's asset management industry review
- Dodd-Frank Wall Street Reform and Consumer Protection Act implementation status

The CIGFO recognizes that it has been 7 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 the following 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*
- 2017- *Audit of the Financial Stability Oversight Council's Efforts to Promote Market Discipline*
- 2017- *CIGFO's Corrective Action Verification on the Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities*
- 2017- *Corrective Action Verification of FSOC's Implementation of CIGFO's Audit Recommendations in the 2013 Audit of FSOC's Financial Market Utility Designation Process*

The corrective actions described by FSOC, with respect to the audits listed above, 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, inspections, evaluations, investigations, and other reviews of the programs and operations of the Board of Governors of the Federal Reserve System (Board) and the Consumer Financial Protection Bureau (CFPB) 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 we prevent and detect fraud, waste, and abuse.
- We share our findings and make 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 6 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 Modernization Act of 2014 (FISMA) 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.

Among other items, we identified the following six major management challenges for the Board that apply to the financial sector in 2016:

- Enhancing Oversight of Cybersecurity at Supervised Financial Institutions
- Ensuring an Effective Information Security Program
- Sustaining an Effective Financial Stability Regulatory and Supervisory Framework
- Establishing an Efficient and Effective Governance System
- Managing the Handling and Release of Sensitive Federal Open Market Committee and Board-Generated Information
- Advancing Efforts to Improve Human Capital Management

Among other items, we identified the following three major management challenges for the CFPB that apply to the financial sector in 2016:

- Ensuring an Effective Information Security Program
- Ensuring Comprehensive Policies and Procedures Are in Place and Followed
- Maturing the Human Capital Program

Opportunities Exist to Increase Employees' Willingness to Share Their Views About Large Financial Institution Supervision Activities, OIG Report 2016-SR-B-014, November 14, 2016

We initiated this evaluation in response to a written request from the Director of the Board's Division of Banking Supervision and Regulation and the Board's General Counsel. Our objectives were (1) to assess the methods for Federal Reserve System decisionmakers to obtain material information necessary to ensure that decisions and conclusions resulting from supervisory activities at Large Institution Supervision Coordinating Committee (LISCC) firms and large banking organizations (LBOs) are appropriate, supported by the record, and consistent with applicable policies and (2) to determine whether there are adequate channels for System decisionmakers to be aware of supervision employees' divergent views about material issues regarding LISCC firms and LBOs.

We found that employees' willingness to share views varies by Reserve Bank and among supervision teams at the same Reserve Bank. We also found that leadership and management approaches play a major role in influencing employees' comfort level in sharing views. We identified five root causes for employees' reticence to share their views; addressing these root causes will likely improve the flow of information to decisionmakers. In addition, we describe several leadership behaviors and processes currently employed by the leadership at certain Reserve Banks that appear particularly effective in helping to convince Reserve Bank supervision employees that it is both safe and worthwhile to share their views.

Our report contains recommendations designed to increase employees' willingness to share their views and improve the flow of information to decisionmakers regarding the supervision of large financial institutions. The Board concurred with our recommendations.

Evaluation of the Board's Oversight of Cybersecurity Threats to Financial Institutions, OIG Report 2017-IT-B-009, April 17, 2017

Our evaluation objective was to assess the Board's cybersecurity examination approach and determine whether it is providing effective oversight of financial institutions' information security controls and cybersecurity risks for select oversight areas. Specifically, this evaluation included an assessment of (1) the Board's current cybersecurity oversight approach and governance structure, (2) the current examination practices for financial market utilities and multiregional data processing servicer (MDPS) firms for which the Board has oversight responsibilities, and (3) the Board's ongoing initiative for the future state of cybersecurity oversight.

We identified opportunities for the Division of Supervision and Regulation (S&R) to enhance its approach to cybersecurity supervision as it continues to implement its multiyear, future-state cybersecurity oversight

program. Specifically, we found that S&R could improve the oversight of MDPS firms by (1) enforcing the reporting requirement in the Bank Service Company Act for financial institutions to notify their primary regulator of new service relationships within 30 days, (2) considering the implementation of an enhanced governance structure for these firms, (3) providing additional guidance to examination teams on the supervisory expectations for these firms, and (4) ensuring that S&R's intelligence and incident management function is aware of the technologies used by MDPS firms. Further, we identified opportunities to improve the recruiting, retention, tracking, and succession planning of cybersecurity resources in alignment with the Board's strategic plan, as well as opportunities to enhance the communication of cybersecurity-related risks.

The Board Can Improve the Effectiveness of Continuous Monitoring as a Supervisory Tool, OIG Report 2017-SR-B-005, March 29, 2017

We assessed the effectiveness of continuous monitoring as a supervisory activity for large, complex financial institutions, including LISCC firms and LBOs.

Although the Board and the Reserve Banks have multiple documents that address the expectations for certain aspects of continuous monitoring, the Board has not issued guidance that harmonizes these expectations across its supervisory portfolios and the Reserve Banks. Such guidance could outline the preferred analytical approach and documentation practices for this activity across the LISCC and LBO supervisory portfolios and minimize the variability that we noted for continuous monitoring activities across the Reserve Banks we visited. Although we noted certain best practices for executing continuous monitoring during our evaluation, those practices have not been broadly implemented across the Federal Reserve System. As a result, supervisory guidance issued by the Board could help to foster more consistent execution of this supervisory activity throughout the Federal Reserve System and maximize its effectiveness.

Our report contains recommendations to improve the effectiveness of continuous monitoring. The Board concurred with our recommendations.

The Board Can Improve Documentation of Office of Foreign Assets Control Examinations, OIG Report 2017-SR-B-003, March 15, 2017

We evaluated the Board's supervision activities for foreign banking organizations following high-profile enforcement actions related to Office of Foreign Assets Control (OFAC) violations. From 2010 to 2014, OFAC issued seven civil money penalties totaling almost \$1.7 billion and the Board issued four civil money penalties totaling \$788 million related to U.S. sanctions programs. Our objective was to assess the Board's approach to evaluating foreign banking organizations' OFAC compliance programs.

The OFAC examinations we reviewed did not always include documentation to adequately explain the rationale for the examination approach or the basis for conclusions. Although the *Examination Manual for U.S. Branches and Agencies of Foreign Banking Organizations* includes guidance on what to include in examination workpapers and the *Bank Secrecy Act/Anti-Money Laundering Examination Manual* includes OFAC examination procedures, there are no guidance or minimum expectations specific to how OFAC examinations should be documented. We also found data reliability concerns in the National Examination Database regarding whether OFAC compliance had been reviewed. These data reliability concerns may have occurred because there is no established definition of what it means to review OFAC compliance and because Reserve Banks do

not have consistent data entry procedures. In addition, the National Examination Database does not capture data that would indicate the extent of coverage of OFAC examinations.

Our report contains recommendations designed to strengthen the Board's supervision of OFAC compliance. The Board concurred with our recommendations.

The CFPB Can Strengthen Its Controls for Identifying and Avoiding Conflicts of Interest Related to Vendor Activities, OIG Report 2017-SR-C-004, March 15, 2017

We assessed whether the CFPB effectively mitigates the risk of potential conflicts of interest associated with using vendors to support fair lending compliance and enforcement analysis. We focused on a contract for fair lending enforcement analysis and expert witness services. Our scope did not include identifying potential or actual conflicts of interest related to the CFPB's fair lending supervision contracts, and our findings are not reflective of all CFPB contracting practices.

We found that the CFPB can strengthen its controls for identifying and avoiding potential conflicts of interest by (1) ensuring that vendors comply with existing documentation requirements; (2) clarifying roles and responsibilities; and (3) better facilitating vendor disclosure of potential conflicts, or affirmation that no conflicts exist, at the issuance of each task order. In addition, although the CFPB currently performs some fair lending enforcement analysis internally, we found that the CFPB should evaluate the potential costs and benefits of performing more fair lending enforcement analysis internally.

Our report contains recommendations designed to strengthen the CFPB's identification and avoidance of potential conflicts of interest and to reduce the agency's exposure to operational and reputational risk. The CFPB concurred with our recommendations.

The CFPB's Coordination for Targeted Consumer Financial Education Aligns With Best Practices and Can Benefit From Federal Partner Insights, OIG Report 2016-MO-C-011, July 25, 2016

Our objectives were (1) to assess the extent to which certain CFPB Division of Consumer Education and Engagement offices' coordination with other federal agencies aligns with best practices for effective interagency coordination and (2) to obtain insights from the federal partners of these Division of Consumer Education and Engagement offices to identify opportunities to strengthen the effectiveness of interagency coordination.

The Dodd-Frank Act mandated that the CFPB develop and implement a strategy to improve the financial literacy of consumers and initiatives to educate and empower consumers to make better-informed financial decisions. The Division of Consumer Education and Engagement is implementing the mandate through various initiatives that may be coordinated with other organizations, including federal agencies.

Overall, we found that the interagency coordination process steps followed by the Division of Consumer Education and Engagement offices that target students, older Americans, servicemembers, and traditionally underserved individuals align with interagency coordination best practices. Further, the targeted offices have processes in place to help mitigate risks related to interagency coordination that were identified by other federal agencies that provide consumer financial education. During our review, we benchmarked with 27

consumer financial education practitioners from 10 federal agencies to understand their coordination efforts and identify which U.S. Government Accountability Office (GAO) best practices on interagency coordination were relevant for consumer financial education coordination. Additionally, the 27 practitioners described agency practices, lessons learned, and associated risks from their own interagency coordination experiences that were not previously identified by GAO. We found that the targeted offices' coordination processes align with GAO and federal agency practices, and we identified some tools that may improve the targeted offices' coordination efforts.

The CFPB's Advisory Committees Help Inform Agency Activities, but Advisory Committees' Administration Should Be Enhanced, OIG Report 2016-MO-C-016, November 30, 2016

We conducted an audit of the CFPB's activities related to its four advisory committees, which provide expert advice on specific issues related to the CFPB's mission. Our objectives were (1) to assess the CFPB's compliance with applicable laws and regulations as they relate to advisory committees, (2) to assess the CFPB's administration of the advisory committees, and (3) to evaluate the CFPB's advisory committees' effectiveness in informing the CFPB's activities.

Overall, we found that the CFPB advisory committees were generally effective and were operating in compliance with applicable laws and regulations for the period we reviewed. We also found that the CFPB should improve its administration of advisory committee activities.

Specifically, the Office of Advisory Board and Councils and the Office of Research can improve their administrative processes by formally tracking the clearance process of documents before dissemination to advisory committee members, determining an optimal method to identify conflict of interests for certain members, retaining application materials, posting summaries of advisory committee meetings to the CFPB's Advisory groups webpage, and centrally retaining advisory committee expenditure information. In addition, we found that assessing advisory committee effectiveness can assist the CFPB in determining whether the committees provide the agency with information and perspectives that help inform agency activities.

Our report contains recommendations designed to improve the CFPB's administrative processes and to establish the formal monitoring of the effectiveness of advisory committee activities. The CFPB concurred with our recommendations.

Evaluation of the CFPB's Implementation of the Digital Accountability and Transparency Act of 2014, OIG Report 2016-FMIC-C-015, November 30, 2016

The Digital Accountability and Transparency Act of 2014 (DATA Act) aims to help policymakers and taxpayers track federal spending by requiring agencies to make accessible consistent data on expenditures and contract information. The CFPB determined that the act applies in full to its Consumer Financial Civil Penalty Fund and in part to its Bureau Fund. Our audit objective was to gain an understanding of the processes, systems, and controls that the CFPB has implemented, or plans to implement, to report financial and spending data as required by the DATA Act.

The DATA Act requires IGs to issue a report to Congress assessing a statistical sample of spending data submitted by the agency and its implementation of the data standards. However, The Council of the Inspectors General on Integrity and Efficiency (CIGIE) identified a timing anomaly for this requirement. The DATA Act states that the first Inspector General report is due to Congress in November 2016; however, the act did not require federal agencies to report spending data until May 2017. As a result, CIGIE encouraged Inspectors General to undertake DATA Act readiness reviews of their respective agencies well in advance of the November 2017 report. Our report is in response to CIGIE's suggestion.

Overall, we identified activities that will help the CFPB successfully implement the DATA Act requirements. We believe that the CFPB's success in implementing the DATA Act requirements will depend in part on (1) the effective execution of its implementation efforts; (2) the finalized designation of a senior accountable official; and (3) the clear documentation of the roles and responsibilities of the Bureau of the Fiscal Service, Administrative Resource Center. Our report contains no recommendations.

ONGOING WORK

Evaluation of the Board's Organizational Governance

Governance refers to the processes and structures implemented by the Board to inform, direct, manage, and monitor its activities to achieve its organizational objectives. Strong governance systems increase the likelihood that organizations will efficiently and effectively meet their objectives. This evaluation will (1) describe the current state of the Board's organizational governance structures and processes and (2) assess the extent to which these structures and processes align with those of other relevant institutions and governance principles. We are focusing on organizational governance at the highest levels of the Board. We are also focusing on select aspects of the Board's governance, including organizational structure; delegated responsibilities, authorities, and decision rights; and communication and transparency at the highest levels of the Board.

In-Depth Review of the Failure of Allied Bank

In accordance with section 38(k) of the FDI Act, as amended, when a state member bank failure occurs that does not result in a material loss to the DIF, our office conducts a failed bank review to assess whether the failure presents unusual circumstances that would warrant an in-depth review. On conducting a failed bank review of Allied Bank, we determined that this state member bank failure warrants an in-depth review. As a result, we are conducting an in-depth review to

- assess the Board's supervision of the failed institution, including the Board's implementation of prompt corrective action
- ascertain why the institution's problems resulted in a nonmaterial loss to the DIF
- make recommendations for preventing any such loss in the future.

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 (CIDs) 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 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 is assessing 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's Compliance With the Requirements for Issuing Civil Investigative Demands

Section 1052(c) of the Dodd-Frank Act authorizes the CFPB to issue CIDs when the agency has reason to believe that a person has documentary materials, tangible things, or any other information relevant to a possible violation of federal consumer financial law. These CIDs may be issued to produce documents, produce tangible things, or compel testimony. Section 1052(c) contains a series of compliance requirements related to the use of CID authority, ranging from mandatory content requirements to procedures for issuing CIDs. This evaluation is assessing the CFPB's (1) policies and procedures for issuing CIDs, (2) training programs and materials related to the issuance of CIDs, and (3) compliance with section 1052(c)'s requirements, applicable regulations, and the agency's policies and procedures for issuing CIDs.

Evaluation of the Effectiveness of the CFPB's Management of Examiner Commissioning Training

CFPB examiners review compliance with federal consumer financial laws in certain institutions. In October 2014, the CFPB issued a policy implementing the agency's examiner commissioning program. The OIG is undertaking this evaluation to determine whether the CFPB is effectively managing examiner commissioning and training. Our work will include reviewing applicable policies, procedures, and agency practices; reviewing the curriculum for the examiner commissioning training program; meeting with CFPB officials and staff members; and reviewing documentation associated with the examiner commissioning training program.

Audit of the CFPB's Offboarding Process

Recent events at federal agencies have highlighted the importance of an effective employee separation process to mitigate reputational, security, and other risks to federal agencies. To help mitigate these risks, the CFPB has developed offboarding guidance for when an employee separates from the agency. Our audit will assess the CFPB's offboarding process to determine whether controls are in place and operating effectively to mitigate key agency risks.



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's Process for Identifying and Reporting Major Information Security Incidents

The Federal Information Security Modernization Act of 2014 (FISMA) requires federal agencies to develop, document, and implement an agency-wide information security program that includes, among other things, procedures for detecting, reporting, and responding to information security incidents. Such procedures are to include notifying and consulting with, as appropriate, the Congressional Committees referenced in the statute for major incidents. According to FISMA, Congressional notification and consulting is to occur not later than 7 days after the date on which there is a reasonable basis to conclude that a major incident has occurred.

FISMA requires the Office of Management and Budget (OMB) to develop guidance on what constitutes a major incident and directs agencies to report incidents designated as major. Accordingly, OMB issued Memorandum M-16-03, Fiscal Year 2015-2016 Guidance on Federal Information Security and Privacy Management Requirements, dated October 30, 2015, that provided agencies with a definition of the term "major incident" and a framework of factors, the combination of which agencies had to consider when characterizing an incident as major.¹ The OMB memorandum stated that agencies should notify affected individuals, in accordance with FISMA, as "expeditiously as practical, without unreasonable delay." The memorandum added that although agencies may consult with the Department of Homeland Security's United States Computer Emergency Readiness Team when determining whether an incident is considered a "major incident," it is ultimately the responsibility of the victim agency to make the determination.

We conducted an audit to determine whether the FDIC had established key controls that provide reasonable assurance that major incidents would be identified and reported in a timely manner. As part of the audit, we conducted a detailed review of the FDIC's incident investigation-related activities, records, decisions, and reports for one specific incident, referred to in our report as the "Florida Incident."

¹ On November 4, 2016, OMB issued Memorandum M-17-05, which included, among other things, a revised definition and framework for assessing whether incidents are major.

Our audit focused on the FDIC's processes for addressing one particular type of information security incident—a breach of sensitive information—because the Florida Incident was a breach. This incident involved a former FDIC employee who copied a large quantity of sensitive FDIC information, including personally identifiable information, to removable media and took this information when the employee departed the FDIC's employment in October 2015. The FDIC detected the incident through its Data Loss Prevention tool, a technology used to monitor network activity.

We reported that although the FDIC had established various incident response policies, procedures, guidelines, and processes, these controls did not provide reasonable assurance that major incidents were identified and reported in a timely manner. Specifically, we found that:

- The FDIC's incident response policies, procedures, and guidelines did not address major incidents.
- The large volume of potential security violations identified by the Data Loss Prevention tool, together with limited resources devoted to reviewing these potential violations, hindered meaningful analysis of the information and the FDIC's ability to identify all security incidents, including major incidents.

Further, based on our analysis of the Florida Incident, we concluded that the FDIC had not properly applied the criteria in OMB Memorandum M-16-03 when it determined that the incident was not major. Specifically, the FDIC based its determination on various mitigation factors related to the "risk of harm" posed by the incident. Although such factors have relevance in determining the mitigation actions to be taken in addressing incidents, the factors were not among those listed in OMB Memorandum M-16-03 for agencies to consider when determining whether incidents were major and, therefore, were not relevant.

We notified the FDIC's Chief Information Officer (CIO) on February 19, 2016 that our analysis of the Florida Incident found that reasonable grounds existed to designate the incident as major as of December 2, 2015, and, as such, the incident warranted immediate reporting to the Congress. The FDIC subsequently reported the Florida Incident to the Congress as major on February 26, 2016.

When the FDIC did notify the Congress of the incident, certain risk mitigation factors in the notifications were either unsupported by adequate evidence and/or inconsistent with information available at the time. As a result, in our view, the notifications did not accurately portray the extent of risk associated with the incident. Our analysis of the Florida Incident also found that:

- More than 4 weeks had elapsed between the initial discovery of the incident and a determination that the incident was a breach.
- The decision about whether individuals and organizations potentially affected by the incident would be notified was untimely, and a required notification to another federal agency was not made in a timely manner.
- Records documenting investigative activities were not centrally managed and sometimes contained unreliable information, and the underlying rationale and discussions pertaining to certain decisions were not always documented.

The results of our analysis of the Florida Incident prompted the CIO to initiate a review of similarly situated information security incidents that occurred after the OMB issued Memorandum M-16-03 to determine whether additional incidents warranted designation as major. The CIO's review resulted in six additional incidents being reported to the Congress as major between March and May 2016.

On May 5, 2016, the CIO provided our office with an outline of a plan describing a number of initiatives aimed at addressing policy and program shortcomings in the FDIC's incident response processes. Such initiatives included, but were not limited to, developing an overarching incident response program guide, hiring an incident response coordinator, implementing a new incident tracking system, updating incident response policies and procedures, and performing a comprehensive assessment of the FDIC's information security and privacy programs.

We made five recommendations to the CIO that were intended to provide the FDIC with greater assurance that major incidents would be identified and reported consistent with FISMA and OMB Memorandum M-16-03, in effect at that time. We pointed out that addressing these recommendations would facilitate the Congress' ability to provide the oversight intended by FISMA and contribute to the OMB's goal of having effective interagency communication so that incidents are mitigated appropriately and as quickly as possible. FDIC management concurred with the recommendations.

The FDIC's Controls for Mitigating the Risk of an Unauthorized Release of Sensitive Resolution Plans

Section 165(d) of the Dodd-Frank Act requires certain financial companies designated as systemically important financial institutions (SIFI) to report to the FDIC on their plans for a rapid and orderly resolution under the Bankruptcy Code in the event of material financial distress or failure. The resolution plans, or "living wills," required by the Dodd-Frank Act contain some of the most sensitive information that the FDIC maintains. Accordingly, safeguarding the plans from unauthorized access or disclosure is critically important to achieving the FDIC's mission of maintaining stability and public confidence in the nation's financial system.

In September 2015, an employee working in the FDIC's Office of Complex Financial Institutions (OCFI) abruptly resigned from the Corporation and took sensitive components of resolution plans without authorization. We conducted an audit to determine the factors that contributed to this security incident involving sensitive resolution plans and assess the adequacy of mitigating controls established subsequent to the incident.

By way of background, on September 29, 2015, FDIC personnel detected that an employee who had previously worked for OCFI had copied sensitive components of three resolution plans from the network onto an unencrypted Universal Serial Bus (USB) storage device. This activity violated OCFI policy which expressly prohibited the storage of resolution plans on removable media. In addition, the activity appeared suspicious because the information was copied to the USB device immediately prior to the employee's departure. Further, the employee did not have authorization to take any sensitive FDIC information, including resolution plans, upon departure.

Law enforcement officials subsequently recovered the USB device that contained the components of the resolution plans copied by the employee. In the course of doing so, these officials also identified and recovered from the employee a sensitive Executive Summary for a fourth resolution plan that was in hard

copy. In early October 2015, the FDIC notified each of the SIFIs impacted by the incident. In addition, law enforcement officials learned that the employee had interviewed for employment with two of the four SIFIs impacted by the incident following the employee's resignation, suggesting that the employee may have taken the resolution plans for personal gain. Further, there were indications prior to the incident that the employee presented a heightened security risk and may not have been suited to have access to highly sensitive information, such as resolution plans.

We identified a number of factors that contributed to the security incident involving sensitive resolution plans. Most importantly, our report noted that an insider threat program would have better enabled the FDIC to deter, detect, and mitigate the risks posed by the employee. In addition, a key security control designed to prevent employees with access to sensitive resolution plans from copying electronic information to removable media failed to operate as intended. The remaining factors involved OCFI employees having access to resolution plans that exceeded business needs; OCFI's inability to effectively review and revoke employee access to resolution plans because employees were allowed to store copies of the plans outside of the FDIC's official system of record; and OCFI's inability to monitor all downloading of resolution plans stored in the system of record.

With respect to insider threats, our report noted that the FDIC had a number of long-standing controls designed to mitigate risks associated with trusted insiders. Also during 2014 and 2015, the FDIC began to take steps toward establishing a formal insider threat program by, among other things, developing a proposed governance structure and drafting program policies. However, these activities were not completed or approved, and progress toward establishing an insider threat program stalled in the fall of 2015.

Following the incident involving resolution plans, OCFI officials assessed the associated risks and began implementing new or enhanced security controls over resolution plans. Our report recommended additional control improvements that the FDIC should implement to better safeguard sensitive resolution plans. Of particular importance, we recommended that the FDIC establish a corporate-wide insider threat program.

After we issued our preliminary audit results in May 2016, senior FDIC management placed a high priority on establishing a formal insider threat program. On September 20, 2016, the Insider Threat and Counterintelligence Program was formally established.

In connection with the two reports discussed above related to the information security breaches at the FDIC, the Acting Inspector General testified on two occasions before the Committee on Science, Space, and Technology, U.S. House of Representatives. These hearings shed light on the Corporation's information security posture and the manner in which the FDIC has responded to Committee requests for information and document productions.

Given the critical significance of the risks in the FDIC's information security environment, we continue to conduct follow-on assignments as well as new work requested by the Chairman of the Senate Banking Committee to address cybersecurity concerns.

The FDIC's Resolution Plan Review Process

As referenced earlier, under current law, Section 165(d) of the Dodd-Frank Act requires bank holding companies with \$50 billion or more in consolidated assets and nonbank financial companies designated by

FSOC to periodically submit to the FDIC, the Federal Reserve Board (FRB), and FSOC, resolution plans that detail how the companies could be resolved in a rapid and orderly manner in the event of material financial distress or failure. The FDIC and FRB then determine whether the plans are complete and credible for achieving that purpose.

The FDIC and the FRB may jointly determine that a plan is not credible or would not facilitate an orderly resolution of the company under the Bankruptcy Code as part of their new authorities. If a company ultimately fails to submit a plan that demonstrates its resolvability in bankruptcy, the FDIC and the FRB may jointly impose more stringent capital, leverage, or liquidity requirements on the company or its subsidiaries. Additionally, the agencies may restrict a firm's growth, activities, or operations.

We assessed the FDIC resolution plan review process for determining whether (1) resolution plans are informationally incomplete and (2) shortcomings exist to the plans' credibility. The FDIC Board of Directors uses information resulting from the resolution plan review process when determining whether the resolution plans are not credible. We judgmentally selected 8 of the 12 resolution plans submitted as of July 1, 2015, and evaluated the resolution plan review process conducted from July 2015 to September 2015.

We reported that the FDIC had established a process and framework for determining whether resolution plans are informationally incomplete and identifying any shortcomings to the plans' credibility. The FDIC also built controls within the process to promote consistency and help ensure that management's program objectives are met. For example, the FDIC provided guidance to the resolution plan reviewers for conducting the completeness and shortcomings assessments. Program controls also included assigning qualified reviewers who had experience with large bank analysis and/or resolution plan reviews; developing relevant training and standardized templates for conducting the plan reviews and documenting the results; and building multiple levels of review and supervision into the review process, including an executive oversight group function.

Based on our review of eight resolution plans, the plan review teams complied with the established framework for conducting completeness and shortcomings reviews, and we concluded the review teams assessed the eight SIFI resolution plans in a consistent manner. In addition, the FDIC met its Dodd-Frank Act requirement for reviewing and notifying the firms of their plans' informational completeness within 60 days of receipt.

FDIC management concurred with the report's conclusions.

The FDIC's Monitoring of Systemically Important Financial Institutions

We issued a third review involving the Dodd-Frank Act related to monitoring SIFIs. In that review, we evaluated the progress the FDIC had made in developing criteria and a process for assessing SIFIs' proximity and speed to default or danger of default so that the FDIC is positioned to undertake necessary preparatory actions for a SIFI resolution.

To fulfill its responsibility, the FDIC has undertaken numerous initiatives, including risk monitoring of larger institutions for which FDIC is not the primary federal regulator. This monitoring includes understanding SIFIs:

- structure, business activities, and resolution/recovery capabilities to inform FDIC resolution planning efforts;
- business activities and risk profiles to gauge both proximity to a resolution event and the speed at which an institution's condition could potentially deteriorate to a resolution event; and
- recovery plans, early warning signals and triggers, escalation, and the range of FDIC remedial actions to be taken should a triggering event occur.

As of June 2016, the FDIC was monitoring 16 SIFIs in its financial institution portfolio with assets over \$13 trillion.

We determined that the FDIC had made steady progress in developing criteria and a process, namely the Systemic Monitoring System (SMS), for assessing the proximity and speed to default for the 16 large and complex SIFIs in the FDIC's portfolio. The SMS gathers and analyzes SIFI supervisory reports and market information using standardized metrics that are then combined with FDIC onsite institution monitoring teams' perspectives and analyses of the risks shown by those metrics. Ultimately, an FDIC committee assesses the indicated risks from institution monitoring team submissions and other sources to assign a quarterly risk rating for each SIFI on its proximity and speed to default. As the proximity to default increases, the FDIC may take a number of actions, including increased monitoring and a resolution strategy refresh.

We made three recommendations relating to improving SMS documentation and independently evaluating the SMS tool's output. Management agreed to take corrective action.

Financial Institution Contracts with Technology Service Providers

Financial institutions (FIs) increasingly rely on technology service providers (TSPs) to provide or enable key banking functions. Every FI has an affirmative and continuing obligation to respect the privacy of its customers and to protect the security and confidentiality of those customers' nonpublic personal information, including when such FI customer information is maintained, processed, or accessed by a TSP. Based on results from two prior evaluations, we determined that greater scrutiny of the sufficiency of TSP contracts with FDIC-supervised institutions was warranted.

We conducted work to assess how clearly FDIC-supervised institutions' contracts with TSPs address the TSP's responsibilities related to (1) business continuity planning and (2) responding to and reporting on cybersecurity incidents. We reviewed a sample of 48 TSP contracts from 19 financial institutions.

Based on our work, we did not see evidence, in the form of risk assessments or contract due diligence, that most of the FDIC-supervised FIs we reviewed fully considered and assessed the potential impact and risk that TSPs may have on the FI's ability to manage its own business continuity planning and incident response and reporting operations. Documentation supported that only 8 of the 19 institutions completed both a risk assessment and contract review to understand the business and legal risks, as recommended by supervisory guidance. Further, when completed, the quality of these assessments varied.

Typically, FI contracts with TSPs did not clearly address TSP responsibilities and lacked specific contract provisions to protect FI interests or preserve FI rights. Contracts also did not sufficiently define key terminology related to business continuity and incident response. As a result, FI contracts with TSPs we

reviewed provided FIs with limited information and assurance that TSPs could recover and resume critical systems, services, and operations timely and effectively if disrupted and would take appropriate steps to contain and control incidents and report them timely to appropriate parties.

In the past 2 years, the FDIC independently and the Federal Financial Institutions Examination Council (FFIEC) members collectively took numerous steps to provide institutions comprehensive business continuity, cybersecurity, and vendor management guidance, and to enhance the FDIC and FFIEC's IT examination programs. We concluded that more time is needed to allow FDIC and FFIEC efforts to have a demonstrable and measureable impact on FI and TSP contract language.

Notwithstanding the FDIC's efforts, we recommended that RMS continue to communicate to FIs the importance of (1) fully considering and assessing the risks that TSPs present, (2) ensuring that contracts with TSPs include specific detailed provisions that address FI-identified risks and protect FI interests, and (3) clearly defining key contract terms that would be important in understanding FI and TSP rights and responsibilities. We also recommended that, at an appropriate time, the FDIC study and assess to what extent FIs have effectively addressed the issues we identified. The FDIC concurred with our recommendations.

FDIC OIG Investigations Target Bank Fraud and Seek to Ensure Integrity

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 many 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 Groups, the Financial Fraud Enforcement Task Force, and numerous Suspicious Activity Report Working Groups.

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, 2017 included 268 active investigations. Of these, 187 related to open bank matters and 47 to closed bank matters. These cases involve fraud and other misconduct on the part of senior bank officials, and include commercial loan and mortgage 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 investigations as of March 31, 2017 included cases involving misrepresentations of FDIC insurance or affiliation, computer crimes, and a small number of FDIC employee cases. 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, 2017 include the following: 104 indictments; 42 arrests; 91 convictions; potential monetary recoveries (fines, restitution, and asset forfeitures) of more than \$117.9 million.

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 have included 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 have also participated in training activities sponsored by the First Information Operations Command of the U.S. Army to better understand the authorities, roles, and responsibilities of the defense and intelligence communities to identify, analyze, and respond to potential cyber threats.

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, contractor personnel, 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



Office of Inspector General

The 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; informing the public; and engaging in robust enforcement efforts to protect the interests of the American taxpayers.

In September 2008, FHFA placed the Enterprises in conservatorship and undertook the extraordinary dual role of supervisor and conservator. Now in their ninth 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 2016, the Enterprises have paid to Treasury approximately \$255.8 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 (MBS) is more than 65 percent. The Enterprises' combined total assets are approximately \$5.3 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 and keep; 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.

Background

In October 2016, we updated our assessment of FHFA's major management and performance challenges. These four challenges are described below:

- **Conservatorship Operations.** Under HERA, the Agency's actions as conservator are not subject to judicial review or intervention, nor are they subject to procedural safeguards that are ordinarily applicable to regulatory activities such as rulemaking. As conservator of the Enterprises, FHFA exercises control over trillions of dollars in assets and billions of dollars in revenue, and makes business and policy decisions that influence and impact the entire mortgage finance industry. For reasons of efficiency, concordant goals with the Enterprises, and operational savings, FHFA has determined to delegate revocable authority for general corporate governance and day-to-day matters to the Enterprises' boards of directors and executive management.
- **Supervision of the Regulated Entities.** As discussed earlier, FHFA plays a unique role as both conservator and regulator for the Enterprises and as regulator for the FHLBank System. Effective supervision by FHFA is fundamental to ensuring the safety and soundness of its regulated entities. Within FHFA, the Division of Federal Home Loan Bank Regulation (DBR) is responsible for supervision of the FHLBank System, and the Division of Enterprise Regulation (DER) is responsible for supervision of the Enterprises. FHFA's supervisory activities include designing a comprehensive, risk-based supervisory strategy (examination planning), conducting on-site examinations (examination execution), and monitoring remediation of deficiencies identified during examinations (oversight). Based on assessments of different elements of DER's supervision program, FHFA OIG identified four recurring themes: (1) FHFA lacks adequate assurance that DER's supervisory resources are devoted to examining the highest risks of the Enterprises; (2) many supervisory standards and guidance issued by FHFA and DER lack the rigor of those issued by other federal financial regulators; (3) the flexible and less prescriptive nature of many requirements and guidance promulgated by FHFA and DER has resulted in inconsistent supervisory practices; and (4) where clear requirements and guidance for specific elements of DER's supervisory program exist, DER examiners-in-charge and examiners have not consistently followed them. Without prompt and robust Agency attention to address the shortcomings, FHFA OIG has cautioned that safe and sound operation of the Enterprises cannot be assumed from FHFA's current supervisory program.
- **Counterparties and Third Parties.** The Enterprises rely heavily on counterparties and third parties for a wide array of professional services, including mortgage origination and servicing. That reliance exposes the Enterprises to counterparty risk—that is, the risk that the counterparty will not meet its contractual obligations. FHFA has delegated to the Enterprises the management of their relationships with counterparties and FHFA reviews that management largely through its regulatory responsibilities. One of the most significant counterparty risks is the risk posed by loan originators and servicers that are not depository institutions (also called nonbanks). As participants in the mortgage market change, counterparties can affect the risks to be managed by Fannie Mae and Freddie Mac. In recent years, the

Enterprises' businesses have changed dramatically in terms of the types of institutions originating and selling mortgages to them and servicing mortgages on their behalf. Both Enterprises report that the share of Enterprise single-family loan purchases from depository institutions has fallen while the share of purchases from nonbanks has risen.

- **Information Technology Security.** Systems security continues to be a preeminent issue for businesses and individuals alike. The regulated entities, like most modern institutions, rely on numerous, complex information technology (IT) systems to conduct almost every aspect of their work. These systems manage processes to guarantee and purchase loans, supporting more than \$5 trillion in Fannie Mae and Freddie Mac mortgage assets. Both Enterprises and the FHLBanks have been the subject of cyber attacks, although none caused significant harm. All of the entities regulated by FHFA acknowledge that the substantial precautions put into place to protect their information systems may be vulnerable and penetration of their systems poses a material risk to their business operations. Further, the Enterprises are increasingly relying on third-party service providers, requiring the sharing of sensitive information between Enterprise and third-party systems.

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

Conservatorship Operations

Update on the Status of the Development of the Common Securitization Platform (COM 2017 001; issued December 9, 2016)

In 2012, FHFA, as the conservator of Fannie Mae and Freddie Mac, directed them to build a Common Securitization Platform (CSP or Platform). As originally envisioned by FHFA, the CSP was intended to provide a platform for multiple market participants to issue MBS in a future housing finance reform system that had yet to be defined. FHFA believed the Enterprises' back-office systems were "outmoded" and assumed that the cost to build the CSP and integrate the Enterprises' legacy financial and IT systems into the Platform would be less than the combined costs for the Enterprises to upgrade their back-office systems. In 2013, FHFA directed the Enterprises to establish and fund a joint venture, Common Securitization Solutions, LLC (CSS), to develop and ultimately operate the CSP.

In May 2014, after extensive discussion within FHFA and with the Enterprises, FHFA concluded that the many variables in the CSP project created extreme risks and determined to de-risk the project by breaking it down into smaller pieces. In its May 2014 Strategic Plan for the Conservatorships, FHFA clarified that the CSP's primary focus would be on supporting the Enterprises' current securitization activities, although the Platform would use standard industry technology and interfaces so that future market participants could connect to it. FHFA also announced three key goals of the conservatorships, one of which was to build a new infrastructure for the Enterprises' securitization functions and enable them to replace their separate MBS with a single, common security that would be issued and serviced via the CSP. According to FHFA, Enterprise issuance of a single common security through the CSP would improve liquidity in the housing finance system.

In a May 2014 evaluation report, we assessed the status of the CSP's development since 2012. Among other things, we found that, as of December 31, 2013, the Enterprises had spent a total of \$65 million on the CSP program. FHFA and the team building the CSP had constructed a Platform prototype, and associated software testing was underway. We also found that FHFA had not adopted schedules and timelines for the completion of the project, and lacked an estimate of the cost to complete the CSP project. We recommended that FHFA take steps to address these limitations in its oversight, and it agreed to do so. In June 2016, we closed our recommendations based on the corrective actions reported by FHFA.

When FHFA announced its revised goals for the CSP in May 2014, FHFA committed to be transparent in its development—a commitment the Agency reaffirmed on several occasions. From May 2014 through early July 2016, FHFA issued a number of public reports in which it discussed the status of the CSP's development.

In view of FHFA's repeated commitment to transparency about the development of the CSP, we reviewed these reports to assess the extent to which they disclosed information about the project's status. We found that FHFA had collected a significant amount of information on the actual and projected costs of the CSP from the Enterprises, and had conducted regular assessments of the risks to successful completion of the CSP. In our view, FHFA has not disclosed this information, even at a high level, in its public reports.

- **Actual and Projected Costs of the CSP.** All of the costs associated with the development of the CSP have been, and will be, borne by the Enterprises. Since 2014, FHFA has collected data from the Enterprises on the costs to develop the CSP and the costs they have incurred to modify their legacy financial and information systems to integrate them into the CSP. We found that FHFA only disclosed specific CSP cost data once in a September 2015 status report, and those reported costs totaled \$146 million to develop the actual CSP Platform. We found that FHFA never reported the costs incurred by the Enterprises from 2012 through 2015 to integrate their legacy systems into the Platform, even though it had collected this data from the Enterprises. These unreported costs are substantially higher than the \$146 million reported by FHFA as the costs to develop the actual Platform.
- **CSP Software Development Risks.** FHFA reported publicly that the Enterprises and CSS were "making progress" in developing and testing the CSP's software. FHFA has not disclosed that since 2014 it has internally rated the risks to CSP's successful development on a monthly basis. These internal reports identify elevated risks facing CSP's development, particularly related to integrating the Enterprises' legacy systems with the Platform.

Management Alert: Need for Increased Oversight by FHFA, as Conservator of Fannie Mae, of the Projected Costs Associated with Fannie Mae's Headquarters Consolidation and Relocation Project (COM 2016 004, issued June 16, 2016)

Fannie Mae Dallas Regional Headquarters Project (OIG 2017 002; issued December 15, 2016)

In response to an anonymous complaint to FHFA OIG's hotline, we conducted a special project review of alleged excessive spending on Fannie Mae's relocation to a new headquarters in downtown Washington, DC. We found that Fannie Mae's budget estimates for the build-out costs for the DC headquarters building—for items such as furnishings and office configurations—increased 53% from the time FHFA approved the project in January 2015 to March 2016. Further, the FHFA office responsible for overseeing the project was unaware of these cost increases. We also found that Fannie Mae's planned expenditures on the project included items

that may not be appropriate for an entity in a taxpayer-supported conservatorship, such as spiral staircases and glass bridges.

We recommended that the Agency take immediate action to ensure that it had adequate internal staff or contractors with the necessary professional expertise and experience to oversee the project, and that it direct Fannie Mae to provide regular updates and formal budgetary reports for Agency approval through the design and construction process. The Agency accepted our recommendations.

Similarly, our review of the facts involving consolidation and relocation of Fannie Mae's offices in the Dallas metro area found a lack of oversight by FHFA as to the reasonableness of budgeted build-out costs for the project, and we questioned \$24.2 million in budgeted build-out costs for the building leased by Fannie Mae in Plano, Texas, for its consolidated offices in the Dallas metro area.

Here, FHFA, as conservator, delegated to Fannie Mae the authority to consolidate and relocate its Dallas metro offices. Fannie Mae's presence in the Dallas metro area is significant: its Dallas metro offices are the second largest of the Fannie Mae offices and employ approximately 2,000 full-time employees and contractors. Fannie Mae determined to consolidate these offices and relocate to leased space in a new building in Plano, and its budget for the build-out of this leased space is \$234.02/square foot. Although the cost of living in Plano is 31.3% lower than in the D.C. metro area, Fannie Mae's budgeted build-out of its leased space in Plano is virtually identical to its budgeted build-out costs of \$235.35/square foot for its D.C. headquarters.

FHFA's delegation of authority does not relieve FHFA of responsibility to obtain adequate information to satisfy itself that Fannie Mae is properly exercising that delegated authority. We found that FHFA lacks any basis on which to determine whether Fannie Mae's current budget for its build-out costs in Plano is reasonable for an entity in conservatorship.

The expert consultant retained by FHFA to assist in overseeing both Fannie Mae's build-out of its new headquarters in D.C., and its leased space in Plano, questioned the basis for Fannie Mae's budgeted build-out costs for Plano, but was directed by FHFA to focus its attention on the build-out of its D.C. corporate headquarters. Absent review by FHFA, we believe that the same significant financial and reputational risks that we identified in connection with Fannie Mae's build-out of its headquarters space in D.C. attach to its build-out of its Plano space.

Supervision of the Regulated Entities

Safe and Sound Operation of the Enterprises Cannot Be Assumed Because of Significant Shortcomings in FHFA's Supervision Program for the Enterprises (OIG 2017 003; issued December 15, 2016)

As FHFA recognizes, effective supervision of the entities it regulates is fundamental to ensuring their safety and soundness. Between July 2015 and September 2016, FHFA OIG published 12 evaluation, audit, and compliance review reports in which we assessed different critical elements of DER's supervision program for the Enterprises. These elements included:

- DER's assessment of risks at the Enterprises and documentation of those risks in semiannual risk assessments;

- DER's plan for each annual supervisory cycle, based on the results of its risk assessments, and risk-related changes and updates to that plan;
- DER's planned examination procedures for its supervisory activities, which are designed to identify the objectives of the activity and describe the examination steps to be performed, including sampling and testing;
- DER's communication of its findings from its supervisory activities, including its supervisory concerns, to each Enterprise's board of directors;
- DER's follow-up on efforts by each Enterprise to correct identified deficiencies throughout the remediation period to ensure that remediation is timely and adequate; and
- DER's communication of its examination conclusions, findings, and composite/component examination ratings after the end of each annual supervisory cycle to each Enterprise board of directors in a written Report of Examination (ROE).

For each element that we assessed, we found shortcomings and recommended actions to address these shortcomings and upgrade DER's supervisory activities. We published reports setting forth the facts, findings, conclusions, and recommendations on each of these critical elements. FHFA steadfastly maintains that its supervision of the Enterprises is effective and ensures their safe and sound operation. In our view, our evaluation, audit, and compliance review reports, when read together, call into question the effectiveness of FHFA's supervision program for the Enterprises.

Based on our assessments of different elements of DER's supervision program, we identified four recurring themes and published a roll-up report identifying and discussing the themes we identified in the course of 12 evaluation, audit, and compliance review reports. In that roll-up, we discuss each of the following themes:

1. FHFA lacks adequate assurance that DER's supervisory resources are devoted to examining the highest risks of the Enterprises.

Among our findings was that FHFA had difficulty completing its planned targeted examinations over four supervisory cycles from 2012 through 2015 and that the number of targeted examinations planned and completed during each supervisory cycle has fallen since 2012 for Freddie Mac and has diminished significantly for Fannie Mae. We found that DER did not conduct more than half of the targeted examinations it planned for Fannie Mae between 2012 and 2015 and did not conduct slightly less than half of the targeted examinations it planned for Freddie Mac for that same period. We also found that no targeted examinations of Fannie Mae planned for the 2015 supervisory cycle were completed before the annual ROE was issued.

In addition, DER's practices for assessing Enterprise risks called into question the utility of the risk assessments and the basis on which priorities are assigned to planned targeted examinations. Almost half of DER's planned high-priority targeted examinations for 2014 and 2015 could not be traced to underlying risk assessments, and none of the risk assessments supported the priority assigned to planned targeted examinations. Further, DER failed to implement its commission program to develop a corps of commissioned examiners with the necessary technical competencies and practical examination experience to lead risk-based examinations.

2. Many supervisory standards and guidance issued by FHFA and DER lack the rigor of those issued by other federal financial regulators.

FHFA's statutory supervisory obligations are similar to the obligations imposed on the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Federal Reserve), and the Federal Deposit Insurance Corporation, and FHFA has been afforded the same legal privileges as federal banking regulators. We found, however, that FHFA's requirements and guidance are less prescriptive and more flexible than the other federal financial regulators for a number of elements of DER's supervision program and FHFA has offered no reason to explain why its requirements and guidance should be less robust than those of its peer regulators. FHFA has consistently rejected our recommendations to revise its requirements and guidance to align them with those adopted by other federal financial regulators.

3. The flexible and less prescriptive nature of many requirements and guidance promulgated by FHFA and DER has resulted in inconsistent supervisory practices.

The determination by FHFA and DER to refrain from adoption of defined requirements and comprehensive standards for structuring and communicating ROEs, preparing risk assessments, and following up on Enterprise correction of identified deficiencies leaves the execution of these elements to the discretion of the Examiners-in-Charge (EICs) and examiners. We found that exercise of discretion has resulted in a lack of consistency in supervisory practices for these elements.

4. Where clear requirements and guidance for specific elements of DER's supervisory program exist, DER EICs and examiners have not consistently followed them.

Our assessments found that DER EICs and examiners, in contravention of requirements issued by FHFA and DER: revised supervisory plans without risk-related reasons; failed to create and maintain complete supervisory documentation in the official system of records; failed to ensure issuance of the annual ROEs to Enterprise directors and obtain written affirmations that supervisory concerns will be addressed; and did not consistently conduct and document independent assessments of the Enterprises' remediation activities during the period of ongoing remediation. Further, DER did not establish a comprehensive quality control review process for examinations over a four-year period, including two years in which the Division was required to do so by Agency directive. Taken together, these practices demonstrate a lack of commitment to follow established requirements.

Although FHFA asserted in its management responses that it was generally receptive toward our recommendations, it rejected a number of them and did not propose alternative corrective actions for most of the recommendations it rejected. Given FHFA's disagreement with a number of our recommendations to correct shortcomings identified in our reports as well as its unwillingness to propose alternative corrective actions, it was our view that these elements of DER's supervisory program remained deficient. It remains to be seen whether the corrective actions that FHFA has agreed to take to address other shortcomings identified by us will, in fact, be implemented effectively.

Together, and as mentioned above, the Enterprises own or guarantee approximately \$5 trillion in mortgages and are among the largest financial institutions in this country. Should either or both Enterprises sustain losses in the future that exceed their decreasing capital reserves, the Treasury—and the American taxpayers—will be on the hook for those losses. Pursuant to HERA, FHFA is charged with ensuring the safety and soundness

of the Enterprises. Without prompt and robust Agency attention to address the shortcomings we have identified, we cautioned stakeholders that the safe and sound operation of the Enterprises could not be assumed from FHFA's supervisory program.

Other regulators have sought the assistance of independent third parties in assessing the effectiveness of their supervision programs. In 1997 and again in 2009, the Federal Reserve Bank of New York retained an outside independent expert to assess the effectiveness of its supervisory procedures and its internal processes to understand and foresee systemic problems and undertook internal initiatives to improve its practices and procedures. In 2013, the OCC asked a team of international regulators to provide an independent perspective on the OCC's approach to the supervision of large and midsize banks and thrifts and, based on that team's recommendations, the OCC reorganized its supervision programs and instituted practices designed to foster better communication and assessment of risks, among other things. FHFA has acknowledged that it considers the guidance and examination practices of its peer financial regulators when developing its own guidance and requirements. In view of FHFA's unwillingness to accept a number of FHFA OIG recommendations to address shortcomings in critical elements of DER's supervision program, we concluded that it would be prudent for FHFA to follow the lead of the Federal Reserve Bank of New York and the OCC and engage independent external experts to review different critical elements of DER's supervision program.

The Agency stated that it would continue to pursue the corrective actions to which it previously agreed and consider additional ways to make its supervision program more effective and efficient.

Counterparties and Third Parties

FHFA's Examinations Have Not Confirmed Compliance by One Enterprise with its Advisory Bulletins Regarding Risk Management of Nonbank Sellers and Servicers (EVL 2017 002, issued December 21, 2016)

The Enterprises carry out their statutory mission to provide stability and liquidity to the secondary mortgage market by, in large part, purchasing mortgage loans from banks and other lenders that originate them. The Enterprises did not originate and do not service the over \$5 trillion in loans they hold or are exposed to in mortgage-backed securities. Instead, the Enterprises rely upon third parties for loan origination and servicing, according to standards and guidelines set by the Enterprises.

Since 2010, the role of nonbanks—non-depository firms unaffiliated with commercial banks—in selling and servicing single-family mortgages has increased dramatically. While nonbanks originated less than 10% of the mortgages purchased by the Enterprises in 2010, the nonbank share of mortgages purchased in 2015 increased to almost 50%. On the servicing side, the nonbank share of mortgages held by the Enterprises saw similar growth, increasing five-fold between 2010 and 2015 from 7% to almost 35%.

The increase in nonbank sellers and servicers has yielded increased risk. Between 2012 and 2016, both the Enterprises and FHFA have acknowledged several risk factors associated with nonbank seller/servicers, including the lack of a federal prudential regulator, potential liquidity and financial strength issues, and operational problems caused by rapid acquisitions of servicing portfolios and the higher costs associated with servicing delinquent loans.

FHFA has issued three advisory bulletins setting forth its supervisory expectations for Enterprise oversight of mortgage sellers and servicers, whether depository institutions or nonbanks. In this evaluation, we assessed FHFA's efforts to determine whether the Enterprises' practices were in compliance with these advisory bulletins regarding risk management of nonbank seller/servicers.

We found that DER conducted supervisory activities to assess whether one Enterprise's practices comply with the supervisory expectations set forth in the three advisory bulletins. We further found that DER examined the other Enterprise's compliance with only one of the advisory bulletins. DER conducted no supervisory activities to determine that Enterprise's compliance with the other two advisory bulletins and, as a result, issued no findings or conclusions related to its compliance.

We also reviewed DER's supervisory plan for 2016 and found no targeted examinations that would position DER to reach conclusions regarding whether the second Enterprise's practices comply with the supervisory expectations set forth in these two advisory bulletins. Although DER is conducting limited ongoing monitoring of the Enterprise's risk management related to seller/servicers, these activities are not specific to nonbank seller/servicers and do not identify nonbank risk management as a focus area.

Identifying and communicating supervisory expectations does not meet the goal of safety and soundness if an Enterprise fails to meet those expectations. Absent sufficient examination work, FHFA does not have assurance that the Enterprises have met its expectations and are exercising sufficient risk management with respect to nonbank seller/servicers.

Based on our findings, we recommended that FHFA conduct examination activities necessary to determine whether the Enterprise's risk management of nonbank seller/servicers satisfies FHFA's supervisory expectations as expressed in its advisory bulletins. FHFA generally agreed with this recommendation. FHFA's response, however, did not commit the Agency to complete the specific actions described in our recommendation. Given the Agency's statement that it "generally agree[s]" with our recommendation, we are treating its response as an agreement to implement the recommendation as written.

Information Technology Security

Kearney & Company, P.C.'s Results of the Federal Housing Finance Agency's Cybersecurity Act Audit (AUD 2016 004; issued August 11, 2016)

In addition to cybersecurity being an challenge for the regulated entities, FHFA, as a federal financial regulator maintaining sensitive information about the regulated entities and other matters in its systems, must also maintain a strong security posture against cyber attacks.

The Cybersecurity Act of 2015 required FHFA OIG to report to Congress on FHFA computer systems that provide access to personally identifiable information (PII). We contracted with the independent certified public accounting firm of Kearney & Company, P.C. (Kearney) to conduct a performance audit to meet this reporting requirement.

In its audit, Kearney concluded FHFA has established and implemented the required privacy controls according to National Institute of Standards and Technology (NIST) Special Publication (SP) 800-53, Revision 4, *Security and Privacy Controls for Federal Information Systems and Organizations*, for "moderate" impact systems as of June 30, 2016. Additionally, FHFA has satisfied the NIST SP 800-53 required privacy controls for six

reviewed systems and has implemented a combination of preventive and detective security controls (e.g., network firewalls, encryption, intrusion detection systems, etc.) to protect sensitive information such as PII.

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, analysts, and attorney advisors. OI conducts criminal and civil investigations into those, whether inside or outside of government, who waste, steal, or abuse government monies in connection with programs and operations of the Agency and the GSEs. Depending on the type of misconduct uncovered, OI 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, restitutions, fines, and penalties. Civil claims can lead to settlements or verdicts with restitutions, fines, penalties, forfeitures, assessments, and exclusion of individuals or entities from participation in federal programs. Four of FHFA OIG's attorney-investigators 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, which has contributed to an increase in FHFA OIG's effectiveness.

CIVIL CASES

OI continued to actively participate in residential mortgage-backed securities (RMBS) investigations. In 2012, an RMBS Working Group was created to investigate individuals and entities responsible for misconduct involving the pooling of mortgage loans and sale of RMBS. During the reporting period OI special agents continued to work closely with U.S. Attorneys' offices around the country and with a state attorney general to investigate allegations of fraud committed by financial institutions and individuals in connection with RMBS. FHFA OIG, as the lead investigating agency on RMBS frauds, has conducted its investigatory activities through OI. OI special agents and attorneys have 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 \$51 billion.

During this reporting period, Goldman Sachs agreed to pay \$5.06 billion to resolve claims related to its conduct in the marketing, sale, and issuance of RMBS; Société Générale, SA, agreed to pay a \$50 million civil monetary penalty, acknowledge certain false statements or representations made to investors, including Fannie Mae, Freddie Mac, and federally insured financial institutions, and cooperate fully with the Department of Justice in all future investigations and any prosecution arising out of the conduct covered by the agreement; Credit Suisse agreed to pay \$5.28 billion related to its conduct in the packaging, securitization, issuance, marketing, and sale of RMBS between 2005 and 2007; Deutsche Bank agreed to pay \$7.2 billion—the single largest RMBS resolution for the conduct of a single entity—to resolve federal civil claims that it misled investors in the packaging, securitization, marketing, sale, and issuance of RMBS between 2006 and 2007; and Ally Financial Inc. agreed to pay the United States \$52 million to settle allegations that its subsidiaries acted improperly in relation to 10 subprime RMBS in 2006 and 2007.

CRIMINAL CASES

Trial Conviction of Former CFO Of Resort and Indictment of Former JP Morgan Chase Bank Officer In Connection with Multi-Million Dollar Fraud, Florida

Last year, we reported that in December 2015, Fred Davis “Dave” Clark Jr., former Chief Executive Officer 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). 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.

During this period, in March 2017, former Cay Clubs Resorts Chief Financial Officer (CFO) David Schwarz was convicted after a jury trial on charges of conspiracy to commit bank fraud, bank fraud, and interference with the administration of Internal Revenue laws.

Schwarz was CFO and partial owner of the Cay Clubs Resorts which 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. Cay Clubs Resorts incentivized investors by promising an upfront “leaseback” payment of 15-20% of the unit sales price at the time of closing. These incentives were concealed from the lenders and the Enterprises.

As the Cay Clubs enterprise experienced financial difficulties, Schwarz conspired with others at Cay Clubs to recruit insiders as straw buyers to obtain mortgages on Cay Clubs condominiums. The loan proceeds were then diverted to the failing Cay Clubs company and to pay out investor leaseback payments.

In a related case, in December 2016, Ross Pickard was indicted on charges of conspiracy and loan and credit application fraud for his role in this scheme. According to the indictment, Pickard was a senior loan officer at JP Morgan Chase Bank. He allegedly conspired with others in a scheme to defraud the bank by completing, certifying, and submitting mortgage loan applications on behalf of borrowers that contained false and fraudulent statements. The alleged false statements included, but were not limited to, false occupancy, overinflated income and assets, as well as the understated liabilities. By relying on Pickard’s false and fraudulent statements on the loan applications, JP Morgan Chase was induced into funding mortgage loans for otherwise unqualified borrowers.

The fraud scheme caused losses to Fannie Mae and Freddie Mac in excess of \$11 million.

24 Year Prison Sentence in Mortgage Fraud Scheme, Colorado

In October 2016, Jose Ricardo Sarabia-Martinez was sentenced to 288 months in prison followed by 5 years of parole and in March 2017, he was ordered to pay \$951,571 in restitution, jointly and severally, for his role in a fraud scheme.

Sarabia-Martinez and others used their status as professionals in the real estate industry to facilitate a mortgage fraud scheme. Sarabia-Martinez and co-defendants collaborated to fraudulently acquire loans on behalf of victim straw buyers. Eventually the borrowers defaulted, resulting in foreclosure of their homes and the destruction of their credit. The investigation of this fraud scheme identified 12 properties and \$4.6 million in fraudulent loans acquired for securitization by the Enterprises and others.

Three Indicted in Multi-State Loan Modification Scheme with Over 550 Victims, Kansas

In November 2016, Tyler Korn, Amjad Daoud, and Ruby Price were indicted on charges of conspiracy to commit mail and wire fraud, and mail fraud for their roles in a loan modification/foreclosure rescue scheme. Korn and Price were additionally charged with wire fraud.

Korn and Daoud operated Reliant Home Financial Group, and Price operated the Arize Group, Incorporated. Together, they allegedly devised a scheme to defraud homeowners with false promises of protecting them from foreclosure. The indictment alleges the defendants fraudulently promised the victims to lower their interest rates, lower their monthly mortgage payments, and help them obtain loan modifications. When victims received foreclosure notices, the defendants allegedly advised them not to worry about it. In some instances, the victims would stop making their monthly mortgage payments to their lenders and instead, make payments to Reliant Home Financial Group or Arize Group, Incorporated. The co-conspirators allegedly used the victims' monies for personal gain.

To date, over 550 victims have been identified in 24 states. The victims suffered approximately \$1,271,640 in direct monetary loss; this loss does not include additional fees paid by victims to their lenders or losses to lenders caused by subsequent foreclosures.

Former Bank Employees Indicted and Pled Guilty in Bank Fraud Scheme; Fraudulent Mortgage Applications Totaled At Least \$19.4 Million, Washington

In January 2017, four former employees of PC Bank Home Loans (PCBHL), the mortgage lending branch of Pierce Commercial Bank (PCBank), were indicted for their alleged roles in a large scale bank fraud scheme. Sam Tuttle, former vice president and loan officer, Benjamin Leske, former loan officer, Angela Crozier, former senior loan processor, and Ed Rounds, former loan officer, were indicted for conspiracy to make false statements on loan applications and to commit bank fraud, and bank fraud.

PCBHL offered mortgage loans to borrowers and assisted borrowers with their loan applications. The mortgages originated by PCBHL were funded by its parent, PCBank. In turn, PCBank sold the mortgages to financial institution investors. The investors relied on the representations made by borrowers in the loan application prepared by PCBHL.

Tuttle, Leske, Crozier, Rounds, and other co-conspirators allegedly defrauded PCBank and investors by facilitating the submission of fraudulent loan applications to PCBank. According to the indictment, the misrepresentations included inflated appraisals, fake employment histories and rental agreements, and false statements regarding loan applicant's intentions to live in the homes as their primary residences. As a result of their intentional submission of false documents, the co-conspirators caused PCBank to personally enrich themselves with salaries, commissions, fees, and bonuses. During their employment at PCBHL, the co-conspirators originated fraudulent loans of at least \$19.4 million. Many of the borrowers defaulted on the loans resulting in large losses which contributed to the eventual failure of PCBank, a member bank of the FHLBank of Seattle. At the time of its failure, PCBank had more than \$17 million in outstanding advances with the FHLBank of Seattle. The Enterprises, as owners of some loans involved in this scheme, suffered additional losses.

During March 2017, Tuttle and Rounds pled guilty to bank fraud for their roles in this scheme.

In a related case, during January 2017, Craig Meyer, a former vice president and loan officer at PCBHL, pled guilty to making false statements in a loan application.



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. By promoting better stewardship and accountability, HUD OIG staff ensures that we have a lasting, positive impact on the Department and our communities for the benefit of the American people.

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 \$46.9 billion annual congressional appropriation.

In addition, within HUD are the Federal Housing Administration (FHA) and Government National Mortgage Association (Ginnie Mae). FHA provides mortgage insurance for single-family homes, multifamily properties, nursing homes, and hospitals. FHA is self-funded through mortgage insurance premiums and receives limited congressional funding. FHA generated more than \$1.2 trillion in insured loans in fiscal year 2016, and Ginnie Mae securitized more than \$1.73 trillion in mortgage-backed securities. The majority of the mortgage-backed securities are FHA-insured 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, HUD's Office of Public and Indian Housing, the U.S. Department of Veterans Affairs, 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 and Ginnie Mae's systems and infrastructure to adequately meet their requirements and perform their services.

These concerns were also expressed by OIG to FHA and Ginnie Mae 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, after 6 years of being below the statutorily required minimum capital ratio of 2 percent, the FHA Mutual Mortgage Insurance Fund has 2 years of being above the required minimum.

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 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 and beyond.

In recent years, HUD OIG has enhanced its efforts to identify and investigate civil fraud and pursue civil actions and administrative sanctions, frequently combining efforts from its multiple disciplines to create teams of auditors, special agents, attorneys, and data analysts to conduct civil investigations. The central hub to these efforts is HUD OIG's Joint Civil Fraud Division, a distinct team of forensic auditors and special agents dedicated to investigating major civil fraud and pursuing civil and administrative remedies.

HUD OIG's joint civil fraud teams work closely with the U.S. Department of Justice, U.S. Attorney's Offices, HUD's Office of General Counsel and Office of Single Family Housing staff, and local prosecutors to pursue civil remedies under a variety of statutes and regulations, including the False Claims Act; Program Fraud Civil Remedies Act; and Financial Institutions Reform, Recovery, and Enforcement Act. HUD OIG also works with HUD's Departmental Enforcement Center to pursue debarments, suspensions, and limited denials of participation when appropriate.

HUD OIG's efforts, in conjunction with those of other enforcement groups, result in civil outcomes that are meant to help HUD recover from unwarranted financial damages sustained due to fraud.

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

- HUD OIG's Joint Civil Fraud Division recovered more than \$1.58 billion in settlement agreements from lenders.
- For the third year, OIG issued a disclaimer of opinion on Ginnie Mae's fiscal years 2015 and 2016 financial statements.
- Four examples are included of Office of Investigation completed mortgage fraud cases.
- The Office of Evaluation issued a brief on the ever-increasing number of nonbanks as Ginnie Mae issuers.

Joint Civil Fraud

Wells Fargo

On April 8, 2016, Wells Fargo entered into a settlement agreement with the United States. Wells Fargo admitted, acknowledged, and accepted responsibility for, among other things, submitting to HUD certifications stating that certain loans were eligible for FHA mortgage insurance when they were not and not reporting to HUD the majority of the FHA loans that its internal quality assurance reviews had identified as having material findings. Wells Fargo agreed to pay to the Government \$1.2 billion, of which FHA was to receive \$642 million. (Memorandum: 2016-KC-1803; Office of Audit Region 7-8-10, Office of Investigation Region 2, and Joint Civil Fraud Division)

Freedom Mortgage Corporation

HUD OIG assisted the U.S. Department of Justice, Washington, DC, and the U.S. Attorney's Office, District of New Jersey, in the civil investigation of Freedom Mortgage Corporation. Freedom has its principal place of business in Mount Laurel, NJ, and became an FHA-approved direct endorsement lender in 1993. As a direct endorsement lender, Freedom 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.

On April 15, 2016, Freedom entered into a settlement agreement with the Federal Government to pay \$113 million to avoid the delay, uncertainty, inconvenience, and expense of lengthy litigation. As part of

the settlement, Freedom agreed that it engaged in certain conduct in connection with its origination, underwriting, quality control, self-reporting of loans with unacceptable risk, certification of compliance with program requirements, and endorsement of certain single-family residential mortgage loans insured by FHA. The settlement was neither an admission of liability by Freedom nor a concession by the United States that its claims were not well founded. Of the total settlement of \$113 million, HUD FHA will receive \$76 million. (Memorandum: 2016-CF-1806; Joint Civil Fraud Division and various Office of Investigation regions)

Franklin American Mortgage Company

HUD OIG assisted the U.S. Department of Justice, Washington, DC, and the U.S. Attorney's Office, District of Colorado, in the civil investigation of Franklin American Mortgage Company. Franklin American has its principal place of business in Franklin, TN. Franklin American became an FHA-approved direct endorsement lender in 1995. As a direct endorsement lender, Franklin American 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 a borrower defaults on an FHA-insured loan underwritten and endorsed by a direct endorsement lender, such as Franklin American, the lender (or its representative) has the option of submitting a claim to HUD to compensate the lender for any loss sustained as a result of the default. Therefore, once a mortgage loan is endorsed for FHA insurance, HUD insures the risk of the borrower's defaulting on that mortgage, which is realized if an insurance claim is submitted.

On December 2, 2015, Franklin American entered into a settlement agreement with the Federal Government to pay \$70 million to avoid the delay, uncertainty, inconvenience, and expense of lengthy litigation. As part of the settlement, Franklin American agreed that it engaged in certain conduct in connection with its origination, underwriting, and quality control of certain single-family residential mortgage loans insured by FHA. The settlement was neither an admission of liability by Franklin American nor a concession by the United States that its claims were not well founded. (Memorandum: 2016-CF-1801; Joint Civil Fraud Division and various Office of Investigation regions)

Manufacturers and Traders Trust Company

HUD OIG assisted the U.S. Department of Justice, Washington, DC, and the U.S. Attorney's Office, Western District of New York, in the civil investigation of Manufacturers and Traders Trust Company, also known as M&T Bank. M&T Bank has its principal place of business in Buffalo, NY. On March 19, 2013, a former employee of M&T Bank filed a civil complaint, alleging improprieties in M&T Bank's loan origination and underwriting practices in violation of the False Claims Act. Based on further investigation, the Government alleged that M&T Bank submitted false certifications to HUD concerning compliance with program rules and certain endorsed loans between January 2006 and December 31, 2011, in violation of these rules.

On May 9, 2016, M&T Bank entered into a settlement agreement with the Government to pay \$64 million to avoid the delay, uncertainty, inconvenience, and expense of lengthy litigation. As part of the settlement, M&T Bank agreed that it engaged in certain conduct in connection with its origination, underwriting, property appraisal, and quality control of certain single-family residential mortgage loans insured by FHA. The settlement was neither an admission of liability by M&T Bank nor a concession by the United States that its claims were not well founded. Of the total settlement of \$64 million, HUD FHA will receive \$43.35 million. (Memorandum: 2016-CF-1804; Joint Civil Fraud Division and Office of Investigation Region 5)

Regions Bank

HUD OIG assisted the U.S. Department of Justice, Washington, DC, and the U.S. Attorney's Office for the Middle District of Florida in a civil investigation of Regions Bank. Regions Bank has its principal place of business in Birmingham, AL, and became an FHA-approved direct endorsement lender in 1985. As a direct endorsement lender, Regions 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.

On September 13, 2016, Regions Bank entered into a settlement agreement with the Federal Government to pay \$52.4 million to avoid the delay, uncertainty, inconvenience, and expense of lengthy litigation. As part of the settlement, Regions Bank agreed that it engaged in certain conduct in connection with its origination, underwriting, and quality control of certain single-family residential mortgage loans insured by FHA. The settlement was neither an admission of liability by Regions Bank nor a concession by the United States that its claims were not well founded. Of the total settlement of \$52.4 million, HUD FHA was to receive \$37.7 million, and the remaining portion will be paid to other Federal entities. (Memorandum: 2016-CF-1811; Joint Civil Fraud Division and Office of Investigation Regions 4 and 6)

Branch Banking and Trust Company

HUD OIG assisted the U.S. Department of Justice, Washington, DC, and the U.S. Attorney's Office of the Northern District of Georgia in the civil investigation of Branch Banking and Trust Company (BB&T). BB&T's principal place of business is in Winston-Salem, NC. Based in part on OIG's review, the Federal Government alleged that BB&T violated the False Claims Act when it originated and underwrote certain FHA mortgage loans that did not meet applicable requirements. The Federal Government also alleged that BB&T did not maintain a quality control program that complied with requirements.

On September 29, 2016, BB&T entered into a settlement agreement with the Federal Government to pay \$83 million to avoid the delay, uncertainty, inconvenience, and expense of lengthy litigation. As part of the settlement, BB&T agreed that it engaged in certain conduct in connection with its origination, underwriting, and quality control of single-family residential mortgage loans insured by FHA. The settlement was neither an admission of liability by BB&T nor a concession by the United States that its claims were not well founded. Of the total \$83 million settlement, HUD FHA was to receive \$35.7 million, and the remaining portion will be paid to other Federal entities. (Memorandum: 2016-AT-1802; Office of Audit Region 4 and Joint Civil Fraud Division)

Ginnie Mae's Disclaimer for the Third Consecutive Year

In fiscal year 2016, for the third consecutive year, HUD OIG was unable to obtain sufficient and appropriate evidence to express an opinion on the fairness of the \$4.2 billion (net of allowance) in nonpooled loan assets from Ginnie Mae's defaulted issuers' portfolio as of September 30, 2016. Ginnie Mae also continued to improperly account for FHA reimbursable costs as an expense instead of capitalizing them. The combination of these unresolved issues for a number of years was both material and pervasive because it impacted multiple financial statement line items across all of Ginnie Mae's basic financial statements. As a result of the scope limitation in OIG's audit work and the effects of material weaknesses in internal control, OIG has

not been able to obtain sufficient and appropriate evidence to provide a basis for an audit opinion on Ginnie Mae's fiscal years 2016 and 2015 (restated) financial statements. A combination of internal control weaknesses in financial reporting and continued financial management governance issues contributed to these deficiencies. OIG identified four material weaknesses, one significant deficiency, and one reportable noncompliance with selected provisions of laws and regulations.

Again, the overall 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 OIG's audit work and the effects of material weaknesses in internal control, OIG continues being unable to obtain sufficient evidence to provide a basis for an audit opinion on Ginnie Mae's fiscal year 2016 financial statements. Accordingly, OIG did not express an opinion. In addition, OIG identified four material weaknesses and one significant deficiency. Ginnie Mae's inadequate monitoring, oversight, and governance of its accounting and reporting functions by its executive management team and its inability to track accounting transactions and events at a loan level due to system limitations were all factors contributing to these issues.

Office of Investigation's Fiscal Year 2016 Examples of Closed Mortgage Fraud Cases

Case Number: 2010MA000441I

Seven employees of an FHA-insured lender were sentenced in U.S. District Court for their earlier guilty pleas to conspiracy and wire fraud for their roles in a mortgage fraud conspiracy. Collectively, the defendants were sentenced to a total of 17 years' probation and ordered to pay almost \$57 million in restitution to FHA. The employees participated in a mortgage fraud scheme by accepting, processing, and submitting fraudulent loan applications for as many as 189 FHA-insured mortgages that contained false information pertaining to borrower income, assets, employment, rental payments, and other credit worthiness documentation.

Case Number: 2010CP002749I

Five codefendants were sentenced in U.S. District Court following their convictions of mail fraud, wire fraud, and conspiracy. Collectively, the defendants were sentenced to 10 years in jail and ordered to pay more than \$1.8 million in restitution to FHA and \$3.1 million to various victims. The codefendants recruited individuals to purchase renovated houses owned by development companies and falsified income and asset information in order for borrowers to qualify for the home loans. The defendants then received substantial payments from the proceeds of the sales.

Case Number: 2015MW000495I

In a civil judgement filed in U.S. District Court, the founder of a mortgage company was ordered to pay the government \$10.3 million for violations of the False Claims Act. The owner submitted false verification forms stating that the HUD-approved loan correspondent was not involved in any proceeding "that could result in or has resulted in a criminal conviction, debarment, limited denial of participation, suspension or civil monetary penalty," when he was under indictment at the time. FHA realized losses of more than \$3.4 million when 237 FHA-insured loans defaulted.

Case Number: 2015NE001006I

Seven employees of a mortgage modification company were sentenced in U.S. District Court in connection with earlier guilty pleas to conspiracy to commit mail fraud, wire fraud, and misprision of a felony. Collectively, the defendants were sentenced to more than 26 years imprisonment and ordered to pay more than \$2.4 million in restitution to the victims. The defendants jointly operated a series of California-based companies that falsely purported to provide home loan modification services to numerous homeowners in exchange for upfront fees. To induce homeowners to pay these fees, the defendants told the homeowners they had been approved for modifications on extremely favorable terms, the modification already had been negotiated with the homeowner's lenders, and they would receive financial assistance under various government relief programs. None of those promises were true, and few homeowners received any type of mortgage loan modification through the defendants' companies.

Office of Evaluation Brief on the Ever-Increasing Number of Nonbanks as Ginnie Mae Issuers

As of fiscal year 2016, Ginnie Mae's mortgage-backed securities portfolio exceeded 1.73 trillion. Through these mortgage-backed securities, Ginnie Mae facilitates capital inflows to the U.S. housing market. Since 2010, Ginnie Mae's RPB has grown by approximately 62 percent. During this time, Ginnie Mae's business has increasingly relied on nonbanks, which now represent a majority of issuances annually.² As OIG and Ginnie Mae have previously noted, the increase in the number of nonbank issuers and their complexity present a challenge for monitoring efforts. OIG is highlighting monitoring challenges so HUD leadership is aware of and can be better prepared to address them. It is imperative that Ginnie Mae has the appropriate staffing with the skills, knowledge, and abilities to monitor nonbanks. OIG is focusing on Ginnie Mae's capacity to monitor nonbanks with an ongoing audit.

During preliminary work, OIG found that Ginnie Mae's organizational structure and staff levels have not kept pace with the growth and changes in the mortgage industry. OIG believes this poses a greater risk to Ginnie Mae's ability to properly monitor and mitigate the risks posed by nonbanks than whether its compliance reviews ensure that nonbank issuers service loans in accordance with its rules and requirements. If the final audit results confirm this condition, it will correspond with the finding of a fall 2016 study self-initiated by Ginnie Mae.³

2 The U.S. Government Accountability Office has defined banks as "bank holding companies, financial holding companies, savings and loan holding companies, insured depository institutions, and credit unions, including any subsidiaries or affiliates of these types of institutions." Nonbanks are any other entities.

3 KPMG LLP conducted a business process reengineering study and delivered its results to Ginnie Mae on September 26, 2016. KPMG concluded that understaffing creates "...an impaired ability for Ginnie Mae to monitor its Issuers for sources of risk that could impair investor confidence in the Ginnie Mae Mortgage-Backed Security (MBS), to resolve Issuer failures effectively and with minimal cost and disruption, and to support the government mortgage finance system by allowing a competitive market to flourish." KPMG found that contractors account for 68 percent of the full-time employees performing Ginnie Mae core competencies and 84 percent of all Ginnie Mae full-time employees. When KPMG benchmarked Ginnie Mae staffing, KPMG determined that the Ginnie Mae workforce difference, when compared to similarly situated entities, was 582, meaning that Ginnie Mae staffing would be approximately 1,434 rather than 852 if it were staffed at a level comparable to similarly situated entities.

Beyond this audit, OIG will regularly collect and analyze data to focus on Ginnie Mae's most pressing challenges. OIG analytics are intended to identify trouble spots before they become a situation, as was seen when Ginnie Mae was required to acquire and manage a multi-billion-dollar defaulted issuers' portfolio, Taylor, Bean & Whitaker, which is a noncore segment of Ginnie Mae's business. OIG looks forward to continuing a respectful and productive relationship that maintains its independence, while furthering its role in helping HUD and Ginnie Mae identify risks and overcome challenges to their missions.

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 HUD 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 (Share Insurance Fund). The agency also manages the Operating Fund,⁴ the Temporary Corporate Credit Union Stabilization Fund,⁵ the Community Development Revolving Loan Fund,⁶ and the Central Liquidity Facility.⁷

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 Share Insurance Fund, a federal fund backed by the full faith and credit of the United States government.

The agency'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, NCUA is further dedicated to upholding the integrity, objectivity, and independence of credit union oversight. The agency continually implements initiatives designed to meet these goals.

4 The Operating Fund was created by the Federal Credit Union Act of 1934. It was established as a revolving fund in the United States Treasury under the management of the NCUA Board for the purpose of providing administration and service to the federal credit union system. A significant majority of the Operating Fund's revenue is comprised of operating fees paid by federal credit unions. Each federal credit union is required to pay this fee based on its prior year asset balances and rates set by the NCUA Board.

5 Managed by the NCUA Board, the Temporary Corporate Credit Union Stabilization Fund is a revolving fund in the U.S. Treasury that gives NCUA the necessary flexibility to manage costs to the credit union system resulting from losses on faulty mortgage-backed securities purchased by five failed corporate credit unions NCUA liquidated during the financial crisis. The Stabilization Fund is currently scheduled to close in 2021.

6 The NCUA's Community Development Revolving Loan Fund, which was established by Congress, makes loans and Technical Assistance Grants to low-income designated credit unions.

7 The Central Liquidity Facility is a mixed-ownership government corporation the purpose of which is to supply emergency loans to member credit unions.

Major NCUA Programs

Supervision

The agency'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 agency 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 Share Insurance Fund. 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. The office is positioned to adapt its examination and supervision process and procedures to keep pace with a changing financial and operational environment.

Insurance

NCUA administers the Share Insurance Fund, which provides insurance for deposits held at federally insured natural person and corporate credit unions nationwide. The fund is capitalized by credit unions. The agency 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, NCUA fosters credit union development, particularly the expansion of services provided by small credit unions to eligible consumers. The agency fulfills this goal through training, partnerships, and assistance. A major source of assistance is the Community Development Revolving Loan Fund, which provides loans and grants to credit unions that serve low-income customers. Fund assistance enables these credit unions to provide basic financial services and stimulate economic activities in their communities. The office 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. The Office of Consumer Financial Protection and Access (OCFPA), created in 2010, is responsible for consumer protection in the areas of fair lending examinations, member complaints, and financial literacy. The office consults closely with the Consumer Financial Protection Bureau (Bureau). The Bureau 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 the agency, OCFPA responds to inquiries from credit unions, their

members, and consumers involving consumer protection and share insurance matters. Additionally, the office processes member complaints filed against federal credit unions.

Asset Management

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

Office of Minority and Women Inclusion

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

Office of Continuity and Security Management

The Office of Continuity and Security Management evaluates and manages security and continuity programs across NCUA and its regional offices. The office is responsible for continuity of operations, emergency planning and response, critical infrastructure and resource protection, cyber threat and intelligence analysis, insider threats and counterintelligence, as well as facility security and personnel security.

The NCUA Office of Inspector General

The 1988 amendments to the *Inspector General Act of 1978* (IG Act), 5 U.S.C. App., established IGs in 33 designated Federal entities (DFEs) including the NCUA.⁸ NCUA Office of Inspector General (OIG) was established in 1989. The NCUA Inspector General (IG) is appointed by, reports to, and is under the general supervision of, a three-member presidentially appointed Board. Currently, one seat on the NCUA Board remains vacant. OIG staff consists of ten FTEs: the IG, the Deputy IG/Assistant IG for Audit, the Counsel to the IG/Assistant IG for Investigations, the Director of Investigations, two senior auditors, one Senior IT auditor, two auditors, and an office manager. OIG promotes the economy, efficiency, and effectiveness of agency 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. 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.

8 5 U.S.C. App., §8G.

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 led the working group with participation from other CIGFO members, including NCUA OIG. On February 28, 2017, CIGFO issued a report titled *Audit of the Financial Stability Oversight Council's Efforts to Promote Market Discipline*. In the report, the working group concluded the FSOC made progress in promoting market discipline. However, the group found that the wide range of views that still exist on the issue of "too big to fail" indicate that there is a lack of consensus regarding whether FSOC has eliminated expectations on the part of shareholders, creditors, and counterparties of large bank holding companies or nonbank financial companies that the federal government will shield them from losses in the event of failure. According to individuals with whom working group members spoke, FSOC faces challenges in meeting this purpose due to its limited authorities, having to rely on the actions of others, difficulty measuring whether expectations have been eliminated, and the recent legal challenge to its designation authority. CIGFO did not make any recommendations to FSOC as a result of this audit.

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 OIG work that focuses on issues particular to NCUA as well as those that may apply to the broader financial sector.

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.

During this reporting period, NCUA OIG continued its review of the agency'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.

I. Background

The SEC's mission 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 integrity. Its core values consist of integrity, excellence, accountability, effectiveness, teamwork, and fairness. 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 Commission's performance through effective alignment and management of human, information, and financial capital.

The SEC is responsible for overseeing the nation's securities markets and certain primary participants, including broker-dealers, investment companies, investment advisers, clearing agencies, transfer agents, credit rating agencies, and securities exchanges, as well as organizations such as the Financial Industry Regulatory Authority, Municipal Securities Rulemaking Board, and the Public Company Accounting Oversight Board. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), the agency's jurisdiction was expanded to include certain participants in the derivatives markets, private fund advisers, and municipal advisors.

The SEC's headquarters are in Washington, DC, and the agency has 11 regional offices located throughout the country. The agency's functional responsibilities are organized into 5 divisions and 24 offices, and the regional offices are primarily responsible for investigating and litigating potential violations of the securities laws. The offices also have examination staff to inspect regulated entities such as investment advisers, investment companies, and broker-dealers.

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, 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.

II. 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

Evaluation of the SEC Division of Enforcement's Coordination Related to a Federal Civil Action, June 30, 2016

A Federal court in a civil action filed by the SEC issued an opinion and order that discussed a perceived lack of coordination of SEC investigations with overlapping factual circumstances. The court suggested that the SEC examine agency procedures for ensuring that such investigations are properly coordinated and that scarce agency resources are deployed efficiently.

The OIG evaluated the Division of Enforcement's coordination of investigations 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. We also assessed the SEC's efforts to coordinate the Enforcement investigation that was the subject of the Federal court's opinion and order.

We determined that the SEC has processes and systems for coordinating enforcement actions internally and, when appropriate, across agency divisions and offices. We also found that the SEC must rely on staff judgment to coordinate investigations and that Enforcement staff judgment led to an instance of untimely information-sharing during the investigation at issue. However, Enforcement management stated that earlier information-sharing would not have changed the theory of liability or remedies Enforcement staff

pursued in the investigation. Finally, we found that by adding an alert function to the Hub, the web-based application accessible to all Enforcement staff that tracks information about all Enforcement matters, the SEC had enhanced its processes for coordinating Enforcement investigations, reducing the likelihood of untimely information-sharing in the future.

We issued a final management letter summarizing the results of our evaluation on June 30, 2016, and made three recommendations for corrective action to further strengthen the SEC's policies and procedures for coordinating investigations. Management concurred with the recommendations, which have been closed.

Audit of the SEC's Process for Reviewing Self-Regulatory Organizations' Proposed Rule Changes, Report No. 537, September 23, 2016

Privately funded nongovernmental entities, referred to as self-regulatory organizations (SROs), conduct much of the day-to-day oversight for the U.S. securities markets and broker-dealers under their jurisdiction. SROs, including national securities exchanges, registered securities associations, and registered clearing agencies, establish rules that govern member activities.

The SEC reviews SROs' proposals for new rules and changes to existing rules (referred to as proposed rule changes) to ensure compliance with applicable SEC rules and regulations and the Securities Exchange Act of 1934, as amended by the Dodd-Frank Act. The SEC must review and then either approve or disapprove SROs' proposed rule changes according to certain requirements and within specified timeframes. Proper review of SROs' proposed rule changes helps the agency achieve its mission to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation. The SEC's Division of Trading and Markets (TM) and Office of Municipal Securities (OMS) are responsible for reviewing SROs' proposed rule changes.

The OIG conducted an audit of the SEC's process for reviewing proposed rule changes submitted by SROs. We determined that TM's and OMS' policies and procedures were consistent with statutory requirements for reviewing and processing proposed rule changes. In addition, SROs we surveyed were generally satisfied with the system used to file SROs' proposed rule changes. These SROs reported that TM and OMS staff (1) applied processes for reviewing and processing proposed rule changes consistently, and (2) communicated effectively with SROs and other stakeholders when the agency initiated proceedings to determine whether to disapprove an SRO's proposed rule change.

We also reviewed TM's and OMS' processing of 345 of the 3,494 proposed rule changes received by the SEC in fiscal years 2014 and 2015 and found that TM and OMS staff complied with statutory requirements and generally complied with agency policies and procedures. However, TM and OMS staff did not consistently document the basis for rejecting proposed rule changes, as required by agency policy. As a result, we determined that the SEC, in some cases, may not have a complete historical record for proposed rule changes received in fiscal years 2014 and 2015.

In addition, we found that the information security controls for the system used to file and track SROs' proposed rule changes need improvement. We also found that contingency planning controls for the system were inadequate.

We issued our final report on September 23, 2016, and made seven recommendations for corrective action. The recommendations included the need to better document TM's and OMS' basis for rejecting SROs' proposed rule changes, and needed improvements in system information security controls and contingency planning documents. Management concurred with the recommendations. Three recommendations have been closed, and the remaining four recommendations will be closed upon completion and verification of corrective action.

Audit of the Division of Corporation Finance's Management of Requests for No-Action and Interpretive Letters, Exemptions, and Waivers, Report No. 540, March 27, 2017

The SEC's Division of Corporation Finance (CF) responds to requests for guidance from individuals and other market participants about specific provisions of the Federal securities laws. Requesters may seek (1) interpretations of Federal securities laws or regulations, (2) assurances that no enforcement action will be taken if the individual or market participant engages in a specified activity, or (3) exemptions from securities laws. CF's response letters provide a current statement of the staff's views concerning the application of the securities laws to a particular set of facts. Although CF generally makes written responses publicly available, there is no statutory requirement for how quickly CF must process requests.

CF's informal guidance and administrative interpretations of the Federal securities laws and SEC rules are a key component to the SEC's strategic objective of helping market participants understand the obligations under the securities laws. CF legal policy and accounting offices received almost 2,000 requests for no-action and interpretive letters, exemptions, and waivers between January 1, 2014, and June 30, 2016.

The OIG initiated this audit to assess CF's effectiveness in managing the requests it receives for no-action and interpretive letters, exemptions, and waivers. We sought to determine whether CF timely responds to requests using a consistent process and makes written responses publicly available.

We found that CF has sought ways to improve the efficiency and effectiveness of its processes and procedures for responding to requests. During the last 5 years, CF has met or surpassed its internal performance goal for how quickly it initially responds to requests. However, CF can make further improvements to strengthen its management of requests. Specifically, we found that (1) some legal policy and accounting office policies and procedures were outdated or did not exist, and (2) the database CF used to track requests for no-action and interpretive letters and produce externally-reported performance metrics may be incomplete.

We noted that in fiscal year 2016, three long-tenured CF office chiefs retired or assumed new positions at the SEC. CF described these transitions as demanding on its senior officers. To mitigate CF's vulnerability to a loss of institutional knowledge, CF legal policy and accounting offices should develop and maintain current, written policies and procedures outlining the process for responding to requests. In addition, management should ensure that CF's data are accurate and complete so that management can assess CF's performance in responding to requests.

The OIG issued a final report to the agency on March 27, 2017. To improve CF's management requests for no-action and interpretive letters, exemptions, and waivers, we recommended that CF (1) update or develop, as necessary, standardized policies and procedures for receiving, recording, and responding to requests, and

communicate those policies and procedures to staff; and (2) perform periodic validations of data recorded in the no-action letter database to ensure the data's accuracy and completeness. Management concurred with the recommendations, which will be closed upon completion and verification of corrective action.

The report is available on our website at <https://www.sec.gov/files/Audit-of-CorpFins-Management-of-Requests-for-No-Action-and-Interpretive-Ltrs-Exemptions-Waivers.pdf>.

Final Management Letter: Progress on the SEC's Tips, Complaints, and Referrals Intake and Resolution System Redesign and Vulnerability Remediation Efforts, May 31, 2017

The SEC encourages the public to file complaints or submit tips of possible securities law violations, broker or firm misconduct, or unfair practices in the securities industry that pose a risk of harm to investors (collectively referred to as tips, complaints, and referrals [TCRs]). According to the SEC, it receives, on average, 15,000 TCRs every year from multiple sources in a variety of ways. These include TCRs from, among others, the public, attorneys, and members of the regulated community, including broker-dealers, investment advisers, self-regulatory organizations, and public companies.

In May 2015, the OIG reported observations about the SEC's Tips, Complaints, and Referrals Intake and Resolution System (TCR system) and the agency's project to redesign the system—one of the SEC's multi-year, mission-critical technology projects. Since May 2015, the OIG has continued to monitor the SEC's progress toward implementing a redesigned TCR system and addressing information security vulnerabilities in the current system. The OIG did not conduct an audit in conformance with generally accepted government auditing standards. However, based on the work performed, on May 31, 2017, the OIG issued a final management letter reporting additional observations that warrant management's attention.

Specifically, the OIG reported that the TCR system redesign project has continued to experience difficulties and delays, resulting in additional cost increases. The SEC has successfully tested and conditionally accepted the redesigned TCR system. However, the agency has not implemented the system, as the system's multiple users are considering new requirements and enhancements not previously required in the development effort. Therefore, the SEC does not expect the redesigned TCR system to go-live until October 2, 2017 (more than 3 years behind schedule). Moreover, since May 2015, the value of the SEC's contract to implement the system has increased by another \$8.5 million, for an overall increase of about \$12.2 million, or 170 percent. To date, the SEC has obligated about \$16.6 million and expended about \$14.4 million of the total contract value, or twice the amount initially planned. The contract cost will likely continue to rise as the agency continues to pursue new system requirements and enhancements.

At the same time, the SEC has continued to operate the current TCR system but has not timely remediated some of the system's security vulnerabilities.

The OIG requested by June 14, 2017, the agency provide detailed information about its plans to complete the TCR system redesign project, remediate information security vulnerabilities in the current TCR system, and perform a comprehensive lessons learned review.

ONGOING WORK

Audit of the Office of Compliance Inspections and Examinations' Controls Over Its Investment Adviser Examination Completion Process

The Office of Compliance Inspections and Examinations (OCIE) administers the SEC's National Examination Program. OCIE's mission is to protect investors, ensure market integrity, and support responsible capital formation through risk-focused strategies that improve compliance, prevent fraud, monitor risk, and inform regulatory policy. Examiners in Washington, DC, and the SEC's 11 regional offices conduct examinations of the nation's registered entities, including investment advisers, to ensure registrants' compliance with Federal securities laws.

At the conclusion of an examination, examination staff provide the examined entity with written notification of the examination's completion and, if any deficiencies are noted, a letter outlining those deficiencies. Examined entities must respond to deficiency letters in writing, generally within 30 days, and include steps taken and/or planned corrective actions to address the issues identified.

In addition, OCIE conducts a limited number of Corrective Action Reviews to verify whether examined entities took the corrective actions discussed in their responses to deficiency letters.

The OIG has initiated an audit of OCIE's controls over its investment adviser examination completion process. The objective of the audit is to determine whether OCIE has established effective controls over its investment adviser examination completion process, including but not limited to the issuance and resolution of deficiency letters and the performance of Corrective Action Reviews, to foster compliance with Federal securities laws. In addition, we will follow up on the implementation of corrective actions from our prior audit, Office of Compliance Inspections and Examinations' Management of Investment Adviser Examination Coverage Goals, Report No. 533, dated March 10, 2016.

We expect to issue a report summarizing our findings during 2017.

Evaluation of the Division of Corporation Finance's Comment Letter Process

Companies subject to the registration and reporting requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934 are generally required to disclose certain information to investors through regular filings with the SEC. Specifically, these companies must disclose the information required by Federal securities laws and regulations and any additional material information necessary to make those required statements not misleading in light of the circumstances under which they are made.

The SEC's CF selectively reviews filings both to monitor and to enhance compliance with disclosure and accounting requirements. In the course of a review, CF staff may issue comments to a company to elicit better compliance with applicable disclosure requirements. In response to those comments, a company may revise its financial statements or amend its disclosure to provide additional or enhanced information, or may revise its financial statements or other disclosures in future filings. To increase the transparency of the review process, CF makes its comment letters and company responses to those comment letters public once the review is closed.

In July 2016, Congressional members requested that the SEC OIG provide information on, among other things, CF's comment letter process. Accordingly, the OIG has initiated an evaluation of that process. Our overall objective is to review CF's policies, procedures, and processes for issuing, tracking, and facilitating public access to comment letters and related correspondence.

We expect to issue a report summarizing our findings during 2017.

Audit of the U.S. Securities and Exchange Commission's Progress in Enhancing and Redesigning the Electronic Data Gathering, Analysis, and Retrieval System (EDGAR)

The Office of Management and Budget and the Government Accountability Office have recognized the challenges Federal agencies face in attempting to modernize and enhance their information technology systems and capabilities. Throughout the years, the SEC has initiated various efforts to modernize and enhance its information technology systems, including its EDGAR system. The EDGAR system performs automated collection, validation, indexing, acceptance, and forwarding of submissions by companies and others who are required by Federal securities laws to file forms with the SEC. The EDGAR system is complex, consisting of multiple subsystems, and receives over 700,000 disclosure documents every year from companies and individuals.

The OIG has initiated an audit of the SEC's progress in enhancing and redesigning EDGAR. The objective of the audit is to determine whether the SEC has established effective controls over EDGAR enhancements and redesign efforts. Specifically, we will determine whether the SEC (1) has effective controls to ensure the agency completes EDGAR system enhancements as planned and in accordance with the SEC's performance and budget goals; (2) has effective controls to ensure that the agency implements EDGAR system enhancements in compliance with Federal and SEC change management controls; and (3) has effective planning and governance controls to ensure that the EDGAR redesign program meets agency needs.

We expect to issue a report summarizing our findings during 2017.



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

SIGTARP uses an analytical, experience-based approach to identify hidden crime at financial institutions or other TARP recipients. Once our special agents—who have the authority to search, seize, and arrest—investigators, and forensic agents build a strong case against an individual or institution, we work with the Justice Department and other prosecutors to bring accountability to individuals and institutions that break the law by taking the case to trial or securing a guilty plea and recovering dollars lost to fraud.

SIGTARP maximizes recoveries—dollars that the Government can use to fund operations or decrease the cost of Government. Our work offsets Government TARP losses through criminal and civil investigations, ensuring that crime (and civil fraud) does not pay, taking the profit out of crime (and civil fraud). SIGTARP's law enforcement counters additional threats to public safety by investigating criminal actors, and neutralizing the threat they pose through referrals to the Department of Justice for prosecution.

As a watchdog over Federal dollars and programs, SIGTARP audits ongoing TARP programs to prevent fraud, identify cost savings, wasteful spending, inefficiency and mismanagement, particularly TARP housing programs focused on America's working class in towns that have not fully recovered.

When our team of forensic auditors, in depth auditors, and evaluators find a program at risk, they get to work reviewing documents, interviewing, and analyzing. When an audit confirms a program is at risk, we look for ways to fix the problem by leveraging best practices with data analytics and trend analysis. We then issue recommendations to Treasury, which we share with Congress and the public. Our forensic audit team dives deep to root out waste and refer potential fraud to SIGTARP special agents.

Cross-authority jurisdiction allows SIGTARP to audit everyone involved in TARP programs, not just Treasury, allowing for more complete findings. This includes for example, all Federal agencies, along with state agencies, city agencies, demolition contractors and subcontractors, and mortgage servicers.

SIGTARP saves the Government money and continues to be on watch for waste, mismanagement, inefficiency and situations where TARP dollars are at risk of being lost to fraud.

OIG Work Related To The Broader Financial Sector

Special Inspector General's Recommendation To Congress For CEO Accountability

In order to prevent fraud, Special Inspector General Goldsmith Romero has proposed that Congress consider requiring an annual crime and fraud certification for the largest TARP banks. Specifically, this would require the CEO, CFO, COO, and CCO at the six largest banks that collectively received more than \$160 million in TARP bailout funds to sign an annual certification to law enforcement that they have conducted due diligence and can certify that there is no criminal conduct or civil fraud within their organization.

This would be a law enforcement tool. SIGTARP's investigative approach has resulted in the successful prosecution of senior executives including 16 CEOs, 4 CFOs, and 7 COOs or CCOs in medium sized and smaller banks. In each of these cases, SIGTARP obtained evidence required to prove criminal intent of the bank official based on their knowledge of the fraud. In comparison, SIGTARP has faced significant difficulties proving criminal intent of senior officials in large organizations that are designed to insulate high level officials from knowing about crime or civil fraud. This certification to law enforcement would apply to Bank of America, Wells Fargo, Citigroup, Goldman Sachs, Morgan Stanley, and JP Morgan. All have faced a law enforcement action in recent years based on major violations of the law that caused massive harm to victims. Several of those actions resulted from SIGTARP's investigations, which found major fraud in the way these banks conducted business.

SIGTARP does not have the law enforcement tools required to prove criminal intent of large bank CEOs, CFOs, COOs or CCOs as long as they continue to insulate themselves from knowledge of crime or fraud within their organization. Until CEOs, CFOs, COOs and CCOs have an affirmative duty to look for crime or civil fraud in their organization, it is likely that they will continue to be "in the dark" about wrongdoing. By staying in the dark, these high level officials lose a critical opportunity to stop the crime or fraud and save victims from harm. A change in the laws is required to remove the insulation around CEOs, CFOs, COOs and CCOs at these six Wall Street banks that took TARP funds.

An annual certification requirement provides an incentive to CEOs, CFOs, COOs and CCOs to look for crime and fraud within their organization so that they can stop it. In other words, to give them an incentive to be "in the know" about crime or civil fraud within their company (particularly major fraud in the way the company does business), rather than stay "in the dark." This is something that these CEOs, CFOs, COOs and CCOs should already be doing. The incentive for a CEO to be "in the know" about crime in his or her bank already exist naturally for CEOs of mid-sized and smaller banks because that crime can take down the bank. Changing incentives for leaders of the top six Wall Street banks that took TARP funds could change culture to one of increased accountability.

DOJ Enforcement Action Against Goldman Sachs In Connection With Its Sale of Residential Mortgage Backed Securities—Goldman Pays More Than \$5 Billion

As a result of SIGTARP's investigation, on April 11, 2016, the Justice Department brought an enforcement action against Goldman Sachs related to the bank's conduct in the packaging, securitization, marketing, sale and issuance of RMBS between 2005 and 2007. Goldman agreed that it made false and misleading representations to prospective investors about the characteristics of the loans it securitized and the ways Goldman would protect investors in its RMBS from harm. Goldman Sachs took \$10 billion in TARP bailout funds. 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, including taxpayers trading RMBS through a TARP program. Goldman paid \$5.06 billion, including a \$2.385 billion fine, \$1.8 billion in consumer relief, \$575 million to the National Credit Union Administration, \$75 million to Federal Home Loan Banks, \$190 million to the state of New York, \$25 million to the state of Illinois, and \$10 million to the state of California.

DOJ Enforcement Action Against Ally Financial In Connection With Sale of Mortgage-Backed Securities—Ally Pays \$52 Million

As a result of SIGTARP's investigation, on November 21, 2016, Ally Financial Inc., which received substantial TARP bailout funds, agreed to pay the United States a \$52 million civil penalty to resolve an investigation and settle allegations that its subsidiaries violated FIRREA concerning the packaging, securitization, marketing, sale, and issuance of 10 subprime RMBS in in the RASC-EMX series between 2006 and 2007. Ally agreed to wind down and de-register its broker-dealer, Ally Securities, LLC. As the lead underwriter, Ally Securities recognized in 2006 and 2007 that there was a consistent trend of deterioration in the quality of the mortgage loan pools underlying the RASC-EMX Securities that stemmed, at least in part, from deficiencies in the subprime mortgage loan underwriting guidelines and diligence applied to the collateral prior to securitization. All of the RASC-EMX Securities sustained losses as a result of underlying mortgage loans falling delinquent.

Jefferies & Co. RMBS Trader Convicted Of Securities Fraud By Federal Jury

As a result of SIGTARP's investigation, on January 27, 2017, following a three-week trial, a federal jury found senior trader and managing director at Jefferies & Co, Inc. ("Jefferies") Jesse C. Litvak guilty of securities fraud. As a broker-dealer, only Litvak – not the bond seller or buyer – knew the selling and asking prices of the parties. Litvak exploited this information by misrepresenting to his victim the price Jefferies paid for a RMBS bond in order to increase Jefferies' profit on the trade. The victim included TARP's Public-Private Investment Program (PPIP), a program that used TARP dollars to trade in RMBS to restart frozen credit markets.

Cantor Fitzgerald RMBS Trader Charged With Securities Fraud

As a result of SIGTARP's investigation, on December 7, 2016, former Cantor Fitzgerald & Co. trader and managing director David Demos was indicted, charged with securities fraud for allegedly conspiring to overcharge customers trading RMBS, including an investment firm that managed PPIP funds. The indictment alleges that Demos defrauded customers by fraudulently inflating the purchase price at which Cantor

Fitzgerald 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 Cantor Fitzgerald could sell a RMBS bond to induce their victim-customers to sell bonds at cheaper prices. The indictment alleged that, as a result of this scheme, Cantor Fitzgerald and Demos profited illegally, and victim customers sustained millions of dollars of losses. The victims of this alleged scheme included TARP.

CEO of Failed Gulfsouth Private Bank Convicted For Bank Fraud By Federal Jury, Bank Vice President Also Convicted

As a result of SIGTARP's investigation, on March 10, after a five-day trial, CEO of Gulfsouth Private Bank Anthony Atkins was convicted of conspiracy to commit bank fraud, four counts of false statements to a federally insured financial institution, bank fraud, and mail fraud affecting a financial institution after a federal jury found him guilty. On February 27, 2017, Bank Vice President Samuel Cobb pled guilty to conspiracy, four counts of false statement to a financial institution, and bank fraud. Gulfsouth received \$7.5 million in TARP funds, which were lost when the bank failed. On March 10, 2017, co-conspirator borrower Bruce Houle pled guilty to conspiracy to commit bank fraud and one count of false statement to a federally insured financial institution, making him the fourth convicted co-conspirator borrower.

Chief Operating Officer and Director of Failed Tennessee Commerce Bank Convicted of Deceiving Federal Regulators

As a result of SIGTARP's investigation, on April 24, 2017, Lamar Cox, former Tennessee Commerce Bank (TCB) Chief Operating Officer and Director was convicted for causing the bank to make a false statement to the FDIC in a scheme to delay reporting losses by TCB so that TCB's books would look better to federal bank examiners, who were scheduled to soon examine TCB. In order to accomplish the deception, Cox's actions caused TCB to understate its net loss by \$440,000 reported in the Call Report filed with the FDIC for the third quarter of 2009, concealing the true financial condition of TCB from shareholders, examiners and the public.

Chairman of Premier Bank Sentenced To Five Years Prison For Crime That Led To Failure of Bank, Bank General Counsel Sentenced To Probation

As a result of SIGTARP's investigation, on November 1, 2016, Zulfikar Esmail, Premier Bank's Chairman was sentenced to five years in prison. His wife, Shamim Esmail, who was the bank's general counsel and director, was sentenced to probation. Premier Bank lost \$6.7 million in TARP funds when the bank failed, in addition to \$64.1 million estimated cost to the FDIC due to the bank's failure. They were convicted of a massive six-year bank fraud conspiracy and criminal enterprise scheme that led to the collapse of the bank.

5 Employees of Pierce Commercial Bank's Mortgage Subsidiary Charged and Convicted In Mortgage Fraud Scheme That Led To Failure of The Bank, Bringing Number of Bank Officers Convicted To 10

As a result of SIGTARP's investigation, in January 2017, four loan officers and one loan processor at Pierce Commercial Bank's mortgage subsidiary were indicted for a mortgage fraud scheme that resulted in the collapse of the bank. Subsequently, four of these defendants were convicted by guilty plea. Previously five Pierce Commercial Bank officers were convicted, including Shawn Portmann, former Senior Vice President

and Loan Officer, who was sentenced to 10 years in prison, and three other bank employees who were sentenced to prison. Between 2004 and 2008, Portmann with these co-conspirators closed over 300 loans in which they falsified information about the borrowers' qualifications and their intention to reside in the homes being financed. More than half the loans defaulted or otherwise caused bank losses. Pierce Commercial Bank received \$6.8 million in TARP funds, all of which was lost when the bank failed due to this fraud scheme.



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 (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, D.C., and has an audit office in Boston, MA, and investigative offices in Greensborough, NC and Jacksonville, FL.

Treasury OIG has oversight responsibility for the Office of the Comptroller of the Currency (OCC). OCC is responsible for approximately 1,028 national banks, 375 federal savings associations, and 49 federal branches of foreign banks. The total assets under supervision are \$11.6 trillion, making up 71 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 Office of Minority and Women Inclusion within Treasury's Departmental Offices (DO) and (4) Office of Minority and Women Inclusion within 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 December 2016, the funding capacity available to the two entities is \$258 billion covering future net worth deficiencies.

Under the Federal Deposit Insurance Corporation Improvement Act (FDICIA) Treasury OIG is required to conduct a material loss review of OCC regulated failed financial institutions 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). Under the act Treasury OIG is also required to review all banks regulated by OCC 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.⁹ As appropriate, Treasury OIG also makes recommendations for preventing any such loss in the future. During the period covered by this annual report, we did not perform a material loss review or a review of any bank failure with losses under the material loss review threshold.

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 26, 2016, the Inspector General reported three management and performance challenges that were directed towards financial regulation and economic recovery. Those challenges are: Cyber Threats, Anti-Money Laundering and Terrorist Financing/Bank Secrecy Act Enforcement, and Management of Treasury's Authorities Intended to Support and Improve the Economy.¹⁰

Cyber Threats

Cybersecurity continues to represent 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.

9 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.

10 The Treasury Inspector General's memorandum included one other challenge not directly related to financial regulation and economic recovery: Efforts to Promote Spending Transparency and to Prevent and Detect Improper Payments. The memorandum also discussed concerns about three matters: currency and coin production, documenting key activities and decisions, and enterprise risk management.

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.

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. 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.

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 (ESSA), 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.

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 process¹¹ 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 Fannie Mae and 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 \$6.5 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.

Completed and In-Progress Work on Financial Oversight

Treasury's Departmental Offices' Office of Minority and Women Inclusion

Section 342 of Dodd-Frank required Treasury to establish an Office of Minority and Women Inclusion (OMWI) within DO. OMWI is charged with responsibility for all matters of DO related to diversity in management, employment, and business activities, except for the enforcement of statutes, regulations, or executive orders pertaining to civil rights. We initiated an audit to determine whether OMWI was established and carrying out its functions consistent with Section 342 of the Dodd-Frank Act.

We reported that OMWI was generally carrying out its functions consistent with Section 342 of Dodd-Frank. OMWI had engaged in numerous activities including staffing the office, issuing annual reports, advising Treasury management, and taking affirmative steps to seek diversity in the workforce. However, OMWI was still in the process of addressing the requirement to develop and implement procedures to determine whether contractors are making a good faith effort to include minorities and women in their workforce.

We recommended that OMWI complete with deliberate speed the process of developing and implementing procedures to review and evaluate whether agency contractors have made good faith efforts to include minorities and women in their workforce.

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

OCC's Supervision of Financial Institutions' Student Loan Lending Activities

Student loan debt stood at \$1.36 trillion as of March 2016, and was second only to mortgage debt as the largest form of consumer debt. The Federal Government backs approximately \$1.26 trillion or 92.5 percent of outstanding student loans. The remaining 7.5 percent of the higher education student loan market is made up of about \$102 billion in private student loans. While private student loans have a small share of the total outstanding student debt, they are an important part of the market given their disproportionate use by high-debt borrowers. We initiated an audit 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.

We reported that OCC effectively supervised financial institutions' private student lending activities for the banks included in our sample. We did not make any recommendations to OCC as a result of our audit.

OCC's Supervision of Banks' Use of Independent Consultants Under Enforcement Actions

In April 2013, the Senate Banking Subcommittee on Financial Institutions and Consumer Protection held a hearing focused on the independence, oversight, and quality of services provided by independent consultants, who are hired by banks at the request of regulators. The lawmakers raised doubts about the independence of consultants handpicked by financial firms accused of wrongdoing, and criticized OCC for providing poor oversight of the consultants. We initiated an audit 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.

We reported that OCC's supervisory offices generally complied with OCC Bulletin 2013-33, *Use and Review of Independent Consultants in Enforcement Actions* and Policies and Procedures Manual 5310-11, *Use and Review of Independent Consultants in Enforcement Actions*. There was one instance where a supervisory office did not follow the requirement in Policies and Procedures Manual 5310-11 that states "determinations related to the consultant's independence and qualifications should be documented by the supervisory office and reviewed by the responsible Deputy Comptroller."

We recommended that the Comptroller of the Currency determine if a Deputy Comptroller's review of determinations related to the consultant's independence and qualifications is necessary at all times or whether there are circumstances that could warrant an exception to this requirement. If so, we recommended updating the applicable guidance. Supervisory offices should be reminded of the need for a Deputy Comptroller's review in those circumstances where such review is required.

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 previously, 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 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.

OCC's Supervision of Wells Fargo Bank (In Progress)

We initiated an audit of OCC's supervision of Wells Fargo Bank's sales practices. The objectives of this audit are to assess (1) OCC's supervision of incentive-based compensation structures within Wells Fargo and (2) the timeliness and adequacy of OCC's supervisory and other actions taken related to Wells Fargo sales practices, including the opening of accounts.

OCC's Supervision Related to De-risking by Banks (In Progress)

We initiated an audit of OCC's supervisory impact on the practice of de-risking by banks. The objectives of this audit are to determine (1) whether supervisory, examination, or other staff of the OCC have indirectly or directly caused banks to exit a line of business or to terminate a customer or correspondent account, and (2) under what authority OCC plans to limit, through guidance, the ability of banks to open or close correspondent or customer accounts, including a review of laws that govern account closings and the OCC's authority to regulate account closings.

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 acquires the goods and services needed to accomplish its mission; and (2) these acquisitions are made in compliance with applicable procurement regulations.

Appendix A:
**Audit of the Financial Stability Oversight Council's Efforts
to Promote Market Discipline**

Prepared by the Council of Inspectors General on Financial Oversight

2017

Abbreviations

BHC	Bank holding company
CIGFO	Council of Inspectors General on Financial Oversight
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
FDIC	Federal Deposit Insurance Corporation
FMU	Financial market utility
FRB	Board of Governors of the Federal Reserve System
FSOC or Council	Financial Stability Oversight Council
GAO	Government Accountability Office
OFR	Office of Financial Research
SEC	Securities and Exchange Commission
TBTF	Too big to fail
Treasury	Department of the Treasury



February 28, 2017

The Honorable Steven T. Mnuchin
Chair, Financial Stability Oversight Council
Washington, D.C. 20220

Dear Mr. Chairman:

I am pleased to present you with the Council of Inspectors General on Financial Oversight (CIGFO) report titled, *Audit of the Financial Stability Oversight Council's Efforts to Promote Market Discipline*.

One of the statutory purposes of the Financial Stability Oversight Council (FSOC) is to promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties, of large, interconnected bank holding companies and nonbank financial companies that the United States Government will shield them from losses in the event of failure. Accordingly, CIGFO convened a Working Group to assess FSOC's efforts to promote market discipline.

In this resulting audit report, we concluded that FSOC has made progress in promoting market discipline. However, the wide range of views that still exist on the issue of "too big to fail" indicate that there is a lack of consensus regarding whether FSOC has eliminated expectations on the part of shareholders, creditors, and counterparties of large bank holding companies or nonbank financial companies that the federal government will shield them from losses in the event of failure. According to those we spoke with, FSOC faces challenges in meeting this purpose due to its limited authorities, having to rely on the actions of others, a difficulty in measuring whether expectations have been eliminated, and the recent legal challenge to its designation authority. We are not making any recommendations to FSOC as a result of this audit.

I would like to take this opportunity to thank the the FSOC members for their support, especially those Treasury officials who assisted with this effort.

CIGFO looks forward to working with you on this and other issues. In accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act, CIGFO is also providing this report to Congress.

Sincerely,

/s/

Eric M. Thorson

Chair

Council of Inspectors General on Financial Oversight

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Executive Summary

Why and How We Conducted this Audit

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) created a comprehensive regulatory and resolution framework designed to reduce the likelihood, and severe economic consequences, of financial instability. The Dodd-Frank Act established the Financial Stability Oversight Council (FSOC or Council) and charged it with identifying risks to the nation's financial stability, promoting market discipline, and responding to emerging threats to the stability of the nation's financial system. Among other duties, Title I of the Dodd-Frank Act requires FSOC to report to Congress annually about: (1) its activities; (2) significant financial market and regulatory developments; (3) potential emerging threats to the financial stability of the U.S.; and (4) recommendations to: (i) enhance the integrity, efficiency, competitiveness, and stability of U.S. financial markets; (ii) promote market discipline; and (iii) maintain investor confidence.

The Dodd-Frank Act also created a Council of Inspectors General on Financial Oversight (CIGFO), whose members include the Inspectors General with oversight authority for the majority of FSOC member agencies. The Dodd-Frank Act authorizes CIGFO to convene a Working Group of its members to evaluate the effectiveness and internal operations of FSOC. In October 2015, CIGFO convened 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 (BHC) and nonbank financial companies that the government will shield them from losses in the event of failure.

To accomplish CIGFO's objective, the Working Group reviewed the Dodd-Frank Act to determine FSOC's statutory purposes and duties. It reviewed FSOC's governance documents, annual reports, and meeting minutes. It also interviewed staff from the FSOC Secretariat at the Department of the Treasury (Treasury) as well as other FSOC member agency representatives to develop a better understanding of FSOC's efforts to promote market discipline. In addition, the Working Group interviewed knowledgeable parties outside of FSOC to obtain their perspectives of FSOC and its efforts to promote market discipline.¹ The Working Group conducted fieldwork from October 2015 through August 2016 in accordance with generally accepted government auditing standards. On December 1, 2016, the Working Group briefed FSOC representatives on the overall results of our audit. Appendix I provides additional details about the objective, scope, and methodology of this audit.

What We Learned

FSOC has made progress in promoting market discipline; however, the wide range of views that still exist on the issue of "too big to fail" (TBTF) indicates that there is a lack of consensus regarding whether FSOC has eliminated expectations on the part of shareholders, creditors, and counterparties of large BHCs or nonbank financial companies that the federal government will shield them from losses in the event of

¹ Knowledgeable outside parties included banking and law professors, public policy research analysts, and economists. See Appendix I for more detail

failure.¹ According to those we spoke with, FSOC faces challenges in meeting this purpose due to its limited authorities, having to rely on the actions of others, a difficulty in measuring whether expectations have been eliminated, and the recent legal challenge to its designation authority. We are not making any recommendations to FSOC as a result of our audit.

FSOC Response

In a written response, FSOC stated that it has used its existing authorities to make progress in promoting market discipline following the financial crisis. FSOC also stated it has used its authorities to make progress in identifying risks to the United States financial stability and in responding to emerging threats to the stability of the nation's financial system.

¹ The term "too big to fail" (TBTF) is a market notion that the federal government would intervene to prevent the failure of a large, complex financial institution to avoid destabilizing the financial sector and the economy. This definition of TBTF is taken from the Government Accountability Office (GAO) report, *Large Bank Holding Companies: Expectations of Government Support* (GAO-14-621; July 2014), <http://www.gao.gov/assets/670/665162.pdf>, page 2 of 94.

CIGFO Working Group Audit

This report presents the results of the CIGFO Working Group's audit of FSOC's efforts to promote market discipline. This is the fifth audit report that CIGFO has issued to FSOC and Congress as part of CIGFO's responsibility to oversee FSOC under the Dodd-Frank Act. CIGFO issued its first four audits in June 2012,² July 2013,³ July 2014,⁴ and July 2015.⁵

BACKGROUND

The Dodd-Frank Act established FSOC to create joint accountability for identifying and mitigating potential threats to the stability of the nation's financial system. By creating FSOC, Congress recognized that protecting financial stability would require the collective engagement of the entire financial regulatory community. As shown in Figure 1⁶, the Council consists of 10 voting members and 5 non-voting members and brings together the expertise of federal financial regulators, state regulators, an insurance expert appointed by the President with Senate confirmation, and others. The voting members of FSOC provide a federal financial regulatory perspective as well as an independent insurance expert's view. The non-voting members offer different insights as state-level representatives from bank, securities, and insurance regulators or as the directors of offices within Treasury — the Office of Financial Research (OFR) and the Federal Insurance Office.

Within Treasury, a dedicated policy office, led by a Deputy Assistant Secretary, functions as the FSOC Secretariat and assists in coordinating the work of the Council among its members and member agencies.

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- 2 CIGFO, Audit of the Financial Stability Oversight Council's Controls over Non-public Information, June 2012, [https://www.treasury.gov/about/organizational-structure/ig/Documents/CIGFO Document/Audit of the Financial Stability Oversight Council's Controls over Non-public Information.pdf](https://www.treasury.gov/about/organizational-structure/ig/Documents/CIGFO%20Document/Audit%20of%20the%20Financial%20Stability%20Oversight%20Council's%20Controls%20over%20Non-public%20Information.pdf)
 - 3 CIGFO, Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities, July 2013, [https://www.treasury.gov/about/organizational-structure/ig/OIG Sorter/CIGFO_AUDIT_71713.pdf](https://www.treasury.gov/about/organizational-structure/ig/OIG%20Sorter/CIGFO_AUDIT_71713.pdf).
 - 4 CIGFO, Audit of the Financial Stability Oversight Council's Compliance with Its Transparency Policy, July 2014, [https://www.treasury.gov/about/organizational-structure/ig/Documents/CIGFO Audit July 2014.pdf](https://www.treasury.gov/about/organizational-structure/ig/Documents/CIGFO%20Audit%20July%202014.pdf).
 - 5 CIGFO, Audit of the Financial Stability Oversight Council's Monitoring of Interest Rate Risk to the Financial System, July 2015, [https://www.treasury.gov/about/organizational-structure/ig/Documents/CIGFO Document/Audit of the Financial Stability Oversight Council's Monitoring of Interest Rate Risk.pdf](https://www.treasury.gov/about/organizational-structure/ig/Documents/CIGFO%20Document/Audit%20of%20the%20Financial%20Stability%20Oversight%20Council's%20Monitoring%20of%20Interest%20Rate%20Risk.pdf).
 - 6 12 U.S.C. § 5321(b).

Figure 1: FSOC Council Membership	
Federal and Independent Members	State Members
<ul style="list-style-type: none"> ☐ • Secretary of the Treasury, Chairperson (v) • Chairman of the Board of Governors of the Federal Reserve System (v) • Comptroller of the Currency (v) • Director of the Consumer Financial Protection Bureau (v) • Chairman of the Securities and Exchange Commission (v) • Chairperson of the Federal Deposit Insurance Corporation (v) • Chairperson of the Commodity Futures Trading Commission (v) • Director of the Federal Housing Finance Agency (v) • Chairman of the National Credit Union Administration Board (v) • Director of the Office of Financial Research • Director of the Federal Insurance Office • Independent member with insurance expertise (v) <p>(v) Indicates Voting Member</p>	<ul style="list-style-type: none"> ☐ • State Insurance Commissioner • State Banking Supervisor • State Securities Commissioners

The statutory purposes of FSOC are to:

- identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected BHCs or nonbank financial companies, or that could arise outside the financial services marketplace;
- promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the United States Government will shield them from losses in the event of failure; and
- respond to emerging threats to the stability of the U.S. financial system.¹

¹ 12 U.S.C. § 5322(a)(1).

FSOC's duties under the Dodd-Frank Act include:

- collecting information from member agencies, other federal and state financial regulatory agencies, the Federal Insurance Office and, if necessary to assess risks to the U.S. financial system, directing OFR to collect information from BHCs and nonbank financial companies;
- providing direction to, and requesting data and analyses from OFR;
- monitoring the financial services marketplace in order to identify potential threats to U.S. financial stability;
- monitoring domestic and international financial regulatory proposals and developments, including insurance and accounting issues, and advising Congress and making recommendations in such areas to enhance the integrity, efficiency, competitiveness, and stability of the U.S. financial markets;
- facilitating information sharing and coordination among the member agencies and other federal and state agencies regarding domestic financial services policy development, rulemaking, examinations, reporting requirements and enforcement actions;
- recommending to the member agencies general supervisory priorities and principles reflecting the outcome of discussions among the member agencies;
- identifying gaps in regulation that could pose risks to the financial stability of the U.S.;
- requiring supervision by the Board of Governors of the Federal Reserve System (FRB) for nonbank financial companies that may pose risks to the financial stability of the U.S. in the event of their material financial distress or failure, or because of their activities;
- making recommendations to FRB concerning, among other things, the establishment of heightened prudential standards, resolution plans, and enhanced public disclosures for nonbank financial companies and large, interconnected BHCs;
- identifying systemically important financial market utilities (FMUs) and payment, clearing, and settlement activities;
- making recommendations to primary financial regulatory agencies to apply new or heightened standards and safeguards for financial activities or practices that could create or increase risks of problems spreading among BHCs, nonbank financial companies, and United States financial markets;
- reviewing and, as appropriate, submitting comments to the Securities and Exchange Commission (SEC) and any standard-setting body with respect to an existing or proposed accounting principle, standard, or procedure;
- providing a forum for discussion and analysis of emerging market developments and financial regulatory issues as well as resolution of jurisdictional disputes among the members of the Council, and
- annually reporting to and testifying before Congress.²

² 12 U.S.C. § 5322(a)(2).

Each year, FSOC is to issue an annual report to fulfill its Congressional mandate to report on the activities of the Council, significant financial market and regulatory developments, potential emerging threats, and its recommendations.

One of the purposes of the Dodd-Frank Act is to end TBTF. As noted above, FSOC's statutory purpose in this area is focused on eliminating expectations that the United States Government will shield shareholders, creditors, and counterparties of large BHCs and nonbank financial companies from losses in the event of failure. This report focuses on FSOC's activities related to eliminating those expectations.

AUDIT APPROACH

Our audit objective was to assess FSOC's efforts to promote market discipline by eliminating expectations on the part of shareholders, creditors, and counterparties of large BHCs or nonbank financial companies that the government will shield them from losses in the event of failure. Our audit scope focused on FSOC's efforts to promote market discipline from the Council's establishment, in 2010, through August 2016. To accomplish our objective, participating Offices of Inspector General collected information from FSOC members and/or FSOC member representatives regarding their views on FSOC's efforts to promote market discipline as well as each FSOC member agency's involvement in those efforts. Also, we obtained perspectives from knowledgeable outside parties regarding their views on FSOC's efforts to promote market discipline. Where available, we reviewed public statements of pertinent entities, such as credit rating agencies. In addition, we interviewed officials of the FSOC Secretariat and reviewed past FSOC annual reports and laws applicable to FSOC's authority to promote market discipline. We conducted our audit fieldwork from October 2015 through August 2016 in accordance with generally accepted government auditing standards. We provided an exit briefing on the results of our work to FSOC representatives on December 1, 2016.

FSOC'S ACTIVITIES TO PROMOTE MARKET DISCIPLINE

We identified four primary areas where FSOC has taken steps to promote market discipline. These areas relate to FSOC's designations, convening authority, annual reporting, and consulting responsibilities.

FSOC Designations

FSOC has the authority to designate nonbank financial companies for heightened supervision and enhanced prudential standards. FSOC also has the authority to designate FMUs, and payment, clearing, and settlement activities for enhanced risk management standards. On July 8, 2013, the Council voted to designate American International Group, Inc. and General Electric Capital Corporation, Inc.,¹ for supervision by FRB and enhanced prudential standards.² On September 19, 2013, the Council voted to so designate Prudential Financial, Inc., and on December 18, 2014, the Council voted to so designate MetLife, Inc.³ Previously, on July 18, 2012, FSOC voted to designate eight FMUs as systemically important.⁴ The Council conducts annual re-evaluations for

1 General Electric Company reorganized in 2015, which resulted in General Electric Capital Corporation, Inc. being replaced by GE Capital Global Holdings.

2 On June 28, 2016, the Council voted to rescind the designation of GE Capital Global Holdings.

3 A federal district court rescinded the designation of MetLife, Inc. on March 30, 2016. The Department of Justice has appealed this decision.

4 The designated FMUs are: The Clearing House Payments Company, L.L.C., on the basis of its role as operator of the Clearing

nonbanks, or periodic re-evaluations for FMUs, of these designations. The Council has not designated any payment, clearing, and settlement activities as systemically important.

Convening Authority

FSOC has a statutory duty to facilitate information sharing and coordination among its member agencies.⁵ Through this role, FSOC works to reduce gaps and weaknesses within the regulatory structure, and to promote a safer and more stable financial system. FSOC exercises its convening authority both through meetings of FSOC members and through its staff-level committee structure. FSOC reports that it operates under a committee structure to promote shared responsibility among the member agencies and to leverage the expertise that already exists at each agency. These committees consist of senior or staff level representatives from each of the FSOC members and member agencies. FSOC has formed committees around its various statutory responsibilities and core issues that relate closely to financial system risks where more than one agency has a significant interest. For example, FSOC's Regulation and Resolution Committee is tasked with identifying potential gaps in regulation that could pose risks to the financial stability of the U.S. All FSOC member agencies that we interviewed or coordinated with indicated that their agency participated in the Regulation and Resolution Committee. As another example, FSOC's Systemic Risk Committee supports FSOC in identifying risks to, and in responding to emerging threats to, the stability of the U.S. financial system. An FSOC Secretariat official stated that the committee structure helps the dialogue around TBTF to continue by allowing the full Council to meet about 10 times per year although the Dodd-Frank Act requires the principals to meet only four times per year.⁶

Annual Reporting

FSOC has issued six annual reports since its inception, each containing recommendations to various financial regulators and entities in the financial industry. Some of these recommendations relate to the issue of TBTF, such as risk-taking by large, complex institutions. One FSOC member stated that the annual report, among other ongoing FSOC communications, has worked to raise public awareness of the issues FSOC is working on and concerned about. This member stated that he believes that FSOC's focus on topics like interest rate risk and cybersecurity are resulting in financial firms taking steps to address these issues, which in turn is mitigating the likelihood of TBTF bailouts in the future.

Consulting Authority

FSOC has the authority to make recommendations to FRB concerning the establishment of prudential standards in regards to the reporting and disclosure requirements applicable to certain nonbank financial companies and large, interconnected BHCs supervised by the FRB.⁷ An FSOC Secretariat official stated that FSOC has on several occasions provided consulting input/feedback to FRB on the development of

House Interbank Payments System; CLS Bank International; Chicago Mercantile Exchange, Inc.; The Depository Trust Company; Fixed Income Clearing Corporation; ICE Clear Credit LLC; National Securities Clearing Corporation; and The Options Clearing Corporation.

5 12 U.S.C. 5322(a)(2)(E).

6 FSOC meetings are publicly announced and open to the public, whenever deemed possible.

7 12 U.S.C. 5322(a)(2)(I)

these standards. FSOC also has the authority to issue recommendations to regulators to apply new or heightened standards and safeguards for a financial activity or practice conducted by financial institutions. FSOC has issued one proposed recommendation, regarding reforms of money market mutual funds. In addition, one FSOC member agency representative stated that FSOC has conducted studies on and issued recommendations related to the implementation of the Volcker Rule,¹ concentration limits among financial institutions, and risks related to industry-wide products and activities across the asset management sector.

FSOC HAS MADE PROGRESS IN PROMOTING MARKET DISCIPLINE

Most FSOC members and/or representatives and some knowledgeable outside parties that we spoke with stated that FSOC has made progress in promoting market discipline. One FSOC member representative stated that FSOC's purpose of promoting market discipline is a continuous effort. Other FSOC member representatives stated that FSOC has fulfilled or is fulfilling its purpose related to TBTF. One knowledgeable outside party stated that FSOC has made progress in promoting market discipline through various steps such as analyzing and assessing risk throughout the financial system.

Changing Behavior of Companies

In response to its designation by the Council, General Electric announced in April 2015 that it would work closely with its regulators to take the actions necessary to seek rescission of the designation of General Electric Capital Corporation, Inc. The announcement included plans to create a simpler, more valuable company by reducing the size of its financial businesses through the sale of most General Electric Capital Corporation assets. Those efforts resulted in the Council rescinding the designation of GE Capital Global Holdings in June 2016. The Treasury Secretary stated that "the Council designated GE Capital in 2013 after identifying a number of key concerns, including the company's reliance on short-term wholesale funding and its leading position in a number of funding markets. Since then, GE Capital has made fundamental strategic changes that have resulted in a company that is significantly smaller and safer, with more stable funding." A knowledgeable outside individual told us that as some companies are reorganizing or selling parts of their business, she is encouraged that the footprints of these larger institutions will become smaller, and they will cease to be designated allowing for a reduction in systemic risk overall.

Credit Rating Agencies

Three major credit rating agencies² removed the expectation of government support from their company ratings for the eight U.S. global systemically important financial institutions.³ Specifically, in November 2013, Moody's Investor Service considered the systemic support assumptions in its ratings and removed all uplift⁴ from United States Government support in the ratings for BHC debt. In May 2015, Fitch Ratings downgraded the support ratings for the eight U.S. global systemically important banks from '1' (a bank for which there

1 The Volcker rule generally restricts insured depository institutions and any company affiliated with an insured depository institution from engaging in proprietary trading and from acquiring or retaining ownership interests in, sponsoring, or having certain relationships with a hedge fund or private equity fund.

2 The three credit rating agencies are Standard & Poor's Global Ratings, Moody's Investors Service, and Fitch Ratings.

3 The eight U.S. global systemically important banks are Bank of America Corporation, The Bank of New York Mellon Corporation, Citigroup, Inc., The Goldman Sachs Group, Inc., JP Morgan Chase & Co., Morgan Stanley, State Street Corporation, and Wells Fargo & Company.

4 Uplift is the difference between the stand-alone credit rating assigned by a credit rating agency to an issuer, based on that issuer's intrinsic financial strength, and the higher credit rating that considers the possibility of implicit external (e.g., government) support.

is an extremely high probability of external support) to '5' (a bank for which there is a possibility of external support, but the support cannot be relied upon). In December 2015, Standard and Poor's Global Ratings considered the likelihood that the United States Government would provide extraordinary support to be "uncertain" and removed the uplift from its ratings.

Regulatory Changes

Section 120 of the Dodd-Frank Act states that FSOC may issue recommendations to a primary financial regulatory agency to apply new or heightened standards for a financial activity or practice conducted by financial companies under the regulator's jurisdiction.⁵ In November 2012, FSOC issued for public comment a proposed Section 120 recommendation to the SEC to implement reforms in money market mutual funds to address structural weaknesses in this market. In July 2014, the SEC adopted structural and operational reforms to the rules governing money market mutual funds.⁶ Representatives from one FSOC member agency stated that this was an example of FSOC not needing to complete the exercising of its Section 120 recommendation authority because its consultative and facilitating role functioned appropriately. Several knowledgeable outside individuals also stated that they believed that FSOC played a role in encouraging the SEC to adopt reforms of its regulation of money market mutual funds.

FSOC FACES CHALLENGES IN ELIMINATING EXPECTATIONS OF GOVERNMENT SUPPORT

There are a wide range of views on the issue of TBTF. On one side of the argument, some believe that the Dodd-Frank Act ended TBTF as a matter of law while others believe that it only made it more likely the United States Government would provide support. One FSOC member commented that the best way to demonstrate that the era of TBTF has ended will occur when a financial firm is allowed to fail in accordance with the rules put in place by the Dodd-Frank Act, including the execution of a living will to unwind the firm.

When asked whether they believed that FSOC has fulfilled its purpose of promoting market discipline by eliminating expectations of government support in the event of a company failure, FSOC member agency representatives and knowledgeable outside parties stated the following:

- FSOC has fulfilled its purpose in eliminating expectations of government support.
- FSOC has not fulfilled its purpose in eliminating expectations of government support.
- FSOC is making a good faith effort in meeting this purpose.
- FSOC has made significant progress.
- FSOC has fulfilled this purpose to the extent feasible given its legal authorities.

5 12 U.S.C. § 5330

6 Money Market Fund Reform; Amendments to Form PF; 79 FR 47736

- FSOC cannot eliminate the expectation of TBTF, but instead only reduce those expectations.
- FSOC's ability to eliminate TBTF is limited and that despite its authorities, FSOC is not able to control what market participants think and perceive to be true based on experience, regardless of its actions.

These responses indicate a lack of consensus regarding whether FSOC has eliminated expectations of government support. FSOC faces several challenges in fulfilling this purpose.

FSOC's Mandate is Broad but its Authority is Limited

Our review focused on FSOC's efforts to promote market discipline by eliminating expectations of government support. However, several FSOC member agencies were granted authorities related to this issue. For example, Title I, Section 165(b) of the Dodd-Frank Act directs FRB to establish prudential standards for nonbank financial companies designated by FSOC and BHCs with total consolidated assets of \$50 billion or more.¹ These standards are to include (1) risk-based capital requirements and leverage limits, (2) liquidity requirements, (3) overall risk management requirements, (4) resolution plan and credit exposure report requirements, and (5) concentration limits. Further, Title I, Section 165(d)(3) requires the Federal Deposit Insurance Corporation (FDIC), and FRB, to review the resolution plans of these companies.

We solicited input from FSOC members and/or representatives and knowledgeable outside parties as to whether they believed that FSOC, by its actions alone, could eliminate expectations of government support. The members and/or representatives and outside parties stated the following:

- FSOC cannot, by its actions alone, fulfill its purpose related to TBTF.
- FSOC has limited direct authority to address threats to U.S. financial stability by its actions alone. However, FSOC member agencies have taken actions under their own authorities to address systemic issues such as TBTF.
- By statute, FSOC may only make recommendations, coordinate discussions, and designate financial firms for supervision by others. FSOC does not have authority to supervise or regulate any financial companies.
- FSOC has to rely on the member agencies to fulfill this purpose; therefore, FSOC alone is not sufficient.
- The ultimate responsibility for regulation rests with the FSOC member agencies.
- Other entities such as FDIC, FRB, and Congress have an impact on whether FSOC can fulfill its purpose, and FSOC's actions alone are not sufficient.

An FSOC Secretariat official stated that FSOC is not a "super regulator" and cannot require the regulators to take specific actions. Similarly, in the Government Accountability Office's (GAO) report *Complex and Fragmented Structure Could Be Streamlined to Improve Effectiveness*,² GAO concluded that "FSOC has authorities to designate certain entities or activities for enhanced supervision by a specific regulator, but these authorities may not allow FSOC to address certain broader risks that are not specific to a particular entity. For such risks, FSOC can recommend but not compel action."

Difficulty in Measuring Perceptions or Expectations

1 12 U.S.C. § 5365

2 GAO, Financial Regulation: Complex and Fragmented Structure Could Be Streamlined to Improve Effectiveness (GAO-16-175; February, 2016), <http://www.gao.gov/assets/680/675400.pdf>.

An FSOC Secretariat official stated that there is difficulty surrounding this topic in terms of what to measure and that there could never be a permanent answer to the question of whether TBTF has been eliminated. The same official further stated that some people may think that Congress can and will change laws to support banks in the event of failure; however, one can only look at the law as it stands today. One FSOC member agency representative stated that empirical research suggests that this expectation [of government support] cannot be eliminated and questioned how it could ever be measured.

Challenge to FSOC's Authority

In March 2016, a decision by a federal district court rescinded FSOC's designation of the nonbank financial company MetLife, Inc. One knowledgeable outside individual stated that this decision, if upheld, could be debilitating for FSOC and the Dodd-Frank Act, and could encourage risky behavior among the remaining nonbank financial institutions and weaken one of FSOC's primary authorities related to the issue of TBTF. On behalf of the United States Government, the Department of Justice has appealed the federal district court's decision.

Conclusion

According to knowledgeable parties we interviewed, FSOC has made progress in promoting market discipline. However, there is a lack of consensus regarding whether FSOC has eliminated expectations on the part of shareholders, creditors, and counterparties of large BHCs or nonbank financial companies that the government will shield them from losses in the event of failure. According to the FSOC members, FSOC member agency representatives and knowledgeable outside parties we spoke with, FSOC faces challenges in meeting this purpose due to its limited authorities, having to rely on the actions of others, and a difficulty in measuring whether expectations have been eliminated. Also, as noted above, the legal decision involving its designation authority is another challenge FSOC faces.

We believe that the divergent views on TBTF and FSOC's role and success in meeting its statutory purpose of promoting market discipline requires sustained FSOC attention to manage expectations as to what the United States Government will or will not do in the event large financial institutions fail. We are not making any recommendations to FSOC as a result of our audit.

FSOC Response

In a written response, FSOC stated that it has used its existing authorities to make progress in promoting market discipline following the financial crisis. FSOC also stated it has used its authorities to make progress in identifying risks to the United States financial stability and in responding to emerging threats to the stability of the nation's financial system.

Appendix I: Objective, Scope, and Methodology

Objective

The audit objective was to assess the Financial Stability Oversight Council's (FSOC) efforts to promote market discipline by eliminating expectations on the part of shareholders, creditors, and counterparties of large bank holding companies (BHC) and nonbank financial companies that the government will shield them from losses in the event of failure.

Scope and methodology

The scope of this audit included FSOC's efforts to promote market discipline from its establishment, in 2010, through August 2016.

To accomplish our objective, we:

- reviewed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) to determine FSOC's statutory purposes and duties;
- interviewed staff from the FSOC Secretariat to determine FSOC's efforts to promote market discipline;
- interviewed or coordinated with FSOC members and staff from FSOC member agencies to obtain their views and to determine their involvement in FSOC's efforts to promote market discipline;
- interviewed knowledgeable outside parties regarding their views on FSOC's efforts to promote market discipline, including the following:
 - a professor and former high ranking official at the Department of the Treasury, as well as a writer on domestic and international financial regulation issues;
 - a professor, and member of several private and public sector councils and committees that deal with financial regulatory issues;
 - a professor and author of numerous articles and book chapters in the fields of banking law and American constitutional history;
 - a dean at a private university, and former high ranking officer at the National Association of Insurance Commissioners; and
 - a member of a think tank who focuses on banking regulation, and a former senior staffer on a Congressional committee that deals with banking issues;
- reviewed public statements of pertinent entities, such as the credit rating agencies; and
- reviewed past FSOC annual reports, governance documents, meeting minutes, and laws applicable to FSOC's authority to promote market discipline.

We performed fieldwork from October 2015 through August 2016. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings

and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: FSOC Response



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

January 11, 2017

The Honorable Eric M. Thorson
Chair, Council of Inspectors General
on Financial Oversight
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Re: Response to CIGFO's Draft Audit Report: Audit of the Financial Stability Oversight
Council's Efforts to Promote Market Discipline

Dear Mr. Chairman:

Thank you for the opportunity to review and respond to your draft audit report, Audit of the Financial Stability Oversight Council's Efforts to Promote Market Discipline, (the Draft Report). The Financial Stability Oversight Council (Council) appreciates the Council of Inspectors General on Financial Oversight (CIGFO) working group's review of the Council's efforts to promote market discipline. This letter responds on behalf of Secretary Lew, as Chairperson of the Council, to the Draft Report.

As the Draft Report notes, the Council has used its existing authorities to make progress in promoting market discipline following the financial crisis. The Draft Report cites several specific tools the Council has used to meet this statutory purpose, including its authority to designate nonbank financial companies for heightened supervision and enhanced prudential standards, its power to convene federal and state regulators, its annual reports identifying risks to financial stability, and its consultations with regulators. The Council has used these authorities to make progress in identifying risks to U.S. financial stability, promoting market discipline, and responding to emerging threats to the stability of the nation's financial system. CIGFO also noted challenges the Council faces in promoting market discipline, including that the Council's mandate in this area is broad in contrast to its limited direct authorities. CIGFO made no recommendations as a result of the working group's review.

Thank you again for the opportunity to review and comment on the Draft Report. We value CIGFO's ongoing input and look forward to working with you in the future.

Sincerely,

/s/

Jonah Crane
Deputy Assistant Secretary
Financial Stability Oversight Council

Appendix III: CIGFO Working Group

Department of the Treasury Office of Inspector General, Lead Agency		
Eric M. Thorson, Inspector General, Department of the Treasury, and CIGFO Chair		
Deborah Harker	Lisa Carter	Jeffrey Dye
Eduardo Coney	Susan Marshall	Clyburn Perry III
Board of Governors of the Federal Reserve System and the Consumer Financial Protection Bureau Office of Inspector General		
Mark Bialek, Inspector General, Board of Governors of the Federal Reserve System and Consumer Financial Protection Bureau		
Charlene Fadirepo	Saurav Prasad	Sam Withers
Federal Deposit Insurance Corporation Office of Inspector General		
Fred W. Gibson, Jr., Acting Inspector General, Federal Deposit Insurance Corporation		
Robert Fry	Travis Sumner	
Federal Housing Finance Agency Office of Inspector General		
Laura Wertheimer, Inspector General, Federal Housing Finance Agency		
Marla Freedman	Bob Taylor	Tara Lewis
Terese Blanchard	Pamela L. Williams	
National Credit Union Administration Office of Inspector General		
James Hagen, Inspector General, National Credit Union Administration		
Marvin Stith		
Securities and Exchange Commission Office of Inspector General		
Carl Hoecker, Inspector General, Securities and Exchange Commission		
Rebecca Sharek	Colin Heffernan	Lee Richardson

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Appendix B:
**CIGFO's Corrective Action Verification on the Audit of the
Financial Stability Oversight Council's Designation of Financial Market
Utilities**

Prepared by the Council of Inspectors General on Financial Oversight

2017

Abbreviations and Acronyms

CIGFO	Council of Inspectors General on Financial Oversight
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
FMU	Financial market utility
FMU Committee	Financial Market Utilities and Payment, Clearing, and Settlement Activities Committee
FSOC or Council	Financial Stability Oversight Council
PCS	Payment, clearing, and settlement
SEC	Securities and Exchange Commission
Treasury	Department of the Treasury



**DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220**

May 26, 2017

The Honorable Steven T. Mnuchin
Chair, Financial Stability Oversight Council
Washington, D.C. 20220

Dear Mr. Chairman:

I am pleased to present you with the Council of Inspectors General on Financial Oversight (CIGFO) report titled, *CIGFO's Corrective Action Verification on the Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities*.

One of the statutory duties of the Financial Stability Oversight Council (FSOC) is to identify systemically important financial market utilities (FMUs) and payment, clearing, and settlement activities. Accordingly, CIGFO convened a Working Group to determine whether FSOC had taken actions responsive to recommendations made in CIGFO's July 2013 report titled Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities.

In this resulting audit report, we concluded that FSOC has taken corrective actions responsive to each of the five recommendations made by CIGFO in the July 2013 report titled Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities. We are not making any recommendations to FSOC as a result of this audit.

I would like to take this opportunity to thank the FSOC members for their support, especially those Treasury officials who assisted with this effort.

CIGFO looks forward to working with you on this and other issues. In accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act, CIGFO is also providing this report to Congress.

Sincerely,

/s/

Eric M. Thorson
Chair
Council of Inspectors General on Financial Oversight

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Executive Summary

Why and How We Conducted this Audit

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) created a comprehensive regulatory and resolution framework designed to reduce the likelihood, and severe economic consequences, of financial instability. The Dodd-Frank Act established the Financial Stability Oversight Council (FSOC or Council) and charged it with: identifying risks to the nation's financial stability, promoting market discipline, and responding to emerging threats to the stability of the nation's financial system. Among other things, Title I of the Dodd-Frank Act requires FSOC to report to Congress annually about: (1) its activities; (2) significant financial market and regulatory developments; (3) potential emerging threats to the financial stability of the U.S.; and (4) recommendations to: (I) enhance the integrity, efficiency, competitiveness, and stability of U.S. financial markets; (II) promote market discipline; and (III) maintain investor confidence.

The Dodd-Frank Act also created a Council of Inspectors General on Financial Oversight (CIGFO), whose members include the Inspectors General with oversight authority for the majority of FSOC's member agencies. The Dodd-Frank Act authorizes CIGFO to convene a Working Group of its members to evaluate the effectiveness and internal operations of FSOC. In May 2016, CIGFO convened a Working Group to determine whether FSOC has taken corrective actions responsive to the recommendations in CIGFO's July 2013 report titled *Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities*¹.

To accomplish CIGFO's objective, the Working Group interviewed FSOC Secretariat officials from the Department of the Treasury (Treasury) to develop a better understanding of FSOC's efforts to address the recommendations included in the July 2013 CIGFO report. In addition, the Working Group obtained and reviewed relevant documentation from the FSOC Secretariat and publicly available sources. The Working Group conducted fieldwork from July 2016 through September 2016 in accordance with generally accepted government auditing standards. On March 23, 2017, the Working Group briefed FSOC representatives on the overall results of the audit. Appendix I provides additional details about the objective, scope, and methodology of this audit.

What We Learned

FSOC has taken corrective actions responsive to each of the five recommendations made by CIGFO in the July 2013 report titled *Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities*.

FSOC Response

In a written response, FSOC thanked the working group for the opportunity to review and comment on the report. FSOC noted that CIGFO made no recommendations to FSOC as a result of the working group's review.

1 CIGFO, *Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities*, July 2013, [https://www.treasury.gov/about/organizational-structure/ig/OIG Sorter/CIGFO_AUDIT_71713.pdf](https://www.treasury.gov/about/organizational-structure/ig/OIG%20Sorter/CIGFO_AUDIT_71713.pdf).

CIGFO Working Group Audit

This report presents the results of the CIGFO Working Group’s corrective action verification audit on the July 2013 report titled *Audit of the Financial Stability Oversight Council’s Designation of Financial Market Utilities*. CIGFO is issuing this report to FSOC and Congress as part of its responsibility to oversee FSOC under the Dodd-Frank Act. See Appendix II for a listing of previous CIGFO reports.

BACKGROUND

The Dodd-Frank Act established FSOC to create joint accountability for identifying and mitigating potential threats to the stability of the nation’s financial system. By creating FSOC, Congress recognized that protecting financial stability would require the collective engagement of the entire financial regulatory community. As shown in Figure 1,¹ the Council consists of 10 voting members and 5 non-voting members and brings together the expertise of federal financial regulators, state regulators, an insurance expert appointed by the President by and with the advice and consent of the Senate, and others. The voting members of FSOC provide a federal financial regulatory perspective as well as an independent insurance expert’s view. The non-voting members offer different insights as state-level representatives from bank, securities, and insurance regulators or as the directors of offices within Treasury — the Office of Financial Research and the Federal Insurance Office.

Within Treasury, a dedicated policy office, led by a Deputy Assistant Secretary, functions as the FSOC Secretariat and assists in coordinating the work of the Council among its members and member agencies.

Figure 1: FSOC Council Membership	
Federal and Independent Members	State Members
<ul style="list-style-type: none"> • Secretary of the Treasury, Chairperson (v) • Chairman of the Board of Governors of the Federal Reserve System (v) • Comptroller of the Currency (v) • Director of the Consumer Financial Protection Bureau (v) • Chairman of the Securities and Exchange Commission (v) • Chairperson of the Federal Deposit Insurance Corporation (v) • Chairperson of the Commodity Futures Trading Commission (v) • Director of the Federal Housing Finance Agency (v) • Chairman of the National Credit Union Administration Board (v) • Director of the Office of Financial Research • Director of the Federal Insurance Office • Independent member with insurance expertise (v) <p>(v) Indicates Voting Member</p>	<ul style="list-style-type: none"> • State Insurance Commissioner • State Banking Supervisor • State Securities Commissioners

The statutory purposes of FSOC are to:

- identify risks to the financial stability of the U.S. that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace
- promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the Government will shield them from losses in the event of failure; and
- respond to emerging threats to the stability of the U.S. financial system.¹

In February 2013, CIGFO convened a Working Group to examine the rules, procedures, and practices established by FSOC to designate financial market utilities (FMUs) as systemically important and therefore be subject to the requirements of Title VIII of the Dodd-Frank Act. In its July 2013 report, CIGFO made five recommendations to FSOC relevant to designations of FMUs and payment, clearing, and settlement (PCS) activities.

CORRECTIVE ACTIONS TAKEN BY FSOC

Recommendation 1

CIGFO recommended that FSOC establish a formal structure for the Financial Market Utilities and Payment, Clearing, and Settlement Activities Committee (FMU Committee)², including designating a chairperson and keeping a record of committee meetings to document, among other things, its deliberations and key recommendations.

In its June 2013 written response to the recommendation, FSOC stated that it is focused on continuously improving governance over its activities. FSOC also indicated that Council staff had already begun examining ways to further enhance the governance of the Council's staff committees, and this recommendation would be included as part of that review. The Working Group commented that FSOC's commitment to include this recommendation in its review of its staff committees was responsive to CIGFO's recommendation.

The Working Group determined that on May 19, 2015, the Council adopted formal charters for all of its committees, including the FMU Committee. The FMU Committee charter outlines its purpose, duties, committee oversight, committee authorities, composition, administrative duties, meetings, committee action, working groups and analytical teams, and confidentiality. With regard to the designation of a chairperson, an FSOC Secretariat representative stated that the Council determined that it would be more appropriate for the FSOC Secretariat to assume the administrative functions that are typically assigned to a chairperson. Some of the reasons given for this were to avoid issues related to staff turnover and differences in records management among the member agencies. The FMU Committee charter states that the FSOC Secretariat will perform the administrative functions to facilitate the operations and work of the FMU Committee, and that such functions may include among others, calling meetings of the FMU Committee, preparing meeting

¹ 12 U.S.C. § 5322(a)(1).

² The purpose of the FMU Committee is to support FSOC in fulfilling the Council's responsibilities relating to FMUs and PCS activities under the Dodd-Frank Act.

agendas, developing work plans, distributing materials, producing analysis, coordinating the production of FMU Committee work products, maintaining distribution lists for purposes of communications to participants on the FMU Committee, and retaining custody of all records of the FMU Committee. Although formal meeting minutes of FMU Committee meetings are not recorded, an FSOC Secretariat representative stated that FSOC maintains records of key recommendations made by the FMU Committee and stores any documents sent to committee members on a SharePoint site which also contains all other Council records. The Working Group obtained and reviewed relevant documentation, including FMU Committee meeting invitations and agendas.

Recommendation 2

CIGFO recommended that FSOC determine a course of action with regard to foreign-based FMUs consistent with its authorities, as foreign-based FMUs may be systemically important to the stability of the U.S. financial system.

In its June 2013 written response to the recommendation, FSOC stated that the FMU Committee is expected to continue its discussions on this matter at its upcoming meetings and would communicate any developments to the Deputies Committee¹ and the Council as appropriate. The Working Group commented that FSOC's commitment to continue its discussions was responsive to CIGFO's recommendation.

The Working Group was told by an FSOC Secretariat representative that the FMU Committee formed a group in the third quarter of 2013 to consider the range of issues associated with the potential designation of foreign-based FMUs. The group discussed its analysis with the FMU Committee and the Deputies Committee in 2014. Our review of the documented presentation to the Deputies Committee shows the group's analysis considered the regulatory landscape for significant foreign-based FMUs with potential U.S. connections, existing avenues for U.S. authorities to exercise oversight, legal considerations, and the potential policy implications of designation. Based on the group's analysis, the consensus of the Deputies Committee members in May 2014 was to not take any further action at that time with respect to the potential designation of foreign-based FMUs. Subsequently, an FSOC Secretariat representative informed the CIGFO Working Group that the Council, through its staff committees, will continue to monitor any potential risks associated with FMUs, including foreign-based FMUs as appropriate, as part of its regular, ongoing efforts to identify risks to U.S. financial stability. This representative also communicated that individual Council members may present matters associated with foreign-based FMUs for consideration, or the Council may direct further work to be done, at its discretion.

Recommendation 3

CIGFO recommended that FSOC continue deliberations on the process and rules regarding possible future designation of PCS activities conducted by financial institutions as systemically important.

In its June 2013 written response to the recommendation, FSOC stated that the FMU Committee is expected to continue its discussions on this matter at its upcoming meetings and would communicate any developments to the Deputies Committee and the Council as appropriate. FSOC indicated that proposals for the designation of PCS activities would be considered in the ordinary course of the FMU Committee's

¹ The Deputies Committee's duties include coordinating and overseeing the work of the committees of the Council, coordinating the Council's agenda, and assisting the Council in fulfilling its duties.

work. Specific procedures and rules for the future designation of PCS activities were not being considered by the FMU Committee at that time, although such procedures and rules may be developed in the future as a result of FMU Committee discussions or as directed by the Council. The Working Group commented that FSOC's commitment to continue its discussions with respect to PCS activities was responsive to CIGFO's recommendation.

An FSOC Secretariat representative stated that this topic is always on the radar of the FMU Committee, and that there is a process in place for FSOC members to bring an issue to the forefront with the other members. The FSOC Secretariat representative stated that an example of this was when the Securities and Exchange Commission (SEC) presented a trade matching service for consideration during the April 2015 FMU Committee meeting. The Working Group confirmed that the agenda for the quarterly FMU Committee meeting held on April 3, 2015 included the SEC's presentation of the PCS activity and a discussion of PCS activities.

Recommendation 4

CIGFO recommended that FSOC define the nature, frequency, and communication of updates on designated FMUs from the FMU regulators.

In its June 2013 written response to the recommendation, FSOC stated that the FMU Committee would be asked to continue the work it has begun in this area by proposing specific procedures to address this matter. The Working Group commented that FSOC's planned action was responsive to CIGFO's recommendation.

An FSOC Secretariat representative stated that although the final rule on *FSOC's Authority to Designate Financial Market Utilities as Systemically Important*² states that the FMU Committee will review designated FMUs on a periodic basis, FSOC has always reviewed designated FMUs annually. We reviewed FSOC's internal written procedures used to guide these reviews. Those procedures state that the supervisory agencies provide submissions of quantitative supervisory data annually, which is generally year-end data from the previous year. FSOC staff subsequently formats those submissions to achieve consistency and compiles them into a presentation. The written procedures also state that the supervisory agencies and FSOC staff review the quantitative factors that served as the basis for the designations, and this information is presented to the FMU Committee during the third quarter of each year. During the third quarter FMU Committee meeting, agencies walk through material quantitative changes and also provide qualitative updates if there are notable changes in businesses and strategies. An FSOC Secretariat representative confirmed that this is generally the process and timing that FSOC has followed since the initial designations were made in 2012, although the review has in some cases concluded in the fourth quarter rather than the third quarter of the year.

Recommendation 5

CIGFO recommended that FSOC establish a timeline for periodic reviews of non-designated FMUs that may be systemically important.

In its June 2013 written response to the recommendation, FSOC stated that the FMU Committee will be asked to continue the work it has begun in this area by proposing specific procedures to address this matter. The Working Group commented that FSOC's planned action was responsive to CIGFO's recommendation.

² 76 Fed. Reg. 44,763

FSOC's internal written procedures also state that the FMU Committee will review non-designated FMUs annually for potential future designation, if the supervisory or other agencies believe they could be considered systemically important. An FSOC Secretariat representative stated that non-designated FMUs are reviewed during the third or fourth quarter of each year as part of the same process as reviewing the designated FMUs.

Conclusion

The CIGFO Working Group determined that FSOC has taken corrective actions consistent with the intent of each of the five recommendations made in the July 2013 report titled *Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities*.

FSOC Response

In a written response, FSOC thanked the working group for the opportunity to review and comment on the report. FSOC noted that CIGFO made no recommendations to FSOC as a result of the working group's review.

Appendix I: Objective, Scope, and Methodology

Objective

The audit objective was to determine whether the Financial Stability Oversight Council (FSOC) has taken corrective actions responsive to the Council of Inspectors General on Financial Oversight's (CIGFO) recommendations made in its July 2013 report titled Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities.

Scope and methodology

The scope of this audit included the actions FSOC has taken to respond to CIGFO's recommendations regarding the designation of financial market utilities (FMU) from July 2013 to September 2016.

To accomplish our objective, we:

- reviewed the CIGFO recommendations made in the July 2013 report titled Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities;
- queried the Department of the Treasury's Joint Audit Management Enterprise System to review the status of the recommendations;
- interviewed FSOC Secretariat officials and obtained documentation to support their responses, including FMU Committee meeting invitations and agendas, internal FMU designation and review process guidance, summary reports reflecting FMU Committee activities, documentation showing communication among the FMU Committee members and between the FMU Committee and the Deputies Committee; and
- reviewed publicly available information regarding FSOC's designation activities.

We performed fieldwork from July 2016 through September 2016. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Prior CIGFO Audit Reports

The Council of Inspectors General on Financial Oversight (CIGFO) has issued the following prior audit reports:

- Audit of the Financial Stability Oversight Council's Controls over Non-public Information, June 2012
- Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities, July 2013
- Audit of the Financial Stability Oversight Council's Compliance with Its Transparency Policy, July 2014
- Audit of the Financial Stability Oversight Council's Monitoring of Interest Rate Risk to the Financial System, July 2015
- Audit of the Financial Stability Oversight Council's Efforts to Promote Market Discipline, February 2017

Appendix III: FSOC Response



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

April 26, 2017

The Honorable Eric M. Thorson
Chair, Council of Inspectors General
on Financial Oversight (CIGFO)
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Re: Response to Draft Audit Report: CIGFO's Corrective Action Verification on the Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities

Dear Mr. Chairman:

Thank you for the opportunity to review and respond to your draft audit report, CIGFO's Corrective Action Verification on the Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities (the Draft Report). The Financial Stability Oversight Council (Council) appreciates the CIGFO working group's review of the Council's efforts to address the recommendations included in the July 2013 CIGFO report on the Council's designation of financial market utilities. This letter responds on behalf of Secretary Mnuchin, as Chairperson of the Council, to the Draft Report.

As the Draft Report notes, in its 2013 report CIGFO made five recommendations to the Council relevant to designations of financial market utilities and payment, clearing, and settlement activities. The Draft Report notes that the Council has taken corrective actions responsive to all five of the 2013 recommendations. CIGFO made no recommendations as a result of the working group's review.

Thank you again for the opportunity to review and comment on the Draft Report. We value CIGFO's input and look forward to working with you in the future.

Sincerely,

/s/

Eric Froman
Principal Deputy Assistant General Counsel
(Banking and Finance) and Executive Director of
the Council

Appendix IV: CIGFO Working Group

Department of the Treasury Office of Inspector General, Lead Agency		
Eric M. Thorson, Inspector General, Department of the Treasury, and CIGFO Chair		
Deborah Harker	Lisa Carter	Jeffrey Dye
Clyburn Perry	Eduardo Coney	Susan Marshall
Board of Governors of the Federal Reserve System and the Consumer Financial Protection Bureau Office of Inspector General		
Mark Bialek, Inspector General, Board of Governors of the Federal Reserve System and Consumer Financial Protection Bureau		
Laura Shakarji	Jennifer Ksanznak	
Securities and Exchange Commission Office of Inspector General		
Carl Hoecker, Inspector General, Securities and Exchange Commission		
Rebecca Sharek Francis Encomienda	Colin Heffernan	Elizabeth Palmer Gontarek

