

Federal Housing Finance Agency
Office of Inspector General



**FHFA's Oversight of the
Federal Home Loan Banks'
Compliance with Regulatory Limits
on Extensions of Unsecured Credit**

Evaluation Report • EVL–2013–008 • August 6, 2013



Synopsis

August 06, 2013

FHFA's Oversight of the Federal Home Loan Banks' Compliance with Regulatory Limits on Extensions of Unsecured Credit

Why OIG Did This Report

The Federal Home Loan Bank System (FHLBank System) was established in 1932 to support housing finance among other purposes. The 12 Federal Home Loan Banks (FHLBanks), which comprise the FHLBank System, fulfill their mission primarily by making secured loans, known as advances, to their member financial institutions, such as banks and credit unions. These members can use the advance proceeds to originate mortgages and other loans.

FHLBanks also make a variety of investments, including extensions of short-term unsecured credit to domestic and foreign-owned financial institutions. Such credit can pose greater financial risks than advances because it is not secured by collateral.

In June 2012, we issued a report that identified potentially risky unsecured credit management practices by some FHLBanks. These practices include large exposures to counterparties located in the financially troubled Eurozone. Moreover, the report found that several FHLBanks violated FHFA's regulatory limits on unsecured credit that exposed them to potentially greater losses in the event of a counterparty's failure or default. We recommended that FHFA (1) assess the extent of regulatory violations as part of its 2012 horizontal review of unsecured credit risk management practices across the FHLBank System, and (2) consider revising its regulation to mitigate the risks associated with unsecured credit. FHFA agreed with these recommendations.

In this follow-up evaluation report, we assessed FHFA's (1) implementation of the 2012 horizontal review, and (2) supervisory and enforcement responses to identified violations.

What OIG Found

Finding #1: FHFA's 2012 Horizontal Review Was Proactive and Thorough

FHFA conducted a proactive and thorough horizontal review in 2012 that identified over 900 unsecured credit violations at 7 FHLBanks and risk management deficiencies of varying degrees at the other 5. FHFA established a comprehensive examination workplan for the horizontal review, and our review of examination documentation for three FHLBanks concluded that the Agency largely complied with its workplan in these cases.

Finding #2a: FHFA's 2012 Supervisory Response to the Violations Was Consistent with Agency Policy

In 2012, FHFA's general supervisory response to the unsecured credit violations identified at seven FHLBanks was consistent with Agency policy. In particular, the Agency used its supervisory authority to issue Matters



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Requiring Attention (MRAs) or other requirements. Under the MRAs and other requirements, the FHLBanks were required to remediate deficiencies in their compliance and risk management systems within specified time periods.

Finding #2b: FHFA Must Diligently Monitor and Enforce the FHLBanks' Ongoing Compliance with Its 2012 Supervisory Requirements

During 2013, FHFA has been in the process of assessing, among other things, the FHLBanks' compliance with the MRAs and other requirements it issued in 2012. Although this process is in its initial stages, FHFA has already concluded that one FHLBank, which violated the regulatory lending limits 201 times between 2005 and 2012 (see table, below), continued to face challenges in implementing several key controls required by the 2012 MRA. In the first quarter of 2013, the FHLBank breached unsecured credit requirements established in the MRA on 5 separate occasions, resulting in potential overages to 12 counterparties.

NUMBER OF REGULATORY LENDING LIMIT VIOLATIONS BY AN FHLBANK AND AVERAGE OVERAGE PER VIOLATION, IN MILLIONS

2005	2006	2007	2008	2009	2010	2011	2012	Total Period	Average Overage
19	19	38	10	6	39	45	25	201	\$208.5

Although FHFA has not yet decided on a supervisory strategy for the FHLBank, we believe this case demonstrates that the Agency must diligently monitor compliance with established MRAs and other supervisory requirements on an ongoing basis to ensure that unsecured credit remedial actions are implemented over time. Moreover, FHFA must be willing to use all of the authorities at its disposal—including enforcement actions such as cease and desist orders—when, for example, an FHLBank fails to implement a supervisory directive to improve its unsecured credit risk management practices and avoid further regulatory violations.

What OIG Recommends

We recommend that FHFA thoroughly assess the FHLBanks' compliance with its unsecured credit supervisory requirements during the 2013 and 2014 examination cycles, and take enforcement actions as required to ensure that corrective and remedial actions are implemented over time. FHFA agreed with these recommendations.

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ABBREVIATIONS

FHFA or Agency	Federal Housing Finance Agency
FHLBank	Federal Home Loan Bank
FHLBank System	Federal Home Loan Bank System
MBS	Mortgage-Backed Securities
MRA	Matter Requiring Attention
OIG	Federal Housing Finance Agency Office of Inspector General

PREFACE.....

The FHLBank System is comprised of 12 regional FHLBanks whose primary mission is to support housing finance.¹ To carry out this mission, the FHLBank System’s Office of Finance issues debt, the proceeds of which are lent by the FHLBanks to their members in the form of secured loans known as advances.² These member financial institutions can then use the advance proceeds to originate residential mortgages and other loans.

FHLBanks may also make certain investments, including short-term extensions of unsecured credit (i.e., loans not backed by collateral), to domestic and foreign-owned financial institutions.³ Extensions of unsecured credit can help FHLBanks to meet their advance liquidity needs and generate income. However, such credit extensions may pose higher credit risks than advances to the FHLBanks because they are not secured by collateral.

As demand for FHLBank advances declined following the financial crisis, system-wide extensions of unsecured credit to domestic and foreign private counterparties nearly doubled from \$66 billion to \$123 billion between 2008 and early 2011. In a June 2012 evaluation report on extensions of unsecured credit by the FHLBanks during this period, we identified certain potentially risky practices that raised safety and soundness concerns.⁴ In particular, we noted that several FHLBanks had relatively large unsecured credit exposures to counterparties located in the financially troubled Eurozone.

Moreover, our review of FHFA internal financial reports found that in 2010 and 2011 several FHLBanks violated FHFA’s regulatory limits on unsecured credit extensions. Such violations are troubling from a safety and soundness standpoint because the regulatory limits are intended to mitigate the risks associated with extensions of unsecured credit. By

¹ The FHLBanks are chartered by the federal government, but owned as cooperatives by their member financial institutions, which include banks, credit unions, thrifts, and insurance companies. For more information on the FHLBank System, see *OIG, An Overview of the FHLBank System’s Structure, Operations, and Challenges* (online at <http://www.fhfa.gov/Content/Files/FHLBankSystemOverview.pdf>).

² FHLBank advances are secured by eligible collateral such as single-family mortgages or investment grade securities, among other assets.

³ FHFA regulation 12 C.F.R. § 1267 restricts FHLBank extensions of unsecured credit to domestic (U.S.) financial institutions and U.S. branches of foreign-owned banks that are subject to some U.S. governmental regulation.

⁴ See *OIG, FHFA’s Oversight of the Federal Home Loan Banks’ Unsecured Credit Risk Management Practices* (EVL-2012-005) (June 28, 2012) (online at http://fhfa.gov/Content/Files/EVL-2012-005_1_0.pdf) (hereinafter, “*OIG Unsecured Credit Report*”).

exceeding the limits, these FHLBanks exposed themselves to an increased risk of loss in the event of a counterparty's failure or default.

To determine the extent of their violations, we recommended that FHFA assess the FHLBanks' compliance with its regulatory limits as part of its 2012 system-wide horizontal review of unsecured credit risk management practices.⁵ We also recommended that FHFA consider revising its regulation because, as currently drafted, it may permit the FHLBanks to incur large unsecured credit exposures and considerable financial risks. FHFA agreed to implement these recommendations.

We initiated this follow-up evaluation to assess FHFA's (1) implementation of the unsecured credit horizontal review, and (2) supervisory and enforcement response to identified violations.

This evaluation report was prepared by Jon Anders, Program Analyst; Wesley M. Phillips, Senior Policy Advisor; Nicole Mathers, Program Specialist; Alan Rhinesmith, Senior Financial Advisor; and Simon Wu, Chief Economist. The OIG appreciates the cooperation of all those who contributed to this effort.

This evaluation report has been distributed to Congress, the Office of Management and Budget, and others, and will be posted on OIG's website, www.fhfoig.gov.



Richard Parker
Director, Office of Policy, Oversight, and Review

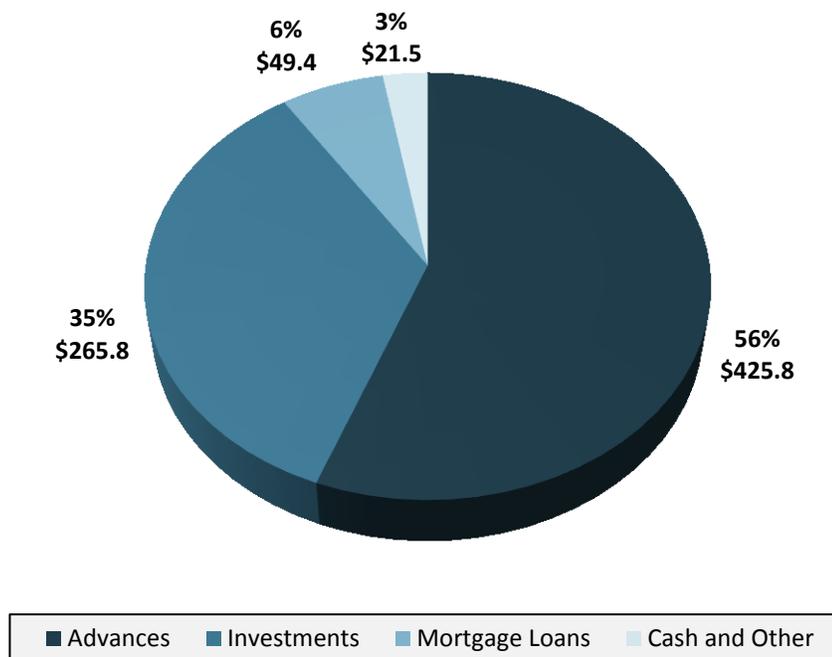
⁵ During a horizontal review, FHFA assesses the FHLBanks' risk management across a particular area – such as unsecured credit – in conjunction with its annual examination of each FHLBank. The purpose of a horizontal review is to develop a consistent assessment of risk management practices across the FHLBank System and ensure comprehensive remediation of identified deficiencies as may be appropriate.

BACKGROUND

Overview of FHLBank System Unsecured Credit Extensions

As of December 31, 2012, the FHLBanks' combined advances of \$425.8 billion constituted 56% of the FHLBank System's total assets of \$762.5 billion (see Figure 1). The FHLBanks' assets also include investment portfolios comprised of, among other things, mortgage-backed securities (MBS) and extensions of unsecured credit to domestic and foreign-owned financial institutions. At the end of 2012, the FHLBanks' investment portfolios totaled \$265.8 billion.

FIGURE 1. FHLBANK SYSTEM ASSETS AS OF DECEMBER 31, 2012, IN BILLIONS⁶



⁶ Source: FHLBanks Office of Finance, *Combined Financial Report for the Year Ended December 31, 2012*, at F-84 (online at http://www.fhlf-of.com/ofweb_userWeb/resources/12yrend.pdf).

According to FHFA officials, the FHLBanks' extensions of unsecured credit typically involve **commercial paper**, **banknotes**, or **federal funds**.⁷ Such credit extensions take place either on an overnight basis or for a term of no longer than 270 days.⁸ FHFA classifies unsecured credit as a non-core mission asset.⁹

The volume of FHLBank unsecured credit extensions has risen and fallen dramatically in recent years (see Figure 2, below).

Although FHLBank advances declined by more than 50% between 2008 and 2011—from \$929 billion to \$418 billion—extensions of unsecured credit to private financial institutions nearly doubled from \$66 billion at the end of 2008 to \$123 billion

in early 2011.¹⁰ In our June 2012 report, we observed that much of the unsecured credit extended by the FHLBanks was to private foreign counterparties, including Eurozone banks that were placed at risk by the European sovereign debt crisis. We also noted that the FHLBanks' unsecured credit exposures declined over the course of 2011 as FHLBank officials curtailed their activities due to financial instability in Europe as well as increased

Commercial Paper: Unsecured, short-term debt instruments issued by corporations, typically for the financing of accounts receivable, inventories, and meeting short-term liabilities. Maturities on commercial paper rarely range any longer than 270 days.

Banknotes: Negotiable promissory notes issued by banks and payable to the bearer on demand. The amount payable is stated on the face of the note.

Federal Funds: Extensions of unsecured credit between financial institutions that are generally made on an overnight basis.

⁷ According to the Federal Reserve Bank of New York, federal funds are unsecured loans of reserve balances at Federal Reserve Banks between depository institutions. Banks keep reserve balances at the Federal Reserve Banks to meet their reserve requirements and to clear transactions. Transactions in the federal funds market enable depository institutions with reserve balances in excess of reserve requirements to lend such funds to institutions with reserve deficiencies. The FHLBanks are not required to maintain their bank reserves at the Federal Reserve. However, they may participate in the federal funds market and extend unsecured credit to domestic and foreign-owned financial institutions.

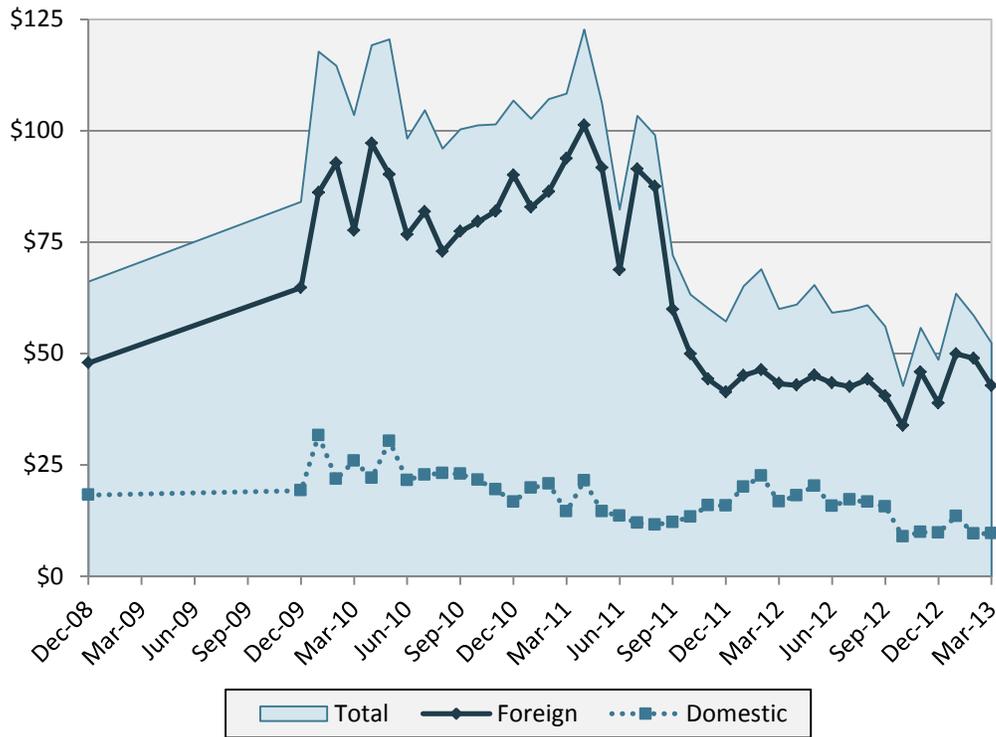
⁸ *OIG Unsecured Credit Report*, at 11.

⁹ FHFA's regulation at 12 C.F.R. § 1265.2 emphasizes that the FHLBanks' mission is to provide their members with financial products and services that assist them in financing housing and community lending. Activities that FHFA deems to further this mission are referred to as "core mission activities," e.g., lending secured advances. See 12 C.F.R. § 1265.3. Extending unsecured credit is not considered a core mission activity. In other words, FHFA does not view these investments as contributing to the FHLBank System's overall goal of promoting housing finance. Furthermore, FHFA's Acting Director has raised concerns about the high levels of non-core mission activities of certain FHLBanks. See FHFA Acting Director Edward J. Demarco, *The Franchise Value of Federal Home Loan Banks*, 2011 Federal Home Loan Bank Directors Conference, Washington, DC (May 11, 2011) (online at www.fhfa.gov/webfiles/21197/FHLB51111Final.pdf).

¹⁰ The FHLBanks also purchase unsecured debt from federal agencies and government-sponsored enterprises. Such debt is not included in the amounts presented above.

scrutiny by FHFA examiners. In 2012 and 2013, unsecured credit extensions continued to decline with lending levels reaching \$52 billion by March 31, 2013.

FIGURE 2. FHLBANK SYSTEM UNSECURED CREDIT EXPOSURES TO PRIVATE COUNTERPARTIES, IN BILLIONS¹¹



As we noted in our June 2012 report, FHLBank officials have stated that their investments, such as unsecured credit, help them to meet FHLBank System liquidity needs. For instance, unsecured credit is often extended on an overnight basis, which means that it can serve as a ready source of liquidity available to fund potential advance demand. FHFA officials said that some FHLBanks also extend unsecured credit because it can yield higher returns than advances and increase their return on capital. FHFA also concluded that FHLBanks extend unsecured credit to offset the overall decline in demand for advances by members in recent years.¹²

According to FHFA, the primary risk associated with such investments is credit risk, i.e., the risk that a counterparty may fail or otherwise default on its obligation to repay the loan. As

¹¹ Source: FHFA. For 2008 and 2009, data are only available for the end of the year. Monthly data are shown for 2010–2013.

¹² *OIG Unsecured Credit Report*, at 9–10.

their name implies, extensions of unsecured credit are not secured or backed by collateral. Therefore, an FHLBank's losses, in the event of a counterparty's default, would be expected to be greater than would be the case if a member institution failed to repay an advance, which by definition is secured by collateral.¹³ FHFA officials view FHLBank extensions of overnight unsecured credit as being less risky than term extensions of up to 270 days because counterparties are required to repay overnight extensions on a daily basis.

FHFA's Regulation Establishes Both Limits on Extensions of Unsecured Credit and Reporting Requirements

In 2002, the Federal Housing Finance Board, a predecessor agency to FHFA, finalized 12 C.F.R. § 932.9, which governs the FHLBanks' ability to extend unsecured credit to individual counterparties. The regulation also establishes reporting requirements associated with extensions of unsecured credit.

Under the regulation an FHLBank's ability to extend unsecured credit to a single counterparty is limited by the counterparty's overall credit rating. The lending limits are greater for higher-rated counterparties and become progressively more restrictive for lower-rated counterparties. Specifically, an FHLBank's exposure to a particular counterparty is a defined percentage of the lesser of the FHLBank's total **regulatory capital** or the counterparty's Tier 1 capital. Figure 3, below, defines applicable percentages based upon the counterparty's credit rating. Using this method, FHFA seeks to limit the potential for, and severity of, an FHLBank's unsecured credit losses in the event of a counterparty's failure or default on its financial obligation.¹⁴

Regulatory Capital: FHFA requires each FHLBank to maintain regulatory capital that is equal to at least 4% of its total assets. According to FHFA's requirements, regulatory capital includes the capital investments of FHLBank members (i.e., proceeds of stock purchases); retained earnings (i.e., profits not paid out as dividends to members); a general allowance for losses, consistent with generally accepted accounting principles; and any other funds available to absorb losses.

¹³ For example, in 2008, Freddie Mac lost \$1.2 billion on an unsecured loan to the Lehman Brothers investment bank when Lehman declared bankruptcy. The \$1.2 billion represented the entire value of the unsecured loan. See, OIG, *Case Study: Freddie Mac's Unsecured Lending to Lehman Brothers Prior to Lehman Brothers' Bankruptcy* (EVL-2013-03) (March 14, 2013) (online at http://fhfa.ig.gov/Content/Files/EVL-2013-03_1.pdf).

¹⁴ OIG *Unsecured Credit Report* at 15.

FIGURE 3. MAXIMUM LIMITS ON UNSECURED CREDIT TO A SINGLE COUNTERPARTY¹⁵

Credit Rating of Counterparty	Term Lending Limits	Total Exposure Limits
Highest Investment Grade (AAA)	15	30
Second Highest Investment Grade (AA)	14	28
Third Highest Investment Grade (A)	9	18
Fourth Highest Investment Grade (BBB)	3	6
Below Investment Grade or Other	1	2

As indicated in Figure 3 above, an FHLBank may offer a *term* extension of unsecured credit to a particular institution in an amount up to the limit provided in the regulation. In addition, the FHLBank may offer an *overnight* extension of unsecured credit to the same institution in an amount not to exceed twice the term limit established by the regulation. Thus, for example, an FHLBank may lend up to 14% percent of its regulatory capital to a AA-rated institution on a term basis,¹⁶ and an additional 14% – for a total exposure of 28% – on an overnight basis.¹⁷

The regulation, 12 C.F.R. § 932.9, also establishes the FHLBanks’ reporting requirements in association with extensions of unsecured credit. In particular, the FHLBanks must report the amount of their total unsecured credit extensions, as well as any extension to a single counterparty that exceeds 5% of the FHLBank’s regulatory capital or the counterparty’s Tier 1 capital.¹⁸

FHFA documents indicate that violations of unsecured lending limits are referred to as “**primary violations**,” and failing to report such violations can result in “**secondary violations**” of the regulation. For each primary violation, FHLBanks are required to report the counterparty, the amount by which the limit was exceeded, and the dates of non-compliance, among other items.

¹⁵ Source: 12 C.F.R. § 932.9(a).

¹⁶ Assuming the AA-rated institution’s Tier 1 capital is greater than the FHLBank’s regulatory capital.

¹⁷ Alternatively, FHLBanks may lend up to the total unsecured exposure limits on an overnight basis. Thus, for example, an FHLBank could extend overnight unsecured credit equal to 28% of its regulatory capital to a AA-rated borrower.

¹⁸ Historically, the FHLBanks reported on their unsecured credit exposures by counterparty on a monthly basis. However, in November 2011, amidst heightened concerns about the risks associated with such lending, FHFA imposed weekly unsecured credit reporting requirements on the FHLBank System.

In our June 2012 report, we found that the regulation may be overly permissive in that it does not include an overall limit on an FHLBank's unsecured credit exposures. That is, the regulation limits only the FHLBanks' per counterparty exposures, leaving their overall exposures unlimited. FHFA officials identified examples of such concerns in internal analyses undertaken in early 2011. Specifically, the officials noted that some FHLBanks had overall unsecured credit exposures that were 150% to 400% of their regulatory capital. Accordingly, we recommended that FHFA consider revising the regulation to mitigate these potential risks by, for example, placing limits on individual FHLBank's overall unsecured credit exposure.¹⁹

FHFA's 2012 Horizontal Review Identified More than 900 Primary and Secondary Violations of Its Regulation on Extensions of Unsecured Credit

In early 2012, FHFA examiners initiated a horizontal review of regulatory compliance and unsecured credit risk management across the FHLBank System.²⁰ The review identified more than 900 primary and secondary violations of the regulation at 7 of the 12 FHLBanks, and risk management deficiencies of varying degrees of seriousness at the remaining 5 FHLBanks.²¹ Most of the violations appear to be the result of system failures and personnel errors at the FHLBanks. However, one FHLBank's violations appear to be particularly egregious for several reasons, including the length of time over which they were committed, the involvement of a senior official who failed to report the violations as required, and the significant financial risks to which the FHLBank was exposed over the entire period.

Most Violations Appear to Be the Result of System Failures and Personnel Errors

FHFA examination materials and other records indicate that several FHLBanks accounted for the vast majority of the regulatory violations of the unsecured credit limits (see Figure 4). Indeed, FHLBanks A and B accounted for 876 (over 90%) of the 927 identified

¹⁹ FHFA agreed with the recommendation and is in the process of considering revisions to the rule that have the potential to limit the FHLBanks' overall unsecured credit risk.

²⁰ FHFA initiated the 2012 horizontal review based upon concerns about the FHLBanks' unsecured credit risk management practices that were identified in 2011.

²¹ FHFA examiners also noted varying risk management deficiencies at the five other FHLBanks that did not violate the regulation. Accordingly, the Agency recommended that some of the FHLBanks undertake comprehensive counterparty credit analyses on an annual basis, update their risk management systems to reflect their counterparties' credit ratings in a more timely fashion, and ensure that controls are in place to prevent additional extensions of unsecured credit until prior extensions are repaid.

violations. In contrast, FHLBank F violated the regulation only twice and FHLBank G only once.²²

FIGURE 4. FHLBANK VIOLATIONS OF 12 C.F.R. § 932.9 IDENTIFIED IN CONJUNCTION WITH THE 2012 HORIZONTAL REVIEW OF UNSECURED CREDIT²³

FHLBank	Number of Violations	Time Period	Causes of Violations
FHLBank A	474	January 2011 – May 2011	Automated system error
FHLBank B	201 Primary 201 Secondary	June 2005 – March 2012	<ul style="list-style-type: none"> • Manual update system error • Senior manager aware of violations but did not report them to FHFA (Personnel Error) • Insufficient oversight by internal audit
FHLBank C	33†	January 2010 – November 2011	Automated system error
FHLBank D	9	December 2011	Automated system error
FHLBank E	6	February 2012 – June 2012	Automated system error
FHLBank F	1 Primary 1 Secondary	February 2011	Manual update system error
FHLBank G	1	March 2012	Personnel error
Total Violations	927		

† FHFA determined that FHLBank C’s aggregate term extensions of credit to two counterparties exceeded the regulatory limits for a combined total of 33 months, 15 months of which are attributable to one counterparty, and 18 months to the other. The number of individual transactions in excess of the regulation is likely higher.

FHFA records and our discussions with Agency officials indicate that, as a general matter, regulatory violations are often caused by systems failures. In some cases, the FHLBanks’ manual or automated systems failed to record, in a timely manner, downgrades in their counterparties’ credit ratings or their placement on “credit watch.”²⁴ In other cases, the FHLBanks’ systems contained inaccurate information about their counterparties’ capital levels. As a result, the affected FHLBanks did not lower their counterparties’ unsecured

²² We do not disclose the identities of the FHLBanks in question in deference to FHFA’s concern that doing so would constitute the disclosure of confidential information that, in turn, could engender adverse financial consequences.

²³ Source: FHFA.

²⁴ A credit rating agency’s review of an institution’s credit rating is referred to as placing the institution on “credit watch.” This can occur in the wake of circumstances or events that could affect an institution’s credit rating in the near term, such as the reporting of significantly increased losses. Under 12 C.F.R. § 932.9(a)(5)(iv), the lending limit for a counterparty that has been placed on credit watch must be reduced to the next lowest level.

credit limits, causing them to breach the regulatory lending limits and incur additional violations.

FHLBank A, which had the highest number of violations at 474, illustrates how a poor management system can result in multiple regulatory violations. According to FHFA records, during the period January 2011 – April 2011, the FHLBank’s credit risk control system received inaccurate capital numbers from an automatic data feed. This, in turn, caused the FHLBank to extend unsecured credit averaging \$193 million per day above the regulatory limits.²⁵ As a result, FHLBank A was placed at considerable financial risk given that some of its counterparties were located in the financially troubled Eurozone. Eventually, the FHLBank’s internal audit department identified these violations and they were reported to FHFA as required by its regulation.²⁶ Consequently, the FHLBank did not commit any secondary violations.

Personnel errors can also cause an FHLBank to violate the regulations. In one case an FHLBank trader extended unsecured credit in excess of the regulatory limits to a federal government-sponsored enterprise on the mistaken belief that such unsecured debt is a direct obligation of the U.S. Government and, therefore, not subject to the regulatory lending limits. The FHLBank discovered the violation the following day during a routine check of unsecured credit extensions and reported it to FHFA.

FHLBank B’s Regulatory Violations Appear to Be More Egregious than Those of the Other FHLBanks

While system failures and personnel errors appear to have caused most of the FHLBanks’ primary violations, our analysis of FHFA documents and discussion with Agency officials indicates that FHLBank B’s violations were of a more serious nature for the following reasons:

- The FHLBank violated the regulation over the course of eight years, i.e., 2005–2012, which is much longer than any of the other FHLBanks that violated the lending limits. In fact, the next longest period over which violations occurred was 23 months;
- A senior manager at FHLBank B failed to report the 201 primary violations although he was fully aware of them throughout the 8-year period over which they occurred. This, in turn, caused FHFA to find that the FHLBank also committed 201 secondary

²⁵ This represents the daily average of FHLBank A’s combined overages for 12 term and 462 overnight extensions of unsecured credit above the regulatory limits.

²⁶ See 12 C.F.R. § 932.9(e)(3).

regulatory violations.²⁷ FHFA found that only one other FHLBank, FHLBank F, committed a secondary violation – and it committed only one such violation; and

- FHLBank B was afflicted with numerous credit risk management deficiencies that inhibited the detection and remediation of its regulatory violations. For example, the FHLBank’s internal audit department failed to conduct adequate reviews of unsecured credit and, therefore, failed to detect the violations.

Moreover, FHFA records indicate that FHLBank B incurred considerable financial risks resulting from its unsecured credit violations. Figure 5, below, shows the frequency of the FHLBank’s violations as well as the average average per violation from 2005 through 2012 of \$208.5 million.

FIGURE 5. NUMBER OF REGULATORY LENDING LIMIT VIOLATIONS BY FHLBANK B AND AVERAGE OVERAGE PER VIOLATION, \$ IN MILLIONS²⁸

2005	2006	2007	2008	2009	2010	2011	2012	Total Violations	Average Overage
19	19	38	10	6	39	45	25	201	\$208.5

The dollar value of FHLBank B’s annual average overage per violation often exceeded—or constituted a significant percentage of—its total retained earnings, which are a critical buffer against losses.²⁹ In 2005, for example, FHLBank B’s average overage was more than 100% of retained earnings. In these circumstances, the potential loss from a counterparty’s failure or default would have been exacerbated because the amount lent over the regulatory limit alone likely could have eliminated the FHLBank’s retained earnings, thereby diminishing its financial position and threatening its ability to fulfill its housing mission.³⁰ Over time, FHLBank B’s annual average overages have decreased as a percentage of its retained earnings.³¹ For example, in 2012, FHLBank B’s average overage exceeded 25% of its

²⁷ According to FHFA, the senior manager was aware of the violations but other FHLBank officials were not. Nevertheless, FHFA concluded that the senior official’s failure to report the violations resulted in secondary violations of the regulation. The official departed the FHLBank following an internal review of the violations.

²⁸ Source: FHFA.

²⁹ See, *OIG Unsecured Credit Report*, at 14.

³⁰ FHFA officials said that the FHLBank’s extension of unsecured credit on an overnight rather than a term basis somewhat mitigated its risk of losses in the event of a counterparty’s default.

³¹ OIG notes that ratio of annual average overages to retained earnings declined between 2005 and 2012, in part, because—while FHLBank B’s annual average overages generally remained stable during the time period in question—its retained earnings more than doubled in a manner consistent with retained earnings growth across the FHLBank System. For more information on FHLBank retained earnings trends, see FHFA, *Report to Congress 2012*, at 31, 32 (June 13, 2013) (online at http://www.fhfa.gov/webfiles/25320/FHFA2012_AnnualReport.pdf).

retained earnings. While the percentage of annual average overages to retained earnings declined, the financial effects of a counterparty failure still could have been significant.

FHFA Has Required the FHLBanks That Committed Violations to Take Corrective Actions Within Specified Timeframes

In early April 2012, FHFA issued an Advisory Bulletin that establishes categories of safety and soundness examination findings at the FHLBanks.³² The Advisory Bulletin states that “examination findings are deficiencies related to risk management, risk exposure, or violations of laws, regulations, or orders that affect the performance or condition of a regulated entity.” Effectively, the bulletin establishes a hierarchy of FHFA examination findings based upon increasing levels of seriousness. These findings serve to identify the affected FHLBank’s remediation priorities and guide FHFA in the development of supervisory strategies designed to achieve them.

In descending order of seriousness, FHFA has identified its three examination finding categories as **Matters Requiring Attention, Violations, and Recommendations**.³³ The issuance of an MRA or a Violation requires the affected FHLBank to submit to FHFA a remediation plan containing specific milestones tied to the severity of the matter. FHFA examiners are charged with reviewing FHLBank remediation plans and testing them as appropriate. The failure of an FHLBank to implement a remediation plan could result in

Matters Requiring Attention: MRAs are the most serious supervisory matters. They include, among other things, non-compliance with laws or regulations that result or may result in significant risk of financial loss or damage to the regulated entity; repeat deficiencies that have escalated due to insufficient action or attention; unsafe or unsound practices; and matters that have resulted, or are likely to result, in a regulated entity being in an unsafe or unsound condition. MRAs also include breakdowns in risk management, significant control weaknesses, or inappropriate risk-taking.

Violations: Violations are any matter in which the examination discloses reason to suspect that a regulated entity is in non-compliance with laws, regulations, or orders. Violations that have serious implications regarding the condition or practices of the regulated entity might also be identified as MRAs.

Recommendations: Recommendations are advisory in nature and represent suggested changes to a policy, procedure, practice, or control to improve or prevent deterioration in condition, operations, or performance.

³² See, FHFA, *Advisory Bulletin AB 2012-01, Categories for Examination Findings* (April 2, 2012) (online at http://www.fhfa.gov/webfiles/23874/AB2012-01_Categories_for_Examination_Findings.pdf).

³³ See *id.*, at 2–4.

FHFA taking an informal or formal enforcement action, such as the issuance of a cease and desist order.³⁴

In response to the findings in its 2012 horizontal review, FHFA classified—pursuant to the Advisory Bulletin standards—the examination findings involving the seven FHLBanks that violated the unsecured credit regulation (see Figure 7). For example, FHFA assigned MRAs to FHLBanks A and B because, among other things, they each committed more than 400 violations. In contrast, FHFA assigned a “Violation” finding to FHLBank G in response to its sole violation of the unsecured credit regulation.

The Agency required the seven FHLBanks to correct their systems and other deficiencies

within specified time periods between September 30, 2012, and March 31, 2013. Further, FHFA directed the FHLBanks to make significant improvements in their operations, such as updating counterparty credit ratings on a timelier basis. FHFA also required the FHLBanks to implement annual audits of their unsecured credit practices and analyze each extension of credit pursuant to a cost/benefit analysis that encompasses potential risks and related costs.

During its ongoing 2013 FHLBank examination cycle, FHFA is assessing the seven FHLBanks’ compliance with the supervisory requirements and remedial plans established in 2012. As described in the next section, FHFA concluded that FHLBank B, which committed the most egregious violations identified in the horizontal review, failed to adhere to certain supervisory requirements established in 2012.

FIGURE 7. FHFA’S SUPERVISORY ACTIONS TAKEN IN RESPONSE TO UNSECURED CREDIT REGULATORY VIOLATIONS³⁵

FHLBank	Violations	Supervisory Action	Remediation Date
FHLBank A	474	MRA	3/31/2013
FHLBank B	201 Primary 201 Secondary	MRA	12/31/2012
FHLBank C	33 [†]	MRA	3/31/2013
FHLBank D	9	MRA	10/31/2012
FHLBank E	6	MRA	3/31/2013
FHLBank F	1 Primary 1 Secondary	MRA	12/31/2012
FHLBank G	1	Violation	9/30/2012

[†] FHFA determined that FHLBank C’s aggregate term extensions of credit to two counterparties exceeded the regulatory limits for a combined total of 33 months, 15 months of which are attributable to one counterparty, and 18 months to the other. The number of individual transactions in excess of the regulation is likely higher.

³⁴ According to Advisory Bulletin AB 2012-01, recommendations are discretionary in nature and, therefore, do not require specific remediation plans. However, if changes based on recommendations are not made, the finding can be raised to an MRA in the following examination cycle.

³⁵ Source: FHFA.

FINDINGS

1. FHFA’s Horizontal Review of FHLBank Unsecured Credit Risk Management Was Proactive and Thorough

In response to the risks in FHLBank unsecured credit practices that it identified in 2011, the Agency initiated a horizontal review of the FHLBanks’ associated risk management practices in 2012. For the reasons that follow, we find that FHFA conducted the horizontal review in a proactive and thorough manner.

- FHFA developed a comprehensive 9-module examination work plan for the horizontal review. The plan covered all phases of unsecured credit transactions, including their approval, execution, monitoring, and reporting.
- A single FHFA examiner, supported on occasion by other FHFA examiners and financial experts, conducted the unsecured credit horizontal review at all 12 FHLBanks. This process ensured consistency in both the conduct of the horizontal review and the reporting of its results.
- FHFA implemented procedures to identify regulatory violations as we recommended in our June 2012 report. FHFA’s procedures identified over 900 regulatory violations at 7 of the 12 FHLBanks, as well as risk management deficiencies or weaknesses of varying degrees at the other 5 FHLBanks.
- We reviewed FHFA’s examination documentation for the work done at three of the FHLBanks during the horizontal review. We found that the Agency largely complied with its work plans.³⁶

2. Findings Related to FHFA’s Supervisory and Enforcement Responses to the Unsecured Credit Violations First Identified in 2012

a. FHFA’s General Supervisory Response in 2012 Was Consistent with Agency Policy

As discussed previously in this report, FHFA complied with the Advisory Bulletin in its 2012 supervisory response to the unsecured credit violations identified at seven FHLBanks. In six of the seven cases, FHFA classified the FHLBanks’ examination findings as MRAs, which is the most serious supervisory designation. In the other case, FHFA classified the FHLBank’s single instance of non-compliance with the regulation as a Violation.

³⁶ Initially, we noted a lack of documentation from which to conclude that work had been performed in some areas specified in the plan. Upon inquiring with FHFA, however, we were able to determine that the work in question had been performed to a sufficient extent.

Consistent with its Advisory Bulletin, FHFA also required the seven FHLBanks to correct the conditions underlying the violations and other risk management deficiencies within various specified timeframes between September 30, 2012, and March 31, 2013.

b. FHFA Must Diligently Monitor and Enforce FHLBanks' Compliance with Unsecured Credit Supervisory Requirements

During its 2013 FHLBank examination cycle, FHFA has been assessing the FHLBanks' compliance with the MRAs it issued in 2012, as well as other supervisory requirements FHFA put in place to strengthen their unsecured credit risk management practices. It is still relatively early in the process and, in many cases, FHFA has not yet reached final conclusions about the FHLBanks' compliance or whether additional supervisory or enforcement steps may be necessary. However, for the reasons set forth below, we believe the 2013 experience of FHLBank B, which committed the most egregious violations identified in the 2012 horizontal review, demonstrates the need for FHFA to diligently monitor and enforce FHLBank compliance with its supervisory requirements.

FHFA Has Identified Ongoing Control Deficiencies in FHLBank B's Unsecured Credit Risk Management

According to Agency officials and preliminary documentation, although FHLBank B has taken a number of steps to comply with its 2012 MRA requirements, it nevertheless continues to experience control deficiencies as follows:

- The FHLBank did not adequately implement a series of requirements designed to enhance its ability to monitor its unsecured credit exposures. As a result, on 5 occasions in early 2013, the FHLBank breached unsecured credit requirements established in its 2012 MRA. These breaches resulted in potential overages to 12 counterparties.³⁷ A senior manager in the credit risk department, who failed to ensure implementation of the required unsecured credit controls, was subsequently terminated. The FHLBank also transferred day-to-day responsibility for its unsecured credit risk monitoring from the credit risk department to another department.

³⁷ FHLBanks generally calculate their regulatory capital based upon the previous month's ending capital amount. In its 2012 MRA, FHFA recommended that FHLBank B analyze reducing its regulatory capital figure for unsecured credit limit calculations more frequently than monthly should its regulatory capital fall by a certain threshold. The FHLBank's credit risk department implemented daily monitoring of changes in regulatory capital, but it failed to identify and report reductions in capital that would have required a management review of the unsecured credit limits. Upon examination, FHFA determined that, although the FHLBank breached the internal policies it established to comply with its 2012 MRA, it did not violate the regulation itself.

- The FHLBank’s internal audit department failed to detect and communicate deficiencies in its unsecured credit practices. As part of its 2012 MRA, FHLBank B was required to ensure that its internal audit department did a better job assessing its compliance with FHFA’s unsecured credit requirements. However, in early 2013, FHFA found that the internal audit department had given the credit risk department a “Satisfactory” review despite the deficiencies cited immediately above. Although FHFA found that the internal audit department was aware of the deficiencies, it did not obtain a commitment from the corresponding department responsible for unsecured credit to establish controls and correct the deficiencies.

FHFA Has Authority to Take Enforcement Actions When FHLBanks Fail to Comply with Its Supervisory Requirements

Although FHFA has not yet decided upon a final supervisory strategy for FHLBank B in response to its control failures in 2013, we observe that the Agency is authorized by statute and policy to take informal or formal enforcement actions when an FHLBank fails to comply with its supervisory requirements.³⁸ Formal actions, which are made public by the Agency, serve to demonstrate that an FHLBank’s failure to undertake a required supervisory requirement can be consequential. For example, the Agency may require an FHLBank to incur the cost of its failure to implement a supervisory requirement by directing it to seek restitution for a loss, limit its growth, or prohibit the payment of dividends or redemption of capital stock. Some formal actions, such as consent orders, may be enforced through the federal court system. And an FHLBank’s failure to comply with certain formal actions could result in the imposition of civil money penalties upon it, or even its placement into receivership.

In our view, FHFA should be willing to use all of its authorities, including enforcement actions, to ensure compliance with MRAs and other supervisory requirements. As documented in this report, seven FHLBanks violated FHFA’s unsecured credit regulation and another five had varying risk management deficiencies. These violations and deficiencies across the FHLBank System, as well as FHLBank B’s failure to implement key controls in 2013 as required, suggest that improving unsecured credit risk management involves considerable challenges. Moreover, FHFA will need to monitor the FHLBanks’ progress in making needed improvements on an ongoing basis and consider the use of enforcement actions as necessary to ensure that improvements in unsecured credit risk management are sustained.

³⁸ In 2012, FHFA’s Division of Federal Home Loan Bank Regulation implemented an enforcement policy governing the use of informal and formal enforcement actions against FHLBanks. A key principle of the policy is that the Agency should take an enforcement action when an FHLBank fails or is unwilling to implement remedial actions established by MRAs and other supervisory requirements.

CONCLUSIONS

In 2012, FHFA conducted a thorough horizontal review during which it identified over 900 primary and secondary unsecured credit regulatory violations at 7 FHLBanks and risk management deficiencies of varying degrees at the other 5. Moreover, in 2012, FHFA acted in accordance with Agency supervisory policy in, among other things, directing the seven FHLBanks that committed violations to undertake remedial actions within specified timeframes. However, given the widespread nature of the violations and risk management deficiencies within the FHLBank System, as well as FHLBank B's failures to implement certain required controls in 2013, FHFA must exercise diligent and forceful oversight on an ongoing basis in order to ensure that corrective action is undertaken and sustained over time.

RECOMMENDATIONS

We recommend that FHFA's Deputy Director, Division of Home Loan Bank Regulation, ensure that Agency examiners thoroughly assess FHLBank compliance with MRAs and other supervisory requirements to remediate unsecured credit violations and risk management deficiencies during the 2013 and 2014 examination cycles. We also recommend that the Deputy Director, in consultation with the General Counsel and others, consider the use of informal or formal enforcement actions as appropriate to ensure the remediation of any further regulatory violations or failures to adhere to supervisory requirements.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objectives of this study were to assess FHFA’s (1) implementation of the unsecured credit horizontal review, and (2) supervisory and enforcement response to identified violations.

To address these objectives, OIG interviewed officials in FHFA’s Division of Federal Home Loan Bank Regulation, Division of Supervision Policy & Support, and Office of General Counsel.

OIG also reviewed FHFA’s regulation that pertains to FHLBank unsecured credit extensions; Advisory Bulletins concerning prudential credit risk management, examination classifications, and the Agency’s enforcement policy; FHLBank examination reports; work papers and programs, findings memoranda, and MRAs associated with the unsecured credit horizontal review; and Agency correspondence with FHLBanks concerning examination findings and MRA remediation.

Further, OIG tested three of the on-site examinations from the horizontal review for compliance with the work program. To test the depth of review across the FHLBank System, we purposefully selected two FHLBanks that violated the regulation and one that did not. We reviewed all of the work papers associated with these examinations for completeness and compliance with the examination work program.

This study was conducted under the authority of the Inspector General Act, and is in accordance with the *Quality Standards for Inspection and Evaluation* (January 2012), which was promulgated by the Council of the Inspectors General on Integrity and Efficiency. These standards require OIG to plan and perform an evaluation that obtains evidence sufficient to provide reasonable bases to support its findings and recommendations. OIG believes that the findings and recommendations discussed in this report meet these standards.

The performance period for this evaluation was March 2013 and July 2013.

OIG provided FHFA staff with briefings and presentations concerning the results of its fieldwork, and provided FHFA an opportunity to respond to a draft report of this study. In its comments, which are reprinted in their entirety in Appendix A, FHFA agreed with the evaluation report’s recommendations. FHFA also provided technical comments on report drafts, which were incorporated as appropriate.

APPENDIX A

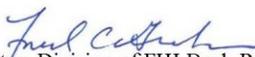
FHFA's Comments on OIG's Findings and Recommendations



Federal Housing Finance Agency

MEMORANDUM

TO: Richard Parker
Director, Office of Policy, Oversight, and Review
FHFA-OIG

FROM: Fred Graham 
Deputy Director, Division of FHLBank Regulation
FHFA

SUBJECT: OIG Draft Report "FHFA's Oversight of the Federal Home Loan Banks' Compliance with Regulatory Limits on Extensions of Unsecured Credit"

DATE: July 19, 2013

FHFA management appreciates the opportunity to respond to the draft OIG report *FHFA's Oversight of the Federal Home Loan Banks' Compliance with Regulatory Limits on Extensions of Unsecured Credit* (the Report).

The Report discusses violations of unsecured credit regulations and FHFA's supervisory activities related to those violations. Although it finds that FHFA's 2012 Horizontal Review of unsecured credit at the FHLBanks was thorough and that FHFA's follow-up on the violations uncovered was consistent with Agency policy, the Report provides two recommendations for FHFA.

Recommendation #1: *We recommend that FHFA's Deputy Director, Division of Bank Regulation, ensure that Agency examiners thoroughly assess FHLBank compliance with MRAs and other supervisory requirements to remediate unsecured credit violations and risk management deficiencies during the 2013 and 2014 examination cycles.*

We agree with this recommendation. Nearly every violation identified in the 2012 Horizontal Review and the weaknesses that led to those violations are documented as Matters Requiring Attention, or MRAs. MRAs are the most serious form of examination finding at FHFA, and we expect the FHLBanks to remediate our concerns.

FHFA has already assessed FHLBank remediation activities for some MRAs. While we found the FHLBanks resolved most outstanding issues, our work will continue through the 2013 examination cycle. We expect to complete the documentation of our assessments for existing MRAs by March 31, 2014.

Recommendation #2: *We also recommend that the Deputy Director, in consultation with the General Counsel and others, consider the use of informal or formal enforcement actions as*

appropriate to ensure the remediation of any further regulatory violations or failures to adhere to supervisory requirements.

We agree with this recommendation. FHFA considers the actions an FHLBank takes or commits to take in response to FHFA findings and conclusions in determining whether an enforcement action is warranted. With respect to the 2012 MRAs on unsecured credit, the FHLBanks largely fixed internal control problems upon identification of the violations, and committed to further enhancements of controls or practices to address weaknesses identified by FHFA. Given these actions and commitments made by these FHLBanks, FHFA did not use enforcement actions for these supervisory matters in 2012.

FHFA will continue to consider enforcement actions, consistent with its Enforcement Policy, in its supervision of the FHLBanks. We historically have found the use of enforcement actions most consistent with deterioration of overall FHLBank condition, performance, operations, management, or any combination thereof.

We will document, no later than March 31, 2014, our decisions, and how we came to them, about possible enforcement actions related to unsecured credit MRAs and any underlying regulatory violations we discover during the 2013 examination cycle.

cc: Bruce Crandlemire
John Major

APPENDIX B.....

OIG's Response to FHFA's Comments

On July 19, 2013, FHFA provided comments on a draft of this report in which it agreed with the recommendations. The Agency also identified the actions that it has taken to date and will take to implement them. OIG considers FHFA's proposed actions to be sufficient to resolve the recommendations, which will remain open until OIG determines that the Agency's corrective actions are completed in a manner that is responsive to the recommendations. OIG has attached the Agency's full response (see Appendix A), which was considered in finalizing this report.

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