FEDERAL HOUSING FINANCE BOARD
FY 2008 AUDIT OF THE THOROUGHNESS OF THE OFFICE OF SUPERVISION'S BANK EXAMINATIONS

Audit Report No. 08-A-01-OS

NOTICE OF SUBSEQUENT EVENTS

On July 30, 2008 and after substantial completion of this audit, the President signed the "Housing and Economic Recovery Act of 2008" (ACT). The Act gives the Finance Board responsibility for winding up the affairs of the Federal Housing Finance Board (FHFB) by July 30, 2009. Consequently, recommendations in this report that relate to matters associated with winding up the affairs of FHFB will be forwarded to the Chairman of FHFB for action under the authorities delegated to him by the Federal Housing Finance Board.

Dembo, Jones, Healy, Pennington & Marshall, P.C.
Certified Public Accountants and Consultants

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FEDERAL HOUSING FINANCE BOARD
THOROUGHNESS OF THE OFFICE OF SUPERVISION's BANK EXAMINATIONS

I. Background

We were asked by the Office of Inspector General (OIG) of the Federal Housing Finance Board (FHFB) to perform an audit of the thoroughness of the Finance Board's Office of Supervision's (OS) examinations of the 12 Federal Home Loan Banks (FHLB's or Banks) and their Office of Finance. The Federal Housing Finance Board regulates the 12 Federal Home Loan Banks that were created in 1932 to improve the supply of funds to local lenders, who in turn, finance loans for home mortgages. The FHFB also has regulatory authority and supervisory oversight responsibility over the Federal Housing Finance System's Office of Finance, which issues debt to facilitate the funding needs of Federal Home Loan Banks. The Finance Board ensures that the FHLBanks, which are privately capitalized, government-sponsored enterprises, operate in a safe and sound manner, carry out their housing and community development finance mission, and remain adequately capitalized and able to raise funds in the capital markets. Annual Bank examinations are an important part of the Finance Board's oversight.

Our audit was conducted from September 17, 2007 to July 21, 2008 in accordance with auditing standards generally accepted in the United States of America and the standards applicable to audits contained in Government Auditing Standards, issued by the Comptroller General of the United States.

II. Objectives, Scope and Methodology

Our primary objective was to audit the thoroughness of the Bank examinations. We held discussions with Office of Supervision and Federal Home Loan Bank personnel concerning their insight into the effectiveness and thoroughness of the examinations, qualifications of OS examiners, adequacy of training, and related topics. Our methodology included reviewing a sample of Reports on Examinations (ROE) for 2005 to 2007 examination periods. We focused on FHLBanks where safety and soundness problems existed in the past few years but also sampled examinations where no serious issues were identified. Our sample was based on our initial discussions with OS and OIG personnel concerning results of examinations over the past several years. We reviewed a sample of work papers prepared by examination teams, reviewed consultants' reports for certain FHLB's, interviewed a sample of FHFB Board members, and reviewed recent Office of Inspector General's work in this area. In addition, OIG representatives attended a few recent FHFB Board meetings. We reviewed documentation for report findings, and reviewed work papers to determine if findings were being properly included in the ROE's. We met with the Director of OS and obtained information concerning recent changes in OS that relate to our findings.

In reading Reports on Examinations, we documented findings for a sample of Banks from examination periods 2005 to 2007. Our objective in doing this was to determine if the examination process has been proactive, rather than reactionary, a key indicator of thoroughness of the examinations. A goal was to be in a position to make objective comments about the thoroughness of the examinations, in order to assist the FHFB in improving the examination process.

III. Executive Summary

In general, we found the examination process to be thorough. Examination reports build on analysis and findings from one examination to the next. Serious safety and soundness issues that we reviewed were identified in earlier years as appropriate and identified as potentially serious issues in the Reports on Examination. We were able to trace issues back to preceding years where OS properly identified them. While serious safety and soundness issues have risen to the point where the Board of the FHFB has had to take serious actions, we found that the examinations and the Reports on Examinations did highlight potentially serious safety and soundness issues timely. The FHFB called upon the FHLBanks to engage experts to examine highly technical safety and soundness issues when needed. Warnings of serious issues were presented by these experts and discussed in the Reports on Examinations over a period of years.

As a result of our work, we have a series of observations, findings and recommendations. They are described in this report under the categories of work papers, reports and training. The main theme of our findings and recommendations centers on communication. We found that communication needs to be strengthened among examiners, between work paper preparers and reviewers, during the examinations with Bank officials, between examiners in the field and OS management and FHFB Board members. Best practices for examinations were previously not routinely shared, work papers are not always complete, findings are sometimes omitted from the Reports of Examinations without documented explanations, Bank officials are often surprised by the tone of ROE's, and FHFB Board members do not always receive timely information concerning important issues discovered during examinations.

As a result, we recommend the ADD:

Work Paper Preparation Deficiencies

1) Initiate another work paper standardization project. Best practices should be incorporated into this project. As a result, the efficiency and effectiveness of work papers should improve. At a minimum, develop procedures to reduce the risk of findings being omitted from ROE's. This should include what we saw some teams are successfully doing. An example is to clearly document the disposition of findings, to indicate whether they are meant for inclusion in the ROE, a matter to be just discussed orally with the FHLBank personnel, or not communicated at all. Document the quality review of examination work papers to be sure they are completed in full, which includes the identification of the work paper preparer(s) and reviewer(s).

2) Improve the documentation of work paper review. Develop or purchase a system to document the work paper review.

3) Document the linkage between findings, recommendations and violations, and their place in the ROE.

4) Conduct a formal evaluation of the use of electronic audit work paper tools, or other examination tools to facilitate the sharing of work papers and improve their quality control.

Report Deficiencies

1) Develop a standard method in the work papers to track findings and other issues that are intended to be included in the ROE.

2) Provide initial draft ROE to Bank officials. Consider their comments before finalizing the ROE. Add this process to the examination policies and procedures and the Bank Examination Manual.

3) Inform Bank officials that they still have the option of appending management comments to the ROE.

4) Review the cited reference in Profiles of the FHLBanks to see if it should be improved.

5) Provide status meetings during the examination process (documented) to FHFB Board of Directors and Chairman on any potentially significant issues to get their input on additional scope requirements if any that might be required for OS.

6) Integrity of the examiners is important and there should be adequate procedures in place to ensure the objectivity of OS examiners and staff. For example, Generally Accepted Government Auditing Standards (GAGAS) provide criteria for each of our audit staff completing annual reporting on potential conflict of interest situations and providing notification to OIG management of any potential conflict of interest situations. It is recommended that the Bank Examination Manual be updated to include similar procedures for FHFB OS examiners and staff.

Training Needs to be Improved

1) Provide improved training for new inexperienced examiners, to improve their efficiency and effectiveness in performing examinations.

2) Analyze the tools currently available to OS for the examination process, such as the Bloomberg system, and determine what, if any, should be made available to examiners in the field, to help them with their job.

3) Improve the use of the intranet as a communication tool among examiners.

4) Provide more training for all examiners on the examination process, and environments they will encounter, to try to reduce inconsistencies in examination methodologies.

5) OS should assign examiners to new teams, in an effort to provide each team with experts in certain technical areas, rather than having the same examination team go to the same four Banks, as is currently done.

In his September 11, 2008 response to our report (See Appendix 1), the Acting Deputy Director, Division of FHLBank Regulation, Federal Housing Finance Agency (ADD) concurred with our overall conclusion that the examination process was thorough. The ADD agreed with thirteen (13) of our fifteen (15) recommendations. Specifically, he disagreed with "Report Deficiency" recommendations 2, and 5.

With regard to Report Deficiency Recommendation No. 2, he commented that the ROE is not a negotiated document and should not be shared and vetted with FHLBanks before it is issued. We do not agree with the ADD. We believe that OS' obtaining and incorporating FHLBank input into draft examination reports would help reduce the likelihood of inaccurate or incomplete ROE's being issued.

With regard to Report Deficiency Recommendation No.5, the ADD commented that the head of FHLBank examination office was correct in using the examination report as the vehicle to communicate all examination issues to the Finance Board. We disagree. We believe there should be a process for reporting significant examination issues in advance of completing a Report of Examination as OIG officials have observed that on occasion, Finance Board members have expressed a need for such reporting.

OBSERVATIONS, FINDINGS AND RECOMMENDATIONS - *COMMUNICATION ISSUES*

Criteria:

The Federal Housing Finance Board Examination Manual is a resource that provides standards and expectations for examinations of the Federal Home Loan Banks, the Office of Finance, and the Financing Corporation. The Examination Manual documents examination objectives and procedures, provides guidance to examination staff, and promotes an effective, consistent, and efficient examination process.

The Examination Manual describes a process that notes the Office of Supervision must rely on communication among a variety of individuals to be successful in its mission. The successful coordination of the communication processes is key to administering its safety and soundness examinations. Policies and procedures for Bank examinations are established by OS, and examiners in the field carry out the examination plans. These examiners interact on both a regular and periodic basis with Bank officials and other Bank employees. Examiners need to keep OS officials informed of significant findings, and OS must communicate such issues to the FHFB Board. Without timely communication with OS officials and the FHFB Board, serious issues could be discovered during examinations, but not brought to the attention of those charged with oversight timely. The Bank officials need to communicate with OS examiners and FHFB officials concerning findings in order to eliminate confusion and disagreement once the ROE's are presented to the Banks.

Work Paper Preparation Deficiencies

Conditions/Causes:

1) We found instances where work papers documented issues that were to be part of the Report on Examination (ROE), however they were left out of the ROE. In other cases, some findings and recommendations were intentionally dropped from ROE inclusion, but this fact was not documented in the work papers. Some findings were merged into one finding in the ROE, but this fact was not clear from the work papers.

   OS does not have a standard method to summarize findings and document, or link, which issues are to be brought forth to the ROE. As a result, findings intended for the ROE could be overlooked. Since a standard method does not exist to document the resolution of findings for inclusion in the ROE, it becomes difficult to trace some findings directly to the ROE. OS personnel believe there may have been a communication break down between examiners and Portfolio Managers during the work paper review stage in some cases.

2) We found instances where work papers were not complete. Also, in most cases, we could not tell if work papers were reviewed by anyone other than the preparer. We could not tell who the preparer was in some cases. Examination programs are not used consistently among examination teams to outline the examination steps to be followed. In some cases, we could not find examination programs for key areas of the examinations.

   OS has had different methods of documenting work paper completion and review. As a result, in several circumstances, work papers were identified as incomplete and there was no way for us to evidence a review of the work papers. OS has informed us they are researching improved ways to document work paper completion and review, possibly through the use of new examiner software tools. The OS recognized the need to improve work paper completion and review processes, and included this in the performance plans and assessments for 2007.

3) Reports are not referenced back to supporting work papers prepared by the examiners.

   OS has not established a policy of cross-referencing the ROE to the work papers. A summary matrix is used to identify major standard sections of the ROE and where the relevant work papers can be found, however, the ROE itself is not cross-referenced to specific work papers.

4) Work paper preparation is not consistent. OS best practices are not being followed between examination teams of Portfolio Managers (PM). For example, one Portfolio Manager instructs his team to use an excel work paper to track findings from one year to the next. If used correctly, this work paper could be effective. We noted that some other teams do not use a similar tool, and, as a result it was hard to determine how they track open findings from one year to the next.

Examination teams are led by a Portfolio Manager (PM), who oversees examiners for four banks. A mechanism was not previously in place for the teams to interact on a periodic basis to learn from each other. Also, due to geographical dispersion of the teams, on-site training in a central location is not routinely provided. Work paper preparation recommendations are provided by the PM's to their respective teams. As a result, different approaches emerge among different PM examination teams. This led to inconsistencies among the teams work papers as to the tracking of findings and their disposition. Specialty Working Groups (SWG) were formed in 2007 to address these types of issues.

5) Some issues have not been resolved on a timely basis, and remain open for several years. Work papers do not clearly document the reasons. An example of this is the lack of receipt of an expense reduction detailed plan from one of the FHLBanks, even after several requests.

The issue of not obtaining the expense reduction plans from one of the FHLBanks was part of the overall problem with the FHLBank and part of the overall attempts to improve the financial and operational condition of the Bank. This was not documented fully, however.

6) Work papers are now available for review between examination teams by accessing a network drive on the FHFB network. However, an off the shelf electronic or customized work paper product is not utilized. Such a product could improve consistency in work paper preparation and review, and improve access among examination teams.

OS has made many improvements over the last few years, as it migrated to a paperless work paper environment. Quality control over the work paper completion, review and consistency needs further attention to insure that work papers and audit programs are fully completed, and all findings intended to be part of the ROE make their way to the ROE's. We understand that this is an area OS has been addressing. Improvements made include, among many others, that each examination has a work paper lead sheet structure that leads to consistency in filing of work paper documentation, common programs are intended to be used, risk assessments are well documented and work papers are accessible to others once this fact is made known to other examiners and they are encouraged to learn from each other's work. However, an audit, or examiner work paper software tool is not utilized that could improve the availability of work papers to authorized viewers and users. As a result, the ability to access other examiners work papers is hampered. We are, however, aware that OS is considering the joint use of another regulatory agency's examination tools.

Work Paper Preparation Deficiencies

Effect:

1) A significant risk exists that Reports on Examinations may not contain all issues that OS intends for them to contain for a particular examination. This was evidenced in our review, and the risk is significant that it could happen in future ROE's. For instance, on one examination in our sample, we found findings that were intended to be in the ROE, but were omitted.

2) The accuracy of a ROE could be called into question due to the lack of evidenced review of work papers. As discussed above, there was an evidenced example discovered by us where the ROE was incomplete as to all findings. A reviewer of work papers could question the accuracy of a report based on the lack of work paper review.

3) Examination teams do not share best practices in work paper preparation, thereby they miss opportunities to improve the effectiveness of the work papers. For instance, one team uses an excel spreadsheet that appears to be a very efficient and useful tool in following up on prior year finding. It was much more difficult for us to clearly determine how other teams in our sample followed up on prior year findings, since there was no evidence of a similar work paper tool.

Work Paper Preparation Deficiencies

We recommend that the ADD:

1) Initiate another work paper standardization project. Best practices should be incorporated into this project. As a result, the efficiency and effectiveness of work papers should improve. At a minimum, develop procedures to reduce the risk of findings being omitted from ROE's. This should include what we saw some teams are successfully doing. An example is to clearly document the disposition of findings, to indicate whether they are meant for inclusion in the ROE, a matter to be just discussed orally with the FHLBank personnel, or not communicated at all. Document the quality review of work papers to be sure they are completed in full, which includes the identification of the work paper preparer(s) and reviewers(s).

Management's Response: The ADD agreed with the recommendation.

2) Improve the documentation of work paper review. Develop or purchase a system to document the work paper review.

Management's Response: The ADD indicated agreement with this recommendation.

3) Document the linkage between findings, recommendations and violations, and their place in the ROE.

Management's Response: The ADD agreed with this recommendation.

4) Conduct a formal evaluation of the use of electronic audit work paper tools, or other examination tools to facilitate the sharing of work papers and improve their quality control.

Management's Response: The ADD indicated agreement with this recommendation.

Report Deficiencies

Conditions/Causes:

1) A ROE was issued with findings left out.

A standard work paper is not utilized to track findings and link them to the ROE.

2) Some Bank officials informed us that they would like to have the opportunity to append management comments to the ROE. They do not believe they have the opportunity to do this, even though OS representatives have informed us the Banks do have this opportunity.

OS officials informed us that they do not want the release of reports to extend beyond their goal of releasing the ROE two months after an exit conference. They feel that providing Bank officials with an opportunity to review draft ROE's or add individual comments to the ROE would significantly slow down the release of the reports. However, we were told by the Director of OS that he will again inform the Banks that their comments to the final ROE can be appended to the ROE.

3) Some Bank officials commented that the tone and content of ROE's are different than that presented at exit conferences by Examiners in Charge.

The examination manual states that Examiners should avoid creating inconsistencies between the tone or message conveyed at the closing conferences and that contained within the report of Examination. The OS Director believes that the tone of an exit conference may be muted due to the nature of the ongoing relationship between Examiners in Charge and the Banks they examine. He feels that the tone is often muted, which causes concern to Bank officials when they read an ROE that is much more serious in tone after OS officials consider all issues.

4) Reports generally take two and a half months to be released after an exit conference. The OS goal is two months.

The goal of releasing a ROE within 60 days after the conclusion of field work is not being achieved regularly due to the time it presently takes to arrive at a final ROE. The ROE is subject to review and input by a large number of OS officials, which can delay the ROE release. OS is reviewing possible stream lining options.

5) We read the Profile of the Federal Home Loan Bank System report, dated June 30, 2007. We noted that in Section V, Market Risk Monitoring Reports, page 6, a qualifier statement is made by the author that gives us concern, indicates that:

"Differences may also arise from operational differences, such as data entry, market price inputs, and modeling assumptions. Moreover, not all Banks measure assets the same way. Some include all derivative values as we request but others do not. In short, some of the differences in apparent risk exposure to rate shocks may actually be the result of modeling and reporting differences across Banks".

We question why the information provided by the Banks cannot be provided in a format that leads to consistency among the twelve banks. For instance, if it was requested that the Banks include all derivatives values, why doesn't OS insist that this be obtained? A reader of this paragraph could question the accuracy of the Market Risk Monitoring in its entirety.

The OS Director has informed us he will look into the misleading information in the Profiles of the FHLBanks referred to above. We have also been told by the FHFB Associate Director, Risk Modeling that OS may insist that the Banks report the data consistently. This may be enforced as part of an OS project to address the implementation of a new accounting standard at the Banks.

6) Significant issues detected during examinations may not always be communicated to Board members of the FHFB until the ROE is presented to them for review. This was evidenced recently where an issue involving another FHLBank was of major concern, but it was not communicated to the Board before the ROE was presented to them.

A formal mechanism is not in place for communicating significant findings to FHFB Board members. As a result, Board members may be unaware of significant issues until they read the ROE. The OS Director does meet with the Chairman of FHFB and Board member representatives weekly. However, since OS believes the Board, in essence, acts as an appellate body, not all issues are purposely brought to the Boards attention in advance of the ROE delivery. We find this lack of timely communication is contradictory to a critical role the FHFB assumes: that of a regulatory oversight body responsible for resolving safety and soundness issues in the FHLBanks.

7) While the FHFB has policies and procedures covering financial disclosures and maintains an ethics program, the OS itself does not have a formal policy for employees to certify independence and no conflicts of interest on an annual basis.

OS does not have a documented policy of requiring employees to certify that they do not have conflict of interest or independence issues with the Banks, since the FHFB as a whole has a Designated Agency Ethics Official and an ethics program.

Report Deficiencies

Effect:

1) A ROE could be issued with findings omitted. As stated in the work paper section previously, we did find at least one example of this occurring for a ROE. The responsible Portfolio Manager was shown the OS work paper that discussed the findings that were omitted. He agreed that they should have been part of the ROE.

2) A ROE could be issued that would be incorrect, since the FHLBank management does not have a chance to review it, and provide comments, before it is issued. This was evidenced by the recall of a ROE for the Seattle Bank.

3) Since so many OS Officials are involved in the ROE review process, the ROE can be delayed beyond sixty days regularly.

4) Reports on the Profiles of the FHLBanks could be incorrect since all Banks do not report data consistently. A reader could question the validity of the reports.

5) When ROE's are not released within the sixty day goal, the Board of the FHFB loses time in which it could effectively respond to serious issues in the ROE. Since there is not a mechanism in place to notify the Board of <u>all</u> serious issues before the release of an ROE, a delay in the release could seriously affect their ability to respond.

6) A conflict of interest could exist with OS employees and the Banks for a variety of reasons. This issue may not be brought to the attention of OS Officials since a formal documented periodic certification process is not in place concerning conflicts of interest disclosure in OS.

Report Deficiencies

We recommend that the ADD:

1) Develop a standard method in the work papers to track findings and other issues that are intended to be included in the ROE.

<u>Management's Response</u>**:** The ADD agreed with this recommendation.

2) Provide initial draft ROE to Bank officials. Consider their comments before finalizing the ROE. Add this process to the examination policies and procedures and the Bank Examination Manual.

Management's Response: The ADD disagreed with this recommendation. He believes that the ROE is not a negotiated document and should not be shared and vetted with FHLBanks before it is issued. OIG: We do not agree with the ADD. We believe that OS' obtaining and incorporating FHLBank input into draft examination reports would help reduce the likelihood of inaccurate or incomplete ROE's being issued.

3) Inform Bank officials that they still have the option of appending management comments to the ROE.

Management's Response: The ADD agreed with this recommendation.

4) Review the cited reference in Profiles of the FHLBanks to see if it should be improved.

Management's Response: The ADD indicated agreement with our recommendation.

5) Provide status meetings during the examination process (documented) to FHFB Board of Directors and Chairman on any potentially significant issues to get their input on additional scope requirements if any that might be required for OS.

Management's Response: The ADD commented that the head of FHLBank examination office was correct in using the examination report as the vehicle to communicate all examination issues to the Finance Board. We disagree. We believe there should be a process for reporting significant examination issues in advance of completing a Report of Examination as OIG officials have observed Finance Board members express a need for such reporting on occasion.

6) Integrity of the examiners is important and there should be adequate procedures in place to ensure the objectivity of OS examiners and staff. For example, Generally Accepted Government Auditing Standards (GAGAS) provide criteria for each of our audit staff completing annual reporting on potential conflict of interest situations and providing notification to OIG management of any potential conflict of interest situations. It is recommended that the Bank Examination Manual be updated to include similar procedures for FHFB OS examiners and staff.

Management's Response: The ADD indicated that the Finance Board will explore with the Office of General Counsel and with the Office of Government Ethics, the advisability of adopting annual reporting of conflicts of interest for all staff involved in FHLBank examinations.

Training Needs to be Improved

Conditions/Causes:

1) Some OS Examiners-in-charge indicated that examiners need to "get out of their silos and learn from each other." A certain amount of frustration was communicated to us to indicate that OS examiners do not share best practices on a regular basis.

   Due to a shortage of examiners, examiners were not taken from the field routinely to interact with each other for training purposes. A mechanism was not in place to hold periodic training and information sharing sessions between examination teams. This caused the "silo effect" among examiners. OS has more recently taken action to address these concerns by forming Specialty Working Groups and by sponsoring annual conferences for examination personnel.

2) The availability of software tools such as the Bloomberg system and ABS Net Software are examples of tools that we understand are not available to examiners in the field. An OS Examiner-in-charge did comment that these tools could be a valuable resource for examiners, however not all examiners have the ability to access them.

   Officials informed us that they do survey the Portfolio Managers to determine what tools, such as the Bloomberg system, are needed in the field. They indicated to us they will expand their survey to others besides the PM's to address these issues.

3) While the intranet does exist within OS, some examiners feel it is not used effectively to communicate across examination teams. The examiners felt that research information found by OS personnel was not shared as well as it could be among examination teams. Examples given were that of news releases and research analysis.

   Specialty Working Groups and training sessions are now in place and will be used to encourage more use of the intranet. In the past, examiners did not use it to communicate as much as they could have.

Training Needs to be Improved

Effect:

1) Examiners did not have the opportunity to benefit from learning of best practices since a forum did not exist to share such information on a regular basis. This was evidenced in our review of a sample of work papers from different teams. The Specialty Working Groups, however, have been formed to address this currently.

2) Since not all examiners have the same tools available to them, such as financial market data bases currently available only in the FHFB headquarters, examination effectiveness could be diminished if assistance is not sought.

3) Technical information is not shared routinely that otherwise would improve the effectiveness of the examinations. For instance one examiner commented that he occasionally sends important technical market information to other examiners. The information is accessed from systems only available to examiners in FHFB headquarters. However, a process is not in place to make this sharing of relevant information a regular practice at OS.

Training Needs to be Improved

We recommend that the ADD:

1) Provide improved training for new inexperienced examiners, to improve their efficiency and effectiveness in performing examinations.

2) Analyze the tools currently available to OS for the examination process, such as the Bloomberg system, and determine what, if any, should be made available to examiners in the field, to help them with their job.

3) Improve the use of the intranet as a communication tool among examiners.

4) Provide more training for all examiners on the examination process, and environments they will encounter, to try to reduce inconsistencies in examination methodologies.

5) OS should assign examiners to new teams, in an effort to provide each team with experts in certain technical areas, rather than having the same examination team go to the same four Banks, as is currently done.

Management's Comments: The ADD indicated agreement with these recommendations.

APPENDIX

AUDITEE'S COMMENTS

FEDERAL HOUSING FINANCE BOARD
Office of the Chairman

Date: September 23, 2008

To: Edward Kelley
Inspector General

From: Ronald A. Rosenfeld
Chairman

2008 SEP 23 P 08

Subject: Response to the Office of Inspector General's Draft Audit Report of the Thoroughness of the Office of Supervision's Examinatons of the Federal Home Loan Banks (FHLBanks) and Office of Finance (OF)

I am pleased we had the opportunity to meet on September 18, 2008 to discuss the Office of Inspector General's Draft Audit Report (Report) of the "Thoroughness of the Office of Supervision's Bank Examinations." This memorandum memorializes that discussion.

I concur with the Report's overall conclusion. The Report states that the examination process is thorough and reports of examination (ROEs) build on analysis and findings from one examination to the next. It also concludes that Finance Board examiners identified serious safety and soundness issues in a timely and appropriate manner. Finally the Report states that the Examination Manual adequately documents examination objectives and procedures, provides guidance to examination staff, and promotes effective, consistent, and efficient examination processes.

The Report devoted significant attention to procedural issues and recommendations intended to enhance the quality of our supervision. The Report included recommendations for more stringent workpaper documentation requirements, expanded communications with FHLBank management prior to the issuance of a final Report of Examination (ROE), and more explicit mechanisms for ensuring compliance with existing conflict of interest rules. As we discussed, we agree with the principles underlying those recommendations.

We will carefully consider ways to link more explicitly the documentation in workpapers to the content of the ROE and to track the disposition of findings as you recommend. We will also reinforce with examination staff the importance of ongoing, substantive discussion of examination findings and conclusions throughout the examination and reiterate to Bank management and boards of directors the opportunity to request that their comments be appended to the ROE. While we welcome the FHLBanks input in a variety of ways throughout the examination, the ROE is not, and should not be, a negotiated document that is shared and vetted with the FHLBank before it is issued. Finally, the meeting helped to clarify your

recommendation that we develop procedures for examiners to complete annual reporting on potential conflicts of interest. As we discussed, the agency has stringent ethics policies to govern conflicts of interest, but we will explore with our Office of General Counsel and with the Office of Government Ethics the advisability of adopting affirmative, annual reporting of potential conflicts of interest. If such a reporting mechanism is established, however, the requirement should apply to all agency staff, not just examination staff.

Thank you for the opportunity to meet and discuss your Report and to comment on its recommendations. We look forward to continuing this dialogue as a means of further enhancing the thoroughness and quality of our examinations of the FHLBanks.