PREFACE

We are pleased to publish this first edition of the Office of Federal Housing Enterprise Oversight (OFHEO) *Examination Handbook*. OFHEO's Office of Examination and Oversight conducts comprehensive annual risk-based examinations of Fannie Mae and Freddie Mac to determine the condition of the Enterprises for the purpose of ensuring financial safety and soundness.

This *Examination Handbook* is intended to guide the examination staff in the performance of their examination-related activities, and it will be updated from time to time to reflect current practice.

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OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT
OFFICE OF EXAMINATION AND OVERSIGHT
EXAMINATION HANDBOOK

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INTRODUCTION

The purpose of this *Examination Handbook* is to guide the examination staff of the Office of Federal Housing Enterprise Oversight's ("OFHEO") Office of Examination and Oversight ("OEO") in the performance of examination activities. This introduction briefly describes Fannie Mae and Freddie Mac (collectively, the "Enterprises"), and the formation of OFHEO as their financial safety and soundness regulator. Chapter 1 describes the core principles that drive examination work, and Chapter 2 describes the elements of the examination program itself. Chapter 3 describes OFHEO's standards for communication and emphasizes the sensitive and confidential nature of information gained through the examination program. The Appendix is reserved for Examination Guidance Bulletins that will be issued as needed to provide examiners with guidance on selected topics and for supplements to the handbook.

This Examination Handbook does not describe the full range of OFHEO activities or powers granted by Congress to OFHEO under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (or the "1992 Act"). Where the handbook does not directly address a particular matter of interest, examiners should seek guidance from other sources within OEO or OFHEO.

CREATION OF THE ENTERPRISES AND THEIR PUBLIC MISSION

Federal Intervention to Promote Housing Credit. Congress created Fannie Mae and Freddie Mac in 1938 and 1970, respectively, to expand the availability of mortgage credit in America. These actions were based on the perception at that time that the private capital market was not effectively meeting the country's housing credit needs.

The Public Mission. Fannie Mae and Freddie Mac are required by law to serve important public purposes. These public purposes include providing liquidity to the residential mortgage market and increasing the availability of mortgage credit benefiting low- and moderate-income families and areas that are underserved by lending institutions. The Enterprises engage in two principal businesses: purchasing residential mortgages and guaranteeing residential mortgage securities.

Government-Sponsorship. The Enterprises operate under Federal charters that, as Federal statutes, are controlled by Congress. Each Enterprise is governed by an 18-member board of directors, of which 5 directors are

appointed annually by the President of the United States. The remaining directors are elected annually by the shareholders.

The Enterprises' shares are privately owned and publicly traded on the New York Stock Exchange. The Enterprises are self-supporting, but receive significant benefits from the Federal government in order to help them fulfill their public mission. These benefits are described below.

Congress provided the Enterprises with specific benefits to help them accomplish their mission. These benefits include, for example:
(1) exemptions from the registration and periodic reporting requirements (but not the anti-fraud provisions) of Federal securities laws; (2) discretionary authority on the part of the Secretary of the Treasury to purchase up to $2.25 billion of outstanding securities of either Enterprise on terms and conditions established by the Secretary; and (3) exemptions from state and local income taxes.

Although the Enterprises further public purposes, the Federal government does not guarantee any of the Enterprises' obligations, and has no legal duty to protect the Enterprises' creditors. Nevertheless, the financial markets behave in a way that reflects the implicit presumption that the United States Government would not permit the Enterprises to fail—and thereby provides the Enterprises with enhanced access to markets that may not be available to other private sector firms.

OFHEO—THE ENTERPRISES' FINANCIAL SAFETY AND SOUNDNESS REGULATOR

OFHEO's Mission Statement reads: "**OFHEO effectively protects the interests of the American taxpayer and contributes to the strength and vitality of the nation's housing finance system through independent and fair safety and soundness regulation of Fannie Mae and Freddie Mac**."

Formation of the Office of Federal Housing Enterprise Oversight. Congress created OFHEO in 1992 through the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 to be the Enterprises' financial safety and soundness regulator. Congress recognized that the Enterprises have important public missions for housing in America. Congress stated that, as of the date the 1992 Act was passed, the Enterprises posed a low financial risk of insolvency. Because of the Enterprises' sheer size and enormous impact to the market resulting from the failure of either Enterprise, however, Congress concluded that more effective Federal regulation is needed to reduce the risk of failure of the Enterprises. OFHEO's primary objective is to fulfill this Congressional mandate.

The 1992 Act established OFHEO as an independent office within the Department of Housing and Urban Development (HUD), and created the framework within which OFHEO conducts its activities as financial safety and soundness regulator. The 1992 Act also defines the respective roles of OFHEO and HUD in regulating the Enterprises. The following description of OFHEO's authority is limited in scope, and is intended to provide examiners with a brief background.

OFHEO's Exclusive Authority in Matters of Financial Safety and Soundness. OFHEO and HUD share primary oversight responsibility over the Enterprises, however, the OFHEO Director exercises *exclusive* authority in matters of safety and soundness. The most important of the Director's exclusive authorities, in relation to this E*xamination Handbook*, are the exclusive authorities to conduct annual safety and soundness examinations. The OFHEO Director also exercises exclusive authority to establish minimum and risk-based capital standards for each Enterprise.

The OFHEO Report to Congress. Once a year (by June 15, as required by the 1992 Act), the OFHEO Director submits a written report to Congress. OFHEO's Annual Report to Congress describes the financial safety and soundness of each Enterprise—including the results and conclusions of the annual examinations. This is an important document because it provides OFHEO with the opportunity to share with Congress, the public, the housing finance industry, and others, OFHEO's views on each Enterprise's current financial condition. The report also allows OFHEO to comment on matters that could affect financial safety and soundness in the future.

CHAPTER 1

THE EXAMINATION PHILOSOPHY AND CORE PRINCIPLES

THE EXAMINATION APPROACH

Background—Public Statements of Purpose and Objectives. The main sources of information that explain OFHEO's examination activities are this *Examination Handbook*; section 1317 of the 1992 Act (12 U.S.C. § 4517); the 1998 OFHEO Report to Congress; the OFHEO Mission Statement; and the Strategic Plan and corresponding Annual Performance Plan ("APP"). When considered in the aggregate, these sources provide the examination staff with the information necessary to understand OFHEO's examination authority, responsibilities, objectives, and approach.

The Mission Statement, Strategic Plan and Annual Performance Plan. As previously noted, the Mission Statement states that "OFHEO effectively protects the interests of the American taxpayer and contributes to the strength and vitality of the nation's housing finance system through independent and fair safety and soundness regulation of Fannie Mae and Freddie Mac." The strategic plan builds on the broad declaration contained in the Mission Statement. The OFHEO Strategic Plan for 1998-2003 identifies three strategic goals that will enable OFHEO to realize its mission. Those goals are to: (1) effectively regulate the Enterprises by ensuring that they are adequately capitalized and operate in a safe and sound manner; (2) promote an efficient secondary mortgage market through an independent and balanced approach to regulatory oversight of the Enterprises; and (3) effectively regulate the Enterprises by ensuring that they comply with all laws under OFHEO's jurisdiction. The Strategic Plan describes OFHEO's approaches to achieving its strategic goals, including the conduct of annual, comprehensive, risk-based examinations of the Enterprises. The APP (which is revised for each fiscal year) establishes specific performance measures that apply to OEO's examination activities. Examination staff should familiarize themselves with each of these documents.

OFHEO'S CORE EXAMINATION PRINCIPLES

OFHEO has identified certain core examination principles that examination staff should apply when evaluating Enterprise activities. The core examination principles are the foundation of OFHEO's risk-based examination

program that is described in Chapter 2. These principles comprise OFHEO's view on the important considerations that serve as the foundation for OFHEO's annual assessments of each Enterprise's financial safety and soundness.

Statement of Core Examination Principles

Principle One - Effective examination (which incorporates all examination-related activities) evaluates the existing financial condition and state of risk management, and attempts to anticipate the onset of potential issues or problems that have the capacity to adversely impact the financial health of an Enterprise. OFHEO monitors relevant indicators and developments to analyze market conditions, considers management's expectations (including applicable forecasts and projections), and uses this knowledge to assess the implications for safety and soundness. Risk taking in a dynamic environment is a natural element of the Enterprises' operations and is fundamental to the mortgage finance business. OFHEO's examination program works to anticipate, rather than merely react to, potential problems.

Principle Two - Effective examination requires each Enterprise's management to exercise a degree of oversight and control that is commensurate with the risks at the Enterprise. The financial safety and soundness of an Enterprise does not require operations to be flawless in every area. OFHEO's oversight does not endeavor to *eliminate* risk, but to ensure that: (1) management and the Boards of Directors implement controls that are appropriate for the risks the Enterprises take, and (2) the risks taken are consistent with financial safety and soundness. The term "oversight" in this context includes all examination-related activities—including, for example, research, planning, testing, surveillance, and monitoring. As a financial safety and soundness regulator, OFHEO is concerned with volatile performance and with exposures to risk in the midst of market conditions that raise the probability that the Enterprise may suffer financial impairment.

Principle Three - Effective examination focuses examination resources on those areas where weaknesses could impair the financial health of an Enterprise and where weaknesses are pervasive or result from intentional disregard. Effective oversight accepts the reality that no business is free of errors or mistakes in judgment, and does not impose an unreasonable standard of performance on the Enterprises' managements and Boards of Directors. Examination activities should focus on matters that, if not sufficiently managed, could threaten financial safety and soundness.

Principle Four - Effective examination incorporates the opportunity to share with each Enterprise the regulator's unique perspective on best practices and emerging issues, promoting operations and performance enhancements through sharing knowledge. OFHEO is well-positioned to assess best practices in the secondary mortgage market, and to identify emerging issues from a knowledgeable and reasonable perspective. In light of this fact, OFHEO will share with Enterprise management nonproprietary information that can promote enhancements in the Enterprises' operations and performance.

Principle Five - Effective examination is goal- and results-oriented and does not rigidly prescribe the means by which an Enterprise achieves the desired goals or results. OFHEO will consider the operating environment and competitive pressures of the mortgage finance business when assessing the financial safety and soundness of each Enterprise. OFHEO recognizes that Enterprise management functions in a dynamic, competitive environment that requires management to make decisions on the best information available at any given time. This environment rewards innovative solutions to operating challenges, and it is appropriate for management to consider the full range of practical options before reaching a final decision in response to such challenges. Effective oversight recognizes that each Enterprise's business goals can be met in more than one way, and that minimizing competitive inefficiencies is an important factor for management to consider when deciding among options.

Principle Six - Effective examination uses the regulator's resources efficiently and does not impose unwarranted costs on an Enterprise. Effective oversight ensures that examination resources focus only on activities that could impact safety and soundness including violations of law, thereby avoiding inefficiencies in the use of examination resources. This approach will impose on the Enterprises only those constraints and costs necessary to ensure the appropriate balance of controls and financial performance. The oversight of the Enterprises should not impose costly incremental demands that do not benefit financial safety and soundness and promote adherence with applicable policies, laws and regulations.

CHAPTER 2

RISK-BASED EXAMINATION AND OVERSIGHT

INTRODUCTION

This chapter describes the attributes of a quality risk-based examination and oversight program. It sets out the four examination areas in the Office of Examination and Oversight (OEO) and identifies the Examination Objectives and Assessment Factors for each area. This chapter also describes the comprehensive examination framework and the process OEO employs both to maintain a current understanding of the financial safety and soundness of the Enterprises, and to report annually to the Enterprises' Boards of Directors and Congress.

As described in Chapter 1, OEO established its examination philosophy and core principles. OEO then developed a risk-based examination and oversight approach that is consistent with the established philosophy and core principles. A risk-based approach promotes the efficient use of OFHEO resources by focusing on areas of relatively higher risk in each Enterprise. Examiners will pay particular attention to those risks that can represent either an actual or potential threat to the stable operations of an Enterprise.

RISK-BASED APPROACH

OFHEO recognizes that the Enterprises must accept risks in order to meet their public purposes of providing a secondary mortgage market for conforming mortgages and to achieve acceptable financial performance. OEO's focus is on whether the risks assumed by the Enterprises are warranted and properly managed. ***A key to reaching these judgments is examiners evaluating whether the Enterprises knowingly accept risks and have the capacity to identify, measure, monitor and control or alter risks on an ongoing basis***. In making these evaluations, examiners will place equal emphasis on the Enterprise's actual practices - the actions it takes – and not singularly focus on the Enterprise's policies. An Enterprise that in OEO's opinion appropriately identifies, measures, monitors, and controls or alters its risks and effectively prices those risks would be considered to operate in a safe and sound manner.

OEO also recognizes that an Enterprise may reach a sound conclusion that certain marginal improvements in risk management do not warrant the associated costs. OEO's risk-based approach to examination will assess the process by which the Enterprises make such decisions. OEO's oversight role is to determine whether the decisions that are reached impair the safety and soundness of the Enterprise, are premised on sound information. OEO's role is first to determine that the Enterprise's operations and activities meet safety and soundness standards

and are in compliance with laws and regulations. A second role is to share with the Enterprises information and guidance that, if applied, would result in operations that exceed or even substantially exceed the safety and soundness standards. OEO will not substitute examiner's judgment for the well-reasoned judgment of the Enterprise not to implement marginal improvements where operations adhere to safety and soundness standards.

OEO's risk-based approach focuses OFHEO's resources on the areas of relative higher risk in the Enterprises. A corollary is that OEO expects the Enterprises to spend their resources (both capital and human) to improve weaknesses in proportion to the risk posed by the weakness. This means OEO will require an Enterprise to address in a timely fashion any issue that OEO deems to introduce an actual or potential impairment to the overall safety and soundness of the Enterprise. It also means that OEO does not expect the Enterprises will implement all enhancements OEO identifies to Enterprise practices or activities when OEO has found these practices or activities to be conducted in a safe and sound manner.

Through its examination and oversight activities, OEO will identify issues that require the attention of three different groups at the Enterprises. These groups are the Boards of Directors, executive management, and operating/technical management. Issues that fall within the normal range of duties and responsibilities of the Board and executive managers, or that have the actual or potential ability to disrupt the stability of the Enterprise, will be addressed to the Board and executive management. This is a high standard that recognizes that only matters of appropriate significance warrant discrete Board or executive management involvement. By limiting the issues presented to the Board and executive management to those that pose potential safety and soundness concerns, OEO increases the likelihood that the Board and executive management will respond aggressively to the issues OEO raises with them. OEO is keenly aware that its effectiveness could be undermined if it presents relatively minor or insignificant issues to the highest level of the Enterprises.

Issues that should be addressed by the Enterprises but do not pose a safety and soundness concern will be addressed to operating/technical management. OEO will apprise the Board and executive management that issues have been presented to operating/technical managers to address, and share with the Board and executive management OEO's expectation that appropriate personnel will address the issues and report on the follow-up. OEO will maintain an inventory of outstanding and resolved operating/technical issues so it can evaluate over time whether these issues are isolated or pervasive. If such issues are pervasive, then OEO will communicate with operating/technical management, executive management, or the Board, as appropriate.

In addition to identifying the appropriate level at the Enterprises to discuss examination identified issues, and consistent with the risk-based approach to examination and oversight, OEO will also categorize the level of risk and quality of risk management of examination identified issues. The categories OEO will use

are: substantially exceeding safety and soundness standards; exceeding safety and soundness standards; meeting or modestly exceeding safety and soundness standards; falling short of safety and soundness standards but posing neither an immediate nor serious threat to the Enterprise's financial stability; or substantially deficient in meeting safety and soundness standards and requiring immediate corrective action.

KEY ATTRIBUTES OF RISK-BASED EXAMINATIONS

OEO has identified five key attributes that will be the hallmark of its risk-based examination work. These attributes complement the examination core principles set forth in Chapter 1. The five key attributes are: transparency, customization, timeliness, flexibility, and comprehensiveness.

Transparency. OFHEO's effectiveness in its examination and oversight role is enhanced when the Enterprises are aware of and understand the examination objectives, approach and criteria used to assess the financial safety and soundness of the Enterprises. The examination and oversight role is also enhanced when the Enterprises understand OEO's examination strategies. A transparent risk-based examination program that defines terms and sets out expectations facilitates effective communication between the Enterprises and OEO. A transparent risk-based examination program should also expedite the Enterprises' taking corrective measures.

Customization. While the same examination standards are used at both Enterprises, OEO will customize its examination strategies to each Enterprise's risk profile, which reflects not only the Enterprise's operations and activities, but also the quality of risk and risk management. Customized examination strategies focus examination resources on the areas presenting the greatest potential exposure to each Enterprise. OEO will routinely review and validate each Enterprise's risk profile. OEO's examination strategies will reflect both risks that are unique to each Enterprise and risks that are common across the industry or in the economic environment.

Timeliness. The examination program is designed so that an examination cycle corresponds to one calendar year and a Report of Examination is delivered to the Enterprises' Boards of Directors no later than 60 days after the end of each calendar year. Although they operate with an annual examination cycle, examiners will not delay sharing significant issues and/or requiring the Enterprise to take corrective action until the annual Report of Examination is delivered to the Board of Directors. Instead, OEO will communicate significant issues to management and the Board as soon as practical.

Flexibility. The examination program demands that OEO review risk profiles and examination strategies quarterly to determine if adjustments in scheduling or resources are necessary to reflect changes in an Enterprise's risk profile, the state of the industry, or the economic environment. These processes

allow the examination program to adapt to changes in each Enterprise's practices and the environment in which the Enterprises operate.

Comprehensiveness. OEO's risk-based examination program takes a comprehensive view of the sources of risk that have the potential to impair the Enterprises' safety and soundness and the quality of risk management and controls to address those sources of risk. OEO has identified four examination areas: Credit, Market, Operations and Corporate Governance. As described in detail below, these four areas, and the ten corresponding examination programs, are designed to assess the prudent operation and management of the Enterprises. OEO's examination resources will be directed toward:

- assessing the appropriateness of the levels of risk;
- assessing the appropriateness of Board of Directors and Executive Management governance;
- determining the adequacy of the policies, procedures, and limits intended to control risk;
- determining the appropriateness of the risk selection, and the effectiveness of risk measurement, management and reporting mechanisms;
- evaluating the adequacy of the framework for internal controls; and
- assessing the quality of issue resolution.

The Risk-Based Examination Program

OEO will have completed a full-scope examination when it has: 1) achieved the examination objectives in each of the four examination areas (the categories of risk and risk management); and 2) concluded at least annually on each of the assessment factors for the ten program areas. The process by which OEO conducts its comprehensive, annual, risk-based examinations is depicted on the chart on the ensuing page. The remainder of this Chapter describes the examination program in detail and walks the examiner through each step of the examination program, beginning with the creation of the risk profile and concluding with the communication of examination findings.

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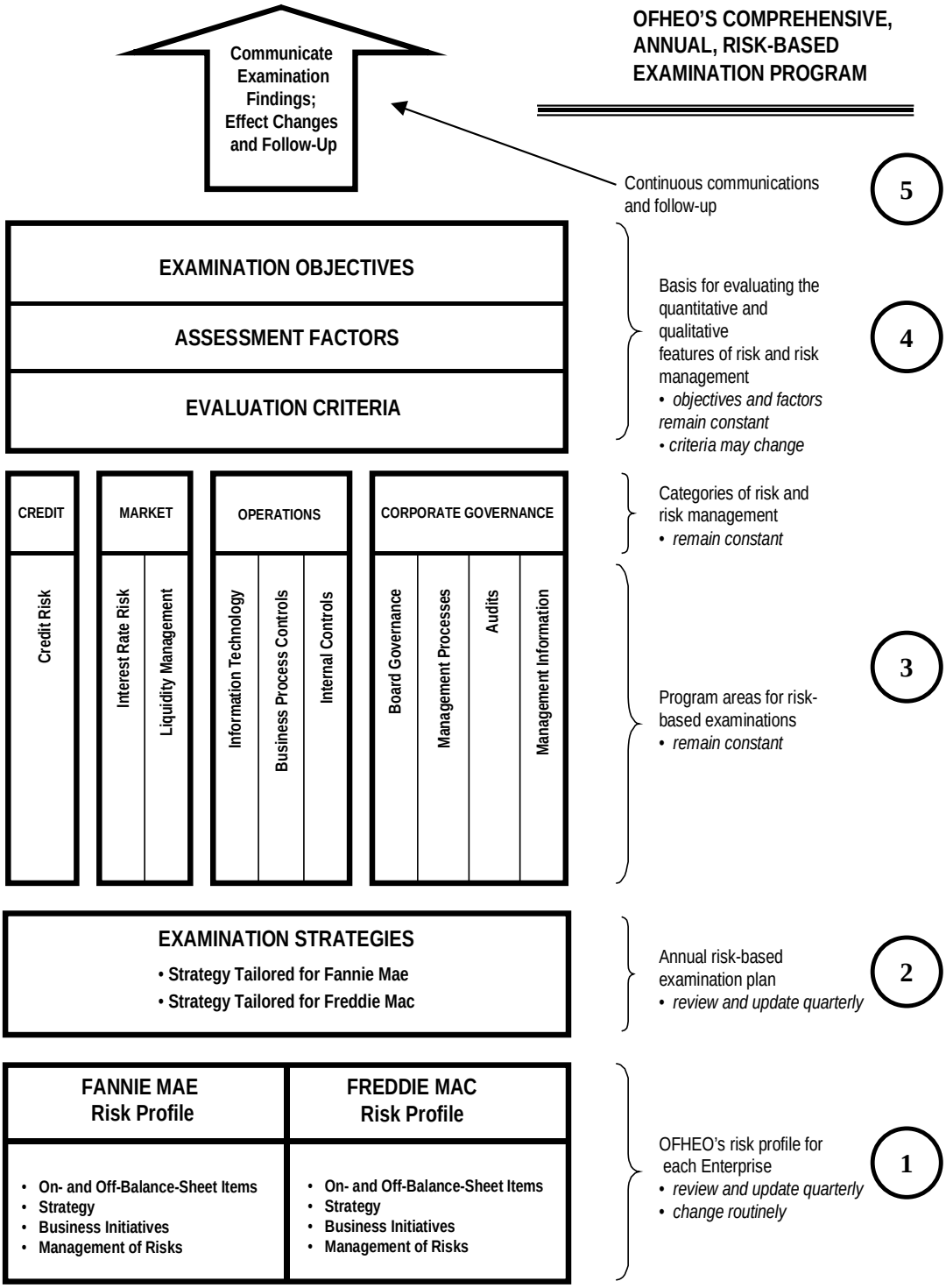
OFHEO'S COMPREHENSIVE, ANNUAL, RISK-BASED EXAMINATION PROGRAM
Communicate Examination Findings; Effect Changes and Follow-Up
Continuous communications and follow-up
5
EXAMINATION OBJECTIVES
ASSESSMENT FACTORS
EVALUATION CRITERIA
Basis for evaluating the quantitative and qualitative features of risk and risk management
• objectives and factors remain constant
• criteria may change
4
CREDIT
MARKET
OPERATIONS
CORPORATE GOVERNANCE
Credit Risk
Interest Rate Risk
Liquidity Management
Information Technology
Business Process Controls
Internal Controls
Board Governance
Management Processes
Audits
Management Information
Categories of risk and risk management
• remain constant
Program areas for risk-based examinations
• remain constant
3
EXAMINATION STRATEGIES
• Strategy Tailored for Fannie Mae
• Strategy Tailored for Freddie Mac
Annual risk-based examination plan
• review and update quarterly
2
FANNIE MAE Risk Profile
FREDDIE MAC Risk Profile
• On- and Off-Balance-Sheet Items
• Strategy
• Business Initiatives
• Management of Risks
• On- and Off-Balance-Sheet Items
• Strategy
• Business Initiatives
• Management of Risks
OFHEO's risk profile for each Enterprise
• review and update quarterly
• change routinely
1

RISK PROFILE – ①

OEO's examination program begins by considering each Enterprise's risk profile, and then giving form to that profile in an examination strategy. Building on knowledge gained through both previous examinations and ongoing continuous examination and oversight, OEO assesses the quantity of risk and the quality of risk management at each Enterprise, and derives an appropriate risk profile. In developing risk profiles, OEO considers each Enterprise's: corporate strategies; business initiatives; risk management practices; and on- and off-balance sheet portfolios. This consideration includes an assessment of management's responses to issues OEO raises through its examination program. OEO also considers relevant market factors; and current and prospective issues that impact, or have the potential to impact, each Enterprise's overall safety and soundness.

Every quarter, in keeping with the continuous nature of the examination program, OEO will review the Enterprises' risk profiles and will adjust the examination strategy where appropriate to address changes in an Enterprise's practices or operating environment.

EXAMINATION STRATEGIES – ②

To prepare for each examination cycle, OEO develops detailed, customized examination strategies that reflect each Enterprise's unique risk profile. As noted in the preceding section, OEO bases the examination strategies on OEO's knowledge of each Enterprise's management, strengths, weaknesses, past performance, and environment. The examination strategies take into account relevant economic conditions and reflect the potential or actual impact of those conditions on the Enterprise. The strategies also reflect OFHEO's priorities and statutory examination requirements. OEO will share the strategies with the applicable Enterprise's executive management, and encourage executive management to share the strategies with the appropriate Enterprise personnel.

Each strategy focuses OEO's efforts on monitoring the effectiveness of the Enterprise's risk management processes, enhancements management has made and, if applicable, actions management has taken in response to previously identified issues.

The examination strategies also detail examination activities that directly correlate to the level of risk in the Enterprise or the applicable business proposition. The work plans included in the examination strategies outline the scope, timing, and resources needed to meet the examination objectives and complete examination activities.

In addition, the examination strategies detail both the means by which OEO will maintain a sound understanding of the condition of the Enterprise,

(including the quality of management, the degree of control provided by risk management systems and business strategies) and a communication plan that details the means and frequency of communication with the Enterprise.

The examination strategies are dynamic. They are reviewed and updated quarterly based on Enterprise, industry, and economic developments.

PROGRAM AREAS – ③

In order to complete examinations and allocate resources efficiently, OFHEO has grouped the ten program areas into four categories of risk and risk management and aligned its examiner force into four teams that correspond to the categories of risk and risk management. The four categories of risk and risk management are: credit, market, operations and corporate governance. The ten program areas, grouped by category, are:

Credit

- **Credit Risk Program –** assesses the risk that borrowers and counterparties will fail to meet their contractual or other obligations to the Enterprise

Market

- **Interest Rate Risk Program –** assesses the risk associated with movements in interest rates, including changes in: the level of interest rates; the shape of the yield curve; the level of volatility; and the relationships or spreads among various yield curves or indices.
- **Liquidity Management Program** – assesses the Enterprise's ability to meet its obligations as they come due and to transact the next incremental dollar of business cost effectively.

Operations

- **Information Technology Program** – assesses the infrastructure, or the general controls, needed to safeguard data, protect computer application programs, prevent system software from unauthorized access, and ensure continued computer operations in case of unexpected interruptions.
- **Business Process Controls Program** – assesses the process employed to ensure business initiatives and endeavors are considered and evaluated within a complete business context with particular attention directed to risk assessment and risk management framework.
- **Internal Controls Program** – assesses the plan of organization, methods and procedures adopted by management to ensure that: goals and objectives are met; resource use is consistent with laws, regulations and policies; resources are safeguarded against waste, loss and misuse; and reliable data are obtained, maintained and fairly disclosed in reports.

Corporate Governance

- **Board Governance Program**- assesses the manner in which the Board discharges its duties and responsibilities in governing the Enterprise.

- **Management Processes Program –** assesses the processes used to drive behaviors to support the Enterprise's defined corporate goals, standards and risk tolerances.
- **Audit Program** – assesses the appropriateness of Board and management's reliance on internal or external audits.
- **Management Information Program** – assesses the effectiveness, accuracy and completeness of information and reports.

EXAMINATION OBJECTIVES
ASSESSMENT FACTORS - ④
EVALUATION CRITERIA

EXAMINATION OBJECTIVES

OFHEO conducts examination work in each of the ten program areas by using evaluation criteria, assessment factors and examination objectives. The examination objectives are broad in scope, the assessment factors are more narrowly focused and the evaluation criteria are narrower still. For each program area there are four to six examination objectives. These are the broad statements of what OFHEO's examiners will determine through their work and are substantially similar across the ten program areas. The examination objectives are the foundation for all activities and work plans. The objectives allow OFHEO's oversight activities to be focused and efficient. They also help OFHEO to ensure consistent and appropriate application of policy and resources.

The examination objectives for the ten program areas are:

CREDIT RISK PROGRAM

- ✓ Evaluate the risk management framework surrounding credit risk.
- ✓ Identify and evaluate any changes occurring in the level and quality of credit risk as well as the potential impact on the Enterprise.
- ✓ Assess the overall adequacy and effectiveness of credit risk management. Determine how well the Enterprise manages and/or hedges credit risk.
- ✓ Communicate OFHEO's determinations about credit risk and effect changes when appropriate.
- ✓ Follow-up on examination findings and planned initiatives by the Enterprise for credit risk management.

INTEREST RATE RISK PROGRAM

- ✓ Evaluate the risk management framework surrounding interest rate risk.
- ✓ Identify and evaluate any changes occurring in the level and quality of interest rate risk as well as the potential impact on the Enterprise.
- ✓ Identify and evaluate the use of derivative instruments.
- ✓ Assess the overall adequacy and effectiveness of interest rate risk management. Determine how well the Enterprise manages and/or hedges interest rate risk.
- ✓ Communicate OFHEO's determinations about interest rate risk and effect changes when appropriate.
- ✓ Follow-up on examination findings and planned initiatives by the Enterprise for interest rate risk management.

LIQUIDITY MANAGEMENT PROGRAM

- ✓ Evaluate the liquidity positions and the surrounding management framework.
- ✓ Identify and evaluate any changes occurring in the quality of liquidity and the Enterprise's position in the credit markets.
- ✓ Communicate OFHEO's determinations about liquidity management and effect changes when appropriate.
- ✓ Follow-up on examination findings and planned initiatives by the Enterprise for managing liquidity.

INFORMATION TECHNOLOGY PROGRAM

- ✓ Evaluate the information technology infrastructure and the surrounding risk management framework
- ✓ Identify and evaluate changes that may influence the risks associated with information technology as well as the potential impact on the Enterprise.
- ✓ Assess the overall adequacy and effectiveness of risk management and controls for information technology.
- ✓ Communicate OFHEO's determinations about risk management and controls for technology management and effect changes when appropriate.
- ✓ Follow-up on examination findings and planned initiatives by the Enterprise for managing the risks associated with information technology.

Business Process Controls Program

- ✓ Evaluate the framework for building the control environment surrounding substantive revisions to the business proposition or new initiatives.
- ✓ Identify changes to the business proposition that may influence the quality of controls and the potential impact on the Enterprise.
- ✓ Determine the adequacy and effectiveness of the due diligence process for new or substantially revised business initiatives.
- ✓ Communicate OFHEO's determinations about the business process control framework and effect changes when appropriate.
- ✓ Follow-up on examination findings and planned initiatives by the Enterprise that impact the process employed in governing the control framework for new or substantially revised business initiatives.

Internal Controls Program

- ✓ Evaluate the framework for internal controls and the management of this framework.
- ✓ Identify and evaluate any changes that may influence the quality of internal controls and the potential impact on the Enterprise.
- ✓ Determine the adequacy and effectiveness of the Enterprise's system of internal controls.
- ✓ Communicate OFHEO's determinations about internal controls and effect changes when appropriate.
- ✓ Follow-up on examination findings and planned initiatives by the Enterprise that impact internal controls.

Audit Program

- ✓ Assess the overall adequacy and effectiveness of both internal and external audit functions and the management of the audit program.
- ✓ Identify and evaluate any changes occurring in internal and external audit functions or roles, as well as the potential impact on the Enterprise.
- ✓ Communicate OFHEO's determinations about the audit program and effect changes when appropriate.
- ✓ Follow-up on examination findings and planned initiatives by the Enterprise that impact the audit program.

Management Information Program

- ✓ Evaluate the framework employed to produce reliable management information.
- ✓ Identify and evaluate any changes occurring that may substantially alter the production of management information.
- ✓ Determine whether the Enterprise's management information produces timely, accurate and meaningful information and reports that are appropriately tailored for their audiences and purpose.
- ✓ Communicate OFHEO's determinations about management information and effect changes when appropriate.

- ✓ Follow-up on examination findings and planned initiatives by the Enterprise for management information.

MANAGEMENT PROCESS PROGRAM

- ✓ Evaluate the framework for key management processes influencing organizational talent and behavior and the management of this framework.
- ✓ Identify and evaluate any changes occurring that may influence the quality of the key management processes, as well as the potential impact on the Enterprise.
- ✓ Determine the adequacy and effectiveness of the key management processes influencing organizational talent and behavior on a company-wide basis.
- ✓ Communicate OFHEO's determinations about the key management processes and effect changes when appropriate.
- ✓ Follow-up on examination findings and planned initiatives by the Enterprise that impact the key management processes.

BOARD GOVERNANCE PROGRAM

- ✓ Evaluate the framework the Board of Directors uses to govern the Enterprise.
- ✓ Identify and evaluate the changes occurring in the structure and composition of the Board of Directors as well as the potential impact on the Enterprise
- ✓ Determine whether the board effectively discharges its duties and responsibilities for governing the Enterprise.
- ✓ Communicate OFHEO's determinations about board governance and effect changes when appropriate.
- ✓ Follow-up on examination findings and planned initiatives by the Enterprise that impact board governance.

ASSESSMENT FACTORS

Together with the examination objectives, the assessment factors form the basis for OEO's evaluating the qualitative and quantitative features of risk and risk management in the Enterprises. In fact, OEO's examination and oversight activities are centered on the assessment factors. There are between six and thirteen assessment factors for each program area. The assessment factors link directly to one or more examination objectives, and are the means OEO uses to achieve the examination objectives. Before OEO can make a determination on an examination objective, examiners must make judgments on each of the assessment factors supporting that examination objective.

Consistent with the fundamentals of the risk-based oversight approach, the type and scope of examination work OEO performs on each assessment factor will vary. Underlying the assessment factors are points for the examiner to consider. These points are the evaluation criteria. These evaluation criteria, which are

discussed below, establish the parameters within which OEO will make its determination on each assessment factor.

Every quarter, based on the examination activities performed through the quarter, the Examination Managers responsible for each program area, in consultation with the Director of OEO, will update conclusions on all of the assessment factors for the ten program areas. The assessment factors will be characterized as substantially exceeding safety and soundness standards; exceeding safety and soundness standards; meeting or modestly exceeding safety and soundness standards; falling short of safety and soundness standards but posing neither an immediate nor serious threat to the Enterprise's financial stability; or substantially deficient in meeting safety and soundness standards.

Table 1: Credit Risk

Examination Objectives
Evaluate the risk management framework surrounding credit risk.
Identify and evaluate any changes occurring in the level and quality of credit risk as well as the potential impact on the Enterprise.
Assess the overall adequacy and effectiveness of credit risk management. Determine how well the Enterprise manages and/or hedges credit risk.
Communicate OFHEO's determinations about credit risk and effect change when appropriate.
Follow-up on examination findings and planned initiatives by the Enterprise for credit risk management.
Assessment Factors
Determine the degree and trend of diversification of credit risk. Determine whether there are any noteworthy concentrations. For the concentrations identified, determine the nature of any identifiable trends. Determine whether the actual profile of credit risk is in compliance with prescribed limits or guidelines.
Determine the quality of policies, procedures, internal controls, and management reporting for the credit function. Share determinations with the examination teams responsible for internal controls, management process, management information and board governance.
Determine whether the enterprise is adequately compensated for the credit risk it assumes. Determine whether credit models produce accurate and reliable results.
Determine whether management prudently manages counterparty exposure.
Determine the manner and extent to which new products, programs or initiatives impact the credit risk profile.
Determine the adequacy of the reserve determination process.
Determine whether credit risk management tools are effective. Share determinations about proprietary risk management programs and systems with the examination team responsible for management processes.
Determine the effectiveness of credit risk sharing strategies.
Determine the quality of the Enterprise's methodology for identifying and quantifying credit risk exposure.
Determine the quality of the Enterprise's tracking and analyzing of credit risk exposures.
Determine the effectiveness of technology and controls supporting the credit management function. Share determinations with the examination teams responsible for information technology and internal controls.
Determine whether management appropriately/effectively reconciles differences between actual and expected credit portfolio performance.
Determine whether management has an effective means of following up on credit related issues. Share determinations with the examination teams responsible for audit, management information, management process and internal controls.

Table 2: Interest Rate Risk

Examination Objectives
Evaluate the risk management framework surrounding interest rate risk.
Identify and evaluate any changes occurring in the level and quality of interest rate risk and the potential impact on the Enterprise.
Identify and evaluate the use of derivative instruments.
Assess the overall adequacy and effectiveness of interest rate risk management.

Determine how well the Enterprise manages and/or hedges interest rate risk.
Communicate OFHEO's determinations about interest rate risk and effect changes when appropriate.
Follow-up on examination findings and planned initiatives by the Enterprise for interest rate risk management.
Assessment Factors
Determine the quality of policies, procedures, internal controls, and management reporting relating to interest rate risk. Share determinations with the examination teams responsible for internal controls, board governance, management process and management information.
Determine whether management has established a meaningful methodology for quantifying and monitoring the level and nature of interest rate risk and determine whether management routinely evaluates the impact of events or alternative environments.
Determine management's effectiveness in following up on issues related to interest rate risk. Share determinations with the examination teams responsible for audit, management information, management process and internal controls.
Determine the manner and extent to which new products, programs or initiatives impact the interest rate risk profile. Share determinations with the examination team responsible for business process controls.
Determine the effectiveness of technology and controls supporting the interest rate risk management function. Share determinations with the examination teams responsible for information technology and internal controls.
Evaluate the quality of the tools used to model interest rate risk and the strategies to alter the exposures to interest rates. Share determinations about proprietary risk management programs and systems with the examination team responsible for management processes.
Determine management's effectiveness at incorporating tactical and strategic issues into the management of interest rate risk. Share determinations with the examination team responsible for management processes.
Determine whether the appropriate separation of responsibilities exists between the strategy and analytics function and the execution function.
Identify the various derivative instruments being used and determine whether these derivative instruments are used prudently.
Determine whether management governs the use of derivatives in accordance with the standards used by other large financial intermediaries.

Table 3: Liquidity Management

Examination Objectives
Evaluate the liquidity positions and the surrounding management framework.
Identify and evaluate any changes occurring in the quality of liquidity and the Enterprise's position in the credit markets.
Communicate OFHEO's determinations about liquidity risk and effect changes when appropriate.
Follow-up on examination findings and planned initiatives by the Enterprise for liquidity management.
Assessment Factors
Determine the quality of policies, procedures, internal controls, and management reporting for liquidity management. Share determinations with the examination teams responsible for internal controls board governance, management process and management information.
Determine whether management has established an effective methodology for quantifying and monitoring liquidity and determine whether management routinely evaluates the impact of events or alternative environments and develops appropriate contingency plans.
Evaluate the quality of the planning process for liquidity management including tactical, strategic, and contingency planning.
Determine the manner and extent to which new products, programs or initiatives impact the liquidity management profile. Share determinations with the examination team responsible for business process controls.
Determine management's effectiveness in following up on issues or initiatives that influence liquidity.
Determine the effectiveness of technology and controls for the liquidity management program. Share determinations with the examination teams responsible for information technology and internal controls.
Evaluate the quality of the tools used to manage and monitor liquidity, and the quality of tools used to perform scenario analyses. Share determinations about proprietary risk management programs and systems with the examination team responsible for management processes.
Determine whether the appropriate separation of duties exists between the strategy and analytics function and the execution function.
Determine trends and/or anomalies in funding spreads.
Determine the quality of integration of liquidity management with other management and financial performance issues.

Table 4: Information Technology (IT) Infrastructure

Examination Objectives
Evaluate the information technology infrastructure and the surrounding risk management framework.
Identify and evaluate changes that may influence the risks associated with information technology as well as the potential impact on the Enterprise.
Assess the overall adequacy and effectiveness of risk management and controls for information technology.
Communicate OFHEO's determinations about risk management and controls for technology management and effect changes when appropriate.
Follow-up on examination findings and planned initiatives by the Enterprise for managing the risks associated with information technology.
Assessment Factors
Determine whether operating processes are in place to ensure secure, effective and efficient data center processing and problem management.
Determine whether there are effective policies and processes in place to ensure that data, information and computing resources are secure and accessed only by authorized users.
Determine whether there are effective policies and processes in place to ensure the timely and appropriate resumption of business in the event of a disaster.
Determine whether management has an adequate process to ensure information technology plans effectively addresses business unit and corporate objectives.
Determine whether effective processes are in place to ensure appropriate controls are implemented and documentation is complete for system development and maintenance.
Determine whether effective processes have been implemented for the processing of data and information to ensure accuracy and timeliness.

The following three assessment factors will be dropped from the examination program once the Enterprises demonstrate satisfactory information and data processing after the millenium date change.
Determine whether there is an effective plan for identifying, renovating, testing and implementing solutions for the Year 2000 issue.
Determine whether the Year 2000 processing capabilities are effectively coordinated with customers, vendors and business partners.
Determine the effect of Year 2000 efforts on strategic and operating plans.

Table 5: Business Process Controls

Examination Objectives
Evaluate the framework for building the control environment surrounding revisions to the business proposition or new initiatives.
Identify changes to the business proposition that may influence the quality of business process controls and the potential impact on the Enterprise.
Determine the adequacy and effectiveness of the due diligence process for new or revised business initiatives.
Communicate OFHEO's determinations about business process control framework and effect changes when appropriate.
Follow-up on examination findings and planned initiatives by the enterprise that impact the business process control framework.
Assessment Factors
Determine if there is an effective "process" or "control environment" used when considering or developing new or substantially revised business initiatives.
Determine the appropriateness of criteria used to subject a business initiative to review as new or substantially revised.
Evaluate the quality of the analysis and review conducted for new or substantially revised business initiatives.
Evaluate after consulting with the other examination teams, the quality of the communication flows associated with new or substantially revised business initiatives.
Evaluate the appropriateness of the balance between risk management, internal controls and the pressure to deliver new or substantially revised business initiatives.
Determine the effectiveness of pilot programs used with new or substantially revised business initiatives.
Determine if corporate culture and desired employee behavior are appropriately considered when plans for managing and marketing new or substantially revised business initiatives are developed.
Evaluate the quality of analysis conducted after new or substantially revised business initiatives are launched that determine whether the initiative is a success and/or has aspects that warrant reconsideration or modification.
Evaluate after consulting with the other examination teams, the corporate environment to determine if the introduction of new ideas and intellectual capital are promoted and supported.
Determine after consulting with the other examination teams whether the Board and executive management are appropriately informed about the adequacy of due diligence for new or substantially revised business initiatives. Share determinations with the examination teams responsible for management information and board governance.

Table 6: Internal Controls

Examination Objectives
Evaluate the framework for internal controls and the management of this framework
Identify and evaluate any changes that may influence the quality of internal controls and the potential impact on the Enterprise.
Determine the adequacy and effectiveness of the Enterprise's system of internal controls.
Communicate OFHEO's determinations about internal controls and effect changes where appropriate.
Follow-up on examination findings and planned initiatives by the enterprise that impact internal controls.
Assessment Factors
Determine after consulting with the other examination teams whether management has an accurate and reliable process for identifying risks to business processes and implementing the appropriate controls.
Determine after consulting with the other examination teams whether implemented controls properly address the risks assessed by management.
Determine after consulting with the other examination teams whether management has a reliable process for ensuring timely resolution of control-related issues.
Determine after consulting with the other examination teams whether internal audit appropriately identifies and communicates internal control deficiencies to management and the Board of Directors. Share determinations with the examination team responsible for audit and board governance.
Determine after consulting with the other examination teams whether there are established policies and procedures that delineate internal control process and standards for the control environment.
Determine after consulting with the other examination teams whether management ensures compliance with established internal controls.

Table 7: Audit

Examination Objectives
Assess the overall adequacy and effectiveness of both internal and external audit functions and the management of the audit program.
Identify and evaluate any changes occurring in internal and external audit functions or roles as well as the potential impact on the Enterprise.
Communicate OFHEO's determinations about the audit program and effect changes when appropriate.
Follow-up on examination findings and planned initiatives by the Enterprise that impact the audit program.
Assessment Factors
Determine if the Audit Functions have the appropriate independence.
Determine if the auditors performing the work possess the appropriate professional proficiency.
Determine after consulting with the other examination teams if the scope of the audit work performed is appropriate.
Determine after consulting with the other examination teams if the performance of the audit work has been complete.
Evaluate the quality of the management of the Internal Audit Department.
Determine after consulting with the other examination teams the appropriateness of executive management's involvement and follow-up of identified audit issues. Determine the quality of the Board of Directors' involvement and follow-up of identified audit issues.
Determine after consulting with the other examination teams the quality of the auditor's risk assessment process.
Determine after consulting with the other examination teams the appropriateness of internal audit's involvement with new products and new initiatives. Share determinations with the examination team responsible for business process controls.

Table 8: Management Information

Examination Objectives
Evaluate the framework employed to produce reliable management information.
Identify and evaluate any changes occurring that may substantially alter the production of management.
Determine whether the Enterprise's management information produces timely, accurate and meaningful information and reports that are appropriately tailored for their audiences.
Communicate OFHEO's determinations about management information and effect changes when appropriate.
Follow-up on examination findings and planned initiatives by the Enterprise for management information.
Assessment Factors
Determine if executive management and the Board of Directors receive necessary reports on the Enterprise's performance relative to established goals and objectives.
Determine if management reporting provides the levels of management with the necessary information to carry out their responsibilities efficiently and effectively, and to gauge the quality of their decisions.
Determine if information systems are linked to the Enterprise's overall strategy, and if the information systems are developed and refined pursuant to a strategic plan for information systems.
Evaluate after consulting with the other examination teams the accuracy of reports used by management for decision making.
Determine after consulting with the other examination teams the effectiveness with which Enterprise strategy, roles and responsibilities are communicated.
Evaluate the effectiveness of channels of communication available to employees to provide feedback, report irregularities, and suggest enhancements.
Determine after consulting with the other examination teams the effectiveness of communication across the Enterprise.

Table 9: Management Process

Examination Objectives
Evaluate the framework for key management processes influencing organizational talent and behavior, and the management of this framework.
Identify and evaluate any changes occurring that may influence the quality of the key management processes, as well as the potential impact on the Enterprise.
Determine the adequacy and effectiveness of the key management processes influencing organizational talent and behavior on a company-wide basis.
Communicate OFHEO's determinations about the key management processes and effect changes when appropriate.
Follow-up on examination findings and initiatives by the Enterprise that impact the key management processes.
Assessment Factors
Evaluate the comprehensive nature of the planning process.
Determine after consulting with the other examination teams the effectiveness of business unit goals, implementing plans and programs to achieve the corporate plans.
Determine after consulting with the other examination teams management's ability to monitor and manage change.
Determine after consulting with the other examination teams if key performance measures are appropriate, effective and align with strategy.
Determine after consulting with the other examination teams if the behavior management programs are designed to achieve corporate goals and objectives.
Determine if the Enterprise has an effective program for career and management development.
Determine if the Enterprise has effective programs for recruiting competent people.
Determine after consulting with the other examination teams the effectiveness of proprietary risk management systems or programs.
Determine after consulting with the other examination teams whether management effectively conveys an appropriate message of integrity and ethical values.
Determine after consulting with the other examination teams the pervasive effect of management's philosophy and operating style on the Enterprise.
Determine after consulting with the other examination teams if the decision making roles and the assignment of responsibilities provide for accountability and controls. Share determinations with the examination team responsible for internal controls.

Table 10: Board Governance

Examination Objectives
Evaluate the framework the Board of Directors uses to govern the Enterprise.
Identify and evaluate the changes occurring in the structure and composition of the Board of Directors as well as the potential impact on the Enterprise.
Determine whether the Board effectively discharges its duties and responsibilities for governing the Enterprise.
Communicate OFHEO's determinations about board governance and effect changes when appropriate.
Follow-up on examination findings and planned initiatives by the Enterprise that impact board governance.
Assessment Factors
Determine whether the Board has been engaged in the development of a strategic direction for the Enterprise.
Determine whether the Board ensures that executive management appropriately defines: the operating parameters and risk tolerances of the Enterprise consistent with the strategic direction; legal standards; and ethical standards.
Determine whether the Board has a process for hiring and maintaining a quality executive management team.
Determine whether the Board holds the executive management team accountable for achieving the defined goals and objectives.
Determine after consulting with the other examination teams, whether the Board remains appropriately informed of the condition, activities and operations of the Enterprise.
Determine whether the Board has sufficient well-organized time to carry out its responsibilities.

EVALUATION CRITERIA

For each assessment factor, OEO has developed evaluation criteria. These evaluation criteria are designed to assist the examiners and to ensure that the examination work done across the Enterprises is consistent. The evaluation criteria detail items that examiners may consider when making decisions about the assessment factors. There are hundreds of evaluation criteria. Examiners will be guided by the evaluation criteria when rendering judgments on the assessment factors. It is neither expected nor appropriate for examiners in all cases to perform or document examination activities on every one of the evaluation criteria. Depending on the condition of the Enterprise, the industry and the economy, such examination work may be both unnecessary and inconsistent with the fundamentals of the risk-based approach to examination and oversight. Because the evaluation criteria are more likely to change over time than either the examination objectives or the assessment factors, the evaluation criteria are included in an appendix to this Handbook as examination guidance.

EFFECT CHANGES AND FOLLOW-UP COMMUNICATE EXAMINATION FINDINGS - ⑤

EFFECT CHANGES AND FOLLOW-UP

A primary goal of the examination process is to effect needed changes in the Enterprises to enhance their financial safety and soundness. Both the degree of specificity OEO provides to the Enterprises about items to be changed, and the level of follow up with the Enterprises, relate directly to the risk presented by an issue. If, for example, OEO identifies a practice that is substantially deficient in meeting safety and soundness standards, OEO will require management to develop and execute a corrective action plan that, at a minimum, ensures the practice will be changed to meet safety and soundness standards. In such a case, OEO will also expect the Board to hold management accountable for executing the action plan. OEO will review the action plan to ensure that it identifies the steps or methods management expects will cure the root causes of significant deficiencies, and to determine whether the plan is likely to result in a safe and sound practice within an appropriate time frame. As part of follow up, OEO will verify that the action plan has been executed and evaluate its success. OEO will also consider the responsiveness of the Enterprise in recognizing the issue and formulating an effective solution when determining if OFHEO needs to take further action. If an Enterprise is unresponsive or does not effect the resolution of meaningful issues, OFHEO will take more formal steps to ensure deficiencies are corrected.

On the other hand, if OEO determines that a practice already meets or exceeds safety and soundness standards, OEO will provide information or guidance to the Enterprises about ways to further enhance the safe and sound practice. The detail in follow-up in such cases, consistent with the risk-based

examination and oversight approach, will be less than in those instances in which OEO finds a practice that does not meet safety and soundness standards.

When following up on corrective actions at the Enterprises, examiners will be attuned to the fact that new deficiencies can arise during the process of correcting others. This can occur either directly or indirectly. For example, corrective action may be flawed, creating new or unanticipated issues.

COMMUNICATE EXAMINATION FINDINGS

Throughout the course of conducting examinations, OFHEO communicates with Enterprise personnel not only to gather information, but also to share findings and discuss observations. The type of communication runs the gamut from a hallway discussion with a technical expert to clarify a point, to a letter addressed to executive management or the Board of Directors. Regardless of the format, OFHEO has the same goal for all communications: that the free flow of information furthers the objective of ensuring the safe and sound operations of the Enterprises. OFHEO is committed to continuous, effective communication with the Enterprises. Examiners are expected to engage in open, continuous and effective communications with the Enterprises throughout the examination and oversight process. Effective communication is so important to the examination program that the supervisory strategies include communication plans.

OEO's communications are tailored to the individual structure and dynamics of the Enterprise. The timing of the communication will depend on the situation being addressed. However, OEO will communicate with the senior levels of the Enterprises at least quarterly. This quarterly communication is in addition to the ongoing and regular communications examiners have with the business units and personnel throughout the Enterprises. It is essential that examiners are certain executive management and the Board are appropriately informed. OEO will communicate with them as often as required by the Enterprise's condition and the findings from examination and oversight activities.

Examiners must clearly and concisely communicate their safety and soundness concerns (including significant material weaknesses, unwarranted risks or violations of law) to the Enterprise, and not focus on items that have minimal safety and soundness impact. Whenever discussing significant weaknesses or unwarranted risks, examiners will allow management an opportunity to understand the examiner's position and to respond to the examiner's concerns and commit to corrective action. Consistent with the risk-based approach, OEO has identified different levels at the Enterprises with whom it is appropriate to have particular discussions. For those issues that have the actual or potential ability to disrupt the stable operation of the Enterprise, fall under the normal duties and responsibilities of the Board, or otherwise warrant the attention of the Board and executive management, OEO will communicate with executive management and the Board immediately. On technical issues and matters relating to a single line of business or activity, OEO will generally communicate with technical and operating managers,

and will keep the Board and executive management appropriately informed on both the nature of any concern and the quality of follow-up.

In addition to regular and routine communications, OEO will provide each Enterprise with an annual Report of Examination that describes OEO's assessment of the Enterprise's safety and soundness. Each Report of Examination will have an open date and a close date. The open date will be January 1 and the close date will be December 31. The annual written Report of Examination will be delivered to each Enterprise within 60 days following the close date. It should be emphasized that the annual written Report of Examination is separate and distinct from the OFHEO Annual Report delivered to Congress.

The Report of Examination will reflect the cumulative conclusions made throughout the year-long examination process and will address the Enterprise's safety and soundness on an ongoing basis. The Report of Examination will not be a snapshot of the Enterprise's condition on a given date but will reflect assessments made during the course of the year. The Report of Examination also will reflect the focus of the examination activities at each Enterprise. Thus, while the same examination standards will be applied to each Enterprise, the same issues may not be highlighted in both Reports of Examination. It is expected that the emphasis and level of detail in the Reports of Examination will vary between Enterprises and from year to year, consistent with changes in the Enterprises' risk profiles.

CHAPTER 3

STANDARDS FOR EXAMINATION-RELATED COMMUNICATIONS

OVERVIEW

The collection of sensitive and proprietary information, the analysis of that information, and the formulation and communication of assessments of each Enterprise's financial safety and soundness are essential examination activities. Effective communication is essential to the successful fulfillment of OFHEO's examination objectives. This chapter describes OFHEO's standards of effective communication; the prohibition against unauthorized disclosure of Enterprise information; and the protection of examination-related materials from public disclosure.

STANDARDS FOR COMMUNICATION

The examination function is a confidential, iterative process through which OFHEO staff interact with Enterprise management and business staff to gather and evaluate information sufficient to determine each Enterprise's financial safety and soundness. In order to develop a complete and balanced understanding of each Enterprise's activities and operations, formulate opinions, conclusions, and recommendations, and effect change where appropriate, OFHEO staff must communicate with Enterprise staff at all levels. The following section, "Attributes of Effective Communication," describes the OFHEO qualitative standards that should be observed at all times by OFHEO examination staff.

Attributes of Effective Communication. Though not a comprehensive list, the following collection of qualities are common to effective communication. The purpose of describing the following qualities is to provide the examination staff with guidance to maximize the value of OEO's risk-based examination program. The examination staff should apply these qualities in all communications within OFHEO and with Enterprise representatives.

Candor. Candor means the open, uninhibited sharing of knowledge and opinion, and ensures a genuine exchange of views within OEO and OFHEO, and between OFHEO and the Enterprises. OFHEO and Enterprise representatives must be candid with each other at all times or the risk-based examination program will be seriously undermined. For example, the examination function requires OEO personnel to make many qualitative assessments, some of which are preliminary in nature, in order to achieve OFHEO's examination objectives. OEO personnel rely, in part, on

management and business staff responses and representations when reaching these qualitative assessments. Likewise, Enterprise management and staff benefit when OEO personnel share their preliminary observations and allow the Enterprises the opportunity to confirm or supplement information as appropriate. Clearly, OEO's assessments will lack integrity unless *all* participants in the examination process candidly share their perspectives and knowledge.

Accuracy. Accuracy means the absence of material error or omission. The issue of accuracy arises in various ways in the examination environment. Two examples are the accuracy of financial information and the accuracy of descriptions or characterizations (whether generated by the Enterprises or OFHEO) of Enterprise policies, procedures, and practices upon which OFHEO opinions, conclusions, and recommendations are to be based. In these contexts, inaccuracy may result from incomplete, as well as incorrect, information.

Clarity. Clarity means the unambiguous expression of one's message. The lack of clarity may result in confusion, misperception, and distortion. These adverse consequences impair effective communication between OFHEO and the Enterprises. Clarity is achieved when there are no significant gaps between the message one intended to send and the message that is actually received.

Focus. Focus means tailoring the communication to the appropriate recipient(s), identifying the relevant, substantive issue, and providing the appropriate degree of detail, given the audience and the nature of the information to be conveyed. The concept of focus recognizes that, in the examination environment, communication occurs within, and across, hierarchical levels at OEO and the Enterprises. The concept further recognizes, for example, that the degree of detail that is appropriate for a communication from OEO to mid-level management or a business unit employee generally is not appropriate for a communication to the Boards of Directors or an executive officer. Focus promotes effective communication because it ensures that the right level of information gets to the right people.

Customization. Customization means crafting communications in a manner that appropriately reflects each Enterprise's corporate organization and culture. Although the Enterprises share many similarities, each Enterprise is unique — and OFHEO will customize its communications to maximize its effectiveness and achieve the desired objective.

CONFIDENTIALITY OF INFORMATION

Communications in the Regulatory Environment. Under OFHEO's examination program, examination activities take place throughout the year. A successful examination program requires frequent and expansive contact between OEO and Enterprise personnel, particularly where preliminary views

and opinions may benefit from clarification and additional information. The exchange of information, observations, and opinions must be conducted in a climate of mutual respect and trust in order to promote meaningful dialogue and effect results. To promote the open exchange of views and opinion necessary for effective oversight, Congress and the courts have consistently recognized that examination-related communications between a safety and soundness regulator and the regulated institutions are confidential.

Examination-Related Materials are Withheld from the Public. OFHEO's reports of examination, and all other examination-related materials are protected from public disclosure under an exemption to the Freedom of Information Act. The reports of examination and the related materials are the property of OFHEO, and are not disclosed unless expressly permitted by the Director or by OFHEO regulations. OFHEO provides the reports to the Enterprises' respective Boards of Directors for each Enterprise's confidential use.

CRIMINAL PENALTIES FOR UNAUTHORIZED DISCLOSURE OF ENTERPRISE INFORMATION

OEO staff cannot disclose otherwise nonpublic information learned during the course of an examination or obtained through employment with OFHEO to any person or organization outside OFHEO, except as authorized by the Director of OFHEO or in accordance with OFHEO regulations. All OFHEO employees, and any person acting on behalf of OFHEO, are subject to criminal penalties under Federal law for the unauthorized use or disclosure of reports of examination (18 U.S.C. § 641) and the unauthorized disclosure of proprietary Enterprise information (18 U.S.C. § 1905).

MISCELLANEOUS

The Feedback Questionnaire. OFHEO intends to provide each Enterprise the opportunity to submit feedback to OEO regarding the examination program. The questionnaire seeks Enterprise feedback on aspects of the examination activities. OFHEO believes the information obtained through the questionnaire will be useful in evaluating the success of the examination program and identifying opportunities for OFHEO to enhance the examination program.

Examination Guidance Bulletins. OFHEO will issue *Examination Guidance Bulletins* from time to time that address examination-related topics and provide further guidance to examination personnel. The purpose of these bulletins is to aid the examination staff by explaining the standards and practices to be used when applying the program to the specific topic. These bulletins, and this handbook, will be shared with each Enterprise, and will be available to the public.