

**Table of Contents**

**Introduction ..... 2**

    Regulated Entities in Conservatorship ..... 3

**Background ..... 4**

    Roles and Responsibilities of the Board of Directors and Individual Directors .. 4

        Board’s Role in Corporate Governance ..... 4

        Board’s Responsibilities ..... 5

        Individual Responsibilities of Directors ..... 17

    Roles and Responsibilities of Senior Management ..... 19

        Risk Management ..... 20

        Ensure Control Effectiveness ..... 21

    Roles and Responsibilities of the Board and Senior Management in Planning . 23

        Capital Planning ..... 23

        Other Areas of Planning ..... 24

    Issues Specific to the FHLBanks ..... 25

**Regulatory Environment ..... 25**

**Examination Workprogram ..... 28**

## **Introduction**

This Federal Housing Finance Agency (FHFA) examination manual module for *Board of Directors and Senior Management* is designed as a resource and reference for all FHFA examiners. It contains information and procedures intended for the examination of the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Home Loan Banks (FHLBanks). These organizations will be referred to collectively as the regulated entities or individually as a regulated entity. Fannie Mae and Freddie Mac may also be referred to collectively as the Enterprises or individually as an Enterprise. The module contains a workprogram with a broad range of worksteps within five categories, and examiners should identify and perform those worksteps most relevant to reach conclusions given the scope of the examination.

For the purposes of this module, the term “board” refers to the board of directors or a designated committee, unless otherwise stated. The term “senior management” refers to those employees who plan, direct, and formulate policies, and provide the overall direction of the regulated entity for the development and delivery of products or services, within the parameters approved by the board. A “member” is defined as an institution that has been approved for membership in one of the FHLBanks and has purchased capital stock in the FHLBank in accordance with FHFA regulations.

Senior management may include, but is not limited to, individuals with the following titles, or individuals, regardless of title, who perform the functions of: chief executive officer (CEO), president, chief financial officer, chief operating officer, chief accounting officer, chief risk officer (CRO), chief information officer, chief compliance officer, chief credit officer, chief audit executive, chief market risk officer, chief member/client officer, and general counsel. The module uses the term “CEO” to refer to the individual appointed by the board to oversee the regulated entity’s day-to-day activities. The term “management” refers to managers responsible for carrying out the regulated entity’s day-to-day activities, including goals established by senior management.

This module communicates FHFA’s examination standards for corporate governance and risk governance. Corporate governance is essential to the safe and sound operation of a regulated entity and it provides the board of directors and senior management authorities and responsibilities for governing a regulated entity’s operations and structure. Corporate governance involves the relationships among the regulated entity’s board, management, and shareholders or members. It also incorporates risk management; integrity and ethics; ownership rights; disclosure of material matters; and financial reports.

Risk governance is an important element of corporate governance. Risk governance applies the principles of sound corporate governance to the identification, measurement, monitoring, and controlling of risks to ensure that risk-taking activities are in line with the regulated entity’s strategic objectives and risk appetite. Risk governance is the regulated entity’s approach to risk management and includes the policies, processes, personnel, and control systems that support risk-related decision making.

The board’s role in corporate governance is distinct from senior management’s role. The board is responsible for the strategic direction and oversight of the regulated entity—but is not responsible for managing the regulated entity’s day-to-day activities and operations. The board oversees and holds senior management accountable for meeting strategic objectives within the regulated entity’s risk appetite and established parameters. Senior management implements the board’s objectives, ensures the regulated entity is operating in a safe and sound manner and within its risk appetite, complies with laws and regulations, and adheres to guidance, policies, and procedures.

General requirements for regulated entity boards and senior management can be found at 12 CFR Part 1236 Appendix, Prudential Management and Operations Standards. Specific requirements can be found at 12 CFR 1239, Responsibilities of Boards of Directors, Corporate Practices, and Corporate Governance (Corporate Governance Rule). Additional requirements for FHLBank directors are in the Federal Home Loan Bank Act (FHLBank Act) at 12 U.S.C. 1427 and at 12 CFR 1261, Federal Home Loan Bank Directors.

### **Regulated Entities in Conservatorship**

On September 6, 2008, each Enterprise was placed into a conservatorship by FHFA. As conservator, FHFA succeeded to “all rights, titles, powers, and privileges of the regulated entity, and of any stockholder, officer, or director of such regulated entity with respect to the regulated entity and the assets of the regulated entity.”<sup>1</sup> FHFA is expressly authorized to “provide for the exercise of any function by any stockholder, director, or officer” of the conserved entity.<sup>2</sup> These powers give FHFA the authority to act as a board of directors, manage its conservatorship obligations directly without what is commonly recognized as a board of directors, appoint a board to serve only as an advisory board, or take on the role of day-to-day management.

FHFA chose to reconstitute the board of directors of each Enterprise as an active body overseeing Enterprise management. Under this arrangement, the reconstituted boards and each board member owes the traditional fiduciary duties of care and loyalty to FHFA as conservator, rather than to the shareholders. In addition, for an Enterprise in conservatorship, the following considerations are to be taken into account:

- FHFA as conservator communicates its strategic direction and priorities to the Enterprise in such documents as the Conservatorship Strategic Plan, the annual Conservatorship Scorecard, and other documents and communications as needed. In addition, FHFA as conservator retains its right and authority to give direction to an Enterprise on any subject at any time.

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<sup>1</sup> Housing and Economic Recovery Act of 2008, 12 U.S.C. § 4617(b)(2)(A) (2008).

<sup>2</sup> Housing and Economic Recovery Act of 2008, 12 U.S.C. § 4617(b)(2)(C) (2008).

- Enterprise boards should include compliance with communications from FHFA as conservator in their oversight of senior management.
- Boards and board members function in accordance with their duties and authorities under the same applicable laws and regulations—including the Corporate Governance Rule—that govern board members when they serve in non-conservatorship operations, except to the extent that these duties or authorities are modified by FHFA as conservator.
- Enterprise board members should understand the key legal principles, powers and authorities, and conservator expectations of the Enterprise’s board of directors.
- The board is encouraged to raise any questions or concerns with FHFA as conservator when and if it believes that implementation of any communication from FHFA as conservator would be inconsistent with the Enterprise's safety and soundness, the accomplishment of its statutory mission, or any other reason.

This module applies to directors and management of all regulated entities. Exceptions that may be due to the Enterprises’ conservatorships will be noted.

## **Background**

### **Roles and Responsibilities of the Board of Directors and Individual Directors**

#### **Board’s Role in Corporate Governance**

The board has a pivotal role in the effective governance of a regulated entity. The board sets the strategic objectives, establishes the risk appetite, and directs the conduct and affairs of the regulated entity in furtherance of its statutory mission. The board oversees senior management by holding them accountable to strategic objectives, the risk appetite, safe and sound operations, and attendant policies and procedures. The board sets the tone from the top by establishing a corporate culture and core values. The board should set the strategic direction of the regulated entity and confirm the establishment of a corporate governance system, including effective risk governance, which facilitates the oversight of organization’s strategic planning, risk appetite, and culture.

An effective board has a clear understanding of its roles and responsibilities, including the fiduciary duties of care and loyalty. In general, duty of care requires that directors act in good faith and in a manner that the directors reasonably believe is in the regulated entity’s best interests, based on an analysis of available information. For each regulated entity, the applicable definition of duty of care will depend upon the body of state law that the regulated entity has chosen to follow for its corporate governance and indemnification practices. Duty of loyalty requires that directors exercise their powers in the best interests of the regulated entity and its shareholders rather than in the directors’ own self-interests or in the interests of any other person.

Directors of an FHLBank owe their fiduciary duties of care and loyalty to the FHLBank and its members. For an Enterprise in conservatorship, the conservator is the successor to all rights, titles, powers, and privileges of the regulated entity, and of any shareholder, officer, or director of such regulated entity and the assets of the regulated entity. Therefore, directors of an

Enterprise under conservatorship owe their fiduciary duties of care and loyalty to the conservator.

The board should remain informed of the condition, activities, and operations of the regulated entity. It should collectively have the skills and qualifications, committee structure, communication and reporting systems, and processes necessary to provide effective oversight of the regulated entity. The board should be willing and able to act independently and effectively challenge senior management.

Good corporate governance provides for independent assessments of the quality, accuracy, and effectiveness of the regulated entity's risk management functions; financial reporting; compliance with laws and regulations; and adherence to guidance, policies, and procedures. Independent assurances, most often performed by the regulated entity's audit function, are essential to the board's effective oversight of management. Good corporate governance also includes self-assessments of board effectiveness.

#### Board's Responsibilities

The key corporate governance responsibilities of the board include the responsibility to:

- 1) Establish the strategic objectives and oversee the strategic planning process and management's implementation of the strategic business plan;
- 2) Approve and review the regulated entity's risk appetite and significant policies;
- 3) Select and oversee a competent senior management team;
- 4) Understand and provide effective oversight of the regulated entity's operations and business environment;
- 5) Establish a corporate culture and set an ethical tone at the top;
- 6) Confirm the proper disclosure of material matters and financial reports; and
- 7) Establish and maintain an appropriate board structure.

#### *Establish the strategic objectives and oversee the strategic planning process and management's implementation of the strategic plan*

A strategic business plan defines the regulated entity's long-term goals and its strategy for achieving those goals consistent with its statutory mission. The regulated entity should have a strategic planning process that results in a board-approved, written strategic business plan.

The board is responsible for overseeing the regulated entity's strategic planning process and management's implementation of the strategic business plan. During the planning phase, the board should provide an effective challenge to senior management's assumptions and recommendations. The board should understand the risks associated with the success and failure of the plan. The strategic business plan should articulate measurable goals and objectives, which can guide management's actions and decisions. The use of progress reports assists the board in carefully monitoring and assessing the implementation of the strategic business plan. When

necessary, the board should challenge management's decisions, direct corrective actions, or revise the strategy.

For additional guidance about strategic planning, refer to the *Strategic Planning* examination manual module. Specific requirements for FHLBank strategic business plans are in the Corporate Governance Rule at 12 CFR 1239.31, with related guidance in the Division of Bank Regulation (DBR) Advisory Bulletin (AB) 2010-02 Strategic Plans.

*Approve and Review Risk Appetite and Significant Policies*

The board approves and periodically reviews a regulated entity's risk appetite and attendant policies. The risk appetite is based upon the regulated entity's financial capacity and risk management systems. A regulated entity should only assume a risk level commensurate with the ability to absorb unforeseen events while still adhering to its statutory mission. Risk systems and risk management capabilities, *i.e.*, enterprise risk management, should be able to identify, assess, monitor, and control assumed risks allowed by the risk appetite. Enterprise risk management ensures alignment of the risk appetite with the regulated entity's strategies and objectives and addresses the regulated entity's exposure to credit risk, market risk, liquidity risk, business risk, and operational risk.

The board must adopt and maintain bylaws that govern the manner in which the regulated entity administers its affairs. The board should also approve significant policies that guide the operation and administration of the regulated entity. The policies should cover all key areas of the regulated entity's operations, and address matters as required by law or regulation. Policies should be consistent with the regulated entity's strategic goals and business plans, risk appetite, and regulatory requirements.

The board should periodically review and approve updates to significant policies. If there are frequent and/or significant exceptions to a policy, then the board should direct senior management to evaluate the cause and take appropriate action, which may include assessing operating procedures, policy requirements, risk appetite levels, or business strategies.

*Select and Oversee a Competent Senior Management Team*

One of the most important decisions the board makes is selecting the regulated entity's CEO. The board should be actively engaged in the CEO selection process. The board should specifically define, review, and update as appropriate, the selection criteria for the CEO, including the desired experience, expertise, and personal character. The board should ensure that the CEO has the leadership skills, competencies, and integrity to carry out his or her responsibilities that are consistent with safety and soundness, the regulated entity's statutory mission, the board's corporate culture, and the vision for the regulated entity.

In addition to selecting a qualified CEO, the board is also responsible for overseeing the CEO and other senior management. The board should:

- Set formal performance standards for the CEO and senior management consistent with the regulated entity’s strategy, risk appetite, financial objectives, culture, risk management practices, and statutory mission;
- Monitor the CEO’s performance relative to established performance standards;
- Align compensation with performance and confirm that incentive compensation arrangements do not encourage inappropriate risk taking;
- Oversee the talent management process, which includes maintaining succession plans for key senior management positions;
- Approve diversity policies and strategic plans;
- Meet regularly with senior management and maintain lines of communication;
- Critically review explanations, assumptions, and information provided by senior management;
- Assess whether senior management’s knowledge and expertise remain relevant given the nature and complexity of the regulated entity’s strategy and risk profile; and
- Take decisive action to address problems or concerns with CEO or senior management performance or misconduct.

For a regulated entity in conservatorship, FHFA as conservator may, at its discretion, operate the regulated entity with all the powers of the shareholders, the directors, and the officers of the regulated entity and conduct all business of the regulated entity. This could include selection of, or participation in the selection of, the CEO and other members of the senior management team.

*Understand and Provide Effective Oversight of the Regulated Entity’s Operations and Business Environment*

Qualified and actively involved directors who exercise independent judgment, challenge senior management when appropriate, and hold senior management accountable are key to effective board oversight. Board oversight is critical to maintain the regulated entity’s operations in a safe and sound manner; to supervise senior management; to confirm compliance with laws and regulations; and to confirm adherence to guidance, policies, and procedures. To fulfill its responsibilities, the board relies on senior management to implement key decisions, and on management to carry out the regulated entity’s day-to-day activities. The board also relies on senior management to provide sound recommendations on organizational strategies and objectives, corporate structure, and significant policies. The board also expects senior management to ensure reports for the board contain accurate and timely information about the regulated entity’s risks and financial performance.

Effective oversight involves the board developing and maintaining an understanding of the regulated entity’s operations and business environment. Boards accomplish this through remaining informed about:

- Current and emerging risks in the regulated entity’s operating environment;
- Significant laws and regulations applicable to the regulated entity’s activities;

- Material risks and the suitability of the risk management system given the regulated entity's size, complexity, third-party relationships, and activities;
- The regulated entity's business performance, financial reporting, and disclosures; and
- The status of the regulated entity's statutory mission-related goals or obligations.

*Establish a Corporate Culture and Set an Ethical Tone at the Top*

Corporate culture refers to the norms and values that drive behaviors within an organization. The corporate culture at a regulated entity should support the regulated entity's statutory mission and should not condone or encourage imprudent risk taking, unethical behavior, or the circumvention of laws, regulations, or safe and sound practices, policies, or procedures in pursuit of profits or business objectives. An ethical corporate culture holds employees accountable. Corporate culture starts with the board, which is responsible for setting a tone at the top and overseeing senior management's role in fostering and maintaining ethical behaviors. To promote a good corporate culture, the board should:

- Set the expectations for desired behaviors, convey the expectations, and confirm those behaviors are linked to performance reviews and compensation practices; and
- Promote clear lines of authority and accountability.

In addition, the board should confirm that senior management:

- Communicates regularly with employees and provides training regarding risk management practices and standards of conduct;
- Provides employees with outlets (such as a whistleblower hotline) to report illegal or unethical activities, or violations of laws, regulations, or regulated entity policies; and
- Reports and escalates material risk issues, suspected fraud, and illegal or unethical activities to the board and other authorities as required.

The board should confirm that the regulated entity establishes and administers a written code of conduct (code) that is reasonably designed to assure that directors, senior management, and employees discharge their duties and responsibilities in an objective and impartial manner. The code should address conflicts of interest; confidentiality; use of regulated entity property for personal gain; fair dealing; protection of regulated entity assets; compliance with laws, rules, and regulations; and encourage the reporting of any illegal or unethical behavior. The code should also include provisions that are reasonably designed to promote proper, accurate, and understandable public disclosures and other communications on the regulated entity's financial condition.

For additional guidance about conflict of interest policies at an FHLBank, refer to AB 2001-04 Conflicts of Interest.



*Confirm the Proper Disclosure of Material Matters and Financial Reports*

The board should confirm that the regulated entity properly discloses material matters in a timely and accurate manner to shareholders, members, and the public. Where required by the federal securities laws, disclosures must include information that is prepared in accordance with Generally Accepted Accounting Principles (GAAP). Material matters include the regulated entity's financial condition, performance, ownership and voting rights, board and senior management compensation, governance structures, significant policies, and matters required by federal securities laws.

The board should confirm that financial reports and disclosures prepared for shareholders or members and for FHFA are transparent, accurate, timely, and complete. The board should also confirm that any filings or disclosures required by the federal securities laws comply with those laws. The board should oversee the design, implementation, and monitoring of the regulated entity's risk management and internal control over financial reporting.

For additional guidance about financial reports, refer to the *Financial Reporting* and the *Internal and External Audit* examination manual modules.

*Establish and Maintain an Appropriate Board Structure*

*Board Composition, Qualifications, and Selection*

Board composition should facilitate effective oversight. The ideal board is diverse and is composed of individuals with a mix of knowledge and expertise in line with the regulated entity's size, strategy, risk profile, and complexity. The board and its directors must meet statutory and regulatory requirements. Although the qualifications of individual directors will vary, collectively the directors should possess the expertise, experience, and perspectives necessary to effectively oversee the regulated entity.

To fill board vacancies, the board should establish and document a process to identify, assess, and select director candidates.<sup>3</sup> Diversity among directors is an important attribute of an

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<sup>3</sup> For vacancies on the board of directors of the FHLBanks, the board of each FHLBank is required to fill the vacancy only with a person who is eligible to hold the particular vacant directorship, i.e., in the case of a member directorship, a person who is an officer or director of a member located in the same state as the departed director, who may serve only for the remainder of the unexpired term. 12 USC 1427(f). Another regulation, 12 CFR 1261.9, Federal Home Loan Bank Boards of Directors: Eligibility and Elections, speaks to the election of directors by the FHLBank's members, and imposes limitations on the extent to which an FHLBank's board and its individual directors may support the nomination or election of any individual as a member director and from taking any action to influence the voting with respect to any member director or independent director candidate. That provision, however, permits an FHLBank's board of directors to conduct an annual assessment of the skills and experience possessed by the board as a whole to determine whether the capabilities of the board would be enhanced through the addition of individuals with particular skills and experience. If the board determines that the FHLBank could

effective board. The board should actively seek a pool of candidates that includes a range of gender, minority, and disability classifications.

The board should consider whether the director candidate has the necessary knowledge, skills, and experience in light of the regulated entity's business and its risks, as well as sufficient time to effectively carry out his or her responsibilities.<sup>4</sup> The director candidate should have a record of integrity in personal and professional dealings and a good reputation. The director candidate should also have a willingness to place the interests of the regulated entity above any conflicting self-interest, consistent with the expected duty of loyalty. Accordingly, the director candidate should disclose any relationships or potential conflicts of interest that the candidate or any of his or her related interests has with the regulated entity.

Specific requirements for Enterprise directors are in the Corporate Governance Rule at 12 CFR 1239.20. Specific requirements for FHLBank directors are at 12 U.S.C. 1427, and at 12 CFR 1261.2 –1261.16, Federal Home Loan Bank Directors. Additional requirements for nominating regulated entity directors are in the Minority and Women Inclusion Rule at 12 CFR 1223.21(b)(7).

#### *Board Chair*

The board chair plays a crucial leadership role in board conduct and operations. The board chair should be a respected and trusted board member, and have relevant leadership and communication skills. The board chair should promote candid dialogue among board members and encourage critical discussion and expression of dissenting views. The board chair should strive to promote a well-functioning, informed, independent, and deliberative decision-making process.

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benefit by the addition to the board of individuals with particular qualifications, it may identify those qualifications and so inform the members as part of its announcement of elections. As provided in 12 CFR 1223.21(b)(7), Minority and Women Inclusion Rule, an FHLBank's board may also encourage the consideration of diversity in nominating or soliciting nominees for board positions.

<sup>4</sup> While an FHLBank's board is responsible for nominating independent director candidates, and thus can evaluate their knowledge, skills, or experience, the FHLBank's board has no involvement in the nomination of member director candidates for those attributes. The legal authority to nominate member director candidates of an FHLBank is vested solely in the FHLBank's member institutions, and an FHLBank's board may decline to place a nominee's name on the ballot only if the nominee does not meet the statutory and regulatory eligibility requirements for a member director, which are set forth at 12 USC 1427 and at 12 CFR 1261.5, Federal Home Loan Bank Boards of Directors: Eligibility and Elections. Those eligibility requirements include no prerequisites as to knowledge, skills, or experience. In contrast, an FHLBank's board does have the legal authority to nominate independent director candidates, who must meet the qualifications as to knowledge, skills, and experience set forth at 12 USC 1427(a) and at 12 CFR 1261.7(e).

*Board Committees*

Board committees help the board execute its oversight duties and responsibilities. Delegating work to a committee can enhance board effectiveness by enabling the board, through its committees, to cover a wide range of issues with greater depth of analysis.

Committees allow the directors to better focus their time and attention on areas or subject matters on which they can lend their specific expertise. Committee meetings can encourage directors to thoroughly consider issues, promote more detailed discussions than would be appropriate in a full board meeting, and gain better insight into the regulated entity's activities.

The board of directors may establish committees to aid it in carrying out its responsibilities, and is required to have the committees described below. Each committee must have a written charter, approved by the full board, which outlines the committee's powers and responsibilities, its structure, processes, and membership requirements. FHFA regulations require each committee to meet regularly, and with frequency of meetings sufficient to carry out the committee's obligations and duties. In addition to regularly scheduled meetings, committees may meet more frequently in light of relevant conditions and circumstances to fulfill their obligations and duties. Committee charters may also include requirements for meeting conduct, attendance, minutes, use of consultants, and an annual performance evaluation of the committee.

If possible, directors should be assigned to committees that align with their skills and experience. Committee assignments should be balanced with individual director's time commitments and should avoid overburdening any single director. Periodically rotating committee membership may help to achieve optimal objectivity, but frequent rotation can sometimes adversely affect the knowledge base and effectiveness of a committee. The board should find the right balance between maintaining institutional knowledge and gaining new perspectives.

In general, attendance at committee meetings should be limited to the members of the committee, in order to promote maximum effectiveness and dialogue among committee members. Though other directors not serving on the committee may occasionally observe a specific committee's meetings, such as for training purposes, regular attendance by board members that are not committee members may adversely affect the committee's effectiveness.

While the board is responsible for determining the committees it needs to effectively govern the regulated entity, the Corporate Governance Rule, at 12 CFR 1239.5(b), requires each regulated entity to have at least the following four committees, however styled: audit, risk management, compensation, and corporate governance.

A. Audit Committee

The audit committee should oversee the regulated entity's audit program to ensure it is sufficiently robust to identify, test, and report on the key risks of the regulated entity. According to the Corporate Governance Rule, the audit committee must not be combined with any other committee. The main areas of responsibility of the audit committee are to:

- Carry out the appointment and termination, set the compensation, and assess the performance of the chief audit executive;
- Ensure that senior management establishes and maintains adequate and effective internal control systems and processes;
- Work with internal and external auditors to ensure that the regulated entity has comprehensive audit coverage for the risks posed by its current and planned activities;
- Establish schedules and agendas for regular meetings with internal and external auditors;
- Provide oversight over the appointment, retention, and performance of external auditors;
- Approve the external auditor’s engagement letter;
- Monitor the financial reporting process and oversee the regulated entity’s accounting policies and practices, including accounting estimates and financial reporting judgments;
- Review and approve financial statement and material non-financial statement disclosures;
- Ensure the establishment and maintenance of whistle-blower procedures for employees;
- Monitor, track, and hold senior management accountable for addressing deficiencies identified by auditors or regulators; and
- Evaluate its performance at least annually.

For additional guidance about audit committees, refer to AB 2016-05 *Internal Audit Governance and Function* and the *Internal and External Audit* examination manual module. Specific requirements for FHLBank audit committees are in the Corporate Governance Rule at 12 CFR 1239.32. FHFA regulations separately provide that all Enterprise committees are to comply with the charter, independence, composition, expertise, duties, responsibilities and other requirements set forth in the rules of the New York Stock Exchange, as well as with Section 301 of the Sarbanes-Oxley Act. *See* 12 CFR 1239.5(b). Thus, those provisions would apply to the audit committees of each Enterprise.

#### B. Risk Management Committee

The risk management committee’s primary responsibility is risk management oversight. Section 12 CFR 1239.11 of the Corporate Governance Rule requires that the risk management committee must include at least one member with risk management experience commensurate with the regulated entity’s size, complexity, and risk profile. The committee must also include members that have (or acquire within a reasonable time of being appointed to the committee) a practical understanding of risk management principles and practices relevant to the regulated entity. The risk management committee must not be combined with any other committee. As with all other committees, the risk management committee’s roles and responsibilities must be explicitly defined in the committee’s charter. Under 12 CFR 1239.11(b)(2), (c), the risk management committee must:

- Periodically review and recommend for board approval an enterprise risk management program that is commensurate with the regulated entity’s capital structure, risk appetite, complexity, third-party relationships, activities, size, and other applicable risk-related factors. For regulated entities in conservatorship, the risk management program must also comply with any direction received from the conservator;

- Receive, review, and assess regular reports from the CRO;
- Review the effectiveness and adequacy of resources allocated to enterprise risk management; and
- Oversee and direct the work of the CRO.

In addition, the risk management committee should:

- Recommend any appropriate revisions to the regulated entity's board-approved risk appetite;
- Confirm that the regulated entity's risk appetite aligns with its strategies and objectives;
- Ensure that the risk management program addresses the regulated entity's exposure to credit risk, market risk, liquidity risk, business risk, and operational risk;
- Review and approve risk limits;
- Ensure the regulated entity has policies and procedures for risk governance, risk management practices, and the risk control infrastructure;
- Work with senior management to establish processes for identifying and reporting risks;
- Regularly discuss the regulated entity's material risks in aggregate and by risk type;
- Regularly discuss the effect of the risks to capital, earnings, and liquidity under normal and stressed conditions;
- Ensure the independence of risk management functions; and
- Ensure effective and timely escalation of material issues to the board and hold senior management accountable for timely and appropriate corrective action.

### C. Compensation Committee

The compensation committee oversees compensation arrangements and should provide periodic reports to the full board on compensation and benefits matters. For the Enterprises in conservatorship, compensation and benefit arrangements are subject to approval by the conservator. The committee should work closely with the board's risk and audit committees to confirm that compensation committee decisions regarding executive compensation and employee compensation plans align with the regulated entity's strategic objectives and risk appetite, and balance risk and reward. The committee also should safeguard against payment of compensation, fees, and benefits that are excessive or that could lead to material financial loss to the regulated entity. In fulfilling its responsibilities, the committee should have an understanding of the regulated entity's compensation and benefits arrangements, including:

- The use of performance measures that are based on industry peer performance comparisons;
- The relationship between the regulated entity's compensation arrangements and the risks or behaviors that the arrangements may motivate;
- Whether compensation arrangements are designed to promote long-term shareholder or member value and discourage excessive risk taking; and
- The legal and regulatory requirements governing executive compensation arrangements.

The committee should also review and recommend compensation for directors, including the board and board committee fee structure. Director compensation should be competitive and sufficient to attract and retain qualified individuals, should align with regulatory requirements and industry standards, and should be commensurate with an individual director's responsibilities.

Specific requirements for senior management compensation are at 12 CFR 1230 Executive Compensation. Specific requirements for Enterprise directors' compensation are in the Corporate Governance Rule at 12 CFR 1239.21. Specific requirements for FHLBank directors' compensation are at 12 CFR 1261.20–1261.24, Federal Home Loan Bank Directors.

D. Corporate Governance Committee

The regulated entity corporate governance committee is responsible for overseeing corporate governance practices related to board composition and independence. An FHLBank corporate governance committee assists the full board of directors in identifying and vetting nominees for independent directorship positions; member directors are nominated by the members. An Enterprise corporate governance committee is responsible for recommending the nomination of all board of director candidates. The composition of the board for an Enterprise in conservatorship is subject to review and approval by the conservator.

As part of its director nomination process, the corporate governance committee should verify that nominees for whom it is responsible meet qualification and independence requirements. The committee should further assess the contributions of current directors in connection with their re-nomination. The committee should help ensure that the board reflects a diverse mix of talent, expertise, and perspectives relevant to the regulated entity's needs.

Other responsibilities of the corporate governance committee are to:

- Oversee the evaluation of board performance and individual director contributions;
- Conduct an evaluation of its own performance;
- Assist other board committees with their self-assessments;
- Establish procedures for the retirement or replacement of directors;
- Assess the reporting channels and mechanisms through which the board receives information and the quality and timeliness of the information; and
- Oversee director education and training.

Additional specific qualifications for FHLBank directors are in the FHLBank Act at 12 U.S.C. 1427, and in the regulations governing eligibility and election of FHLBank directors at 12 CFR 1261.2–1261.15.

*Senior Management and Staff Access*

Directors should have full access to all employees, particularly to senior management. Staff may be required to provide services related to regulated entity governance and report directly to the

board or a board committee. The board's direct interaction with key employees can balance viewpoints and help ensure that information going to the board includes a full spectrum of risks. Direct interaction also can help directors oversee succession planning. In addition, direct interaction allows board members to assess how the corporate culture has been implemented throughout the regulated entity.

*Outside Consultants*

From time to time, the board may need to seek advice from outside consultants. For example, there may be technical or legal aspects of the regulated entity's business—such as accounting matters or compensation—where additional expert advice would be useful.

Although qualified consultants can provide expertise and counsel, the board should confirm that no conflicts of interest exist between the regulated entity or members of the board and the consultants so that the board receives objective and independent advice.

*Board Meeting Minutes and Materials*

Minutes of board and board committee meetings are essential parts of the regulated entity's records. Meeting minutes should be complete and accurate. Minutes should document the review and discussion of material items on the agenda, any actions taken, follow-up items to be addressed at subsequent meetings, and any other issues that may arise (including approval of previous meeting minutes and board-approved policies).

Minutes should be prepared timely and should reflect the attendance of each director, other attendees, and directors' votes or abstentions. The minutes should include all materials distributed to the board for informational, oversight, or monitoring purposes. These materials should be accurate and clear.

Board minutes should include sufficient information to reflect that directors were fully informed about the relevant facts, deliberated the issues, provided effective challenges when necessary, and made decisions consistent with the board's duties of loyalty and care.

Each director should have the opportunity to review and, if appropriate, suggest clarification and correction of the minutes before the board or committee approves them. In addition, the full board should receive minutes from the meetings of board committees.

For additional guidance about FHLBank board minutes, refer to AB 2004-02 *Board Minutes*.

*Director Orientation and Training*

The board should provide an orientation program for new directors. The program should explain:

- The regulated entity's statutory mission, organizational structure, corporate culture, operations, strategic plans, risk appetite, risk exposures, and significant issues;

- The importance of regulatory requirements;
- The individual and collective roles and responsibilities of board members, the roles of the various board committees, and the roles and responsibilities of senior management; and
- For regulated entities in conservatorship, the role of corporate governance in conservatorship, as well as the powers and authorities of the conservator.

Directors should understand their roles and responsibilities and pursue training to deepen their knowledge of the regulated entity's business, operations, risks, and management. The board should periodically assess its skills and competencies relative to the regulated entity's size and complexity, identify gaps, and take appropriate actions to address any gaps. Management can help the board develop an ongoing education and training program to keep directors informed and current on general industry trends and regulatory developments.

### *Board Tenure*

A tenure policy can provide a road map for the board's natural evolution and create a structured process to obtain fresh ideas and promote critical thinking from new directors. A tenure policy protects against the board losing objectivity. Any such policy for the FHLBanks must be consistent with statutory requirements for both member and independent directors, which authorize FHLBank members – and not the FHLBanks themselves – to nominate and elect member directors, and which authorize FHLBank members to elect the independent directors. Statutory term limits apply to both member and independent directors of an FHLBank, and provide that a person may be elected to no more than three consecutive full four-year terms of office.

Specific requirements for Enterprise director terms are in the Corporate Governance Rule at 12 CFR 1239.20(a)(1) and for FHLBank director terms in the FHLBank Act at 12 U.S.C. 1427(d).

### *Board Self-assessments*

A self-assessment evaluates the board's effectiveness and functionality, committee operations, and directors' skills and expertise. Boards should periodically undertake some form of self-assessment which can be valuable in improving the board's overall performance. Further, by acknowledging that the board holds itself responsible for its performance, self-assessments help affirm the "tone at the top."

Self-assessments may take the form of questionnaires to all directors, a group self-assessment, formal interviews with each director, peer evaluations, or a combination of these methods. The board may use an independent third party to administer the self-assessments and provide feedback to the directors.

A board self-assessment addresses the board's structure, activities, and oversight, such as:

- Director qualifications;
- Level of director participation;



- Quality of board meetings and discussions, including whether one director or a group of directors dominates the discussion;
- Quality and timeliness of board materials and information;
- Relevance and comprehensiveness of meeting agendas;
- The board’s relationship with the CEO, including whether the relationship is supportive but independent;
- Effectiveness of challenges to senior management;
- Effectiveness of strategic and succession planning;
- Effectiveness of executive sessions; and
- Effectiveness of board committees and committee structure.

An important component of any assessment is documenting how action items identified to improve performance are resolved. Such resolution should include measurable results. The board or its corporate governance committee should oversee the implementation of recommendations arising from board self-assessments. As part of its oversight duties, the corporate governance committee may identify skill and expertise gaps among the members of the board, and may recommend that the entity seek persons with those skills as nominees for directorship positions, consistent with the voting rights of members, in the case of the FHLBanks.

#### Individual Responsibilities of Directors

##### *Attend and Participate in Board and Committee Meetings*

Directors should demonstrate a willingness and ability to contribute to the oversight of the regulated entity by preparing for, attending, and participating in all board and assigned committee meetings. Directors should attend board and committee meetings to stay informed about the regulated entity’s risks, business and operational performance, the environment in which the regulated entity operates, and to participate in board decision making. Being informed and participating in board meetings also is a component of a director’s fiduciary responsibilities.

Each member is responsible for keeping board and committee meetings focused and productive. The meetings should follow agendas that permit adequate time for presentation and discussion of material issues. The thoughtful preparation of an agenda for each meeting should provide directors with reasonable assurance that all important matters are brought to their attention. While the agenda should be carefully planned, it should be flexible enough to accommodate unexpected developments. The board and its committees should have processes for soliciting potential agenda items from individual directors and from others within the regulated entity.

##### *Request and Review Meeting Materials*

Board members are responsible for working with senior management to determine what information the board needs to monitor the regulated entity’s operations, make decisions, confirm compliance with laws and regulations, and confirm adherence to guidance, policies, and

procedures. Information should give directors a complete and accurate overview of the regulated entity's condition, activities, and significant issues. Management is responsible for providing information in a concise and meaningful format. Reports presented to the board should highlight important performance measures, trends, and variances. Raw data would benefit from documented analysis in order for it to be useful to the board.

Directors should be provided with information from a variety of sources, including management, board committees, outside experts and advisors, risk management and compliance personnel, and internal and external auditors. The board should agree on a set of key performance measurements and risk indicators that are tracked and assessed at each board meeting.

Directors should have sufficient information about the regulated entity's material risks, including emerging risks, to effectively oversee the regulated entity's adherence to the agreed-upon strategy and risk appetite. Directors should receive the information in advance of their meetings so there is sufficient time to review the information, reflect on key issues, prepare for discussion, and request supplemental information as necessary.

*Exercise Independent Judgment*

Directors should exercise independent judgment in carrying out their responsibilities, and adhere to the written code of conduct that describes, among other items, situations when directors should abstain from deliberations or decision-making. Each director should examine and consider management's recommendations, but exercise independent judgment. Effective challenges are healthy and can suggest that the board is independent and not operating under undue influence by senior management or from an individual director.

To strengthen director independence, the board should convene executive sessions. Executive sessions allow the directors to discuss the effectiveness of management, the quality of board meetings, and other issues or concerns without the potential influence of senior management. Executive sessions also can provide a forum for director training and meetings with advisors and regulators.

*Make Decisions and Seek Explanations*

The board's decision-making process should include constructive, effective challenge by directors to the information and views provided by senior management. The ability to provide an effective challenge is predicated on the qualifications of the directors and receipt of accurate, complete, and timely information. The quality of information received by the directors affects their ability to perform the board oversight function effectively. If a director is unable to make an informed decision because management provided inadequate information, the decision should be postponed until sufficient information is provided and the board has additional time to discuss and review the information. If this is a recurring problem, the board should review the format of board meetings or senior management's responsiveness to director inquiries.

Oversee Financial Performance and Risk Reporting

Sound operations and financial performance are key indicators of the regulated entity's success. The board is responsible for overseeing financial performance, risk reporting, financial reports, and disclosures. As such, the board should determine the types of reports required for its oversight and decision-making responsibilities. The reports should be accurate, timely, relevant, complete, and succinct.

The board should ensure that it has sufficient information to keep itself informed about the financial condition and performance of the regulated entity's material lines of business. The number and variety of reports depend on the regulated entity's size, complexity, and risks.

Performance and risk reports should enable the board to:

- Understand the drivers of financial performance;
- Understand and evaluate the potential impact of risk to the business units' financial performance;
- Assess the adequacy of capital, liquidity, and earnings;
- Monitor performance trends and projections;
- Monitor financial performance against strategic goals;
- Monitor risk positions in relation to the risk appetite;
- Monitor the types, volumes, and impacts of exceptions to policies and operating procedures;
- Understand model risks and reliance;
- Assess the impact of new products or services;
- Assess evolving risks related to changing technologies and market conditions;
- Monitor risks related to third-party relationships involving critical activities; and
- Assess potential litigation costs and reserves.

**Roles and Responsibilities of Senior Management**

The board delegates authority to senior management for directing day-to-day management of the regulated entity within the established risk appetite. Senior management is responsible for developing and implementing policies, procedures, and practices that translate the board's goals, strategic objectives, risk appetite, and risk limits into prudent standards for the safe and sound operation of the regulated entity.

Senior management is responsible for the regulated entity's operational and financial performance. In addition, senior management should have the expertise to design and administer the systems and controls necessary to carry out the regulated entity's strategic plan within the risk governance framework, to ensure compliance with laws and regulations, and to ensure adherence to mission objectives, guidance, policies, and procedures.

Specifically, the CEO and the senior management team should:

- Execute the regulated entity’s strategic plan and ensure the adequacy of funding, personnel, and technology in carrying out the strategic plan;
- Develop a risk management framework that enables management to effectively identify, measure, monitor, control, and report on risk exposures consistent with the regulated entity’s risk appetite;
- Implement an ethical corporate culture;
- Establish and maintain an effective system of internal controls;
- Develop accurate and reliable management information and reporting systems;
- Maintain internal processes, including stress testing, to ensure capital and liquidity levels are commensurate with the regulated entity’s risks in normal and stressed conditions (note that FHFA-directed regulatory capital requirements are not binding for an Enterprise in conservatorship);
- Allocate staff resources and effectively oversee personnel;
- Comply with laws, regulations, and internal policies, including codes of conduct;
- Adhere to supervision guidance;
- Establish talent management and compensation programs; and
- Keep the board apprised of the regulated entity’s strategic direction, risk profile, business operations, financial performance, and reputation.

Senior management may use management committees to ensure that in its day-to-day activities, the regulated entity is operating in a safe and sound manner; is in compliance with laws and regulations; and is adhering to guidance, policies, and procedures. Senior management should determine which management committees are appropriate and the optimum structure of those committees.

### Risk Management

Senior management is responsible for the design, implementation, and effectiveness of risk management at the regulated entity. The CRO heads the independent enterprise risk management function and, according to 12 CFR 1239.11(c) of the Corporate Governance Rule, is responsible for the enterprise risk management function, including:

- Allocating risk limits and monitoring compliance with risk limits;
- Establishing policies and procedures relating to risk management governance, practices, and risk controls, and developing processes and systems for identifying and reporting risks, including emerging risks;
- Monitoring risk exposures, including testing risk controls and verifying risk measures; and
- Communicating within the regulated entity about any risk management issues and/or emerging risks and ensuring that risk management issues are effectively resolved in a timely manner.

The CRO must report regularly to the board’s risk management committee and to the CEO on significant risk exposures and related controls, changes to risk appetite, risk management

strategies, results of risk management reviews, and emerging risks. The CRO also must report regularly on the regulated entity's compliance with, and the adequacy of its current risk management policies and procedures, and shall recommend adjustments to such policies and procedures that he or she considers necessary or appropriate.

For additional guidance about risk management, refer to the *Enterprise Risk Management* examination manual module.

### Ensure Control Effectiveness

Senior management is responsible for the control functions and the effectiveness of controls at the regulated entity. Management carries out this responsibility through quality control, quality assurance, compliance management, management information systems, third-party relationship risk management, and insurance programs.

### Quality Assurance

Quality assurance proactively verifies that established standards and processes are designed effectively, followed, and consistently applied. An independent party performs the quality assurance review. Management uses the results of the quality assurance review to assess the effectiveness of policies, procedures, programs, and practices in a specific area. The results help management identify operational weaknesses, risks associated with the specific area, training needs, and process deficiencies. Senior management should determine which areas of the regulated entity require a quality assurance review and should ensure that results of the reviews are properly reported.

### Quality Control

Quality control ensures that the regulated entity has consistently applied standards, complied with laws and regulations, and adhered to policies and procedures. The quality control review may be performed internally or outsourced to a third party. Quality control promotes an environment in which management and employees strive for the highest standards. An effective quality control process identifies errors, allowing management to take corrective action before the errors become systemic issues or have a negative impact on the regulated entity's operations. Senior management, in consultation with the board, should determine what activities require a quality control review. Management also should determine the reporting of quality control reviews based on regulatory requirements and risk exposure to the regulated entity.

### Compliance Management

According to the Corporate Governance Rule, the regulated entity must establish and maintain a compliance program that is reasonably designed to assure that the regulated entity complies with applicable laws, rules, regulations, and internal controls.

The regulated entity must have a compliance officer who ensures the regulated entity complies with board-approved policies. The compliance officer should develop a system to monitor compliance, including the training of appropriate personnel. The CEO, compliance officer, and management are responsible for the timely correction of deficiencies found by internal and external auditors, compliance personnel, risk managers, and regulators. The CEO, compliance officer, and management also are responsible for ensuring that processes are in place to promptly escalate material issues to the board and communicate those issues to other responsible members of senior management. The compliance officer must report regularly to the board, or a committee thereof, on the adequacy of the regulated entity's compliance policies and procedures, including the regulated entity's compliance with them, and recommend revisions, as necessary.

*Management Information System (MIS)*

MIS broadly refers to a comprehensive process, supported by computer-based systems, that provides the information necessary to manage the regulated entity. The five elements of an effective MIS are timeliness, accuracy, consistency, completeness, and relevance. The effectiveness of MIS is hindered whenever one or more of these elements is compromised.

MIS does not necessarily reduce expenses. Development of meaningful systems and their proper use lessen the probability that poor decisions will be made because of inaccurate or untimely information. Poor decisions invariably misallocate or waste resources, which may adversely affect earnings or capital.

For additional guidance about MIS, refer to the *Information Technology Risk Management* examination manual module.

*Third-party Relationship Risk Management*

Regulated entities often rely on third-parties to provide technological, administrative, and operational services. The use of third parties does not diminish senior management's responsibility to ensure that the activity is performed in a safe and sound manner and complies with applicable laws and regulations.

Senior management should adopt risk management processes appropriate for the level of risk and complexity of the regulated entity's third-party relationships and organizational structure. The risk-focused third-party risk management process should follow a continuous life cycle for all relationships and incorporate planning, due diligence, third-party selection, contract negotiation, ongoing monitoring, and termination. The process should include oversight and accountability, documentation and reporting, and independent reviews.

*Insurance Program*

Part of senior management's responsibility is to ensure that the regulated entity has an insurance program that identifies risk to be retained versus risk to be transferred. A regulated entity may mitigate risk through insurance or a contractual transfer. A basic tenet of risk management is

that risks carrying the potential for catastrophic or significant loss should not be retained. Conversely, it typically is not cost-justified to insure losses that are relatively predictable and not severe.

Management may obtain insurance for losses above the maximum amount the board determines the regulated entity is able and willing to assume. Once the decision is made to insure a particular risk, a knowledgeable, professional insurance agent can help with selecting an underwriter. The choice of coverage should be based on a well-informed analysis of the cost and benefits, as well as the potential impact that could result from exclusions. Senior management should annually assess and review with the board the financial capacity of the insurance underwriter and the regulated entity's insurance program.

For additional guidance about insurance, refer to the *Insurance Management* examination manual module.

## **Roles and Responsibilities of the Board and Senior Management in Planning**

### Capital Planning

Capital planning is integral to ensuring safe and sound operations and viability of a regulated entity. The board and senior management should ensure that the regulated entity has sufficient capital to fully support the current and anticipated needs.

#### *Capital Planning for an Enterprise in Conservatorship*

Capital planning for an Enterprise in conservatorship is a collaborative process in which the Enterprise works with FHFA to determine an appropriate capital structure. Existing statutory and FHFA-directed regulatory capital requirements and capital classifications are suspended during conservatorship.

#### *Capital Planning for a Regulated Entity*

As part of the board's oversight of the capital management function, it should direct senior management to ensure the integrity, objectivity, and consistency of the capital planning process. The board should confirm that the planning process addresses the regulated entity's capital needs in relation to material risks and strategic plans. In addition, the board and senior management should evaluate internal and external sources of capital to develop a strategy to increase capital if necessary. The board should hold management accountable for identifying and taking effective corrective action if shortcomings or weaknesses in the capital planning process become apparent or if the level of capital falls below identified needs.

Senior management should anticipate changes in the regulated entity's strategic direction, risk profile and risk appetite, business plans, operating environment, and other factors that materially affect capital adequacy. Senior management should establish contingency plans, including

identification or enhancement of realistic strategies for capital preservation during economic downturns or other times of stress.

For additional guidance about capital planning, refer to the *Capital* examination manual module.

#### Other Areas of Planning

##### Operational Planning

The responsibility for establishing and implementing operational plans to meet strategic plans rests with the CEO and senior management. Operational plans flow logically from the strategic plan by translating long-term goals into specific, measurable targets. The board should approve operational plans after concluding that they are realistic and compatible with the regulated entity's risk appetite and strategic objectives.

##### Information Technology Activities

A regulated entity relies heavily on information technology to process transactions, maintain critical records, and supply reports to the board, senior management, and management. As such, a regulated entity's information technology systems should have the capability to aggregate risks across the regulated entity in a timely manner and under stress situations. Information provided by management in reports should be accurate, timely, and sufficiently detailed to oversee the regulated entity's safe and sound operation. The board should establish a regulated entity-wide risk culture for assessing information technology demands and providing processes to meet those demands. Senior management can then develop a framework of supporting policies, standards, and procedures to describe how the regulated entity will operate within the risk parameters established by the board.

For additional guidance about information technology, refer to the *Information Technology Risk Management* examination manual module and AB-2016-04 Data Management and Usage.

##### Information Security

The board is responsible for the oversight of the information security program and should establish a framework and risk appetite to include an acceptable level of information security risk. It is not the expectation that the board consists of information security experts, as it is not responsible for the design and implementation of the information security program. Management is accountable for the implementation and coordination of the information security program.

For additional guidance on information security, refer to AB-2017-02 Information Security Management.



*Disaster Recovery and Business Continuity Planning*

The board should review and approve adequate disaster recovery and business continuity plans at least annually. Additionally, the board should confirm that management updates the business continuity plan to reflect the current operating environment and adequately tests the plan to confirm its viability.

Senior management is responsible for establishing and implementing policies and procedures and defining responsibilities for the regulated entity's business continuity planning. Management should document, maintain, and test the regulated entity's business continuity plan and backup systems periodically to mitigate the consequences of system failures, natural and other disasters, and unauthorized intrusions. Senior management also should report the tests of the plan and backup systems to the board annually.

For additional guidance about business continuity planning, refer to the *Business Continuity Planning* examination manual module.

**Issues Specific to the FHLBanks**

A section of the FHLBank Act (12 U.S.C. 1427) provides for the management of each FHLBank to be vested in the FHLBank's board of directors. It describes the duties of the board of directors to administer the affairs of an FHLBank fairly and impartially and without discrimination, and with due regard to the maintenance of adequate credit standing for the FHLBank and its obligations. The FHLBank Act sets out requirements for: the board's makeup; the selection criteria for both independent and member directors; director terms, nominations, elections, vacancies, compensation, and indemnification; and elections and terms of the chairperson and vice chairperson.

Directors of an FHLBank are responsible for ensuring the FHLBank achieves the statutorily-mandated mission of promoting housing finance and community lending, and meets the FHLBank's statutory obligations of making contributions to its affordable housing program.

**Regulatory Environment**

The primary rules, regulations, and references of the Federal Housing Finance Agency (FHFA) pertaining to the structure, duties, and responsibilities of the regulated entities' boards of directors and senior management are set forth below.

**Rules and regulations relevant to the board of directors and senior management of all regulated entities:**

- FHFA, Minority and Women Inclusion Rule (12 CFR 1223)
- FHFA, Executive Compensation (12 CFR 1230)
- FHFA, Golden Parachute Payments (12 CFR 1231)

- FHFA, Responsibilities of Boards of Directors, Corporate Practices and Corporate Governance Matters (12 CFR 1239)
- FHFA, Prudential Management and Operations Standards, Responsibilities of the Board of Directors and Senior Management (Appendix to 12 CFR 1236)
- FHFA, Prudential Management and Operations Standards, Standard 1: Internal Controls and Information Systems (Appendix to 12 CFR 1236)
- FHFA, Prudential Management and Operations Standards, Standard 2: Independence and Adequacy of Internal Audit Systems (Appendix to 12 CFR 1236)
- FHFA, Prudential Management and Operations Standards, Standard 3: Management of Market Risk Exposure (Appendix to 12 CFR 1236)
- FHFA, Prudential Management and Operations Standards, Standard 4: Management of Market Risk – Measurement Systems, Risk Limits, Stress Testing, and Monitoring and Reporting (Appendix to 12 CFR 1236)
- FHFA, Prudential Management and Operations Standards, Standard 5: Adequacy and Maintenance of Liquidity and Reserves (Appendix to 12 CFR 1236)
- FHFA, Prudential Management and Operations Standards, Standard 6: Management of Asset and Investment Portfolio Growth (Appendix to 12 CFR 1236)
- FHFA, Prudential Management and Operations Standards, Standard 7: Investments and Acquisitions of Assets (Appendix to 12 CFR 1236)
- FHFA, Prudential Management and Operations Standards, Standard 8: Overall Risk Management Processes (Appendix to 12 CFR 1236)
- FHFA, Prudential Management and Operations Standards, Standard 9: Management of Credit and Counterparty Risk (Appendix to 12 CFR 1236)
- FHFA, Prudential Management and Operations Standards, Standard 10: Maintenance of Adequate Records (Appendix to 12 CFR 1236)
- FHFA, Equal Opportunity in Employment and Contracting (12 CFR 1207.21(a))

Laws, rules, and regulations relevant to the board of directors and senior management of an Enterprise

- FHFA, Responsibilities of Boards of Directors, Corporate Practices and Corporate Governance Matters, Enterprise Specific Requirements, Board of Directors of the Enterprises (12 CFR 1239.20)
- FHFA, Responsibilities of Boards of Directors, Corporate Practices and Corporate Governance Matters, Enterprise Specific Requirements, Compensation of Enterprise Board Members (12 CFR 1239.21)

Laws, rules, and regulations relevant to the board of directors and senior management of an FHLBank

- The Federal Home Loan Bank Act (12 U.S.C. 1421, et. seq.)
- FHFA, Responsibilities of Boards of Directors, Corporate Practices and Corporate Governance Matters, Bank Specific Requirements, Bank Member Products Policy (12 CFR 1239.30)

- FHFA, Responsibilities of Boards of Directors, Corporate Practices and Corporate Governance Matters, Bank Specific Requirements, Strategic Business Plan (12 CFR 1239.31)
- FHFA, Responsibilities of Boards of Directors, Corporate Practices and Corporate Governance Matters, Bank Specific Requirements, Audit Committee (12 CFR 1239.32)
- FHFA, Responsibilities of Boards of Directors, Corporate Practices and Corporate Governance Matters, Bank Specific Requirements, Dividends (12 CFR 1239.33)
- FHFA, Federal Home Loan Bank Board of Directors: Eligibility and Elections (12 CFR 1261.2 – 1261.15)
- FHFA, Federal Home Loan Bank Directors' Compensation and Expenses (12 CFR 1261.22)

**FHFA examination and guidance resources relevant to board of directors and senior management of all regulated entities**

- AB 2017-02: Information Security Management
- AB 2017-01: Classifications of Adverse Examination Findings (3/13/2017)
- AB 2016-05: Internal Audit Governance and Function (10/7/2016)
- AB 2014-02: Operational Risk Management (2/18/2014)
- AB 2013-07: Model Risk Management Guidance (11/20/2013)
- AB 2013-03: FHFA Enforcement Policy (5/31/2013)
- AB 2012-02: Framework for Adversely Classifying Loans, Other Real Estate Owned, and Other Assets and Listing Assets for Special Mention (4/9/2012)
- Examination Guidance: Examination for Accounting Practices (10/27/2009)

**FHFA examination and guidance resources relevant to the board of directors and senior management of an FHLBank**

- AB 2010-02: Strategic Plans (11/9/2010)
- AB 2004-02: Board Minutes (5/13/2004)
- AB-2001-04: Conflicts of Interest (2/14/2001)

**Examination Workprogram**

The workprogram for the examination of *Board of Directors and Senior Management* is detailed below. Examiners are expected to develop procedures that satisfy the specific objectives of the examination. The procedures should support the examination workprogram and, when executed, provide sufficient evidence to support a conclusion regarding the objective. Examiners should not exclusively rely upon representations made by management or work performed by other internal or external parties to support conclusions regarding an examination objective.

Examination procedures should include testing designed to confirm that policies, processes, controls, or models operate as intended. This may be achieved through transaction testing or other testing methods. In limited circumstances, examiners may determine that testing cannot be reasonably conducted. Examples of such circumstances include cases where there is insufficient data, a program or product is too new to test, or when testing cannot be scaled to a manageable level. In these instances, examiners are expected to document in the examination procedures, with the examination manager’s approval, the rationale for not conducting testing.

An examiner may leverage testing performed by internal and external parties, such as internal or external audit functions, if (i) the testing used to support the examiner’s conclusions is clearly applicable in the scope of the examination activity, and (ii) the examiner has assessed the methodology and results of any testing that is used to support the examiner’s conclusions.

**NOTE: *Text in italics referenced in a workstep represents illustrative guidance that serves as suggestions for specific inquiry.***

**1. Scope of Examination Work Performed**

- 1) Review workpapers from the most recent examination when the scope included a review of the board and senior management.
- 2) Assess the status or review the remediation progress based on management’s commitments of any outstanding examination findings (*e.g.*, Matters Requiring Attention, Violations or Recommendations) pertaining to the board and senior management.
- 3) Review internal audit or quality assurance reports for outstanding issues relating to the board and senior management.
- 4) Review and address any applicable portions of FHFA-issued ABs or other examination guidance (*e.g.*, Supervisory Directives).
- 5) Review FHFA off-site monitoring or analysis reports, and workpapers produced as part of on-going monitoring, related to the board and senior management.

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- 6) Review recent minutes of meetings of the board of directors and relevant board and management committees for any issues regarding the board and senior management.
  - 7) Review past reports for outstanding issues. Evaluate the adequacy of the regulated entity's responses. Consider the following:
    - a) Prior examination workpapers with respect to (1) governance, (2) strategic planning, and (3) operating performance;
    - b) Prior quarterly reviews and correspondence;
    - c) External audit reports;
    - d) Current year strategic plan and budget; and/or
    - e) Actual versus budget from prior business plans.
  - 8) Evaluate work completed by other offices within FHFA related to the regulated entity's efforts to achieve stated goals. *(For a regulated entity in conservatorship, has the regulated entity achieved the objectives in the Conservatorship Scorecard?)*

Summarize the work performed in the examination of the regulated entity's board and senior management. To the extent there were modifications to the originally planned scope based on concerns identified during the examination, document those changes and the reasons for such changes.

<b>2. Description of Risks</b>
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Examiners should have an understanding of how the board and senior management identify, measure, monitor, and control risks to the regulated entity.

- 1) Conclude on the effectiveness of the board of directors and senior management's efforts to identify the risks facing the regulated entity. *(Does the board engage in meaningful self-assessments of its effectiveness and functionality? Are independent assessments conducted to determine the effectiveness of the regulated entity's risk governance?)*
- 2) Analyze the information provided to the board about the risks facing the regulated entity. *(Does the board receive sufficient information about the level and nature of all material risks facing the regulated entity? Does the board receive information about risks from sources other than senior management? Is the information about risks provided to the board subject to audit? Does the board challenge management's conclusions about risks at the regulated entity?)*

- 3) Conclude on whether reports to the board adequately identify, measure, and monitor risks. *(Do reports provide meaningful information in a concise and easy to understand manner in order to effectively assist the board?)*

### **3. Risk Management**

#### ***Risk Identification Process***

- 1) Evaluate the processes to identify the regulated entity's exposure to risk. *(Does the board receive sufficient information about the regulated entity's business activities and the associated risks? How are risks reported to the board?)*
- 2) Evaluate the analysis conducted that provides the basis for the regulated entity's chosen risk appetite. *(Does the analysis support the board's business decisions? Is the analysis timely, complete, and relevant?)*

#### ***Organizational Structure***

- 1) Evaluate the composition and role of board and management committees. *(Do committees have formal, written charters? Are minutes kept for all committee meetings? Do committee members have sufficient expertise to contribute to the effective operation of the committee? Does the regulated entity have the following four board committees, however styled, required by the Corporate Governance Rule: Audit, Risk Management, Compensation, and Corporate Governance?)*
- 2) Evaluate the adequacy of the board's qualifications. *(Are the collective qualifications of the directors adequate given the size and complexity of the regulated entity? Is there an up-to-date orientation program for new directors explaining their duties, including ethical and other obligations? Do all board members have a working familiarity with accounting and finance allowing them to understand financial reports? At the Enterprises, is the board informed of significant changes to the requirements of laws, rules, regulations, and guidelines on an annual basis as required by the Corporate Governance Rule?)*
- 3) Evaluate the appropriateness of the frequency of the board of directors' meetings. *(Are special meetings convened to address changing conditions? Does the board convene executive sessions?)*
- 4) Evaluate the process for recruiting the senior management team, including the process for hiring the FHLBank's CEO. (FHFA, as conservator, approves the hiring of the CEO for Fannie Mae and Freddie Mac.) *(What were the selection criteria in the CEO hiring process? Is the selection process well-documented?)*

- 5) Evaluate the management succession plan. *(Did the process include an evaluation of the individual's current and potential management skills? Does the plan address developing the necessary skills needed for new responsibilities? Is the plan regularly reviewed and updated by the board and senior management?)*
- 6) Evaluate the board of directors' process for assessing senior management performance. *(Does the board hold management accountable for achieving desired results?)*

***Policy and Procedure Development***

- 1) Determine if the board of directors has approved a comprehensive set of operational policies that sufficiently addresses significant risks, as well as regulatory requirements.
- 2) Evaluate operational and risk management practices that are established to implement board-approved policies. *(Are all critical activities addressed?)*
- 3) Determine if the board has approved a comprehensive set of policies that promote the timely disclosure of material matters and transparent financial reports to shareholders or members. *(Do disclosures include material information on objectives, related-party transactions, foreseeable risk factors, and legal matters?)*
- 4) Determine if the board has an established process to oversee critical third-party relationships.
- 5) Evaluate the board of directors' role in adopting and approving enterprise risk management policies. Consult with the examiner responsible for completing the Enterprise Risk Management workprogram. *(For the FHLBanks, does the board annually review the member products policy as required by the Corporate Governance Rule?)*
- 6) Evaluate management's controls implemented to ensure adherence to board-approved policies. *(How are exceptions to policy documented, reported, and approved?)*
- 7) Evaluate the code of conduct established to promote ethical conduct by directors, management, and staff. *(Are all directors, officers, and employees required to discharge their duties in an objective and impartial manner? Does the code promote honest and ethical conduct; compliance with applicable laws, rules, and regulations; accountability for adherence to the code; and prompt internal reporting of violations? Does the regulated entity provide a means for employees, officers, and directors to disclose potential, actual, or apparent conflicts of interest? Are disclosures of potential, actual, or apparent conflicts of interest reviewed and resolved in accordance with the regulated entity's policies and procedures? Are the CEO, chief financial officer, and chief accounting officer required to promote full, fair, and accurate disclosures in publically filed financial reports? Are material risk issues, suspected fraud, and illegal or unethical activities reported to the board or an appropriate committee? Is the code reviewed at least every three years?)*

- 8) Evaluate the strategic planning process. *(Does the strategic planning process result in a board-approved, written strategic plan? Does the board carefully monitor and assess the implementation of the strategic plan? Does the board approve the operational plans stemming from the strategic plan? For the FHLBanks, does the board establish management reporting requirements and monitor implementation of the strategic plan as required by the Corporate Governance Rule? For the FHLBanks, does the Board annually review and re-adopt the strategic plan at least every three years as required by the Corporate Governance Rule?)*
- 9) Evaluate the adequacy of the board's oversight of the regulated entity's business planning process. *(Does the board annually review and approve the capital planning process and capital goals? Does the board annually review and approve disaster recovery and business continuity plans? Does senior management provide annual reports to the board regarding tests of the business continuity plan and backup systems?)*

**Risk Metrics**

- 1) Evaluate the process for establishing risk limits. *(Do risk limits appropriately reflect the risk appetite established by the board of directors? Does the board review and approve the risk limits?)*
- 2) Review and assess any deviations from the established risk limits. *(Is there a board policy that allows exceptions to the established risk limits? What is the approval process for exceptions?)*
- 3) Review non-executive incentive compensation policies. *(How is incentive compensation aligned with the regulated entity's risk appetite?)*

**Reporting**

- 1) Determine if the board of directors is appropriately informed of the financial condition and operations of the regulated entity and receives the necessary reports to evaluate operational results. *(Does the board receive information from outside sources, such as management consultants, in addition to internal reporting? Do reports show progress toward achieving long- and short-term goals?)*
- 2) Determine if information reported to the board of directors is supplied with meaningful context. *(Do reports to the board adequately identify, measure, and monitor risks? Are results presented along with strategic plan benchmarks? Do reports include trend analysis? Are the reports timely?)*



***Internal/External Audit***

- 1) For internal audits completed on the board of directors and senior management area since the previous examination, consult with the Office of the Chief Accountant (OCA) regarding any findings about the adequacy of the scope and testing performed by internal audit.
- 2) If there are no prior findings, select internal audits related to the board of directors and senior management and determine whether or not the scope of the audit work was adequate and assess the adequacy of workpapers to support findings. *(Does the scope include an assessment of internal policies and procedures? Does the scope include testing compliance with policies? Does the scope include an evaluation of internal controls and testing of operational processes? Do the workpapers include a clear trail to conclusions? Do the workpapers identify areas for further review?)*
- 3) Coordinate with OCA to determine whether or not external audit performed work for the board of directors and senior management oversight and whether OCA performed an evaluation of the adequacy of the scope and testing completed by external audit.
- 4) Determine if the audit function is free from management influence. *(Does the internal audit function report directly to the audit committee of the board of directors? Do internal and external auditors have unrestricted access to the audit committee without the need for any prior management knowledge or approval? Does the board meet with internal audit in executive sessions? Does the audit committee review and approve the internal auditor's workplan? Does the audit committee approve the external auditor's annual engagement letter? Does the audit committee review the performance of the external auditor?)*
- 5) For the FHLBanks, assess if the audit committee is fulfilling its duties and responsibilities. *(Does the audit committee review and approve the internal auditor's work plan as required by the Corporate Governance Rule? Does the audit committee approve the external auditor's annual engagement letter as required by the Corporate Governance Rule?)*

***Information Technology***

- 1) Determine if the regulated entity has developed a quality assurance framework. *(Have appropriate steps been taken to address concerns identified by management?)*

***Compliance***

- 1) Assess and conclude on the regulated entity's efforts to conform to PMOS standards at 12 CFR 1236. Consult with the examiners responsible for completing other workprograms included in the scope of the examination.
- 2) Assess compliance with the Corporate Governance Rule, including the Subparts 1239.20 – 1239.21 for Enterprise-specific requirements at 12 CFR 1239.20 – 1239.221, and FHLBank-specific requirements at 12 CFR 1239.30 – 1239.33.

**4. Testing**

- 1) Review a sample of information packages provided to the board of directors prior to regularly scheduled board meetings. *(Do the information packages contain ad hoc reports in addition to standard reports? Are the information packages complete with sufficient disclosure to be understandable to the members of the board? Is the data in information packages consistent with management reports that are not provided to the board?)*
- 2) Review board committee charters. *(Are committee activities consistent with its charter? In the case of committees required by regulation, is the charter consistent with the relevant regulation?)*

**5. Conclusions**

- 1) Summarize conclusions for all examination work performed, including work performed by other FHFA staff, as it relates to the regulated entity's board and senior management. Develop a memorandum describing the risks to the regulated entity resulting from weaknesses identified in the regulated entity's board and senior management practices. The memorandum should describe the basis of conclusions reached and summarize the analysis completed. Within the memorandum, discuss the types of risk the regulated entity is exposed to (e.g., market, credit, operational); the level of risk exposure; the direction of risk (stable, decreasing, increasing); and the quality of risk management practices (strong, adequate, weak). A memorandum must be prepared irrespective of whether the examiner's assessment is positive or negative.
- 2) Conclude on the responsiveness to previous examination findings. Evaluate the adequacy of the regulated entity's response to previous examination findings and concerns.
- 3) Draft a conclusions letter (for Enterprise examinations) or prepare findings memoranda (for FHLBank examinations), as appropriate. Findings should identify the most significant risks to the regulated entity and the potential impacts to the regulated entity resulting from the concerns identified. Significant findings should describe a specific end result that will resolve the issue. Communicate preliminary conclusions and findings, if applicable, to the EIC. Discuss conclusions and findings, if applicable, with regulated entity personnel to confirm the analysis and findings are free of factual errors.
- 4) Develop a list of follow-up items to evaluate during the next examination. In addition to findings developed in the steps above (if any), include concerns noted during the examination that do not rise to the level of a finding. Potential concerns include issues the regulated entity is in the process of addressing, but require follow-up work to ensure actions are completed appropriately. In addition, potential concerns should include anticipated changes to the

regulated entity's practices or anticipated external changes that could affect the regulated entity's future governance practices.