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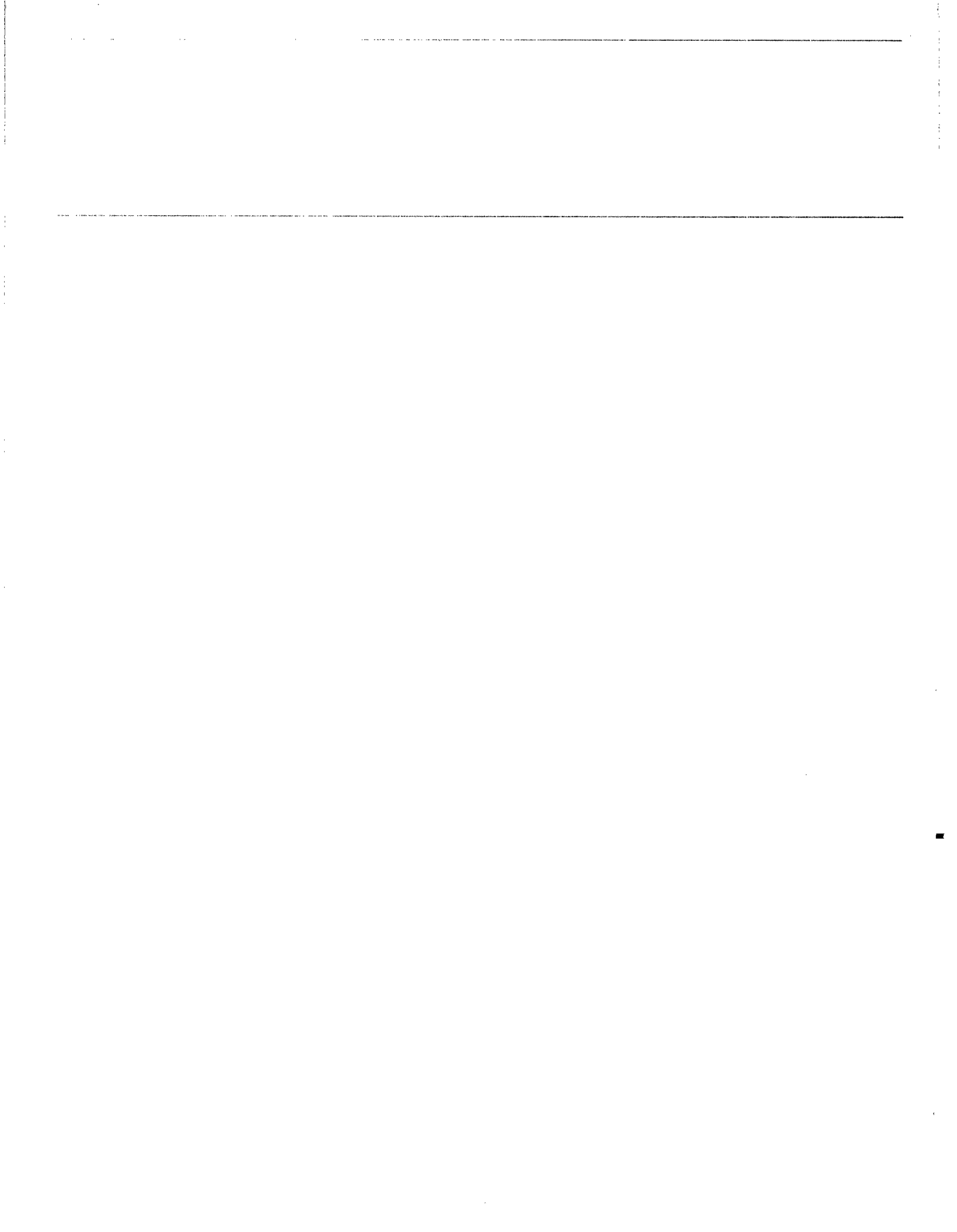
GOVERNMENT-  
SPONSORED  
ENTERPRISES

System of Internal  
Controls at Freddie  
Mac, Fannie Mae, and  
Sallie Mae



146229





**General Government Division**

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March 31, 1992

The Honorable Donald W. Riegle, Jr.  
Chairman, Committee on Banking, Housing  
and Urban Affairs  
United States Senate

The Honorable Edward M. Kennedy  
Chairman, Committee on Labor  
and Human Resources  
United States Senate

The Honorable Henry B. Gonzalez  
Chairman, Committee on Banking, Finance  
and Urban Affairs  
House of Representatives

The Honorable William D. Ford  
Chairman, Committee on Education and Labor  
House of Representatives

Three government-sponsored enterprises (GSE)—the Federal Home Loan Mortgage Corporation (Freddie Mac), the Federal National Mortgage Association (Fannie Mae), and the Student Loan Marketing Association (Sallie Mae)—held more than \$800 billion in obligations at the end of 1990, exposing the federal government to potential losses should these GSEs experience financial difficulties. The Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989 required us to study the risk-taking and capital adequacy of these GSEs. This is the last of three reports that respond to the FIRREA requirement.

We concluded in our first report that additional federal oversight is needed over the risk-taking and capital adequacy levels of Freddie Mac, Fannie Mae, and Sallie Mae to keep any problems from imposing losses on taxpayers.<sup>1</sup> In the second report, we recommended that Congress establish a Federal Enterprise Regulatory Board with sufficient authority to achieve those goals, including authority to set and enforce risk-based capital rules.<sup>2</sup>

<sup>1</sup>Government-Sponsored Enterprises: The Government's Exposure to Risks (GAO/GGD-90-97, Aug. 15, 1990).

<sup>2</sup>Government-Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks (GAO/GGD-91-90, May 22, 1991).

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In our earlier reviews, we did not find anything that suggested any of the GSEs was at risk of immediate failure, although we did not independently test the financial vulnerability of the GSEs. For this report we reviewed certain parts of the internal control structures at Freddie Mac, Fannie Mae, and Sallie Mae to improve our confidence in the descriptive information we had been provided on controls over various GSE risks. Our approach was twofold. First, we looked at work done by other auditors—internal and external—to see if they had identified significant weaknesses. Second, we looked for control weaknesses in limited tests we performed at regional offices.

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## Results in Brief

Our review of findings and selected work papers of calendar year 1990 audits and examinations by internal and external auditors at Freddie Mac, Fannie Mae, and Sallie Mae uncovered no significant weaknesses in GSE activities except for Freddie Mac controls over its multifamily business. Our limited tests of the controls involving (1) asset acquisition and preservation and (2) quality control over business partners uncovered no significant additional weaknesses in the GSEs' operations. This work was not sufficiently comprehensive to render an opinion on the design or operations of the entire internal control system of each GSE.

Internal auditors, a Freddie Mac consultant, and we all found significant weaknesses in the design and implementation of Freddie Mac's controls over purchasing and servicing multifamily loans. As a result of these weaknesses and other factors, Freddie Mac charged off over \$300 million against reserves from 1986 through 1990. Freddie Mac made senior level personnel changes in its multifamily program; suspended buying new multifamily loans in October 1990; and has made or planned several changes in its purchasing, servicing, and monitoring of multifamily loans. Freddie Mac does not plan to resume purchasing new multifamily loans until sometime in 1992.

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## Background

GSEs are federally chartered, privately owned for-profit corporations, most of which are designed to provide a continuing source of credit nationwide to specific economic sectors. Congress created Freddie Mac, Fannie Mae, and Sallie Mae to ensure continuous nationwide availability of reasonably priced loans to home buyers and students.<sup>3</sup> Generally, Freddie Mac and Fannie Mae promote financing for homes by purchasing mortgages from

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<sup>3</sup>Freddie Mac was created in 1970, Fannie Mae in 1938, and Sallie Mae in 1972.

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lenders, replenishing the lenders' funds so they can make additional mortgages. Sallie Mae buys student loans from primary lenders. The student loans are guaranteed by state and nonprofit agencies and reinsured by the Department of Education. Sallie Mae loan purchases provide lenders with additional funds for student loans. Sallie Mae also makes loans, which are secured by student loans and other collateral, to encourage lending institutions to make student loans.

As of December 31, 1990, Freddie Mac had on-balance-sheet assets of \$41 billion and off-balance sheet mortgage-backed securities outstanding of \$316 billion, Fannie Mae had on-balance-sheet assets of \$133 billion and off-balance sheet mortgage-backed securities outstanding of \$300 billion, and Sallie Mae had on-balance-sheet assets of \$41 billion.

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### Risks Undertaken by the GSEs

In our August 1990 report, we identified four types of risks facing GSEs: (1) interest rate risk, (2) credit risk, (3) business risk, and (4) management and operations risk. Interest rate risk is the risk of possible losses arising from changes in interest rates. Credit risk is the risk of loss that can occur when borrowers fail to repay their loans or other parties fail to meet their obligations to service or insure loans. Business risk is the risk that factors beyond an organization's control—such as changes in demand for mortgages or student loans—could lead to unexpected changes in earnings, growth, or capital. Management risk is the potential for losses resulting from the decisions or indecisiveness of a company's managers.

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### The Role of Internal Control Systems

Generally, the most comprehensive and direct way for GSEs to manage their exposure to risk is through a structure of internal controls. Internal controls are an organization's policies and procedures established by senior management to provide reasonable assurance that specific objectives and goals will be achieved. Internal controls are designed to guide the daily operations of GSEs in ways that reflect corporate objectives and goals envisioned in the GSEs' strategic and operational plans.

GSEs have established a variety of policies and procedures to control risk as they acquire or service their assets (loans).<sup>4</sup> For example, as Freddie Mac and Fannie Mae acquire mortgages, they limit their credit risk by, among other safeguards, dealing only with "eligible lenders." Eligible lenders are

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<sup>4</sup> Servicing includes all activities necessary to administer a loan, including collecting and disbursing payments.

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those that meet the GSEs' standards for financial strength, past performance, and quality of management. Moreover, Freddie Mac and Fannie Mae require eligible lenders to guarantee that loans they sell to GSEs meet the GSEs' underwriting standards, unless negotiated otherwise.

Underwriting standards are guidelines used to (1) limit the type and amount of risk permitted in a financial portfolio and (2) establish methods to control such risks. The underwriting standards for single-family residential loans pertain to factors such as the age of the loan, the purpose of the loan, the type of loan, the loan-to-value (LTV) ratio,<sup>5</sup> and the borrower's income level.

The three GSEs also have policies and procedures to protect them from risk resulting from poor performance by organizations, called counterparties, that insure or service the loans held by GSEs. Examples of counterparties are lenders that collect and process monthly principal and interest payments on mortgages sold to Freddie Mac and Fannie Mae and student loan servicers who contract with Sallie Mae. Policies generally require a GSE to routinely review selected counterparties to verify that the counterparties have instituted adequate controls and procedures for loan originating, servicing, reporting, and accounting.

The audit function at the three GSEs is provided by external auditors, which we refer to as "independent public accountants" (IPA), and internal audit departments. Because the purposes of external audits by IPAs and internal audits differ, the IPAs' and internal auditors' evaluations of internal controls will also differ.

The purpose of an external financial audit is to enable the IPA to express an opinion on the GSE's financial statements. In planning and performing the audit, the IPA considers the entity's internal control structure in order to determine the auditing procedures needed to offer its opinion. Two options are available. The IPA can rely on accounting controls that have been thoroughly tested and evaluated or the IPA can test account balances directly. While either method gives some insight about the operations of accounting controls, these auditing procedures are typically insufficient to provide reasonable assurance that a company's entire internal control structure is designed appropriately and operating as intended. For

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<sup>5</sup>The LTV ratio is the relationship of the principal amount of a mortgage to the estimated value of a property. The higher the LTV, the higher the credit risk. For example, a mortgage with a principal amount of \$80,000 backed by a house valued at \$100,000, has an LTV of 80 percent.

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example, the IPA's work will typically provide little insight into the operations of management or administrative controls that do not relate directly to the financial statements.

One purpose of internal audits is to provide an ongoing review and evaluation of the adequacy of an organization's system of internal control. Internal auditors are supposed to maintain an understanding of the operations, internal controls, and risks associated with all the business functions of a GSE. To be truly effective, internal audits must have support from the highest level of management, which ensures that the internal auditors will have access to all areas of an organization; that those being audited will cooperate; and that the audit results, recommendations, and corrective actions will be reported to and acted upon by top management.

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## Scope and Methodology

To accomplish our objective, we reviewed past assessments of three GSEs' internal controls by internal audit and IPA. In addition, we observed key internal control procedures operating at 7 of the GSEs' 14 field offices.<sup>6</sup> For Freddie Mac, we also considered the design and effectiveness of internal controls in its multifamily programs. (See app. II for background on Freddie Mac's multifamily loan purchase program.) (See app. I for a more detailed discussion of our objective, scope, and methodology.)

In this report, we disclose the findings of our evaluations of GSE internal and external auditors' work. We also report findings from our direct testing of selected controls when we found weaknesses. Relevant portions of a draft of this report were sent to Freddie Mac, Fannie Mae, and Sallie Mae. Freddie Mac responded with written comments that are evaluated in the text and reprinted in Appendix III. Fannie Mae and Sallie Mae provided oral comments and changes have been incorporated into the final report where appropriate. We did our audit work between August 1990 and October 1991 in accordance with generally accepted government auditing standards.

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<sup>6</sup>Freddie Mac had four regional offices and an office in Dallas, Texas, that did not market or purchase loans. Fannie Mae had five regional offices, and Sallie Mae had five service centers at the time of our visits and has since added a sixth center in Tampa, Florida.

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## Conformance of External and Internal Audits With Standards

On the basis of our review of the policies, procedures, and field work of each GSE's IPA and internal auditors, we found the auditors to be competent and objective. We reviewed 1990 IPA audit working papers and work programs and verified that they were properly reviewed; the auditors completed the audit steps outlined in their work programs; the findings in their working papers were included in their management letter, which they submitted to the audit committee and which noted any identified control weaknesses; and they properly reviewed the internal audit department's work to the extent they relied on it. We also found that the external auditors' policy and procedures for planning, supervision, evidence, reporting, and objectivity met the applicable standards.

We and the IPAs determined that, at the time of our respective reviews, the internal audit departments of Freddie Mac, Fannie Mae, and Sallie Mae were sufficiently competent and objective. Our determinations and those of the IPAs were based on applying the guidance for assessing competence and objectivity contained in the American Institute of Certified Public Accountants' (AICPA) Statement on Auditing Standards (SAS) No.9, "The Effect of an Internal Audit Function on the Scope of the Independent Audit." Internal auditors' fieldwork met the applicable standards. Specifically, the working papers supported conclusions reached, and the findings were included in the reports. In addition, the reporting policies and positions in the organizations helped ensure the objectivity of the internal auditors and the attention to their work by top management. The internal auditors had unrestricted access to all operations, and the audit reports were all sent to the presidents, IPAs, responsible vice presidents, and managers of the audited operations.

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## Freddie Mac Prepared Its Staff for Our Interviews

During our review, we learned that Freddie Mac's senior management and internal auditors held a series of regional briefings to prepare Freddie Mac staff to answer our interview questions. Freddie Mac explained that its intent in preparing its staff for our regional visits was to facilitate, not obstruct, our audit. However, these briefings appeared to have a chilling effect on many of the employees that we interviewed. At the two Freddie Mac regions where we tested controls, we observed that Freddie Mac employees appeared reluctant to provide us with complete information and appeared very uneasy in dealing with us. We were particularly concerned that the internal audit department's participation in the briefings might have given the appearance of a lack of independence from management.



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In commenting on a draft of this report, Freddie Mac said that it had reported the matter to its Audit Committee and requested an investigation by its independent auditor, Arthur Andersen. Arthur Andersen found that the intent of the management activities to prepare for our visit and the involvement of internal audit was appropriate. However, Arthur Andersen also observed that management's actions were not successful in constructively facilitating our audit and suggested that management and/or the audit committee review the scope of internal audit's activities to determine whether any of these activities may adversely impact internal audit's effectiveness. We concur with Arthur Andersen's observation and encourage Freddie Mac to implement Arthur Andersen's suggested action.

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### GSEs' Audit Committees Were Correctly Designed

We found that the three GSEs' boards of directors' audit committees were designed consistent with the recommendations of the National Commission on Fraudulent Financial Reporting, a multiorganizational effort funded by AICPA and other professional organizations that is also known as the "Treadway Commission."<sup>7</sup> In its October 1987 report, the Treadway Commission recommended that the boards of directors of public companies develop and approve a written charter stating the audit committee's duties and responsibilities. It also recommended that the heads of internal audit have unrestricted and direct access to both the audit committee and the Chief Executive Officer.

Each of the three GSEs' boards of directors developed and approved written charters specifying the audit committee's duties and responsibilities. Each committee has overall responsibility for the GSE's internal controls, including reviewing and approving internal audit's annual audit plans. In addition, each audit committee is responsible for meeting regularly and as needed with the head of internal audit to discuss audit results and progress in meeting the audit plan. Each audit committee also has unrestricted and direct access to the head of internal audit, and the auditors have unrestricted access to the audit committees. Finally, each audit committee meets regularly with the IPA to discuss its audit findings.

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<sup>7</sup>The Treadway Commission was formed in June 1985 in response to allegations of financial reporting fraud and a record number of Securities and Exchange Commission enforcement actions regarding fraud.

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## Results of Our Limited Tests of Freddie Mac's Controls

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### Delinquency Reporting Errors

Some of the data on delinquent loans that lenders reported to Freddie Mac through its automated system appeared to be unreliable. We reviewed all 3,702 delinquency reports for 1990 from lenders who serviced mortgages for Freddie Mac and found inconsistent or contradictory data in 18 percent of the reports. For example, one lender reported no 30-day and no 60-day delinquencies during 1 month, while the next month the lender reported over 800 30-day delinquencies and more than 100 60-day delinquencies. Logically, the 60-day delinquencies in the second month should have been reported as 30-day delinquencies in the first month. Freddie Mac researched these discrepancies and reported that 429 servicers made reporting errors. Forty percent of these 429 servicers had errors in more than 1 month, and 9 of the servicers had reporting errors for more than 3 months. Freddie Mac said its worst-case analysis indicated a maximum reporting error of 3 percent. Freddie Mac believes that this number of reporting errors is acceptable given the size of its portfolio and the number of servicers reporting. Officials said that Freddie Mac staff normally check such inconsistencies but focus on mortgages that are 90-days delinquent.

We also found that 17 percent of the delinquency reports, which Freddie Mac officials said represented about 1 percent of total loans in the portfolio, reported no delinquencies during 1990. We could not independently determine from the files what caused the reports to show no delinquencies. Freddie Mac officials said that showing no reported delinquencies could result from (1) lenders having no delinquencies during the year, (2) the failure to record accurate data in the automated system, or (3) the lenders not reporting data. Freddie Mac said that 90 percent of those servicers reporting zero delinquencies had portfolios of fewer than 100 loans. Because of this small portfolio size, the reporting of zero delinquencies was correct, Freddie Mac believes, but it did not verify the accuracy of the reports. Freddie Mac also reported that only 2 of the 617 servicers who reported zero delinquencies had portfolios exceeding 500 loans. Freddie Mac did not indicate whether these cases involved reporting errors or failure to report delinquencies on the part of servicers.

Freddie Mac officials said that they have released an information system revision that is expected to improve the accuracy of delinquency reporting

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by certain seller/servicers. Freddie Mac said it has not had adequate time to assess the effectiveness of this enhancement.

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**Multifamily Controls Were  
Not Appropriately Designed**

Our review of internal audit reports and a report by Laventhol & Horwath (L&H), an outside consultant of Freddie Mac's, as well as our observations, indicated that Freddie Mac's controls over purchasing and servicing multifamily loans were not appropriately designed or implemented. Freddie Mac used as key underwriting standards LTV and debt coverage ratios (DCR) that were both riskier than the industry norms at the time and based on unverified information in unreliable appraisals.<sup>8</sup>

In a separate review of Freddie Mac's underwriting of 35 multifamily properties in the Bronx, New York, we found that a number of the properties had been refinanced at values that greatly exceeded the price that the borrower reportedly had paid to purchase the property.<sup>9</sup> For this report, we wanted to describe the extent to which the refinanced values of Freddie Mac's multifamily portfolio exceeded the most recent sales price.

We reviewed the loan origination files for a statistically valid sample of 307 of the refinanced multifamily loans in Freddie Mac's portfolio as of September 30, 1990. The loans were purchased between May 1983 and July 1990. (See app. I for details on our sampling methodology.) We compared the selling price at the time that the borrower purchased the property, increased by any improvements reported in the loan files, with the appraised value that Freddie Mac used as a basis for determining the

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<sup>8</sup>A DCR measures the ratio of net operating income to debt service payments. Income-producing properties, such as multifamily apartment buildings, must earn at least enough to pay the monthly mortgage and other expenses. Otherwise, they lose value, and the borrower is likely to default. A DCR of 1.10 means that net operating income exceeds debt service expenses by 10 percent.

<sup>9</sup>See Federal Home Loan Mortgage Corporation: Abuses in Multifamily Program Increase Exposure to Financial Losses (GAO/RCED-92-6, Oct. 7, 1991).

amount of loan it would purchase. We then calculated the annual rate of increase from the time the property was acquired by the borrower until the property was appraised.<sup>10</sup> The results of this analysis are shown in table 1.

**Table 1: Annual Rates of Property Value Increase From Time of Borrower Acquisition to Time of Refinance**

Annual percentage increase	Percentage of Freddie Mac's refinanced multifamily portfolio <sup>a</sup>
0 or below	8
Greater than 0 to less than 20	64
20 to less than 40	18
40 to less than 60	4
60 to less than 80	2
80 and above	5

<sup>a</sup>Numbers do not add to 100 percent because of rounding. Sampling errors range from 2 percent to 8 percent. Sufficient data were available in loan files to calculate the annual rate of increase for 171 loans in sample. We do not know the effect that the large number of loan files with missing data could have had on these results.

Source: GAO estimate based on data from Freddie Mac files.

Examples of the higher increases included one property for which the appraised value was twice as high as the borrower had paid for it at a sheriff's sale about 4 months earlier, increasing the value by \$2.5 million. The borrower said that \$300,000 in property improvements were made. In another case, a borrower reported that \$4.3 million was paid to acquire a

<sup>10</sup>We calculated the annual rate of increase using a standard compounding formula:  $AP(1+r)^n = AV$ , where AP is acquisition price, AV is appraised value, n is number of years between the acquisition of the property and the appraisal, and r is annual rate of increase.

When the property was held for less than 1 year, we calculated a simple annual rate of increase under the assumption that the compounding period could not be less than 1 year.

$$r = \frac{AV-AP}{AP} (1/n)$$

In both cases, if the property had improvements noted in the file, we added the value of the improvements to the acquisition price.

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property and said that \$744,000 in improvements were made. We found no documentation in the file to support the improvements.<sup>11</sup> Less than 4 months after the borrower's purchase, the property was appraised at \$6.25 million.

In its written comments, Freddie Mac said that our analysis of multifamily properties presented misleading comments, unsupported by facts, on appreciation rates. Freddie Mac said that it disagreed with the report's conclusion that the presence of high appreciation rates raises questions about the valuations of the underlying properties. According to the Chairman of Freddie Mac, "The inappropriate methods and factual inaccuracies used to represent property value appreciation do not support potential overfinancing in apartment properties."

Our report describes the purpose of our analysis—to discuss the extent to which the values of refinanced multifamily properties serving as collateral for loans purchased by Freddie Mac exceeded the most recent sales price of the property. We undertook this analysis because work we had done in a separate review of 35 multifamily properties in the Bronx showed dramatic changes in the property's valuation between the time when the borrower purchased the property and the time when it was appraised for refinancing. Our Bronx multifamily work showed that inaccurate and incomplete appraisal information led Freddie Mac to overfinance 27 of these 35 properties by 20 percent. For example, in 1 of the 35 cases, a borrower purchased a property for \$975,000, and it was appraised 1 month later for \$3,261,066. The owner defaulted on the mortgage 3-1/2 years later. These findings were troubling, but the 35 properties represented a small portion of Freddie Mac's multifamily business that was not randomly selected. We wanted to examine the extent to which such high appreciation rates were evidenced in the entire refinanced multifamily business.

Freddie Mac is correct in pointing out that our analysis is insufficient to prove that Freddie Mac overfinanced or overvalued any part of its multifamily business. Freddie Mac could evaluate these issues by testing the relationship between appreciation rates, loan amounts, defaults, and losses. Our sample did not include sufficient numbers of defaulted properties to evaluate these relationships.

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<sup>11</sup> Freddie Mac does not typically require documentation of capital improvements, other than a signed, certified multifamily loan application, clearly stating that any information contained in the loan package signed by the borrower is true and correct under penalty of law.

Freddie Mac also raised a number of specific objections to our analysis that deserve comment. First, Freddie Mac said that the report did not consider the real estate market conditions at the time it purchased the loan. We disagree. In our analysis of change in valuation, we used the property appraisal value as one measure of valuation—the same measure used by Freddie Mac in reporting its LTV ratios. Such appraisals are to assess current market conditions and comparable properties in determining the property's valuation. The other valuation measure we used was the sale price of the property, which, for most transactions, should involve the best estimate of market condition.

Second, Freddie Mac commented that our report did not compare their properties' appreciation rates with the appreciation rates of similar apartment buildings. This is true. While initially we had hoped to make such an assessment, we were unsuccessful in identifying historical indexes for multifamily properties within a specific market that would result in credible comparisons. Freddie Mac itself uses Commerce Department indexes to gauge the appreciation of its multifamily properties and has calculated a mark-to-market LTV for its multifamily loans.<sup>12</sup> However, Freddie Mac officials told us that they do not have confidence in these indexes and that they do not report their mark-to-market LTVs for multifamily properties publicly. Freddie Mac said a review of land records in New York showed that it was common for properties in the Bronx to appreciate in value by 30 to 40 percent each year since the early to mid-1980s. Freddie Mac, however, agreed that such an analysis was not comparable to the appreciation rates we presented because owner improvements would not have been available from land records to factor into the calculation.

Third, Freddie Mac said that our analysis ignored current cash flows from the property, the borrower's credit experience, and other relevant factors that are standard factors used by the real estate industry and are critical in evaluating a multifamily property. Our analysis presented the valuation of the property serving as collateral for the loan at two points in time—when the borrower purchased the property and when it was appraised for Freddie Mac refinancing. We believe that with few exceptions both valuations would have been based on standard factors used in the real estate industry. When we had direct evidence that one valuation or the

<sup>12</sup>Over time, housing inflation tends to increase the market value of the property, while payments lower the unpaid principal balance of the mortgage. Freddie Mac adjusts a property's initial LTV for estimated house price appreciation (inflation) and payment amortization and calls this adjusted LTV its mark-to-market LTV.

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other was questionable, we eliminated that loan from our sample. For example, we eliminated a case in which a borrower purchased a property for \$1 and two other cases in which the appraised value for conversion of a multifamily property into a cooperative was suspect.

Fourth, Freddie Mac said that cash investments made by the property owners to rehabilitate a property were not properly included in our analysis. Freddie Mac suggested that improvements should be valued at an amount greater than their cost because there is added value, beyond cost, that results from the rehabilitation process. However, Freddie Mac has not suggested a specific alternative. While we agree that in any specific case the value of improvements could exceed their cost, it is also true that certain improvements (such as repairing boilers or roofs) may not increase the property's income or value. For example, in several cases in our sample, the borrower's cost of improvements could not be fully recovered through operating income because rent controls were in place. On average, we believe that the cost of improvements is the most reasonable estimate of the value of improvements.

Freddie Mac also disagreed with our use of the property appraisal as the valuation of the property. In responding to a draft of this report, Freddie Mac said that its basis for lending decisions on multifamily properties was its underwriter's valuation, not the appraiser's final valuation of the property. When Freddie Mac used the underwriter's value and supplied additional data on the sale dates and prices that we did not find in the files, Freddie Mac reported to its board of directors that the percentage of properties having appreciation rates of 20 percent or higher dropped from 31 percent to 20 percent.

We used the appraised value of the property because Freddie Mac officials consistently explained during the audit that it was the valuation that they used for their multifamily properties. The appraised value is the property valuation that was entered into the data system, and it was also the valuation Freddie Mac has used to calculate LTV ratios.<sup>13</sup> Furthermore, in certain cases, Freddie Mac loan purchases would not have conformed to its underwriting standards had the underwriter's valuation been used. Freddie Mac also has used the appraised value as its property valuation in public reports—such as reports to shareholders on the status of its multifamily

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<sup>13</sup>A Freddie Mac official told us that its policy was to enter the appraised value into the data system. In 253, or 82 percent, of the 307 cases in our sample, the property value entered into the data system was the appraised value.

operations. We think it would be inconsistent and unreliable for Freddie Mac or us to use one valuation for LTV ratios and a different valuation to calculate appreciation rates on the same properties.

For a number of high appreciation properties, major renovations or unusual purchase scenarios made these properties significantly different from the time of purchase to the time of refinance, according to Freddie Mac. Officials said that these transactions did not represent the typical appreciation for multifamily housing. We have not suggested that there is a typical appreciation rate for multifamily housing. However, in our sample, properties with substantial improvements did not seem to be concentrated in the highest appreciation categories. For example, there were 13 properties in which the cost of improvements exceeded the purchase price of the property. Of these 13, 2 had appreciation rates greater than 40 percent, and 1 of these 2 properties had been foreclosed and repossessed by Freddie Mac during the course of our review. Another 12 properties had improvements valued between 50 and 100 percent of the property purchase price. Of these 12, 1 property had an appreciation rate above 40 percent, and this property was reported to us as delinquent.

Freddie Mac also objected to the annualization of appreciation rates for properties held less than 1 year. Officials explained that the short time that elapsed between when the borrower purchased the property and when it was refinanced overstated the appreciation rate and was a factor in making the appreciation rates of certain properties seem high. We believe we used the most appropriate means to annualize the appreciation rate. Freddie Mac did not propose another alternative. Furthermore, properties held for short periods of time were not exclusively found in the highest appreciation categories. For example, 21 cases in our sample were owned for less than 1 year before the owner refinanced. Six had annual appreciation rates of zero percent or less, 4 had rates between zero and 20 percent, 1 had a rate between 20 and 40 percent, and 10 had annual appreciation rates more than 40 percent.

Finally, Freddie Mac said that we made numerous errors in computing appreciation rates, which resulted in incorrect factual representations. We relied on the data available in Freddie Mac's files to make our calculations. To the extent that information in the files was inaccurate, incomplete, inconsistent, or unavailable, our results could have been affected. We used a standardized data collection instrument to collect information from the files. For the most part, this process involved locating specific forms and examining specific data fields to obtain the information on sale price, sale



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date, appraisal value, and improvements. For example, we checked for the date and price of the property when purchased by the borrower by examining four documents. We also checked a minimum of four forms—the borrower’s application, Freddie Mac’s inspection reports, the appraiser’s report, and the underwriting summary—each of which has specific fields in which property improvements and their costs should be described.

Freddie Mac reviewed the files that we included in our sample and in some cases identified discrepancies between their results and ours. We re-reviewed the 50 cases of highest appreciation and made changes to our analysis. Some evidence presented by Freddie Mac had not been available when we reviewed the file. For example, in one case with a high appreciation rate, our file review showed no evidence of any improvements on the loan application, the appraisal, the inspection report, or other forms. Freddie Mac subsequently produced a loan application that showed \$300,000 worth of improvements on the property. We revised our information to count these improvements, although we had not found evidence of such improvements on this or any other form when we reviewed the file several months earlier. After making such changes on the 50 cases with the highest appreciation, the results of their analysis and ours were not significantly different.

Our sample indicated that the appraisals for Freddie Mac’s multifamily loans were completed, on average, within 220 days of Freddie Mac’s funding of the loans, which is within Freddie Mac’s 230-day allowable time frame.<sup>14</sup> However, 7 percent of the appraisals were completed more than 360 days before the loan was funded. These appraisals did not necessarily violate Freddie Mac’s standards because Freddie Mac may have taken longer than its required 30 days to underwrite the loans, or lenders may not have delivered all of the required documents in their final loan delivery package. Freddie Mac standards allow either of these situations to delay the funding date. Nevertheless, the greater the time that elapses between the appraisal date and the funding date, the more Freddie Mac is exposed to the risk that properties will decrease in value before the loan is funded.

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<sup>14</sup>Plus or minus 17 days.

## Freddie Mac Attempted to Strengthen Controls

Freddie Mac took a series of steps to strengthen its controls over multifamily purchases before ultimately suspending the program in October 1990. In October 1988, December 1989, and June 1990, Freddie Mac required some independent checking of information in property appraisals and tightened its underwriting ratios. Specifically, Freddie Mac's multifamily underwriters were required to do detailed inspections of the property backing the loans and note any maintenance and repair needs. According to officials, Freddie Mac now demands certification that required maintenance has been completed before it will buy a loan. Furthermore, during the inspection, the underwriters were also required to knock on 10 percent of the doors and verify with the occupants that the rent listed on the rent roll was the amount they actually paid each month. Rather than relying strictly on information from appraisals, Freddie Mac underwriters were also required to make their own estimates of the properties' expenses, using published data sources when possible as a basis for comparison. Freddie Mac underwriters were allowed to use either their own estimates or the appraiser's estimate in making underwriting decisions. Freddie Mac decreased its maximum LTV ratio from 85 percent to 60 percent for loans without recourse<sup>15</sup> in December 1989 and increased its minimum DCR to 1.30 from 1.15 in June 1990.<sup>16</sup>

Freddie Mac's multifamily cash purchases totaled \$1.8 billion in 1989 and \$1.3 billion in 1990. Recognizing that weaknesses still existed in its purchasing and servicing of multifamily loans, Freddie Mac suspended its multifamily cash purchases in October 1990. According to Freddie Mac officials, Freddie Mac has taken several actions to strengthen its servicing of multifamily loans since suspending its multifamily program. Freddie Mac officials said that, in November 1990, a senior executive was assigned to manage the multifamily program; the Chairman of the Board assumed overall responsibility for the program; and a special multifamily committee of the board of directors was established. The officials said that 40 employees were hired in early 1991 to help manage multifamily assets, and a new senior vice president was hired in May 1991 to manage the program. As of July 1991, Freddie Mac had not acquired any new multifamily loans since suspending its cash purchases. The new senior vice president told us that new multifamily programs will be developed only after a strategic

<sup>15</sup>A recourse agreement between a GSE and a lender or servicer obliges the lender or servicer to cover some or all of the losses arising from loans sold to the GSE.

<sup>16</sup>Freddie Mac officials said that the minimum DCR had been increased above 1.15 in declining markets before June 1990.

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review of the multifamily business has been completed. He said he expects the new programs to be available for implementation in 1992.

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## Results of Our Limited Tests of Fannie Mae's Controls

Our direct testing found nothing to suggest material weaknesses in Fannie Mae's internal controls. Although we did not find instances in which Fannie Mae failed to comply with its standards for lender eligibility, we found two instances at a regional office in which we believe Fannie Mae could have better protected itself against risk by improving or more carefully enforcing its controls over lenders. In the first instance, a lender that had been suspended for not meeting Fannie Mae's net worth<sup>17</sup> requirement made an unaudited reclassification in its financial statements that brought its net worth into compliance. On the basis of this adjustment, Fannie Mae negotiated a contract to purchase mortgages from that lender. To ensure that the reclassification was appropriate and that the lender was financially sound – given the risk involved should the lender fail – we believe Fannie Mae should have taken additional steps to ensure that the reclassification was accurate. For example, Fannie Mae could have required approval by the lender's IPA. Fannie Mae officials said that the decision to negotiate a contract with this lender was appropriate because of past experience with the lender and the small size of the lender's portfolio with recourse.

In the second instance, a very large lender continued to receive the best risk ranking and, thus, the lowest prices even though it had continuing problems reconciling its Fannie Mae account balances. Because these problems could increase the risk of doing business with that lender, and price is one of the methods used to compensate for the risk undertaken, Fannie Mae could have better protected itself by lowering the risk ranking of the large lender and thus increasing the price received from that lender. Fannie Mae officials said they believed that the risk of doing business with this lender was minimal because the lender had a strong financial position and a record of consistently delivering high-quality loans to Fannie Mae.

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## Results of Our Limited Tests of Sallie Mae's Controls

Our direct testing found nothing to suggest material weaknesses in Sallie Mae's internal controls. Officials in Sallie Mae's Texas Loan Servicing Center officials initially provided us with an incorrect criterion on refiling returned claims for guaranteed student loans that had defaulted. Using this incorrect criterion, we identified 21 claims as being refiled late out of our sample of 31 of 861 returned claims outstanding as of October 31, 1990.

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<sup>17</sup>Net worth is a measure of financial solvency, typically the difference between assets and liabilities.

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Late refiling of claims can cause Sallie Mae to lose the principal and interest on those claims.

After reviewing a draft of this report and following up with the Texas Loan Servicing Center, Sallie Mae headquarters officials said that the information that the Texas Center had given us was incorrect. Although we had originally been told that refiling was required within a 30-day period, headquarters officials said the allowable refiling period was actually 60 days. On the basis of the new information, all of the 21 returned claims originally identified as late had been refiled on time. However, Sallie Mae officials said that, due to problems in obtaining correct information from an outside servicer, one of the claims was refiled with an incorrect guaranty agency.<sup>18</sup> By the time this error was discovered and the claim was refiled with the correct guaranty agency, the allowable period for refiling had elapsed and the claim was rejected.

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We are sending copies of this report to other interested congressional committees, Fannie Mae, Freddie Mac, Sallie Mae, and the Departments of the Treasury, Education, and Housing and Urban Development. We will also make copies available to others upon request.

Other major contributors to this report are listed in appendix IV. If you have any questions about this report, please contact me on (202) 275-8678.



Craig A. Simmons  
Director, Financial Institutions  
and Markets Issues

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<sup>18</sup>A guaranty agency is a state or nonprofit agency that insures and pay claims on student loans. Guaranty agencies operate under reinsurance agreements with the Department of Education.



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**Abbreviations**

AICPA	American Institute of Certified Public Accountants
DCR	debt coverage ratio
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act
GSE	government-sponsored enterprise
IPA	independent public accountant
L&H	Laventhol & Horwarth
LTV	loan-to-value
SAS	Statement on Auditing Standards

# Objective, Scope, and Methodology

The objective of our review was to improve our confidence in the operations of various credit risk control procedures used by three government-sponsored enterprises (GSE). The three GSEs were the Federal Home Loan Mortgage Corporation (Freddie Mac), the Federal National Mortgage Association (Fannie Mae), and the Student Loan Marketing Association (Sallie Mae). To accomplish our objective, we considered the assessments of the GSEs' internal controls and financial statements by the internal and external auditors and observed key internal control procedures operating at each of the three GSEs. The independent public accountants (IPA) were Arthur Andersen & Company for Freddie Mac, KPMG Peat Marwick for Fannie Mae, and Ernst & Young for Sallie Mae.

We evaluated the competence and objectivity of the internal and external auditors of the three GSEs. The standards we used for evaluating the work of internal auditors are set forth in the American Institute of Certified Public Accountant's (AICPA) Statement on Auditing Standards (SAS) No. 9, "The Effect of an Internal Audit Function on the Scope of the Independent Audit," which was issued December 1975 and in force at the time of our review. We followed our December 1988 "Guide for Review of Independent Public Accountant Work" in determining the reliability of the work of IPAs. Both the AICPA standards and our guide require a review of the policies and procedures and the auditors' actual working papers to verify the auditors' objectivity and competence. Essentially, the work of the auditors should not be adversely affected by pressure from GSE management and the actual work should meet the applicable standards for fieldwork, as well as reporting and general standards.

In our review of the internal and external auditors' work, we visited various GSE regional offices and interviewed GSE and IPA staff, reviewed IPA and internal audit planning documents, and examined work papers. We interviewed staff to verify the existence of policies and procedures that meet applicable standards for ensuring independence from management and for staffing jobs with qualified people. We reviewed the audit planning process to see if risk was systematically identified and if high-risk areas were targeted for review, testing, and evaluation. We reviewed audit progress reports of IPAs and internal auditors to see if they carried out their plans, and we reviewed selected working papers to see if they complied with audit standards for job planning, supervision, internal control evaluation, evidence, and reporting.

In addition, we reviewed each GSE's board of directors' audit committee charter for compliance with the recommendations of the National



Commission on Fraudulent Financial Reporting, known as the "Treadway Commission," a multiorganizational effort funded by AICPA and other professional organizations. In its October 1987 report, the Treadway Commission recommended that the boards of directors of public companies should develop and approve a written charter stating the audit committee's duties and responsibilities. It also recommended that the heads of internal audit departments have unrestricted and direct access to both the audit committee and the Chief Executive Officer.

We observed selected internal controls related to (1) asset acquisition and preservation and (2) quality control over business partners at 7 of the GSEs' 14 regional offices. Most of the mortgages and student loans that Freddie Mac, Fannie Mae, and Sallie Mae purchased or recommended for purchase were processed by GSEs at their respective regional offices, making those offices an important line of control over credit risk. To gather information about how the regional offices operate and to test some of their key controls, we visited the Southeast and Northeast Regional Offices of Freddie Mac, the Southeastern Regional Office of Fannie Mae, and Sallie Mae's Virginia Loan Servicing Center, which is similar to a regional office. For a detailed review of the actual operation of internal controls over credit risk, we visited Freddie Mac's Western Regional Office, Fannie Mae's Northeastern Regional Office, and Sallie Mae's Texas and Virginia Loan Servicing Centers.

To understand the designs of the selected controls we observed at each GSE, we compared the description of those controls with the management objectives for an internal control structure set forth by AICPA in SAS No. 55, "Consideration of the Internal Control Structure in a Financial Statement Audit," effective after January 1, 1990. The objectives require the following:

- Transactions should be executed in accordance with management's general or specific authorizations.
- Transactions should be recorded as necessary to permit preparation of financial statements presented in conformity with generally accepted accounting principles and to maintain accountability for assets.
- Access to assets should be permitted only in accordance with management's general or specific authorization.
- The recorded accountability for assets should be compared with the existing assets at reasonable intervals, and appropriate action should be taken with respect to any differences.

Most publicly traded corporations that are issuers of securities subject to Securities and Exchange Commission's registration and reporting requirements are required by the Foreign Corrupt Practices Act of 1977 to meet the above management objectives in designing internal controls. Congress' intent in enacting the internal control provisions of the law was to provide shareholders with reasonable assurances that a business is adequately controlled. Congress felt that providing a system of internal controls is a fundamental responsibility of management and that the expected benefits to be derived are of basic importance to investors and the maintenance and integrity of the capital market system. Congress recognized, however, that no system of internal controls is perfect and that management must also consider the costs involved. Although the GSEs' securities as exempt securities are not covered by the internal control provisions of this law, we analyzed the internal control structures of Freddie Mac, Fannie Mae, and Sallie Mae against these management objectives because we believe that these objectives are the most reasonable available.

We reviewed the assessments of the controls by internal and external auditors and external consultants. We also observed selected key controls in operation to see if they were operating as designed. In reviewing key controls, we initially examined small samples to see if controls were operating as designed. If this initial review showed that a control was not operating as designed, we took larger samples and reviewed them to see if a potential weakness existed. It is important to note that professional auditing standards acknowledge the limitations of internal control systems imposed by cost. Specifically, AICPA SAS No. 55, section 14, states that "the concept of reasonable assurance recognizes that the cost of an entity's internal control structure should not exceed the benefits that are expected to be derived."

In our firsthand observations of the regional offices' internal controls, we characterized the controls as having two major functions: (1) asset acquisition and preservation and (2) quality control over business partners. For the first function, we observed controls in (1) vault operations (the receipt, storage, and safekeeping of notes and related documents); (2) negotiated transactions (the purchasing of most mortgages from lenders); and (3) delinquency reporting (lenders' notifications to a GSE of loan delinquencies, which enables asset preservation) or handling of returned or rejected claims (Sallie Mae's efforts to ensure guarantor payment on defaulted student loans, which enables asset preservation). For the second function, we observed controls designed to ensure that Freddie Mac and

Fannie Mae lenders and loan servicers met the GSEs' eligibility requirements to participate in GSE programs.

---

## Review of Freddie Mac's Multifamily Program

Freddie Mac provided us with information on its 1990 multifamily loan portfolio.<sup>1</sup> Freddie Mac officials had estimated that approximately 95 percent of its multifamily loans were refinanced transactions. They said, however, that their data systems could not identify refinanced properties. We drew a random sample of 407 loans on a nationwide basis from the universe of 10,186 loans provided to us by Freddie Mac.<sup>2</sup> We requested that Freddie Mac provide us with underwriting files for these 407 loans. Freddie Mac was unable to find 17 (4 percent) of these files.<sup>3</sup> In addition, 83 (20 percent) of the loans in the sample were not refinanced properties and, thus, were excluded from our analysis. Taking into account both the missing and ineligible loan files, our sample estimates from 307 loans can be generalized to an adjusted population of 7,675 loans. We calculated the sampling errors, and we reported any that exceeded 5 percent. We estimate, based on the 17 loan files missing from our sample, that Freddie Mac is missing 425 loan files (plus or minus 194).

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<sup>1</sup>We had no means to verify the completeness of the information provided.

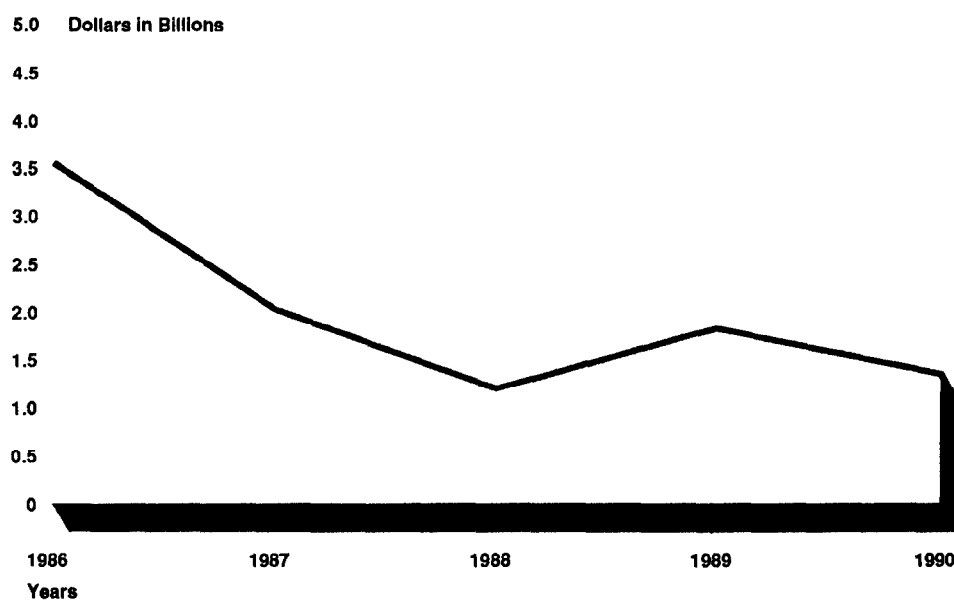
<sup>2</sup>Subsequently Freddie Mac provided information on approximately 1,100 additional multifamily loans. These loans differed somewhat in characteristics from the universe of loans from which we drew our sample. For example, 88 percent of the additional loans were active (that is, payments were current) compared with 96 percent of the loans from which we drew our sample.

<sup>3</sup>Freddie Mac had difficulty retrieving its files in a reasonable time frame. Freddie Mac told us on December 17, 1991, approximately 13 months after we requested the loan files, that it had been able to locate 7 of the missing 17 files and offered these for our review. We drew our random sample in October 1990 and reviewed all files that Freddie Mac presented to us by March 21, 1991.

# Brief History of Freddie Mac's Multifamily Loan Purchase Program

In 1972, Freddie Mac bought its first multifamily mortgages and purchased only a few multifamily loans during the 1970s. But enhancements to the multifamily program in the 1980s significantly increased the volume of such purchases. In 1983, Freddie Mac began offering two loan plans from which lenders could choose to deliver multifamily mortgages. As a result, in 1983, volume in Freddie Mac's multifamily purchase program reached \$287.3 million, more than 4 times the 1982 volume. In 1984, Freddie Mac began offering multifamily mortgage-backed securities. Between 1984 and 1990, Freddie Mac's total multifamily business continued to grow, with Freddie Mac financing about 12,000 loans valued at \$11 billion in 1990. Figure II.1 depicts Freddie Mac's multifamily loan purchases for 1986-90.

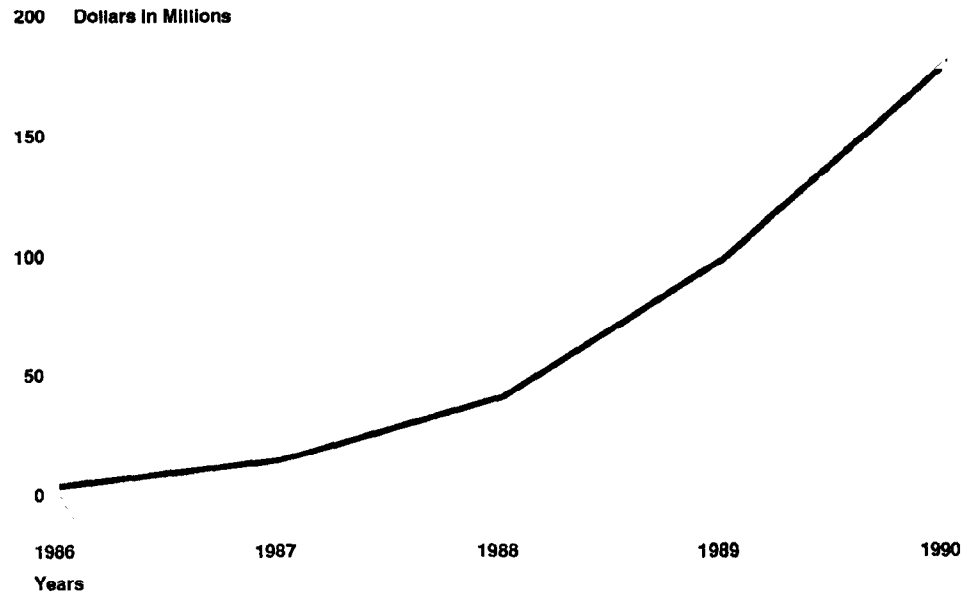
**Figure II.1: Freddie Mac's Multifamily Loan Purchases, 1986-1990**



Source: Freddie Mac Annual Reports.

The growth in the multifamily program was accompanied by a corresponding increase in losses. In 1990, multifamily loans accounted for 3 percent of the \$338 billion in mortgages owned by Freddie Mac but more than 50 percent of its \$474 million in mortgage default losses. Figure II.2 depicts Freddie Mac's multifamily loan chargeoffs for the last 5 years.

Figure II.2: Freddie Mac's Multifamily  
Loan Chargeoffs, 1986-1990



Source: Freddie Mac.

In October 1990, Freddie Mac suspended purchasing new loans for cash but continued its program of "swaps" of its mortgage-backed securities for multifamily loans. This suspension effectively ended the multifamily program.

## Freddie Mac's Reasons for Multifamily Losses

Freddie Mac attributed its poor performance in the multifamily program to several factors, including the following:

- Freddie Mac failed to understand that multifamily investing has important distinctions from the single-family business. As a result, Freddie Mac did not dedicate sufficient people or capital to management of its multifamily business.
- Freddie Mac's multifamily portfolio had heavy concentrations in higher-risk market areas that have been more severely affected by current economic conditions than real estate markets in general.

- Freddie Mac's seller/servicers provided service of irregular quality.<sup>1</sup> This problem affected Freddie Mac's ability to adequately assess local market conditions.
- Freddie Mac did not have well-defined internal controls, including procedures and authorization levels for its multifamily program. The professional analytical skills required for effective underwriting and portfolio management were not well developed. Neither clear strategic direction nor effective divisional management were present.

---

### **Laventhol & Horwath's Study Found Other Problems**

In April 1988, Freddie Mac hired Laventhol & Horwath (L&H), a national public accounting firm offering real estate advisory services, to review the underwriting and servicing policies of the multifamily program. L&H was to identify any corrective actions that might improve the overall quality of Freddie Mac's multifamily loan portfolio.

L&H's September 1988 report concluded that Freddie Mac had underwritten a high-quality multifamily loan portfolio, had experienced a relatively low delinquency rate at that time, and had established routine servicing policies that appeared to be very adequate.

In addition to these conclusions, the report noted a number of areas for improvement in Freddie Mac's multifamily program. For example, Freddie Mac used a minimum debt coverage ratio (DCR) of 1.10 and a maximum loan-to-value ratio (LTV) of 85 percent. According to Freddie Mac officials, appraisals supplied most of the information used to compute these ratios. The L&H report noted that appraisals by certified appraisers were often unreliable.

The report stated that Freddie Mac's 63 loan files for real estate owned (property that had reverted back to Freddie Mac after loans were in default) included numerous appraisal problems that were common in the files. For example,

- comparable appraisal properties for rentals and sales were too distant from the appraised property or too different from the appraised property to

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<sup>1</sup>Loan servicing includes monitoring the performance of the loan and the value of collateral, managing delinquency and default, and preserving and selling the collateral if necessary.

- yield meaningful comparisons;<sup>2</sup>
- estimates of rents at the appraised property failed to adjust for smaller size units than the comparables;
  - seasonally high occupancy levels were accepted as normal occupancy rates;
  - market data needed to assess the reasonableness and stability of rent and occupancy rate estimates used in forecasting net income were seldom provided;
  - extremely low expense estimates, relative to normal expense ratios, were used in the income approach; and
  - estimates of maintenance expense requirements for older properties were often unrealistically low.

Although L&H evaluated only appraisals for properties that had become real estate owned, or loans that were rejected by Freddie Mac, the report concluded that the overall quality of appraisals among the rest of Freddie Mac's loans was reasonably comparable to those L&H had reviewed.

L&H concluded that Freddie Mac's standards for LTV and DCR, which depended on information that was often unreliable, were riskier than those used by most others in the multifamily industry. An L&H survey of other multifamily lenders conducted during June and July 1988 revealed that only 11 percent of industry participants used a minimum DCR as low as 1.10, 66 percent used 1.20 or higher, and none used a maximum LTV as high as 85 percent. In fact, 67 percent used LTVs of 75 percent or lower.

L&H found other weaknesses in Freddie Mac's underwriting standards and practices. L&H found that (1) according to lenders that were interviewed, the sophistication of Freddie Mac's regional underwriters was inconsistent both between and within regions; (2) property inspection reports prepared by Freddie Mac underwriters contained information too vague to be useful; (3) 17 percent of the 63 files for real estate owned lacked evidence of any analysis of the appraiser's income and expense projections; and (4) another 10 percent of the 63 files indicated acceptance of the appraiser's income and expense projections with no changes.

L&H reported that Freddie Mac often made only weak efforts to ensure that the performance of sellers/servicers was appropriate. L&H reported, for

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<sup>2</sup>Rental comparables are used to compare the appraised property's rent estimates with rents in similar buildings; sales comparables are used to determine the sales prices of similar buildings in close proximity to the appraised property.

example, that lenders were not inspecting property as required, Freddie Mac was not ensuring that property was inspected as required, and lenders were not meeting Freddie Mac's requirements for managing delinquencies.

---

**Internal Audit Department's  
1989 Study**

In July 1989, Freddie Mac's internal audit department completed a limited review of the profitability of multifamily mortgage acquisition programs. The resulting report focused on pricing and profitability but also discussed multifamily management information systems, staffing, and operating controls.

The audit revealed that multifamily regional directors controlled both the marketing and the underwriting functions. The audit found that single employee control of both of these functions could be a potential conflict of interest since these functions could have conflicting goals. Internal audit suggested that Freddie Mac management review the reporting relationships of the underwriting and marketing functions to ensure that the information used to price loan purchases is complete and objective and fully discloses any risks associated with transactions.

The internal audit report said that underwriters needed more training to be able to properly evaluate projections of income and expense, cash flows, and liquidity. Internal audit also noted that because Freddie Mac purchased more than 60 percent of its multifamily loans from partnerships or corporations, the financial statements submitted with loan applications were often quite complex. According to the internal audit report, the underwriters did not have the expertise to review complex financial statements.

The internal audit report noted weaknesses in the quality and reliability of property appraisals used to make pricing decisions. Internal audit recommended that Freddie Mac monitor the performance of the various appraisers and appraisal companies. In addition, internal audit suggested that Freddie Mac study the costs and benefits of obtaining current appraisals to establish a price for seasoned mortgages (mortgages older than 1 year), rather than determining prices using a discount for seasoned mortgages.



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**Changes in Underwriting Standards**

In October 1988, December 1989, and June 1990, in response to concerns raised in the L&H and internal audit studies, Freddie Mac changed its multifamily underwriting standards and practices to decrease its dependence on lenders, appraisers, and borrowers and reduce its exposure to loss. Freddie Mac officials said that, in October 1988, Freddie Mac required its underwriters to independently check the income, expenses, capitalization rates, and property improvements that are reported by appraisers.<sup>3</sup> They said that Freddie Mac's underwriters use the first three items to independently calculate the value of the property, but the underwriters may use either their calculated value or the appraiser's value when the values differ. In December 1989, Freddie Mac decreased the maximum LTV for multifamily mortgages from 85 to 60 percent of the appraised value of the property if no recourse was offered by the lender. In June 1990, Freddie Mac increased the minimum DCR to 1.30 and required its underwriters to independently review the borrower's credit reports and financial statements. In response to its multifamily problems, Freddie Mac also made personnel changes at the executive level in 1990.

Freddie Mac officials said they anticipated that the changes made would not have a significant impact on the level of multifamily losses until after 1990 because most losses occurring during 1990 would relate to multifamily mortgages already owned or subject to purchase by Freddie Mac before the changes.

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**Internal Audit's 1990 Study**

In September 1990, Freddie Mac's internal audit department completed another review of multifamily operations. In this review, internal audit found that certain multifamily pricing was based only on LTV and the type of property. Internal audit said that this practice could attract loans that would be too risky according to other measures, such as DCR. Internal audit also found a lack of

- communication from headquarters to the regions about policies related to marketing and underwriting;
- communication between Freddie Mac's legal personnel and the regional multifamily organizations;
- automated systems to support the multifamily program;
- effective staffing, expertise, and operating procedures to ensure recovery of maximum sales values for real estate owned.

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<sup>3</sup>The capitalization rate is the expected rate of return on the owner's investment.

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## Freddie Mac's Valuation of Multifamily Loans

Freddie Mac made two studies of its multifamily portfolio in the last half of 1990 that resulted in adjustments to its loan loss provision. In one study, Freddie Mac analyzed the properties backing each of its delinquent and foreclosed mortgages and multifamily properties owned because of foreclosure (these are considered "nonperforming" loans). In this analysis, Freddie Mac contracted with third parties (primarily real estate brokers) to value each of the properties. Based on the valuations, Freddie Mac recorded a \$45 million loan chargeoff in the third quarter of 1990. Arthur Andersen & Company, an independent public accountant, reviewed Freddie Mac's work and concluded that \$45 million was an adequate write-down of Freddie Mac's assets.

In the second study, Freddie Mac contracted with the Roulac Group, a division of the accounting firm of Deloitte and Touche, to help it evaluate "performing" loans in the portfolio. The Roulac Group developed a computer model, based on multifamily data in 150 markets nationwide, to calculate collateral deficiencies in Freddie Mac's multifamily portfolio. On the basis of the results of the model and other factors, Freddie Mac recorded a special, one-time \$100 million loan loss in the fourth quarter of 1990. Arthur Andersen's real estate services group reviewed the methodology and assumptions used in the model and concurred with the overall approach. Overall, Arthur Andersen concluded that Freddie Mac's total loss reserve in 1990 for multifamily loans was adequate but not excessive.

# Comments From Freddie Mac

Federal  
Home Loan  
Mortgage  
Corporation

Leland C. Brendsel  
Chairman  
Chief Executive Officer  
703/903.3000

**Freddie  
Mac**



December 10, 1991

Mr. Charles A. Bowsher  
Comptroller General of the United States  
General Accounting Office  
Washington, D.C. 20548

Dear Chuck:

Thank you for the opportunity to discuss with you Freddie Mac's concerns over certain issues that are raised in the GAO's draft audit report entitled **Government-Sponsored Enterprises: Internal Controls at Fannie Mae, Freddie Mac, and Sallie Mae.**

I was deeply troubled by the references in the draft audit report regarding our preparations for the audit. As I mentioned, I promptly took a series of steps. First, I had our audit committee notified of the concerns and allegations. Next, I requested an independent investigation of this matter be made by Arthur Andersen & Co., our auditors, to research and report their findings to me. Finally, I requested an opinion letter from the Institute of Internal Auditors on the propriety of certain actions taken by Freddie Mac internal auditors in preparing our management and staff for the upcoming audit. After reading Arthur Andersen & Co.'s report and the Institute of Internal Auditors opinion letter, I find no support for the conclusions and judgements reached by GAO's audit team. These documents are enclosed for your review. In fact, both the report and the letter support the conclusion that management's approach and conduct in preparing employees for the GAO audit was appropriate. Any questions or concerns raised by the draft GAO audit report undermine the integrity of the Corporation, its Board of Directors and management where there is no factual or ethical basis for doing so. Integrity is the foundation on which investor and public confidence is built and maintained. It is for this reason that this section of the audit report should be deleted.

The draft audit report also includes representations made by the auditors concerning our multifamily portfolio. These comments mislead readers and cannot be supported by fact. The report concludes that the presence of high appreciation rates raises questions about the valuation of the underlying properties. We do not agree with this conclusion. The report does not consider the real estate market conditions at the time we purchased the loans. No information is included in the report to compare the implied appreciation rates for our properties with similar apartment buildings in the market. Without market comparisons, assessing real estate values is meaningless. Current cash flows from the property, the borrower's credit experience or other relevant factors which are standard factors used by the real estate industry and are critical in evaluating a multifamily property were ignored in the GAO's analysis.

8200 Jones Branch Drive  
McLean, Virginia 22102

Mr. Charles A. Bowsher  
Comptroller General of the United States  
Page 2

In addition, cash investments made by the property owners to rehabilitate or improve the property have not been properly included in the analysis. No accounting has been made for the added value, beyond cost, which results from the rehabilitation process. Clearly, property owners expect appropriate financial returns to compensate them for the risks taken when making investments to upgrade their apartment buildings.

Moreover, the audit team made numerous errors in computing appreciation rates which resulted in incorrect factual representations in the draft report. In fact, errors made with this frequency raises questions concerning the validity of the audit report. In short, I believe the inappropriate methods and factual inaccuracies used to represent property value appreciation do not support potential overfinancing in apartment properties.

Since Freddie Mac shut down the then existing multifamily program last year, we have twice conducted extensive reviews of the collateral value of every multifamily loan, both performing and non-performing. In each case, this information was used to evaluate the adequacy of our loan loss reserves. As recently as last week, our auditors completed their review of our multifamily portfolio and reported to Freddie Mac's audit committee they agreed with our judgement -- Freddie Mac is well reserved for potential multifamily losses.

We have included, as attachments, the information you requested in our meeting last week. I hope you will carefully review our work and have the draft audit report modified to reflect the facts and conclusions that appropriately address the issues raised by the draft reports.

Sincerely,



attachments

cc: Richard L. Fogel (w/attachments)

GAO Note: We did not reproduce the Attachments.

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# Major Contributors to This Report

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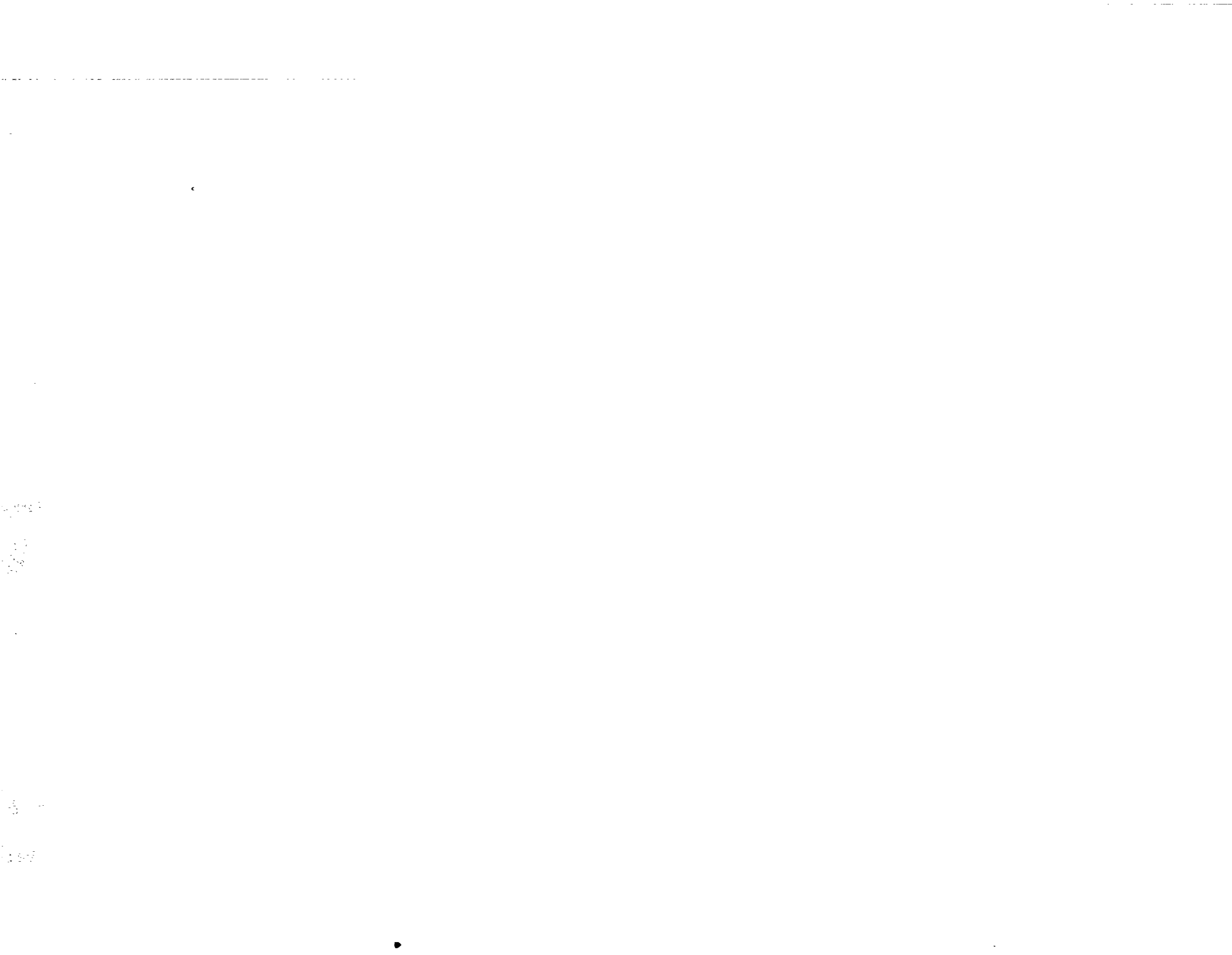
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