FEDERAL HOUSING FINANCE AGENCY
OFFICE OF INSPECTOR GENERAL

FHFA's Oversight of the Asset Quality of Multifamily Housing Loans Financed by Fannie Mae and Freddie Mac

AUDIT REPORT: AUD-2013-004

February 21, 2013

FEDERAL HOUSING FINANCE AGENCY
OFFICE OF INSPECTOR GENERAL

AT A GLANCE

FHFA's Oversight of the Asset Quality of Multifamily Housing Loans Financed by Fannie Mae and Freddie Mac

Why OIG Did This Audit

The housing crisis has led to increased demand for rental housing. Since 2006, the nation has lost 1.9 million homeowners and has added 4.9 million renters. However, as the housing crisis intensified in 2008, private sector financing for multifamily loans (e.g., loans to buy apartment buildings) largely vanished.

Fannie Mae and Freddie Mac (the Enterprises) stepped into the financing gap by continuing to provide a steady source of financing in the secondary mortgage market for multifamily loans. In 2009, for example, the Enterprises bought 85% of the nation's multifamily loans, and they continued their dominant presence in the market through 2011 when they bought nearly 57% of the multifamily loans, valued at $44 billion.

FHFA (the agency) uses onsite safety and soundness examinations as its primary oversight tool to assess the Enterprises' financial condition, performance, and operations. Given the size of the Enterprises' investment and their dominant role in the secondary market for multifamily loans, OIG performed this audit to assess FHFA's supervisory oversight of the Enterprises' controls over multifamily loan underwriting.

What OIG Found

OIG found that the agency can improve its examination policies in the area of sample selection. For instance, FHFA recently conducted, at each Enterprise, a multifamily asset quality examination that included a review of the Enterprises' compliance with their underwriting standards. OIG noted that the examinations had the same scope and objective, but FHFA examiners selected loans differently during their review of each Enterprise. The agency's Fannie Mae examiners chose for review a sample of 30 loans across major risk categories and dollar values. That sample may have been adequately representative. However, the examiners did not retain sufficient documentation to permit OIG to assess fully their sampling methodology.

On the other hand, the agency's Freddie Mac examiners reviewed a more limited sample of 17 loans. When compiling their sample, the examiners excluded from their sample universe 829 multifamily loans valued at approximately $11.5 billion. Some of the excluded loans may have represented a higher risk because they were subject to relaxed underwriting standards. Further, in all but one case, the face amounts of the loans in the sample were less than the average Freddie Mac multifamily loan of $13 million. As a result of the sampling differences, the Freddie Mac sample may not have been sufficiently representative and potentially did not give the agency reasonable assurance of asset quality—one of the examination's objectives.

OIG attributes the difference between the sampling techniques used by FHFA's two examination teams to the absence of FHFA policies or procedures articulating how to select samples for review during targeted examinations. In contrast, industry peers—as well as FHFA's Federal Home Loan Bank examiners—have adopted sampling guidance that requires implementation of representative or proportional sampling methods to select adequate samples from loan populations.

What OIG Recommends

FHFA can increase its confidence in the efficacy of loan reviews during targeted examinations by providing its examiners with clear guidance about how to select samples, and by requiring them to maintain documentation adequate to support their sampling methodology.

FHFA provided comments agreeing with the recommendations in this report.

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ABBREVIATIONS

Enterprises..... Fannie Mae and Freddie Mac

Fannie Mae..... Federal National Mortgage Association

FDIC ..... Federal Deposit Insurance Corporation

FHFA .....Federal Housing Finance Agency

Freddie Mac .....Federal Home Loan Mortgage Corporation

HERA.....Housing and Economic Recovery Act of 2008

OCC ..... Office of the Comptroller of the Currency

OIG .....Federal Housing Finance Agency Office of Inspector General

MBS .....Mortgage-Backed Securities

Federal Housing Finance Agency
Office of Inspector General
Washington, DC

PREFACE

A series of reports by OIG has assessed FHFA's examinations of the Enterprises and its oversight of their underwriting standards. For example, OIG has found that FHFA can strengthen its oversight of Fannie Mae's underwriting standards for single-family housing.[1] Also, OIG has recommended that FHFA improve how it assesses risks posed by the Enterprises' real estate owned properties.[2] In addition, OIG has identified shortfalls in FHFA's examination coverage of the Enterprises.[3] This report continues OIG's work by assessing FHFA's oversight of the Enterprises' controls over multifamily underwriting, specifically in connection with two agency examinations of the Enterprises' multifamily asset quality.

OIG is authorized to conduct audits, evaluations, investigations, and other law enforcement activities pertaining to FHFA's programs and operations.[4] As a result of its work, OIG may recommend policies that promote economy and efficiency in administering FHFA's programs and operations, or that prevent and detect fraud and abuse in them. OIG believes that this report's recommendations (along with those in prior reports) will increase FHFA's assurance that the Enterprises are operating safely and soundly, and that their assets are preserved and conserved.

OIG appreciates the cooperation of all those who contributed to this audit, which was led by Tara Lewis, Audit Director, who was assisted by Irene Porter, Audit Manager.

Russell A. Rau
Deputy Inspector General for Audits

[1] *FHFA's Oversight of Fannie Mae's Single-Family Underwriting Standards* (AUD-2012-003, March 22, 2012), available at http://www.fhfaoig.gov/Content/Files/AUD-2012-003_0.pdf.

[2] *FHFA's Supervisory Risk Assessment for Single-Family Real Estate Owned* (AUD-2012-005, July 19, 2012), available at http://www.fhfaoig.gov/Content/Files/AUD-2012-005_2.pdf.

[3] *Evaluation of Whether FHFA Has Sufficient Capacity to Examine the GSEs* (EVL-2011-005, September 23, 2011), available at http://www.fhfaoig.gov/Content/Files/EVL-2011-005.pdf.

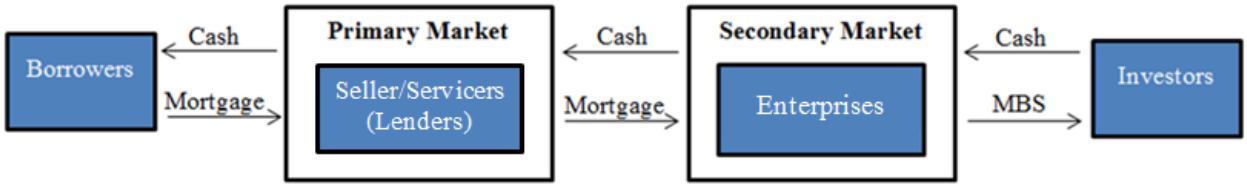
[4] See the Housing and Economic Recovery Act of 2008, Public Law No. 110-289, which established OIG by amending the Inspector General Act of 1978, Public Law No. 95-452.

BACKGROUND

Enterprises' Role in Primary and Secondary Residential Mortgage Markets

Fannie Mae and Freddie Mac buy mortgages and related assets secured by single-family homes and multifamily projects (e.g., apartment buildings). The Enterprises do not originate loans or lend money directly to borrowers in the primary residential mortgage market. Instead, they provide liquidity and stability in the secondary market where they buy mortgages originated by lenders such as banks. The Enterprises may hold the mortgages that they buy in investment portfolios or package them into mortgage-backed securities (MBS) for sale to investors.[5] Meanwhile, as shown in Figure 1 below, lenders (also known as seller/servicers) can use the proceeds from selling mortgages to originate more loans.

Figure 1: Enterprises' Role in the Mortgage Market



With respect to multifamily loans, which tend to be valued at several million dollars each, the Enterprises buy only loans that conform to their purchasing requirements.[6] These requirements include underwriting standards, which are guidelines to ensure the loans are safe and secure. For example, generally both Enterprises' guidelines require that multifamily loans cannot exceed 80% of the property value.

Below, OIG describes how the rising U.S. rental market along with the financial crisis positioned the Enterprises as a dominant presence in the secondary multifamily mortgage market. Then, OIG identifies some indications that the Enterprises have relaxed their underwriting standards. Because one consequence of relaxed underwriting standards may be increased risk, OIG concludes that FHFA's ongoing supervision of the Enterprises' multifamily businesses through targeted examinations and other measures is imperative.

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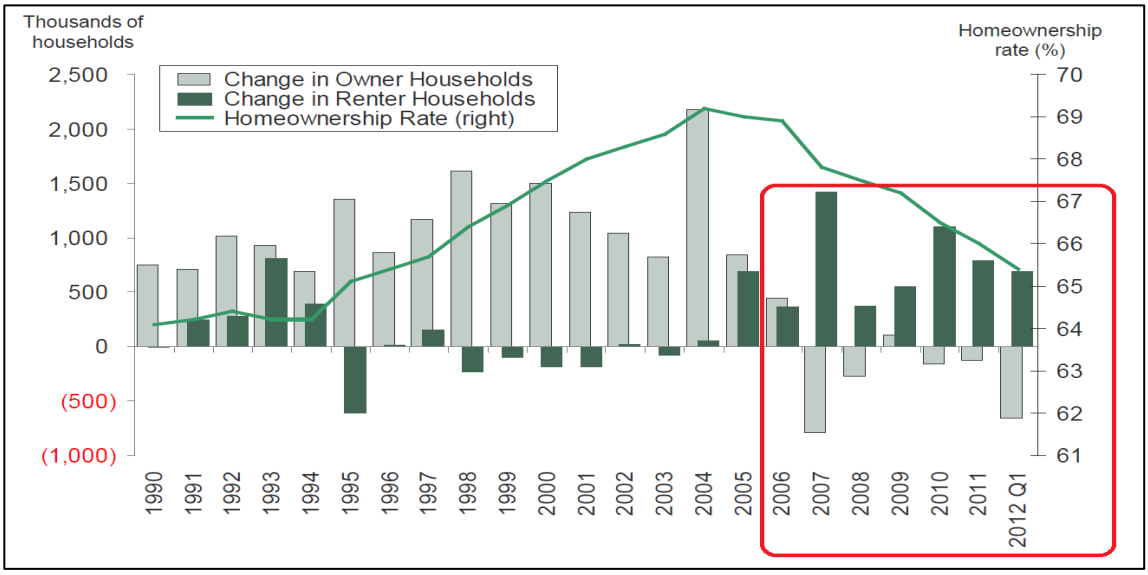
[5] Securities backed by multifamily properties are known as commercial MBS.

[6] Generally, multifamily properties are established as separate, special-purpose entities that are owned by one or more key principals and investors, who are typically experienced commercial real estate managers. Structurally, these entities are often limited liability companies or corporations that hold title to the real estate and owe money to lenders as the result of mortgages on the properties, but which have no other assets or liabilities. Lenders frequently require this structure as a condition of extending a mortgage loan because it insulates the collateral (multifamily property) from claims by the creditors of the principals and investors.

Multifamily Housing Loan Market

When the financial crisis began in 2007, the number of homeowners fell and the number of renters increased as renting a home became a more affordable option for many people. As shown below, millions of households have switched from owning to renting. With the exception of a brief respite in 2009, this trend continued through the first quarter of 2012.

Figure 2: Owners and Renters, 1990-2012[7]



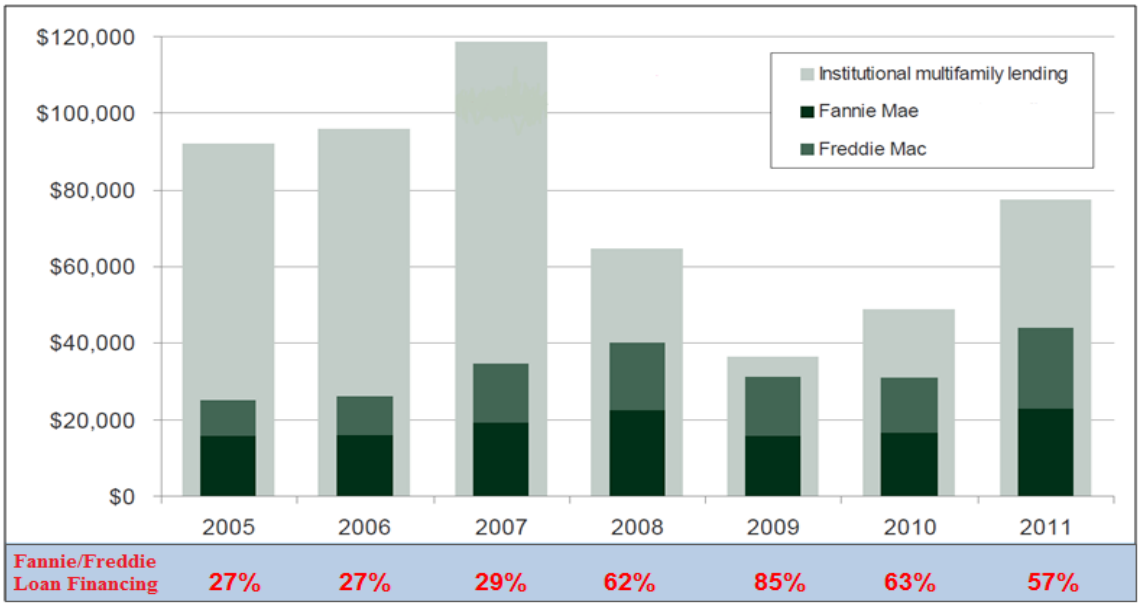
As the demand for rental housing increased, the private sector's supply of financing for multifamily housing—typically the source of most rental housing—dried up. Specifically, banks and other entities tightened their lending in the wake of the financial crisis, their market share contracted, and the overall volume of business decreased. On the other hand, the Enterprises' market share increased.

Enterprises' Presence in the Multifamily Loan Market

As shown below, from 2007 to 2009, multifamily loans purchased by the Enterprises as a percentage of the overall market nearly tripled from 29% to 85%. Although the actual total dollar value of loans they purchased did not increase significantly over this period, the Enterprises were key to maintaining liquidity in a contracting multifamily housing market.

[7] Source: Mortgage Bankers Association, *Multifamily Real Estate and Multifamily Real Estate Finance Markets* presentation (June 2012).

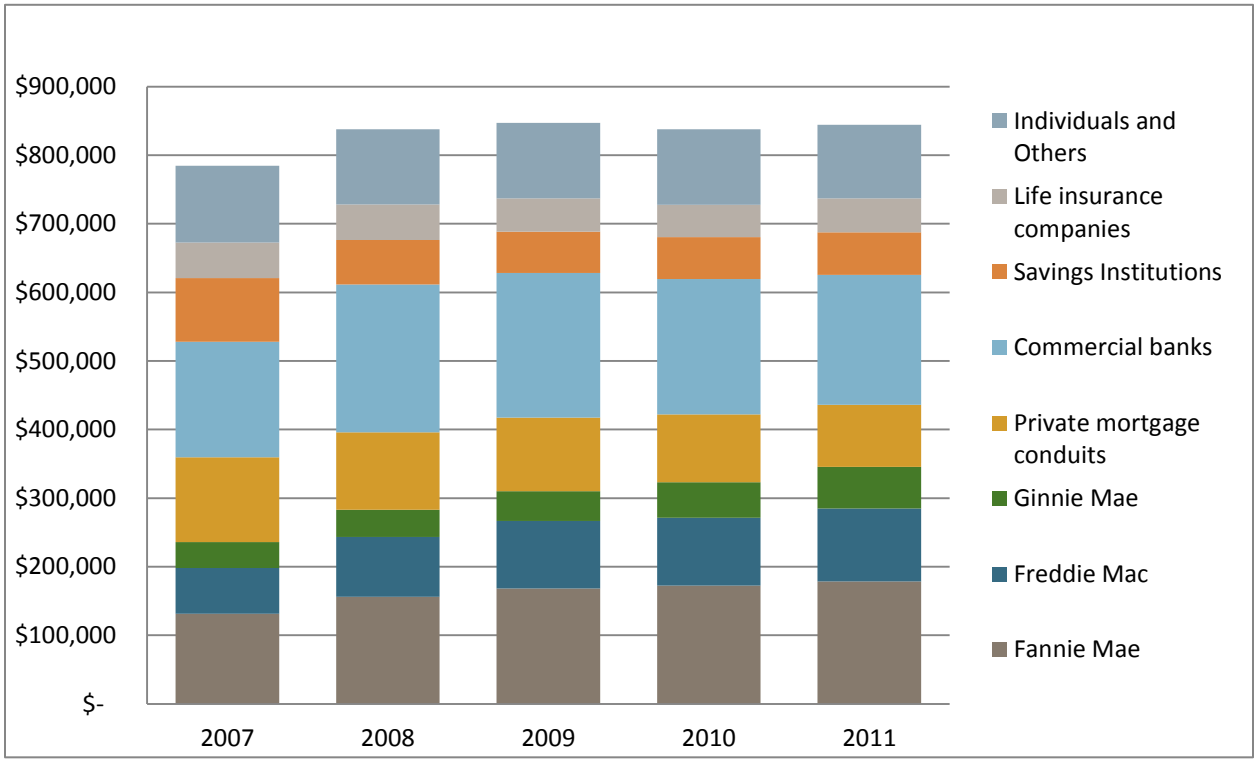
Figure 3: Originations and Subsequent Loan Purchases for the Enterprises and Total Institutional Multifamily Lending (Dollars in Millions)[8]



By 2010, private capital began to return to the market and expanded multifamily mortgage lending. Overall, from 2007 to 2011, outstanding multifamily housing debt grew from $785 billion to $844 billion. As of December 2011, the Enterprises collectively held over a third of the total outstanding debt from multifamily mortgage loans, or $285 billion (see Figure 4 below).

[8] Source: Mortgage Bankers Association: *Multifamily Real Estate and Multifamily Real Estate Finance Markets* presentation (June 2012).

Figure 4: Multifamily Mortgage Debt Outstanding 2007-2011 (Dollars in Millions)[9]



Ultimately, however, the value of the Enterprises' considerable multifamily mortgage holdings depends on the underlying quality of the loans that they bought. As the financial crisis demonstrated, if loans are not underwritten well, made to eligible borrowers, and supported by adequate collateral, then the Enterprises' investments may be at greater risk. Accordingly, the Enterprises' respective multifamily underwriting standards significantly influence the quality of the loans that they buy.

Enterprises' Relaxed Multifamily Underwriting Standards

OIG has found indications that the Enterprises relaxed some of their multifamily underwriting standards from 2009 to 2011. This relaxation could cause increased risk in the Enterprises' investment portfolios.[10] For example, in 2009, based on dollar value, 34% and 40% respectively

[9] The chart includes assets that institutions hold in their non-consolidated trusts, which are not included in their consolidated financial statements. Source: Federal Reserve, *Economic Research & Data: Mortgage Debt Outstanding* (March 2012).

[10] It should be noted that from 2005 through 2010, the Enterprises' multifamily loans had lower default rates than loans purchased by competitors (with the exception of life insurers). See GAO, *Mortgage Financing: Fannie Mae and Freddie Mac's Multifamily Housing Activities Have Increased*, GAO-12-849 (September 2012), available at http://www.gao.gov/assets/650/647800.pdf.

of Fannie Mae's and Freddie Mac's newly purchased multifamily loans were interest-only or partial-interest only. But by 2011, the percentages of such higher-risk loans held by the Enterprises had risen to:

- 43% of Fannie Mae's multifamily loans, valued at $10 billion, and
- 62% of Freddie Mac's multifamily loans, valued at $11 billion.

In total, through 2011, the Enterprises' multifamily originations have increased to carry over $21 billion in interest-only and partial-interest loans. These types of loans are riskier because, initially, borrowers pay little to no principal, but payments can soar as the temporary partial-interest or interest-only options expire. Then, borrowers have to start paying principal plus interest, or repay the entire mortgage balance (i.e., a balloon payment). In addition, during the loans' interest payment phase, mortgage payments have done little or nothing to reduce the loans' principal, which exposes the Enterprises to greater risk than traditional loans that amortize over time. The Enterprises have indicated, however, that their underwriting standards require the borrower to qualify for a payment to include both principal and interest; thus, the risk of an interest-only loan is mitigated. Nonetheless, the fact remains that the overall risk to the Enterprises may be higher with such loans because little or no amortization of principal takes place during the early years. In other words, interest-only and partial-interest loans still expose the Enterprises to enhanced risk because the borrower's equity does not necessarily increase over time with recurring payments.

OIG also found that Fannie Mae made some changes to its *Multifamily Selling and Servicing Guide and Underwriting Standards* between 2008 and 2011 that potentially increased risk (e.g., allowing borrowers to produce less income to cover the loan payment).[11] For example, in 2010 Fannie Mae allowed interest-only periods to increase to 2.5 years for some of its 10 year loans. Also, in 2011, Freddie Mac financed 207 loans with about $743 million of cash out—in other words, borrowers received about $3.6 million in cash per loan. Essentially, these loans allow borrowers to trade mortgage equity for cash and are riskier because they simultaneously increase the borrowers' debt, decrease their equity in the properties, and give them what can be a substantial amount of cash that does not have to be reinvested in the project.[12]

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[11] In August 2012, Fannie Mae tightened some of their underwriting standards for multifamily loans. Before November 2012, FHFA did not review changes to the Enterprises' underwriting standards before they were released if they were within authorities delegated to managers by the Enterprises' board of directors; after November 2012, the agency updated its policies and procedures, and began to review all changes to the Enterprises' underwriting standards prior to issuance.

[12] As of the third quarter of 2012, Freddie Mac issued one underwriting policy change to reduce credit risk for multifamily loans.

The business decision to relax or tighten underwriting standards balances risk and profit. Tightening underwriting standards can lead to a portfolio with less risky loans, but may also restrict lending, reduce potential sources of profit, and slow the secondary mortgage market. On the other hand, relaxing underwriting standards may make more credit available for mortgage loans, but it also can lead to future heavy losses from the present purchase of riskier loans.

FHFA's examinations of asset quality, including selecting individual loans for review, are intended to help ensure the Enterprises effectively manage these underwriting and other risks.

FHFA's Supervision of the Enterprises' Multifamily Businesses

FHFA's Oversight Responsibilities

In July 2008, as the housing crisis deepened, the Housing and Economic Recovery Act of 2008 (HERA) was enacted and established FHFA as the Enterprises' supervisor and regulator. Two months later, in September, the agency placed Fannie Mae and Freddie Mac in conservatorships. As conservator, FHFA has authority to preserve and conserve the Enterprises' assets and property, and it is responsible for restoring them to soundness and solvency.

Among other means, FHFA carries out its supervision and regulation by examining the Enterprises to ensure that they operate safely and soundly, and that they comply with legal requirements. The examinations are driven by FHFA's risk assessments, which can yield a variety of specific supervisory activities, such as ongoing monitoring. FHFA's supervisory process is cyclical in that risk assessments guide supervisory planning, which leads to supervisory activities such as examinations. The examinations' results can, in turn, identify fruitful areas for future risk assessments.

FHFA's Multifamily Risk Assessment and Examination Planning for the Enterprises

According to FHFA, a risk assessment is a planning exercise that sets out a risk-focused view of the Enterprises.[13] Risk assessments convert information obtained through supervisory activities into a common understanding of the Enterprises' existing and emerging risk characteristics. Additionally, risk assessments feed the supervision workplans that govern all of the supervisory activities conducted in the course of FHFA examinations.

Since 2009, FHFA has conducted annual risk assessments that identified various aspects of the Enterprises' multifamily housing business as major risk areas. As a result, FHFA has planned and performed various supervisory activities for different aspects of multifamily housing, such as the targeted examinations discussed below.

[13] FHFA, *Supervisory Guide*, Version 2.0 (September 8, 2009).

FHFA's Supervision Planning and Supervisory Activities

Depending on the issues identified during FHFA's risk assessments, the agency can plan four types of supervisory activities:

1. **Continuous supervision:** routine day-to-day monitoring in real-time.

2. **Targeted examinations:** focused reviews of all or parts of a single business line, a functional area, a specific risk or program area, a business process, or a supervisory concern.

3. **Special projects:** all other supervision projects or assignments with specific tasks and goals.

4. **Remediation activities:** supervisory actions to verify that an Enterprise has taken remedial steps required to operate safely and soundly.

Based on its continual risk assessments from 2009 to 2011, the agency initiated targeted examinations of the Enterprises' multifamily businesses. At the time of OIG's audit, some of the multifamily examinations had concluded while others were ongoing.

Ongoing Examinations: Several of the ongoing examinations touch on multifamily underwriting. Because these examinations are in process, OIG did not review them.

Concluded Examinations: Of the concluded examinations, some focused on multifamily underwriting.[14]

- FHFA initiated examinations focused on the Enterprises' pricing of multifamily whole loans, which were initially included as part of OIG's review. However, prior to rendering official conclusions, FHFA cancelled the examinations because of inadequate resources and the amount of time that had elapsed since the agency completed fieldwork.

- OIG concentrated its review on the remaining multifamily underwriting examinations, which focused on the quality of multifamily assets financed by the Enterprises.

[14] The concluded examinations that did not focus on underwriting and thus were outside the scope of OIG's review concentrated on the Enterprises' asset and risk management. Regarding the examination related to risk management, although multifamily underwriting was not the examination's objective, FHFA identified concerns related to Fannie Mae not monitoring or tracking exceptions and waivers from its multifamily underwriting standards that it grants to its lenders. Because the concern derived from FHFA's examination of Enterprise multifamily risk, OIG reviewed FHFA's conclusion related to this examination, but did not assess its overall examination work.

FHFA's Multifamily Asset Quality Examinations

FHFA's multifamily asset quality examinations—one at each Enterprise—focused on underwriting controls and included in their scope:

- Level and trend in asset quality, growth, and portfolio changes;
- Adequacy of and compliance with underwriting policies and procedures;
- Underwriting, risk rating, waiver processes and controls, and pricing (which was eventually excluded because examiners determined it merited a separate examination);
- Problem loan identification and assignment of adverse risk ratings; and
- Adequacy of credit reserves for problem loans.

As part of its examinations of multifamily asset quality, FHFA's respective examiners for Fannie Mae and Freddie Mac separately selected samples of loans from each Enterprise's portfolio to determine if they complied with the Enterprise's underwriting standards.

Results of the Asset Quality Examinations

In January 2012, FHFA identified significant concerns for the Enterprises' management to address. For example, from the Fannie Mae examination, FHFA noted issues related to underwriting assumptions and appraisal weaknesses. Meanwhile, the Freddie Mac examination found significant concerns such as the Enterprise's management of potentially troubled assets.

FHFA raised its concerns to Fannie Mae and Freddie Mac. As of February 2013, FHFA has accepted Fannie Mae's resolution strategies for all multifamily asset quality concerns and is monitoring the implementation of the strategies. In addition, FHFA has concluded Freddie Mac fully remediated the agency's asset quality concerns.

Sampling Methodology for the Asset Quality Examinations

Although FHFA's Fannie Mae and Freddie Mac examination teams uncovered significant issues that warranted corrective action, they used different sampling methodologies when examining each Enterprise. OIG attributes the teams' disparate approaches to a lack of FHFA guidance on loan sampling.

Regarding their different sampling methodologies, FHFA's Fannie Mae examiners used a random sample generator to select 60 multifamily loans fitting various criteria from the Enterprise's portfolio. The criteria included loans with various risk ratings (including

delinquencies), loans that had and had not passed through the Enterprise's quality controls, and loans for $10 million and above. Subsequently, the examiners exercised their judgment and reduced their review to 30 loans due to resource constraints. In spite of the reduction, the examiners' sample still included multifamily loans ranging in value from $500,000 to $56 million. That sample may have been adequately representative, but the examiners did not retain sufficient documentation to permit OIG to assess fully their sampling methodology.

FHFA's Freddie Mac examiners followed a different sampling strategy for the 17 loans they selected for review. They excluded over half of the Enterprises' multifamily loans (829 loans, totaling $11.5 billion) from their selection pool because, according to the lead examiner, the loans had additional "nuances," such as credit enhancements.[15] However, some of these nuanced loans had significant risks. For example, Freddie Mac delegated to lenders the underwriting responsibility for its targeted affordable housing loans, which can have lower expected returns and relaxed underwriting criteria. Further, FHFA's examiners did not ensure that the selected loans included loans that were delinquent or at risk of delinquency.

As a consequence of their exclusion—based on the overall population of loans—FHFA's Freddie Mac examiners selected a disproportionate number of lower value loans. The overall loan population included loans ranging from $52,000 to $205 million, averaging $13 million. However, of the 17 loans selected for the examination, only one was above the average dollar value of Freddie Mac's loan population.

The Freddie Mac loans selected for review by FHFA may not be sufficiently representative. Industry standards suggest that loan portfolio reviews should include representative or proportional samples. For example, in its risk management examination manual, the Federal Deposit Insurance Corporation (FDIC) directs that the percentage of the portfolio selected for review should provide reasonable assurance that all major credit risks have been identified.[16] Similarly, the American Institute of Certified Public Accountants holds that sample "items should be selected in such a way that the sample can be expected to be representative of the population. Therefore, all items in the population should have an opportunity to be selected."[17] Additionally, when examining underwriting standard compliance, the Office of the Comptroller of the Currency (OCC) suggests using proportional sampling, which selects larger loans according to their presence in the overall loan population.[18] Further, FHFA's manual for

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[15] Credit enhancements are added loan requirements, such as mortgage insurance, that mitigate the Enterprises' exposure to potential losses in the event of a default.

[16] FDIC, *Risk Management Manual of Examination Policies*, section 3.2, pg. 3 (December 2004).

[17] American Institute of Certified Public Accountants, Statements on Auditing Standards No. 39, *Audit Sample Manual,* sec. 350, pg. 516 (June 1983).

[18] OCC, *Sampling Methodologies,* pgs. 5-6 (August 1998).

examining Federal Home Loan Banks' investment portfolios generally agrees with the aforementioned industry standard that "the sample should generally include investments in all major categories."[19]

In the finding that follows, OIG discusses how FHFA's Enterprise examinations can benefit from guidance about how to select samples sufficient to strengthen the agency's assurance in its conclusions about the loan population under review. OIG concludes that FHFA will benefit from considering industry sampling standards when they are relevant and developing sampling selection guidelines to benefit its examiners.

[19] FHFA, Federal Home Loan Banks' *Investment Portfolio Management Examination Manual,* pg. 38 (April 2007).

FINDING

FHFA can increase its confidence in the efficacy of loan reviews during targeted examinations by providing its examiners with guidance about how to select samples. Lacking such instruction, FHFA examiners conducted targeted examinations of the Enterprises (that were supposed to have identical scopes and objectives) that varied significantly in terms of how samples of loans for review were selected for each Enterprise. Consequently, FHFA's selection of loans in one of the examinations may not have been sufficient to give the agency reasonable assurance of the multifamily loans' asset quality—one of the examination's objectives.

Based on information provided to OIG, the agency's selection of 30 Fannie Mae loans from various risk categories and dollar values may have been adequately representative of Fannie Mae's loan population. However, FHFA's examiners did not retain documentation sufficient to assess fully the merit of their sampling methodology, such as the precise scope and composition of Fannie Mae's universe of multifamily loans. In future sampling, retaining such information will help the agency support its sampling approach and defend its conclusions.

On the other hand, FHFA's examination of Freddie Mac's asset quality may not have included a representative sample of loans. The sample of 17 loans excluded over half of the Enterprise's multifamily loans—including major risk areas, such as loans that are subject to relaxed underwriting standards. The examiners also disproportionately sampled smaller loans, selecting only one loan that was valued above $13 million, which is the average value of a Freddie Mac multifamily loan. Not only are larger loans inherently more risky—one $90 million loan in default may be worse than nine $5 million loans in default—but Freddie Mac's underwriting requirements become more restrictive as loan values and risks rise. Because the largest loan FHFA examined was $18 million, whereas the overall population included loans up to $205 million, these more restrictive underwriting standards were effectively outside of the examination's review.

For example, as shown in Figure 5 below, Freddie Mac loan values determine approval authority: the larger the loan, the higher the approval needed. Additionally, other increasingly restrictive underwriting requirements apply as loans become riskier. For instance, Freddie Mac's independent valuation unit must review loans above $35 million.

Figure 5: Freddie Mac's Multifamily Loan Approval Authority[20]

Loan Amount	Required Approval
Above $500 million	Freddie Mac Board of Directors
$200-500 million	Freddie Mac CEO and Chief Enterprise Risk Officer
$100-200 million	Sr VP Multifamily and Chief Credit Officer Multifamily
$50-100 million	VP Multifamily Underwriting & Credit
$35-50 million	Home Office Underwriting
Below $35 million	Lower Levels of Regional Management

Additional Conditions

- If property value used to compute Loan-to-Value ratio > appraised value, obtain approval from VP Multifamily Mortgage Credit Risk Management
- Appraisals must be approved by Freddie Mac Independent Valuation Unit
- Property inspection by third parties must be approved by VP Multifamily Underwriting & Credit

Highest dollar value loan tested by FHFA: $18 million

By not selecting larger dollar value loans, FHFA may have excluded important underwriting controls from its examination.

As discussed above, several industry peers—ranging from FDIC to OCC—provide sample selection guidance for reviewing loans and generally agree that sampling should be representative or proportional. That is, every major risk area should be present for selection, or the selection itself should be proportional so that larger loans have a chance of being selected equal to their presence in the overall loan population.

OIG believes that FHFA's examiners will benefit from similar guidance tailored to the agency's mission and needs, which will provide increased confidence that FHFA's loan samples are commensurate with the overall loan population under review and adequate to answer the examinations' objectives.

[20] Freddie Mac, *Multifamily Securitization* presentation, pg. 15 (January 2013).

CONCLUSION

Thorough, comprehensive examinations are important because they form the basis for FHFA's opinions on the safety and soundness of the Enterprises. FHFA examinations of the Enterprises' controls over underwriting of multifamily loans are also important to FHFA's mission to help stabilize the housing finance market and to ensure that additonal risks assumed by the Enterprises are properly managed and that losses are minimized. These examinations are particularly critical to supervising risk given indications that the Enterprises are expanding their multifamily books of business and have relaxed some of their underwriting standards in the past. These standards have a direct, material impact on the level of risk associated with their multifamily loans. Thorough FHFA oversight is key to balancing these risks with the potential returns in order to ensure that the taxpayers' interests are protected. Accordingly, the recommendations below are designed to help enhance the effectiveness and efficiency of FHFA's examinations of the Enterprises' multifamily businesses.

RECOMMENDATIONS

OIG recommends that FHFA:

1. Update its examination guide (*Supervision Reference and Procedures Manual, Credit Risk-Multifamily*), in consideration of industry standards, to include qualitative guidance for examiners to follow when determining the sampling size and testing coverage of loan files.
2. Require examiners to maintain documentation adequate to support adherence to the sampling methodology developed in Recommendation 1.

SCOPE AND METHODOLOGY

This performance audit's objective was to assess FHFA's supervisory oversight of the Enterprises' controls over underwriting of multifamily loans with a specific focus on FHFA's targeted examinations of the Enterprises' multifamily asset quality.

OIG performed its fieldwork for this audit from January 2012 through November 2012. OIG conducted this audit at FHFA's and Fannie Mae's offices in Washington, D.C., and Freddie Mac's office in McLean, Virginia. OIG interviewed FHFA, Fannie Mae, and Freddie Mac personnel. OIG relied on computer-processed and hardcopy data from FHFA, Fannie Mae, and Freddie Mac. This included data contained in FHFA's electronic document repository. Computer-processed data was used for background purposes only and not to support the audit conclusion.

To achieve its objective, OIG:

- Assessed the adequacy of FHFA's underwriting examination programs;
- Judgmentally selected and tested multifamily underwriting loans reviewed by FHFA;
- Analyzed selected changes in Enterprise risk limits as they apply to multifamily underwriting; and,
- Interviewed FHFA officials on the examination risk assessment, planning, performing, supervising, and reporting for multifamily underwriting.

OIG assessed the internal controls related to its audit objective. Internal controls are an integral component of an organization's management that provides reasonable assurance that the following objectives are achieved:

- Effectiveness and efficiency of operations;
- Reliability of financial reporting; and,
- Compliance with applicable laws and regulations.

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives, and include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance. Based on the work completed on this performance audit, OIG considers weaknesses in FHFA's supervisory oversight of the asset quality of multifamily housing loans financed by Fannie Mae and Freddie Mac to be significant

in the context of the audit's objective. Additionally, OIG identified other less significant matters that came to its attention during the audit. These matters were communicated separately in writing to FHFA in an audit memorandum.

OIG conducted this performance audit in accordance with Generally Accepted Government Auditing Standards. Those standards require that audits be planned and performed to obtain sufficient, appropriate evidence to provide a reasonable basis for OIG's finding and conclusions based on the audit objective. OIG believes that the evidence obtained provides a reasonable basis for the finding and conclusion included herein, based on the audit objective.

APPENDIX A:
FHFA's Comments on Finding and Recommendations

Federal Housing Finance Agency

MEMORANDUM

TO: Russell Rau, Deputy Inspector General for Audit, FHFA-OIG

FROM: Jon D. Greenlee, Deputy Director, Division of Enterprise Regulation

SUBJECT: FHFA Response – OIG Audit 2011-019, *FHFA's Oversight of the Asset Quality of Multifamily Housing Financed by Fannie Mae and Freddie Mac*

DATE: December 17, 2012

This memorandum transmits the Federal Housing Finance Agency's (FHFA or Agency) management responses to the recommendations in the draft report prepared by FHFA-OIG on Audit 2011-019, FHFA's *Oversight of the Asset Quality of Multifamily Housing Financed by Fannie Mae and Freddie Mac*. We appreciate the opportunity to provide feedback on this report and the FHFA-OIG findings. As these findings and recommendations primarily affect FHFA's supervision function, the responses are being provided by the Division of Enterprise Regulation (DER), in coordination with the Division of Supervisory Policy and Support (DSPS).

The audit report recommendations focus on sampling procedures followed by FHFA examination staff. FHFA agrees that effective sampling is an important means to ensure that examinations result in a full understanding of controls in place for sound risk management and minimization of losses. FHFA agrees that there is an opportunity to enhance its supervisory approach by providing additional guidance to examiners in the area of sample selection, specifically for the review of multifamily loans. The audit report notes variance within the FHFA examination teams on sampling processes followed for examinations with identical scope and objectives. FHFA agrees that a more consistent approach could be achieved through further guidance on sampling for multifamily loans, and also agrees that sample methodology should be well-documented for every examination.

FHFA's response to the audit recommendations is set forth below.

FHFA-OIG recommends that FHFA:

1. **Update its examination guide (Supervision Reference and Procedures Manual, Credit Risk – Multifamily) in consideration of industry standards, to include qualitative guidance for examiners to follow when determining the sampling size and testing coverage of loan files.**

Management Response: Agree

Efforts are underway to develop examination guidance that focuses on certain business lines and products of the regulated entities. As part of those efforts, a series of specific modules in the multifamily area will be developed and available for field testing by December 1, 2013. The new *Multifamily Mortgage Acquisitions and Underwriting* module in that series will incorporate guidance regarding sample selection and will prompt examiners to consult colleagues in the risk modeling group in the Division of Supervision Policy and Support for help in identifying the appropriate sample criteria consistent with the examination scope. The Agency will also consider industry standards during the development of this guidance.

2. **Require examiners to maintain documentation adequate to support adherence to the sampling methodology developed in Recommendation 1.**

Management Response: Agree

FHFA examiners are already required to document their analysis, conclusions, and findings of their supervisory work. Documentation to support the sampling method and sample size as part of a multifamily examination or other examination that includes loan review will be included as part of the workprogram. Requirements specific to the documentation of sampling methodology will be in effect concurrently with the issuance of the *Multifamily Mortgage Acquisitions and Underwriting* module, which will be available for field testing by December 1, 2013.

APPENDIX B:
OIG's Response to FHFA's Comments

On December 17, 2012, FHFA provided comments to a draft of this report agreeing with both recommendations and identifying FHFA actions to address each recommendation. OIG considers the actions sufficient to resolve the recommendations, which remain open until OIG determines that agreed upon corrective actions are completed and responsive to the recommendations. OIG has attached the agency's full response (see Appendix A), which was considered in finalizing this report. Appendix C provides a summary of management's comments on the recommendations and the status of agreed-to corrective actions.

APPENDIX C:
Summary of Management's Comments on the Recommendations

This table presents management's responses to the recommendations in OIG's report and the status of each recommendation as of the date when the report was issued.

Rec. No.	*Corrective Action: Taken or Planned*	*Expected Completion Date*	*Monetary Benefits*	*Resolved[a] Yes or No*	*Open or Closed[b]*
1.	FHFA will develop examination guidance regarding sample selection and will prompt examiners to consult colleagues in the risk modeling group in the Division of Supervision Policy and Support for help identifying the appropriate sampling criteria consistent with the examination scope.	12/31/2013	$0	Yes	Open
2.	FHFA will include documentation of the sampling method used and sample size as part of the work program.	12/31/2013	$0	Yes	Open
Total			$0		

(a) Resolved means: (1) management concurs with the recommendation, and the planned, ongoing, or completed corrective action is consistent with the recommendation; (2) management does not concur with the recommendation, but alternative action meets the intent of the recommendation; or (3) management agrees to the OIG monetary benefits, a different amount, or no ($0) amount. Monetary benefits are considered resolved as long as management provides an amount.

(b) Once OIG determines that the agreed-upon corrective actions have been completed and are responsive to the recommendations, the recommendations can be closed.

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