United States General Accounting Office

GAO

Report to Congressional Requesters

October 1991

FEDERAL HOME LOAN MORTGAGE CORPORATION

Abuses in Multifamily Program Increase Exposure to Financial Losses

145014

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United States
General Accounting Office
Washington, D.C. 20548

Resources, Community, and
Economic Development Division

B-244603

October 7, 1991

The Honorable Alfonse M. D'Amato
United States Senate

The Honorable Eliot L. Engel
House of Representatives

The Honorable José E. Serrano
House of Representatives

The Honorable Ted Weiss
House of Representatives

In a September 14, 1990, letter, you asked us to examine whether the Federal Home Loan Mortgage Corporation (Freddie Mac) was adequately protecting its investment in certain Bronx, New York, multifamily (apartment building) mortgages it had purchased. As you know, Freddie Mac is a federally chartered corporation that buys multifamily as well as single-family mortgages from primary lenders (seller/servicers) who then usually service the mortgages for Freddie Mac after the sale. By purchasing these mortgages, Freddie Mac provides liquidity to primary lenders, thereby making additional credit available to qualified borrowers.

Freddie Mac reported losses in its multifamily program totaling $278 million for 1989 and 1990.[1] These losses accounted for over 50 percent of Freddie Mac's total losses during the period, although multifamily mortgages constituted only 3 percent of the corporation's over $300-billion investment.

You expressed concern about Freddie Mac's mortgages for 35 Bronx properties, which a community group had charged were overfinanced and were allowed to deteriorate. As agreed, for the 35 properties, we examined whether Freddie Mac

- accepted overvalued appraisals when it purchased the mortgages, which resulted in overfinancing (for purposes of this report, we defined overfinancing as a mortgage purchase that exposed Freddie Mac to more risk of loss than it had knowingly accepted);

[1]These losses were covered by reserves that Freddie Mac had previously established. In addition, Freddie Mac increased its loan loss reserves by $100 million in 1990 to cover future multifamily losses.

- had in effect a loan servicing process in the years after the mortgage purchase that protected it against additional risk; and
- has new procedures to address the problems that resulted in overfinancing and servicing problems.

Freddie Mac relied on property appraisals submitted by seller/servicers to assess whether the properties had sufficient value to secure the multifamily mortgages it purchased. In the loan servicing process, Freddie Mac oversees the performance of seller/servicers who are required to monitor and report on the physical and financial condition of the properties.

Results in Brief

Because of weak controls, Freddie Mac did not detect patterns of inaccurate and incomplete information in the appraisals and reports on the physical and financial condition of the properties that were provided by seller/servicers. As a result, Freddie Mac overfinanced 27 of the 35 properties by about 20 percent of its total investment in them, or $5.4 million, and increased opportunities for fraud and program abuse to occur. In this regard, we have referred certain matters discussed in this report to the U.S. Attorney for appropriate action. As of July 15, 1991, Freddie Mac had foreclosure actions in process on 7 of the 35 properties and 5 others were 90 or more days delinquent in mortgage payments.

The internal control weaknesses we identified have also been found in other reviews of Freddie Mac's multifamily program nationwide. In response to these weaknesses as well as to its financial losses, Freddie Mac suspended purchases in its major multifamily program in September 1990. It is currently developing new procedures for the multifamily program and will resume purchases when it determines that these procedures are adequate to prevent problems in the future. Freddie Mac expects the new procedures to be in place in early 1992. The changes that Freddie Mac had instituted and planned as of July 15, 1991, should strengthen its controls over the multifamily program, but they do not address all of the problems we identified. Unless Freddie Mac develops additional controls to ensure that it makes decisions on the basis of accurate and complete information, it will continue to be exposed to program abuse and avoidable financial losses.

Background

Freddie Mac was established by federal law as a private, for-profit corporation. It promotes the availability of mortgage credit by operating a secondary market for mortgage loans.[2] Freddie Mac's authorizing statute grants the corporation a number of benefits, such as access to a $2.25-billion line of credit from the Treasury and exemption from state and local income taxes, to help promote the accomplishment of its public purpose. Moreover, as we pointed out in 1990,[3] the investment community generally expects that the government would assist a government-chartered corporation such as Freddie Mac to maintain its public purpose and prevent significant repercussions in financial markets.

Freddie Mac buys mortgages from financial institutions, such as banks, thrifts, and mortgage brokers, that lend directly to borrowers. These financial institutions, or seller/ servicers, also typically service the mortgages for Freddie Mac after the purchase. In its Sellers' & Servicers' Guide, Freddie Mac publishes requirements that seller/servicers must follow to ensure that the mortgages they sell to Freddie Mac are of investment quality and that the physical and financial condition of the properties is adequately monitored. Seller/servicers earn fees for selling and servicing the mortgages; the fees are typically a percentage of the unpaid principal balance of the mortgage.

Freddie Mac's underwriting standards for multifamily properties—requirements to ensure investment-quality mortgage purchases—are that (1) net income from the property exceed mortgage payments by a comfortable margin and (2) borrowers have a substantial ownership interest in the property, usually measured by the ratio of the mortgage loan amount to the property's appraised value—the loan-to-value (LTV) ratio. High LTVs mean that the properties were financed mostly with money obtained from Freddie Mac. After purchasing the mortgage, Freddie Mac requires seller/ servicers to report to it on the results of annual property inspections, collect and forward the borrowers' mortgage payments and financial statements, and monitor sales and mortgage transactions on the properties.

About 90 percent of Freddie Mac's multifamily mortgages (and all of the 35 we reviewed) are for existing rather than new buildings that were refinanced by their owners under Freddie Mac's prior approval program. In a refinance transaction, the mortgage amount is based not on the borrower's purchase price but on the property's current appraised

[2]In the primary market, loans or other security interests are created; in the secondary market, already existing securities or loans are sold or traded.

[3]Government-Sponsored Enterprises: The Government's Exposure to Risks (GAO/GGD-90-37, Aug. 15, 1990).

value. Borrowers may choose to refinance a property in order to replace an existing mortgage with one having a lower interest rate or to obtain cash by converting some of their equity in the property into debt. Under the prior approval program, Freddie Mac approves the mortgage as a satisfactory purchase after reviewing the underwriting package submitted by the seller/servicer, who subsequently executes the mortgage with the borrower.

About 23 percent of the total value of Freddie Mac's multifamily mortgages is for housing in New York City, and 29 percent of that amount, or more than $740 million, is invested in the Bronx. Early in 1989, the Northwest Bronx Community and Clergy Coalition charged that Freddie Mac had overfinanced many of these Bronx properties and allowed the buildings to deteriorate. The coalition identified the 35 properties as an example of the larger problem with Freddie Mac-financed properties in the Bronx. Freddie Mac had purchased the mortgages on these 35 properties between 1985 and 1989; the total value of the 35 mortgages was $33,053,000. (See app. I for a listing of the properties and the mortgage amounts and dates of Freddie Mac's purchases.)

In addition to reviewing Freddie Mac files and New York City and State records on the 35 properties, we hired an independent appraiser to review the original 35 appraisals submitted to Freddie Mac. This appraiser was asked to determine whether the valuation of each property was supported by the evidence provided in the appraisal. While the appraiser did not reappraise the property, he was asked to adjust the appraisal value for each of the 35 properties to the extent that he identified inaccurate and incomplete information in the appraisals. (See app. I for additional details on the scope and methodology of our work.)

Because some of the matters discussed in this report involve the submission to Freddie Mac of information that may represent intentional misrepresentations of fact, in possible violation of federal law, we have referred those matters to the U.S. Attorney for appropriate action.

Inaccurate and Incomplete Appraisals Led to Overfinancing

Freddie Mac did not detect patterns of serious deficiencies in the appraisals it received from seller/servicers before purchasing the 35 multifamily mortgages. Appraisals for the 35 properties contained inaccurate and/or incomplete information for one or more key variables used to determine the value of the properties, including the following:

- Inaccurate information on the sales dates and prices of comparable properties used to estimate the market value of the appraised properties. For example, 17 appraisals used comparable sales that had not occurred, overstated the selling prices of comparable properties, and/or reported incorrect dates of sale.
- Incomplete information on previous sales transactions on the appraised properties. Freddie Mac requires that all sales of the appraised property within the previous 3 years be reported in the appraisals. Most of the appraisals subject to this requirement did not contain the information.
- Overstatements of the annual net income of the appraised properties. For example, tenants at four properties told us they had never paid rents as high as those the borrowers reported. In addition, we were able to compare the net income statements that 10 borrowers provided to the appraisers with the net income the borrowers reported to the New York City Tax Commission for the same year. Nine of the 10 reported higher incomes to the appraisers, by an average of about $88,000 per property.
- Overestimates of expected annual net income. For example, 31 of the 35 appraisals overstated expected rental income by a total of $296,000, or $9,555 per property, by including expected rent increases but holding expenses at current levels. In addition, 11 appraisals understated current expenses by excluding standard items such as replacement reserves and/or by understating items such as maintenance and repairs.
- Overstatements of some of the appraised properties' physical condition and neighborhood. For example, 11 properties were appraised at approximately the same time as New York City housing violations reports on the properties. Four of the 11 appraisals showed no items requiring repairs, while the New York City reports showed from 47 to 166 hazardous and/or falsely certified violations for each of these properties.[4] The remaining 7 appraisals showed from 1 to 7 items requiring repairs, while the New York City reports showed from 18 to 208 hazardous and/or falsely certified violations per property.
- Understatements of the rates of return that borrowers expected on their investments. These understatements inappropriately increased the appraised values of 26 properties. The rates of return on these properties ranged from 10 to 12 percent and did not reflect the higher rates operating in the market at the time, according to our independent appraiser.

[4]Hazardous housing violations, according to New York City regulations, are those that endanger life, health, or safety. The city reports a violation as falsely certified when a city inspector determines that repairs the owner certified as having been made were, in fact, not made.

The cumulative effects of such deficiencies are illustrated by an appraisal for one property that our independent appraiser considered substantially overvalued. This property was purchased in November 1986 for $975,000. It was appraised 1 month later for $3,261,066. The appraiser did not report the November purchase price in his appraisal. Freddie Mac purchased a $2,475,000 mortgage (that is, with an LTV of 76 percent) on the property in April 1987, 5 months after the owner purchased the property. Our independent appraiser valued the property at $2,498,000.[5] Thus, Freddie Mac purchased a mortgage that, according to our independent appraiser's value, had an LTV of 99 percent rather than 76 percent. The owner defaulted on the mortgage 3-1/2 years later, in October 1990. As of July 15, 1991, the foreclosure process was still ongoing.

Additional deficiencies in the appraisal included reporting a selling price for one comparable property that was $400,000 higher than the actual price. Also, all three properties used as comparable properties were in locations that were superior to the appraised property's and two were in superior condition, according to our independent appraiser. In calculating the income of this property, the original appraiser included income from a day care center, although New York City officials stated that the required license was never granted to a center at that location. Tenants and employees who had lived or worked in the building for many years told us that they knew of no such center.

Our independent appraiser adjusted for the inaccurate and incomplete information in the appraisals and provided a revised appraised value for each of the 35 properties. Using the revised appraised values, we calculated that Freddie Mac overfinanced 27 of the 35 properties by a total of $5.4 million because it loaned borrowers more than

- the value of the property in 5 cases,
- its underwriting standards allowed in 14 cases, and
- it intended in 8 cases (Freddie Mac intended its LTV ratios to average 70 percent in the 8 cases; with the revised appraised values, the LTV ratios averaged 83 percent).

[5]The independent appraiser's revised value is not a reappraisal of this property. Rather, it is based on the information provided to Freddie Mac in support of the 1986 appraisal, adjusted to the extent that he identified incomplete and inaccurate information in the appraisal.

Because Freddie Mac did not have internal controls in place that required seller/servicers to verify or document the appraisal information they submitted, it relied on inaccurate and incomplete information; consequently, it overfinanced properties. Freddie Mac also had inadequate standards for evaluating the reasonableness of appraisal methods used or appraiser performance. As a result, Freddie Mac was vulnerable to unprofessional practices by seller/servicers, appraisers, and/or borrowers. For example, Freddie Mac accepted appraisals on 6 of the 35 properties from an appraisal company whose president's candidacy for membership in the American Institute of Real Estate Appraisers had been terminated for unethical behavior. The termination had occurred 3 years before Freddie Mac accepted the first of the six appraisals. All six appraisals contained inaccurate information, according to our review.

The internal control weaknesses we found in our review were not limited to the 35 Bronx properties; such weaknesses have also been found in other reviews of Freddie Mac's multifamily program nationwide. Laventhol & Horwath, a consulting firm hired by Freddie Mac, concluded in September 1988 that 51 percent of a sample of 63 original appraisals for multifamily properties that had been foreclosed and subsequently acquired by Freddie Mac were significantly deficient and overestimated property values by 10 to 20 percent. The consultant recommended that Freddie Mac become more selective in accepting appraisals and provide more guidance to seller/servicers regarding acceptable appraisers.

Similarly, in a report on the multifamily program issued in July 1989, Freddie Mac's Internal Audit Department found that during the course of its interviews with Freddie Mac's underwriting and servicing staff, concern was expressed about the reliability of the appraisals provided to the corporation. The internal auditors concluded that Freddie Mac did not have procedures to monitor the performance of appraisers and appraisal companies for purposes of identifying appraisals that should be reviewed more closely. They recommended that Freddie Mac strengthen its controls over property appraisals to reduce its exposure to financial losses.

In its most recent review of the multifamily program, published in September 1990, the Internal Audit Department concluded, "In general, policies and procedures in the multifamily program are inadequate or not fully implemented consistently across regional levels." With respect to appraisals, the auditors found that (1) Freddie Mac did not require appraisers to be professionally certified and (2) unqualified appraisers might be used.

Through July 15, 1991, Freddie Mac had instituted foreclosure proceedings on 11 of the 35 properties, and 5 others were 90 or more days delinquent in mortgage payments. Of the 11 properties, 1 was acquired by Freddie Mac and the mortgages on 3 others had been reinstated and were current in mortgage payments, leaving 7 properties in foreclosure. (App. II further discusses overfinancing problems on the 35 Bronx properties.)

Inaccurate and Incomplete Information Led to Uninformed Servicing

After it purchased the 35 mortgages, Freddie Mac did not detect patterns of inaccurate and incomplete information from the seller/servicers on the physical and financial condition of the properties. This occurred because Freddie Mac did not have controls in place to verify the information submitted by seller/servicers, and its existing controls did not ensure compliance with its reporting requirements. As a result, Freddie Mac could not make informed decisions to address the properties' maintenance and financial problems or to protect its investment in the mortgages.

Inaccurate and incomplete information that Freddie Mac received from seller/servicers on maintenance problems in the properties included, for example, documents certifying that hazardous housing violations had been removed from seven properties when New York City reports show that significant numbers of hazardous violations were still on record. Moreover, inspection reports did not disclose critical information. This information included the following:

- The 35 properties had an average of about 100 hazardous and/or falsely certified housing violations, ranging from 5 to 725, for 1989 and 1990.
- New York City sued the owners of 19 of the properties for overall poor maintenance and/or failure to provide heat and hot water.
- New York City had to make emergency repairs in 17 properties, including lead removal and repairs to plaster, roofs, and plumbing systems.

With respect to emergency repairs and suits by New York City, we could find no evidence that Freddie Mac was aware that, after it had purchased these mortgages, New York City made emergency repairs to one property six times and to another four times in 1-1/2 years. The city also sued the two owners for housing violations and for failure to provide heat and hot water.

Undetected maintenance problems threaten the collateral value of a property and can decrease the borrower's net income and ability to sustain mortgage obligations. For example, the New York State Division of Housing and Community Renewal ordered rent reductions on 8 of the 35 properties for poor maintenance buildingwide. Also, the cost of emergency repairs made by the city, if unpaid, becomes a lien on the property, and these costs are higher than if borrowers arrange their own repairs, according to city housing officials. Finally, conditions that result in hazardous housing violations and require emergency repairs are severe enough to threaten the health and safety of tenants in the buildings.

Freddie Mac was unaware of certain financial activities involving some of the 35 properties because of incomplete, inaccurate, or contradictory information that it received from seller/servicers and/or borrowers:

- The corporation was unaware of certain unauthorized financial transactions that had occurred on some properties, according to our review. Contrary to Freddie Mac requirements, owners of 10 properties had sold the properties and/or assumed secondary mortgages without Freddie Mac's approval. According to Freddie Mac officials, unauthorized secondary mortgages can delay or prevent payments on primary mortgages. Unauthorized sales introduce new owners who may not meet Freddie Mac's standards for borrower creditworthiness or managerial experience.
- Many borrowers were not making mortgage payments or were consistently late in their payments, often without Freddie Mac's knowledge. According to Freddie Mac officials, seller/servicers often advance monthly interest payments to Freddie Mac, although the borrower has not actually made the payments. As long as it receives the interest payments, Freddie Mac regards the mortgages as current unless the seller/servicers file a separate, required report that the borrower is delinquent. If the borrower eventually defaults on the mortgage, Freddie Mac returns the interest payments to the seller/servicer, thus absorbing the loss. Seller/servicers advanced such monthly interest payments to Freddie Mac on 15 of the 35 properties.
- For eight properties, the annual net incomes that borrowers reported to Freddie Mac could be compared with those they reported to New York City's Department of Finance and Tax Commission. Six borrowers reported higher net incomes to Freddie Mac than to the city. They

reported an average net income of $107,683 to Freddie Mac, compared with an average of $43,122 to the city, a difference of $64,561 per property.

In one instance involving unauthorized financial transactions, we found no evidence in Freddie Mac's files that the corporation was aware that the property owner had transferred the property between himself as an individual and as president of a corporation two times in 1989 and obtained three additional mortgages on the property in that same year.

The internal control weaknesses we identified are not limited to the 35 Bronx properties. In 1988, Laventhol & Horwath concluded that "discussions with Freddie Mac servicing personnel confirm that seller/servicers are regularly deficient with respect to the Guide's requirements for routine monitoring of properties." The consultant's review of files on properties that had been foreclosed and subsequently acquired by Freddie Mac and discussions with Freddie Mac servicing personnel suggested that the corporation's own efforts to ensure seller/servicer performance of routine servicing responsibilities were often weak and regionally inconsistent.

In July 1989, the Internal Audit Department recommended that Freddie Mac strengthen its servicing policies to increase controls over losses. More recently, in September 1990, the Internal Audit Department concluded that proactive loss prevention efforts were nonexistent or ineffective; some servicing functions were being marginally performed; and seller/servicer performance was inadequate. The internal auditors recommended that Freddie Mac follow up with seller/servicers to ensure current quality inspections and complete financial reporting. (App. III further discusses servicing problems on the 35 Bronx properties.)

Freddie Mac's New and Proposed Procedures

Freddie Mac has acknowledged that problems exist in its multifamily program and has taken action to remedy many of them. Since purchasing mortgages on the 35 Bronx properties, Freddie Mac has instituted "Program Plus" to purchase multifamily mortgages primarily from a select group of seller/servicers. It has also lowered its maximum LTV ratio from 85 percent to 70 percent for Program Plus seller/servicers and to 60 percent for all others. It has increased its maximum debt coverage ratio from 1.10 to 1.15 for Program Plus and to 1.30 for all others. A debt coverage ratio of 1.15, for example, means that income from the property exceeds the sum of expenses and mortgage payments by 15 percent. Particularly for buildings more than 20 years old, Freddie Mac may now require certifications from licensed engineers for major building systems. Freddie Mac has also added a multifamily appraiser to its staff.

In servicing, Freddie Mac has implemented automated systems to track compliance with reporting requirements; resolved to follow up more diligently when seller/servicers do not submit required reports; and developed criteria and management procedures for a "watch-list" of high-risk loans to be serviced more intensively. Freddie Mac has supplemented its previous requirement that seller/servicers report to the corporation upon learning of an unauthorized transaction; it now requires them to "be alert" to such transactions by, for example, noticing changes in names on insurance policies. It has also required seller/servicers to submit annual borrower payment histories, and implemented systems to track delinquencies more carefully and to move more quickly from delinquency to foreclosure. Finally, Freddie Mac has opened an office in New York City to more effectively deal with the expected volume of delinquencies and foreclosures in the area.

When it reinstitutes its multifamily mortgage purchase program in its Northeast Region, Freddie Mac plans to require that additional information accompany the loan applications from seller/servicers. Specifically, the loan applications must include (1) certified engineering reports for most properties over 20 years old that address the condition of major building systems, (2) copies and analyses of any commercial leases for the properties, and (3) confirmation of the borrowers' rent registrations from the New York State Division of Housing and Community Development, for loans in New York State. For loan applications in New York City, Freddie Mac will require seller/servicers to carefully analyze any housing violations before submitting the loan package for purchase.

Conclusions

The steps taken and planned by Freddie Mac, if properly implemented, should strengthen its controls over the purchasing and servicing of multifamily mortgages. However, while these changes address many of the problems we identified, they do not address all of them. Freddie Mac still lacks controls to detect some of the inaccurate and incomplete information contained in appraisals and servicing reports submitted by seller/servicers, appraisers, and/or borrowers. Lowering the maximum LTV ratio, for example, will not eliminate the risk of overfinancing if Freddie Mac continues to rely on inflated appraisals. Similarly, receiving all required inspection reports and financial statements will not lead to more informed servicing if the reports understate maintenance and financial problems. Unless Freddie Mac develops additional controls to ensure that it makes decisions on the basis of accurate and complete information, it will remain exposed to financial losses through overfinancing, uninformed servicing, and, potentially, fraud and program abuse.

Improved controls to better detect inaccurate and incomplete information will reduce Freddie Mac's exposure to financial losses on the new mortgages it purchases and improve the servicing of existing mortgages. However, the extent to which Freddie Mac may have received and relied on inaccurate appraisal and servicing information in accumulating and servicing its $11-billion portfolio of multifamily loans is uncertain. Because of the limited nature of this review, we cannot determine the extent to which the problems identified exist in other Freddie Mac multifamily loans. However, since other reviews of the program found that appraisals and servicing information on multifamily properties contained unreliable information and that weak controls were in place at the time these mortgages were purchased and serviced, it is distinctly possible that Freddie Mac may have received and relied on inaccurate information for other multifamily mortgages in its portfolio.

Recommendations

To ensure that key appraisal and servicing information submitted by seller/servicers on multifamily properties is accurate and complete, we recommend that the Chief Executive Officer of Freddie Mac direct program controls to be further strengthened. Specifically, we recommend the following:

- Seller/servicers should be required to submit documentation verifying key appraisal and servicing information. For appraisals, seller/servicers should be required to obtain, to the extent available, and include as part of the loan package, documentation verifying key information on the selling prices and dates of sale of comparable and appraised properties, rents, expenses, the physical condition of the properties, and the professional standing of appraisers. For servicing, the documentation and verification requirement should cover updated reports on maintenance problems, rental income and expenses, property sales and secondary mortgages, and the timeliness of borrower mortgage payments. The information should be verified with data obtained from independent sources such as public records, government agencies, and reputable data services, or with documentation such as audited financial statements, signed contracts, or cancelled checks.

- Freddie Mac should establish standards governing appraisers' methods of forecasting net income, determining the appropriateness and completeness of expense items, calculating tax savings, and justifying capitalization rates.

We further recommend that Freddie Mac review its $11-billion portfolio of multifamily loans to identify other instances in which it received inaccurate appraisal and servicing information that may constitute misrepresentation of fact and refer these matters to the U.S. Attorney for appropriate action. Freddie Mac could focus such a review, for example, on (1) appraisals associated with loans that became delinquent within a short time after it purchased them or that have frequently been delinquent and (2) servicing information provided for properties on its watch-list of high-risk loans.

Agency Comments

We received written comments from Freddie Mac on a draft of this report (see app. IV). The comments focused on steps Freddie Mac took after initially becoming aware of problems in its multifamily program and its commitment not to resume purchasing multifamily loans until it is satisfied with changes made to correct the problems. Freddie Mac did not comment on our conclusions and recommendations for further strengthening its program controls over purchasing and servicing multifamily mortgages. Nor did Freddie Mac comment on our recommendation that it initiate efforts to identify other properties for which it may have received inaccurate information that may have intentionally misrepresented facts.

Specifically, Freddie Mac commented that management had informed its Board of Directors of its concerns about the multifamily program in September 1990 and, because of those concerns, the program was shut down. Freddie Mac also said that, as pointed out in our report, it had already taken many steps to correct operational or control weaknesses in the program since that time. Specifically, Freddie Mac mentioned that the individuals who were immediately responsible for managing the multifamily program no longer work for Freddie Mac, experienced multifamily management and staff have been hired, lenders and servicers have been terminated, and legal actions have been instituted. We agree that the changes Freddie Mac has instituted and planned should strengthen its controls over the multifamily program, but we do not believe these changes address all of the problems we identified.

Freddie Mac also commented that it will not resume purchasing multifamily loans until it is satisfied that (1) the program is appropriately staffed with experienced, trained individuals; (2) the existing multifamily portfolio is being managed effectively; and (3) it can guarantee that a well-conceived and sound purchase program has been put in place. Only then, stated Freddie Mac, can it ensure that its program operates in a financially safe and sound manner and meets its congressional mandate to provide safe, affordable rental housing for Americans.

As requested, we plan no further distribution of this report until 5 days from the date of this letter. At that time, we will send copies to appropriate congressional committees, the Chief Executive Officer of Freddie Mac, and other interested parties. We also will make copies available to others upon request.

This work was conducted under the direction of John M. Ols, Jr., Director of Housing and Community Development Issues, who may be reached on (202) 275-5525. Other major contributors to this report are listed in appendix V.

J. Dexter Peach
Assistant Comptroller General

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Abbreviations

Freddie Mac	Federal Home Loan Mortgage Corporation
LTV	loan-to-value ratio
REDI	Real Estate Data, Inc.

Objectives, Scope, and Methodology

On September 14, 1990, four Members of Congress from New York State—Senator Alfonse M. D'Amato and Representatives Eliot L. Engel, José E. Serrano, and Ted Weiss—requested that we determine whether Freddie Mac's procedures governing the purchasing and servicing of multifamily mortgages were adequate to protect its investments. The requesters were concerned about charges they had received from the Northwest Bronx Community and Clergy Coalition that Freddie Mac had overfinanced multifamily properties in the Bronx and that the landlords, either unable or unwilling to support the debt, had cut back on maintenance. The coalition provided a list of 35 multifamily properties as specific instances of their general concerns about Freddie Mac's activities in the Bronx. Table I.1 lists these properties and the amounts and dates of their mortgages.

Table I.1: 35 Mortgaged Bronx Properties

Address	Date of purchase	Mortgage amount
240 E. 175 St.	4/22/87	$2,475,000
176 E. 176 St.	9/10/86	1,035,000
130 W. 183 St.	11/29/88	1,200,000
200 E. 205 St.	4/29/87	1,200,000
144 E. 208 St.	3/02/88	495,000
225 W. 232 St.	8/28/87	1,450,000
2550 Briggs Ave.	11/21/86	365,000
2900 Briggs Ave.	8/11/87	210,000
2969 Briggs Ave.	5/08/86	499,000
3021 Briggs Ave.	1/15/86	400,000
1985 Creston Ave.	6/21/88	510,000
1995 Creston Ave.	6/20/88	450,000
1765 Davidson Ave.	6/20/89	1,525,000
2820 Decatur Ave.	10/23/86	680,000
2543 Decatur Ave.	2/29/88	1,410,000
3195 Decatur Ave.	7/09/87	700,000
3025 Godwin Terr.	12/02/88	920,000
2701 Grand Concourse	10/09/85	850,000
2780 Grand Concourse	9/06/85	750,000
3034 Grand Concourse	11/13/85	750,000
3111 Heath Ave	2/01/85	650,000
2876 Jerome Ave.	10/17/86	875,000
2630 Kingsbridge Terr.	6/11/85	1,335,000
3422 Knox Pl.	6/26/87	775,000
2420 Morris Ave.	4/01/85	750,000
115 E. Mosholu Pkwy.	5/29/87	1,485,000
239 E. Mosholu Pkwy.	7/10/86	499,000
309 E. Mosholu Pkwy.	9/04/87	830,000
21 W. Mosholu Pkwy.	9/22/87	765,000
65 Mt. Hope Pl.	10/14/88	1,425,000
215 Mt. Hope Pl.	4/14/87	1,385,000
240 Mt. Hope Pl.	3/23/87	1,020,000
3155 Rochambeau Ave.	12/14/87	1,270,000
3280 Rochambeau Ave.	7/06/87	1,360,000
1790 Weeks Ave.	12/27/88	755,000
Total		**$33,053,000**

Source: New York City Department of Housing Preservation and Development and Freddie Mac records.

As subsequently agreed with the requesters, we examined whether Freddie Mac

- accepted overvalued appraisals when it purchased the 35 mortgages, which resulted in overfinancing;
- had in effect a mortgage servicing process in the years after the mortgage purchase that protected it against additional financial risk on the properties; and
- has developed new procedures to address the problems that resulted in overfinancing and servicing problems in the multifamily program.

We reviewed Freddie Mac files on the 35 properties, its required procedures described in the Sellers' & Servicers' Guide, and internal and external audit reports on the multifamily program. We interviewed Freddie Mac officials regarding these procedures and files. We also used New York City and State records on the 35 properties, including (1) their sales and mortgage histories and the histories of the properties used as comparable properties for them, (2) legal suits against their owners, (3) their maintenance problems, and (4) the legal maximum rents reported by their owners. In addition, we obtained information from New York City on borrowers' financial statements filed for tax purposes. We did not verify the data systems maintained by New York City or New York State. Together with our Office of Special Investigations, we also interviewed selected appraisers, and tenants and employees in some of the properties.

We also hired an independent appraiser, James A. Cowan, CRE, MAI,[1] to review the original 35 appraisals submitted to Freddie Mac and determine whether the valuation of each property was supported by the evidence provided in the appraisal. While the appraiser did not reappraise the property, he was asked to adjust the appraisal value for each of the 35 properties to the extent that he identified inaccurate and incomplete information in the appraisals. Mr. Cowan has 18 years experience in real estate appraisals in New York City, most recently as President of J.A. Cowan & Associates, Inc.

Our work was conducted in accordance with generally accepted government auditing standards between October 1990 and July 1991.

[1]Counselor, Real Estate and Member, Appraisal Institute.

Inaccurate and Incomplete Information Led to Overfinancing

This appendix discusses the appraisal process at the time Freddie Mac purchased the 35 mortgages and whether this process resulted in overfinancing. Freddie Mac relied on property appraisals to assess whether the value of the property was sufficient to secure the mortgages it purchased. If appraisals were overstated, the mortgage based on that appraisal exposed Freddie Mac to more risk of loss than it had knowingly accepted. However, to provide a margin for a reasonable difference of opinion on the appraised values of the properties, we considered properties to be overvalued only if the review appraiser's value differed from the original appraised value by 10 percent or more. Consequently, we considered that Freddie Mac overfinanced a property only if its investment was 10 percent or more higher than it would have been if Freddie Mac had based the mortgage on the review appraisal.

The appraisals Freddie Mac accepted overvalued 27 of the 35 properties by 10 to 31 percent, according to our independent appraiser. Table II.1 provides information on the appraised values accepted by Freddie Mac and our independent appraiser's values for these properties. Because of the inflated appraisals, Freddie Mac overfinanced the 27 properties by about 20 percent of its total investment in them, or about $5.4 million. Table II.2 provides information on the mortgage amounts Freddie Mac purchased and the amounts it would have purchased if it had based the mortgages on the review appraisals.

Table II.1: Freddie Mac-Accepted and Independent Appraiser's Values on 27 Overfinanced Properties

Property and overvaluation	Freddie Mac's appraised value	Independent appraiser's adjusted value	Percent difference
Overvalued (10-19 percent)			
2876 Jerome Ave.	$1,100,000	$990,400	10
3025 Godwin Terr.	1,235,000	1,100,000	11
225 W. 232 St.	1,800,000	1,570,000	13
3195 Decatur Ave.	826,000	720,000	13
200 E. 205 St.	1,400,000	1,202,900	14
3422 Knox Pl.	950,000	815,000	14
3034 Grand Concourse	1,100,000	943,415	14
215 Mt. Hope Pl.	1,631,000	1,395,000	14
2420 Morris Ave.	1,265,000	1,075,760	15
1790 Weeks Ave.	1,000,000	850,000	15
2701 Grand Concourse	1,100,000	925,000	16
3111 Heath Ave.	935,000	785,000	16
115 E. Mosholu Pkwy.	1,750,000	1,460,000	17
240 Mt. Hope Pl.	1,236,000	998,000	19
Substantially overvalued (20-31 percent)			
130 W. 183 St.	1,577,000	1,265,000	20
1765 Davidson Ave.	2,160,000	1,715,000	21
3021 Briggs Ave.	630,000	492,600	22
240 E. 175 St.	3,261,066	2,498,000	23
3155 Rochambeau Ave.	1,800,000	1,387,600	23
309 E. Mosholu Pkwy.	1,250,000	960,000	23
1985 Creston Ave.	715,000	535,000	25
65 Mt. Hope Pl.	1,980,000	1,471,000	26
2550 Briggs Ave.	550,000	400,000	27
2820 Decatur Ave.	854,000	610,000	29
1995 Creston Ave.	660,000	470,000	29
2543 Decatur Ave.	1,935,000	1,375,000	29
3280 Rochambeau Ave.	1,881,000	1,300,000	31
Total	**$36,581,066**	**$29,309,675**	20

Source: Freddie Mac records and independent appraiser values.

Table II.2: Freddie Mac-Purchased Mortgages Adjusted for Review Appraisals on 27 Overfinanced Properties

Property and overvaluation	Amount of Freddie Mac mortgage	Mortgage amount with review appraisal	Dollar difference
Overvalued (10-19 percent)			
200 E. 205 St.	$1,200,000	$1,031,057	$168,943
225 W. 232 St.	1,450,000	1,264,722	185,278
3195 Decatur Ave.	700,000	610,169	89,831
3025 Godwin Terr.	920,000	819,433	100,567
2701 Grand Concourse	850,000	714,773	135,227
3034 Grand Concourse	750,000	643,238	106,763
3111 Heath Ave.	650,000	545,722	104,278
2876 Jerome Ave.	875,000	787,818	87,182
3422 Knox Pl.	775,000	664,868	110,132
2420 Morris Ave.	750,000	637,802	112,198
115 E. Mosholu Pkwy.	1,485,000	1,238,914	246,086
215 Mt. Hope Pl.	1,385,000	1,184,595	200,405
240 Mt. Hope Pl.	1,020,000	823,592	196,408
1790 Weeks Ave.	755,000	641,750	113,250
Substantially overvalued (20-31 percent)			
240 E. 175 St.	2,475,000	1,895,868	579,132
130 W. 183 St.	1,200,000	962,587	237,413
2550 Briggs Ave.	365,000	265,455	99,545
3021 Briggs Ave.	400,000	312,762	87,238
1985 Creston Ave.	510,000	381,608	128,392
1995 Creston Ave.	450,000	320,455	129,545
1765 Davidson Ave.	1,525,000	1,210,822	314,178
2543 Decatur Ave.	1,410,000	1,001,938	408,062
2820 Decatur Ave.	680,000	485,714	194,286
309 E. Mosholu Pkwy.	830,000	637,440	192,560
65 Mt. Hope Pl.	1,425,000	1,058,674	366,326
3155 Rochambeau Ave.	1,270,000	979,029	290,971
3280 Rochambeau Ave.	1,360,000	939,926	420,074
Total	**$27,465,000[a]**	**$22,060,732[a]**	**$5,404,268[a]**

[a]Totals do not add due to rounding.

Source: Freddie Mac records and independent appraiser values.

The level of risk that Freddie Mac assumed on the 27 overfinanced properties increased from an intended average of a 75-percent loan-to-value (LTV) ratio to an average 94-percent ratio. Specifically, when the review appraisals are substituted for those accepted by Freddie Mac,

- 5 mortgages exceeded the value of the properties (had LTV ratios over 100 percent);
- 14 mortgages exceeded Freddie Mac's standard LTV ratio of 85 percent, in effect at the time they were purchased; and
- 8 mortgages had higher LTV ratios than Freddie Mac intended (Freddie Mac intended an average of a 70-percent LTV ratio for the 8 mortgages; with the review appraisal values, the LTV ratios averaged 83 percent). Table II.3 lists the properties in each category.

Table II.3: LTV Ratios for 27 Overfinanced Properties

Address	LTV standard[a] at purchase	Freddie Mac-approved LTV	LTV with review appraisal[b]
LTV exceeds 100 percent			
2543 Decatur Ave.	85	73	103
2820 Decatur Ave.	100	80	111
115 E. Mosholu Pkwy.	85	85	102
240 Mt. Hope Pl.	85	83	102
3280 Rochambeau Ave.	85	72	105
LTV exceeds 85-percent standard			
240 E. 175 St.	85	76	99
130 W. 183 St.	85	76	95
200 E. 205 St.	85	86	100
225 W. 232 St.	85	81	92
1985 Creston Ave.	85	71	95
1995 Creston Ave.	85	68	96
1765 Davidson Ave.	85	71	89
3195 Decatur Ave.	85	85	97
3422 Knox Pl.	85	82	95
309 E. Mosholu Pkwy.	85	66	86
65 Mt. Hope Pl.	85	72	97
215 Mt. Hope Pl.	85	85	99
3155 Rochambeau Ave.	85	71	92
1790 Weeks Ave.	85	76	89
LTV exceeds original but not maximum			
2550 Briggs Ave.	100	66	91
3021 Briggs Ave.	100	63	81
3025 Godwin Terr.	85	74	84
2701 Grand Concourse	100	77	92
3034 Grand Concourse	100	68	79
3111 Heath Ave.	100	70	83
2876 Jerome Ave.	100	80	88
2420 Morris Ave.	100	59	70
Average for overfinanced properties		75	94

[a]Freddie Mac's maximum LTV ratio was lowered from 100 to 85 percent on Jan. 30, 1987.

[b]LTV ratio we computed using the ratio of the actual loan amount to the independent appraiser's values.

Overfinancing occurred principally because Freddie Mac used appraisals submitted by seller/servicers containing inaccurate and incomplete information that led to overstatements of property values. Multiple appraisal components were responsible for the high appraised values Freddie Mac accepted: inaccurate previous selling prices for comparable properties and, for the appraised properties, incomplete information on previous selling prices, inflated net incomes, low capitalization rates, and overstatements of physical conditions. The capitalization rate, a factor in estimating the value of income-producing property, reflects the appraiser's judgment of the rate of return that investors in a given type of property would expect to receive. For 27 of the 35 properties, the appraisal problems were of such magnitude that Freddie Mac's investment exceeded our threshold of 10 percent or more. Therefore, we considered these properties to be overfinanced.

Table II.4 summarizes the problems we identified in the appraisals for the 35 properties.

Table II.4: Summary of Inaccurate and Incomplete Appraisal Information

Address	Inaccurate comparables[a]	Not comparable	Inflated income	Low expenses	Low capitalization rate
240 E. 175 St.	X	X	X		X
176 E. 176 St.		X	X		
130 W. 183 St.	X	X	X		X
200 E. 205 St.	X	X	X		X
144 E. 208 St.	X		X		X
225 W. 232 St.	X	X	X		X
2550 Briggs Ave.		X	X	X	X
2900 Briggs Ave.			X		X
2969 Briggs Ave.	X		X	X	
3021 Briggs Ave.				X	X
1985 Creston Ave.	X	X	X		X
1995 Creston Ave.	X	X	X		X
1765 Davidson Ave.	X	X			X
2543 Decatur Ave.		X	X	X	X
2820 Decatur Ave.	X	X	X	X	X
3195 Decatur Ave.			X		X
3025 Godwin Terr.		X	X		X
2701 Grand Concourse	X	X	X	X	
2780 Grand Concourse			X	X	
3034 Grand Concourse	X	X	X	X	
3111 Heath Ave.		X	X	X	
2876 Jerome Ave.	X	X	X	X	X
2630 Kingsbridge Terr.					
3422 Knox Pl.		X			X
2420 Morris Ave.		X	X		
115 E. Mosholu Pkwy.	X	X	X	X	X
239 E. Mosholu Pkwy.	X		X		
309 E. Mosholu Pkwy.		X	X		X
21 W. Mosholu Pkwy.	X	X	X		X
65 Mt. Hope Pl.		X	X		X
215 Mt. Hope Pl.		X	X		X
240 Mt. Hope Pl.		X	X		X
3155 Rochambeau Ave.	X	X	X		X
3280 Rochambeau Ave.		X	X		X
1790 Weeks Ave.		X	X		X
Total properties	**17**	**27**	**31**	**11**	**26**

[a]Includes sales that never occurred, inaccurate selling prices, and/or incorrect sales dates.

Source: New York City Department of Housing Preservation and Development records and independent appraiser's assessment.

Through July 1991, Freddie Mac had instituted foreclosure proceedings on 11 of the 35 properties, and 5 others were 90 or more days delinquent in mortgage payments. Of the 11 properties, 1 was acquired by Freddie Mac and 3 have had their mortgages reinstated and are current in mortgage payments, leaving 7 properties in foreclosure at that time.

The internal control weaknesses we identified in our review are not limited to the 35 Bronx properties. The same weaknesses, causing similar problems, have also been found in other reviews of Freddie Mac's multifamily program nationwide. Laventhol & Horwath, a consulting firm hired by Freddie Mac, concluded in September 1988 that 51 percent of a sample of 63 original appraisals for multifamily properties that had been foreclosed and subsequently acquired by Freddie Mac were significantly deficient and overestimated the properties' values by 10 to 20 percent. Although Laventhol & Horwath evaluated only appraisals for properties that were foreclosed and subsequently acquired by Freddie Mac, the consulting firm stated, "we expect that the overall quality of appraisals among the rest of Freddie Mac's loans is reasonably comparable to those we reviewed." The "common appraisal problems" identified by Laventhol & Horwath included comparable sales that were too distant, or too different, from the appraised property to yield meaningful comparisons; unrealistically low capitalization rates for older properties; and extremely low expense estimates, particularly for maintenance of the properties. Laventhol & Horwath recommended that Freddie Mac become more selective in accepting appraisals and provide more guidance to seller/servicers regarding acceptable appraisers.

Similarly, in a report on the multifamily program issued in July 1989, Freddie Mac's Internal Audit Department concluded that (1) Freddie Mac underwriters were concerned about the reliability of the appraisals provided to Freddie Mac; (2) Freddie Mac did not have a formal process or procedures in place to enable the underwriting staff to monitor the performance of appraisers and appraisal companies in order to identify appraisals that should be reviewed more closely; and (3) errors and misstatements in appraisals increased the risk that Freddie Mac would purchase loans that did not meet its standards or purchase them without reflecting its risk. The Internal Audit Department concluded that Freddie Mac's exposure to financial losses could be reduced by strengthening controls over property appraisals.

In its most recent review of the multifamily program, published in September 1990, the Internal Audit Department concluded, "In general, policies and procedures in the multifamily program are inadequate or not fully implemented consistently across regional levels." For appraisals, the internal auditors found that appraisers were not required to be professionally certified and that unqualified appraisers might be used.

Inaccurate Comparable and Appraised Property Sales Information

Of the 35 appraisals, 17 contained inaccurate information on comparable sales, according to our review of New York City records and the independent appraiser's review of these same records and the REDI book published by Real Estate Data, Inc., a nationally known data service. Eight appraisals used comparable sales that had not occurred, 12 overstated the selling price of comparable properties by an average of 27 percent, and 8 reported an incorrect date of sale that differed from the actual date by 1 to 14 months.

Moreover, Freddie Mac had accepted 23 appraisals whose sources of data for one or more comparable sales were not verifiable—for example, "owner," "inspection," and "data service." According to our independent appraiser, "owner and inspection are not recognized as acceptable or reliable [sources] without further verification" and "without knowing what data service the appraiser utilizes, it is impossible to verify the reliability of the data."

Our Office of Special Investigations interviewed two appraisers who had reported higher comparable sales prices to Freddie Mac than were contained in the data sources they said they used. When the appraisers were presented with the discrepancy, they could not provide a satisfactory explanation for these errors.

Furthermore, appraisals for 27 properties used at least 1 inappropriate comparable property, according to our independent appraiser. The properties were inappropriate because they were located in superior neighborhoods or contained features, such as retail space or cooperative apartments, that made them more valuable. Therefore, they were not comparable to the appraised properties.

Many appraisers also did not report the most recent selling price of the appraised property. Of the 18 appraisals subject to Freddie Mac's requirement that all sales of the appraised property within the previous 3 years be reported, 12 did not contain the information. The appraised value of these 12 properties reported to Freddie Mac exceeded their unreported prior selling price by about 180 percent.

Net Income Inflated

Property values were also inflated when appraisers used contradictory and inaccurate information from borrowers to develop their income forecasts. For 10 of the 35 properties, borrowers reported a specific year's actual net income to both the appraiser and the New York City Tax Commission. Of the 10, 9 reported higher annual net incomes to the appraiser than they reported to the Tax Commission, by an average of about $88,000 a property, ranging from about $10,000 to $169,000 per property. Tenants we interviewed at four of the properties told us that they do not now and had never paid rents as high as those reported to the appraisers. The building manager of another property confirmed to us that an apartment included in the rent rolls submitted to the appraiser does not exist. In another case, the borrower on one property reported income from a day care center at the property, although New York City officials stated that the required license was never granted. Three tenants and four employees living and/or working in the building for many years also told us that they knew of no such center.

Appraisers also used methods that inappropriately inflated their forecasts of the properties' net income. Thirty-one of the 35 appraisals used a method that projected increases in rental income but held expenses at current levels to derive the net income of the properties. This is a "clear attempt to maximize the income of the property," according to our independent appraiser. By using this method, appraisers inflated rental income for the 31 properties by about $296,000, or $9,555 per property. Appraisers also used inappropriate methods that inflated the value of tax abatements on 11 of the properties, according to our independent appraiser. In addition, appraisers understated current expenses for 11 of the properties by excluding such standard items as legal and audit expenses and replacement reserves and/or by underestimating such items as maintenance, repairs, and insurance.

Capitalization Rates Low

Appraisals for 26 of the properties used low capitalization rates, ranging from 10 to 12 percent, that did not reflect market conditions at the time. According to our independent appraiser, the capitalization rates should have ranged from 12 to 13.5 percent. Because the capitalization rate, or expected rate of return on the owner's investment, is divided into the property's net income to derive the appraised value, the lower the rate, the higher the appraised value. For example, if an investor expects a 10-percent rate of return, a property with a net annual income of $90,000 would be valued at $900,000; if an investor expects a 15-percent rate of return, then the same property would be valued at $600,000. Many of the appraisals with low rates used an inappropriate method to derive them or lacked support for the derivation, according to our independent appraiser. Eight of the 26 appraisals based the low rate on an expected appreciation in property value, which tends to inflate appraised values; this method was outdated by the mid-1980s. Twelve of the 26 appraisals provided no explanation or support for the rate used, contrary to accepted appraisal methods, according to our independent appraiser.

Condition of Properties and Neighborhoods Overstated

Appraisers also inflated property values by overstating the physical condition of the properties and their surrounding neighborhoods. Of the 35 appraisals, 12 were dated within 2 months of a New York City housing violations report. Of the 12, 11 understated maintenance problems in the properties. Four of the 11 appraisals showed no items requiring repairs, while the New York City reports showed from 47 to 166 hazardous and/or falsely certified violations per property; the remaining 7 appraisals showed from 1 to 7 items requiring repairs, while the New York City reports showed from 18 to 208 hazardous and/or falsely certified violations per property. Hazardous housing violations, according to city regulations, are those that endanger life, health, or safety. Violations are identified when the city receives a complaint and a city inspector visits the property and certifies the complaint as valid. New York City reports a violation as falsely certified when a city inspector determines that repairs the owner certified as having been made were, in fact, not made.

Seventeen of the appraisals overstated the condition of the surrounding neighborhoods, according to our independent appraiser. Our Office of Special Investigations visited two of these properties, immediately adjacent to each other, and noted five vacant or abandoned buildings within a 1-square-block radius, including one immediately behind the properties. The five buildings had been vacant or abandoned since at least 1984, according to the New York City Fire Department. Nevertheless, the appraiser who appraised both properties in 1987 did not note this condition in his appraisals. The appraiser submitted photographs of the properties taken from an angle that excluded the vacant and abandoned buildings, although two of them could be observed from another angle. The appraiser was not able to explain to our investigators why he did not report these conditions.

Inaccurate and Incomplete Servicing Information Led to Uninformed Servicing

This appendix discusses the servicing process in effect in the years after Freddie Mac purchased the mortgages and whether this process protected Freddie Mac against additional financial risk. Freddie Mac delegates servicing responsibilities to seller/servicers, requiring them to report regularly on the condition of the properties. Adequate servicing ensures that Freddie Mac is informed of maintenance and financial problems so that it can take remedial action, either by itself or through the seller/servicers.

Inaccurate and Incomplete Information on Maintenance Problems

When it purchased the mortgages on 19 of the properties, Freddie Mac required the seller/servicers to certify within 90 days that all hazardous housing violations had been removed from the properties. Freddie Mac received certifications for only eight of these properties, and seven certifications were inaccurate, stating that violations had been removed, while New York City reports show that a significant number of hazardous violations were still on the record. Table III.1 lists the 19 properties for which certification of removal of hazardous housing violations was required, those properties for which the required certificate was received, and those on which violations were still on the record. Moreover, on one property, a vendor whose signature appeared on a document attesting to the soundness of the property's boiler and roof said that he had not prepared the document and was not qualified to attest to the soundness of boilers and roofs.

Table III.1: Inaccurate and Incomplete Information on Removal of Hazardous Housing Violations

Properties requiring satisfactory completion certificates	Certificate received	Violations on record
240 E. 175 St.	Yes	Yes
130 W. 183 St.	No	
144 E. 208 St.	No	
225 W. 232 St.	No	
2900 Briggs Ave.	No	
1985 Creston Ave.	Yes	Yes
1995 Creston Ave.	Yes	Yes
1765 Davidson Ave.	No	
2543 Decatur Ave.	Yes	Yes
3195 Decatur Ave.	Yes	Yes
3025 Godwin Terr.	No	
3422 Knox Pl.	No	
115 E. Mosholu Pkwy.	No	
309 E. Mosholu Pkwy.	Yes	Yes
21 W. Mosholu Pkwy.	No	
65 Mount Hope Pl.	No	
3155 Rochambeau Ave.	Yes	No
3280 Rochambeau Ave.	Yes	Yes
1790 Weeks Ave.	No	
Total	**8**	**7**

Source: New York City Department of Housing Preservation and Development and Freddie Mac records.

In the years after the mortgage purchase, Freddie Mac relied on seller/servicers' annual inspection reports to ascertain the condition of the properties. For nine of the properties, at least one required annual inspection report was not in Freddie Mac's files. Also, Freddie Mac did not require inspection reports to include updated information on housing violations or other maintenance problems from New York City, and it did not receive this information from other sources. Consequently, Freddie Mac was not informed that the 35 properties had an average of about 100 hazardous and/or falsely certified housing violations as of 1989 and 1990. In 1989, the violations ranged from 5 to 725, and in 1990, they ranged from 5 to 395. Freddie Mac also was not informed that New York City sued the owners of 19 of the properties for overall poor maintenance and/or failure to provide heat and hot water and had to make emergency repairs in 17 properties, including lead removal and repairs to plaster, plumbing, and roofs. Table III.2 lists the maintenance problems that New York City identified for the 35 properties.

Table III.2: Maintenance Problems Identified by New York City

Address	Hazardous housing violations[a] As of 7/19/89[b]	As of 6/27/90	Emergency repairs by NYC	Lawsuits by NYC
240 E. 175 St.	208	214	X	X
176 E. 176 St.	92	96	X	X
130 W. 183 St.	52	103		X
200 E. 205 St.		13		
144 E. 208 St.	39	40	X	
225 W. 232 St.	249	123	X	X
2550 Briggs Ave.	22	37		X
2900 Briggs Ave.	115	113	X	X
2969 Briggs Ave.	18	23		X
3021 Briggs Ave.	37	49	X	
1985 Creston Ave.	241	395	X	X
1995 Creston Ave.	134	249	X	X
1765 Davidson Ave.	725	150		
2543 Decatur Ave.	39	28		X
2820 Decatur Ave.	22	29	X	
3195 Decatur Ave.	35	48		
3025 Godwin Terr.	32	18		
2701 Grand Concourse	82	161	X	X
2780 Grand Concourse	94	93		
3034 Grand Concourse	97	128		X
3111 Heath Ave.	114	106	X	
2876 Jerome Ave.	95	230		X
2630 Kingsbridge Terr.		55	X	
3422 Knox Pl.	37	107	X	X
2420 Morris Ave.	10	13	X	
115 E. Mosholu Pkwy.		32	X	X
239 E. Mosholu Pkwy.	5	5		
309 E. Mosholu Pkwy.	120	178		
21 W. Mosholu Pkwy.	96	116		
65 Mount Hope Pl.	35	59		X
215 Mount Hope Pl.		26		X
240 Mount Hope Pl.	29	41		
3155 Rochambeau Ave.	31	33	X	
3280 Rochambeau Ave.	80	180	X	X
1790 Weeks Ave.	51	55		X
Average violations	98	96		
Total properties			**17**	**19**

[a]The total number of hazardous violations includes some that New York City categorized as "falsely certified," i.e., in a subsequent inspection, the repairs the owner certified had been made were found not to have been made. For 1989, the violations for 13 properties include a total of 50 "falsely certified" violations, of which 30 were hazardous and 20 nonhazardous. In 1990, 17 properties had a total of 97 "falsely certified" violations, of which 56 were hazardous and 41 nonhazardous.

[b]Violations reports dated 7/19/89 were available for 31 of the 35 properties.

Source: New York City Department of Housing Preservation and Development and Freddie Mac records.

If Freddie Mac had received this information from New York City, it could have determined that the annual inspection reports significantly understated the extent of maintenance problems. In 1989, for example, inspection reports for 13 properties, dated within 2 months of a New York City violations report, showed from 0 to 8 items requiring repairs, for an average of 3.5 items per property. New York City records, however, showed that all 13 properties had hazardous and/or falsely certified housing violations, ranging from 22 to 249, for an average of about 100 violations per property.

Undetected maintenance problems threaten the collateral value of properties and can decrease their net income and ability to sustain mortgage obligations. For example, the New York State Division of Housing and Community Renewal ordered rent reductions on 8 of the 35 properties for poor maintenance buildingwide. According to a New York State housing official, these reductions can reduce the income of a property by as much as 10 percent. Also, the cost of emergency repairs made by the city, if unpaid, becomes a lien on the property, and these costs are higher than if borrowers arrange their own repairs, according to city housing officials. In addition, conditions that result in hazardous housing violations and require emergency repairs are severe enough to threaten the health and safety of tenants in the buildings.

Inaccurate, Incomplete, and Contradictory Information on Financial Conditions

Contrary to Freddie Mac's requirements, owners of 12 properties sold them and/or obtained a secondary mortgage without Freddie Mac's approval. At the time of our review, we found no evidence that Freddie Mac was aware of all the unauthorized financial transactions we identified on 10 of these 12 properties. Freddie Mac had become aware of all the unauthorized transactions on 2 of the 12 properties and some of the unauthorized transactions on 2 other properties. Except in one case, however, Freddie Mac did not learn of these transactions until many months—from 8 to 25—after the transactions had occurred. Undetected transactions can increase Freddie Mac's exposure to loss. According to Freddie Mac officials, an unauthorized second mortgage can delay or prevent payments on the Freddie Mac mortgage. In cases of unauthorized sales, Freddie Mac has not been able to approve the new owners, as required, and determine whether they are creditworthy. Table III.3 lists the properties that had experienced unauthorized transactions at the time of our review.

Table III.3: Unauthorized Transactions

Address	Date property sold	Date Freddie Mac learned of sale[a]	Date of secondary mortgage	Date Freddie Mac learned of mortgage[a]
176 E. 176 St.			4/90	
130 W. 183 St.	2/89		3/89	
	2/89		3/89	
			7/89	
3021 Briggs Ave.	2/86			
	7/88		7/88	
	7/88			
2543 Decatur Ave.			7/90	
2701 Grand Concourse	9/86	5/87	9/86	7/87
2876 Jerome Ave.	7/89			
2630 Kingsbridge Terrace	1/88	5/89	1/88	
3422 Knox Pl.			8/87	9/89
			9/87	
			11/87	
			8/88	
			10/88	
2420 Morris Ave.	5/87		5/87	
21 W. Mosholu Parkway	4/89	5/89		
215 Mt. Hope Pl.			4/90	
240 Mt. Hope Pl.			4/90	

[a]Freddie Mac records indicate that, at the time of our review, it had not learned of the property sales or secondary mortgages on the properties for which no date is shown.

Source: New York City Department of Housing Preservation and Development and Freddie Mac records.

Moreover, Freddie Mac was often not aware that many borrowers were not making mortgage payments or were consistently late in their payments. According to Freddie Mac officials, seller/servicers often advanced monthly interest payments to Freddie Mac although the borrower had not actually made them. As long as it received the interest payments, Freddie Mac continued to regard the mortgages as current unless the seller/servicer filed a separate, required report that the borrower was delinquent. If the borrower eventually defaulted, Freddie Mac returned the interest payments to the seller/servicer, thus absorbing the loss. For 15 of the 35 properties, seller/servicers advanced to Freddie Mac monthly interest without principal from 1 to 18 times. This practice can lengthen the time between a borrower's delinquency and Freddie Mac's action to foreclose. For example, on 4 of the 11 properties subject to foreclosure as of July 1991, seller/servicers advanced from 6 to 9 monthly interest payments to Freddie Mac before requesting foreclosure. A longer period between delinquency and foreclosure adds to the number of missed payments and, according to Freddie Mac officials, can threaten the collateral value of the property.

In addition, Freddie Mac received incomplete and contradictory information about the properties' annual net income. It did not receive all required annual net income statements for 32 of the properties. Also, for eight properties, the annual net income that the borrowers reported to Freddie Mac could be compared with the income they reported to New York City's Department of Finance and Tax Commission. Six of the eight borrowers reported higher net incomes to Freddie Mac than to the city. They reported an average net income of $107,683 to Freddie Mac, compared with an average of $43,122 reported to the city, a difference in average net income of $64,561 per property.

Other Reviews Report Similar Weaknesses

The internal control weaknesses we found in our review are not limited to the 35 Bronx properties. In 1988, Laventhol & Horwath concluded that "discussions with Freddie Mac servicing personnel confirm that seller/servicers are regularly deficient with respect to the Guide's requirements for routine monitoring of properties." The consultant's review of Freddie Mac's files on foreclosed and subsequently acquired properties and discussions with Freddie Mac servicing personnel indicated that seller/servicers often perceived Freddie Mac's ability or willingness to enforce its servicing requirements as weak. The consultant's file reviews and discussions also suggested that Freddie Mac's own efforts to ensure seller/servicer performance of routine servicing responsibilities were often weak and regionally inconsistent.

In July 1989, Freddie Mac's Internal Audit Department recommended that Freddie Mac strengthen its servicing policies to increase controls over losses. More recently, in September 1990, the Internal Audit Department concluded that proactive loss prevention efforts were nonexistent or ineffective; some servicing functions were being marginally performed; and seller/servicer performance was inadequate. The internal auditors recommended that Freddie Mac follow up with seller/servicers to ensure current quality inspections and complete financial reporting and that it consider periodic title searches by seller/servicers to improve identification of unauthorized transactions.

Comments From the Federal Home Loan Mortgage Corporation

Federal
Home Loan
Mortgage
Corporation

Leland C. Brendsel
Chairman
Chief Executive Officer
703/903.3000

Freddie Mac

August 30, 1991

Mr. J. Dexter Peach
Assistant Comptroller General
U.S. General Accounting Office
441 G Street, NW
Washington, DC 25048

Dear Mr. Peach:

Thank you for the opportunity to respond on behalf of the Federal Home Loan Mortgage Corporation ("Freddie Mac") to GAO's study regarding selected Freddie Mac multifamily loans in the Bronx, New York.

See pp. 10-11 and 13-14.

On September 7, 1990, prior to the Congressional request for this GAO study, Freddie Mac management advised its Board of Directors of its concerns regarding the corporation's multifamily program. Those concerns resulted in the shutdown of that program. In fact, as the GAO study indicates, Freddie Mac management had already taken many steps to correct operational or control weaknesses in its multifamily program based on information developed by an independent consulting firm and our own staff. As a result, the program as it then existed no longer exists and the individuals immediately responsible for management of the program no longer work for Freddie Mac. Of course, we have gone further. Experienced multifamily management and staff have been recruited and hired. Lenders and servicers have been terminated. Legal actions have been instituted.

See p. 13.

See pp. 2 and 13-14.

See p. 14.

Last year, when I announced the discontinuation of the old multifamily program, I stated that Freddie Mac would not resume the purchase of multifamily loans until I was satisfied that significant changes were made. First, I wanted to be sure that the program was appropriately staffed with experienced, trained individuals. Second, I wanted to assure myself that the existing multifamily portfolio was being managed effectively. Finally, I wanted to guarantee that we would put in place a well conceived and sound purchase program.

I am pleased with the progress we have made in these areas, but as I and other senior management have made publicly clear on numerous occasions, Freddie Mac will not resume a multifamily purchase program until I am satisfied that appropriate systems and controls in underwriting,

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8200 Jones Branch Drive
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See p. 14.

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purchasing and servicing are firmly in place. Only then can we ensure that our program operates both in a financially safe and sound manner and in a manner in which we meet our Congressional mandate to provide safe, affordable rental housing for Americans.

I am confident that the course we have set is the right one. If there is any other information you need, I would be pleased to provide it.

Very truly yours,

Leland C Brendsel

Leland C. Brendsel

BD.1641

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