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## Observations – Allowance Process and Methodology

Overall, we found oversight of the allowance process inadequate at both Fannie Mae and Freddie Mac. We noted significant weaknesses in the processes and methodologies employed by both entities. Furthermore, while our interaction with Risk Management was admittedly limited, the approach at both entities appeared to be highly fragmented and passive (versus cohesive and proactive, as expected). Consequently, we have significant reservations about the adequacy and effectiveness of Risk Management.<sup>1</sup>

### Fannie Mae and Freddie Mac

In order to ensure the proper level of independence, Risk Management must “own” the allowance process. (Notwithstanding the comments above—assumes qualified and experienced Risk staff and effective processes.) Ownership includes the responsibility, accountability, and authority necessary to ensure that the methodology appropriately identifies and provides for the inherent loss in the portfolio, and that the final allowance balance is sufficient to absorb the expected loss (minimum of 12 months). Risk Management does not own the process at either enterprise; rather, this responsibility rests with various financial units. As a result, decisions appear to be unduly influenced by financial, accounting, and other concerns that undermine the integrity of the process and ultimately, the protection afforded by the allowance.

Another significant shortcoming at both institutions is the lack of model discipline. Models at both entities are and have been deemed unreliable in the current environment, as evidenced by the level of management adjustments. Yet there is no process in place to ensure that such weaknesses are promptly and appropriately addressed. Policies and procedures should specifically address: model development, documentation, and validation requirements; redevelopment schedules and triggers; and oversight responsibilities, including required certifications and MIS. Models that are no longer deemed accurate should be decommissioned and alternate arrangements made. (See OCC Bulletin 2000-16 regarding modeling and model validation.)

Current allowance methodology and Risk metrics are tied to “default”—basically, the recognition of loss. (Note: Banks and other financial services providers use a 60+ or 90+ days past due definition of default operationally.) The GSEs allowance methodologies must be revised to recognize inherent loss in their portfolios regardless of the timing of the loss event. This is critical given extremely liberal latitude with respect to loss recognition, and compounded by significant business initiatives undertaken by the GSEs to defer losses (incentives to lengthen the foreclosure process, wide-scale use of loss mitigation programs without prudent qualification criteria, etc.).

The methodologies employed require increased segmentation. While Risk reportedly monitors performance at fairly granular levels, this information is not incorporated into the allowance models/process. Consequently, the methodology is not sufficiently risk sensitive and has not kept pace with the current business and market/economic conditions.

Both entities use a number of loss forecasting models (including allowance methodologies). However, there is no clear explanation of the differences in the forecasts and the purposes for which they are used. An effort to reconcile the various loss forecasts would prove beneficial and may result in better estimates going forward.

<sup>1</sup> **DISCLAIMER.** We participated in this review at the request of and as a consultant to the Federal Reserve in its consultative capacity (Regulatory Reform Act); we have no official standing with respect to the GSEs or OFHEO/FHFA. Due to the conditions imposed, this was not a typical review. We did not talk to all relevant GSE management and staff. We did not perform the types of analysis deemed typical to reach conclusions on these topics (information provided lacked sufficient granularity—depth and time series). We based our conclusions on information provided by OFHEO/FHFA and the GSEs without the opportunity to verify accuracy or completeness. Furthermore, we completed this work in two weeks, recognizing that it would take months to properly understand the GSEs and their processes.

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Other practices that differ from regulatory expectations for banks: use of point in time versus expected losses for allowance purposes (under the auspices of GAAP); and lack of a subjective/qualitative component of the allowance balance.

### Fannie Mae

Fannie Mae reserves for principal and interest losses; key driver is “default.” Process/methodology weaknesses include:

- Limited risk segmentations which may result in less accurate loss projections. Analysts test various segments to determine whether risk is sufficiently different to warrant separate treatment. As a result, Fannie carved out the 2006 and 2007 vintages for analytical purposes. However, other carve-outs were dismissed (Alt-A and I/O, geography) in spite of promising model lift.
- Insufficiently responsive loss projection methodology. Loans are assigned to default curves by cohort (vintage, product, original LTV). The loss curves were developed based on a long-run (20-year) historical average, adjusted for more recent performance. However, the methodology essentially reverts to a 2003 vintage base default curve. Consequently, there is no guarantee that the loss rates appropriately reflect current conditions and experience, e.g., 2005 and 2008 vintages display significantly different performance than the 2003 vintage.
- Inadequate recognition of the risk associated with loss mitigation (including first mortgages associated with HomeSaver Advance) and loss deferral programs. Default curves are not adjusted until losses are recognized, and then not necessarily on a regular basis. Therefore, every action taken to defer losses will in effect reduce the true probability of default and loss projections for every loan on the curve. (See request item FNM #219, OFHEO Questions for Fannie Mae Meeting July 23, 2008.)
- Inadequate support for reducing portfolio severity from 29% to 23% to convert gross to net charge-offs (i.e., recoveries from MI, rep and warranty, and make-wholes, as well as recognizing “lock-downs”—adjustments made for the one-month prior to quarter-end financial statement cut-off).
- Risk misclassification arising from Alt-A definition changes. In 2006, management redefined Alt-A and reclassified loans that did not meet the new definition as prime. Management could not provide documentation of definitional differences or of the number of loans affected; consequently, there is no way to determine the appropriate risk profile of the loans moved. In addition, this category excludes streamlined programs such as “Fast and Easy” (low doc programs allowed by Desktop Underwriter).
- Failure to incorporate updated risk information in the allowance analysis. Current information that should be considered includes Market LTV (MLTV) and updated FICO or other credit scores.

In recognition of deficiencies in the existing Loss Reserve Model (LRM), Fannie has embarked on the Credit Loss Initiative. The purpose of this project is to develop a model to benchmark the performance of LRM. Management is (mistakenly) reluctant to abandon LRM in spite of its deficiencies because of the perceived need for a consistent approach and belief that the current model complies with GAAP.

### Freddie Mac

Freddie Mac reserves separately for principal and interest losses; key driver of the Loan Loss Reserve (LLR) model is serious delinquency (defined as 90 or more days past due). Process/methodology weaknesses include:

- Egregious lack of controls. Internal Audit performed a review of the allowance process, issuing its report in February 2008. The previous review was performed in 2000. This is an unacceptable lapse; the allowance process

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warrants annual reviews, at a minimum. Furthermore, Audit noted numerous significant deficiencies, yet allowed for prolonged response and corrective action periods. Failure to address these items in a timely fashion has compromised the loan loss reserve risk management process.

- Inadequate support for model assumptions and adjustments. It is important to note that all judgmental adjustments to allowance model output since 3Q07 have been reductions. This is considered unsafe and unsound given the current environment. Examples of questionable adjustments include reductions for repurchase volume (\$1.5 billion) and the use of 10 versus 16 basis points for loans current through 30 days past due (\$1.4 billion).
- Inadequate support for the allowance allocated to T-Deals. At \$256MM, the balance seems insufficient to support \$14 billion in total exposures with delinquencies of some 16%.
- Antiquated model segmentations. The model segments are based on region, origination LTV, and year booked. Not only has Freddie failed to keep pace with industry practice, it is not making the best use of its extensive database. At a minimum, Freddie should consider incorporating updated LTVs, refreshed FICOs, original DTIs, etc.—anything to promote better segmentation of the portfolio in general and the current population in particular. In addition to improving model performance, analysis of this information over time will promote the effective identification of and response to risk.

Given the role of the GSEs and their market dominance, they should be industry leaders with respect to effective and proactive risk management, productive analysis, and comprehensive reporting. Instead they appear to significantly lag the industry in all respects. Their Boards of Directors and executive management teams should take steps to address these weaknesses immediately.

### Other:

- Both entities should ensure sufficient valuation reserves for REO properties given current and projected levels. Fannie does not have a reserve, and Freddie's reserve is currently considered inadequate. The reserving methodology should adequately consider the need for ongoing valuation adjustments for those properties that remain in inventory for protracted periods.