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The Beginning of the End for Freddie Mac

The end was slow in coming; much slower than it ought to have been. Both the events and the responses to them as set out in this chapter will explain the reasons for that. Moves to improve the regulation of the two GSEs and to remove certain SEC exemptions continued throughout 2003, accompanied by a recognition of the need for full disclosure of the MBSs.

The GSEs' commitment to voluntary disclosure and registration

Mortgage-backed securities

The GSEs were quick to recognize where voluntary commitments were to their advantage. They fended off the removal of their market advantages, and retained their image as virtuously fulfilling their affordable housing mission. OFHEO, the Treasury and the SEC jointly produced a report on “Enhancing Disclosure in the Mortgage-Backed Securities Market.”¹ Based on interviews with market participants, lenders and non-GSE-issuers, who all took the view that the market would function more effectively with additional pool level disclosure, the Task Force proposed a number of additional items of information, which should be included in disclosures. These were:

- Loan purpose
- Original loan-to-value ratios
- Standardized credit scores of borrowers
- Service information
- Occupancy status
- Property type

At the time, Fannie Mae and Freddie Mac disclosed information about the underlying mortgages that support mortgage-backed bonds on an aggregate basis for a number of similar issues of securities, rather than for each individual

issue. The aggregating of data about such loan characteristics as initial and average time to maturity, interest rates paid by home owners on individual loans, the initial size of the loans, and the geographic locations of mortgaged properties may conceal significant differences in the pool of mortgages backing individual MBS issues. If investors had more specific information about the mortgages behind the pools, they would have a better understanding of the risks they were taking on, and be able to price them more efficiently. The data are important for understanding prepayment risk, which is likely to occur when interest rates fall. Home owners get a better deal in the form of lower interest rates, but the investor then does not receive the expected return on their investment.² The Task Force report regarded prepayment risk as the most important, though it also included interest rate and credit risk.

The most common type of MBS is a pass-through security backed by a pool of single-family mortgage loans, created by pooling or packaging mortgages together in a trust or other collective investment vehicle and selling the interests in a trust. In this case, the certificate holders own undivided interests in the pool. All payments on the underlying mortgage loans, including principal, scheduled interest and unscheduled payments, are passed through, on a pro rata basis, to the holders of the pool interest or participation certificates after deducting service fees, Fannie and Freddie guarantee fees and trust expenses. Private label issuers often used REMICs (real estate mortgage investment conduits), where the underlying assets were either other MBSs or whole mortgage loans. The structure allows the issuers to create securities with short, intermediate or long-term maturities. The assets are pooled and the cash flows are distributed to the various REMIC classes according to agreements made in advance. For the GSEs, REMICs are based on the GSEs' own MBSs, for which there are two basic mechanisms: a "cash" program and a "swap" program.

Such disclosures for the GSEs would largely be made after sales, because most securities are initially sold in the To Be Announced (TBA) market before such information is available. In most cases, and especially with a single lender, the mortgage originators pool the loans and then obtain a guarantee from either Freddie Mac or Fannie Mae, which evaluates the loans to ensure that they meet its credit quality standards. In those transactions, the lender swaps a pool of loans for MBSs representing the ownership in the same mortgages. Exchanging pools of mortgages for MBSs is useful to the lenders, because the securities have lower capital requirements and are more liquid. For Fannie Mae and Freddie Mac, agreements were already in place to deliver the MBSs in the market for forward sales (TBAs). In 1998, the Bond Market Association estimated that about 90% of all transactions, measured by dollar volume, were TBAs. Private label MBSs do not trade in the TBA market; because of the varying credit and other risks of private label issues, the market sets prices for those MBSs individually. The prices for TBAs are based on the assumption that the nature of the risks of the GSEs' MBSs is known.

The purpose of the report was to bring Fannie and Freddie's disclosure requirements up to the then level of private label MBS issuances as required by the SEC, where collateral and structural terms sheets together with a prospectus had to be registered with the SEC, unless a specific exemption was sought, subject to Rule 144A (regarding qualified institutional investors). In July 2002, the Treasury, OFHEO and the SEC jointly announced Fannie and Freddie's intention to voluntarily register their common stock under the SEC 1934 Act. This, however, would not apply to disclosure requirements regarding MBSs, which was the point of this report. Therefore the Task Force recommended both enhanced disclosures for private label MBSs, and their application to the GSEs.

In response, on April 1, 2003, Fannie voluntarily began releasing both the weighted average and the quartile loan-to-value ratios, borrowers' credit scores for the loans making up its MBS pools, identifying servicers for the pools, occupancy status of the property, property type (single-family or two-to-four unit dwellings), and the purpose of the mortgage (purchase or refinance). Freddie committed itself to similar disclosures in June 2003. It was not enough to satisfy all market participants, who wanted the points paid by borrowers to be included, together with loan level documentation and borrowers' debt-to-income ratios. Both the Treasury and the SEC wanted such disclosures as well, but, since the basis was voluntary, OFHEO had no means of enforcing them.

Fannie and Freddie saw voluntary disclosure as their solution. They may have overlooked the possibility that, "when voluntary disclosure programs appear to have no harmful effects on secondary market liquidity, on GSE profitability, or on the costs of homeownership, justification for retaining the exemption loses its persuasiveness."³ Perhaps they thought that once their voluntary disclosures were in place, their extensive lobbying machine would take over.

The voluntary disclosures are never enforced. The examinations of Fannie and Freddie did not cover the mortgages they bought and sold as MBSs. Apart from the unswerving belief in the implicit guarantee of Fannie and Freddie's creditworthiness, the notion that, as the report put it, investors could rely on all their documentation and extensive financial reporting, was shattered by their accounting irregularities. If all this information had been available, and if the risks involved in purchasing the GSEs' MBSs were fully revealed, then the purchasers and packagers of the MBSs, followed by the investors and the CDOs would have known what they were. But Fannie and Freddie consistently represented the mortgages they bought as "conforming" mortgages and as being of good quality.

Voluntary registration under the SEC Act, 1934

However, the decision to register voluntarily under the SEC Act of 1934, rather than the 1933 Act, had certain advantages from the point of view of the GSEs. It enabled them to register one class of securities (common stock) without

registering their preferred stock, debt and MBSs. Voluntary regulation also meant that they would not have to face all the SEC's legal requirements. Congressmen Shays and Markey were well aware of the implications and importance of their proposals for legislation, but it often seemed as though some of their colleagues were not; nor were some of the witnesses. They did not win, perhaps partly because of the immediate decision to offer voluntary registration.

The Secondary Mortgage Market Regulation Act, H.R. 2575

Purpose of the bill

On June 25, 2003, Richard Baker introduced another bill to reform and modernize the oversight of Fannie Mae and Freddie Mac, which he introduced by referring to the enhancement of regulatory oversight under the Sarbanes-Oxley Act, following the fall of Arthur Anderson in June 2002. Mr Baker noted that only two Fortune 500 corporations were exempted from the Act, because "they are too well run to worry about. They have set a standard of corporate governance to be emulated by others. And ... we want to make sure we don't throw any out of the opportunity of homeownership."⁴ His frank opening statement shows the problems with Fannie and Freddie: they were exempt from relevant regulatory oversight, a remarkably favorable position, and any criticism of them was immediately construed as a denial of the American dream. He also warned that "if the nation's GSEs were to suffer a financial reversal of a similar scale [to Enron], the systemic consequences are difficult to comprehend."⁵ He was not the only one to warn of the risks of their failure, but all such warnings went unheeded.⁶

The legislation was designed to fulfil only three goals: an independent regulator; proper funding (which meant that the regulator's budget would not be funded through the appropriations process); and ensuring that the regulator had all the necessary tools, as possessed by any other regulator in the financial market place. Of course, Congress, as Richard Baker reminded them, was "directly responsible for their supervision and regulation." The bill was debated at subsequent meetings of the Committee, notably in September 2003.

Lukewarm support from the Administration

H.R. 2575 did not have the full support of the Administration. The Secretary of the Treasury, John Snow, gave testimony at the September 10 hearing, at which he made it clear that the Administration supported a new Federal agency to oversee the activities not just of Fannie Mae and Freddie Mac, but also of the Federal Home Loan Bank System. Its powers should include the execution

of on-site and off-site supervision; the review and rejection of proposals to transfer controlling interests or significant ownership to other parties; the establishment and enforcement of criteria for new lines of business, acquisitions or investments by the GSEs; the ability to supervise consolidated organization; the ability to ensure that the GSEs have adequate measurements, monitoring arrangements and controls over market risk; and the ability to set appropriate capital requirements, together with all the powers and resources required. The duties of the new regulator should reflect the powers it would have. The Administration was prepared to place the new agency within a Cabinet department.

John Snow's testimony was accompanied by that of the Secretary for Housing, Mel Martinez, who stated that the Administration wished to see a new GSE housing authority within HUD to enforce its own housing goals; to introduce civil penalties for its failure to meet housing goals; and explicitly to provide that the GSEs act to increase home ownership. He also referred to expanding HUD's authority to set housing goals and subgoals beyond the current categories. It is at this point that the potential conflict of interests arose, between the persistent and overriding aim of continually increasing home ownership, and the proper regulation of the GSEs.

What crisis?

The response of two members of the House Financial Services Committee was interesting, given that Freddie Mac's accounting difficulties had already come to light, and in the context of the post-Enron era. Barney Frank, who has been a member of the Congressional Financial Services Committee since 1981, and who became its Chairman in 2007 until the Democrats lost control of the House in November 2010, was deeply sceptical of the need for reform. This is what he had to say on September 10, 2003:

I want to begin by saying that I am glad to consider legislation, but I do not consider that we are facing any kind of crisis ... Fannie Mae and Freddie Mac are not in a crisis. We have recently had an accounting problem with Freddie Mac, with people being dismissed ... I do not think at this point that there is a threat to the Treasury. Fannie Mae and Freddie Mac have played a very useful role in helping make housing more affordable both in leveraging the mortgage market ... and they have a mission which this Congress has given them in return for some of the arrangements which enables them to focus on affordable housing and that is what I am concerned about here. I believe that we, as the Federal Government, have probably done too little rather than too much to meet the goals of affordable housing and to set reasonable goals.⁷

Mr Frank had the strong support of Representative Maxine Waters, who stated that she was a member of the Committee, when they enhanced the structure of these GSEs in 1992, to assure the safety and soundness of their housing mission in particular. "However, I have sat through nearly a dozen

hearings when we have tried to fix something that wasn't broke. Housing is the economic engine of our economy, and in no community does this engine need to work more than in mine ... We do not have a crisis at Freddie Mac, and in particular at Fannie Mae, under the outstanding leadership of Mr Frank Raines. Everything in the 1992 Act has worked just fine. In fact the GSEs have exceeded their housing goals. What we need to do today is to fix the regulator, and this must be done in a manner so as not to impede their affordable housing mission, a mission that has seen innovation flourish from desktop writing to 100% loans."⁸

The GSEs' "support" for a strong regulator

The last hearing in 2003 took place on September 25, at which Franklin Raines and George D. Gould (Presiding Director, Freddie Mac) gave evidence. Given the questions about the financial status of Freddie Mac, the focus was inevitably on both the evidence and the responses to issues raised by the Committee from Fannie Mae. In his evidence, Raines gave his full support to the existence of a strong, credible and well-funded regulator, and hence to the Department of the Treasury's plan. He was critical of the proposals of H.R. 2575, arguing that it would "harm the functioning of the housing finance system ... It would make unwise changes in our capital standards. It would impose on Fannie Mae an enforcement and prompt correction regime that is far more harsh than the provisions applicable to any other financial institution. It would force disclosures of proprietary information ... we urge the committee to reject H.R. 2575 in its current form ... We believe policy makers will find consensus around the approach outlined by Secretary Snow."⁹

None of the somewhat sweeping assertions made in his testimony were seriously questioned by members of the Committee. One or two issues came to the fore and are valuable in terms of the insight they give into Fannie Mae's practices. Raines strongly opposed prior approval of programs and products, and the reasons for this are clear in his reply to a question from the Chairman (Michael Oxley):

"This committee may be faced with an issue as early as next week in terms of the mark-up and trying to determine how we deal with the program approval, at the same time dealing with the safety and soundness, because ... the Treasury proposal is very heavily tilted towards Treasury ... but the other issue in terms of programs is still kind of out there. From your perspective, and having experience in that area, what would you suggest?" Mr Raines replied, "Our focus in discussions with them (the Treasury) and others has been more on what the decision-making criteria are. And within the context of the Treasury discussions, they have indicated to us that they believe that a prior approval regime isn't necessary at all ... And that has some attractive features obviously from the point of view of innovation. However, we have also been talking to a

wide range of our friends in the housing industry who have a very substantial concern that putting together the approval of our new program activities with the safety and soundness regulator might have a detrimental impact on housing. And we share a lot of those concerns ... The most important issue is that there be a standard that encourages innovation and that we not ignore that fact that it has been through innovation that we have been able to serve more and more people. It is not from just doing that same plain vanilla 30-year fixed mortgage that we started doing in 1938. It is by having new programs with low down payments and with the ability to deal with people with impaired credit and other innovations that have really allowed us to expand affordable housing.”¹⁰

Mr Raines was, of course, correct in arguing that it was only through such “innovations” as disregarding credit history and requiring low down payments that more mortgages could be offered and home ownership extended, especially to those on low or very low incomes. It comes as no surprise that he wanted such approvals (if they were imposed on him) to be quite separate from “safety and soundness” issues when the kind of mortgage products Fannie Mae and Freddie Mac bought, were precisely those which would impact most on the capital required to cover the risks. Their “friends in the housing industry” would naturally be concerned if they would then find it difficult or even impossible to sell their “innovative” loans to the GSEs.

Another bill bites the dust

The bill, however, was too weak to attract the support of the Administration, so that, contrary to Chairman Oxley’s hopes, it did not receive a “mark-up” (that is, a reference back to the full Committee for approval, often with amendments and changes to it). The bill simply died in Committee.¹¹ The debates in the hearings show that H.R. 2575 was weaker than the Administration’s proposals, so attention turned to the Senate in early 2004.

Federal Enterprise Regulatory Reform Act, S. 1508

Purpose of the bill

Another bill had been introduced in the Committee on Banking, Housing and Urban Affairs on October 16, 2003 by Senator Hagel, together with Senators Sununu and Dole. This was the Federal Enterprise Regulatory Reform Act, S. 1508. In introducing it, Senator Hagel set out the principles contained in his bill and the Administration’s proposals:

The new regulator at the Treasury Department must have the authority to approve new programs and ensure that Fannie and Freddie continue to focus on their core missions as defined and established by the Congress of the United States.

Second, an effective regulator must have broad authority over capital standards and the ability to adjust them as appropriate to balance risk and ensure safety and soundness.

The Committee held a further four hearings, and called a wide range of witnesses as well as the key players: Secretary John Snow; Secretary for Housing, Mel Martinez; Alan Greenspan;¹² Franklin D. Raines, CEO Fannie Mae; George D. Gould, Presiding Director, Freddie Mac; Norman Rice, President and CEO, Federal Home Loan Bank of Seattle; John Korsmo, Federal Housing Finance Board; Armando Falcon, Jr, OFHEO; Douglas Holtz-Eakin, Director, Congressional Budget Office; and representatives of the various bankers' organisations and other financial services regulatory bodies, sometimes on more than one occasion. Fannie Mae, in particular, and Freddie Mac held to the positions on proposed legislation that they had spelt out in the Congressional hearings, with the only difference being that questioning was somewhat more rigorous in those of the Senate.

An awkward passage

The bill was reported from the Committee on April 1, 2004, but on March 26, Chairman Shelby of the Senate Banking Committee released a draft bill which was offered as a substitute for S. 1508 during the mark-up. This bill was designed to create a new independent regulator for Fannie, Freddie and the FHLB System, who would be responsible for safety and soundness and the housing mission. The new regulator under the bill would have the power to alter the GSEs' minimum and risk-based capital requirements, and prior approval authority over new lines of business the enterprises wished to undertake. Over 30 amendments were debated during the Committee's deliberations. Shelby's bill contained a proposal to give the director of the regulatory authority power to appoint a receiver for any GSE which failed; this proved to be controversial and Senator Bob Bennett's amendment, which Shelby accepted in exchange for his vote, gave Congress the power of veto. Some members of the Committee regarded the amendment as being designed to confirm the belief in the implicit federal guarantee. The final version was passed by the Senate Committee with several amendments on a 12-9 vote, showing a split along party lines with one Democrat, Senator Zeil Miller, voting with the Republicans.

On the following day, the Secretaries of the Treasury and HUD issued a joint statement of opposition to the revised version of S. 1508. Their statement referred to an amendment adopted in the mark-up, which would allow Congress to overrule the regulator's decision to appoint a receiver. They characterized this amendment as one which would significantly weaken "a core power needed for a strong regulator," which would be likely to "reinforce a false impression" that the GSEs have a government guarantee.

(Under the amendment, Congress would have 45 days after the appointment of a receiver to pass a joint resolution of disapproval.) Not only would it weaken the regulator, but if such circumstances arose, a delay of 45 days would no doubt have disastrous effects.¹³

This in itself made it more difficult to move the bill forward to a full floor vote, especially since, at that time, the Senate had 51 Republicans, 48 Democrats and 1 Independent. After the Committee's decision, Shelby issued a prepared statement in which he said, "I supported the receivership compromise and many other provisions adopted today, in the hopes of putting together a package that might attract support from across the aisle. I will not support such a compromise in the future. I do not believe that the receivership provisions that the committee has adopted today provide a workable solution for resolving a GSE crisis."

Fannie on the attack

Senator Shelby was also aware that the kind of campaign which Fannie Mae, in particular, would continue to wage against any changes in the regulation of the GSEs had already begun the previous day. A widely reported advertisement appeared on TV, featuring a worried-looking Hispanic couple:

MAN: "Uh-oh."

WOMAN: "What?"

MAN: "It looks like Congress is talking about new regulations for Fannie Mae."

WOMAN: "Will that keep us from getting that lower mortgage rate?"

MAN: "Some economists say rates may go up."

WOMAN: "But that could mean we won't be able to afford the new house."

MAN: "I know."

Senator Hagel was shocked. "Here is an organization that was created by the Congress ... spending money questioning the Congress's right to take a serious look at oversight," he said during the April 1 hearing. "I find it astounding. Astounding!"¹⁴ Such an advertisement was typical of the tactics which Fannie Mae adopted whenever they thought it necessary. They continually stressed the importance of their role in the housing markets in their public statements, and through the statements that they persuaded various associations to make on their behalf, given that these associations had benefitted from the ever-expanding housing markets and from their relationships with the GSEs, which the latter had carefully cultivated over the years. Later that year, Raines was to find that he had won a battle, but not the war; he had not taken sufficient note

of the many voices which had began to criticize Fannie Mae's activities, ranging from those of OFHEO, the Treasury, the Council of Economic Advisers, and the Office of Management and Budget, and still less of the post-Enron context, one in which the Bush Administration did not want to see any further scandals and in which Freddie Mac had already raised anxieties about the extent of accounting malpractices.

Accounting irregularities at Freddie Mac

The accounting scandals of 2001 and 2002 led to the collapse of two of America's largest companies: Enron in December, 2001 and Worldcom in July, 2002. Both Senate and Congress held a large number of hearings regarding the accounting practices that led to their collapse; by July 30, 2002 they had passed the Sarbanes-Oxley Act, designed to enhance corporate governance and strengthen corporate accountability by requiring full transparency. Attention turned to Freddie Mac, partly because the GSE had had the same auditors as Enron, Arthur Andersen, a defunct firm by then, Freddie Mac replaced them with PricewaterhouseCoopers.

Freddie announces the restatement of its earnings

Anxieties were aroused, however, when Freddie Mac announced on January 22, 2003 that it would have to restate its earnings for 2002, 2001 and possibly 2000, because of a change in accounting for certain derivative transactions. Freddie Mac also announced that it would delay its planned issuance of euro-denominated bonds until after it had published its unaudited earning figures for 2002 on January 27, which it expected to be at a record level. The SEC, with its new powers over Fannie Mae and Freddie Mac, would be likely to investigate, and OFHEO was considering restating Freddie's capital adequacy for the third quarter. OFHEO had just declared that both companies met the minimum risk-based capital requirements as of September 30, 2002, with Freddie Mac being better able to withstand severe economic shocks. The initial shock led to a fall in the value of Freddie Mac's shares, dropping \$2.30 to close at \$61.60 (a 3.5% decline), but Standard & Poor's Ratings Services affirmed all of its ratings in the light of the announcement, stating that the AAA/A-1+ unsecured debt senior ratings on Freddie Mac reflected the "implied government support for the securities of this government-sponsored enterprise (GSE), as elaborated in its charter and governing legislation. The rating agency pointed out that the AA- subordinated debt, preferred stock and risk-to-government ratings are based on an analysis of the company's financial strength and the operating benefits it received as a GSE."

Top management goes

The first announcement was followed on June 9, 2003 by a more significant announcement by the Board of Directors that the President and Chief Operating Officer had been sacked; that the Chairman and CEO had retired; and that the Chief Financial Officer had also resigned (it transpired in a later press release that Brendsel had retired at the request of Freddie Mac). New appointments were announced: Gregory J. Parseghian as Chief Executive Officer and President; Paul Peterson as Chief Operating Officer; Martin Baumann as Chief Financial Officer; and Shaun O'Malley being elected by the Board of Directors as non-executive Chairman of the Board. The same press release stated that David Glenn had been sacked "because of serious questions as to the timeliness and completeness of his co-operation with the Board's Audit Committee counsel, retained in January 2003 to review the facts and circumstances surrounding the principal accounting errors identified in the accounting process." The Dow Jones Newsletter reported that Vaughn Clarke had been asked to resign "due to questions about his honesty to the company's Audit Committee counsel." It also reported that the share price fell with the news, to \$50.60, down 15% or \$9.20 on the Friday close.¹⁵

OFHEO stumbles

Unfortunately for OFHEO, it released its annual report to Congress on June 4, the very day that Freddie Mac's alleged employee misconduct came to light. In the course of the report, OFHEO stated that it considered a "re-audit and delay in 2002's statements is prudent and appropriate under the circumstances ... In addition, management and its board of directors initiated efforts in 2002 to enhance the expertise and controls in the areas of financial accounting and operational control ... We remain satisfied that the Board of Directors and executive management are taking appropriate action."¹⁶ A few days later, OFHEO announced its special examination, which was eventually published in December 2003.

At the same time, Freddie Mac announced that it expected to delay its restated earnings, probably until the third quarter from the previously stated second quarter, but that the likely cumulative effect would be to "materially" increase reported earnings for the earlier periods and "materially" increase the company's capital surplus under OFHEO's minimum capital requirements as at the end of 2002. Freddie also said it expected that there may be significant volatility in quarterly earnings for those periods. Adjustments affecting its income would relate to changes in the timing of income recognition; and, as a result, cumulative increases related to adjustments would have offsetting effects in future periods, which may be accompanied by increased volatility.¹⁷ Freddie Mac released a more detailed statement later the same month, in which they

indicated that the restatement would mean the statement of retained earnings as of December 31, 2002 would be in the range of \$1.5bn to \$4.5bn. In the event, it turned out to be \$5.5bn. The increase was due to gains on certain derivatives and mortgage retained earnings marked to fair value during periods in which interest rates were falling.

The new CEO, Gregory Parseghian, announced that “the new management team of Freddie Mac, working closely with our Board of Directors, is determined to set high standards for candor and transparency in our financial reporting. Our investors and the public should expect and demand nothing else ... At the same time we remain focused on our business and our mission.”¹⁸ He was also determined to get the message across to the public, so once again the GSE practice of advertising was adopted, this time in major newspapers. The advertisements took the form of an open letter from the new CEO, referring to the “skilled and energetic” new management team, installed by the Board of Directors, which was working with outside auditors to quickly complete the company’s restatement of its financial results for 2000–2002.¹⁹

But by August 21, 2003, OFHEO recommended that Parseghian should be fired, since as the previous Director of the Funding and Investment Division, he had been involved in the accounting problems. He was removed by the Board and replaced in December, 2003 by Richard Syron, former President of the Boston Federal Reserve Bank.²⁰

Much more to Freddie’s problems than met the eye

The view is sometimes expressed that the accounting irregularities, involving complex rules for accounting for derivatives, rules sometimes regarded as being controversial, in that they involve mark-to-market accounting, were not so serious as to threaten what many saw as the vital role played by Freddie Mac (and Fannie Mae) in enabling those on low-to-moderate incomes, as well as those on very low incomes, to own their own homes.

In fact, the extremely detailed and thorough report produced by OFHEO in December 2003 showed that the “accounting irregularities” were much more than that. Accounting procedures and practices were entirely focused on “earnings management” to such an extent that they were not in any way designed to provide a “true and fair” picture of the company, but instead distorted every aspect of its management. The OFHEO report describes the activities of what was once known as “Steady Freddie,” the image which the company promoted of itself in the early 1990s, a company with strong and steady growth in profits. That led to a corporate culture which made its priority one of meeting those obligations. “Freddie Mac cast aside accounting rules, internal controls, disclosure standards, and public trust in the pursuit of steady earnings growth. The conduct and intentions of the Enterprise were hidden and were revealed only by a chain of events that began when Freddie changed

auditors in 2002.”²¹ The executive summary provides key examples of the manipulation of transactions in order to smooth out the volatility of earnings. They were as follows:

- Management executed several interest rate swap transactions that moved \$400m in operating earnings from 2001 to later years. These transactions had virtually no other purpose than management of earnings, specifically, making operational results appear to be less volatile than they were.
- Management created an essentially fictional transaction with a securities firm to move approximately \$30bn of mortgage assets from a trading account to an available-for-sale account. Other than to reduce potential earnings volatility, the transaction had no other meaningful purpose.
- From 1998–2002, management purposefully kept loan loss reserves at an unusually high level by using aggressive assumptions, even though both actual and foreseeable credit losses were rapidly declining. Both management and the Board of Directors were aware that the Securities and Exchange Commission had criticized that practice as an inappropriate form of earnings management.

These examples show that the whole thrust was to manipulate earnings, and was not due to the difficulties of accounting for derivatives or any difficulties that might have arisen from implementation of the Statement of Financial Accounting Standards 133 (FAS 135). “The management of the Enterprise went to extraordinary lengths to transact around FAS 133 and to push the edge of the GAAP envelope.”²²

Current and former staff members describe what really went on

The interviews with staff and the examination of documents (including emails and tapes) contained in the OFHEO report are illuminating, in that they show the full extent of the deep and persistent faults with the entire conduct of business at Freddie Mac over a decade. The report notes that the use of inappropriate accounting strategies began in 1994, when the Enterprise established a \$200m reserve account to cushion itself against the fluctuations caused by the unpredictable amortization of premium resulting from mortgage prepayment speeds. This policy of an FAS 91 reserve was continued until 2002, and then against FAS 133.²³ But senior management and the Board believed that conformity to these standards gave a “distorted impression of the financial performance of Freddie Mac.”²⁴ Worse than that, of course, application of the standards could reduce their earnings.

The first step in the process was to meet the expectations of the Wall Street analysts, which was apparently the main responsibility of Vaughn

Clarke, Freddie Mac's Chief Finance Officer. This was explained in OFHEO's interviews with employees of Freddie Mac, such as the Corporate Controller, Mr E. Sannini:

"There was an objective to try to get as close to the analysts' estimates ... forecasts as possible ... [this] came in communications to me primarily from Vaughn Clarke," and more particularly in the Deputy Corporate Controller, Lisa Roberts' statements:

[The issue of meeting analysts' expectations] would be discussed in terms of communicating either Shareholder Relations or Vaughn would inform the group of where the expectation happened to be at that point given the information available to the company. The company would track and monitor where the analysts were expecting the company to come out for a particular quarter, so that knowledge typically was being evaluated and monitored by Shareholder Relations and Vaughn as an individual. So he would come to the table with that ... The purpose of providing that information was if the Funding and Investments Division needed to execute a transaction in order to meet that expectation, those types of strategies, alternatives and options were discussed. On the other hand, Vaughn waited to see actually what business activity had been executed for the month and wanted to look at where the results were coming in, and then based on where the results were coming in compared to where he felt the street expectations were, the options and alternatives were discussed.²⁵

All of this was being carried out with a serious lack of resources, including the lack of sufficient and skilled staff. Lisa Roberts in her interview stated that "during the past five years (with the exception of 2002), management maintained roughly the same number of resources within the Corporate Accounting Department and the decentralized accounting units. During this time ... we increased the complexity of our products and strained our operating systems. In addition to a steady stream of new products and transactions, management was also challenged by a number of major events including the conversion of the general ledger ... the implementation of compliant systems (in preparation for Y2K) and the adoption of major accounting principles such as FAS 133 and 140. These challenges redirected key resource and management focus from the baseline operation to the issue at hand and further challenged the remaining resources to maintain the control structure." In 1996, Corporate Accounting still managed the entire portfolio accounting process on Excel spreadsheets, and it was not until 2000 that a more robust Treasury accounting system was introduced.

It was all about earnings management

It is worth noting in further detail the lengths to which the senior management were prepared to go in order to preserve the impression of a steady stream of earnings, especially in 2000. Mr Parseghian (briefly CEO of Freddie Mac in 2003) stated that the management knew the derivatives gain would be substantial,

but that the gain would have “detracted from future period earnings;” that is, a transition adjustment from a large derivatives gain in the first quarter of 2001 would be much less desirable than having the same amount of earnings spread out over several quarters. David Glenn’s diaries showed that management had been working on such a plan for some time, and that it had been extensively discussed with the Funding and Investments Division. The plan anticipated an exchange of \$10bn to \$15bn of PCs (participation certificates in a pool of mortgages) with embedded losses in the retained portfolio for a Giant (Coupon Trade-up Giants, or CTUGs). The purpose of this transaction was to move securities with embedded losses from the held-to-maturity category (where losses are unrecognized) into trading (where losses would be immediately recognized in net income and would offset derivative gains) and then into available-for-sale, where securities gains and losses only hit “other comprehensive income,” not “net income.”

But in November and December 2000, interest rates were falling rapidly, leading to increased market values for PCs in Freddie Mac’s portfolio. The losses were now too small, bringing the total amount of PCs to be exchanged up to about \$30bn. In addition, the market value of the options-based portfolio was still too high and the management wanted that to be reduced by the losses created by the CTUG transaction. The PCs had been converted into Giants by Freddie Mac when this should have been carried out by the securitization group at the Enterprise instead of by Salomon Smith Barney. An additional problem was that Salomon Smith Barney only held the securities for a few hours before retuning them to Freddie Mac.

When Freddie Mac carried out the transaction in 2001, management did not obtain a legal opinion, because the external counsel considered that “the transaction would fall under the umbrella of the comprehensive legal letter written in connection with the Giant sales in general.” This was because “the transaction was considered to be a typical Giant sale from an operational standpoint.” It was, however, not only a very large transaction (\$30bn), but, as PricewaterhouseCoopers ascertained in 2003, the PCs were not actually sent to Salomon Smith Barney, cash did not move from the firm to the Enterprise and back again, and no fee was paid by Salomon to the Enterprise; instead, Freddie paid Salomon a fee on the transaction.²⁶

The ostensible purpose was to stabilize the earnings flow, but that was not the only reason. As OFHEO put it, “the CTUGs are an example of a transaction with little or no economic substance that Freddie Mac manufactured to obtain a particular accounting result.”²⁷ That was not the only problem. Operational risks were created by the transaction, including the fact that CTUGs contributed to the Guaranteed Mortgage Securities (GMS) reconciliation problem in 2001. This was presented to the Audit Committee in December 2001.

The Report then turned to the issue of executive compensation, especially when linked to earnings per share, and concluded that this certainly contributed

to the improper accounting and management practices at Freddie Mac. Compensation of executive officers had three key components: a base salary, an annual cash bonus, and a long-term stock incentive (stock options and restricted stock), according to the Charter, which required that a “significant portion of potential compensation” should be based on the performance of the Corporation.²⁸ About 54% of the total cash pay (salaries, bonuses and other compensation) to executive officers was based on performance. The practice was to set a “target bonus” incentive for each executive, a percentage of the salary at the beginning of each year. The target bonuses were known as the “bonus pool” and then Freddie Mac used a corporate score card to assess how much was in the bonus pool, depending on profitability, core capabilities and strategic positioning, but which ensured that the bonus funding percentage was above plan or on plan. It was always on plan at least, but the way in which the plan and the score card were structured meant that all executive officers had an interest in achieving the bonus plan, since a substantial part of their earnings depended on it. The way in which the whole process was managed, especially to the benefit of David Glenn and Leland Brendsel, is described in detail in the OFHEO report.²⁹

The key point, however, is to see just how many transactions Freddie Mac initiated in order to shift and smooth its reported earnings. The report refers to various derivative transactions, including a pair of linked swaps, which were executed in order to move large amounts of operating income into the future.³⁰ In August 2001, Freddie Mac entered into eight pairs of swaps, each of which had a notional amount of \$5bn, resulting in a total notional value of \$80bn for the eight pairs. In September, the Enterprise entered into the ninth pair of swaps; this time they were leveraged swaps with a notional value of \$5bn, but with the leverage factor of five, they had the same effect as swaps with a notional value of \$100bn.

Morgan Stanley also entered into linked swaps with Freddie Mac, but because the terms of the two swaps substantially offset each other, the transactions did not pose any real risk for them. One such conversation is included in the text of the report. A Freddie Mac employee, Mr Powers, called Morgan Stanley to get pricing for one of these swaps and, since it was an unusual request, Brendan Lavelle, who had to approve such transactions, spoke to Mr Powers:

MR LAVELLE (MORGAN STANLEY): “We’ve been trained whenever people come in and start doing this kind of stuff, we gotta ask why. Like not why but like, everything’s ... I don’t want to be taken off in handcuffs here for doing something that’s not kosher.”

MR POWERS (FREDDIE MAC): “How much are you making off this trade? [*Laughs*]”

MR LAVELLE: “I don’t know.”

MR POWERS: “You haven’t even looked at it. [*Laughs*]”

MR LAVELLE: “I’m just ... You know what I’m saying ... I mean, I don’t mind if there’s an accounting reason for you to do this and it makes you guys money. That’s fine. You know we’re OK with it.”

MR POWERS: “That’s where we are. We have an accounting reason for doing it. And, um, we’re basically ... we’re offsetting some ...”

MR LAVELLE: “I mean you could tell me that there’s some asset liability reasons for you doing this, and I’m OK with that.”

MR POWERS: “Yeah, I think that’s as much as I’d ... I don’t want to tell you ...”

MR LAVELLE: “I don’t want to be taken into the courtroom, though, Ray, is what I’m saying OK?”

MR POWERS: “Yeah ... No, no, no. This is not ... This is basically an asset liability, cash flow management issue.”

MR LAVELLE: “OK, I’m with you.”

MR POWERS: “The thing is ... because of the shape of the curve, um, the geography of our carry in terms of the calendar gets screwed up. So all of a sudden, we have an uneven carry picture to manage and we strive for stability.”

MR LAVELLE: “What you’re trying to do is, yeah, you’re evening out the cash flow.”

MR POWERS: “Exactly.”

MR LAVELLE: “OK. Alright, I’m with you.”

MR POWERS: “Otherwise, like we have all of our portfolios, our 30-year portfolios with all the carry in this year.”

MR LAVELLE: “If that’s what you want to do, I’m, we’re OK with that and we’re happy to do it with you, so we can do a lot of this if you want.”³¹

OFHEO comments that Mr Lavelle seems to propose a business purpose to his customer, and once the customer agrees with that, Mr Lavelle approves the deal. Mr Wong, an operations officer with compliance responsibilities, at Morgan Stanley advised against any further trades of this kind when it came to his attention; Morgan Stanley decided to handle the situation by pricing the

transaction unattractively when Mr Powers requested similar trades. It appears that Morgan Stanley was not the only one who was willing to enter into such arrangements. Other examples are given in the report, and the value of such deals in fee income is recorded there. The Salomon Smith Barney deal was approximately \$4.7m for receiving Giant securities, holding them for under three hours and then returning them to Freddie Mac, at virtually no risk to themselves, so that Freddie Mac could place them in the 'available for sale' portfolio, which would not be marked to market.

Blaylock and Partners, a small broker-dealer, acted as an intermediary as well for at least ten trades between 2000 and 2001, where the securities went from the Securities Sales & Trading Group (SS&TG) of the Enterprise to the retained portfolio. Charles Foster, then Vice President of the SS&TG, said that the Blaylock trades were "relatively large for an entity of that size in terms of the capitalization of that company." He explained to OFHEO that the trades were done at the request of the Funding and Investment division, because the SS&TG had mortgage securities in their inventory that were either about to pass through a 30-day window (beyond which SS&TG could no longer sell the securities to Funding and Investment), or were already beyond their 30-day window. He recalled a discussion taking place about whether they could take those assets and sell them to a particular counterparty from whom the retained portfolio could later repurchase them. He was also advised by a colleague in Funding and Investment that Blaylock was not highly capitalized and was therefore a credit risk. The result was that approximately \$572m in mortgage-backed securities that had been held for longer than 30 days by SS&TG were sold to Funding and Investment, and Blaylock's commission part of those transactions was 0.25%.³² By October 2004, Richard Syron had announced that the Securities, Sales & Trading Group would be dismantled, accepting the criticisms that the group added to the GSE's risk and profits without making a contribution to further its mission. Freddie Mac would be a less active trader of MBSs. It would purchase MBSs only to retain in its own portfolio and not for trading accounts. It would not deal with the group of relatively small broker-dealers as it had done in the past.

A total failure of governance

The OFHEO report identified the widespread weaknesses in accounting in terms of staffing, skills and resources. The acute shortage of accounting staff, the inadequacies of successive Chief Financial Officers and Controllers, and the outdated or non-existent accounting policies and manuals between 1991 and 2003 are fully documented. John Gibbons, CFO until March 2000, lacked the skills for that position. He was replaced by Mr Vaughn Clarke, "who had even fewer skills, and hoped he would grow into the job." He was appointed as CFO by default, since Freddie Mac, after extensive searches, failed to find anyone else.

Before he left the company, Mr Gibbons told Mr Brendsel that a fully qualified Deputy Controller should be hired, but the Chairman insisted on appointing Mr Brian Green as deputy in August, 2000. He was already in the company, but Mr Gibbons assessed him as a “person who was not a senior executive ... but back to an entry-level type.” This led to an excessive reliance on Arthur Andersen even for basic accounting functions and decisions, which meant that the firm was auditing its own work.³³

As has been pointed out, the problems at Freddie Mac went much deeper than “accounting irregularities” or difficulties in applying complex accounting standards to derivatives, but from the evidence set out in the report, it appears that the GSE did not organize its affairs with due skill, care and diligence, or indeed control them effectively. For example, it did not ensure that there were senior managers and directors who were able to carry out their roles in a proper manner; nor did they set the right “tone at the top”, instead involving every aspect of company in the drive for steady mid-teens growth, whatever the circumstances, with a view to the bonuses that executive staff would receive. That this was the case is shown also in the weakness of the internal audit function.

However, internal audit also failed to meet its own principles and purposes, namely, to “add value and improve the operations of an organization by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and the governance process.”³⁴

OFHEO found significant weaknesses in three areas, including its failure to evaluate the Enterprise’s risk exposures, due largely to its failure to take responsibility for the reliability and integrity of financial information. Internal audit failed to ensure that adequate systems and controls were maintained, or to follow up on any actions agreed with the board and senior management. In fact, the internal audit department did nothing beyond reviewing whether or not corrective action had taken place. In response to their reports back to management, management may well have “reset the target completion date based upon priorities or reduced the seriousness of the issue from a major to another because they have partially remediated it and that may have taken it off our screen.”³⁵ OFHEO records that internal audit had identified significant weaknesses in eight areas, dating from 1996: these included multi-family accounting and support; corporate information quality; financial reporting; derivatives and hedging instruments; financial forecasting; SS&TG sales, trading and operations; and corporate management and control systems. Because of endless extensions, none of the target dates were ever met and all of the issues were still outstanding by the time the report was completed in 2003. Alongside internal audit, Freddie Mac had another system, designed to cover every functional area of the organization, called Management Assessment, Risk and Controls (MARC) reports, but this system was very expensive and cumbersome, according to Melvin Kann. The MARC reports

did not at any rate comply with IIA risk management or control performance standards.

The Board of Freddie Mac

So far the role of the Board has not been mentioned. According to the Charter, the Board consisted of 18 members, five of whom were Presidential appointees. The latter were appointed for one year and the average period served by the political appointees was 14.6 months between May 1998 and May 2003; since 1990, none of them had ever chaired a permanent Board committee. Clearly in the time spent in the appointment, the initial months would be taken up by understanding the business of a complex company. Of the remainder, three were executive officers and the others were elected by the shareholders, most of whom had been elected in 1990, when the shares of Freddie Mac were first publicly traded. In late 1989 and early 1990, CEO Brendsel recruited the Board within 60 days, “promising prospective board members that Freddie Mac would not make much demand on their time.”³⁶

The shareholder-elected directors expected to remain on the Board until they reached the mandatory retirement age.³⁷ In fact there was hardly any turnover. Until May 2001, 11 of the original 13 shareholder-elected directors were still on the Board, ten of the original directors until December 2002, and then nine until from 1990 until Messrs Brendsel and Glenn left abruptly in June 2003. Leland Brendsel served as Chairman and CEO continuously until 2003, and David Glenn was a member until he was appointed as Vice Chairman in 2000.

The issue of corporate governance

OFHEO published its first guidance to the Board in 2000 and strengthened its requirements in 2002. Given the extensive discussion of the late 1990s on improving corporate governance, the guidelines issued in 2000 and again in 2002 do not seem to place sufficient emphasis on the key features of those developments. For example, given the SEC’s experience in the late 1990s, with enforcement actions involving financial misstatement or fraud, which involved bringing about 100 cases per year, including 30 cases in just one day in September 1999, OFHEO should have been aware, and its guidance published in 2000 should have reflected that.³⁸ Following a recommendation by Arthur Levitt, then Chairman of the SEC in 1998, the Blue Ribbon Committee produced its Report and Recommendations on “Improving the effectiveness of the corporate audit committees” in 1999. This was followed by regulations set out by the SEC, New York Stock Exchange and NASDAQ

in December of that year, as well as the American Institute of Certified Public Accountants. CalPERS had also published a wider ranging series of recommendations on US Corporate Governance principles and guidance in 1998. Its stress was on the independence of directors and the Board's leadership of the company.³⁹

Neither Freddie Mae nor Fannie Mac were subject to SEC regulations, but given the context in which such developments were taking place, OFHEO should have demanded more from the Board and more closely examined its financial statements. It refers to "working with the management" to establish the strategy and goals and to "oversee the development of strategies," and to "being provided with accurate information about the operations and financial condition of the Enterprise in a timely fashion."⁴⁰ Its 2002 statement was stronger, but already late. OFHEO could, as the regulator, have required Freddie Mac and Fannie Mae to conform to the general principles as set out by the SEC following the Blue Ribbon report.

Given the fact that the majority of directors and the Chairman and the Chief Operating Officer had worked together for so long, the chances of the Board acting independently were remote indeed. Board meetings were rushed, but this was in part because from the start, Leland Brendsel had only allowed for five full Board meetings a year, with one held together with the annual meeting of shareholders, and one held at the end of every quarter, as well as committee meetings. And that was not the only problem. The directors were aware that the executive management tightly controlled the flow on information to the Board, even to the extent that the executives due to give a presentation to the Board were subjected to a "dry run." The Chairman and the Vice Chairman together with the General Counsel reviewed the presentations prepared by senior management, and made "binding decisions" about what information should be included in the presentations and any other information given to the Board. In addition, it was known that reports of internal audit went to the Chairman instead of being reported directly to the Audit Committee, since the General Auditor also went through the "dry run" process.

Even so, by September 2000 the General Auditor was able to convey to the Audit Committee that there were major weaknesses in various aspects of the GSE's financial reporting systems. These included system and data integrity in debt and derivative accounting; staff and skill shortages; account reconciliation issues; outdated accounting policy issues; the lack of sufficient financial reporting standards and performance objectives in the decentralized account units; the lack of an effective process within corporate accounting to react promptly to new transactions; a labor-intensive financial reporting process; and little time allowed in the reporting deadlines for preventative and early detection controls.⁴¹ The then Chairman of the Audit Committee, Mr Palmer, insisted on a report to the full Board, and that progress should be reported on putting these matters right, but a further 18 months passed before the Board

finally exercised its authority and agreed that 25% of the bonuses for 2002 would be tied to the successful resolution of these issues.⁴²

More Congressional hearings on Freddie Mac

House Subcommittee on Commerce, Trade and Consumer Protection

Further hearings were held by Congressional committees. These included the presentation of the Doty report, commissioned by the Board of Freddie Mac, to the House Subcommittee on Commerce, Trade and Consumer Protection, on September 25, 2003.⁴³ The report described the way in which Doty stated that the company “transacted around” FAS 133 because the company believed that “it did not reflect the economic fundamentals of the company’s business.”⁴⁴ It also “found weaknesses in the company’s internal compliance and governance processes, disclosure practices that fell well below the standards required of a public company, weaknesses in corporate accounting that resulted in excessive reliance on independent auditors.”⁴⁵ The OFHEO report both echoes and develops some of these criticisms, but it clearly found the Doty report to be inadequate and noted this in the Congressional hearing on January 21, when Mr Falcon, Director of OFHEO, stated that the “law firm’s cooperation and disclosures ... were inadequate.”⁴⁶

A much more robust view of the findings of the Doty report is contained in Professor Baruch Lev’s prepared statement to the hearing, concerning what is missing from the report and summing up Freddie Mac’s attitude to financial accounting as, “If it complies with GAAP, it’s fine.” Professor Lev commented that the attitude of the former management of Freddie Mac towards financial reporting seems to be well-represented by Mr Parseghian, briefly Chief Executive of Freddie Mac.

“Parseghian has acknowledged that he was well aware of the use of reserves to meet earnings goals, but he understood that these reserves were being managed consistent with GAAP”. Thus according to Parseghian’s view, “financial information can be ‘managed’ by elaborate devices aimed at making investors believe that the company’s performance is different from reality ... as long as the scheme is within the wide latitude allowed by GAAP ... What users of financial reports need is information that *complies with reality*. They need to be assured that the financial reports portray a truthful and unbiased picture of the company’s real earnings, assets and liabilities.”⁴⁷

That is the purpose of financial reports, but instead Freddie Mac wanted to provide investors with a particular view of its earnings for their own purposes. Professor Lev also rejected the Doty report’s claim that the accounting irregularities were merely “blunders.”⁴⁸ They were designed to “portray a steady growth of earnings; to eliminate reported volatility to meet analysts’ forecasts; to hide

large gains until ‘needed’ in the future and so on.” They constituted the “climate of manipulation and intrigue which must have permeated Freddie Mac.”

Professor Lev was very dismissive of the Doty report, which claimed that Freddie Mac “just” wanted to portray reality. The report concluded that Freddie Mac sought to avoid any disclosure that would require subsequent explanation or lead investors to any conclusion other than the one management believed reflected the economics of the companies’ business. Professor Lev found that much of the evidence from witness statements and documents supported the conclusions he had drawn from their report, rather than their conclusions, which he regarded as glossing over their own evidence.

The tone of the subcommittee on Commerce, Trade and Consumer Protection was quite different from that of the House Financial Services Committee, where there were many supporters of Fannie Mae and Freddie Mac. They focussed on cross-examining Professor Lev and to a lesser extent James Doty, about “certain accounting matters,”⁴⁹ the implications for Freddie Mac and indeed for GAAP generally. Only one voice expressed the kind of support for Freddie Mac often found amongst members of Congress. Representative Hilda Solis in her written statement said, “We must not allow the reported accounting irregularities at Freddie Mac to obscure the important role the housing GSEs play in making affordable mortgage lending available to communities across the USA.” Commitment to the affordable housing ideology led too many to want to ignore failings of the housing GSEs, which they certainly would not have tolerated in any private company.

Regulating the GSEs

Here the issues being discussed were the hearing on the Views of the Department of the Treasury on the regulation of the GSEs on September 10, 2003; and the hearing on H.R. 2575, the Secondary Mortgage Market Enterprises Regulatory Improvement Act and the Administration’s proposals for Reform, September 2003. These hearings on reforming the regulation of the GSEs have already been discussed, but it is worth noting that the committee was divided on the significance of Freddie Mac’s June announcement of the departure of three of its top executives, and that there would be a further delay of its long-promised restatement of its financial results for three years.

Both the Chairman and other members of the Committee, such as Congressman Christopher Shays, saw the events as requiring a reform of the regulation of the GSEs which others such as Barney Frank and Maxine Waters rejected. On September 10, 2003, Barney Frank stated that “the two government enterprises we are talking about here, Fannie Mae and Freddie Mac, are not in a crisis. We have recently had an accounting problem with Freddie Mac that has led to people being dismissed, as appears to be appropriate. I do not think at this point there is a problem with a threat to the Treasury.” Maxine Waters

insisted on September 25, 2003, “we do not have a crisis at Freddie Mac ... nothing in the concerns at Freddie Mac had to do with their capital.”

At the hearing on the OFHEO report on January 21, 2004, the Committee heard the witness statements of the Director of OFHEO, Armando Falcon and Martin Baumann, the newly appointed Chief Financial Officer of Freddie Mac. Falcon, as OFHEO Director, came in for criticism for only responding after Freddie Mac’s announcement of the earnings statement, which only came to light with the change of auditor. This complaint was from the Committee which had over the years refused to increase the annual appropriation for OFHEO’s budget. Most members of the Committee were relieved as they concluded that Martin Baumann would be able to bring about the necessary changes. He stated, “We are implementing a corporate-wide remediation program to ensure that the accounting of financial control issues that led to the need for restatement will never happen again ... Freddie Mac has added over 100 professionals in accounting reporting and control areas, including senior officers and senior managers. We have also retained leading experts in the areas of public disclosure and corporate governance to assist the company in designing and implementing processes and practices in these areas.”⁵⁰

Freddie Mac struggles to reform itself

Freddie Mac also hired a Chief Compliance Officer, a Chief Enterprise Risk Officer, and was in the process of developing new systems to ensure the quality, integrity, transparency and timeliness of its financial reporting. The GSE’s focus at the time was on bringing its financial statements up-to-date and releasing the quarterly and full-year results for 2003 by June 30, 2004; it would only be after these were completed that they would be able to keep their voluntary agreement to conform to SEC registration requirements. The very fact that so much needed to be done and so many qualified staff had to be hired, itself speaks volumes about the deep-seated management failures at the company over many years.

For all their efforts, there were still delays. The 2003 accounts were produced in June, but these included a 52% drop in income for the year, with wide variations in earnings, from a net loss of \$288m in the third quarter to earnings of \$2.5bn in the second quarter, which the GSE blamed on wide swings in the value of derivative contracts used to hedge its interest rate risks, and on FAS 133. Their earnings were also affected by \$2.13bn of losses on securities classified for accounting purposes as available for trading, compared with gains of \$291m on such securities a year earlier. It also reported a \$208m write-down in the value of securities backed by loans to buyers of mobile homes. Freddie Mac then announced further delays in the reporting of its 2004 results until March 2005; the company could not say when it would be able to make timely financial statements each quarter or fulfil a promise to file financial reports with the SEC.

A major fraud raises the question: Did Freddie really ever know what it was buying and selling?

Further indications of the lack of oversight and control at Freddie Mac emerged with the outcome of the Taylor, Bean & Whitaker Mortgage Corporation in June 2011. The fraud first surfaced in 2000, when Samuel Smith, an executive at Fannie Mae, realized that the company had sold him a mortgage it did not own. Over the following two years, Fannie Mae ascertained that over 200 mortgages obtained from Taylor Bean were bogus, non-performing or lacked critical components such as mortgage insurance. Fannie Mae officials did not, however, report the fraud to law enforcement or indeed to anyone outside the company, but merely cut all ties with Taylor Bean.

A week later, Freddie Mac began to acquire some of Taylor Bean's mortgages and soon became its largest customer and one of its largest revenue producers, accounting for 2% of the single-family home mortgages by volume in 2009. The company's business consisted of originating, selling and servicing residential mortgage loans, which came from a network of small mortgage brokers and banks.

The decision to allow Taylor Bean to continue in business was made by senior officials at Fannie Mae, such as Samuel Smith and Zach Oppenheimer, then Senior Vice President, according to the latter's deposition and a Fannie Mae memorandum, although Fannie Mae officials were not required to appear in court. It seems that Fannie was concerned about the signal this would send to the industry regarding poor loan quality, and that the value of the servicing rights would drop. In April 2002, after Fannie Mae had terminated its relationship with Taylor Bean, the Chief Executive asked Raymond Bowman to call his contact at Freddie Mac, which at that time was buying between 5% and 10% of the loans generated by the company, and in a short time, Freddie Mac had agreed to buy any conventional loans the company originated. Mr Farkas, CEO of Taylor Bean, apparently explained that eight bogus loans sold to Fannie Mae were the result of a clerical error and that the termination was due to a personality clash. Freddie Mac accepted the explanation. The case ended with Mr Farkas receiving a prison sentence of 30 years. The fraud amounted to \$3bn.⁵¹

But during the years 2002 to 2009, despite all the new systems and changes in corporate culture, the fraud remained undetected. That information was obviously not available to members of Congressional and Senate committees at the time, but the Doty report, and still more the OFHEO report, ought to have motivated all the committee members to move ahead with regulatory reform bills. It did not.