

Behind Freddie Mac's Troubles: Strategy to Take On More Risk

U.S.-Chartered Middleman of Mortgages Was Transformed Into Financial Highflier

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For years, Freddie Mac was known as "Steady Freddie." Created and supported by the U.S. government to help the housing market by buying and selling mortgages, it turned in predictable earnings. Bankers were known to walk out during statistics-filled speeches by its low-key chief executive -- confident there wouldn't be any surprises.

But last month, Freddie Mac jolted investors by ousting its CEO -- for a second time in three months. That followed revelations that Freddie Mac had been pushing the accounting envelope for years, hiding more than a billion dollars in profits to smooth out earnings zigzags. Now the company is facing multiple federal investigations and planning to restate financial results for three years.

Freddie Mac's problems had roots that run far deeper than a handful of unwise accounting decisions. Behind this astonishing turn is a fundamental shift in the company's business. Far from the sleepy mortgage company of its carefully cultivated reputation, Freddie Mac in recent years has evolved into a giant, sophisticated investment company, running a business laden with volatility and complexity. That change has sent risks soaring, not just for investors but for U.S. taxpayers, who likely would be on the hook if the federally chartered company stumbled. This is the story of how this pillar of the U.S. housing market transformed itself into what some call a giant hedge fund.

Freddie Mac buys home mortgages, freeing the lenders to lend again. For two decades after its founding in 1970, it resold nearly all of these loans, converted into securities. But after going public in 1989, and acquiring shareholders thirsty for profit growth, Freddie gradually began to keep more and more of the loans as investments. It was as if an art dealer decided to amass his own collection and thus became much more exposed to art's rise in value -- or its fall.

Freddie Mac owned just \$22 billion of mortgages in 1990, a year after going public. Now it has about \$600 billion. Building this giant portfolio led Freddie Mac into elaborate transactions to hedge risk. It began dealing heavily in the investment contracts known as derivatives, structured to offset interest-rate shifts that could quickly change the loans' value.

At the same time, Freddie Mac moved beyond the home loans it was chartered by the government to buy. It bought corporate bonds and securities that included mortgages for office buildings, strip malls and hotels. It built a Wall Street-style trading floor, filled with young traders glued to terminals buying billions of dollars a year in mortgage bonds and related securities. Freddie Mac even has its own brokerage operation, which executes trades in mortgage and Treasury bonds for hundreds of investor clients.

All this ran counter to the image of a conservative business that hit its earnings targets almost on the nose. It was to hide its volatility that Freddie Mac indulged in elaborate efforts at earnings management, which first came to light this summer in an investigation by an outside law firm. Freddie Mac used convoluted transactions with names such as "linked swaps" and "CTUGs" (for "coupon trade-up giants"). Once, to squelch a profit flare-up that would have drawn attention to its heavy use of derivatives, it temporarily changed the way it valued the instruments -- instantly erasing a \$731 million gain.

"They basically just cheated," says Dwight Jaffee, a finance professor at the University of California, Berkeley, who studies Freddie Mac and its cousin Fannie Mae. The scheme "could only have occurred in this setting where you have a lot of risk, the use of a large number of complex hedging instruments and complicated accounting." Freddie Mac, he says, is now "basically a hedge fund."

Freddie Mac officials say they're aware some think the company has grown too complex and high-risk for its own good. They say that its evolution was inevitable given the rapid growth of the housing market, and that the company is well able to manage its risk. Freddie Mac "is just a phenomenal success story about the ability to attract capital to the U.S. housing market and at the same time do it in a safe and sound manner," says Paul Peterson, chief operating officer. "If we were to go back to the old model, which we're totally against, ... it would significantly decrease the amount of capital that's available to fund the housing market."

Even so, the company doesn't dispute conclusions reached in the outside investigation, done by the law firm Baker Botts LLP. The law firm said senior management had encouraged the use of complex capital-market transactions in order to get within two or three cents of analysts' profit estimates and "avoid the effects of earnings volatility."

Unlike most recent corporate accounting misbehavior, the infractions ascribed to Freddie Mac usually minimized profits rather than boosted them. Some Freddie Mac officials who were involved in the matter privately say they believed the maneuvers actually gave a truer picture of the business, by eliminating the effect of accounting rules they considered misguided. The Baker Botts report confirmed this motivation.

The company now faces investigations into possible accounting fraud and other improprieties. The Securities and Exchange Commission, the Justice Department and the federal multiagency Corporate Fraud Task Force all are involved, as is Freddie Mac's regulator, the Office of Federal Housing Enterprise Oversight. One thing OFHEO will report, say people familiar with the situation, is that employees may have breached an internal "firewall" dividing the company's investment portfolio from its brokerage operation.

In the wake of the controversy, some Freddie Mac directors are informally discussing the idea of slowing the growth of the investment portfolio, says a person familiar with the board's discussions. Such a move could chill stock investors' enthusiasm for the company by lowering its potential growth rate. But it also could reduce risks faced by taxpayers.

Freddie Mac officials say their huge loan portfolio benefits housing. The idea is that more buying of mortgages tends to push the prices of the loans higher. And since interest rates move in the opposite direction, just as on a bond, the buying pressure tends to push down on interest rates. "If we start cutting back [on the portfolio], we have to cut back on our mission," says Shaun O'Malley, Freddie Mac's chairman.

The imbroglio also affects Fannie Mae, the other big government-sponsored mortgage buyer. It holds an even larger loan portfolio, more than \$800 billion. Because both companies now perform the same services, Fannie Mae could come under pressure to slow its growth as well if Freddie Mac did so, either on its own accord or under the direction of federal overseers. OFHEO is planning to take a look at Fannie Mae's accounting, too, to make sure it is all above-board. To stiffen regulation of the mortgage buyers, the Bush administration and congressional critics are pushing to shift the job to the Treasury Department from OFHEO. The Treasury would be able to change the companies' capital requirements, affecting their ability to accumulate loans.

The U.S. government chartered Freddie Mac in 1970, 32 years after creating Fannie Mae. Some lenders thought a second loan buyer was needed to support the housing market. Though both organizations ultimately became shareholder-owned, they retained their government perks. They don't pay state income taxes, they have lines of credit with the U.S. Treasury, and they are able to borrow cheaply because lenders assume the U.S. would bail them out if they ever got in trouble.

They buy mortgages with borrowed funds, so this low-cost credit is critical in making their businesses more profitable. This low cost of credit could be endangered if investors knew the extent of Freddie Mac's complexity and volatility.

Though Fannie Mae usually retained most of the mortgages it bought, Freddie Mac sold most of its loans. Freddie Mac pooled thousands of loans and sold investors slices of the pools, in the form of

interest-paying securities. It also guaranteed that the mortgages would be repaid, collecting a fee for its guarantee.

Reselling its mortgages relieved Freddie Mac of most of the peril from interest-rate shifts. To illustrate: A mortgage buyer who borrows at 5% and buys mortgages that pay 6% can pocket the difference. But if the mortgage buyer's borrowing costs spike to 7%, it can be stuck losing money on those 6% loans. Today, mortgage buyers have elaborate hedging operations to protect themselves from this danger. But in the early 1980s, before hedging was as sophisticated, a jump in interest rates rocked Fannie Mae so badly it was technically insolvent for a time.

Freddie Mac, which at the time was reselling most loans it bought, remained unscathed. Its CEO, Leland Brendsel, told Congress in 1989 Freddie Mac would never take the risk of building a large portfolio of mortgages held for investment. That was soon to change.

Enhancing its image as the tame alternative to Fannie Mae were Mr. Brendsel's low-key persona and frugal ways. A former University of Utah professor, he had grown up on a South Dakota farm and later worked as a welder. He eschewed first-class plane tickets and hired people from universities and mortgage banking, not Wall Street.

The Freddie Mac culture had a kind of academic quirkiness. Some senior executives sported ponytails and rode to work at the company's McLean, Va., campus on motorcycles. The chief economist was also a painter, whose imaginative rendering of the Grateful Dead at the Last Supper hung in the CEO's office. There was a sand volleyball court out back.

After Freddie Mac went public, it began to look more kindly on the idea of holding mortgages, in part for the profit potential. This meant beefing up its risk management. For that, it hired a superstar Wall Street bond strategist named Greg Parseghian. Though paid handsomely, Mr. Parseghian fit in with Freddie Mac's oddball culture when he arrived in 1996. He drove a 1987 Lincoln Mark VII, and when it failed inspection because of faulty fog lights, he ripped them out and kept driving.

But Mr. Parseghian also made the place more like Wall Street, knocking down walls to bring traders and managers together and turn his space into more of a trading room. In the cafeteria, his traders playfully honed their quest for market inefficiencies. If salad items sold for \$1 a pound, they were known to load up on the salad bar's chicken and beat the higher price of chicken at the grill.

In his first year, mortgages that Freddie Mac kept rather than resold swelled by \$30 billion. Soon they were growing an average of more than \$80 billion a year. Freddie Mac's debt ballooned too, to \$649 billion last year from \$120 billion when Mr. Parseghian arrived.

He invested heavily in derivatives. The purpose was to protect Freddie Mac from risk. Indeed, the company stresses that some financial moves that might strike outsiders as dicey, such as derivatives, are routine bond-market safety strategies. However, they also greatly increased the complexity of the company's portfolio.

Even though its mission is to support housing, Freddie Mac has accumulated a large sum of other holdings in other areas. For its investment portfolio, it bought securities backed by mortgages on commercial properties such as office buildings.

At the same time, it built up a separate fund that included investments such as Philip Morris Cos. corporate bonds. It discloses little information about this fund, which at the end of 2001 totaled \$83 billion. Freddie Mac says these are a form of insurance, assets it could sell for cash if it was ever unable to borrow. It says the Philip Morris bonds, some bought in 1997, have been sold.

Freddie Mac also bought "interest-only strips," which are slices of mortgages that provide just interest and leave the principal payments to others. They are unusually risky because they're highly sensitive to changes in the interest-rate environment. In 2001, by which time Freddie Mac held \$10 billion of these securities, they dealt it a paper loss of \$226 million. Freddie Mac hid this loss through convoluted transactions, just as it did with the big gains its derivatives threw off.