

# CRS Report for Congress

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## Accounting and Management Problems at Freddie Mac

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### Summary

For most of 2003, Freddie Mac, one of the two government-sponsored enterprises (GSEs) that dominate the secondary market for home mortgages, was embroiled in a controversy over improper accounting methods. The company announced in January 2003 that a major revision of past financial statements was underway. The restatement was issued on November 21, 2003. Net income for 2002 and earlier years was revised upward by \$5.0 billion. Freddie Mac has admitted that some of its accounting policies were selected in order to produce a steady stream of earnings, and that numerous transactions were undertaken for the sole purpose of “smoothing out” reported earnings. These accounting problems have led to the replacement of Freddie’s top executives and payment of \$125 million in fines. The company expects to begin filing timely quarterly and annual reports by the end of the first quarter of 2006. This report will be updated as events warrant.

Freddie Mac, one of the two government-sponsored enterprises (GSEs) that dominate the secondary market for home mortgages, announced in January 2003 that its financial reports for the past three years would have to be restated. The reaction was mild; the markets assumed that interpretations of complex accounting rules were at issue rather than fundamental economic problems at Freddie Mac. On June 9, 2003, without providing any new information about the nature of the accounting issues, Freddie dismissed its top three executives, including CEO Leland Brendsel. This action raised the specter of an Enron-like financial scandal, and Freddie’s stock price plunged by nearly 20%. A subsequent report to Freddie’s board of directors found that accounting controls had been weak and that certain accounting decisions and market transactions had been implemented to “smooth out,” or reduce volatility in reported earnings. On August 21, 2003, the Office of Federal Housing Enterprise Oversight (OFHEO) recommended that Freddie’s replacement CEO be fired, on the grounds that he had been involved in the accounting problems. Greg Parseghian was removed by Freddie’s board, and was replaced in December 2003 by Richard F. Syron.

On November 21, 2003, the restatement of past accounting results was released,<sup>1</sup> as summarized in the table below. It is noteworthy that while the net effect of the restatement was to increase reported earnings, restated net income for 2001 was almost \$1 billion *less* than originally reported. Freddie Mac notes that the restatement shows “significantly greater volatility than previously reported.”

**Table 1. Restated Financial Results for the Three Years Ended December 31, 2002**  
(in millions)

Year Ended	Net Income			Regulatory Core Capital			Stockholders' Equity		
	As Previously Reported	As Restated	Change	As Previously Reported	As Restated	Change	As Previously Reported	As Restated	Change
December 31, 2000	\$2,547	\$3,666	\$1,119	\$14,380	\$16,273	\$1,893	\$14,837	\$17,357	\$2,520
December 31, 2001	\$4,147	\$3,158	(\$989)	\$19,336	\$20,181	\$845	\$15,373	\$19,624	\$4,251
December 31, 2002	\$5,764	\$10,090	\$4,326	\$23,792	\$28,990	\$5,198	\$24,629	\$31,330	\$6,701

**Source:** Freddie Mac press release, November 21, 2003.

The restatement does not end the company’s accounting uncertainties: the restated results are not audited, and so may possibly be revised again. Freddie Mac, which is exempt from the registration and disclosure requirements that apply to other companies that sell stock to the public, committed itself in 2002 to voluntary compliance with Securities and Exchange Commission (SEC) disclosure standards. In its restatement, Freddie announced that it would begin voluntary SEC reporting “as soon as possible after the company’s return to timely reporting.” This has not happened yet, but the current projection is to begin filing timely quarterly and annual reports by the end of March 2006.

## Background

Freddie Mac is a GSE that plays an important role in the secondary mortgage market. Like Fannie Mae,<sup>2</sup> its rival GSE, Freddie buys mortgages from lenders and repackages them in the form of securities, which it may hold or sell to public investors. Freddie finances its purchases of mortgage loans by selling bonds: either bonds backed by its own financial resources (called “straight debt”), or mortgage-backed securities, where interest and principal payments made by homeowners are passed through to holders of the bonds. As GSEs, Fannie and Freddie are exempt from state and local taxes, from certain regulatory requirements, and have a line of credit with the U.S. Treasury. Their most significant advantage, however, is what is called the implicit guarantee — although the

<sup>1</sup> See [[http://www.freddiemac.com/news/archives/investors/2003/restatement\\_112103.html](http://www.freddiemac.com/news/archives/investors/2003/restatement_112103.html)].

<sup>2</sup> Freddie Mac was formally chartered as the Federal Home Loan Mortgage Corporation, and Fannie Mae as the Federal National Mortgage Association. The abbreviated forms are now the official corporate names.

bonds they sell are not backed by the full faith and credit of the U.S. government, market participants behave as though they were. Because the markets do not believe that the Treasury would allow Fannie or Freddie to default, the GSEs are able to sell bonds at lower interest rates than other financial institutions.

Over 60% of all single family mortgage debt has been sold in the secondary market, or “securitized.” As the leading players in this market, the housing GSEs represent an extraordinary concentration of financial risk. Because there is a strong public interest in ensuring that Freddie and Fannie remain financially strong, Congress created the OFHEO, a safety and soundness regulator dedicated exclusively to oversight of these two institutions, in 1992.

The savings and loan crisis of the 1980s illustrated the riskiness of the mortgage market. If interest rates rise, financial institutions may find that their cost of funds exceeds their income from long-term, fixed-rate mortgages. If rates fall, homeowners refinance their mortgages and reduce income streams to institutions, which must still pay off debt previously issued at higher interest rates. Protection from interest rate risk is critical to the soundness of the GSEs, and it appears that strategies to avoid, or “hedge,” risk were partly responsible for Freddie’s recent accounting problems.

## Freddie Mac’s Accounting Problems

Appendix II to Freddie Mac’s November 21 restatement discusses the accounting errors that made revision necessary. The major factors underlying the accounting errors are described as “lack of sufficient accounting expertise and internal control and management weaknesses....” In addition, certain transactions and accounting policies were implemented to achieve steady growth in reported earnings. The two accounting policies that appear to have been most important in this regard — yielding 88% of the upward revision in pre-tax net income — are the classification of securities and accounting for derivatives instruments.<sup>3</sup> How these issues affect net earnings is discussed below.

Since 2000, interest rates have fallen dramatically — mortgage rates from over 8% to as low as 5.2%. The fall in rates had two major impacts on Freddie Mac’s financial statements. Both Freddie’s bond portfolio<sup>4</sup> and the derivatives contracts Freddie had purchased to hedge the risk of falling interest rates<sup>5</sup> increased sharply in value. Under generally accepted accounting principles (GAAP), these gains in asset value should have been reported as current income. However, Freddie chose accounting treatments for these asset gains that deferred recognition of income until later years, thus “smoothing out” the

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<sup>3</sup> Appendix II, p. 2. Available online at [[http://www.freddiemac.com/news/archives/investors/2003/restatement\\_112103.html](http://www.freddiemac.com/news/archives/investors/2003/restatement_112103.html)].

<sup>4</sup> Bond prices rise when interest rates fall, because old bonds then pay higher interest relative to newly issued bonds.

<sup>5</sup> Derivatives are financial instruments whose value is linked to changes in some price or variable, in this case interest rates. To hedge against falling rates, Freddie purchased interest rate swaps in which Freddie agreed to pay floating-rate interest to the swap dealer, while the swap dealer agreed to pay Freddie a fixed rate of interest. (The size of the payments is calculated by reference to a notional principal amount that does not actually change hands.) As rates fell, Freddie’s floating rate obligation diminished, while it continued to receive the fixed payment.

effects of falling interest rates. The restatement of earnings is based upon Freddie's and its new auditor's decision that these accounting policies were incorrect.

Much of Freddie's bond portfolio was held in an accounting category called "held to maturity" (HTM). This meant that the bonds would not be sold, and that therefore day-to-day fluctuations in their market value were irrelevant; all that mattered was the amount of principal and interest payments, which was fixed and known in advance. These bonds were carried on Freddie's balance sheet at historical cost, which meant that increases in the bonds' market value (as interest rates fell after 2000) were essentially ignored, and did not appear as current earnings. However, during the 2000-2002 period, some of the bonds classified as HTM were sold. As a result, the restatement reclassifies much of the entire bond portfolio as "available for sale" (AFS), and changes in market value are recognized. Gains in the bonds' value over the period appear in the restated earnings as either current earnings or stockholders' equity.<sup>6</sup>

Derivatives accounting is governed by FAS 133 of the Financial Accounting Standards Board (FASB). Under FAS 133, the fair value of all financial derivatives must be calculated ("marked-to-market") at the end of each accounting period. Changes in fair value from the previous accounting period must be reported as current income, unless the derivatives are used for hedging. If a derivative is used to hedge an asset, the value of that asset — the hedged item — will move in the opposite direction to the derivative's value. Thus, a fall in the price of the hedged asset will be offset by a gain in the derivative (or vice versa). Under FAS 133, the firm can recognize as earnings both the change in the derivative's value *and* the offsetting change in the hedged item's. If the gains and losses are closely correlated, the net effect on reported earnings will be very small or zero.

There is another form of hedge accounting under FAS 133, covering derivatives held to hedge a future transaction or cash flow. Since the hedged item in this case does not yet exist, it cannot be marked to market and used to offset gains in the derivative's fair value. However, FAS 133 allows the gain or loss in a derivative used to hedge a future event to be assigned to comprehensive income, a subcategory of stockholders' equity. When the future transaction or cash flow occurs, the derivative is marked to market and changes in fair value are recognized as current income, but presumably gains or losses in the derivative will be offset by the hedged item.

Either form of hedge accounting has the effect of reducing the impact of changes in derivatives' fair value on current earnings and the bottom line. To qualify for this accounting treatment, however, FASB requires that there be a close relationship between changes in the value of the derivative and the hedged item. Derivatives that do not meet FASB's hedge test are considered speculative trading instruments, and changes in fair value from period to period must be recognized and reported as current earnings.

Freddie Mac, like most U.S. corporations that use derivatives, states in its annual report that it does not use derivatives for speculative purposes. In its restatement, however, Freddie concludes that most of its derivatives in 2001 and 2002 did not qualify as accounting hedges. This means that, from a GAAP perspective, these were speculative

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<sup>6</sup> Stockholders' equity is separate from current earnings; it represents the proprietary interests of the owners (stockholders) of a corporation, or the going-concern value of assets over liabilities.

positions. Recognition of fair value gains and losses in derivatives positions resulted in an upward revision of pre-tax net earnings by \$5.0 billion.

Based on the November 21, 2003 restatement, the accounting treatments of derivatives and bond portfolios were the major factors in the restatement. In both cases, the drop in interest rates to 1950s levels produced unexpected windfall gains in the value of financial instruments. Freddie chose not to recognize these gains to avoid creating an impression of earnings volatility, knowing that these gains would be reversed if the trend in interest rates turned upwards. According to the June 25 statement, accounting policies were designed “with a view to their effect on earnings in the context of Freddie Mac’s goal of achieving steady earnings growth.” In other words, Freddie sought to “smooth out” reported earnings and reduce volatility by deferring to future years earnings that should have been recognized under GAAP as current income.

An internal report to Freddie’s board of directors issued in July 2003 provides further detail on specific transactions designed to defer earnings and produce the desired accounting results.<sup>7</sup> The report concludes that these transactions, and the accompanying accounting policies, indicated serious deficiencies in Freddie Mac’s internal controls, disclosure practices, and in the governance policy of former management. The report notes, however, that these transactions do not appear to have been made “at the expense of the company’s risk management policies and practices.”<sup>8</sup> In the November 21, 2003 restatement, Freddie Mac stated that it “accepts” the report’s conclusions.

In November 2005, Freddie announced that its reported income for the first half of 2005 would have to be restated and reduced by about \$200 million, because of problems in a “legacy” computer system.

## **Freddie Mac’s Management and Regulatory Problems**

The June 25 release noted several actions taken to fix weaknesses in accounting and management controls. These include the expansion of senior accounting staff, creation of an operating risk oversight unit, and strengthening the review of accounting and other critical business operations. In conjunction with OFHEO, Freddie has embarked on a “comprehensive remediation program,” to effect “broad changes in the finance function.”

The “smoothing out” of reported earnings through questionable interpretations of GAAP is normally regarded as a violation of accounting rules. The SEC’s view is that if a firm deals in volatile financial instruments, that volatility should be fully reflected on its accounting statements. In August 2004, Freddie announced that an SEC investigation was continuing, involving possible violations of regulations involving fraud, deceptive practices, and insider trading.

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<sup>7</sup> Baker Botts L.L.P., *Report to the Board of Directors of the Federal Home Loan Mortgage Corporation: Internal Investigation of Certain Accounting Matters*, December 10, 2002 - July 21, 2003, 107 p.

<sup>8</sup> *Ibid.*, p. iii.

In December 2003, OFHEO settled its investigation of Freddie Mac's accounting problems with a consent agreement. Freddie admitted to no wrongdoing, but agreed to pay a \$125 million fine.

In September 2005, Freddie agreed to help federal investigators pursue former CEO Leland Breindsel and former CFO Vaughn Clarke, who were forced out in 2003. Freddie also agreed to seek recovery of their severance pay and stock awards, which totaled tens of millions of dollars, if the regulators determine that misconduct was involved in the accounting scandal.

There have been calls to reform regulation of the housing GSEs. Two bills in the 109<sup>th</sup> Congress — S. 190 (reported by the Senate Banking Committee on July 28, 2005) and H.R. 1461 (passed the House on October 26, 2005) — propose to restructure GSE regulation.<sup>9</sup> The bills would replace OFHEO with an independent agency with authority over Fannie, Freddie, and the Federal Home Loan Banks. The bills would enhance the safety and soundness tools available to the GSE regulator, giving it more flexibility to establish and enforce risk management and operational and capital standards, and allowing it to put a GSE into receivership, if necessary.

As for the criminal investigation that was announced by federal prosecutors in Northern Virginia, where Freddie Mac has its headquarters, no indictments have been handed down, and there are no indications that any will be. Press reports focused on the withholding (or destruction) of pages in a personal notebook kept by Freddie's former chief financial officer (and requested by counsel to the board of directors), but it is not clear that such actions would violate any federal securities law.

The facts that Freddie Mac's former management's conduct may not constitute criminal fraud and that the institution appears to remain financially sound do not suggest that the episode should be dismissed lightly. If Freddie's management cut corners with accounting rules to conceal an inconvenient excess of earnings, how might it respond to a shortfall in earnings that presaged serious trouble in the company? The size of the housing GSEs and the volume of their debt securities held by other financial institutions make management and regulatory reform important public policy issues.

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<sup>9</sup> For a summary of the provisions of these bills, see CRS Report RL32795, *Government-Sponsored Enterprises: Regulatory reform Proposals*, by Mark Jickling.