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CORPORATE SCANDALS

Freddie Mac caught in the crosshairs

When mortgage giant flinches, the housing market gasps

Analysts said it is "premature" to speculate that Freddie Mac's problems will lead to a housing bubble collapse or a credit crunch in the mortgage industry.


Stefan Zaklin / Getty Images file

By Martin Wolk
MSNBC

June 11 — News that federal prosecutors have opened a criminal investigation into possible wrongdoing at Freddie Mac sent another ripple of concern through financial markets Wednesday, as the little known and poorly understood mortgage giant came under increasingly harsh scrutiny.

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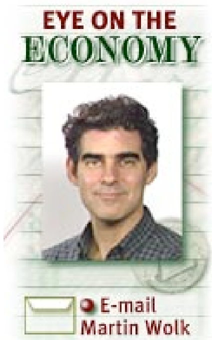


EXECUTIVES AT THE COMPANY say they are unaware of any fraud or criminal activity linked to the accounting problems that led them to replace three top executives this week. They contend that when new financial statements are published covering the past three years, they will show that Freddie Mac's earnings and financial position are stronger than previously reported.

Critics of Freddie Mac and its sister enterprise in the mortgage industry, Fannie Mae, say the time has come to consider whether the two firms, which provide the underpinning of the vast U.S. housing market, should retain the special government relationship they enjoy by virtue of their unique congressional charters.

"It's obviously a good time to reassess their role," said Peter Barth, a senior fellow at the Milken Institute. A radical restructuring is highly unlikely, he said, especially given the emergence of the two companies as heavyweight political contributors and aggressive lobbyists on Capitol Hill.

Fannie Mae and Freddie Mac are the dominant players in an obscure but crucial part of the nation's $6 trillion residential mortgage market. The two companies, which are known as government-sponsored enterprises, buy mortgages from banks and other lenders, absorbing any risk and freeing the lenders to make more housing loans than they otherwise could. Fannie and Freddie then bundle many of the mortgages they buy, turning them into securities for sale mainly to institutional investors.

The system generally is credited with lowering mortgage rates and making home loans more widely available. Any threat to this underpinning of the housing industry could be disastrous to the economy. Housing has been among the few bright spots in a generally bleak U.S. economy in recent years, with historically low interest rates sparking rising prices, record sales and massive waves of mortgage refinancing that have buoyed consumer spending.

While Fannie Mae and Freddie Mac are not backed by the full faith and credit of the U.S. government, like a Treasury bond for instance, they are perceived as being "too big to fail." That allows them to raise money on capital markets at rates only slightly higher than Treasury securities.

Data: MSN MoneyCentral Investor and S&P Comstock 20 min.delay.

"Oddly enough whenever these companies get in trouble, Congress steps in and bails them out," said Peter Wallison of the American Enterprise Institute. "Investors don't have any illusions. There is no way the government is going to allow them to fail."

Freddie Mac was created by Congress in 1970, and Fannie Mae took on its current role in 1968, but both companies have their roots in the politics of the Depression era, when government first assumed the role of encouraging broad ownership of housing.

"Our economy has been pretty strongly committed to this theme of home ownership," said Ronnie Phillips, an economic historian at Colorado State University. "As a consequence there is a large role for government, directly or through these government-sponsored enterprises."

A 2001 Congressional Budget Office study found that Fannie Mae and Freddie Mac's special status is worth more than $10 billion a year, largely in the form of below-market interest rates they are able to obtain. Most of that savings is passed on to borrowers, but part of it is retained by shareholders of the two companies, which now both rank among the nation's top 35 companies in terms of revenue, according to Fortune magazine.

The company's management also benefits. Chairman and Chief Executive Officer Leland Brendsel was making an annual salary of $1.2 million plus bonus when he was asked to retire on Monday, and he exits with stock and options worth $21 million, according to Freddie Mac. The company ranked No. 11 among all corporate contributors in the 2002 congressional election cycle, with personal and corporate political donations totaling more than $4 million, according to the Center for Responsive Politics. And it spent $5.6 million lobbying Congress last year, according to the Senate Office of Public Records.

FACT FILE

Twin titans

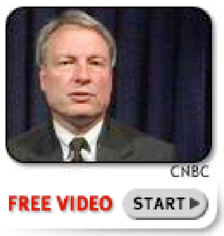
Fannie Mae and Freddie Mac provide the backbone of the nation's housing market by purchasing mortgages from lenders. Uniquely among the nation's biggest companies, they were established by congressional charter. Here is how the two companies compare.

	Fannie Mae	Freddie Mac
Headquarters	Washington, D.C.	McLean, Va.
Year chartered	1968	1970
Chairman	Franklin Raines	Shaun O'Malley
CEO	same	Gregory Parseghian
Revenue	$11.9 billion (2002)	$7.4 billion (2001)
Net income	$4.6 billion (2002)	$4.1 billion (2001)
Total assets	$888 billion	$617 billion
Fortune 500 rank	No. 16	No. 32
Employees	4,700	3,900
Latest stock price	FNM	FRE

Source: Fannie Mae, Freddie Mac

Wallison, who served as a Treasury official in the Reagan administration, said the time has come to consider a radical change. He suggested cutting Freddie Mac's ties with the government, ending its special privileges, and breaking it up into five or six companies that would compete with each other to offer the same services.

U.S. Rep. Richard Baker, R-La., a leading congressional critic of Freddie Mac and Fannie Mae said Tuesday he plans to hold at least one hearing to investigate the "true story" of what happened at the mortgage giant.



June 10, 2003 — Rep. Richard Baker (R-LA) of the Financial Services Commitee talks about the regulation of the Federal Home Mortgage Corporation.

In an interview with CNBC, he was highly critical of the federal agency that is supposed to regulate the two companies, the Office of Federal Housing Enterprise Oversight (OFHEO). He advocated a new regulatory structure, saying OFHEO has been chronically underfunded and lacks the ability to understand the complex financial derivatives used by the two companies to hedge against shifting interest rates.

As it has unfolded, the Freddie Mac fiasco has carried with it the faint whiff of corporate scandals that have wrought havoc in financial markets over the past two years. Few investors paid much attention in January, when Freddie Mac announced it would restate its financial results for the past three years.

But Wall Street sat up and took notice when Freddie opened the week by announcing it had fired president and chief operating officer David Glenn for failing to cooperate with the company's internal audit. The company also replaced two other top executives including Brendsel, who had been its CEO since the mid-1980s and chairman since 1990.

"That is not usually done when they are arguing over what is the best way to report your financials," said Wallison. "That is done when something very serious has happened. Whatever that thing is that has happened has not been disclosed."

In a conference call, newly appointed CEO Gregory Parseghian said Glenn had altered certain entries in his personal diaries and removed some pages before handing them over to internal auditors. "These are personal diaries — not books and records of the firm," Parseghian said with emphasis. “We have not characterized anything that has occurred as fraud or criminal or any other such legal designation.”

Other analysts said there is no reason to suspect that Freddie Mac’s problems pose any kind of broad risk to the secondary mortgage market, and Freddie Mac had no problem selling $1 billion in five-year notes this week, according to Reuters. The company’s stock is down 16 percent, near its 52-week high, but still earns the highest recommendation of Morningstar, an independent research firm.

“My opinion is it is a fundamentally very sound company,” said Morningstar analyst Richard McCaffrey. “It’s been exceptionally well run for a lot of years. This isn’t fun, having to wait for the financials, but it hasn’t changed my basic opinion on the soundness of the company.”

Barth said it is “premature” to speculate that Freddie Mac’s problems will lead to a housing bubble collapse or a credit crunch in the mortgage industry.

“People are concerned about any firm that talks about accounting problems,” he said. “There is no indication yet that the firm is grossly overvalued or that they are at systemic risk.”

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