US mortgage financier in derivatives trouble

What is going on at Freddie Mac?

Nick Beams
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The ousting of three top officials from Freddie Mac, the second biggest financier of residential mortgage loans in the US and one of the world's biggest financial institutions, and the launching of criminal investigations has sent a shiver through US financial markets.

David Glenn, the president of Freddie Mac (formerly known as the Federal Home Loan Mortgage Corporation), was sacked on Monday after the company auditor, PricewaterhouseCoopers (PwC), claimed he was not cooperating with an internal investigation into accounting practices. The company's other two most senior officials stepped down shortly afterwards. Leland Brensdel, the chairman and chief executive, retired and the chief financial officer, Vaughan Clarke, resigned.

In the wake of Monday's purge, the investigation has rapidly widened. The Securities and Exchange Commission, which had been conducting an informal investigation since January, has told the company that it will upgrade the status of the probe to formal, thereby enabling it to subpoena witnesses and testimony.

Now federal prosecutors have opened a criminal investigation into possible misconduct. Announcing the decision on Wednesday, US Attorney Paul McNulty would say only that the US Attorney's Office in the Eastern District had initiated an investigation.

Freddie Mac's accounting methods first came under scrutiny after PwC, which took over auditing duties from the disgraced Arthur Andersen firm last year, raised questions about whether it had properly dealt with income from derivatives transactions, largely interest rate swaps. Glenn was sacked when he told the special counsel in charge of the investigation that a notebook in which he kept notes of business meetings had been altered.

Freddie Mac and its sister organisation Fannie May (the Federal National Mortgage Association) are government sponsored institutions set up 30 years ago to facilitate a wide access to mortgage finance. The two organisations buy up mortgages from the banks and finance these purchases through the issuing of security bonds, backed by these mortgages, to financial investors. This process returns cash to the banks, which are then able to issue more home loans. The overall effect of the process is to increase capital in the home loan market, thereby helping to lower interest rates.

The significance of the mortgage securities market in which they operate can be seen from the fact that with around $7 trillion worth of securities it is the world's largest credit market. Freddie Mac owns or insures around $1.3 trillion in home loans—an amount equivalent to more than 10 percent of the US gross domestic product.

The majority of home loans in the US are at fixed interest rates over a 30-year period. But interest rates fluctuate, changing the value of the home mortgage portfolios held by Freddie Mac and Fannie May. Therefore in order to reduce risk and smooth out fluctuations caused by interest rate movements, both organisations use derivatives, mainly financial arrangements based on interest rate swaps.

It is in the accounting for these derivatives that the problems have arisen at Freddie Mac. According to a report published by the Dow Jones Newswire, Arthur Andersen had a different interpretation of the income from derivatives than that held by PwC. Some derivatives previously classified as hedges will be classified as assets.

The change affects the profit figure because the income from a hedge is recognised as part of company income gradually, over its full life, whereas if it is

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classified as an asset the income (or loss) has to be recognised in the same period that the asset was purchased.

Under the changes sought by PwC, Freddie Mac would increase its earnings for the years 2000, 2001 and 2002, but would suffer lower earnings in the future as a result.

The company has issued reassuring statements that it will not be seriously impacted by the turmoil. The new chief executive Gregory Parseghian said he did not know the details of the missing notes but that the documents Glenn had failed to provide did not affect "the economics or the value of Freddie Mac." But until there is a complete disclosure this is a question that remains to be answered.

In the meantime, the company's assurances do not seem to be cutting much ice. According to James Bianco, a Chicago-based analyst of mortgage business cited by the *Financial Times*: "Freddie Mac was telling us consistently that [the restatement] was just a technical argument among accountants. But there are a lot of investigations going on for something that they tell us isn't that serious."

The obvious question which arises is that if all that is involved are technical differences in the treatment of derivatives then why have three top officials gone? And why did the company president find it necessary to alter his notebook? What were are the implications for the company of the changes to its profit results and how much is involved?

It is clear that traders in financial markets thought there was more to the story than met the eye because they responded to the news by sending Freddie Mac shares down by 16 percent, wiping some $6 billion of its market value. Fannie May also suffered a 4.8 percent drop in its share price.

On top of the immediate situation at Freddie Mac, there are questions concerning the stability of US financial markets. Freddie Mac and Fannie May are integral to the stability of the US financial system. At the end of last year their combined assets totalled nearly $1.6 trillion, about 44 percent more than those of Citigroup, the biggest US bank.

Both companies are "government-sponsored enterprises" (GSE) enjoying an implicit guarantee that the government would step in to rescue them in a crisis. But there have been calls for the companies to increase their capital as a defence again upheaval in financial markets.

Speaking last August in support of such a measure, William Poole, president and chief executive of the Federal Reserve Bank of St Louis, said: "In the case of the GSE's, the massive scale of their liabilities could create a massive problem in credit markets. If the market value of GSE debt were to fall sharply because of ambiguity about the financial soundness of GSE's and about the willingness of the federal government to backstop the debt, what would happen? I don't know, and neither does anyone else?"

Setting aside the questions of the stability of financial markets as a whole, the upheaval could have an impact on the housing mortgage market, which has been central to the financing of consumption spending and kept US growth rates positive in the recent period.

According to the *New York Times*, applications for the refinancing of existing mortgages and mortgages to buy homes have reached record levels with the estimate of mortgage lending for the year rising to as much as $4 trillion, compared to last year's record of $2.5 trillion.

But this expansion could be jeopardised if disturbances at Freddie Mac result in concerns over its accounting methods. Such doubts would lead to increases in the interest rate on its security bonds, which in turn would work their way into the home mortgage market where the level of indebtedness is such that a small increase can have a significant impact.

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