



**WMRC Article**

08 January 2004

---

**CONTENTS**

---

Freddie Mac Scandal Latest  
to Plague Corporate America

---

## United States: Freddie Mac Scandal Latest to Plague Corporate America

*Federally chartered housing lender, Freddie Mac, is the latest major corporation in the US to face a federal probe for financial impropriety by the firm's top leadership.*

<b>WMRC Perspective</b>	
<b>Significance</b>	Freddie Mac is a dominant player in the US mortgage market and a bellwether stock on Wall Street. The escalating scandal - which has already seen several top executives ousted - invites comparison with Enron, WorldCom <i>et al.</i>
<b>Implications</b>	Uncertainty about the company's financial health will likely hurt stockholders, raise the price of capital for the lender in the future, and could cool the stock and bond markets, which have been seeing minor but steady gains in recent weeks. Moreover, it may increase Congressional pressure for even tighter regulation of corporate governance practices.
<b>Outlook</b>	Despite Freddie Mac's weight in the mortgage market and on Wall Street, the scandal should have a relatively minor impact on the market as a whole. Savvy investors and analysts still view their stock as relatively secure since it is backed by mortgage payments that have been bundled together for sale and securitisation. However, the lender will likely begin to lose market share and regulatory changes look set to erode its privileged position.

### Freddie is a Friend of Mine

Sixty-eight percent of Americans own their home, the epitome of the American Dream. In 1970, the federal government created Freddie Mac, joining sister company Fannie Mae, to help make home-buying affordable for virtually anyone who wanted one. Freddie has been a vital player in making home ownership so widely accessible in the US, which many experts also credit as a key element of the historically strong US economy. As a secondary market for mortgage loans, Freddie has been successful in helping to keep mortgage markets stable. The company has lowered mortgage rates, saving home-owners interest payments and reducing apartment rents, made home mortgage credit readily available, eliminated regional disparities, expanded the variety of mortgage loan products available and attracted investors from national and global capital markets. The company has served one out of every six homebuyers and more than two million renters in the US. Freddie and Fannie together are now guarantors of some 42% of the US\$6trn mortgage market in the US.

Freddie has also been a friend to investors. In 2001, for example, Freddie Mac generated operating earnings of US\$3.2 billion and diluted operating earnings per common share of US\$4.21. At year-end 2001, its total mortgage portfolio was US\$1.138 trillion.

### Et Tu, Freddie?

Enron. WorldCom. Tyco. ImClone. Global Crossing...

The trouble for Freddie began following an audit by PricewaterhouseCoopers, who replaced Anderson as the company's auditor after the firm imploded due to the Enron scandal, which revealed numerous accounting problems. Earlier this year, Freddie announced that it would be restating earnings for 2000, 2001, and 2002.

On 11 June, one day after three top executives left the company, federal prosecutors opened a criminal investigation into the firm's finances. The Securities and Exchange Commission (SEC) had already opened its own investigation. These are in addition to two separate private suits being brought by groups of Freddie Mac shareholders who accuse the company of using 'cookie jar' accounting methods to misrepresent financial results. The US attorney heading up the federal investigation refused to state the specifics of the case, but speculation points to improper accounting methods including overstated earnings, deferred expenses and falsified record-keeping practices. If the suspected allegations prove to be true, it would mirror many of the same activities that brought down executives at several other major firms over the last two years, such as those mentioned above.

Congress' response to the spate of high-profile corporate scandals resulted in the Sarbanes-Oxley bill which, among other things, increased penalties for corporate wrongdoing and gave prosecutors more tools to charge officers for tampering with or altering records. Certain documents previously off-limits, such as the subpoenaed personal diary kept by Freddie's fired chief operating officer, are now considered exculpable evidence in an investigation. The implicated executives at Freddie are putting these new laws to their first real test, and everyone will be waiting to see if the laws truly have teeth.

The market, however, is not waiting for the results of the probe before weighing in. Freddie's stock lost 17% of its value on Monday (9 June) after the announcement of the management shake-up. The stock would have most likely continued to fall if trading had not been suspended until information about the SEC investigation had been disseminated.

## Outlook and Implications

Concern about the possible impact of Freddie Mac's troubles on the housing market, one of the economy's few bright spots, is mixed. The bearish view is that banks could sell fewer mortgages to the company and the international stream of capital into the US mortgage market could be reduced; investors could lose confidence in the safety of the typically more secure and predictable bond markets; and American consumers could view the scandal as a sign that corporate leaders are still running amok despite the promises of Congress to clean up Wall Street, which could lead them to further reduce discretionary spending and increase the drag on a broader economic recovery. The modest gains made in the market since the end of hostilities in Iraq has been tenuous, and this is the kind of monkey wrench that could derail a more sustained, and steady return to stability.

In the short term, the news will be viewed as bad by already skittish investors, but the bullish will consider the fundamental health of Freddie and the strength of the mortgage market, and likely overcome an initial dip in overall market value in the medium term, depending on what is revealed about the depth of the scandal as the investigation proceeds. But, by all accounts, the rabbit hole is not nearly as deep and dark as Enronland.

Congress will most likely weigh in, regardless of what is unearthed by investigators. Some members have been calling for reforms at both Freddie Mac and Fannie Mae for over a year, insisting that the two leading mortgage firms adhere to the same level of transparency as all other publicly traded firms. The efforts of Freddie's leadership and lobbyists have held off the bill, but the case for being treated differently will probably crumble given the current situation.

**WMRC Contact**

**David Rice** ([david.rice@wmrc.com](mailto:david.rice@wmrc.com))

© 2004 World Markets Research Centre. All rights reserved. **Important Notice**



part of the Global Insight group of companies