SPECIAL EXAMINATION OF FREDDIE MAC

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTEREPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

JANUARY 21, 2004

Printed for the use of the Committee on Financial Services

Serial No. 108–64

U.S. GOVERNMENT PRINTING OFFICE

93–838 PDF WASHINGTON : 2004

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
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SPECIAL EXAMINATION OF FREDDIE MAC

Wednesday, January 21, 2004

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE
AND GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:05 a.m., in Room 2128, Rayburn House Office Building, Hon. Richard H. Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Ose, Shays, Bachus, Oxley, Kelly, Ney, Shadegg, Ryun, Biggert, Kennedy, Harris, Renzi, Kanjorski, Inslee, Hinojosa, Lucas of Kentucky, Clay, McCarthy and Scott.

Chairman BAKER. I would like to call this meeting of the Capital Market Subcommittee to order and welcome back Members to start off a new year.

This morning we are meeting to formally receive the report of OFHEO with regard to their special examination of the business operations of Freddie Mac. This is indeed an important study and analysis, which I believe will assist the committee in making important policy determinations as we go forward. But we are also pleased to have a representative of Freddie Mac to appear later in the hearing this morning to give their analysis and comment with regard to the findings and recommendations of the Agency.

I believe it should be clearly understood by now that the current regulatory staff has done its best work in attempting to supervise and oversee the two most complex financial organizations in the world, but they have been historically underfunded and, I believe, lacking appropriate regulatory tools to be responsive to the complexities of these ever-changing enterprises.

The effort to create an enhanced regulatory system, however, should be viewed in its proper light, and that is we are attempting to provide stability for the secondary mortgage market into the next decade. We have been extremely fortunate. If any other public operating company had reported multi-billion-dollar restatements over a multiyear period, market reaction to that announcement would have been severe.

To date, we have seen no market dislocation, interest rates continue to remain low, pursuit of home ownership opportunities remains high, and we have been blessed with these unique circumstances in a time of significant corporate governance dislocation.

We cannot let this window of opportunity pass us by, however. We must act on the findings of the regulator. We must take advice from all interested stakeholders and ensure in the years ahead that the oversight and supervision is more than just adequate; that it is world class in nature, and that we can be hopefully preemptive in setting aside events which might bring adverse consequences to innocent home purchasers.

I view this as an extremely important effort, and I am appreciative of the willingness of the participants in the hearing today to give us their perspectives.

Chairman BAKER. Mr. Kanjorski.

Mr. KANJORSKI. Mr. Chairman, we meet for the first time this year for the purposes of reviewing the special examination report issued and the consent agreement reached in December by the Office of Federal Housing Enterprise Oversight regarding Freddie Mac's financial restatement of more than $5 billion. The report makes serious revelations about how insufficient accounting, audit and internal controls and a troubling culture nurtured by top managers resulted in an environment that led to significant earnings management at Freddie Mac. The constant decree also—the consent decree also requires Freddie Mac to adopt numerous remedial reforms to prevent a similar situation in the future.

One year ago Freddie Mac first revealed that it would delay the release of the 2002 accounting reports pending the completion of a restatement of its financial records for earlier years. This announcement raised considerable concerns for those who monitor GSEs. It also began a period of intense scrutiny of the company by its regulators, lawmakers and the press.

Six months later, Freddie Mac's Board announced an unexpected management shakeup. This change in corporate leadership produced even greater concerns among those with knowledge of GSEs. For example, I observed that government-sponsored enterprises with public responsibilities and private capital have a special obligation to operate fairly, safely, and soundly. I believe and I continue to believe that today. The management of these entities must ensure that they produce accounting statements that reflect their real financial conditions.

At the time I also said that Freddie Mac must maintain sufficient capital reserves, adopt prudent management reforms, expedite completion of its earnings restatements, and employ appropriate accounting techniques to prevent similar problems in the future. I suspect that, before we complete today's hearing, we will discuss each of these issues in great depth. We have a responsibility to study these matters and ensure that the company follows its statutory mandate to operate in a safe and sound manner.

Additionally, the financial reporting problems by Freddie Mac renewed efforts by some to modify GSE regulation. As I said at our very first hearing on oversight of government-sponsored enterprises in March of 2000, we need to have strong independent regulators that have the resources they need to get the job done. I continue to support strong GSE regulation. A strong regulator will protect the continued validity of our capital markets and promote confidence in Freddie Mac and Fannie Mae. It will also ensure tax-

payers against systemic risk and expand opportunities for all Americans.

Today more than 68 percent of Americans own the homes in which they live. Government-sponsored enterprises have contributed greatly to this accomplishment. Because our housing marketplace is one of the most important sectors in our persistently struggling economy, we must also tread carefully in our forthcoming debates over any legislation to modify the regulation of GSEs.

In closing, Mr. Chairman, I commend you for your sustained leadership in these matters and for convening this timely hearing.

Thank you.

Chairman BAKER. I thank the gentleman for his statement.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 51 in the appendix.]

Chairman BAKER. Mr. Shays?

Mr. SHAYS. Thank you, Mr. Chairman.

Mr. Chairman, Fannie Mae and Freddie Mac constitute the twentieth and fortieth largest institutions on the New York Stock Exchange and the second and fourth largest financial institutions. They play an extraordinary role, they are vital to our economy, they are vital to housing, but they play by different rules, and when you play by different rules, you have to have greater oversight, not lesser oversight, and, frankly, we have had both. They do not have to conform to the 1993 act—excuse me, the 1933 act. They do not have to conform to the 1934 act.

When we put them under the 1934 act voluntarily is when the problems of Freddie Mac became apparent. It just seems to me is an indication that we should get these very excellent companies under the same rules and make sure that they have a regulator that is going to do the job necessary.

I think OFHEO has done an excellent job in this report. It is just too bad we haven't seen this kind of effort earlier.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Shays.

Chairman BAKER. Mrs. McCarthy?

Mrs. MCCARTHY. Thank you, Mr. Chairman. I will wait until their testimony. Thank you.

Chairman BAKER. Thank you.

Mr. Ryun?

Oh, I am sorry. I did not see your arrival.

Chairman Oxley?

Mr. OXLEY. Thank you, Mr. Chairman, and I want to thank you for convening the hearing today on the recent report issued by the Office of Federal Housing Oversight—Enterprise Oversight. This report details the causes of Freddie Mac's restatement and management reorganization that followed, and this is a comprehensive report that highlights many of the concerns we have heard about the operations and the oversight of the GSEs.

As a result of this investigation, OFHEO and Freddie Mac have entered into a consent agreement which Freddie Mac agreed to pay $125 million in fines and made several significant changes to its corporate governance.

I appreciate all the hard work that Director Falcon and his staff has done on this report. Freddie Mac currently has debts out-

standing in the trillions of dollars. There is no doubt that this company is critical to the housing market. Freddie supplies liquidity to institutions so they can provide loans to consumers seeking to purchase homes; however, with this important mission comes an equally important mandate to protect the taxpayers and to be honest with investors. As the OFHEO report demonstrates, Freddie Mac's senior management misled its investors, its Board of Directors and the U.S. taxpayers.

I am encouraged by the remediation efforts underway at Freddie. Mr. Baumann and his team have worked hard at difficult times to formulate a plan to return Freddie Mac to financial stability, and they should be commended for that. I believe with continued diligence and real reforms, confidence can be restored in the operation of this important company.

Director Falcon has presented an in-depth review of Freddie Mac, but the question remains where was OFHEO when these important trades were taking place? This investigation was not commenced when Freddie Mac announced its restatement; rather it began after the Chairman and CEO along with two other senior executives were released from the company. In fact, if Arthur Andersen had not been removed as the auditor for Freddie Mac, there would be no guarantee that the improper trading practices would not still be going on today.

I believe that OFHEO is underfunded and lacks many of the necessary powers to adequately oversee Freddie and Fannie. I support additional funding for OFHEO so it can fully examine the GSEs and hire a sufficient number of examiners to monitor these financial institutions.

The report we consider today makes several important recommendations for changes both at Freddie and at OFHEO. These recommendations are well thought out, and many of them should be implemented.

I look forward to the testimony of Director Falcon and Mr. Baumann. I hope this hearing will shed some light on what went wrong with Freddie Mac, what steps are being taken to remedy the situation, as well as what changes should be made to ensure that both Freddie Mac and Fannie Mae are properly regulated.

Mr. Chairman, I want to personally commend you for your steadfast interest in this issue going back years, and there is no question that, had you not been a bulldog in pursuing some of these issues, many of these would have not come to light. We would not be on the—really on the cusp of some major reforms with the GSEs, and had it not been for you, this would not have happened, and I appreciate the opportunity to be here, and I yield back.

Chairman BAKER. Thank you, Mr. Chairman, for your kind words.

[The prepared statement of Michael G. Oxley can be found on page 46 in the appendix.]

Chairman BAKER. Mrs. Biggert.

Mrs. BIGGERT. No.

Chairman BAKER. Mr. Ney?

Mr. NEY. I have something for the record.

Chairman BAKER. Mr. Ney submits a statement for the record. Without objection, it is adopted.

[The prepared statement of Hon. Robert W. Ney can be found on page 52 in the appendix.]

Chairman BAKER. Ms. Harris, do you have a statement?

Ms. HARRIS. Thank you, Mr. Chairman, and thank you for having this hearing today. I want to express my appreciation for your willingness to conduct these hearings concerning the special report of Freddie Mac.

I also want to thank Mr. Falcon of OFHEO and Mr. Baumann of Freddie Mac for their insights and willingness to testify before this committee.

Freddie Mac has taken encouraging organizational steps to improve their internal controls and to reform their corporate climate. Likewise, the OFHEO has drafted 16 carefully developed recommendations.

The vitality of the housing market and the importance of accurate corporate reporting are beyond dispute. Our Nation's economy requires beds to thrive. A healthy housing industry has helped buoy us, while other sectors of our economy have struggled. At the same time our consumer confidence levels have remained incredibly resilient, reaching levels typically associated with economic expansion. The result is a real growth rate in 2003, which is 4.4 percent up from 2.8 percent in 2002.

We must continue pursuing policies that support economic growth. MIT economist Lester Thurow argues that scandal always follows boom in capitalism. Ironically, Freddie Mac was still booming when the accounting irregularities were discovered, making this a truly unique situation requiring special attention.

I am sincerely interested in the measures that would restore public confidence while maintaining a strong housing industry, and I look forward to your comments.

Chairman BAKER. Thank you, Ms. Harris.

Chairman BAKER. Mr. Renzi, do you have a statement?

Mr. RENZI. No. Thank you.

Chairman BAKER. You're welcome.

With that, I would like to welcome back, who is certainly no stranger to the committee room, the Director of the Federal Office of OFHEO, Mr. Falcon. Thank you very much for being here today.

STATEMENT OF ARMANDO FALCON, DIRECTOR, OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

Mr. FALCON. I am pleased to be here. Thank you, Mr. Chairman. I am pleased to be here.

Mr. Chairman, Ranking Member Kanjorski, Chairman Oxley and members of the subcommittee, I appreciate the opportunity to discuss with you OFHEO's report of the special examination of Freddie Mac. My prepared testimony will summarize the key findings and conclusions, and I request the committee include it, as well as the full special examination report, in the record.

Chairman BAKER. Without objection.

Mr. FALCON. My testimony expresses my own views and not necessarily those of the President or the Secretary of Housing and Urban Development.

A year ago tomorrow, Freddie Mac announced that completion of its 2002 financial audit would be delayed and that earlier periods

would be reaudited. A switch to internal auditors from Arthur Andersen to PricewaterhouseCoopers had triggered a reevaluation of Freddie Mac's accounting policies, especially those relating to hedge accounting treatments for derivatives occasioned by implementation of FAS 133.

However, the reaudit and restatement process itself raised questions beyond merely the choice of accounting policies. On June 7, as Freddie Mac announced the abrupt departure of three of its principal officers, I ordered a special examination of the conditions that led to the accounting failures and management changes. Although some aspects of the special examination are not yet complete, the bulk of the work was finished this past fall. OFHEO issued a report of the examination, containing the findings and conclusions along with the appropriate recommendations, which the committee received in December.

Since the early 1990s, Freddie Mac promoted itself to investors as Steady Freddie, a company strong in profits, and developed a corporate culture that placed a very high priority on achieving such results. The examination showed that, to do so, Freddie Mac used means that failed to meet its obligations to investors, regulators, and the public. The company employed a variety of techniques ranging from improper reserve accounts to complex derivative transactions to push earnings into future periods and meet earnings expectations. Freddie Mac cast aside accounting rules, internal controls, disclosure standards, and the public trust in the pursuit of steady earnings growth. The conduct and intentions of the enterprise were hidden and were revealed only by a change of events that began when Freddie Mac changed auditors in 2002.

I will now summarize the areas covered in our report. First, the improper management of earnings. By 1999, Freddie Mac had established a practice of engaging in transactions for the express purpose of managing its reported earnings. Freddie Mac used several strategies to shift earnings into future reporting periods, reflecting the proclivity of management to increase operations risk in the quest for more stable earnings. Although some of the most egregious examples relate to earnings volatility challenges associated with the implementation of FAS 133, there were numerous other instances when Freddie Mac management engineered transactions with little or no economic substance to obtain specific accounting results.

Second, the incentives created by executive compensation. The compensation of senior executives of Freddie Mac, particularly compensation tied to earnings per share, also contributed to the improper accounting and management practices of the enterprise. The size of the bonus pool for senior executives was tied in part to meeting or exceeding annual earnings per share targets. While not tied directly to smoothing earnings growth, actions shifting earnings from one quarter to future periods helped to ensure that earnings per share goals, and consequently the bonuses tied to them, would be achieved in the future.

Third, weak accounting, auditing, and internal controls. The management of any corporation, especially a government-sponsored one, is responsible for maintaining a control environment that will accurately record transactions to provide for publicly financial

statements that are consistent with the true financial condition of the firm. In that regard, the obsession of Freddie Mac with steady, stable growth and earnings was at the expense of proper accounting policies and strong accounting controls. Weaknesses in the staffing skills and resources in the corporate accounting department led to weak or nonexistent accounting policies and overreliance on the external auditor, weak accounting controls and an overreliance on manual systems. Given the size of the company and its role in the housing finance and capital markets, those weaknesses effectively increased the systemic risk posed by the enterprise.

Fourth, disclosure. In some instances, Freddie Mac normally circumvented prevailing public disclosure patterns in order to obfuscate specific market accounting transactions. A disdain for appropriate disclosure standards, despite all stated management assertions to the contrary, misled investors and undermined market awareness of the true financial condition of the enterprise.

Within Freddie Mac, no one took responsibility for public disclosures. Failure to assign responsibility and accountability for disclosure to an internal division contributed directly to inaccurate corporate and financial reporting. Such lack of assigned responsibility reflected a low regard that executive management had for that function.

Fifth, the Board of Directors. For the most part, the same long-tenured, shareholder-elected Directors oversaw the same CEO, COO, and general counsel of Freddie Mac from 1990 to 2003. The nonexecutive Directors allowed the past performance of those officers to color their oversight.

Directors should have asked more questions, pressed harder for resolution of issues, and not automatically accepted the rationale of management for the length of time needed to address identified weaknesses and problems. The oversight exercised by the Board might have been more vigorous if there had been a regular turnover or shareholder-elected Directors, or if Directors had not expected to serve on the Board until mandatory retirement age or beyond. Conversely, the service periods of Presidentially-appointed Directors are far too short, averaging just over 14 months, for them to play a meaningful role on the Board.

Based on these findings, the examination report recommended that OFHEO and Freddie Mac take a broad range of actions. As a general matter, the report concluded that OFHEO must ensure that Freddie Mac has established an adequate remediation plan and is allocating the necessary resources to establish a new corporate culture that rewards integrity and the acceptance of responsibility and that penalizes failure to meet appropriate standards of conduct.

The report also detailed a number of specific actions. To improve the effectiveness of the Board of Directors, Freddie Mac should separate the functions of the chief executive officer and the Chairman of the Board, impose strict term limits on Directors, and require the Board meet more frequently.

To address Freddie Mac's general neglect of operations risks and compliance issues, the report recommends that Freddie Mac establish a formal compliance program and a position of chief risk officer

reporting directly to the CEO, with explicit responsibility for operations risk, as well as credit and market risk. In addition, Freddie Mac's central audit department needs to be strengthened so that it can play a more effective role.

To address accounting weaknesses, the report recommends that OFHEO consider and require the exchange of external audit firms. Freddie Mac needs to establish and maintain superior accounting controls and prevent underreliance on its external auditor. It should also document the legitimate business purpose of every significant business transaction.

To address inappropriate management incentives, the report recommended that Freddie Mac refocus its compensation program more on long-term goals, not on short-term earnings.

Until remediation efforts have taken full effect, Freddie Mac remains exposed to substantial management and operations risk. The report recommends that OFHEO consider addressing this concern by requiring Freddie Mac to hold significant regulatory capital surpluses, at least until it can produce timely and GAAP-consistent financial reports.

Finally, the Board recommends that OFHEO take three additional steps. First, OFHEO should implement regulations that provide for mandatory disclosure similar to that required of SEC-registered companies if Congress does not repeal the exemptions of the enterprises from securities laws. Second, OFHEO should expand its capacity to investigate and detect misconduct by including more substantive tests of internal control frameworks at the enterprises, including procedures to identify pressures to commit fraud and opportunities to carry it out. Third, OFHEO should conduct a special examination of the accounting practices of Freddie Mac.

Mr. Chairman, I want to inform you not just about the report, but also of actions OFHEO has taken prior and subsequent to the report. OFHEO directed the holding of termination benefits of senior management pending our review.

OFHEO directed that the current CEO and general counsel be replaced.

OFHEO entered into a consent order with the company's former COO, David Glenn, and secured both his cooperation in our investigation and a strong civil money penalty.

OFHEO entered into a consent order with the company, securing a significant money penalty, and imposing a plan of remedial action on the company that requires issues identified by our investigation be addressed.

Finally, OFHEO is pursuing legal actions requiring the termination for cause of the company's former CEO and CFO.

I have undertaken actions at OFHEO as well. Our examination force is being strengthened. The new Office of Chief Accountant will elevate our work in the important field of corporate accounting and reporting, and a new office of compliance will expand our capacity to conduct in-depth reviews of enterprise activities and better ensure their compliance with laws and regulations.

I would like to close my testimony with an urgent appeal to the committee for assistance in obtaining our 2004 budget. Once again, severe constraints have been placed on our operations. The short-term continuing resolution we are operating under prevents us

from hiring the additional examiners and analysts we need to strengthen our oversight. In addition, we are unable to hire the help we need to conduct our review of Fannie Mae. If the long term is enacted which freezes our budget at 2003 levels, we will need to scale back oversight at a time when greater oversight has never been more urgent.

I urge the committee to help OFHEO to get the resources its needs as soon as possible.

Thank you, Mr. Chairman, and I would be happy to answer any questions the committee may have.

Chairman BAKER. Thank you, Mr. Falcon.

[The prepared statement of Hon. Armando Falcon Jr. can be found on page 61 in the appendix.]

Chairman BAKER. As I understand it, there were 16 different recommendations that were made as a result of your analysis, and I think it should be clear that, given the circumstances in which you addressed the significant attention given to this staff by this matter, there is no one better poised to make recommendations for reform than your office.

What troubles me is they are, frankly, recommendations; that it is up to the enterprise to determine which, if any, it chooses to implement.

One that I find extremely important, OFHEO should require Freddie to hold in a capital surplus limiting growth until they produce timely and certified statements. It appears that at least June of this year would be the soonest it might occur, and, as in the past, that date has the potential to slip.

Do you have the authority to mandate additional capital at this time?

Mr. FALCON. Let me be clear about these recommendations. I may not have been earlier, Mr. Chairman. These recommendations were produced by my staff to myself, and these are recommendations that I will decide whether or not they get implemented, not the enterprise, and I have taken them under consideration, and I agree with all of these recommendations.

Chairman BAKER. Well, in light of that determination, do you believe you have the authority to implement number 5?

Mr. FALCON. Yes.

Chairman BAKER. In light of your prior statement this morning, wherein you indicate if appropriations are not adjusted immediately, you will enter into a period of time in which there is great market uncertainty, great congressional uncertainty, about the ultimate resolution of these matters, why would we not move forward on the great majority or all of these recommendations, particularly in light of your inability to move forward on the forensic accounting analysis of conduct at Fannie Mae?

Mr. FALCON. It is my intent, Mr. Chairman, to move forward on these recommendations. Some will be implemented pursuant to an amendment to our corporate governance regulations, which we are currently drafting. Some of them will be fulfilled through action taken by the company, through working with the company to see them implemented, and others we are working to develop right now.

The one of specific interest to you on the capital surplus, I expect by the end of next week we will have developed a plan which would implement that provision.

Chairman BAKER. Well, given where we are and the uncertainty of what may be further determined as to the actual accounting conduct, no one hopes for any more bad news, but, in light of the fact we do not now know that the Agency may face budgetary limitations on its ability to pursue further examination at great detail, I would strongly recommend or encourage that action be taken as timely as possible, rather than waiting on the enterprise to certify its financials.

Do you have the authority to separate the functions of the CEO from the Chairman, or is that an enterprise determination?

Mr. FALCON. No, that is something we do have the authority to do, Mr. Chairman.

Chairman BAKER. Is there any item on your 16 elements that you feel you are constrained at this time to act on without proper authority to act, or all of these, without reciting them all, or is it in the posture of being reviewed by you at this time and determinations being made as to whether they will be required?

Mr. FALCON. I believe we have the authority to implement all of the recommendations that are included in this report. Now, whether or not any of our actions are challenged by one or more of the enterprises remains to be seen.

Chairman BAKER. And explain for me what that would mean procedurally should someone at the Freddie Mac Board adopt a resolution saying, we do not want to do "X." what are their rights under the current structure, and what would be your ability to impose it under objection?

Mr. FALCON. Well, we would follow the normal procedures act of promulgating regulation and finalizing regulation. Once the regulation is final, they would certainly be free to challenge it in court.

Chairman BAKER. Back at the beginning of this, when Mr. Brendsel's departure occurred, there was an announcement of a severance package that amounted to almost $40 million that was going to be granted without adequate determination of his participation in the accounting manipulations. I wrote at that time and asked that you take whatever action might be permissible under law to preclude the granting of that bonus until such time as final determinations of fault had been made. It is my understanding that that is now in some state of legal discussion.

It triggered a similar question that we wrote a letter in December to your office asking, first, do you review and approve—and I understand that you do review and approve—compensation and severance terms for both enterprises—for executives at both enterprises? We were informed that, perhaps, by the middle of January we might receive an answer to our request for an analysis of the Fannie Mae severance packages, and to date we have not yet received it. Can you give me an idea as to when we might receive that information as well?

Mr. FALCON. Let me—I believe—is that the request where we may have partially fulfilled the request, but there is still a portion that is outstanding, Mr. Chairman?

Chairman BAKER. There was a request relative to salaries and compensation and a second part relative to severance, and you have provided the compensation information, but we have not yet received the severance information.

Mr. FALCON. Let me look into that and make every effort to try to get that to you by the end of the week.

Chairman BAKER. Terrific, because the principal concern there was we had clearly identified wrongdoing, and it appears—not factually known—that the executive may have had some responsibility for that wrongdoing. And to allow someone to profit as a result of those actions is highly inappropriate.

Before we would enter into—and I am not alleging any improper or inappropriate conduct of Fannie Mae, but I think we should know and have in advance the disclosure of those terms and to ensure that you as a regulator have the ability to stop, withhold, and ensure that the taxpayer interest is protected before determinations are made about someone's ability to mismanage numbers and be rewarded financially.

I have exceeded my time. I will be back.

Mr. Kanjorski.

Mr. KANJORSKI. Maybe next year, Mr. Chairman.

Mr. Director, I listened with great interest in your report, and let me see if I understood you correctly.

First and foremost, it was not your Agency that discovered the misstatement. The misstatement or the realization of the misstatement came about because sometime in 2002, an accounting firm was changed, and, in the process of that change, the second accounting firm picked up the restatement; is that correct?

Mr. FALCON. That is correct, Congressman.

Mr. KANJORSKI. That is very disturbing to me, because listening to some of your recommendations, I was trying to interpose myself as Director of Freddie Mac, and I was trying to figure out if the regulator did not pick up this manipulation that had been occurring for years, and only a new accounting firm picked it up, how would you expect a Director to have either access to the information necessary to discover this occurrence or to have the expertise necessary to pick up that?

Mr. FALCON. I think what we expect of the Board is that they ensure that there are adequate accounting controls and internal controls relating to the accounting function, such that——

Mr. KANJORSKI. They did. They hired one of the best accounting firms in the country.

Mr. FALCON. Right; but this conduct occurred prior to the hiring of PricewaterhouseCoopers. This conduct occurred when Arthur Andersen was their external auditor, and it had occurred at a time when their internal audit function was very weak, and the external auditor was serving in essence as the internal auditor for the company as well. So you really had an internal auditor auditing their own work.

Mr. KANJORSKI. And I understand that, but how would you expect a member of the Board of Directors to know whether or not the internal auditing function is reliable? How would you know that? I mean, I have sat on Boards, and I rely on what the certified accountant firm says the condition of the company is, what the re-

port back of the executive management—high executive management firm reports to the Board. How would I be expected to know whether or not there is compliance, whether there is stretching or smoothing of earnings, whether it is driven in 2004, for whatever reason?

In this instance, you suspect it is driven for remuneration under the contract, the employment contract, to the high management? I am just a little worried about that, because, one, we have spent, obviously, millions of dollars to have a regulator, and the regulator—I am not attacking you, at all, you have done a great job, but it shows the need for regulation at these large entities is so great from a standpoint of understanding what is going on that it is obviously not clear to most people that you would pick up an irregularity like this, and yet that irregularity can be horrendous in cost to the company and to the taxpayer ultimately.

I do not know what we do about it, short of having maybe dual auditing, or someone came up with the idea in the past a change of auditors periodically, because if we had not had a change of auditors here, they would still be doing what they were doing, and you would not have picked it up. The regulator for the government would not have picked it up.

Mr. FALCON. Right. The nature of the conduct that we found with the company was, by its nature, hidden and not transparent to regulators and to—fully to the Board as well.

The Board was aware of weaknesses in the accounting function of the company, and, in fact, a plan was developed to try to improve the accounting function at the company, but that was not adequate to what was ultimately needed at the company. This was an area—as far as OFHEO's standpoint goes, this involved accounting transactions, the accounting for transactions which were designed to shift earnings into future periods.

Now, the role of a safety and soundness regulator is not to, on the secondary level, certify the work of the auditor. No safety and soundness regulator is equipped to do that, but I do not think that is adequate in the future.

What we are going to work on going forward through the creation of an office of a chief accountant is to look at expertise where we can look at more closely the work of a company to implement new accounting standards, the work of a company to account for certain novel or unique transactions which might be questionable. We have to do what has not been done by the safety and soundness regulators. That is what I think is necessary going forward.

Mr. KANJORSKI. The only thing I am trying to relate to you is I do not have a high degree of confidence at this point that we are any more prepared to meet a challenge of this nature in another entity; that we would either discover it, that we have the tools to handle it, that we have the transparency within the company to pick it up. And it is all nice and good to say, well, Directors are going to have to be more cautious and more responsible.

I do not know what you do as a Director. If your top manager is lying to you, if your auditors are lying to you, and if the government regulator that regulates you cannot pick it up, how do you expect the Director to pick it up? Short of camping on the site and

shadowing the operations of the company, I do not know how you do it.

The other thing I am interested in here: Did you find that this was purely a profit-driven vehicle for top management to get a better return on their bonus programs or whatever it was?

Mr. FALCON. That was part of the cause of the problems in the company. It was not the only reason for the actions in the company.

The company very much wanted to try to show steady earnings growth, and because of market conditions in early 2001, they reaped a windfall in net income at the company. The result was they sought to shift that money around. In addition, they had to try to shift income around that was the result of——

Mr. KANJORSKI. Right, I understand what they did, but do you feel you have gotten to the motive? Was the motive for self-reward under the schemes of the bonuses or payment system of management, or was there some other scheme?

I am sort of hurt to think that some of these fellows would have subjected this company's reputation and assets to extraordinary losses. I mean, the way I am running in my mind, this is probably a cost of over a billion dollars to this company, and certainly they did not get that kind of a package return from their—as a motive from their salary situations. So it seems the expense to the company far exceeds the benefits, the package benefits, these people received, so I am looking for some other motive that was there.

Mr. FALCON. And I think it is addressed in the chapter in our book which talks about the tone at the top. The company took great pride in meeting the expectations of analysts; hence, the nickname Steady Freddie. And ultimately it engaged in whatever means were necessary to continue to meet those expectations of investors.

Mr. KANJORSKI. I am sorry to be so long. I am shadowing the Chairman, however.

You found some difficulty with the counterparties in the derivatives, and, as I understand it in prior discussions with you, you do not necessarily know whether or not—how far your authority allows you to reach into determining whether the counterparties are sufficient to honor the commitments they make in derivatives. And of course that is vitally important as to whether there is any validity or value in the derivatives.

If you have a fake counterparty or a less than adequate counterparty, you have nothing, and it seems to me when we are dealing in the hundreds of billions of dollars, some people say trillions of dollars, of derivatives today, particularly with these GSEs, what scope of a program do you have to authorize or to ask Congress to authorize you with greater authority to get into the review, oversight and understanding of the effectiveness of counterparties in these transactions, derivative transactions, or does not that scare you?

It scares the hell out of me. I do not sleep very well. If these folks are doing what they did in Enron and manipulating what they did here, now they are playing a sissy game. They ought to be out playing with derivatives and setting off false counterparties, and they could be ripping off tens of hundreds of billions of dollars. What is your feeling of that?

Mr. FALCON. We are currently looking at the role of counterparties in the Freddie Mac situation, trying to discover whether improper conduct was engaged in by facilitating some of the key transactions the company used to shift earnings. We have not concluded that review yet.

Ultimately our authority—we do not have direct authority over these counterparties; however, we do have authority over the two companies we regulate, and if we thought their entering into transactions with certain counterparties was an unsafe and unsound practice, we could take steps to limit their business dealings with those counterparties.

Mr. KANJORSKI. Do you examine or have the authority to examine the financial statements of counterparties?

Mr. FALCON. No, we do not.

Mr. KANJORSKI. So you have no idea whether they are strong counterparties or effective and well-asseted counterparties, do you?

Mr. FALCON. We do look at the counterparty's credit rating.

Mr. KANJORSKI. That is the whole point. You are relying on secondary, and whoever did the credit rating is probably relying on their oversight by a government regulator. There is sort of a tendency for everybody to think the other guy is making the examination, the study, or the determination; in fact, nobody is, and it could just as easily be a very similar transaction to Enron. A very bright financial fellow could structure counterparties that are straw counterparties, that have absolutely no value out there, and yet are handling these multi-billion-dollar transactions, with the assistance in a way of internal management, because they have a goal to affect their income stream as a result of success, but, in fact, the counterparty would be interested in eluding the operation, getting paid for something that they are not putting value up for.

Chairman BAKER. Mr. Kanjorski, if I might, the recommendation number 11 is Freddie should document legitimate business purpose for every significant derivative transaction, so the regulators have identified that as an area of concern. I am very anxious to see if they have the ability to enforce that.

Mr. KANJORSKI. Right.

Chairman BAKER. I thank the gentleman.

Mr. Shays.

Mr. SHAYS. Thank you. I have questions, but I would like to follow other Members and hear what they have to ask.

Chairman BAKER. Mr. Ryun.

Mrs. Biggert?

Mrs. BIGGERT. Thank you, Mr. Chairman, Director Falcon.

Going back to the Board of Directors, just for clarification, the Board is made up of Directors who are shareholder-elected, and then there is also the Presidential-appointed Directors?

Mr. FALCON. Yes, Congresswoman. There are five of them for each company.

Mrs. BIGGERT. Five?

Mr. FALCON. Five.

Mrs. BIGGERT. And in your statement you say the shareholder-elected Directors, I assume, are going to stay until they reach 65 or even beyond?

What is the average a Director has been a shareholder?

Mr. FALCON. The average tenure of a Director for Freddie Mac?

Mrs. BIGGERT. Mm-hmm.

Mr. FALCON. I believe it is probably over 10 years.

Mrs. BIGGERT. Okay. And then you say that, conversely, the service of the Presidential Directors is—averages just over 14 months, or was your statement that that is when they become effective?

Mr. FALCON. That is their average tenure on the Board. Their terms are for 1-year appointments, and some of them are reappointed, but the average tenure of a Director is 14 months.

Mrs. BIGGERT. Right. So do you think if they are serving as a Presidential appointment, if the tenure was longer, that maybe they would have been more effective, and maybe they would have been able to participate to something that was going on, misconduct?

Mr. FALCON. I think they could be more effective on the Board if they were allowed a longer term on the Board. However, my preferred approach is, I think, corporate governance would be better enhanced if shareholders were allowed to elect all Directors of the Board, rather than 13 of the 18 Board members.

Mrs. BIGGERT. Do you have any background in why there were Presidential appointments made, the reasoning for it?

Mr. FALCON. Just the nature of these being government-sponsored enterprises and the charters. That was part of the original—I believe it was one of the original charter provisions of both companies.

Mrs. BIGGERT. So there would be more oversight if there were just the shareholders?

Mr. FALCON. I believe shareholders would have a larger voice in the company if they elected the members of the Board, as opposed to just a portion of the Board members.

Mrs. BIGGERT. Okay. One of the—something that companies—when there is rapid growth, that is often seen as a stress on the institution, and we have seen dramatic growth in the operations of Freddie Mac over the last several years. Did not this growth as much as 30 percent raise concerns at OFHEO?

Mr. FALCON. Much of the growth has come in the form of the retained portfolio, which, over the last 10 years, I think, has grown maybe 7—maybe 700-fold. They began their retaining portfolio operations with well less than $100 million, and I think they were at a 600- or $700 million enterprise, depending on what you are talking about.

That reflects a shift in the company's business strategy. As they became more of a portfolio lender, they began to take on credit risk associated with guaranteed mortgages, but the growth presented a new risk, which was market risk, which was part of holding these portfolios.

Mrs. BIGGERT. So that does not raise any red flag with OFHEO to investigate or ask for an examination?

Mr. FALCON. It does mean that the company has to devote appropriate resources to making sure they adequately understand and manage the risk associated with holding those large retained portfolios.

Up to this point we have seen them manage the risk associated with those portfolios in a very prudent manner, so we do watch the

growth rate carefully. As long as they are able to manage the growth, we haven't seen the need to step in and slow down the growth.

Mrs. BIGGERT. So there is nothing that you would want to change in that which you think, maybe looking back, that you should have?

Mr. FALCON. No, Congresswoman.

Mrs. BIGGERT. All right. So do you know whether the enterprise or their auditors conducted their own stress test?

Mr. FALCON. They did maintain their own stress test while we were in the process of developing our stress test. I believe they have discontinued the use of those stress tests; in fact, I think it was one of their voluntary steps they had taken internally at the companies, but with OFHEO's stress test now fully implemented, I do not know if they continued to use their internal stress test.

Mrs. BIGGERT. So did you review their data that they had accomplished?

Mr. FALCON. We are familiar with the operations of the stress test they were running during this interim period, but we do run our own stress test, based on the data submitted by the enterprises to OFHEO, and I believe the stress test is a very robust gauge of risk, and it ties capital very closely to risk.

Mrs. BIGGERT. Thank you very much.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mrs. Biggert.

Mr. Scott?

Mr. SCOTT. Thank you, Mr. Chairman.

Mr. Falcon, let me ask you about the culture at Freddie Mac. Do you think there is a permissive corporate culture that neglected accounting and oversight and focused on the wrong incentives for executive pay there?

Mr. FALCON. I do, Congressman.

Mr. SCOTT. Have you seen any improvement in that culture at Freddie Mac?

Mr. FALCON. I have. Since the time that new management has been brought in, including the new Chairman of the Board of the company, the company has done a lot of good work in trying to implement a remediation plan, as well as steps to bring about a new corporate culture within the company, so I think they have done a lot of good work.

I think, since the events of that transpired in the past year, the Board has been very active in fulfilling its responsibilities, so I think companies also cooperated very well with OFHEO. So I think as a general matter the company has done a lot to resolve a lot of these problems.

Mr. SCOTT. Is there anything particular that you could put your finger on that might have caused this permissive culture there?

Mr. FALCON. It was the result of senior management at the very top focusing first and foremost on the desire to try to meet the earnings expectations of the investment community; and it meant trying to smooth out any spikes in income, whether they be down or up. In this case, it was upward spikes in income that were shifted into future periods. I think the company became overly concerned with the fact that if there was a spike that went up very

high that the analyst community might then expect the—raise their expectations for the company. So the desire was to try to meet expectations but not by too much, not exceed them by too much.

Mr. SCOTT. Now, you say that until—you stated that until Freddie Mac fully complies with remediation, it remains exposed to substantial management and operation risk. Will OFHEO require Freddie Mac to hold significant capital surpluses?

Mr. FALCON. Well, as I have said, they have made good progress in turning around the corporate culture at the company and focusing on the highest standards. There remains much to be done. The company still has a ways to go before it can produce timely quarterly financial statements. The requirements of our consent order will need time to get fully implemented, and there are several very senior management positions that remain to be filled. So there is still much to be done at the company. In the meantime, these remediation efforts that are required in our consent order with the company will work to address shortcomings in the accounting area, in the internal controls area. However, in the interim, I think it is an appropriate for the company to hold additional capital until all of these corrective actions have taken full effect; and that is what we will address by the end of next week.

Mr. SCOTT. Okay. Well one final question, Mr. Chairman, if I could. The examination report recommended that OFHEO conduct a special examination of the accounting practices of Fannie Mae. On January 2nd, the Wall Street Journal stated that Fannie Mae has lost so much capital in the past 3 years that its capital is now below OFHEO's required minimum. Are you aware of that article?

Mr. FALCON. I am aware of the issue that you raise. I don't think it is comparing the same thing though.

Mr. SCOTT. What is your opinion on this?

Mr. FALCON. May I? I think the focus there has been on capital as reflected in fair value statements, as opposed to capital as calculated in our core capital standard. Our core capital standard is similar to that of every other safety and soundness regulator and is consistent with GAAP.

What a fair value statement does is try to market all the assets and liabilities of the company; and, in this case, that capital as reflected in fair value statements is lower than the capital as we calculated for core capital and minimum capital purposes. However, while fair value statements are useful indicators of the company's current liquidation value, it does not reflect—it has some limitations. It does not reflect the ongoing concern value of a company. So that is the difference between the two standards, Congressman.

Mr. SCOTT. Thank you.

That is all my questions, Mr. Chairman.

Chairman BAKER. I thank you, Mr. Scott.

Mr. Shadegg, do you have questions? Mr. Bachus?

Mr. BACHUS. I thank the Chairman.

Director Falcon, as I recall, it was January when Freddie Mac made the announcement that it planned to restate its earnings. Then in June they announced the departures of Mr. Glenn and Mr. Clark and Mr. Brendsel, and it was at that time or the next day or two that you formed a special investigative unit to investigate.

Mr. FALCON. Yes, Congressman.

Mr. BACHUS. That is a lag of 6 months. Was there—did you do anything with—immediately after the restatement announcement or——

Mr. FALCON. Yes, we did, Congressman. What we did was we were primarily focused on making sure that the company got the restatement and the reaudit done as soon as possible so that the company could be operating with certified financial statements. For a company of this size and their importance to our housing finance market to be operating without certified financial statements was not a good position to be in, and so we directed our focus mainly on making sure that that got done as quickly as possible. In the meantime, we agreed that the Board took the correct action in hiring an outside law firm to conduct a review of the circumstances arising from the restatement. In time, it turned out that that law firm's cooperation and disclosures to us were not adequate, and so we decided rather than wait for the completion of the restatement whereupon we would decide whether or not to conduct our own investigation under the circumstances, I decided it was no longer correct to wait any longer for the law firm or the restatement to get completed and we would conduct our own examination of this.

Mr. BACHUS. Were you caught off guard by the announcement that they would restate their earnings?

Mr. FALCON. I think it is never a position that any regulator wants to be in. At the time, until we got deeply into this, much of the appearance was, was this a matter of simply a disagreement between accountants, two different accounting firms or was this more, or was there more to it? As it has turned out, there was more to it. This wasn't just a disagreement between two accounting firms. This was a result of the misapplication of accounting rules, of the misuse of transactions to achieve accounting results. All of this was, by its very nature, misconduct that was concealed from us. Only with greater depth of examination can we try to catch this kind of stuff going forward, which is why I have pressed for greater resources and I am retooling the agency to be able to better focus and catch these kinds of accounting problems.

Mr. BACHUS. Well, let me ask you this. You formed the special investigative unit. Actually, it was 6 months after the original announcement of restatement. It was a 6-month lag, and it wasn't until after—the day after they announced the departures, which indicates a really fundamental problem, I think, also. But why did it take so long to form this unit? In hindsight, would you have been better off to have began investigating it with your own unit in January?

Mr. FALCON. In hindsight, yes. However, this is a common practice of safety and soundness regulators, where often regulators will direct the Board of a bank or a thrift to hire independent outside counsel to undertake a review of any particular issues. So it is a common practice of regulators. However, given what we now understand was the seriousness of this and the conduct that was uncovered, yes, I would have preferred to have been in there much sooner.

Mr. BACHUS. Okay. Thank you.

Chairman BAKER. Yield back?

Mr. Hinojosa.

Mr. HINOJOSA. Thank you, Mr. Chairman.

Before I ask my question, Mr. Falcon, I want to stress that the housing market has served as the foundation of the U.S. economy since the stock market declined post-Clinton and post-9/11. During that time, Fannie Mae, and Freddie Mac have played a key role in supplying liquidity for the housing market, thereby supporting our economy in a time of need, especially when we had gone from a budget surplus to an incredible and dangerous deficit. It is my firm belief that whatever action that we decide to take in Congress, if any, with respect to any of the GSEs, we must not alter their internal structure or any aspect of their regulation that would harm them or our economy.

In your testimony, you ask for increased funding for OFHEO for fiscal year 2004. Some critics will say you don't deserve it because you failed to uncover Freddie Mac's problem. Others would say you need it because otherwise additional problems could arise if you don't have the manpower to oversee these two giants. Even though there is discussion of the creation of a new regulator, that likely will not be up and running until 2005, if at all. Consequently, you will need funding. How much money do you need to oversee the GSEs in this year, and how much is in your proposed budget in the omnibus bill which we have not yet passed?

Mr. FALCON. I appreciate your interest in this, Congressman. Our budget is $40 million. That is our 2004 budget. And that $40 million includes an amendment that the President requested to our 2004 request which would allow us to fund the special review of both Fannie Mae and the continuing review of one aspect of the Freddie Mac issue. In addition, it will allow us to hire additional examiners, I think some 18 examiners as well as a few other analysts to help us enhance our oversight. They are funds that we do need very much. We have developed plans on how we will utilize these additional staff resources and we are just waiting for the funding so we can begin to hire these people and plug them into our oversight.

Mr. HINOJOSA. Finally, Mr. Falcon, I have two short questions for you. How much money would you want Congress to give you if it decides to pass a supplemental early this year in addition to those $40 million? And, also, what is your opinion of the various proposals for new regulation of GSEs?

Mr. FALCON. As far as additional funds beyond the $40 million, we do have plans to increase the size of our examination staff beyond the amount that is included in our 2004 budget. It would be optimal to be able to begin to hire those individuals as soon as we can identify them, however, we have to manage our growth appropriately. I think the 2004 budget is of a sufficient amount that will allow us to do the growth that we desire for this year. Beyond this year, we will need additional funds to continue to enhance and strengthen our supervision. But we have to manage this growth in a proper way. So I think the 2004 budget is adequate. However, for 2005 we would like additional funds beyond our 2004 budget.

Mr. HINOJOSA. On the second question, what is your opinion of those proposals that are out there now for the regulation of the GSEs?

Mr. FALCON. My position remains the same as my testimony that I gave the committee last year. I do support strengthening of the safety and soundness regulation of Fannie Mae and Freddie Mac. I do think that we should start with the premise that a safety and soundness regulator for these companies should have all the same powers and authorities as every other safety and soundness regulator, and that is what I have tried to establish since I became Director of OFHEO. That involves a strong independent regulator, not part of the appropriations process, and I think this is appropriate because we are not funded with taxpayer dollars. We are funded through assessments on the two companies that we regulate. It also requires, I think, expedited hiring authority.

Let me just, instead of going on, just refer you to my testimony from my last appearance at the committee and say that remains my position as I stated in that testimony.

Mr. HINOJOSA. Thank you, Mr. Falcon.

With that, Mr. Chairman, I yield back.

Chairman BAKER. Thank you, Mr. Hinojosa.

Mr. Shays.

Mr. SHAYS. Thank you, Mr. Chairman.

I can't disagree more strongly with anyone who believes that somehow allowing Fannie Mae and Freddie Mac to play by different rules than any of the other businesses that they compete with should be allowed to continue; and I would just like to ask Mr. Falcon, why shouldn't I feel that OFHEO is a captive of Freddie and Fannie? What confidence should I have that this organization isn't held captive by these—by both companies?

Mr. FALCON. I think since I have been Director of this agency we have demonstrated our willingness to take whatever action we feel is appropriate as a regulator, whether or not the enterprises agree or disagree with our actions. We have always conducted ourselves in this way, and we will continue to do so.

Mr. SHAYS. Let me ask you this: What has been your position on getting Fannie and Freddie to be under the 1933 and 1934 Securities Acts?

Mr. FALCON. I support removing those exemptions, the exemptions from those two acts.

Mr. SHAYS. Okay.

Mr. FALCON. I think our experience with Freddie Mac demonstrates that a system of voluntary disclosures just cannot work for these two companies.

Mr. SHAYS. When did you come to that conclusion?

Mr. FALCON. I think the report of our examination demonstrated that a voluntary system just cannot work well enough, and it is when I was presented with the results of our special examination that I came to this conclusion.

Mr. SHAYS. So we have had Treasury going back over a decade and a half recommend they be under Fannie and Freddie. We have had the head of the Federal Reserve suggest that they be under the 1933 and 1934 Act for many, many years. You come to this conclusion based on what you learned recently with what has happened with Freddie and this investigation?

Mr. FALCON. Yes.

Mr. SHAYS. Okay. How have you conveyed your feeling that this needs to happen?

Mr. FALCON. The rationale?

Mr. SHAYS. No, no. How have you conveyed to Congress and others that they should be under the '33 and '34 Act?

Mr. FALCON. It is a recommendation contained in the report that I submitted to the committee.

Mr. SHAYS. Okay. Can you cite that and read it for us?

Mr. FALCON. Yes. Congressman, if you look at the recommendations it is contained in page 164 of the report and it is number three.

Mr. SHAYS. Would you read it?

Mr. FALCON. Yes. OFHEO should establish a regulatory system of mandatory disclosures for the enterprises or their securities exemptions should be repealed.

That is the heading. Would you like me to read the entire——

Mr. SHAYS. Pick out the most juicy part.

Mr. FALCON. The disclosure failures of Freddie Mac were extensive and damaging to the trust of the public in the future disclosures of the enterprise. It is clear that the financial disclosures of an enterprise should not be left to a system of voluntary commitments. Fannie Mae has registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934, and Freddie Mac has promised to do so as soon as possible. To address the issue of the adequacy of enterprise disclosures completely, OFHEO should implement mandatory regulations that provide for mandatory disclosure similar to that required of SEC-registered companies and build staff resources necessary to oversee compliance. Alternatively, the Congress should repeal the exemptions of the enterprises from the Exchange Act and the Securities Act of 1933. Either option should result in the type of mandatory disclosure and oversight regime necessary to ensure safe and sound conduct.

Mr. SHAYS. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Shays.

I just have a couple of follow-ups.

With regard to your assessment of the enterprises' capital adequacy, it has been clearly stated that the retained portfolios have grown, depending on the enterprise, 6 to 700 percent. I have knowledge that the purchase of their own mortgage back securities which was initially contemplated moving more risk out of the portfolio into the other sectors of the market now having been brought back in significant amount into their retained portfolio has resulted in significant increased leverage ratios. Given the uncertainties of accounting condition, is there any explanation why we shouldn't see some increase in capital surplus and at least some consideration of another approach to help with market discipline, given the financial constraints which you face and the uncertainties of the condition of the enterprises if we were to move to quarterly fair value disclosures?

Now I understand the calculation of fair value is distinct and different from core capital calculation. But any consistent measure against which previous quarter performance can be measured against the current data I think is a helpful tool to the markets

to better understand the risk profiles of the various enterprises. Would you think it advisable or ill-advised to consider requiring quarterly disclosure of fair value?

Mr. FALCON. I think it might be well-advised if we could make sure that the calculations are consistent by both companies. They might not necessarily be consistent, and therefore you might not be able to properly compare one against the other.

Chairman BAKER. And that is the case together with general disclosure. We are moving toward comparability, but we don't have it today, do we, in a broad sense?

Mr. FALCON. In a broad sense, yes.

Chairman BAKER. With regard to the point made by members previously with the lack of adequate funding, it is my understanding—and please confirm if I am correct—that OFHEO is the only principal Federal financial regulator that is subject to congressional appropriations for its enterprise operation, meaning that each year you must submit for budgetary consideration a budget which then has to be acted on by the Congress as contrasted, for example, with the OCC which oversees large commercial banks. They have a formula that results in an assessment, and that is an automatic calculation that enables that enterprise to engage in its regulatory function without the necessity of making its case, as it were, to the Congress. Is OFHEO's condition in that regard a unique one?

Mr. FALCON. Absolutely, Congressman.

Chairman BAKER. So that if we were to create a regulatory enhancement for your shop, having you funded independently of congressional action would be a very significant benefit to you.

Mr. FALCON. Absolutely. It would benefit us in many ways. It seems every year we have to slow down our operations as far as hiring goes and major acquisitions purchases by the agency until we wait for a budget to get enacted after the CR period is over. Being out of the appropriations process would allow us to engage in long-term planning and meet immediate funding needs on a real-time basis. Right now, we have to set our budget 2 years in advance and hope that the budget we had put together at that time still matches the requirements that we have. As we have found with this Freddie Mac situation, our budgetary needs have not kept up with our requirements, but we are trying to adapt as quickly as possible. We would have much more flexibility to do so were we not part of the appropriations process.

Chairman BAKER. And if you had those resources you would probably implement all 16 and get on with that forensic accounting business, too.

Mr. FALCON. Right, Congressman. Although, appropriations or no appropriations, we will look at moving on as many of these 16 as soon as possible.

Chairman BAKER. As a sort of follow up to Mr. Shays' line of questioning, with regard to recommendation number three, if you are unable to establish or find it unwise to establish a mandatory disclosure regime or part of that recommendation or their securities exemption should be repealed, that would require action by the Congress, would it not?

Mr. FALCON. Yes.

Chairman BAKER. Okay.

Mr. Kanjorski, do you have any follow-up?

Mr. KANJORSKI. Just if I could ask your opinion. After having made this detailed study and having the new accounting operations at Freddie Mac, do you have an opinion as to whether or not there is any systemic risk involved here with these GSEs or have you satisfied in your own mind that you know all the occurrences that have taken place and in your opinion is there any risk now to the system or to the taxpayers?

Mr. FALCON. There are two aspects of this that I would like to get into. First is, as a general matter, we published a study a year ago which identified and explained the nature of the systemic risk posed by the companies. Now, systemic risk is different from an imminent threat of a systemic disruption which would happen if either company experienced severe financial difficulties such that they would default on counterparty obligations or risk insolvency at this point or at any time. While Freddie Mac has experienced these accounting problems, have we felt that the company's safety and soundness was compromised? These were very improper practices which were not safe and sound practices, and we have taken all the action necessary. But is the company unsafe and unsound? We don't think so.

Mr. KANJORSKI. Now, just one other question. I have met with a lot of Directors in the Federal Home Loan Bank system and they have expressed to me their desire to have more expertise in the derivative area and particularly with the counterparties they are engaging in. Have you developed any scheme within the—your agency as to what can or should be done here to take the risk out of the counterparty situation, or are we just going along in the way it has occurred before, the restatement?

Mr. FALCON. I think there are mechanisms in place to try to manage the risk of counterparty defaults where the company—I mentioned the ratings of the companies, but that is not the main one. I think when the companies engage in derivative transactions they do obtain collateral for their exposure if there was a default and a need to replace the derivative. And there are netting agreements in place as well for the company. So I think there are mechanisms in place to try to deal with a potential default of a counterparty. But, ultimately, each player in this, whether it is us as the regulator, Fannie, Freddie or a bank regulator as a regulator of a bank counterpart, has to fulfill their mission in making sure that their part remains safe and sound.

Mr. KANJORSKI. Well, what do we do, though, to—I mean, I was impressed when Directors come forward and say, look, this is beyond our understanding as Directors. We just don't know whether we are doing the right things or not doing the right things, and we have no one to call upon to provide with us that expertise. How can we—with this new derivative area that we are in, how can we take that risk or that absence of knowledge away and provide the knowledge that the Directors or the companies need or the taxpayers need with our oversight to see that that risk doesn't exist anymore? Is there any way of lessening it?

Mr. FALCON. On the part of the Board which you have mentioned, I think they have to be certain that they have adequate ex-

pertise within the company to understand and manage that risk, and they have to receive frequent and adequate reports from management about their activities in managing that risk. Now, ultimately, do you expect the Board to be experts in derivative transactions? I don't think you can reasonably expect that every Board member will have that kind of specialized expertise. So it is important for the Board to make sure that the company retains that expertise, but they have to adequately oversee that expertise as the Board of Directors, and it is the responsibility of OFHEO to make sure that all that takes place as well.

Chairman BAKER. If I can, I have just been advised that approximately noon or shortly thereafter we will have a series of votes. If members don't have any additional questions for Mr. Falcon at this time, then I would like to express my appreciation to him for his appearance so that we may get our next witness up.

Did you have any further, Mr. Bachus?

Mr. BACHUS. Mr. Chairman, if I could just ask one brief question.

Director, I asked earlier—asked a question in January. When Freddie Mac announced that they were going to restate earnings, I asked you what response OFHEO took; and your response was that the outside law firm was hired to investigate the circumstances. But now they were hired by the Board of Directors, weren't they?

Mr. FALCON. Yes, that is correct.

Mr. BACHUS. Not by OFHEO.

Mr. FALCON. Correct.

Mr. BACHUS. Now what you said you all focused on was getting the restatements done.

Mr. FALCON. Yes.

Mr. BACHUS. Now let me ask you two questions. First, the outside law firm that was hired by the Board of Directors, they made a report which basically did not reveal what your special investigating unit found. I mean, it is rather incomplete, would you agree?

Mr. FALCON. It didn't cover all the areas or make the same kind of critical analysis that our's did, I believe.

Mr. BACHUS. Right.

Mr. FALCON. Yes, sir.

Mr. BACHUS. Do you think that there was any concealment? The reason maybe they didn't find some of these things, do you think there was any concealment?

Mr. FALCON. I don't have any evidence of that, Congressman.

Mr. BACHUS. Do you think that the report—that their report was in some way compromised by——

Mr. FALCON. In what way? I think——

Mr. BACHUS. Well, that is the Doughty report I think you are referring to.

Mr. FALCON. Yes.

Mr. BACHUS. But your special investigative unit began to investigate the same matters, you found additional things, and that was—is that correct?

Mr. FALCON. Yes, that is correct.

Mr. BACHUS. I'm just saying, why do you think that they weren't found in the investigation that was authorized by the Board of Directors and you were able to find these things?

Mr. FALCON. Well, I think that report was focused primarily on the transactions and the nature of the transactions. We tried to get at the root cause of what happened with the company and how it got to that point, and we were going to look at not just the transactions but also the conduct of management and the conduct of the Board of Directors. Now, I guess an obvious limitation of that report by the outside law firm was its client was the Board and it was hired by the Board and I don't think it was going to take as critical a look at the conduct of the Board as we were prepared to do.

Mr. BACHUS. All right. Well, that is what I would suspect, also, that because it was hired by the Board and not OFHEO, does that indicate to you maybe if this were to happen again that it would be better for OFHEO to select then or investigate itself or at least select and charge the outside firm?

Mr. FALCON. I think that would be the presumptive course to take. Here, again, until a deeper review was conducted, it wasn't evident what kind of conduct we were really talking about at the company.

Mr. BACHUS. You said, as opposed to investigating the circumstances, you allowed the Board to hire an outside investigator which was charged with only limited scope which is—in hindsight is a mistake. But you said you focused on the restatements, but those are still not complete.

Mr. FALCON. Our position at the time, Congressman, was we were focused on getting the timely financial statements and getting the reaudit, restatement done. At the same time, the Board hired this outside law firm to conduct its analysis of the circumstances that brought about the reaudit. At the time, we believed were making good progress with the restatement and that we would assess the work of this law firm to decide whether or not it was necessary for us to conduct additional review. When the events of June took place, it became clear that we could not wait for the law firm to finish its work and we would not wait for the restatement and reaudit to get completed either.

Mr. BACHUS. Well, that is why I am saying it only became obvious to you after the resignations that it wasn't a sufficient investigation of the circumstances.

Mr. FALCON. Right. And it was beginning to become clear that this was not just about a disagreement between the auditors but rather there was more going on at the company.

Mr. BACHUS. Okay. Now, there are still restatements to be done so Freddie Mac is still not current in that, am I correct?

Mr. FALCON. Right. Technically, the restatements have been done. What is lacking is there aren't quarterly statements for 2003 nor will there be a year end 2003 financial statement. That is what the company is working on right now.

Mr. BACHUS. All right. Thank you.

Chairman BAKER. The gentleman's time has expired.

Mr. Falcon, I wish to again thank you for your courtesy in appearing here today. We look forward anxiously to the final rec-

ommendations you may choose to make with regard to potential reform and certainly into the next year we will do our best to be of assistance with those funding concerns. Thank you very much for your presence.

Mr. FALCON. Thank you very much, Mr. Chairman, Congressman Kanjorski.

Chairman BAKER. At this time, I would invite Mr. Martin Baumann, Chief Financial Officer of Freddie Mac, to come forward.

Welcome to Capital Markets, Mr. Baumann. We certainly appreciate your courtesy in appearing here today, given the interest the committee has in this important matter.

As is the usual custom, your formal statement will be made part of the record. To the extent possible, if remarks can be targeted toward the 5-minute rule then that will enable members to ask appropriate follow-up questions.

With that, we welcome you as the Chief Financial Officer of Freddie Mac to make your statement.

STATEMENT OF MARTIN F. BAUMANN, CHIEF FINANCIAL OFFICER, FREDDIE MAC

Mr. BAUMANN. Thank you, Chairman Baker, Ranking Member Kanjorski and members——

Chairman BAKER. I think that button on the bottom will have to be pushed. Try that.

Mr. BAUMANN. Thank you.

Chairman BAKER. No, try again.

Mr. BAUMANN. Can you hear me now?

Chairman BAKER. There we are.

Mr. BAUMANN. Thank you Chairman Baker, Ranking Member Kanjorski and members of the subcommittee.

My name is Martin F. Baumann. I am the Executive Vice President and Chief Financial Officer of Freddie Mac. I joined Freddie Mac in April of 2003. I was hired to build a strong finance function within Freddie Mac and restore confidence in the company's financial reporting. I am committed to developing an exemplary finance function that produces accurate, timely, well-controlled and transparent financial reports. Prior to joining Freddie Mac, I worked at PricewaterhouseCoopers for more than 30 years as a partner, as deputy chairman of the World Financial Services Practice and as the Global Banking Leader.

2003 was a challenging year for Freddie Mac. In January, we announced a restatement of prior year earnings; and in June our Board of Directors made changes in the company's senior management. Freddie Mac has been working hard to regain the confidence of all of our stakeholders. Last year, we completed the restatement of prior year financial results. OFHEO completed its special examination, and we entered into the consent order. We are implementing a corporate-wide remediation program to ensure that the accounting of financial control issues that led to the need for the restatement will never happen again. We appreciate the subcommittee's patience as we have worked through these tough times.

Freddie Mac's mission is to insure a stable supply of low-cost mortgages for America's families, whenever and wherever they

need them. We recognize our special responsibility to home owners, the public, Congress and investors. Despite our difficulties last year, we maintained our focus on fulfilling these responsibilities.

As the President said last night, the country is experiencing record home ownership rates. We are proud of the role we are playing in this important accomplishment.

Our highest priorities are remediation and compliance with the consent order, along with bringing our financial statements current. We are firmly committed to building a new organizational culture based on transparency, openness, and building of long-term results. We are headed in the right direction, and we have the right leadership to reach our goals in our new Chairman and Chief Executive Officer, Richard F. Syron.

Before addressing our remediation and compliance efforts, allow me to say a few words about the completion of our restatement and prior year results.

On November 21, 2003, Freddie Mac's Board of Directors and management team announced the release of the company's restated and revised financial results for the years 2000 through 2002. We are now completing our annual report for 2002 and expect to hold the related annual stockholders meeting this quarter.

Freddie Mac completed this restatement while maintaining our business fundamentals and delivering on our congressional mandate to make mortgage credit more available for America's families. We remain fully committed to our mission of helping make housing more affordable for more Americans and maintaining liquidity in the housing market which for the past several years has bolstered the U.S. economy.

The restatement did not affect the fundamental strength of Freddie Mac's business. Our business operations remain strong and interest rate risk and credit risk remain low. Our risk profile remains conservative, with an average duration gap of zero for November, 2003, unchanged from October.

Freddie Mac is currently engaged in an active remediation program that began in the spring of 2003 when the governance committee of the Board asked me to develop a remediation program to ensure that the factors contributing to the restatement would never recur. Thereafter, the Board approved a comprehensive remediation program that has been and is effecting far-reaching changes in the company's financial reporting, control and management functions. The consent order added further key items to our existing remediation program, resulting in an enhanced, comprehensive remediation program designed to ensure the integrity of Freddie Mac's financial reporting, controls and governance. We have been working closely with OFHEO to make sure that we take the remediation steps required by the consent order on a timely basis.

Our commitment to implementing the requirements of the consent order and the remediation program is unwavering. The activities we have already taken and are continuing and our continuing plans, including fulfillment of the requirements of the consent order, demonstrate our commitment to create a corporate culture in which the type of problems that led to the restatement will never happen again.

In implementing the consent order, Freddie Mac will be building upon its very significant efforts to improve the quality and depth of internal accounting personnel, the strength of the accounting function and management oversight of that function.

Freddie Mac has added over 100 professionals in accounting reporting and control areas, including a significant numbers of new officers and senior managers. We have also retained leading experts in the areas of public disclosure and corporate governance to assist the company in designing and implementing processes and practices in these areas.

We hired a Senior Vice President and Chief Compliance Officer who is responsible for overseeing Freddie Mac's compliance with policies, procedures and practices, including compliance with laws and regulations; and we have established and filled the new position of Chief Enterprise Risk Officer. We are also working to implement new systems to ensure the quality, integrity, transparency and timeliness of our financial reporting.

Finally, we have taken steps to ensure that Freddie Mac's corporate culture promotes integrity, high ethical standards and the importance of compliance. In this regard, virtually all of our employees have completed a corporate-wide training program on the company's code of conduct and the provisions of the Sarbanes-Oxley act.

Through the extraordinary efforts of Freddie Mac's Board of Directors, current management team and employees, we have met the challenges of the past year and we are looking forward to continuing to improve our reporting, governance and financial controls.

Together with Freddie Mac's new Chairman and CEO as well as our senior management team I will insure that we set the right tone at the top.

Now that the restatement is complete, Freddie Mac is focused on bringing our financial statements completely up to date. Our objective is to release quarterly and full-year 2003 results by June 30, 2004, and to provide the 2003 annual report shortly thereafter.

Freddie Mac remains irrevocably committed to completing the process of registering our common stock with the Securities and Exchange Commission under the 1934 Act, with the objective of completing that process as soon as possible after the company's return to timely reporting.

In 2004 we look forward to working with Chairman Baker, Congressman Kanjorski and the members of this subcommittee as you consider regulatory oversight proposals. Freddie Mac has long supported a strong regulator as critical to the achievement of our mission.

As I have outlined today, Freddie Mac is bringing our financial statements current and building for the future. We have taken significant steps toward achieving our goal of exemplary financial reporting and controls. The work that we have done, and continue to do as part of our remediation program, together with our commitment to fulfilling the obligations of the consent order, will enable us to reach that goal. While we complete this work, we are continuing to fulfill our important public mission, maintain our safety and soundness and meet our business objectives.

Thank you for the opportunity to appear here today.

Chairman BAKER. Thank you, Mr. Baumann.

[The prepared statement of Martin F. Baumann can be found on page 54 in the appendix.]

Chairman BAKER. I would assume that your public statements on the agreement reached with OFHEO came pursuant to direction by the Board. In mid December, press accounts give attribution to you for several points that appeared to be disputing the need for the recommendations of the regulator.

One, you stated it doesn't believe it needs to slow its growth with reference to Freddie Mac. We don't see any reason to change our business activities. We don't need to raise more capital. Freddie Mac hasn't agreed to OFHEO's recommendations. And then, finally, sort of the fitting last piece, putting a constraint on our growth could create risk. It would limit opportunity to create profits for shareholders.

Since that time, till now, has the Board's opinions been modified or are those your personal views at the time that have now been modified? I think the recommendations made by Mr. Falcon, or at least that he is contemplating, more accurately, are highly appropriate. Can you rectify the two sets of statements, or four sets of statements, together with the recommendations and your stated intent this morning to move toward implementation of those recommendations?

Mr. BAUMANN. Yes. Those responses are to a question regarding the accuracy of our capital; and as demonstrated by our reports that we have filed with OFHEO, we meet our minimum capital guidelines and, in fact, we exceed our capital guidelines with a healthy surplus. So Freddie Mac has a very strong capital base today. Freddie Mac uses this capital base to fulfill its housing mission on a day in and day out, buying mortgages, entering into transactions, raising our funds in the capital markets, bringing debt holders around the world to the investors around the world into our—into Freddie Mac to invest into the U.S. mortgage market. This is a—this is improving the mortgage market all the time and lowering the cost to families to acquire their mortgages and their homes.

So I think our activities have been operated in a safe and sound manner, as the Director mentioned today that the safety and soundness of Freddie Mac was not in jeopardy during this period of time when the financial statements were untimely, but our market risk and our credit risk have been well managed during all of those times and we have been able to fulfill our goal of continuing to invest in the mortgage market, to provide liquidity to that market and to attract investors, both in the U.S. and around the world, to our securities so that we can further invest in that market.

Chairman BAKER. Well, I appreciate the answer with regard to capital. I don't necessarily agree with your view of the matter. But set capital aside for the moment. There are 15 other recommendations. I can be specific. Does the Board intend to separate the functions of the CEO from the Chairman of the Board? That is number one.

Mr. BAUMANN. The new Chairman of the Board was appointed and it was discussed with the Director of OFHEO before he was hired and it is understood that that role would be a combined role

of the Chairman and CEO at this point in time and that over time that that recommendation would be implemented.

Chairman BAKER. Okay. Number two, do you think that the financial incentives for compensation that are currently based on short-term goals and maintaining earning stability should be modified or has it been modified or do you intend to modify it, the method by which executives are compensated for performance?

Mr. BAUMANN. We are modifying greatly and already have modified greatly the way in which executives are compensated. There are—in the past, there were short-term earnings targets, short-term growth in operating earnings and earnings per share targets that were part of the company's scorecard. The current year scorecard has no short-term earnings per share or operating earnings targets attached to it. Management compensation is being driven by a variety of factors. Mission is the first and foremost part of that. Building internal controls and getting our financial statements current is the second largest piece of that. Growing long-term value in the company is another part of that. But short-term earnings goals are not part of the scorecard for management compensation.

Chairman BAKER. Do you contemplate term limits for Board members, Board of Directors?

Mr. BAUMANN. These factors with respect to corporate governance are under consideration by the Board, and we will be talking to OFHEO about these recommendations. Again, these were recommendations, first of all, to Director Falcon from his staff. Director Falcon is the one who will determine how they would be implemented in terms of working with our Board and with management.

Chairman BAKER. And to the generic question, do you agree with Mr. Falcon's assessment that he has the authority to implement all 16 recommendations if he so chooses, or is that a position which Freddie would have objection to and take steps to litigate the implementation of proposed rules?

Mr. BAUMANN. We are working with OFHEO. We understand the issues that surrounded Freddie Mac in the past. The questions around the internal controls and the lack of accounting expertise, I, among others, was hired to fix those problems as well as the new CEO Dick Syron was hired to fix those problems and change the culture. We are working with OFHEO to accomplish all of these needed reforms.

Chairman BAKER. Well, let me hone in one more time because my time's expired, and I want to make sure other members have a chance for questions before we get into votes.

For example, go back to number one, splitting the functions of the CEO and the Chairman. Given the current understanding of the current CEO with regard to the combination of those responsibilities, can Mr. Falcon require the enterprise to separate those two functions, or is that something that you believe you have independent authority to maintain business structure?

Mr. BAUMANN. I think Director Falcon has already said that he can enforce regulation. He can put regulation into law and then we would have to comply with that. But having said that, we have no—we are not trying to argue these recommendations. We have signed a consent order and agreed to that consent order and imple-

menting remedial actions. We are working—these particular recommendations again are not yet immediate recommendations to us. These are recommendations to Director Falcon from the staff, and he is working on his determination of how they should implemented.

Chairman BAKER. So, to conclude, if Mr. Falcon is to determine any or all of these are appropriate actions to recommend or put into place, it would be your understanding as of today, understanding the Board may direct you at a later time, that Freddie Mac would not object to obfuscate, block, otherwise take legal actions to preclude the implementation of the recommendations of the Director.

Mr. BAUMANN. Again, as I said, we are working closely with OFHEO to try to implement these recommendations. To the extent Director Falcon agrees with all of them, and appropriate recommendations, we would work along with them to implement.

Chairman BAKER. And inappropriate ones you would not.

Mr. BAUMANN. If Director Falcon believes these recommendations are appropriate and makes the recommendations, we would work with him to implement them.

Chairman BAKER. Thank you.

Mr. Kanjorski.

Mr. KANJORSKI. In as simple a way as possible, could you tell us what the root core of the failure at Freddie Mac was in terms of not getting the restatements done? Do you believe that, as Mr. Falcon indicated, that it was just in the interest of executive compensation that this action was undertaken and no other reason?

Mr. BAUMANN. Since I joined the company in April, 2003, I have been working hard to improve our financial reporting capabilities and our internal controls and to get the restatements of prior years results done, which we accomplished in November of 2003, now working on getting the 2003 results issued. At the same time, the Board engaged Baker Botts to do an independent study of the factors leading up to the restatement and then OFHEO performed its own investigation of the factors leading up to the restatement. I think those reports speak for themselves, and I have not done any further investigation beyond those.

Mr. KANJORSKI. Are you satisfied that what has been indicated today here as to the root cause of this problem was simply the executive compensation desires? Or is there something more? I am trying to get to whether or not you are satisfied now in your nine months with Freddie Mac that we know what precipitated and caused this activity and that it is only simply a desire to increase compensation of a limited number of the executives. Is that your judgment now?

Mr. BAUMANN. Well, that is—that was the statement that came out of Director Falcon and his interpretation.

Mr. KANJORSKI. Well, I am asking you whether you agree with that interpretation or do you have some other sense or are you satisfied it was simply this exuberance, if you will, of the executives to gain compensation, additional compensation.

Mr. BAUMANN. I am satisfied that the investigations done by Baker Botts and the investigations done by OFHEO were thorough and examined the transactions and the culture in the company that

led to the use of certain capital markets transactions for—with a view towards their effect on earnings. I am satisfied that the events have been uncovered that led to the conditions at Freddie Mac, and I think those two reports both put a lot of facts on the table about them. What individual motivations may have been back then I have not done any work to understand those individual motivations. I don't know of any other motivations other than those expressed so far.

Mr. KANJORSKI. What I am primarily interested in is getting to what the cause of this problem was, whether or not it is in your mind solved now. But particularly, again, going to the role of Directors, it seems to me this whole problem was discovered by the need or the decision to change auditors and that if auditors hadn't been changed even today these occurrences would be occurring and we wouldn't know about it. What, internally, have you done or can you do to correct that possibility in the future?

Mr. BAUMANN. Right. Thank you. We can do a lot, and we have done a lot.

As I mentioned in my oral testimony, I have hired more than 100, 100 accounting professionals who now work with me in the financial function. We have recruited some of the best people that we can find to add to accounting expertise needed in this company.

In addition to that, in my job as the Chief Financial Officer I don't have any direct responsibility for what the earnings numbers are. I don't run any businesses in the company, and I don't—and I am not tied to any earnings objective. My responsibilities as Chief Financial Officer are to ensure that we report results accurately, completely and transparently, with no bias whatsoever as to what the outcome is as to what those results are. My responsibility is to oversee internal controls in the company and to report if there were any weaknesses in our internal controls or oversight. So I have no responsibility for running the businesses.

As the Chief Financial Officer I have responsibility different than the past in the company. I have responsibility for the credibility of financial reporting and the quality of our internal controls. That, along with hiring of a new Chief Executive Officer, setting the right tone at the top in the company, along with building the accounting expertise and using consultants to build the right accounting expertise and controls will prevent this situation from ever happening again.

Mr. KANJORSKI. Are you completely independent of the Chairman, the CEO, and do you report directly to the Board or are you still dependent on your superiors in the chain of command?

Mr. BAUMANN. Okay. I report directly to the Chairman and chief executive of the company. I have direct reporting lines to the Board. I am the lead liaison in the company to the audit committee. I am the lead liaison directly to the chair of the audit committee with respect to matters that get reported there. But I do have a direct reporting line to our Chief Executive Officer.

Mr. KANJORSKI. How do you see that the Board in the future would know if there is this problem occurring? What are the controls that are in place now that would clearly give the Directors or the auditing committee or the Board the insight as to the existence

or the potential existence of a problem and how would they know about it any greater than prior to this occurrence?

Mr. BAUMANN. In any company, as you were suggesting earlier, a Board does have to rely on the quality of the people and processes put in place at that company.

The Board has hired people that they believe are appropriate in the circumstances.

When I was hired in April, I interviewed with the Chairman of the Audit Committee, the Chairman of the Compensation Committee, the presiding Director of the company, all of whom set the ground rules for me, in terms of what their expectations were. I spent 33 years in the practice of public accounting, working with some of the largest financial companies in the world, ensuring that their financial statements were accurate and reliable and reporting to those audit committees of those companies in doing that.

I am committed to reporting to this Board of Directors on a regular basis on any matter that I think they would find to be important, and that is a message that I have delivered throughout this company, but this company is going to operate in an absolutely open and candid way, and anybody that has concerns about any issue, they should be reporting them to their superiors and to me, and we will report that to the Board.

We have also implemented certain things such as a hotline, which is a call base where employees can call outside of the company to a third company to discuss anything that they have a concern about, and we have mentioned that in a code of conduct in Sarbanes-Oxley that we have conducted.

Mr. KANJORSKI. It seems to me, again, because of your high ethical standards and the code you set you are satisfied this cannot happen again, but what happens if you get replaced?

Is it the chief financial officer, depending on what his ethical standards are, that could determine whether or not this could happen again?

Mr. BAUMANN. Certainly, again, the people one hires, the people one hires is important to the credibility of the process.

I believe the people I am hiring are highly ethical and also that have the same culture with respect to financial reporting, so the people I am hiring are of the same type.

We are also working on a succession planning model, such that we have in place, should I disappear for whatever reason, have in place succession plans with the right people, with the right skill sets, and that the Board will have preapproved that succession planning in order to keep this kind of culture of accuracy and culture of integrity alive.

Mr. KANJORSKI. One other question: Looking at this whole problem, have you estimated what the cost to the company is actually, what it has been, and what benefit would flow from the people who set up the mechanism of these restatement manipulations?

I am trying to get a proportion.

Did it cost the Board or the company a billion dollars?

Mr. BAUMANN. I do not know what benefit people got in the past, and again I——

Mr. KANJORSKI. Not the people now. I am just talking about what is the cost in your judgment to the company?

Mr. BAUMANN. The cost that we spent in connection with the restatement during the year 2003 was a little bit more, approximately $100 million, and we anticipate spending similar amounts in 2004 on consultants in connection with building systems.

Mr. KANJORSKI. 100 million or billion dollars?

Mr. BAUMANN. $100 million, $100 million.

Mr. KANJORSKI. Of course, the fine, 125 million.

Mr. BAUMANN. $125 million fine is in addition to that, sir.

Mr. KANJORSKI. Now, do you have an idea, a rough calculation, as to the perpetrators, what did they gain out of this in terms of dollars?

Mr. BAUMANN. No, I do not have that, sir.

Mr. KANJORSKI. I mean, did they gain more than that 225 million or much less?

Mr. BAUMANN. I have no way to calculate that.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Kanjorski.

Mr. Shays?

Mr. SHAYS. I defer.

Chairman BAKER. Mrs. Biggert?

Mrs. BIGGERT. Thank you, Mr. Chairman.

Mr. Baumann, in your testimony, you set deadlines for completion of the financial reporting for 2003 and 2004, and additionally I think you thought that the company would be registered with the SEC by 2005, and it seems like these dates have been moving since the agreement in 2001.

What steps will Freddie Mac take to meet these deadlines?

Mr. BAUMANN. Since I have been hired in April of 2003, as I said earlier, I have hired 100 accounting professionals, and I am using the resources of the best accounting consulting firms to work with us, in terms of building appropriate internal accounting systems and financial reporting capability.

As stated in the Baker Botts report, the company has lacked the accounting expertise in the past which led to the restatement and has therefore also led to the fact that we are not yet registered with the SEC.

We are 100 percent committed to the improving of the accounting expertise in the company and bringing in the kind of talent we need to get the financial statements current again and then to go on with our registration with the SEC.

I have met with the SEC on a number of occasions already as part of the restatement. They have agreed in discussions with me that they would reengage with us as soon as we complete our 2002 annual report, which I have indicated we expect to complete this quarter, and then using the 2002 annual report we will begin to go over the registration process and start to prepare the registration documents and get the decisions regarding disclosure matters for registration agreed with by the SEC.

We cannot become a registrant until our financial statements are again timely, but as soon as they are timely we hope to complete that as soon as possible thereafter.

Mrs. BIGGERT. Just a question about the SEC. If Freddie Mac had registered with the SEC, would disclosures that were man-

dated in the forms 10K and 10Q, would those have revealed the trading irregularities and the mismanagement misconduct?

Mr. BAUMANN. Well, one cannot completely answer those questions in hindsight, so the real answer is I do not know, but certainly the process of registering with the SEC is a very detailed process, where the SEC's Division of Corporation Finance reviews the financial statements, asks a lot of deep questions about financial reporting and the quality of disclosures around accounting principles, and a lot is uncovered as part of the registration process, so——

Mrs. BIGGERT. With the registry with the SEC, what impact will it have on Freddie Mac business?

Mr. BAUMANN. Registering with the SEC under the 1934 act would not have any particular impact on the business. It will demonstrate that the financial reports of Freddie Mac are of the same caliber as other companies that are registered. We are building that expertise to get that registration done.

Mrs. BIGGERT. Okay.

Thank you, Mr. Chairman. I yield back.

Chairman BAKER. Thank you, Mrs. Biggert.

Mr. Scott?

Mr. SCOTT. Thank you, Mr. Chairman.

How are you, Mr. Baumann?

Mr. BAUMANN. Fine.

Mr. SCOTT. I wanted to ask you about the incentive compensation plans.

How have you changed those incentive compensation plans for the senior officers at Freddie Mac?

Mr. BAUMANN. There are incentive compensation plans that officers of Freddie Mac and many employees of Freddie Mac participate in, both long-term incentives and short-term incentives.

The short-term incentives no longer have a current year's earnings per share or current year's growth in reported earnings as a major factor of that; in fact it is not a factor at all.

As I stated earlier, the incentives are based largely on meeting our housing mission, meeting our affordable housing goals as the largest component of the compensation package, of the incentives.

The second largest is geared towards completion of these requirements to get our financial statements current and to get financial statements issued by June 30, 2004, which is the target for the 2003 results for completing the internal control improvements, the remediation plan, and now the consent order required by us, by OFHEO.

There are some other goals about growing the fair value of the company, increasing the long-term fair value of the company as well, but they are minor parts of the goal, of the incentives.

The longer term incentives are really geared with employees involved in the short-term goals over a longer period of time and geared to their longer term success in achieving the mission of the company. So the answer is the short-term earnings goals have been removed, replaced by goals around our mission, more goals around our mission, affordable housing, and more towards our goals of improving our mission in the company.

Mr. SCOTT. One other question, recently Fannie Mae has expressed its preference for a new regulator as a Bureau of the Treasury Department rather than a new independent agency.

Has Freddie Mac taken a similar position in terms of a nonindependent regulator?

Mr. BAUMANN. No, we have not taken a similar position.Our position is that we support strong and vital, vigorous regulation. We think it is important for us and for the credibility of Freddie Mac and the fulfilling of its mission, and we are ready to work with this committee and with Congress at large and the administration in whatever regulator they choose to put in place.

Mr. SCOTT. Do you agree with Fannie Mae's preference for the Treasury Department?

Mr. BAUMANN. We are—we would be happy with that outcome, but we would also be happy to work with other outcomes as well. We are not stating a particular preference for this outcome, other than a strong regulation.

Mr. SCOTT. Okay.

Last December the Federal Reserve released a report that stated that Freddie Mac and Fannie Mae provided meager help to home purchasers.

Also, on January 9, in USA Today, they ask whether or not Americans were getting a bad return on their tax funded subsidies.

How do you respond to these charges, and if you disagree, what efforts will you undertake to further expand home ownership to communities that previously have been left behind?

Mr. BAUMANN. We do disagree with those findings, and we are committed to expanding home ownership, and we are supporting and want to work with the administration in initiatives to support home ownership.

Our job is far from complete. Home ownership is great in this country. The number of homeowners is great in this country, but that is not equal among all the entire population of the United States, and it is important to increase minority home ownership in the United States.

We are eager to participate in those efforts. Our new chairman and CEO Dick Syron is long a champion of home ownership for Americans as President of the Home Loan Banks in Boston and as President of the Federal Reserve Bank in Boston. He is eager to work with this committee and others to support home ownership among minorities and to grow home ownership.

The study was by an employee of the Fed. Certainly there are other third party studies that disagree with that report, and one can just look in the papers, as I have done recently, this weekend, and if you look at the survey of what the interest rates are for jumbo mortgages, which we do not participate in, versus conventional mortgages, which Freddie and Fannie do participate in, there is a difference of 26 basis points on average between the jumbo mortgage and the conventional mortgage. On a $200,000 mortgage that adds up to $11,900 savings for a purchaser of that home and that mortgage. That is a considerable savings for a homeowner, so we think we are fulfilling our mission, adding considerable value to Americans and home ownership and considerable savings to Americans.

Mr. SCOTT. Do you think there is any one piece of information why the Federal Reserve would release such a report, although you say it isn't one individual that was released through the Federal Reserve with their permission, with their permission, authority, so there must be some credibility there?

What did they hang their hat on to make such a negative statement about the performance of your agency?

Mr. BAUMANN. Their interpretation of numbers is often complex and different parties with the best intentions can come to different interpretations of results. A study was made and that was that particular person's interpretation of a variety of different measurements of economic data. There are other studies out there as well that would show a different answer.

I happen to think the easiest way to look at the information is to look at the variation between jumbo rates, which Freddie Mac did not participate in, jumbo mortgages, and conventional mortgages, which we do, and that is a savings, just as I said to you today. That is 26 basis points today, or 11-, over $11,000 savings to an American who has a $200,000 mortgage.

Mr. SCOTT. My final point, Mr. Chairman, is this: I am looking at a chart on home ownership rates, and it is broken down into the total USA, the white, black, Hispanic, other race, central cities, suburbs, and in each one of these categories there has been a slight increase in home ownership rate except for one, and that is the African American community.

It went down between 2001, 2002, when all of the other categories of, total, white went up, Hispanic went up, other races went up, but for the black home ownership, it went down.

What caused that? Why is there that aberration with that particular group when all the other groups, home ownership rates went up? What do you think accounted for that?

Mr. BAUMANN. I cannot answer that question exactly in terms of why that happened. I can tell you unequivocally that Freddie Mac is committed to minority home ownership, especially home ownership by African Americans of homes.

I am happy to bring that question back to Freddie Mac and ask our people to do—our economists who work in those areas to give me a report on their assessment of that, and I would be glad to share those findings with you, Congressman.

Mr. SCOTT. I would be very interested in that because we would be doing our mission a great service if we could come back with some valuable information of what we are not doing for this minority group as opposed to other groups, because it is obvious that there is something there, and I would like for us to try to put our fingers on it so we can address it, and I appreciate that.

Mr. BAUMANN. We will do that.

Chairman BAKER. Thank you, Mr. Scott.

Mr. Shays.

Mr. SHAYS. Thank you, sir.

I welcome you. Thank you.

In the report that OFHEO did, it said the special examination demonstrated that Freddie Mac knowingly departed from good public disclosure practices so as to obfuscate particular enterprise policies as well as specific capital markets and accounting transactions

used to implement them. As a result, the public disclosures of Fannie Mae during the period investigated by the special investigation failed to comport with disclosures required by SEC registered companies which were assertively adhered to by the enterprise. The deliberate disdain of Freddie Mac for appropriate disclosure status in the face of its asserted compliance with best practices misled investors and constituted conduct that undermined market awareness of the true financial condition of the enterprise.

You would agree with that statement?

Mr. BAUMANN. There are many disclosures that were lacking, based on my review of transactions in the past, and we have said that we have agreed with the findings of the Baker Botts report that disclosures that were made in many cases were not those that would be expected of a public SEC registrant.

Mr. SHAYS. Okay, but I just asked you: Do you agree with the paragraph I read?

Mr. BAUMANN. I guess I would have to go back and read it word for word.

Mr. SHAYS. I will read it again.

Mr. BAUMANN. Sure.

Mr. SHAYS. You had my respect and admiration until you failed to even acknowledge what is in this report, and you were supposed to be in charge.

I will read the whole thing over again. I want to know if you agree or disagree.

The special examination has demonstrated that Fannie Mae knowingly departed from good public disclosure—Freddie Mac knowingly departed from good public disclosure practices so as to obfuscate particular enterprise policies as well as specific capital market and accounting transactions used to implement them. As a result the public disclosures of Fannie Mae—Freddie Mac, excuse me, during the period investigated by the specific examination failed to comport with disclosures required of SEC registered companies that were assertively adhered to by the enterprise. The deliberate disdain of Freddie Mac for appropriate disclosure status in the face of its asserted compliance with best practices misled investors and constituted conduct that undermined market awareness of the true financial condition of the enterprise.

Do you agree with that statement?

Mr. BAUMANN. I agree with the fact that the public disclosures were lacking by Freddie Mac. The characterizations of why, et cetera, there are OFHEO's characterizations of why they were lacking.

Mr. SHAYS. Tell me what you would disagree with this statement.

Mr. BAUMANN. I have not done the investigation to determine what the intentionality was. OFHEO did the investigation. I agree that the disclosures were lacking. I have not done the investigation to determine——

Mr. SHAYS. I will read sentence by sentence, and you tell me what you agree or disagree with.

The specific examination has demonstrated that Freddie Mac knowingly departed from good public disclosure practices so as to obfuscate particular enterprise policies as well as specific capital

market of Freddie Mac during the period investigated by the special examination.

Excuse me, I am going to read it over again.

The special examination has demonstrated that Freddie Mac knowingly departed from good public disclosure practices so as to obfuscate particular enterprise policies as well as particular capital market and accounting transactions used to implement them.

Do you agree with that statement?

Mr. BAUMANN. I agree that Freddie Mac's public disclosures were lacking in many respects. I do not know the extent to which they were knowingly lacking at the time and what decisions were made knowingly versus inadvertently. I have not done the investigation.

Mr. SHAYS. No, you just happen to be the Chief Financial Officer of the company.

Mr. BAUMANN. I——

Mr. SHAYS. As a result the public disclosures of Freddie Mac during the period investigated by special examination failed to comport with disclosures required of SEC registered companies that were assertively adhered to by the Enterprise.

Do you agree or disagree with that statement?

Mr. BAUMANN. I agree our public disclosures in many cases failed to meet the disclosures of an SEC registrant.

Mr. SHAYS. The deliberate disdain of Freddie Mac for appropriate disclosure status in the face of its asserted compliance with best practices misled investors and constituted conduct that undermined market awareness of the true financial condition of the enterprise.

Do you agree or disagree with that?

Mr. BAUMANN. I do not know if there was a deliberate disdain or not.

Mr. SHAYS. Do you believe that it misled investors and constituted conduct that undermined market awareness of the true financial condition of the enterprise?

Mr. BAUMANN. I do not know whether it did or not. I know that there were some.

Mr. SHAYS. You do not think investors were misled?

Mr. BAUMANN. There is an SEC investigation going on right now to look into that, Congressman.

Mr. SHAYS. Do you think the disclosures of Freddie Mac did not mislead investors?

Mr. BAUMANN. We have said in the past that our public disclosures were not those——

Mr. SHAYS. Why do you have such a difficult time answering my questions? It seems to me the answer would be yes and we can get on with it. How can I have confidence in your capability to run this company if you have a hard time even acknowledging that their practices misled investors and constituted conduct that undermined market awareness of the true financial condition of the enterprise?

That is a no-brainer for someone in your condition and position. Why do you have trouble answering that question?

Mr. BAUMANN. I did not do the investigation.

Mr. SHAYS. That is not what I asked.

You came in here and you told us you did not have enough people to properly provide information. You are asking us to wait 2 more years before you come under the 1934 act.

Hello?

You came up to me, shook my hand, said: I am looking forward to testifying, and I am asking you a basic question, and I thought: Gosh, this is nice. We have someone finally taking over, he doesn't have to apologize for the past, and you think somehow you have to apologize for the past and obfuscate, it seems to me, some very logical questions.

Let me ask this again: The deliberate disdain of Freddie Mac for appropriate disclosure status in the face of its asserted compliance with best practices—this is the part I am asking—misled investors and constituted conduct that undermined market awareness of the true financial condition of the enterprise.

Am I to agree that it misled or not misled?

Mr. BAUMANN. The SEC is making an investigation of——

Mr. SHAYS. That is not what I asked you.

Mr. BAUMANN. It was not my job to make an investigation of the past reporting practices.

Mr. SHAYS. Do you think past reporting practices misled investors?

Think about it a second before you answer.

Do you think that the disclosures that have so far happened misled investors?

Mr. BAUMANN. I do not make answers like that until I do an investigation and come to a conclusion. The SEC is doing that.

Mr. SHAYS. So you do not think they were misled?

Mr. BAUMANN. There were two investigations that have been done.

Mr. SHAYS. That is not what I asked.

Were they misled?

Mr. BAUMANN. I have not made an investigation of past reporting practices to determine whether or not investors——

Mr. SHAYS. I did not ask about intentions.

Why were you hired?

Mr. BAUMANN. I was hired to build the financial function that has sound internal controls, that produces, going forward, accurate, complete, and transparent financial results.

Mr. SHAYS. Was the information accurate that was disclosed by Freddie Mac?

Chairman BAKER. Mr. Shays, you are going to have to make that your last one, because we are going to——

Mr. BAUMANN. Freddie Mac has clearly said that the financial statements in the past were not accurate. We have restated them to the extent of $5 billion.

Mr. SHAYS. So if they were not accurate, did not they mislead?

Listen to my question: If they were not accurate, is not it true, therefore, they would have misled investors?

Mr. BAUMANN. The financial statements in the past were not accurate.

Mr. SHAYS. And if they were not accurate, would that not mean it misled investors?

Mr. BAUMANN. I have not done a review to determine whether or not financial statements of the past were misleading or not.

Mr. SHAYS. If you had looked at the statements, would you have been misled?

Mr. BAUMANN. I would have been misinformed that the financial results were $5 billion different than previously recorded.

Mr. SHAYS. Let me just put on the record then that, Mr. Martin—excuse me, sir—Mr. Baumann, you and I are going to have a big problem. We are going to be on your back as much as you can imagine because all you had to do was say: Yes, it was in the past; that is why I am hired; I am hired to straighten out all this mess; I am sorry we misled investors by over $5 billion of earnings; that is why we hired 100 people; and we are going to get on it and we are going to make sure it never happens in the past.

The fact that you find so much trouble even agreeing to the basic logic of what was said in this report blows me away.

Chairman BAKER. And the gentleman's time has expired.

Do you choose to respond, Mr. Baumann?

Mr. BAUMANN. We are responding by improving our financial reporting, building best in class culture around the company, and building accurate, complete, transparent financial reporting.

There were some 20 civil suits that will address the question of how investors were either informed or not informed, and there is an SEC investigation.

Mr. SHAYS. Mr. Chairman, I would submit that the culture hasn't changed if the company cannot even acknowledge the fact that investors were misled by inaccurate information. Clearly the information was inaccurate. Therefore investors are misled. It doesn't take a brain surgeon to be able to say yes.

Chairman BAKER. Thank you, Mr. Shays.

Just a couple quick questions. Mr. Kanjorski wanted to ask a question as well.

On the example of the $200,000 mortgage, in excess of $11,000 savings to the home owner, I assume that was if the home was held to maturity over the course of the life of the loan. Typically, lower income individuals are going to be in that lower $100,000 range.

If you cut that $12,000, I rounded up to 12, over 30 years, cut it in half for a $100,000 loan, divide it by 30 years, crank it down to a monthly figure, that is $11.50. I am assuming that the average residential mortgage in your portfolio is somewhere around 100,000, probably is not—probably a little higher, but if we are trying to help first-time low-income home buyers, is an $11.50 a month risk worth taking?

I do not have an answer to that. That is just editorial comment.

Secondly, I have concerns and in discussion of GSE governance, with regard to guarantee fees and how those are apparently assessed varying institutions who engage in business activities with the Enterprises. I am not going to take the time today to get into it, but I will advise you that I am going to forward a letter with some amount of specificity and would like to request that a disclosure of the guaranty fee relationship at least to the committee be made.

I understand that as a course of business customarily there is a confidentiality clause that is signed by the counterparty that precludes them from making public statements about the guaranty fees, but it is something that I think has a dramatic effect on the cost of home ownership, and with that I yield to Mr. Kanjorski.

Mr. KANJORSKI. I just want to say I appreciate your responding to some of the questions propounded to you. I think it probably was done with good sense and good reality.

Mr. SHAYS. Could I ask the gentleman why?

Mr. KANJORSKI. Because this gentleman has testified previously in his opening statement why he came to this company, what he was charged with, what he has carried out, and he should not testify to a matter of subjective conclusion which is a matter of lawsuit. He would be putting his company at great risk without having done the detailed analysis himself, and that would be irresponsible.

Mr. SHAYS. Can I ask the gentleman one question, though?

Is it hard for someone to say that inaccurate information, therefore, would mislead?

Mr. KANJORSKI. I do not think it naturally follows that inadequate information does mislead. You have to get into the mind of the investor or the person that received that inadequate information, and in reality we may have found here that there in fact was no negative impact on the investor, that it was an internal matter of a very small proportion done by greedy or self-interested executives that caused this entire occurrence to come about, but in fact Freddie Mac may come out stronger as a result of what they put in place, and Chris, I like you very much but I do not think it is nice. Mr. Baumann is an executive of incredible experience and to put him on cross-examination, to try to force him to make an overwhelming conclusion that is not based on all the facts is, in my mind, not fair.

Now, Mr. Baumann, all that being said, that was just editorial on my part, I do want to get to one question.

In your testimony you said you were in favor of a strong regulator, and that is not quite the contest up here. There are some of us who believe it should be an independent strong world class regulator, something analogous to the OCC, and Mr. Scott had asked you questions on that, and it is very important, and I was not aware that Fannie Mae has gone back to the idea that they want some regulator under Treasury, which upset me quite frankly.

What would be your position if this Congress established a strong independent world class regulator analogous to the OCC? Would that be proper? Would Fannie Mae support that, or have you not taken a position on that?

Mr. BAUMANN. We have not taken an official position on that, and again we believe that the most important thing is for this Congress and the administration to resolve the question of regulation and to come to the best answer for Freddie and Fannie to support our mission going forward.

There are a couple of things we do think are important with respect to that, more around the level of capital and where it is set, between the Congress versus in the regulator itself and around approval of programs and activities that are we think today appropriate the way it is set up and we think that is an important matter so we can fulfill our housing mission. So we think those are important to discuss, and we hope they are discussed.

Our CEO Dick Syron is anxious to talk to this committee about regulation. He has a very, very enthusiastic interest and the best

regulatory answer for Freddie and Fannie that winds up being in the best interest for the American homeowner.

Chairman BAKER. I thank the gentleman. I certainly express to you, Mr. Baumann, my appreciation for your willingness to appear here today. Certainly hope that, in the coming weeks and months, this committee can, with continuing counsel from the Enterprises, construct a regulatory system that is adequate to ensure continued home ownership and protection of taxpayers.

I do not believe they are mutually exclusive. I believe the goal can be——

Mr. SHAYS. Mr. Chairman?

Chairman BAKER. Yes, Mr. Shays.

Mr. SHAYS. I want to apologize to the gentleman based on Mr. Kanjorski's comments. If I am getting into intent and they have a lawsuit, it was not my intent to try to have impact over the lawsuit. I was trying to, with all due respect, understand the mind of this company, to see if this company has changed, and so to you, sir, I apologize, in that respect, but would you just give me some hope that somehow the culture of this company is different?

Chairman BAKER. Mr. Shays.

Mr. SHAYS. With all due respect, sir.

Chairman BAKER. Sure.

Mr. SHAYS. Is there anything you can say that tells me there is a difference here and we can see something changed about this company?

Chairman BAKER. Mr. Shays, if I can respond, and Mr. Baumann can certainly make his own statement.

I would propose that if this committee forwards legislation and the Enterprise refrains from exercising its political power in blocking or obstructing meaningful reform, that in itself will determine whether or not there has been a change in the outlook on an independent regulator, and Mr. Baumann has repeatedly said this morning that he does not even wish to express an opinion as to the domicile of the regulator, be it independent, be it Treasury. If the Congress decides that it is an appropriate step for us to take, that the Enterprise would accept those determinations as independent judgments of this Congress, I respect that, and, Mr. Baumann, would you choose to respond to Mr. Shays?

Mr. BAUMANN. Thank you. I appreciate your comment, Congressman.

The press release that we issued on November 21, which described in excruciating detail the accounting errors that were made in the past, the level of the restatement and the accounting and control issues of the company, I think are at least a start of the evidence to show that we are committed to transparency and accuracy and completeness and candidness, and going forward we expect that that is what you will see on a regular basis, that our financial reports will be very candid, very accurate, very transparent and very complete.

Chairman BAKER. We have 4 minutes remaining.

Mr. SHAYS. Thank you.

Chairman BAKER. We have 4 minutes remaining. Our meeting stands adjourned.

Thank you.

[Whereupon, at 12:20 p.m., the subcommittee was adjourned.]

A P P E N D I X

January 21, 2004

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

January 21, 2004
"Hearing on the Report of the Special Examination of Freddie Mac"

I want to thank Subcommittee Chairman Baker for convening this important hearing on the recent report issued by the Office of Federal Housing Enterprise Oversight. This report details the causes of Freddie Mac's restatement and the management reorganization that followed. This is a comprehensive report that highlights many of the concerns we have heard about the operations and the oversight of the GSEs. As a result of this investigation, OFHEO and Freddie Mac have entered into a consent agreement in which Freddie Mac agreed to pay $125 million in fines and make several significant changes to its corporate governance. I appreciate all the hard work Director Falcon and his staff have done on this report.

Freddie Mac accounts for billions of dollars of mortgage backed securities and currently has debts outstanding in the trillions of dollars. There is no argument that this company is critical to the housing market. Freddie supplies liquidity to institutions so they can provide loans to consumers seeking to purchase homes. However, with this important mission comes an equally important mandate to protect the taxpayers and to be honest with investors. As the OFHEO report demonstrates, Freddie Mac's senior management mislead its investors, its board of directors, and the U.S. taxpayers. I am, however, encouraged by the remediation efforts underway at Freddie Mac. Mr. Baumann and his team have worked hard through difficult times to formulate a plan to return Freddie Mac to financial stability and they should be commended. I believe that with continued diligence and real reforms confidence can be restored in the operations of this important company.

Director Falcon has presented an in-depth review of Freddie Mac, but the question remains – where was OFHEO when these improper trades were taking place? This investigation was not commenced when Freddie Mac announced its restatement, rather it began after the Chairman and CEO, along with two other senior executives were released from the company. In fact, if Arthur Andersen had not been removed as the auditor for Freddie Mac, there is no guarantee that the

earnings management and improper trading practices would not still be going on today. I believe that OFHEO is under-funded and lacks many of the necessary powers to adequately oversee both Freddie Mac and Fannie Mae. I support additional funding for OFHEO so that it can fully examine the GSEs and hire a sufficient number of examiners to monitor these complex financial institutions.

The report we consider today makes several important recommendations for changes both at Freddie Mac and at OFHEO. These recommendations are well thought out, and many of them should be implemented. I look forward to the testimony of Director Falcon and Mr. Baumann and hope that this hearing will shed some light into what went wrong at Freddie Mac, what steps are being taken to remedy the situation, as well as what changes should be made to ensure that both Freddie Mac and Fannie Mae are properly regulated.

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January 21, 2003

Opening Statement by Congressman Paul E. Gillmor

House Financial Services Committee
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
Hearing to discuss the Office of Federal Housing Enterprise Oversight's (OFEHO) December report on the report of the Special Examination of Freddie Mac

Thank you, Mr. Chairman, for holding this important hearing and for your continued leadership on this issue and the overall topic of reforming the regulatory structure governing Government Sponsored Enterprises (GSEs).

I applaud OFEHO's efforts in conducting this investigation of Freddie Mac's accounting and management failures, resulting in Freddie Mac's $5 billion restatement of earnings. However, I do have some questions regarding its timing. OFEHO began its investigation only after the management and accounting problems at Freddie Mac became publicly apparent. This does not leave me with great confidence in OFEHO's ability to effectively oversee our GSEs.

I look forward to hearing from Director Falcon on this issue and to further this committee's discussion of pending legislative proposals to improve the regulatory oversight of both Fannie Mae and Freddie Mac. As an original cosponsor of HR 2575, the Secondary Mortgage Market Enterprises Regulatory Improvement Act, I would like to see its prompt consideration by this committee.

In the meantime, I was pleased to see that OFEHO and Freddie Mac have entered into a consent agreement requiring Freddie Mac to pay a civil monetary penalty of $125 million and make significant internal management and operational changes. The most important aspect of this agreement, in my view, is the formulation of a plan to improve Freddie Mac's public disclosures and regulatory reporting. Freddie Mac and all our housing GSEs are tasked with the responsibility to do a public good and enjoy certain special circumstances in order to accomplish their corresponding goals. Accordingly, they should be accountable to the public in their financial activities.

Thank you again, Mr. Chairman, for bringing us here this morning. I look forward to an informative discussion.

OPENING REMARKS OF THE HONORABLE RUBEN HINOJOSA
HOUSE FINANCIAL SERVICES COMMITTEE
SUBCOMMITTEE ON CAPITAL MARKETS
OFHEO'S REPORT ON THE SPECIAL EXAMINATION OF FREDDIE MAC
JANUARY 21, 2004

Chairman Baker and Ranking Member Kanjorski,

I want to thank you for holding this hearing.

Before we address OFHEO's report, I want to stress that the housing market has served as the foundation of the U.S. economy since the stock market decline post-Clinton and post-9/11. During that time, Fannie Mae and Freddie Mac have played a key role in supplying liquidity for the housing market, thereby supporting our economy in a time of need.

It is my firm belief that whatever action that we decide to take in Congress, if any, with respect to either of these institutions, we must not alter their internal structure, or any aspect of their regulation, that would harm them or our economy.

I understand that OFHEO has not closed its examination of Freddie Mac completely and continues to seek to compel former Chief Executive Officer Leland Brendsel and former Chief Financial Officer Vaughn Clark to testify to the actions they took at Freddie Mac. It is also my understanding that this matter is pending before the U.S. District Court for the Eastern District of Virginia, that the SEC is investigating whether Freddie Mac possibly violated U.S. securities laws, and that the U.S. Attorney for the Eastern District of Virginia is conducting a criminal investigation. It is important that I note all of this to stress again that any action Congress takes prior to the conclusion of these investigations and court actions would be premature. Consequently, I will refrain from drawing any conclusions until all of these investigations are concluded.

Having said that, I look forward to hearing the testimony of Mr. Falcon from OFHEO and Mr. Baumann of Freddie Mac.

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON THE REPORT OF THE SPECIAL EXAMINATION OF FREDDIE MAC

WEDNESDAY, JANUARY 21, 2004

Mr. Chairman, we meet for the first time this year for the purpose of reviewing the special examination report issued and the consent agreement reached in December by the Office of Federal Housing Enterprise Oversight regarding Freddie Mac's financial restatement of more than $5 billion. The report makes serious revelations about how insufficient accounting, audit and internal controls and a troubling culture nurtured by top managers resulted in an environment that led to significant earnings management at Freddie Mac. The consent decree also requires Freddie Mac to adopt numerous remedial reforms to prevent a similar situation in the future.

One year ago, Freddie Mac first revealed that it would delay the release of its 2002 accounting reports pending the completion of a restatement of its financial records for earlier years. This announcement raised considerable concerns for those who monitor GSEs. It also began a period of intense scrutiny of the company by its regulators, lawmakers, and the press.

Six months later, Freddie Mac's board announced an unexpected management shakeup. This change in corporate leadership produced even greater concerns among those with knowledge of GSEs. For example, I observed that government-sponsored enterprises "with their public responsibilities and private capital have a special obligation to operate fairly, safely and soundly." I continue to believe that today. The management at these entities must ensure that they produce accounting statements that reflect their real financial condition.

At the time, I also said that Freddie Mac must "maintain sufficient capital reserves, adopt prudent management reforms, expedite completion of its earnings restatements, and employ appropriate accounting techniques" to prevent similar problems in the future. I suspect that before we complete today's hearing we will discuss each of these issues in great depth. We have a responsibility to study these matters and ensure that the company follows its statutory mandate to operate in a safe and sound manner.

Additionally, the financial reporting problems at Freddie Mac renewed efforts by some to modify GSE regulation. As I said at our very first hearing on the oversight of government-sponsored enterprises in March 2000, "we need to have strong, independent regulators that have the resources they need to get the job done." I continue to support strong GSE regulation. A strong regulator will protect the continued viability of our capital markets and promote confidence in Freddie Mac and Fannie Mae. It will also insure taxpayers against systemic risk and expand housing opportunities for all Americans.

Today, more than 68 percent of Americans own the homes in which they live. Government-sponsored enterprises have contributed greatly to this accomplishment. Because our housing marketplace is one of the most important sectors in our persistently struggling economy, we must also tread carefully in our forthcoming debates over any legislation to modify the regulation of GSEs.

In closing, Mr. Chairman, I commend you for your sustained leadership in these matters and for convening this timely hearing. OFHEO's report and consent agreement merit our full attention. Hence, I urge my colleagues to give these matters the careful study that they deserve.

Opening Statement

The Honorable Bob Ney

Hearing on OFHEO's Report on Freddie Mac

Committee on Financial Services

Wednesday, January 21, 2004

I want to welcome our two witnesses this morning. I look forward to hearing their testimony on the Office of Federal Housing Enterprise Oversight's (OFHEO) December report on the Special Examination of Freddie Mac and the current state of GSE regulatory oversight.

OFHEO's recent report on the activities asserts that there were insufficient accounting, audit and internal controls in place to prevent earnings manipulation. The lack of control displayed by the internal accounting executives at Freddie is deeply troubling. The blatant manipulation of earnings to project consistent growth has turned the mortgage companies into ideal representatives of necessary regulatory reform.

As Chairman of the Housing Subcommittee, I have a keen interest in the strength of our secondary mortgage market. Fannie Mae and Freddie Mac were chartered by Congress to create a secondary trading market and to improve the functioning of home mortgage markets; as a result, the United States mortgage and credit markets are second to none.

A strong, vibrant housing market also is vital to the health of our economy. Recent studies have found that housing accounted for more than one-third of economic growth from 2000-2002. Many observers, including Federal Reserve chairman Alan Greenspan, have noted that refinancing provided crucial support to the economy during the past recession by enabling homeowners to reduce their debt burdens and maintain adequate levels of consumer spending by tapping into the equity of their homes.

There can be no doubt that we must take steps to strengthen the GSE by establishing a new 'world class' regulator. With the growing presence of GSEs in the capital markets and the possible risks they could pose to the financial system, reconstituting the safety and soundness regulator would be a prudent step. Such a move would send an important signal that we understand the importance of GSEs and the secondary mortgage markets in maintaining a stable economy.

As I have said before, I believe that there are several important components that are integral to providing enhanced regulation for GSEs while not impeding their ability to support affordable housing in America. Everyone agrees that strong regulatory oversight is critical to maintaining public confidence in this remarkable

system. However, I believe it is important to permit the housing GSEs to have sufficient flexibility to adapt to a changing mortgage market. The liquidity that Fannie and Freddie provide to the market should not be compromised by unnecessary government regulation.

It is in the public interest to continue to encourage homeownership and maintain the proven housing finance system we have today. Mistakes have certainly been made at Freddie Mac, but I'm not convinced that means we must throw out the whole system. The GSEs deserve some credit for the vibrancy of our country's secondary mortgage market.

For more than 70 years, federal policy has encouraged homeownership. As we move forward, we must make certain that we do not begin to close the door to homeownership and curtail many Americans from realizing the American Dream.

Again, Mr. Chairman, I want to thank you for holding this hearing and our witnesses for taking the time to be here. I look forward to their testimony.

STATEMENT OF MARTIN F. BAUMANN

CHIEF FINANCIAL OFFICER

FREDDIE MAC

BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

U.S. HOUSE OF REPRESENTATIVES

JANUARY 21, 2004

Thank you, Chairman Baker, Ranking Member Kanjorski and Members of the Subcommittee. It is a pleasure to be here today.

My name is Martin F. Baumann. I am the Executive Vice President and Chief Financial Officer of Freddie Mac. I joined Freddie Mac in April 2003. I was hired to build a strong finance function in Freddie Mac and to restore confidence in the company's financial reporting. I am committed to developing an exemplary finance function that produces accurate, timely, well-controlled and transparent financial reports.

Prior to joining Freddie Mac, I worked at PricewaterhouseCoopers for more than 30 years as a partner, as deputy chairman of the World Financial Services Practice, and as the Global Banking Leader. At PricewaterhouseCoopers, I was responsible for certifying the financial statements of some of the largest United States and international banking, insurance and other financial services companies.

I welcome the opportunity to be here today to discuss Freddie Mac's remediation program and compliance with the Consent Order between Freddie Mac and the Office of Federal Housing Enterprise Oversight (OFHEO).

Last year was a challenging year for Freddie Mac. In January, we announced a restatement of prior-year earnings and in June, our Board of Directors made changes in the company's senior management.

We have been working hard to regain the confidence of all of our stakeholders. We are implementing a corporate-wide remediation program to ensure that the accounting and financial control issues that led to the need for the restatement will never happen again. We have completed the restatement of prior-year financial results. This past December, OFHEO completed its special examination of Freddie Mac. At the same time, we entered into a Consent Order and Settlement with OFHEO that resolves matters relating to our restatement. We appreciate the Subcommittee's patience as we have worked through this process.

Freddie Mac's mission is to ensure a stable supply of low cost mortgages for America's families – whenever and wherever they need them. For more than 30 years, Freddie Mac has helped meet the home financing needs of families at all income levels, in all communities, and in all parts of the country. We recognize our special responsibility to homebuyers, the public, the Congress and investors. Despite our difficulties last year, we maintained our focus on fulfilling these responsibilities.

Freddie Mac's highest priorities are remediation and compliance with the Consent Order, along with bringing our financials current. We are firmly committed to building an environment that delivers comprehensive and understandable information incorporating the highest level of financial transparency, accounting controls, compliance, and professional standards.

Now, Freddie Mac is focused on the future. We are headed in the right direction, and we have the right leadership to reach our goals in our new Chairman and Chief Executive Officer Richard F. Syron. Dick has extensive industry expertise, and corporate leadership and financial experience, having led a Fortune 500 firm, served as chairman and chief executive officer of the American Stock Exchange, and served as the president of the Federal Reserve Bank of Boston and as president of the Federal Home Loan Bank of Boston. He is committed to our important public mission and to regaining the full confidence of the public and our stakeholders.

Before addressing our remediation and compliance efforts, allow me to say a few words about the completion of our restatement of prior financial results.

Completing our Restatement and Fulfilling our Mission in 2003

On November 21, 2003, the Freddie Mac Board of Directors and our management team announced the release of the company's restated and revised financial results for the years 2000 through 2002. The restatement was a significant step in Freddie Mac's progress toward achieving accurate and timely financial reporting.

Freddie Mac completed this restatement while maintaining our business fundamentals and delivering on our congressional mandate to make mortgage credit more available for America's families. We remain fully committed to our mission of helping make housing more affordable for more Americans and maintaining liquidity in the housing market, which, for the past several years, has bolstered the US economy.

In fulfilling our mission, Freddie Mac plays an important role in maintaining the strength of the housing sector, a sector that directly accounts for approximately 15 percent of the Gross Domestic Product (GDP) and has accounted for 36 percent of the growth in GDP over the last two years.[1] Furthermore, we have contributed to growth in the economy by helping homeowners refinance into lower rate mortgages and redeploy some of their housing equity.[2] These benefits are directly attributable to the long-term, prepayable fixed rate mortgage, which our activities make widely available.

The restatement did not affect the fundamental strength of Freddie Mac's business. Freddie Mac's business operations remain strong and interest-rate risk and credit risk remain low. Our risk profile remains conservative, with an average duration gap of zero

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[1] These percentages are based on data published by the Bureau of Economic Analysis, U.S. Department of Commerce for 1996 through 2003 and data for the same years available upon request from Freddie Mac.

[2] See Remarks by Federal Reserve Chairman Alan Greenspan before the Annual Convention of the Independent Community Bankers of America, Orlando, Florida, March 4, 2003, available online at www.federalreserve.gov.

for November 2003, unchanged from October. In fact, we maintained a low duration gap throughout 2003.

Now, let me return to the focus of my testimony: Freddie Mac's remediation program and compliance with the Consent Order between Freddie Mac and OFHEO.

Remediation Program

Freddie Mac is currently engaged in an active remediation program. The steps that we are taking combine the steps required by the Consent Order with the actions that were underway in our preexisting remediation program.

Freddie Mac's Board of Directors has been working closely with management to carry out a remediation program that will advance our mission and serve all of our stakeholders. During the spring of 2003, the Governance Committee of the Board of Directors tasked me with the development of a remediation program to ensure that the factors contributing to the need for the restatement would not recur. Thereafter, the Board of Directors approved a comprehensive remediation program that has been and is effecting far-reaching changes in the company's financial reporting, control and management functions.

Freddie Mac's Board of Directors is actively overseeing management's implementation of the remediation program. During 2003, the Board's Governance Committee overseeing the remediation program, and the Audit and Ad Hoc Committees overseeing the restatement, held individual or joint committee meetings on 55 separate occasions to review the progress on the restatement and consider aspects of remediation implementation. Throughout this period, we provided periodic updates on our remediation program to OFHEO.

On December 9, 2003, Freddie Mac entered into a Consent Order and Settlement with OFHEO. On the same day, OFHEO released the report of its special examination of Freddie Mac.

Under the terms of the Consent Order, Freddie Mac agreed to undertake remedial actions relating to corporate governance, internal controls, internal audit, internal accounting capabilities, risk management transactions, and public disclosures and regulatory reporting. The Consent Order and the company's completion of the required resulting remedial actions are essential to restoring full confidence in Freddie Mac.

The Consent Order added further key items to our existing remediation program resulting in an enhanced comprehensive remediation program designed to ensure the integrity of Freddie Mac's financial reporting, controls and governance, and also to prevent a recurrence of the problems that led to the need for the restatement. We have been

working closely with OFHEO to make sure that we take the remediation steps required by the Consent Order on a timely basis. Actions must be completed within various timeframes, and the Board of Directors and senior management have emphasized to Freddie Mac employees the importance of timely compliance.

Our commitment to implementing the requirements of the Consent Order and the remediation program is unwavering. The remediation program underway at Freddie Mac is moving the company forward.

The activities we have already undertaken as part of the remediation, and our continuing plans, including fulfilling the requirements of the Consent Order, demonstrate our commitment to create a corporate culture in which the type of problems that led to the restatement will never happen again.

Key Remediation Steps

In implementing the Consent Order, Freddie Mac will be building upon its very significant efforts to improve the quality and depth of internal accounting personnel, the strength of the accounting function, and management oversight of that function. This has been, and continues to be, a key priority of the company in the wake of the restatement.

The goals of Freddie Mac's remediation program are to ensure that we have the highest level of accounting expertise, compliance with generally accepted accounting principles and regulatory reporting, and fully accurate, timely, and transparent financial reporting.

Keeping in mind our unwavering commitment to meeting the terms and the spirit of the Consent Order, today I would like to highlight some of the important steps Freddie Mac has already taken.

Freddie Mac has made significant progress in strengthening resources and personnel dedicated to accounting, control and reporting issues. The company has added over 100 professionals in the accounting, reporting and control areas, including a significant number of new officers and senior managers.

Freddie Mac has also retained leading experts in the areas of public disclosures and corporate governance to assist the company in designing and implementing processes and practices in these areas. In October 2003, we hired a Senior Vice President — Chief Compliance Officer who is responsible for overseeing Freddie Mac's compliance with policies, procedures and practices, including compliance with laws and regulations. Additionally, in October 2003, we created the position of Chief Enterprise Risk Officer. This executive has oversight responsibility for credit and market risk.

We are also working to create and implement new infrastructure and systems to ensure the quality, integrity, transparency, and timeliness of our financial reporting. These enhancements will create durable, automated systems that will keep up with the sophistication of our risk management and business activities.

In addition, we have taken steps to ensure that Freddie Mac's corporate culture promotes integrity, high ethical standards, and the importance of compliance. Virtually all of our employees have completed a corporate-wide training program on the company's Code of Conduct and the provisions of the Sarbanes-Oxley Act.

Looking Ahead

Through the extraordinary efforts of Freddie Mac's Board of Directors, current management team, and employees, we have met the challenges of the past year, and we are looking forward to continuing to improve our reporting, governance, and financial controls.

Together with Freddie Mac's new Chairman and CEO as well as our senior management team, I will ensure that we set the right "tone at the top." Throughout this difficult and challenging period, Freddie Mac has focused on ensuring that we will emerge a stronger, more disciplined company. And, we have done so while remaining fully committed to fulfilling our mission.

While the restatement represented an important milestone, now that it has been completed, Freddie Mac is focused on bringing our financials completely up-to-date. The company expects to provide an annual report for 2002 and to hold the related annual stockholders' meeting in the first quarter of 2004. Our objective is to release quarterly and full-year 2003 results by June 30, 2004 and to provide the 2003 annual report and hold the related stockholders' meeting as soon as possible thereafter.

Freddie Mac remains irrevocably committed to completing the process of voluntarily registering its common stock with the Securities and Exchange Commission under the Securities Exchange Act of 1934, with the objective of completing the process as soon as possible after the company's return to timely reporting. Freddie Mac reaffirmed this commitment in a letter to Treasury Secretary John Snow on July 14, 2003, in our restatement announcement and in other public statements.

In 2004, we look forward to working with Chairman Baker, Congressman Kanjorski and the Members of this Subcommittee as you consider regulatory oversight proposals. Freddie Mac has long supported a strong regulator as critical to the achievement of our mission.

Conclusion

As I have outlined today, Freddie Mac is bringing our financial statements current and building for the future. We have taken significant steps toward achieving our goal of exemplary financial reporting and controls. The work that we have done, and continue to do as part of our remediation program, together with our commitment to fulfilling the requirements of the Consent Order, will enable us to reach that goal. While we complete this work, we are continuing to fulfill our important public mission, maintain our safety and soundness, and meet our business objectives.

Thank you for the opportunity to appear today. I look forward to working with Chairman Baker, Ranking Member Kanjorski and the Members of this Subcommittee. I would be happy to answer any questions the Subcommittee might have.

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Statement of the Honorable Armando Falcon, Jr., Director of OFHEO,
before the
House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises Hearing
on
The Office of Federal Housing Enterprise Oversight's December Report of the Special Examination of Freddie Mac

January 21, 2004

Mr. Chairman, Ranking Member Kanjorski, and Members of the Subcommittee, I appreciate the opportunity to discuss with you OFHEO's Report of the Special Examination of Freddie Mac. My prepared testimony will summarize the key findings and conclusions, and I request that the Subcommittee include the full text of the report in the record. My testimony expresses my own views and not necessarily those of the President or the Secretary of Housing and Urban Development.

A year ago tomorrow, Freddie Mac announced that completion of its 2002 financial audit would be delayed and that earlier periods would be reaudited. A switch in external auditors – from Arthur Andersen to PricewaterhouseCoopers – had triggered a reevaluation of Freddie Mac's accounting policies, especially those relating to hedge accounting treatments for derivatives occasioned by implementation of FAS 133. Ultimately, a much broader range of accounting policies was reconsidered. Many were changed, resulting in one of the largest corporate financial restatements ever; including a cumulative net increase in retained earnings of $5 billion.

The reaudit and restatement process raised questions beyond the selection of accounting policies. On June 7, as Freddie Mac prepared to announce the abrupt departure of three of its principal officers, I ordered a special examination of the conditions and activities that led to the accounting failures and management changes. This examination was to expand and supplement an ongoing OFHEO examination of the financial condition of the Enterprise and its reaudit and restatement process.

Our previous examination work had engendered increasing concern about weaknesses in controls and personnel in accounting areas. I believed that the removal of three members of the management team only went part of the way toward correcting serious problems with management practices and controls. We created a special examination unit that ultimately comprised 24 staff members taken from several OFHEO departments on a full or part-time basis. The group was tasked with reviewing the events leading to the restatement and deficiencies in accounting practices and controls. I further asked that the report of the special examination make recommendations for any additional steps that needed to be taken to help ensure the continuing safe and sound operations of the Enterprise.

I instructed the Board of Directors of Freddie Mac to provide its full cooperation with the special examination and to make available to the special examination all

communications to the Board and management regarding deficiencies in accounting practices or its investigation of employee misconduct. I also instructed the Board to provide an explanation of its rationale for the compensation packages the Enterprise proposed for the three individuals in light of the circumstances surrounding their departures.

I also informed the Board of Directors that, in the case of personnel terminated for misconduct, OFHEO would object to any re-employment of these individuals, and that OFHEO could hold them liable for indemnification to Freddie Mac for losses that may have resulted from their conduct.

Finally, I instructed the Board to provide to OFHEO, for review and approval, plans to address reform of the supervision of accounting practices by management; personnel and systems changes; plans for implementing accounting services quality controls; and a program for routine communications by the Board with OFHEO on the progress of the plan of remediation.

The special examination unit reviewed documents generated by the operations of Freddie Mac or obtained by OFHEO over ten years in the course of its regular examination process. Documents, including emails and audio tapes, were produced by the Enterprise pursuant to OFHEO subpoena. OFHEO also obtained, pursuant to subpoena, testimony under oath from numerous employees and members of the Board of Directors of Freddie Mac. In developing this information, OFHEO has cooperated with the Securities and Exchange Commission and the Office of the United States Attorney for the Eastern District of Virginia.

Although some aspects of the special examination are not complete, the bulk of the work was finished this past fall, and I asked for a report of the examination containing the findings and conclusions reached thus far, along with appropriate recommendations, which you received in December.

REPORT SUMMARY

In the early 1990s, Freddie Mac promoted itself to investors as "Steady Freddie," a company of strong and steady growth in profits, and the company developed a corporate culture that placed a very high priority on achieving such results. The examination showed that, to do so, Freddie Mac used means that failed to meet its obligations to investors, regulators and the public. The company employed a variety of techniques ranging from improper reserve accounts to complex derivative transactions to push earnings into future periods and meet earnings expectations. Freddie Mac cast aside accounting rules, internal controls, disclosure standards, and the public trust in the pursuit of steady earnings growth. The conduct and intentions of the Enterprise were hidden and were revealed only by a chain of events that began when Freddie Mac changed auditors in 2002.

Corporate Culture and "Tone at the Top"

The corporate culture fostered by the "tone at the top" resulted in intense and sometimes improper efforts by the Enterprise to manage its reported earnings, compromised the integrity of many employees, and limited the effectiveness of its internal control structure. The culture placed an inordinate emphasis on meeting the expectations of Wall Street analysts regarding earnings levels and steady growth, but it neglected key elements of the infrastructure of the Enterprise needed to support growth. Freddie Mac created and maintained reserve accounts that did not comply with GAAP and entered into transactions with little or no economic substance to achieve desirable accounting results.

A tension developed between the more administrative elements of Freddie Mac, responsible for supporting and reporting transactions, and the "financial engineers," who designed products and strategies to achieve corporate earnings goals. Compounding that problem, the Enterprise managed its general and administrative expenses to a rigid guideline, regardless of the level of profits. The preoccupation of management with adhering to expense limits resulted in an insufficient allocation of resources—both dollars and staffing—to divisions responsible for accounting, financial reporting, and internal controls. The lack of attention by senior management and the Board of Directors to those functions resulted in transactions not being recorded in financial statements in accordance with GAAP. Finally, senior management and the Board failed to establish and maintain adequate internal control systems.

Improper Management of Earnings

By 1999, Freddie Mac had established a practice of engaging in transactions for the express purpose of managing its reported earnings. Freddie Mac used several strategies to shift earnings into future reporting periods, reflecting the proclivity of management to increase operations risk in the quest for more stable earnings.

Although some of the most egregious examples relate to the desire of management to address earnings volatility challenges associated with the implementation of Statement of Financial Accounting Standards 133 (FAS 133), there were numerous other instances when Freddie Mac management misused accounting resources or engineered transactions with little or no economic substance to obtain specific accounting results:

- Management executed several interest rate swap transactions that moved $400 million in operating earnings from 2001 to later years. Those transactions had virtually no other purpose than management of earnings —specifically, making operational results appear to be less volatile than they were.

- Management created an essentially fictional transaction with a securities firm to move approximately $30 billion of mortgage assets

from a trading account to an available-for-sale account. Other than to reduce potential earnings volatility, the transaction had no other meaningful purpose.

- Freddie Mac adopted, and then quickly reversed, a dubious change in its methodology for valuing swaptions. That change had the effect of reducing the value of the derivatives portfolio of the Enterprise by $730 million.

- On at least one occasion, a transaction was entered into at the instruction of management for the purpose of disguising the effective notional amount of the Freddie Mac derivatives portfolio and thereby allay the concerns of an investor.

- From 1998 to 2002, management purposefully kept loan loss reserves at an unusually high level by using aggressive assumptions, even though actual and foreseeable credit losses were rapidly declining. Both management and the Board of Directors were aware that the Securities and Exchange Commission had criticized that practice as an inappropriate form of earnings management.

- Freddie Mac used another, non-GAAP reserve to dampen earnings fluctuations occasioned by unpredictable premium amortization caused by changing mortgage prepayment speeds. Management changed key assumptions in the calculation of the reserve when necessary to achieve a desired earnings result.

Management went to extraordinary lengths to avoid undesirable accounting results. It then failed to disclose to the public information that would have revealed more fully the nature of transactions undertaken to manage earnings and the intent to do so.

Incentives Created by Executive Compensation

The compensation of senior executives of Freddie Mac, particularly compensation tied to earnings per share, contributed to the improper accounting and management practices of the Enterprise. The size of the bonus pool for senior executives was tied, in part, to meeting or exceeding annual specified earnings per share targets. It was not tied directly to smoothing earnings growth, but actions to shift earnings from one quarter to future periods helped ensure that earnings per share goals, and consequently the bonuses based upon them, would be achieved in the future.

Freddie Mac used a corporate scorecard involving a formulaic approach to setting the size of the corporate bonus pool. Achieving earnings per share targets played a substantial role in the formula, but former CEO Leland Brendsel and former COO David Glenn also exercised considerable discretion over the outcome. The

informal process by which Mr. Brendsel and Mr. Glenn revised the scorecard results, and therefore the amount of funds available for individual bonuses, further contributed to the importance of achieving earnings per share targets.

Weak Accounting, Auditing and Internal Controls

The management of a corporation is responsible for maintaining a control environment that will, among other things, accurately record transactions to provide for published financial statements that are consistent with the true financial condition of the firm. In that regard, the obsession of Freddie Mac with steady, stable growth in earnings was at the expense of proper accounting policies and strong accounting controls. Weaknesses in the staffing, skills, and resources in the Corporate Accounting Department of the Enterprise led to weak or nonexistent accounting policies, an over-reliance on the external auditor, weak accounting controls, and an overreliance on manual systems. Given the size of the company and its role in the housing finance and capital markets, those weaknesses effectively increased the systemic risk posed by the Enterprise.

The deficiencies of the company resulted in improper accounting of many complicated transactions in which the Enterprise engaged during the period of the restatement. Although management developed plans to address identified weaknesses, those plans were neither well conceived nor fully implemented.

The Internal Audit Department of Freddie Mac did not accept responsibility for the reliability and integrity of the financial information of the Enterprise, did not follow-up effectively on identified deficiencies, and did not communicate effectively with management and the Board. In combination, the weaknesses in Corporate Accounting and Internal Audit meant that there were weak points at each major control juncture at Freddie Mac.

Management and the Board failed to meet their responsibilities for sound accounting policies and a strong internal control system to assure that financial statements were prepared in accordance with GAAP. The Board appeared to operate under the misconception that as long as the external auditor signed off on an accounting policy or a process, its responsibilities and those of management were fulfilled.

Inadequate Disclosure

In some instances, Freddie Mac knowingly circumvented prevailing public disclosure standards in order to obfuscate particular policies and specific capital market and accounting transactions. A disdain for appropriate disclosure standards, despite oft-stated management assertions to the contrary, misled investors and undermined market awareness of the true financial condition of the Enterprise. Overly general disclosures reflected a conscious decision by Freddie Mac to provide minimal amounts of specific, useful information.

Freddie Mac executives, without objection from the non-executive members of the Board or its Audit Committee, accepted a convenient and mechanical but inadequate definition of materiality accepted by the external auditor in order to exempt from scrutiny and specific disclosure as "immaterial" accounting errors of up to five percent of profits, or $100 million to $285 million.

Within Freddie Mac, no one took responsibility and was ultimately accountable for public disclosures. Failure to assign responsibility and accountability for disclosure to an internal division contributed directly to inaccurate corporate and financial reporting. Such a lack of assigned responsibility reflected the low regard executive management had for that function.

Board of Directors

For the most part, the same long-tenured shareholder-elected Directors oversaw the same CEO, COO, and General Counsel of Freddie Mac from 1990 to 2003. The non-executive Directors allowed the past performance of those officers to color their oversight. Directors should have asked more questions, pressed harder for resolution of issues, and not automatically accepted the rationale of management for the length of time needed to address identified weaknesses and problems. The oversight exercised by the Board might have been more vigorous if there had been a regular turnover of shareholder-elected Directors or if Directors had not expected to continue to serve on the Board until the mandatory retirement age or beyond. Conversely, the service periods of the presidentially appointed Directors are far too short, averaging just over 14 months, for them to play a meaningful role on the Board.

Recommendations

Based on these findings, the examination report recommended that a broad range of actions be taken by OFHEO and Freddie Mac. The report concluded that OFHEO must ensure that Freddie Mac has established an adequate remediation plan and is allocating the necessary resources to establish a new corporate culture that rewards integrity and the acceptance of responsibility, and that penalizes failure to meet appropriate standards of conduct. Remediation must also eliminate existing accounting and control weaknesses, including infrastructure planning for future growth and a dedication to adequate management of operations risks.

The report also detailed a number of specific actions, and I have appended a list of them at the end of my written testimony. To improve the effectiveness of the Board of Directors, Freddie Mac should separate the functions of the Chief Executive Officer and the Chairman of the Board, impose strict term limits on Directors, and require that the Board meet more frequently. The report further recommended that OFHEO establish a materiality standard for the provision of sufficient information by management to the Board.

To address Freddie Mac's general neglect of operations risks and compliance issues, the report recommended that Freddie Mac establish a formal compliance program and a position of Chief Risk Officer, reporting directly to the CEO, with explicit

responsibility for operations risk, as well as credit and market risk. In addition, Freddie Mac's Internal Audit Department needs to be strengthened so that it can play a more effective role.

To address accounting weaknesses, the report recommended that OFHEO consider requiring a periodic change of external audit firms. Freddie Mac needs to establish and maintain superior accounting controls and prevent undue reliance on its external auditor. It should also document the legitimate business purpose of every significant business transaction.

To address inappropriate managerial incentives, the report recommended that Freddie Mac refocus its compensation program more on long-term goals, not on short-term earnings.

Until remediation efforts have taken full effect, Freddie Mac remains exposed to substantial management and operations risk. The report recommended that OFHEO consider addressing this concern by requiring Freddie Mac to hold significant regulatory capital surpluses, at least until it can produce timely and GAAP – consistent financial reports.

Finally, the report recommended that OFHEO take three additional steps to reduce the possibility of future Enterprise difficulties. First, OFHEO should implement regulations that provide for mandatory disclosure, similar to that required of SEC-registered companies, and build staff resources necessary to oversee compliance if Congress does not repeal the exemptions of the Enterprises from securities law. Second, OFHEO should expand its capacity to detect and investigate misconduct by including more substantive tests of the internal control frameworks at the Enterprises, including procedures to identify pressures to commit fraud and opportunities to carry it out. Third, OFHEO should conduct a special examination of the accounting practices of Fannie Mae.

OFHEO SUPERVISORY ACTIONS

Mr. Chairman, I want to inform you not just about the report, but also about actions taken prior and subsequent to its release.

OFHEO has been active in carrying out its supervisory responsibilities. OFHEO directed Freddie Mac to provide continuous briefings for us on implementation of their remediation plan, which already addresses some of the recommendations in the report. OFHEO directed the holding of termination benefits for separated employees pending its review. OFHEO directed that the current CEO and General Counsel be terminated.

Next, OFHEO entered into a consent order with the company's former COO David Glenn and secured both his cooperation in our investigation and a very strong civil money penalty. OFHEO then entered into a consent order with the company securing a significant civil money penalty and imposing a plan of action on the company that requires that issues identified by our investigation be addressed, including "tone at

the top" and corporate culture, internal controls, review of existing Board and senior management practices and compensation, and changes to the role of Board Chairman and company CEO and terms for the Board of Directors. Finally, OFHEO is pursuing legal actions requiring the termination for cause of the company's former CEO and CFO.

Our review of Freddie Mac practices continues, as we now will look into counterparty activities and oversee Freddie Mac's implementation of the consent order.

I have undertaken actions at OFHEO as well. Our examination force is being strengthened. A new office of chief accountant will elevate our work in the important field of corporate accounting and reporting and a new office of compliance will expand our capacity to address ongoing Enterprise compliance with OFHEO rules and requirements and be available to investigate more deeply targeted areas of concern.

On this latter point, I would note that we have, within budget constraints, begun our review of accounting and corporate controls at Fannie Mae.

THE CURRENT BUDGET SITUATION

Mr. Chairman, I would like to close my testimony with an urgent appeal to the Committee for assistance in obtaining our 2004 budget. Once again, the appropriations process has placed severe constraints on our operations. The short-term continuing resolutions we are operating under prevent us from hiring the additional examiners, accountants and analysts we need to strengthen our oversight. In addition, we are unable to hire the forensic accounting help we need to assist in the Fannie Mae review.

If a long-term CR is enacted which freezes OFHEO's budget at 2003 levels, we will need to scale back oversight at the very time that greater oversight has never been more urgent. I urge the Committee to help OFHEO get its full resources as soon as possible.

Mr. Chairman, thank you for the opportunity to testify. I will be pleased to answer any questions you and the Subcommittee may have.

Appendix

OFHEO must ensure that the management of Freddie Mac has established an adequate remediation plan and is allocating the necessary resources to ensure that all of the remedial recommendations are promptly implemented. OFHEO should also take steps to ensure that the following recommendations are implemented:

1. Freddie Mac Should Separate the Functions of the CEO and the Chairman of the Board
2. Freddie Mac Should Develop Financial Incentives for Employees Based on Long-Term Goals, not Short-Term Earnings
3. OFHEO Should Establish a Regulatory System of Mandatory Disclosures for the Enterprises or Their Securities Exemptions Should be Repealed
4. OFHEO Should Consider Requiring a Periodic Change of the External Auditors at the Enterprises, Not Just a Change in Engagement Partner
5. OFHEO Should Require Freddie Mac to Hold a Capital Surplus and Should Consider Limiting the Growth of the Retained Portfolio Until Freddie Mac Produces Timely and Certified Financial Statements
6. OFHEO Should Establish a "Materiality" Standard for the Provision of Sufficient Information to the Board of Directors
7. Freddie Mac Should Impose Strict Term Limits on the Members of the Board of Directors
8. OFHEO Should Ensure that the Board Becomes More Actively Involved in Oversight of the Enterprise
9. Freddie Mac Should Establish a Formal Compliance Program
10. Freddie Mac Should Establish the Position of Chief Risk Officer
11. Freddie Mac Should Document the Legitimate Business Purpose of Every Significant Derivative Transaction
12. Freddie Mac Should Establish and Maintain Superior Accounting Controls
13. Freddie Mac Should Prevent Undue Reliance on the External Auditor
14. Freddie Mac Should Strengthen and Clarify the Role of the Internal Audit Department
15. OFHEO Should Expand Its Capacity to Detect and Investigate Misconduct
16. OFHEO Should Conduct a Special Examination of the Accounting Practices of Fannie Mae

Report of the Special Examination of Freddie Mac

December 2003

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EXECUTIVE SUMMARY

In the early 1990s, Freddie Mac promoted itself to investors as "Steady Freddie," a company of strong and steady growth in profits. During that period the company developed a corporate culture that placed a very high priority on meeting those expectations, including, when necessary, using means that failed to meet its obligations to investors, regulators and the public. The company employed a variety of techniques ranging from improper reserve accounts to complex derivative transactions to push earnings into future periods and meet earnings expectations. Freddie Mac cast aside accounting rules, internal controls, disclosure standards, and the public trust in the pursuit of steady earnings growth. The conduct and intentions of the Enterprise were hidden and were revealed only by a chain of events that began when Freddie Mac changed auditors in 2002. This report describes the circumstances leading to Freddie Mac's $5 billion restatement and makes recommendations on corrective and preventative measures.

Corporate Culture and "Tone at the Top"

The corporate culture fostered by that "tone at the top" resulted in intense and sometimes improper efforts by the Enterprise to manage its reported earnings. Beginning in the early 1990s, Freddie Mac promoted expectations of steady, rapid growth in profits. A corporate culture evolved that placed a very high priority on meeting the earnings estimates of Wall Street analysts but neglected key elements of the infrastructure of the Enterprise needed to support growth. The senior management of Freddie Mac placed an inordinate emphasis on meeting stock analyst expectations regarding non-volatile earnings growth.

The corporate culture fostered by that "tone at the top" resulted in intense and sometimes improper efforts by the Enterprise to manage its reported earnings, compromised the integrity of many employees, and limited the effectiveness of its internal control structure. Freddie Mac created and maintained reserve accounts that did not comply with GAAP and entered into transactions with little or no economic substance, all for the express purposes of obtaining accounting results that would support the goal of reporting steady earnings growth and meeting analyst expectations.

A tension developed between the more bureaucratic elements of Freddie Mac responsible for supporting and reporting transactions and the "financial engineers" who designed products and strategies to achieve corporate earnings goals. Compounding that problem, the Enterprise managed General and Administrative expenses to a rigid guideline, regardless of the level of profits. The preoccupation of management with adhering to the expense limits resulted in an insufficient allocation of resources—both dollars and staffing—to divisions responsible for accounting, financial reporting, and internal controls. The lack of attention by senior management and the Board of Directors to those functions resulted in transactions not being recorded in financial statements in accordance with GAAP. Finally, senior management and the Board failed to establish and maintain adequate internal control systems. The culture of Freddie Mac even allowed certain persons and business units to change or avoid established written policies and controls, in part because management of operations risk was not a priority.

Improper Management of Earnings

By 1999 Freddie Mac had established a practice of engaging in transactions for the express purpose of managing its reported earnings and other measures of financial performance included in the financial statements of the Enterprise. Freddie Mac used several strategies to shift earnings into future reporting periods, reflecting the proclivity of management to increase operations risk in the quest for more stable earnings.

Although some of the most egregious examples relate to the desire of management to address earnings volatility challenges associated with the implementation of Statement of Financial Accounting Standards 133 (FAS 133), there were numerous other instances when Freddie Mac management engineered transactions with little or no economic substance to obtain specific accounting results:

- Management executed several interest rate swap transactions that moved $400 million in operating earnings from 2001 to later years. Those transactions had virtually no other purpose than management of earnings —specifically, making operational results appear to be less volatile than they were.

- Management created an essentially fictional transaction with a securities firm to move approximately $30 billion of mortgage assets from a trading account to an available-for-sale account. Other than to reduce potential earnings volatility, the transaction had no other meaningful purpose.

- Freddie Mac adopted, and then quickly reversed, a dubious change in its methodology for valuing swaptions. That change had the effect of reducing the value of the derivatives portfolio of the Enterprise by $730 million.

- On at least one occasion, a transaction was entered into at the instruction of management for the purpose of disguising the effective notional amount of the Freddie Mac derivatives portfolio and thereby allay the concerns of an investor.

- From 1998 to 2002, management purposefully kept loan loss reserves at an unusually high level by using aggressive assumptions, even though actual and foreseeable credit losses were rapidly declining. Both management and the Board of Directors were aware that the Securities and Exchange Commission had criticized that practice as an inappropriate form of earnings management.

- Freddie Mac used another, non-GAAP reserve to dampen earnings fluctuations occasioned by unpredictable premium amortization caused by changing mortgage prepayment speeds. Management changed key assumptions in the calculation of the reserve when necessary to achieve a desired earnings result.

It is clear that management went to extraordinary lengths to transact around FAS 133 and to push the edge of the GAAP envelope. One could reasonably ask if communicating the true nature of the transition gain in the derivatives portfolio of Freddie Mac to equity investors would have been more difficult than disguising the amount of that gain.

Senior Freddie Mac management failed to disclose to the public information that would have revealed more fully the nature of transactions undertaken to manage earnings and the intent to do so. Such disclosure would have called into question the accounting treatment of the transactions adopted by Freddie Mac.

Incentives Created by Executive Compensation

The compensation of senior executives of Freddie Mac, particularly compensation tied to earnings per share, contributed to the improper accounting and management practices of the Enterprise. The size of the bonus pool for senior executives was tied, in part, to meeting or exceeding annual specified earnings per share targets. It was not tied directly to meeting earnings forecasts of analysts but actions to shift earnings from one quarter to future periods helped ensure that earnings per share goals, and consequently the bonuses based upon them, would be achieved in the future.

Freddie Mac used a corporate scorecard involving a formulaic approach to setting the size of the corporate bonus pool. Achieving earnings per share targets played a substantial role in the formula but former CEO Leland Brendsel and former COO David Glenn also exercised considerable discretion over the outcome. The informal process by which Mr. Brendsel and Mr. Glenn revised the scorecard results, and therefore the amount of funds available for individual bonuses, reinforced in the minds of managers and other employees the importance of achieving earnings per share targets.

Weak Accounting, Auditing and Internal Controls

The management of a corporation is responsible for maintaining a control environment that will, among other things, accurately record transactions to provide for published financial statements that are consistent with the true financial condition of the firm. In that regard, the obsession of Freddie Mac with steady, stable growth in earnings was at the expense of proper accounting policies and strong accounting controls. Weaknesses in the staffing, skills, and resources in the Corporate Accounting Department of the Enterprise led to weak or nonexistent accounting policies, an over reliance on the external auditor, weak accounting controls, and an over reliance on manual systems. Given the size of the company and the role in the housing finance and capital markets, those weaknesses effectively increased the systemic risk posed by the Enterprise.

The deficiencies of the company resulted in improper accounting of many complicated transactions in which the Enterprise engaged during the period of the

restatement. Although management developed plans to address identified weaknesses, those plans were neither well conceived nor fully implemented.

For most of the period in question the Chief Financial Officer and the Controller of Freddie Mac promoted an attitude that the Enterprise should transact around GAAP because, they believed, financial statements prepared in accordance with GAAP would not reflect the true economics of the business of Freddie Mac. In that regard, the attention of the CFO and the Controller on meeting senior management desires and analyst expectations at the expense of accounting policies of high quality and strong accounting controls led to aggressive accounting and ultimately led to the restatement of years of incorrectly reported and misleading financial results.

The Internal Audit Department of Freddie Mac did not accept responsibility for the reliability and integrity of the financial information of the Enterprise, did not follow-up effectively on identified deficiencies, and did not communicate effectively with management and the Board. In combination, the weaknesses in Corporate Accounting and Internal Audit meant that there were weak points at each major control juncture at Freddie Mac.

Management and the Board failed to meet their responsibilities for adopting sound accounting policies and establishing and maintaining a strong internal control system to assure that financial statements were prepared in accordance with GAAP. The Board operated under the misconception that as long as the external auditor signed off on an accounting policy or a process, its responsibilities and those of management were fulfilled.

Inadequate Disclosure

In some instances, Freddie Mac knowingly circumvented prevailing public disclosure standards in order to obfuscate particular policies and specific capital market and accounting transactions. A disdain for appropriate disclosure standards, despite oft-stated management assertions to the contrary, misled investors and undermined market awareness of the true financial condition of the Enterprise. Overly general disclosures

reflected a conscious decision by Freddie Mac to provide minimal amounts of specific, useful information.

Freddie Mac executives, without objection from the non-executive members of the Board or its Audit Committee, accepted a convenient and mechanical but inadequate definition of materiality accepted by the external auditor in order to exempt from scrutiny and specific disclosure as "immaterial" accounting errors of up to five percent of profits, or $100 million to $285 million.

Within Freddie Mac, no one took responsibility and was ultimately accountable for public disclosures. Failure to assign responsibility and accountability for disclosure to an internal division contributed directly to inaccurate corporate and financial reporting. Such lack of assigned responsibility reflected the low regard executive management had for that function.

Board of Directors

For the most part, the same long-tenured shareholder-elected Directors oversaw the same CEO, COO, and General Counsel of Freddie Mac from 1990 to 2003. The non-executive Directors allowed the past performance of those officers to color their oversight. Directors should have asked more questions, pressed harder for resolution of issues, and not automatically accepted the rationale of management for the length of time needed to address identified weaknesses and problems. The oversight exercised by the Board might have been more vigorous if there had been a regular turnover of shareholder-elected Directors or if Directors had not expected to continue to serve on the Board until the mandatory retirement age. Conversely, the terms of the presidentially appointed Directors are far too short, averaging just over 14 months, for them to play a meaningful role on the Board. The position is an anachronism that should be repealed so shareholders can elect all Directors.

The Board of Directors was apprised of control weaknesses, the efforts of management to shift income into future periods and other issues that led to the restatement, but did not recognize red flags, failed to make reasonable inquiries of

management, or otherwise failed in its duty to follow up on matters brought to its attention.

Recommended Actions

Freddie Mac should implement a comprehensive, Enterprise-wide initiative to establish a proper "tone at the top" and develop a corporate culture that rewards integrity and the acceptance of responsibility and individual accountability, and that penalizes failure to adhere to legal and regulatory requirements or professional standards of appropriate conduct. Furthermore, safe and sound operations require that Freddie Mac prudently plan for any future growth. Such planning includes taking steps to attract and retain personnel with the skills necessary to manage the growing risks associated with future growth. The Enterprise should have a plan for managing future growth. That plan should include provisions that specifically address anticipated problems that may arise as a result of growth and pay particular attention to anticipated staffing and systems needs to address those problems.

The experience of Freddie Mac shows that the management of the Enterprise must dedicate itself to managing operations risk as effectively as possible. Freddie Mac is under a statutory mandate to operate in a safe and sound manner, which includes having systems and management structures in place to ensure that operations risk receives the same attention as credit and interest rate risks. An inadequate provision of resources to compliance and internal controls is an unsafe and unsound practice. Specifically, the reliance of the Enterprise on manual processes to "work around" inadequately integrated information systems is a significant source of operations risk that Freddie Mac must resolve expeditiously.

OFHEO must ensure that the management of Freddie Mac has established an adequate remediation plan and is allocating the necessary resources to ensure that all of the remedial recommendations are promptly implemented. OFHEO should also take steps to ensure that the following recommendations are implemented:

1. Freddie Mac Should Separate the Functions of the CEO and the Chairman of the Board
2. Freddie Mac Should Develop Financial Incentives for Employees Based on Long-Term Goals, not Short-Term Earnings
3. OFHEO Should Establish a Regulatory System of Mandatory Disclosures for the Enterprises or Their Securities Exemptions Should be Repealed
4. OFHEO Should Consider Requiring a Periodic Change of the External Auditors at the Enterprises, Not Just a Change in Engagement Partner
5. OFHEO Should Require Freddie Mac to Hold a Capital Surplus and Should Consider Limiting the Growth of the Retained Portfolio Until Freddie Mac Produces Timely and Certified Financial Statements
6. OFHEO Should Establish a "Materiality" Standard for the Provision of Sufficient Information to the Board of Directors
7. Freddie Mac Should Impose Strict Term Limits on the Members of the Board of Directors
8. OFHEO Should Ensure that the Board Becomes More Actively Involved in Oversight of the Enterprise
9. Freddie Mac Should Establish a Formal Compliance Program
10. Freddie Mac Should Establish the Position of Chief Risk Officer
11. Freddie Mac Should Document the Legitimate Business Purpose of Every Significant Derivative Transaction
12. Freddie Mac Should Establish and Maintain Superior Accounting Controls
13. Freddie Mac Should Prevent Undue Reliance on the External Auditor
14. Freddie Mac Should Strengthen and Clarify the Role of the Internal Audit Department
15. OFHEO Should Expand Its Capacity to Detect and Investigate Misconduct
16. OFHEO Should Conduct a Special Examination of the Accounting Practices of Fannie Mae

I. INTRODUCTION

On January 22, 2003, Freddie Mac announced that the Enterprise would restate its financial results for 2002, 2001, and possibly 2000. That restatement occurred on November 21, 2003. The restatement resulted from the evaluation by management—conducted in conjunction with the external auditor of Freddie Mac, PricewaterhouseCoopers—of certain accounting policies previously used by management and approved by the previous external auditor of the Enterprise, Arthur Andersen. Those issues involved primarily the hedge accounting treatment of certain transactions, including those occasioned by the implementation of Statement of Financial Accounting Standards (FAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The restatement resulted in a cumulative increase in retained earnings of $5 billion and in regulatory core capital of $5.2 billion.

On June 7, 2003, Armando Falcon, the Director of the Office of Federal Housing Enterprise Oversight (OFHEO), ordered a special examination to be conducted into the events leading to the public announcement on June 9, 2003, of the termination, resignation, and retirement of three principal executive officers of Freddie Mac. On that date, the Enterprise announced the retirement of former Board Chairman and Chief Executive Officer Leland Brendsel, the termination of former President and Chief Operating Officer David Glenn, and the resignation of former Executive Vice President—Chief Financial Officer Vaughn Clarke. The special examination was ordered to expand and supplement an ongoing OFHEO examination of the financial condition of the Enterprise and the decision of Freddie Mac to restate its financial reports for 2000, 2001, and 2002.

Over the months during which OFHEO was conducting its examination of the restatement process, the agency became increasingly concerned about facts that came to light regarding weaknesses in controls and personnel in accounting areas and about the disclosure of misconduct on the part of Freddie Mac employees. The Director concluded that the initiative of the Enterprise in removing three members of the management team only went part of the way toward correcting serious problems with management practices

and controls. The special examination was tasked with reviewing those events leading to the restatement that revealed deficiencies in accounting practices and controls as well as employee misconduct discovered by Freddie Mac on or before June 4, 2003. The Director instructed the special examination to make recommendations to him as to additional steps that needed to be taken to help ensure the continuing safe and sound operations of the Enterprise.

By letter dated June 7, 2003, Director Falcon instructed the Board of Directors of Freddie Mac to provide its full cooperation with the special examination and to make available to the special examination all communications to the Board and management regarding deficiencies in accounting practices or its investigation of employee misconduct. The Director also instructed the Board to provide an explanation of its rationale for the compensation packages the Enterprise proposed for the three individuals in light of the circumstances surrounding their departures. That compensation is subject to the approval of OFHEO.

Director Falcon also informed the Board of Directors that, in the case of personnel terminated for misconduct, OFHEO would object to any re-employment of these individuals, and that OFHEO may hold them liable for indemnification to Freddie Mac for losses that may have resulted from their conduct.

Finally, the Director instructed the Board to provide to OFHEO, for review and approval, plans to address reform of Board oversight of the supervision of accounting practices by management; personnel and systems changes; plans for implementing accounting services quality controls; and a program for routine communications by the Board with OFHEO on the progress of the plan of remediation.

The special examination reviewed documents generated by the operations of Freddie Mac or obtained by OFHEO over ten years in the course of its regular examination process. Documents, including emails and audio tapes, were produced by the Enterprise pursuant to OFHEO subpoena. OFHEO also obtained, pursuant to subpoena, testimony under oath from numerous employees and members of the Board of

Directors of Freddie Mac. OFHEO is cooperating with the Securities and Exchange Commission and the Office of the United States Attorney for the Eastern District of Virginia.

During the months of August and September 2003, the special examination provided recommendations to the Director for action concerning members of the current management of Freddie Mac and the former management of the Enterprise. Certain information provided to the Director has been excluded from this report to ensure the continuing integrity of the examination and regulatory processes. This report presents the conclusions and recommendations of the special examination.

II. CORPORATE CULTURE AND "TONE AT THE TOP"

The accounting and management problems of Freddie Mac were largely the product of a corporate culture[1] that demanded steady but rapid growth in profits and focused on management of credit and interest rate risks but neglected key elements of the infrastructure of the Enterprise needed to support growth. That culture led Freddie Mac to commit a host of accounting errors in 1999-2002 and encouraged concerted management efforts to manipulate the reported earnings of the Enterprise and other financial measures during that period. Those efforts absorbed much of the time of many of the most talented employees of Freddie Mac; prevented investors, the public, and OFHEO from receiving accurate disclosures of the financial condition of the Enterprise; and ultimately led to one of the largest restatements in U.S. corporate history.

This chapter describes the corporate culture of Freddie Mac and indicates how the inappropriate tone at the top set by the senior management of the Enterprise created and sustained that culture. The chapter also indicates how the culture encouraged and promoted inappropriate earnings management; prevented adequate investment in accounting and financial reporting policies, procedures, and controls; and neglected operations risk management.

The Culture of "Steady Freddie"

The corporate culture of Freddie Mac began to change in 1990, after the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) severed the ties of the Enterprise to the Federal Home Loan Bank System, authorized it to issue stock directly to the public, and created a Board with a majority of shareholder-elected Directors. Those changes led Freddie Mac to change its business model. The Enterprise buys mortgages from lenders and finances those purchases through the creation and sale

[1] "Organizational culture refers to the basic values, norms, beliefs, and practices that characterize the functioning of a particular institution. At the most basic level, organizational culture defines the assumptions that employees make as they carry out their work; it defines 'the way we do things here.' An organization's culture is a powerful force that persists through reorganizations and the departure of key personnel." Columbia Accident Investigation Board Report, National Aeronautics and Space Administration, v.1, August 26, 2003, p. 101.

of guaranteed mortgage-backed securities (MBSs), which are collateralized by pools of loans, or the issuance of debt.[2] Before 1990, Freddie Mac maintained a very small debt-financed mortgage portfolio. That exposed the Enterprise to mortgage credit risk but very little interest rate risk.

In 1992, Freddie Mac began to fund a greater proportion of the loans it purchased with debt. The retained mortgage portfolio of the Enterprise grew rapidly over the next decade, as did its outstanding debt.[3] To manage the interest rate risk associated with that portfolio, Freddie Mac began, in the early 1990s, to issue debt securities with embedded call features and, in the mid-1990s, to rely heavily on interest rate derivatives. Today, the Enterprise is one of the largest issuers of debt and end-users of financial derivatives in the world.

Freddie Mac was extraordinarily successful financially in the 1990s. That financial success and the rapid growth of the Enterprise contributed to a belief among management and employees that Freddie Mac was an organization of unique expertise and sophistication. Every year, the Enterprise contributed to its statutory mission of supporting the secondary mortgage market and promoted housing, maintained low levels of credit and interest rate risk, and produced rapid growth in earnings per share for shareholders and substantial levels of compensation for its officers.

In that context, a corporate culture evolved at Freddie Mac that valued and sustained exceptional levels of sophistication in the debt and derivatives markets and required the development of in-house technical capabilities and expertise with regard to those markets. That culture also placed a heavy emphasis on the steady, strong growth in earnings per share that rapid growth in the retained mortgage portfolio and disciplined

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[2] Freddie Mac also guarantees MBSs issued by lenders that are backed by mortgages underwritten to the guidelines of the Enterprise.

[3] Today, slightly less than half of the total mortgage portfolio of Freddie Mac is held on the balance sheet. The on-balance sheet assets of the Enterprise grew rapidly from 1992 to the present, rising at an average annual rate of about 30 percent. At year-end 2002, the assets of Freddie Mac totaled $752.2 billion, up from $59.5 billion at year-end 1992. The debt outstanding of the Enterprise rose from $29.6 billion at the end of 1992 to $665.7 billion at year-end 2002. 2003 Office of Federal Housing Enterprise Oversight Report to Congress, June 2003, pp. 94-112; and Freddie Mac, "Freddie Mac Announces Restatement Results," November 21, 2003.

risk management produced. Mid-teens growth in earnings per share was a "message" of the senior management of the Enterprise as early as 1992 and 1993, and that message soon became an explicit goal.[4]

The Freddie Mac track record of achieving steady, strong earnings growth enabled its shares to outperform the market, which reinforced the emphasis of management on the goal of continued earnings growth. The primary goal of Freddie Mac, as expressed by its culture, was to perform in such a way as to meet the expectations of Wall Street stock analysts.[5] If analyst expectations differed from the corporate earnings forecast of Freddie Mac, the Enterprise would try to change the expectations of the analysts. If unsuccessful, Freddie Mac would manage its activities to meet those expectations.

Former Chief Executive Officer (CEO) Leland Brendsel, former Chief Operating Officer (COO) David Glenn, and other senior executives of Freddie Mac are financial economists. They emphasized sophisticated, quantitative risk modeling and management and were less interested in other aspects of the operations of the Enterprise. They and many other employees believe that Freddie Mac is as good as or better than anyone at modeling and managing credit and interest rate risks.[6]

The emphasis on quantitative risk measurement and management contributed to tensions between administrative units of Freddie Mac such as Corporate Accounting, which was responsible for supporting the accounting and financial reporting of

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[4] Memorandum prepared by Baker Botts, Re: David Glenn Interview, May 7, 2003, OF 2016107.

[5] Representative of that view is a statement made in a letter to former Freddie Mac Chief Executive Officer (CEO) Leland Brendsel and former Chief Operating Office David Glenn, dated December 6, 2000, from George Gould, an original member of the Board of Directors of Freddie Mac and former CEO of Donaldson, Lufkin and Jenrette: "[t]here may be a limited number of actions we can take to change the earnings nature of Freddie Mac over the next few years, especially since we are now operating from a much larger base than in earlier years. But, at the very least, I think we should try to safeguard our multiple by stressing the quality of our earnings and by making sure that the financial markets have confidence in our public statements and by not letting analysts get too far ahead of reality. Wall Street is not kind to earnings 'disappointments'," letter to Leland Brendsel and David Glenn, Freddie Mac Board of Directors, December 6, 2000, OF 2016501.

[6] "Regardless of the conflict I just mentioned or anything else, the discipline we have around interest rate risk management and credit risk management is unparalleled. There is nobody who manages those risks as well as we do." OFHEO Interview of Freddie Mac Chief Operating Officer, Paul Petersen, August 27, 2003, p. 140.

transactions, and Funding & Investments, the division that was responsible for managing investments and designing new financial products and strategies to achieve corporate earnings goals. A cultural divide developed between the business units of the Enterprise that used sophisticated credit and interest rate risk models and those business units that were viewed as "overhead." As Freddie Mac grew rapidly in the 1990s, management spent less time with and allocated proportionally fewer resources to the "overhead" units, whose employees viewed themselves as "second-class citizens."[7]

The Tone at the Top and Earnings Management

The preoccupation of Freddie Mac with meeting stock analyst expectations regarding non-volatile earnings growth resulted in intense efforts by the Enterprise to manage its reported earnings, compromised the integrity of many employees, and limited the effectiveness of the internal control structure of Freddie Mac. The Enterprise created and maintained reserve accounts that did not comply with Generally Accepted Accounting Principles (GAAP) and entered into many transactions with little or no economic substance, all for the express purpose of obtaining accounting results that would support the goal of reporting steady earnings growth.

The use of inappropriate accounting strategies by Freddie Mac to achieve steady earnings growth began in the mid-1990s, well before the restatement period. In 1994, the Enterprise established a $200 million reserve account to cushion against the fluctuations caused by the unpredictable amortization of premiums (or accretion of discounts)

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[7] OFHEO Interview of former Freddie Mac Controller Gregory Reynolds, October 2, 2003, pp. 135-136.

Q: How is that reflected, that second class citizenship?

A: I think it's reflected in a number of ways. They're always the last ones to get the budget dollars. The money in the company was always – it was far easier to get money allocated to some new security product, some new trading plan. To get money allocated to back office and infrastructure was a serious uphill battle. It wasn't appreciated, the importance of it was not recognized and, therefore, the resources were not allocated.

I think that within sort of the just culture of the company, if you will, the leadership of the company was far more visible in their support, encouragement and endorsement of people in, if you will, the first class citizen departments. You would see Leland [Brendsel] and David [Glenn] wander into the trading room and ask the traders how it's going. In my 12 years at the company, I never once saw Leland or David wander into the area of the company that my team worked in. It was that kind of a thing.

resulting from changing mortgage prepayment speeds. FAS 91 requires that amortization,[8] but the use of an amortization reserve does not comply with GAAP. The establishment of the reserve, which was a contra-asset on the balance sheet, coincided with an unexpected favorable tax event that resulted in approximately $200 million of income.[9] The policy of maintaining the FAS 91 reserve continued until 2002. That policy was coupled with another policy that, from 1998 to 2002, maintained the loan loss reserve of Freddie Mac at a level that was unjustifiably high relative to actual and projected credit losses. Both policies appear to have been driven more by the desire to achieve earnings targets than by proper accounting policy and documentation.

The preoccupation of Freddie Mac with steady earnings growth and achieving earnings targets was well established when Statement of Financial Accounting Standards (FAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities*,[10] a new accounting standard that was certain to inject volatility into the timing of earnings recognition, appeared on the horizon. Many of the transactions undertaken by the Enterprise were designed to mitigate the effects on its reported earnings of FAS 133 and other complex new accounting standards. Senior management and the Board believed that those standards gave a distorted impression of the financial performance of Freddie Mac.

FAS 133 requires that all derivatives of a corporation be marked to market on the balance sheet and the changes recorded in earnings or other comprehensive income

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[8] Financial Accounting Standards Board (FASB) 1986, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases." Statement of Financial Accounting Standards, No. 91, Norwalk, CT: FASB.

[9] Memorandum prepared by Baker Botts, Re: Jeff Harris Interview, February 24, 2003. OF 2000326- OF 2000328.

[10] Statement of Financial Accounting Standards Number 133 (FAS 133), *Accounting for Derivative Instruments and Hedging Activities*, requires, among other things, that entities recognize each derivative as an asset or liability on their balance sheets as a fair value or cash flow hedge, or as a derivative with no hedge designation. Different accounting applies to each of those alternatives, with different implications for the equity of shareholders and current earnings. Freddie Mac adopted FAS 133 on January 1, 2001. The Enterprise was also affected by, among other new financial accounting standards, Statement of Financial Accounting Standards Number 140 (FAS 140), *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, a replacement of FAS 125. FAS 140 revises the standards for accounting for securitizations and other transfers of financial assets and collateral and requires certain disclosures, but carries over most of the provisions of Statement 125 without reconsideration. That statement provides consistent standards for distinguishing transfers of financial assets that are sales from transfers that are secured borrowings.

(OCI). However, FAS 133 does not allow for the marking to market of all hedged items. Freddie Mac submitted extensive comments to the Financial Accounting Standards Board prior to the adoption of FAS 133, pointing out the effect that accounting statement would have on its financial reporting. The management and Board of the Enterprise were concerned that those changes, combined with its continued use of interest rate derivatives, would create artificial earnings volatility in future periods.

After FAS 133 was formally adopted, Freddie Mac devoted significant time and resources to develop strategies that would mitigate those accounting effects.[11] Senior management of the Enterprise actively encouraged the development of those strategies and the execution of the transactions that implemented them.

The special examination has determined that the efforts of Freddie Mac to inappropriately manage earnings were a direct result of an inappropriate tone at the top set by senior management—primarily CEO Brendsel, COO Glenn, and Chief Financial Officer (CFO) Vaughan Clarke. That tone at the top was the most important determinant of the corporate culture of the Enterprise in the 1999-2002 period covered by the restatement. Senior management established the goal of steady mid-teens earnings growth,[12] as well as other more specific goals, such as minimizing the FAS 133 transition gain,[13] discussed in detail in Chapter III. Senior management demanded whatever level of management of earnings was necessary and the execution of transactions to meet those

[11] "[T]he company tried to manage the impacts of a financial statement pronouncement that was going to distort the economics of the company ...." OFHEO Interview of Chairman of the Freddie Mac Board of Directors Audit Committee, Thomas Jones, August 12, 2003, on the impact of FAS 133, pp. 124-125.

[12] In a May 2, 2002, presentation to the Board, Gregory Parseghian described the investment management framework of the Enterprise from 1996 to that time as "'strong stable growth' of net interest income." Board Presentation, Gregory Parseghian, May 2, 2002, OF 2011428. Annual performance goals for the Enterprise regularly included a mid-teens earnings growth target: 18 percent in 1998, Performance Highlights, "1998 Company Performance," Leland Brendsel and David Glenn, 1999, OF 0000033; 17 to 20 percent in 1999, Performance Highlights, "1999 Company Performance," Leland Brendsel and David Glenn, 2000, OF 0000041; 13 to 15 percent in 2000, Performance Highlights, "2000 in Review," Leland Brendsel and David Glenn, 2001, OF 0000047; 13 to 15 percent in 2001, Performance Highlights, "2001 Results: Above Plan," Leland Brendsel and David Glenn, 2002, OF 0000051; and 16 to 18 percent in 2002, Performance Highlights, "2002 Results: Above Plan," Leland Brendsel and David Glenn, 2003, OF 0000056.

[13] In an interview with Baker Botts on February 25, 2003, Mr. Brendsel said that he indicated that he wanted to minimize the FAS 133 transition gain and keep earnings volatility at a low number. Memorandum prepared by Baker Botts, Re: Leland Brendsel Interview, February 25, 2003, OF 2000118.

goals.[14] Those individuals were aware of and encouraged reserve adjustments to move earnings as necessary on a quarterly basis to meet analyst expectations.[15]

Vaughn Clarke, as CFO of Freddie Mac, played a key role in setting the tone at the top that placed a priority on meeting the earnings targets set by Wall Street analysts at the expense of other objectives. The position description of Mr. Clarke included duties related to "Earnings' Performance Management."[16] Freddie Mac executives and employees at all levels viewed Mr. Clarke as a person who encouraged a policy of smooth earnings growth and placed a high emphasis on meeting the expectations of Wall Street analysts. In an interview during the special examination, Corporate Controller Edmond Sannini noted:

> A: There was an objective to try to get as close to the analysts' estimates or, I'm sorry, the analysts' forecast as possible.
>
> Q: Could you identify for us the source of your understanding of that objective; in other words, who did you identify the people responsible for formulating that business objective?
>
> A: The objective of cutting it as close to the analyst came in communications to me primarily from Vaughn Clarke.[17]

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[14] OFHEO Interview, Gregory Parseghian, v.1, August 4, 2003, "They [Leland Brendsel, David Glenn, and Vaughn Clarke] would meet weekly in private sessions. And it appeared to me that the earnings goals of the firm, both ... for the following year and then the management of those goals throughout ... the year would emanate from those meetings in that group." p. 139. "There was a clear goal to manage the interest income ... [w]e would propose transactions and strategies that would attempt to meet those goals." p. 140. When asked about discussions of discretionary transactions with an impact of reducing earnings other than debt repurchases, Mr. Parseghian said: "Internally, you know, not necessarily – but among David [Glenn], Leland [Brendsel], Vaughn [Clarke], myself, and Nazir [Dossani], all of these things were discussed." p. 286.

[15] 1998 NII/EPS Forecast, December 15, 1998, OF 2011318. The Senior Staff presentation explained that the improved outlook for net interest income (NII) "can be offset by a change in assumption around the accounting amortization of debt concession (currently over the life of the debt but should be amortized much faster). John Gibbons to make this decision, which will offset NII increase by three cents per share." Notes from a Senior Staff meeting on November 22, 2000 contain the following: "L.B .... Reserve option-may still be available to offset earning volatility – GR [Gregory Reynolds, Controller] – maybe mitigate 1-2¢/qtr," Senior Staff meeting notes, Gregory Reynolds, November 22, 2000, OF 2011546. Memorandum prepared by Baker Botts, Re: Leland Brendsel Interview, April 21, 2003, OF 2000125 - OF 2000126. Mr. Brendsel said he was aware of the review of reserves each quarter to determine if they were appropriate or if there was any "flexibility" in changing them. Although he said he was not aware that reserves were used to fine tune earnings to meet analyst expectations, he also said there was an "informal practice" to hit estimates within 1 to 2 cents a share. OF 2000125 - OF 2000126.

[16] The "Earnings Performance Management" duties of Mr. Clarke included in the position description are broad, including such duties as "manage corporation's short- and long-term performance," Federal Home Loan Mortgage Corporation, Position Description, EVP-Chief Financial Officer, provided to OFHEO October 31, 2001.

[17] OFHEO Interview, Edmond Sannini, August 1, 2003, p. 115.

Current CEO Gregory Parseghian was asked if he remembered ever getting any kind of feedback that recording substantial gains or losses would not be valued by the analyst community.

A: Yes.

Q: And from whom would you get that kind of feedback?

A: Well, I recollect that feedback most vividly coming from Vaughn Clarke.[18]

Former Deputy Corporate Controller Lisa Roberts was asked how she would describe the approach of Freddie Mac to the issue of the expectations of Wall Street stock analysts and meeting the expectations of those analysts. Her reply was:

A: I would describe it very simply as the company was very concerned relative to meeting analysts' expectations.

Q: And who in the company was very concerned?

A: I would say that the CFO was concerned.

Q: And are you referring to Vaughn Clarke?

A: Correct.[19]

Mr. Clarke quantified earnings goals "to the penny."[20] Mr. Clarke also made clear the level of net interest income that was desired[21] and communicated to other

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[18] OFHEO Interview, Gregory Parseghian, v.1, August 4, 2003, p. 110.

[19] OFHEO Interview, Lisa Roberts, August 6, 2003, pp. 49-50.

[20] OFHEO Interview, Gregory Parseghian, v.1, August 4, 2003, p. 270.

Q: The memorandum goes on to say that you said that Mr. Clarke worked with the analysts. And that would be outside street analysts, correct?

A: Correct.

Q: And that Clarke has historically communicated to Dossani, quote, to the penny what they wanted us to produce, closed quote.

A: Yes.

[21] OFHEO Interview, Gregory Parseghian, v.1, August 4, 2003, p. 271.

Q: So that's what you would have expected Mr. Clarke to do, is to say this is our target, this is what we need to do, find a way to do it, in essence right?

A: Yes, that's correct.

Q: And Mr. Dossani would keep you up to date, Vaughn just called me—

A: He wouldn't call me every couple of days, but I had a general sense of what level of NII (net interest income) was desired."

executives a corporate objective to have earnings be as close to the forecasts of Wall Street stock analysts as possible. Further, Mr. Clarke engaged in regular meetings with Freddie Mac staff to discuss the expectations of analysts and to develop and execute Enterprise strategies and transactions to ensure that earnings were close to those expectations. Deputy Corporate Controller Lisa Roberts described one of those regular meetings in an interview with the special examination.

> Q: Now you said that in the context of these meetings this issue about meeting analysts' expectations would come up. Is that right?
>
> A: Correct.
>
> Q: How would it be raised?
>
> A: It would be discussed in terms of communicating either Shareholders Relations or Vaughn would inform the group of where the expectation happened to be at that point given the information available to the company. The company would track and monitor where the analysts were expecting the company to come out for a particular quarter, so that knowledge typically was being evaluated and monitored by Shareholder Relations and Vaughn as an individual. So he would come to the table with that.
>
> Q: What was the purpose of providing that information?
>
> A: The purpose was to—if F&I [the Funding & Investments Division] needed to execute a transaction in order to meet that expectation, those types of strategies and alternatives and options were discussed. On the other hand, Vaughn wanted to see actually what business activity had been executed for the month and wanted to look at where the results were coming in and then based upon where the results were coming in compared to where he felt the street expectations were, then options and alternatives were discussed.[22]

According to PricewaterhouseCoopers, Mr. Clarke viewed his principal responsibility as shareholder relations, set a bad tone from the top regarding financial reporting, and was deeply involved in transactions that gave rise to the restatement.[23]

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[22] OFHEO Interview, Lisa Roberts, August 6, 2003, pp. 53-54.

[23] Memorandum prepared by Baker Botts, Re: Conference Call and meeting with Representatives of PricewaterhouseCoopers Relating to Management Representations, June 19, 2003, OF 2009621.

Failure to Allocate Adequate Resources to Accounting and Infrastructure

As Freddie Mac rapidly grew the retained mortgage portfolio in the 1990s, management turned to Wall Street to recruit highly credentialed staff with the skills and experience necessary to fund and manage the interest rate risk associated with the portfolio. There was far was less attention to the need to develop more sophisticated accounting and financial reporting policies, procedures, and systems and internal controls to keep up with the volume and growing complexity of the transactions associated with that growth. Those operations did not receive increases in resources proportionate to those allocated to managing interest rate risk.

In fact, Freddie Mac actively managed the ratio between its administrative expenses and its average total mortgage portfolio (securitized plus retained mortgages). The current COO of the Enterprise, Paul Petersen, described that effort in an interview during the special examination:

> [T]he G&A [general and administrative expenses] at Freddie Mac was always managed that we need to keep G&A between seven and eight basis points of total portfolio and so as something would occur in one area of the business that became a crisis, it would start sucking up the G&A which meant that you had to pull it away from some other part of the business.[24]

That approach ignored the additional resources needed to develop the accounting, financial reporting, and internal controls necessary to support the growth of the burgeoning retained portfolio.

Those mechanical limitations on G&A growth had a particularly strong impact on accounting.[25] As discussed in more detail in Chapter V, an increasing shortage of

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[24] OFHEO Interview of Freddie Mac Chief Operating Officer, Paul Petersen, August 27, 2003, p. 142.

[25] OFHEO Interview, Gregory Reynolds, October 2, 2003, pp. 189-191.

Q: Freddie Mac was a profitable company during this period of time .... What was the reason for not increasing more rapidly resources to accounting?

A: [T]he company was very focused in its management decision-making process on its total cost structure, so you're correct that profits were quite high, were growing quite rapidly.

As I observed the decision-making process about what the budget was going to be year to year, the factor that was brought into consideration in deciding on the budget was not growth and profits, it was growth and cost relative to the size of the portfolio and/or

accounting staff and experience caused key-person dependencies in crucial control areas. Simply stated, the quality and quantity of accounting expertise was too weak to assure proper accounting of the increasingly complicated transactions and strategies being pursued by Freddie Mac. From 1993 through 1996, the first four years of rapid retained portfolio growth, management actually reduced accounting and reporting personnel by nearly 20 percent.[26] As described in a memorandum by Lisa Roberts, staffing remained a problem in subsequent years:

> During the past five years (with the exception of 2002), management maintained roughly the same number of resources within the Corporate Accounting department and the decentralized accounting units. During this time, as mentioned above, we increased the complexity of our products and strained our operating systems. In addition to a steady stream of new products and transactions, management was also challenged by a number of major events including the conversion of the general ledger ... the implementation of compliant systems ... in preparation for Y2K, and the adoption of major accounting principles such as SFAS 133 and SFAS 140. These challenges redirected key resource and management focus from the baseline operation to the issue at hand and further challenged the remaining resources to maintain the control structure.[27]

Freddie Mac also failed to provide adequate funding for accounting systems. For example, in 1996 Corporate Accounting still managed the entire portfolio accounting process on Excel spreadsheets. That system was improved slightly in 1997, but repeated requests for a more robust Treasury accounting system were denied until 2000.[28] Accounting needs were regularly given a low priority in allocating the limited amounts that Freddie Mac was willing to devote to general and administrative expenses.[29]

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relative to Fannie Mae .... why did accounting have to take the short end? —it was always viewed as a second-class citizen.

[26] OFHEO Interview, Gregory Reynolds, October 2, 2003, pp. 142-143.

[27] Memorandum to Cindy Gertz, from Lisa Roberts, April 16, 2003, OF 1401526.

[28] Memorandum to Files, "Issues History," Gregory Reynolds, October 2, 2003, pp. 88-90, GR1-89.

[29] Memorandum from former Chief Financial Officer, John Gibbons, to Leland Brendsel, October 7, 1999, "All of these departures reflected frustration with systems development at Freddie Mac, and, in particular, the judgment that developing finance systems was not valued in the corporation. This is a situation, which puts critical corporate processes at risk and reflects, I believe, a distorted view of how systems development and infrastructure support the corporation's success."

See also, OFHEO Interview, Gregory Reynolds, October 2, 2003, p. 135, GR1-71.

Q: That developing these financial systems was not sufficiently valued at the corporation?

Failure to Manage Operations Risk

Another significant aspect of the corporate culture of Freddie Mac is a narrow definition of operations risk and a related neglect of operations risk management. The Basel Committee on Bank Supervision defines operations risk as "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events."[30] That definition is broad enough to encompass the risk of loss from failures to maintain appropriate accounting policies, practices, and controls or financial reporting controls, as may result from inadequate staffing and resources in those areas.

During the period covered by the restatement, Freddie Mac did not define operations risk that broadly. Management viewed operations risk as the potential for losses due to technology-related failures—for example, the losses that would be incurred if firewalls at file servers were breached, the Enterprise was not Y2K ready, or a disgruntled employee sabotaged an internal computer system. Freddie Mac failed to view operations risk as including failure to maintain or comply with written accounting and financial disclosure policies, procedures, and controls.

Illustrative of that narrow definition of operations risk and of the implications of that view for operations risk management oversight at Freddie Mac, is a presentation entitled "Risk Management, Controls and Oversight," presented to the Board of Directors of the Enterprise on March 1, 2002. That document lists and defines the four primary business risks facing Freddie Mac: Credit, Market/Interest, Operations, and Financial Reporting and Disclosure Risks. Operations risk is defined as "the risk of loss due to an interruption of critical business operations or processes, inadequate resources, capacity or capital, inefficiencies or inadequate controls over the delivery of products or services."[31]

A: Developing financial systems ... that applies not just to the financial systems, but, frankly, to the financial functions themselves.
Within the corporate culture of Freddie Mac, the financial functions were the second-class citizens, so within the IT [Information Technology] arena, those that worked on the financial systems were the second-class citizens in the IT arena.

[30] Basel Committee on Banking Supervision, *Sound Principles for Management and Supervision of Operational Risk*, Basel, Switzerland: Bank for International Settlements, February 2003, p. 2.

[31] PowerPoint presentation to the Freddie Mac Board of Directors, March 1, 2002, OF 2016956 – OF 2016987, OF 2016958.

The document provides an extensive, multi-page review of the Freddie Mac oversight process for credit and market risk. There is no discussion of operations risk oversight. There is a section on the role of Internal Audit as an independent reviewer of risk relative to the other units in the organization. Later in the document, a table shows the internal review process at Freddie Mac for the four primary risks. The Credit Risk Oversight business unit is listed as providing an internal review of credit risk, the Market Risk Oversight business unit is listed as responsible for internal review of interest rate and market risk, and the Corporate Controller is listed as responsible for the internal review of financial reporting and disclosure risk. The chart lists "none" for internal review of operations risk.[32] Internal Audit is listed as an external reviewer of each of those risk areas. The presentation concludes:

> While our control framework is sound, implementation of several aspects of the framework can be strengthened, including management's oversight of operations risk and the risk and control self-assessment process. Nevertheless, the overall management of operations risk is sound.[33]

The special examination does not agree with that conclusion. As discussed in detail in Chapters V and VII, significant weaknesses existed in the Internal Audit function of Freddie Mac and in the ways in which senior management and the Board responded to weaknesses identified by the General Auditor. Those weaknesses existed, in part, because the culture of the Enterprise had a narrow view of operations risk and saw no need to implement a broad framework for monitoring and managing that risk. The absence of such a framework contributed, in part, to decisions by senior management to execute transactions that were intended to manage reported earnings, had little or no effect on interest rate risk, and increased operations risk.

It was not until mid-2002 that Freddie Mac began to make controlling operations risk a corporate goal. Management created an Operating Risk Management Forum,[34] which first met April 16, 2002, to parallel its existing Market Risk and Credit Risk

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[32] *Id.*, OF 2016967.
[33] *Id.*, OF 2016982.
[34] The members of the Operating Risk Forum included: David Glenn, Gregory Parseghian, Paul Peterson, Adrian Corbirre, Maud Mater, Michael Hager and William Ledman. OFHEO Interview, Edmond Sannini, August 1, 2003, pp. 31-32.

Forums. On May 1, 2002, in a major reorganization two months after the Board of Directors presentation, Freddie Mac created the Control and Operating Risk Division. That reorganization consolidated in one division responsibility for establishing and maintaining an internal control structure over business risk, operations, and financial reporting; compliance with laws, regulations and other legal requirements; and safeguarding of Freddie Mac assets. The division is now responsible for Operating Risk Oversight, Financial Information Technology (financial reporting application systems), and Financial Reporting.[35]

[35] Q4-2002 Internal Control Assessment Update – Control and Operating Risk Division, 2002, OF 1303861 – OF 1303865.

III. IMPROPER MANAGEMENT OF EARNINGS

The term "earnings management" came into widespread use among accountants, lawyers, and others following a now famous September 1998 speech by the then Securities and Exchange Commission Chairman, Arthur Levitt[36] The term is perhaps unfortunate, in that almost all business activity is designed to enhance earnings, and the essence of good corporate management is maximizing profit (earnings) for shareholders. As used in this report, it means inappropriate manipulation of reported accounting results through various devices.

This chapter reviews how Freddie Mac manipulated its reported earnings and disclosed other financial information in a misleading way in 1999 through 2002. The chapter provides a chronology of relevant events, reviews the strategies that the Enterprise employed to manipulate earnings, and indicates that the Board was made aware of transactions whose sole purpose was to shift income. The chapter also examines how the executive compensation program of Freddie Mac, particularly compensation tied to earnings per share, influenced accounting and management practices at the Enterprise during the period.

The special examination concludes that excessive attention and dedication of corporate resources of a government-sponsored enterprise to management of earnings for the purpose of meeting securities market expectations, without an additional, overriding business purpose, is an unsafe and unsound practice.

Strategies Employed by Freddie Mac

As discussed in Chapter II, in the period covered by the special examination, senior management at Freddie Mac placed an inordinate emphasis on achieving steady, stable growth in earnings per share. The Enterprise used a number of strategies in an effort to shift earnings among quarters and years so as to achieve that objective. A useful way to

[36] Arthur Levitt, "The Numbers Game," Address, the NYU Center for Law and Business, September 29, 1998.

review those strategies is to present a chronology of the situations that Freddie Mac faced and the transactions it conducted to improperly manage earnings during the period.

June 1999

On June 4, 1999, Gregory Reynolds, the Controller of Freddie Mac, gave a presentation to the Audit Committee of the Board of Directors titled "Management Assessment of Current SEC Accounting Concerns."[37] The purpose of the presentation was to provide the Audit Committee with an assessment of the management control system and Board oversight processes of the Enterprise with respect to concerns that SEC Chairman Arthur Levitt expressed at that time regarding the prevalence of "earnings management." Mr. Reynolds noted that the SEC was concerned that earnings management was deteriorating the quality of financial reporting, and that the SEC was questioning the effectiveness of the oversight role provided by audit committees relative to earnings management. Mr. Reynolds identified several areas that the SEC thought potentially problematic, including issues surrounding materiality, revenue recognition, and "cookie jar" reserves. He then detailed the framework of management control and Board oversight at Freddie Mac that should prevent any of those issues from becoming a problem.

Interestingly, notes from a "dry run" of that presentation conducted in the office of Chief Executive Officer (CEO) Leland Brendsel indicate that management presented the subject of SEC concerns at the request of Russ Palmer, then chairman of the Audit Committee. A note from the dry run states that "[w]e have managed earnings via reserves but that is not frequent or significant/material; i.e., several cents."[38]

While the Audit Committee listened to Mr. Reynolds, the Investment Committee of the Board was also convening. One of the presentations before the Investment Committee that day, on "Multi-Year Net Interest Income Planning,"[39] was prepared by

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[37] Presentation to the Audit Committee of the Board of Directors of Freddie Mac, "Management Assessment of Current SEC Accounting Concerns," June 4, 1999, OF 5001159.
[38] Meeting Summary, "Audit Dry Run," May 21, 1999, ODG 0002664.
[39] Presentation to the Investment Committee of the Board of Directors of Freddie Mac, "Multi-Year Net Interest Income Planning," June 4, 1999, OF 5001460A.

Nazir Dossani, Senior Vice President of Asset/Liability Management and Research in Funding & Investments (F&I). Mr. Dossani noted in his presentation that the net interest income (NII) outlook for 1999 was $3.50 per share, which was at the high end of the "On-Plan" range of $3.39 to $3.51 per share set by management. The presentation stated that the Enterprise could achieve income on the high end of the range with lower negative convexity[40] relative to the plan but that pursuing the low convexity strategy would lead to an "unfavorable pattern of NII for 2000 versus 1999." The presentation by Mr. Dossani advocated keeping the level of convexity where it was and recommended the implementation of other strategies to improve the time pattern of earnings between 1999 and 2000. In addition to strategies involving capital markets transactions (delaying settlement of 1999 purchases, buying back high-coupon debt, selling mortgages with gains in 2000), the presentation also recommended "analyzing the adequacy of reserves (amortization and loan loss)." Ironically, that was recommended to the Investment Committee while the Audit Committee was learning about the concerns of the SEC regarding managerial cookie jars.

The entire Board of Directors of Freddie Mac also met that day. John Gibbons, who was then the Chief Financial Officer (CFO) of the Enterprise, gave his "Financial Review and Outlook."[41] The first page noted that the financial prospects of Freddie Mac were bright, thanks to strong retained portfolio purchases and favorable credit results: "NII is surging and we are undertaking transactions to smooth the time pattern over 1999-2000." Mr. Gibbons noted that 1999 net interest income was running substantially above plan and that without rebalancing transactions "1999 net interest income could exceed 2000 net interest income." Thus, page four of the slide presentation by Mr. Gibbons stated, "[we] are undertaking transactions to smooth the time pattern of net interest income." To minimize any misunderstanding by the Board, the final page of the presentation repeats the message of Mr. Gibbons: "NII is surging and we are undertaking transactions to smooth the time pattern over 1999 – 2000."

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[40] Convexity is a measure for fixed-income instruments used in conjunction with duration to estimate how an instrument's value will change given a change in interest rates.

[41] Presentation to the Board of Directors of Freddie Mac, "Financial Review & Outlook," John Gibbons, June 4, 1999, OF 50001004 – OF 5001016.

The meetings held on June 4, 1999 do not mark the beginning of the earnings management era at Freddie Mac. There is evidence suggesting that the practice started at an earlier date. For example, Gregory Parseghian, who joined the Enterprise in February 1996 and is currently its CEO, told the special examination that he became aware of the management goal of stable earnings growth "one or two days" after joining Freddie Mac.[42] A series of e-mails in late 1997 and early 1998 written by Enterprise employees after receipt of an OFHEO query on derivatives refers to "earnings management swaps" and notes that as of the third quarter of 1996 there were $7.2 billion in "Earnings Management Derivatives."[43] In one of the e-mails, Gregory Reynolds, who was then the Controller of Freddie Mac, wrote this: "We need to make sure we describe these swaps appropriately. The term 'earnings management swaps' must not be used." However, a later e-mail shows that there was a general ledger code for "Earnings management/Macro swaps."

Leland Brendsel told interviewers acting on behalf of the Board of Directors that Freddie Mac adopted the goal of steady earnings growth in the early 1990s after some investors, including Berkshire Hathaway, told management that the Enterprise needed to communicate clear and simple messages that the public could easily understand.[44] Fifteen to sixteen percent earnings growth was the simple message that management began to propagate.[45] According to Mr. Brendsel, that goal was fairly easy when Freddie Mac was primarily a securitizer of mortgages.[46] However, as the retained mortgage portfolio of the Enterprise grew and its earnings became more sensitive to interest rates, steady mid-teens growth became a more challenging goal. In that regard, the June 4th presentation to the Board by John Gibbons may have been a major turning point for Freddie Mac. David Glenn asserted that was when the policy of earnings management began and that "the Board knew about the Company's activities in conducting capital market trades with an eye toward shifting earnings. They were a part of that culture."[47]

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[42] OFHEO Interview, Gregory Parseghian, v.1, August 4, 2003, p. 252.
[43] Email correspondence, Gregory Reynolds, January 13, 1998, OF 2011310 – OF 2011316.
[44] Memorandum prepared by Baker Botts, Re: Leland Brendsel Interview, May 7, 2003, OF 2016015.
[45] *Id.*
[46] *Id.*
[47] Memorandum prepared by Baker Botts, Re: David Glenn Interview, May 7, 2003, OF 2016107.

Not much was said in the June 4th Board minutes about the presentation made by Mr. Gibbons. Among the comments in the minutes were that Mr. Gibbons "noted ... that net interest income (NII) is very strong," and that "Mr. Gibbons then discussed trends in NII ...." Mollie Roy, an Associate General Counsel, noted that after Gregory Reynolds gave his presentation on Arthur Levitt's "five deadly sins," management carefully reviewed the Board minutes to ensure that there were no references to earnings management.[48]

The Year 2000

Compared to 1999, 2000 was a more challenging year for Freddie Mac from an earnings perspective. The growth rate of Participation Certificates (PCs) held in the retained portfolio of the Enterprise slowed from 25.6 percent in 1999 to 16.6 percent in 2000.[49] Also, initial spreads on purchased mortgages were lower than plan. That may be partially attributed to Treasury Undersecretary Gary Gensler, whose testimony before Congress on March 22, 2000 roiled the agency debt market.[50]

As shown in Figure 1, the spread between Treasury and agency debt widened dramatically after the testimony of Undersecretary Gensler, increasing from 84 basis points on March 22nd to 118 basis points on April 4th. [51] That sudden change in the relationship between Treasury and agency debt negatively affected the funding cost of Freddie Mac, and also had an adverse effect on rebalancing trades that F&I had previously executed. For 2000, Nazir Dossani had in his Employee Performance & Development Summary an objective to "[create] $75 - $125 million of value (pre-tax) through rebalancing transactions ...." However, in the review of the performance of Mr. Dossani for the year 2000, Gregory Parseghian wrote that "[we] expect a loss of

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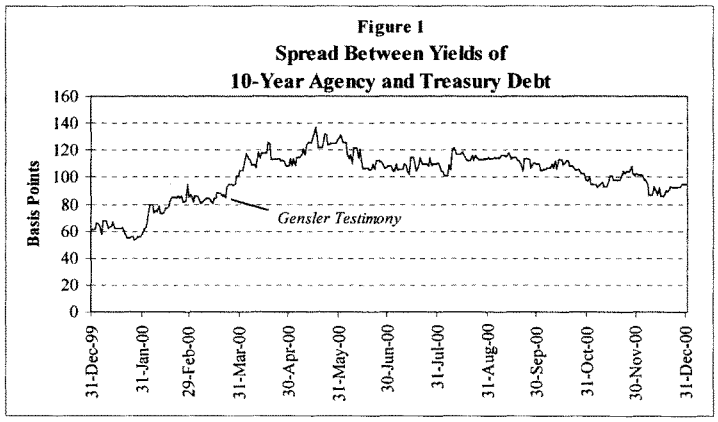
[48] Memorandum prepared by Baker Botts, Re: Mollie Roy Interview, February 13, 2003, OF 2000588.

[49] Freddie Mac Mortgage Volume Summaries, December 1999 and December 2000. Freddie Mac uses the term Participation Certificate (PC) to refer to single-class mortgage-backed securities that it has guaranteed.

[50] Testimony to the House Banking Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises, Treasury Undersecretary Gary Gensler, March 22, 2000. Among other things, Mr. Gensler voiced support for a repeal of the Treasury line of credit for the housing government-sponsored enterprises (GSEs). Agency debt includes notes and bonds issued by Freddie Mac, Fannie Mae, other GSEs, certain federal agencies, and multinational corporations such as the World Bank.

[51] Reduced Treasury borrowing needs associated with an increasing federal government budget surplus also contributed significantly.

about $250 million this year. The loss early in the year on our basis positions (Treasury and swap shorts) has been difficult to overcome despite many areas where we had strong performance. While our debt has outperformed swaps since the agreement on voluntary disclosure, the loss from a widening of debt relative to treasuries at the long end of the curve is essentially locked in because the Treasury short positions have been liquidated."[52] The losses Mr. Parseghian refers to were fair value losses on derivatives that, although not immediately realized that year, were indicative of the more difficult earnings environment that Freddie Mac faced in early 2000.



Source: Bloomberg

Some members of the Board of Directors of Freddie Mac, while aware of a more challenging economic environment in 2000, continued to press management for mid-teens earnings growth. In a March 15th letter[53] to Leland Brendsel, Board member George Gould, Chairman of the Investment Committee, suggested that investors would view the year 2000 as "a test of our corporate earning power under less than the ideal low interest rate, boom conditions of 1998 and 1999." Mr. Gould noted that the current projection for earnings per share growth of the Enterprise was only 11 percent, and stated

[52] Employee Performance Management Form for Nazir Dossani, Gregory Parseghian, January 11, 2001, OF 0000237.
[53] Letter to Leland Brendsel, from George D. Gould, March 15, 2000, OF 2016494 – OF 2016495.

that if "Freddie Mac is perceived as only a 10% grower under less than ideal macro conditions, then our valuation decline may not be over – especially under current market attitudes." While making clear that he was "not talking about 'manipulating' earnings upward," Mr. Gould asked if management could review the 15 percent return-on-equity threshold for portfolio purchases "in light of sluggish overall projected growth." He also noted that management "had suspended the purchase of asset-backed securities because of a query from [Berkshire Hathway[54] Chairman] Warren Buffet, and yet as a group these purchases were responsible for noticeable growth last year."

Mr. Gould expressed similar themes when the Board of Directors of Freddie Mac met on June 2, 2000. Notes from that meeting indicate that Mr. Gould pointed to the competition: "don't want qual deterioration in earnings but FNM is pounding the table re 15% earning growth over next 5 yrs."[55]

Pressure to sustain earnings growth may have provided the impetus for a program to change the "geography" of income. That program included selling of short-dated options to shift unrealized gains from the swaptions portfolio of Freddie Mac to its net interest income account. Specifically, management wrote swaption contracts that had short exercise periods[56] against swaptions that had already been purchased to hedge the retained mortgage portfolio. Management amortized the premiums received on the written options through net interest income, and recorded changes in the market value of the options in other income. The Enterprise recorded $144 million in net interest income from written options, while reducing other income by $124 million.[57] While the net gain in income was slight (approximately $21 million), the geographic shift from other income to net interest income was substantial. That is important, as many investors were focused on the steadiness of the net interest income of Freddie Mac, and net interest income was a

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[54] Berkshire Hathaway at the time was among the largest shareholders of Freddie Mac. The query of Mr. Buffet prompted a review by management of underwriting practices for housing-related asset-backed securities. As a result of that review, Freddie Mac sharply curtailed its investments in manufactured housing securities, which proved to be a good decision given the current problems in that sector.

[55] Notes from the Freddie Mac Board of Directors meeting, George D. Gould, June 2, 2000, OF 1625226. "FNM" is the New York Stock Exchange symbol for Fannie Mae.

[56] The purchasers paid premiums to Freddie Mac for the option to enter into an interest rate swap with pre-specified terms a few months after the options were purchased.

[57] Market Risk Oversight Forum, January 9, 2001, p. 7, OF 1611982.

key performance objective for management. Indeed, Gregory Parseghian noted in the 2000 review of Nazir Dossani that the short-dated option portfolio was a key factor in achieving the NII and net interest margin objectives of their division.[58]

The short-dated options program was well controlled from a risk management perspective. The options sold were all covered by swaptions with embedded gains that had already been purchased, and management monitored the positions closely. However, there was no disclosure of the short-dated options portfolio in the Annual Report of Freddie Mac for 2000, even though the $144 million in net interest income created by the strategy represented five percent of the net interest income of $2.8 billion of the Enterprise and almost half of the increase in net interest income from 1999 to 2000.[59] Freddie Mac should have disclosed and discussed that information.

Ultimately, the shift in income geography did not survive the scrutiny of the reaudit process of Freddie Mac. An accounting policy memo written on March 16, 2003, stated that "Freddie Mac incorrectly amortized the premiums received through Net Interest Income under the premise that premiums received were for monetization of premiums paid for the purchased option portfolio (and the purchased options premiums were being amortized as expense through net interest income). That logic is not supported by the GAAP literature or any accounting interpretations at the time." Therefore, management reversed the shifts in amortization income from other income to net interest income.[60]

The FAS 133 Transition

As the end of 2000 approached, Freddie Mac was on a mission to comply with FAS 133, *Accounting for Derivative Instruments and Hedging Activities*. Given the large size of the derivatives portfolio of the Enterprise, FAS 133 presented management with numerous operational challenges relating to systems, documentation, and accounting

[58] Employee Performance Management Form for Nazir Dossani, Gregory Parseghian, January 11, 2001, OF 0000236.
[59] Freddie Mac Annual Report, 2000, p. 44.
[60] Memorandum to the Files from Thomas Stuber, "Short Dated Written Options Strategy," March 16, 2003, OF 1707108.

infrastructure. However, in addition to the operational challenges, FAS 133 presented Freddie Mac with further obstacles with respect to steady earnings. Specifically, FAS 133 required management to record a transition adjustment based upon any embedded gain or loss in its derivatives portfolio upon adoption of the standard, which for the Enterprise would be January 1, 2001. The portfolio of derivatives of Freddie Mac, in particular its portfolio of swaptions, had substantial gains that had to be recognized on the transition date and management was concerned about that prospect. Gregory Parseghian told the special examination that there were "broad discussions in the firm" among members of senior management in Finance & Administration and Funding & Investments "to discuss techniques by which we could try to have as low as possible transition adjustment."[61] When asked why management wanted to minimize the transition adjustment, Mr. Parseghian thought there were several motivations:

> One was that we didn't—we didn't feel as though there was any economic event—there was no economic change in the company's finances simply by the passage of a date on a calendar, so I think that that was one motivation. Secondly was that we felt that a—either a gain or a loss, significant gain or loss on the implementation of FAS 133 would lead to a very difficult time in messaging for the marketplace, for the equity marketplace, what had happened, why there was a gain or a loss. So we thought it would be destabilizing. And in the case of, obviously, we knew or believed that it would be a substantial gain, it would have detracted from future period earnings to have written up essentially the derivative without writing down the item that it was hedging.[62]

With respect to the first point made by Mr. Parseghian—"we didn't feel as though there was any economic event"—he is correct. There was no *economic* event, but the adoption of FAS 133 was a significant *accounting* event. Specifically, FAS 133 declared that derivatives were no longer off-balance sheet items, but were either assets or liabilities, depending upon their market value. Also, FAS 133 required the difference between the previous carrying amount of a derivative and its fair value to be reported as a transition adjustment, so the embedded market-value gains in the derivatives portfolio of Freddie Mac would soon be recorded on its income statement.

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[61] OFHEO Interview, Gregory Parseghian, v.1, August 4, 2003, pp. 64-65.
[62] *Id.*, pp. 65-66.

The second point made by Mr. Parseghian was that a significant gain would create challenges for management in properly communicating the nature of the gain, and that "it would be destabilizing." Those points seem to underscore the desire of management to portray Freddie Mac as a smooth and steady money machine, never perturbed by changes in interest rates, mortgage volumes, or other exogenous factors. To maintain that image, it is now clear that the management of the Enterprise went to extraordinary lengths to transact around FAS 133 and to push the edge of the GAAP envelope. One could reasonably ask if communicating the true nature of a derivatives gain to equity investors would have been more difficult than disguising the amount of the derivatives gain.

Third, Mr. Parseghian states that the management of Freddie Mac knew that the derivatives gain would be substantial, but that the gain would have "detracted from future period earnings." Specifically, a transition adjustment from a large derivatives gain in the first quarter of 2001 would be much less desirable than having the same amount of earnings spread out over several quarters—that would better serve the corporate goal of steady, mid-teens earnings growth. Indeed, the diaries of David Glenn indicate that management had been working for some time to devise a plan to spread those earnings out. For example, Mr. Glenn had a dinner meeting on October 2, 2000 with several employees from Funding & Investments. During that dinner, Nazir Dossani, a Senior Vice President in F&I, told Mr. Glenn that he was spending a third of his time on FAS 133. At the same dinner, Peter Federico, a Vice President in F&I, told Mr. Glenn that the transition adjustment was estimated to be $350 million and "we need to decide how to spread that over several years."[63] Due to changes in market conditions, the potential transition adjustment grew even larger as the end of the year approached, and management had to develop creative methods to disguise it.

On November 22, 2000, CFO Vaughn Clarke met with employees from Corporate Accounting and Funding & Investments to discuss plans to minimize the FAS 133 transition gain. The agenda identified their strategic objective: "Recognize book losses in 1Q01 that offset the FAS 133 transition gain AND replace lost earnings in subsequent

[63] Journal, David Glenn, October 2, 2000, DG 0117: Mr. Glenn told Baker Botts that he altered the statement of Mr. Federico in his journal from "We need to" to "We're trying to."

periods."[64] The plan anticipated an exchange of $10 to 15 billion of PCs with embedded losses in the retained portfolio for either a REMIC or a Giant security.[65] The strategy was further outlined in a VIU[66] memorandum dated November 29, 2000 that dealt with "FAS 133 Transition Trades." That memo outlined nine steps that would need to be executed in order to effectively recognize a loss on the "sale" of the securities and then bring the same securities back to the portfolio. The earlier REMIC idea was soon abandoned due to its complexity and an exchange for Giants became the focus. Those trades became known as Coupon Trade-Up Giants (CTUGs).

CTUGs took advantage of a window created by the Financial Accounting Standards Board (FASB) that, upon adoption of FAS 133, allowed companies to re-designate securities from held-to-maturity (HTM) to available-for-sale (AFS) or trading without tainting the rest of their HTM securities. By using that window, Freddie Mac could identify held-to-maturity PCs in its portfolio with mark-to-market losses and move them to a trading account, where a loss could be immediately recognized as income.

The maneuver planned by management was to execute forward sales of mortgage-backed securities in November and December 2000 to lock-in the market value of PCs with embedded losses. On January 1, 2001, management would move the PCs to the trading account and recognize a loss to offset gains on the derivatives portfolio. That would minimize the FAS 133 transition adjustment. The problem for Freddie Mac remained, however, that leaving the securities in the trading account would subject the Enterprise to significant exposure to earnings volatility. Trading account securities must be continuously marked-to-market with changes in market value realized in income. To eliminate that risk, the PCs were to be transferred to a counterparty—Salomon Smith Barney—and swapped for a Giant security, which, according to the VIU memo, would consist of no more that 90 percent of the original securities transferred by the Enterprise in order to create a true sale. The last point is important, as a true sale would be needed to transfer the securities out of the trading account. The Giant would then be purchased

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[64] Meeting agenda, FAS 133 Transition Gain, November 22, 2000, OF 2002155.
[65] A REMIC is a Real Estate Mortgage Investment Conduit, which is a type of multi-class mortgage-backed security. A Freddie Mac Giant is a large single-class PC comprised of smaller PCs.
[66] David Glenn required VIU memoranda for transactions deemed "Visible, high Impact, or Unique."

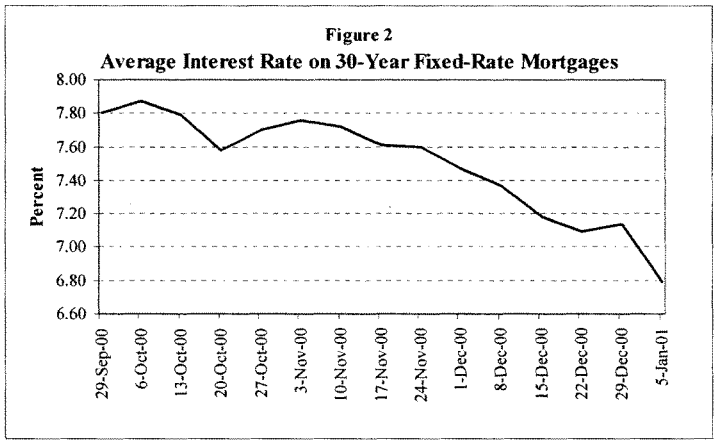
by Freddie Mac and placed in its available-for-sale portfolio, where future market value changes would be reflected on the balance sheet but not the income statement of the Enterprise.

Put succinctly, the purpose of the CTUG transactions was to move securities with embedded losses from the held-to-maturity category (where losses are unrecognized) into trading (where losses would be immediately recognized in net income and would offset derivative gains), and then into available-for-sale (where securities gains and losses only hit "other comprehensive income," not "net income"). There is a "have-your-cake-and-eat-it-too" flavor to those maneuvers, as management wanted the benefit of having its securities in a trading account but only for enough time to realize a loss and reduce its FAS 133 transition gain.

Changing Swaption Values

As if the difficulties Freddie Mac faced in managing earnings were not already substantial, changes in market conditions raised the bar. In November and December 2000, mortgage rates were falling rapidly, as shown in Figure 2. The rapid fall in rates resulted in increased market values for PCs in the portfolio of the Enterprise, reducing the losses in PCs that management had previously identified for transfer to the trading account. Those losses were now too small to cover the anticipated gain in the derivatives portfolio, so management had to identify more PCs with losses to include in the transaction. That brought the total amount of PCs to be exchanged up to approximately $30 billion. Peter Federico of F&I said that Freddie Mac used "everything they had" in the mortgage portfolio to "spike" the transaction – that is, increase the losses – and catch up with the moving market.[67]

[67] Memorandum prepared by Baker Botts, Re: Peter Federico Interview, February 26, 2003, OF 2000253.

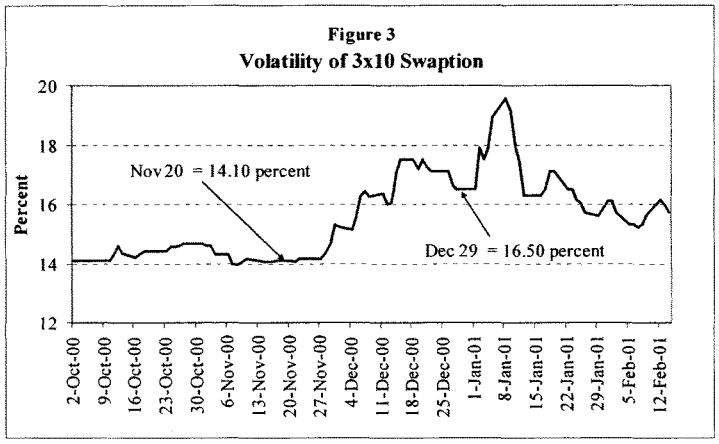


Sources: Mortgage Bankers Association, Bloomberg

In addition to the rapid moves in the mortgage markets, management had to contend with a moving target on the derivatives side. Freddie Mac had a substantial portfolio of swaptions, which are options to enter into interest-rate swaps on a future date. The investment portfolio of the Enterprise consists mainly of mortgages with embedded prepayment options, so that Freddie Mac must hedge those mortgages with option-embedded debt and derivatives; swaptions are a key component of that funding and hedging strategy. The value of swaptions is quoted in the market in terms of volatility.[68] Volatility is a key variable that traders and portfolio managers use in their models to determine option values, including swaptions. In late November 2000, swaption volatility quotes began climbing upward. Figure 3 shows volatility for a 3x10 swaption—a 3-year option to enter into a 10-year swap. Swaption volatility increased as the demand for derivatives to hedge mortgage prepayment risk increased with the decline in mortgage rates noted above. The rise in volatility resulted in a large increase in the value of the swaptions portfolio of the Enterprise. It raised the specter of a significant

[68] Volatility is a measure of the change in price of a financial instrument over a given time period. The premium for a swaption is computed by using an appropriate options pricing model, such as the Black model, with the market volatility of the swaption as a key input.

transition adjustment on January 1, 2001, even after considering the losses management hoped to realize through the CTUGs strategy.



Source: Bloomberg

According to Robert Dean, Senior Vice President of Market Risk Oversight, participants in a Rebalancing Committee[69] meeting on December 12, 2000 noted that the marked-to-market net worth of Freddie Mac "had suddenly increased by a very large amount."[70] The rise was due to the increased value of the options-based derivatives of the Enterprise, including swaptions. At that point, Mr. Dean, who in addition to being in charge of Market Risk Oversight was also one of the Strategy Sponsors of the FAS 133 Project[71], embarked upon a mission, with the assistance of F&I personnel, to develop an alternative valuation methodology for the swaptions portfolio.

Although market quotes for swaptions volatility were available from numerous sources, including Bloomberg, BlackRock, and the Salomon Yield Book,[72] Mr. Dean and

[69] The Rebalancing Committee is comprised of Funding & Investments staff. The committee meets weekly to discuss market conditions and strategies to fund and hedge the retained mortgage portfolio.
[70] OFHEO Interview, Robert Dean, July 31, 2003, p. 45.
[71] FAS 133 project organization chart, FM 101680.
[72] Robert Dean indicated to OFHEO staff during his interview that volatility indications from BlackRock and Salomon Yield Book were market quotes. OFHEO Interview, Robert Dean, July 31, 2003, pp. 71-72.

his staff wrote a memorandum that outlined a method for determining a pricing date for volatility when "volatility quotes may not be consistent with where transactions can be executed due to a market event."[73] The memo described a complex procedure for determining a pricing date for volatility whenever "a market event has occurred."[74]

The facts surrounding the creation of that memorandum suggest that the process for determining swaptions volatility on December 31, 2000 was not objective, but rather designed to reach a predetermined result:

- The memo purports to be from Mustafa Chowdhury, a Vice President and derivatives specialist in Funding & Investments. However, the memo was actually written by the staff of Market Risk Oversight, which is responsible for overseeing F&I.[75] Mr. Dean told OFHEO staff that while his staff "did the legwork" on the memo, he wanted a derivatives expert in F&I to have ownership of it, because F&I personnel had the requisite derivatives expertise to create such a policy. Mr. Dean apparently desired to hide his authorship of the memo, since he later approved it and did not want to appear to be approving his own work.

- The date of the memorandum is January 2, 2001, which is one day after the transition gain for FAS 133 was to be recorded. The methodology in that memo prescribed a pricing date (November 20, 2000) that reduced the increase in the market value of the swaptions portfolio of Freddie Mac to $731 million. That amount was almost identical to the losses realized in the CTUGs transactions, which seems more than coincidental.

- The memo was not officially approved by anyone in Corporate Accounting but was instead signed by Mr. Parseghian, Mr. Dossani, and Mr. Dean, putting Mr. Dean in an unusual position of approving a policy that he and his staff had drafted. Thus, Mr. Parseghian, Mr. Dossani, and Mr. Dean were approving the valuation policy to be used for the external financials of Freddie Mac, rather than Corporate

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[73] Memorandum from Mustafa Chowdury to the Files, "FAS 133 Valuation Approach on Options Portfolio," January 2, 2001, OF 2001827.

[74] *Id.*, OF 20001828. The procedure required a comparison of the percentage change in volatility from the previous day to two standard deviations of the daily percentage change in volatility. Any grouping of at least ten daily changes in volatility quotes outside the two standard deviation band constituted a trigger, which then required checking with options dealers to determine if the exception is due to a "fundamental change in the market's risk premium or a technical imbalance in the market." If a technical imbalance is indicated, the memo then required a complex procedure using 10- and 20-day moving averages to identify a pricing date that would be used to determine the volatility to put into a model to price swaptions.

[75] OFHEO Interview, Robert Dean, July 31, 2003, p. 60.

Accounting. In effect, F&I created and approved its own accounting policy, instead of obtaining a written accounting policy from Corporate Accounting.

- A second set of data (Salomon Yield Book) was used to derive the methodology to determine the November 20, 2000 pricing date, after the first data set (BlackRock) did not produce enough spikes in volatility to establish an alternative pricing date that accomplished the goals of management. The Enterprise typically used BlackRock data for valuing swaptions. That indicates that management searched for data that would provide the results they wanted, which were swaption values as low as possible.

- The valuation method was used only for the FAS 133 transition adjustment of Freddie Mac, and not for any risk management purpose. F&I continued to use unadjusted market volatility from BlackRock for determining the portfolio market value sensitivity (PMVS) of the Enterprise. That indicates that management changed its swaption valuation method only to obtain a particular accounting result, rather than for risk management.

- There was no VIU memorandum prepared for the new option-valuation methodology, although it had a high impact on the financials of Freddie Mac. There is also no evidence that management discussed the new policy with the Board of Directors or any of its committees.[76] That indicates that F&I did not want this valuation ploy to become highly visible.

- A Market Risk Oversight Forum package indicates that swaptions liquidity for both November 30 and December 29, 2000, was "Somewhat < Normal," although there is no indication that business could not be transacted or that different pricing techniques should be used for risk management purposes.[77] That casts doubts on the assertions of management that the swaptions market was too illiquid to facilitate transactions.

- The fact that market quotes were available from several market sources—for example, Bloomberg, BlackRock, and Salomon Yield Book—indicates that there was a market for swaption transactions during the period of increased volatility.

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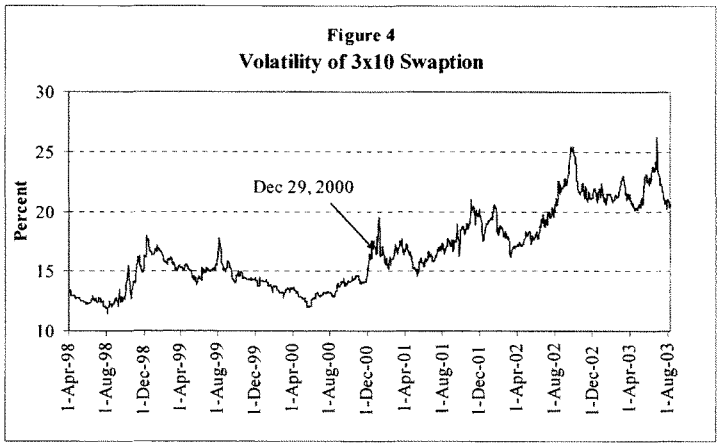
[76] Thomas Jones, Audit Committee Chairman, told the special examination that he would have expected a methodology change with as much effect as this one had to have been brought to a committee of the Board for preapproval. OFHEO Interview, Thomas Jones, August 12, 2003, pp. 82-83.
[77] Market Risk Oversight Forum package, January 9, 2001, OF 1611981.

- Although swaptions volatility was high in December 2000, the level of volatility was not unprecedented, and volatility was to reach significantly higher levels in later years (see Figure 4). That appears to have been a one-time policy, as Freddie Mac made no subsequent use of that valuation methodology.

Those facts indicate that management created the policy only to achieve its accounting objective.

FAS 107, *Disclosure about Fair Value of Financial Instruments*, states that "quoted market prices, if available, are the best evidence of the fair value of financial instruments."[78] Freddie Mac, per FAS 107, would only be permitted to use its own estimate of fair value in circumstances where quoted prices are unavailable, even if such quotes would be for smaller transaction volumes than those typically executed by the Enterprise. Freddie Mac never provided evidence that dealer quotes were unavailable. Indeed, as noted above, dealer quotes were available from several sources.



Source: Bloomberg

[78] Financial Accounting Standards Board (FASB), 1991 "Disclosure About Fair Value of Financial Instruments." Statement of Financial Accounting Standards No. 107, Norwalk, CT: FASB.

That swaption valuation method (referred to by management as "constant volatility" in a summary of FAS 133 transition activities[79]) contributed to a misstatement of the 2001 financial results of Freddie Mac, as the effect of using that method was a reduction in the value of derivatives of $730 million.[80] The fact that the head of Market Risk Oversight, Mr. Dean, worked hand-in-glove with a unit whose compliance he was responsible for overseeing to craft a dubious swaptions valuation methodology discredits the control environment at the Enterprise and highlights the willingness at all levels of management of Freddie Mac to disguise earnings.

Problems with Coupon Trade-Up Giants (CTUGs)

Even with the revised method for valuing swaptions, the market value of the options-based derivatives portfolio was still high, and the management of Freddie Mac wanted that value to be offset by losses created by the CTUG transactions described above. However, the losses management created by moving the Giant securities from Trading to Available-for-Sale were eventually unwound when the Enterprise and PricewaterhouseCoopers revisited that transaction during their reaudit in 2003. In addition to operational problems that resulted in the PCs being converted into Giants by the securitization group at Freddie Mac instead of by Salomon Smith Barney,[81] and the fact that the latter only held the Giants for a few hours before shipping them back to the Enterprise,[82] management ultimately concluded that the classification from Trading to Available-for-Sale should not have been permitted. In an Accounting Policy Interpretation memo, management noted that while FAS 115 (*Accounting for Certain Debt and Equity Securities*) states that transfers into or from the trading category should be rare, "rare" is generally interpreted to mean "never" both in practice and by the SEC.[83] Additionally, Freddie Mac and PricewaterhouseCoopers were told by outside counsel in

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[79] Asset Liability Management Forum, "Asset Liability Management and NII Implications Under Changing Market Conditions," April 3, 2001, p. 15, OF 1620839.
[80] Memorandum from Thomas Stuber to the Files, "Swaption Valuation from December 29, 2000 to February 5, 2001," February 23, 2003, OF 1706904.
[81] Memorandum prepared by Baker Botts, Re: Smirti Popenoe Interview, February 12, 2003, OF 2000490.
[82] *Id.*, OF 2000491.
[83] Accounting Policy Interpretation, "Reclassification of Securities from Trading to AFS I 1Q01," Sandy Kurtis, May 30, 2003, OF 1706872.

January 2003 that the law firm "would be apprehensive about providing a legal true sale opinion on these transactions."[84]

However, when Freddie Mac executed the CTUG transactions in 2001, management did not obtain a legal opinion, since external counsel felt "that the transaction would fall under the umbrella of the comprehensive legal letter written in connection with the Giant sales in general."[85] That was because "the transaction was considered to be a typical Giant trade from an operational standpoint."[86] However, the transaction was anything but typical, particularly operationally. One would think that the $30 billion aggregate size of the CTUG transactions would mark them as distinctly atypical but the operational details are what make the CTUGs unique. A draft memo on CTUGs written early in the reaudit process makes reference to a "streamlined method of pool formation,"[87] meaning that the PCs were not actually sent to Salomon Smith Barney, cash for the transaction did not move from Salomon Smith Barney to the Enterprise and back again, and no fee for the transaction was paid by Salomon Smith Barney. All of that was called for under the Giant transaction agreement then in effect between Freddie Mac and Salomon Smith Barney.[88] In fact, although no fee was paid by Salomon Smith Barney to the Enterprise, Freddie Mac did pay Salomon Smith Barney a fee on the transaction.[89]

The CTUGs are an example of a transaction with little or no economic substance that Freddie Mac manufactured to obtain a particular accounting result. Indeed, the economic aspects of the deal were negative when one considers the operational hazards created by the transaction, including the fact that CTUGs contributed to the Guaranteed Mortgages Securities (GMS) reconciliation problem that emerged as a significant control issue in 2001.[90] It is just one example of the proclivity of management to assume

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[84] *Id.*
[85] Internal Freddie Mac email memorandum to Gail Vance, an attorney in the Office of the General Counsel, from Sandy Kurtis, January 14, 2003, OF 2016662.
[86] *Id.*
[87] Draft memorandum to Jamie Amico and Robert Mailloux, from Gail Vance, January 14, 2003, OF 2016664.
[88] *Id.*, OF 2016665.
[89] The role of Salomon Smith Barney in the CTUG transactions is discussed in more detail later in this chapter.
[90] Draft presentation to the Audit Committee on the GMS Reconciliation, December 2001, OF 2016877.

operations risk in the quest to reduce earnings volatility. The willingness of management to assume operations risk was noted by Mike Hager, Senior Vice President of Human Resources, in a set of discussion points for David Glenn regarding the 2001 bonus of Gregory Parseghian. In one of the discussion points, Mr. Hager noted that Mr. Parseghian and Vaughn Clarke made a decision "to take on additional operational risks and compound well-known accounting and control weaknesses."[91]

Positive Carry

In the fourth quarter of 2000, as management made its preparations for FAS 133, the decline in mortgage rates shown above in Figure 2 was having an effect on the retained portfolio of Freddie Mac. Declining mortgage rates resulted in faster prepayments for the mortgages in the portfolio, thus shortening the duration of the assets of the Enterprise. As a rebalancing measure in late 2000 and early 2001, management executed a series of derivatives transactions to offset the reduction in asset duration. Those transactions included $60 billion in receive-fixed/pay-floating interest rate swaps. As shown in Table 1, the fixed sides of those swaps were tied to 5-, 7-, and 10-year swap rates. The floating sides were tied to 3-month LIBOR.[92]

When management put on the swap positions, the swap curve was relatively flat. As shown in Figure 5, the difference between 3-month LIBOR and 10-year swap rates was small in the fourth quarter of 2000; in fact, 3-month LIBOR was higher than the 10-year swap rate in December 2000.

[91] Discussion points to David Glenn, Re: Gregory Parseghian, from Mike Hager, March 8, 2002, OF 2016887.
[92] LIBOR is the acronym for London Interbank Offered Rate.

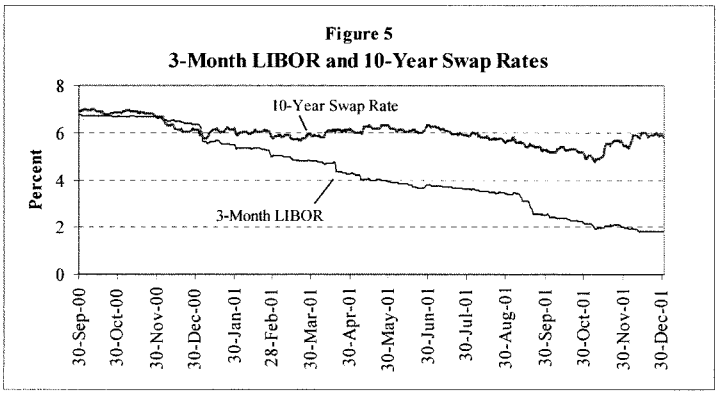
Table 1.
Freddie Mac Rebalancing Activity,
Fourth Quarter 2000

Maturity of Swap (years)	Receive-Fixed Notional Principal ($ in billions)	Average Swap Rate (percent)
5	17	6.4
7	15	6.5
10	28	6.6
Total	60	6.5

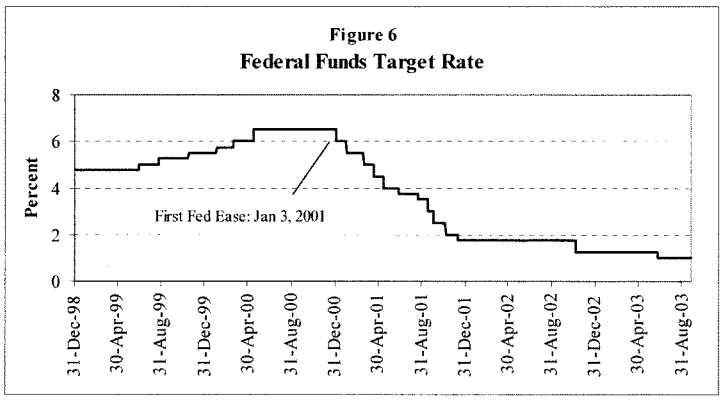
Source: Asset Liability Management Forum, "Asset Liability Management and NII Implications Under Changing Market Conditions," April 3, 2001, p. 13, OF 1620837.

In January 2001, the shape of the yield curve began to change dramatically in favor of Freddie Mac. As shown in Figure 6, the Federal Reserve lowered its target for the Fed funds rate by 50 basis points on January 3, 2001, from 6.50 percent to 6.00 percent. That was the first of many Federal Reserve rate reductions in 2001; those moves eventually took the Fed funds rate down to 1.75 percent by the end of 2001 and resulted in a much steeper yield curve. A steep yield curve, where short-term interest rates are lower than long-term rates, results in a significant amount of "positive carry" for institutions like Freddie Mac that fund long-term, fixed-rate mortgages with a mix of short- and long-term liabilities. CFO Vaughn Clarke reported to the Managing Committee on March 27, 2001 that the news with respect to earnings growth was all positive, but that created some challenges, one of which was "smoothing out" the acceleration of income.[93]

[93] Notes from Freddie Mac Managing Committee meeting, Bob Ryan, March 27, 2001, OF 1680060.



Source: Bloomberg



Source: Bloomberg

In addition to the positive carry from funding a higher than expected volume of newly purchased mortgages when the yield curve was steep, the rebalancing trades summarized in Table 1 began to pay off faster than asset yields declined due to faster mortgage prepayments. The rebalancing trades were designed to offset the effects of just such an increase in prepayment speeds but the timing of income flows was different. On the $60 billion of pay-fixed interest rate swaps, the gap between the floating-rate paid and the fixed-rate received by Freddie Mac grew wider as 2001 progressed. In the first six

months of 2001, 3-month LIBOR declined 257 basis points, from 6.34 percent to 3.77 percent. Robert Dean noted in an August 6, 2001, memorandum to David Glenn that as of June 30, 2001, net interest income for the year was approximately $650 million ($0.90 per share) higher than the forecast provided to the Investment Committee in December 2000.[94] With other factors offsetting each other, Mr. Dean attributed virtually all of the excess earnings to the rebalancing position, as noted in Table 2.

Mr. Dean further explained that the increase in net interest income was a result of management choosing not to hedge all of its exposure to the risk of a more inverted yield curve. That left Freddie Mac in a position to benefit from falling short-term interest rates. In effect, the Enterprise had been speculating on its ability to predict the direction of interest rate movements and had won its bet. Mr. Dean noted that the swap curve had steepened 150 basis points, which represented the largest six-month reshaping of the yield curve in the last 15 years.[95] The yield curve measure (PMVS-YC, or Portfolio Market Value Sensitivity – Yield Curve) publicly disclosed by the Enterprise did not reflect the full extent of that exposure because it is an estimate of exposure from a change in the yield curve slope of only 25 basis points.

Table 2.
Breakdown of Estimated Freddie Mac
Excess 2001 Earnings Per Share
(June 30, 2001)

Higher than expected retained portfolio growth	$0.25
Larger than expected spreads on new mortgages	$0.25
Decline in asset yields due to runoff	($0.50)
Carry income on 4Q2000 rebalancing activity	$0.90
Increase in projected 2001 net interest income	$0.90

Source: Freddie Mac

[94] Memorandum from Robert Dean to David Glenn, "Follow-up on issues discussed at July 2001 MRO Forum," August 6, 2001, ODG 0001915.
[95] *Id.*, ODG 0001920.

The detailed explanation of above-plan earnings growth provided by Mr. Dean to Mr. Glenn was more comprehensive than that provided to the public by Freddie Mac. In its public earnings releases, management explained the growth in operating net interest income for the first two quarters of 2001 as follows:

- First quarter, 2001: "The increase in operating net interest income from fourth quarter 2000 was driven by a $34 billion, or 9 percent, increase in the average balance of the retained portfolio."[96]

- Second quarter, 2001: "The increase in operating net interest income from first quarter 2001 was driven by a $34 billion, or 9 percent, increase in the average balance of the retained portfolio."[97]

No mention was made in those public disclosures of the significant gains resulting from the positive carry. However, there was much discussion of the rapid increase in earnings within Freddie Mac and much hand wringing as to how to deal with it. Bob Ryan, an assistant to David Glenn, wrote this: "Gregory [Parseghian] – needs help in earnings mgmt of $1.3b above current target of (5.37 vs. 7.14) he can manage $1.1b needs help w/$200M some sort of reserve acct."[98]

"Managing the Time Pattern of Net Interest Income Recognition"

One place where the steepness of the yield curve was cited as a factor in above-plan earnings was in a presentation made to the Investment Committee on June 1, 2001. In that presentation,[99] Nazir Dossani cited strong mortgage growth at wider-than-normal initial spreads and higher levels of convexity risk as reasons for above-plan income growth, along with the steep yield curve. Until recently, the interest-rate risk management framework of Freddie Mac had as its primary objective the creation of steadily growing net interest income, with the constraints being (1) return-on-equity thresholds for mortgage purchases and (2) portfolio market value sensitivity (PMVS) limits. The presentation by Mr. Dossani cited two long-term challenges to achieving the

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[96] Freddie Mac First Quarter 2001 Earnings Release, April 24, 2001.
[97] Freddie Mac Second Quarter 2001 Earnings Release, July 18, 2001.
[98] Notes to David Glenn, Bob Ryan, May 24, 2001, OF 2010236.
[99] Presentation to the Investment Committee of the Board of Directors of Freddie Mac, "Managing the Time Pattern of Net Interest Income Recognition," Nazir Dossani, June 1, 2001, OF 5021331 – OF 5021342.

net interest income goals of the Enterprise: (1) spread compression on the existing mortgage portfolio and (2) managing the time pattern of net interest income. The presentation noted that the "opportunistic investment strategy [of Freddie Mac] and the complexities created by FAS 133" would present a challenge to the goal of management of "achieving stable NII growth."[100]

The presentation by Mr. Dossani listed three strategies for managing net interest income to targeted levels:

- Reducing convexity risk;
- Buying back high-coupon debt; and
- Reserve and G&A [General & Administrative expenses]-related actions.

The statement on reducing convexity risk echoed a memorandum Mr. Dossani and Robert Dean wrote to David Glenn on April 25, 2001.[101] Therein, Messrs. Dossani and Dean wrote that "[the] level of convexity and volatility risk that F&I takes on is almost entirely driven by Freddie Mac's income needs."

Mortgage assets in the portfolio of Freddie Mac have negative convexity because of the prepayment options provided to mortgage borrowers.[102] The Enterprise can offset some of that convexity risk by adjusting the amount of callable debt it issues, or the amount of option-based derivatives it purchases. Some of that coverage is purchased as soon as mortgages are funded and additional derivatives may be purchased throughout the life of the mortgages. The amount of prepayment option coverage that is on the books at any point in time is a key driver of net interest income.

A risk in that strategy is that prepayment option protection that is not immediately purchased may become more expensive over the life of the mortgage assets. The

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[100] *Id.*, OF 5021334.

[101] Memorandum to David Glenn, "Refinements to F&I's Framework for Convexity and Volatility Risk," from Nazir Dossani and Robert Dean, April 25, 2001, ODG 0004539.

[102] A financial instrument has negative convexity if the responsiveness of its price to changes in interest rates increases as interest rates rise and decreases as interest rates fall. A portfolio of assets and liabilities has convexity risk if its value is disproportionately affected by increasingly large changes in interest rates.

statement in the memo written by Messrs. Dossani and Dean that the level of coverage is "almost entirely driven by Freddie Mac's income needs" reflects the distorted culture of the Enterprise. Indeed, Maryann Murphy, PricewaterhouseCooper lead engagement partner for Freddie Mac, later cited that memo in a conversation with Mr. Glenn, suggesting to him that the priority may have been backwards and that risk management should have been first and income second, as opposed to income first and risk management second.[103]

Actions related to reserves, included in the third strategy cited in the presentation by Mr. Dossani on "managing the time pattern," would be highly inappropriate with respect to earnings management. As explained later in this chapter, management used its loan loss reserve and a FAS 91 reserve (whose existence was not in compliance with GAAP) as tools to reduce earnings volatility. In fact, notes for a presentation to the full Board of Directors given the same day as the presentation by Mr. Dossani state that "we are looking at all of our Reserve levels (Loan Loss, Tax, Legal, Contingency, etc.) up to 5 cents," meaning changes that would affect earnings by up to five cents a share.[104]

The use of reserve accounts was explicitly cited by Mr. Dossani as an earnings management strategy. The special examination uncovered no evidence that anyone in management or on the Investment Committee objected. Robert Arnall, former Arthur Andersen engagement partner, told the General Counsel of Freddie Mac that the title of the presentation by Mr. Dossani was "offensive" but that the material included in the presentation was not as problematic.[105]

Changing Metrics

The technique suggested by Mr. Dossani of adjusting the convexity risk of Freddie Mac to meet earnings targets had previously been the subject of several discussions among members of management. David Glenn recounted an "ugly" meeting that took place in the fall of 2000 between himself, Bob Ryan (assistant to Mr. Glenn), and Messrs. Dossani

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[103] Internal notes prepared by OFHEO, Re: PricewaterhouseCoopers interview, July 22, 2003.
[104] Notes for oral remarks by Vaughn Clarke from presentation to Freddie Mac Board of Directors, "Financial Review and Outlook, 2001 Baseline Operating Earnings," June 1, 2001, OF 2016766.
[105] Memorandum prepared by Baker Botts, Re: Robert Arnall Interview, February 25, 2003, OF 2000064.

and Parseghian.[106] At that meeting, the group discussed potential difficulties in continuing to meet the publicly stated goal of mid-teens earnings growth without changes to the risk management practices of the Enterprise. According to Mr. Glenn, at that meeting and other meetings that followed, management consciously decided to change its risk profile and take more convexity risk—that is, speculate on interest rates— in order to maintain mid-teens earnings growth.[107] An entry in the diary of Mr. Glenn for February 1, 2001,[108] indicates that he met with Messrs. Parseghian and Dossani, who suggested changes in the risk management approach of Freddie Mac, including loosening the limit for portfolio market value sensitivity (PMVS).[109] The key determinants of the PMVS of Freddie Mac are estimates of duration and convexity for its entire balance sheet, so if the Board of Directors allowed management to raise the PMVS limit, management could take more duration or convexity risk. The management of Freddie Mac prefers to modify its risk profile by increasing or decreasing its convexity risk, while generally keeping its duration risk within narrow bands.

The Board of Directors did, in fact, raise the reporting and operating limits for PMVS at its March 2, 2001 meeting.[110] The extra leeway provided by the higher PMVS limits gave management the option of hedging less of its prepayment risk, although the need for extra income vanished quickly in 2001 as the "positive carry" created by the steep yield curve gave Freddie Mac more income than it had forecast.

Management often saw a bleaker future of single-digit earnings growth, however, as it peered into the out-years. When the senior management of the Enterprise convened for a Managing Committee Meeting on March 26 and 27, 2001, it looked for ways to defer some of its earnings growth. In his "2001 Earnings Outlook," CFO Vaughn Clarke noted that the outlook for 2001 earnings-per-share of $4.50 was far above even the highest analyst estimate of $4.05.[111] That "creates some challenges," according to notes taken by Bob Ryan (assistant to David Glenn) about remarks of Mr. Clarke, including a

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[106] Memorandum prepared by Baker Botts, Re: David Glenn Interview, May 7, 2003, OF 2016106.
[107] *Id.*, OF 2016107.
[108] Diary Excerpt, David Glenn, February 1, 2001, DG 0147.
[109] In his diary, David Glenn refers to "PMVS" as "VaR," which stands for "Value at Risk," which is how Freddie Mac once referred to PMVS internally.
[110] President's Report, Freddie Mac Board of Directors Meeting, March 2, 2001, OF 5020037.
[111] 2001 Earnings Outlook, Managing Committee Meeting, March 26 and 27, 2001, OF 1650599.

need for "smoothing out acceleration of income – minimize acceleration beyond unexpected growth."[112] Mr. Clarke provided bullet-point strategies to cool off projected 2001 earnings, including "Redefine Operating EPS" and "FAS 133 reserve." The strategy to redefine operating earnings highlights the ease with which that measure could be manipulated.[113] The idea of establishing a reserve against FAS 133 volatility went far beyond even the most liberal interpretation of GAAP. There is no evidence that management ever created such a reserve. However, as the earnings forecast for 2001 continued to rise, management developed more robust financial engineering techniques to smooth earnings.

Lowering the Bar

In an August 7, 2001 Asset Liability Management Forum attended by David Glenn, Vaughn Clarke, Gregory Parseghian, and others, Mr. Parseghian noted that the outlook for 2001 NII was much higher than planned, and spoke of the "continuing challenge" of managing the tradeoffs between generating current period earnings, managing risk, and meeting future expectations. The minutes of that meeting contain comments regarding the enormous success of Freddie Mac in 2001 and in past years, which raised the bar for future years with respect to meeting earnings expectations. The minutes then note, "(the) group decided to take up this discussion outside this meeting."[114]

Although there is no documentary evidence detailing any discussions after the Forum, it was only a week later (August 14, 2001) that management executed the first of several interest-rate swap transactions that have become known as the "linked swaps." The terms of each pair of swaps substantially offset each other; in each pair, there was a swap that began immediately where Freddie Mac paid a fixed-rate to the counterparty and received a floating rate, coupled with a forward-swap starting one to nine months later where the Enterprise paid a floating rate and received fixed.[115] The steep slope of

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[112] Notes of Managing Committee Meeting, Bob Ryan, March 26 and 27, 2001, OF 1680060.
[113] PricewaterhouseCoopers later discovered significant control problems around operating earnings, and Freddie Mac recently dropped that measure.
[114] Asset/Liability Management Forum Meeting Summary, August 7, 2001, OF 1621000.
[115] Counterparties for the linked swaps were Morgan Stanley ($10B), UBS Warburg ($30B), Lehman Brothers ($10B), Merrill Lynch ($20B), and Goldman Sachs ($10B, plus $20B in levered swaps equivalent to $100B unlevered). OF 1706935. The role of those counterparties is discussed later in this report.

the yield curve at that time caused Freddie Mac to pay a substantially higher rate on the fixed legs of the initial swaps than it received from the floating legs. The opposite was true for the forward swaps, when they commenced, and the net effect on the overall risk position of the Enterprise was very small. The swaps also had little effect on GAAP income but the negative cash flow from the first swaps in each pair was reflected in operating earnings, a non-GAAP metric that management spotlighted for the investing public. Indeed, in the 2001 annual report of Freddie Mac, management asserted that "...results presented on an operating basis are beneficial in understanding and analyzing Freddie Mac's financial performance because they better reflect the economic impact of Freddie Mac's risk management activities."[116]

The linked swaps, in aggregate, moved approximately $456 million in operating earnings from 2001 into later years.[117] Mr. Parseghian told OFHEO that the linked swaps were discussed at the Asset/Liability Management Forum noted above, and that the first linked swaps were done shortly afterward.[118] The purported business purpose was to reduce the key rate duration (KRD) exposure of Freddie Mac at certain points on the yield curve, which is why those swaps often appear in management documentation as "KRD Swaps." However, the effect on the KRD exposure of the Enterprise was slight,[119] and Mr. Parseghian told OFHEO staff that the business purpose of the swaps was marginal relative to their income effects,[120] likening their use as a risk management tool to traveling from Washington, DC to McLean, Virginia via St. Louis.[121] Indeed, a Freddie Mac accounting policy memo written in 2003 noted that the swaps were "primarily executed for their impact on Operating Earnings, with a distant secondary purpose of risk management."[122]

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[116] Freddie Mac 2001 Annual Report, p. 22.
[117] Freddie Mac presentation: "Cash Flow Management Swaps," January 10, 2003, OF 2001612.
[118] OFHEO Interview, Gregory Parseghian, v.1, August 4, 2003, p. 134.
[119] Memorandum from Eric Reiser to the FAS 133 File, "Accounting Treatment of the KRD Swaps with Levered Coupon," January 13, 2003, OF 1706939.
[120] OFHEO Interview, Gregory Parseghian, v.1, August 4, 2003, p. 135.
[121] *Id.*, p. 136.
[122] Memorandum from Thomas Stuber to Files, "Accounting Treatment of the KRD Swaps with Levered Coupon – Cover Memo," April 10, 2003, OF 1706956.

Further, Mr. Parseghian said that using a leverage factor on one pair of linked swaps was quite possibly his idea.[123] A leverage factor of five was applied to the interest-rates of $20 billion in linked swaps. That gave the swaps the income-moving capacity of $100 billion notional while allowing Freddie Mac to minimize its notional swap balances at a time when senior management was concerned with the perception of equity investors regarding the size of its derivatives portfolio.

> ... Senior management had a desire to have us limit the notional balance of the derivatives ... so this was a way to attempt to—to achieve the senior management objective.[124]

When asked if the "purpose of doing the leverage ... [was] to limit the notional balance of derivatives," Mr. Parseghian responded "Yes."[125] He further explained that senior management, particularly David Glenn,

> ... may have gotten adverse feedback from one of the equity investors that they met with about the growth of derivatives -- notional balance of derivatives on the balance -- or on the reports, so I think that that probably motivated their directive to us, but they were -- they were informed as to the leveraged nature of the swap, and it achieved their objective of limiting the—you know, working towards limiting the notional balance of the derivatives.[126]

In effect, the efforts of Mr. Parseghian in Funding & Investments sought to disguise $80 billion notional in derivatives by using a leverage factor. Although the leveraged swaps were executed, the Enterprise subsequently chose not to report a lower level of notional balance. The records reviewed by the special examination do not explain why management did not proceed with the scheme of Mr. Parseghian.

Although Mr. Parseghian admitted that the business purpose of the linked swaps was marginal relative to their income effects, there is no evidence that he or his staff checked with Arthur Andersen before executing the swaps, and there is no written evidence that Corporate Accounting provided approval before the swaps were executed. Robert Arnall, the Arthur Andersen engagement partner, found out about the swaps after

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[123] OFHEO Interview, Gregory Parseghian, v.2, August 4, 2003, pp. 117, 119.
[124] *Id.*, pp. 117-118.
[125] *Id.*, p. 118.
[126] *Id.*

they were executed and complained to David Glenn and others, including F&I employees Nazir Dossani and Peter Federico. Mr. Arnall told them that the swaps were bare minimum on GAAP compliance and encouraged them to terminate the transactions.[127] However, management did not unwind the transactions until much later, when nearly all of the intended effect on operating earnings had been achieved.

The management of Freddie Mac provided the Board of Directors with commentary on the use of derivatives to manage earnings. In a presentation to the Board on September 7, 2001, CFO Vaughn Clarke reported on strategies to shift income from 2001 to 2002, including the use of derivatives. Notes from Mr. Clarke's presentation to the Board that day include the following entries:

> "transferring income"
>
> Growth is understated[128]

The same notes record the following comments in an exchange between Director George Gould and Mr. Clarke:

> GG – Steep yield curve front end load the spread?
>
> VC – Yes…Shifting income in future yrs through derivs. Strategies – debt buy backs, swaps[129]

Other notes from the same meeting record an exchange between Mr. Glenn and his fellow directors regarding earnings management activities at both Fannie Mae and Freddie Mac, as well as how Wall Street might view such activities:

> SR [Stephen Ross] – FNMA banking this yrs gain
>
> DG [David Glenn] – Yes – Don't know how much
>
> TJ [Thomas Jones] - $ No. shifting
>
> DG - $.80 share roughly
>
> JMc [John McCoy] – Street sees – e.g. buybacks

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[127] Memorandum prepared by Baker Botts, Re: Robert Arnall Interview, February 25, 2003, OF 2000063.
[128] Handwritten notes from Board of Directors meeting, September 7, 2001, OF 1625380.
[129] Handwritten notes from Board of Directors meeting, September 7, 2001, OF 1625381.

DG – Won't realize extent[130]

The Standard Reports to the Investment Committee for September 7, 2001, which Mr. Parseghian presented, noted that certain items offset favorable short-term debt costs in 2001, including "using swaps to transfer NII to 2002 and beyond."[131] Mr. Parseghian told OFHEO staff that he sought to include more quantitative detail about the swaps in his Investment Committee report, but the detail was removed at the behest of senior management present at the dry run, a group that included Leland Brendsel, then-General Counsel Maud Mater, and David Glenn.[132] However, the Investment Committee may have been told more. Notes taken from a breakfast review of the September 7th board committee meetings by the assistant to Mr. Glenn include the following for the Investment Committee: "derivatives position trillion, to back load income. $400b to shifting income."[133]

Ultimately, management did not unwind the swaps until they had already moved large amounts of operating earnings. That earnings movement began late in the third quarter of 2001, a time many Americans will always associate with attacks on the World Trade Center and the Pentagon. In view of those events, the Earnings Release of Freddie Mac for that quarter reminded investors that, despite those tragic events, investors could count on a steady stream of earnings:

> "We are all saddened by the terrible events of September 11," said Leland C. Brendsel, Chairman and Chief Executive Officer. "As a leader in the housing finance system, Freddie Mac again proved to be a rock of stability, providing an uninterrupted supply of mortgage funds. Even with greater uncertainty in the economy, Freddie Mac is well positioned to produce mid-teens earnings growth in 2002."[134]

A New External Auditor

As 2001 was winding down, headlines appeared about Enron, the once highly regarded energy company in Houston, Texas. Previously a mundane distributor of natural gas,

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[130] Handwritten notes from Board of Directors meeting, September 7, 2001, OF 1625371.
[131] Investment Committee Standard Reports, p. 4, OF 5021913.
[132] OFHEO Interview, Gregory Parseghian, v.1, August 4, 2003, pp. 122-133.
[133] Journal excerpt, Bob Ryan, September 11, 2001, OF 2010250.
[134] Freddie Mac Third Quarter 2001 Earnings Release, October 17, 2001.

Enron later seemed to make spectacular profits on trading energy derivatives and bandwidth futures. However, stories were emerging about the management of Enron, who allegedly engaged in transactions to create nonexistent profits and enrich themselves. That cast the external auditors of Enron, Arthur Andersen, in an extremely unfavorable light. The firm fired David Duncan, the lead partner for Enron, in January 2002, after alleging that he ordered the destruction of documents upon learning of a government investigation. The situation could not have come at a worse time for Arthur Andersen, soon after high-profile restatements at Waste Management, for which the SEC ordered Arthur Andersen to pay $7 million for "improper professional conduct," and Sunbeam, which resulted in Andersen paying $110 million to settle shareholder lawsuits.[135]

Given the unfavorable publicity engulfing Arthur Andersen, companies using the audit firm had to rethink their relationship with them. Freddie Mac had been an Arthur Andersen client since the early 1970s and relied on the firm to an unusual degree. However, the Audit Committee of the Board of the Enterprise decided, at a January 2002 meeting, that it was time to move on. In describing that meeting, Ronald Poe, a member of the Audit Committee, said the committee believed "that Arthur Andersen as a firm with its involvement in Enron was headed down a rocky road and that we should probably get out in front of the curve in terms of replacing Arthur Andersen. We then called Leland in and directed Leland to begin a process for replacement of Arthur Andersen ...."[136]

The diary of David Glenn indicates that he had considerable angst concerning the possibility of switching to a new auditor. For example, Mr. Glenn wrote in a January 27, 2002, entry that Andersen "signs off on mk to mkt, FAS 133, operating earnings. Andersen people play key role in getting work done."[137] In a memo to Mr. Brendsel of January 30, 2002, Mr. Glenn expressed other concerns about the decision to hire a new auditor, writing that "I find it difficult to understand how such an important issue could

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[135] *See,* "Enron: After the Collapse," http://www.pbs.org/newshour/bb/business/enron/player6.html.
[136] OFHEO Interview, Ronald Poe, September 16, 2003, p. 48.
[137] Diary excerpt, David Glenn, January 27, 2002, DG 0015.

have been made without my knowledge or involvement."[138] It appears that Mr. Glenn later took steps to keep Arthur Andersen a viable candidate to remain as external auditor, as documents from his office indicate that Freddie Mac formed a Management Selection Committee to interview candidate firms for the external audit engagement. In a presentation document titled "Auditor Selection: Process and Recommendation," the Management Selection Committee recommended that the Audit Committee meet and interview both PricewaterhouseCoopers and Arthur Andersen. One of the selection criteria listed in the document is called "Transition Risk." For that criterion, the Management Selection Committee gave Arthur Andersen good marks: "No transition risk if AA is retained for 2002 audit. Due to lack of tenure of key FM financial managers, AA knowledge of policy and process is critical to FM's financial reporting process." [139] In an earlier draft, that committee recommended the reappointment of Arthur Andersen and noted that a transition of auditors "presents significant risks" including "the possibility of restatements."[140]

Despite the views of management, the Audit Committee decided to hire PricewaterhouseCoopers. The PricewaterhouseCoopers engagement commenced in March 2002, and the new auditors soon raised issues regarding the size of the loan loss reserve, requiring management to reduce the reserve by $250 million. PricewaterhouseCoopers later discovered other problems relating to transactions surrounding the FAS 133 transition, including the CTUG transactions and the change in the method for valuing swaptions. After Freddie Mac hired the law firm of Baker Botts to investigate allegations in "whistleblower" letters, PricewaterhouseCoopers relayed those issues to Baker Botts. The firm investigated them and found numerous problems relating to specific transactions as well as a culture of earnings management at the Enterprise. The continuing emergence of issues ultimately led to the decision by PricewaterhouseCoopers in January 2003 that a reaudit of the financial statements of Freddie Mac for 2000 and 2001 was necessary.

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[138] Memorandum to Leland Brendsel, "Audit Issues," David Glenn, January 30, 2002, ODG 0003983.
[139] Auditor Selection: Process and Recommendation, February 25, 2002, FM C0003298.
[140] Auditor Selection: Process and Recommendation (Draft), February 24, 2002, ODG 0005127.

Loan Loss Reserves and Earnings Management

Senior management kept the loan loss reserve of Freddie Mac at an unusually high level relative to actual and projected losses from 1998 to 2002, a period when earnings at the Enterprise were growing rapidly. Senior management justified the high reserve levels by citing the need to protect against large and unexpected credit losses, such as those that actually occurred in 1990. While such losses are possible, management could not support that they were probable, which is a key requirement of FAS 5, *Accounting for Contingencies*.

The failure of Freddie Mac to reduce the loan loss reserve in recent years stemmed in part from past experience. In 1990, the Enterprise had incurred large loan losses in its multifamily mortgage portfolio. Those losses required Freddie Mac to increase its loan loss reserve by $100 million. The size of that loan loss provision embarrassed management at that time, particularly because the Enterprise had only recently become a public company. In later years, the loan loss reserve grew larger, but in 1998, losses started declining rapidly, as shown in Table 3.

Current and former employees, as well as Board members, have said that the loan loss reserve was kept at a high level because of the conservative credit culture of Freddie Mac, rather than it being a "cookie jar" to manage earnings. For example, former Controller Gregory Reynolds recalled that "Russ Palmer [a former Chairman of the Audit Committee] specifically said . . . I don't want to see this number going down." [141] Mr. Reynolds also said that "the view that we should be conservative was a view that was held by the CEO, COO, and CFO, in addition to the Audit Committee." [142] Lynne Oliver of Corporate Accounting also noted that Mr. Palmer "was very risk-averse and asked why they [Corporate Accounting] were not increasing reserves."[143] The current Audit Committee Chairman of Freddie Mac, Thomas Jones, expressed similar sentiments when he told OFHEO staff "that strong financial companies want to maintain conservative

[141] OFHEO Interview, Gregory Reynolds, October 2, 2003, p. 44.
[142] *Id.*, p. 29.
[143] Memorandum prepared by Baker Botts, Re: Lynne Oliver Interview, February 10, 2003, OF 2000451.

reserve levels, and this was a company that had a not too distant history of not having adequate loan loss reserves."[144]

Table 3.
Freddie Mac Loan Loss Reserve and Net Losses

Year	Net Losses ($ in millions)	Provision ($ in millions)	Loan Loss Reserve ($ in millions)	Loan Loss Reserve/ Net Credit Losses	Loan Loss Reserve/ Total Mortgage Portfolio (percent)
2001	($28)	$45	$801	29x	0.07%
2000	($28)	$40	$784	28x	0.08%
1999	($56)	$60	$772	14x	0.09%
1998	($116)	$190	$768	7x	0.10%
1997	($296)	$310	$694	2x	0.11%
1996	($323)	$320	$680	2x	0.11%
1995	($305)	$255	$683	2x	0.12%
1994	($227)	$200	$733	3x	0.14%
1993	($325)	$300	$760	2x	0.15%
1992	($377)	$425	$785	2x	0.18%
1991	($290)	$407	$737	3x	0.19%
1990	($251)	$450	$665	3x	0.20%
1989	($173)	$260	$466	3x	0.16%

Source: Freddie Mac Investor/Analyst Reports

Although the conservative preferences of Freddie Mac management and the Board with respect to loan loss reserves are not inherently problematic, the assumptions and techniques used to determine the size of the loan loss reserve of the Enterprise were not well supported. Freddie Mac set the size of the reserve high enough to absorb a loss that forecasting models and other methodologies indicated was very unlikely. That approach is inappropriate given that FAS 5 specifically requires that the reserve only be established to cover losses that are probable, not just possible.

The Audit Committee was aware of the low probability that the full reserve would be needed. The "Key Financial Reporting Estimates" presented to the committee on March 2, 2001 included a comment that "(the) most probable case anticipates a mild slow down in the economy" but that "the current reserve balance is well in excess of the most

[144] OFHEO Interview, Thomas Jones, August 12, 2003, p. 171.

probable case."[145] Similarly, the same report presented to the committee on September 7, 2001, notes that "the current reserve balance continues to be in excess of the most probable case" and that "we are adequately reserved even if a more significant economic downturn were to occur."[146]

The maintenance of an unnecessarily high loan loss reserve has the appearance of creating a "cookie jar" that can be used to suppress or support earnings when convenient. There is some evidence that the loan loss reserve of Freddie Mac was so used, although the reserve consistently grew at a slow rate between 1998 and 2001. Suggestive notes from an April 1, 1998 meeting in the office of Mr. Brendsel indicate that "JG [then-CFO John Gibbons] to determine whether to reduce the first quarter loan loss provision from $75 million to $60-65 million to maintain a flat earnings stream."[147] However, actual and probable future losses were declining sharply at the same time, so while the reduction in the provision was convenient, its timing appears appropriate. In an interview Deputy Controller Lisa Roberts recalled that, three years later, then-CFO Vaughan Clarke attempted to get Corporate Accounting to raise the reserve by $5 million to narrow the gap between preliminary earnings results and the expectations of stock analysts.[148]

In the fall of 2001, Freddie Mac hired Edmond Sannini as its new Controller. Not long after starting that job, Mr. Sannini expressed concern at the level of the loan loss reserve, "not so much the absolute level but at least the documentation that we had to support that did not seem to be commensurate that I would have expected to have."[149] The new auditors from PricewaterhouseCoopers started their engagement in March 2002, and Mr. Sannini told Messrs. Clarke and Glenn that "I thought that [PricewaterhouseCoopers] would come in, would be taking a hard look at our loan loss reserve based upon our documentation that we had."[150] Sometime in the second quarter of 2002, said Mr. Sannini, it became clear "that it was broader than a documentation

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[145] Key Financial Reporting Estimates, Audit Committee, March 2, 2001, OF 2011150.
[146] Key Financial Reporting Estimates, Audit Committee, September 7, 2001, OF 2011178.
[147] Meeting Preparation and Feedback Form, Office of the President, April 1, 1998, LD ODG 0005980.
[148] OFHEO Interview, Lisa Roberts, August 6, 2003, p. 62.
[149] OFHEO Interview, Edmond Sannini, August 1, 2003, p. 53.
[150] *Id.*, p. 55.

issue, that the levels that we were reserving to were most likely not probable and estimatable ...."[151]

Ultimately, Freddie Mac made a $250 million reduction in the loan loss reserve, booking the entire amount in the third quarter of 2002. That reduction in the loan loss reserve increased earnings, but was largely offset in the fourth quarter of that year by a $225 million cash contribution by the Enterprise to the Freddie Mac Foundation and the corporate giving program of Freddie Mac.[152]

FAS 91 and the Improper Management of Earnings

As noted in Chapter II, the use of inappropriate accounting strategies to dampen earnings volatility began well before the reaudit and restatement period. In 1994, Freddie Mac management created a reserve account to cushion against the fluctuations caused by the unpredictable amortization of premiums (or accretion of discounts) resulting from changing mortgage prepayment speeds. That amortization is required by FAS 91,[153] which, among other things, requires that purchase premiums and discounts on loans (including debt securities) be recognized as an adjustment of yield, generally by the interest method based on the contractual terms of the loan. The debt securities the Enterprise owns are primarily mortgage-backed securities, which means that management must re-cast continually the amortization of premiums and discounts based on the prepayment speeds of the underlying mortgages. In a volatile interest rate environment, prepayment speeds can change rapidly, thus leading to changes in mortgage premium amortization and making net interest income volatile and difficult to forecast.

The creation of the FAS 91 reserve by Freddie Mac was itself an act of earnings management. Management created the reserve to offset a $200 million windfall gain from an unexpected tax event.[154] The reserve was presented quarterly to the Audit Committee of the Board in a report of "Key Financial Reporting Estimates." A reserve

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[151] *Id.*, p. 58.
[152] Freddie Mac Fourth Quarter 2002 Earnings Release, January 27, 2003.
[153] Financial Accounting Standards Board (FASB) 1986, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases." Statement of Financial Accounting Standards, No. 91, Norwalk, CT: FASB.
[154] Memorandum prepared by Baker Botts Re: Jeff Harris Interview, February 24, 2003, OF 2000327.

account to protect against potential changes arising from FAS 91 is not permitted by GAAP. There is no evidence that the Board was ever told that the reserve was a departure from GAAP, but there is also no evidence that the Board ever questioned if it was permitted by GAAP. Management used the reserve to absorb "catch-up" amortization when actual mortgage prepayments differed significantly from those previously forecasted, specifically one or two standard deviations away from a base-case interest rate forecast. The reserve peaked at $216 million in the fourth quarter of 1999, which was approximately 5.4 percent of net income.[155] When the reserve was depleted in the second quarter of 2001, management established a narrower range for catch-up amortization of plus or minus $25 million; any amortization outside of that range had to be recorded as income or expense. Getting the amortization numbers to fall within the range was sometimes an all-night process; according to one employee, it was "classic" for Freddie Mac to "play with the numbers until they got the right one."[156]

Some of the problems relating to FAS 91 amortization relate to an outdated "amortization engine" used by Corporate Accounting to determine the correct amount of premium and fee amortization in a given reporting period. That amortization engine is inadequate for a company with a balance sheet as large as that of Freddie Mac, particularly since most of the assets of the Enterprise are mortgages whose prepayments are sometimes difficult to forecast.[157] Difficulties in computing premium and fee amortization may have played a role in the decision to create an amortization reserve, but the reserve was also useful to management for earnings management purposes, and management made the Board aware of that. For example, a presentation by management to the Investment Committee in June 1999 states that "analyzing the adequacy of reserves (amortization and loan loss)" is among the "strategies we are investigating for improving the time pattern of NII between 1999 and 2000."[158]

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[155] Memorandum from Mary Beth Perdue to the Files, "Amortization Reserve," Attachment A, February 20, 2003, OF 2012954.
[156] Memorandum prepared by Baker Botts, Re: Luis Betancourt Interview, February 6, 2003, OF 2000084 – OF 2000085.
[157] Internal notes prepared by OFHEO, Re: John Woods Interview, July 25, 2003.
[158] Presentation to the Investment Committee of the Board of Directors of Freddie Mac, "Multi-Year Net Interest Income Planning," June 4, 1999, OF 5001460A.

Management used various interest rate and yield curve assumptions to determine amortization amounts. At various times management used a forward yield curve[159], a 60-day average yield curve,[160] and a flat yield curve.[161] The multiple interest-rate methodologies used by management to estimate amortization at various points in time violated the consistency principle of GAAP.[162] One example of management changing its interest-rate assumptions to obtain a more desirable earnings number occurred in the first quarter of 2002. Because the yield curve was steep at that time, as it had been in 2001, and because management had pushed forward operating earnings from 2001 into 2002 with linked swaps, earnings for the first quarter of 2002 were on a pace to come in significantly above forecasted results. The FAS 91 amortization component of net interest income was highly sensitive to assumptions regarding future interest rates, and the choice of the yield curve used was a critical one. Management decided to use a flat yield curve for the first quarter of 2002, which resulted in a $141 million difference relative to using a forward curve.

Freddie Mac employees in Corporate Accounting justified their use of the flat yield curve in part on the basis of conversations with PricewaterhouseCoopers in early 2002. Stephen Bledsoe, who headed the Net Interest Margin group in Corporate Accounting at the time, said that his understanding of the amortization process at that time was that it was reasonable to use a number of different interest rate forecast assumptions, including a flat or constant yield curve. He said that belief was based upon a conversation that he had with PricewaterhouseCoopers. However, partners from PricewaterhouseCoopers working on the Freddie Mac engagement later said that they were asked by Freddie Mac staff in a meeting in 2002 if there were companies that used a flat yield curve in their valuation processes. The partners answered that they were aware

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[159] The forward curve is an interest rate curve derived point by point from the traditional yield curve. The forward curve shows the implied forward interest rate for each period covered by the yield curve.

[160] Memorandum from Stephen Bledsoe to the Files, "Use of average rates in asset amortization process," June 28, 2002, OF 2012955.

[161] What has been described as a "flat yield curve" in other reports describing the Freddie Mac SFAS 91 process was actually the spot rate curve for a particular date, which would generally appear flatter than a forward yield curve.

[162] Financial Accounting Standards Board (FASB) 1980, "Qualitative Characteristics of Accounting Information." Statement of Financial Accounting Concepts No. 2, paragraph 120. Norwalk, CT: FASB.

that some companies used a flat yield curve, but those companies had different businesses than Freddie Mac, and the purposes of the valuations were different as well.

The key problems with the FAS 91 reserve are 1) the use of a reserve account that was not compliant with GAAP; 2) the use of that account to reduce earnings volatility; 3) changing a key assumption used in the calculation of the reserve to achieve a desired earnings result; and 4) failing to disclose that a non-GAAP reserve account was being maintained and that a key assumption in the calculation of the reserve had been changed. Those problems resulted from weaknesses in the accounting policies, accounting controls, and disclosure policies of the Enterprise.

The Aftermath

Many of the transactions described above did not survive under the scrutiny of the reaudit of Freddie Mac. As the Enterprise dissolved many of its earnings management strategies in 2003, there were cascading effects throughout its financial statements, since those strategies were interconnected. The unwinding of the CTUGs, for example, killed the viability of the Embedded PC Option (EPCO) hedging strategy, a complex and operationally challenging attempt to reduce earnings volatility resulting from FAS 133. EPCO used combinations of interest rate swaps, swaptions, and other derivatives to hedge prepayment options embedded in the retained mortgage portfolio of Freddie Mac. Management developed EPCO in order to record fair value gains and losses for its embedded PC options[163] that could then be used to offset fair value changes in the derivatives portfolio of the Enterprise. For EPCO to work, the hedged securities must be designated as available-for-sale, because investments classified as held-to-maturity or trading are ineligible for FAS 133 treatment. Thus, when management unwound the CTUGs and transferred its available-for-sale securities back to the trading account, those securities could no longer be included in the EPCO strategy. The "linked swaps" were also connected with EPCO, as they were used in EPCO hedge relationships in order to receive favorable accounting treatment.[164] Additionally, management identified other errors in measuring the effectiveness of the hedge relationships under EPCO and

[163] "PC option" refers to the prepayment options in Freddie Mac PCs.
[164] Memorandum from Thomas Stuber to the Files, "EPCO Hedge Strategy," May 16, 2003, OF 1707016.

ultimately decided to end the strategy. The effect of terminating EPCO on the restatement of Freddie Mac was an upward pre-tax income adjustment of $6.5 billion.[165]

On November 21, 2003, Freddie Mac announced the results of its restatement and its need to delay publication of its audited financial statements for 2003. That delay is due to the need to correct many problems described in this report relating to weak accounting functions and a poor internal control environment. Undoubtedly, the desire to manage earnings played a major role in the creation of those problems, as the focus of senior management and the Board of Directors was more on the growth of earnings and the share price rather than best practices in accounting, controls, and operating infrastructure. Thomas Jones, Chairman of the Audit Committee of the Board, recalled expressing his views to Leland Brendsel in March 2003 regarding the lack of audited financial statements of the Enterprise:

> Leland, with all due respect, in my view you've put the company in a very difficult situation. You've effectively lost control of our accounting and financial reporting status and we're now sitting in a situation where we don't have audited financial statements in the market and we're one of the most critical financial entities in the capital markets. In my view it is unpardonable to not have audited financial statements that investors can rely upon and in my view in this league you don't get second chances. You've been paid a lot of money to do this job and to me it's unacceptable that we don't have audited financial statements that investors can rely upon.[166]

The intense efforts to manage reported earnings at Freddie Mac drained the skills of many of the most talented employees of the Enterprise. Those efforts compromised the integrity of many employees and damaged the effectiveness of the internal control structure of Freddie Mac. The quest to manage earnings eventually led to the termination of the most senior executives of the Enterprise, and resulted in one of the largest restatements in U.S. corporate history.

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[165] Freddie Mac Board Briefing, "Overview of Accounting Errors," August 12, 2003, OF 5093860.
[166] OFHEO Interview, Thomas Jones, August 12, 2003, pp. 88-89.

The Role of the Executive Compensation Program of Freddie Mac

The special examination analyzed whether executive compensation, particularly compensation tied to earnings per share, may have contributed to the improper accounting and management practices at Freddie Mac. The special examination concludes that it did. The special examination considered compensation matters from a broad safety and soundness perspective.[167]

Corporate Performance and Executive Compensation

The direct compensation of Freddie Mac executive officers includes three key components: base salary, an annual cash bonus, and long term stock incentives—for example, stock options and restricted stock.[168] The Freddie Mac charter act requires that a "significant portion of potential compensation" for executive officers of the Enterprise be based on the performance of the Corporation.[169] Corporate performance-based compensation for executive officers generally comprises a larger share of direct compensation than that for other employees.[170] Approximately 54 percent of the total cash compensation (salaries, bonuses, and other compensation) paid by Freddie Mac to executive officers for performance in 2001 was based on corporate performance for that year.[171]

At the beginning of each performance year, it was the practice of Freddie Mac to establish a "target bonus" incentive for each executive that was a percentage of the salary of that executive. For example, an executive with a salary of $400,000 might have a target bonus equal to 50 percent of salary—that is, $200,000. The sum of the various

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[167] The special examination reviewed executive compensation for various officers involved in transactions and events under consideration. It did not limit the scope of the review to executive officers covered under the OFHEO regulation on executive compensation. 12 CFR Part 1770.

[168] "Employee Compensation Policies and Practices at Freddie Mac," Report to Congress, June 30, 2003, p. 5. The use of stock options as a form of compensation by Freddie Mac and Fannie Mae has been criticized by former Federal Reserve Board Chairman Paul Volcker and former U.S. Comptroller General Charles Bowsher, both of whom maintain such stock option use is "inappropriate." "Volcker hits Fannie Mae, Freddie Mac Stock Option Use," Reuters, October 2, 2003.

[169] Section 303(c) of the Federal Home Loan Mortgage Corporation Act, 12 U.S.C. 1452 (c).

[170] Report to Congress, "Employee Compensation Policies and Practices at Freddie Mac," June 28, 2002, Freddie Mac, p. 6.

[171] *Id.*, p. 11.

target bonuses for executives became known as the target "bonus pool."[172] Freddie Mac then used a corporate scorecard as a basic metric to determine the actual amount of total funding in the bonus pool. Depending on how well the Enterprise performed when assessed by certain metrics—for example, profitability, core capabilities, and strategic positioning—the scorecard produced a bonus funding percentage that was well above 100 percent ("above plan"); just above, at, or just below 100 percent ("on plan"; or well below 100 percent ("below plan").[173] That process generally resulted in Freddie Mac determining that it was "on plan" or "above plan,"[174] which resulted in bonus plan funding ranging from 125 percent to 185 percent (See Table 4). The eventual bonuses paid to executives, particularly Mr. Brendsel, Mr. Glenn, and certain F&I executives, were substantial (See Table 5).

Earnings Per Share (EPS) Targets: A Key Scorecard Factor

The actual metrics of the corporate scorecard determined the overall amount of bonus pool funds available for awards.[175] Accordingly, the components of that scorecard, and the weight assigned to those components, were of direct interest to all Freddie Mac executives.[176] Hitting "on-plan" targets for operating earnings per share (EPS) in the

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[172] Bonus targets for Executive and Senior Vice Presidents are set by the Board of Directors Human Resources Committee in March of the performance year, "Freddie Mac Executive Bonus Plan Step-By-Step Summary of Process and Execution," August 6, 2003, OF 0000476.

[173] *Id.*, OF 0000477.

[174] For the years examined, Freddie Mac always determined itself to be "on plan" or "above plan." While Freddie Mac missed a major threshold in 1999 and the bonus funding was limited to 30-50 percent, the corporate performance was nonetheless viewed as "on plan." OF 0000036.

[175] "Freddie Mac Executive Bonus Plan Step-by-Step Summary of Process and Execution," Freddie Mac, August 6, 2003, OF 0000480.

[176] Freddie Mac Executive Vice President, Chief Operating Officer Paul Peterson noted why the scorecard was of interest to executive officers. OFHEO Interview, Paul Peterson, August 27, 2003, p. 146.

> Q: Is any part of your compensation, salary, bonus, and part of your compensation tied to meeting earnings per share targets?
>
> A: Well, the corporate score card had an earnings objective on it. In fact, I think it probably counted for about 40 percent of the funding of the bonus plan. So my own IOPs relative to how I was compensated were based on my score card and my contract that I would have had with David Glenn and I would have been rated relative to that.

Former General Counsel Maud Mater also indicated familiarity with the role meeting earnings per share targets played in determining compensation. OFHEO Interview, Maud Mater, July 30, 2003, pp. 221-222.

"profitability" portion of the scorecard accounted for a growing portion of the scorecard weight from 1998-2002.[177]

A review of the evolution of the corporate scorecard, particularly as it relates to the role of hitting EPS targets, is instructive. In 1998, for example, the "profitability" portion of the scorecard, which was weighted at 50 percent, had two thresholds and two targets. As a threshold for that scorecard component, Freddie Mac had a "total return"[178] metric that required the corporation to outperform at least 125 of the S&P 500 companies. In addition, there was "value-at-risk" threshold measurement that had to be met. Once those two thresholds were met, EPS targets accounted for 60 percent of that portion of the scorecard, while meeting net-interest income-per-share targets was weighted at 40 percent.[179] Overall, the weight of the EPS target for that year was 30 percent.

Table 4.
Corporate Bonus Plan Funding History

Year	Assessment	Funding (percent)
1998	Above Plan	170
1999	On Plan	30-50
2000	On Plan	125
2001	Above Plan	185
2002	Above Plan	N/A[180]

N/A: Not Available.

Sources: Freddie Mac briefing to OFHEO, Discussion Document, August 8, 2003, p. 11, OF 0000494; and "Performance Highlights: Freddie Mac's Quarterly Progress Update—2002 Results: Above Plan," p. 3, OF LR 01759.

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[177] Freddie Mac met and sometimes exceeded the EPS growth rate targets in that period. In 2002, for example, the target EPS growth rate in the corporate scorecard was 16-18 percent. The 24 percent EPS growth rate in that year meant that portion of the scorecard was "above plan." Corporate Scorecard, "Performance Highlights: Freddie Mac's Quarterly Progress Update—2002 Results: Above Plan," 2003, OF 0000056.

[178] This metric measured both the price change for common stock and dividends paid during the year. "Performance Highlights: Freddie Mac's Quarterly Progress Update—1998 Company Performance," 1998, OF 0000033.

[179] *Id.*

[180] In January, 2003, Leland Brendsel indicated that the total bonus available for senior officers for 2002 would not be announced until after the release of audited financials, which Mr. Brendsel somewhat optimistically predicted would be released "in a few months." Brendsel indicated that even though the audited financials were delayed, the performance of the Enterprise was "above plan." Freddie Mac: Office of the Chairman, Script for Telephone Call with John McCoy, January 28, 2003, FM 151615.

Table 5.
Summary of Bonus Payouts of Senior Freddie Mac Officers,
1998-2001 Performance Years[181]

Name	2001	2000	1999	1998
Leland Brendsel	$2,123,438	$1,700,000	$380,000	$1,950,000
David Glenn	$1,275,000	$1,009,000	$210,000	$950,000
Vaughn Clarke	$333,000	$203,723	$56,100	N/A
Maud Mater	$445,927	$356,665	$91,875	$277,356
Gregory Parseghian[182]	$750,000	N/A	N/A	N/A
Paul Peterson	$729,167	$429,853	$78,750	$252,000

N/A: Not Applicable
Source: Memorandum to OFHEO from SVP, Human Resources, Freddie Mac, Mike Hager, August 6, 2003, pp. 4, 6. OF 0000469 - OF 0000482.

Although the "total return" threshold was not particularly aggressive, Freddie Mac nonetheless failed to meet it in 1999. In that year, Freddie Mac shareholders lost 26 percent on their investment and the Enterprise placed 403rd among S&P 500 companies in total return to shareholders.[183] Bonuses paid to senior executives for 1999 ranged from 30-50 percent.[184] Apparently management and the Board did not care for that result so by the year 2001, the "total return" threshold for the profitability scorecard component that contributed to the reduction in bonus funds available was no longer a scorecard threshold.[185] That profitability threshold was replaced by a requirement that Freddie Mac pass its quarterly interim risk-based capital stress tests. In addition, the net interest income metric was no longer a threshold for the profitability scorecard component, and earnings per share targets alone were weighted at 40 percent.[186] By the year 2002, there was no longer any threshold for the profitability portion of the scorecard. Meeting EPS

[181] Freddie Mac did not award bonuses to senior executives for performance year 2002 until after completion of the restatement. Other officers, however, did receive bonuses before then. OF 0000474.
[182] Mr. Parseghian, who had an employment agreement with Freddie Mac, did not participate in the bonus program for the years 1998 through 2000. OF 0000472.
[183] "Performance Highlights: Freddie Mac's Quarterly Progress Update—1999 Company Performance," 1999, OF 0000038, p. 3.
[184] "Executive Compensation Briefing, Discussion Document, August 2003," Freddie Mac briefing to OFHEO, August 8, 2003, p. 11.
[185] Leland Brendsel took note of the laggardly stock performance of Freddie Mac in 2001. "Freddie Mac's stockholders lost 4 percent on their investment for the year, compared to losses of 9 percent for the S&P financials and 7 percent for Fannie Mae. Our stock price performance put us at 270 out of the S&P 500 companies, which would have met the threshold we used in past years but is not particularly impressive." 2001 Senior Executive Performance Review, Leland Brendsel, 2001, OF 0000325 – OF 0000328.
[186] "Performance Highlights: Freddie Mac's Quarterly Progress Update—2001 Results: Above Plan," 2001, OF 0000051.

targets continued to be given a 40 percent weight,[187] which Human Resources Committee Chairman John McCoy asserted in an interview with OFHEO was "conservative" compared with other companies.[188]

The "Informal Process" of Determining Bonus Pools: The Role of Glenn and Brendsel

Although the weighting of factors in the corporate scorecard suggests a relatively formulaic approach to setting the size of the bonus pool, senior management shaped the actual results. In practice, the ultimate setting of the bonus pool funding amount involved an "informal" process in which both Mr. Glenn and Mr. Brendsel maintained considerable discretion over the final outcome. [189]

The process worked as follows: at the end of the performance year, Mr. Glenn applied a scoring range to each of the metrics in the corporate scorecard.[190] That range, which was subjective and discretionary in nature, reflected current performance, unusual influences on performance for the current year, and the historical performance of certain metrics. Mr. Glenn reviewed the performance of a scorecard component and then assigned a score within a scoring range, a process that involved a quantitative scoring methodology and a qualitative "reasonableness check" that produced a weighted average performance result. That process, which involved discretion at the establishment of the scoring range and the ultimate score assigned to each metric, determined the overall portion of the funded bonus pool. The portion of the funded bonus pool that was likely attributable to EPS performance can be estimated by dividing the score finally assigned by Mr. Glenn to the EPS metric by the total score determined by the informal process.[191] Using 2001 as an example (where the approved bonus pool was 185 percent) and

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[187] "Performance Highlights: Freddie Mac's Quarterly Progress Update—2002 Results: Above Plan," 2002, OF 0000056.

[188] "I think we can always argue should it be 35, 40 or what number. I actually think that number is a conservative company compared to what I've seen in other companies." OFHEO Interview, John McCoy, September 24, 2003, p. 47.

[189] "Freddie Mac Executive Bonus Plan Step by Step Summary of Process and Execution," August 6, 2003, OF 0000478.

[190] Mr. McCoy, the Chairman of the Freddie Mac Human Resources Committee, indicated he was not aware of the actual role of Mr. Glenn in determining the final amount in the bonus pool. OFHEO Interview, John McCoy, September 24, 2003, pp. 37-39.

[191] Memorandum to OFHEO, from Freddie Mac Human Resources SVP, Mike Hager, August 6, 2003, OF 0000469 – OF 0000482.

assuming, for simplicity, a target bonus pool of $100, the funded bonus pool would have been $185 ($100 x 185 percent). Accordingly, the performance of the EPS metric contributed to 63 percent of the overall score (EPS score of 1.2 divided by 1.9). As a result, approximately $117 out of the $185 in the funded bonus pool was attributable to earnings per share performance.[192] Table 6 below illustrates the results of that informal but critical process for the years 1998-2001.

Table 6.
Earnings Per Share in the Informal Scoring Process[193]

	1998	1999	2000[194]	2001
EPS Score	5	2.13	Unknown	1.2
Total Score	8.53	3.5	Unknown	1.9
EPS as a Share of Total Score (percent)	59	61	40	63
Bonus Funding (percent)	170	50	125	185

Source: Freddie Mac.

Mr. Brendsel had the discretion to make changes once the recommendation was received from Mr. Glenn. Bonus recommendations for Executive Vice Presidents and Senior Vice Presidents, once endorsed by Mr. Brendsel[195] and Mr. Glenn, were forwarded to the Human Resources Committee, which then decided whether to approve them, a process that typically occurred in March following the performance year.[196] Mr. Brendsel nominated the members of the Human Resources Committee and set the agenda.[197]

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[192] *Id.*, OF 0000470.
[193] *Id.*
[194] Freddie Mac indicted that no scoring mechanism could be found for the year 2000, OF 0000470.
[195] "So basically it was objective, but when we saw them -- so if you go down and look at the bonuses, they're different for everybody because each one is based on the individual. And so we could sit there and then sometimes I can remember having discussions with some of the executive vice presidents and senior vice presidents why is it this, should it be this, should it be this much, and there occasionally would be changes. So Leland had that ability to make those changes." OFHEO Interview, John McCoy, September 24, 2003, pp. 59-60.
[196] In an interview with Baker Botts on April 24, 2003, Mr. Glenn suggested that Mr. Brendsel decided compensation matters. OF 2000298. In an interview with Baker Botts, on April 21, 2003, Mr. Brendsel indicated that he would sit down with Mr. Glenn to determine compensation of senior executives. OF 2000126.
[197] OFHEO Interview, John McCoy, September 24, 2003, pp. 13-14.
Q: Mr. Brendsel makes the initial recommendation to your committee for new

The bonus recommendations for Mr. Brendsel and Mr. Glenn were developed by multiplying their bonus targets by the bonus funding level arrived at in the process described above.[198] Those recommendations were then reviewed by an external executive compensation consultant of the Human Resources Committee and delivered to that committee during the March meeting following the performance year.[199] The committee could adjust or endorse that amount. The influence of Mr. Brendsel in determining the size of the bonus for Mr. Glenn, however, was substantial. John McCoy, Chairman of the Freddie Mac Human Resources Committee, said in an interview with OFHEO:

> When we did David, it was 90 percent of Leland's input and 10 percent of our input.[200]

Executive Performance Reviews and Improper Management of Earnings

The criteria by which the performance of individual employees were evaluated, typically reflected in annual Employee Performance Management forms, showed that management of earnings was a major factor in judging executive performance. Mr. Glenn, for

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membership?
A: Yes.
Q: And then your committee approves that?
A: Correct.
Q: How does the human resources committee set its agenda?
A: Historically—well, either Leland and/or the head of HR would call me before the committee meeting and would review an agenda they had put together and would actually go into a lot of detail and then would get me to agree to that agenda and then that would be the agenda that would be sent to the full committee.

[198] OFHEO Interview, John McCoy, September 24, 2003, pp. 50-51.
Q: Thank you. I have two more questions. You mentioned earlier the 40/60 break on bonuses versus—the fixed versus variable. For Mr. Brendsel and Mr. Glenn, there was no break; is that correct? How were their bonuses determined?
A: Well, basically the net over—well, their bonus was determined by the score that they used for the score card. So if we paid the company at 110 percent, that's where we would begin with Mr. Brendsel. So they were affected by their score card.
Q: They made the recommendation on the score card?
A: Okay. The process was Leland would come in, would do the score card and what that was we'd take care of the senior VPs and executive VPs. Leland would then make his recommendation for David, and then we would do Leland's independent of David's. And Leland never recommended his own.

[199] Memorandum to OFHEO, from Freddie Mac Human Resources Senior Vice President, Mike Hager, August 6, 2003, OF 000482.

[200] OFHEO Interview, John McCoy, September 24, 2003, p. 65.

example, who reviewed the 1998 performance of then-CFO John Gibbons, noted the "achievement of EPS results within an acceptable range of consensus"[201] on the evaluation form for Mr. Gibbons for that year. A 1999 assessment for Mr. Gibbons also cited his "achieving EPS results within an acceptable range of consensus."[202]

The position description for CFO Vaughn Clarke included duties related to "Earnings Performance Management."[203] Mr. Glenn rated the performance of Mr. Clarke, in part, based on his ability to manage shareholder and investor EPS expectations. In the course of the 2001 review of that evaluation component—"Ability to manage shareholder and EPS expectations: Analyst consensus with forecast,"—Mr. Glenn noted: "I have questions about our role here due to the tendency to use accounting to meet shareholder expectations." Mr. Clarke was rated "on plan."[204]

In the 2000 performance review for Mr. Robert Dean conducted by Mr. Clarke, Mr. Dean maintains explicitly that one of his accomplishments in 2000 involved FAS 133 and the transition gain related to swaptions valuation: "Reduced size of transition gain from $1 bn to .02 bn by recognizing that swaptions valuation was not indicative of where options could be traded, due to a large imbalance in the market."[205] The bonus of Mr. Dean for 2000 was $111,175.[206] In response to an OFHEO request for a copy of the evaluation of Mr. Dean for 2001, Freddie Mac indicated that the evaluation was "missing,"[207] although records show that Mr. Dean received a somewhat more substantial bonus of $145,833 in that year.[208]

The 2001 evaluation form for Peter Federico of F&I, who was reviewed by Nasir Dossani, said in reference to FAS 133 that Mr. Federico "managed transition adjustment

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[201] 1998 Employee Performance Management Form, John Gibbons, 1998, OF 0000082-OF 0000086.
[202] 1999 Senior Executive Performance Review of the Executive Vice President and Chief Financial Officer, John Gibbons, OF 0000163.
[203] The description of Mr. Clarke's "Earnings Performance Management" duties included in the position is a broad one, including such duties as "manage corporation's short-and long-term performance." Federal Home Loan Mortgage Corporation, Position Description, EVP-Chief Financial Officer, provided to OFHEO October 31, 2001.
[204] OF 0000329.
[205] OF 0000228.
[206] OF 0000472.
[207] OF 0000313.
[208] OF 0000472.

to income from $1.75 billion to 6 million."[209] The 2000 evaluation form for Nazir Dossani, who was reviewed by Mr. Parseghian, notes: "The scope of Nazir's responsibilities in the corporation's FAS 133 efforts was systematically expanded during the course of the year; his group has taken on this challenge and developed and implemented an approach that is both innovative and exceeds any reasonable expectations of earnings volatility (e.g. if we had adopted Fannie Mae's approach we would expose ourselves to higher earnings volatility by a factor of 10)."[210] In his 2000 Employee Performance Management Form, Mr. Dossani listed as an accomplishment: "Transition adjustment (which could have affected income by $1.75 billion) had close to zero impact on EPS as a result of ALM strategies that included large, complex but effective asset restructuring and other actions."[211]

The Effect on Compensation of the Achievement of Earnings Targets

Assessing the effects of the corporate earnings targets on the behavior of Freddie Mac executive officers is complicated. It is clear, though, that whether or not those goals were met affected the compensation of key individuals significantly.

As discussed above, the total funding for bonuses depended heavily on meeting the EPS range on the corporate scorecard, which amounted to 63 percent for 2001. For Messrs. Brendsel and Glenn, bonuses appear to have been closely tied to the scorecard results.

> For example, of the $2,618,906 bonus awarded to Leland Brendsel in 2001, an estimated $1,649,911 was directly attributable to Freddie Mac meeting the operating earnings per share target. Of the $1,572,500 awarded to David Glenn, $990,675 was attributable to meeting that target.[212]

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[209] The evaluation also noted, relative to FAS 133: "Managed hedge ineffectiveness to 2 cents per share (1Q-3Q)": Peter Federico, 2001 Employee Performance Management (EPM) Form, OF 0000355 – OF 0000358.

[210] 2000 Employee Performance Management (EPM) Form, Nasir Dossani, 2000, OF 0000236 – OF 0000239.

[211] 2001 Employee Performance Management (EPM) Form, Nasir Dossani, 2001, OF 0000350 – OF 0000354.

[212] OF 1626590.

For other senior officers, 40 percent of the bonus was determined in that manner, and the rest was based on the performance of the division led by the officer and on his or her own individual performance.[213] Thus, for most senior officers, 25 percent (63 percent of 40 percent) of their bonuses were directly tied to the corporate EPS performance. However, division and individual performance was in key cases based in part on such things as meeting the earnings expectations of stock analysts or managing the FAS 133 transition adjustment. Other forms of compensation—salaries and long-term incentive awards—may also have been indirectly affected by how well an employee contributed to such goals. In summary, although the effects of earnings performance on the compensation of any officer cannot be precisely quantified, those effects were substantial for all senior executives and appear sufficient to have affected behavior as, indeed, they were designed to do.

"Tone at the Top," Earnings Per Share Growth, and Employee Performance

The "tone at the top" at Freddie Mae created an environment that strongly emphasized hitting earnings per share targets, and tying corporate bonuses to meet certain EPS targets contributed to that environment. PricewaterhouseCoopers viewed the EPS component of the corporate scorecard as a warning flag to senior management about problems in corporate accounting and the possibility of errors in financial statements and indicated that it could lead to behavior by certain employees motivated by a desire to hit certain earnings targets.[214] According to PricewaterhouseCoopers, the inclusion of that component in the scorecard helped to bring about a widespread understanding within Freddie Mac about the importance of meeting shareholder expectations.[215]

Earnings per share figures, unlike some other corporate performance measurements such as stock prices, are generated internally. Thus, they cannot be viewed as the best measurement of corporate performance. The guidance supplied by the National Association of Corporate Directors Blue Ribbon Commission Report on

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[213] "Freddie Mac Executive Bonus Plan Step-by-Step Summary of Process and Execution," Freddie Mac, August 6, 2003, OF 0000480.
[214] Internal notes prepared by OFHEO, Re: PricewaterhouseCoopers Interview, July 22, 2003.
[215] *Id.*

Executive Compensation, issued in 2000, is direct and straightforward. The Blue Ribbon Commission said:

> Accounting performance is often measured relative to a 'target' set by the board and the management team at the beginning of the year. Although targets are a sensible outgrowth of the corporate strategy-setting process, it is generally not advisable to base compensation based on an internally derived target. Targets (and overall strategy decisions) cannot be made without substantial input from the top management team, and basing pay on targets may pressure executives to support *attainable* targets and strategies rather than those that increase shareholder wealth. Externally based industry, financial and market targets (not set or influenced by top managers) offer viable alternatives.[216]

Mr. Glenn noted the internal derivation of earnings per share figures, and the problems such figures posed, in the course of a performance review of CFO Vaughn Clarke. Mr. Glenn was required to rate Mr. Clarke for the performance category: "Ability to manage shareholder and investor EPS expectations—Analyst consensus and forecast." In an interview with OFHEO, Freddie Mac Board of Directors Chairman Shaun O'Malley noted the control aspects of basing a substantial amount of compensation on performance:

> I don't think this means that the person is going to commit a fraud. I think I worry about it if I'm an auditor if there is an arrangement like that and I'm going to be more attentive to how the figure was calculated and what possibilities there are for manipulating the figure.[217]

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[216] "Report of the National Association of Corporate Directors Blue Ribbon Commission on Executive Compensation: Guidelines for Directors." National Association of Corporate Directors, Washington, D.C., 2000, p. 26.

[217] OFHEO Interview, Shaun O'Malley, September 24, 2003, p. 29. O'Malley also indicated that Freddie Mac should consider revisions to its executive compensation practices to discourage any motivation for earnings management. *Id.*, pp. 31-32.

> Q: Should Freddie Mac consider revisions in its executive compensation practices to discourage any motivation for earnings management that may result for compensation incentives?
>
> A: Yes. For example, Mr. Bauman's compensation is totally removed from any achievement of any earnings goals. I think the HR committee and the management committee are looking at the whole range of pay and pay incentives going forward. I don't think there's anything wrong in having incentives for performance but I think we have to be very careful that they don't incent people to do the wrong thing.

A September 2002 report by the Conference Board Commission on Public Trust and Private Enterprise recommended that performance-based incentives support long-term strategic objectives established by the Board of Directors. The Commission recommendations included such measurements as cost-of-capital, return on equity, economic value added, market share, quality goals, compliance goals, revenue and profit growth, cost containment, and cash management.[218]

Executive Compensation and Earnings Management

> The system for financial rewards to management is frequently skewed toward participation in the growth of an entity's worth in the marketplace, especially, although not exclusively, for top management. At many levels within an entity, financial incentives based directly or indirectly on accounting results can be significant. At some point in the continuum, the motivation behind earnings management may become strong enough to result in fraud.[219]

The size of the bonus pool at Freddie Mac was tied, in part, to meeting or exceeding an annually specified earnings per share target for the current year, and was not tied directly to meeting an analyst-based target future range of earnings. Nonetheless, the actions by Freddie Mac executives to move "front loaded" earnings from one quarter to a future quarter had the effect of helping to ensure that the EPS compensation goals would be easily met in future quarters,[220] as well as to possibly bolster the value the stock on which options would presumably be exercised in future quarters.

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[218] Findings and Recommendations—Part 1: Executive Compensation. The Conference Board Commission on Public Trust and Private Enterprise, September 17, 2002, p. 9.

[219] Public Oversight Board, Panel on Audit Effectiveness. Report and Recommendations, August 12, 2000, p. 80. Available online at: http://www.pobauditpanel.org/download.html.

[220] Mr. John McCoy, Chairman of the Freddie Mac Human Resources Committee, indicated that one result of moving earnings forward could be increased earnings per share targets.

> Q: Do you think that actions to move earnings to future quarters could have the effect, intentional or not, of ensuring that earnings per share compensation goals would be easily met in future quarters?
>
> A: The simple answer is yes. In reality, since the bonus program was based on earnings per share and what level the earnings per share was, if the income was moved and somebody then increased the requirement for earnings per share to be that much higher, then the answer would be no."

OFHEO Interview, John McCoy, September 24, 2003, p. 70.

There is a growing perception that reported earnings are increasingly "noisy" as a performance indicator.[221] Income-decreasing accounting choices by corporate managers to maximize the value of bonus awards have been observed elsewhere. For example, if "true" earnings in a quarter are too low to trigger bonus awards or so high that the cap on bonuses is exceeded, management may manipulate reported earnings downward in order to increase earnings in future quarters.[222] When flexible accounting rules are permitted, managers can shift income between years and thereby increase total bonus payoffs.[223] In addition, managers who anticipate large options awards may make income-decreasing accrual choices as a means to decrease the exercise price of their stock option awards.[224]

The peril of tying a major amount of compensation to increases in the growth of Freddie Mac earnings per share should be considered in the context of a February 1, 2001 meeting described by Mr. Glenn in his journal. In that meeting, attended by Mr. Parseghian and Mr. Dossani, it appears that Mr. Parseghian maintained that there was a possibility that, due in part to the fact that earnings are front loaded, the Enterprise

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[221] Nwaeze, E.T., Yang, S. and Jennifer Yin, "The Role of Cash Flows in Executive Compensation: A Re-examination," Unpublished manuscript, April 2002, p. 4.

[222] Pengji, G. and R. Shrieves, "Earnings Management and Executive Compensation: A Case of Overdose of Option or Underdose of Salary," p. 5. Presented to EFA 2002 Berlin Conference, Humboldt University, Berlin, July 29, 2002. The authors note on page 4 that actions to decrease reported earnings in a given period which result in an increase in earnings in a future period may imply that there is a dynamic aspect to earnings management, manifested by such actions as the establishment of "cookie jar" reserves; Holthausen, R.W, Larcker,D.F. and R.G. Sloan, "Annual Bonus Schemes and the Manipulation of Earnings," *Journal of Accounting and Economics,* 19 (1995) pp. 29-74.
See also, Healy, P.M. and J.M. Wahlen. "A Review of Earnings Management Literature and Its Implications for Standard Setting," Preliminary Draft, November, 1998. Available online at http://papers.ssrn.com/sol3/delivery.cfm/99031602.pdf?abstractid=156445; and Bollinger, G. and Kast, M. "Executive Compensation and Analyst Guidance: The Link Between CEO Compensation and Expectations Management,' Preliminary Draft, June, 2003. Available online at http://www.sirif.org.uk/papers/p861.pdf. Regarding the manipulation of "true" earnings based on bonus incentives, see Lin, Z.X an M. Shih, "Variation of Earnings Management Behaving Across Economic Settings, and New Insights into Why Firms Engage in Earnings Management," Unpublished manuscript, National University of Singapore, p. 21. Available online at http://207.36.165.114/Denver/Papers/variation of earnings management behavior.pdf

[223] Naciri, A. "Earnings Management and Bank Provision for Loan Losses," Working Paper 04-2002, Centre de Recherche en Gestion, January 2002, p. 5. Regarding smoothing of earnings, the author notes, on page 7: "To perform smoothing of earnings, managers sometimes pay more attention to the accounting consequences of major decisions than to the economics. It is believed that managers devote such attention to earnings because they believe that it is what matters most to shareholders. Reports that please shareholders serve a manager's self interest. Managers appreciate a lot of their bonuses and other perquisites are tied to reported earnings."

[224] Baker, T., Collins, D and A. Reitenga, "Stock Option Compensation and Earnings Management Incentives," December, 2002, p. 23.

would not be able to sustain double-digit earnings growth within a few years.[225] If Mr. Parseghian was correct in that assessment, the earnings per share target in the corporate scorecard, which was in the mid-to-high teens in the years examined, would not be met in the out years, absent a revision of the target or a change in corporate strategy.[226] That is a matter that likely would be of interest to executives anticipating bonuses.

The problematic nature of the approach to giving employees incentives used by Freddie Mac in the period covered by the restatement has been recognized by the Enterprise. According to Human Resources Committee Chair John McCoy, earnings per share will not be a factor in the corporate scorecard in 2003.[227]

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[225] Diary excerpts, David Glenn, DG 0147.

[226] On or about the time of the meeting described by Mr. Glenn (from February 1, 2001 through February 8, 2001), Mr. Parseghian sold a substantial amount of restricted stock (87,454 shares) and exercised options on 278,880 shares. Freddie Mac Securities Transaction by Directors and Executive Officers. Filings—Form 4, FM B000086.

[227] "Well, each score card is different based on what's going on that year. The scorecard that we looked at the other day has no earnings measure in it for this year, and the rewards are basically for getting the restatement done, getting the first and second and third quarters announced this year, for working on the remediation, for changing the structure of the company." OFHEO Interview, John McCoy, September 24, 2003, pp. 47-48.

IV. COUNTERPARTIES

Numerous financial institutions, including some of the largest investment banks on Wall Street, were counterparties to transactions initiated by Freddie Mac in order to shift and smooth the reported earnings of the Enterprise. Those transactions had little legitimate business purpose and were structured to achieve a certain accounting result and to mislead investors about the finances of Freddie Mac.

OFHEO has not concluded its investigation of the role of the counterparties in those improper transactions. The agency is reviewing whether the counterparties met their obligations to ensure that they were not part of a scheme to mislead investors and whether they encouraged improper conduct in any way. In addition, OFHEO will examine the willingness of the counterparties to accommodate Freddie Mac in order to maintain other profitable business relationships. For example, all of the counterparties to the linked swaps are members of the Reference Notes Securities Auction Dealer Group, which underwrites the largest debt issues of Freddie Mac and is a source of substantial underwriting income for its members.[228] The counterparties on the linked swaps also rank highly among the dealers that Freddie Mac uses for its normal derivatives activities, as indicated in Table 7, which shows linked swaps counterparties in italics. Corrective actions that OFHEO could take with respect to a culpable counterparty range from imposing conditions or limits on its future business relationships with Freddie Mac and Fannie Mae to prohibiting it from doing business with the Enterprises in the future.

There is evidence to date that one or more of the counterparties to the transactions that Freddie Mac undertook to manage earnings may not have acted properly. Transcripts of recorded telephone conversations between the staffs of the Enterprise and various broker/dealers appear to indicate that those counterparties did not adequately determine if transactions had a legitimate business purpose or were part of a scheme to mislead investors. In at least one instance, a trader at a counterparty—Morgan Stanley—suggested to a Freddie Mac trader a plausible-sounding business purpose for a pair of

[228] Members of that group are listed at http://www.freddiemac.com/debt/html/refnoteaucdealerlist.html.

linked swaps[229] that were executed for the sole purpose of moving large amounts of operating income into the future. Given that many of the deals generated substantial commissions with minimal risk, the counterparties may have had a strong disincentive to inquire about the actual purposes of the transactions.

Table 7. Freddie Mac Derivatives Counterparties by Notional Amount Outstanding As of April 30, 2003 ($ Millions)	
JP Morgan Chase Bank	78,213
Lehman Brothers Special Financing Inc	63,969
Credit Suisse First Boston International	60,187
Citibank NA	54,830
Goldman Sachs Capital Markets, LP	50,333
Morgan Stanley Capital Services, Inc	48,893
Deutsche Bank AG	38,952
UBS AG	28,983
Merrill Lynch Capital Services, Inc	28,885
BNP Paribas	28,156
Bear Stearns Capital Markets, Inc	24,167
ABN Amro Bank, NV	22,975
Barclays Bank plc	22,761
Wachovia Bank, NA	13,082
Bank of America, NA	11,812
Greenwich Capital Derivatives, Inc	5,372
HSBC Bank USA	4,918
Dresdner Bank AG	3,988
Kreditanstalt fur Wiederaufbau	2,500
Bank One, NA	1,788
Bank of New York	1,658
Commerzbank AG	690
General Re Financial Products Corp	607
AIG Financial Products Corp	43

Source: Freddie Mac Investment Committee Standard Reports, Board of Directors Meeting, June 6, 2003, OF 5041348.

[229] Audio tape transcript, Ray Powers (AUD_80), August 14, 2001, OF 2001659.

The remainder of this chapter provides some details on the role of counterparties in three groups of transactions: the linked swaps, the Coupon Trade-Up Giants (CTUGs), and the Blaylock trades.

The Linked Swaps

In August 2001, Freddie Mac entered into eight pairs of interest rate swap transactions. As described earlier in this chapter, the terms of each pair of swaps substantially offset each other. For each pair, there was a swap that began immediately where the Enterprise paid a fixed rate to the counterparty and received a floating rate, coupled with a forward swap starting one to nine months later where Freddie Mac paid a floating rate and received fixed. Each of the swaps had a notional amount of $5 billion, thus resulting in a total notional value of $80 billion for the eight pairs of swaps.

In September 2001, Freddie Mac entered into a ninth pair of swaps that were similarly offsetting. Those swaps were distinct, however, in that the interest rate on them had a leverage factor of five—thus, they are called "leveraged swaps." The notional value of that last pair of swaps was $20 billion, but with the leverage factor of five, they had the same effect as swaps with a notional value of $100 billion.

Although the nine pairs of swaps were purported to reduce interest rate risk by a small amount, it is clear that the main purpose of the transactions was to shift operating income from 2001 to future periods. Table 8 shows each pair of swaps and the associated counterparty.

Table 8. Linked and Leveraged Swaps		
Linked Swaps		
Date	**Notional Amount**	**Counterparty**
8/14/2001	$10 Billion	Morgan Stanley
8/15/2001	$10 Billion	UBS Warburg
8/16/2001	$10 Billion	Lehman Brothers
8/17/2001	$10 Billion	Merrill Lynch
8/20/2001	$10 Billion	Goldman Sachs
8/22/2001	$10 Billion	UBS Warburg
8/23/2001	$10 Billion	Merrill Lynch
8/27/2001	$10 Billion	UBS Warburg
Leveraged Linked Swap		
9/7/2001	$20 Billion Leveraged x 5 (Unleveraged Equivalent = $100 Billion)	Goldman Sachs

Source: Attachment for Freddie Mac Accounting Policy Memo on KRD Swaps, via e-mail from Pamela Poisson, May 8, 2002 (OF 1706935).

The present value of the spread on the linked swap transactions between Freddie Mac and Morgan Stanley was $300,000. Because the terms of the two swaps substantially offset each other, the transaction posed essentially no risk to Morgan Stanley. One individual commented at the time that the earnings would result from a riskless trade. Given that the other pairs of swaps shown in Table 4 had similar terms, it is not unreasonable to assume that the counterparties to those transactions made similar amounts on deals that posed little or no financial risk.

The Morgan Stanley linked swaps, like seven of the other sets of linked swaps executed by Freddie Mac, involved a $5 billion pay-fixed swap commencing immediately, coupled with a $5 billion pay-floating swap commencing at a later date but with the same maturity date as the first swap. Ray Powers, an Enterprise employee who executes derivatives trades, called Morgan Stanley on August 14, 2001, to get pricing for those offsetting transactions. The request of Mr. Powers was unusual, and Brendan Lavelle, the Morgan Stanley trader who would have to approve the transaction, called Mr. Powers. That call was captured on the telephone recording system used by Freddie Mac to record calls on its trading floor. A portion of the transcript of the call follows:

Mr. Lavelle (Morgan Stanley): We've been trained whenever people come in and start doing this kind of stuff, we gotta ask why. Like not why, but like, everything's…yeah. I don't want to be taken off in handcuffs here for doing something that's not kosher.

Mr. Powers (Freddie Mac): How much are you making off this trade? (Laughs)

Mr. Lavelle: I don't know.

Mr. Powers: You haven't even looked at it. (Laughs)

Mr. Lavelle: I'm just…You know what I'm saying...I mean, I don't mind if there's an accounting reason for you to do this and it makes you guys money. That's fine. You know, we're okay with it.

Mr. Powers: That's where we are. We have an accounting reason for doing it. And, um, we're basically…we're offsetting some…

Mr. Lavelle: I mean you could tell me there's some asset liability reasons for you to be doing this, and I'm okay with that.

Mr. Powers: Yeah, I think that's as much as I'd…I don't want to tell you…

Mr. Lavelle: I don't want to be like taken into a courtroom, though, Ray, is what I'm saying, okay?

Mr. Powers: Yeah…No, no, no. This is not…. This is basically an asset liability, cash flow management issue.

Mr. Lavelle: Okay, I'm with you.

Mr. Powers: The thing is…because of the shape of the curve, um the geography of our carry in terms of the calendar gets screwed up. So all of a sudden, we have an uneven carry picture to manage and we strive for stability.

Mr. Lavelle: What you're trying to do is…yeah you're evening out the cash flow.

Mr. Powers: Exactly.

Mr. Lavelle: Okay. Alright, I'm with you.

> Mr. Powers. Otherwise, like we'd have all of our portfolios, our 30-year portfolio with all the carry in this year.
>
> Mr. Lavelle: If that's what you want to do, I'm, we're okay with that and we're happy to do it with you, so we can do a lot of this if you want.[230]

Note that Mr. Lavelle seemed to suggest a business purpose to his customer, Mr. Powers: "I mean you could tell me there's some asset liability reasons for you to be doing this, and I'm okay with that." Once the customer agreed with his suggestion, Mr. Lavelle said "we're okay with that and we're happy to do it with you, so we can do a lot of this if you want." After the conversation, Mr. Lavelle approved the trade.

Soon after the swaps were executed, they attracted the attention of David Wong, an operations officer at Morgan Stanley with compliance responsibilities. Mr. Wong had many other operational roles at the firm that may have prevented him from being fully focused on his compliance duties. In his compliance capacity, Mr. Wong asked another Morgan Stanley employee about the linked swaps and told him to do no more of these trades without asking him first. Mr. Powers of Freddie Mac soon called again to price some more interest rate swaps with offsetting terms. The management of Morgan Stanley decided to handle that situation by pricing the transactions unattractively, instead of just saying no to their valued customer, because it was less confrontational.

Transcripts of recorded telephone conversations reveal that other counterparties who engaged in linked swap transactions with Freddie Mac were just as eager to please their customer as Morgan Stanley was. An employee from Goldman Sachs, in a phone conversation with Nazir Dossani, Peter Federico, and Ray Powers of the Enterprise, told them that "obviously we're, we're extremely appreciative of the opportunity and you know and you guys kind of coming to us with this inquiry ...."[231] The inquiry had to do with linked swaps with a leverage ratio of five, which was multiplied against the interest rates of the swaps to minimize their notional value. Another Goldman Sachs employee on the same call almost apologizes for doing his job: "Uh, I guess just one last question

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[230] Audio tape transcript, Ray Powers (AUD_80), August 14, 2001, OF 2001659.

[231] Audio tape transcript, Peter Federico (AUD_3AF, AUD_3B0); Nazir Dossani (AUD_359, AUD_35A); Ray Powers (AUD_5A1, AUD_5A2); Sean Flanagan (AUD_3EA, AUD_3EB), September 10, 2001.

and uh, if you think it's impertinent, don't hesitate to tell me, but we're just curious, have you done any of these other levered trades away from us or is the amount that we've done thus far all?"[232] (The answer from Mr. Dossani was "I do not know the answer to that.")[233] Those transcripts show that the desire to keep an important customer happy overrode any obligation to exercise proper due diligence on the linked swaps.

Coupon Trade-Up Giants (CTUGs)

As discussed earlier in chapter III, the original plan for the CTUG transactions called for Freddie Mac to sell $30 billion in PCs to Salomon Smith Barney. Salomon Smith Barney would then sell and transfer those PCs to the securitization group of the Enterprise, which would then resecuritize the PCs into Freddie Mac Giant securities and send them back to the dealer. However, the Enterprise took some operational short cuts and simply securitized the PCs in-house rather than having Salomon Smith Barney do it.[234] Thus, only the Giant securities were sent to Salomon Smith Barney, not the precursor PCs. The dealer kept the Giant securities for fewer than three hours before sending them back to Freddie Mac. That round-trip was the basis for Freddie Mac moving its securities from the trading portfolio, where gains and losses in market value are immediately realized in income, to the available-for-sale portfolio, where market value changes are not realized in income, but go instead into Other Comprehensive Income.

Smriti Popenoe, a Freddie Mac employee in F&I, later said that the fee paid to Salomon Smith Barney for the transaction was either 1/16th or 1/64th of a point.[235] One 64th of a point on $30 billion would be approximately $4.7 million, which is a substantial amount of money for a trade with virtually no risk. Because the PCs were securitized into a Giant at the Enterprise and shipped to Salomon Smith Barney in that form, the role of the counterparty in the transaction appears highly questionable, and one can easily

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[232] *Id.*
[233] *Id.*
[234] Freddie Mac Accounting Policy Interpretation, "Reclassification of Securities from Trading to AFS 1Q01," from Sandy Kurtis, May 30, 2003, OF 1706872.
[235] Memorandum prepared by Baker Botts, Re: Smriti Popenoe Interview, February 27, 2003, OF 2000493.

understand why Freddie Mac was unable to obtain a "true sale" opinion for the transaction.[236] The value-added by Salomon Smith Barney in the transaction is certainly suspect.[237]

The Blaylock Transactions

As discussed in detail in Chapter V, Blaylock & Partners, a small broker-dealer, was an intermediary in at least ten trades in 2000 and 2001 where securities went from the Securities Sales & Trading Group (SS&TG) of Freddie Mac to the retained portfolio of the Enterprise. The trades were done at the behest of Funding & Investments because SS&TG had mortgage securities in its inventory that were either about to pass or had already passed through a 30-day window beyond which SS&TG could no longer sell the securities to F&I. Although Blaylock was not highly capitalized and presented a potential credit risk, the firm was designated by F&I as the counterparty to whom it wanted SS&TG to sell the securities.[238]

Approximately $752 million in mortgage-backed securities that had been held longer than 30 days by SS&TG were sold to F&I via Blaylock.[239] Transcripts of recorded phone conversations between a trader in SS&TG (Buck Buchanan) and F&I (Smriti Popenoe) indicate that the commission to Blaylock on a portion of those transactions was 0.25 percent.[240]

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[236] Freddie Mac Accounting Policy Interpretation, "Reclassification of Securities from Trading to AFS 1Q01," from Sandy Kurtis, May 30, 2003. Footnote 1 of that document states that "the overall circumstances of the transaction were such that external legal counsel evidently was not comfortable providing a 'true sale' legal opinion." OF 1706872.

[237] See "Problems with Coupon Trade-Up Giants (CTUGs)," *supra*, for more details of this transaction.

[238] OFHEO Interview, Charles Foster, October 3, 2003, page 98.

[239] Baker Botts, "Executive summary of Blaylock transactions." FM B000324.

[240] Trader tape, (AUD_10E5), Buck Buchanan, February 14, 2001, FM A019096.

Smriti Popenoe: We'll do that up 3 and ¾ to me…
Buck Buchanan: Right
Smriti Popenoe: …and I'll pay them a ¼.

Other Counterparties

Table 9 below identifies the counterparties associated with other transactions mentioned elsewhere in this report. The role of the counterparties in those transactions may warrant further investigation by OFHEO.

Table 9. Counterparties to Other Transactions	
Transaction	**Counterparty**
J-Deals[241]	Morgan Stanley
Third-party trades to move bonds from SS&TG to F&I[242]	Salomon Smith Barney[243]
$8 billion repurchase transaction[244]	Credit Suisse First Boston

Source: Freddie Mac.

In summary, many of the transactions employed by the management of Freddie Mac to shift income and achieve certain accounting results may not have been possible without the help of various broker/dealer counterparties. The interactions described above between employees of Freddie Mac and their Wall Street counterparts reveal that the efforts of some of these counterparties to determine the true business purposes of those transactions appear, at least initially, to have been half-hearted. Given the substantial financial rewards for making the transactions happen and the desire of the counterparties to keep a large customer happy, and given the significant role they played in the transactions, their activities should be the subject of further investigation by OFHEO.

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[241] During the first quarter of 2001, Freddie Mac entered into four securitization transactions that became know as the "J-Deals" because their numbers all had "J" prefixes. The Enterprise entered into the deals in order to minimize the volatility associated with FAS 133 and EITF 99-20. Disclosure of the transactions by Freddie Mac was generally inadequate and the accounting staff of the Enterprise did not understand the complexity of EITF 99-20 sufficiently to properly structure the transactions. Baker Botts, "Executive Summary of J-Deals," OF 2010869 – OF 2010870.

[242] *See*, trades with Salomon Smith Barney discussion, *infra*, Chapter V, "Accounting and Auditing."

[243] The Salomon Smith Barney subsidiary of Citigroup is now known as Citigroup Global Markets, Inc. *See* http://www.hoovers.com/free/co/factsheet.xhtml?COID=11315.

[244] In 2002, Credit Suisse First Boston sold $8 billion of mortgage-backed securities to Freddie Mac, with a simultaneous agreement to repurchase the same type and amount of securities at a specified future date. The trade tickets for those transactions indicate that "CSFB simply does not have the balance sheet available to carry all that they are long." OF 2020600, OF 2020615. OFHEO is still investigating the circumstances surrounding the transactions.

V. ACCOUNTING AND AUDITING

The special examination has reviewed the accounting policies, controls, and expertise in existence at Freddie Mac during the restatement period. We conclude that weaknesses in the staffing, skills, and resources in the Corporate Accounting Department of the Enterprise led to weak or nonexistent accounting policies, an over reliance on the external auditor, weak accounting controls, and an over reliance on manual systems. Corporate Accounting appears to have been at its weakest during 2000-2001. In those years, Freddie Mac was experiencing record growth and implementing several of the more complex accounting standards promulgated to date, standards that affected a large proportion of the transactions of the Enterprise. Simply stated, the accounting expertise and controls of Freddie Mac were too weak to ensure proper accounting of the complicated transactions in which it engaged during the period. Although management developed plans to address those deficiencies, those plans were neither well conceived nor fully implemented.

The special examination has also reviewed the performance of the Internal Audit (IA) Department of Freddie Mac during the period. We conclude that Internal Audit did not accept responsibility for the reliability and integrity of the financial information of the Enterprise, did not follow-up effectively on identified deficiencies, and did not communicate effectively with management and the Board. In combination, the weaknesses in Corporate Accounting and Internal Audit meant that there were weak points at each major control juncture at Freddie Mac.

The weaknesses in the Corporate Accounting and Internal Audit Departments of Freddie Mac documented in this chapter created an opportunity for management to promote an attitude that the Enterprise should "transact around" Generally Accepted Accounting Principles (GAAP). In that regard, the inordinate attention management paid to meeting analyst expectations at the expense of proper accounting policies and strong accounting controls led to aggressive accounting and, in due course, the restatement. Management and the Board did not fulfill their responsibilities for adopting sound accounting policies and establishing and maintaining a strong internal control system to

assure that financial statements were prepared in accordance with GAAP. The Board operated under the misconception that as long as the external auditor signed off on an accounting policy or process, its responsibilities and those of management were fulfilled.

Weaknesses in Accounting

In the period covered by the restatement, weaknesses in the staffing, skills, and resources in Corporate Accounting at Freddie Mac led to deficient accounting policies, fragile accounting controls, and an over reliance on manual systems. Those problems existed during a period in which the Enterprise engaged in intricate transactions and was implementing complex accounting standards.

Inadequate Accounting Personnel and Expertise

Information obtained during this examination demonstrates that staffing levels and experience in the financial accounting and reporting functions of Freddie Mac were insufficient throughout the restatement period. There was lack of balance among the key finance functions, with major vacancies either left unfilled or filled with interim personnel who had inadequate skills. Those shortages of staff and experience caused key person dependencies in crucial control areas. The need for skills and experience was heightened by the complex process of accounting for the derivatives and securitization transactions of the Enterprise. Freddie Mac has determined that the accounting for many of the transactions undertaken during the period did not comply with GAAP. As a result, the Enterprise was required to make one of the largest restatements in U.S. corporate history.

The primary responsibility for the financial statements of a firm rests with management.[245] Part of that responsibility is to assure that staffing levels in financial accounting are sufficient to support a control environment within the financial reporting process that ensures that significant errors are prevented or detected at an early stage. Senior management and the Board of Freddie Mac failed to provide adequate resources to

[245] American Institute of Certified Public Accountants (AICPA) 2002 *Codification of Auditing Standards and Procedures*, Statement of Auditing Standards No. 1, Section 110.03. New York, NY: AICPA.

the corporate accounting function, even though they were continuously informed of those weaknesses throughout the restatement period.

As Maryann Murphy, the PricewaterhouseCoopers Engagement Partner at Freddie Mac, stated during the special examination, "warning signs" about problems in Corporate Accounting—noted in internal audit reports, Management Assessment of Risk and Controls (MARC) self-assessment reports, and instability in Corporate Accounting positions—existed throughout the restatement period.[246] Among the many documents reviewed in the special examination that provided such warning signs, the following are cited as examples:

- A 1999 Market Risk Oversight (MRO) report discussing issues related to the implementation of Financial Accounting Standard (FAS) 133[247] stated that "[a]ccounting resources are strapped with few full-time people with questionably the right skills."[248]

- An April 2000 memorandum from Vice President of Corporate Accounting Jeff Harris told then-Chief Financial Officer (CFO) Vaughn Clarke that "[o]ur primary risks relate to the significant amount of change occurring within the company generally and resource issues relative to turnover and recruitment."[249]

- A June 2000 memorandum from Mr. Harris to then-Controller Gregory Reynolds continued to voice that concern, stating that "[t]he FAS 133 project has a critical dependence on external resources due to strategy development delays, team turnover and a lack of available skilled, knowledgeable resources ... [which] presents challenges in transferring knowledge to internal resources."[250]

- An August 2000 Internal Audit Report on Derivatives & Hedging Instruments revealed that "[s]taffing levels and experience in the financial accounting and reporting functions have been insufficient and this causes key person dependencies. The lack of trained and knowledgeable staff in the derivatives group has contributed to the

[246] Internal notes prepared by OFHEO, Re: PricewaterhouseCoopers Interview, July 22, 2003.
[247] Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities."
[248] MRO Observations of Accounting Issues – 1999, FM C0003761.
[249] Memorandum from Jeff Harris to Vaughn Clarke, April 3, 2000, FM C000376262.
[250] Memorandum from Jeff Harris to Gregory Reynolds, June 22, 2000, FM C0003791-FM C0003794. The same text was relayed to Leland Brendsel and David Glenn in a June 7, 2000, memo from Vaughn Clarke. FM C0003823- FM C0003825. FAS 133.

delays in processing journal entries and to a number of adjusting journal entries for errors in prior periods." The report stated further that "CA's [Corporate Accounting's] derivative accounting group has three vacant positions out of a total of nine staff level positions. Additionally, the six current employees have all been in the group for less than a year and most are relatively inexperienced in their new positions."[251]

- On the same date Internal Audit issued a Financial Reporting Audit that indicated that "key person dependencies exist in the entire financial reporting process, both inside and outside of Corporate Accounting."[252] The audit also confirmed that management had initially identified this weakness through the MARC process as early as 1998. FAS 125[253] and FAS 133 were placing enormous burdens on this inadequately staffed area.

- A presentation proposed for a Board meeting on December 1, 2000, prior to the dry run process, suggested telling the Board that "Corporate Accounting systems are already under a severe strain. It's not clear how well they will respond to FAS 133 additional demands."[254]

As those documents indicate, Freddie Mac senior management and the Board were quite aware that the skills and systems in Corporate Accounting were challenged and that the derivatives group lacked sufficient knowledge and training. They also knew that those weaknesses had already contributed to delays in the processing of transactions and to accounting errors. Nonetheless, they chose to move forward with an approach to FAS 133 hedging that was especially complicated and required a huge volume of monthly accounting events as hedges were redesignated, and chose to structure some very complicated securitization transactions without proper accounting guidance.[255] In

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[251] Derivatives & Hedging Instruments Audit #2000-44, August 11, 2000, OF 1670023.

[252] Financial Reporting Audit #2000-64, August 11, 2000, OF 1670057.

[253] Statement of Financial Accounting Standards No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities."

[254] Freddie Mac Managing Committee Meeting, "Proposed Board Presentations." October 17, 2000, OF 1650433.

[255] OFHEO Interview, Shaun O'Malley, September 24, 2003, pp. 60-61.

Q: ... since you became a director, have you ever had concerns that the growth of Freddie Mac's retained portfolio is outpacing its operational capacity?

A: Certainly in terms of the accounting function. It's not just the growth of the retained portfolio. It's the overall growth and complexity of the company and the market in which it does business and the fact that the accounting department had just not kept pace in terms of talent, in terms of numbers. It just wasn't keeping pace.

an interview, Controller Edmond Sannini was asked about staffing levels when he arrived on October 29, 2001.

> Q: Did you identify any other issues that you needed to fix?
>
> A: I think in conjunction with that we began to address the people issues of how do we increase the depth and skill set of the group.
>
> Q: Are there any particular areas of skill set that concerned you in this initial say, six–month period?
>
> A: Probably the first area would be accounting policy and derivatives experience more from a depth point of view.
>
> Q: How many people had that derivative experience when you got there?
>
> A: It's difficult to estimate, but I would say there were probably six to eight individuals who I think had skills commensurate with business activities.
>
> Q: Have you increased that since that time, that number?
>
> A: Yes. Probably by three or four times that number.[256]

A Financial Reporting Controls Improvement Plan was developed to, among other things, address issues regarding the level of staffing in Corporate Accounting by April 2001. However, on January 31, 2002, and again on June 6, 2002, the General Auditor[257] reported to the Audit Committee of the Board of Directors that staffing deficiencies were still a problem, a weakness that had now persisted for over five years.[258] One year later, on January 29, 2003, PricewaterhouseCoopers reported to management that "[t]here were only six people in Accounting Policy, 2 of which should be there. We don't know what the other people do."[259] Senior management either simply ignored those "warning signs" about problems in Corporate Accounting or did not

[256] OFHEO Interview, Edmond Sannini, August 1, 2003, pp. 113-114.
[257] The General Auditor leads the Internal Audit Department at Freddie Mac.
[258] Report of the General Auditor, January 31, 2002, and Report of the General Auditor, June 7, 2002, OF 1670124 and OF 1670125.
[259] Diary of David Glenn, ODG 0006999.

consider the problems important enough to provide adequate supervision and funding or insist on a timely resolution.[260]

The weaknesses in the accounting personnel and expertise of Freddie Mac extended to the CFO and the Controller. Former CFO John Gibbons, who departed in March 2000, lacked adequate skills for that position. Nonetheless, senior management replaced Mr. Gibbons with Vaughn Clarke, who had even fewer skills, and hoped he would grow into the job.[261] The employment of Mr. Clarke by Freddie Mac began in August 1998, when he was named Senior Vice President Finance, reporting to then-CFO Gibbons.[262] Upon the resignation of Mr. Gibbons, Mr. Clarke assumed the responsibilities of CFO on an interim basis, and the Enterprise began a search for a permanent CFO. Freddie Mac hired an executive search firm, which talked with more than 250 candidates, seven of whom were interviewed by the Enterprise. The only candidate with significantly deep skills and experience decided not to pursue the position, and, almost by default, Freddie Mac offered the position of Executive Vice President and CFO to Mr. Clarke in November 2000.[263] That hiring decision was made with the knowledge that the Enterprise faced the task of implementing FAS 133, and at a time when the Controller job was in a state of flux.

In 1999, Controller Gregory Reynolds was spending part of his time as financial advisor to the Business Development unit of Freddie Mac. He told the special examination that in the fall of 1999:

> I went to the CFO and ultimately to the CEO, and told them both that I felt that if the company expected to continue looking at these types of third party relationships and wanted the Corporate Controller to continue to be a financial advisor or overseer of that process, that I was going to need to be allocated meaningful senior resources to help me get the job done because it physically was not possible for me to do it all myself without eventually running the risk of neglecting some of those baseline operations.

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[260] Leland Brendsel indicated that the group had a lot of work to do, but that he was generally satisfied with the accounting operations of Freddie Mac in 2001 and 2002. Memorandum prepared by Baker Botts, Re: Leland Brendsel, February 25, 2003, OF 2000121.
[261] *Id.*
[262] 2000 Performance Summary, Vaughn Clarke, EVP Chief Financial Officer, January 2001. OF0000218.
[263] Script for the meeting of Leland Brendsel with the Board Re: CFO Position. ODG 0004512-4514.

> So I made a specific request to the CFO, which ultimately had to go to the CEO for approval, to hire a Deputy Controller. I requested that the Deputy Controller meet one of two definitions, either be somebody who had enough sophistication in these Business Development type of activities ... or somebody who had enough financial sophistication that they could stand between me and some of the baseline operations, like accounting and tax, et cetera, and be more of the day-to-day active role of the Controller than I was able to do.
>
> I made it clear to the CFO, and ultimately the CEO, that this couldn't be balanced any longer if we didn't get some resources in place.[264]

After Mr. Gibbons resigned, the Controller reminded Mr. Brendsel about the need for a qualified Deputy Controller who could assume a significant amount of the responsibilities of Mr. Reynolds.[265] Brian Green was named Deputy Controller in August 2000 over the strong objections of Mr. Reynolds. Mr. Reynolds felt so strongly about that matter that he took the unusual step of raising his objections to the Chief of Staff of Mr. Brendsel before the latter signed the paperwork appointing Mr. Green Deputy Controller.[266]

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[264] OFHEO Interview, Gregory Reynolds, October 3, 2003, pp. 84-85.

[265] *Id.*, p. 164.

[266] In an interview with the special examination, Mr. Reynolds indicated his views.

> I objected, saying that I did not feel that this candidate was what we were looking for. The person was not a senior executive; it was back to an entry-level type. It was not a person that was going to afford me the opportunity to materially delegate any of the responsibilities that I had, and it was a person who had very little experience with the company and had very little experience in our industry, and I felt it was effectively filling a slot as opposed to doing what we had committed to do, which was to truly shore up my job .... The candidate that was being imposed upon me I said doesn't remotely, in my opinion, present a succession opportunity for many years, if ever, but I was told to put the person in the job.

In his meeting with the Chief of Staff, Mr. Reynolds noted,

> [I] told him that I was being instructed to fill the position. I said at some level I see why ... the company might want to find a position for Brian; his position elsewhere in the company had just been eliminated because of a reorganization. I said I understand why somebody needs to find Brian a job, but I want you to understand that if this is the job we put him in, we are explicitly not achieving the goals that we set out for this position in terms of either long-term succession planning, or even short-term significantly supporting the breadth of duties that I was trying to cover." OFHEO Interview, Gregory Reynolds, October 2, 2003, pp. 90-92.

Mr. Clarke then decided to replace Mr. Reynolds. Mr. Reynolds recalled the following:

> A: ... [O]ur working relationship was not very good, and it got progressively worse as the year went on, and dramatically so after the decision was made in September that I would move on .... I was not really in the loop on some of the things that were being decided in the fourth quarter of that year.
>
> In September, the way David Glenn described the decision to me was you're moving to Business Development, but you need to stay in the old job concurrently until we hire a qualified successor. On February 2nd, Vaughn Clarke calls me into his office and he said we're going to go ahead and finalize your transfer to Business Development now. I said I thought David's expectations were that I needed to stay in place until you hired a qualified successor. He said I've talked it over with David, and you're moving to Business Development now.
>
> Q: Did you follow up with Mr. Glenn yourself?
>
> A: I did. I first had several interactions with Mr. Clarke that day expressing my reservations. I told him point blank, from a personal standpoint, I want to go to the new job ... [But] I am concerned from a corporate standpoint that you're moving me over without a qualified successor in place. You're in the middle of a transition of FAS 133, a very complicated accounting requirement both technically and operationally; you are in the middle of an annual report preparation season ... you've got process issues within the financial reporting process ... I seriously question whether the financial reporting process can afford to give up one more leadership person, and I expressed my reservations. He told me that Brian Green was going to be appointed as the Interim Controller, and that would cover that problem. I said, "Let me remind you that I didn't believe Brian Green was qualified to be the Deputy Controller in the first place, and six months later you're saying he's qualified to be the Interim Controller?" ... I called Vaughn again later that afternoon, and I said, "I really want to state my objections one more time." I said, "I really am concerned that the financial reporting process needs a qualified leader with strong financial skills that truly understands this company ...." He didn't respond very favorably to that, so I got more specific, I said, "Who's going to make the difficult decisions that need to be made over the next several months, such as our disclosure obligations now that FAS 133 is in place, some of the remaining open issues in our FAS 133 adoption? Who is going to make these decisions?" And Vaughn said, "I'll make them myself."[267]

[267] OFHEO Interview, Gregory Reynolds, October 2, 2003, pp. 169-172.

At that point Mr. Reynolds moved to the Business Development area and Brian Green became Interim Controller. Not only was Mr. Green not a CPA, he assumed the Controllership two months after Freddie Mac implemented FAS 133. The selection of Mr. Green for that position is extremely troubling since he admits that prior to February 5, 2001, when he became acting Controller, he had never read FAS 133 and did not know what was being done at Freddie Mac in response to it.[268] A Controller with strong GAAP skills was not brought on board for another nine months, and Mr. Clarke continued in the capacity of CFO until the spring of 2002.

On May 8, 2003, Maryann Murphy of PricewaterhouseCoopers informed certain members of the Board of Directors of Freddie Mac that, in connection with its certification of the financial statements of the Enterprise, PricewaterhouseCoopers would not accept representations from Mr. Clarke in connection with the 2000, 2001, and 2002 audits. Her reasons were that Mr. Clarke had little knowledge of GAAP, financial accounting, or disclosure rules, and that he was deeply involved in the transactions that have given rise to the restatement.[269]

Director and current Board Chairman Shaun O'Malley confirmed that as he became more acquainted with Freddie Mac as a Board member throughout 2002, he had growing concerns that senior management was not acting fast enough to enhance the capability of the Corporate Accounting Group.[270] The lack of attention to staffing, skills, and resources led to weak or nonexistent accounting policies, weak accounting controls, over reliance on manual systems, and over reliance on the external auditor. Each of those areas will be discussed below.

Out-of-Date or Nonexistent Accounting Policies

The information obtained during the special examination indicates that a thorough review and update of accounting policies had not occurred at Freddie Mac in over twelve years. Accounting policies should be researched and documented regularly to assure proper

[268] Memorandum prepared by Baker Botts, Re: Brian Green Interview, March 18, 2003, OF 20000314.
[269] Memorandum prepared by Baker Botts, Re: "Conference Call and Meeting with PWC Relating to Management Representations," June 19, 2003, OF 2009621.
[270] OFHEO Interview, Shaun O'Malley, September 24, 2003, p. 114.

accounting treatment of existing and new business transactions and the adherence to established accounting practices. Policies should be used as a mechanism to guide employees and keep them informed of how to account for new and recurring transactions. Many of the transactions and accounting practices at Freddie Mac that the special examination investigated did not have established accounting policy guidance, or the policies in place were outdated, insufficient, or incorrect. Those conditions led to misapplication of GAAP and, ultimately, the need to restate the financial statements of the Enterprise.

The weaknesses in accounting policies at Freddie Mac created an environment that allowed for and even encouraged transacting around GAAP. The resulting accounting errors committed were pervasive and persistent. Working with its current external auditor, Freddie Mac has found errors—often multiple errors—in more than 30 different accounting issue groups. Those accounting policy weaknesses also encouraged an over reliance on the external auditor—Arthur Andersen—that raises questions about its independence.

The primary responsibility for adopting sound accounting policies and for establishing and maintaining internal controls rests with management.[271] The senior management and the Board of Freddie Mac failed to provide adequate resources and to meet that responsibility. Moreover, in some cases executives throughout the Enterprise took advantage of policy weaknesses to establish or use questionable accounting practices.

> Internal Audit had identified outdated accounting policies as a problem as early as 1995. A November 1995 Financial Reporting Audit revealed that the current [Accounting Policy] Manual is not the effective link that the introduction describes ... it has not been significantly revised since it was first issued in 1991.[272]

[271] American Institute of Certified Public Accountants (AICPA), 2002, *Codification of Auditing Standards and Procedures*, Statement of Auditing Standards No. 1, Section 110.03. New York, NY: AICPA.
[272] Financial Reporting Audit #95048, November 29, 1995, OF 1600664.

Over four years later, the external auditor noted, in a March 3, 2000 letter to the Audit Committee, that:

> A thorough review and update of the Accounting Policy Manual has not occurred in over four years. Certain of the documented policies are not reflective of the current practices .... This has made it difficult for the new staff and consultants to maintain a comprehensive understanding of how certain transactions should be processed.[273]

Later that year, Internal Audit, in an August 11, 2000 Financial Reporting Audit, stated:

> In the case of the Accounting Policy Manual, we have noted in our previous two financial reporting audit reports (#1995-048 and #1998-054) that many policies are years out-of-date and the manual is not fulfilling its control purpose. Corporate Accounting does not have an effective process to react to new transactions and provide timely, accurate accounting guidance ....[274]

On that date, Internal Audit also issued an Internal Audit Report on Derivatives & Hedging Instruments that revealed:

> Although there are some guideline documents available, Corporate Accounting does not have current policies and procedures to ensure that accounting processes are performed consistently.[275]

That weakness was still outstanding a year later in the March 2, 2001 letter of the external auditor to the Board.

Freddie Mac operated without proper accounting guidance during the crucial period of 1999-2001, when FAS 133, FAS 140,[276] and Emerging Issues Task Force (EITF) 99-20[277] were adopted. Those weaknesses in accounting policy were common knowledge at the Enterprise. Deputy Corporate Controller Lisa Roberts, when questioned about the process of setting accounting policies, stated:

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[273] Letter from Arthur Andersen of March 3, 2000, OF 0000010. In fact, no thorough update had occurred in nine years.
[274] Financial Reporting Audit #2000-44, August 11, 2000, OF 1670023.
[275] Derivatives & Hedging Instrument Audit #2000-44, August 11, 2000, OF 1670023, OF 1670031.
[276] Statement of Financial Accounting Standards No. 140, "Accounting for Transfer and Servicing of Financial Assets and Extinguishment of Liabilities," which replaced FAS 125.
[277] Emerging Issues Task Force 99-20, "Recognition of Interest Income and Impairment of Purchased and Retained Beneficial Interest in Securitized Financial Assets."

A: It was, I think, very situation specific. I think that in the years in question, and I'm going to define that as the restatement period, there were a tremendous amount of weaknesses across the organization .... And so there was no consistent pattern of what we just described as a potential standard with the way the process would work. There were times when the accountants were involved and there were times when they were not. I would say as far as documentation and things that people would hold out as a standard for the internal controls were not lived up to.

Q: Now when you mentioned the number of weaknesses throughout the organization, can you give me a sense of the types of weaknesses that you were referring to?

A: In that specific example I was referring to weaknesses in the accounting skill sets within accounting policy. I think there were a handful of capable individuals but not nearly the level or depth the staff needed to meet the challenges of the volume and complexity of transactions and strategies that were being executed across the organization. I don't think that the company had a well defined change management process, and by that I mean: what is the right protocol in terms of who needs to be at the table when transactions are being done and what are their individual roles and responsibilities to ensure on the back end that these transactions are getting recorded accurately and completely.[278]

Freddie Mac management took advantage of the weak accounting policy group and the lack of a process for setting accounting policies to justify a practice of determining the accounting treatment of transactions after they had taken place, rather than allowing the policy group to set "best practice." When questioned about the process surrounding the issuance of accounting policies before his arrival at Freddie Mac, Controller Edmond Sannini told the special examination:

A: My understanding is the documentation of the policy may have occurred in some instances after the transaction was undertaken.

Q: I take it that you would prefer to have it go in reverse order; that is, the policy gets formulated and documented and then the transactions?

A: Yes, I would say stronger than prefer: I would mandate.

[278] OFHEO Interview, Lisa Roberts, August 6, 2003, pp. 21-23.

Q: Do you have any specific accounting policies in mind that came in the reverse order than the one that you would mandate?

A: ... I think the whole – from what I understand looking back, the entire policies around the implementation of FAS 133 were done on more of what I would call investing real-time basis with the implementation of that policy.[279]

Freddie Mac developed, at the request of Gregory Reynolds, a 1995 accounting memorandum on the strategy later known as "Participation Certificate (PC) smoothing." The acknowledged intent of that strategy was to reduce volatility in earnings due to changes in the rate of prepayments by recognizing the PC variance expense over the entire period Freddie Mac held the funds.

In 2002, Freddie Mac, concluded that the accounting policy adopted for PC smoothing was an incorrect interpretation of GAAP. The newly adopted policy states that the interest expense owed to the PC holder should be recognized in the month in which the prepayment occurs and not spread over the period between prepayment by the mortgage borrower and pass-through of prepaid funds to the PC investor.

There are numerous other examples of transactions that Freddie Mac entered into without proper accounting research or where the accounting policy was developed after the fact to fit the transaction or reduce earnings volatility.[280] In a March 2003 briefing on Accounting Issues for the Chief Executive Officer (CEO), the General Auditor was asked

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[279] OFHEO Interview, Edmond Sannini, August 1, 2003, p. 134.

[280] Statements from Baker Botts interviews:

- Jamie Amico stated that there was definitely a culture of trying to make transactions work and to keep explaining how we could do a particular structure, even if it was barely compliant. He also commented that Gregory Reynolds pushed things. Memorandum prepared by Baker Botts, Re: Jamie Amico Interview, (CA), February, 14, 2003, OF 2000038.
- Luis Betancourt stated that the traders would come up with the transactions and choose to inform (or not inform) Accounting Policy about the transactions on a case-by-case basis. He also indicated "if you speak up you get pushed aside." He recounted a few instances when accounting staff were fired. Memorandum prepared by Baker Botts, Re: Luis Betancourt Interview, (CA), February 6, 2003, OF 2000084.
- Stephen Bledsoe stated that with regard to J008 he believed the purpose was to achieve a favorable accounting result in the IO/PO structure. He also stated that the company had to give up economics in order to achieve the favorable accounting treatment. Memorandum prepared by Baker Botts, Re: Stephen Bledsoe Interview, (CA), February 11, 2003, OF 2000099.

to identify the root causes of the various restatement issues identified to date. He identified weak accounting policies as one of the root causes in all cases.[281] Freddie Mac, as part of its restatement process, has rewritten or reviewed over 150 accounting policies.

Reliance on External Auditor for Basic Accounting Functions and Decisions

The shortage of accounting staff and expertise and weak or non-existent accounting policies of Freddie Mac encouraged reliance on the external auditor, Arthur Andersen, for basic accounting functions and decisions. That dependence led to the external auditor acting in a first-line management capacity, taking part in day-to-day operations, and, to an extent, auditing its own work.[282]

Arthur Andersen was retained by Freddie Mac as a consultant on FAS 133 implementation. In an interview with the special examination, the Arthur Andersen audit engagement partner, Robert Arnall, stated that he did not have any concerns regarding independence because Arthur Andersen only provided customized service for, but did not

[281] Internal Audit Briefing of CEO on Accounting Issues, March 18, 2003, OF 16669210 – OF 16669219.

[282] Statements from Baker Botts interviews:

- Tracy Abruzzo believes that too much reliance was placed on the auditors. She communicated her concerns to Lou Betancourt, who agreed with her concerns. Memorandum prepared by Baker Botts, Re: Tracy Abruzzo Interview, (CA), February 12, 2003, OF 2000007.
- Business people directly called Robert Arnall for advice. He seemed to be making all decisions alone. Memorandum prepared by Baker Botts, Re: Luis Betancourt Interview, (CA), February 6, 2003, p. 4, OF 2000082.
- Regarding the coupon trade ups, Dossani and Federico would talk to (Woods and Arnall) early on in the process to see if Arthur Andersen could come up with any ideas. Memorandum prepared by Baker Botts, Re: Peter Federico Interview, (F&I), February 26, 2003, OF 2000251.
- Brian Green recalls that Corporate Accounting was not properly equipped to handle accounting issues, and F&I would in some ways bypass Corporate Accounting and go straight to Arthur Andersen. Memorandum prepared by Baker Botts, Re: Brian Green Interview (CA), February 20, 2003, OF 2000304.
- Lisa Roberts stated that she did not have a lot of support in Corporate Accounting, "Robert Arnall is my controller at this point." Memorandum prepared by Baker Botts, Re: Lisa Roberts Interview, (CA), March 11, 2003, OF 2000563.
- It was "just obvious" that there was a problem in Corporate Accounting. There were not enough resources and Andersen was the "sounding board." In hindsight, Andersen would give the advice but then would be the auditor on it. Memorandum prepared by Baker Botts, Re: Steven Dinces Interview, (Legal), March 13, 2003, OF 2016066.
- Arthur Andersen has taken over running details for the Company's accounting. Memorandum prepared by Baker Botts, Re: Bob Ryan Interview, (Glenn's Office), May 20, 2003, OF 2016264.

execute transactions or sell pre-packaged strategies or products to, the Enterprise. He also believed Arthur Andersen could rely on guidance provided by the Independence Standard Board (ISB) and the American Institute of Certified Public Accountants (AICPA) and its own internal guidance with respect to how an external auditor can also provide consulting services and retain its independence.[283] Mr. Arnall noted that the Sarbanes-Oxley Act of 2002.[284]

However, the SEC had addressed that issue in its auditor independence rule, which became effective in February 2001, before the enactment of the Sarbanes-Oxley Act of 2002. In that rule, the SEC stated that one of the four principles to consider when measuring auditor independence was whether the auditor, in the conduct of the audit, will end up auditing its own work.[285] In 2001, Arthur Andersen received $1 million for its audit work and $3.7 million for its consulting fees, of which $1.5 million related to FAS 133 consulting.[286] The special examination believes that the type of work and the size of the consulting fees may have compromised the independence of Arthur Andersen.

SEC requirements for independence of auditors are clear that in day-to-day operations of the business, an external auditor may not function as management or as an employee of its audit client.[287] Arthur Andersen appears to have disregarded that principle in its counseling Freddie Mac on issues ranging from FAS 133 implementation to the accounting affects of new products.[288] The many organizational changes in the leadership of the Accounting Department, especially at the Controller position, led the

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[283] Internal notes prepared by OFHEO, Re: Robert Arnall Interview, July 21, 2003.
[284] Sarbanes-Oxley Act of 2002, § 201, Pub. L. No. 107-204, 116 Stat. 745 (2002), § 10A, 1934 Act.
[285] Securities Act Release, October 15, 2001, 33-7919, 17 CFR Part 210, 65 Fed. Reg, 76008 (December 5, 2000).
[286] Presentation to the Audit Committee March 1, 2002, OF 5030457.
[287] Securities Act Release, October 15, 2001, 33-7919, 17 CFR Part 210, 65 Fed. Reg. 76008 (December 5, 2000).
[288] Internal notes prepared by OFHEO, Re: Robert Arnall Interview, July 21, 2003. Mr. Arnall stated that Arthur Andersen answered a lot of questions regarding FAS 133 and other standards. Sometimes the audit side of Arthur Andersen discussed the accounting impacts of ideas. When looking at a new product, Freddie Mac would call in an Arthur Andersen team regarding the accounting guidance and impact. The Single Family division often discussed the impact of various accounting rules on customers with Arthur Andersen (e.g., Frederico and others would inquire whether certain things were derivatives and how to account for them). Arthur Andersen reviewed FAS 133 Steering Committee work on a regular basis.

accounting staff to rely heavily on Mr. Arnall.[289] Deputy Corporate Controller Lisa Roberts described the situation in an interview with the special examination:

> Q: During the period of time [in late 2000], the last few months that you referred to when Mr. Reynolds was not fully engaged with the controller responsibilities, was there anyone who took up the slack?
>
> A: I was working on financial reporting as we established, reporting up through Jeff Harris, who then reported to Greg. During the interim time while he was distracted and/or when Brian Green came on, I was left in a very difficult position when I needed advice and information. I did not have individuals lined up ahead of me that I felt like I could get the right advice from. I was turning a lot to Rob Arnall to talk through issues with and to get advice, seek advice.
>
> Q: And Rob Arnall of course is with Arthur Andersen?
>
> A: Right.
>
> Q: Did he serve in your mind as sort of the de facto controller?
>
> A: Well, I was certainly asking him questions similar to how I would interact with a controller or department head.[290]

When she was questioned later about corporate accounting not meeting the needs of Funding & Investments (F&I), she responded:

> Q: Let's focus on F&I for the moment. Where would they go to get those services? How would that need be met?
>
> A: I think it was a combination, and I just want to clarify, it was not in all circumstances that it wasn't met. But it was my sense that they would use Andersen, tap into their skills for accounting advice.[291]

That practice of business units going directly to Arthur Andersen for first-line decisions was confirmed in the special examination interview with Edmond Sannini:

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[289] OFHEO Interview, Lisa Roberts, August 6, 2003, pp. 31-32.
[290] *Id.*
[291] *Id.*, p. 114.

Q: Based on your experience, would it be standard practice for the company—for a company to consult with its external auditor before engaging in a transaction.

A: I don't believe it would be standard practice for a company, although I think it may have been standard practice during that period of time at Freddie Mac.

Q: What is the basis for that belief, Mr. Sannini?

A: Based on my understanding, the lack of depth around accounting policy had led certain business managers to go directly to Arthur Andersen with regard to transactions that they wanted to take.[292]

In an interview with the special examination, former Controller Greg Reynolds answered questions about the shortage of resources.

Q: Did it result in increased reliance by the Corporate Accounting department on Arthur Andersen?

A: Yes.

Q: In what areas?

A: I think we borrowed resources from them just as staff augmentation more than we might otherwise have liked to. I think that we looked more to them for technical guidance than we would have wanted to. In the end, as the auditor, they've got an opinion to draw, but what a well-rounded accounting department tries to do is really do its research as much as possible, not have to pay somebody to do it for them, and then let the auditor come in and react to your research. We often times had to pay Andersen to do the research for us because we didn't have enough staff to do it ourselves.[293]

The special examination concludes that Arthur Andersen staff members were participating in day-to-day decisions and often acting as employees of Freddie Mac or in a management capacity. They also performed extensive consulting work. All those factors may have led to the use of extreme assumptions to support the accounting treatment of specific transactions.

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[292] OFHEO Interview, Edmond Sannini, August 1, 2003, pp. 183-184.
[293] OFHEO Interview, Gregory Reynolds, October 2, 2003, p. 259.

Other aspects of the relationship between Freddie Mac and Arthur Andersen were unusual. One employee of the Enterprise stated in an interview that, "with Arthur Andersen, Freddie Mac could 'negotiate' a lot more than one would think would be the case."[294] Perhaps more importantly, management of the Enterprise may have at least implicitly threatened to change external auditors if desired results were not achieved.

When faced with the implementation of FAS 140, Jamie Amico, Director of Accounting Policy, prepared a document titled "Current Disagreement with Arthur Andersen: Accounting for Repurchased PCs." In brief, the document stated that Arthur Andersen believed FAS 140 compelled a change in accounting for repurchased PCs, whereas Freddie Mac disagreed and believed that its current practice should not change. Among the alternatives listed in the document were to 1) continue current practice despite the views of Arthur Andersen; 2) solicit the opinion of another certified public accounting firm and, if the opinion was favorable, use it to influence the views of Arthur Andersen; 3) solicit the opinion of another firm and, if the opinion was favorable, switch to that firm; 4) engage FASB directly; or 5) accept the position of Arthur Andersen.[295] It should be noted that FAS 140 is one of the major issues in the restatement.

The special examination did not find evidence that the presentation of Mr. Amico was shared with Arthur Andersen. However, the preparation and existence of such a document raises the question whether management may have used the threat of changing external auditors in an effort to influence Arthur Andersen. Other documentation reviewed by the special examination reveals verbal comments along that line made by CEO Brendsel.[296]

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[294] Memorandum prepared by Baker Botts, Re: Usha Chanudhary Interview, February 14, 2003, OF 2000136.

[295] PowerPoint presentation by Jamie Amico, "Current Disagreement with Arthur Andersen," FM 167969 – FM 167975.

[296] "When asked why he let the trades go this time, Mr. Arnall stated that the GAAP accounting was proper and that this was his responsibility. No one leaned on him about these trades .... He did recall one time when Mr. Brendsel, in a joking manner, said that Merrill Lynch used Deloitte & Touche as its auditors, that Mr. Brendsel knew Merrill's chairman and that Freddie Mac could always use Deloitte if it wanted .... Mr. Arnall took it as a joke, but it did happen, either one or two times." Memorandum prepared by Baker Botts, Re: Robert Arnall, Lead Partner with Arthur Andersen, Interview, April 11, 2003, OF 2000070. A similar presentation discussing the implementation of EITF 99-20 listed the same five alternatives,

When asked if in his professional judgment it was ever appropriate for management to remind its external auditors that it can switch auditors during a discussion of an accounting policy disagreement, Board Chairman O'Malley, retired chairman of PricewaterhouseCoopers and chairman of the Panel on Audit Effectiveness,[297] responded:

> [B]ut if you start the talk about having a consultation with the threat that if we get another answer you're finished, that's bad, that shouldn't happen. You're trying to yourself compromise the independence of the auditor. If you're threatening, you're trying to take away his independence and get him to act based on the threat rather than on his professional opinion.[298]

The special examination also concludes that the Board of Directors of Freddie Mac relied excessively on the external auditor for accounting expertise. That contradicts accounting literature, which holds management accountable for the accuracy of the financial statements of a firm.[299] For example, when Thomas Jones, the Chairman of the Audit Committee, was asked about control weaknesses in corporate accounting that dated as far back as 1995, he responded:

> I think these kinds of comments ... I've been on the board since 1997 and I think these kinds of comments have been consistently made during that period. The corrective action, the response to the shortcomings was various types of manual processes, manual reconciliations, back end controls, and so on. So put this in the context of yes, while we were being told about these deficiencies, we were also being told by Arthur Andersen every year that, you know, the financial statements are okay; you've got these manual processes and manual reconciliations and back end controls and that isn't the best way to do it but it seems to be working even though it's bubble gum and wrapping paper ....[300]

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including that of changing the external auditor if Arthur Andersen did not agree with the accounting practice of Freddie Mac. OF LR 12965-74.

[297] The Panel on Audit Effectiveness was a panel of the Public Oversight Board (POB), an independent, private-sector body established by the AICPA to monitor and comment on matters that affect public confidence in the audit process. The POB terminated its own existence after the Sarbanes-Oxley Act of 2002 established the Public Company Accounting Oversight Board (PCAOB).

[298] OFHEO Interview, Shaun O'Malley, September 24, 2003, p. 39.

[299] American Institute of Certified Public Accountants. 2002, *Codification of Auditing Standards and Procedures*, Statement of Auditing Standards No. 1, Section 110.03. New York, NY: AICPA.

[300] OFHEO Interview, Thomas Jones, August 12, 2003, pp. 28-29.

When questioned later in the interview about the transactions surrounding the FAS 133 transition adjustment he replied:

> [W]hat happened was that the company tried to manage the impacts of a financial statement pronouncement that was going to distort the economics of the company and they made every effort that they could reasonably make to try to do it within the boundaries of GAAP. It turns out that the outside expert on GAAP upon whom they relied, you know, the senior partner on the engagement from Arthur Andersen, gave them the opinion that they did it the right way and he turned out to be wrong.[301]

Finally, key Freddie Mac staff generally believed that, if the external auditor did not object, then the accounting of the Enterprise must be all right. For example, in an interview with the special examination, when questioned about the issue of outdated accounting policy manuals, the General Auditor, Melvin Kann, replied:

> Considering that the public accountants were satisfied on the application of accounting policies, it was getting out of my realm other than commenting on the fact that the documentation was outdated.[302]

Those statements illustrate the lack of acceptance of responsibility by the Board and management for establishing sound accounting policies and assuring appropriate financial reporting, and the resulting over reliance of Freddie Mac on the external auditor.

Lack of Accounting Controls

The special examination concludes that management and the Board of Directors of Freddie Mac failed to ensure that controls over the financial reporting process during the restatement period were sufficient to ensure that significant errors would be prevented or detected and remedied at an early stage. Statement of Auditing Standards (SAS) No.1 states that "the primary responsibility for adopting sound accounting policies and for

[301] *Id.*, pp. 124-125.
[302] OFHEO Interview, Melvin Kann, August 22, 2003, p. 104.

establishing and maintaining internal control rests with management."[303] The SEC defined "internal control over financial reporting" as:

> A process designed by, or under the supervision of, the registrant's principal executive and principal financial officers, or persons performing similar functions, and effected by the registrant's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:
>
> 1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the registrant;
>
> 2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the registrant are being made only in accordance with authorization of management and directors of the registrant; and
>
> 3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the registrant's assets that could have a material effect on the financial statements.[304]

The special examination has concluded that senior management and the Board did not establish and maintain an adequate internal control system. As a result, they could not provide reasonable assurance that transactions were recorded as necessary to permit preparation of financial statements in accordance with GAAP. As a direct result of management and the Board not addressing the internal control weaknesses of the Enterprise in a timely fashion, Freddie Mac went more than ten months before releasing financial statements for 2002, has been forced to restate its financial statements for 2000 and 2001, and will not be able to provide investors with timely quarterly information until at least June 2004.

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[303] American Institute of Certified Public Accountants (AICPA), *Codification of Auditing Standards and Procedures*, Statement of Auditing Standards No. 1, Section 110.02. New York, NY: AICPA.

[304] Securities Act Release, October 15, 2001, 33-7919, 17 CFR Part 210, 240, 65 Fed. Reg. 76008, December 5, 2000.

As noted above, the staffing levels and expertise in the financial accounting area at Freddie Mac have been insufficient since at least 1998. Moreover, as was also demonstrated above, the Enterprise operated from 1991 to 2003 with nonexistent or outdated accounting policies and manuals. There were also insufficient controls over the financial reporting process, including system and data integrity issues in debt and derivatives accounting, account reconciliation issues, an ineffective process to react promptly to new transactions, and a labor intensive close-out process.

The remainder of this section discusses a number of specific weaknesses in the accounting controls of Freddie Mac identified by the special examination that went unresolved during the period of the restatement.

Derivatives Execution, Administration, and Accounting

In an internal audit report dated December 1996, General Auditor Kann, reported that the accounting controls of Freddie Mac needed strengthening. Specifically:

> Controls over the derivatives execution, administration, and accounting processes require improvement .... Further deterioration in controls could prevent objectives relating to the effectiveness and efficiency of operations and the reliability of financial reporting from being achieved.[305]

Management also identified those same deficiencies through the MARC process. Weaknesses within the derivatives area continued to be identified, but were not fully addressed by management, internal audit, or the external auditor, over the next seven years.[306] The latest internal audit report reviewed as part of the special examination, dated November 2002, reported that controls had weakened and were now marginal. That report identified significant weaknesses:

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[305] Derivatives Execution, Administration, and Accounting Audit #96078, December 19, 1996, OF 1669908.

[306] For example: Hedging Audit #1998-027, August 117, 1998, OF 1669964; Derivatives, Futures, & Options #1998-002, February 18, 1999, OF 1669982; Derivatives & Hedging Instruments #2000-044, August 11, 2000, OF 1670182; Letter from Arthur Andersen of March 3, 2000, OF 1669964 – OF 1670045.

> Inadequate documentation of hedge effectiveness and other required information could disqualify the use of favorable FAS 133 accounting treatment .... Significant functional limitations in the derivatives accounting systems create an elevated risk of material operational error. Procedures for derivatives accounting processes, including documentation, effectiveness testing, quality control, analysis, and management review, need improvement to ensure compliance with hedge accounting standards.[307]

It should be noted that inadequate documentation and controls surrounding the accounting for derivatives have been identified as one of the six major restatement issues and constitutes the largest dollar impact of the restatement.

Guaranteed Mortgage Securities Reconciliation

General ledger account reconciliations serve as a key internal control that provides reasonable assurance that the financial statements of a corporation fairly present its financial position and results of operations. Not reconciling general ledger accounts dramatically increases the risk that financial reports will not be accurate.

The root causes of the internal control problems that led to the Guaranteed Mortgage Securities (GMS) reconciliation issue had been identified in other areas and were later addressed by the Financial Reporting Controls Improvement Plan. The issue regarding reconciliation was brought to the attention of management as early as 1995. A financial reporting audit from that year noted that:

> Corporate accounting is not effectively monitoring account reconciliations performed by the decentralized account units ....[308]

Internal Audit again identified reconciliation weaknesses in their 1998 audit.[309] In 1998 and 1999 Arthur Andersen addressed issues regarding reconciliation and data integrity in its management letters. In fact, in 1998 Arthur Andersen said that guidance

[307] Derivatives Audit #2002-039, November 22, 2002, OF 1670182.
[308] Financial Reporting Audit #95048, November 29, 1995, OF 1600664.
[309] Financial Reporting Audit #1998-054, November 24, 1998, OF 1600671.

should be provided for the timely and consistent reconciliation of data to the general ledger and other approved sources of data.[310]

In the 2000 and 2001 letters to Freddie Mac prepared by Arthur Andersen, the auditor specifically addressed the need to enhance the reconciliation process of the GMS portfolio.[311] Controller Brian Green also voiced his concerns in an August 13, 2001 e-mail:

> We are experiencing some "major $ swings" in the reconciliation of the GMS portfolio. Apparently, this has been a long-standing issue and the reportable unreconciled balance for the month of June could range from $50-$90 million .... [That] will be the first time a number this significant is being presented.[312]

Contributing to the GMS reconciliation issue was the lack, mentioned above, of an infrastructure to handle new products. Again, that weakness had been identified by management and internal audit, but was not addressed in a timely fashion.[313] A PricewaterhouseCoopers partner concluded that the various initiatives or projects put in place to deal with warning flags, internal audit reports, or identified concerns were either ineffective or did not address identified problems.[314]

The special examination concludes that senior management and the Board of Freddie Mac simply did not devote sufficient time and resources to see that the GMS reconciliation problem was addressed in a timely manner.

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[310] Letters from Arthur Andersen for 1998 and 1999, OF 0000001 – OF 0000014.
[311] Letters from Arthur Andersen for 2000 and 2001, OF 00000015 – OF 00000026.
[312] Email from Brian Green to Jeanne Raeder and Vaughn Clarke, August 13, 2001, FM C0003912.
[313] GMS Issues Analysis, OF 2016902. Memorandum to David Glenn from Edmond Sannini, December 14, 2001, "GMS Reconciliation: Summary and Issues Paper," stated that "[c]omments made with regard to this issue by Arthur Andersen did not receive sufficient management attention and we have no contemporaneous documentation of our assessment and prioritization of the issue." OF ES 04913 – OF ES 04927.
[314] Internal notes prepared by OFHEO, Re: PricewaterhouseCoopers Interview, July 22, 2003.

Trades with Blaylock & Partners and with Salomon Smith Barney

Trades between Freddie Mac and Blaylock & Partners and between the Enterprise and Salomon Smith Barney raise serious questions about the quality of internal controls at Freddie Mac. Blaylock & Partners, a small broker-dealer, was an intermediary in 10 trades in 2000 and 2001 where securities went from the Securities Sales & Trading Group ("SS&TG") of the Enterprise to the retained portfolio. Charles Foster, Vice President of the SS&TG, said with respect to the Blaylock trades that they were "relatively large for an entity of that size in terms of their capitalization of that company."[315]

In five identified instances, the internal policies of Freddie Mac regarding tax issues were violated because the sales of securities that had been held longer than 30 days had been prearranged. Specifically, audio tapes revealed that Enterprise traders in F&I made it clear to Blaylock that securities that Blaylock purchased from SS&TG were to be sold to F&I. The tapes also show that traders in SS&TG and F&I coordinated their sales and purchases to make this happen.[316] In this manner, SS&TG was able to transfer securities with desirable prepayment characteristics that would meet the return-on-equity (ROE) and present-value-added (PVA) thresholds set by F&I. Both of those metrics were included in the corporate scorecard of Freddie Mac. The trades are indicative of the operations and legal risks the Enterprise was willing to assume in order the meet its corporate scorecard metrics.

Freddie Mac executed similar trades with Salomon Smith Barney in late December 2000 and early January 2001. Those transactions moved bonds from SS&TG

[315] OFHEO Interview, Charles Foster, July 28, 2003, pp. 90-91, 98-99. Mr. Foster explained that the trades were done at the behest of F&I, because SS&TG had mortgage securities in their inventory that were either about to pass through a 30-day window (beyond which SS&TG could no longer sell the securities to F&I) or had already passed through the 30-day window. In an interview with the special examination, Mr. Foster recounted a discussion of whether there was a way to take those assets and sell them to a particular counterparty from whom the retained portfolio could later purchase them. Mr. Foster spoke to Byron Boston, a Vice President in Mortgage Portfolio Management, a group within F&I, regarding the credit-worthiness of Blaylock. Mr. Foster told Mr. Boston that Blaylock was not highly capitalized and presented a potential credit risk. However, F&I designated Blaylock as the counterparty to whom that they wanted SS&TG to sell the securities.

[316] For example, Smriti Popenoe, an F&I trader, told Buck Buchanan, a trader in SS&TG, that "I am just going to sell you the TBAs [mortgage-backed securities to be delivered at a future date] through Blaylock and I'm just going to buy these bonds from you directly." Trader audio tape, February 14, 2001, Buchanan AUD – 10E5.

to F&I that had been held in inventory by SS&TG for longer than 30 days. F&I purchased from Salomon Smith Barney $1 billion of Gold seasoned 6.0s[317] on December 27, 2000, $600 million of Gold seasoned 6.0s on January 2, 2001, and $1.2 billion of Gold seasoned 6.0s on January 8, 2001. SS&TG sold to Salomon Smith Barney $1.2 billion of Gold seasoned 6.0s on January 2, 2001 and $1.2 billion of Gold seasoned 6.0s on January 8, 2001. Through three trades, F&I purchased a total of $2.8 billion of Gold seasoned 6.0s from Salomon Smith Barney. During the same time period, SS&TG sold $2.2 billion of Gold seasoned 6.0s to Salomon Smith Barney.[318]

While similar to the Blaylock trades, in that F&I and SS&TG violated internal policies of Freddie Mac to sell securities held for more than 30 days in a prearranged sale, the Salomon Smith Barney trades were different in one respect: only $1.3 billion of the $2.8 billion of Gold seasoned 6.0s purchased by F&I were prearranged to obtain securities held by SS&TG.

In addition to potential tax violations, traders in F&I facilitated transactions that cast serious doubt on the independence of the retained portfolio from SS&TG. The trades contributed to the tainting of the entire held-to-maturity portfolio of Freddie Mac. Additionally, the relationship between F&I and SS&TG is an example of an interdivisional relationship that did not receive sufficient scrutiny before the restatement. Although the Enterprise has written "Chinese wall" policies regarding the flow of information between SS&TG and F&I, trades such as those with Blaylock and Salomon Smith Barney make those barriers seem rather ineffective.

Their efficacy was put further in doubt by a memo drafted by Mr. Foster in September 2000 regarding the transfer of SS&TG Head Trader, Gary Kain, to F&I. Mr. Foster proposed in that memo that Mr. Kain split his time 75 percent/25 percent between SS&TG and F&I in October 2000 and 50 percent/50 percent between the two

[317] 6.0 percent coupon Gold Participation Certificates guaranteed by Freddie Mac. Those securities had been classified as "seasoned 6.0s", meaning that they had been originated previously.
[318] Memorandum prepared by Baker Botts, Re: Mike Lynch Interview, August 21, 2003, OF 2022446.

units in November 2000.[319] Although Paul Peterson, former head of the Single-Family Division of Freddie Mac, could not recall if the proposal of Mr. Foster was implemented,[320] the fact that the head of SS&TG would even draft a memo proposing such an arrangement raises doubts about how seriously management regarded the firewalls between SS&TG and F&I.

Inadequate Implementation of the Financial Reporting Controls Improvement Plan

A major project that was not implemented effectively was the Financial Reporting Controls Improvement Plan (FRCIP). That plan was developed after an August 2000 audit of financial reporting deemed that controls were marginal. The significant findings of the audit included the following:

> There are insufficient controls over the financial reporting process to ensure that significant errors are either prevented or detected at an early stage and the accuracy and timeliness of the financial reporting process is dependent on key people. [321]

The FRCIP was devised by a group headed by Controller Reynolds to address those specific findings. Director Russell Palmer, who was the Chairman of the Audit Committee of the Board, reviewed the plan, which was then approved by that committee. The FRCIP initially had twelve projects that were designed to address the specific problems identified in the audit. A thirteenth project was added in mid-2001 to define the term 'operating earnings.'[322] Quarterly progress reports were provided to the Audit Committee. Those reports were prepared by the Controller and his staff, reviewed by the CFO and Internal Audit, and then presented to the committee with the External Auditor and Internal Audit in attendance.

On March 1, 2002, Phase I of the FRCIP was reported to be complete. A new plan then replaced the FRCIP, taking into account progress made under the latter as well

[319] Draft memo from Charles Foster, Subject: Reassignment of Gary Kain from SS&TG to Funding & Investments, September 15, 2000, OF CF 01654.
[320] OFHEO Interview, Paul Peterson, August 27, 2003, p. 117.
[321] Financial Reporting Audit, August 11, 2000, OF 1600176.
[322] "Operating Earnings" is a non-GAAP metric used in the 2001 and 2002 disclosures of Freddie Mac.

as problems identified as a result of the GMS reconciliation issue. The FRCIP appeared to address all issues that had been identified in the 2000 financial reporting audit. However, several events or "red flags" had occurred that should have led management and the Board to question how well the FRCIP was being implemented:

- The GMS reconciliation problem noted in late 2001 revealed that problems still existed in reconciling the general ledger to subsidiary and third-party data suppliers, which was inconsistent with the progress reported in implementation of the FRCIP.

- In an October 23, 2001 memo concerning the re-assignment of Vice President of Corporate Accounting Jeff Harris, interim Controller Brian Green said that, "[t]o be successful, the Corporate Accounting organization needs to improve more rapidly. Jeff's approach is to envision plans and process changes to change the organization over an extended period of time vs. the need to bring about positive change in the shorter time frames required." Mr. Green went on to voice concern about the interaction of Mr. Harris with the Internal Auditors, specifically commenting on Mr. Harris' "lack of ownership for miscommunications on the FRCIP to include personnel turnover statistics, over hire risk and the appropriate status of key systems project initiatives."[323]

- In February 2002 Bernard Bethke, a Director in Internal Audit, raised some important issues regarding the FRCIP. Mr. Bethke pointed out that the Service Level Agreements (SLAs)[324] still needed to be implemented (progress reports only indicated that SLAs were available for all suppliers of data). He also stated that the reporting of unreconciled differences was misstated because Corporate Accounting subtracted some items that were considered to have a material financial impact even though they had not been fully reconciled.[325] Finally, Mr. Bethke asked the most important question: would the FRCIP achieve the desired results? The substance of that e-mail raised

[323] Memorandum from Brian Green to John Williams, "Reassignment of Jeff Harris," October 23, 2001, FM C0003928 – FM C0003929.

[324] Service Level Agreements attempted to identify the roles and responsibilities of Division Controllers in the financial reporting process. It was felt that those positions needed to be held more accountable for the quality of information supplied to Corporate Accounting.

[325] An example includes a $27 million unreconciled interest accrual that CFO Clarke appears to have withheld, after its discovery in December 2001, because it was reportedly still under investigation and the Audit Committee had not yet been informed of the item. The Audit Committee was informed of the item after it was reconciled and taken into income in the third quarter of 2002. Baker Botts did not find that management "deliberately attempted to hide" this issue. Baker Botts, "Supplemental Report to the Board of Directors of the Federal Home Loan Mortgage Corporation Regarding the Internal Investigation of Certain Accounting and Related Matters," November 18, 2003, pp. 22-23.

a concern as to whether the FRCIP fully addressed problems in financial reporting and whether reports to the Audit Committee provided sufficient information to monitor the progress of management. There is no evidence that senior management ever addressed those issues.[326]

- Mr. Bethke also reported that there were no material staffing shortages within Corporate Accounting, although significant key dependencies still existed. He stated further that there was insufficient back-up to address key dependencies, which contradicted his statement that there were no material staff shortages.[327]

- The FRCIP Progress Reports prepared for the Audit Committee were difficult to read and understand. That is clear from inconsistencies in the responses to special examination questioning about the staffing in Corporate Accounting given by Director Thomas Jones, Internal Auditor Melvin Kann, and former Controller Gregory Reynolds. According to Mr. Jones, a progress report only indicated that a plan was in place to attain staffing, but to Mr. Kann and Mr. Reynolds it meant that Corporate Accounting was fully staffed. Those inconsistencies are not surprising, given those in the e-mail of Mr. Bethke.[328]

- It seems that the FRCIP had control issues of its own. The Financial Reporting Audit in November 2002 again rated controls as "marginal" while finding many of the same problems as well as some new ones:[329]

> Corporate Accounting's oversight and monitoring of corporate–wide accounting processes needs improvements …
>
> The lack of systems processing capabilities and systems integration between the general ledger and business area systems results in significant manual intervention, creates bottlenecks, and increases the risk of error in the financial statements …
>
> Corporate Accounting's procedures for documenting and supporting some reserve accounts need improvement …
>
> Changes in accounting rules and the supporting accounting guidance are not implemented timely into operational

[326] Email Bernard Bethke to Barry Goldman, February 20, 2002. OF 1670934.
[327] *Id.*
[328] OFHEO Interview, Melvin Kann, August 22, 2003, pp. 122-123; OFHEO Interview, Thomas Jones, August 12, 2003, pp. 18-19; and OFHEO Interview, Gregory Reynolds, October 2, 2003, p. 103.
[329] Financial Reporting Audit #2002-49, November 21, 2002, OF 1600485 – OF 1600513.

> accounting policies and procedures. Some accounting practices are not consistent with Corporate accounting policies and/or GAAP.

Despite another negative evaluation of the financial reporting controls of Freddie Mac and the increased number of significant findings, the Audit Committee felt that the FRCIP was meeting its objectives.[330] In testimony before the special examination, former Controller Reynolds stated that management and the Board were aware of the problems. When questioned about the knowledge of the Audit Committee concerning control and resource issues, he replied:

> I certainly told them that we had significant control resource issues in the process. I talked specifically about the convergence of the rapidly growing business, particularly in the portfolio management arena, the stress on the system of having to provide resources to support a general ledger implementation, having to provide the resources to support a Y2K conversion, and having to provide the resources to prepare for major accounting rule changes, probably most generally FAS 133 on derivatives accounting. So I definitely told the Audit Committee that there were significant resource stresses on the process.[331]

Evidence to date suggests that senior management and the Board of Directors of Freddie Mac knew of a serious problem and yet refused to accept full responsibility and commit the resources necessary to assure that the problem was corrected.

Weaknesses in the Internal Audit Function

Many of the accounting weaknesses discussed above were identified by the Internal Audit (IA) Department of Freddie Mac but remained outstanding for a number of years. The special examination revealed that the performance of IA did not comport with industry standards or best practices in the areas of competency and communication with management and the Board. Specifically, the IA function did not fully meet the Standards for the Professional Practice of Internal Auditing promulgated by the Institute of Internal Auditors (IIA). Those standards define the objective of the IA function as

[330] OFHEO Interview, Thomas Jones, August 12, 2003, p. 18.
[331] OFHEO Interview, Gregory Reynolds, October 2, 2003, pp. 60-61.

"adding value and improving the operations of the organization by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and the governance processes."[332]

The remainder of this section focuses on the weaknesses noted in the IA function as it relates to the areas of competency and communication with the Board and management and the inability of IA to evaluate risk management and control. By their nature, those identified weaknesses diminished the ability of IA to assist management in evaluating and improving its corporate governance processes. The special examination has classified the weaknesses into three areas:

1. Ineffective evaluation of risk exposures relating to the governance and operations of the Enterprise. The ineffective evaluation of risk exposures resulted from the lack of responsibility on the part of IA for the reliability and integrity of financial information.

2. Inefficient maintenance of effective controls and promotion of continuous improvement. The inefficient maintenance of effective controls resulted from the insufficient review and follow-up by IA of audit "Agreed Upon Actions" to ascertain proper implementation and performance.

3. Ineffective communication to the Board and Senior Management of the status of significant risk exposures and control issues.

Lack of Responsibility Regarding Financial Information

The December 3, 1993 Charter of the Internal Audit Department of Freddie Mac is silent concerning the responsibility of IA for the integrity of the financial information of the Enterprise. However, the Charter does explicitly assert that the IA Department should

[332] Excerpted from the Institute of Internal Auditors (IIA), Guidance Overview of the Professional Practices Framework, October 18, 2001. In June 1999, the IIA approved a new definition of internal auditing and a new Professional Practices Framework (PPF). The purpose of that Framework was to organize the full range of internal audit guidance in a manner that is readily accessible on a timely basis. The PPF is intended to assist practitioners throughout the world in being responsive to the expanding market for high-quality internal audit services. The PPF describes its Standards as the criteria by which the operations of an internal audit department should be evaluated. The standards are intended to represent best practices for internal auditing. The PPF clearly states that its guidance is intended to be applicable to all members of the internal audit profession, whether or not they are members of IIA. The special examination looked to those standards in evaluating the IA function of Freddie Mac.

adhere to the standards and guidelines of the IIA. In fact, pursuant to Freddie Mac Corporate Policy 1-155, in order "[t]o carry out its mission, [the] IA Department will conduct its activities in accordance with standards established by the Institute of Internal Auditors and in accordance with IA Department policies and procedures approved by the Senior Vice President - General Auditor."

In interview during the special examination, Melvin Kann, General Auditor of Freddie Mac, answered questions about the responsibility of IA with regard to the financial reporting of the Enterprise:

> Q: Did your department have any responsibility for determining whether the numbers that are reported in the various financial reports were accurate?
>
> A: No.
>
> Q: Was that a function that was overseen or commented on by Arthur Andersen if you know?
>
> A: They audited numbers. We audited the process.
>
> Q: Can you be more explicit when you say we audited the process?
>
> A: Our focus was a control system and whether the control system provided reasonable assurance that the transactions were recorded in the books and records, that they were authorized in accordance with management's criteria, and that the assets and the information was properly safeguarded. It was the process, the checks and balances, which surround the production of the numbers. We did not deal with the numbers directly.[333]

Here, Mr. Kann asserts that the IA function has no responsibility to assess the integrity of the financial information. However, the International Standards for the Professional Practice of Internal Auditing explicitly state that "the Internal Audit activity should evaluate risk exposures relating to the organization's governance, operations, and

[333] OFHEO Interview, Melvin Kann, August 22, 2003, pp. 21-22.

information systems regarding the reliability and integrity of financial and operational information."[334]

Best practices do not require internal auditors to conduct financial audits, but the IA Department of Freddie Mac should have policies and procedures in place to address its obligation to evaluate risk exposures relative to the reliability and integrity of the financial information of the Enterprise. Given the volume and wide range of accounting errors made by Freddie Mac, the conclusion of the IA Department that financial accounting and reporting controls were marginal was a substantial overstatement of their quality. Thus, the IA Department bears a portion of the responsibility for the errors related to the restatement of the financial reports of Freddie Mac.

Inadequate Follow-Up of Identified Deficiencies

According to the Report of the General Auditor dated March 7, 2003, which was presented to the Audit Committee of the Board, IA describes its follow-up process as follows:

> IA follows-up on all of its Critical and Major Findings (regardless of area risk) and significant regulatory recommendations three months after management has taken corrective action. IA will report back to the [Audit] Committee if management does not complete corrective action by the agreed-upon date or if management extends its target completion date. When it follows-up, IA issues an opinion on the status of the weakness it reported.[335]

Pursuant to the Institute of Internal Auditors Professional Practice Framework, Performance Standards on Control, "[i]nternal auditors should review operations and programs to ascertain the extent to which results are consistent with established goals and

[334] The Institute of Internal Auditors' *International Standards for the Professional Practice of Internal Auditing, Performance Standards – Risk Management 2110.A2*. October 18, 2001.
[335] Report of the General Auditor, March 7, 2003, presentation to the Audit Committee, OF 1669866 – OF 1669872.

objectives to determine whether operations and programs are being implemented or performed as intended."[336]

The special examination selected relevant internal audit reports and noted several instances where major control weaknesses identified in 1998 remain unresolved five years later. In addition to identifying weaknesses, each internal audit report contains a section that outlines "Agreed Upon Actions"—the corrective actions to be taken by appropriate management. The "Agreed Upon Actions" detail the steps that will be taken by management to either correct or mitigate control risks and include completion dates for the actions.

In an interview with the special examination, Mr. Kann was asked about the follow-up process used by IA to review the agreed upon corrective actions:

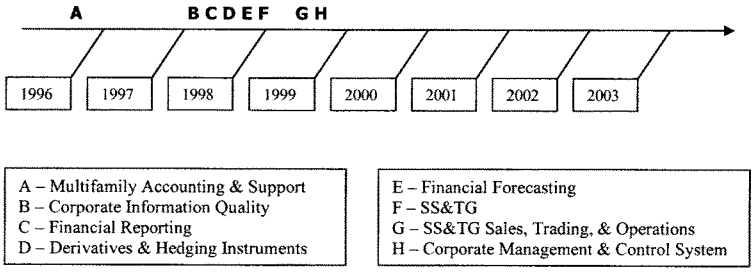
> Q: What follow-up does Internal Audit do to make sure that corrective action has been taken within the time frames as suggested or agreed to by management?
>
> A: Generally, within 90 days after any major or critical recommendation is made, 90 days of the planned corrective action, we will follow up to see if they met their target date and if it was corrected.
>
> Q: How do you follow up?
>
> A: We visit the area, we talk to management, and we make review documentation.[337]
>
> Q: ... And in certain instances you find that the corrective action has not been satisfied or taken, is that correct?
>
> A: In certain instances.
>
> Q: Then what is the next step after that?
>
> A: Management may have reset the target completion date based upon priorities. They may have reduced the seriousness of the issue from a

[336] The Institute of Internal Auditors (IIA), Guidance Overview of the Professional Practices Framework, October 18, 2001.
[337] OFHEO Interview, Melvin Kann, August 22, 2003, pp. 36-37.

> major to another because they have partially remediated it and that may have taken it off our screen. There are a number of others.[338]

Based upon the testimony of Mr. Kann, the special examination has determined that the process of review described is subject to abuse and may allow key outstanding control issues to remain unresolved for excessive periods of time. In fact, the special examination compiled a timeline, shown below, which chronicles several major control weaknesses identified by the IA Department that remained outstanding as of June 2003.

Internal Audit Control Weakness Timeline



In each instance, IA identified the major control weakness and set "Agreed Upon Actions" as well as target completion dates. However, the completion dates of the corrective actions were repeatedly extended. As a result, each of the issues currently remains outstanding. The special examination concludes that the review process utilized by the IA Department was devoid of management accountability for completion of agreed-upon corrective actions in a timely fashion. The process enables area managers to manipulate target completion dates, a practice that the special examination finds unacceptable.

By not following up quickly enough or failing to report the failure of management to remedy major control weaknesses during the period of the restatement, the IA function increased the exposure of Freddie Mac to risk and violated its risk management

[338] *Id.*, p. 86.

objectives. The IIA has outlined the duty of the internal audit function regarding risk management as follows: "The internal audit activity should assist the organization by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and control systems."[339] The MARC review process failed to mitigate adequately the exposure to risk of Freddie Mac and did not comply with either the IIA Risk Management or Control Performance Standards.

Ineffective Communication to the Board and Senior Management

During the period covered by the restatement, senior management and the Board of Freddie Mac used a set of reports which were meant to capture the key control issues and help management analyze and implement effective corporate strategy. Those reports cover every functional area of the corporation and are known as the Management Assessment, Risk, and Controls (MARC reports).

In reviewing several internal audit reports for the years 1998 through 2002, the special examination noted a number of instances where the risk assessment made as a result of the internal audit differed from the assessment made in the MARC report. We also noted several internal audit reports that cited, as a major control weakness, the limitations of the MARC reports. During an interview, we questioned Mr. Kann about the quality of the MARC reports:

> Q: What's your opinion of the MARC system?
>
> A: I think that it's extremely costly and it's very burdensome and there is a more efficient and effective way to get to the result that management desires, but it's a very good step in the right direction even though it's very burdensome.[340]

Although IA noted the deficiencies of the MARC reports as early as 1999, those problems were not addressed. For example, the 1999 audit of Corporate Management

[339] The Institute of Internal Auditors' *International Standards for the Professional Practice of Internal Auditing, Performance Standards – Risk Management 2110,* October 18, 2001.
[340] OFHEO Interview, Melvin Kann, August 22, 2003, p. 80.

and Controls Systems (1999-056) and the follow-up audit that was conducted in 2002 (2002-056) contained the following statements:

> 1999 Audit Comment: Corporate policy defines the MARC as a tool for monitoring controls. However, it was noted that the MARC process is inefficient and inconsistent. The MARC process is time consuming, and the format and quality of the control assessment varies considerably among the business units. Significant differences were noted in the approaches used by various business units to create the MARC and in the quality of assessments.
>
> Agreed Upon Action: Control has worked with Servicer Division on a new reporting prototype to better relate risks and controls. Control will evaluate this new format by June 30, 2000.
>
> 1999 Audit Comment: Corporate policy provides a means for management to accept risks and the level of management approval needed when risks are accepted. This policy is not well known to operating management and the policy does not extend beyond internal audit reports to the MARC process. Finally, there is no delegation of authority to assume risk.
>
> Agreed Upon Action: Control will work with Internal Audit to develop a plan to implement a new MARC reporting process by August 31, 2000.[341]
>
> 2002 Audit Comment: The MARC process is time consuming and the format and quality of the control assessment varies considerably among the business units. It lacks standard definitions of risk, leading to inconsistent approaches by business units to identify risks and control techniques that address those risks. Furthermore, the MARC process does not provide a structured approach to prioritize control weaknesses and operating risks.
>
> Agreed Upon Action: Operation Risk Oversight is currently redesigning the MARC process by incorporating process definitions and common risk language, risk and control rankings, and linkages to top down assessments. The new MARC process, known as MARC II, will utilize the Horizon automated self-assessment tool. The timetable to begin implementation, training and education in selected business areas is the 1st quarter of 2003, with a target completion date for the 4th quarter of 2003.[342]

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[341] Corporate Management and Control System Audit #1999-056, May 26, 2000, OF 1600564.
[342] Corporate Management and Control System Audit #2002-056, January 9, 2003, OF 1600155.

Those statements not only provide evidence of a major control weakness that remained outstanding for an excessive period; they also highlight the reliance of management on a risk-analysis tool that the IA Department identified as a major control weakness. Despite the documented limitation of that tool, management continued to rely on the MARC reports to assess risk exposure and evaluate control activities for three years after the weakness was identified.

During an interview with the special examination, Mr. Thomas Jones, Chairman of the Audit Committee, described the reliance of the Board on the MARC reports and the effectiveness of the IA function as follows:

> Q: What are your duties or how do you see your duties as a member of the audit committee?
>
> A: To execute the responsibilities of overseeing the quality and quantity of resources in the accounting and financial reporting functions; the effectiveness of the controlled environment; the accuracy of the financial statements; the appropriateness of the accounting principles that are adopted; the reliability of the disclosures that are made, disclosures and communications that are made to investors.
>
> Q: How do you go about—Audit Committee—achieving those responsibilities that you've just identified for a member of the Audit Committee?
>
> A: In the case of Freddie Mac, there is a series of standard reports that are presented to the audit committee that addresses those various areas in sensitive accounting estimates, accounting principles, financial control standards, management assessment of controls, an internal audit plan, assessment of effectiveness of a change in the internal audit plan, communications with the outside auditor, an outside auditor opinion on the effectiveness of internal controls, a management letter from the outside auditor; the outside auditor's opinion on the accuracy of the financial statements, the appropriateness of the disclosures. All of those pieces kind of fit into a calendar of reports that are made to the audit committee and then follow-up discussion and inquiry by the audit committee.[343]
>
> Q: Do you think you were getting adequate reports during that period of time from both management and Internal Audit?

[343] OFHEO Interview, Thomas Jones, August 12, 2003, pp. 59-61.

A: Yes. I have no reason to believe otherwise.[344]

The testimony of Mr. Jones reflects the confidence of the Audit Committee and the Board in the quality and candor of the information that it was receiving from the IA Department. The fact that the IA Department did not qualify the reliability of the MARC reports and the Board continued to reply on those reports to assess risk call into question the compliance of IA with the IIA Performance Standard regarding Reporting to the Board and Senior Management.[345]

[344] *Id.*, p. 30.

[345] IIA Performance Standard 2060, Reporting to the Board and Senior Management: "The chief audit executive should report periodically to the Board and Senior Management on the internal audit activity's purpose, authority, responsibility, and performance relative to its plan. Reporting should also include significant risk exposures and control issues, corporate governance issues, and other matters needed or requested by the Board and Senior Management."

VI. DISCLOSURE

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 ("the Act") established OFHEO as an independent office charged with exclusive and autonomous regulatory authority to ensure that the Enterprises maintain adequate capital and operate safely and in accordance with the Act.[346] OFHEO is explicitly authorized to, among other things, "establish capital standards, *require financial disclosure*, prescribe adequate standards for books and records and other internal controls, conduct examinations when necessary, and enforce compliance with the standards and rules that [OFHEO] establishes."[347]

Generally, companies that raise money in public offerings of securities are required to register those offerings with the Securities and Exchange Commission (SEC) under the Securities Act of 1933 (Securities Act).[348] Additionally, such companies must register with the SEC pursuant to the Securities Exchange Act of 1934 (Exchange Act)[349] and file periodic reports. Pursuant to the terms of its federal charter act, Freddie Mac is exempt from all but the antifraud provisions of the federal securities laws.[350] Freddie Mac has announced that it will voluntarily register with the SEC pursuant to Section 12(g) of the Exchange Act upon the completion of the restatement of its financial condition and once it is again making timely filings of financial information. The Enterprise will, however, remain exempt from the registration requirements of the Securities Act.

Freddie Mac routinely issues public disclosure documents that closely track the format and type of content of the annual, quarterly, special reports, and proxy materials filed with the SEC by registered companies. Further, in numerous public statements

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[346] 12 U.S.C. 4513(a).
[347] 12 U.S.C. 4501(6), emphasis added.
[348] 15 U.S.C. 77f.
[349] 15 U.S.C.78*l*(g)(1).
[350] Federal Home Loan Mortgage Corporation Act, 12 U.S.C. 1455. Section 306(g) provides that "[a]ll securities issued or guaranteed by the Corporation ... shall, to the same extent as securities that are direct obligations of or obligations guaranteed as to principal or interest by the United States, be deemed to be exempt securities within the meaning of the laws administered by the Securities and Exchange Commission."

senior Freddie Mac officials maintained that the public disclosures of the Enterprise are best in class and "meet or exceed"[351] SEC reporting standards.

The special examination has demonstrated that Freddie Mac knowingly departed from good public disclosure practices so as to obfuscate particular Enterprise policies as well as specific capital market and accounting transactions used to implement them. As a result, the public disclosures of Freddie Mac during the period investigated by the special examination failed to comport with disclosures required of SEC registered companies that were assertedly adhered to by the Enterprise. The deliberate disdain of Freddie Mac for appropriate disclosure standards in the face of its asserted compliance with best practices misled investors and constituted conduct that undermined market awareness of the true financial condition of the Enterprise.

Disclosures Required by the SEC

Broadly, SEC registrants disclose information to the public through annual reports (Form 10-K), quarterly reports (Form 10-Q), and "special" reports (Form 8-K). Freddie Mac uses forms that are essentially similar to the SEC forms to disclose information to the public on an annual, quarterly, and event-driven basis.

Annual reports of SEC registrants contain audited financial statements and a section providing a discussion and analysis by management of financial condition and results of operations ("MD&A"). SEC rules covering the MD&A section, assertedly adhered to by Freddie Mac, require a company to discuss "any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing

[351] For example, on July 12, 2002, Freddie Mac issued a press release, which stated:

> McLean, VA – Freddie Mac (NYSE: FRE) today announced yet another step in demonstrating its unparalleled financial transparency by initiating ongoing Securities and Exchange Commission (SEC) review of its financial disclosures under the same standards used for other publicly traded companies.
>
> "Freddie Mac has long been at the vanguard of disclosure practices," said Leland C. Brendsel, Chairman and CEO of Freddie Mac. "Because of the vital role we play in America's housing finance system, it is essential that investors, policymakers and regulators have confidence in our financial strength. Freddie Mac already meets or exceeds SEC reporting standards, and today's announcement leaves no doubt that Freddie Mac is subject to the same standards as every other public company."

operations."[352] The use by Freddie Mac of a variety of significant transactions that were specifically designed to "smooth" the earnings of the Enterprise resulted in financial statements that misled investors and the general public. Those transactions should have been fully disclosed. They were not.

Materiality

SEC Rule 10b-5 makes it unlawful for any person "to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading."[353] Consequently, a threshold test in determining whether an information item must be disclosed, in either the context of financial statements or corporate disclosure documents, must be a determination of whether the information is "material." OFHEO promotes corporate transparency in order to enhance safe and sound operations of the Enterprises. The agency looks to evolving best practices for disclosure that go beyond legal minimums in determining what information should be disclosed.

The special examination has established that the accommodating external auditor of Freddie Mac approved accounting treatments for an array of transactions that had little or no economic purpose but "smoothed out" spikes in earnings. In some cases, however, the interpretations of accounting rules left internal and external auditors admittedly uncomfortable with the accounting treatment accorded the transactions. In those cases the Enterprise went forward with its desired accounting interpretation, conferring with the outside auditors, and concluded that even if it the accounting treatment was questionable or wrong, the transactions were immaterial. Objections to adjustments of millions of dollars—for example, the creation of a FAS 91 reserve that is unsupported by Generally Accepted Accounting Principles (GAAP)[354]—were dismissed by auditors and management as immaterial to a company of the size of Freddie Mac.

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[352] Item 303(a)(3)(ii) of Regulation S-K, 17 CFR Part 229.
[353] 17 CFR § 240.10b-5, 15 U.S.C. 78j.
[354] *See,* FAS 91 reserve discussion, *infra,* Chapter III, "Improper Management Earnings."

To that end, Freddie Mac adopted a mechanical definition and application of the concept of materiality. The engagement partner for Arthur Andersen, Robert Arnall, said that his firm applied a five percent of net income "rule of thumb" standard to determine materiality.[355] For the years 1999, 2000, 2001, and 2002, those net income amounts would be approximately 2.2, 2.5, 4.1, and 5.7 billion dollars respectively, thereby allowing transactions ranging from 100 million to 285 million dollars to be deemed immaterial. However, the engagement partner for Arthur Andersen, the outside auditing firm for Freddie Mac, believed nothing was wrong in such treatment of multimillion-dollar transactions.[356]

The SEC has addressed and specifically rejected the five percent of net income approach as a mechanical and inadequate standard for determining materiality. In SEC Staff Accounting Bulletin 99 (SAB 99),[357] issued in August 1999, the SEC took the position:

> The staff is aware that certain registrants, over time, have developed quantitative thresholds as "rules of thumb" to assist in the preparation of their financial statements, and that auditors also have used these thresholds in their evaluation of whether items might be considered material to users of a registrant's financial statements. One rule of thumb in particular suggests that the misstatement or omission[1] of an item that falls under a 5% threshold is not material in the absence of particularly egregious circumstances, such as self-dealing or misappropriation by senior management. The staff reminds registrants and the auditors of their financial statements that exclusive reliance on this or any percentage or numerical threshold has no basis in the accounting literature or the law ... Materiality concerns the significance of an item to users of a registrant's financial statements. A matter is "material" if there is a substantial likelihood that a reasonable person would consider it important.
>
> [1] As used in this SAB, "misstatement" or "omission" refers to a financial statement assertion that would not be in conformity with GAAP.

Freddie Mac defends its actions on the grounds that it relied on the opinions of Arthur Andersen, including on materiality determinations. Unfortunately, Arthur

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[355] Internal notes prepared by OFHEO, Re: Robert Arnall Interview, July 21, 2003.
[356] *Id.*
[357] Staff Accounting Bulletin (SAB) No. 99, "Materiality," on August 12, 1999, 17 CFR Part 211, Subpart B.

Andersen was as incorrect as their engagement partner was adamant. Robert Arnall, the Arthur Andersen engagement partner, explained that the Arthur Andersen materiality standard for public companies was five percent of expected net income. While Arthur Andersen did not base that standard on any specific SEC interpretation of materiality, the firm considered the standard to be consistent with SEC interpretations.[358]

A review of the accounting literature amplifies the rejection by the SEC of the five percent test. The Financial Accounting Standards Board, in its Statement of Financial Accounting Concepts No. 2, opined that the essence of materiality is:

> The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.[359]

As subsequently noted by the SEC in SAB 99, the

> formulation in the accounting literature is in substance identical to the formulation used by the courts in interpreting the federal securities laws. The Supreme Court has held that a fact is material if there is—a substantial likelihood that the ... fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available...[1]
>
> The shorthand in the accounting and auditing literature for this analysis is that financial management and the auditor must consider both 'quantitative' and 'qualitative' factors in assessing an item's materiality.[2] Court decisions, Commission rules and enforcement actions, and accounting and auditing literature have all considered 'qualitative' factors in various contexts.[3]
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> [1] TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also Basic, Inc. v. Levinson, 485 U.S. 224 (1988). As the Supreme Court has noted, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him ...." TSC Industries, 426 U.S. at 450.
>
> [2] *See*, e.g., Concepts Statement No. 2, 123-124; AU § 312.10 (" ... materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations."); AU § 312.34 ("Qualitative considerations also influence

[358] Internal notes prepared by OFHEO, Re: Robert Arnall Interview, July 21, 2003.

[359] Financial Accounting Standards Board (FASB) 1980, "Qualitative Characteristics of Accounting Information." Statement of Financial Accounting Concepts No. 2, paragraph 132. Norwalk, CT: FASB.

the auditor in reaching a conclusion as to whether misstatements are material."). As used in the accounting literature and in this SAB, "qualitative" materiality refers to the surrounding circumstances that inform an investor's evaluation of financial statement entries. Whether events may be material to investors for non-financial reasons is a matter not addressed by this SAB.

[3] *See*, e.g., Rule 1-02(o) of Regulation S-X, 17 CFR 210.1-02(o), Rule 405 of Regulation C, 17 CFR 230.405, and Rule 12b-2, 17 CFR 240.12b-2; AU §§ 312.10 - .11, 317.13, 411.04 n. 1, and 508.36; In re Kidder Peabody Securities Litigation, 10 F. Supp. 2d 398 (S.D.N.Y. 1998); Parnes v. Gateway 2000, Inc., 122 F.3d 539 (8th Cir. 1997); In re Westinghouse Securities Litigation, 90 F.3d 696 (3d Cir. 1996); In the Matter of W.R. Grace & Co., Accounting and Auditing Enforcement Release No. ("AAER") 1140 (June 30, 1999); In the Matter of Eugene Gaughan, AAER 1141 (June 30, 1999); In the Matter of Thomas Scanlon, AAER 1142 (June 30, 1999); and In re Sensormatic Electronics Corporation, Sec. Act Rel. No. 7518 (March 25, 1998). have all considered "qualitative" factors in various contexts.

The special examination finds particularly noteworthy the analysis by the SEC staff of factors that could lead to misstatements of relatively small amounts that could have a material effect on the financial statements. Among the considerations listed by the SEC that may well render material a quantitatively small misstatement of a financial statement item, a number apply to the actions of Freddie Mac we have investigated. For example, the SEC suggested that such circumstances would be whether the misstatement masks a change in earnings or other trends.[360] That was exactly the issue at Freddie Mac in that those transactions had little or no business purpose and were entered into almost exclusively for the purpose of managing earnings.

OFHEO notes that the disclosure practices of Freddie Mac failed to embrace the SEC definition of materiality. That failure was effectively encouraged by the outside auditor of the Enterprise, with which Freddie Mac concurred. As noted above, Robert Arnall stated that the five percent standard for materiality used by Arthur Andersen was not based on any SEC guidance.

A second example given by SEC staff of when seemingly immaterial transactions are nonetheless significant occurs when a misstatement hides a failure to meet consensus expectations of stock analysts.[361] The special examination has documented extensive preoccupation at the Enterprise with achieving analyst earnings estimates.

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[360] SAB 99, pp. 3-4.
[361] SAB 99, pp. 3-4.

Of particular concern to the special examination was the statement by Mr. Parseghian that transactions undertaken to manipulate earnings could be justified solely by their favorable impact on the regulatory capital requirements of the Enterprise.[362] The SEC staff stated that one consideration in determining if a relatively small issue might be material is whether the misstatement affects the compliance with regulatory requirements of the registrant.

Finally, with a large portion of the bonus of an executive being tied to earnings, the manipulation of those figures through transactions that were otherwise arguably immaterial in size, might be material by applying the SEC-suggested criterion of whether the misstatement has the effect of increasing the compensation of management—for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation.[363]

The actions by Freddie Mac to manipulate earnings through inappropriate accounting practices are hardly a new issue for disclosure regulators. Similar attempts by other companies have been so frequent that the SEC staff bulletin explicitly addresses materiality in the context of management of earnings. The special examination finds that analysis persuasive and applicable to Freddie Mac as reflecting industry standards. As stated in Staff Bulletin 99:

> ... the staff believes that a registrant and the auditors of its financial statements should not assume that even small intentional misstatements in financial statements, for example those pursuant to actions to "manage" earnings, are immaterial.[1] While the intent of management does not render a misstatement material, it may provide significant evidence of materiality.
>
> The evidence may be particularly compelling where management has intentionally misstated items in the financial statements to "manage" reported earnings. In that instance, it presumably has done so believing

[362] "... [W]e viewed it as a legitimate business purpose to—with no loss of risk management goals—if we could have more stable GAAP earnings. Our minimum capital is based on GAAP earnings, and so we did and continue to view it as a legitimate business purpose if we can—in—in transactions that are consistent with GAAP—have no adverse impact on our—on our risk managers, if we can have more consistent, stable GAAP earnings, because that will lead to more stable minimum capital requirements." OFHEO Interview, Gregory Parseghian, August 4, 2003, p. 46.

[363] SAB 99, p. 4.

> that the resulting amounts and trends would be significant to users of the registrant's financial statements.[2] The staff believes that investors generally would regard as significant a management practice to over- or under-state earnings up to an amount just short of a percentage threshold in order to "manage" earnings. Investors presumably also would regard as significant an accounting practice that, in essence, rendered all earnings figures subject to a management-directed margin of misstatement.[364]
>
> [1] Intentional management of earnings and intentional misstatements, as used in this SAB, do not include insignificant errors and omissions that may occur in systems and recurring processes in the normal course of business. See notes 75 and 87 *infra*.
> [2] Assessments of materiality should occur not only at year-end, but also during the preparation of each quarterly or interim financial statement. *See*, e.g., In the Matter of Venator Group, Inc., AAER 1049 (June 29, 1998).

The representative of Arthur Andersen either did not know or understand the impropriety of an exclusively quantitative, five percent approach. However, some directors at Freddie Mac were apparently aware of the legal and accounting standard for materiality. In an interview with the special examination, Freddie Mac Director Thomas Jones, the Chairman of the Audit Committee, stated:

> A: ... [P]ut it in context. Frankly, from many perspectives the only material reserve on the balance sheet was the loan loss reserve. I guess that was at a level of, if I recall correctly, eight or nine hundred million dollars. Most of these other reserves, most of the ones we looked at, tax loss reserve, the legal contingency, I think this FAS 91, were $100 to $200 million, which were not very big numbers.
>
> Q: Is materiality determined in your view solely by the amount?
>
> A: No. There is such a thing as qualitative materiality as well, so if at any time—and that's where Rob Arnall could have made the point if he wished to, that even though the numbers going through these reserves are relatively small, measured in the context of Freddie Mac's balance sheet and P&L, even though the numbers were relatively small and therefore don't meet a quantitative materiality test, there is a qualitative materiality test which is if you're not in compliance with GAAP it can be qualitatively material even if it's not quantitatively material. That point was never made.
>
> Q: You understand that there are those two components of materiality irrespective of whether Mr. Arnall brought it to your attention. Is that right?

[364] *Id.*, p. 5.

A: Yes, I do.

Q: And you understood that for some time prior to 2003, is that correct?

A: I never understood that we had any questions, any issues of qualitative materiality.

Q: I appreciate that you may not but I want to make sure of this. You understood that there were these two components of materiality, qualitative and quantitative, is that right?

A: Yes.

Q: And what I understand you to be saying is Mr. Arnall never brought to your attention that there was an issue about the qualitative nature of this?

A: Right. To the best of my knowledge he never raised an issue of non-compliance with GAAP with regard to any of these reserves.[365]

Despite the expressed knowledge of the Chairman of the Audit Committee, the special examination has found no evidence that any member of the Board or Audit Committee objected to the use of the mechanical five percent test suggested by Arthur Andersen or its engagement partner.

In at least one interview, the Corporate Controller of Freddie Mac demonstrated he, too, was familiar with the issue and the relevant SEC Staff Bulletin. Edmond Sannini testified:

A: We began to mark the derivatives to market as would be required. We measured the effect of that on previous quarters to determine whether in any previous period that error would have been material under SAB 99 and actually prepared the schedule.

Q: SAB is staff –

A: Staff accounting bulletin of the Securities and Exchange Commission dealing with materiality.

Q: And that deals with materiality not only as to amount but also as to accuracy of the statement; isn't that right?

[365] OFHEO Interview, Thomas Jones, August 12, 2003, pp. 176-179.

A: Correct. Both quantitative and qualitative measures.

Q: And so even though a particular accounting treatment would be nonmaterial in the sense of quantitative, there would still be an analysis to determine whether a particular accounting treatment was qualitatively correct; isn't that right?

A: That is true.[366]

The testimony of other executives of Freddie Mac, however, ranged from denials of understanding the law governing materiality to memory lapses concerning their understandings at the times in question. For example, the Market Risk Oversight Officer, Robert Dean, did not believe that a set quantitative standard had been applied at Freddie Mac.

Q: The question is in disclosing PMVS measures for a particular point in time, did he consider whether he should base that result on the swaptions valuation approach that was being used for the fair value balance sheet and the accounting statements as opposed to some other methodology of getting the values…

A: The answer is yes, we did consider it. The analysis I just referred you to was what we used to do the consideration. We concluded that a .15 change in the PMVS would be immaterial and therefore decided that there was no reason to adjust, specifically adjust the PMVS measure.

Q: Did you have a materiality standard of some sort? How did you come to that conclusion?

A: We did not have—we have really just a standard of reasonableness. There may not have been a set policy but at that point in time we said .15 relative to 2.4 percent where the 2.4 is already an extremely low number, to us common sense says that's a very small change on a very low number already.[367]

The former head of Funding and Investments and later Chief Executive Officer, Gregory Parseghian, indicated that he might not have understood the legal and accounting standard at the time it was being applied to various specific transactions, and thought the only issue involved was the requirement to avoid fraud.

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[366] OFHEO Interview, Edmond Sannini, August 1, 2003, pp. 141-142.
[367] OFHEO Interview, Robert Dean, July 31, 2003, pp. 105-106.

Q: Does GAAP recognize a component of materiality that involves misleading statements? In other words, in order to comply with GAAP, did the statements that you would make in connection with your financial statements have to be not misleading?

A: You know, you're asking me areas of disclosure now, disclosure law.

Q: Yes.

A: It's—I'm not—you know, it's my understanding that disclosures cannot be misleading.

Q: And whether that's part of GAAP or not is why I'm hearing you pause—

A: Yes, yes.

Q: —in your answer?

A: I know now that—I'm not sure what I knew on January 18, 2001 about disclosure. I, again, did not really have a level of knowledge at that time that I'm proud of today. I know more today, and I certainly know that disclosures cannot be misleading.[368]

The chief legal officer, General Counsel Maud Mater, in testimony that lacks credibility, did not remember addressing the materiality issue at a time when the SEC was questioning the Enterprise on the issue in connection with loan loss reserves:

Q: Does it appear to you that the middle column is to identify what Freddie Mac's management is doing in response to the SEC's concern?

A: That's the column heading, yes.

Q: And so that's the way it appears to you?

A: I would infer that the items under the column heading are related to the column.

Q: Now if you look at an example of another SEC concern in the middle of the page that I have.

A: Yes, I see.

[368] OFHEO Interview, Gregory Parseghian, v.2, August 4, 2003, p. 20.

Q: Page 4 of Exhibit 5, there's a heading. Do you see that?

A: I do see it.

Q: And do you see that an SEC concern about or examples of quote, "Earnings management is intentionally recording errors, (i.e., violation of GAAP) and arguing that the effect is immaterial?"

A: I do see that, yes.

Q: Do you recall back in this time period having knowledge that that was an SEC concern?

A: I don't have any recollections.

Q: Did you have at any time that it was or is an SEC concern that intentionally recording errors i.e., violation of GAAP and arguing that the effect is immaterial is one of the concerns they had about earnings management, "they" being the SEC?

A: I don't have particular recollections of that aspect of the SEC's perspectives.

Q: How about in general? Do you have any general recollection that that was of concern to the SEC under this general rubric of earnings management?

A: I don't have particular recollections in that area, no.[369]

The special examination concludes that the executive officers of Freddie Mac, acting in conjunction with the outside auditor of the Enterprise, in interpreting materiality by means of a five percent of net income standard, without consideration of clearly relevant qualitative factors, acted improperly and in a manner that resulted in numerous inadequacies in financial disclosures of Freddie Mac.

A Culture of Minimal Disclosure

The specific failures of Freddie Mac to make adequate disclosures were not isolated instances, but reflected an Enterprise-wide culture. That culture contributed to many of the problems noted by the special examination in the disclosure area.

[369] OFHEO Interview, Maud Mater, July 30, 2003, pp. 104-105.

For example, according to Lisa Roberts, Corporate Accounting, Freddie Mac had a "philosophy or culture, if you will, to minimize disclosure."[370] Ms. Roberts felt that culture was in large part due to a fear that providing more detailed disclosure to the public could result in the investors reaching inappropriate conclusions. Ms. Roberts also thought that there was some concern that by providing more detailed disclosure, Freddie Mac would be disclosing proprietary strategies.[371]

That view of the disclosure philosophy of Freddie Mac was widely held throughout the Enterprise. For example, Mr. Parseghian testified that both CEO Leland Brendsel and General Counsel Maud Mater preferred less disclosure.[372] Ms. Roberts also testified that Shareholder Relations cited a preference for limited disclosures out of a "concern with a typical user's ability to grasp and understand the issues."[373]

The Legal Department also appears to have applied that "less is more" philosophy when formulating legal opinions regarding the disclosure of specific transactions. Steven Dinces, a Vice President and Deputy General Counsel, told the special examination that he used an always exclusionary, two-pronged test to determine whether a transaction should be individually disclosed: 1) Does the transaction have a valid business purpose? or 2) Was the transaction properly recorded in accordance with GAAP?[374] Under questioning, however, Mr. Dinces could not recall any instance where a specific transaction executed by Freddie Mac failed to meet either prong of the test and thus would have needed to be specifically disclosed.[375] It should have been clear that the test was inappropriate.

Illustrative of the "culture of minimal disclosure" of Freddie Mac is the internal reporting and public disclosure by the Enterprise of Coupon Trade-Up Giants (CTUGs).[376] Mr. Parseghian failed to provide the Board with adequate information regarding the CTUG transactions necessary to make an informed decision about those

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[370] OFHEO Interview, Lisa Roberts, August 6, 2003, p. 44.
[371] *Id.*, p. 45.
[372] OFHEO Interview, Gregory Parseghian, v.1, August 4, 2003, p. 249.
[373] OFHEO Interview, Lisa Roberts, August 6, 2003, p. 46.
[374] OFHEO Interview, Steven Dinces, August 20, 2003, p. 54.
[375] *Id.*
[376] *See,* CTUGs discussions, *infra.* Chapter III, "Improper Management of Earnings."

transactions. The public disclosures of the transactions by Freddie Mac were also inadequate.

Throughout 2000, Freddie Mac management made the Board of Directors aware of the challenges posed by implementation of FAS 133 and the fact that the Enterprise employed measures to lessen the impact of the new standard. The December 1, 2000 Financial Outlook report to the Board of Directors[377] suggested that "FAS 133 will create EPS volatility ... one time transition adjustment; $600-$700 million pre-tax gain ... potential transactions will make this gain earnings neutral."[378] Senior management notified the Board of its intention to minimize the volatility caused by FAS 133 but failed to disclose the methods by which the effects of FAS 133 were to be mitigated.

For example, management provided the Securitization Committee of the Board with only partial information about the $30 billion CTUGs. Freddie Mac internal procedures required transactions in excess of $5 billion to be disclosed to the Board. Transactions in excess of $11 billion had to be approved.[379] For mostly business reasons, the CTUGs were separated into four parts. Thus, no single transaction reached the $11 billion threshold for Board approval.[380] Mr. Parseghian disclosed only a single $10 billion CTUG transaction, which exceeded the disclosure but not the approval level, to the Securitization Committee in December 2000.[381] Furthermore, Mr. Parseghian knew that each of the four transactions was, in fact, part of a $30 billion strategy, and should have informed the Board of the total.[382] Ronald Poe, chairman of the Securitization Committee, testified that he could not recall either he or the committee being advised of

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[377] Meeting of the Board of Directors, "2001 Business Plan, Financial Outlook," December 1, 2000, OF 5012089 – OF 5012108.

[378] *Id.*, OF 5012099.

[379] OFHEO Interview, Gregory Parseghian, v.1, August 4, 2003, p. 176.

[380] The CTUGs were executed as four separate transactions—two $10 billion transactions (executed on 11/30/00 and 12/8/00), one $6 billion transaction (executed on 12/8/00), and one $4 billion transaction (executed on 11/30/00). That detail was provided in the November 29, 2000 VIU memorandum Mr. Parseghian approved. OF 2013067 – OF 2013069.

[381] As of the December 1, 2000 Securitization Committee meeting, only one of the three CTUG transactions over $5 billion had been executed. However, Mr. Parseghian was aware of the other two transactions on that date. While Mr. Parseghian testified that he reported orally on those other two transactions, there is no documentary or testimonial evidence that the two CTUG transactions that were executed on December 8, 2000, were ever reported to the Securitization Committee.

[382] Transactions of greater than $5 billion are to be reported to the Securitization Committee. OFHEO Interview, Ronald Poe, September 16, 2003, p. 17.

the other three transactions,[383] and that he would have wanted the disclosure made to the committee: "[i]t would have permitted me to understand the entire scope of ... the CTUG transaction rather than just the $10 billion piece of which I was made aware."[384] As a direct result of the failure of Mr. Parseghian to inform the Securitization Committee of the details of each CTUG transaction, Director Poe incorrectly reported a $10 billion CTUG transaction to the Board of Directors instead of the actual $30 billion transaction.[385]

The public disclosures of Freddie Mac regarding the CTUGs were inadequate and thereby misleading.[386] None of those transactions were fully described in public disclosures made by the Enterprise or its officers. The only disclosure of the specific amounts at issue in the CTUG transactions was minimal and came at the end of 2001.[387] The inadequacies of the CTUG disclosures relate to accounting standards FAS 115 and FAS 140. Per FAS 115, Freddie Mac should have disclosed the gross movement of securities from hold-to-maturity to trading, along with the loss on that transfer of securities in the first quarter 2001 Investor Analyst report of the Enterprise.[388] Per FAS 140, disclosure was required of 1) the characteristics of the securitizations and 2) cash flows between the securitization special purpose entity and the transferor, unless reported separately elsewhere in the financial statements or notes.[389]

The disclosure of the CTUG transactions demonstrates the inadequacy of the process of reporting to the Board of Directors of Freddie Mac and of the public statements of the Enterprise. The special examination has identified similar problems of

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[383] OFHEO Interview, Ronald Poe, September 16, 2003, p. 24.
[384] *Id.*, p. 27.
[385] *Id.*, pp. 24-25.
[386] For example, Vaughn Clarke did not "plan to discuss the specific items/amounts that resulted in our small net transition adjustment to earnings as part of the Earnings Release/Conference Call" for 1st quarter 2001. FM 159412-FM 159419.
[387] Freddie Mac Year-End 2001 Financial Statement, Note 3, "On January 1, 2001, Freddie Mac transferred approximately $36 billion of PCs from the held-to-maturity portfolio to the trading portfolio, generating a $708 million loss reflected as a component of the FAS 133's cumulative change in accounting principle. Additionally, as part of the FAS 133 transition adjustment, Freddie Mac transferred $59 billion of PCs from the held-to-maturity portfolio to the AFS portfolio resulting in a $419 million gain in AOCI ($272 million, net of tax)." OF 2013256 – OF 2013257.
[388] Freddie Mac Executive Summaries and Chronologies Updated through May 16, 2003, OF 2010769 – OF 2010770.
[389] *Id.*, OF 2010769.

inadequate disclosure with respect to swaptions valuation,[390] linked swaps,[391] J-Deals,[392] Participation Certificate (PC) smoothing,[393] Government Securities Clearing Corporation (GSCC) short sales and spreadlocks,[394] and transactions involving the FAS 91 reserve and loan loss reserves.[395]

The Failure of the Internal Controls of Freddie Mac

An effective internal controls system is a necessary condition for the successful production of materially accurate public disclosures and financial statements. At Freddie Mac there were differing opinions, discussed below, about whom, if anyone, in the Enterprise was ultimately responsible for disclosure. The lack of acknowledged responsibility and accountability for public disclosure matters reflects a critical deficiency in the internal control structure of the Enterprise—and inattention of management and the Board to such controls.

The Sarbanes-Oxley Act of 2002 and supporting SEC regulations[396] require public companies to have internal control over financial reporting that encompasses a process designed by, or under the supervision of, the registrant's principal executive and

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[390] *See,* swaptions valuation discussion, *infra,* Chapter III, "Improper Management of Earnings."

[391] *See,* linked swaps discussions, *infra,* Chapter III, "Improper Management of Earnings."

[392] *See,* discussion of J-Deals, *infra,* Chapter IV, "Counterparties," footnote 241.

[393] "PC smoothing" relates to a methodology for recognizing interest expense arising from prepayments of Freddie Mac Participation Certificates (PCs) that the Enterprise receives and later remits to investors. Beginning in 1985, Freddie Mac recognized that expense over the period from the date of prepayment to the date of remittance to the investor, rather than in the month the mortgage prepayment occurred. Following discussions with its new auditor, PricewaterhouseCoopers, the Enterprise now recognizes the entire interest expense in the month of the prepayment. *See* Baker Botts, "Executive Summary for PC Smoothing," OF 2010900.

[394] The Government Securities Clearing Corporation ("GSCC") is a not-for-profit entity providing netting and settlement services for dealers in U.S. Treasury and agency securities. Freddie Mac attempted to achieve hedge accounting by simulating the purchase/sale of Treasury securities with one counterparty and simultaneously entering into a repo/reverse repo with another counterparty by executing the transactions through GSCC. PricewaterhouseCoopers deemed the classification of those Treasury-based transactions as derivatives to be incorrect. Baker Botts, "Executive Summary for GSCC Short Sales and Spreadlocks," OF 2010906. The cumulative effect of the restatement of those transactions was an upward adjustment of $768 million in Net Income Before Taxes, and a $404 million upward adjustment in Accumulated Other Comprehensive Income Before Taxes, in 2000 to 2002. See Freddie Mac Restatement Results, November 21, 2003, Appendix II, page 6.

[395] *See,* loan loss reserve and FAS 91 reserve discussions, *infra,* Chapter III, "Improper Management of Earnings."

[396] The Sarbanes Oxley Act, 107 Pub. L. No. 204, 116 Stat. 745, July 30, 2002, required the SEC to adopt regulations to carry out the provisions of the act. These are found in SEC Release No. 34-46079.

principal financial officers, or persons performing similar functions, and effected by the registrant's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that: (1) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the registrant; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the registrant are being made only in accordance with authorizations of management and directors of the registrant; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the registrant's assets that could have a material effect on the financial statements.[397]

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, the SEC recently adopted rules requiring public companies to include in their annual reports a management report regarding control over financial reporting at a company. The SEC requires an

> internal control report [to] include: a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company; management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year; a statement identifying the framework used by management to evaluate the effectiveness of the company's internal control over financial reporting; and a statement that the registered public accounting firm that audited the company's financial statements included in the annual report has issued an attestation report on management's assessment of the company's internal control over financial reporting.[398]

Although Sarbanes-Oxley was enacted after the events under consideration here took place, examining its provisions is an instructive guide to evolving best practices.

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[397] Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, SEC Release No. 33-8238, June 5, 2003. 68 Fed. Reg. 36636, 36640 (2003).
[398] *Id*, p. 13.

The special examination concludes that the failure of Freddie Mac to establish and maintain effective internal controls, particularly to assign clear responsibility and accountability for disclosure issues, contributed to the deficiencies reviewed here. That in turn is the direct result of senior management failing to prioritize adequately the goal of maintaining and further developing the financial reporting systems of the Enterprise. Indeed, the culture that was nurtured at Freddie Mac created an environment in which senior management treated the accounting and financial reporting systems of the Enterprise like "second class citizens."[399] That inappropriate "tone at the top" regarding financial reporting was largely responsible for the longtime failure of management to allocate adequate resources to Corporate Accounting and its financial reports and controls group.

Notably, the internal control system of Freddie Mac did not include an effective compliance program. The compliance operations of the Enterprise are decentralized, separated among its individual business units and without central oversight by the Legal Department or anyone else. Freddie Mac did not have a standard corporate policy governing the compliance function, including procedures for consulting the legal and accounting departments of the Enterprise. As such, the business units were expected to function on the basis of the individual assessment of each unit of the adequacy of its compliance with legal and accounting standards. Neither the Legal Department of Freddie Mac nor Financial Reporting within Corporate Accounting had charge of the compliance operations of the Enterprise. In fact, General Counsel Maud Mater stated emphatically to the special examination that "the Legal Department did not have a compliance role" under her watch.[400] The Legal Department would respond to specific business unit questions regarding specific compliance issues, but was "not a compliance operation."[401]

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[399] OFHEO Interview, Gregory Reynolds, October 2, 2003, pp. 135-136. According to Mr. Reynolds, that group was "always the last ones to get the budget dollars ... it was far easier to get money allocated to some new security product, some new trading plan. To get money allocated to back office and infrastructure was a serious uphill battle. It wasn't appreciated, the importance of it was not recognized and, therefore, the resources were not allocated." According to Gregory Reynolds, former Comptroller, that corporate culture has existed since the 1980's. *Id.*, p. 137.
[400] OFHEO Interview, Maud Mater, July 30, 2003, p. 21.
[401] *Id.*

Significantly, the special examination has revealed confusion and inconsistency in Freddie Mac as to which division, if any, had final control of and responsibility for the public disclosures of the Enterprise. Ms. Mater asserted that the procedures of Freddie Mac for quarterly and annual financial reporting are "owned and run by the Chief Financial Officer and the Controller."[402] Indeed, the financial disclosures of the Enterprise were mainly prepared by the Finance and Administration division, which included the Financial Reporting Unit. Finance and Administration had the task of drafting the disclosure documents, which included the financial statement with the accompanying footnotes and the MD&A section of the annual and quarterly information statements of Freddie Mac. Finance and Administration was expected to monitor the professional standards necessary to comply with appropriate accounting and SEC reporting standards. It also reviewed the reports of other business units to insure the consistency of such disclosures with reporting standards.

At the same time, the Legal Department had "dramatic amounts of responsibility for disclosure in practice at Freddie Mac."[403] As explained by one official, "[t]he final say on whether the disclosure is adequate to meet both GAAP and SEC or related disclosure rules was really jointly owned by Accounting from a GAAP perspective and by Legal from an SEC and other [regulatory] disclosure purpose."[404] That view is supported by the position description of the Executive Vice President, General Counsel, and Corporate Secretary of the Enterprise, which includes as a critical area of responsibility "... legal aspects of the corporation's securities disclosure program including the Information Statements, Offering Circulars, and other releases and documents."[405] Corporate Controller Edmond Sannini testified, "[f]or the 2001 process, the one that I was witness to, it was not a clear owner of the entire process. And,

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[402] *Id.*, p. 51.
[403] OFHEO Interview, Gregory Parseghian, v.1, August 4, 2003, p. 240.
[404] OFHEO Interview, Robert Dean, July 31, 2003, p. 184. Leland Brendsel also said the disclosures process was the responsibility of "legal and the CFO." Memorandum prepared by Baker Botts, Re: Leland Brendsel Interview, April 21, 2003, OF 2000126.
[405] "Federal Home Loan Mortgage Corporation, Position Description, Executive Vice President, General Counsel, and Corporate Secretary provided to OFHEO October 31, 2001. As indicated by her testimony cited above, Ms. Mater's view of her position is inconsistent with the position description.

actually, that was a recommendation that I made at the end; that there were a number of people involved, but nobody seems to own the overall process."[406]

The special examination also revealed that both Chairman and CEO Leland Brendsel and General Counsel Maud Mater played significant roles in reviewing and revising the public disclosures of Freddie Mac, although both parties denied playing a significant role in producing them.[407]

Senior counsel repeatedly asserted that the Legal Department was not responsible for the public disclosures of Freddie Mac. According to Steven Dinces, a senior attorney responsible for securities matters, "[d]isclosure is the province of the chief financial officer that Legal has a role in that policy ... if Legal had a view on disclosure that the chief financial officer or the Corporate Accounting people didn't have ... the general counsel or the chief financial officer would sit down and discuss it and what would occur if they couldn't agree."[408]

General Counsel Maud Mater asserted that the chief financial officer of Freddie Mac was ultimately responsible for the public disclosures of the Enterprise.[409] She admitted, however, that such disclosure was not a "front and center job description item" for the former chief financial officer, Vaughn Clarke.[410] Consequently, she acknowledged that the disclosure process was often pushed by the Legal Department. According to Ms. Mater, there was a lack of desire to focus on disclosure—'neglect

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[406] OFHEO Interview, Edmond Sannini, August 1, 2003, p. 227.

[407] Gregory Parseghian said the following regarding Maud Mater and Leland Brendsel's role in Freddie Mac's disclosure process—"[t]he way external worked, let's say board and external disclosures, the group of people that had the most to do with what went to the board or went externally was a combination of Leland — Leland and his staff, particularly there was a woman that worked for Leland named Beth Price who had a significant role in writing presentations and revising things, this editing process I described earlier and the legal department took. Obviously Maud reported to Leland and I think that the tone which emanated from the top, she applied to the — or instructed her securities lawyer to apply to disclosures." OFHEO Interview, Gregory Parseghian, August 4, 2003, v.1, pp. 242-243.

[408] OFHEO Interview, Steven Dinces, August 20, 2003, p. 17.

[409] Maud Mater said "disclosure should have been the CFO's job." Memorandum prepared by Baker Botts, Re:, Maud Mater Interview, March 17, 2003, OF 2000426. In addition, Vaughn Clarke was evaluated, in part, on his performance in the area of disclosure. Clarke's 2000 performance review, for example, included a category, "[a]ccuracy, timeliness and relevancy of external disclosures," which noted "informal feedback from investors and analysts indicates that the content of disclosures could be enhanced." OF 0000216 – OF 0000219.

[410] Memorandum prepared by Baker Botts, Re: Maud Mater Interview, March 17, 2003, OF 2000424.

rather than venality'—within the business units.[411] Among other instances of specific concern, Ms. Mater said she did not believe the Legal Department had any role in ensuring that the Enterprise was not maintaining "cookie jar" reserves.[412]

The special examination concludes that the failure of the management and Board of Directors of Freddie Mac to designate an office within the Enterprise with specific authority, and therefore, responsibility for corporate disclosures contributed substantially to inadequate and inaccurate corporate and financial reporting by Freddie Mac.

[411] *Id.*, OF 2000426.
[412] OFHEO Interview, Maud Mater, July 30, 2003, p. 134.

VII. THE BOARD OF DIRECTORS

The Board of Directors of Freddie Mac is a creature of federal statute, established in its Corporation Act.[413] There are 18 members, five of whom are appointed by the President of the United States. Board members are elected or appointed to one-year terms,[414] and three executive officers of the Enterprise have served on the Board.[415] After the federal government relinquished control of Freddie Mac in 1990 and authorized the Enterprise to issue stock directly to the public, the first shareholder elected Board was installed.

As set forth in guidance OFHEO published in 2000, the Board of Directors is expected, at a minimum, to:

> work with executive management to establish the strategies and goals of the Enterprise in an informed manner;
>
> oversee the development of the strategies of the Enterprise in key areas and exercise oversight necessary to ensure that management sets policies and controls to implement such strategies effectively;
>
> hire qualified executive management, and exercise oversight to hold management accountable for meeting the Enterprise's goals and objectives;
>
> be provided with accurate information about the operations and financial condition of the Enterprise in a timely fashion, and sufficient to enable the board to effect its oversight duties and responsibilities.[416]

In 2002 OFHEO promulgated a regulation governing the standards for the conduct and responsibilities of the Boards of Directors of the Enterprises. The regulation states that the Board is:

> responsible for directing the conduct and affairs of the Enterprise in furtherance of the safe and sound operation of the Enterprise and must

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[413] 12 U.S.C. 1452.

[414] 12 U.S.C. 1452 (a)(2)(A).

[415] Leland Brendsel and David Glenn served on the Board from 1990 – June 2003. Mr. Brendsel served at all times as the Chairman of the Board. Mr. Glenn was named Vice Chairman in June 2000. *See* http://www.freddiemac.com/news/archives2000/glennre.htm. Maud Mater served as a member of the Board from May 1996 to December 1998, and from May 3, 2001, to September 7, 2001. Freddie Mac's 2001 Proxy at 6, available at http://www.freddiemac.com/news/archives2001/boardelection2001.htm.

[416] 12 CFR § 1720, Appendix A, section VII.

> remain reasonably informed of the condition, activities, and operations of the Enterprise. The responsibilities of the board of directors include having in place adequate policies and procedures to assure its oversight of, among other matters, the following:
>
> (1) Corporate strategy, major plans of action, risk policy, and corporate performance;
> (2) Hiring and retention of qualified senior executive officers and succession planning for such senior executive officers;
> (3) Compensation programs of the Enterprise;
> (4) Integrity of accounting and financial reporting systems of the Enterprise, including independent audits and systems of internal control;
> (5) Process and adequacy of reporting, disclosures, and communications to shareholders, investors, and potential investors; and
> (6) Responsiveness of executive officers in providing accurate and timely reports to Federal regulators and in addressing the supervisory concerns of Federal regulators in a timely and appropriate manner.[417]

Since the mid-1980s and the thrift and banking crises of 1987-1991, boards of regulated financial institutions have faced increased expectations of strong oversight. It could not have come as a surprise to the Directors of Freddie Mac, many of whom have substantial experience with the financial marketplace and regulated financial institutions, that the OFHEO guidance and regulation charged them with providing vigorous and effective oversight of the operations of Freddie Mac.

Chapters II and III have discussed how two executive officers who were also Directors of Freddie Mac—former Chairman and Chief Executive Officer (CEO) Brendsel and former Vice Chairman and Chief Operating Officer (COO) Glenn—set an inappropriate "tone at the top" and demanded whatever level of earnings management was necessary to achieve steady, rapid growth in Enterprise profits. Chapter III also provided evidence that non-executive members of the Board were aware, and supportive of, management in this regard, including the use of derivatives to improperly manage the earnings of Freddie Mac.[418]

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[417] 12 CFR § 1710.15(b).

[418] *See,* letter to Brendsel from Gould, March 15, 2000, OF 2016494; discussion of a September 2001 presentation to the Board on the use of derivatives to manage earnings and a subsequent exchange among Directors, *infra,* Chapter III, "Improper Management Earnings."

This chapter discusses a number of other specific deficiencies in the conduct of the non-executive members of the Board:

(1) non-executive Board members failed to make adequate inquiries of management and obtain sufficient information upon which to make decisions;

(2) non-executive Board members became complacent and simply acquiesced to the views of management;

(3) non-executive Board members did not ensure the hiring of qualified executives in key positions; and

(4) non-executive Board members failed to hold management accountable for inadequate performance.

The chapter also examines how Mssrs. Brendsel and Glenn and a third executive Director—former General Counsel/Corporate Secretary Maud Mater—acted in concert to influence the quality of information provided to the non-executive members of the Board.

Failure of Non-Executive Directors to Make Adequate Inquiries

The Board of Freddie Mac was aware of control weaknesses and other management issues that were root causes of many of the problems that led to the ongoing restatement of the financial reports of the Enterprise. The non-executive Directors either 1) did not recognize those "red flags" and make reasonable inquiries of management or 2) failed to take appropriate actions to address the issues raised by the "red flags".

Presentations were made to the Directors about matters of concern yet they failed to make appropriate, additional inquiry or demand that management take effective, timely action. For example, in June 1999, the Directors of Freddie Mac:

(1) were informed that the SEC had concerns about companies that took actions to change the timing of income recognition or used reserves to avoid earnings surprises;[419]

[419] "Management Assessment of Current SEC Accounting Concerns" Presentation to Audit Committee, OF 5001159-5001166. All directors receive all presentations, whether or not they serve on a particular committee. OFHEO Interview, Shaun O'Malley, September 24, 2003, pp. 10-12. Therefore, all Directors received that presentation.

(2) were told at least three times by the then-Chief Financial Officer (CFO) that the Net Interest Income of Freddie Mac was "surging and we are undertaking transactions to smooth the time pattern over 1999-2000;"[420]

(3) were more specifically informed that the 1999 Net Interest Income of Freddie Mac "is running substantially above plan ... [and that] without rebalancing transactions, 1999 Net Interest Income could exceed 2000 Net Interest Income;"[421] and

(4) were informed that management was "investigating strategies to ... improve the time pattern of Net Interest Income between 1999 and 2000" that included "analyzing the adequacy of reserves" and delaying the "settlement of 1999 purchases."[422]

The special examination found few indications that the non-executive Directors questioned management about how the planned actions or strategies to improve the time pattern of net interest income squared with the concern of the SEC about corporate actions to change the timing of income recognition. There is evidence, however, that non-executive Directors clearly understood the intent of management to smooth earnings. Indeed, one non-executive Director expressed no concern about how the SEC would view the propriety of the action of management, but instead questioned "how transparent smoothing of growth would be to others."[423]

Another example concerns the failure of the Board to respond to the red flags related to the change in duties and reassignment of the then-Controller, Gregory Reynolds. Freddie Mac named Mr. Reynolds, a CPA, Controller in September 1998.[424] Beginning in September 1999, Mr. Reynolds was also "assigned as the point person for negotiating" a "third party alliance opportunity for distributing mortgage technology".[425] After September 1999, there were times when Mr. Reynolds spent "well in excess of 50

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[420] Financial Review & Outlook presentation to the Board of Directors, June 4, 1999, OF 5001005, OF 5001008, OF 5001015.
[421] Financial Review & Outlook presentation to the Board of Directors, June 4, 1999, OF 5001008.
[422] Multi-Year Net Interest Income Planning presentation to the Investment Committee, June 4, 1999, at OF 5001460D, which was provided to all Directors. OFHEO Interview, Shaun O'Malley, September 24, 2003, pp. 10-12.
[423] Handwritten notes of June 4, 1999 Board meeting at OF 1625064, attributed to George Gould.
[424] OFHEO Interview, Gregory Reynolds, October 2, 2003, p. 229.
[425] *Id.*, p. 82.

percent" of his time working on those "Business Development Initiatives."[426] Although the non-executive Directors knew Mr. Reynolds was involved in the initiatives from his participation in presentations to the Board,[427] the Board did not ask management how Mr. Reynolds was able to perform his critical functions as Controller and, at the same time, play a crucial role in the initiatives.

The non-executive Directors failed again when then-CFO John Gibbons unexpectedly resigned in March 2000.[428] Those Directors failed to ask management, in light of the Business Development obligations of Mr. Reynolds and the credentials of the interim CFO,[429] who was going to assume responsibility for that important function. Nor did they ascertain who would oversee the activities and efforts of the Corporate Accounting unit that was stretched thin and facing increasing volumes and ever more complex transactions.

There is no evidence that when acting CFO Vaughn Clarke informed the full Board in September 2000 that the Controller would be leaving his position, any of the non-executive Directors asked if it was significant that within six months of the resignation of the Chief Financial Officer, the Controller was also leaving his position. Nothing suggests those Directors recognized the cumulative impact those changes could have on an Enterprise with financial reporting controls that had deteriorated to the point that the Internal Audit Department informed the Board they were marginal.[430] Given the lack of qualifications of the new CFO and the marginal controls in financial reporting, the fact that the Directors took no appropriate action to ensure that the Interim Controller had the skills needed at that critical juncture is significant.

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[426] *Id.*, pp. 82-83, 109-111. Mr. Reynolds' supervisor, Chief Financial Officer John Gibbons, requested that Mr. Reynolds accept the assignment. OFHEO Interview, Gregory Reynolds, October 3, 2003, pp. 79-80.

[427] *Id.*, p. 231 and handwritten notes of January 22, 2000, Board meeting, OF 1625178 – OF 1625185.

[428] On March 1, 2000, Freddie Mac announced that John Gibbons was leaving the Enterprise, effective March 31, 2000. See http://www.freddiemac.com/news/archives2000/gibbons.htm.

[429] Vaughn Clarke's expertise was in finance and shareholder relations, not in accounting. He was not a CPA.

[430] See, for example, handwritten notes taken at the September 8, 2000, Board meeting, OF 1625246 – OF 1625269, OF 1625270 – OF 1625272 and the handwritten notes taken at the September 8, 2000, Audit Committee meeting, OF 1625997 – OF 1626000.

Another example of the failure of the Directors to make adequate inquiries relates to a March 2000 letter from Arthur Andersen to the Audit Committee. That letter indicated that a

> thorough review and update of the Accounting Policy Manual has not occurred in over four years. Certain of the documented policies are not reflective of the current practices within the Corporate Accounting department. This has made it difficult for the new staff and consultants to maintain a comprehensive understanding of how certain transactions should be processed. The Corporate Accounting Policies should be updated to reflect the current environment and be used as a mechanism to keep resources informed of how to account for recurring transactions.[431]

On its face, that statement should have stimulated greater inquiry about the management of the Corporate Accounting unit and the ability of Freddie Mac to properly account for transactions. It also should have raised questions about the ability and willingness of Arthur Andersen to identify weaknesses in the control framework of the Enterprise and bring them to the attention of the Audit Committee.

The special examination is led to the conclusion that the Board of Directors of Freddie Mac played no meaningful role in the oversight of the critically important area of accounting policies and practices, as required by law and regulation. Examination shows the non-executive Directors deferred to management almost completely. To exercise more vigorous and effective oversight, Directors could have:

- questioned Arthur Andersen about why the accounting policies had to be outdated for more than four years before the firm thought it appropriate to bring such a weakness to the attention of the Audit Committee;
- inquired whether Arthur Andersen was aware of other long-standing problems at Freddie Mac; or
- raised questions about inconsistencies between information the Directors received from management[432] and from Arthur Andersen.

[431] March 3, 2000, letter from Arthur Andersen to the Audit Committee, OF 0000010.
[432] Audit Committee Briefing, March 3, 2000, OF 5010297 and OF 5010306.

The special examination found few indications that Directors took those actions. It concludes that Directors simply did not fulfill their responsibility to inquire and follow up on concerns of which they were or should have been aware.

Failure of Non-Executive Board Members to Secure Adequate Information

The non-executive Directors of Freddie Mac failed not only to act appropriately when presented with critical information but also to ensure that they received the information necessary to oversee Freddie Mac effectively. Directors have an obligation to maintain a current and appropriate level of knowledge of the condition, activities, and operations of the firm. The information directors need to fulfill their obligations is different from the information management uses to run the day-to-day operations of the company. For example, directors may not need the raw data managers use to monitor key performance measures. Directors must ensure however, that they have reliable and accurate information about how results compare to key performance measures and about the trends and any anomalies in those measures. Ultimately, as articulated in an OFHEO regulation, it is the responsibility of the Directors to ensure that they remain "reasonably informed of the condition, activities, and operations of the Enterprise."[433]

Management provided voluminous information packages to the Board and Board committees of Freddie Mac for each meeting during the period covered by the restatement. While the volume of information was large, its quality was affected by a concerted effort of executive management—including the executives who served on the Board of Directors, Chairman CEO Brendsel, Vice Chairman and COO Glenn, and the General Counsel/Corporate Secretary Mater—to limit the flow of specific information provided to the non-executive Directors. The non-executive Directors were aware that the executive Directors tightly controlled the process by which the non-executive Directors received information. For example, as one non-executive Director told the special examination, if a non-executive Director were to call a Freddie Mac employee,

[433] 12 CFR § 1710.15(b)

the employee was instructed to "report in to David and Leland," and five minutes later the Director would get a call from Mr. Brendsel.[434]

The Chairman and Vice Chairman of the Board tightly controlled the information presented at each Board and Board committee meeting.[435] Together with the General Counsel,[436] they conducted "dry runs" during which they reviewed the presentations prepared by senior management and made binding decisions about what information would be contained in the presentations and other materials provided to the non-executive Directors.[437] The goal of the dry run process was to ensure that a consistent message was delivered to the non-executive Directors, even if it meant often obfuscating rather than illuminating the practices, events, or conditions of Freddie Mac.[438]

The special examination concludes that the dry run process went beyond reasonable controls and had the apparent purpose of limiting reports to the non-executive

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[434] OFHEO Interview, John B. McCoy, September 24, 2003, p. 93.

[435] However, the chairs of the various Board committees had input into the committee agendas OFHEO Interview, Ronald Poe, September 16, 2003, p. 12; OFHEO Interview, John B. McCoy, September 24, 2003, p.14; OFHEO Interview, Michelle Engler, October 3, 2003, p. 7), the CEO and COO controlled the agendas. Board Meeting Preparation presentation, dated July 10, 2000, OF 1650058.

[436] The special examination also found that the General Counsel failed to convey relevant information to the non-executive Directors. For example, in late 2001, the External Auditor of Freddie Mac informed the General Counsel that he was not comfortable with the leveraged linked swap transaction. The External Auditor informed her that it was not the type of transaction he wanted Freddie Mac to engage in again. Instead of ensuring that the Board was apprised about the unusual transaction and the fact that Arthur Andersen objected to it, the General Counsel did not bring the matter to the attention of the Audit Committee. OFHEO Interview, Maud Mater, July 30, 2003 pp. 192-193 and 33-34. Indeed, the General Counsel advised the External Auditor that he could improve his relationship with the Audit Committee by being more crisp and concise in his presentations. OFHEO Interview, Maud Mater, July 30, 2003, p. 197. The decision of the External Auditor to follow the General Counsel's advice and not to bring the matter to the attention of the Audit Committee raises questions about the fitness of the External Auditor.

[437] The executives demonstrated the lengths to which they would go to control the flow of information to the non-executive Directors by inserting themselves in the ostensibly independent reporting line from Internal Audit to the Audit Committee and requiring that reports to that committee by the General Auditor go through the dry run process. The very fact that the executives inserted themselves into those communications threatened to compromise the integrity of the Internal Audit function and suggests that the control of communications by the executives overrode their concerns for good governance.

[438] For example, in an interview with the special examination, Gregory Parseghian recalled an instance when the General Counsel (who at the time was serving as an executive Director) and the CEO instructed him to remove details from a proposed presentation, the result of which "was, in my view, to make less clear the presentation of certain facts to the investment committee of the board" and to make the "comments that accompanied these fields ... less robust." In the expressed view of Mr. Parseghian, the dry run process was a means by which the three senior executives filtered materials to the non-executive Directors to reflect their own "sensitivities." OFHEO Interview, Gregory Parseghian, v.1, August 4, 2003, vol.1, pp. 121-122, 124, 130.

Directors. That process not only resulted in Mssrs. Brendsel, Glenn, and Mater determining what was important for the Directors to know, but also meant that non-executive Directors did not obtain all the information they needed to fulfill their obligations.[439]

While the executives did not inform the Board about the means by which they controlled the information provided to the non-executive Directors, there is evidence that some Board members were aware that such a process existed. For example, the chairman of the Audit Committee knew there was a review process and considered it "reasonable for management to be relied upon"[440] to determine what would be reported to the Board. Another non-executive Director shrugged off the process as "one more step in what appeared to me at the time to be [the CEO and COO's] goal of perfection."[441] Despite their knowledge of a management process that controlled the flow of information to the Board, the non-executive Directors did not take any action either to learn the nature and extent of the filtering by management or to ensure that they received all the information necessary to effectively oversee Freddie Mac.

Limited Time for Board Discussion and Reflection

It was a challenge for the Board and its committees to get through their agendas.[442] In interviews conducted during the special examination, non-executive Directors were divided over whether they needed additional time to conduct their business. Some brought that concern to the attention of management,[443] while others interviewed reported that they had sufficient time.[444] The special examination found that Board agendas were

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[439] The non-executive Chairman of the Board of Freddie Mac has "eliminated the dry runs from the chairman's arsenal." OFHEO Interview, Shaun O'Malley, September 24, 2003, p.80.
[440] OFHEO Interview, Thomas W. Jones, August 12, 2003, p. 69.
[441] OFHEO Interview, Ronald Poe, September 16, 2003, p. 79.
[442] The executive Directors appeared to be concerned about this. "I got the feeling that both COO and CEO would prefer a more streamlined discussion." OFHEO Interview, Henry Kaufman, August 14, 2003, p. 56. "Mr. Glenn and Mr. Brendsel had a desire to keep the board meetings on a rigid specified time." OFHEO Interview, Gregory Parseghian, v.1, August 4, 2003, p. 157. *See* supporting comment at OFHEO Interview, Maud Mater, July 30, 2003, pp 38-43.
[443] See for example, Board Questionnaires at: OF 5092449 (1998); OF 5092664 (1999); OF 5092874 (2000); OF 5093064 (2001); OF 5093367 (2002); and OF 5093620 (2003).
[444] OFHEO Interview, John B. McCoy, September 24, 2003, p. 91; OFHEO Interview, Shaun O'Malley, September 24, 2003, p. 12; OFHEO Interview, Thomas W. Jones, August 12, 2003, pp. 70-71; OFHEO

full and Directors acquiesced to the limited time available for discussion of all the matters before them.[445]

The rushed pace of Board meetings was likely the result of several factors, including the fact that the regular schedule of the Board called for only five meetings per year. The meeting schedule of the Board was established when the shares of Freddie Mac became publicly traded in 1990. In late 1989 and early 1990, CEO Brendsel worked to identify eleven individuals to place before the shareholders as nominees to the Board.[446] Charged with assembling a large board in a relatively short time frame, the Enterprise decided that its chances of recruiting a qualified Board would be improved if the number of Board meetings were limited. Thus, CEO Brendsel established and the Board agreed with the practice of scheduling five regular Board meetings a year—one in conjunction with the annual meeting of the shareholders and one in the last month of every quarter.[447]

That meeting schedule did not keep pace with changes in the external environment within which Freddie Mac operated, or indeed, with the volume and complexity of the business of the Enterprise. By failing to change their own practices and increase the number of regular Board and committee meetings, the Directors consistently faced very full agendas that limited their ability to oversee management effectively and discuss and reflect upon the matters before them.

Interview, George Gould, August 12, 2003, pp. 33-34; OFHEO Interview, Henry Kaufman, August 14, 2003, pp. 53-57, 59-62, 141-142.

[445] The Vice Chairman and COO emphasized the need to adhere to the tight meeting schedule rather than the need to ensure Directors were fully and appropriately informed. OFHEO Interview, Gregory Parseghian, v.1, August 4, 2003, pp. 155-161.

[446] Mr. Brendsel and the Chief Operating Officer of Freddie Mac, David Glenn, rounded out the slate of directors presented to shareholders.

[447] "Brendsel recruited the Board within a 60 day time period, promising prospective Board members that Freddie Mac would not make much demand on their time." Memorandum prepared by Baker Botts, Re: Mollie Roy Interview, February 13, 2003, OF 2000589. As a rule the Board adhered to that five-meetings-a-year schedule from 1990 through 2002. Throughout that period, the Board and its committees held special meetings, but the regular meeting schedule did not change. Since early 2003, and in response to extraordinary circumstances, the Board and Board committees of Freddie Mac have held an unusual number of special meetings. In the case of the Audit, Ad Hoc, and Governance Committees, those "special" meetings have occurred on a regular and frequent basis. That is as it should be given the circumstances facing the Enterprise. The frequency of the meetings is in stark contrast to what had been the Board's practice before 2003—that is, five Board and four committee meetings per year.

The ineffective oversight of management and the operations and condition of Freddie Mac by the non-executive Directors resulted from their decisions to: allow themselves to be buried in volumes of complex written materials, accept packed meeting agendas, allow inadequate time for discussion of and reflection upon subjects, and not investigate the practice of management of carefully vetting presentations before they were made to the Board.

Complacency of Non-Executive Board Members

In general, the directors of a corporation may place reasonable reliance on management but they cannot blindly accept the representations of management. Directors are not expected to independently verify information provided to them by management. However, directors should, at a minimum, determine that the information they receive comes from expected sources and that the data and systems used to generate the information are subject to appropriate and effective controls. Directors should review information to determine if it reflects attention to a range of goals of the company, including compliance with legal and regulatory regimes and corporate bylaws, and not whether it simply presents a reasonable business summary.

The non-executive Directors of Freddie Mac did make some inquiries to ascertain the reliability of information provided to the Board[448] and about management conclusions and assumptions on certain topics.[449] Events demonstrate that those inquiries were not sufficient or effective.

The Board might have exercised more vigorous oversight if there was a regular turnover of shareholder-elected Directors, or if shareholder-elected Directors did not have an expectation, as articulated by one of them, that they would continue to serve on the Board until they reached the mandatory retirement age.[450] There has been minimal turnover in the shareholder elected Directors since 1990. Until May 2001, eleven of the

[448] The Audit Committee regularly received information about the reliability of management reports from the Internal Auditor's assessments and the results of the Management Assessment of Risks and Controls reports. *See*, e.g., OF 5010295-5010306; OF 5020261-OF 5020272; and OF 5030477-OF 5030489.
[449] Handwritten notes of Board and Board committee, OF 1625016, OF 1625062, OF 1625152.
[450] OFHEO Interview, John B. McCoy, September 24, 2003, p. 9.

original thirteen shareholder elected directors were still on the Board. There were ten original directors until December 2002, and nine of the thirteen shareholder elected directors were on the Board from 1990 until the abrupt, unplanned departures of Messrs. Brendsel and Glenn in early June of this year.[451] In summary, there was no change in 77 percent of the shareholder elected Directors for the twelve years from 1990 until early December 2002.

The same long-tenured shareholder elected Directors dominated the Board of Freddie Mac and oversaw and served with the same CEO, COO, and General Counsel from 1990 through 2002. It is not surprising then, as one Director observed in an interview, that the Directors gave management the benefit of the doubt and allowed the past performance of those officers to color their approach to meeting their oversight responsibilities.[452] That approach manifested itself in an unwillingness to hold management accountable for addressing identified weaknesses in a timely manner. The long-serving Board believed it was familiar with the Enterprise but increasingly that belief was unjustified. One particularly relevant example, described in detail in a later section of this chapter, concerns the failure of the Board to follow up and to ensure management implemented plans to address weaknesses in financial reporting controls.

It has been suggested that the statutory scheme requiring the President of the United States to appoint five Directors to the Board of Freddie Mac results in sufficient turnover. Experience shows that argument is not persuasive. It assumes that presidentially appointed and shareholder elected Directors are on an equal footing with other directors.[453] While the law may intend parity among Directors and the rules of Freddie Mac do not discriminate among Directors by method of selection,[454] presidential

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[451] George D. Gould, Henry Kaufman, John B. McCoy, Ronald F. Poe, Donald J. Schuenke, Christina Seix, and William J. Turner are the current members of the Board who have served since 1990. Leland Brendsel and David W. Glenn served from 1990 to June 2003, James F. Montgomery served from 1990 to December 2002, and Russ Palmer served from 1990 to May 2001.

[452] OFHEO Interview, George Gould, August 12, 2003, pp. 22-25.

[453] Both appointed and shareholder elected Directors have the same legal duties and obligations.

[454] OFHEO Interview, Michelle Engler, October 3, 2003, p. 7:

Q: Does Freddie Mac's management treat presidential-appointed directors in the same manner as it does shareholder-elected directors?

A: Yes, it does.

appointees must spend significant time during their short tenures[455] learning about the business operations and corporate culture of the Enterprise. Freddie Mac maintains it treats presidentially appointed and shareholder elected Directors the same. It is a fact, however, that since 1990 no presidentially appointed Director has ever chaired a permanent Board committee. In addition to the difficulties involved in getting up to speed on the business and operations of this complex company, the short-term presidentially appointed Directors join a Board where the majority of Directors have long service and have worked together for years.

Long-serving non-executive Directors working with much the same executive management team over the years lost much-needed skepticism.[456] It is not surprising that Board members became comfortable with management of the Enterprise and reluctant to challenge the individuals they had worked with for years. That process is illustrated by the response of a Freddie Mac Director in an interview during the special examination.

> Q: Did the audit committee feel constrained from taking action until an actual problem developed? You mentioned that there was bubble gum and wrapping paper but when you finally had the GMS[457] evidence, then you were able to take action.
>
> A: We weren't constrained in any formal sense. I think the constraint is self-imposed discipline of respect for senior management. This was a senior management team that was very highly regarded, a company with an outstanding track record, reputation for the highest standards of integrity and ethics .... I think the board properly relies upon the senior management to make the judgments with regards to the pace of addressing the issues until such time as you are presented with more evidence that perhaps the pace they selected or executed isn't good enough. That's what happened when the GMS problem became apparent.[458]

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[455] From May 1998 to May 2003, the average tenure of a presidentially appointed Director was 14.6 months.

[456] For example, handwritten notes from the December 1, 2000, Human Resources Committee indicate that the rationale of two long-serving Directors for approving the Preliminary 2001 Corporate Scorecard OF 501240 was "if LB [Leland Brendsel] happy, we're happy," OF 1625903 - OF 1625904.

[457] That refers to a problem with the reconciliation of the Guaranteed Mortgage Securities (GMS) account in the general ledger that had been brought to the attention of the Audit Committee.

[458] OFHEO Interview, Thomas W. Jones, August 12, 2003, pp. 30-31.

The record of Freddie Mac reporting strong, consistent earnings in line with the expectations of stock analysts also contributed to the complacency of the non-executive Directors of the Enterprise. The steady growth in reported earnings overshadowed the problems and weaknesses of which non-executive Directors were aware and apparently lulled them into accepting both the status quo and representations of management that issues were being addressed effectively.

Failure to Ensure the Hiring of Qualified Executives for Key Positions

A critical function of the board is to ensure that a company has a qualified executive management team in place. At Freddie Mac, that responsibility assigned to the Human Resources Committee (HR Committee).[459] Given the events at Freddie Mac, that committee and the Board failed to ensure that the Enterprise had a qualified CFO in place to run and control, among other operations, the financial reporting function. Perhaps no other management failure discovered in the special examination is as clear as the inattention of senior management to the task of aggressively seeking out a qualified individual to be responsible for the duties of CFO. Although that failure is not the only cause of the problems that led to the restatement, the lack of a qualified CFO is involved in the evolution of almost every one of those problems.

Similarly, an example of the failure of the Board to ensure that management hired qualified individuals in a timely fashion concerns their inaction in filling a vacant CFO position. The Board learned in early March 2000 that CFO Gibbons was leaving Freddie Mac at the end of that month.[460] The Enterprise did not hire a permanent CFO until November 15, 2000, more than eight months after Mr. Gibbons announced his departure. Furthermore, serious questions arise concerning whether the Board met its responsibilities when action was finally taken and a CFO of highly questionable qualifications was hired.

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[459] *See*, Human Resources Committee charter, amended and restated September 6, 2002, OF 5032262 – OF 5032264; OFHEO Interview, Donald J. Schuenke, September 30, 2003, p. 25.
[460] http://www.freddiemac.com/news/archives2000/gibbons.htm.

In September 2000, six months after the resignation of Mr. Gibbons, the Audit Committee learned that Internal Audit had rated Financial Reporting "[m]arginal".[461] The Audit Committee chairman reported this to the full Board[462] and informed the Board that Freddie Mac needed to hire "a traditional type" CFO, which the Enterprise had not had "for 4-5 years."[463] After two additional months, on November 15, 2000, Freddie Mac announced that Vaughn Clarke had been named permanent CFO.[464] The background of Mr. Clarke was in finance; he was not an accountant and, indeed, did not even have a strong accounting background.[465]

The Directors did not object to the hiring of Mr. Clarke as the CFO of Freddie Mac even though it was acknowledged that Mr. Clarke was out of his depth in accounting matters and lacked some of the fundamental skills looked for in a CFO.[466] The Board agreed with management that Mr. Clarke should be permitted to "work his way" into the job of CFO. It is difficult to reconcile that decision with effective oversight. Effective Board oversight would not include considering the CFO position to be so inconsequential that an individual would be allowed to "grow into it", particularly at a time when a major accounting change with significant implications for the Enterprise –FAS 133– was on the horizon.

Some Directors suggested to the special examination that it was not necessary for the CFO to have a strong accounting background, and that the Controller could bring those skills to Freddie Mac. By September 2000, however, the Board knew that the Controller was going to be leaving his position and was already spending significant time working on Business Development Initiatives. Even so informed, the Board did not act to ensure that the CFO hired by Freddie Mac had the necessary skills to address the

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[461] General Auditor's Report, OF 5011644.
[462] Handwritten notes taken at the September 2000 Board meeting, OF 1625262.
[463] *Id.*
[464] Freddie Mac's November 15, 2000 press release. *See* http://www.freddiemac.com/news/archives2000/vaughnclarke.htm.
[465] Freddie Mac hired Vaughan Clarke as Mr. Gibbon's replacement with the idea that the new position would be a stretch for Mr. Clarke. Letter of Leland Brendsel to Director George Gould, August 31, 2002: "At the time Vaughan Clarke was appointed to this position, management recognized that he did not have all the requisite skills and expected that given the opportunity he would develop these skills." OF GG 00784.
[466] *Id.*

serious weaknesses that had been identified in a critical area of responsibility of that executive.[467]

At some point, the Board and the CEO decided that Mr. Clarke was not up to the job of CFO. While the Directors interviewed by the special examination do not all have the same recollections, one Director recalls that at a special meeting of the Audit Committee in New York in January 2002, the committee instructed CEO Brendsel "to take the necessary steps to find a chief financial officer to replace Vaughn Clarke .... I can't recall if it was as clear cut as replacement, but it was certainly the fact that Vaughn Clarke wasn't the person for the job."[468] The decision to move Mr. Clarke out was made sometime before the June 2002 press release in which Freddie Mac announced that it had "created a new, broader role for an executive vice president of finance ... [who] will have charge of ... the office of the chief financial officer."[469] The new position of Executive Vice President of Finance was filled in March 2003,[470] fifteen months after the Audit Committee instructed the CEO to find a replacement. It was nine months after the Enterprise publicized its search for an individual to fill the new position of Executive Vice President of Finance. The special examination believes that the position could have been filled in a shorter time period had the Board of Directors attached a sense of urgency to filling the position prior to January 2003.[471]

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[467] For example, while one non-executive Director questioned management's decision to hire Mr. Clarke, he did not raise strenuous objections to Mr. Clarke's selection. OFHEO Interview, John B. McCoy, September 24, 2003, pp. 117-120.

[468] OFHEO Interview, Ronald Poe, September 24, 2003, pp. 48.

[469] *See* http://www.freddiemac.com/news/archives2002/newposts_061802.html.

[470] *See* http://www.freddiemac.com/news/archives/corporate/2003/baumann_031903.html.

[471] OFHEO Interview, John B. McCoy, September 24, 2003, pp. 79-80.

Q: Were you satisfied with the length of time that it took to hire that new EVP of finance?
A: Once we got the urgency to it, we hired him pretty quick.
Q: When did you get the urgency to do it?
A: Early in January.
Q: January of—
A: 2003.
Q: So in 2002 you knew that Mr. Clarke ... did not have all the skills that the company wanted or needed in a CFO ... and it wasn't until 2003 that the company realized there was an urgency to getting an EVP with the requisite skills?
A: The company ... did a search and whether they saw the urgency or not ... that search dragged on longer than it should have dragged on ... They didn't get it done.

Failure to Hold Management Accountable

Numerous examples exist of the failure of the Board to fulfill its duty to follow up on matters brought to its attention. None is more striking than the response of the Board to information the General Auditor of Freddie Mac provided the Audit Committee in September 2000.

At the September 8, 2000 meeting of the Audit Committee[472], as part of his standard report, Mel Kann, the General Auditor, informed the committee that the Internal Audit Department assessed the controls over the financial reporting of Freddie Mac as "[m]arginal".[473] That was a statement announcing a significant deterioration in the quality of controls. Two years earlier, Internal Audit had assessed the controls as "[s]atisfactory", a rating two grades higher than "[m]arginal".

The materials provided to the committee in advance of its September 2000 meeting summarized the reasons for the two-step downgrade to a marginal rating. Those materials indicated that since the previous audit, Corporate Accounting and Finance and Administration had

> re-deployed resources to implement a new general ledger system, prepare for the year 2000 and for FAS 133 implications. They have also experienced a high turnover at the management and staff levels. These factors caused a deterioration of controls in 1999 and the lowering of the control opinion.[474]

The materials provided to the Directors also indicated that:

> management reported major weaknesses in (1) system and data integrity issues in debt and derivative accounting, (2) staff and skill shortages ... (3) account reconciliation issues and (4) and outdated Accounting Policy Manual (reported in the past two audits) .... [Internal Audit] also found (A) the DAUs [decentralized accounting units] do not have sufficient financial reporting standards and performance objectives, (B) Corporate Accounting does not have an effective process to react promptly to new

[472] The discussions at the Audit Committee meeting related to the Financial Reporting audit are memorialized in handwritten notes taken at the meeting. OF 1625998 - OF 1626000.
[473] The Internal Audit Report, OF 1600176 – OF 1600188.
[474] Audit Report Summary from the General Auditor's Report, OF 5011644.

> transactions, and (C) the financial reporting process is labor-intensive and the reporting deadlines allow little time for preventative and early-detection controls .... Key person dependencies exist in the entire financial reporting process, both inside and outside of Corporate Accounting. This is the case with financial accounting, the preparation of financial statements, and the review process used to detect errors.[475]

Management assured the committee that it was phasing in software that would address many of the weaknesses identified in the Audit Report and that manual controls were sufficient to ensure the integrity of financial statements.[476] Management committed that

> By October 31, 2000, key person dependencies will be reduced within the financial reporting process through an increase in both staffing levels (+ 20 headcount) and training.[477]

While the External Auditor, Robert Arnall of Arthur Andersen, agreed with the assessment that manual intervention increases risk, he also told the Audit Committee on September 8, 2000 that, in his view, Freddie Mac had processes in place to "catch" errors.[478] After discussing the matter, the committee directed the CEO to review the issue. The Chairman of the Audit Committee, Russell Palmer, instructed management that financial reporting was a "top priority." When one member of the committee noted that the matter was merely a "difference of opinion" between the Internal and the External Auditor, Mr. Palmer disagreed by reiterating his direction to management to "get it done."

Although Mr. Arnall offered the Audit Committee assurances that the financial reporting of Freddie Mac was acceptable, the Chairman of the Committee deemed the matter worthy to be brought to the attention of the full Board. In his report to the Board later that day (September 8, 2000), Mr. Palmer discussed the financial reporting audit at length. He expressed his concern that financial reporting is a "basic foundation" and that the multiple manual interventions associated with the back-end controls increased the risk

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[475] *Id.*
[476] Response to Financial Reporting Audit, OF 5011645.
[477] Audit Report Summary from the General Auditor's Report, OF 5011644.
[478] Handwritten notes of the Audit Committee meeting, OF 1625998 – OF 1626000.

that the financial statements could be inaccurate.[479] In response to a question from a non-executive Director of whether there was a risk that the weaknesses in Internal Audit identified would cause Freddie Mac to restate earnings, Mr. Palmer replied that there was a "high risk that the present system could result" in a restatement. He also indicated that while there was a high risk of errors, the Audit Committee was not aware of any such errors. Mr. Palmer told the Board that Freddie Mac needed both systems and people to address the weaknesses in financial reporting.

In response to the comments of the Chairman of the Audit Committee to the full Board, COO and Vice Chairman Glenn, who had received a copy of the internal audit report in mid-August,[480] replied that "the issue had been with the company for a while." Mr. Glenn also stated that the core issue was hedging in the retained portfolio. He agreed that the financial reporting process was too manual and assured the Board that it would be fixed. CEO and Chairman Brendsel, who was also copied on the audit report in August, informed the Board that Mr. Palmer had asked that the solution proceed "up the chain" and be documented.

The Directors exercised their oversight authority to address weaknesses in financial reporting by approving the Financial Reporting Controls Improvement Plan (FRCIP);[481] reviewing progress reports of the Audit Committee;[482] and through the Audit Committee making regular inquiries of the General Auditor and the External Auditor about their views about the progress of management on the FRCIP.[483] In carrying out their oversight duties, the non-executive Directors relied heavily on the Audit Committee progress reports and the reports of the General Auditor. As the Chairman of the Audit Committee said in an interview with the special examination:

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[479] Handwritten notes of the Board meeting, OF 1625261 – OF 1625263.
[480] Memorandum distributing Financial Reporting Audit, August 11, 2000, OF 1600176.
[481] OFHEO Interview, Thomas W. Jones, August 12, 2003, p. 9.
[482] Audit Committee Report, December 2000, OF 5012176 - OF 5012179; Audit Committee Report, March 2001, OF 5020249 - OF 5020252; Audit Committee Report, June 2001, OF 5021146 - OF 5021149; Audit Committee Report, September 2001, OF 5021632 - OF 5021640; Audit Committee Report December 2001, OF 5022216 - OF 5022224.
[483] The General Auditor included his observations in his standard report to the Audit Committee beginning in June 2001. See, for example, the Audit Committee Report, June 2001, OF 5021187; the Audit Committee Report, September 2001, OF 5021690; and the Audit Committee Report, December 2001, OF 5022268. OFHEO Interview, Thomas W. Jones, August 12, 2003, pp. 10, 13.

> "I don't know what we could have done except receive regular reports by the responsible personnel that progress was being made. That's what we did. We required regular reporting."[484]

It does not appear however, that the non-executive Directors held management responsible for actually implementing the necessary actions to address the myriad weaknesses that resulted in the "[m]arginal" rating of the Financial Reporting audit. For example, the non-executive Directors were satisfied with progress reports that addressed the planning to adequately staff Corporate Accounting, rather than the actual staffing of that unit.[485]

Eighteen months after the first marginal audit rating of Corporate Accounting and after the GMS reconciliation issue emerged, the Audit Committee recommended and the Human Resources Committee and full Board agreed that 25 percent of the bonuses of senior management for 2002 would be tied in part to the successful resolution of accounting issues identified by the Audit Committee.[486] By directly linking compensation to the resolution of problems, the Board finally acted in a manner designed to hold management accountable.

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[484] OFHEO Interview, Thomas W. Jones, August 12, 2003, p. 13. As noted in the Office of the Comptroller of the Currency's *Director's Book: The Role of a National Bank Director* (Washington, DC: 1997), directors not only can, but should do more: "The board can monitor the operations ... through management reports, but it must do more than merely accept and review these reports; it must be confident of their accuracy and reliability." *Director's Book*, p. 31.

[485] "It says that the hiring plan is fully staffed which means they are staffed to do the hiring. I don't interpret that as saying that all of the various accounting projects have been fully staffed." OFHEO Interview, Thomas W. Jones, August 12, 2003, pp. 18-19.

[486] *Id.*, pp. 11, 29, 40-42; and, President's Report, March 1, 2002, OF 5030086.

VIII. RECOMMENDED ACTIONS

The special examination is drawn to several general conclusions, which in turn lead to specific recommendations.

General Recommendations

Freddie Mac should implement a comprehensive, Enterprise-wide initiative to establish a proper "tone at the top" and develop a corporate culture that rewards integrity and the acceptance of responsibility and individual accountability, and that penalizes failure to adhere to legal and regulatory requirements or professional standards of appropriate conduct. Furthermore, safe and sound operations require that Freddie Mac prudently plan for any future growth. Such planning includes taking steps to attract and retain personnel with the skills necessary to manage the growing risks associated with future growth. The Enterprise should have a plan for managing future growth. That plan should include provisions that specifically address anticipated problems that may arise as a result of growth and pay particular attention to anticipated staffing and systems needs to address those problems.

The experience of Freddie Mac shows that the management of the Enterprise must dedicate itself to managing operations risk as effectively as possible. Freddie Mac is under a statutory mandate to operate in a safe and sound manner, which includes having systems and management structures in place to ensure that operations risk receives the same attention as credit and interest rate risks. An inadequate provision of resources to compliance and internal controls is unsafe and unsound. Specifically, the reliance of the Enterprise on manual processes to "work around" inadequately integrated information systems is a significant source of operations risk that Freddie Mac must resolve expeditiously.

OFHEO must determine whether the management of Freddie Mac has established an adequate remediation plan and is allocating the necessary resources to ensure that all of the remedial recommendations are promptly implemented. OFHEO should take steps to ensure that the following recommendations are implemented:

1. Freddie Mac Should Separate the Functions of the CEO and the Chairman of the Board

There is an inherent conflict between the role of leading those charged with overseeing and guiding management and the role of heading the management team. As the experience of Freddie Mac in recent years shows, when the CEO sets the agenda of Board meetings, controls information flowing to the Board and its committees, and selects nominees to the Board, the quality of Board oversight may be seriously diminished. In June of this year, the Enterprise divided the roles of CEO and Chairman. As Freddie Mac moves to fill the top management positions of the company, it should permanently implement this management structure.

2. Freddie Mac Should Develop Financial Incentives for Employees Based on Long-Term Goals, not Short-Term Earnings

The special examination recognizes that tying the compensation of employees to the performance of an Enterprise is good management and required by statute. However, the creation of compensation incentives that excessively focus the attention of management and employees on short-term earnings performance is improper. Freddie Mac should develop financial incentives that motivate employees to achieve the long-term objectives of the Enterprise. Incentives should not be focused on short-term earnings; such incentives may misdirect employees or otherwise lead to improper conduct.

3. OFHEO Should Establish a Regulatory System of Mandatory Disclosures for the Enterprises or Their Securities Exemptions Should be Repealed

The disclosure failures of Freddie Mac were extensive and damaging to the trust of the public in the future disclosures of the Enterprise. It is clear that the financial disclosures of an Enterprise should not be left to a system of voluntary commitments. Fannie Mae has registered with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934 (Exchange Act), and Freddie Mac has promised to do so as soon as possible. To address the issue of the adequacy of Enterprise disclosures completely,

OFHEO should implement mandatory regulations that provide for mandatory disclosure similar to that required of SEC-registered companies and build staff resources necessary to oversee compliance. Alternatively, the Congress should repeal the exemptions of the Enterprises from the Exchange Act and the Securities Act of 1933. Either option should result in the type of mandatory disclosure and oversight regime necessary to ensure safe and sound conduct.

4. OFHEO Should Consider Requiring a Periodic Change of the External Auditors at the Enterprises, Not Just a Change in Engagement Partner

The accounting problems at Freddie Mac were discovered only after Arthur Andersen, which had been the only external auditor of the Enterprise since it was chartered in 1970, was replaced by PricewaterhouseCoopers. Given the importance of auditor independence, OFHEO should study the feasibility of mandating a periodic change in the external audit firm to determine if that would enhance the safety and soundness of the Enterprises.

5. OFHEO Should Require Freddie Mac to Hold a Capital Surplus and Should Consider Limiting the Growth of the Retained Portfolio Until Freddie Mac Produces Timely and Certified Financial Statements

Until all reconciliation efforts have taken full effect, Freddie Mac remains exposed to substantial management and operations risk. Accordingly, OFHEO should require Freddie Mac to hold a specific surplus of up to 30 percent over its regulatory capital requirement—the greater of its minimum capital requirement or its risk-based capital requirement—until such time as the Director determines that the Enterprise has produced complete and accurate financial statements that are certified and current. In addition, those requirements would enhance the safety and soundness of Freddie Mac as the Enterprise implements its remediation plan.

Financial regulators frequently impose growth restrictions on institutions facing operational difficulties. OFHEO should consider requiring that the remediation plan of Freddie Mac include appropriate limits on the growth of its retained mortgage portfolio

until such time that the Director has determined that the Enterprise has made satisfactory progress in the implementation of its remediation plan.

6. OFHEO Should Establish a "Materiality" Standard for the Provision of Sufficient Information to the Board of Directors

Our review found instances where management failed to provide the Board with information it should have received in order to fulfill its oversight role. Therefore, OFHEO should establish, through formal guidance or regulation, a standard requiring the provision of adequate and appropriate information by management to the Board. That standard should draw upon the materiality standard in the accounting profession, which we believe is appropriate to the wider spectrum of reporting and disclosure issues facing the Enterprises. As a general matter, information should be provided by the management of an Enterprise to its Board and Board committees if a reasonable director would find the information important to the fulfillment of the director's fiduciary obligation.

7. Freddie Mac Should Impose Strict Term Limits on the Members of the Board of Directors

A Board of Directors capable of exercising independent judgment is essential to the safety and soundness of Freddie Mac. In order to promote the highest level of Board functioning, the Enterprise should adopt bylaws providing that no Director may serve on the Board for more than ten years or past the age of 72, whichever comes first.[487]

8. OFHEO Should Ensure that the Board Becomes More Actively Involved in Oversight of the Enterprise

The Board of Freddie Mac must be more involved in the oversight of the Enterprise, not just in times of crisis, but in the normal course of business. That will require the Board and Board committees to meet at least twice each quarter to ensure they can exercise adequate oversight of management. In addition, the Congress should enact legislation

[487] A transition period may be necessary to permit an orderly turnover of current Directors.

abolishing the presidentially appointed Board member positions. Also, representatives from OFHEO should periodically attend meetings of the Board.

9. Freddie Mac Should Establish a Formal Compliance Program

The failure of Freddie Mac to develop formal written policies or procedures regarding legal and accounting compliance has contributed to the development of an ineffective compliance program and frequently inadequate disclosures. The Enterprise should establish a comprehensive compliance program and create a position of Chief Compliance Officer to direct that program. The Chief Compliance Officer should report to the CEO and be responsible for ensuring that Freddie Mac complies with all regulatory requirements and internal controls and adheres to best practices. The Chief Compliance Officer should formally establish written internal controls and disclosure controls and procedures[488] for the Enterprise and provide for their periodic review and updating. The compliance program should designate areas of business to be covered and develop procedures for discharging compliance within such areas.

To support the compliance program, Freddie Mac should establish an easily accessible channel through which employees can report information about instances of potential non-compliance to a designated compliance official. The Enterprise should encourage employees to report such information and ensure that the anonymity of reporting employees is protected.

The Chief Compliance Officer should meet periodically with the Board of Directors as a way to ensure the Board is able to 1) assess adherence to the current policies and procedures of the Enterprise regarding compliance, 2) fine-tune such policies and procedures as needed, and 3) stay abreast of senior management judgments regarding "close-calls" when determining whether compliance is adequate.

[488] The SEC has adopted rules requiring companies to include in their annual reports a report of management on the internal controls over financial reporting of the company pursuant to section 404 of the Sarbanes-Oxley Act of 2002. 68 Fed. Reg. 36636 (June 18, 2003).

OFHEO acknowledges the recent hiring by Freddie Mac of a Chief Compliance Officer and other related steps taken by the Enterprise, and will evaluate the sufficiency of those actions.

10. Freddie Mac Should Establish the Position of Chief Risk Officer

Certain problems arising at Freddie Mac can be attributed to imbalances of power within the organizational structure of the Enterprise. For example, the Funding & Investments Division (F&I) of Freddie Mac included many of the most highly paid employees of the Enterprise. That division wielded significant clout over the entire organization, and the Market Risk Oversight unit tasked with overseeing the activities of F&I did not have the requisite stature to be effective. The effectiveness of Market Risk Oversight was compromised in part by reporting to the Chief Financial Officer.

Freddie Mac should establish a position of Chief Risk Officer charged with enhancing the risk management of the Enterprise. The Chief Risk Officer should report directly to the CEO of Freddie Mac, which would give the Chief Risk Officer the stature to deal effectively with the business units. The heads of Market Risk Oversight, Credit Risk Oversight, and Operational Risk Oversight should all report directly to the Chief Risk Officer, so that those units would combine their efforts to oversee activities that pose multiple risks.

OFHEO acknowledges the recent creation by Freddie Mac of a Chief Enterprise Risk Oversight Officer position. OFHEO will evaluate the effectiveness of the new organizational structure for risk oversight, particularly with respect to resource allocation and efforts to hire a new Market Risk Oversight Officer.

11. Freddie Mac Should Document the Legitimate Business Purpose of Every Significant Derivative Transaction

The special examination found that Freddie Mac engaged in large derivative transactions that had little or no risk management purpose and whose only business purpose was to shift income to future periods. In order to prevent such transactions from occurring in the

future, Freddie Mac should document the business purpose of all of its significant derivative transactions. That information should be included as part of any hedge documentation for the derivative instrument.

12. Freddie Mac Should Establish and Maintain Superior Accounting Controls

The senior management and Board of Directors of Freddie Mac are responsible for establishing and maintaining a strong internal control system that will provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. Management and the Board should identify and, most importantly, follow-up expeditiously on all control weaknesses, including those identified by OFHEO, management, Internal Audit, and the external auditor. Each business unit should take responsibility and be held accountable for ensuring that corrective actions are undertaken within established deadlines or seeking written approval from the Audit Committee to accept the risk of non-compliance. The Enterprise should make a superior accounting control system a top priority in terms of time and budget, and not attempt to use its external auditor for this purpose.

13. Freddie Mac Should Prevent Undue Reliance on the External Auditor

Freddie Mac should take measures to prevent undue reliance on its external auditor. The measures should include, but should not be limited to, adequate accounting staffing levels and expertise, sound and comprehensive accounting policies, and a comprehensive and fully operating internal control system. Those measures should provide for a control environment where reliance on the external auditor in day-to-day operations would not be needed or tolerated. Finally, the Board and senior management should review all consulting work performed by the external auditor to assure, at a minimum, compliance with the Sarbanes-Oxley Act of 2002.

14. Freddie Mac Should Strengthen and Clarify the Role of the Internal Audit Department

The Internal Audit (IA) Charter of Freddie Mac should be revised to address the responsibility of the IA Department regarding the reliability and integrity of financial and operational information. That Department should consult the applicable standards and develop the appropriate policies and procedures to accomplish that task. The process for audit corrective actions should be revised to identify a designated accountable party in the IA Department and incorporate hard deadlines for remedying identified weaknesses. The Department should designate a staff member to follow up with the responsible person in the business unit to ensure that the audit corrective actions have been completed by the deadline. That policy should also identify the appropriate procedures the IA Department should follow if the business unit does not comply and the consequences for the business unit. Finally, the IA Charter should be revised to indicate that the head of the Internal Audit Department (General Auditor) is responsible for full disclosure of control weaknesses, related risk exposures, and progress on remedial actions to the Audit Committee. Furthermore, the Charter should note that the General Auditor may be culpable for non-compliance in the event that an identified weakness is not reported to the appropriate level of management and the Board.

15. OFHEO Should Expand Its Capacity to Detect and Investigate Misconduct

A risk-based examination program is a key component of the supervisory framework of OFHEO. OFHEO should evaluate ways to strengthen the ability of its supervisory program to detect misconduct. For example, although OFHEO examiners regularly assess internal controls to determine if such controls are strong enough to prevent fraud, the effectiveness of the OFHEO examination program would and should be enhanced by including more substantive tests of the internal control framework. Those tests should include procedures to assess the risk of management actions to override Enterprise controls. The examination program should also include procedures to identify incentives or pressures to commit fraud, as well as opportunities to carry out fraud. OFHEO should

seek additional resources to assure that those procedures can be implemented as part of its supervisory framework.

16. OFHEO Should Conduct a Special Examination of the Accounting Practices of Fannie Mae

Freddie Mac management engaged in questionable and often improper accounting practices in an effort to produce steady, stable earnings growth. The success of management in doing so was expected to be rewarded by favorable opinions of Wall Street analysts that would, in turn, 1) result in the expansion of price/earnings multiples and improved performance of the stock and stock options of the Enterprise and 2) provide comfort to private credit rating agencies, thus securing continued high credit ratings of the debt offerings of Freddie Mac and, thereby, maintaining its low cost of capital. As substantial holders of stock and stock options of the Enterprise, Freddie Mac executives and Board members had a personal financial stake in the success of the operations of the Enterprise and that performance being reflected favorably in the price of its securities. The same incentives and motivating forces exist at Fannie Mae.

We recommend that OFHEO conduct a special examination of Fannie Mae to investigate those and any other transactions by the Enterprise, including any that have any unusual characteristics, that raise similar issues. OFHEO should retain and work with an independent forensic accounting firm to review the accounting policies, controls, and governance structure of Fannie Mae. The scope of that special examination should include a focus on transactions that significantly accelerate or defer the pattern of income recognition, or transactions undertaken for the purpose of allowing the Enterprise to explicitly change the character or classification of an asset or liability. In both cases, such transactions proved problematic at Freddie Mac; OFHEO should determine if similar problems exist at Fannie Mae.

Also, the special examination should pay particular attention to any transaction that was not executed at prevailing market prices or does not appear to have a valid business or risk management purpose or economic substance. Further, the scope of the

examination should cover any transaction executed without appropriate authorization or that has not been accurately recorded in the financial records of Fannie Mae.

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