Freddie Mac Now Threatens the Global Bubble It Propped Up

by Richard Freeman

"Freddie Mac sent a shiver through the financial markets after it announced an abrupt change of top management, raising concerns about the stability of the number-two U.S. mortgage lender," the *Financial Times* of London reported June 10. The day before, Freddie Mac (originally called the Federal Home Mortgage Loan Corporation) had fired its president, and forced the resignation of two top officers. Its reason was that its derivatives holdings had been improperly stated, and that it was therefore restating its balance sheets from 2000 through 2002. Fewer and fewer people accept the huge mortgage-finance company's official version of the ousters. It's stock plunged 20%, wiping out almost $8 billion of Freddie Mac's market capitalization. Freddie Mac also took the extraordinary step of buying back $10 billion of its financial paper on the open market, in order to stabilize the markets.

Knowledgeable observers are looking for far more serious problems at Freddie Mac. Highly speculative financial derivatives are a major concern, typified by the *Washington Post* headline on June 10, "Firing Fuels Doubts on Derivatives." An unnamed bank chairman told the June 12 *New York Post* that the Freddie Mac crisis "sounds like the derivatives disaster that nearly wiped out everyone back in 1998"—when the Long Term Capital Management (LTCM) hedge fund collapsed, almost melting down the world financial system. The banker continued, "It frightens a lot of us that it could happen again, but worse."

The reality is that the world financial system is bankrupt, overburdened by $400 trillion of speculative instruments. In this setting, the Freddie Mac crisis is both a symptom of the untenable system, and a potential detonator of its demise. Since 1995, Freddie Mac, and Fannie Mae (Federal National Mortgage Association), with the help of Federal Reserve Chairman Alan Greenspan's activities, have built the biggest housing bubble in world history, now valued at $11.9 trillion, which cannot be sustained. The failure of Freddie Mac, in the world of derivatives and other speculative entanglements, means not only imploding the over-leveraged U.S. housing bubble, but triggering new shock waves throughout the already-shattering world financial system.

Manipulation of Derivatives

The Freddie Mac crisis steadily escalated since early June. On June 9, the company announced the firing of David Glenn, its president and chief operating officer, for refusing to fully cooperate with, and possibly obstructing, the work of auditors who were assigned to review and restate the company's earnings over 2000-2002. Freddie Mac also forced the retirement of its chairman and chief executive officer, Leland Brendsel, and of its chief financial officer Vaughn Clarke. Its press release stated that Glenn was fired "because of serious questions as to the timeliness and completeness of his cooperation and candor with the board's audit committee."

At the beginning of the year, at the behest of its new accounting firm, PricewaterhouseCoopers (which had replaced Freddie Mac's previous accountants, Arthur Andersen), the company launched a review of its financial statements dating back to 2000. At issue is the manner by which Freddie Mac states its derivatives portfolio. The media have leaked the story that Freddie Mac manipulated its statement of derivatives' profits and gains, to understate derivatives profits during good years, and to overstate their profits during bad years, to boost earnings in those years.

Apparently, Glenn kept a diary/journal, which the audit committee had asked to see. According to reports, Glenn ripped out some pages and altering others before handing the diaries over to an independent counsel hired by the Freddie Mac audit committee.

It may be true that David Glenn and Freddie Mac manipulated derivatives holdings and profits to dress up the overall reported earnings; but that is secondary. More fundamental is that Freddie Mac aggressively used derivatives, over the last few years, to prop up, and simultaneously to prevent the U.S. housing bubble from blowing out. The practice had made Freddie Mac a darling of Wall Street, whose bankers criticized Fannie Mae (which has troubles of its own), for not being as "smart" in derivatives use. The volatility of the derivatives market in general, and the problems of housing paper in particular, may have created the troubles in Freddie Mac's derivatives portfolio: This is what should be seriously investigated, as we will discuss below.

Alan Greenspan's Federal Reserve, in the week of June 9, issued reassuring statements about the ability of the U.S. banking system to handle the upheaval in Freddie Mac and related bonds—a clear sign of "systemic effects" fears underneath.

Three Probes Under Way

Investigations were launched by three different U.S. government agencies into Freddie Mac's alleged misdoings.

The Office of Federal Housing Enterprise Oversight (OFHEO), of the Department of Housing and Urban Development, has oversight of Freddie Mac and Fannie Mae, originally creations of the Federal government. OFHEO knew at least as early as June 4, of the pending management shake-up at Freddie Mac. OFHEO's director Armando Falcon released a statement on June 7, expressing that "I have become increasingly concerned about evidence that has come to light of weakness in controls and personnel expertise in accounting areas and the disclosure of misconduct on the part of Freddie Mac employees. The removal of members of the management team only goes a part of the way toward correcting serious problems—concerns surrounding management practices and control remain. . . . OFHEO is deploying a special team to investigate all aspects of the issues surrounding the review of the re-audit that revealed deficiencies in accounting practices and controls and the matter of employee misconduct discovered on June 4, 2003. I expect the Board and management's full cooperation with this initiative."

In fact, as early as Feb. 4, 2003, Falcon and OFHEO released a 115-page report, entitled "Systemic Risk: Fannie Mae, Freddie Mac and the Role of OFHEO." In which OFHEO stated that a severe crisis could cause Fannie Mae and Freddie Mac to default on its debt, and such a default "could lead to contagious illiquidity in the market for those [debt] securities, [and] cause or worsen liquidity problems at other financial institutions . . . potentially leading to a systemic event." This could, in turn, the report said, deliver a shock to the entire financial system (see *EIR*, March 14, 2003). On Feb. 5, not 24 hours after the report became public, the Bush Administration demanded Falcon's resignation, and announced that he would be replaced by Mark Brickell, who for 15 years had headed the derivatives desk at JP Morgan Bank. However, Falcon, who may be determined to get to the bottom of the matter, still holds office, because Brickell's nomination is still pending.

Early in the week of June 9, the U.S. Securities and Exchange Commission announced that it had opened up an investigation of Freddie Mac. And, on June 11, the U.S. Attorney for the Eastern District of Virginia, in Alexandria, announced it had initiated a criminal investigation involving the company.

Fed Assurance 'There Is No Crisis'

Immediately, investors stampeded out of Freddie Mac stock and other financial instruments.

The day that Freddie Mac dismissed its top executives, its stock dropped 16.3%. Freddie was able to stabilize the stock price for the next two days, but on June 12, selling forced the stock down by 20% for the week, wiping out almost $8 billion in market capitalization.

At the same time, investors sold significant amounts of Freddie Mac bonds and financial paper (as well as those of Fannie Mae, on a smaller scale), and used the cash to heavily purchase U.S. Treasury securities. Predictably, this sent the price of U.S. Treasuries up, and the yields down: By June 12, the yields on 10-year Treasuries had crashed to 3.16%, the lowest level in 45 years.

Freddie Mac is one of the most indebted companies in the world. Should the sell-off of Freddie Mac bonds continue, it would destabilize the Freddie Mac bond market, with adverse international implications. Over June 12-13, Freddie Mac bought back its bonds on the open market, to the tune of nearly $10 billion—triple its prior record buy-back.

Finally, as the crisis deepened, Federal Reserve Board Governor Susan Bies stated, presumably in her most reassuring voice, on June 11, "The housing market is still very strong. And banks as a whole are very liquid right now, they have plenty of room to extend credit. So I haven't seen any signs that there will be a short-run impact" triggered by Freddie Mac.

When it reaches the point that the Federal Reserve Board has to state publicly that "there is no fire," one can generally assume that there *is* a fire. When the Fed must issue a public statement, that banks "have plenty of room to extend credit"—that there is no crisis and that plenty of liquidity is being made available—it indicates that the problem is mushrooming, and that the Fed has been working overtime in crisis mode, with central banks and financial institutions, to print money and apply measures that attempt to stop an expanding Freddie Mac crisis from blowing apart the U.S. and world financial system.

Origin of the Housing Bubble

But one can only fully fathom how the crisis at Freddie Mac has turned into the burning fuse to the world financial-monetary powderkeg, if one looks at its role in creating the biggest housing bubble in history, a bubble which started in the 1980s, and became a significant factor in world finance in 1995. The bubble-blowers viciously subverted the original purpose of Fannie Mae and Freddie Mac, which were intended to create and maintain the housing market to make available decent, inexpensive, and affordable homes to the average-income family.

The foundation of the Federal National Mortgage Association—nicknamed Fannie Mae—is in 1934 housing legislation, sponsored by the Roosevelt Administration, and Fannie Mae itself was established in 1938. During the mid-1930s, when housing was depressed, many home mortgage lending institutions were still skittish about making new mortgage loans. President Franklin Roosevelt sought to ease their fears, by having an institution buy housing mortgages from mortgage lenders: A mortgage lending institution, which had just issued a new mortgage to a homeowner, could sell that mortgage to Fannie Mae for cash; it would then use that cash, to make another new mortgage, and sell that to Fannie Mae, and so on.

Freddie Mac—the Federal Home Mortgage Loan Corp.—was born in 1970 to perform a function very similar to that of Fannie Mae. During normal times, these two would merely be providing liquidity to the housing market.

But the perversion of these institutions' function, in order to build the bubble, was undertaken by Federal Reserve Board Chairman Paul Volcker, who imposed a regime of high interest rates, in line with his policy for "controlled disintegration of the economy." Starting in October 1979, Volcker jacked up interest rates until the best rates reached 21.5% in December 1980. This destroyed the savings and loan associations, and with them, housing financing. It opened the door for changing the function of Fannie Mae and Freddie Mac to the building of the housing bubble (see "Fannie and Freddie Were Lenders," *EIR*, June 21, 2002.)

Beginning in the early 1980s, and accelerating since 1995, Fannie and Freddie have been used to allow mortgage lending institutions to make mortgages to finance home purchases priced up to the conventional loan limit, which is now $310,000; the mortgage lending institutions sell the mortgage to Freddie or Fannie, and with the cash, make another mortgage loan for up to $310,000, etc. *This mechanism is crucial for the perpetuation of the housing bubble, providing lending institutions the gargantuan volume of liquidity to finance the purchase of vastly overpriced homes.*

Since 1995, home prices have been exploding. Just between the first quarter of 2002 and the first quarter of 2003, housing prices soared in Rhode Island by 14.6%, for example. Prices in other states ballooned by a minimum of 10%, year on year, including in the District of Columbia, California, New Jersey, Florida, and New York. The *average* new home price in San Francisco now exceeds $500,000. And, the quality of many of these homes is far inferior to those built 30 years ago.

Millions of families spend 35-50% of their annual income on mortgage payments, "in over their heads." However, *there is a physical constraint on their ability to pay, and thus, ultimately, a constraint on the housing bubble itself:* Many of these families work two, three, or more jobs spread out among the family members. These families are one or two missed paychecks—never mind losing a job—away from defaulting on their mortgage.

Nonetheless, rejecting reality, Fannie and Freddie decided to defy physics, and continue to move the purchase of unaffordable homes. Consider the case in which a bank with $200 million in assets, seeks to lend half that amount in housing mortgage loans. If the bank were unable to sell its mortgage loans to Fannie Mae or Freddie Mac, and had to hold them until they reached maturity—let's assume these are 30-

year mortgages—the bank would very soon exhaust its $100 million limit. But, if the bank can sell Freddie and Fannie the mortgage loans, up to the $310,000 limit, technically, it can make an unlimited number of $310,000 loans. This schema still leaves the bank with enough capital unrestricted, to make some mortgage loans above the conventional loan limit, called "jumbo loans." These jumbos could finance home purchases in the range of a half-million dollars, $1 million, or above.

'John Law' $11.92 Trillion Housing Bubble

Freddie Mac and Fannie Mae have built up a huge housing bubble. They can carry out this operation by issuing three types of highly risky obligations: 1) corporate bonds that Freddie and Fannie issue; 2) mortgage-backed securities (MBS), in which Freddie and Fannie group mortgages, put a guarantee on it (for which they earn a fee), and then package these MBSs for sale to insurance companies, pension funds, and international investors; and 3) derivatives, which Fannie and Freddie have.

Adding these obligations together, Fannie Mae and Freddie Mac have a combined total of $4.80 trillion of risky obligations outstanding. Other institutions that perform similar functions, such as the Federal Home Loan Bank Board, possess an additional $900 billion in risky obligations. Thus, the total of housing-related high-risk obligations is $5.70 trillion. However, at the same time, home mortgages in the United States total $6.22 trillion. The Fannie and Freddie financial obligations are undergirded by these mortgages, but they are totally distinct financial instruments, that are additional to the $6.22 trillion. Altogether, the U.S. housing bubble totals $11.92 trillion. Democratic Presidential pre-candidate Lyndon LaRouche has called this the "John Law housing bubble," burdening the homes and the incomes of America's homeowners. It is also unsustainable.

Spreading and Interconnecting the Risks

There are innumerable ways in which the international financial world is exposed to and interconnected with the housing bubble, and vice versa.

Together, Freddie Mac and Fannie Mae have $1.50 trillion in debt outstanding, most of it which they have issued as bonds; together, they have also put a guarantee upon and packaged $1.78 trillion worth of mortgage-backed securities. A great many institutions own Freddie Mac- and Fannie Mae-issued bonds and MBSs: this includes pension funds, mutual funds, institutional investors, insurance companies, and international investors.

Consider that at year-end 2001, some 60% of the banks owned Fannie or Freddie bonds in excess of 50% of their equity capital (the value of its stock, which represents the funds it would draw upon to cover its losses in case of emergency). Should either Fannie Mae or Freddie Mac default on its bonds, a large part of the U.S. banking system would be sent to the poor-house.

TABLE 1

Derivatives Holdings of Fannie Mae and Freddie Mac

($ Billions)

	Fannie Mae	Freddie Mac
1997	161	96
1998	188	313
1999	275	424
2000	320	474
2001	533	1,052
2002	657	867

Sources: Fannie Mae (Federal National Mortgage Association); Freddie Mac (Federal Home Mortgage Loan Corporation); Office of Federal Housing Enterprise Oversight.

And, the exposure works also in the opposite direction: **Table 1** shows the domain where the highly leveraged derivatives bubble and the highly leveraged housing bubble intersect. Freddie and Fannie have made use of derivatives to prevent the housing bubble from exploding. Freddie Mac doubled its derivatives holdings to above $1 trillion, as it aggressively turned to derivatives. Freddie claims that during 2002, its notional derivatives holdings outstanding fell by $185 billion. The figure is rather dubious, and could be an example of where Freddie Mac distorted the size, or undereported its derivatives portfolio.

This exemplifies the deadly interpenetration of markets. Volatility of the derivatives market could add—as it may have already—to the pressures that could blow out Freddie Mac. Meanwhile, Freddie Mac's mounting instabilities could infectiously transmit instabilities into the derivatives market. The problem is that in such highly-leveraged markets, a sudden shift in interest rates or a credit cut-off, even by a small amount, can produce an amplified effect.

The U.S. housing market, ballooned to $11.92 trillion, is bankrupt. It is threatened by the reality that as workers are laid off, they cannot pay their greatly inflated mortgages, attached to greatly inflated home prices. Freddie Mac's primary mission for the last 15 years has been to build that bubble, and to employ every variety of financial manipulation, including derivatives, to keep it aloft. Fed Chairman Greenspan has pumped in credit at very low rates to further that bubble process. The unsustainable bubble and the interconnected dangers from other unstable markets, govern the activity of Freddie Mac, but also make it very vulnerable to collapse, which would radiate through the world financial system. The criminal activity is at the higher level of the housing bubble, and what was done to keep it going: The U.S. agencies that have announced criminal investigations into Freddie Mac, should look into that.