Richard Syron Aims to Strengthen Freddie Mac's Foundation -- and Its Accounting Practices

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Richard F. Syron, chairman and CEO of mortgage-securities giant Freddie Mac, says he remains "bearish" on the housing market and sees a rising tide of mortgage defaults and foreclosures on the horizon. He doesn't believe a rebound will happen until late summer of 2007 when the nation's housing inventory, bloated from weak sales, gets whittled down.

"I don't think it will be catastrophic and I don't want to be the guy out there saying the sky is falling," said Syron, who talked with Knowledge@Wharton before delivering a Wharton leadership lecture. "But I don't think it will be a soft landing," he said of the mortgage industry's exposure to the housing slump.

Many people these days are facing higher mortgage bills because of adjustable-rate mortgages. At the same time, the labor market has faltered, pulled down by slower economic growth. Both the residential housing and the U.S. vehicle-manufacturing industries, which directly employ almost two million workers, are stumbling.

Mortgage standards loosened at the end of the housing cycle, allowing some home buyers to squeak by the qualification process with extra earnings from overtime and outside jobs. When extra earnings disappear, and/or as layoffs occur, homeowners default on mortgage payments. To top it off, housing sales -- and the prices these homes now go for -- are weakening which means, for example, that selling a home to downsize has disappeared as an option for many owners. The convergence of these three trends -- a weaker economy, higher mortgage bills and a slumping housing market -- has the industry worried. "It's amazing to us that we have not seen a [mortgage default upturn] yet," Syron said, adding that Freddie Mac officials anticipate an increase in defaults down the road.

In the first week of January, Freddie Mac -- officially called The Federal Home Loan Mortgage Corp. -- said it expected to register losses for the third and fourth quarters of 2006. Specifically it predicted a loss of $550 million for the third quarter, compared to a profit of $880 million a year earlier. The company pegged the losses to a decline in interest-rates.

Freddie Mac got into trouble in 2003 for understating earnings by about $5 billion in an apparent attempt to smooth out volatility in its profit statements. Freddie Mac paid $125 million in penalties to its regulator, the Office of Federal Housing Oversight, to settle charges of accounting fraud. Its accounting transgressions, however, paled in comparison to those that surfaced two years ago at Fannie Mae [The Federal National Mortgage Association], which has been the focus of several federal investigations for manipulating earnings, off-balance-sheet arrangements and poor internal controls. Earlier this year, Fannie Mae agreed to pay federal regulators $400 million in penalties. On December 6, the company announced it had officially erased $6.3 billion in profits for misstating earnings from 2001 through June 2004. And on December 18, the government filed civil charges against Franklin Raines, former head of Fannie Mae, and two other executives, for their alleged role in the scandal. The government is attempting to recover more than $115 million the men earned in bonus money, and another $100 million in fines.

Both Freddie Mac and Fannie Mae -- which were created in 1970 and 1938, respectively, to help ensure that moderate-income Americans were not priced out of the housing market -- have faced criticism from the Republican-led Congress and former Federal Reserve chairman Alan Greenspan, who say they are too large financially and pose a threat to private mortgage companies. Detractors claim the companies use their government charters -- which allow them to borrow money cheaply and which some say amount to subsidies -- to boost profits. The Fannie Mae and Freddie Mac accounting scandals, which came after the corporate implosions at Enron and WorldCom, led to calls for the companies to dismantle their investment holdings or lose their federal charters.

Freddie Mac, which is considered a pioneer in the secondary mortgage market, does not originate mortgages, but buys them from commercial banks, mortgage banks, savings institutions and credit unions, supplying the housing industry with liquidity for new home sales. The McLean, Va., company says it bought mortgages at a rate of one every seven seconds in 2004. Freddie Mac keeps some mortgages for its own investment portfolio, and packages and sells the rest to investors, including Asian or European institutions.

Many investors believe that because of Freddie Mac's legal charter, the U.S. government would prevent it from defaulting in a financial crisis. Freddie Mac pays federal taxes but is exempt from state and local income taxes and has less stringent capital requirements than banks. Its cost of capital is low, or only slightly higher than long-term Treasuries. This gives it an advantage when competing against other banks or financial-services companies, experts say.

Some Cause for Optimism

Before joining Freddie Mac in 2003, Syron had been chairman of Thermo Electron, a Waltham, Mass.-based scientific instruments company which recently purchased Fisher Scientific International. He went to Thermo Electron from the American Stock Exchange, where he was CEO from 1994 to 1999. He held top posts at the Federal Reserve Bank of Boston between 1989 and 1994 and, before that, was president of the Federal Home Loan Bank Corp. A graduate of Boston College, Syron earned master's and doctorate degrees in economics from Tufts University.

Syron readily admits that Freddie Mac brought the trouble on itself with its accounting practices, but he predicts that calls to dismantle the company are likely to fade with the newly elected Democratic-controlled Congress. At the same time, he expects that both Freddie Mac and Fannie Mae will face more stringent regulations and other pressure, especiallyif the new Congress calls for expandinghomeownership opportunities. "People no longer think we're crooked," Syron said. But the issue now is getting them to believe that the company is well-run.

Despite the current uncertainty in the housing market, Syron said the housing slump shouldn't be as deep as the one in the early 1990s, when it took some regions eight years to recover. Syron singled out three areas -- Boston, Los Angeles and Houston -- hurt by the last housing downturn, all for different reasons. The Boston economy in the late 1980s and early 1990s was driven by a construction boom, including new office towers. When the construction ended, the region's economy weakened and took the housing market with it. The end of the Cold War battered Southern California's defense industry, a beating that cascaded into the housing market. In Texas, Houston's housing market was hitched to declining oil prices. These three areas, Syron said, appear more prepared to handle the current housing pullback.

Other experts have noted that the banking system is stronger in this downturn than during the one in the late 1980s and early 1990s. Then, the nation's savings-and-loan industry needed a huge bailout, further straining the mortgage market. Becausespeculation drove the imbalance in housing this decade, Syron doesn't see similar regional problems. But he worries about the impact of the persistently weakening dollar on international currency markets and the U.S. trade and budget deficits.

As Syron noted, overseas investors have not lost their appetite for buying U.S. mortgage-backed securities. Yet Freddie Mac officials have noticed some reluctance among Asian investors for dollar-denominated investments, such as U.S. mortgages, given that the value of the dollar has declined on international currency markets in recent weeks. "The greater concern we have seen overseas is what has happened to the dollar," he said.

As an institution, Freddie Mac has confidence it can get through the downturn without nasty surprises, Syron added. Ironically, the accounting scandals forced the company to proceed cautiously during the boom, insulating it from some excesses. For example,because of its accounting and computer problems, Freddie Mac did not participate aggressively in popular and risky new mortgage products. These include interest-only mortgages, which allow buyers to pay only the interest, and not the principal, on the loan for a number of years. The mortgages were designed to help people buy houses that they couldn't otherwise afford. Other products included negative amortization mortgages, which allow a borrower to plow some interest back into the mortgage principal. This delays repayment of the loan and can lead to sharp increases in monthly payments. It also could lead to a mortgage holder owing more on a mortgage than the underlying property is worth.

"I'd like to think that wewouldn't do some of the dicier stuff," Syron said, at the same time acknowledging that the company's "internal system was not configured" to handle a large volume of new mortgage products. "We still don't have the capacity to buy everything that is being originated," he noted, adding that mortgage standards are tightening in the downturn, as they should. "Anytime you come to the end of a boom, you get a natural tightening."

As housing prices spiked in the boom, Freddie Mac found itself closed out of many deals because of price. By regulation, the largest mortgage it can purchase from an originator is $417,000. Consequently, Freddie Mac did not participate in the explosion of high-priced homes in fashionable zip codes. Some of these areas were convulsed by speculation and are now bearing the brunt of the slump. Toll Bros., the nation's largest luxury homebuilder whose average selling price in 2005 was about $700,000 per home, recently reported a 57% decline in contracts for single-family homes and a 37% cancellation rate by prospective home buyers in the fourth quarter. Syron said it appeared that large "McMansion"-style homes have "gone out of fashion."

Freddie Mac is in the midst of spending about $1 billion to fix problems related to accounting and other financial reporting systems, which still aren't ready for prime time. "It was a supertanker on the chassis of a '49 Ford," Syron said of Freddie Mac's old accounting system and its inability to cope with growth. "Think of a 7-Eleven that became a Wal-Mart."