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SEC Fannie Mae Probe Said to Examine CEO's Testimony to Congress

By Joshua Gallu - Apr 6, 2011

As the housing market deteriorated in April 2007, Fannie Mae Chief Executive Officer Daniel Mudd reported to Congress on his company's health. The firm's exposure to subprime loans, he told lawmakers, "remains minimal, less than 2.5 percent of our book."

Within 18 months, U.S. regulators seized the government- sponsored mortgage firm and its smaller sibling, Freddie Mac, after losses on soured loans pushed them to the brink of insolvency. The two firms have drawn more than $150 billion in life support from the Treasury since then.

Mudd's statements to Congress are being scrutinized as part of a Securities and Exchange Commission probe, according to a person briefed on the matter. Regulators may be examining what Mudd knew about the loans and how he defined subprime when he testified before the House Financial Services Committee.

The questions are part of a larger investigation into whether Washington-based Fannie Mae and Freddie Mac of McLean, Virginia, told investors enough about the risky loans they loaded into their portfolios as the credit crisis loomed, according to two other people with direct knowledge of the investigation.

The SEC has already sent so-called Wells notices -- warnings that the staff intends to pursue a civil enforcement action -- to Mudd and at least three other former executives of the firms. If claims are filed, the probe could become one of the widest to emerge from the financial crisis.

The investigation echoes the agency's case against Citigroup Inc. (C), which agreed in July to pay $75 million after the SEC accused the bank and two executives of failing to disclose $40 billion in subprime assets before losses surged.

Freddie CEO

At the same April 2007 hearing where Mudd testified, Richard Syron, who was then the CEO of Freddie Mac and has also received a Wells notice, said his firm hadn't "been heavily involved in subprime all along."

Others who have acknowledged receiving Wells notices are Donald Bisenius, Freddie Mac's former executive vice president for single-family credit guarantee, and Anthony "Buddy" Piszel, Freddie Mac's chief financial officer from November 2006 to September 2008.

Last week, U.S. District Judge John Keenan in New York threw out a shareholder lawsuit alleging that Freddie Mac, Syron and Piszel misrepresented the firm's investments in risky mortgage products and hid its true financial condition through "a series of partial disclosures." Keenan said the lawsuit failed to prove intentional fraud and he dismissed the suit without prejudice, meaning others can file similar claims.

In the SEC's case, regulators could file civil claims contending that the executives intentionally misled the public or, in a lesser allegation, that they should have known their statements were misleading.

'Disagree' with SEC

Bisenius didn't return a phone call seeking comment. Piszel declined to comment through his assistant at Santa Ana, California-based CoreLogic Inc. (CLGX) Mark Hopson, Syron's attorney at Sidley Austin LLP in Washington, didn't respond to an e-mail seeking comment.

Mudd has been CEO of Fortress Investment Group LLC (FIG) since 2009. He confirmed in a March 11 statement that he'd received the Wells notice, saying he "could not disagree more" with the SEC staff's decision to pursue claims. "These disclosures and procedures that are subject of the staff's investigation were accurate and complete," he said.

During Mudd's tenure as CEO of Fannie Mae, from 2004 through the government takeover in 2008, the firm ramped up its business with lower-quality mortgages. Mudd said in a 2006 interview that he planned to expand the companies' holdings to include more higher-risk loans. Anything else would be "counterproductive," he told investors in March of that year.

Narrow Definition

Just how much of Fannie Mae's portfolio was subprime by 2007 depends on how loans are categorized. Regulators may question whether the 2.5 percent Mudd calculated for the lawmakers was consistent with how he defined subprime for them.

Mudd told the committee that subprime wasn't "precisely defined" by the industry. "About 2.5 percent of our book could be represented as being in subprime, either by virtue of coming from a lender that's designated as a subprime lender or as terms that would, generally, be considered subprime," he said. That echoed the broad definition Fannie Mae used in regulatory filings that subprime loans are those to borrowers "with a weaker credit profile than that of a prime borrower."

The 2.5 percent didn't include billions of dollars in so- called Alt-A loans from lenders that made subprime loans, including Countrywide Financial Corp. of Calabasas, California, and New Century

Financial Corp. and Ameriquest Mortgage Co., both based in Irvine, California. All three went bankrupt or were forced to sell.

10 Percent

While Alt-A loans weren't considered the riskiest mortgages, they typically came with less documentation than prime mortgages about the borrower's ability to pay. When the Federal Housing Finance Agency, the regulator of the two big mortgage firms, assessed Fannie Mae's portfolio of single-family mortgages in 2008, it reported that Alt-A alone made up about 10 percent of the loans.

Including Alt-A, as much as 30 percent of the firm's single-family loan purchases between 2003 and 2007 "would generally be considered subprime, even if they were not always categorized by Fannie Mae in such a manner," Mark Calabria, director of financial regulation studies at the Cato Institute in Washington, said in a March 7 analysis.

The impact of the risky loans was felt in 2008, when Fannie Mae reported that Alt-A mortgages, particularly those purchased in 2006 and 2007, made up a "disproportionate" share of its $58.7 billion in losses. Regulators seized Fannie Mae and Freddie Mac in September 2008.

'Thoughtful and Careful'

During Mudd's tenure, Fannie Mae provided details of its portfolio in corporate filings, breaking down its holdings of low-documentation, negative-amortizing, interest-only and adjustable-rate loans. The company also detailed the portion of subprime loans that had low down payments and categorized the loans by borrowers' credit scores.

Rodgin Cohen, the senior chairman of Sullivan & Cromwell LLP who worked with Fannie Mae on some of its 2008 disclosures, said in an interview that Mudd "was as thoughtful and careful about proper disclosure as anybody I know."

"As conditions deteriorated, there was always the question of whether you would spook the market if you said too much," Cohen said, recounting a 2008 meeting at Fannie Mae to discuss second-quarter results. "Dan came into the meeting and took the position that it was not going to be a pretty release but it had to be real."

Evolving Disclosure

Fannie Mae's disclosures about subprime have evolved. In its 2010 annual report, the company revised its definition to exclude loans from subprime lenders that were acquired "in accordance with our standard underwriting criteria." Fannie Mae spokeswoman Janis Smith declined to comment on the change, which could bring the definition closer to Mudd's 2007 testimony.

Freddie Mac spokesman Michael Cosgrove and SEC spokesman John Nester declined to comment on the investigation.

The SEC's probe comes amid pressure from lawmakers and judges who have criticized the agency for not being aggressive enough in punishing executives it accuses of misconduct. In the Citigroup lawsuit, U.S. District Judge Ellen Huvelle faulted the agency for only sanctioning two executives and imposing "unimpressive" penalties.

Former Citigroup CFO Gary Crittenden agreed to pay $100,000 to settle claims he didn't disclose the risk after getting internal briefings. Arthur Tildesley, the former investor relations chief, agreed to pay $80,000 to resolve claims he helped draft misleading disclosures. They didn't admit or deny wrongdoing.

'What's the Point?'

Huvelle also noted at the time of the settlement the U.S. government's stake in Citigroup at the time, asking "if the taxpayer is paying the SEC, what's the point of all this?"

Adam Pritchard, a former SEC attorney who teaches law at the University of Michigan in Ann Arbor, said the SEC may find it tricky to pursue penalties against Fannie Mae and Freddie Mac as companies while they remain wards of the government.

"The SEC is working under the political constraint that they can't be imposing penalties on a U.S. government entity," Pritchard said. "The executives are the perfect scapegoats."

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