FEDERAL HOUSING FINANCE AGENCY
OFFICE OF INSPECTOR GENERAL

Case Study:
Freddie Mac's Unsecured Lending to Lehman Brothers Prior to Lehman Brothers' Bankruptcy

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AT A GLANCE

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Why FHFA-OIG Did This Evaluation

On September 6, 2008, the Federal Home Loan Mortgage Corporation (Freddie Mac or Enterprise) entered into a conservatorship overseen by its regulator, the Federal Housing Finance Agency (FHFA). That was done after it was determined that Freddie Mac and the Federal National Mortgage Association (Fannie Mae) (collectively, the Enterprises) faced billions of dollars in losses as a result of the collapse of the housing market.

In August 2008, just weeks prior to conservatorship, Freddie Mac provided to Lehman Brothers Holdings Inc. (Lehman) two short-term unsecured loans totaling $1.2 billion. The loans were the last of a series of loans Freddie Mac had been making to Lehman since January 2008.

The August loans were due and payable on September 15, 2008. On that day, however, Lehman filed for bankruptcy and defaulted on its repayment obligation. This resulted in Freddie Mac recording a loss of the entire $1.2 billion.

This report examines the circumstances surrounding Lehman's unsecured loans and the steps Freddie Mac and FHFA have taken—including efforts to recover the loans through the bankruptcy process—in response to Lehman's default. It seeks to identify the lessons learned from these events in an effort to prevent similar problems in the future.

What FHFA-OIG Found

FHFA-OIG found that in the months following Lehman's default, Freddie Mac determined that a failure of corporate culture at Freddie Mac allowed management to override its counterparty risk management policies, which would have altered the terms of the loans and, in turn, reduced the Enterprise's risk.

Since the default, FHFA and Freddie Mac have taken steps to improve the Enterprise's corporate governance environment and to correct its risk management failures. In addition, FHFA, acting as Freddie Mac's conservator, is actively engaged in recovering the $1.2 billion loss from Lehman, based on FHFA's determination that Lehman's improper conduct was the direct cause of the loss. (This report does not analyze Lehman's risk management and control systems; nor does it make findings regarding Lehman's conduct or legal liability.)

Clearly, FHFA and Freddie Mac must follow through on their remedial initiatives. In particular, FHFA should continue to: (1) monitor Freddie Mac's implementation of its counterparty risk management policies and procedures, including (a) ensuring that the independence and decisions of the Enterprise's risk management staff are not overridden by business management staff, and (b) directing Freddie Mac Internal Audit to audit the Counterparty Credit Risk Management function annually; (2) pursue all possible avenues to recover the $1.2 billion in the Lehman bankruptcy proceeding; and (3) develop an examination program and procedures encompassing Enterprise-wide risk exposure to all of Freddie Mac's counterparties.

What FHFA-OIG Concludes

This case study provides several important lessons that must be followed in order to avoid recurrence of Freddie Mac's serious missteps preceding Lehman's bankruptcy: corporate culture cannot be allowed to override or negate protections afforded by formal controls; key voices, such as risk management officials, must not be marginalized in favor of opportunistic business decisions; and policies and procedures should be adhered to and enforced. Corporate culture is a critical element in effective governance and risk management. Therefore, it needs to be the target of vigilance and oversight, specifically with respect to risk management. Corporate leaders must set the tone at the top.

Further, regulatory oversight, including robust examination and audit programs, is essential to reinforce even the most fundamental and widely embraced controls.

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ABBREVIATIONS

CCRM	Counterparty Credit Risk Management
Enterprises	Fannie Mae and Freddie Mac
Fannie Mae	Federal National Mortgage Association
FHFA or Agency	Federal Housing Finance Agency
FHFA-OIG	Federal Housing Finance Agency Office of Inspector General
Freddie Mac	Federal Home Loan Mortgage Corporation
HERA	Housing and Economic Recovery Act of 2008
Lehman	Lehman Brothers Holdings Inc.
OFHEO	Office of Federal Housing Enterprise Oversight
OG	Office of Governance
PSPAs	Senior Preferred Stock Purchase Agreements
SVP	Senior Vice President
Treasury	U.S. Department of the Treasury

Federal Housing Finance Agency
Office of Inspector General
Washington, DC

PREFACE

FHFA-OIG was established by the Housing and Economic Recovery Act of 2008 (HERA),[1] which amended the Inspector General Act of 1978.[2] FHFA-OIG is authorized to conduct audits, investigations, and other studies of the programs and operations of FHFA; to recommend policies that promote economy and efficiency in the administration of such programs and operations; and to prevent and detect fraud and abuse in them.

This report is intended to promote the economy and efficiency of FHFA's programs. It examines the steps taken by Freddie Mac and FHFA to remediate corporate governance issues that may have contributed to losses on unsecured loans made by Freddie Mac to Lehman in the period leading up to Lehman's bankruptcy. It seeks to identify the lessons learned from these events in an effort to prevent similar problems in the future.

As of the publication of this report, FHFA is actively engaged in recovering the loss from Lehman, based on FHFA's determination that Lehman's improper conduct was the direct cause of the loss. This report does not analyze Lehman's risk management and control systems; nor does it make any findings regarding legal liability of the firm or any of its employees.

This report was prepared by an FHFA-OIG interdisciplinary team consisting of: David P. Bloch, Director, Division of Mortgage, Investments, and Risk Analysis; Christopher G. Poor, Investigative Counsel; David Z. Seide, Director of Special Projects; and Robert C. Hinkley, Attorney Advisor. FHFA-OIG appreciates the assistance of FHFA and Enterprise staff in completing this report. It has been distributed to Congress, the Office of Management and Budget, and others and will be posted on FHFA-OIG's website, www.fhfaoig.gov.

George Grob

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Deputy Inspector General for Evaluations

[1] Pub. Law No. 110-289.

[2] Pub. Law No. 95-452.

BACKGROUND

The enactment of HERA on July 30, 2008, established FHFA as supervisor and regulator of Fannie Mae and Freddie Mac. Prior to the enactment of HERA, the Enterprises were regulated by the Office of Federal Housing Enterprise Oversight (OFHEO).

By August 2008, the housing crisis had taken a significant toll on the American economy and financial institutions, which were absorbing billions of dollars in losses on defaulted loans with insufficient collateral. The Federal Reserve had already bailed out the investment bank Bear Stearns in March and government regulators were concerned with the health of the entire domestic financial system.

On September 6, 2008, Fannie Mae and Freddie Mac entered into **conservatorships** supervised by FHFA out of concern that the deteriorating financial conditions of the Enterprises threatened the stability of the financial markets. At the same time, the U.S. Department of the Treasury (Treasury) began to provide financial support to the Enterprises to prevent their insolvency. Nine days later, Lehman filed for bankruptcy protection.

> **Conservatorship**
> A conservatorship is the legal process in which a person or entity is appointed to establish control and oversight of a company to put it in a sound and solvent condition. In a conservatorship, the powers of the company's directors, officers, and shareholders are transferred to the designated conservator.

Under the conservatorships, FHFA may "take such action as may be necessary to put the regulated entity in a sound and solvent condition" or carry out the business to preserve and conserve the assets of the regulated entity. To date, Treasury has invested $71.3 billion to maintain Freddie Mac's solvency.

Leading up to the financial crisis in 2008, Freddie Mac and the investment bank Lehman were two of the largest participants in the financing of the U.S. housing market. Freddie Mac is a government-sponsored enterprise whose mission is to keep money flowing to mortgage lenders in support of homeownership.[3] To carry out its function, Freddie Mac purchases mortgages from banks and securitizes them, issuing residential mortgage-backed securities. For a fee, the Enterprise guarantees these securities, which are sold to investors around the world.

Prior to its bankruptcy filing in September 2008, Lehman was the fourth largest investment bank in the United States with $639 billion in assets. Lehman traded and underwrote stocks and bonds, traded commodities, was active in the credit derivatives market, and became a major player in both commercial and residential securitization markets.

[3] *See* 12 U.S.C. § 1451.

In 2007, Lehman underwrote more mortgage-backed securities than any other firm. Its $85 billion mortgage-backed portfolio was equal to approximately four times its shareholders' equity. Thus, Lehman's high degree of leverage—the ratio of total debt to equity—made it vulnerable to the increasing losses it was incurring in its residential housing and commercial property investments. On June 9, 2008, Lehman announced a $2.8 billion loss for its second fiscal quarter ending May 31, 2008. On September 10, 2008, Lehman posted a third-quarter loss of $3.9 billion, after a $5.6 billion write-down on toxic mortgages in its investment portfolio.

The effect of Lehman's increasing losses, its exposure to the mortgage markets, and its deteriorating financial condition were reflected in the decreasing price of shares of its common stock, as shown in Figure 1.

Figure 1: Lehman Brothers Closing Stock Price Jan. 2008 – Sept. 2008[4]

By Thursday, September 11, 2008, Lehman had only $1 billion in cash on hand and was actively seeking assistance from the federal government to avoid bankruptcy. Over the weekend of September 13-14, talks were held among the Federal Reserve, Treasury, and a consortium of banks in an effort to rescue Lehman. But, the talks produced no rescue, and on September 15, 2008, Lehman filed for bankruptcy protection, the largest bankruptcy case in United States history. On the day Lehman filed, it owed Freddie Mac $1.2 billion—the result of short-term unsecured loans made less than a month earlier.

[4] Source: Bloomberg.

Freddie Mac Loans to Lehman

Prior to the bankruptcy, Freddie Mac and Lehman had extensive business relations. Lehman sold mortgages to Freddie Mac and also served as one of Freddie Mac's investment bankers. Lehman underwrote common and preferred stock offerings for Freddie Mac as well as various debt securities offerings.

Additionally, through the first half of 2008, Freddie Mac made significant short-term unsecured loans to Lehman. Freddie Mac had been making what it described as "Fed Funds" available to Lehman on an overnight basis with a limit of $200 million since February 2005.

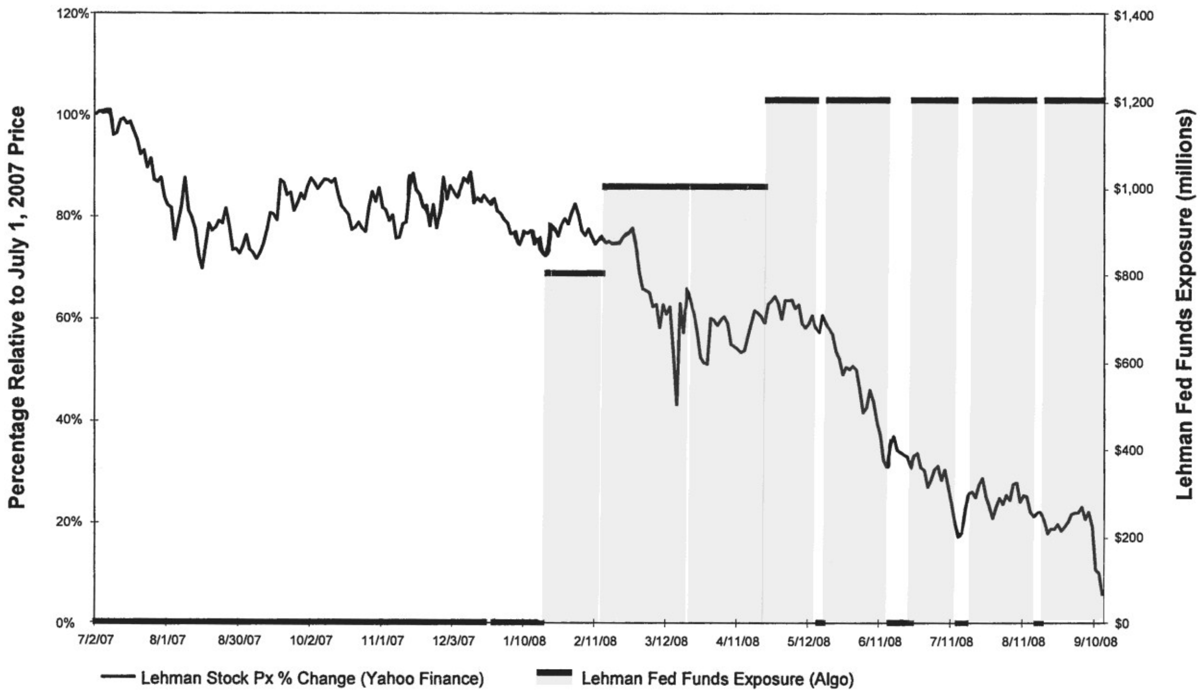
According to the Federal Reserve Bank of New York, "Fed Funds," or Federal Funds, are unsecured loans of reserve balances at Federal Reserve Banks that depository institutions make to one another. Participants in the Fed Funds market include commercial banks, thrift institutions, agencies, branches of foreign banks in the United States, and government securities dealers. The most common term for a Fed Funds transaction is overnight. A "true" Fed Funds transaction is between member banks of the Federal Reserve System, although the term is also used more loosely to describe any short-term, unsecured loans between financial institutions. Neither Lehman nor Freddie Mac is a member of the Federal Reserve System, and typically the maturity terms of their 2008 transactions were not overnight.[5] Nonetheless, Freddie Mac has historically been a significant supplier of funds to the Fed Funds market with member banks acting as intermediaries.

The term and the size of Freddie Mac Fed Funds loans to Lehman changed in 2008. Rather than periodically making overnight loans to Lehman as had previously been the case, the 2008 loans were made for longer terms (up to one month) and they often rolled over as they became due. Thus, the loans made in May 2008 were rolled over in June 2008; they were again rolled over in July, and then again in August. Each time the principal and interest on such loans were repaid by Lehman, the funds were re-sold (lent) by Freddie Mac to Lehman for an additional term.

The principal amount of the loans to Lehman also grew in 2008. From an initial aggregate principal amount of $800 million in January 2008, the amount increased to $1 billion in February and to $1.2 billion in April. Figure 2 shows the amount and terms of the loans made by Freddie Mac to Lehman for the period January to September 2008 (indicated by the bars on the right side of the graph), as Lehman's stock price deteriorated (indicated in the downward trending line beginning in July 2007).

[5] Regardless of any technical definition, this report adopts Freddie Mac's use of the phrase "Fed Funds."

Figure 2: Lehman Stock Percentage Change and Freddie Mac's Lehman Fed Funds Exposure, July 1, 2007 – Sept. 15, 2008[6]



The last of these transactions involved two loans totaling $1.2 billion. The first loan was provided on August 19, 2008, for $450 million. The second loan was executed on August 20, 2008, for $750 million.[7] Both loans were scheduled to mature on September 15, 2008, at 9:30 a.m.

Counterparty Credit Risk Management at Freddie Mac

The Freddie Mac staff responsible for facilitating the Fed Funds loans to Lehman worked on the Liquidity and Contingency Desk, within Freddie Mac's Investments and Capital Markets Division.[8] These personnel are responsible for making Freddie Mac's short-term liquid investments. Because Freddie Mac's business generates large amounts of cash from principal and interest collections, this office often has billions of dollars to invest each day. Such investments take into consideration Freddie Mac's short-term cash disbursement needs (to ensure it always has funds available to pay its bills) as well as the safety and soundness of the

[6] Sources: Yahoo Finance and Algo Research Group.

[7] The interest rate on the loans was 2.55%, the prevailing Fed Funds rate at the time.

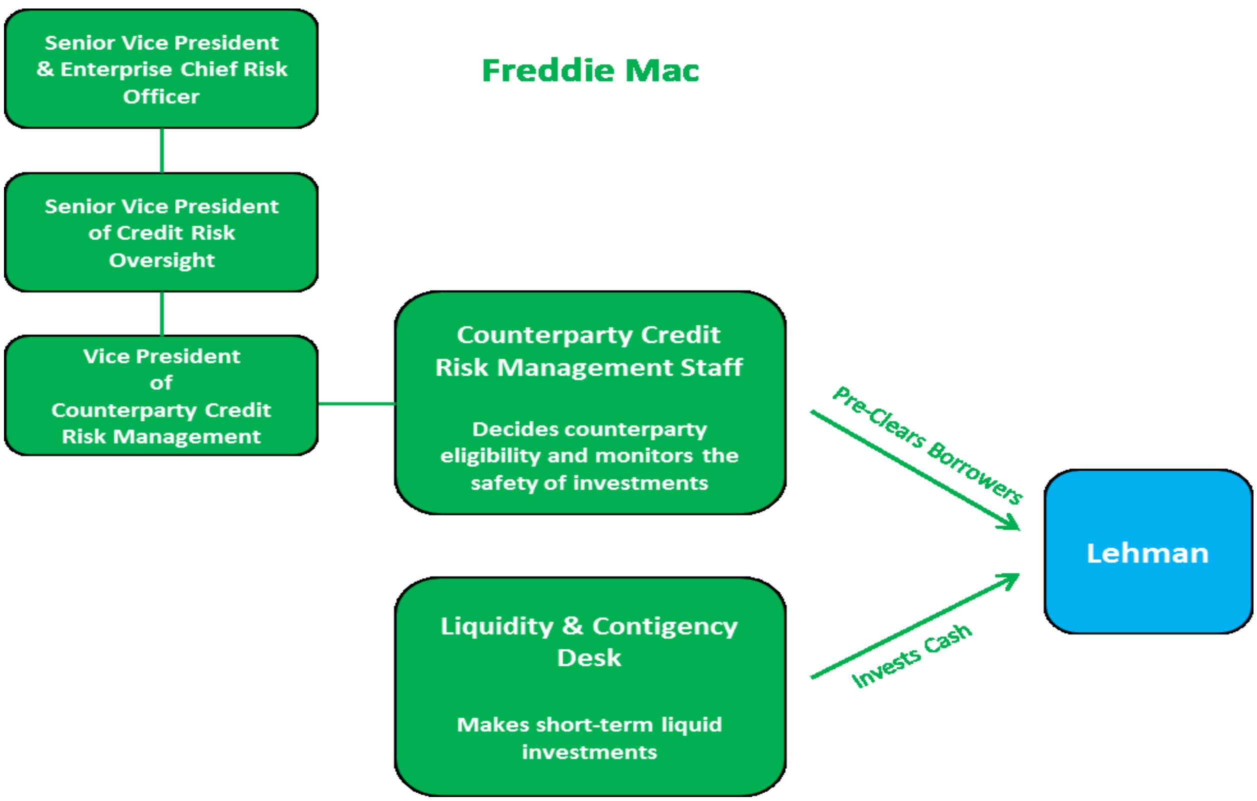
[8] Freddie Mac's Investment and Capital Markets Division is responsible for managing Freddie Mac's retained portfolio of mortgages and securities, hedging against interest rate and other risks, and investing Freddie Mac's available cash. This group is led by a senior vice president and includes traders and investment managers.

counterparty in which the funds are invested. The rate the counterparty is willing to pay is also a consideration.[9]

Responsibility for monitoring the safety and soundness of Freddie Mac's Fed Funds investments rests with the Counterparty Credit Risk Management (CCRM) staff of Freddie Mac's Risk Oversight Division.[10] The CCRM is headed by the Vice President, Counterparty Credit Risk Management, who reports to the Senior Vice President (SVP), Credit Risk Oversight, who, in turn, reports to the SVP and Enterprise Chief Risk Officer.

Figure 3 illustrates the responsibilities and relationships of the key offices involved in these investment decisions at Freddie Mac.

Figure 3: Freddie Mac Investment and Credit Risk Management Offices



9 The Federal Reserve sets a target level for its Fed Funds rate, and the Federal Reserve's announcements of changes in monetary policy specify the changes in the Federal Reserve's target for that rate. According to the Federal Reserve Bank of New York, the actual Fed Funds rate is determined by market participants and is not actually "set" by the Federal Reserve.

10 The Risk Oversight Division had responsibility for "setting counterparty specific counterparty exposure limits and certain terms of business" pursuant to Freddie Mac's Policy 11-104, *Credit Risk Oversight Corporate Policy*.

Like other companies, Freddie Mac typically invests its cash in a manner intended to ensure that such funds will be returned to it in time to pay its obligations as they become due. This requires Freddie Mac to choose counterparties that it deems reliable and capable of meeting their obligations to pay principal and interest when they are due.

Assessing reliability and capability is not only a function of the counterparty's financial condition and credit history—it is also a function of time. That is, the longer the term for which money is lent, the greater the risk (due to the possibility of intervening events) of default.

Freddie Mac relies on its Risk Oversight Division and the CCRM staff to clear suitable counterparties eligible for investments. CCRM has three primary means of managing counterparty risk: (1) determining counterparty eligibility; (2) limiting the duration of investments; and (3) limiting the size of investments. Once CCRM pre-clears a counterparty and establishes the maximum duration and size of loans that may be made to the counterparty, the Liquidity and Contingency Desk is authorized to lend to the counterparty up to the maximum amount and duration. That authorization remains in place until the Liquidity and Contingency Desk is advised otherwise by the Risk Oversight Division.

During 2008, CCRM's oversight of risk with regard to the Lehman loans focused primarily on the term of such loans; namely, whether such loans should be limited to overnight (24 hours) or longer (up to 30 days) terms. In principle, lenders of overnight loans can eliminate their credit exposure every 24 hours because once the loan ends it need not be renewed. On the other hand, the 30-day loans made by Freddie Mac to Lehman could not be called prior to their stated maturity and therefore resulted in longer credit risk exposure to the Enterprise. Indeed, in 2008, some CCRM staff questioned whether Freddie Mac should be making unsecured loans to Lehman at all based on the perceived heightened risk. However, those concerns, which would have reduced the extent of the Enterprise's exposure, were overruled at senior levels within Freddie Mac.

Lehman's financial condition in 2008 was of concern to CCRM staff. In the wake of Bear Stearns' collapse and rescue in mid-March 2008, CCRM staff indicated that they preferred that the duration of the unsecured Fed Funds loans to Lehman be shortened. They made these assertions on three separate occasions. The first such occasion was March 17, 2008, the day after Bear Stearns' rescue was publicly disclosed. On that day, CCRM staff advised personnel on the Liquidity and Contingency Desk that CCRM was limiting the duration of unsecured loans being made to Lehman from 30 days to 24 hours, once the outstanding loans matured.

Under Freddie Mac's policies and procedures, the Risk Oversight Division was responsible for limiting the amount and duration of the Lehman loans. However, it appears that business managers influenced CCRM staff because the staff reversed its position two days later. In an email from the Director of Credit Quality dated March 19, 2008, CCRM advised that, following a meeting between Freddie Mac's Chief Business Officer and the SVP of Credit Risk Oversight,[11] the maximum 30-day terms for loans to Lehman were to be reinstated.[12]

Three months later, on June 12, 2008, CCRM staff again recommended reducing Freddie Mac's risk exposure to Lehman. (During the preceding three weeks, the closing price of Lehman's stock had fallen by approximately 30%.) This time, CCRM staff recommended—and requested approval from the SVP, Credit Risk Oversight, to implement—a reduction of the maximum duration from 30 days. The SVP responded that he wanted to discuss the matter further with his business counterpart in Freddie Mac's Investment and Capital Markets Division. Five days later, on June 17, 2008, CCRM staff followed up on its pending request, by recommending that 30-day loans be reduced to 2-week terms.[13] That recommendation was temporarily accepted, as reflected by the fact that when the Lehman loans were rolled over later in June the duration of the loans was reduced by two weeks.

The third time CCRM staff raised concerns regarding the short-term unsecured loans to Lehman occurred in mid-July 2008. In the absence of positive news about Lehman's financial condition, on July 11, 2008, CCRM staff downgraded the internal Freddie Mac risk rating assigned to the Lehman debt. In a July 15, 2008, email to the SVP, Credit Risk Oversight, CCRM staff stated that they believed "a shorter term of one week (instead of 14 days) would be prudent, but it appears upper management is willing to accept this risk." An internal Freddie Mac email dated July 30, 2008, stated that the recommendation to shorten the duration further had not been approved because "of disagreements at very high levels over terms of the Fed Funds line."

On August 19 and 20, 2008, Freddie Mac entered into two loans with Lehman for an aggregate principal amount of $1.2 billion. The loans were set to become due on September 15, 2008, at or near the beginning of the business day.

Freddie Mac entered into conservatorship on September 6, 2008. Three days later, on September 9, Freddie Mac's Risk Oversight Division (which included CCRM) decided to eliminate all unsecured lending to Lehman. On that day, Freddie Mac decided that the two unsecured loans to Lehman would not be renewed when they became due at the start of the business day on September 15, 2008. However, Lehman filed a petition under Chapter 11 of the Federal Bankruptcy Code seeking bankruptcy protection on September 15, 2008, before the business day

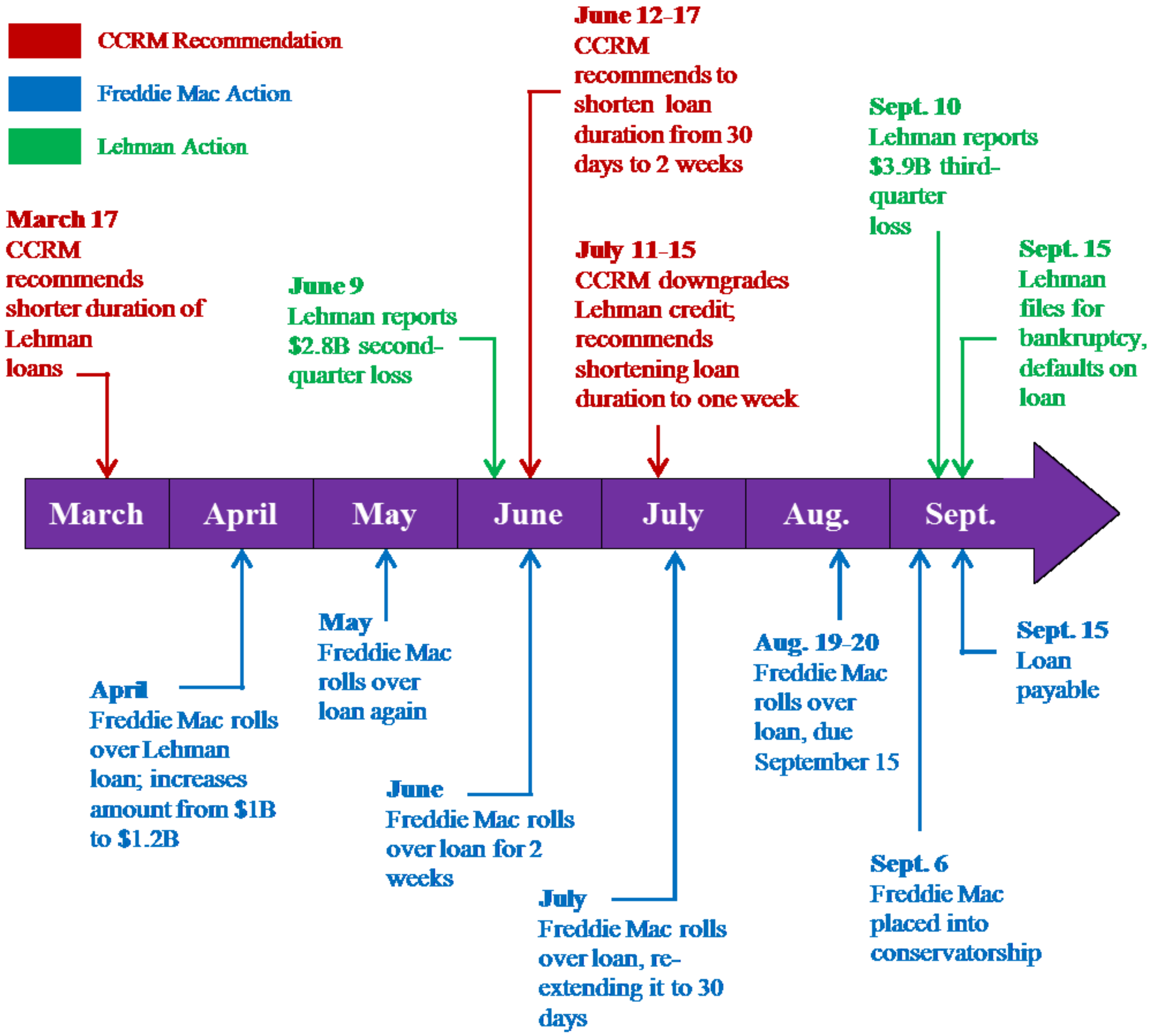
[11] The Director of Credit Quality is a member of the CCRM staff; the SVP of Credit Risk Oversight is the executive overseeing CCRM.

[12] According to interviews conducted in September 2008 by staff under the direction of Freddie Mac's Chief Auditor and Vice President of Audit, various Freddie Mac staffers recalled that when Lehman heard of CCRM's decision to limit the term, a senior person at Lehman contacted senior management at Freddie Mac and challenged the decision.

[13] On the previous day, June 16, 2008, Lehman announced second quarter losses of $3 billion.

began. That filing allowed Lehman to halt payments to all creditors, including Freddie Mac. To date, Lehman has not repaid the $1.2 billion debt owed to Freddie Mac. Figure 4 shows a timeline of the transactions between Freddie Mac and Lehman.

Figure 4: Freddie Mac and Lehman Brothers: Countdown to Default



It is possible that Freddie Mac could have avoided the $1.2 billion loss to Lehman if it had more effectively managed its counterparty risk. For instance, had the duration of the loans been shortened to overnight, as recommended by CCRM staff in mid-March of 2008, Freddie Mac could have halted further loans to Lehman on September 10 or shortly thereafter—potentially ahead of Lehman's September 15 bankruptcy filing. But the record shows that CCRM's risk management recommendations were influenced by Freddie Mac senior business managers.

OFHEO's Oversight of Freddie Mac's Counterparty Risk

As noted earlier, prior to July 30, 2008, Freddie Mac was regulated by OFHEO. Prior to the Lehman bankruptcy in September 2008, no examination work had been performed by OFHEO related to capital markets counterparties. A senior FHFA official acknowledged to FHFA-OIG staff that there was "a hole in the program," referring to OFHEO's historic lack of counterparty examinations in the capital markets area. The same senior FHFA official is now committed to developing a robust examination program regarding counterparty risk.

FHFA's Oversight and Examination of Freddie Mac's Counterparty Risk

Following the Lehman default, FHFA examiners conducted a series of targeted examinations related to counterparty credit risk management and management of Freddie Mac's liquidity and contingency portfolio. FHFA's Division of Enterprise Regulation made a number of findings regarding Freddie Mac's operations and recommended that certain actions be taken to better manage counterparty risk. Most importantly, FHFA's work led to a clarification and correction of Freddie Mac's policies to reflect the fact that Fed Funds investments do not carry with them any implied government guarantee.

At the time of the Freddie Mac-Lehman transactions, OFHEO's Division of Enterprise Regulation's supervision manual did not adequately address examination procedures pertaining to the Enterprises' liquidity and funding. Today, FHFA has developed an examination module on liquidity that has undergone field-testing and is scheduled for finalization shortly. Additionally, the Division of Enterprise Regulation has extensively revised its Examination Manual. Although still in draft form, the Credit Risk Management section lays out supervisory policies that address, among other things, establishing and measuring counterparty risk limits, the responsibilities of the board of directors and enterprise risk management, the need for on-going monitoring, and the development of an internal reporting system that rates risk exposure to counterparties based on various critical criteria.

FHFA's Examiner-in-Charge at Freddie Mac has indicated that the monitoring of counterparty risk is a priority for the Agency and that "significant resources" will be dedicated toward the examination of such risk in the 2013 Examination Plan. Additionally, during the second half of 2012, FHFA conducted several targeted examinations relating to various aspects of counterparty risk. An FHFA Freddie Mac core team examiner who was interviewed by FHFA-OIG staff added that FHFA now requires the Enterprises to report on counterparty risk (quantitatively and qualitatively) on a monthly basis. The data are reported and discussed during a subcommittee meeting held monthly at Freddie Mac.

Freddie Mac's Amendments to Key Investment and Risk Management Policies

Following FHFA's counterparty credit risk management targeted examinations, Freddie Mac re-examined and amended two of its key business policies. First, the Liquidity and Contingency Policy was amended to reflect that its activities are consistent with FHFA and Treasury guidance. Most importantly, the amended policy currently suspends unsecured term lending. Second, the Capital Markets Counterparty Credit Risk Management Policy was revised to, among other things, more clearly define the roles and responsibilities of Freddie Mac staff involved in managing the Enterprise's counterparty credit risk program and sets out a precise definition of Fed Funds including, significantly, that Fed Funds lending in fact constitutes an unsecured investment.

FHFA's Efforts to Recover the $1.2 Billion in the Lehman Bankruptcy Proceeding

After the Lehman bankruptcy proceeding began, Freddie Mac filed a claim as a Lehman creditor.[14] Specifically, on September 22, 2009, Freddie Mac filed a **proof of claim**, which included a priority claim for the $1.2 billion owed on the two loans (the Loans Claim) that were not repaid by Lehman. Freddie Mac is an unsecured creditor and can otherwise expect to be repaid only after secured creditors and creditors with higher priority claims are repaid, but it will be repaid before creditors with lower priority claims are repaid.

Proof of Claim
A proof of claim is a creditor's written statement filed in a bankruptcy case for purposes of showing the basis and amount of the creditor's claim against the debtor. By filing a proof of claim against Lehman, Freddie Mac made other creditors and Lehman aware of its claim and its intention to share in any distribution of Lehman's assets from the bankruptcy estate.

On March 6, 2012, Lehman emerged from bankruptcy. The Lehman bankruptcy reorganization plan recognizes $1.2 billion to be available for payment in full (exclusive of interest) of Freddie Mac's Loans Claim, if it is ultimately allowed.

Investigations by FHFA and Freddie Mac

Soon after Lehman failed to repay the loans totaling $1.2 billion, Freddie Mac and FHFA each conducted investigations into the circumstances surrounding the default. Their goal was to

[14] Freddie Mac's total claims in the Lehman bankruptcy proceedings were $2.23 billion. In addition to the $1.2 billion claim for the two August loans were two claims totaling $1.03 billion under existing derivatives contracts between Freddie Mac and Lehman.

understand the events and identify credit risk management issues that led to the default. Based on the investigations, recommendations have been made and management actions have been taken in an effort to reduce the possibility of losses arising from similar circumstances in the future.

Between September 2008 and December 2009, Freddie Mac and FHFA conducted three investigations: (1) a special investigation conducted by Freddie Mac's General Auditor soon after the default occurred (the Special Investigation); (2) an FHFA assessment of the management of Freddie Mac (the FHFA Key Management Assessment); and (3) an inquiry by Freddie Mac's Operational Risk Oversight staff into the Lehman default (the Risk Oversight Inquiry).[15]

All three examinations came to similar conclusions regarding what caused the $1.2 billion default. Specifically, the examinations concluded that although Freddie Mac had taken steps to manage counterparty risk, the risk management policies and procedures in place had been overridden by senior management. As a result of those overrides, risk management staff within CCRM believed that they had been impeded from taking steps that may have eliminated or at least reduced Freddie Mac's counterparty exposure to Lehman.

2008 Freddie Mac Special Investigation

The Freddie Mac Special Investigation was led by Freddie Mac's Chief Auditor and Vice President of Audit at the direction of the Enterprise's then-newly installed CEO, David Moffett.[16]

The Special Investigation reached a number of conclusions, including that *de facto* approval was required from senior business management before risk managers could change the amount or duration of Lehman loans. According to Freddie Mac internal corporate policy, the Risk Oversight Division alone had responsibility for setting counterparty-specific exposure limits and certain terms of business.[17] However, the investigation found that, in practice, significant decisions related to changing existing counterparty credit limits and terms required the "approval" of senior business managers before such changes could be implemented. The investigative report acknowledged that credit decisions could not be made in a vacuum and without input from other senior management (including senior managers in Investments and Capital Markets), but the report emphasized that Freddie Mac's policy was predicated on the independence, good judgment, and fortitude of the SVP, Credit Risk Oversight, and others in the

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[15] To date, the conclusions of these investigations have not been made public.

[16] CEOs of both Enterprises were replaced by FHFA at the inception of the conservatorships.

[17] Freddie Mac Policy 11-104, *Credit Risk Oversight Corporate Policy*.

Risk Oversight Division. The report found those qualities absent with respect to the loans made in 2008 to Lehman.

FHFA Key Management Assessment

On September 26, 2008, FHFA's Office of Governance (OG) produced a Freddie Mac Key Management Assessment to gauge the effectiveness of Freddie Mac's management and discern what management failures contributed to Freddie Mac entering into conservatorship.[18] Although this assessment was not directly related to the handling of the Lehman loans, it uncovered significant problems with Freddie Mac's leadership that may have had an impact.

Notably, Freddie Mac senior business executives fostered a corporate culture in which the most senior person in the Risk Oversight Division, the Chief Enterprise Risk Officer, was excluded and his team's advice was disregarded. In particular, OG found that multiple senior business executives had disregarded direct advice concerning the risks inherent with the Lehman short-term unsecured loans. Moreover, OG discovered evidence of deliberate efforts by executives to exclude credit risk management officers from participating in key investment decisions and to restrict credit risk management personnel from interacting with Freddie Mac's previous CEO. Many Freddie Mac business personnel who were criticized in the Key Management Assessment left the Enterprise after the report's issuance.

Freddie Mac Risk Oversight Inquiry

Freddie Mac further examined the Lehman loss in a second investigation conducted in late 2008. Freddie Mac found: (1) a failure of corporate culture—including the tone from the top of the management structure—resulted in counterparty credit decisions made by risk management personnel being inappropriately overridden by business personnel; (2) a lack of sufficient independence between Credit Risk Oversight and Investments and Capital Markets; and (3) a lack of transparency regarding risk, which resulted in inadequate review of risks, inadequate understanding of risks, and inadequate involvement by higher-level decision makers concerning those risks.

With regard to the failure of corporate culture, the report found that executive management's views on lending to Lehman were neither documented nor clearly communicated. Furthermore, Risk Oversight Division personnel improperly perceived communications through others as factual executive direction when executive management provided no such direction. Risk management was also ineffective because of the perception of staff in Credit Risk Oversight that senior management would override their decisions. Finally, the inquiry cited the absence of

[18] A key management assessment of each Enterprise is required under HERA.

documentation of escalation to senior credit and business managers of the differing opinions concerning the Enterprise's exposure to Lehman.

Finally, the report found that Freddie Mac had taken a number of steps to prevent losses of a similar nature from recurring. These steps included: (1) the CEO reinforcing (in the fourth quarter of 2008) the authority of the Chief Credit Officer to determine specific exposure limits for counterparties; (2) establishing a Senior Executive Credit Committee; and (3) assigning to that committee the responsibility for making explicit credit decisions based on CCRM staff's independent review.

FINDINGS

1. ***Corporate Governance/Culture*. Former senior business managers at Freddie Mac decided to disregard recommendations made by the Enterprise's risk management staff to reduce the duration of the loans from one month to overnight.**

The $1.2 billion loss on the Lehman loans was facilitated by a corporate culture at Freddie Mac that overrode existing written policies and procedures. This left those responsible for credit risk oversight within the Enterprise reluctant to move forcefully in this direction, due to the perception that their decisions to reduce the amount or duration of the Lehman loans would be overridden. As a consequence, Freddie Mac did not move to revoke Lehman's short-term unsecured credit with the Enterprise until Lehman filed for bankruptcy and it was too late.[19]

2. ***Corrective Action*. FHFA and Freddie Mac have taken appropriate steps to remediate the corporate governance/culture issues identified in this report.**

FHFA has made progress in its efforts to stabilize the corporate governance/culture environment at Freddie Mac. The individuals responsible for the governance failures discussed in this report are no longer employed by Freddie Mac. FHFA has worked to ensure that credit risk management is now an independent organization within Freddie Mac that no longer seeks advice/approval from the business units (including Investments and Capital Markets) before making risk management decisions, and the Senior Executive Team has been replaced by a Senior Executive Credit Committee.

3. ***Risk Management*. FHFA has taken steps to enhance Freddie Mac's counterparty risk and operational risk management, but ongoing enforcement must be maintained.**

FHFA and Freddie Mac have taken a number of steps outlined in this report to remediate the counterparty credit risk management failures that may have contributed to the $1.2 billion default. Both will need to remain vigilant to ensure policies and procedures in this area are enforced and the corporate culture does not override such enforcement.

[19] FHFA-OIG is continuing to review the circumstances that led Freddie Mac senior business managers to disregard recommendations made by the risk management staff.

4. ***Recovery of Funds*. FHFA has made potentially helpful efforts to recover the $1.2 billion from the Lehman bankruptcy estate.**

To its credit, FHFA, through the Office of General Counsel, has worked to improve the chances of Freddie Mac's recovery in the Lehman bankruptcy proceeding. In particular, it is possible that Freddie Mac may ultimately recover $1.2 billion; on the other hand, Freddie Mac stands to recover no less than $251 million.

RECOMMENDATIONS

FHFA and Freddie Mac have already taken steps to address the shortcomings in Freddie Mac's risk management and control systems discussed in this report. Clearly, they need to follow through on these remedial initiatives. In particular, FHFA should:

1. Continue to monitor Freddie Mac's implementation of its counterparty risk management policies and procedures:

    a. ensuring that the independence and decisions of the Enterprise's risk management staff are not overridden by business management staff, and

    b. directing Freddie Mac Internal Audit to audit the CCRM function annually.

2. Continue to pursue all possible avenues to recover the $1.2 billion in the Lehman bankruptcy proceedings.

3. Continue to develop an examination program and procedures encompassing Enterprise-wide risk exposure to all of Freddie Mac's counterparties.[20]

[20] On September 18, 2012, FHFA-OIG issued an audit report concerning FHFA's oversight of the Enterprises' management of their mortgage sales and servicing counterparties. *See* FHFA-OIG, *FHFA's Oversight of the Enterprises' Management of High-Risk Seller/Servicers* (AUD-2012-007) (Sept. 18, 2012). That report recommended that FHFA issue standards for the Enterprises to develop comprehensive contingency plans for high-risk and high-volume seller/servicers, and that the Agency finalize its examination guidance regarding contingency planning. FHFA agreed, and its implementation of the contingency planning recommendation will help to prevent a future Lehman-like event from recurring.

CONCLUSION

Much can be learned from the events that led up to the serious missteps at Freddie Mac preceding the Lehman bankruptcy, the dysfunctional corporate culture at the time of the bankruptcy, and the aggressive and systematic responses by Freddie Mac and FHFA executives in its wake. The lessons learned are applicable to Freddie Mac, Fannie Mae, their counterparties, and FHFA.

The lessons are:

- Corporate culture cannot be allowed to override or negate the formal controls put into place to provide protections.
- Marginalization of key voices can have significant adverse impacts, especially the subordination of risk management to opportunistic business decisions.
- Policies and procedural requirements should be adhered to and enforced.
- Regulatory oversight, including robust examination and audit programs, are essential to re-enforce even the most fundamental and widely embraced controls.

Corporate culture itself is a critical element in effective governance and risk management. Corporate leaders must set the tone at the top. There needs to be constant vigilance and oversight by such leaders to ensure that the culture supports the governance and risk management functions rather than undermines them.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of this evaluation was to assess what actions FHFA has taken to:

1. Assess the causes of the $1.2 billion loss due to Lehman's default;
2. Assess the measures put in place to prevent a recurrence of such losses in the future;
3. Recover the $1.2 billion from the Lehman bankruptcy estate;
4. Remediate the corporate governance issues identified in the wake of the $1.2 billion loss; and
5. Enhance Freddie Mac's counterparty and operational risk management.

To address its objective, FHFA-OIG interviewed senior FHFA officials who were responsible for monitoring and examining Freddie Mac at the time of the controversial loans to Lehman as well as officials from FHFA's Office of General Counsel. FHFA-OIG staff also interviewed senior personnel in Freddie Mac's Internal Audit Department.

FHFA-OIG reviewed documents related to the Lehman loans including, but not limited to: Lehman's bankruptcy pleadings, the report of the examiner in the Chapter 11 proceedings, and a database of documents collected from Freddie Mac and other custodians. Additionally, FHFA-OIG examined Freddie Mac Liquidity and Contingency policies and Counterparty Credit Risk Management policies that were in effect during the pendency of the Lehman transactions and afterwards. Likewise, FHFA-OIG examined FHFA's revised policies and examination modules addressing Counterparty Credit Risk Management for the Liquidity and Contingency portfolio of Freddie Mac and a series of written communications between FHFA and Freddie Mac following the conclusion of examination work conducted by the Agency.

FHFA-OIG also reviewed FHFA written materials such as a key management assessment, findings memoranda, reports of examinations for the credit risk and capital markets groups, Freddie Mac audit reports, and Freddie Mac's preliminary Special Investigation.

FHFA-OIG also reviewed Office of Management and Budget Circular A-123 provisions and requirements relating to management control systems as a benchmark for assessing Freddie Mac's controls relevant to these transactions.

As of the publication of this report, FHFA is actively engaged in recovering the $1.2 billion loss from Lehman, based on FHFA's determination that Lehman's improper conduct was the direct cause of the loss. This report does not analyze Lehman's risk management and control systems; nor does it make any findings regarding legal liability of the firm or any of its employees.

This evaluation was conducted under the authority of the Inspector General Act, and is in accordance with the *Quality Standards for Inspection and Evaluation* (January 2012), which was promulgated by the Council of the Inspectors General on Integrity and Efficiency. These standards require FHFA-OIG to plan and perform an evaluation that obtains evidence sufficient to provide reasonable bases to support the findings and recommendations made herein. FHFA-OIG believes that the findings and recommendations discussed in this report meet these standards.

The performance period for this evaluation was from August 2011 to November 2012.

APPENDIX A:
FHFA's Comments on Findings and Recommendations

Federal Housing Finance Agency

MEMORANDUM

TO: George Grob, Deputy Inspector General for Evaluations

FROM: Jon D. Greenlee, Deputy Director, Division of Enterprise Regulation
Alfred Pollard, General Counsel

SUBJECT: FHFA Response – *Freddie Mac's Unsecured Lending to Lehman Brothers Prior to Lehman's Bankruptcy* (EVL 2012-019)

DATE: February 21, 2013

This memorandum transmits the Federal Housing Finance Agency's (FHFA or Agency) management responses to the recommendations in the FHFA-OIG's draft report, *Case Study: Freddie Mac's Unsecured Lending to Lehman Brothers Prior to Lehman's Bankruptcy*, EVL 2012-019. We appreciated the opportunity to provide feedback on this report and the FHFA-OIG findings in the critical area of counterparty risk management.

The draft report describes events that resulted in the $1.2 billion unsecured loan made from Freddie Mac to Lehman Brothers in 2008, which was not yet due at the time of Lehman's entry into bankruptcy protection on September 15, 2008, and no portion of it has been repaid. We agree with the critical importance of a strong risk management function at the Enterprises, and will continue to focus on issues raised in the draft report. We have no additional comments on the report's audit recommendations.

cc: Edward DeMarco, Acting Director
Richard Hornsby, Chief Operating Officer
Bruce Crandlemire, Senior Advisor for IG Operations
John Major, Internal Controls and Audit Follow-Up Manager

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