

CRS Report for Congress

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Accounting Problems at Fannie Mae

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Summary

On September 22, 2004, the Office of Federal Housing Enterprise Supervision (OFHEO) made public a report that was highly critical of accounting methods at Fannie Mae, the government-sponsored enterprise that plays a leading role in the secondary mortgage market. OFHEO charges that Fannie Mae has not followed generally accepted accounting practices in two critical areas: (1) amortization of discounts, premiums, and fees involved in the purchase of home mortgages and (2) accounting for financial derivatives contracts. According to OFHEO, these deviations from standard accounting rules allowed Fannie Mae to reduce volatility in reported earnings, present investors with an artificial picture of steadily growing profits, and, in at least one case, to meet financial performance targets that triggered the payment of bonuses to company executives. On September 27, Fannie Mae's board of directors agreed to correct the accounting deficiencies, augment the firm's capital surplus, review staff structure and internal controls related to accounting, and to appoint an independent chief risk officer. The Securities and Exchange Commission (SEC) and Justice Department are investigating. On November 15, 2004, Fannie Mae reported that it was unable to file a third-quarter earnings statement because its auditor, KPMG, refused to sign off on the accounting results. Fannie also estimated that if its derivatives accounting is found to be incorrect, it might have to report a third-quarter loss of about \$9 billion. This report will be updated as events warrant.

Background

Fannie Mae and Freddie Mac, the two government-sponsored enterprises (GSEs) that dominate the secondary mortgage market, are huge and complex financial institutions that play a key role in the financial system. Most home mortgage loans made each year are purchased by one or the other of the GSEs and either held in portfolio or repackaged and sold as mortgage-backed securities (MBS). The two GSEs have about \$1.6 trillion in debt outstanding, and large quantities of GSE bonds are held by insured banks, pension funds, and investors of all types. While GSE debt is not guaranteed by the government, the "government sponsored" nature of Fannie and Freddie (their charters grant them a line of credit with the U.S. Treasury and exempt them from certain taxes and securities regulations) leads market participants to put faith in an "implicit" guarantee, a belief that the Treasury will never allow either GSE to become insolvent.

The savings and loan crisis of the 1980s was a painful demonstration of the risks inherent in mortgage markets. Over a thousand S&Ls failed because their long-term revenues (from mortgage loans) fell below their cost of funds (the interest they paid to savers). When interest rates are volatile, holders of mortgages and MBS face a variety of financial risks, and these risks are now concentrated in the two GSEs. Although both institutions manage risk with sophisticated financial techniques far beyond the capacity of any S&L, the accounting problems at Freddie Mac in 2003,¹ and now at Fannie Mae, raise serious questions. Are accounting irregularities simply a reflection of the managements' wish to persuade investors and regulators that, despite the volatile nature of the mortgage market, the firms' earnings are insulated from sudden changes? Or, do they suggest that the firms themselves lack a clear picture of their complex financial positions, risk management strategies, and risk exposures? In either case, improvements in accounting transparency and rigor appear to be needed.

The Accounting Issues

The OFHEO report² identifies three major accounting problems at Fannie Mae. Two have to do with failure to comply with accounting rules, and the third focuses on weaknesses in the firm's accounting processes. These issues are summarized below.

Amortization of Purchase Discounts, Premiums, and Fees (SFAS 91).

When Fannie Mae buys mortgages or MBS, it does not pay the exact amount of unpaid premium balance outstanding on the loans. If the interest rate (or coupon rate) paid by the borrower is above current market interest rates, the loan will sell at a premium, above the unpaid balance. If the coupon rate is below current market rates, the loan is less valuable, and will sell at a discount. To calculate the effective yield on the loan, Fannie Mae must take these premiums and discounts into account. (A loan bought at a premium is less valuable than the coupon rate would imply, and vice versa for loans purchased at a discount.) Under SFAS 91, a Financial Accounting Standards Board (FASB) rule, the amount of these premiums and discounts must be amortized, or recognized over the estimated life of the purchased loans (or MBS). The amounts recognized appear on the income statement as an adjustment to current interest income.

When Fannie Mae purchases mortgages that are riskier than usual (i.e., where the borrowers are less creditworthy), it may accept up-front fees from the loan sellers in lieu of credit guarantees. Conversely, Fannie may pay fees to lenders in exchange for greater protection against credit risk. These fees also have an impact on the effective yield that Fannie will receive over the life of the loans, and must also be amortized according to SFAS 91.

As fees, premiums, and discounts are amortized and recognized for accounting purposes, Fannie Mae's quarterly income is increased or lowered. The size of the adjustment to reported income depends upon the estimated life of the loan: other things being equal, the longer the loan, the smaller the adjustment required to each quarter's

¹ See CRS Report RS21567, *Accounting and Management Problems at Freddie Mac*, by Mark Jickling.

² Office of Federal Housing Enterprise Oversight, Office of Compliance, *Report of Findings to Date: Special Examination of Fannie Mae*, Sept. 17, 2004, 198 p.

earnings. A complication is that Fannie Mae does not know at the outset how long a mortgage will last, because borrowers generally have the right to prepay and refinance their mortgages. Critical to the amortization process, therefore, are the assumptions that Fannie Mae makes about the prepayment rate in a group of mortgages. SFAS 91 requires that those assumptions be updated as market conditions change, and that the amounts amortized into interest income be revised accordingly. This is the point, according to OFHEO, at which Fannie Mae has failed to follow accepted accounting practices.

In the fall of 1998, as central banks struggled to contain global financial panic, interest rates fell dramatically. The drop in rates adversely affected Fannie and Freddie by accelerating the rate of mortgage prepayments. The effect of the speed-up in prepayments on Fannie Mae's earnings was a \$400 million expense, which according to SFAS 91 should have been recognized and charged against 1998 earnings. However, Fannie chose to recognize only \$200 million, and to defer recognition of the other half.

The deferred \$200 million became known within Fannie Mae as the "catch-up." OFHEO claims that Fannie used "inordinate flexibility" in its handling of the catch-up amount, and used it as an accounting reserve, or "cookie jar," that gave it wide discretion to report or defer amortization income in order to obtain the accounting results it wanted. Fannie adopted policies "specifically intended to manage the catch-up position as a buffer to sudden changes in interest rates and the resultant volatility of amortization accounts."³

OFHEO concludes that Fannie Mae's practice was not to produce a single best estimate of prepayment rates, but to generate a range of estimates and choose the one that was most convenient.⁴ "[M]odeling of the catch-up was performed for both the current quarter as well as for prospective reporting periods for the purpose of generating results under varying assumptions in order to achieve a specific desired outcome."⁵

OFHEO puts forward two explanations for Fannie Mae's failure to follow SFAS 91. A key company goal was to minimize the volatility of quarterly earnings to create the impression that the company's operations were stable, predictable, and low-risk. For a company like Fannie Mae that issues billions of dollars in debt each year, even a slight increase in the perception of riskiness can be very expensive, as bond investors demand higher yields. Second, the report analyzes Fannie Mae's earnings in 1998 and concludes that if the full \$400 million had been charged against earnings, top executives would not have received bonuses linked to earnings per share target levels.⁶ The explanations are not mutually exclusive.

Derivatives Accounting (SFAS 133). Derivatives — including futures contracts, options, forwards, swaps, and caps — are financial instruments whose value is linked to changes in some economic variable, most often interest rates. Fannie Mae uses derivatives extensively to manage risk. For example, if Fannie had a portfolio of bonds that would decline in value if interest rates rose and wished to protect itself against

³ OFHEO, *Report of Findings*, p. 13.

⁴ *Ibid.*, p. ii.

⁵ *Ibid.*, p. 40.

⁶ *Ibid.*, pp. 10-12.

that loss, it might purchase a derivative that would gain value by an equal amount as rates went up. The OFHEO report finds major problems in Fannie's accounting for the value of these financial instruments.

Derivatives accounting is governed by SFAS 133.⁷ Under SFAS 133, the fair value of all financial derivatives must be calculated ("marked-to-market") at the end of each accounting period. Changes in fair value from the previous accounting period must be reported as current income, unless the derivatives are used for hedging. If a derivative is used to hedge an asset (as in the example above), the value of that asset — the hedged item — will move in the opposite direction to the derivative's value. Thus, a fall in the price of the hedged asset will be offset by a gain in the derivative (or vice versa). Under SFAS 133, the firm can recognize as earnings both the change in the derivative's value *and* the offsetting change in the hedged item's. If the gains and losses are closely correlated, the net effect on reported earnings will be very small or zero.

There is another form of hedge accounting under SFAS 133, covering derivatives held to hedge a future transaction or cash flow. Since the hedged item in this case does not yet exist, it cannot be marked to market and used to offset gains in the derivative's fair value. However, SFAS 133 allows the gain or loss in a derivative used to hedge a future event to be assigned to comprehensive income, a subcategory of stockholders' equity. When the future transaction or cash flow occurs, the derivative is marked to market and changes in fair value are recognized as current income, but presumably gains or losses in the derivative will be offset by the hedged item.

Either form of hedge accounting has the effect of reducing the impact of changes in derivatives' fair value on current earnings and the bottom line. To qualify for this accounting treatment, however, FASB requires that there be a close relationship between changes in the value of the derivative and the hedged item. Derivatives that do not meet FASB's hedge test are considered speculative trading instruments, and changes in fair value from period to period must be recognized and reported as current earnings.

The OFHEO report identifies several problems with Fannie Mae's compliance with SFAS 133. The most general problem was also a major issue in Freddie Mac's 2003 accounting restatement: "many of [Fannie Mae's] hedging relationships should not qualify for hedge accounting treatment."⁸ Because Fannie Mae does not properly measure the "effectiveness" of its hedges — the correlation between changes in the value of the derivative and the hedged item — they do not meet FASB's hedge test. In many cases, OFHEO finds that Fannie simply assumes perfect effectiveness (that changes in the derivative's fair value and the hedged item's value will exactly offset each other) and fails to perform the calculations and maintain the documentation that SFAS 133 requires.

OFHEO analyzes a number of derivatives transactions in detail and finds numerous specific practices that do not conform with SFAS 133. A common theme is the inappropriate use of "short-cuts" that produce the desired result of perfectly effective hedges that will have no impact on the bottom line. OFHEO finds that Fannie Mae's

⁷ See CRS Report 98-52, *Derivatives: A New Accounting Standard*, by Mark Jickling.

⁸ OFHEO, *Report of Findings*, p. 113.

failures to follow SFAS 133 are consistent with the objectives of minimizing earnings volatility and simplifying operations.⁹

Structural Problems in Accounting Operations and Review. The OFHEO report finds significant problems with the way Fannie Mae's accounting results are generated and reviewed. Individuals involved in the process are encumbered by a "heavy workload, weak technical skills, and a weak review environment."¹⁰ Under these conditions, OFHEO finds that accounting operations rely on a few individuals who exercise wide discretion. In this environment, the process for developing new accounting policies is said to be ineffective, and internal controls are called weak or non-existent. The unfortunate result, in OFHEO's analysis, is an accounting culture where methods are chosen to produce the desired results, rather than to produce an objective and transparent view of the firm's financial condition, which is the basic aim of GAAP.

The Financial Impact

How different would Fannie Mae's financial results appear if the deficiencies identified by OFHEO were corrected? The OFHEO report does not attempt to quantify the impact on earnings, but does suggest that it might not be trivial. A formal restatement of earnings may take many months, if the Freddie Mac precedent is any guide.

Fannie Mae's annual report sets out separately the amounts involved in amortization of (1) premiums and discounts and (2) deferred guaranty fees. For the years 2001 through 2003, adjustments in net amortization increased or decreased net income by annual amounts ranging from \$71 million to \$508 million.¹¹ It is not certain how these figures would be affected by full compliance with SFAS 91, but OFHEO estimates that recognition of improperly deferred earnings could have increased quarter-to-quarter earnings volatility by as much as 16%.¹²

In derivatives accounting, the OFHEO report notes that Fannie Mae has classified \$12.2 billion in losses relating to cash flow hedges as "accumulated other comprehensive income" (AOCI), and that \$7.2 billion in adjustments to the carrying value of liabilities on the balance sheet reflect derivatives classified as fair value hedges.¹³ If Fannie Mae is required to reclassify many of its derivatives contracts from hedges to speculative positions (which must be marked-to-market and reported in current earnings), the impact on past and future earnings could be significant. OFHEO notes that such reclassification could have "a substantial impact on Fannie Mae's compliance with its regulatory capital requirements."¹⁴ On November 15, 2004, Fannie reported that if its derivatives accounting methods were found to be incorrect, its earnings statement for the third quarter might show a net loss of about \$9 billion.

⁹ OFHEO, *Report of Findings*, p. 122.

¹⁰ *Ibid.*, p. 168.

¹¹ Fannie Mae 2003 10-K Report, p. 43.

¹² OFHEO, *Report of Findings*, p. 26.

¹³ *Ibid.*, p. 93. These figures are as of Dec. 31, 2003.

¹⁴ *Ibid.*, p. 93.

As for the financial impact of the general weaknesses in Fannie Mae's accounting structures, perhaps the best indicator is the behavior of Fannie Mae's stock price since the OFHEO report was released to the public on September 22, 2004. Between the close of trading on the 21st and the end of the week (September 24), the share price dropped by \$10.14, or 14.4%. This equals a loss of about \$11 billion for Fannie Mae shareholders.

The Regulatory Response

On September 27, 2004, Fannie Mae's board of directors reached an agreement with OFHEO to take a number of actions to address problems identified in the report. Fannie Mae will (1) correct its accounting practices related to SFAS 91 and 133, (2) supplement its capital surplus by an amount equal to 30% of the required minimum capital, (3) review staff structure, responsibilities, independence, compensation, and incentives, (4) appoint an independent chief risk officer and separate key business functions now performed jointly by certain individuals or departments, and (5) put in place new controls and policies to assure adherence to accounting rules.

The Securities and Exchange Commission (SEC) is reported to be conducting its own investigation, not limited to the issues raised by OFHEO. Although the SEC's jurisdiction over the GSEs is limited, it could require a restatement of past accounting results or bring civil charges against Fannie Mae or individual employees. On November 15, 2004, Fannie informed the SEC that it could not file a third-quarter earnings report because its outside auditor, KPMG, had declined to sign off on the financial statements.

On September 30, 2004, press reports stated that the Department of Justice had opened a criminal investigation.

Congressional Action

The 108th Congress has considered a number of bills that would restructure OFHEO and strengthen its regulatory authority, but none has reached the floor of either chamber.¹⁵ If no bill is passed this year, the issue is likely to be taken up again in the 109th Congress.

The House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises held a hearing on October 6, 2004, where OFHEO's director summarized the report's findings and stressed that serious safety and soundness issues had been raised. Fannie's CEO and CFO argued that the applications of SFAS 91 and 133 challenged by OFHEO were within GAAP and had been accepted by KPMG (Fannie's outside auditor), that there had been no attempt to manipulate earnings, and that the financial condition of the company remained sound. The Presiding Director of Fannie's board described steps taken to respond to OFHEO's charges and insisted that Fannie Mae's current corporate governance structure was up to the tasks of getting the facts and taking any necessary remedial actions.

¹⁵ See CRS Report RL32069, *Improving the Effectiveness of GSE Oversight: Legislative Proposals*, by Loretta Nott and Mark Jickling.