Order Code RS21949
Updated December 7, 2006

CRS Report for Congress

# 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 charged Fannie Mae, the government-sponsored enterprise that plays a leading role in the secondary mortgage market, with not following generally accepted accounting practices in several critical areas, which allowed Fannie Mae to conceal losses, reduce volatility in reported earnings, present investors with an artificial picture of steadily growing profits, and meet financial performance targets that triggered the payment of large bonuses to company executives. Fannie Mae's initial response was to argue that OFHEO's charges involved not improprieties, but merely differing interpretations of highly complex accounting standards. However, on December 15, 2004, the Securities and Exchange Commission (SEC), after finding inadequacies in Fannie's accounting policies and methodologies, supported OFHEO and directed Fannie Mae to restate its accounting results since 2001. Shortly thereafter, the company's CEO and CFO resigned. In May 2006, Fannie Mae reached a settlement with OFHEO and the SEC, agreeing to pay $400 million in civil penalties, undertake a number of remedial steps related to internal controls and oversight of accounting systems, not increase the size of its mortgage portfolio without OFHEO's approval, and be enjoined from future violations of securities laws. In December 2006, Fannie issued the restatement, which reduced reported earnings for 2001-2004 by $6.3 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). Large quantities of GSE bonds are held by insured banks, pension funds, and investors of all types. Although GSE debt is not guaranteed by the government, the "government sponsored" status of Fannie and Freddie leads market participants to put faith in an "implicit" guarantee, a belief that the Treasury will never allow either GSE to default on its obligations.

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 Fannie Mae, and at Freddie Mac in 2003,[1] raise serious questions. The accounting irregularities to date have been portrayed as a byproduct of management's wish to persuade investors that, despite the volatile nature of the mortgage market, the firms' earnings are steady, predictable, and insulated from sudden changes. (Other things equal, higher volatility in earnings will drive investors to demand higher interest rates to compensate for the risk of holding GSE debt, which would lower the profitability of the mortgage portfolios both GSEs hold.) There has been no indication that accounting has been manipulated to conceal fundamental financial problems in the two firms, as was the case at failing firms like Enron and WorldCom. However, given the size of the GSEs and their importance to the financial system, there is clearly a public interest in improving accounting transparency and rigor.

## Why Fannie Mae's Financial Statements Were Manipulated

In May 2006, OFHEO published its final report on its special examination of Fannie Mae.[2] A major finding is that improper accounting practices were largely driven by management's desire to achieve profit targets (expressed as earnings per share, or EPS) that would trigger maximum bonuses. Fannie Mae had three compensation plans linked to EPS figures: two affected only a small group of top executives, but another, called the Annual Incentive Plan, had over 800 beneficiaries.

Achieving the targeted EPS numbers became an overriding goal at Fannie Mae. Accounting personnel received explicit instructions (as well as constant exhortations) regarding the importance of the figures. The OFHEO report presents numerous internal communications that discuss which particular manipulation would be best suited to hit the target in a particular quarter or year. (It was also important not to exceed the target, because bonuses were capped. If earnings appeared likely to exceed the target figure, ways were found to defer recognition of current earnings to future periods.)

In summary, Fannie Mae's accounting systems and policies were designed to produce the results that management wanted, and not to provide investors with an accurate picture of the firm's financial condition. The image management tried to project — of a firm whose financial results were predictable and stable — was false. In 2002 and 2003, when interest rates dropped to very low levels, Fannie Mae incurred large losses due to an increased rate of mortgage prepayments. "The magnitude of those losses, although not large enough to threaten the safety and soundness of Fannie Mae, provides evidence that the Enterprise's interest rate risk exposure during the period was significant

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

[2] *Report of the Special Examination of Fannie Mae,* May 2006, 340 p. (Available on the OFHEO and Fannie Mae websites.)

and is inconsistent with the image of Fannie Mae as a very low-risk institution promoted by senior management."[3]

## The Accounting Issues

The 2004 OFHEO report[4] identified (and the Rudman[5] and May 2006 OFHEO reports confirmed) a number of major accounting problems at Fannie Mae. Several dealt with the failure to comply with specific accounting rules, and a more general critique focused on weaknesses in the firm's accounting processes, corporate culture, the "tone at the top," and failure of the board of governors to provide effective oversight. These issues are summarized below.

**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 interest rate risk. Derivatives accounting is governed by SFAS 133.[6] 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.

OFHEO's 2004 report analyzed a number of derivatives transactions in detail and found 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 found that Fannie Mae's failures to follow SFAS 133 were consistent with the objectives of minimizing earnings volatility and simplifying operations.[7] The Rudman report concludes that Fannie Mae deviated from the clear requirements of SFAS 133 in numerous and important respects, and concurs with OFHEO's assessment of Fannie's motivation.

**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

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[3] Ibid, p. 48.

[4] Office of Federal Housing Enterprise Oversight, Office of Compliance, *Report of Findings to Date: Special Examination of Fannie Mae*, Sept. 17, 2004, 198 p. (Hereinafter cited as OFHEO, *Report of Findings To Date*.)

[5] *A Report to the Special Review Committee of the Board of Directors of Fannie Mae,* Feb. 23, 2006. Available at [http://www.fanniemae.com]. (Hereinafter cited as *Rudman Report*.)

[6] See archived CRS Report 98-52, *Derivatives: A New Accounting Standard,* by Mark Jickling (available from author).

[7] OFHEO, *Report of Findings To Date*, p. 122.

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.

OFHEO found that Fannie Mae did not follow this standard in a consistent manner but chose to apply it as needed to produce the financial results management wanted. 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 deferred recognition of the other half.

The deferred $200 million became known within Fannie Mae as the "catch-up." OFHEO claimed 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 polices "specifically intended to manage the catch-up position as a buffer to sudden changes in interest rates and the resultant volatility of amortization accounts."[8]

OFHEO put forward two explanations for Fannie Mae's failure to follow SFAS 91. First, management sought to create the impression that the company's operations were stable, predictable, and low risk. Second, the report analyzed 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.[9] The Rudman report found that the desire to meet the bonus target provides the only plausible explanation for the 1998 accounting maneuver.

**Classification of Securities (SFAS 115).** Fannie Mae holds a large portfolio of debt securities, mostly mortgage-backed bonds. How these securities are valued affects earnings. The value of bonds falls when interest rates rise and climbs when rates fall. Fluctuations in the value of bond portfolios should be reported in current income, unless the bonds are to be held to maturity (in which case the price changes do not matter, since they do not affect the interest and principal payments the holder receives). SFAS 115 requires firms to classify bond portfolios as either "hold-to-maturity" (HTM) or "available-for-sale" (AFS). Bonds in the latter category must be revalued at every accounting period, and changes in value reported as current income. OFHEO finds that Fannie Mae did not properly apply this rule, but chose the classification that would produce the financial results it wanted.

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[8] OFHEO, *Report of Findings to Date*, p. 13.

[9] Ibid., pp. 10-12.

**Structural Problems in Accounting Operations and Review.** The 2004 OFHEO report found significant problems with the way Fannie Mae's accounting results are generated and reviewed. Individuals involved in the process were encumbered by a "heavy workload, weak technical skills, and a weak review environment."[10] The Rudman report is even more critical: accountants were unqualified, resulting in haphazard implementation of accounting rules, and failed to understand or carry out their roles in making accounting policy. Accounting systems are described as "grossly inadequate."[11] The Rudman report notes at the outset, however, that the remedial steps taken by Fannie Mae since 2004 essentially encompass all the recommendations that report's authors would have made.[12]

**The Supplemental Agreement.** On March 8, 2005, Fannie Mae entered into a supplemental agreement to correct further accounting problems identified by OFHEO.[13] Among the accounting issues (and the relevant FASB standards) are

- valuation of mortgage loans held in portfolio (SFAS 65);
- improper classification of securities as either "hold to maturity" or "available for sale" (SFAS 115);
- policies regarding sale and repurchase of securities, called "dollar rolls" (SFAS 140);
- failure to account for certain purchase and sale commitments relating to mortgage assets as derivatives (SFAS 149); and
- an accounting policy related to pools of mortgage-backed securities (FASB Interpretation No. 46).

According to the Rudman report, Fannie Mae has "diligently pursued" its obligations under the OFHEO agreements.[14]

## The Restatement

On December 6, 2006, Fannie Mae issued a restatement of earnings covering the period from January 2002 through June 2004. Earnings were originally misreported by a total of $9.1 billion, but, because some of the errors understated earnings, the net effect was to reduce retained earnings over the period by $6.3 billion. The largest item in the restatement was unreported derivatives losses totaling $7.9 billion.

[10] Ibid., p. 168.

[11] Rudman Report, executive summary, p. 5.

[12] Ibid., p. 2.

[13] For a description of the agreement, see testimony of OFHEO Director Armando Falcon, before the Subcommittee on Capital Markets, Insurance, and GSEs, House Committee on Financial Services, Apr. 6, 2005.

[14] Rudman Report, executive summary, p. 2.

## 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.

On November 15, 2004, Fannie informed the Securities and Exchange Commission (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 December 15, 2004, the chief accountant of the SEC issued a statement that Fannie Mae's accounting was not in compliance with SFAS 91 and 133.[15] The SEC directed Fannie Mae to restate its financial statements for the period from 2001 through mid-2004.

On March 8, 2005, OFHEO entered into a supplemental agreement with Fannie Mae, relating to further discoveries of accounting irregularity, as described briefly above.

In May 2006, Fannie Mae reached settlements with OFHEO and the SEC. The two regulators will collect about $400 million in fines. The company agreed not to expand its mortgage portfolio beyond the asset level of December 31, 2005 (about $727 billion), except with the advance approval of OFHEO. The firm also agreed to address all the recommendations in the final OFHEO report, including modifications to internal controls, accounting practices, governance, corporate culture, disclosure, and personnel oversight and compensation.

In December 2006, with the release of Fannie Mae's restatement of earnings, OFHEO announced that it intended to file suit against former CEO Franklin Raines and CFO Tim Howard to seek recovery of millions of dollars in bonuses that were linked to manipulated earnings.

## Congressional Action

Two bills in the 109th Congress — S. 190 (reported by the Senate Banking Committee on July 28, 2005) and H.R. 1461 (passed the House on October 26, 2005) — proposed to restructure GSE regulation, by replacing OFHEO with an independent agency with authority over Fannie, Freddie, and the Federal Home Loan Banks.[16] The bills would enhance the safety and soundness tools available to the GSE regulator, giving it more flexibility to establish and enforce risk management, operational, and capital standards, and allowing it to put a GSE into receivership, if necessary.

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[15] "Office of the Chief Accountant Issues Statement on Fannie Mae's Accounting," Press Release 2004-172, Dec. 15, 2004.

[16] For a summary of the provisions of these bills, see CRS Report RL32795, *Government-Sponsored Enterprises: Regulatory reform Proposals*, by Mark Jickling.