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Fannie Mae's Accounting Finds Critics of Its Own

By ALEX BERENSON

Regulators, lawmakers and investors have battered [Freddie Mac](#), the country's second-largest mortgage financier, since it fired its president two weeks ago, after the company said he failed to cooperate with an internal inquiry into its accounting.

Now some money managers and independent accounting experts are raising questions about the profits reported by [Fannie Mae](#), Freddie Mac's even larger corporate cousin. Fannie Mae appears to have suffered a big loss last year that was obscured by the complexity of its accounting, they say. Fannie Mae strongly disputes their analysis.

Fannie Mae, a government-sponsored company that owns or guarantees about 25 percent of all mortgages in the United States, is known for its political savvy in Washington and is highly respected on Wall Street. The company reported \$6.4 billion in profit in 2002, the seventh consecutive year its earnings increased more than 10 percent.

But the money managers argue that Fannie Mae's fair-value balance sheet, a short statement that offers a once-a-year snapshot of the market values of all the company's assets and debts, presents a more accurate picture at its earnings than its cheery income statement. The balance sheet shows that Fannie Mae lost billions of dollars when interest rates plunged last summer, nearly wiping out its profit for the year, the money managers say. Accounting rules enabled Fannie Mae to keep those losses out of its profit report, but the losses will reduce the company's earnings in the future, the managers say.

"On an economic basis, they made no money last year," said Lawrence Kam, president of Sonic Capital, a Boston hedge fund that has sold Fannie Mae stock short, betting that its price will decline. "That's the simplest way to put it."

Dwight Jaffee, a professor of finance and real estate at the University of California at Berkeley who has studied mortgage markets for 35 years and who wrote a paper last year on interest-rate risk at Freddie Mac and Fannie Mae, said the Sonic Capital analysis appeared to be "exactly right." Mr. Jaffee cautioned that he could not confirm the details of Mr. Kam's analysis. (Mr. Jaffee said that in the last week, he had sold short a small amount of Fannie Mae stock. "I'm putting my money where my mouth is," he said.)

Mr. Kam, Mr. Jaffee and others are not contending that Fannie Mae broke any accounting rules, but rather that standard measures of profit and loss do not capture the underlying economic reality of its business. Last year, Fannie Mae reported \$6.4 billion in "core earnings," a nonstandard accounting measure that is used by the company and widely followed by Wall Street analysts, and \$4.6 billion in profits under standard accounting rules.

Fannie Mae disputes the Sonic Capital analysis and says that its reported profit reflects the reality of its business, although it acknowledges that it was hurt when interest rates dropped. Several company officials said in interviews last week that investors were wrong to try to determine the company's profit simply by measuring year-over-year changes in its balance sheet.

"Our core business earnings provide a better measure of our financial results and better reflect our risk-management strategies," a spokesman for Fannie Mae, Chuck Greener, said. Jayne Shontell, the director of investor relations, said investors should look at the company's core earnings, its earnings under standard rules and its balance sheet.

The details of the argument are complicated, but it boils down to this: last year, Fannie Mae underestimated how fast interest rates would decline and homeowners would refinance their mortgages, Mr. Kam and others say. As a result, it did not protect itself from the risk that some of its higher interest-rate mortgages would be replaced with lower-yielding ones, and it lost money as a result. Those losses will only become evident in Fannie Mae's income statement over the next several years, as the company receives less interest than it had expected, but they are already obvious on its balance sheet.

On the other hand, Freddie Mac, which hedged more of the refinancing risk, has acknowledged that it understated its profit in 2001 and 2002. It has said it expects to restate them upward when it completes an audit of its financial statements later this year. Freddie Mac fired David W. Glenn, its president, and forced out two other executives for failing to cooperate with the internal inquiry.

In arguing that Fannie Mae had large losses last year, Mr. Kam and others are relying on the fair-value balance sheet, which gives a once-a-year picture of the company's assets and debts, calculated as of Dec. 31.

Under standard accounting rules, Fannie Mae measures the changes in value of some of its assets and debts each year, while ignoring changes in others until later, leading to very complicated accounting treatments. Fair-value balance sheet accounting is conceptually much simpler. It tries to measure how much money would be left to shareholders if Fannie Mae were forced to liquidate all its assets, including all derivatives contracts, and use the money to repay its debts.

Fannie Mae's assets are mainly the mortgages it has bought from banks, while its debts are mainly bonds it has sold to investors to pay for those mortgages. Essentially, both Fannie Mae and Freddie Mac are giant, highly leveraged bond funds. They make some money from providing guarantees that mortgages

held by other investors will be repaid even if homeowners default. But most of their profit comes from the spread between the interest they pay on their debt and the interest they receive from mortgages.

For example, if Fannie holds a mortgage paying a 7 percent interest rate and finances it with a bond on which it pays 6 percent, it keeps the one percentage point difference. The business is complicated because homeowners can prepay mortgages whenever they like, while the lenders do not have that option with the majority of the bonds they issue. If rates fall, and the 7 percent mortgage on Fannie's books is replaced by a 5 percent mortgage while the company still must pay 6 interest percent on its debt, its profit has turned into a loss.

Fannie Mae and Freddie Mac use a variety of strategies to hedge that risk. They exploit computer models to figure out how many mortgages are likely to be prepaid, and to adjust their mixture of short- and long-term debt in response. They also issue some callable debt, which gives them the option to prepay bondholders, and enter into some derivatives contracts whose value will rise if rates fall.

But neither company hedges all its prepayment risk, because doing so is expensive and lowers profit. Fannie Mae hedges less than Freddie Mac, according to risk models published by both companies, as well as a study last year by the Office of Federal Housing Enterprise Oversight, which regulates Freddie Mac and Fannie Mae.

Last year, as interest rates on 30-year mortgages fell to about 6 percent in September from 7.1 percent in April, homeowners rushed to refinance, and Fannie Mae found itself with too much long-term debt and not enough mortgages.

Generally, Fannie Mae tries to keep what it calls the "duration gap," a measure of the difference between when it receives payments on mortgages and when its debts are due, to six months or less. By August 2002, that had grown to 14 months.

To balance its portfolio, Fannie Mae bought more mortgages and called back some debt, the spokesman, Mr. Greener, said. But in doing so Fannie Mae replaced older, higher-interest mortgages with lower-interest mortgages.

The effect can be seen on the company's 2002 balance sheet, Mr. Kam said. While Fannie Mae reported \$6.4 billion in "core profits" from its existing portfolio of mortgages, its net assets actually fell slightly, indicating that many of the new mortgages it had bought during the year would not be as profitable as the ones they replaced.

"When you don't properly hedge, and interest rates move in a direction faster and more brutally than you expect it, then you incur economic losses," he said.

A comparison of Fannie Mae's balance sheet with its reported profits shows that since 2000, the income that the company has reported to shareholders has risen almost \$10 billion more than the value of its net

assets, even after adjusting for cash it has paid to stockholders in dividends and share repurchases.

Mr. Greener, of Fannie Mae, said relying too much on the balance sheet to judge results is a mistake. Fair-value accounting can produce counterintuitive results, he said. For example, the company benefits from a widening spread between the interest rate it receives on its mortgage portfolio and the rate it pays on its debt, he said. But the wider spread can actually lower Fannie Mae's net asset value, he said, since the debt it issued earlier will be revalued upward.

Mr. Kam acknowledged that Mr. Greener's example was possible, but he said that it did not explain the difference between the balance sheet and the income statement at Fannie Mae. Freddie Mac, which has roughly the same spreads as Fannie Mae, has had a much smaller divergence between the two, which he said proves that the gap at Fannie Mae was related to its failure to hedge, not changes in the interest rate spread.

"They're trying to make something that was a calamity into some sort of positive," Mr. Kam said. "It's disingenuous."