Perspectives

Investment Views

Fannie Mae - Why Investors Still Embrace the Mortgage Giant *Spring, 2005*

Fannie Mae, the government-sponsored entity ("GSE") chartered by the United States Congress to facilitate housing ownership for low to middle-income Americans, is in the midst of a corporate cleansing brought on by regulatory concerns over interpretation of certain accounting rules. As Fannie Mae is one of the most prevalent issuers of debt in the world we thought it worthwhile to discuss the issues facing the company and efforts being made to rectify the situation. While not yet complete, we expect that the actions taken at Fannie Mae will strengthen the company financially, provide for greater accounting transparency and correct internal control deficiencies. Ultimately we believe Fannie Mae will remain a worthy investment for our client portfolios.

Fannie Mae is one of the largest financial institutions in the world with $940 billion of outstanding debt securities and an additional $1.4 trillion of guaranteed mortgage-backed pass-through securities (MBS). The organization is one of two GSEs chartered by Congress, the other being Freddie Mac. Both of these entities are regulated by Congress through the Office of Federal Housing Enterprise Oversight ("OFHEO").

The degree of issuance mentioned above makes Fannie Mae securities nearly mandatory holdings for any fixed income money manager benchmarking against a comprehensive index. Due to the historical origins of the GSEs investors consider Fannie Mae's debt to be nearly as secure as that of US Treasuries while offering incremental yield. That additional yield, or spread, varies by maturity from 10 basis points in the one year area to 25 basis points for five years and approximately 40 basis points for 30 year securities. Despite the negative headlines, spreads have remained relatively stable.

The Issues: Despite the apparent rigidity of generally accepted accounting principles (GAAP), there is almost always room for interpretation when it comes to application of accounting rules. The discoveries that lead to a May 2004 report from OFHEO are prime examples of that. In nearly all instances the underlying issue involves the accounting for derivative contracts. The general principal behind the use of these contracts is simple in nature; to hedge unwanted risk. In situations where these contracts are used for hedging purposes, accounting rules provide a means of withholding from earnings price fluctuations of the underlying securities, both the derivative contract and the hedged securities. While these rules were incorporated to help firms truly using the contracts for risk reduction purposes avoid excessive and unwarranted earnings volatility, the practice can be abused for the sole purpose of producing more consistent earnings results. In Fannie's case this is a part of the regulator's argument.

Accounting issues raised in OFHEO's original report pertain to Financial Accounting Standard ("FAS") 133, accounting for derivatives, and FAS 91, amortization of mortgage premiums and discounts. The more pressing of the two is FAS 133. Fannie appears to have cumulatively overstated earnings by as much as $9.0 billion since the rule was incorporated in 2001. OFHEO and the SEC allege that Fannie improperly characterized derivative contracts such as interest rate swaps, swaptions, and interest rate cap contracts as "perfect hedges." Accounting standards define a perfect hedge as one that offsets positive movements in the underlying security with an opposing movement in the derivative contract one-for-one. Unfortunately, due to the highly complex structure of some of these hedges, they often start as perfect but drift over time and may require adjustment. As such the qualification of a perfect hedge can break down over the term of the structure. And this leads to the other aspect of OFHEO's concern; that the accrued gains and losses can amount to substantial sums that they feel this is inappropriate for a GSE. Such a circumstance would become a problem in the event Fannie was required to unwind the structures prematurely. OFHEO is contesting that in consideration of Fannie's mandate, its oversight by Congress, and its importance to the overall US economy, conservative interpretation of accounting standards are warranted.

As for FAS 91, Fannie is accused of deferring $200 million of estimated expenses in 1998 that arguably allowed management to realize $5.9 million in bonuses for that year that otherwise would have been substantially lower. While the financial implication of this charge is comparatively small, the charge implies possible criminal activity and has resulted in a Department of Justice probe.

In more recent news OFHEO has raised issues over several additional accounting standards, specifically; FAS 115, designation of assets as Available for Sale or Held to Maturity; FAS 65, related to loans acquired from mortgage banks; and FAS 149, a rule governing commitments to purchase mortgages from lenders in the future. To date there has been no formal announcement pertaining to any potential financial implications. As with FAS 133, the underlying issue with most of these new revelations relates to the use of derivative contracts to avoid the use of mark-to-market accounting.

What Does it All Mean? Historically Fannie Mae has had the political clout to supercede OFHEO when it came to disagreements such as derivative accounting. However, it appears that as a result of the potentially criminal motives behind the FAS 91violation, OFHEO has managed to reverse that balance of power. The end result is likely to be a restatement of earnings that will incorporate mark-to-market accounting and result in a charge against earnings and a reduction of balance sheet equity. That charge will put Fannie in violation of OFHEO's already liberal capital requirements.

Corrective Actions: In response to the original OFHEO report, Fannie Mae's board of directors asked for and received the resignations of Chairman and CEO Franklin Raines and CFO Timothy Howard. In doing so, the board decisively moved in a more conservative direction, creating a far more cooperative relationship with its regulator.

From OFHEO's perspective the introduction of derivative contract use has enhanced the financial complexity of the GSEs. For this reason OFHEO has requested that Fannie not only restore its capital levels to a regulatory minimum after posting its pending earnings charge but to achieve a level 30% over the minimum.

Through a highly visible exchange of goodwill it is has become apparent that the relationship between OFHEO and the interim management team at Fannie is quite amicable. Fannie Mae's board began the exchange by separating the function of chairman and chief executive officer and negotiating a June 30, 2005 deadline to restore its capital levels. Management then almost immediately issued $5.0 billion of preferred securities. In exchange OFHEO allowed Fannie to continue issuing equity dividends although at half the previous level. Following on, Fannie has taken to systematically reducing its on-balance sheet mortgage portfolio that now totals $890 billion, down from $915 billion late last year. Subsequently OFHEO granted a three month extension to its capital level deadline, thus allowing for a more gradual restoration schedule. Each of the actions taken by Fannie Mae will contribute significantly to enhancing capital adequacy in the following manner; the issuance of preferred securities increased equity on the balance sheet, the lower dividend will increase retained earnings (a component of equity), and reducing liabilities relative to equity capital improves the capital ratio by lowering the numerator.

Our Perspective: As one of two GSEs serving a highly important role in the US economy Fannie Mae is unlike any other corporate issuer of debt. Fannie Mae is a public entity indirectly regulated by Congress. This oversight body provides a degree of vigilance that investors do not enjoy with any other public or private issuer. While the system is not fail-proof the present exercise is a perfect example of how the regulatory body fills the void of disclosure investors often face.

While the restoration process at Fannie Mae is not yet complete and negative headlines are likely continue appearing in the press, Fannie Mae's capital base should ultimately be restored through the combination of actions discussed above. The conciliatory relationship interim Chairman Stephen Ashley has created with OFHEO is sure to yield a more conservative approach to managing Fannie Mae, which is ultimately to the benefit of fixed income investors. In addition, the apparent nature of negotiations between Fannie and OFHEO reveal that as long as Fannie is making strides in the right direction it will be allowed to operate in a manner that has historically been profitable for the company, thus perpetuating a cycle of improving fundamentals.