

Introduction

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Last week, the Senate Banking Committee adopted a surprisingly strong regulatory reform bill on a party line vote. The absence of bipartisan support for the bill has led some commentators to believe that the legislation will not be brought up for action in the Senate before the end of this session. That is probably true, with one major qualification. Many have noted that if there is another severe jolt to public and investor confidence in Fannie and Freddie—equivalent perhaps to Freddie’s accounting problems—a consensus for action in the Senate could still develop.

That jolt could come from serious questions about Fannie’s own accounting, and the possibility that there may be something seriously wrong with Fannie’s financial reports became considerably more realistic last week. On Wednesday, OFHEO, Fannie’s regulator, which had been conducting what it calls a “forensic audit” of Fannie’s accounting, announced that the audit “may result in a restatement of prior-period results and a revision of the respective capital calculations.” This is an extraordinary statement, and almost certainly indicates that OFHEO has found something in the course of the audit that is serious enough to issue an advance warning to the market.

The following day, after Fannie’s spokesman suggested that the company didn’t know what this was all about, OFHEO issued another statement, noting that Fannie knew very well what the OFHEO statement was referring to, and reporting that the examination is “intensely focused on several specific issues,” including impairments of manufactured housing assets and, according to the OFHEO statement, “other assets as well.”

Questions about the accuracy of Fannie’s financial reports have been circulating on the Internet and occasionally in the press for several weeks. With the publication of Fannie’s 10-K annual report, much of the speculation ended, but what was actually in the 10-K simply raised more questions.

It is not clear, of course, what has been found, but there are certain areas where questions have been consistently raised by analysts—the size of Fannie’s losses on its derivatives, how these losses are treated in the computation of its earnings, whether Fannie has adequately accounted for impaired assets such as its manufactured housing portfolio, and how all of this affects Fannie’s capital position.

Many of these questions are highly complex, and cannot be adequately summarized or explained in news articles. But many people who follow developments on the GSEs need to understand the issues that are involved here, and what it is that OFHEO is likely to be looking at.

For this reason, I asked John Barnett of the Center for Financial Research & Analysis—an independent financial analysis firm—to prepare a presentation on these and other issues. John has been in touch with officials of Fannie over the last several months, to discuss these issues and get answers where he could. It is unlikely that anyone outside Fannie and OFHEO has a more comprehensive understanding of Fannie’s accounting and how it affects the firm’s reported earnings and capital.

I made significant efforts to get a commentator from Fannie Mae to respond to the presentation you will hear today. I first extended an invitation to Peter Niculescu, one of Fannie’s Executive Vice Presidents and a former investment banker, in early March. Eventually, on March 19, Niculescu responded to say he had checked and could not participate. No reason was given. I then asked him, and another Fannie official who has been attending our conferences, whether someone else at Fannie Mae would be able to attend. I never received a reply. I am reciting all of this detail because I want it to be clear that Fannie was given a chance to offer its own views on John Barnett’s presentation, and chose not to do so.

If John’s presentation accurately reflects the issues that OFHEO is now looking at, remember you heard it here first.