

Introduction

Understanding OFHEO's Report on Fannie Mae

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It is said that a good offense is often the best defense, and this was demonstrated once again at Chairman Baker's October 6 hearing on OFHEO's interim report on Fannie Mae's accounting. To the surprise of many, the Chairman and the Chief Financial Officer of Fannie Mae both took on their regulator, and denied under oath that they or the company had done anything wrong in preparing Fannie's financial statements. Their performance stopped in its tracks a budding interest in whether Fannie complied with Generally Accepted Accounting Principles (GAAP) in preparing its financial statements. Whether it will eventually prove to be only a temporary respite is another question. Nevertheless, noting the vigor of the counterattack, many observers concluded that, well, maybe it's just a dispute among accountants, with no right or wrong.

In this conference, we will try to help you understand the relevant GAAP rules and the significance of the issues involved. The members of the panel are long time students, and in some cases critics, of Fannie's accounting, and do not believe—if OFHEO's facts are correct—that many of OFHEO's charges are as debatable as Fannie's officers suggest. Although we usually invite experts on both sides to participate in our panels, in this case we have not done so. The purpose of this conference is to make clear that OFHEO has identified significant problems with Fannie's accounting. It will raise questions that Fannie will have to answer in the weeks to come, with details and explanations that go beyond simply asserting that only complicated accounting is at issue.

As you will see in the discussion today, the relevant rules—although complicated—can be understood. Fundamentally, they were intended to provide *investors*, and to some extent creditors, with a clearer picture of the real economics underlying a company's business. For that reason, as in the recent corporate scandals, it is a serious problem when the rules are manipulated and ignored by companies in order to give a more favorable view of their financial position than the rules would otherwise permit.

But in Fannie's case there is another dimension. Fannie is a regulated company because Congress was concerned that its financial weakness might result in liability for the government and the taxpayers. This places an added burden on Fannie and its management to follow the rules—not only the prudential rules established by its regulator, but the GAAP rules that would allow its regulator, as well and the administration and Congress, to understand its financial position at any given point in time. If Fannie's management manipulated the rules in order to obscure the company's true financial position—or, worse, to guarantee the payment of bonuses—their actions raise questions that go well beyond the concerns of investors.

On October 13, in introducing a panel discussion about a privatization plan for Fannie and Freddie commissioned by AEI, I noted that regulation will not work, and is not a viable solution to the problems associated with Fannie and Freddie, if their managements will not obey the rules. This is especially true if, once the rules are broken, Congress stands idly by and does not support—indeed, attacks—the regulator who is trying to protect the taxpayers.

In the October 6 Baker hearing, we saw a clear demonstration of exactly this scenario. In that hearing, Fannie’s supporters—Democrats and Republicans alike—instead of being concerned by what OFHEO reported, took Fannie’s side and attacked the messenger. Is it possible to imagine that, if this were a bank instead of Fannie Mae, members of Congress would be attacking the Comptroller of the Currency or the Fed for a similar report?

This is exactly what I fear will happen when—at some time in the future—a regulator attempts to clamp down on Fannie’s risk-taking. There will be a similar outcry from the company’s supporters in Congress, and effective regulation will be stymied or suppressed. Chairman Baker take note; if you are truly interested in protecting the taxpayers, you should be aiming at privatization, not simply tighter regulation.

In essence, this is not a dispute among accountants; it is a question whether a uniquely powerful regulated company should—or really, can—be compelled by its regulator to obey the rules.

One other point: it now seems to be accepted that the SEC will be the arbiter of the accounting issues we will discuss today, and if it concludes that Fannie does not have to restate its financial reports the company and its management will be somehow vindicated. But, as I suggested earlier, this is far too narrow a conception of the problem. Although accounting issues are largely within the purview of the SEC, it is necessary to recall that the SEC’s role is to protect *investors*. It interprets GAAP from that perspective, and assumes that investors have some understanding for the different ways that the rules can be applied, and are able to sell their interests if they are dissatisfied either with the way a company has interpreted and applied GAAP rules or with the way its management is behaving.

OFHEO’s role, however, is to protect the *taxpayers*. The taxpayers don’t have the option to protect themselves by selling off their interests in Fannie Mae. From this perspective, OFHEO’s responsibility is to assure that Fannie’s true financial position is reflected in its financial reports and that its management is trustworthy. For that reason, even if the SEC should conclude that Fannie’s management did not violate GAAP to such a material degree that its financial reports would have to be restated, OFHEO would still be justified in requiring that Fannie present its financial reports in such a way—consistent with GAAP—that it fully informs the administration, Congress, and the public about the economic reality underlying its accounting results. And OFHEO would also be justified in seeking the dismissal of a management that it does not believe can be trusted to operate the company in a safe and sound manner.

The interesting question is whether OFHEO will be able to accomplish any of these things without support in Congress, and if that is not forthcoming it will be a real time live demonstration that they cannot be controlled by regulation.