



## A Special Report: Fannie & Freddie Back on Track and Moving Ahead

The Federal National Mortgage Association (Fannie Mae) which was founded in 1934 and its smaller cousin the Federal Home Loan Mortgage Corporation (Freddie Mac) which was founded in 1970 are Government Sponsored Enterprises (GSE) created by Congress in order to expand financing for home mortgages. Today they are private, shareholder-owned companies that operate under a Congressional charter to increase the availability of homeownership.

In order to accomplish this mission, Fannie and Freddie raise capital by issuing bonds. In fact, the two companies are the largest borrowers in the United States after the Federal Government. The agencies use this capital to purchase mortgages from S&Ls, banks, and other lenders. They then "securitize" the mortgages by repackaging them, adding a guarantee to the principal and interest payments, and selling them to other investors. When the GSEs purchase mortgages, it frees up capital for primary lenders to issue more mortgages. The intent is that this process adds liquidity to the mortgage market, thereby lowering interest rates, and making housing more affordable to millions of Americans.

In addition to purchasing mortgages from primary lenders and securitizing them, Fannie and Freddie also buy large quantities of mortgage-backed securities in the secondary market. **In fact, the two agencies do this on such a scale that together they hold nearly \$1.4 trillion in mortgage debt, or about 20% of all outstanding mortgages in the United States.** While the companies' securitization activities provide clear benefits to the US housing market, there is greater debate as to the societal value provided by Fannie and Freddie's investment activities. This debate, combined with concern over the potential systemic risks that result from the sheer size of the companies' portfolios, has led to calls by some to limit the size of the GSEs' investment portfolios. These calls have gotten louder in the wake of

the announcement of Freddie Mac's accounting problems in 2003 and Fannie Mae's similar announcement in 2004.

### **Fannie Mae announced in 2004 that accounting mistakes had resulted in their overstating earnings by at least \$11 billion between 2001 and mid-2004.**

These accounting errors were a direct result of several internal problems at the company. First of all, many of their accounting activities were not in compliance with Generally Accepted Accounting Principles (GAAP). In part, this was due to management's desire to regulate earnings and deliver a consistent earnings stream that would meet with Wall Street's approval. Secondly, both Fannie Mae's Chief Financial Officer and its Controller appear to have overstepped the limits of their responsibility. Finally, the accounting systems that Fannie Mae had in place were inadequate for a company of its size and complexity.

Back in 2003, Freddie Mac also had accounting problems. The company announced that it had understated its earnings for the years 2000 through 2002 by nearly \$5 billion in an effort to manage earnings volatility. Similar to Fannie Mae, Freddie Mac seems to have been excessively concerned with producing a smooth stream of earnings in order to meet with the approval of Wall Street and the investment community.

Despite these difficulties, the Agencies remain financially sound. Taking a closer look at recent developments by the Office of Federal Housing Enterprise Oversight (OFHEO) reflects the level of scrutiny the companies' have undergone to move past these accounting scandals and improve transparency and accountability. For example, the OFHEO, the body that regulates Fannie Mae and Freddie Mac, required the Agencies to maintain a 30% surplus above their minimum capital requirements. Both companies are easily in compliance with these new, tougher regulations.

There have however been difficulties. Since July 2004, Fannie Mae has not released regular quarterly reports. The company

has been in close consultation with the Securities and Exchange Commission though, and SEC Chairman Christopher Cox recently announced that Fannie Mae has established a timetable under which it will resume regular financial statement releases. Fannie Mae has publicly stated that it hopes to complete its earnings restatement by the second half of 2006. Freddie Mac has also begun to recover from its accounting difficulties and has indicated that it should be able to resume regular reporting in 2007.

The long awaited Rudman Report was presented to Congress on February 23, 2006. This report was commissioned by Fannie Mae in order to ascertain the extent of the company's previous accounting errors and disclose them to the public. There was concern in the financial markets that the report might reveal irregularities beyond those already disclosed. Fortunately, the report proved relatively benign, although it did cite Fannie Mae for providing its previous CFO and Treasurer with too much independent discretion and for having a lack of sufficient internal controls in place.

These criticisms were also voiced by OFHEO, which fined Fannie Mae \$400 million on May 23. While these public criticisms are a strong negative commentary on Fannie Mae's previous accounting practices, they were viewed in the financial markets as being relatively benign and are also perceived as representing further progress in the company's efforts to move forward. Both Fannie Mae and Freddie Mac have already taken measures to correct many of the internal problems that led to the accounting errors and have replaced many of their senior executives.

Legislation currently under consideration in Congress would replace OFHEO with a new, more powerful regulator. This regulator would have greater authority to reduce the size of the companies' mortgage portfolios and to further increase capital requirements. While the balance sheets of both Fannie and Freddie appear solid today, the presence of a new regulator would serve to

further strengthen the companies' financial positions. Any such efforts should improve the credit quality of Fannie and Freddie, providing additional assurance to holders of senior Agency debt.

**Throughout this period of negative publicity and accounting difficulties, the balance sheets at both Fannie Mae and Freddie Mac have remained strong and the companies have continued to generate profits.** Fannie Mae and Freddie Mac also continue to enjoy the highest credit ratings possible from both Moody's and S&P. The companies' debt issues are well received in the market place and remain among the most liquid of all securities in the secondary market. Finally, Fannie and Freddie still retain their greatest advantage, which is the unique position that they occupy in the United States' housing market. Congress chartered the two companies in order to make housing more affordable for American consumers, and the Agencies continue to fill this role while simultaneously enjoying the competitive advantages that result from their Congressional charters.

**Although the past several years have been a difficult time for both Fannie Mae and Freddie Mac, the companies appear to be moving ahead.** Once they have put their previous transgressions behind them, the result should be greater transparency, stronger regulatory oversight, and a more rigorous approach to mortgage portfolio management. The combination of these factors should result in a stronger credit profile for fixed income investors.

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