The Mortgage Twins' Demise:
A Need to Look Beyond Financial Reporting Fraud?
By Barry Jay Epstein, Ph.D., CPA, CFF

Fannie Mae (Federal National Mortgage Association, or FNMA) and Freddie Mac (Federal Home Loan Mortgage Corporation, or FHLMC), the formerly government-sponsored, now government-owned, entities that were created to provide liquidity to the mortgage markets and to support social goals relative to housing availability and affordability, have not presented sympathetic images in recent years.

After literally decades of warnings (particularly from the *Wall Street Journal*'s editorial pages) regarding the huge risks that FNMA's and FHLMC's implicit government guarantees had created for taxpayers, the bursting of the housing bubble caused these enterprises to become official wards of the Federal government, in which status they have already cost taxpayers some $153 billion, with more losses anticipated to come.

Albeit with the benefit of hindsight, it seems crystal clear to many that FNMA's and FHLMC's portfolios of loans, mortgage derivatives, and guarantees were riskier than had generally been perceived – and that these entities' financial statements had not appropriately disclosed these risks to shareholders and others. Indeed, the SEC has recently sent so-called "Wells notices" to former executives, alerting them to the fact that they might be targeted in civil actions, and rumor has it that even FNMA and FHMLC themselves (i.e., the companies, not just the former executives) might be named in forthcoming complaints.

But is it really so obvious that financial reporting by these behemoth organizations had been flawed, perhaps even fraudulently so? A revisiting of the financial statements filed by FNMA and FHLMC suggests that this may not necessarily have been the case.

The 2007 FNMA financial statements filed on Form 10-K can usefully serve as an example. By the time these financials were filed, the housing markets were already in distress and had been in decline (gauged by the pace of home sales, average prices, mortgage loan arrearages and defaults, etc.) for two years. Countrywide Financial, FNMA's biggest "customer" (as the originator of mortgages that were then purchased, securitized, and subsequently either sold or held by FNMA), had been on the verge of bankruptcy and was rescued by Bank of America, and the Federal Reserve was massively pumping liquidity into the economy and cutting interest rates, in order to support the faltering economy – and the housing market, in particular. FNMA reported a whopping net loss in 2007 (over $2.5 billion, versus a profit of over $3.5 billion in 2006), including over $1.4 billion in losses on guaranty contracts and over $4 billion in losses on derivatives contracts.

These gloomy facts were elaborately set forth in over 160 pages of narrative materials (the management discussion and analysis, or MD&A, portion of the Form 10-K), plus another 100 pages of financial statements and informative (footnote) disclosures. The former discusses in great detail a wide range of risk factors, including, inter alia: the rising delinquencies, credit losses, volatile and illiquid market conditions portending further possible write-downs of investment securities held, the threat that continuing losses would pose for compliance with regulatory capital requirements, the actual or threatened loss of key counterparties (with Countrywide specifically cited), interest rate risks, the necessary dependence on subjective models to value the loan and securities portfolios and to manage risks, the risks associated with changes in laws and regulations, and so on.

The financial statements and footnotes provide further densely detailed explications of FNMA's performance, liquidity, and position – including 24 pages alone devoted to describing accounting policies employed in this highly complicated business – with substantial details provided about all categories of the entity's investments, obligations, and guarantees.

Of particular interest in the MD&A is the extent of detailed information that was provided concerning the loan portfolios held or securitized by FNMA as of year end 2007, reporting that virtually 100% of the "Alt-A" loans and the vast preponderance of the sub-prime loans were AAA-rated by Standard & Poor's as of that date. More importantly, there was a candid discussion of both the announced post-balance sheet date ratings downgrades (which had been quite modest through the auditors' report date of February 22, 2008) and the still-ongoing reviews for further possible ratings downgrades (happening for a significant portion of the sub-prime loans, and for a minor fraction of the Alt-A loans). The careful reader of these financial statements (and any investor in FNMA or FHLMC needed to be a careful, informed reader – or had no business being involved in such a complex, risky business) was thus provided with copious information upon which to make investment decisions, or so it would appear.

U.S. Generally Accepted Accounting Principles ("GAAP") is formidably complicated when applicable to complex businesses such as FNMA or FHLMC, leaving even experts sometimes confused. It requires that investments in securities be categorized as either held for trading, available for sale, or held to maturity – with very different accounting and disclosures mandated, depending on what amounts to "management intent." Furthermore, GAAP requires extensive disclosures about the fair values of financial instruments (even those not required to be carried at fair value), with yet further disclosure requirements being applicable to derivatives such as mortgage backed securities. Also, the standard on the reporting of contingent losses (including asset impairments) clearly stipulates that losses are to be recognized only when probable of occurrence and reasonably estimable as of the reporting (i.e., balance sheet) date: looking back from subsequent developments, such as later market pricing declines, ratings downgrades, or various catastrophes such as market panics, cannot be used to justify adjustments to reported amounts unless these ensuing events merely confirm losses already extant, if perhaps not timely perceived, at the reporting date.

A first, but fairly detailed, review of the FNMA's 2007 financial statements does not reveal any failure to report the mandated information, and cautionary language is found in abundance, including about the yet-unknown outcomes of ratings reviews. While some technical reporting deficiencies may be found to have existed, it appears to this writer that the fault for FNMA's and FHLMC's respective collapses – and many contributing causes could be readily recited – does not prominently include financial reporting fraud.

Substandard financial reporting certainly exists, and failed audits are legion, but not every failure can be attributed to fraudulent financial statements and/or auditor negligence. When politically imposed-upon private (at least, nominally so) enterprises are forced to implement government-mandated social or economic policies, accuracy in financial reporting sometimes suffers the consequences. Financial reporting aberrations, even if they are found to exist, may thus be more a symptom than a cause. It may be that the FNMA and FHLMC collapses will ultimately be found to have exemplified this phenomenon.

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