Fannie Mae Profit Slides 6.5%, Hurt by Changes in Accounting

By Patrick Barta

WASHINGTON—The impact of a controversial accounting rule finally caught up with **Fannie Mae** in the first quarter, as changes in the way it accounts for its derivatives resulted in a 6.5% drop in net income.

The government-sponsored mortgage finance company said net income was $1.21 billion, or $1.17 a share, compared with $1.29 billion, or $1.25 a share, in the first quarter of 2001. The decline, Fannie Mae's first in more than a decade, occurred because of an unrealized loss of $787.2 million in the market value of some of the company's derivatives.

The unrealized loss was captured as a result of Financial Accounting Standard 133, or FAS 133, which took effect last year. The rule requires companies to record changes in the value of their derivatives each quarter. The company attributed this quarter's decline in derivative values to "interest rate volatility." Derivatives are often complex financial instruments pegged to the underlying value of an asset or an index.

Fannie Mae has argued along with Wall Street analysts that since it doesn't sell its derivatives before they mature, the daily fluctuations in their value are mostly meaningless, and should be ignored when assessing the company's operating performance. For a company like Fannie Mae, the rule "provides misleading results," said Timothy Howard, the company's chief financial officer.

Not counting the effects of FAS 133, Fannie Mae's earnings rose a very healthy 23% to $1.52 billion, or $1.48 a share, compared with $1.24 billion, or $1.20 a share, a year earlier. The growth in the company's underlying business reflected a continued strong mortgage market and attractive interest rates, which allowed the company to earn more on each mortgage it owns than usual.

Company officials had been expecting—and fearing—the day when FAS 133 would cause a hard-to-explain decline in net income. In past quarters, the rule created surprises on the upside, which the company likewise encouraged investors to ignore. During the fourth quarter of 2001, for example, changes in value of the company's derivatives resulted in a gain of $577.9 million, sending its net income soaring 69%.

In 4 p.m. New York Stock Exchange composite trading, Fannie Mae shares fell 66 cents to $80.83.

Even so, some analysts believe the net-income figures are useful in giving investors a sense of how reliant the company is on derivatives to keep its ship afloat, and what its exposure might be if something went wrong. The company uses derivatives, including interest-rate swaps, to better manage its interest-rate risk associated with owning mortgages.

The company, like several others, has taken steps to increase disclosure of its business operations including derivatives in the wake of the Enron scandal. In its earnings release, it said its net exposure to possible losses from derivatives was only $200 million because of collateral agreements with its derivatives counterparties.