How accounting ploys at the mortgage giant, while legal, inflated profits and executive pay. Inside, our full report.
Swept Away
How Fannie Mae keeps its losses from sullying the bottom line
By JONATHAN R. LAING

To the outside world, Fannie Mae presents a face of consistent earnings growth and a transcendent social mission. Investors love the metronomic quality with which the company has delivered double-digit earnings growth over the past decade or more. Consensus analyst forecasts call for earnings to grow smartly from 2003's "core" results of $7.3 billion, or $7.28 a share, to $8.01 a share this year and $8.85 a share in 2005, according to First Call. Twelve-month price targets on the stock run as high as 117 a share, which is about a stretch for a name that currently changes hands at around 70.

And all of this for a company that has supposedly labored since its New Deal beginning in 1938 as a vehicle to make home financing more available to Americans by buying mortgages from banks and other primary lenders so that they have the funds to, in turn, offer yet more mortgages. Fannie constantly hammers the point home with feel-good, prime-time television ads about delivering the "American Dream" of a home of their own to millions of "under-served" Americans.

But this compelling story line has frayed of late. Indeed, a Barron's analysis of Fannie's accounting methods finds that, while legal, they obscure rather than illuminate Fannie's true financial condition, allowing billions of dollars of derivative-related losses not to be reflected on its income statement. As a result, Fannie's capital strength is less robust than the company's many fans on Wall Street and on Capitol Hill would contend.

The Bush administration, meanwhile, has mounted a frontal assault on Fannie and its smaller sibling, Freddie Mac, contending that the companies' high-flying growth in the residential housing market (the pair now guarantee as much as $4 trillion in U.S. residential mortgages outstanding) potentially threatens the financial safety of the U.S. and, indeed, the global financial system. Other critics, including most recently St. Louis Federal Reserve Bank President William Poole, contend that the Treasury should pull its $2.25 trillion line of credit from both Fannie and Freddie in order to end forever the notion that the U.S. government effectively guarantees the companies' now $1.7 trillion in combined debt.

A growing chorus of Fannie and Freddie detractors contends likewise that the companies, since becoming publicly owned more than three decades ago, have subordinated their social purpose to enriching their highly remunerated executives and shareholders. Fannie's current chairman and chief executive, Franklin Raines, for example, knocked down total pay, including salary, bonus, long-term compensation and option awards of nearly $20 million, last year—a lot more than he made as the Clinton administration director of the Office of Management and Budget between 1996 and 1998. His predecessor, James Johnson, who is now heading John Kerry's vice-presidential search team, likewise made millions at the Fannie Mae trough, as did Jamie Gorelick, a high-ranking Clinton Justice Department official who later served as vice chairman of Fannie before going into private practice a year ago.

Traditionally, Fannie mainly repackaged the home loans it purchased into mortgage-backed securities and resold them to investors, guaranteeing the securities' interest and principal. But of late Fannie has emphasized the far more profitable but risky game of buying and keeping mortgages and other mortgage-related securities for its own investment portfolio. Indeed, Fannie's portfolio has grown some fivefold since 1995 to around $5.6 trillion. Last year, Fannie's portfolio activities threw off $4.4 billion of income, compared with just $2.9 billion of income from its credit-guarantee business. The tail is now wagging the dog. Yet the Bush administration has failed over the past two years to force legislation through Congress to rein in Fannie and Freddie. Both companies are prodigious political donors and play the lobbying game far better than any other special interest.

Meantime, however, Fannie's and Freddie's regulator, the Office of Federal Housing Enterprise Oversight, has turned from a lap dog into a tiger. One reason, perhaps, is that Ohe is faced with extinction under some proposed regulatory bills. Too, Ohe was badly embarrassed last year when Freddie fessed up to smoothing its earnings between 2000 and 2002 to hide some $6 billion of income by using derivatives to push the income into future years. Ohe has come down hard on Freddie, encouraging earnings restatements and tagging Freddie with
Fannie is now feeling the heat, too. Early this year, Otero hired the outside auditing firm Deloitte & Touche to probe Fannie's financial books. Then, two weeks ago, Otero announced that the probe had uncovered evidence that Fannie had failed to follow proper generally accepted accounting principles, or GAAP, in determining the size of impairment charges and revenue recognition on investment holdings in manufactured-housing and aircraft-lease securities in prior fiscal quarters. Fannie subsequently argued it had done nothing wrong and will be able to avoid any restatements that, given the size of $80 billion in its manufactured-housing securities and reported $360 million in aircraft-lease paper, could be substantial. In a 10Q last week, Fannie claimed that it had passed SEC muster by agreeing to take an additional $550 million pre-tax charge on the securities, though whether that satisfies Otero remains to be seen.

Whether through eventual litigation or regulatory flat, Fannie may not be able to avoid income restatements or an increase in its mandated capital levels. In addition, investors are no longer likely to overlook the outside possibility that Fannie will no longer be able to borrow profits from growth in an investment portfolio fueled by bonds the market treats as if they had the implicit backing of Uncle Sam.

Yet Fannie officials remain defiant in the face of growing opposition. They put the blame for many of their current problem on an overreaction to the Freddie accounting mess. Moreover, they contend that commercial rivals have used a host of lobbying, organized, and self-help tactics to keep up appearances. A quirk in GAAP accounting has allowed Fannie to defer largely illusory losses from securitization of others' loans and thus avoid the red ink from having a material immediate impact on Fannie's "core" earnings. As a result, Fannie is said to be even more strongly resisting efforts by other agencies to improve earnings. A single investment. A lifetime of diversification.

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like other derivative hedges, shifts in the value of cash-flow hedges don’t hit the income statement immediately in their totality. Instead, they are put into a special “plug account” in the equity portion of the balance sheet called the AOCI, for “accumulated other comprehensive income.” From here, the gains or losses from these cash-flow derivatives bleed only gradually into the income statement over the contractual original life of the hedge that can extend to 10 years or more. And if any hit to profits in a single year is muted. Fannie does a ton of these cash-flow hedges. It mostly uses interest-rate swaps that pay fixed rates of interest and receive floating rates these swaps synthetically convert short-term debt into long-term debt, thus better matching the expected lives of specific mortgages in its portfolio.

Forget the complexity of such swaps for a second. All Fannie is trying to achieve in this trade is to get a counterparty to take over its floating-rate payment obligation over the life of the debt, while Fannie pays a preset fixed rate over the same span.

During 2002 and some quarters of 2001 and 2003, when interest rates plummeted and mortgage pre-payments surged, Fannie got caught in a bind, apparently not expecting the violence of the moves. In the third quarter 2002, for example, the “duration,” or rate sensitivity of its liabilities, exceeded that of its assets by a yawning 14 months, meaning that it was gaining far less on its assets than it was on its liabilities. It had to reduce its liability durations and fast. Fannie didn’t issue enough callable debt to help much, nor did it want to buy back gobs of its existing long-term debt at a premium because the resulting losses would’ve hit its income statement immediately. One noted and savaged earnings. So it hit on the happy expedient of terminating its non-underwater fixed-pay cash-flow hedges. It did so by paying the swaps counterpart a premium necessary to compensate the counterparty for the faster-than-current fixed yields that it was sacrificing over the remaining life of the swap. Also, Fannie contracted for a number of new swaps in which it received fixed rates to offset its open, money-losing swaps in which it received floating rates to protect against further value loss in those derivatives. This, of course, locked in the loss, too.

All three of these strategies are identical in their economic impact on Fannie. But whereas the debt buybacks immediately hit earnings, the losses on the latter two duration-shortening methods went into the AOCI account to be amortized into earnings or turned off at a more decorous pace. If not, Fannie’s 2002 earnings of $6.4 billion...
Fannie’s net asset value, or shareholder equity, has bobbed all over the place, dropping, for example, from $30.8 billion at the end of first quarter of 2002 to $15 billion two quarters later before beginning a gradual rise to $22.4 billion at the end of 2003. This year’s first quarter witnessed yet another drop to $20.8 billion, however, for a round trip back to its level two years ago.

Here again, Fannie leads a charmed life, escaping the discipline imposed on other leveraged financial competitors such as Citi_group and J.P. Morgan Chase. It and the other government-sponsored enterprises, or GSEs, such as Freddie and the Federal Home Loan Banks have to meet the far less onerous capital standard of minimum core capital for regulatory purposes. Given the low credit risk of the mortgages and mortgage-backed securities Fannie buys, government regulations permit Fannie to operate with minimum capital of just 2.5% of its $650 billion investment portfolio and 0.45% of its $1.35 trillion in mortgage-backed securities it packages and guarantees.

Even better, however, Fannie is allowed to exclude from the computation of its regulatory, or core, capital the impact of the AOCI losses because the capital standards applying to the GSEs were developed in 1992, before accounting for derivatives had been developed. That alone boosted Fannie’s regulatory capital level by $34.4 billion from a shareholder equity reading of $22.4 billion at year end 2003. At the end of 2002, Fannie’s core capital stood at $25.1 billion, compared with net equity of just $16.3 billion. Bolstering its core equity number is yet another benefit Fannie derives from taking portfolio losses by closing derivative positions rather than repurchasing debt.

Even with these assists, however, Fannie was barely able to meet Other’s minimum capital requirements, exceeding the levels by just $2.9 billion at year end 2000 and $2.77 billion at the end of 2002. Fannie evidently has been gaming its portfolio growth to exploit almost every bit of leverage available to it.

Fannie’s communications chief, Greener, argues that accounting constructs like traditional shareholder equity can give a distorted view of Fannie’s solvency and leverage. That’s mostly because the AOCI impacts volatility to net asset value from period to period from swings in the value of cash-flow derivative positions and assets held in the available-for-sale category that the AOCI captures. The far bigger swath of Fannie’s portfolio assets in the so-called hold-to-maturity account and most of Fannie’s liabilities aren’t similarly marked-to-the-market. “GAAP shareholder equity provides a highly static and misleading snapshot of our business, which is a growing and ever-dynamic entity,” Greener says.

Perhaps that’s so. But over the past two years Fannie has provided a year-end “fair value” balance sheet, which reflects Fannie’s estimate of the then-current market value of every asset, liability and derivative on its balance sheet. Those balance sheets are anything but highlighted in Fannie’s 10K filings. The 2003 rendering, for example, is buried on page 167 of the 181 pages of densely packed tables and commentary of the latest 10K, accompanied by a short paragraph of boilerplate.

The reason for the short shrift given these fair-value, marked-to-the-market summations seems obvious. The so-called on-balance-sheet, hidden, unrealized gains that Fannie loves to talk about were largely chimerical. The fair-value shareholder equity number in 2003 of $2.1 billion was just $1.5 billion larger that Fannie’s GAAP net worth at your end. The previous year, fair-value net worth of $15.3 billion was actually below the GAAP number of $16.3 billion.

It goes without saying, likewise, that the on-balance-sheet, fair-market equity at both years end was significantly smaller than either Fannie’s core capital or regulatory capital minimums. Even if one adds off-balance-sheet assets of $7.9 billion in 2003 and $6.8 billion in 2002 to fair-value net worth, Fannie still wouldn’t meet minimum regulatory capital requirements in either year by that criterion.

In other words, when measured in this manner, Fannie has far less of a capital cushion to withstand the shocks of more errant interest rates than is commonly believed. Fannie, for its part, claims in recent filings that it has become more circumspect in its hedging practices. Fannie no longer will tolerate the huge duration gaps it ran in the past couple of years, but, like its more conservative rival, Freddie, will try to keep the gap under six months. Fannie is likewisecopying Freddie by using swaptions—options to purchase swaps in the future—more aggressively to ensure that it has access to future interest-rate swaps capable of either lengthening or shortening the duration of share collar.
Some cynics say Fannie’s reluctance to bite the bullet on manufactured-home securities losses may lie in a special options grant made to employees in January 2000. If 2003 earnings per share were double 1998’s, the options would vest in 2004. If results fell short, they wouldn’t vest until 2008.

The ongoing dustup with O’Neal also indicates the regulator is skeptical of some of the mark-to-market valuations that Fannie is showing on its fair-value balance sheet. Illustrative of this is the tangled tale of Fannie’s investment foray into manufactured-housing securities.

Fannie, in fact, loaded up on the sector in the late ’Nineties and just after buying some of the crunchiest vintages of Conseco housing securities shortly before surging loan defaults and repossessions cursed the sector and pushed Conseco into bankruptcy. Other investors took their lumps in the sector last fall; the Federal Home Loan Bank of New York unloaded a similar portfolio for an 18% loss on its $1 billion sale. But Fannie, which is still sitting on nearly $8 billion of the securities, has to date taken a series of “impairment” charges to earnings of $2.17 billion, or 2.7% on its holding. The charges were actually less than that of current holdings considering that $128 million of the charge was taken on past sales as opposed to current holdings.

Fannie officials argue that the FHLB sale occurred at a panic low in an illiquid market, and that the market in the securities has since strengthened some. Moreover, Fannie officials tell Barron’s that they saw little need to materially adjust their projections of future cash flows in the securities since the company has suffered no defaults on interest or principal payments yet. That was at least what they contended until last week, when they consulted the SEC and were persuaded to adjust their valuation methodologies on manufactured-housing and airplane-lease holdings and to take an additional pretax charge in the coming quarter of around $250 million.

The facts argue, however, that more impairment charges above those already announced are likely in the offing. For example, when the FHLB dumped its holdings last September, more than half of its manufactured-housing portfolio still boasted a triple-A rating and none had reached junk status. Fast forward to this March. By then, a series of downgrades had turned over 35% of Fannie’s holdings of manufactured-housing securities to junk and only 24% of its portfolio were still rated triple-A.

Likewise, Conseco paper make up about 70% of Fannie’s holdings, compared with about 40% of the FHLB holdings at the point of their sale. As a result of Conseco’s reorganization out of bankruptcy, its successor servicer is now garnering more than double the service fees formerly charged and has a senior claim to any cash flow to erstwhile triple-A holders like Fannie. Holders in the Conseco tranches junior to Fannie have already suffered dilution of their holdings. It’s only a matter of time before the damage reaches the upper tranches.

Fannie may have modified the SEC with its new methodology for figuring future impairment charges on asset-backed securities, though one wonders what exactly its agreement with the agency, if any, entails. But O’Neal is sticking to his guns. The regulator still wants Fannie to account for the impairments in the periods they occurred going back to the fourth quarter of 2002. That might argue for some restatements of past periods. The agency has yet to address the size of the impairment charges it expects.

Fannie’s apparent reluctance to bite the bullet and take proper impairment charge on its manufactured-housing holdings is something of a mystery. The answer may lie, some cynics have suggested, in a special “earnings per share challenge” options grant that Fannie awarded to every full and part-time Fannie employee in January.
2000, at the height of the stock-market bubble. The general perception was that if Fannie and Freddie were able to double its earnings per share from its 1998 level by calendar 2003, the grant would fully vest in 2004. Otherwise, employees would have to wait another four additional years for vesting of the package.

Of course, Fannie surpassed its 2003 core earnings targets by more than $800 million on earnings of $7.3 billion, or $7.29 a share. But had Fannie taken an impairment charge similar in proportion to the FHLMC's trading loss, the after-tax charge would have put attainment of the earnings goal in jeopardy. Then Fannie chief financial officer Franklin Raines, for example, would've had to put off his full paydays on 215,545 options by four years. Options experts consulted by Barron's put a value on the options package of nearly $8 million at the time of the grant.

For Fannie, like a lot of companies, accounting changes have become all-important. For example, it has struggled mightily over the past three years to ladle as many unrealized gains as possible into its AOCI balance-sheet account to mute the impact of the huge derivative losses residing thence. (See "Bolster stock price with arbitrage?"

One such example occurred in the third quarter of 2002 when Fannie transferred some $155 million in mortgage and nonmortgage securities from its HTM (held-to-maturity) to AFS (available-for-sale) asset classification. While HTM securities are carried for balance-sheet purposes at cost, AFS securities are carried at current market value. The gimmick allowed Fannie to push more than $4 billion in unrealized gains into the AOCI account to offset some of the $7 billion in derivative losses Fannie had suffered that quarter. As a result, Fannie was able to show shareholders' equity at the end of the quarter of $15 billion rather than $11 billion. The former number looked a heck of a lot better the latter, especially when shareholders' equity two quarters earlier had weighed in at $25.8 billion. A nearly 50% drop in shareholders' equity might have attracted undue attention from both regulators and Wall Street.

Fannie's senior vice president for investor relations, Jayne Shontell, disputes that the transfer was dictated by any motive other than to increase the company's financial "flexibility." Likewise, the timing of the shift was fortuitous, she adds. That quarter, its regulator Oheo had imposed a new capital standard for institutions, noting that some of the few circumstances under strict GAAP rules that permit such a transfer. Yet Fannie reluctantly revealed the size of the unrealized gains it was able to siphon into the AOCI some months after the closing of its third-quarter earnings release in 2002, and then only after several press inquiries on the question.

Interestingly, there has been traffic over the past two years of securities going in the opposite direction, from the AFS to HTM category. Some $21 billion in securities that made up 38% of total invested assets at the end of the third-quarter of '02 when the $335 million in securities was trading in the other direction on the same highway. Then $7 billion and $15 billion in securities went from AFS to HTM in the second and third quarters of '03.

Were these three moves dictated by Fanni's desire to increase its financial flexibility? One wonders. Both Groenewold and Shontell had no answer when asked to explain the three additional transfers. A day later a Fannie e-mail stated that the bulk of these transfers constituted "new production markups" that are "in the pipeline" or "in the money" and "therefore would have not negatively impacted the AOCI component of shareholder equity if the transfers had not taken place." Whatever their intent, transfers were more than likely to bolster the AOCI and pump up shareholder equity rather than run Fannie's net worth down. In fact, the stratagem would allow any unrealized capital gains on the in-the-money mortgages to be captured in the AOCI and locked in after the underlying loans had aged and been shifted to HTM. These gains aren't vulnerable to rising interest rates and adverse marks to market in subsequent quarters as are loans and securities classified as available-for-sale. They could, in effect, sit in the AOCI boosting its value for years. They would burn off into earnings only gradually as the bonds matured and steadily chose to maturity. The fact that the gains were on new production would only increase their half-life.

Of course, Fannie has no monopoly on slick accounting. A dozen or so years down, though few companies are as adept as Fanni in what it says, doesn't say and implies in its pronouncements. But clearly Fannie, a quasi-governmental behemoth, has found a winning formula to both boost its profits and enrich its management.

The Congressional Budget Office estimated that Fannie, Freddie and the Home Loan Banks realized $23 billion in implicit subsidies from the federal government last year, of which Fannie and Freddie got to pocket $8.8 billion. The much-vaulted savings to America's homeowners from Fannie and Freddie? A tiny 7/100 of a percentage point on their mortgages, according to CBO. The preserve asset prices for companies that preclude\

ing financial gains gives it the wherewithal to fight off in Congress well-meaning reform attempts.

Likewise, Fannie only professes to pay close attention to its mission of promoting lower-income home ownership. Enforcement of such goals is lax. Fannie is far more interested in buying larger and more lucrative loans. The cut in loans that it will buy is now up to $335.7 billion.

Perhaps, it's time to yank Fannie's special borrowing privileges and federal charter and turn Fannie into another public playing field. Only that probably wouldn't be good for Fannie stock investors.