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Fannie's Fearsome New Year Challenge

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Fannie Mae (FNM:NYSE)	BEARISH
Price: $70 | 52-Week Range: $58.40-75.84	

- Fannie stock is far pricer than Freddie's.
- Regulators are growing more aggressive.
- A deep probe could prove damaging.

Position: **none**

The past year has been truly awful for **Freddie Mac** (FRE:NYSE - commentary - research), but 2004 could easily turn out worse for its larger sibling, **Fannie Mae** (FNM:NYSE - commentary - research).

In 2003, Freddie revealed that it had manipulated earnings over at least three years and ended up shedding nearly all of its top management team as the result of its accounting scandal. Fannie Mae has gotten through the Freddie fracas relatively unscathed. Fannie trades, for example, at a stunning 3.7 times its book value, compared to 1.3 times at Freddie.

But Fannie, which has a much weaker balance sheet than Freddie, faces some nasty challenges in 2004 that could knock the stuffing out of its stock, and even lead to the sort of management cleanout seen at Freddie. In 2004, Congress will likely enact new laws aimed at toughening up the regulation of Fannie and Freddie, and the reformers could remove some of the very lucrative government-granted advantages that both companies operate under.

While any legislation will affect both companies, the high valuation on Fannie's stock makes it vulnerable to a steep decline if the political threat heats up. Moreover, Fannie's markedly weaker equity position means that any interruption to earnings or business could put the company in dire financial straits.

Too Steady?

Many on Wall Street would shriek with outrage to hear Fannie compared to scandal-plagued Freddie. The full debasement of Freddie's earnings-fixated culture was chronicled in a report published this month by its regulator, which spent several months probing the company. But now that regulator, the Office of Federal Housing Enterprise Oversight, is commencing a similar investigation of Fannie's accounting. When announcing the probe in July, OFHEO's chief said that he had no "specific concern" about Fannie's accounting, but, in a reference to Freddie's failings, he said that he felt a review would be "prudent under the circumstances."

So just how will next year look for Fannie?

First, the results of the OFHEO probe should be out by the spring. OFHEO is understaffed for the job, so it is employing a team of accountants to help it forensically investigate Fannie's books.

There are two very important questions that need to be asked of the investigation: Is there any indication that Fannie's been cooking its books? And, if it has, are OFHEO and its helper capable of identifying the chicanery?

Of course, from the outside it is hard to know whether Fannie's accounts are in order. But we can try to reach some conclusions from what we *do* know.

Fan Favorite

Fannie's solid stock

How like Freddie is Fannie? Well, Freddie got into trouble for using incorrect accounting maneuvers to smooth out the volatility of its earnings (investors and credit rating agencies are more impressed with steady profit growth than with big swings in earnings).

Guess what -- Fannie's quarterly earnings growth has also been remarkably steady. From the first quarter of 2001 to the second quarter of this year, Fannie's quarterly "operating" earnings, an in-house profit yardstick closely watched by Wall Street, increased at roughly the same rate over the year-earlier periods. The increase was always within an 18% to 25% range. That's not proof that Fannie did anything wrong, of course, but that earnings performance took place in a period of extraordinarily volatile interest rates, which would normally be expected to cause bigger swings in earnings.

We also know that Fannie is very sensitive about how its earnings look, which suggests it may have been motivated to make them look smoother, or better, than they actually were.

Fannie's habit of emphatically trumpeting its "operating" earnings measure, rather than profits arrived at by applying U.S. accounting rules, shows that the company was keen to present a certain "edited" view of events to investors.

It has also kept a lid on data that might not put Fannie in a good light. For example, the company has been reluctant to publish more regularly a measure of its balance sheet that gives a much more accurate picture of its financial condition. Fannie has declined to provide this so-called fair value balance sheet more than once a year, even though analysts and investors believe it provides extremely valuable insights. In fact, the fair value balance sheet provided at the end of the year shows that, when the market value of *all* assets and liabilities is measured, Fannie is stunningly overleveraged.

There are many areas OFHEO should check at Fannie. Indeed, the regulator may already have stumbled upon one. Its Freddie report includes some notes that suggest a senior Freddie exec thought Fannie was also using maneuvers to shift its earnings around (a full account of this part of the report can be found at the end of this Detox column).

The OFHEO report shows how Freddie moved large amounts of securities around its balance sheet to manipulate earnings. And this column has detailed how odd-looking balance-sheet shifts of securities at Fannie may have been carried out to boost equity.

In a lengthy restatement of past earnings that Freddie issued in November, the company conceded that it had not properly valued its bonds backed with mobile home loans. Fannie's portfolio of mobile home bonds certainly looks dubiously valued.

OFHEO's report on Freddie also criticized compensation structures. While the regulator is probing Fannie, it should make a priority of establishing once and for all what Fannie's CEO Franklin Raines actually earned in recent years, since Fannie's poor disclosure practices have made it impossible to know his true compensation.

Tough Questions

OFHEO has plenty of places to start looking, but does it have what it takes to properly plumb Fannie's books?

Worryingly, there is some evidence that it does not. Its Freddie report was not so much its own work, but chiefly based on an earlier report carried out by a law firm called Baker Botts and commissioned by Freddie's board. And the likely reason that initial report uncovered so many accounting ruses was that it was based on extensive interviews with senior Freddie staff, who, in the aftermath of the accounting revelations, were willing to talk, perhaps to cover their backsides. It is extremely difficult to imagine Fannie execs being as forthcoming with OFHEO.

Thankfully, we don't have to rely fully on OFHEO. Members of Congress are also trying to pry very important information from Fannie. One absolutely critical number that Fannie has refused to divulged is the amount of unrecoverable losses it has sitting in its equity. They could amount to well over $5 billion, due to the devil-may-care manner in which Fannie has hedged against interest rate movements over the past three years. Sen. Chuck Hagel, who has introduced a bill to toughen regulation of Fannie and Freddie, has asked Fannie to supply him with the actual number of unrecoverable losses.

If Fannie answers Hagel's question and the unrecoverable losses are large, the credibility of CEO Raines and his team will plunge overnight. Not so much because they masked the losses for so long -- which would be bad enough -- but because they managed Fannie in such a risky manner that the company ended up booking such huge losses. (Conveniently, such losses don't run through the income statement all at once, but are amortized in slowly over time, and the actual amortization amount isn't broken out.)

Alternatively, a refusal by Fannie to give Hagel the realized loss number would be a clear sign that the company could be embarrassed by its size. If it claims it can't calculate the number, it would show that its systems are even worse than Freddie's.

Yep, there's no way Fannie can avoid a bruising encounter with the truth in 2004.