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Freddie Flap Highlights Fannie Flaw

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Fannie Mae (FNM:NYSE)	BEARISH
Price: $76.71 | 52-Week Range: $58.40-80.05	

- A new capital rule won't hurt Freddie.
- But Fannie remains deeply undercapitalized.
- Its books continue to face scrutiny.

Position: **No position**

It became sorely apparent Thursday that there is no way that **Fannie Mae** (FNM:NYSE - commentary - research) could survive the ordeal that its sibling **Freddie Mac** (FRE:NYSE - commentary - research) is going through.

Freddie has fessed up to a range of accounting missteps over the past six months but still hasn't released financial statements for any period in 2003. Because of the failure to provide 2003 numbers, Freddie's regulator told the company Thursday that it must hold capital that is 30% in excess of its statutory minimum capital requirement. Freddie almost certainly already has enough capital on its books to meet the extra 30% requirement.

But if Fannie were forced to do the same, it would be in dire straits, because it wouldn't have enough capital. In fact, it would have to issue at least $7 billion in stock to pad out its capital number, which, at current levels, looks precariously low. Defenders of Fannie would argue that Fannie isn't going to find itself in trouble with its regulator, the Office of Federal Housing Enterprise Oversight, because it hasn't got into any trouble over its accounting. But in the midst of the Freddie revelations, OFHEO decided it might be a good idea to conduct a probe of Fannie's accounts to see whether it was also up to no good.

The investigation has only just begun. There are plenty of areas where Fannie's accounting looks suspect, so it would not be a total surprise if OFHEO found unsatisfactory financials at Fannie. If it did, it would be a wise regulatory move to instantly demand that Fannie raise a huge slug of new capital to see it through the turmoil, simply because the giant mortgage buyer is much more weakly capitalized than Freddie.

Capital Idea

How do we sort our way through the numbers to show that Fannie would be reeling if OFHEO forced it to do what Freddie did? Let's start with what capital actually is. At financial institutions, capital measurements involve subtracting liabilities from assets to see how much "cushion" against shocks the balance sheet has. For government-sponsored entities such as Fannie and Freddie, there are a number of complex capital yardsticks. One key measurement OFHEO looks at is called the minimum capital requirement. This is a statutory requirement arrived at by mandating that capital must be equivalent to at least 2.5% of assets on Fannie's or Freddie's books, plus 0.45% of the mortgages they have guaranteed but don't own.

In order to pass the minimum capital requirement test, Fannie and Freddie's so-called core capital has to be in excess of the minimum capital requirement. And core capital is basically assets minus liabilities, but excluding gains or losses on certain types of derivatives, which are financial instruments used to hedge against interest rate moves.

So how do Fannie and Freddie's numbers stack up when it comes to these capital measures?

As of Nov. 30, Freddie had a minimum capital requirement of $25.1 billion, but its core capital was well in excess of that at $33.2 billion. If we increase the minimum capital for Freddie by 30%, as OFHEO demands, the new hurdle that Freddie must meet is $32.6 billion. In other words, its core capital is over $500 million in excess of the harsher requirement.

In contrast, Fannie fares very badly under this exercise.

At the end of last year, Fannie said I had an estimated minimum capital requirement of $31.5 billion, exceeded by its core capital of $34.4 billion. However, if we add 30% to the minimum requirement, we get $41 billion. That is $6.6 billion over Fannie's core capital.

Clearly, if Fannie finds itself in Freddie's shoes, the stock would be hammered, as investors would fear a large dilutive equity issuance to boost capital. Of course, any whiff of accounting chicanery at Fannie would already have sent the stock skidding, but fear of dilution would add to the slide.

Derivative Dealings

Indeed, if both companies are found to have accounting issues, the regulators would almost certainly consider introducing new capital rules. If, as is sensible, the authorities started to require that the companies include net derivatives gains or losses in their capital reporting, Fannie would be in the ICU in minutes. Freddie might be OK, though.

If we include the derivatives losses at Fannie, we arrive at a capital number that is equal to shareholders' equity, as measured under generally accepted accounting principles. At the end of last year, Fannie's shareholders' equity was $22.4 billion, a mere faction of its $1 trillion in assets. The real shocker is that Fannie would have to almost double its shareholders' equity for it to meet the $41 billion minimum capital requirement (increased by 30%). That would mean issuing over $20 billion in stock, which is over a fourth of its market value.

Some defenders of Fannie might think that using shareholders' equity is unfair, because they contend that the vast majority of derivatives losses included in that capital measure will be made back in the future. Not so. First, most of the net $12 billion in net derivatives losses are likely to be unrecoverable. Second, the fact that Fannie refuses to give a number for unrecoverable losses, despite congressional pressure, only reinforces the notion that they are scandalously huge.

It might sound drastic to make Fannie issue $20 billion of stock. But the company really ought to do this anyway, because its equity is way too low for the risky manner in which it runs its business and for the size of its asset base. Issuing that much stock may hurt a good number of investors, but failing to do so only risks undermining the entire American housing market at a later date.

To see how badly Fannie has been managed, we need only look at Freddie's shareholders' equity. At the end of 2002 (the latest number available), it was $31.3 billion, but that figure has probably grown through the addition of retained earnings through 2003. That $31 billion number is just short of the $32.6 billion minimum requirement (increased by 30%). And with 2003's profits, Freddie's shareholders' equity, which includes all derivatives gains or losses, could exceed the tougher minimum requirement. Quite simply, Freddie hasn't been taking billions of dollars in unrecoverable losses on its derivatives.

This is not an argument to invest in Freddie. Any company that can't report financials for over a year should not be touched. But it doesn't say much for Fannie if even scandal-plagued Freddie can put it to shame so easily. Just consider the nightmare if Fannie's books are found to be cooked by OFHEO.