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A New Reason to Fret About Fannie

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Fannie Mae (FNM:NYSE)	**BEARISH**
Price: $74.35 | 52-Week Range: $60.11-80.82	

- Regulators are combing Fannie's books.
- Now a problem seems to have arisen.
- This column foresaw an issue with Conseco bonds.

Position: **none**

An unusual remark from **Fannie Mae's** (FNM:NYSE - commentary - research) regulator Wednesday suggests that the nation's second-largest financial institution could soon become the latest company to face accusations of accounting irregularities.

The Office of Federal Housing Enterprise Oversight, which regulates government-sponsored Fannie and its smaller rival **Freddie Mac** (FRE:NYSE - commentary - research), said that a special accounting review that it is conducting of Fannie's books "may result in a restatement of prior period results and a revision of the respective capital calculations." It is extremely rare for a regulator to raise the possibility of accounting adjustments at a company if there are no grounds for suspecting restatements will have to be made.

In a prepared statement, Fannie commented: "The language in the letter with respect to the OFHEO special examination straightforwardly states the fact that it is ongoing. As previously announced, OFHEO has recently retained a national accounting firm to supplement the agency's efforts and obviously has not reached any conclusions. We look forward to continuing to work with OFHEO on the examination."

Last year, Freddie got into trouble for abusing its accounting to understate earnings. The scandal would have been far worse if Freddie had been overstating past numbers, because the company would've been fooling outsiders into believing that it was stronger than it really was.

OFHEO has not said whether Fannie has been overstating or understating earnings, but there are several ways in which Fannie may have been giving its reported numbers an artificial boost. One area of accounting that has received a lot of attention is the valuation of a portfolio of troubled bonds. Fannie may have overstated earnings and capital in 2003 by failing to take the appropriate amount of losses on these bonds.

The bonds in question are backed by loans made to purchase mobile homes. The original lender, Conseco Finance, went through a bankruptcy restructuring in 2003. As a result of the restructuring, the mobile home-backed bonds that Conseco sold have a lesser claim on the cash flows from the underlying loans. This has resulted in their credit rating being reduced. At the end of last year, Fannie had $8 billion of mobile home bonds on its books, 70% of which were originally serviced by Conseco.

Detox first zeroed in on these troubled bonds over a year ago and took some more close looks at the portfolio in the fall. It concluded that Fannie's writedowns on the bonds -- just over $200 million at the end of last year -- weren't sufficient. Using a similar writedown taken by another institution on similar bonds, this column calculated that a writedown of around $1 billion might be in order. But a loss of that size would have been extremely embarrassing for Fannie at a time when Freddie was getting heat for its accounting and when its critics in Congress and the White House were formulating legislation to tighten regulation of Freddie and Fannie.

In addition, taking a large writedown in 2003 could have prevented Fannie from hitting an earnings number that allowed senior executives to receive a lucrative grant of stock options.

Monday, an *American Banker* article, citing several sources familiar with the matter, said that OFHEO examiners had focused on the mobile home portfolio. The article said: "The sources said the agency has serious concerns that Fannie may not be showing enough of a loss." OFHEO is doing nothing to dispel the *American Banker* story by saying Tuesday that its examination may result in accounting restatements at Fannie.

If OFHEO does find that Fannie has underestimated losses on its Conseco bonds, it will be much harder for the company to stop legislation that aims to give a new regulator greater powers.