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Fannie Flap Points to Options Grants

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4/6/2004 7:14 AM EDT
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Fannie Mae (FNM:NYSE)	BEARISH
Price: $74.85 | 52-Week Range: $60.11-80.82	

- Regulators are probing the books.
- But Wall Street has shrugged off worries.
- New issues could soon come to light.

Position: **none**

When a regulator raises questions about a company's accounting, the stock usually gets crushed.

Mysteriously, this hasn't happened to **Fannie Mae** (FNM:NYSE - commentary - research) in the wake of last week's flap over its books. But with all the worries swirling around the mortgage giant, bullish investors could be showing a bit too much confidence in management.

Last Thursday, the Office for Federal Housing Enterprise Oversight (OFHEO) surprised Wall Street by saying Fannie "may not have applied the proper accounting guidance" when writing down the value of certain assets. Though the remarks were highly unusual, the market has since shrugged them off: On Monday, Fannie's stock closed at $75.05 -- which is 1% *above* Wednesday's closing price.

Even so, it's worth noting that Wall Street often ignores the first whiff of scandal (recall **Enron**). And when it comes to Fannie, there is enough material in the public domain to suggest that OFHEO is right to have big doubts about the company's bookkeeping.

Fannie, which throws its weight around in Washington with its lobbying efforts, is unlikely to win this battle. Fannie's numbers strongly suggest that the company wanted to avoid taking losses on certain assets. The motive may have been to ensure that 2003's per-share earnings exceeded $6.46, the level at which senior execs, including CEO Franklin Raines, get to cash in a lush options grant. The company may also have feared a big writedown in assets would strengthen the hand of politicians who want to strengthen regulation of Fannie and also **Freddie Mac** (FRE:NYSE - commentary - research), which was at the center of an accounting scandal last year for understating its earnings.

At the same time, OFHEO, criticized in the past for being ineffectual and uninquisitive, is showing that it is not afraid of Fannie. Washington chatter says that the battle between Fannie and OFHEO has gotten so highly charged that it could result in Raines losing his job if Fannie is seen to be at fault. If OFHEO doesn't come up with any real dirt on Fannie after its review, OFHEO Chief Armando Falcon would be the one resigning.

Investors must care because proof of accounting missteps could trigger a drawn-out process of accounting restatement at Fannie similar to the one that is occurring at Freddie, which has yet to release 2003 financials. Fannie, which holds one dollar of capital for every $45 of assets, is much more weakly capitalized than other financial institutions, which means it is much more vulnerable to shocks. If Fannie had to hold more capital during a restatement process, it would have to raise as much as $15 billion to get leverage to a reassuring level. A capital repair job of that size could involve issuing billions of dollars in stock, which would dilute existing shareholders. And regulators would almost certainly impose limits on future growth.

So what is OFHEO looking at? Its review is giving Fannie's books a broad sweep, but the agency appears to have found something it doesn't like about how Fannie has valued bonds that are backed by mobile home loans, as well as other assets. Detox looked closely at this issue last fall and zeroed in on mobile home loan bonds issued by a company called Conseco Finance, which had gone into bankruptcy protection.

This column argued that Fannie's writedowns on its Conseco bonds were way too small, judging by an impairment charge on similar bonds taken in late September by the Federal Home Loan Bank of New York. This column calculated that, going by the size of FHLB of New York's writedown, Fannie needed to reduce the value of mobile home bonds issued by Conseco by $1.15 billion. In the third quarter of last year, Fannie had written down its mobile home bonds by only $150 million, with $100 million having taken place in 2003.

But why would Fannie want to risk accounting scrutiny by failing to write down these bonds? Perhaps it feared giving its enemies in Congress any ammunition. But Fannie execs may also have feared that a large writedown could deprive them of a generous options grant they would receive if Fannie's core business earnings were $6.46 per share or higher in 2003. Taking a big writedown in the fourth quarter could have left earnings uncomfortably close to the $6.46 mark.

Here is the math. In 2003, Fannie made $7.29 per share in core earnings, which is 83 cents above $6.46. Where would earnings be if Fannie had taken a $1.15 billion impairment charge?

First, Fannie had already taken $150 million in writedowns on Conseco bonds by the fourth quarter, which leaves $1 billion. If we tax-effect that sum at Fannie's tax rate of 26%, we get $740 million. With 974 million shares outstanding at the end of last year, $740 million works out at 76 cents in per-share earnings. Subtract that from the reported core earnings of $7.29 and we get $6.53 -- a mere 7 cents above the $6.46 target.

Fannie has yet to release its proxy statement for 2003, which should detail last year's compensation. But in light of the facts, OFHEO may also want to take a good look at that document.