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## Falcon Has Landed at Fannie Mae

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5/6/2004 7:07 PM EDT  
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<b>Fannie Mae (FNM:NYSE)</b>	<b>BEARISH</b>
Price: \$68.88   52-Week Range: \$60.11-80.82	
<ul style="list-style-type: none"> <li>• The company's regulator has been criticized.</li> <li>• But now OFHEO is acting decisively.</li> <li>• Can CEO Raines survive a restatement?</li> </ul>	
Position: none	

**Fannie Mae** ([FNM:NYSE](#) - [commentary](#) - [research](#)), one of the most powerful companies in Washington and on Wall Street, has long used its clout to fend off efforts to rein in its risk-taking management, which has been led for six years by CEO Franklin Raines.

But Thursday, a small, thinly-staffed government agency known by its inelegant acronym, OFHEO, did something that could lead to strict new legislation to contain Fannie, as well as seriously jeopardize Raines' position at the helm of the nation's second-largest financial institution.

The Office of Federal Housing Enterprise Oversight, Fannie's regulator, said Thursday afternoon that Fannie had failed to properly value a large portfolio of troubled bonds on its balance sheet.

OFHEO, which is in the midst of conducting a probe of Fannie's books, also told the government-sponsored mortgage giant to correctly value the securities by May 14 -- a move that could result in a highly damaging restatement of past financial filings. And a letter Thursday from OFHEO director Armando Falcon to Fannie's Raines made it clear that the regulator is looking at Fannie's books. "Please note that OFHEO's examination is continuing in other areas," Falcon wrote.

A person familiar with the investigation said that OFHEO has found the sort of lapses in documentation and controls that were unearthed in probes of **Freddie Mac** ([FRE:NYSE](#) - [commentary](#) - [research](#)), a rival government-sponsored mortgage buyer that revealed accounting problems in 2002 and 2003. "This is only the beginning for OFHEO," the person familiar with the investigation said.

Fannie didn't return a call seeking comment.

### Long Time Coming

It was clear soon after OFHEO started its probe that it would look at a portfolio of troubled bonds to see if Fannie had marked them down by enough. [Since last October](#), this column has been arguing that Fannie hadn't marked down the troubled bonds by a sufficient amount. The bonds in question are backed with loans made to people to buy mobile homes, which are also called manufactured housing.

Detox estimated that Fannie needed to mark down \$7 billion in mobile-home bonds by \$1.1 billion, using a writedown by another government-sponsored institution as a yardstick. To date, Fannie has marked these bonds down by only \$220 million. In public filings and in investor communications, the company said its valuation methodology was right.

The company that originally made most of the mobile-home loans was poorly run, and it lent at very high interest rates to people who would have trouble paying back the loans. It was always a mystery why Fannie, a blue-chip firm with a reputation for having a social conscience, would buy bonds backed with loans that were made in apparently predatory fashion.

OFHEO said Thursday that it "has directed Fannie Mae to account for manufactured housing and aircraft lease securities impairments in the periods they occur." The agency adds that OFHEO "has determined that [Fannie] is not applying appropriate accounting with respect to determining asset impairments and revenue recognition for these securities."

Don't ask what Fannie, set up by the government to support the housing market, is doing with sophisticated aircraft leases, because no one knows. OFHEO did not comment on the amount of bonds and leases that have questionable valuations.

### **Forcing the Hand**

Why is OFHEO's demand for a "proper" accounting so serious for Fannie? Because it forces Raines into a corner. He can litigate against this, but what financial company really wants to be seen suing its regulator?

At some point, that sort of highly combative strategy would alienate Fannie's investors, driving the yields on its bonds up, and scare off its centrist supporters on Capitol Hill who have been resisting efforts by the White House and certain members of Congress to strengthen the regulation of Fannie and Freddie through legislation and administrative fiat. And it's impossible for Fannie and its defenders to argue that they are the victim of some right-wing attack, since OFHEO's Falcon was a Clinton appointee, and one of the biggest reformers in Washington is Democratic Sen. Jon Corzine of New Jersey.

However, Raines may decide to fight, because he effectively certified the valuations for the mobile-home bonds when he signed off on the numbers in Fannie's 2003 annual report. That document came out long after this column and other media outlets raised questions about the impairment valuations.

Raines may also fight OFHEO on this issue because defeat could mean his having to return some compensation to Fannie. If Fannie had marked down the bonds by \$1.1 billion, it may not have posted the amount of earnings in 2003 that allowed Raines and others to gain access to a lucrative grant of stock options.

OFHEO [proposed a new set of corporate governance rules](#) in April that could force Raines to pay back compensation. The proposals say that the CEOs and CFOs of Fannie or Freddie would have to pay back compensation if the mortgage companies had to restate their accounts, because of a material noncompliance with financial reporting requirements, due to misconduct.

To be sure, the mobile-home markdown alone won't be enough to end Raines' career and give the reformers the ammo they need to bring down Fannie's astronomical leverage. However, mobile-home loan losses are among the lesser problems at the company. The most serious is Fannie's very low level of equity, [caused by huge derivatives losses that are stored away on the balance sheet](#). And Fannie continues to do the most unnerving things. In its first-quarter earnings release, [Fannie couldn't even provide a balance sheet](#).

Fannie may have decided to keep back this most fundamental piece of financial disclosure because its equity may have taken another huge hit due to a failure to properly insure against recent interest rate moves. That balance sheet is supposed to be in a filing with the SEC that is scheduled for release Monday. If that filing is delayed, or if it contains a big drop in equity, Raines and his swashbuckling gang of interest-rate gamblers could soon be out.

And OFHEO would have all the more material to pore over.