Fannie Probe Turns to Derivatives

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Fannie Mae (FNM:NYSE)	**BEARISH**
Price: $73.85 | 52-Week Range: $65.60-$80.82	

- The company's books have long been under the microscope.
- But now it appears regulators are focusing on derivatives losses.
- CEO Franklin Raines could soon be facing a lot of heat.

Position: **none**

Did mortgage giant **Fannie Mae** (FNM:NYSE - commentary - research) cook its books in order to exclude large derivatives losses from its income statement?

Finding an answer to that question is one of the main aims of a probe being conducted by Fannie's regulator, the Office of Federal Housing Enterprise Oversight, or OFHEO. And according to a person familiar with the investigation, one of the reasons that OFHEO has sent subpoenas to Fannie is to obtain information that would help it decide whether the company misapplied generally accepted accounting rules to keep losses on derivatives out of earnings.

As this column has often reported, Fannie has suffered gargantuan losses on derivatives under CEO Franklin Raines. The losses, which ballooned to nearly $17 billion in 2003, appeared to be the result of a risky interest rate hedging strategy that backfired badly. The derivatives losses in question are amortized into earnings over time. The OFHEO investigation aims to determine whether Fannie was amortizing too few losses into its income statement and thus artificially boosting earnings, according to the person familiar with the probe, which began in February and is expected to end by the end of this month.

Fannie has strived hard to give Wall Street earnings that grow at a strong and steady rate. If it was able to do that only because it was abusing its accounts to keep derivatives losses out of earnings, Fannie's reputation would be hurt badly and CEO Raines would come under fire.

Fannie didn't comment. Its stock dropped 60 cents to $73.85 Wednesday.

OFHEO declined to comment on any aspect of its investigation, which the regulator launched soon after its probe of accounting missteps at **Freddie Mac** (FRE:NYSE - commentary - research), Fannie's rival mortgage buyer. Having seen some of the tricks Freddie played, OFHEO said right from the start that its probe of Fannie would look at how earnings were calculated. Back in December, OFHEO said that one of the things it would do in its Fannie probe was to "focus on transactions that significantly accelerate or defer the pattern of income recognition."

With that being one of its main aims, it made perfect sense for OFHEO to look at how Fannie's billions of dollars of derivatives losses were treated. In theory, the accounting rule that covers derivatives -- known as FAS 133 -- could be abused to keep a portion of derivatives losses out of earnings. In a November 2003 letter from OFHEO director Armando Falcon to Raines obtained by *TheStreet.com*, OFHEO asked for documents pertaining to a range of subjects, but specifically requested documents "related to FAS 133."

Preparations for FAS 133 were started under former Fannie chief James Johnson, now a private equity investor and adviser to John Kerry. Johnson didn't return a call seeking comment.

However, Fannie may be doing all it can to avoid scrutiny of its derivatives accounting. At a congressional hearing in July, OFHEO director Armando Falcon has said that Fannie's cooperation with the probe has been "spotty." According to an AP report, he also said, "We've had some instances where deadlines have been missed without explanation, submissions in response to requests for information that weren't complete -- even though there were assertions that they were complete."

The lack of cooperation may have been the reason for the issuance of subpoenas, a development reported by *The Wall Street Journal* on Aug. 20. According to the person familiar with the investigation, the subpoenas are aimed at getting documents that would show whether certain accounting treatments were implemented as part of willful attempts to artificially smooth earnings.

Of course, while the derivatives losses don't all go into earnings when they occur, they have all been reflected in the balance sheet -- in the equity number. However, to the bemusement of many investors, Fannie has asked market participants to look at equity numbers that leave out the FAS 133-related derivatives losses when assessing the strength of the company's capital.

At the end of June, there were $8.5 billion of unrecoverable derivatives losses in Fannie's equity that had yet to be amortized into earnings. If, as makes sense, that sum were subtracted from the capital numbers Fannie asks investors to concentrate on, the company would look weakly capitalized. Since Fannie was betting on a drop in bond prices at the end of the second quarter, the recent rally in bonds may have created more derivatives losses, and the company's true capital base may be even weaker than it was at the end of the second quarter.

OFHEO's ongoing probe has scored a couple of successes. It led to Fannie changing its accounting for some impaired bonds, an issue this column was first to flag. Fannie ended up having to book heavier losses on the bonds.

Also, it would appear that OFHEO is leaning on Fannie to make some changes in its corporate structure to improve risk management. Last week, Fannie said it was going to "move transactional risk management responsibilities to its business units while strengthening the integration of its financial risk assessment capabilities at the corporate level." Why the changes? Well, in the press release containing the news on the organization change, Fannie CFO Timothy Howard implied the impetus for changes in risk management were coming from OFHEO.

Howard said that "because OFHEO's proposed corporate governance rule addresses issues related to the organization of risk management activities, the company anticipates making further changes to its risk-management structure once the final rule is in place."

Falcon's term at OFHEO is due to come to an end at the beginning of October, but an OFHEO spokeswoman said Falcon wants to ensure a smooth changeover and, if necessary, he would stay through the transition to the new director.

A Bush victory in November would be a disaster for Fannie, which has resisted reforms proposed by the White House to tighten regulation of Fannie and Freddie. The two companies have been told by the White House that a second Bush administration's stance would be tougher, according to a person familiar with relations between the administration and the government-sponsored entities, or GSEs.

However, Fannie management could find it hard to resist reform calls even under a possible Kerry presidency if OFHEO finds it did keep derivatives losses out of earnings.

One of the big corporate tricks of the '90s was to find ways to manipulate accounting to defer or bury losses. There would be few supporters left in Congress if Fannie were discovered to have had engaged in Enronesque practices and ethics.