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Fannie Fight Ready to Get Nastier

By Peter Eavis
Senior Columnist
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Fannie Mae (FNM:NYSE)	BEARISH
Price: $69.90 | 52-Week Range: $62.95-80.82	

- Bulls think the company's regulator will be sidelined.
- But there are signs things haven't been going Fannie's way.
- How long can Raines last if there's another dustup?

Position: **none**

He made more than $20 million last year and is highly influential in Washington. But right now, no one in their right mind would want to be **Fannie Mae** (FNM:NYSE - commentary - research) CEO Franklin Raines.

The executive has fought a characteristically tenacious battle to protect his job and defend Fannie as allegations of serious accounting missteps have piled up. Even so, Raines could well be gone from the nation's largest mortgage buyer by the end of this year, with his reputation in tatters. Much rests on what happens Monday.

That's when Fannie is due to file its quarterly financial results with the **Securities and Exchange Commission**, which has launched a formal investigation of Fannie's books.

Raines' days at the company could be counted on one hand if Fannie fails to file quarterly results Monday, or if this quarterly report fails to include the usual statement from Fannie's auditor, KPMG, that indicates it has reviewed the numbers and doesn't see the need for material modifications.

So far, the company has been content to follow Raines' lead. But Fannie Mae and Franklin Raines aren't one and the same -- and it could be just a matter of days before Fannie's board sees that and moves to strip Raines of his post.

Josh Rosner, an analyst at Medley Global Advisors, believes that the board hasn't moved to pressure Raines because if it fired him now, it would have to pay a severance package. If the company indicates that it's going to restate past numbers, the board would have clear cause for getting rid of Raines. A failure to file with the SEC Monday, or the filing of a report without an auditor's stamp of approval, would likely be enough to force the board's hand. (Rosner has no positions in Fannie stock, and his company doesn't do investment banking work.)

Fannie Mae didn't respond to a request for comment. KPMG and OFHEO declined to comment.

Lagging Indicator

In some respects, getting rid of Raines would be good thing for Fannie investors, since he has underperformed on many levels as CEO.

His opponents over the past five years have included both the Bush and Clinton administrations, **Federal Reserve** Chief Alan Greenspan, rival banks and Fannie's own regulator, the Office of Federal Housing Enterprise Oversight, or OFHEO. And don't forget short-sellers, who have long wagered that losses on Fannie's balance sheet will make the company a danger to the U.S. financial system.

The head of any other financial institution would have departed long ago in the face of such a widespread attack. But Raines has hung on, maintaining that he and his company have done nothing wrong -- even in the face of OFHEO's detailed and scathing report on Fannie's accounting.

That said, if Raines goes, it will almost certainly go hand in hand with a massive restatement of past financial results. This column has estimated that a critical measure of regulatory capital could have been overstated by billions of dollars, and that as much as $12 billion of derivatives losses were kept out of the income statement.

A restatement of that size would almost certainly open the door to far-reaching reforms of Fannie and rival **Freddie** (FRE:NYSE - commentary - research), both of which operate under advantageous government charters. Those reforms could reduce the profitability of Fannie Mae, which has run its huge mortgage portfolio aggressively and become severely undercapitalized in the process.

What's more, the Bush administration always said that it would introduce tougher reforms in any second administration. That looks much easier to do, now that the Republicans have upped their majority in the Senate and the House -- and now that Democratic Sen. Tom Daschle, a high-profile Fannie ally, has been voted out of office.

Red Cape

Fannie's supporters -- now confined to a handful of Wall Street analysts who missed all the problems at the company and a bunch of mutual fund managers stuck with huge slugs of Fannie stock -- will try their hardest to argue that Raines will survive and that Fannie's past accounting will be vindicated. Though the Fannie bulls' views could not be further from the truth, it's worth picking apart their arguments, because it's amazing what gets believed on Wall Street sometimes.

The biggest bogus argument of the bulls is that the SEC will come to Fannie's rescue. This argument is based on the fact that SEC Chairman William Donaldson said that he didn't think the subject of Fannie's derivatives accounting was "black and white," seemingly contradicting a statement from OFHEO Chief Armando Falcon that Fannie's accounting issues "are black and white."

But according to *Dow Jones Newswires*, the SEC later issued a statement that said: "Chairman Donaldson's comments were intended to reflect the complexity of this matter. In no way did he intend to indicate a disagreement with Mr. Falcon's position."

The feeling in some quarters has been that Fannie and OFHEO just have differing views of two accounting rules that could, in the final analysis, be seen to be valid in both cases. The thinking has been that the SEC will not push for a restatement of past results and is happy that Fannie has agreed with OFHEO to start applying both rules in a way OFHEO approves of.

But here's why the issue won't pan out this way: According to a person familiar with the SEC probe, Fannie gave a presentation to the SEC Friday that was designed to advance its side of the story. But according to this person, OFHEO also got to attend the meeting, and that would have allowed it to contest Fannie's defense. Another source says Fannie requested the meeting because it didn't feel the SEC probe was going Fannie's way.

Moreover, it is almost impossible to believe that the SEC agrees with Fannie's implementation of accounting rule FAS 133. The alleged misapplication of this rule appears to be responsible for leaving billions of dollars of derivatives losses out of earnings and capital.

The SEC is extremely clear about how this rule needs to be applied, going by a speech given just under a year ago by an official from the SEC's Office of the Chief Accountant. Indeed, this speech cautions companies against misapplying the rule in the way that Fannie is alleged to have done.

Moreover, it's hard to see KPMG aligning itself with Fannie against the SEC and OFHEO. Detox has obtained portions of the accounting firm's handbook for dealing with derivatives accounting. Any company that stuck by the guidelines of this handbook would have a very hard time doing its FAS 133 derivatives accounting in the way that Fannie did. It appears, then, that KPMG allowed Fannie to go against its own guidelines.

Indeed, there are strong clues that suggest that to be the case. Earlier this year, KPMG worked with mortgage company **Impac Mortgage** (IMH:NYSE - commentary - research) to correct its FAS 133 accounting, and that led to Impac recently restating its SEC filings. KPMG and Impac found that the company was misapplying FAS 133 in very much the same way that OFHEO alleges Fannie misapplied FAS 133. The Impac matter went up the head office of KPMG in the U.S., according to a person familiar with the situation. In other words, either KPMG got its Impac position wrong -- or its Fannie opinion. Both cannot be right. KPMG almost certainly checked and double-checked its FAS 133 thinking with Impac, which means it's much more likely to be correct.

Clearly, Raines has nowhere to turn. This is Frank's Fallujah.