




## Fannie Mae Declines on Concern About Credit Losses (Update4)

By James Tyson



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Nov. 16 (Bloomberg) -- Fannie Mae had its biggest two-day decline since 1987 after executives at the mortgage-finance company failed to ease investor concern that it may have downplayed credit losses.

Fannie Mae fell \$2.35, or 5.5 percent, to \$40.69 today in New York Stock Exchange composite trading. The shares were pushed down 10 percent yesterday after a Fortune magazine article said Washington-based Fannie Mae altered how it measures the impact of mortgage foreclosures in a way that understates losses.

A conference call held by Fannie Mae executives today to explain the new accounting did little to reassure investors. A calculation of credit losses

enabled Fannie Mae to report a 4 basis point loss rate for the first nine months of 2007 that was within estimates. The loss would have been as much as 7.5 basis points if the accounting wasn't changed, Fortune reported Nov. 14.

``When there's any sort of hint of an accounting scandal, it's going to take them down," said Thomas Garcia, head of trading at Thornburg Investment Management, which oversees about \$50 billion in Santa Fe, New Mexico. ``Investors seem to have a pretty good memory of bad things that happen at companies."

Fannie Mae's past accounting misstatements heightened concern about potential discrepancies in its latest calculations. The government-chartered company has spent more than three years under regulatory scrutiny because of profit overstatements of \$6.3 billion from 2001 through June 2004 that led to the ouster of Chief Executive Officer Franklin Raines.

The company this month brought its financial filings up-to-date with the release of earnings for the first nine months of the year, setting a path to being freed from some federal constraints.

### What to Believe

Fannie Mae's third-quarter credit losses were \$343 million, a Nov. 9 U.S. Securities and Exchange Commission filing shows. That number excludes \$670 million in unrealized losses for ``a substantial decrease in the market value of delinquent loans we purchased from MBS trusts," versus prices paid, the filing said.

Chief Financial Officer Stephen Swad said the company's current method of highlighting the realized losses is accurate and reflects charges the company is taking related to loan defaults.

``The majority of these loans don't result in any losses," Swad said. A basis point is 0.01 percentage point.

Fannie Mae says it's going to hold these loans in their portfolio, they're ultimately going to be paid out over time and there will be no cash losses as a result, according to Stuart Plesser, an equity analyst with Standard & Poor's in New York.

``If you don't believe that premise then you think that they're masking some of their results," Plesser said. If investors do believe the company, then it's ``like Fannie is presenting it and the numbers are in good light."

More Guidance

Fannie Mae owns or guarantees about 20 percent of the \$11.5 trillion U.S. home loan market. It reports delinquent loans as an unrealized loss when it repurchases the debt from mortgage bonds to fulfill the terms of its guarantees. The gap between the prices Fannie Mae pays for those assets `` and the market values have grown so much that it has become a very material number" said Paul Miller, an analyst at Friedman Billings Ramsey Group Inc., a securities firm in Arlington, Virginia.

With the U.S. housing market slumping to its lowest point in 16 years, any hint of growing losses related to delinquent home loans sparks investor concerns, Miller said. There was little disclosure on the mark-to-market losses for the first nine months of 2007 so `` people were factoring in that a big chunk of that" may become a realized loss, Miller said.

Analysts told Fannie Mae on the conference call `` we want more guidance, you are not giving us enough guidance," he said.

#### Federal Constraints

Fannie Mae shares traded above \$77 in September 2004 before regulators began revealing the accounting errors, and fell below \$42 by October 2005 because of the uncertainty surrounding earnings and a regulatory crackdown. The stock had rebounded this year to above \$70 in intraday trading in August. They are now at their lowest level since April 1997.

Fannie Mae, and competitor Freddie Mac, have been limited in their ability to increase their mortgage portfolios while under the watch of the Office of Federal Housing Enterprise Oversight, and some lawmakers have resisted the companies' efforts to expand their business. Freddie Mac shares are down 40 percent this year.

Congress created Fannie Mae and Freddie Mac to increase mortgage financing by buying loans from lenders. The companies profit by holding mortgages and mortgage bonds as investments and by charging a fee to guarantee and package loans as securities. They see losses when defaults and foreclosures rise.

#### Third-Quarter Loss

The company's third-quarter net loss more than doubled to \$1.39 billion, caused by a \$2.24 billion decline in the value of derivative contracts and \$1.2 billion in credit losses among the \$2.7 trillion of mortgage assets Fannie Mae owns or guarantees.

Credit-default swaps tied to Fannie Mae rose 3 basis points to 51 basis points, according to broker Phoenix Partners Group in New York, signaling investor confidence is declining. A basis point on the five-year credit-default swap protecting \$10 million in debt is equivalent to \$1,000 a year.

The contracts, a gauge of investors' perceptions of risk, pay the buyer face value in exchange for the underlying securities or the cash equivalent should a company fail to adhere to its debt agreements.

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