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## A finance expert questions: Will Fannie Mae's problem impact the condo market?

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As shares of Fannie Mae continue their slide of more than 20 percent over the last year, investors concerns have increased after the U.S. Office of Federal Housing Enterprise Oversight (OFHEO), the government regulator, accused top executives of the mortgage giant of mismanagement and serious accounting misdeeds.

The real impact to date has been limited to shareholders; but the fallout could affect millions of Americans if they have to pay higher rates for new home mortgages. Analysts say this could be one of the consequences if Fannie Mae is forced to pay higher rates on its nearly \$1 trillion of debt.

Fannie Mae was chartered by the United States Congress, but went public in 1970. Fannie Mae and another government-sponsored mortgage financier, Freddie Mac, buy billions of dollars of

mortgages each year from banks and other mortgage lenders. They then package the mortgages into bonds that are sold to investors. These bonds are not directly guaranteed by the US government, however they have special privileges, specifically the ability to borrow directly from the U.S. Treasury, which makes their borrowing rates lower than those of competing firms.

Fannie's stock and debt is widely held by individual and institutional investors in the United States and throughout the world. The company contends that homebuyers, especially low-income borrowers, benefit from lower mortgage rates due to Fannie Mae's over-all cost of capital and stabilized securitization/syndication procedures.

Regulators at the OFHEO who investigated Fannie Mae's books said the problems they found, at least in the key area of accounting, were more serious, far more complex and wider in scope than those at rival Freddie Mac—which was fined a record \$125 million in a settlement related to the improper accounting practices that allowed them to under report earnings by \$5 billion. Concerns raised include evidence that Fannie did not rec-

ognize appropriate losses after the refinancing boom followed the 1999 Russian debt crisis. As interest rates declined during this period, homeowners rushed to refinance their mortgages, this left Fannie with the interest rate risk on higher cost bonds. The OFHEO says Fannie should have recognized the effect of this event immediately, but instead applied the loss over several quarters. This artificially inflated Fannies net income and coincidentally qualified senior management for maximum bonuses!

With CEO Franklin Raines earning a reported \$11.6 million in 2003, according to Forbes Magazine, it is no wonder compensation had become a big issue with federal regulators. If OFHEO can support its claims of accounting irregularities at Fannie, its senior staff will likely go the way of their peers at Freddie who were removed after last year's accounting scandal.

The fall out from Fannie Mae's accounting improprieties could be more dramatic than that of Freddie Mac and have more severe consequences as well. If Congress intervenes and decides to come down hard, they have the ability to remove Fannie's access to the US

Treasury and its lower cost capital. In addition, well publicized differences between Fannie Mae and the Federal Government will draw public attention to the fact that the US does not guarantee Fannie bonds and this might further erode public confidence—especially internationally.

The ultimate outcome of such a series of events would have Fannie paying substantially higher rates to attract bondholders in a rising interest rate environment. These rate increases would have to be passed on to mortgagors (the buyers of condos), which would hamper the ability for end buyers to gobble up homes as they have demonstrated over the past few years. The rent vs. buy analysis by individuals would make middle market condo developers lose the recent sales velocity they have recently enjoyed.

Hopefully, the regulators and Congress can rein Fannie in without using such draconian muscle. Otherwise, we can expect the condo market to suffer for exponentially rising interest costs to end users.

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