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Fannie Mae Faces \$25 Billion Derivative Losses

By Stephen Schurr in New York
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Fannie Mae paid a net \$25.1bn on derivatives transactions in under four years - nearly all of which may represent losses that cannot be recouped, in turn depressing future earnings.

The potential scale of the liabilities, which have yet to be recognised in the company's earnings or in the minimum capital adequacy required by its regulator, raise fresh doubts about the financial health of the mortgage finance giant.

Regulation of Fannie Mae and its sibling Freddie Mac is rapidly moving up the agenda in Washington, amid concerns that the two government-sponsored entities have grown so big that they pose a systemic risk to the US financial system. The two entities own or guarantee mortgages totalling \$4,000 billion.

On Tuesday John Snow, US Treasury secretary, renewed the criticism, saying: "We don't believe in a too-big-to-fail doctrine, but the reality is that the market treats the paper as if the government is backing it."

His comments follow similar warnings from Alan Greenspan, chairman of the Federal Reserve, and Gregory Mankiw, chairman of George W. Bush's council of economic advisers.

Fannie Mae acknowledges it has taken losses in its derivatives trading that have not yet been recognised in its earnings, but declines to disclose the amount. The reason, said Jonathan Boyles, vice-president of financial standards and taxes at Fannie Mae, is that "we don't believe it's all that meaningful".

Next Monday Fannie Mae is due to release its annual "fair value disclosure" - a statement of the current market value of its derivatives positions. Observers will be watching to see if the gap between the company's regulatory capital and fair value has widened further than the \$6bn shortfall of a year ago.

An independent analysis of Fannie's accounts suggests it may have incurred losses on its derivatives trading of \$24bn between 2000 and third-quarter 2003. That figure represents nearly all of the \$25.1bn used to purchase or settle transactions in that period. Any net losses will eventually have to be recognised on Fannie Mae's balance sheet, depressing future profits.

Fannie Mae maintained that the losses from cashflow hedging will have no bearing on the capital adequacy required by its regulator.

However, critics increasingly question whether Fannie Mae's financial disclosure offers a complete picture of its fiscal health.

"They have used the derivative accounting rules for cash flow hedges to defer some losses that they have taken," said John Barnett, senior analyst at the Center for Financial Research & Analysis, an independent research firm. "They may not be as well-capitalised as they appear to be for regulatory purposes."

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