Study of Fannie Mae Cites 'Perverse' Executive-Pay Policy

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By Terence O'Hara
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Fannie Mae's executive-pay policies provided "perverse incentives" to top officers to inflate earnings, a recent academic study has found.

The study, distributed yesterday by the Program on Corporate Governance at Harvard Law School, also took Fannie Mae's past pay practices to task for rewarding "failed" executives and for what it said was inadequate public disclosure about the full pension benefits available to retiring executives.

This month, pressured by its federal regulator, Fannie Mae eliminated the incentives that federal officials and other critics blamed in part for Fannie Mae's current accounting problems. The Washington-based mortgage-finance company overstated its earnings from 2000 to 2003 by as much as $12 billion and is restating its finances for those years. The Office of Federal Housing Enterprise Oversight, Fannie Mae's regulator, has suggested that the accounting errors may have been willful, in part to increase Fannie Mae's earnings per share and thus increase the bonuses available to senior executives.

Fannie Mae's chief executive, Franklin D. Raines, was ousted by the company's board in December over the controversy, as was chief financial officer J. Timothy Howard.

Lucian A. Bebchuk of Harvard Law School and Jesse M. Fried of the University of California at Berkeley School of Law, in a paper distributed by Harvard yesterday, said Fannie Mae rewarded Raines, Howard and other senior executives in such a way that "weakened and distorted" their incentives to create a strong company.

Bebchuk and Fried specifically criticized Fannie Mae's practice of awarding cash bonuses based on growth in earnings per share, saying it provided incentives for senior managers to manipulate accounting in Fannie Mae's huge portfolio of mortgage investments to reach earnings targets.

Fannie Mae this month eliminated all bonus programs based on earnings-per-share growth.

The law professors, who recently wrote a book on what they consider broad failings in executive pay structures at U.S. corporations, also criticized Fannie Mae for providing a "soft landing" for Raines and Howard when they were forced to retire from the company. They were allowed to keep their pension benefits.

They also criticized Fannie Mae's disclosures about Raines's retirement benefits before and after he was forced out. While disclosing the number and current value of stock options Raines was allowed to keep when he retired, as well as his $114,000 monthly pension benefit, Fannie Mae did not disclose any estimates of how much these benefits would ultimately cost shareholders.

Raines was 55 when he retired, and the authors estimated that his retirement package could be worth as much as $25 million to him and his wife.

Bebchuk and Fried noted that such practices are common at many large companies, and said they used Fannie Mae as a highly public example of bad practices that need reform.

Fannie Mae spokesman Charles V. Greener declined to comment on the study. Kevin M. Downey, a lawyer who represents Raines, also declined to comment.

Separately, Raines has been removed from a prominent corporate governance and ethics group he co-founded in 2004, Bloomberg News reported yesterday. A spokesman for the Institute for Corporate Ethics at the University of Virginia's Darden School of Business told the wire service that Raines could no longer be on the institute's advisory board because he is no longer a chief executive of a company that is a member of the Business Roundtable. Raines and Pfizer Inc. chief executive Henry A. McKinnell persuaded the Business Roundtable, a group of large American corporations, to set up the institute in January 2004 to promote corporate ethics programs after prominent scandals such as those at Enron Corp. and WorldCom Inc.

At a ceremony announcing the institute's formation, Raines said, "Our overall goal is to help restore the trust of the American people and American investors in business corporations."