

## Fannie Mae Timeline

September 19, 2007	December 21, 2007	February 7, 2008	February 25, 2008
<b>OFHEO press release re portfolio caps and liquidity</b>	<b>Lockhart quote in American Banker Article re tradeoff between safety and soundness and liquidity</b>	<b>Lockhart testimony re pressure on GSEs to “do more and take on more risks”</b>	<b>Sen. Schumer urges OFHEO to remove capital cushion and portfolio caps</b>
OFHEO loosens portfolio constraints but reports “it would not be prudent at this time to allow any major increases in the portfolio levels because the remediation is not finished, many safety and soundness issues are not yet resolved, and the criteria in the Fannie Mae consent agreement and the Freddie Mac voluntary agreement have not been met.”	Lockhart says, “[t]here’s a real tradeoff between safety and soundness and [the GSEs’] affordable-housing mission and their mission of keeping the secondary market liquid. [W]e’re encouraging them, obviously, to fulfill their mission, but at the same time we have to worry about safety and soundness.”	During his testimony before Senate Banking, Housing and Urban Affairs, Lockhart says, “The risks are beginning to take their toll. Public disclosures indicate that Freddie Mac will report annual losses for the first time its history and Fannie Mae for the first time in 22 years. Their missions, as well as Congressional and many other pressures, are demanding that they do more and take on more risks in areas new to them—subprime and jumbo mortgages.”	Senator Schumer urges OFHEO to lift portfolio caps and eliminate or substantially ease the 30% capital surcharge, stating that “with such a stringent capital requirement, Fannie Mae and Freddie Mac are limited in their ability to provide the volume of financing needed in these troubled times in the market.”

## Fannie Mae Timeline

February 27, 2008	February 28, 2008	March 3, 2008	March 6, 2008
<b>Lockhart statement re relieving portfolio caps</b>	<b>News of GSEs losses overshadowed by removal of growth caps</b>	<b>Nelson email to Treasury re concern over GSEs' credit risk</b>	<b>Farrell email re GSEs being "part of the solution" if OFHEO allows change in risk</b>
<p>OFHEO Director Lockhart issues public statement:</p> <p>"In recognition of the progress being made by both companies, as indicated by the timely release of their 2007 audited financial statements, and consistent with the terms of the relevant agreements, OFHEO will remove the portfolio growth caps for both companies on March 1, 2008."</p>	<p>Steel forwards an email to Treasury Deputy Assistant Secretary for Financial Institutions Policy Norton from FRBNY's Alejandro LaTorre, which says that the news of the GSEs reporting larger than expected 4Q07 losses was overshadowed by OFHEO's removal of the growth caps. Also written that sharper decline in housing environment could result in larger losses for GSEs.</p>	<p>Michael Nelson, a Managing Director at U.S. Structured Finance, sends an email to Steel, Nason, Ryan and other Treasury officials, writing that his company had become increasingly concerned with the level of credit risk at the GSEs</p>	<p>Annaly Capital Management Chairman and CEO Mike Farrell tells Treasury Undersecretary Robert Steel in an email that credit markets could be "nearing a tipping point" and that the GSEs could be "part of the solution ... so long as Treasury and OFHEO are comfortable with the prospective change in their risk profile."</p>

## Fannie Mae Timeline

<b>March 7, 2008</b>	<b>March 8, 2008</b>	<b>March 8, 2008</b>	<b>March 10, 2008</b>
<b>Email exchange with Mudd and Steel re capital raise in exchange for reduction in surplus</b>	<b>Lockhart Email to Steel re: Freddie against raising equity</b>	<b>Source for <i>Barron's</i> article re accounting fraud</b>	<b><i>Barron's</i> article re accounting improprieties</b>
<p>Mudd writes to Steel that OFHEO having “unrestricted capital authority will, as ever, be the sticking point.” Mudd writes to Levin, “it’s a time game... whether they need us more, sooner to show admin action, or if we hit the capital wall first. Be cool.”</p>	<p>Lockhart writes in email that Freddie board is against raising equity, but it may be possible if timed with some capital relief.</p>	<p>Bush Administration economist Jason Thomas sends Steel an email in which he attaches a report identified as the source for the March 10, 2008 <i>Barron's</i> article accusing Fannie Mae of overstating its financial results through accounting improprieties.</p>	<p><i>Barron's</i> publishes a highly critical article about Fannie Mae, suggesting that it is insolvent and predicting that the government will bail the company out.</p>

## Fannie Mae Timeline

March 13, 2008	March 16, 2008	March 16, 2008	March 17, 2008
<p><b>Email thread between Steel and others at Treasury</b></p>	<p><b>Steel email to others at Treasury</b></p>	<p><b>Bear Stearns collapse. Conference call with Paulson, Steel and GSEs re liquidity</b></p>	<p><b>Mudd email to Lockhart, Steel &amp; Syron enclosing proposed press release re initiative to increase mortgage market liquidity</b></p>
<p>Davis writes to Steel that she heard more panic in Levin’s voice than she heard when the Board made him CFO during the accounting disaster. Concern was impact of Carlyle margin calls and dumping of 16 billion agency CMOs.</p>	<p>Steel writes “[Mudd] expressly said, “Lockhart needs to ELIMINATE the negative rhetoric. I have emailed and called Syron and waiting to hear back...I was leaned on very hard by Bill Dudley to harden substantially the gty. I do not like that and it has not been part of my conversation with anyone else. I view that as a very significant move, way above my pay grade to double the size of the US dept in one fell swoop.”</p>	<p>JP Morgan acquires Bear Stearns with \$30 billion of government assistance. According to Paulson’s book, Paulson has Steel arrange conference call with GSEs and Lockhart to get a deal done to calm the markets given the Bear Stearns deal. Steel and Lockhart are pushing for deal whereby OFHEO will reduce capital surplus by \$1 for every \$2 in capital raised.</p>	<p>Mudd emails Steel proposal that OFHEO release capital surplus and consent order and GSEs commit to invest \$300 billion in market and to raise capital as needed.</p>



## Fannie Mae Timeline

March 17, 2008	March 19, 2008	March 19, 2008
<p><b>Lockhart email to Mudd, Steel &amp; Syron describing proposed press release re initiative to increase mortgage market liquidity as “perverse”</b></p>	<p><b>Final OFHEO press release re initiative to increase mortgage market liquidity</b></p>	<p><b>Rosner analyst report re deal shows panic; why regulators shouldn’t be subject to political pressure</b></p>
<p>Lockhart sends email to Mudd, Syron and Steel in which he writes that the proposed deal- to allow the GSEs to invest a significant portion of their capital in mortgages and MBS and that GSEs planned to raise capital as needed- “strikes me as perverse as I assume it would seem perverse to the markets that a regulator would agree to allow a regulate to increase its very high mortgage credit risk leverage...without any new capital.”</p>	<p>OFHEO announces an agreement with the GSEs to increase liquidity to the secondary market in addition to the “release of the portfolio caps announced in February.” The 30 percent capital surplus requirement was immediately reduced to 20% and the GSEs announced they would “begin the process to raise significant capital.” The initiative is expected to provide up to \$200 billion in immediate liquidity and “allow the GSEs to purchase or guarantee \$2 trillion of mortgages this year.”</p>	<p>GrahamFisher GSE analyst Joshua Rosner states that “any reduction [in capital] is a comment not on the current safety and soundness of the GSEs but on the burgeoning panic in Washington.” And that “We believe that OFHEO director Lockhart took this action results in the destabilizing of the GSEs, OFHEO will go from being the only regulator who had prevented their charges from getting into trouble to a text-book example of why regulators should be shielded from outside political pressure.”</p>



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**Office of Federal Housing Enterprise Oversight  
(OFHEO)**

**NEWS RELEASE**

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**For Immediate Release**

September 19, 2007

**OFHEO PROVIDES FLEXIBILITY ON FANNIE MAE,  
FREDDIE MAC MORTGAGE PORTFOLIOS**

Washington, DC – OFHEO Director James B. Lockhart announced today that OFHEO is providing Fannie Mae and Freddie Mac with additional flexibility in managing their mortgage portfolios to comply with the portfolio caps agreed to last year.

“These changes will make it easier for the Enterprises to manage market-based fluctuations in their portfolios and reduce the need to keep large cushions below the portfolio caps,” said Lockhart. “It will also make it easier for OFHEO to monitor compliance with the portfolio caps. Both companies have indicated that this portfolio flexibility, combined with their securitization capabilities, asset sales, and the monthly runoff of their portfolios, should allow them to provide greater assistance to subprime borrowers and others who may have difficulty refinancing their existing mortgages in the current environment,” Lockhart said.

The temporary investment caps on their mortgage portfolios were established in May and July of last year because of both Enterprises’ operational, systems, financial reporting, risk management and internal control shortcomings. They have made progress in remediating some of these issues, including the publication by Fannie Mae of its 2006 financial statements and Freddie Mac of its second quarter 2007 financials, though neither was done in a timely fashion. Both companies have indicated they expect to produce audited, timely, annual financial statements for 2007 in February of 2008.

OFHEO has decided that it would not be prudent at this time to allow any major increases in the portfolio levels because the remediation process is not finished, many safety and soundness issues are not yet resolved, and the criteria in the Fannie Mae consent agreement and Freddie Mac’s voluntary agreement have not been met.

“Given our ongoing significant supervisory concerns, OFHEO will closely monitor the implementation of these portfolio cap flexibilities and will require the Enterprises to report regularly on the resulting changes and risks inherent in their portfolios,” Lockhart said.

With the ongoing concerns about the subprime mortgage market, both Fannie Mae and Freddie Mac have announced commitments to purchase tens of billions of dollars of subprime mortgages over the next several years. The portfolio cap flexibility plus their ongoing ability to securitize mortgages, sell assets, and replace maturing assets, will enhance each Enterprise's ability to purchase or securitize, over the next six months up to \$20 billion or more of subprime mortgages, refinanced mortgages for borrowers with lower credit scores, and affordable multi-family housing mortgages. These efforts should assist lenders in helping some subprime borrowers avoid foreclosure.

OFHEO expects Fannie Mae's and Freddie Mac's Chief Risk Officers and other senior executives to continue to closely monitor the Enterprises' investment activities, as will OFHEO's Office of Supervision, to ensure the activities meet sound credit underwriting and other safety and soundness standards. These standards include the recently implemented Interagency Guidance on Nontraditional Mortgage Product Risks and Statement on Subprime Mortgage Lending.

The specific flexibilities are as follows:

1. Change the portfolio measure from a GAAP number as reported on the balance sheet to Unpaid Principal Balance (UPB), which the Enterprises use in their publicly released monthly summaries. Under present market conditions, the GAAP value can fluctuate widely and we have concluded this adds unnecessary complexity for the Enterprises in managing to the portfolio cap. UPB, which reflects the original principal balance of mortgages and securities less repayments, is not subject to daily market fluctuations.
2. Set the new UPB portfolio cap at \$735 billion on July 1, 2007 and apply it to the third quarter. On that date, the GAAP measured cap was \$728.1 billion for Freddie Mac and \$727.7 billion for Fannie Mae. (UPB often exceeds the GAAP value for the Enterprises. Due to market fluctuations over the first seven months of 2007, this difference has ranged from \$0.1 billion to \$9.4 billion.)
3. Allow Fannie Mae the same moderate increases that Freddie Mac has under its voluntary agreement of 2 percent annual growth and not more than 0.5 percent per quarter. This change for Fannie Mae would be effective Oct. 1, 2007, for the fourth quarter.
4. For the fourth quarter of 2007, the quarterly growth limit of 0.5 percent would be doubled to 1.0 percent, although the 2 percent per annum cap would remain in place.
5. The size of the portfolio used to determine compliance with the portfolio cap will no longer be the closing values at quarter end but rather an average of monthly closing values. The average will start at a specified amount in July 2007 and will build to a twelve-month moving average.
6. Frequent reporting on market conditions, portfolio sizes and new purchases will be required, including a monthly report on the

Enterprises' purchases of subprime and other mortgages to borrowers with lower credit scores and multi-family housing mortgages in relationship to the \$20 billion level.

7. OFHEO examiners will ensure the Enterprises continue to have adequate capital to use this new flexibility and continue to adhere to their internal guidelines and limits on liquidity. OFHEO will also continue to monitor the increased credit and interest rate risk associated with current market conditions.

The combination of these changes should allow the Enterprises more flexibility in managing their portfolios and eliminate the need for a large cushion. This added flexibility will be especially helpful in making multi-billion dollar bulk purchases of subprime and multi-family housing mortgages and fulfilling the Enterprises' commitments to purchase subprime mortgages to help borrowers avoid foreclosure and support affordable housing.

As OFHEO has repeatedly stated, the current portfolio limits are due to ongoing safety and soundness issues at each Enterprise. Some of these safety and soundness issues arose, in part, because of rapid portfolio growth in the past. Pending legislation would provide the Enterprises' new regulator with clarified authorities and direction with respect to setting and enforcing portfolio size and growth as an ongoing matter, based upon their mission and safe and sound operations.

"OFHEO continues to believe that a more permanent solution to the portfolio limit question requires both congressional guidance and strengthened supervisory authorities," said Lockhart.

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*OFHEO's mission is to promote housing and a strong national housing finance system by ensuring the safety and soundness of Fannie Mae and Freddie Mac.*

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**HEADLINE:** Setting an OFHEO Plan, But Wishing Otherwise

**BYLINE:** Steven Sloan

**DATELINE:** WASHINGTON

**BODY:**

As another year ends without passage of a bill to reform the government-sponsored enterprises, James Lockhart, the director of the Office of Federal Housing Enterprise Oversight, finds himself in a position he has tried to avoid - thinking about his agency's future.

"Hopefully it doesn't have a future," Mr. Lockhart said, only half-joking during a recent interview. "It'll be very tough to manage this agency with one or two hands tied behind your back."

The OFHEO chief remains optimistic that legislation creating a new, stronger regulatory agency will emerge from the Senate early next year. But he is also aware that Fannie Mae and Freddie Mac are on track to become timely and current in their regulatory filings in February and that Congress may not act before then.

This scenario would undercut OFHEO's strategy of supervising Fannie and Freddie through consent orders and written agreements, which have included a \$735 billion cap on their mortgage portfolios and a requirement that they hold an extra 30% of capital.

Mr. Lockhart has long used the GSEs' return to filing timely quarterly and annual reports with clean opinions from auditors as the benchmark for beginning talks on easing those restrictions. But many observers had hoped that, by the time this occurred, a new agency would be in place to oversee Fannie, Freddie, and the 12 Federal Home Loan banks.

Mr. Lockhart appears resigned to easing some constraints if Congress does not act.

"At the end of February, assuming they've got their ... [financial reports] out on a timely manner and with clean opinions and there are not material weaknesses, it is certainly possible that we will lift the portfolio caps," he said. "Without legislation, I'm very reluctant to lift the caps, ... but we have to live up to the agreements we made with the companies."

He acknowledged that removing the caps may have little near-term effect because both companies would still need to raise capital to increase their mortgage holdings.

"The question does become, 'Does that matter at this point, if they're capital-constrained?'" he said. "I'm not sure."

Mr. Lockhart is much less willing to remove the extra 30% capital requirement and says he will only discuss the matter once the GSEs bring their accounting up to date.

"The first test to me is to get the financials out, and if they can't get their financials out, there's really no reason to have the conversation," he said. "I've told the two companies we'll look at the cap when they put out their financials in February, and at that point we'll discuss what the tests are to get the 30% removed. ... Both companies would like the 30% removed, and in my view, it would be premature. They haven't resolved all their operational problems, and until they do that, especially in this market, I don't think it would be a very safe and sound thing to do."

Mr. Lockhart is considering his options as both GSEs find themselves battered by the subprime crisis. Fannie's third-quarter net loss more than doubled from a year earlier, to \$1.4 billion, and Freddie's nearly tripled, to \$2 billion.

Freddie's third-quarter report also revealed it had just \$600 million more than its required capital. Both GSEs have struggled with capital requirements and have responded by selling preferred stock. Mr. Lockhart said both proved unprepared for such a significant housing downturn.

"Frankly, they could have conserved capital better than they did, in my view, and we've told them that," Mr. Lockhart said. "That's why they had to react so quickly and issue such a big amount of preferred" stock.

Despite the GSEs' stumbles, he said, they are doing almost everything they can to help the subprime mortgage market.

"They can only be as active as the banks themselves that are doing this, and they haven't been as active," he said. "There's a real tradeoff ... between safety and soundness and ... [the GSEs'] affordable-housing mission and their mission of keeping the secondary market liquid. And we're encouraging them, obviously, to fulfill their mission, but at the same time we have to worry about safety and soundness."

Mr. Lockhart also defended the GSEs' right to charge "adverse market" fees on the loans they buy during the housing slump.

"There's a lot of risk in this marketplace, and that's really related to the potential for bigger losses, and so from our standpoint as a safety and soundness regulator, we can't say you shouldn't raise your fees," he said. "The problem is, everybody so underpriced their product for the last three or four years that you really don't know what the right price is. ... I think they're trying to reprice to get to the right risk level."

As the GSEs move closer to emerging from their accounting scandals, they are still hitting some bumps. Investors were shaken in November by the way Fannie handled the disclosure of a \$670 million provision for credit losses.

"The bottom line was not affected, but the way they disclosed it was probably not as forthright as it could have been, and that concerned the analysts," Mr. Lockhart said. "The analysts now understand what happened. But it was a confusing disclosure of a change."

Mr. Lockhart said hindsight has shown he was right to oppose a proposal offered this fall by Sen. Charles Schumer, D-N.Y., and House Financial Services Committee Chairman Barney Frank, D-Mass., to temporarily raise the portfolio caps by 10% to ease the housing crisis.

"My concern back in September and August when there was a lot of pressure to raise it 10% was, frankly, what happened - that there was a lot of credit risk out there that was going to start to be reflected and potentially hit their capital," he said. "If we'd increased that 10%, that would have been a significant amount of additional capital they would have had to raise."

From his vantage point, Mr. Lockhart says there is near universal agreement that regulation of the GSEs should be reformed, despite tension surrounding proposals to raise the conforming loan limit and require Fannie and Freddie to contribute to an affordable housing fund. Though the House passed a GSE bill in May, the issue has stalled in the Senate, he said, because it has simply failed to become a top priority.

"We've never sort of gotten it to the front burner," he said. "Other bills have passed and I just wish ours was on the front burner but it hasn't made it there."

In part that is because Senate Banking Committee Chairman Chris Dodd is busy campaigning for president. "He is out in Iowa, so obviously he's not spending as much time on this as he normally would," Mr. Lockhart said.

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**GRAPHIC:** photo, Lockhart

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CQ Congressional Testimony

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**TESTIMONY-BY:** JAMES B. LOCKHART, III, DIRECTOR

**AFFILIATION:** OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

**BODY:**

Statement of James B. Lockhart, III Director, Office of Federal Housing Enterprise Oversight  
Committee on Senate Banking, Housing and Urban Affairs  
February 07, 2008

Introduction

Chairman Dodd, Ranking Minority Member Shelby, and Members of the Committee, thank you for the opportunity to testify on the critical need to reform and restructure the housing Government Sponsored Enterprises' (GSE) regulatory regime. The views that I will be expressing today are OFHEO's and do not necessarily represent those of the President or the Secretary of Housing and Urban Development. However, I can tell you the Secretaries of HUD and Treasury, President Bush and Fannie Mae and Freddie Mac support GSE reform.

These are unprecedented times for the housing GSEs - Fannie Mae, Freddie Mac, and the twelve Federal Home Loan Banks (FHLBanks). Their business expanded rapidly in 2007 with their market share rising to record levels in the fourth quarter of 2007. The GSEs have become the dominant funding mechanism for the entire mortgage system in these troubling times. They are fulfilling their

missions of providing liquidity, stability, and affordability to the mortgage markets. In doing so, they have been reducing risks in the market, but concentrating mortgage risks on themselves. Fannie Mae and Freddie Mac support their missions by guaranteeing and issuing mortgage backed securities (MBS), which represents approximately 70 percent of their business in 2007. Their other business activity is buying mortgages and MBS for their retained mortgage portfolios.

The risks are beginning to take their toll. Public disclosures indicate that Freddie Mac will report annual losses for the first time in its history and Fannie Mae for the first time in 22 years. Their missions, as well as Congressional and many other pressures, are demanding that they do more and take on more risks in areas new to them - subprime and jumbo mortgages. As the safety and soundness regulator of Fannie Mae and Freddie Mac, I have to tell you that expansion of their activities would be imprudent unless the regulator has significantly more powers and more flexibility to use those powers. Given the tremendous stresses on the mortgage markets, the American people cannot afford to have Fannie Mae, Freddie Mac, or the 12 FHLBanks incapable of serving their mission.

During 2007, the housing GSEs debt and guaranteed MBS outstanding grew \$870 billion or 16 percent to \$6.3 trillion. It is very hard for anyone to put trillions into perspective, but probably the easiest comparison is to the public debt of the United States, as you can see from the chart (1). The left-hand column is the public debt of the United States. It is \$5.1 trillion, of which about \$700 billion is owned by the Federal Reserve, so there is only about \$4.4 trillion in public hands. The total of Fannie Mae's and Freddie Mac's debt and guaranteed MBS, their credit owned by the public, is \$5.1 trillion. If you add on top of that the rapidly growing FHLBanks' debt of about \$1.2 trillion, you get to that \$6.3 trillion of housing GSE debt and securities.

#### Market Conditions

As has been widely reported, housing market conditions in many parts of the country are quite weak. Virtually all measures of the health of the market have deteriorated very sharply over the last two years, with particularly sharp declines over the latest few quarters.

Home prices are falling in many parts of the country. OFHEO's national purchase-only index fell 0.3 percent on a seasonally adjusted basis in the third quarter, but other indices show much larger drops. Of course, prices are declining at a much quicker pace in many areas such as California and Florida, which had the greatest price run-ups during the boom. Fannie Mae and Freddie Mac are using 4 to 5 percent house price decreases in their 2008 projections, but others are predicting more severe outcomes.

These price declines are closely associated with increases in delinquencies and foreclosure rates. In virtually every state, property foreclosure rates have skyrocketed over the latest year, as have loan delinquency rates. For the third quarter, the Mortgage Bankers Association reported that the overall loan delinquency rate of 5.6 percent was at its highest point since 1986.

Builder confidence and housing starts are at extremely low levels, as inventories of unsold properties have risen. The latest existing home sales data from the National Association of Realtors indicate that, at the current pace, there is approximately 9.6 months worth of supply on the market today, a level well above the six month benchmark for a so-called "balanced" market. With inventory overhang also quite high for new homes, the rate of housing starts has plummeted. In the fourth quarter, the seasonally-adjusted annual rate of housing starts was 44 percent below its rate from the same quarter, two years ago.

### The Enterprises' Response

What have the Enterprises been doing given these challenging market conditions? (Chart 2) They have been fulfilling their mission of providing stability and liquidity to the secondary conforming mortgage market. That has been very critical since early August. They have been securitizing almost a hundred billion dollars a month in mortgages as you can see in blue. The green, which is their mortgage portfolios, has not grown because of their internal control and other operational problems and the related OFHEO imposed limits with respect to capital and portfolios. Given the market conditions and their progress, OFHEO loosened the portfolio limits in September of 2007. Despite that added flexibility, the Enterprises have not increased their portfolios. With accompanying capital they could increase their combined portfolios by over \$100 billion for the next 6 months without violating the new limits.

As OFHEO directed, the Enterprises adopted the bank interagency guidances on non-traditional mortgages and subprime mortgages. The guidances were implemented in September last year. The guidances are not only for all mortgages that the Enterprises directly hold and guarantee, but also the underlying mortgages in private label securities (PLS) that they acquire. At the same time we gave portfolio cap flexibility, they agreed to enhance their programs to support the refinancing of subprime into less risky mortgages.

### The Enterprises' Conditions

Status and Regulatory Action. When I arrived at OFHEO in May of 2006, we were in the process of finalizing a report on the past misadventures and misdeeds at Fannie Mae, which led to a consent agreement listing 81 areas for correction. One element of the agreement was to freeze the growth of their portfolios and another was a renewal of a requirement that they keep capital levels 30 percent higher than the minimum required by law because of their operational, accounting, systems, internal controls and risk management problems. Thus, the effective capital requirement is 3.25 percent of assets rather than the 2.5 percent required in OFHEO's statute. Both are low compared to other financial institutions.

Freddie Mac had earlier agreed to a consent agreement and the 30 percent extra capital requirement. In July of 2006, they voluntarily agreed to restrict the growth of their portfolio as well. In retrospect, those agreements and, especially, the growth restrictions and the capital requirements, were extremely important in reducing the credit losses at Fannie Mae and Freddie Mac and preventing major disruptions of the conforming loan market system.

I am pleased to report that both Enterprises have made major progress on these operational remediation efforts, which required billions of dollars and many thousands of consultants, but significant issues remain.

In OFHEO's 2007 Annual Report to Congress, both Enterprises were rated as having "significant supervisory concerns." They both published third quarter financials for the first time in over three years. The accomplishment was somewhat dampened by the \$3.5 billion of losses that they reported for the third quarter.

They have both stated that they expect to produce timely financials at the end of this month for 2007 results. Unfortunately, they expect to report significant losses for the fourth quarter.

Market Share. In 2006, Fannie Mae and Freddie Mac were losing market share to Wall Street private label MBS (PLS). There is a certain irony that one of the ways they prevented their market

share from falling even farther was that they became the biggest buyers of the AAA tranches sub-prime and Alt-A of these PLS.

The Enterprises' earlier problems, OFHEO's constraints, and the loose underwriting standards in the market made it hard for them to compete. Some observers even suggested that, due to shrinking of market share, their support of, and therefore their risk to, the mortgage market were no longer relevant.

In the last half of 2007, the PLS world shrunk to minimal levels as a result of a long list of well reported problems (Chart 3). As a result, even with the OFHEO constraints, Fannie Mae and Freddie Mac mortgage purchases as a share of new originations grew to unforeseen levels, rising from less than 38 percent in 2006 to over 60 percent in the third quarter of 2007. The just reported fourth quarter results of 75.6 percent are double 2006's market share. If you add in the net increase in outstanding FHLBank advances, especially in the third quarter, the combined market share of the housing GSEs may be 90 percent.

Credit Risk. Another related change over the period was the growth of credit risk. Operational risk and to a lesser extent market risk had been the key focuses of the Enterprises and they still are extremely important with the volatility of the markets and heavy reliance on models for market and credit risk pricing. I remember listing credit risk concerns in an early presentation I did to one of their Boards. Some members were mystified that I thought it was an issue given their track record. I am afraid that was a sign of the times.

The Enterprises were then reporting credit losses of 1 to 2 basis points, a third of normal levels and now they are approaching double normal levels and climbing. Some of this growth in losses was because they lowered underwriting standards in late 2005, 2006, and the first half of 2007 by buying more non-traditional mortgages to retain market share and compete in the affordable market. They also have very large counterparty risks including seller/servicers, mortgage insurers, bond insurers and derivative issuers.

Basis points sound small, but they become important when you are leveraged the way Fannie Mae and Freddie Mac are, as seen in Chart 4. This graph shows the gross mortgage exposure of the Enterprises' combined guaranteed MBS and mortgage portfolios relative to their capital, measured two ways. The statutory core capital is shareholder's equity excluding Accumulated Other Comprehensive Income (AOCI), which is primarily marking their Available for Sale portfolios to market. As AOCI is a large negative number, core capital is significantly higher than shareholder's equity, especially at Freddie Mac, which also has losses on some old closed hedges in AOCI. Their leverage increased in the first nine months of 2007, with Fannie Mae's at 66 times core capital and Freddie Mac's at 58 times core capital as of September 30th. Fair value capital is calculated by marking all on- and off-balance assets and liabilities to market. Measured this way, each Enterprise's leverage increased dramatically in the first nine months of 2007, exceeding 80 times their fair value of equity as of September 30th. Or if you look at it the other way around, there is only 1.2 percent of equity backing their mortgage exposure.

For the first three quarters of 2007, they have each lost \$8 to \$9 billion in fair value of equity. Their combined fair value equity at the end of the third quarter was \$58 billion compared to \$5.1 trillion in mortgage exposure. I should hasten to add in the fourth quarter they raised almost \$14 billion in equity in the form of perpetual preferred stock and cut their dividends as well. That addi-

tional capital is critical as both CEOs recently said at a Wall Street conference, they are going to have very tough fourth quarters and 2008s.

In short, deterioration in the housing and credit markets, along with substantial declines in interest rates that negatively affected the market value of their derivatives, will result in both Enterprises reporting net GAAP losses for the year. Very importantly, they did fulfill their critical mission of providing liquidity and stability to the conforming loan mortgage market. In doing so, however, the systemic risk of the secondary mortgage market has become more concentrated in the housing GSEs, especially Fannie Mae and Freddie Mac.

#### Conforming Loan Limit Increase

Now, I will turn to the temporary increase in the Conforming Loan Limit (CLL) as proposed in the Economic Stimulus package. OFHEO believes any increase in the CLL should be coupled with quick enactment of comprehensive GSE reform. The CLL provision in the stimulus package would increase the Enterprises risks by allowing them to enter the "jumbo" loan market. It would increase the maximum size loan those GSEs could purchase or guarantee from \$417,000, to the lower of 125 percent of median area prices or \$730,000, for mortgages originated between July 1, 2007 and December 31, 2008. This change should help lower interest rates on some jumbo mortgages, but other potential implications deserve attention.

Jumbo loans would present new risks to the already challenged GSEs. The prepayment and credit risks are different than those of conforming loans. The provision also pushes the GSEs to increase their geographic concentration in some of the riskiest real estate markets. Roughly half of all jumbos are in California. Underwriting them successfully will require new models and systems to ensure safe and sound implementation. Capital also would present challenges even if all newly conforming mortgages are securitized. A \$600,000 loan requires as much capital as three \$200,000 loans.

Tying the new limits to FHA limits will likely result in a large number of different loan limits across the country, requiring additional operational challenges. That could delay lender participation, especially for non-FHA lenders. Like the GSEs, they may have to reprogram and adjust their guidelines and agreements to account for a large number of different local loan limits.. All that being said, OFHEO promises to work closely with Fannie Mae and Freddie Mac to ensure that an increase is implemented quickly, and as safely and soundly as possible.

#### Critical Need for GSE Reform

The key question is whether Fannie Mae and Freddie Mac will be able to continue to support the conforming mortgage market in a safe and sound manner while assuming additional responsibilities in the subprime and jumbo markets.

My answer as the safety and soundness regulator is yes, but only if Congress passes comprehensive GSE reform.

#### Why is GSE reform so critical now?

-- As never before the Enterprises and FHLBanks have become the backbone of the mortgage market in very troubling times. They were created for this kind of market. They need to provide liquidity to the mortgage market today and in the future.



-- We need to maintain confidence in the GSEs and their capital position, especially with the holders of their \$6.3 trillion of securities, both foreign and domestic.

-- We need to start to rebuild confidence in the housing and mortgage markets. The conforming loan market continues to perform well, but Fannie Mae and Freddie Mac are now being asked to expand their missions by providing liquidity in the subprime world and temporarily in the jumbo market. We have encouraged the Enterprises to increase subprime rescue mortgages, but we must ensure that they have the capital, models and systems to take on the additional subprime and jumbo risks.

-- Their large losses, growing credit and market risks, model risks, sheer size and market share requires a stronger regulatory framework to reduce the potential for risks to the financial and mortgage markets.

To achieve those goals we need a stronger, single and unified regulator for the housing GSEs. That regulator needs to have all the powers of the bank regulators and more given the Enterprises size, systemic importance, and GSE status. Capital is king in this market. The regulator also has to ensure that they stay focused on their mission of supporting the housing markets, especially affordable housing.

When normal financial institutions get into trouble, the rating agencies downgrade them and the cost of their debt goes up. Fear of such a negative sequence incents them to restrain their risks. However, even during the periods when the Enterprises could not put out financial statements for several years, they were rated AAA. In fact, their debt sells better than AAA paper. Without debt market discipline, there is limited offset to shareholders' pressures to grow. When present, debt market discipline helps to ensure that growth is safe. We need a stronger regulator as a substitute for that lack of debt market discipline. Elements of GSE Reform

Let me now speak briefly to components of comprehensive GSE reform. First, as in the House-passed bill, GSE reform should create a single, unified and independent GSE regulator. This combination would strengthen the GSE regulators, OFHEO and the Federal Housing Finance Board (FHFB). Comprehensive GSE reform would also transfer HUD's mission and new product authority to the new regulator. Comptroller General David Walker testified before this Committee in April 2005: ". . . A single housing GSE regulator could be more independent, objective, efficient and effective than separate regulatory bodies and could be more prominent than either one. We believe that valuable synergies could be achieved and expertise in evaluating GSE risk management could be shared more easily within one agency."

Unlike any other financial regulator, OFHEO is lacking mission and new product authority. That can lead to tensions as there is often a trade-off between mission and safety and soundness. Mission can push you too far to take too many risks and safety and soundness can pull you back. What needs to be done is that significant new products and programs must be evaluated on a balanced basis at one time through both mission and safety and soundness lenses, before they are launched.

There is a strong consensus, including from the Enterprises, that the new regulator needs bank regulator-like powers. Bank regulators have receivership authority which can provide more market discipline and certainty in uncertain markets. We only have conservatorship authority. Another component is stronger independence and that means independent litigation and budget authority.

We are very actively engaged in litigation in the federal courts related to Fannie Mae's past problems and reliance on the Justice Department makes for a cumbersome process.

We have this strange budget mixture where we are funded by Freddie Mac and Fannie Mae, but yet we are appropriated by Congress as if we were funded by taxpayers. In only two of our fifteen years has OFHEO known how much money we had to spend when the year started. Uncertain funding levels and the resulting under-staffing is not the way to run a regulator.

Most critically, OFHEO needs the flexibility to adjust capital requirements. The statutory minimum capital requirements for on-balance sheet assets are too low at two and half percent. While I do not know if the thirty percent increase is the right level, I do know we need more flexibility to regulate minimum capital. I also know our risk-based capital (RBC) requirement is just not working, as it has yet to capture the risks we are currently observing. The problem was that RBC parameters were specified in law and this does not really give OFHEO the flexibility bank regulators have, which is needed to create a modern economic capital framework.

Finally, we need to ensure their focus on mission, not only mortgage market liquidity and stability, but also affordable housing. Only 30 percent of their mortgage assets in their combined retained portfolios represent funding for units that count toward HUD's affordable housing goals beyond that provided by securitization. To continue to provide stability and liquidity, market, credit and operational risks of the retained mortgage portfolios must be understood and managed. Half of their portfolios are in their own MBS. As that represents 17 percent of all their outstanding MBS, it seems excessive for liquidity purposes. The rest of their portfolios are split between mostly AAA subprime and Alt-A PLS mortgage securities and whole mortgage loans. What the new regulator needs is the ability to produce a regulation that considers the missions and risks of the Enterprises. That would give it the tools to more effectively get the job done well to ensure the Enterprises' long-term safety and soundness and mission achievement.

#### Changes that Would Enhance GSE Reform Legislation

I hope that I have conveyed to the Committee the market conditions and the status of the Enterprises that emphasize the urgency of acting upon GSE regulatory reform. It is our highest priority. OFHEO is fully committed to working with you to address any questions you may have and to provide our insights on approaches that you set forth for consideration.

Over the years, there have been many proposed GSE reform bills. I believe that the House-passed measure, H.R. 1427 is a good starting point. It is a strong, balanced and bi-partisan bill that addresses many of the key issues. I would add a few topics that would enhance a final GSE reform bill:

- Requiring an immediate effective date for legislation. Key authorities are now needed by OFHEO to address current safety and soundness issues such as the potential increase in the CLL. Immediate enactment will add to confidence in the financial markets of continuity and certainty in regulatory oversight.

- Clear guidance on portfolio limits along the lines of the House legislation but which adds consideration not only of risks to the Enterprises but to the housing markets and individuals as well.

- Assuring the new agency has discretion with respect to the critical capital levels for Fannie Mae and Freddie Mac as it does for the FHLBanks.

-- Allowing the regulator to refine the definition of core capital with notice and comment rule-making, in light of changing accounting standards.

-- Providing receivership authority with regulator discretion to select the best method of managing the receivership.

#### Conclusion

Housing is a key component to the U.S. economy, and it currently is a very troubled component. We need quick actions that will also yield long term positive effects. The GSEs have been very helpful over the last six months providing stability and liquidity to the conforming market segment, but they are stretched. We need to shore them up going forward to help restore confidence in the mortgage market. Fannie Mae and Freddie Mac face growing pressures to expand their mission and risk levels, especially into the jumbo market. We need to create a much stronger, unified regulator to support the U.S. housing finance system. I look forward to working with you Chairman Dodd, Senator Shelby and all members of this Committee towards achieving a stronger housing finance system with an empowered, unified regulator. GSE reform is critically needed now.

Thank you.

**LOAD-DATE:** February 11, 2008



# United States Senate

WASHINGTON, DC 20510

February 25, 2008

James B. Lockhart III  
Director, Office of Federal Housing Enterprise Oversight  
1700 G Street, NW  
Washington, DC 20552

Dear Director Lockhart,

In your testimony before the Senate Banking Committee on February 7, 2008, you indicated that it was your intention to ease the regulatory penalties imposed on Fannie Mae and Freddie Mac in 2006 if the companies filed current, timely and fully audited 2007 financial results. Given that both companies may fulfill the conditions set forth by OFHEO in 2006 as soon as next week, I would like to ask for further clarification on how OFHEO will respond.

As you know, the housing crisis has spread to all corners of the nation and has left virtually no community untouched. It is critical in these times that the GSEs have the flexibility and the incentive to do everything within their mandate to fulfill their critical mission. Since the restrictions imposed on Freddie and Fannie have a direct impact on their flexibility to assist the struggling housing markets, I am interested to learn, in greater detail, what steps OFHEO plans to take when the GSEs become current and timely in their financial filings.

Specifically, I would like to know if OFHEO plans to completely lift the portfolio caps immediately, or phase in a portfolio cap increase over a period of time. I would also like to know if OFHEO plans to substantially ease or eliminate the 30 percent capital surcharge. With such a stringent capital requirement, Fannie and Freddie are limited in their ability to provide the volume of financing needed in these troubled times in the market. If you have decided that you will be keeping the capital surcharge in place even after Fannie and Freddie become timely filers, I would like an explanation as to why you think upholding that restriction outweighs the importance of providing capital relief that could better position the GSEs to provide rescue products for borrowers stuck in unaffordable loans.

I look forward to hearing from you about these important matters, and appreciate your prompt attention to this important issue.

Sincerely,



Charles E. Schumer  
United States Senator



**Office of Federal Housing Enterprise Oversight  
(OFHEO)**

**STATEMENT**

**Contact** Corinne Russell (202) 414-6921  
Stefanie Mullin (202) 414-6376

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**For Immediate Release**

February 27, 2008

**STATEMENT OF OFHEO DIRECTOR  
JAMES B. LOCKHART**

Fannie Mae published its timely, audited financial statement for 2007 today and Freddie Mac anticipates publishing its statement tomorrow. These steps constitute an important milestone in remediation of their respective operational and control weaknesses that led to multi-year periods when neither company released timely, audited financial statements.

Both companies have been operating under regulatory restrictions stemming from these past problems. These restrictions include growth limits on their retained mortgage portfolios, Consent Orders prescribing necessary remediation actions, and required 30 percent capital cushions above the statutory minimum capital requirements.

*Mortgage Portfolio Growth Caps*

In recognition of the progress being made by both companies, as indicated by the timely release of their 2007 audited financial statements, and consistent with the terms of the relevant agreements, OFHEO will remove the portfolio growth caps for both companies on March 1, 2008.

*Consent Orders*

Both companies have also made substantial progress with respect to completing the requirements of their respective Consent Orders. As each Enterprise nears completion, OFHEO is working with them to undertake a thorough review and validation of the completed work and will test the new systems and controls, as needed. To the extent that OFHEO finds the Enterprise has fulfilled the requirements of its Consent Order and the Enterprise has continued to file timely, audited financial statements, OFHEO will lift the Consent Order.

Fannie Mae has reported to us that its remediation activities under the Consent Order are nearing completion. Freddie Mac has completed most of the requirements under its Consent Order, but still faces the requirement of separating the CEO and Chairman position. Although not in the Consent Order, completion of the SEC

registration process is a critical step.

*OFHEO-Directed Capital Requirements*

Since agreements reached in early 2004, OFHEO has had an ongoing requirement on each Enterprise to maintain a capital level at least 30 percent above the statutory minimum capital requirement because of the financial and operational uncertainties associated with their past problems. In retrospect, this OFHEO-directed capital requirement, coupled with their large preferred stock offerings means that they are in a much better capital position to deal with today's difficult and volatile market conditions and their significant losses.

As each Enterprise nears the lifting of its Consent Order, OFHEO will discuss with its management the gradual decreasing of the current 30 percent OFHEO-directed capital requirement. The approach and timing of this decrease will also include consideration of the financial condition of the company, its overall risk profile, and current market conditions. It will also include consideration of the importance of the Enterprises remaining soundly capitalized to fulfill their important public purpose and the recent temporary expansion of their mission.

###

*OFHEO's mission is to promote housing and a strong national housing finance system by ensuring the safety and soundness of Fannie Mae and Freddie Mac.*

**From:** [Norton, Jeremiah](#)  
**To:** [Steel, Robert](#);  
**Subject:** Re: In-Depth Analysis: GSE Update: 4Q Earnings Reflect Further Credit Deterioration  
**Date:** Thursday, February 28, 2008 5:24:26 PM

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Thx

----- Original Message -----

From: Steel, Robert  
To: Norton, Jeremiah  
Sent: Thu Feb 28 17:23:55 2008  
Subject: FW: In-Depth Analysis: GSE Update: 4Q Earnings Reflect Further Credit Deterioration

fyi

-----Original Message-----

From: [Alejandro.LaTorre@ny.frb.org](mailto:Alejandro.LaTorre@ny.frb.org) [<mailto:Alejandro.LaTorre@ny.frb.org>]  
Sent: Thursday, February 28, 2008 4:49 PM  
To: [Alejandro.LaTorre@ny.frb.org](mailto:Alejandro.LaTorre@ny.frb.org)  
Subject: In-Depth Analysis: GSE Update: 4Q Earnings Reflect Further Credit Deterioration

Fannie Mae and Freddie Mac reported larger-than-expected 4Q07 net losses, largely reflecting on-going weakness in the housing sector and the deterioration in prime mortgage credit. Despite these larger-than-expected net losses, market participants do not expect Fannie or Freddie to resort to additional capital raising activity since they both maintain adequate levels of surplus capital. The earnings news was largely overshadowed by OFHEO's announced removal of Fannie and Freddie's portfolio growth caps which will allow the GSEs to resume their purchases of mortgage-related securities. As such, conditions in the MBS market, which have been strained in recent weeks, improved modestly. However, OFHEO's 30 percent capital surcharge requirement still remains a major binding constraint to portfolio growth. Although credit losses and additional provisioning thus far have largely been a reflection of a deterioration in prime mortgage credit, internal FRBNY analysis suggests that a sharper decline in the housing environment could result in large, cumulative losses from Fannie and Freddie's subprime and Alt-A exposures.

For additional information, please see the following report by Warren Hrung, Michael Holscher, Eric Stein and Wendy Wong:

For FRB Readers:

<https://marketsource.ny.frb.org/report1/smbwxw022808.html>

For other market updates, economic data and in depth reports, please visit the MarketSOURCE homepage:

<https://marketsource.ny.frb.org/index.html>

For Treasury Readers:

<https://www.federalreserve.org/marketsource/report1/smbwxw022808.html>

For other market updates, economic data and in depth reports, please visit the MarketSOURCE homepage:

<https://www.federalreserve.org/marketsource/>

**From:** Michael Nelson  
**To:** maria.fiol@ofheo.gov;  
**cc:** Millman, Phillip; Ryan, Tony; Steel, Robert; Nason, David; roger.cole@frb.gov;  
**Subject:** From DBRS  
**Date:** Monday, March 03, 2008 12:33:23 PM

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Maria,

It was a pleasure speaking with you today.

As I mentioned, I manage the U.S. structured finance group at Dominion Bond Rating Service (DBRS.) At Phillip Millman's invitation, we visited OFHEO in June of 2005, not only providing our model of the U.S. mortgage market, but also providing commentary and a prospective view of the market, including the impending liquidity and credit crises. I believe that OFHEO saw value in our analysis and our prospective opinions, appreciating our directness and our honesty.

Since then, during such turbulent times we have strived to retain our position as the most respected rating agency. In meetings with regulators, including the SEC, Treasury, etc. we have made clear our vision of providing both the most insightful credit assessments and appropriate ratings. With fewer legacy issues, the market has embraced our independent analyses.

We have become increasingly concerned with the level of credit risk at the GSEs. In fact, I quote from my recent e-mail to Under Secretary Steel, Assistant Secretary Ryan and Assistant Secretary Nason:

**'We have spent a significant amount of time with market participants discussing the state of affairs. It is clear that the market is looking for a path towards the future. As we discussed previously, we believe that we can assist in providing a path.**

**Such a path, however, is not just about rating agency transparency. It is about commitment to credibility and leadership.**

**In that light, we have become increasingly concerned about the "new risks to the already challenged GSEs", as indicated by OFHEO director James Lockhart. With the increase in their loan limits, coupled with existing credit and risk management issues, we agree with Director Lockhart's concerns.**

**We believe that leadership for the mortgage market includes independent assessment and analysis of the credit and risk profile of the GSEs. We plan to express that opinion to OFHEO as well as directly to the GSEs and the Fed.'**

We have begun discussions with the GSEs towards providing independent credit and risk analyses and opinions. When would Director Lockhart be available to speak with us regarding this process?

Thank you for your assistance.

Best wishes,

Michael Nelson

Michael Nelson  
Managing Director  
U.S. Structured Finance  
DBRS  
100 Broadway, 15th Floor  
New York, NY 10007-1911  
TEL: +1 212 806 1210  
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**From:** Michael A.J. Farrell  
**To:** Steel, Robert;  
**cc:** Scogin, Matthew;  
**Date:** Thursday, March 06, 2008 12:47:11 PM

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Bob,

Good to see you this week. I appreciated your time, the frank exchange of perspectives, and the opportunity to provide our trench's eye-view of the credit-markets. Like you, we believe that we are nearing a tipping point. What started as a problem with mortgage borrowers and foreclosures has spread to the broader credit markets—the lack of transparency on pricing for virtually every asset class, the tight credit conditions, the dearth of buyers, the extended balance sheets of banks and dealers, the very real prospect for massive, margin-call-induced asset sales as haircuts get ratcheted up and market values get ratcheted down.

Can Fannie Mae and Freddie Mac be part of the solution? I think the answer is yes, so long as Treasury and OFHEO are comfortable with the prospective change in their risk profile. Generally speaking, any incremental liquidity in the market would be welcome, and the potential size of that increment could be meaningful to the conforming and the jumbo market, as well as helping to relieve some of the pressure on stuffed balance sheets. Removing the 30% capital surcharge and expanding the conforming loan limit—within the context of GSE reform and possible additional capital raises—would certainly make it possible for the Agencies to serve the markets in this purpose. We believe that the Agencies themselves would highly value the reduction/removal of the 30% capital surcharge, but putting that capital (and any additional capital) to work may not be viewed with the same common purpose: From where we sit, Treasury's objective in this operation would be to help stabilize the financial markets; while the Agencies' objective should be to fulfill their Charters, they may be more focused on the prospective return on invested capital. They may believe that the return on invested capital is insufficient for their shareholders, particularly because the mere announcement of lifting the surcharge could result in market front-running.

Clearly, they will have to get past that, and focus on fulfilling their Charters. But they could have a point as far as the use of capital goes. Perhaps the reduction in the capital surcharge could come with conditions on the use of that capital and conditions for requiring additional capital, **but also** give the Agencies the ability to extinguish capital (through buybacks, dividends, etc.) once the crisis has passed. From where I sit, the big picture is that right now whatever is best for the economy and the financial security of America trumps the ROI for Fannie and Freddie shareholders. In FedSpeak this



could be expressed that the "balance of risks" between returns to shareholders and serving the nation are currently tilted towards serving the nation.

In any event, you had asked us to come up with ideas on how to measure the success of this operation. We would suggest three (we can provide backup and Bloomberg tickers if you'd like):

- First, there should be a meaningful reduction in the spread between jumbo mortgage rates and conforming mortgage rates: From June 1998 to June 2007, this spread averaged 44.6 bp. From July 2, 2007 to March 5, 2008, this spread averaged 96.7 bp and currently stands at 109 basis points.
- Second, we would look at mortgage spreads to Treasuries. The current coupon mortgage is currently about 207 bp wide to the 10-year Treasury. These spreads are as wide as I've seen them since the post-LTCM blow-out.
- Third, watch the health of the MBS Dollar Roll market. Like the repurchase market, the Dollar Roll market is an important mechanism by which the financing of Agency MBS occurs and thus plays a critical part in the liquidity of Agency MBS. A Dollar Roll is somewhat comparable to a repurchase transaction, but a major difference is that the party borrowing securities and lending cash does not have to return the same securities, but instead return "substantially similar" securities. Nevertheless, the Dollar Roll market provides investors an avenue to finance their Agency MBS holdings at attractive rates, and also gives the dealer community an important source of liquidity. In fact, one of the main reasons Agency MBS have become one of the world's most liquid instruments is because of the Dollar Roll. This is why we consider it to be a critical measure of the "health" of the Agency mortgage market. Currently this "health" measure shows the Agency MBS market running a high fever. Not only is it more expensive to finance Fannie and Freddie paper versus Fed Funds, but also versus Ginnie Mae. First, the spread between the implied financing rate in the GSE Agency MBS Dollar Roll market and the expected overnight Fed Funds rate is around 75 bps. The average over the last two years for this spread has been closer to 30 bps. Second, the spread between the implied financing rate for GNMA MBS vs GSE Agency MBS is also elevated, currently standing at 106 bps vs an average of about 30 bps over the last 2 years. (This puts the implied financing rate of GNMA MBS about 30 bp below expected Fed Funds.)

Fannie and Freddie could be part of the solution, but there are other tactics that could help. Principal reduction, interest rate-freezes and foreclosure moratoriums certainly help the borrower a little bit but, we believe, larger and more permanent liquidity injections or capital preservation techniques would be more important to fixing the market's broadly-based problems. Suspending certain mark-to-market provisions, utilizing pools such as the Exchange Stabilization Fund to hold assets, conducting coupon passes against Agency debentures or MBS or even non-Agency or corporate securities.

Bob, I hope I'm not being too presumptuous by passing along these thoughts, as you've undoubtedly already considered them. My only interest is in sharing with you the sense of urgency that we and other market participants are feeling right now. I hope that we can continue to serve as source of market color and ideas as you direct the financial markets through the current situation.

Best,

Mike

**From:** Levin, Robert J <robert\_levin@fanniemae.com>  
**Sent:** Friday, March 7, 2008 7:45 AM  
**To:** Mudd, Daniel H <daniel\_h\_mudd@fanniemae.com>  
**Subject:** RE: Re: Update..

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You too. Be safe.

This e-mail and its attachments are confidential and solely for the intended addressee(s). Do not share or use them without Fannie Mae's approval. If received in error, contact the sender and delete them.

-----Original Message-----

From: Mudd, Daniel H  
Sent: Friday, March 07, 2008 7:14 AM  
To: Levin, Robert J  
Subject: FW: Re: Update..

It's a time game...whether they need us more, sooner to show admin action, or if we hit the capital wall first. Be cool.

Daniel Mudd

-----Original Message-----

From: Robert.Steel@do.treas.gov [mailto:Robert.Steel@do.treas.gov]  
Sent: Friday, March 07, 2008 07:10 AM Eastern Standard Time  
To: Mudd, Daniel H  
Subject: Re: Re: Update..

Hear you.. Not sure we can get as much capital relief without legislation. I really believe that this is the right political way to get the legislation done... We'll see and I will keep you posted.

----- Original Message -----

From: Mudd, Daniel H <daniel\_h\_mudd@fanniemae.com>  
To: Steel, Robert  
Cc: Levin, Robert J <robert\_levin@fanniemae.com>  
Sent: Fri Mar 07 07:03:05 2008  
Subject: RE: Re: Update..

I suspect the "we raise capital/ 30pct comes off" is the easier trade. Positions on legislation are clear on both sides, and as per our meeting in "the furnace" can be worked out. This regulator with unrestricted capital authority will, as ever, be the sticking point. It would be great for the markets, the government and the companies to link arms and get it done. I'll call. Best Dan

Daniel Mudd

-----Original Message-----

From: Robert.Steel@do.treas.gov [mailto:Robert.Steel@do.treas.gov]  
Sent: Friday, March 07, 2008 06:39 AM Eastern Standard Time  
To: Mudd, Daniel H  
Subject: Re: Update..

No problemo...

Sounds like we are on the same page...I will keep working here. Have had encouraging conversations with Shelby, Frank and hopefully seeing Dodd on Monday.

I have not yet reached out to Syron but will soon and will keep you posted. If I need anything I will call Rob.

Travel safely.

Bob

----- Original Message -----

From: Mudd, Daniel H <daniel\_h\_mudd@fanniemae.com>

To: Steel, Robert

Cc: Levin, Robert J <robert\_levin@fanniemae.com>

Sent: Fri Mar 07 05:35:41 2008

Subject: RE: Update..

Bob: I am also getting positive resonance on the idea we discussed...and based on yesterday, the market could use some love. I am on a plane from Amsterdam to Hong Kong at 7am your time. Rob Levin, my #2, is fully briefed in case we don't connect before I take off...he can also fill you in on some market perspective...in any case if I miss you today, I will call you after arriving. You may also want to consider if you want me to speak to Dick Syron. Hang in there, Dan

Daniel Mudd

-----Original Message-----

From: Robert.Steel@do.treas.gov [mailto:Robert.Steel@do.treas.gov]

Sent: Thursday, March 06, 2008 11:11 PM Eastern Standard Time

To: Mudd, Daniel H

Subject: Update..

Hi Dan..

Hope your trip is going well...messy day in the mkts today.

We are making some progress on the things we discussef before you took off.

If you want to speak tomorrow or over the weekend just shoot me a message or call. I am around all weekend.

Travel well.

Bob

**From:** Lockhart, James  
**To:** Steel, Robert  
**Subject:** Re: A couple of quick updates....  
**Date:** Saturday, March 08, 2008 3:56:27 PM

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Good. I talked with Shelby on Thursday. He seemed to have moved back from last conversation where he said compromise necessary. He went back to old language of no reform is better than weak. I asked him what is too weak about House bill and he said talk with his staff. On the other hand I think he understands the seriousness of the situation.

Also talked with Schummer and he is ready to move on Houes bill, he says. He suggested Administration host a meeting with Dodd, Shelby, him and other Senators. It may be time for that. I think the staffs are fighting the last war. Despite what Dodd told me the Dems are still talking Sarbannes substitute It is getting bad out there. Strangely, Freddie board blamed me on Friday not their numbers or management.

Have you all thought of buying GNMA's with Social Security Trust Fund.? It is within Board's or maybe even just Secretary's powers. Certainly they have much higher yields than Treasuries. Some people have been pushing it for a long while. The only downside is that the purchase is considered an expenditure for the budget.

Although the Freddie board was against raising equity we are hearing it would be possible especially if timed with some capital relief. We are also hearing that the Enterprises might be able to do \$5 billion each in straight/cvt pfd if use of proceeds was to put on profitable business.

Jim

----- Original Message -----

**From:** Robert.Steel@ [REDACTED] <Robert.Steel@ [REDACTED]>  
**To:** Lockhart, James [REDACTED]  
**Sent:** Sat Mar 08 13:59:03 2008  
**Subject:** A couple of quick updates....

Hi Jim...

We are scheduled to see Dodd staff on Monday. I will post you after that session.

How do you think we are positioned with Shelby ?  
What should our strategy be there ?

----- Confidentiality  
Notice: The information contained in this e-mail and any attachments may

**From:** Jason Thomas  
**To:** Steel, RobertDisabled;  
**Subject:** Source document for Barron's article on FNM  
**Date:** Saturday, March 08, 2008 12:50:05 PM  
**Attachments:** [FNM Source Document for Barrons.pdf](#)

---

Attached is the document used as the sourcing for today's Barron's article on the potential collapse of Fannie Mae.

This is for your eyes only. I send it only to help inform potential internal Treasury discussions about the potential costs and benefits of nationalization.

Thank you for your discretion,

Jason Thomas

## FANNIE MAE INSOLVENCY AND ITS CONSEQUENCES

### Summary

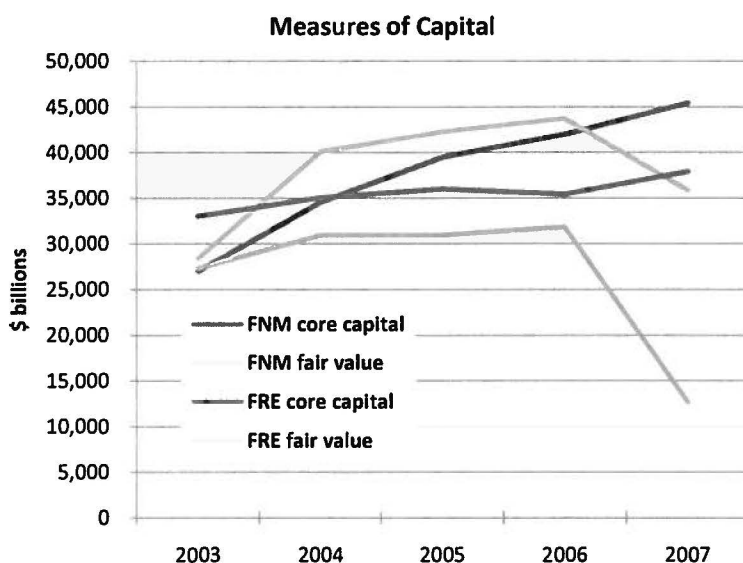
Any realistic assessment of Fannie Mae's capital position would show the company is currently insolvent. Accounting fraud has resulted in several asset categories (non-agency securities, deferred tax assets, low-income partnership investments) being overstated, while the guarantee obligation liability is understated. These accounting shenanigans add up to tens of billions of exaggerated net worth.

Yet, the impact of a tsunami of mortgage defaults has yet to run through Fannie's income statement and further annihilate its capital. Such grim results are a logical consequence of Fannie's dual mandate to serve the housing market while maximizing shareholder returns. In trying to do both, Fannie has done neither well. With shareholder capital depleted, a government seizure of the company is inevitable.

### Core Capital Overstates Fair Value

The primary regulatory capital measure for Fannie Mae is core capital. As pointed out by OFHEO director James Lockhart, "The statutory core capital is shareholder's equity excluding Accumulated Other Comprehensive Income (AOCI), which is primarily marking their Available for Sale portfolios to market. As AOCI is a large negative number, core capital is significantly higher than shareholder's equity, especially at Freddie Mac, which also has losses on some old closed hedges in AOCI."<sup>1</sup>

In addition, Lockhart notes another capital measure, fair value capital, which is calculated by marking all assets and liabilities to market. Fair value is considered by many to be a superior estimate of net worth, as it is unsullied by sometimes arbitrary accounting choices. The following chart shows the fair value and core capital of the GSEs for the past five years.



<sup>1</sup> <http://www.ofheo.gov/media/testimony/2708LockharttestimonyWeb.pdf>, p. 8

For Freddie Mac, due to old closed hedges, the fair value trailed core capital by a fairly constant amount until 2007, when the fair value plummeted. In Fannie Mae's case, the fair value actually somewhat exceeded core capital until 2007, when it likewise plummeted. Such divergences are important because it implies the market is valuing the companies' assets and liabilities significantly worse than the companies' internal accounting assumptions. The last time Fannie Mae's overstated core capital was called into question,<sup>2</sup> a detailed regulatory examination and an extensive, multi-year accounting restatement resulted.

### **Reported GAAP Equity and Fair Value Overstates Economic Reality**

While fair value is supposed to represent market-based estimates of a company's assets and liabilities, in practice, management judgment remains the primary arbiter in Fannie Mae's fair value, as well as GAAP, calculations. A careful examination of Fannie Mae's recent financial disclosures reveals several occurrences of overly optimistic figures that do not comport with the market-based results from peer financial institutions. This is accounting fraud.

In instances where applying reasonable market-based estimates would affect GAAP results, as well as fair value, reductions in GAAP earnings would directly reduce core capital. A shortfall relative to regulatory requirements would put the company at risk of seizure via regulatory conservatorship or receivership.

#### *1. Non-Agency Securities*

Since the third quarter of 2007, the market pricing for the ABX index has collapsed. This is true for all vintages and all tranches, including the senior AAA tranches, reflecting the repricing of risk for an asset class now considered toxic. This has resulted in a writedown wave striking a broad swath of the financial sector. As the Financial Times explains:

Until quite recently, many Wall Street banks tended to value their subprime linked holdings using models, because they (and their auditors) knew it was hard to get prices for these opaque instruments through real market trades. But I am told that this autumn some banks' auditors have started to crack down on this approach, particularly in the US, owing to the so-called "Enron factor."

More specifically, the experience of living through the Enron scandals earlier this decade means that the audit industry is now terrified that it could face lawsuits if it is perceived to be too lax towards its clients. So some now appear to be demanding that their banking clients reprice their mortgage assets according to the only visible market tool – namely the ABX. It is thus little wonder that some banks have suddenly been forced to increase their writedowns in recent weeks.<sup>3</sup>

In October, the Center for Audit Quality, an accounting umbrella group, released a white paper that unequivocally demanded incorporation of market data like the ABX index in subprime valuation models:

Some observers of current market conditions have asserted that market pricing is irrational, and they have suggested that entities should instead default to a model-based measurement that is based on the economic "fundamentals" of

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<sup>2</sup> "Swept Away" by Jonathan R. Laing, *Barron's*, May 17, 2004

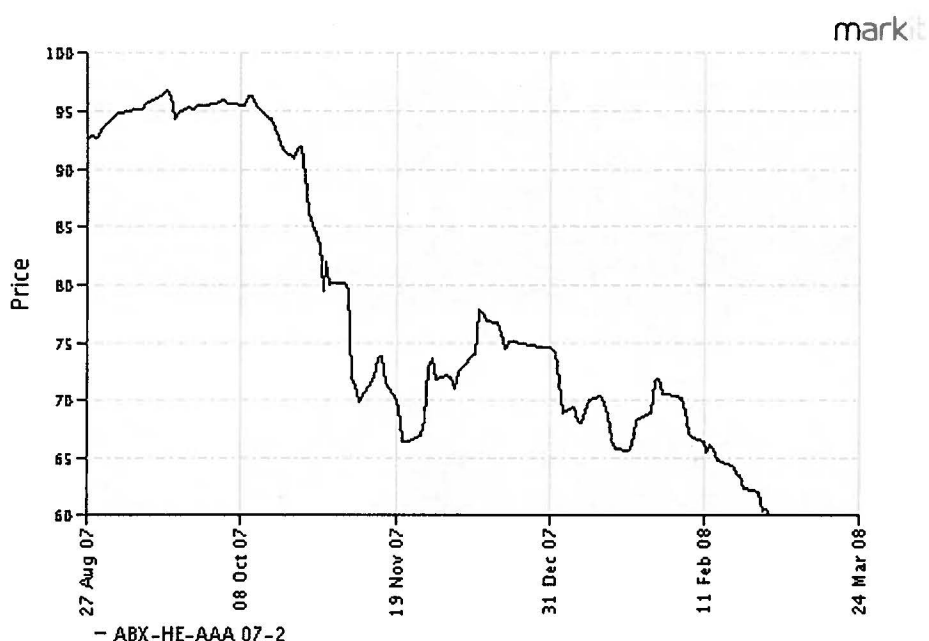
<sup>3</sup> <http://www.ft.com/cms/s/0/a942b328-889f-11dc-84c9-0000779fd2ac.html>



the asset. However, FAS 157 states that the use of an entity's own assumptions about future cash flows is compatible with an estimate of fair value, *as long as there are no contrary data indicating the marketplace participants would use different assumptions. If such data exist, the entity must adjust its assumptions to incorporate that market information...* [emphasis in original]

For example, when using a valuation model to measure the fair value of securities backed by subprime mortgages (when quoted prices are not available), assumption such as prepayment speeds, default rates and discount rates often are key inputs. To the extent that default rate assumptions can be derived from transaction prices observable for similar securities and/or credit default swaps, such data should be used. An additional adjustment, such as a liquidity adjustment, or higher discount rate, might be necessary to ensure the model reflects current market conditions. To test whether the model reflects current market conditions, the model can be applied to similar securities for which price information is available. If the model appropriately reflects current market conditions, it should produce approximately the market price. The parameters and assumptions used in those valuations should also be used, with adjustments where appropriate, to value similar securities where a market price is not currently available. Valuation models that utilize *historical* default data, or an entity's own default assumptions, rather than assumptions that marketplace participants would use, are not appropriately utilizing *market participant* assumptions, even if the default assumptions are "stressed."<sup>4</sup> [emphasis in original]

A chart displaying the fall in the on-the-run AAA tranche of the ABX index is shown below.



Financial firms have so far taken more than \$181 billion in writedowns and credit losses, with hundreds of billions more expected.<sup>5</sup> The process in determining these writedowns have hewed closely to the method described by the Center for Audit Quality white paper. For example, this is Morgan Stanley's explanation of its methodology:

<sup>4</sup> [http://www.aicpa.org/caq/download/WP\\_Measurements\\_of\\_FV\\_in\\_Illiquid\\_Markets.pdf](http://www.aicpa.org/caq/download/WP_Measurements_of_FV_in_Illiquid_Markets.pdf)

<sup>5</sup> <http://www.bloomberg.com/apps/news?pid=20670001&sid=anDZQ703DEn4>

In determining the fair value of the Firm's ABS CDO-related exposures – which represent the most senior tranches of the capital structure of subprime ABS CDOs – Morgan Stanley took into consideration observable data for relevant benchmark instruments in synthetic subprime markets. Deterioration of value in the benchmark instruments as well as the market developments referred to earlier have led to significant declines in the estimates of fair value. These declines reflect increases in implied cumulative losses across this portfolio. These loss levels are consistent with the cumulative losses implied by ABX Indices in the range between 11-19 percent. At a severity rate of 50 percent, these levels of cumulative loss imply defaults in the range of 40-50 percent of outstanding mortgages for 2005 and 2006 vintages.

In calculating the fair value of the Firm's U.S. subprime mortgage related exposures – including loans, total rate-of-return swaps, ABS bonds (including subprime residuals) and ABS CDS – Morgan Stanley took into consideration observable transactions, the continued deterioration in market conditions, as reflected by the sharp decline in the ABX Indices, and other market developments, including updated cumulative loss data. The fair value of the ABS Bonds declined significantly, which was driven by increases in implied cumulative loss rates applied to subprime residuals at levels consistent with those implied by current market indicators.<sup>6</sup>

In this discussion, there is no place for Morgan Stanley's qualitative judgment as to whether the market pricing is fair; Morgan Stanley simply incorporated market data to revalue its assets to reflect the market reality of radically increased perceived risk.

Unlike the ABX index for the subprime market, there is no comparable index for the Alt-A market. However, market data suggests the Alt-A sector is similarly distressed. Like subprime loans, Alt-A loans have recently shown sharp increases in delinquencies and expected losses. Like the subprime market, the Alt-A market has contracted, and new underwriting has all but dried up. Like subprime originations, what little Alt-A originations remain are done at considerably tighter standards and at higher rates, indicating that prior loans were substandard and must be discounted accordingly.

A November 2007 market transaction between E-Trade and Citadel demonstrates the depth of decline in the Alt-A market. Citadel purchased a book of ABS securities, with a cost basis of \$3.059 billion, for \$800 million. Included in this portfolio were \$1.355 billion of prime and Alt-A first lien mortgage securities rated AA or higher.<sup>7</sup> Even using the most generous assumptions that all the other ABS securities are worth nothing and that prime securities did not fetch more than Alt-A, the highest price one could come up with for the AA-rated Alt-A paper is 59 cents on the dollar.

More recently, in its 10-K, Thornburg Mortgage noted the latest strains in the Alt-A market:

Beginning on February 14, 2008, there was once again a sudden adverse change in mortgage market conditions in general and more specifically in the valuations of mortgage securities backed by Alt-A mortgage loan collateral. As of February 15, 2008, our Purchased ARM Assets included approximately \$2.9 billion of super senior, credit-enhanced mortgage securities, all of which are AAA-rated and backed by Alt-A mortgage collateral. Our current credit assessment of these mortgage securities in our portfolio suggests a low possibility of future downgrades and even less risk of actual losses. We have not realized any losses on these mortgage securities to date. However, we have observed deterioration in the liquidity for these securities and increased difficulty in obtaining market prices. Accordingly, market valuations of these securities have decreased between 10 and 15 percent since January 31, 2008, and as a result, we have been subject to margin calls on this collateral. Since February 14, 2008, we have met margin

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<sup>6</sup> <http://www.morganstanley.com/about/press/articles/5779.html>

<sup>7</sup> <http://www.sec.gov/Archives/edgar/data/1015780/000115752307009928/slide26.jpg>

calls in excess of \$300 million on our Reverse Repurchase Agreements, the substantial majority of which is related to the decline in valuations placed on these securities.<sup>8</sup>

Compared to the market-based experience of other financial institutions, Fannie Mae's valuation of its subprime and Alt-A securities portfolio is laughable. Fannie currently holds \$41.4 billion of subprime securities and \$32.5 billion of Alt-A securities. In 2007, Fannie took \$1.4 billion in trading losses in these securities. An additional \$3.3 billion of losses were considered temporary, so these losses were placed in AOCI, avoiding a reduction in net earnings and regulatory capital.<sup>9</sup> Even as its financial sector peers are announcing sizeable writedowns, Fannie management asserts its subprime and Alt-A securities were still worth in the 90s. These marks are not realistic, and do not represent market prices that Fannie could actual receive were it to sell its securities. This is in violation of GAAP.

Were such marks realistic, Fannie would sell these securities with slim discounts and purchase similar securities with much higher discounts, greatly enhance liquidity in the mortgage markets, in accordance with Fannie's supportive role in the mortgage markets. Such trades would also be highly remunerative. Of course, such arbitrage does not exist in reality, simply because Fannie is overvaluing its portfolio relative to the market.

#### Subprime and Alt-A Securities

	reported 2007 results					12/31/07		2/29/08	
	UPB	fair value	AOCI losses	trading losses	% of par	ABX level	additional writedowns	ABX level	additional writedowns
2007	19,306	17,775	(3)	(1,376)	92%	75%	(3,296)	60%	(6,184)
2006	30,906	28,412	(2,432)	0	92%	81%	(3,378)	68%	(7,495)
2005	9,497	9,256	(214)	0	97%	94%	(329)	91%	(616)
2004 and prior	14,201	13,665	(620)	0	96%				
total	73,910	69,108	(3,269)	(1,376)	94%		(7,002)		(14,294)

Using a methodology based on the ABX index level at 2007 year-end would yield an additional \$7 billion in writedowns. In the first quarter, the ABX index has continued to deteriorate. Using the ABX levels at the end of February would result in additional \$14.3 billion in writedowns.

Contrary to Fannie's assertions, these are permanent writedowns, not temporary. The determination of permanent writedowns, or other-than-temporary impairments, is a critical accounting policy for Fannie. Fannie asserts that it "consider[s] many factors that may involve significant judgment in assessing other-than-temporary impairment, including: the severity and duration of the impairment; recent events specific to the issuer and/or the industry to which the issuer belongs; and external credit ratings, as well as the probability that we will be able to collect all of the contractual amounts due and our ability and intent to hold the securities until recovery." This appears consistent with GAAP.

<sup>8</sup> <http://www.sec.gov/Archives/edgar/data/892535/000119312508040737/d10k.htm>, pp. 34-35

<sup>9</sup> <http://www.sec.gov/Archives/edgar/data/310522/000095013308000795/w48295e10vk.htm>, pp. 93

However, Fannie elaborates, "For securities in an unrealized loss position due to factors other than movements in interest rates, such as the widening of credit spreads, we consider whether it is probable that we will collect all of the contractual cash flows. If we believe it is probable that we will collect all of the contractual cash flows and we have the ability and intent to hold the security until recovery, we consider the impairment to be temporary. If we determine that it is not probable that we will collect all of the contractual cash flows or we do not have the ability and intent to hold the security until recovery, we consider the impairment to be other-than-temporary."<sup>10</sup> Here, it appears factors such as severity and duration of impairment, mortgage market duress, and ratings downgrades are set aside in favor of management judgment that all contractual cash flows will be collected. This approach is not GAAP-compliant.

Ignoring ratings downgrades are especially problematic, because Fannie notes, "As of February 22, 2008, the credit ratings of several subprime private-label mortgage-related securities held in our portfolio with an aggregate unpaid principal balance of \$8.4 billion as of December 31, 2007 were downgraded below AAA of which \$63 million or 0.2% of our total subprime securities had ratings below investment grade. Of the \$8.4 billion that have been downgraded, \$6.2 billion are on negative watch for further downgrade. In addition, approximately \$10.2 billion or 32% of our subprime private-label mortgage-related securities had been placed under review for possible credit downgrade or are on negative watch as of February 22, 2008."<sup>11</sup>

Fannie Mae had run into these problems before, in its optimistic valuation of its manufactured housing and aircraft lease securities. In May 2004, OFHEO forced the company to take the appropriate accounting and recognize permanent writedowns.<sup>12</sup>

## 2. *Guarantee Obligations*

Guarantee obligations represent the liabilities that the GSEs take on when they guarantee mortgage backed securities. While the GAAP accounting for guarantee obligations is complicated, the principle governing its fair value is far simpler. As Fannie explains in its 2007 10-k:

Our estimate of the fair value of the guaranty obligation is based on management's estimate of the amount that we would be required to pay a third party of similar credit standing to assume our obligation. This amount is based on market information from spot transactions, when available. In instances when such observations are not available, this amount is based on the present value of expected cash flows using management's best estimates of certain key assumptions, which include default and severity rates and a market rate of return.<sup>13</sup>

This methodology resulted in a fair value liability of \$20.5 billion at year-end 2007. In contrast, Freddie Mac calculated the fair value of its guarantee obligation to be \$26.2 billion.

Kenneth Posner of Morgan Stanley points out, "FNM's guarantee obligation (the estimated market valuation of the total losses it will pay out on its credit book) amounted to 0.74% of the credit book at

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<sup>10</sup> <http://www.sec.gov/Archives/edgar/data/310522/000095013308000795/w48295e10vk.htm>, p. 58

<sup>11</sup> [http://www.fanniemae.com/ir/pdf/sec/2008/2007\\_10K\\_investor\\_summary.pdf](http://www.fanniemae.com/ir/pdf/sec/2008/2007_10K_investor_summary.pdf), p. 26

<sup>12</sup> <http://www.ofheo.gov/media/pdf/FNMacctgattach5604.pdf>

<sup>13</sup> <http://www.sec.gov/Archives/edgar/data/310522/000095013308000795/w48295e10vk.htm>, p. F-90

year-end. For FRE, the guarantee obligation totals 1.5%. This doesn't make any sense to us, especially since FRE's portfolio has much lower delinquencies."<sup>14</sup>

When Mr. Posner asked about the difference on the Freddie Mac earnings conference call, Freddie Mac's Chief Business Officer Patricia Cook responded, "What we do when we go to the market is we go beyond just an assessment of expected default costs with maybe a modest risk premium and actually capture the risk premiums that are in the marketplace in terms of a wider spread on mortgages and mortgage-related assets as we ask dealers for a price, for a spread. So the difference between what is on—what is in our fair value balance sheet and our estimate, is that difference in risk premium, which as I said in my comments, we would expect to earn back over time."<sup>15</sup>

It is clear that the market is far less sanguine about the extent and severity of mortgage losses than the GSEs and therefore expects to be compensated accordingly for taking mortgage credit risk. While neither Fannie nor Freddie discloses the assumptions underlying their guarantee obligation fair values, Fannie is obviously not acknowledging market expectations nearly as much as Freddie.

### 3. *Deferred Tax Assets*

Deferred tax assets (DTA) represent tax credits that can be used to offset taxes on future taxable income. Under GAAP, a corporation must determine that future profits are more likely than not to be large enough to fully utilize its DTA. Otherwise, a valuation allowance must be set up to reduce the DTA to the net realizable amount. DTA are not "tangible" assets in the sense that they could not be easily sold in liquidation or other sale.

Bank regulators do not consider DTA to be of the same quality as other balance sheet assets and raised concerns that banks would include excessive amounts of deferred tax assets in their regulatory capital. Therefore, in December 1992, the Federal Financial Institutions Examination Council recommended that bank regulators limit the amount of DTA that could be counted for regulatory purposes to the lesser of the amount expected to be realizable within one year or to 10% of regulatory capital. The Federal Reserve, FDIC, OCC, and OTS have all implemented rules to that effect. OFHEO does not have a comparable rule, but has reportedly been "looking at" the issue as far back as 2004.<sup>16</sup>

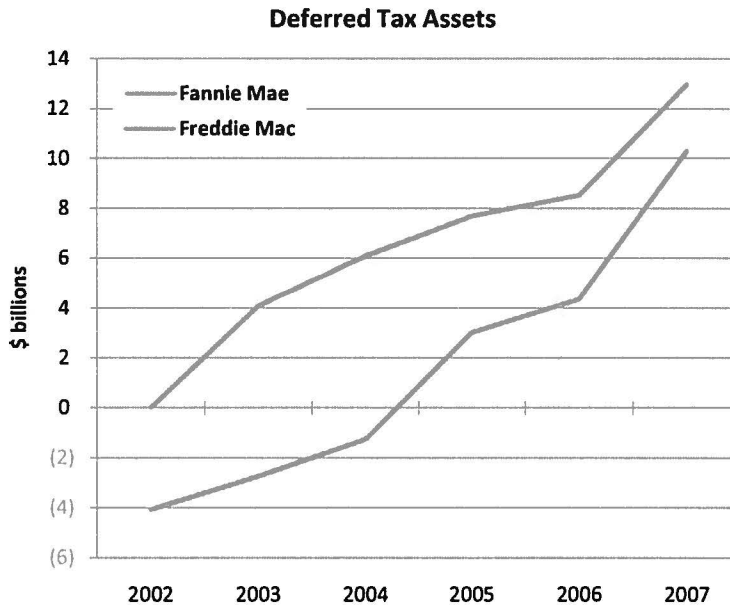
As part of its restatement, Fannie Mae reduced its DTA to zero as of 2002. However, it has since steadily climbed to reach \$13.0 billion, or 29% of core capital. Freddie Mac's \$10.3 billion of DTA is 27% of its core capital.

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<sup>14</sup> "Freddie Mac: Disappointing 4Q07 Results from FRE" by Kenneth A. Posner and Vivian(Wei) Wang, Morgan Stanley, February 28, 2008

<sup>15</sup> [http://www.freddiemac.com/investors/er/pdf/transcripts\\_022808.pdf](http://www.freddiemac.com/investors/er/pdf/transcripts_022808.pdf), pp. 8-9

<sup>16</sup> "Fannie May Face Capital Questions" by James R. Hagerty, *The Wall Street Journal*, July 26, 2004



In its form 10k for fiscal year 2004, Fannie averred, "We have not recorded a valuation allowance against our net deferred tax asset as we anticipate it is more likely than not that the results of future operations will generate sufficient taxable income to realize the entire tax benefit."<sup>17</sup> This contention is repeated in the 10ks for fiscal years 2005, 2006, and 2007 even as the DTA continues its uninterrupted upward march. To fully utilize its DTA, Fannie would need to make over \$37 billion in future profits (\$13.0 billion divided by the 35% statutory tax rate).

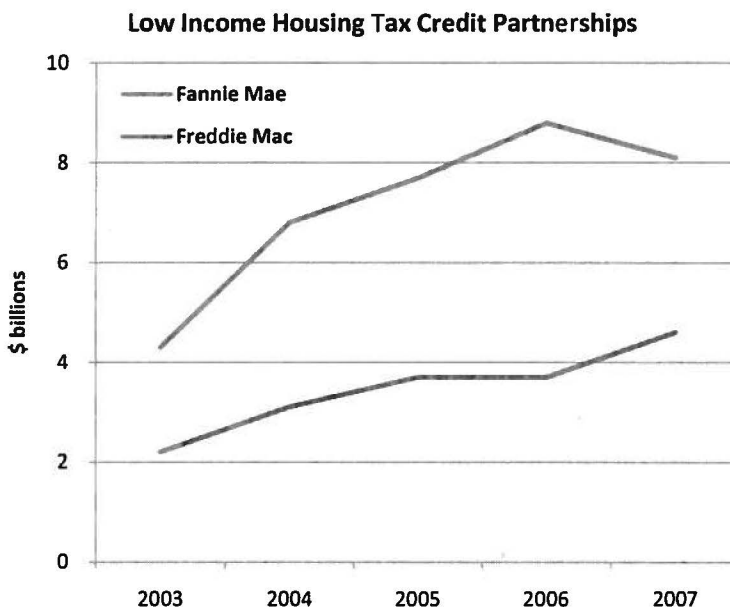
Given the inexorable five-year increase, it is clear that Fannie's past profitability has been insufficient to utilize the DTA. Despite reporting net income of over \$23 billion in 2003 to 2006, the DTA has grown from nothing to \$8.5 billion at the end of 2006. In 2007, with a net loss of \$2.1 billion, the DTA has ballooned to \$13 billion. For the foreseeable future, Fannie will likely continue to report net losses and increase its DTA. Even during the highly felicitous credit environment from 2003 to 2006, in no year was Fannie profitable enough to realize and reduce its DTA. Therefore, it is highly dubious that Fannie would ever be able to utilize its DTA, even were the current stressful credit environment to quickly dissipate. From a GAAP perspective, this requires setting up a valuation allowance against some or all of the DTA. From a regulatory perspective, irrespective of Fannie's GAAP accounting choices, OFHEO should disallow counting excess DTA as capital. Such a stance would only bring its regulatory regime in-line with other financial regulators.

#### 4. Low Income Housing Tax Credit Partnerships

DTA are not only the tax assets that Fannie Mae has on its balance sheet. Fannie also invests in low-income housing tax credit (LIHTC) partnerships. These LIHTC investments are designed to lose money, but generate tax credits and operating losses that Fannie can take deductions on. Fannie's investments

<sup>17</sup> <http://www.sec.gov/Archives/edgar/data/310522/000095013306005230/w26699e10vk.htm>, p. 118

in LIHTC have grown sharply from \$4.3 billion in 2003, to \$8.1 billion today. This comprises 18% of core capital. By comparison, Freddie Mac's \$4.6 billion LIHTC assets are 12% of its core capital.



As with the DTA, the LIHTC tax credits and deductions for Fannie are only useful inasmuch as they can be used to offset future taxable profits. Assuming a dollar-for-dollar tax benefit for the LIHTC investments, to fully exhaust all tax assets, Fannie would have to generate over \$45 billion in future profits (\$8 billion due to LIHTC and \$37 billion due to DTA). As with the DTA, Fannie's LIHTC asset continues to accumulate. The drop in 2007 reflects the sale of \$930 million in LIHTC tax credits for undisclosed amounts of cash and the assumption of capital obligations (\$676 million to Citigroup in March and \$254 to an undisclosed buyer in July). Such sales are an implicit acknowledgement that the future tax benefits are not worth the capital investments required to create them.

The remaining LIHTC investments continue to consume capital and generate operating losses for Fannie. Theoretically, the tax benefits should more than make up for the losses. However, if Fannie is not profitable, or only modestly so, such tax benefits confer no advantage. As Fannie already has a humongous DTA to offset taxable income, the LIHTC tax benefits are all the more futile.

Similar to the DTA, OFHEO should not allow LIHTC assets to count as capital. By design, these assets will waste away to zero, leaving behind worthless tax benefits that Fannie cannot possibly utilize even in the best of times.

#### **Credit Costs Will Spiral Out of Control**

Fannie Mae's unrealistic optimism about its prospects has resulted in inappropriate valuations for its non-agency securities, DTA, LIHTC assets on its GAAP and fair value balance sheets. In addition, the fair value of its guarantee obligations is unrealistically low. An appropriate valuation would reflect market



expectations of the costs of insuring Fannie Mae's \$2.9 trillion of mortgage exposure. On a GAAP basis, however, such costs are accrued over time as credit expenses and sit on the balance sheet as allowance for loan losses and reserve for guarantee losses. At 2007 year-end, these loss reserves are \$3.4 billion, or a measly 0.12% of its credit book.

These loss reserves are against serious delinquencies of 0.98% at 2007 year-end, up 51% from a year ago. Both serious delinquencies and loss reserves are expected to increase markedly for some time.

While no one knows the extent of ultimate mortgage losses, Fannie has large exposures to categories of mortgages deemed to be most troubled, Alt-A and subprime.

Fannie's Alt-A mortgage book is currently \$314 billion, with more than double the serious delinquency rate of its overall book. While only 12% of the single-family business, it constitutes 31% of its 2007 credit losses. If 12.5% of this book defaults with a loss severity of 40% (inclusive of credit enhancement), cumulative losses on this book could be 5%, or \$15.7 billion.

Fannie's subprime mortgage book is currently \$133 billion. While Fannie only designates \$8 billion as subprime, Fannie has an additional \$125 billion in loans to borrowers with FICO scores under 620. Such loans are generally considered subprime. These loans have almost five times the serious delinquency rate of the overall book. Subprime loans are 5% of the single-family business, but 20% of 2007 credit losses. If 25% of this book defaults with a loss severity of 40% (inclusive of credit enhancement), cumulative losses on this book could be 10%, or \$13.3 billion.

If the remainder of Fannie's single-family book defaults at a 4% rate with 30% loss severity (inclusive of credit enhancement), that is an additional \$25 billion in cumulative losses.

All told, losses on the \$2.5 trillion single-family mortgage book could total \$54 billion over the next few years. The actual number could be more or less depending on how the collapse of the housing market bubble plays out. If this were reserved for ratably over the next five years, annual credit expenses would be \$10.8 billion, compared to 2007 credit expenses of \$5 billion.

### **Serving Two Masters – Badly**

As a government-sponsored, privately-owned enterprise, Fannie Mae has a dual mandate to serve the housing market while maximizing shareholder returns. When asked about this at a recent conference, CEO Dan Mudd commented:

I think that your interests are best served by operating this company where the business and the mission are the same thing. So in real life, I very rarely find us debating, or find myself making tradeoffs that say, either we can do something good for the shareholders, or we can save Biloxi, Mississippi. Life doesn't actually turn out that way.

So by virtue of having our mission fully support—the mission of affordability and liquidity and stability, are actually things that we do. They are actually things that we get paid for, and they're actually things that we are structured to make a lot of money from. And I think people are perceiving through this that the more capable we are—Washington people are perceiving through this that the more capable we are, and the more successful we are, the more we can do to generate positive returns on the mission side of it.



So I've always thought that those things exist very much hand in hand, and I'm happy about it. And I think it's a good thing for you, and some years, it's a good thing for me. Other years, it's not so good.<sup>18</sup>

Notwithstanding that his compensation suggests that it is always a good year for Dan Mudd, the mortgage crisis has exposed how horribly Fannie Mae has served both its affordable housing mission and its shareholders.

In its housing mission, Fannie Mae has been an abject failure. In two of the last three years, Fannie has missed some of its HUD-mandated goals and subgoals and warns it may miss them again in 2008. Fannie actively jumped onto the subprime bandwagon when liquidity was plentiful and its participation unnecessary. Now, as the subprime sector is in desperate need of a liquidity provider of last resort, Fannie is nowhere to be found. Instead, Fannie is licking its chops at the prospect of entering the jumbo market. Fannie figures there are more profit opportunities there. Meanwhile, as mortgage availability declines, Fannie is doing its core constituency no favors by tightening underwriting standards and raising guarantee fees.

In the past, Fannie has vehemently defended its right to hold a large retained portfolio, arguing that Fannie acts as a shock absorber role in the market, providing liquidity in times of stress. Currently, mortgage spreads have widened to record levels, but Fannie has neither the ability nor the inclination to rapidly increase its retained portfolio. Instead, it is husbanding capital in preparation for the default deluge that it knows is coming.

For shareholders, the company has failed to deliver despite the inherent advantages of a lower cost of funds and having larger market share in an impenetrable duopoly. Under Franklin Raines, the company developed an appetite for growth and imprudent speculation. Such risky behavior led to large losses on interest rate bets gone bad and accounting fraud to cover them up.

After this was exposed, Fannie undertook a massive multi-year restatement under current CEO Mudd, a Raines protégé. Just as the company has finally caught up with its financial reporting, details are emerging about the tremendous increase in credit risk that the company undertook in recent years. Fannie Mae fully participated in the mortgage industry's fascination with exotic products, from subprime to Alt-A, interest only to negative amortization. What is all the more striking is that this dramatic deterioration in credit standards occurred even while the company was under the watchful eye of its regulator as it worked toward remediating its appalling business controls.

Once again, the company is faced with large losses. Once again, the Fannie Mae management team, led by Dan Mudd, Michael Williams, Robert Levin, and Peter Niculescu, all veterans of the Raines era, has resorted to accounting fraud to delay loss recognition and dance around capital requirements.

Lucrative executive compensation with no accountability to shareholders, it goes without saying, continues at Fannie Mae.

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<sup>18</sup> [http://www.fanniemae.com/media/speeches/Goldman\\_conference\\_transcript.pdf](http://www.fanniemae.com/media/speeches/Goldman_conference_transcript.pdf), pp. 28-29

### **Government Bailout Is Necessary, Likely, And Potentially Helpful**

Fannie Mae is demonstrably a failed social experiment. A realistic assessment of its balance sheet shows its net worth to be overstated by tens of billions of dollars and the company to be already insolvent. Even with all its accounting legerdemain, Fannie's losses are an accelerating horror show, with shareholders losing \$1.5 billion in 07Q3 and \$3.7 billion in 07Q4. Those losses are just the beginning.

As shareholder capital gets wiped, the government will have no choice but to seize the company and place it in conservatorship or receivership. Importantly, mortgage-backed security holders guaranteed by Fannie Mae will see no losses. The government will likely allow debt holders to fare okay, with either no or token losses, perhaps 1%.

Shareholders, both common and preferred, are likely to be left with nothing. However, these shareholder losses have already been locked in by the company's credit decisions over the past few years and cannot be helped. It must be remembered that Fannie is the biggest mortgage risk holder in the biggest mortgage crisis.

A fully government-owned guarantor of mortgage debt might be exactly what is called for given the current housing crisis. While various proposals have been floated to expand the FHA to meet this role, it has neither the infrastructure nor the expertise to address the broader mortgage market. A nationalized Fannie Mae would be refocused to directly address the various problems of illiquidity, affordability, and sustainability in the mortgage market. Without the need to satisfy a fiduciary duty to shareholders, Fannie might finally be able to perform its affordable housing mission in a helpful and proactive manner.



### The Next Government Bailout?

By Jonathan R. Laing

2207 words

10 March 2008

[Barron's](#)

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English

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It's perhaps the cruelest of ironies that in the U.S. housing market's greatest hour of need, the major entity created during the Depression to bring liquidity to housing, **Fannie Mae**, may itself soon be in need of bailout.

Fannie, of course, occupies a curious middle ground between the public and private sector as a result of its privatization in 1968 as a Government Sponsored Enterprise, or GSE. While owned by its shareholders, Fannie is regulated by a government agency and is able to borrow money cheaply, thanks to an implicit guarantee by Uncle Sam. It uses those funds to buy and securitize home loans -- lots of them. At year end, the company owned in its portfolio or had packaged and guaranteed, some \$2.8 trillion of mortgages, or 23% of all U.S. residential mortgage debt outstanding.

Of late, however, Fannie's prospects have darkened notably. The company (ticker: FNM) lost \$2.6 billion last year as a surge of red ink in the final two quarters more than wiped out a nicely profitable first half. And by late last week, credit-market jitters had penetrated the once-unassailable hushed precincts of the market in Fannie debt.

In the wake of margin calls on collateral at the investment concern Carlyle Capital, yields on guaranteed mortgage securities issued by Fannie and its GSE sibling Freddie Mac (FRE) rose to their highest level over U.S. Treasuries in 22 years. Likewise credit default swaps, measuring market concerns over the safety of Fannie corporate debt, have ballooned out to 2% of the insured amount from 0.5% just four months ago.

Company executives attribute such concerns to what Fannie CEO Daniel Mudd last month called "the toughest housing and mortgage market in a generation." He also said that much of 2007's loss came from reducing to market levels the value of derivatives that Fannie uses to hedge its interest-rate risk. And those accounting moves should reverse and fatten earnings in the fullness of time once interest rates stop dropping.

But, if the truth be known, a considerable portion of Fannie's losses also came from speculative forays into higher-yielding but riskier mortgage products like subprime, Alt-A (a category between subprime and prime in credit quality) and dicey mortgages requiring monthly payments of interest only or less. For example, Fannie's \$314 billion of Alt-A -- often called liar loans because borrowers provide little documentation -- accounted for 31.4% of the company's credit losses while making up just 11.9% of its \$2.5 trillion single-family-home credit book. Fannie was clearly looking for love -- and market share -- in some of the wrong places.

Likewise, Barron's has found other areas that may bode ill for Fannie's prospects. Its balance sheet is larded with soft assets and understated liabilities that would leave the company ill-equipped to weather a serious financial crisis. And spiraling mortgage defaults and falling home prices could bring a tsunami of credit losses over the next two years that will severely test Fannie's solvency.

Should Fannie or the similarly hobbled Freddie Mac buckle, the government would no doubt bail them out and honor their debt and mortgage guarantee obligations. Fannie common and preferred shareholders would likely suffer grievously in such a scenario.

Fannie, for its part, insists it's more than adequately capitalized to withstand any future stress. The company also contends that as a result of tightening its standards and making fewer risky loans, the quality of its book of business will improve mightily.

But some financial leaders aren't so sure. At a conference several weeks back, William Poole, president of the St. Louis Federal Reserve Bank, said that the GSEs (clearly a reference to Fannie and Freddie) appeared to be insufficiently capitalized to handle the kind of losses suffered by U.S. major banks in the past six months. "I do not have any information on the GSEs that the market does not have," he said. "Nevertheless, in assessing

the risk of further credit disruptions this year, I would put the GSEs at the top of my list of sources of potentially serious trouble."

And, in commenting on the government's "too big to fail doctrine" for financial institutions, he said: "First, firms in trouble ought not to be bailed out, unless the bailout takes a form that imposes heavy costs on managers and shareholders."

Poole has long been skeptical -- correctly it turns out -- of Fannie and Freddie's ability to serve both God (their social mission of promoting liquidity and affordability) and Mammon (the shareholder and lush management compensation). At Fannie, a generation of Democratic Party insiders, such as James Johnson, Jamie Gorelik and Franklin Raines, made substantial fortunes in Fannie's executive suite. As **Fannie Mae's** top regulator, James Lockhart, pointed out in recent congressional testimony, the absence of debt-market discipline (the government guarantee makes Fannie and Freddie all but impervious to credit downgrades) makes pell-mell growth irresistible to shareholders and managers. Have a hunch, bet a bunch.

A major scandal erupted at Fannie earlier in the millennium when the company was found to be cooking its books to hide a multibillion-dollar loss it had incurred when massive interest-rate bets went awry. Freddie got nailed at the same time for setting hedging profits aside in a cookie jar to boost results in subsequent years. Yet, the recent lending bets made by Fannie are likely to prove far more damaging.

On the surface, Fannie's balance sheet looks fine. At year end, the company reported regulatory net worth of \$45.4 billion, some \$3.9 billion higher than the expanded minimum capital of \$41.5 billion required by federal regulators. But with its extreme leverage -- assets stand at 20 times net worth -- Fannie has little room for error. And there appear to be significant problems with the way Fannie has valued both its assets and liabilities.

For example, some \$13 billion of its \$45.4 billion in net worth consists of deferred tax assets that have value only if Fannie can earn enough money in the near future (say \$36 billion) to employ them. That hardly seems likely. During the housing boom of 2002 to 2006, this tax asset only climbed -- from zero to \$8 billion as Fannie reported \$23 billion in income from 2003 to 2006.

Last year's \$2.6 billion loss compounds the problem, pushing the tax asset to \$13 billion. At a minimum, accountants may require the company to sharply write down the value of this asset, thus slashing net worth. Bank regulators, for example, limit the amount of deferred tax assets for regulatory purposes to the lesser of the amount expected to be used within one year or 10% of regulatory capital. So if Fannie were a bank, this entire asset would be wiped out. Fannie maintains the value of the asset will be realized over time.

Another soft asset is Fannie's \$8.1 billion of Lower Income Housing Tax Credit partnerships. The partnerships' only value, other than helping fulfill Fannie's housing affordability requirements, are the rich tax credits they generate from their intended operating losses. The problem is that Fannie hasn't made enough money to employ these tax credits. Thus the asset is apt to dwindle away to zero without providing Fannie any benefit. Fannie makes no predictions on the future values.

The story is much the same for the liability side of Fannie's balance sheet. There's an item called guaranty obligation, which represents the company's best estimate on what it will have to pay out to make good on any mortgage defaults in its \$2.4 trillion guaranty book. On its regular balance sheet, Fannie carries the item at \$15.4 billion, but on its "fair value" balance sheet, which attempts to mark every asset and liability to current market value, the guaranty obligations are pegged at \$20.6 billion. The problem was, as Morgan Stanley analyst Kenneth Posner discovered, Freddie went through the exact same drill with its guaranty obligations' fair value and chose to mark them much more aggressively. It valued them at 1.5% of its guaranteed book, double the 0.74% of total book that Fannie saw fit to use, even though Freddie's delinquency rate is lower than its rival's.

Had Fannie taken a similar hit, its fair-value net worth would've shrunk by some \$20 billion to a paltry \$16 billion, compared with its juiced-up regulatory capital of \$45.4 billion. Fannie stands by its estimate and says it doesn't know how Freddie arrived at its own.

Finally, Fannie seemed to have been inordinately easy on itself when, in the fourth quarter, it wrote down its \$74 billion holdings of privately packaged, non-agency subprime and Alt-A mortgage securities by a mere 6%, or \$4.6 billion. In addition, Fannie declared that only \$1.4 billion of the write-down constituted a permanent impairment, something that penalized both Fannie's profits and net worth. The remainder of the write-down was deemed a temporary mark-to-market loss that had no such negative impact.

Had Fannie charged off the remaining \$3.2 billion, that would have torched most of the \$3.9 billion in excess regulatory capital that it held at the end of the fourth quarter. Nearly all the major banks, from Merrill Lynch to UBS, have taken much larger percentage write-downs on their holdings of similar mortgage paper, and ran virtually all the losses through their income statements.

In any event, continued deterioration since year end in indexes like the ABX triple-A index indicate that Fannie, based on the different vintages it owns, should conservatively take another \$14 billion charge, according to Barron's estimates. **Fannie Mae** says that since it's a long-term investor, it should incur no permanent decrease in asset value beyond what it has recognized.

The very survival of Fannie as a going concern hinges on the size and speed of the credit losses it faces in the years ahead. Merrill Lynch's Kenneth Bruce sees Fannie suffering losses on its current book of around \$32 billion over the next decade. Yet, he still expects the company to manage recovery earnings per share of between \$2.50 to \$4 between 2009 and 2011.

His forecast, however, is based on spirited 8% average annual growth in Fannie's credit book over the decade. Although Fannie has just been cleared to deal in mortgages of up to \$700,000, from \$420,000 now, 8% growth could be hard to come by if the company's capital remains stretched.

In our view, the rapid decline in home prices and soaring level of foreclosures might cause the wave of credit losses to hit far sooner and with greater ferocity than many imagine, potentially submerging the income Fannie is expecting to harvest from volume growth and higher lending fees.

A new phenomenon of widespread negative equity -- homeowners owing more on their mortgage than the underlying property is worth -- has wrought a sea change in borrower behavior. Borrowers, whether subprime or prime, financially stretched or flush with cash, are walking brazenly from their obligations in stunning numbers.

To be sure, Fannie has a better book of mortgages than most institutions. Fannie requires a layer of credit insurance on much of its high-loan-to-value mortgages. The GSEs have long insisted on higher underwriting standards on the loans they purchase in the secondary market.

Yet using conservative default rates of 40% on its \$133 billion subprime book, 12.5% on its \$314 billion of Alt-A mortgages and 4% on its remaining \$2 trillion of prime home mortgages, Fannie could well be facing cumulative credit losses of over \$50 billion. That's after assuming Fannie will realize recoveries of 60% on its subprime and Alt-A loans and 70% on its prime loans. Should Fannie founder over the next couple of years, the government would have no choice but to step in and back all of its debt and guarantee obligations. Too much of the paper is owned by our major creditors, such as China and Japan.

Perhaps, both Fannie and Freddie can go back to the capital markets to raise more equity, as they did last fall when both sold a combined \$13 billion of preferred stock. Both have said they may take such action should circumstances demand it. But with both stocks in steep decline -- Fannie's is down 65% since last fall -- offerings would bring punishing dilution and growing investor skepticism.

Just maybe a bailout of Fannie, in effect a nationalization, would be a good thing. A retooled Fannie could pursue its important social mission without the distraction of trying to please Wall Street. Of course, it's doubtful if this happens that the shareholders would be along for the ride.

(see related letter: "Barron's Mailbag: A **Toast** to Fannie" -- Barron's March 24, 2008)

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**From:** Davis, Michele  
**To:** Steel, Robert;  
**Subject:** RE:  
**Date:** Thursday, March 13, 2008 9:38:37 AM

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Rob just called me - I have to say, I heard more panic in his voice today than I heard when he told me the Board had just made him CFO in the middle of the accounting disaster...

-----Original Message-----

**From:** Steel, Robert  
**Sent:** Thursday, March 13, 2008 9:31 AM  
**To:** Davis, Michele  
**Subject:** Re:

They are scared..... And understandably so....

----- Original Message -----


**From:** Davis, Michele  
**To:** Steel, Robert; Nason, David; Ryan, Tony  
**Sent:** Thu Mar 13 09:25:19 2008  
**Subject:** RE:

They called me last night too - to remake the point about completing the sentence "raising capital in order to support lending and business activity..."

-----Original Message-----

**From:** Steel, Robert  
**Sent:** Thursday, March 13, 2008 9:08 AM  
**To:** Nason, David; Ryan, Tony; Davis, Michele  
**Subject:** Fw:

----- Original Message -----

**From:** Levin, Robert J <robert\_levin@  
**To:** Steel, Robert  
**Sent:** Thu Mar 13 09:00:40 2008  
**Subject:**

Bob,

Hi. Today is shaping up as a rough day. Rumors of Carlyle margin calls and

dumping of \$16 billion of agency CMO's. Our spreads are already widening. I'm worried about misinterpretations, and questions being raised about F/F.

Thanks again for your help on the rhetoric issue.

Best,

Rob

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**From:** Norton, Jeremiah  
**To:** Steel, Robert; Nason, David; Ryan, Tony;  
Kashkari, Neel;  
**Subject:** Re: GSEs  
**Date:** Sunday, March 16, 2008 8:53:59 AM

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We have harden guarantee legislative language on stand-by.

Line with Treasury process is very informal -- can be executed swiftly.

Your plan on cap raise is best option

----- Original Message -----

**From:** Steel, Robert  
**To:** Nason, David; Ryan, Tony; Norton, Jeremiah; Kashkari, Neel  
**Sent:** Sun Mar 16 08:32:43 2008  
**Subject:** GSEs

As I think all of you know, we are being leaned on as part of the plan for todays series of afternoon announcements to deliver a GSE "plan".

Just to summarize, the idea would be to announce a grand bargain of capital raise and beginning of relaxation of the capital surcharge for housing GSEs. Also some ideas about "commitment" to legislation but that's a bit fuzzy. This would be done at same time as other announcements.

My three constituents are:

Mudd  
Syron  
Lockhart

I have spoken to Mudd and he is good and knows we are on a tight timetable which is cool with him. I told him noon. He expressly said Lockhart needs to ELIMINATE the negative rhetoric.

I have emailed and called Syron and waiting to hear back...I will continually follow up. My thought was to get Syron nailed down...then connect with Lockhart.

Goal should then be a conference call with Dan, Dick, Jim and Hank to finalize language early afternoon.

I was leaned on very hard by Bill Dudley to harden substantially the gty. I do not like that and it has not been part of my conversation with anyone else. I view



that as a very significant move, way above my pay grade to double the size of the US debt in one fell swoop.

That's the update... Pls feel free to share any thoughts re substance or process.

**From:** [Lockhart, James](#)  
**To:** [daniel\\_h\\_mudd@fanniemae.com](mailto:daniel_h_mudd@fanniemae.com);  
[Steel, Robert](#);  
**cc:** [dick\\_syron@freddiemac.com](mailto:dick_syron@freddiemac.com);  
**Subject:** Re: announcement draft  
**Date:** Monday, March 17, 2008 9:35:37 PM

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Does 10 work for you Dick and Bob?  
We will try to circulate a redline version before then.  
Regards,  
Jim

----- Original Message -----

From: Mudd, Daniel H <[daniel\\_h\\_mudd@fanniemae.com](mailto:daniel_h_mudd@fanniemae.com)>  
To: Lockhart, James; Robert.Steel@do.treas.gov <[Robert.Steel@do.treas.gov](mailto:Robert.Steel@do.treas.gov)>  
Cc: Dick Syron <[dick\\_syron@freddiemac.com](mailto:dick_syron@freddiemac.com)>  
Sent: Mon Mar 17 19:50:45 2008  
Subject: RE: announcement draft

10 is a better time for me.

We've made progress (in my view) in our four-cornered discussion by focusing on adding or deleting to/from the document. Director Lockhart-- might it be a starting point for the phone conversation if you took a shot at an improvement to the release? That way we could short circuit all of our varying viewpoints and focus on what we agree on? thanks to all, Dan

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From: Lockhart, James [<mailto:James.Lockhart@ofheo.gov>]  
Sent: Monday, March 17, 2008 7:28 PM  
To: Mudd, Daniel H; Robert.Steel@do.treas.gov  
Cc: Dick Syron  
Subject: RE: announcement draft

Dan & Dick,

Let's discuss in the morning. At first read it appears that OFHEO is being asked to be first, last and only with no firm commitment by you to raise capital.

The idea strikes me as perverse and I assume it would seem perverse to the markets (see for instance today's FBR report) that a regulator would agree to allow a regulatee to increase its very high mortgage credit risk leverage (not to mention increasing interest rate risk) without any new capital. We seem to have gone from 2 to 1 right through 1 to 1 to now 0 to 1.

If you really believe that 2008 business is very profitable, it is not credible that you would not raise very accretive capital to build profits and future capital. Not only would it be good for your shareholders, but it also would be good for the markets in fulfillment of your public purpose.

Does 9 or 10 work for a call tomorrow?

Regards,

Jim

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From: Mudd, Daniel H [[mailto:daniel\\_h\\_mudd@fanniemae.com](mailto:daniel_h_mudd@fanniemae.com)]  
Sent: Monday, March 17, 2008 6:23 PM  
To: Lockhart, James; Robert.Steel@do.treas.gov  
Cc: Dick Syron  
Subject: announcement draft

Gentlemen: here is a statement Dick and I hope reflects our combined intentions, and the best interest of the market. Speaking only for Fannie (though Dick probably has the same issue), I do have to disclaim that there are portions of this agreement that would be subject to the approval of my Board. As ever, thanks, Dan

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**Office of Federal Housing Enterprise Oversight  
(OFHEO)**

**NEWS RELEASE**

**Contact:** Corinne Russell (202) 414-6921  
Stefanie Mullin (202) 414-6376

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**For Immediate Release**

March 19, 2008

**OFHEO, FANNIE MAE AND FREDDIE MAC ANNOUNCE  
INITIATIVE TO INCREASE MORTGAGE MARKET  
LIQUIDITY**

**Washington, DC** - OFHEO, Fannie Mae and Freddie Mac today announced a major initiative to increase liquidity in support of the U.S. mortgage market. The initiative is expected to provide up to \$200 billion of immediate liquidity to the mortgage-backed securities market.

OFHEO estimates that Fannie Mae's and Freddie Mac's existing capabilities, combined with this new initiative and the release of the portfolio caps announced in February, should allow the GSEs to purchase or guarantee about \$2 trillion in mortgages this year. This capacity will permit them to do more in the jumbo temporary conforming market, subprime refinancing and loan modifications areas.

To support growth and further restore market liquidity, OFHEO announced that it would begin to permit a significant portion of the GSEs' 30 percent OFHEO-directed capital surplus to be invested in mortgages and MBS. As a key part of this initiative, both companies announced that they will begin the process to raise significant capital. Both companies also said they would maintain overall capital levels well in excess of requirements while the mortgage market recovers in order to ensure market confidence and fulfill their public mission.

OFHEO announced that Fannie Mae is in full compliance with its Consent Order and that Freddie Mac has one remaining requirement relating to the separation of the Chairman and CEO positions. OFHEO expects to lift these Consent Orders in the near term. In view of this progress, the public purpose of the two companies, and ongoing market conditions, OFHEO concludes that it is appropriate to reduce immediately the existing 30 percent OFHEO-directed capital requirement to a 20 percent level, and will consider further reductions in the future.

Additionally, all parties recognize the need for a world-class regulatory structure and have renewed a shared commitment to work for comprehensive GSE reform legislation.

"Fannie Mae and Freddie Mac have played a very important and beneficial role in the mortgage markets over the last year," said OFHEO Director James Lockhart. "Let me be clear – both companies have prudent cushions above the OFHEO-directed capital requirements and have increased their reserves. We believe they can play an even more positive role in providing the stability and liquidity the markets need right now. OFHEO will remain vigilant in supervising the safe and sound operations of these companies, and will act quickly to address any deficiencies that may arise. Furthermore, we recognize the need to ensure that their capital levels are strong, protecting them from unforeseen risks as the market recovers."

Fannie Mae President and Chief Executive Officer Dan Mudd said, "We are working with our customers, regulators and policy makers to minimize foreclosures, increase affordability – and as of today – to restore liquidity in the market. This progressive, sustainable plan will help bring the stability the market needs."

Freddie Mac Chairman and Chief Executive Officer Dick Syron said, "The recent environment demonstrates the benefits of the GSEs to the U.S. economy. This approach allows us to continue to create these benefits in a way that balances our mission to provide stability, liquidity, and affordability consistent with safety and soundness while enhancing the interests of shareholders."

###

Link to Lockhart statement: <http://www.fhfa.gov/webfiles/1494/31908LockhartStatement.pdf>

*OFHEO's mission is to promote housing and a strong national housing finance system by ensuring the safety and soundness of Fannie Mae and Freddie Mac.*

**\*\*\* "OFHEO Got Rolled" \*\*\***

**"There is no dilutive capital raise planned." - Freddie Mac CFO Anthony S. Pizel (3/13/08)**

The fact that the OFHEO announcement follows on the heels of only a couple of days of intensive dialogue, at the highest levels of the Administration, highlights that current concerns about the extreme fragility of the financial system are foremost in their minds. In fact, these discussions (as many of the recent actions by the Fed, Treasury and the Administration) have occurred without involvement of much of the staff and advisors that are usually involved in the Administration's decisions on GSEs. It is critical to remember however, that none of the actions have addressed the underlying problem of illiquid and unmarkable assets that continue to be stranded in the sixth level of purgatory.

To highlight the about face by various administration officials, OFHEO stated less than a month ago: "As each Enterprise nears the lifting of its Consent Order, OFHEO will discuss with its management the gradual decreasing of the current 30 percent OFHEO-directed capital requirement. The approach and timing of this decrease will also include consideration of the financial condition of the company, its overall risk profile, and current market conditions. It will also include consideration of the importance of the Enterprises remaining soundly capitalized to fulfill their important public purpose and the recent temporary expansion of their mission". We believe that OFHEO Director Lockhart took this action only after considerable pressure and likely against his best judgment. If this action results in the destabilizing of the GSEs, OFHEO will go from being the only regulator who had prevented their charges from getting into trouble to a text-book example of why regulators should be shielded from outside political pressure.

We view any reduction as a comment not on the current safety and soundness of the GSEs but on the burgeoning panic in Washington. Within the past 48-hours we have seen the Administration decide to throw out all the rules in the rulebook in an attempt to stabilize markets and reduce the risk of systemic contagion. While this approach will fuel optimism in the near-term, longer term we expect the OFHEO action and other recent actions to date to fail to achieve their goals. We also expect that the GSEs will use the extra capital to try and grow their way out of their problems by playing the spread instead of doing significantly more business in the higher credit risk markets.

In return for relief from at least a portion of the capital surplus the GSEs will be required to raise additional capital. Although the press has stated that capital would come in the form of preferred that was not stated in the OFHEO release. The GSEs have no specific regulatory limits to their preferred issuance but it has long been understood the rating

agencies have warned that if more than 25% of GSE capital was in the form of preferred they would be at risk of downgrade. Given the increasingly routine forbearance by the rating agencies it is plausible they could get away with such a capital raising approach however we think that the GSEs problems will likely increase the risk of the rating agencies downgrading the agencies only after they end up in more publicly obvious trouble.

Over the past 72 hours the Fed and the Administration have taken unprecedented steps to approach market instability. While many are viewing these actions as a positive sign, we continue to believe that they highlight that the building is shaking from the top to bottom and, unfortunately, would characterize these actions as short term positive to markets but unlikely to reverse the broader financial market problems for the medium and long term. Still, the view in the beltway is now “Desperate times call for desperate measures” even where the probability of the success of those measures cannot be estimated.

While it appears that the Administration has been rolled by the GSEs, and Democrats, we have been told that although no one is comfortable that the GSEs can ultimately manage their risks, sources tell us the Administration is of the view that if desperate measures must risk either the GSEs or FHA, the Administration would rather risk the GSEs. More than one source has suggested that with less capital than they had a year ago and higher conforming limits, if one or both of the GSEs blew themselves up the Democrats would have been responsible for refusing to pass legislation with strong receivership authorities, bright lines on new products and programs and with strong portfolio limits.

We are in an environment where rumors are rampant so it may be worth offering two cents on a couple of rumors:

First, while most regional Fed officers would not support the Fed buying up the weak mortgage paper it has been considered and largely but not fully dismissed. However, it is an action that would not be taken lightly as it would cause many on the Hill to ask on what basis the Fed has been granted the right to make such budgetary decisions of consequence to taxpayers.

Rumors that repeatedly circulate suggesting Treasury will make the GSEs implicit guarantee explicit are obviously being circulated by those without a clear understanding of authorities, any such move would take an act of congress. While such a move could ultimately happen, given the possible future financial condition of the GSEs, we believe that it would not occur until after one or both GSEs were insolvent and Congress had to make a decision on how to stabilize them. Remember, only Congress has the authority to choose to make the agencies explicit guarantees of the Federal Government.



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