A Forensic Look at the Fannie Mae Bailout: Scrubbing the Tricky Accounting of Conservatorship[1]

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As readers of interest in the GSE's are aware, the circumstances surrounding the Conservatorship on September 7, 2008 are often fuzzy with little factual data to support the vast claims of insolvency and failure of business model by various politicians and interest groups. As such, the debate rages on seven years later with little resolution in sight. We have heard many GSE investors claim that the bailout was never necessary and the Conservatorship was illegal to begin with. The purpose of this article is to attempt to prove the true financial condition of the entities at both 1) the time of Conservatorship and 2) in subsequent years leading up to the massive windfall to the US Treasury in 2013.

The first item that we need to address is: what exactly is a bailout? From our friends at Wikipedia, a Bailout is a colloquial term for "*giving financial support to a Company or Country that faces serious financial difficulty or bankruptcy*." What piqued our interest in this project is the question: "What company facing serious financial difficulty borrows 116b from 2008 to 2012, losing supposedly billions of dollars in the process, is then able to pay more than everything back in 2013 and 2014?" Wouldn't a failing company burn through all that cash that it "needed" to ensure continued operations? Let's examine what really happened using a key lesson that I was fortunate enough to learn towards the beginning of my career.

Soon after finishing grad school, I was discussing stocks with my boss, in particular the EPS of one of the companies that I had been following closely. When I stated my case for the Company's financial strength based on its seemingly robust EPS, he sarcastically rolled his eyes and laughed. Surprised by his reaction, I asked him what he thought was funny; we were having a serious conversation after all. He responded: "One day you will realize that Net Income doesn't matter. The fact is; you can make it whatever you want it to be. If you want to understand the Company, you need to follow the other side of the transaction…to the balance sheet." My career has taken me from KPMG to the private world at both financially healthy and struggling entities; all along the way, those words have critically guided my day-to-day work. As a result, I've become quite skilled in understanding the mechanics of balance sheet manipulation…and undoubtedly, Fannie Mae deserves such an analysis.

First, however, we must define two very important non cash expenses: 1) Deferred Tax Asset and 2) Loan Loss/FMV Reserves.

Per Investopedia, a Deferred Tax Asset "is created due to taxes paid or carried forward but not yet recognized in the income statement. For example, deferred tax assets can be created due to the tax authority recognizing revenue or expenses at different times than that of an accounting standard….It is important to note that a deferred tax asset will only be recognized when there is expectation of future profit." The second item, a Loan Loss/FMV Reserve, is defined as an expense set aside as an allowance for bad loans or assumption of reduction in near term fair value of an asset. As a quick example, in the

[1] For support documentation or inquiries, please contact us at gsemath08@gmail.com

case of Fannie Mae, a Loan Loss Reserve would be the expected total of *losses over its entire 30 year portfolio or alternatively, an estimate of 30 years of expected losses estimated at a single point in time*. **Please note that neither of these expenses is a use of cash.** In fact, you can find them on the Statement of Cashflows under cash flow from operations as a "source" of cash. The reason for this classification is that an increase in reserve results in a net loss…with the offset being a reduction of the corresponding asset on the balance sheet (where it stays until it is either used to write off bad loans or reversed if *subsequently* proven to be unnecessary). Finally, a related item which will come into play is valuation losses. These reflect an estimated adjustment for current market value, *independent of intention to liquidate*.

What is the function of these accounting items? In the academic world, we use reserves to quantify as accurately as possible the estimated losses on an asset or collection of assets at a point in time. The reason they are classified as non cash is simply because we haven't sold the asset and may not have any intention of selling the asset so the impairment is not realized. To that extent, the breadth and duration of a reserve is nothing more than a guesstimate. In practice, all management teams know the final number they want or need often working towards that goal. Reserves are a simple means of achieving a certain result within the reasonable confines of GAAP. Also, supportable audit evidence can always be produced due to the level of subjectivity involved.

Now that we understand the primary non cash expenses, let's move to the data.

On December 31, 2007, Fannie Mae disclosed 45.4b in core capital, a level that exceeded regulatory requirements. At the same time, Fannie Mae's net current assets were roughly 135b (or .135t …that t is for Trillion)**.** Note that cash in bank doesn't factor in at this point because there is no "liquidity crisis." Again to Investopedia, a Liquidity Crisis "is a negative financial situation characterized by lack of *Cash Flow*." Defining characteristics during a liquidity crisis are difficulty in converting non-cash current assets into cash to satisfy current liabilities (such as Accounts payable, payroll, and MBS payments to investors). When it's all said and done, Cash is the biggest defense against a liquidity crunch.

As we progress into Q1 of 2008, we'll provide a simple yet revelatory normalized "Cash" Net income figure. This takes the reported Net Loss per the 10Q disclosure and adds back/adjusts for the sizable non cash expenses that we earlier defined: the Deferred Tax Asset and Loan Loss/FMV Reserve. What the figure shows is the **Cash generated or burned by the business *exclusive of reserves that are not a use of cash and are subject to manipulation/subjectivity*.** Another way to look at this Cash Net Income figure is the *true health of the underlying business having scrubbed for the tricky accounting of conservatorship*.[2] **Net loss reported by the Company was 2.2b. This, however, is extremely misleading.** The Company took a non-cash Loan Loss expense of 2.7b. **Fannie Mae generated .5b in cash during Q1 of 2008 adjusted for non-cash items.**

As we delve into Q2 2008, we get into the heart of the media frenzy. Here we touch on the famous Hank Paulson Eton Park meeting (google Hank Paulson, Eton Park). **Interestingly enough, Fannie Mae reported a net loss of 2.3b.** As per our analysis, we must add back the non cash Loan Loss Reserve of 5.5b. After this adjustment, **Fannie Mae shows a cash net income figured of 3.2b**. **You are reading this**

[2] In 2013 and 2014, these reserves were reversed as unnecessary in the first place showing massive net income to the entity.

correctly. Fannie Mae generated roughly 3.2b in cash in Q2 of 2008, the quarter just before conservatorship. This is poor evidence of a "failing business model".

Next we transition into Q3 of 2008. As we know, the FHFA and the US Treasury took Fannie Mae into conservatorship on September 7, 2008. **Q3 of 2008 should be a financial bloodbath if everything was really as portrayed by the invading parties. Accounting net loss for the quarter was 29b.** That sounds really, really bad. Like Paula Deen for your plaque buildup bad. This, however, is where the "first" quarter of FHFA control gets interesting. Loan loss reserve for the quarter was 8.7b, but that doesn't get Fannie Mae anywhere close to positive cash generation. If we dig a little deeper, however, we see a very curious item on the financials. ***The FHFA forced Fannie to write off 21.4b of Deferred Tax Asset. To put this into perspective, the FHFA basically said that in spite of <u>80 years of profitability</u>, after controlling the operations of Fannie Mae for exactly <u>23 days</u>, we feel that it will <u>never, ever,</u> <u>return to profitability (ever) and therefore the tax benefit will not be realized</u>.*** Let that sink in for a second. This smells a bit fishy…or like a sweltering Thai fish market mid-July. Maybe the manufactured 29b loss "wow" factor was an attempt to overcompensate for the shaky legal justification for the conservatorship? We've read treasury lawyers joking about how creative they were going to have to get because they were legally on "thin ice." See Starr docket.

Back to the Q3 2008 financials or the quarter Fannie Mae was taken into conservatorship "because it might take down the global economy" (Hank, you're good you). If we take the 29b of net loss and deduct the two massive - and unnecessary as proven in later years - non cash expenses of 21.4b and 8.7b, **Fannie Mae had <u>Cash Net Income of 1.1b. That's right, Fannie Mae, in the quarter it was taken into conservatorship, generated 1.1b of cash from operations</u>.** Does that sound like a company with a death rattle in its throat, gasping for one last sweet breath? Next, lets address the obvious rebuttal. "Don't be silly, they were in the middle of a liquidity crisis and needed cash!" **As it turns out, Fannie Mae disclosed <u>36.3b of cash in bank</u> on September 30, 2008. Far more cash than they would ever need to pay operating expenses and not just for Q3, but for a long time as well. More on that one line down.**

To demonstrate how liquid or illiquid Fannie Mae truly was when it was invaded, let's take a look at its cash needs. Administrative expenses for the Quarter ending September 30, 2008 totaled 401m. Stated mortgage credit book was 3.1t. If we assume a 6% interest rate and estimate a 30 year fixed rate structure for all loans, the total monthly payment for principal plus interest is approximately 18.5b. Assuming a 10% default rate (far, far worse than what really occurred (5.59% in Feb 2010)), the total quarterly principal and interest payments would come to about 5.6b. Add this to the 400m of admin expense and we get a maximum exposure of roughly 6b per quarter. With 36.3b of cash in the bank at the end of the quarter of conservatorship, Fannie had enough liquidity to survive over 18 months, *assuming it didn't bring in another dime…which it did, lots and lots of them*. This is what we in the business refer to as "a Fortress Balance Sheet. "

"Well, the 'you know what' (s-word alert) is about to hit the fan in Q4, right?" **Net Loss reported for Q4 2008 was 25.2b**. Whoa that sounds awful, like Sharknado awful. Fortunately for us, the ones who pay attention to cash and the balance sheet, that number includes **a 28b non cash expense.** Now, this quarter is slightly more complex because only a portion of this number was for loan loss reserve. There is an additional 12.3b in disclosed fair value impairment as well as 4.6b in securities impairments. With these adjustments, **cash net income from operations was 2.8b for the quarter.** Wow, the

Conservatorship must be working! The crowd goes wild for FHFA! The disturbing trend of deception continues…

Fannie Mae *In Billions*	Dec 31 2007	Q1 08	Q2 08	Q3 08	Q4 08
Core Capital Reported	45.4	42.7	47.0	9.3	(15.2)
Core Capital Excl Non Cash Adj		45.9	49.1	50.2	53.0
Treasury Draw					
Reported Cash and Cash Equivalent		2.0	13.5	36.3	17.9
Reported Net Loss		(2.2)	(2.3)	(29.0)	(25.2)
DTA Reserve (Non Cash)				21.4	
Loan Loss Reserve (Non Cash)		2.7	5.5	8.7	28.0
Cash NI		0.5	3.2	1.1	2.8

One very important item of note, is that the US Government could have provided Fannie Mae with a line of credit for $200 Billion to stave off the perceived market instability and **they never would have had to borrow a penny**. No taxpayer bailout, no taxpayer assistance, nada.

As we transition into 2009, the next item that we need to discuss is the US Treasury's very specific and sneaky selection (alliteration be damned) of the trigger that would drive Fannie Mae's draws. There's a surreptitious reason UST chose "Net Assets" instead of cash, or fair market value, or even current or quick ratio. **Why did they select an accounting measure versus a true cash or liquidity measure to serve as the trigger?** The answer is simple given what the FHFA wrote off in Q3 with the Deferred Tax Asset…**Net Assets is by far the easiest measure to manipulate**. **With it, they can push reserves onto the balance sheet to impair assets while liabilities remain untouched.** *In effect, it gives Treasury the power to force the GSE's to take funding via aggressive reserve assumptions.* **If US Treasury picked a true cash or liquidity measure to serve as the draw trigger, none of the draws would ever have been required; you know, the ones that saddled Fannie Mae with unnecessary, undue burdens. This intentional choice of trigger is not a subtle distinction. Unfortunately, its not one that Journalists, Lawyers, or Politicians would likely pick up on (unless of course they worked for Treasury), especially during the "Bazooka" days of the crisis.**

Hank stated in his biography that he knew he had to **"ambush Fannie and Freddie." (His words)** He also **told James Lockhart, head of Fannie and Freddie's regulator (and "a friend of the President's since prep school days"): "you don't want to trigger a meltdown and ruin your friend's presidency, do you?"** Oh, and let's not forget that Hank told us that the President **"had a deep disdain for entities like Fannie and Freddie, which he saw as part of a permanent Washington elite, detached from the heartland."** You know, the kind of detachment that leads to generations of folks in the heartland having a decent shot at an affordable 30 year mortgage; the kind of detachment that steps up during downturns to bolster Main Street and the largest sector of our economy. Oh, but I digress…

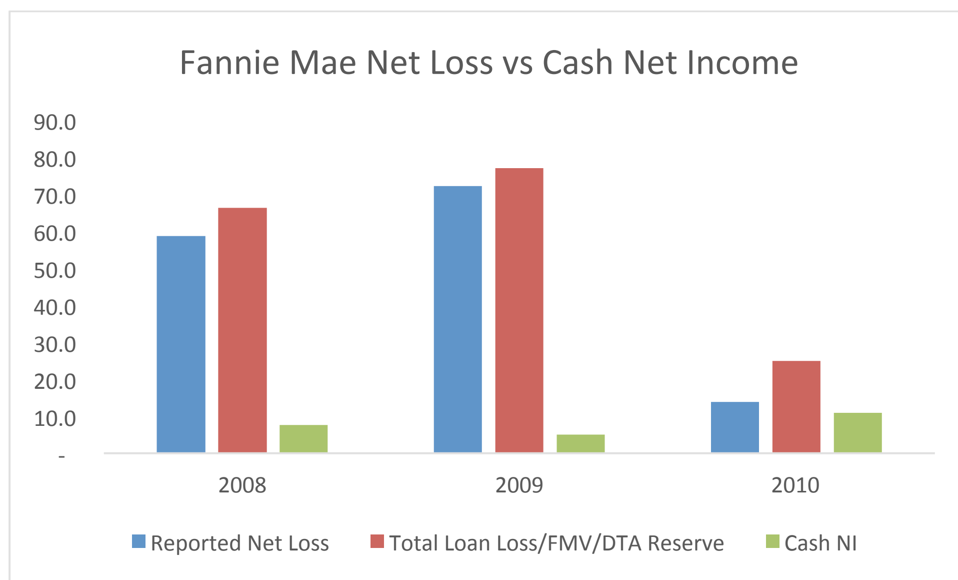
Let us again point to our introduction and the question at hand: "What company requires 116b of a bailout but then pays it back in full within a 2 year period of "returning" to profitability?" **Here is the**

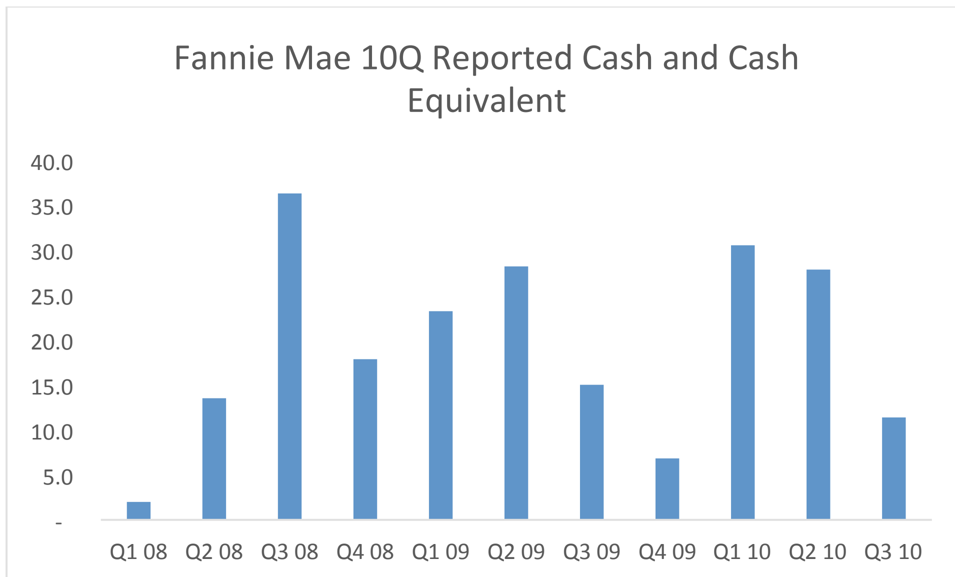
answer: One that non-cash based accounting gimmicks made it seem like it needed in the first place; in terms of operations and cash, it needed nothing.

Presented below in table form are 2009 and 2010. In 2011, the reporting method changes since they stopped disclosing the entire cash flow from operations section. Instead, they only report the net number. **Perhaps this is to hide the fact that the inflated prior reserves are now being relieved, inflating net income and potentially calling into question the massive reported losses of prior periods.**

Fannie Mae *In Billions*	2008	2009	2010
Reported Net Loss	(58.7)	(72.1)	(13.9)
DTA Reserve (Non Cash)	21.4	-	-
Loan Loss Reserve (Non Cash)	44.9	77.1	24.9
Cash NI	7.6	5.0	11.0
Treasury Draw	-	60.3	27.7

As you can see, despite massive paper accounting losses and a well-publicized burning at the stake as the witch that caused the crisis (a focus of Hank's book tour), Fannie Mae's Cash Net Income, adjusted for non cash items, remained "POSITIVE" the entire time. Fannie Mae was not only healthy, but exceptionally prepared to weather the financial crisis (again with that "Fortress Balance Sheet").





Looking at the above graph, it's obvious that Fannie Mae didn't need cash; but boy did Hank want everyone to think that it did. FHFA stated multiple times in disclosure that they were unsettled at the inability of Fannie Mae to generate capital via equity sales. This inability, however, was directly influenced by Paulson's *Eton Park meeting* (July 21, 2008), the one where he disclosed to his Hedge Fund and Goldman Sachs buddies that the companies were going to be placed into conservatorship (short selling anyone?). Further evidence of Treasury intent to unnecessarily cripple the GSE's are found in the **Federal Accounting Standards Advisory Board minutes** from its December 17-18th 2008 session. In them, **Treasury plainly states that the 10% interest rate was "punitive"** and that the **purpose of the warrants was "not to take ownership but to devalue the common stock."** That doesn't seem very ethical now does it? Put simply, this appears to be much more assassination and far less bailout.

Next, we would like to rebut the notions that the reserves were needed and that cash was burning from a different angle. For this example, let us reference the Q1 2013 earnings report. "Release of valuation allowance on deferred tax assets adds 50.6 billion to quarterly net income. Company reported net income of $58.8 Billion for the first quarter of 2013." "Based on net worth of $62.4 billion at March 31, 2013, the company's dividend obligation to the Treasury will be $59.4 billion by June 30, 2013**." For a Company that has reported a roughly 145 billion dollar accounting loss from 2008 to 2011, gone through a "massive liquidity crisis", and required 116b in cash from the Treasury, the ability to pay a $59.4 billion dividend seems impossible. Unless of course, as this analysis suggests, they never burned or needed the cash in the first place.**

Next let's address the legal ability of the FHFA to place Fannie Mae into receivership or conservatorship according to HERA. The exhibit below is taken directly from the legislation:

91. In total, HERA provided for 12 circumstances in which the FHFA could place the Companies into receivership or conservatorship:

A. if a Company's assets were insufficient to meet its obligations;

B. if a Company's assets or earnings were substantially dissipated due to unlawful conduct or unsafe or unsound practices;

C. if a Company was in an unsafe or unsound condition to transact business;

D. if a Company willfully violated a cease and desist order;

E. if a Company concealed books and records from the FHFA Director;

F. if a Company became unlikely to be able to pay its obligations or meet the demands of its creditors in the normal course of business;

G. if a Company incurred, or became likely to incur, losses that would deplete substantially all of its capital with no reasonable prospect of becoming adequately capitalized;

H. if a Company violated the law;

I. if a Company's board of directors or shareholders passed a resolution consenting to a conservatorship or receivership;

J. if a Company became undercapitalized or significantly undercapitalized, as defined by the governing statute, and could not or would not take corrective measures;

K. if a Company became critically undercapitalized, as defined by the governing statute; or

L. if a Company engaged in money laundering.

See 12 U.S.C. § 4617(a)(3)(A)-(L).

Based on this analysis, we have shown the following:

A. We have shown that liquidity was never an issue. **Based on a far-more-drastic-than-experienced scenario, Fannie Mae easily had 18 months of cash to fund operations and MBS payments assuming it didn't bring in another dime (and it brought in many, many dimes).**
B. There was clearly no unlawful conduct

C. **Fannie Mae generated positive cash net income every single quarter when adjusted for non cash reserves that are subject to manipulation.** Fannie Mae was clearly still transacting business; and quite successfully so. In addition the 2007 10k prepared by Deloitte and Touche LLP states "**In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007**, based on the criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission."
D. This item is not applicable as there was no cease and desist order
E. The company did not conceal any documentation to the FHFA, in fact as a public company they are required to disclose similar to all other public companies
F. Clearly the entity has adequate liquidity so this was not an issue
G. This item is the kicker. **Given the FHFA's write down of 20b of Deferred Tax Asset 23 days after initiating the Conservatorship (remember: never, ever, return to profitability, ever, and therefore the tax benefit won't be realized*)*, there appear to be no checks and balances as to the abuse and/or incompetence of the controlling entity. This again is most likely why net assets and item G were added to HERA as only the folks in the US Treasury would understand the significance of net assets versus a liquidity measure. The company, folks, was never undercapitalized.**
H. There have been no claims for law violation. Also see item B.
I. There was no consent as the FHFA fired all directors and seized all shareholder rights the day of the Conservatorship. **This was also perhaps to eliminate any whistleblowers who would be able to identify any of the various points in this analysis.**
J. Let me again refer you to the manipulative nature of Net Assets. Also, let me reference Paulson speaking in July to Hedge Funds opening the door to short the stock as a means of eliminating the option of generating capital through equity sales.
K. This is identical to item G and J.
L. There are no money laundering issues

In summary, the entire Conservatorship, the notion of GSE instability, and a failed model appears to have been fabricated by the US Treasury. HERA was passed by congress during a moment of weakness and panic without any or all of the congressmen and congresswomen understanding the details (fine, fine print) and how these could be manipulated. **As we have seen, Fannie Mae was able to pay back the entire amount of funding from the US Treasury because it never burned or needed the cash in the first place…as proven, strangely enough, via the Company's own disclosures.**

As a parting word, we'd like to do two things: 1) repeat some sage advice and 2) congratulate Hank. Here's the sage advice: "If you want to understand the company, you need to follow the other side of the transaction…to the balance sheet." And a congratulations to Hank on a job well done…referring to Fannie Mae, the company that the President "despised", Hank said: "We're going to move quickly and take them by surprise. The first sound they'll hear is their heads hitting the floor."[3]

[3] Quotes taken directly from Hank's "On the Brink"

A Follow up To:

A Forensic Look at the Fannie Mae Bailout: Scrubbing the Tricky Accounting of Conservatorship

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In "A Forensic Look at the Fannie Mae Bailout: Scrubbing the Tricky Accounting of Conservatorship", we addressed the question of "What company facing serious financial difficulty borrows 116b from 2008 to 2012, losing supposedly billions of dollars in the process, is able to pay more than everything back in 2013 and 2014?" We showed that by simply adjusting GAAP Net Loss for massive non cash "subjective" expenses (Deferred Tax Asset, Loan Loss Reserve, and Fair Market Value Adjustment), it's clear that Fannie Mae generated positive cashflow throughout the entire crisis…in stark contrast to current popular opinion. As further proof of the accuracy of this methodology, the very same subjective non cash expenses were reversed in 2013 and 2014, yielding a massive windfall to the US Treasury. In this follow up exercise, we dive deeper into who created **the false narrative surrounding Fannie Mae and why they did it**. Our only tools will be factual data and quotes from the related parties.

To begin this article, we need to understand the arguments that the US Government is making to defend against multiple lawsuits brought by GSE shareholders. The first argument is that the FHFA is an independent entity that is not guided or improperly influenced by the US Treasury.[4] The second is that Fannie and Freddie were insolvent and in danger of catastrophic failure at the time of conservatorship. We will address each of these.

First, let's start off with something sexy…the minutes from the Federal Accounting Standards Advisory Board (FASAB) Meeting held from December 17-18 2008 (why limit the fun to one day?). Part of this meeting centered around the accounting treatment of Fannie and Freddie's conservatorship. Unsurprisingly, there was very little accounting guidance at the time, primarily because the conservatorship was an unique animal (think un-majestic unicorn), one that differed a bit from failed banks that fell neatly within the FDIC framework. What follows is the first paragraph of the minutes:

> "Department of the **Treasury** representatives Messrs Al Runnels, Deputy CFO; James Lingebach, Director of Accounting and Internal Control; and Joel Grover, Office of the Inspector General, appeared before the Board to provide a briefing and answer questions concerning actions taken by **Treasury** in response to the Emergency Economic Stabilization Act (ESA). The **Treasury**

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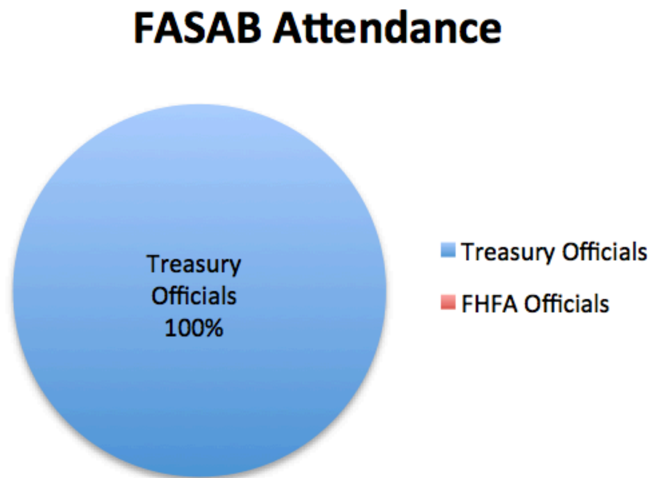
[4] Why is it so important for the government to have folks believe that FHFA acts independently? The reason is that if Treasury (or say perhaps the White House or both) guides or improperly influences FHFA, FHFA fundamentally fails to satisfy the basic elements which justify its existence. As a result of perceived lack of independence, FHFA actions would be subject to, at the very least, immense scrutiny; also, FHFA would be considered "the United States" for purposes of the Tucker Act, allowing plaintiffs to have standing and therefore sue in the Court of Federal Claims. Unsurprisingly, the government adamantly argues that FHFA "is not the United States for purposes of the Tucker Act."

personnel were accompanied by KPMG representatives Ms. Cathy Supernaw and Mr. Mark McFadden."

Please note that the **Deputy CFO at Treasury**, **the Director of Accounting and Internal Control at Treasury** and a rep from **the Office of the Inspector General at Treasury** all appeared and spoke at length. Did anyone from FHFA attend, you know the ones who supposedly call the shots? The answer is a resounding no. See graph below.



As a quick aside, what the heck is the FASAB anyway? Is it something significant? According to FASAB, it "**serves the public interest** by improving **federal financial reporting** through issuing **federal financial accounting standards** and **providing guidance** after considering the needs of **external and internal users of federal financial information**." It continues with: "Financial reports, which include financial statements prepared in conformity with generally accepted accounting principles, **are essential for public accountability and for an efficient and effective functioning of our democratic system of government. *Thus, the Board plays a major role in fulfilling the government's responsibility to be publicly accountable.*** Federal financial reports should be useful in assessing (1) the **government's accountability and its efficiency and effectiveness**, and (2) the **economic, political, and social consequences, whether positive or negative**, of the allocation and various uses of federal resources."

Hmm, FASAB sounds pretty important…because it plays a key role in government accountability…via math. As far as we're concerned, the numbers and attempts to manipulate them are what matter the most.

Since we're talking about accountability and math, right off the bat we're greeted with a bombshell. In the meeting, **Treasury officials state that the $200B figure that the public believes the GSEs desperately need to prevent catastrophic failure wasn't based on "any type of analysis of future (i.e. cash flow) needs."** Cue the jaw drop. So, just to be clear and add a little emphasis, **the scary, massive, eyes-bulging-out-of-your-skull-inducing $200B number wasn't based on math**. Instead, it was "**a figure developed from a public policy perspective**." **So this $200B was trumpeted as widely and as**

loudly as possible based on a public policy perspective NOT based on the fundamentals (true cash flows) of the companies. Here's the larger excerpt:

> "However there was a question regarding the $200b commitment. Treasury had an independent firm evaluation whether or not a liability should be recognized at year end. They advised that since a liability cannot be reasonably estimated, no amount should be reported, but rather disclosed in the footnotes…Mr Lingebach stated that he personally ***did not have much expertise in the valuation process and relied upon Treasury's contractor*** ***to develop the different ranges. Based on their analysis, it was determine that no amount was better (more probable) than another……***Messrs, Lingebach and Runnels then responded by saying that in the ***final analysis, Treasury determined that any number selected would be merely a guess*** and that by doing so, the Treasury financial statements might have been misleading as opposed to supplying full disclosure**…**.Also, the high-end of the range, ***$200b was not an accounting estimate but was a figure developed from a public policy perspective to give confidence to the markets. Mr. Lingebach added that although this amount is capped at $100b for each GSE, it was not developed based on any type of analysis of future (i.e. cash flow) needs***."

Again, because we can't help ourselves, **Treasury is explicitly stating to the Federal Accounting Standards Advisory Board that there was no math behind the $200B number that was quoted over and over and over (and over) again by members of the government and the press.** In our world, we have a term for this kind of figure; it's called an **"ass pull".**[5]

In our first paper, we proved that accounting gimmicks in the form of non-cash charges forced GSE draws, not liquidity concerns. As it so happens, Treasury officials were kind enough to verbally support our conclusion with the following statement to FASAB:

> "Mr. Geiger then noted that: both of the GSE's were going through similar complex processes as SEC filers and that ultimately, the amount ***Treasury did accrue ($13.8b) was for Freddie Mac (as a result of some accounting write-offs in the third quarter***) **and zero for Fannie Mae."**

In the above passage, **US Treasury and FASAB confirm that a non cash charge caused the Q3 2008 Freddie Mac Draw, not liquidity concerns**. So on the outside, the $200B figure reverberates far and wide, but on the inside, non-cash charges force the draws. Mild discrepancy there, no?

There's further evidence of Treasury's plan to **"help"** the GSEs. Treasury lets FASAB know that its "punitive dividend terms" were put in place as a motivational tool…that way, the GSEs wouldn't end up living in a van down by the river.

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[5] "Ass pull" is a technical accounting term for completely making something up. Typically this phrase is used when someone invents data or facts to support their argument. Said another way, to "pull something out of your ass". Example: *"This data is a total ass pull!"* www.urbandictionary.com

"Mr Reid (Treasury) reminded the Board that the government owning the preferred stock with **punitive dividend terms provides incentive for the GSE's** to work its issues out as expeditiously as possible."

What's really sad is that Treasury didn't care enough about the Too Big To Fail banks to provide them with similar motivation. The Too Big To Fail banks were only charged about 2.5% interest. What gives? Didn't Hank know how much that would hurt John Mack's feelings? I mean Morgan Stanley had already borrowed north of $100B by September of '08. John must have been begging Hank to crack the 10% whip across his tail. I mean Morgan Stanley was living in Treasury's basement, raiding Treasury's refrigerator, borrowing Treasury's clean t-shirts (and never, not once, did they throw in a load of laundry)…come on Hank. We discipline the ones we love, right? Didn't you want Morgan Stanley and the other TBTF banks on their feet and out of your basement?

This is an opportune time to step out of the FASAB minutes and dig into some interesting GSE accounting

Since you have read our predecessor piece on GSE accounting, we all know that the GSEs were healthy enough to generate positive cashflow throughout the entire recession. In this section, we'll do a deeper dive into an accounting trick that was used to generate massive GSE paper losses…which in turn triggered Treasury draws.

First, let's look at a very powerful but seemingly innocuous disclosure buried deep (wonder why it was buried deep?…that becomes pretty clear soon) on page F-16 in the Fannie Mae 2009 10-k. It states:

"Prior to April 1, 2009, we considered a debt security to be other-than-temporarily impaired if its estimated fair value was less than its amortized cost basis and we determined that it was probable that we would be unable to collect all of the contractual principal and interest payments or we did not intend to hold the security until it recovered to its previous carrying amount."

On the surface, this sounds innocent enough. All markets ebb and flow and near term price changes certainly occur. When put into historical context, however, the significance of this decision (and the outline of a monster) begin to take shape just below the surface, primarily because **prior accounting (Q1 09 and before) provided for *exclusion of a reserve if the Enterprise intended to hold the security until it recovered.***

Taking the sleepy fishing village by surprise, accounting monster charges the surface with:

"On April 1, 2009, we adopted (management [Treasury/FHFA] elected) the FASB modified standard on the model for assessing other-than-temporary impairments, **applicable to existing and new debt securities held by us as of April 1, 2009. Under this new standard, an other-than-temporary impairment is considered to have occurred when the fair value of the debt security is below its amortized cost basis and we <u>intend to sell or it is more likely than not that we will be *required to sell* the security</u> before recovery."**

If you happen to be the unsuspecting guy gazing down baiting his hook, this may seem innocent enough. Let's couple it, however, with the following:

- The capital markets retained portfolio of Fannie Mae on December 31, 2008 was **$765.1 billion (3/4 of a TRILLION).**
- The **US Treasury has *required* Fannie Mae to liquidate 100% of its retained portfolio by 2018.**
- A quick review of the wording of the accounting change: "Under this new standard, an other-than-temporary impairment is considered to have occurred when the **fair value of the debt security is below amortized cost basis and we intend to sell or it is more likely than not that we will be *required to sell*.**"

By changing this accounting method, Treasury created an unbelievably powerful mechanism to mercilessly write down the retained portfolio, an accounting method with no recourse. Accounting Godzilla has now fully cleared the water; we are forced to watch in horror as Accounting Godzilla furiously stomps and chomps the GSE balance sheets. The retained portfolio has nowhere to hide. Treasury, racing to the scene to offer assistance for the phantom damage it created, forces the GSEs to draw down funds.

Paper losses rule the day and the charade of GSE despair and insolvency continues....

In light of our first paper and what you've just read (including Treasury's admission that $200B had nothing to do with math), it feels like an opportune time to pick up our well-worn copy of Timmy G's tome "Stress Test". In it, Timmy describes his first day in the oval office as the newly minted Secretary of Treasury with the following:

> "On the morning of January 27, 2009, my first full day as secretary of the Treasury, I met with President Barack Obama...For starters, I told the President, we still have five 'financial bombs' to defuse...**Fannie and Freddie...needed the most help**. **They were quickly burning through nearly $200 billion in taxpayer aid, and without another $200 billion or so – the equivalent of more than thee years' worth of federal education department spending – they risked catastrophic defaults."**

Based on our math, description of Treasury's accounting tricks, and Treasury's own statements to FASAB, Timmy's description of Fannie and Freddie burning through $200B of taxpayer aid AND needing another $200B is either 1) the perpetuation of a coordinated cover story or 2) gross negligence.

Let's shift gears and examine the protection the GSEs have based on their loan purchase criteria including the important representations and warranties they require.

The first and most important item to understand is the structure of the loans that Fannie Mae purchases. All loans purchased by Fannie Mae must have an 80% LTV. At a minimum, the 20% equity must require 3% cash down. The remaining 17% can be any variation of cash and Private Mortgage Insurance (PMI). In effect, Fannie is only on the hook for the second 80% of the loan if default occurs. The homeowner's down payment and remaining mortgage insurance covers the initial 20%. This

effectively provides the GSE's with a 20% cushion in the event of a housing downturn like the one we saw in 2008.[6,7]

In addition to the 20% private capital buffer, all originating banks must provide robust representation and warranty clauses for each loan that they sell to the GSEs. They "rep and warrant" many items. As exhibited in the numerous lawsuits that began around 2011 and in the settlements that followed, these clauses were violated to a rather impressive, often shocking degree. In the recently decided FHFA vs. Nomura/RBS case, Judge Denise Cote described the banks behavior with the following: "The magnitude of falsity, conservatively measured, is enormous."

The remedy for violation per the typical enterprise purchase agreement is as follows:

> "**The remedy for any breach of any aforementioned representation or warranty of the Seller in subsection…shall be the repurchase of each affected Mortgage Loan from Fannie Mae by the Seller**; provided, however, that the Seller shall have the option, in lieu of repurchasing a…Loan, to substitute the related…Loan with a Qualified Substitute Mortgage Loan….If Fannie Mae reasonably determines that the repurchase of any Mortgage Loan with respect to which a breach has occurred by the Seller would fail to compensate Fannie Mae or the Trust for losses or damages suffered as a result of such breach, then the Seller shall be obligated to indemnify Fannie Mae or the Trust from and against any and all such losses and damages and the Seller shall defend and indemnify Fannie Mae and the Trust from and against all costs, expenses, losses, damages, claims and liabilities, including reasonable fees and expenses of counsel arising out of any claims which may be asserted against or incurred by Fannie Mae as a result of any Third Party action arising out of any breach of any such representation or warranty."

As you can see, not only are the GSE's insulated by 20% private capital, they are also insulated by defaults in the event that the originating bank breaches its contractual representations and warranty. As we know, the GSEs won every major lawsuit against the originating banks. So why are we spending so much ink on this? Here's why:

Historically, the put back provision ("**shall be the repurchase of each affected Mortgage Loan from Fannie Mae by the Seller")** was an immaterial part of Fannie Mae's accounting. In 2008, the volume of loans subject to put back accounting spiked. **What Fannie Mae did in response, however, was to impair the defaulted loan and push the offset through the income statement as a credit loss. Importantly, this accounting treatment completely ignores the right of the put back clause for breach of rep and warranty. At the time these loans default and are identified as breach, the GSEs should have booked a Receivable from the originating bank to offset the impairment for a net zero income event. The flip side of this would require the originating banks to book large liabilities for GSE repurchases and would have *severely injured their balance sheets*. The result of all of this is that the Net Assets of Fannie Mae and Freddie Mac were severely misstated by failing to record the offsetting receivable from originating banks contractually realized at that time. Like before, this gross**

[6] PMI companies like Genworth Financial, Radian, and MGIC, made it through the housing crisis. This begs the question: if the 2nd loss position (PMI) after homeowner equity survived, how was the third loss position declared dead during the earliest days of the crisis?

[7] Additionally, conforming loans typically require higher credit quality than other originated loans, so the risk of default is less.

misstatement of the balance sheet created significant additional Treasury draws, ones that were never necessary AAAAAAAND (not a typo) guess what? The balance sheets of the Too Big To Fail Banks didn't have to take the punishment (GSE balance sheets did instead).

At the time, Deloitte and Touche LLP was Fannie's auditor. It still continues to provide Fannie audit services to the tune of $10 million a year. **The misstatement described above is materially significant; as such, Deloitte has a serious potential legal liability on its plate. To fix this, Deloitte must restate all quarters beginning in Q1 2008 to properly reflect the *realized put back amount* resulting from Too Big To Fail banks breach of rep and warranty.** [8]

By the way, the office of inspector general of the FHFA released an audit report dated September 13, 2012 addressing Freddie Mac's Loan repurchase process. The report states the following:

> "FHFA's Office of Inspector General undertook an evaluation of the FHFA's oversight of the settlement and issued a report on September 27, 2011. **The report raised concerns about the method that Freddie Mac used to review non-performing loans for repurchase claims for Bank of America and more generally for other loan sellers.** In essence, Freddie Mac followed a practice of examining for repurchase claims those loans that had become non-performing within two years of origination or with repayment problems in the first two years. But the FHFA-OIG report found that – for a variety of reasons[9] – **Freddie Mac's practice effectively excluded from the repurchase claim review process many loans that the Enterprise had purchased or guaranteed during the housing boom years of 2005 to 2008, even though those loans have been defaulting at High Levels. This practice limited Freddie Mac's potential recoveries from repurchase requests. In addition, Freddie Mac's internal auditors questioned the governance, business rationale, and objectives of the historical foreclosed loan review process."**

Thus, the FHFA OIG says that the FHFA managed process for reviewing breaches of rep and warranty is incorrect. Freddie's Internal Audit staff questioned the governance and business rationale…and surprise, surprise, nothing changed. Who benefits? Why the originating banks of course! And who were the largest losers in the post crisis suits? The very same Too Big To Fail banks.

It appears that Deloitte went right along for the ride and neglected to force the FHFA and Treasury to book the proper offsetting receivable to the loan impairment, creating tens of billions in additional forced Treasury draws…that were again, never needed.

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[8] According to ASC 860, the asset must be recorded when default occurs not when repurchase or "put back" occurs. "Whether the transferor exercises or intends to exercise its rights to reacquire transferred assets is irrelevant. The existence of the transferor's right to acquire those specific assets creates the effective control, not the exercise of those rights. For example, if the transferor has the right to repurchase the receivables at a fixed price in the event that the borrower defaults, the transferor would be able to recognize a sale at the onset of the transaction. However, once the borrower defaults, the transferor would need to recognize the asset and related liability, as it has the ability to obtain control of the asset even if it does not exercise it." - Guide to Accounting for Transfers and Servicing of Financial Assets

[9] Perhaps because Treasury/FHFA wiped out the management team and were now running the show?

Speaking of balance sheet optics for the Too Big To Fail banks, let's revisit the September 6, 2008 FHFA memo recommending conservatorship. Christopher Dickerson, FHFA Acting Deputy Director, Division of Enterprise Regulation "writes"[10]:

> "The strength, cohesiveness, and depth of the present executive management team is inadequate to cope with the severity and level of significant issues, as well as to fulfill their mission, and is a critical concern to FHFA."

This means that Treasury felt the entire executive team of both GSEs with over HUNDREDS of combined years of experience in the mortgage industry were inferior compared to what the government regulator could offer. So the FHFA in an effort to "save" the entities, terminated the entire executive team. In essence, Treasury wiped out the only people in the country that knew how to run the enterprises exactly when their services were most needed. I wonder what motivated Treasury to do this? We think a big chunk of the answer is found here…

Thanks to Bloomberg for the assist:

> "**October 13, 2008.** Fannie Mae and Freddie Mac began notifying bond traders last week that **each company needs to buy $20 billion a month in mostly subprime, Alt-A and so-called Scratch-and-dent mortgage securities that contain a higher portion of underperforming loans**, according to the people, who asked not to be identified because the plans are confidential….the Federal Housing Finance Agency, which placed the two companies in conservatorship on September 7, **directed them last month to start increasing their purchases of loans and mortgage-backed securities as the Treasury seeks to absorb underperforming and illiquid assets from financial companies.** A senior FHFA official said the agency hasn't set a specific dollar target for the purchases. **After pulling back from the mortgage markets in August, the companies have been ordered to resume their role to help stabilize the floundering mortgage and housing markets."**

So what did Treasury/FHFA do as soon as they kicked management to the curb? Treasury, through FHFA, used Fannie and Freddie to **1) purchase junk private label securities at most likely par (100 cents on the dollar) from TBTF banks and then 2) immediately impaired the securities to fair market value, which in turn amplified the "Loan Loss and Fair Market Value Reserves" that the GSEs continued to report through the quarters subsequent to conservatorship...which resulted in more draws from Treasury.**

To hide the impact of these "purchases", Treasury may have done one of the following (or something similar) 1) Sell good loan at par and buy bad loan at par and immediately write down x%. Impact is a reduction of pls retained portfolio or 2) "swap" good loan for bad loan and no cash changes hands.

Wow. Slow clap for Hank and Timmy. Wonderful execution.

What's so funny is Hank and Timmy gave an eerily similar backdoor bailout to the TBTF banks using AIG.

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[10] "Writes" is in quotations because we'd say there's an extremely high probability that Hank and Timmy had their folks draft this. Let's not forget that according to Hank's bio, W "despised" the GSEs.

As we know from Starr International Co. v. United States (AIG), **The Special Inspector General for the Troubled Asset Relief Program (SIGTARP)** wrote:

> "**Irrespective of their stated intent, however, there is no question that the effect of FRBNY's decisions - indeed the very design of the federal assistance to AIG – was that tens of billions of dollars of Government money was funneled inexorably and directly to AIG's counterparties"**

Who were those counterparties? The TBTF banks. Not surprisingly, the government fought like hell to keep the identities of these counterparties a secret. Wonder why? Oh and AIG similarly had no choice, because the management had been removed and the people who were installed had no real power.

> **In regards to this decision to pay off counterparties at PAR, Liddy stated at trial that: "AIG did not participate in any way" AND it was a decision AIG management "Had no say in and no control over."**

Well, we had a nice break from the FASAB meeting, but it's time to get back to those minutes. Specifically, we want to take a look at how 1) Treasury was adamant about keeping the GSEs off the government books and 2) how Treasury stated that its intent was to drive the GSEs stock price to zero. Quick observation: What's the end result of this bitchin' combo? Treasury can use the shareholders to keep the GSEs off the books while simultaneously depriving them of any and all economic benefit. Sounds like a sweet deal for Treasury.

Treasury and FASAB discuss consolidation to the US Federal Balance sheet:

> "Mr. Allen clearly believes this is an area for interpretation since many would argue differently than Treasury and would come to a different conclusion. **Mr. Dancey agrees that there certainly is control over the GSE's even though there is no ownership**, however, this puts the Board in a position of second guessing Treasury. Mr. Reid believes that the consolidation decision was not primarily based on the FASAB guidance or criteria but rather past Federal practice and coupled with the fact that these GSE's are not in the budget one can clearly understand why the Treasury did not consolidate. **Mr Allen noted to the contrary stating that Treasury clearly said they followed FASAB standards and that in so doing, they came up with a conclusion that many of us would not necessarily agree with**. Mr. Diamond noted that Treasury pointed to paragraph 50 which clearly excludes bailout entities…**Mr. Jackson noted however that those exclusions were prior to the government exercising its right of conservatorship."**

In the last little tidbit, Treasury is arguing that even though FASAB disagrees, the GSEs shouldn't be consolidated into the US Federal Balance Sheet because the GSEs weren't included in the budget.

> "Mr. Farrell noted that regardless of the exercise of the warrants, it seems that the government has at least the appearance of control **as it can replace management and dictate Board appointments, approve certain transactions, etc**…..Mr Reid (Robert Reid of the Department of the Treasury) reminded the Board that the government owning the preferred stock with **punitive dividend terms** provides incentive for the GSE's to work its issues out as expeditiously as possible. Furthermore, by design, **the warrants were issued not to take ownership but rather to devalue the common stock."**

> "Mr. Werfel (Danny Werfel of the Office of Management and Budget) then explained that it is important to understand the government's intention. The intention was not to eliminate the ownership interests but to **prevent current shareholder speculation resulting in speculators taking advantage of government intervention at the expense of others.**[11] **Driving the stock market value to zero prevents this manipulation from happening**."

So the US Treasury issued 79.9% warrants to devalue the common stock of the GSEs. Did the US Treasury commit securities fraud by intentionally manipulating the stock price (per their own words), without public disclosure? This is a publically traded SEC registrant after all.

Needless to say, this whole thing smells absolutely awful, like those gym socks I forgot in my car for a week after bailing 15 minutes into a spin class.

"Hear my song. People won't you listen now? Sing along. You don't know what you're missing now." – The Song Remains the Same, the mighty Led Zeppelin

Unsurprisingly, the people who are responsible for and benefit from the conservatorship are still promoting the GSE cover story, the one that facilitated the use of GSEs as tools.

Timmy's book was published in 2014 or 6 years after the conservatorship. Let's revisit. He wrote: "**Fannie and Freddie...needed the most help**. **They were quickly burning through nearly $200 billion in taxpayer aid**, **and without another $200 billion or so – the equivalent of more than thee years' worth of federal education department spending – they risked catastrophic defaults."**

Our first analysis and this follow up show that Timmy's statement is false. It's either 1) the continued promotion of a cover story or 2) evidence of gross negligence. We're going with what's behind door #1.

In 2010, Hank described the GSEs as **"the two government-sponsored housing enterprises that brought our nation's financial system and our entire economy to the brink of collapse."**

Our first analysis and this follow up show that Hank's statement is false. It is either 1) the continued promotion of a cover story or 2) evidence of gross negligence. We're going with what's behind door #1 on this one too.

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[11] Treasury just told FASAB that it didn't want speculators taking advantage of government intervention at the expense of others. What's particularly interesting in light of this supposed motivation is that Hank met with hedge fund and goldman sachs buddies at Eton Park on July 21, 2008. This was before HERA was passed and before FHFA had authority to force Conservatorship. A story about the meeting from Bloomberg: "After a perfunctory discussion of the market turmoil, the fund manager says, the discussion turned to Fannie Mae and Freddie Mac. Paulson said he had erred by not punishing Bear Stearns shareholders more severely. The secretary, then 62, went on to describe a possible scenario for placing Fannie and Freddie into 'conservatorship'…Paulson explained that under this scenario, the common stock of the two government sponsored enterprises, or GSE's, would be effectively wiped out. So too would the various classes of preferred stock, he said. <u>The fund manager says he was shocked that Paulson would furnish such specific information</u>." End quote. Treasury sure would hate for "speculators to take advantage of government intervention at the expense of others" now wouldn't they.

HANK AND TIM TOOK THE GSEs BECAUSE IT WAS
THE EXPEDIENT AND IDEOLOGICALLY ATTRACTIVE MOVE

Hank told **the Financial Crisis Inquiry Committee** that:

> "Fannie and Freddie were 'the only game in town' once the housing market dried up in the Summer of 2007. And by the Spring of 2008, 'the [GSE's] **more than anyone, were the engine we needed to get through the problem."**

Quite simply, Hank and Tim saw the engine that they needed and took it. 36 days after putting the GSEs into conservatorship, the GSEs were each ordered to purchase $20B a month in toxic assets from TBTF banks because Treasury wanted the toxic assets off of the TBTF banks' balance sheets.

Again from Bloomberg: "**October 13, 2008.** Fannie Mae and Freddie Mac began notifying bond traders last week that each company **needs to buy $20 billion a month in mostly subprime, Alt-A and so-called Scratch-and-dent mortgage securities that contain a higher portion of underperforming loans**… **as the Treasury seeks to absorb underperforming and illiquid assets FROM FINANCIAL COMPANIES.** " (emphasis ours)

It's important to remember how much Hank, Tim & Co despised the GSEs and decried them as a "failed" business model. **With this move, they were able to permanently cripple the GSEs (they hoped) and overcome seemingly insurmountable legislative hurdles to reform the GSEs in a manner that they would find palatable.**

SAME OLD SONG AND DANCE

Alarmingly, the GSE cover story is still being used as a political tool, as a means to roll back Dodd-Frank, and as a driver to help hand over large chunks of GSE business to TBTF banks…you know, because they clearly deserve it (TBTF banks have paid *hundred of billions* in fines/settlements). On May 1, 2015, Republican presidential candidate Carly Fiorina, former CEO of a Fortune 20 company, stated that Fannie Mae and Freddie Mac were "the original start of the financial crisis."

Again, a congratulations to Hank on a job well done…referring to Fannie Mae, the company that the President "despised", Hank said: "We're going to move quickly and take them by surprise. The first sound they'll hear is their heads hitting the floor."[12]

[12] Quotes taken directly from Hank's "On the Brink"

Deloitte! Restate Thou Must!!

(Or A Follow Up to the Follow Up to: A Forensic Look at the Fannie Mae Bailout: Scrubbing the Tricky Accounting of Conservatorship)

Adam Spittler CPA, MS
Mike Ciklin JD, MBA, MRE

In the first two papers, we showed mathematically that Fannie Mae remained both solvent and liquid throughout the entire housing downturn. We also pointed out and emphasized the multiple layers of capital that insulated it from losses. In this paper we attempt to quantify - in the event of a Deloitte restatement (hint hint Deloitte, take your hands off of your ears and stop saying "la la la la la la") - what the true Net Income or Loss was for each year. In completing this exercise, we make some particularly interesting discoveries.

As we stated in Paper 2, Deloitte has significant skin in the game for signing off on the audited financials of Fannie Mae, *particularly because there is no recourse for inflated draws from Treasury*. In effect, Treasury is claiming the borrowings were an equity investment that can never be repaid. Unfortunately for Deloitte, these draws are calculated directly from the audited financial statements, which materially misrepresent the true financial health of Fannie Mae…as such *the financial statements should and must be restated.*

The method we use to calculate the adjusted Net Income or Loss figure is as follows:

Reported Net Income/(Loss)
Plus – Reserve against Deferred Tax Asset
Plus – Total Loan/Guarantee Loss Reserve
Less – Total Realized Credit Write-offs net of recoveries
Less – Net of Total reserve less recoveries @ 35% implying a lower Deferred Tax Asset
Plus – Total Derivative Fair Market Value Adjustment
Less – Realized Derivative Gain/Loss on cash cost and actual loss on expired derivatives
Plus – Estimated Put Back Receivable (derived from Rep and Warranty Verbiage)
Equals - Net Income Adjusted for Historically proven inaccurate reserves

Note: this paper contains some technical accounting items, so we will explain in detail the reason for the adjustment in the context of proper financial reporting.

Reported Net Income/(Loss)

Reported Net Income/ (Loss) is pulled directly from the 10k. This is the figure that rolls into equity on the balance sheet. In the event of a loss, it increases the total debt plus equity triggering a net asset draw according to the terms of Treasury's Preferred Senior Purchase Agreement.

"Within 15 business days following the determination of the deficiency amount, if any, as of the end of each fiscal quarter of Seller which ends on or before the Liquidation End Date….Purchaser shall provide such funds within 60 days of its receipt of such request." Think about this for a second. Quarter end close in a normal company takes 3 weeks or 21 calendar days. At day 21, the GSEs are able to

determine if there is a deficiency (negative net assets). At which point they have 15 days to request funds. At this point, they are 5 weeks into the process, *paying payables every single day*. Then, Treasury has a **full 60 days or 8 and a half weeks to fund.** At this point, the Bailout Funds are now available 13 ½ weeks after the date of determination for the supposed cash needs. If the GSEs were on the verge of diabetic coma (we have mentioned Paula Deen here in the past) and they needed their insulin from Treasury, they'd be stone cold dead. So how did Fannie or Freddie keep operations going while they were supposedly insolvent? The answer is simple: ***they were never insolvent***…the smoke and mirrors of accounting reserves were used to make them appear that way.

Total Loan/Guarantee Loss Reserve

Total Loan/Guarantee Loss Reserve was disclosed as two items prior to 2010 but it was then consolidated (wonder why?). Per our exercise, it must be added back net of Total Realized Credit Write-offs net of recoveries because it's a non-cash expense and merely a guesstimate.

Net of Total reserve less recoveries @ 35% implying a lower Deferred Tax Asset

Next we need to back out the net tax impact of total loan loss reserve less realized credit losses. Much like Donald Trump's track record, Guarantee/Loan loss reserves were significantly overstated. In fact, Fannie currently has around 30b in reserve on its balance sheet while its historic annual loss is approximately 250m.

Importantly, in attempting to adjust GAAP financials, we have to add back 35% of the non-cash reversal when we reduce the Loan Loss Reserve net of realized credit losses. The reason for this is that the DTA would effectively decline by the net tax impact. Now this would be less of an issue if the FHFA had kept some of the DTA available. In 2008, however, they effectively reserved 100% against the DTA. As a result, this adjustment is a dollar for dollar reduction in the asset, so the reserve must also decline by the same amount. This creates an increased net loss for the net tax impact of the non-cash reserve reduction in the analysis.

Derivatives[13]

We then add back any derivative losses net of actual cash cost as well as realized losses on expired derivatives.

Put Back Receivables[14]

Finally, we must add back an estimate for Put Back recapture which is Fannie's legal claim based on Rep and Warranty. Our method was to take actual settlement numbers and allocate prorata based on realized credit losses. Per GAAP, if there is a repurchase right in a MBS sale, the counterparty receivable must be recognized *at the time of default (*Accounting Standards Codification - ASC 860). This

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[13] Deutsche Bank just can't get enough of these things can they?

[14] ASC 860 – "Effective Control for Transfers with Forward Agreements to Repurchase Assets and Accountings for Repurchase Financings" was submitted as exposure draft by the FASB on January 15, 2013 effectively clarifying the accounting for repurchase agreements. This was required as the surge in defaults during the Housing Crisis created a very material financial obligation that was historically immaterial to the GSEs and other institutions financial statements.

analysis brings up an interesting secondary set of data that will be discussed as we estimate the actual Rep and Warranty losses versus bank settlement figures.

Where Do These Adjustments Get Us and Why Is It Important?

This totals to what we call "Net Income Adjusted for Historically Proven Inaccurate Reserves*". Remember, this figure is vitally important because Treasury has said there are no paybacks once they money is borrowed. Therefore, if the source of data used to determine the need for borrowings is incorrect, there must be recourse to the audit firm.*

The Results: Actual Capital Consumed

Once we calculated our adjusted GAAP net income or loss, we then rolled the disclosed December, 31 2007 Capital figure from Fannie Mae forward through 2014. Fannie definitely consumed during the historic housing downturn….*what we show is the actual amount of capital consumed when GAAP financials are properly stated*. Remember, if the capital figure turns negative, a draw is triggered under the SPSA. If the figure stays positive, however, a draw isn't required…

Fannie Mae *In Billions*	2007	2008	2009	2010	2011	2012	2013	2014
Ending Adjusted Treasury Independent Capital	45.4	45.5	26.1	19.7	23.1	22.6	27.4	28.9
Reported Net Income/(Loss)		(58.7)	(72.0)	(14.0)	(16.9)	17.2	84.0	14.2
Reserve against Deferred Tax Asset (Non Cash)		30.8	21.9	3.6	7.8	(5.2)	(58.3)	(0.4)
Total Loan/Guarantee Loss Reserve (Non Cash)		28.0	72.6	24.9	26.7	(0.9)	(8.9)	(4.0)
Realized Credit Write-offs (net of recoveries)	(2.0)	(7.0)	(32.5)	(20.0)	(16.0)	(13.5)	(6.4)	(5.2)
Net Provision Add Back @ 35% tax effect (DTA impact of lower Loan Loss Reserve)		(7.3)	(14.0)	(1.7)	(3.7)			
Total Derivative value adjustment		15.0	4.7	1.8	6.1	1.9	(2.8)	4.6
Realized Derivative loss		(1.3)	(3.4)	(2.9)	(2.2)	(1.4)	(0.8)	(1.1)
Put Back Receivable (estimated)		0.7	3.2	2.0	1.6	1.3	(2.0)	(6.8)
Net Income Adjusted for Historically proven inaccurate reserves		0.1	(19.4)	(6.4)	3.3	(0.5)	4.8	1.5

…as we see in Ending Adjusted Treasury Independent Capital (See above), the lowest level capital hit *was 19.7b* in 2010. In light of Fannie's large amount of Realized credit Write-offs, this is especially remarkable. In summary, Fannie weathered the storm impressively. As proven in paper #1 and reiterated in the table above, the 116.1b drawn was pure fiction based on aggressive non-cash accounting reserves.

Now let's look at the Adjusted Capital including Treasury Impact (both borrowing and repayment)

	2008	2009	2010	2011	2012	2013	2014
Net Treasury Draw/Repayment	15.2	57.5	7.3	16.3	(11.6)	(82.5)	(20.6)
Adjusted Capital including Treasury Impact	60.7	98.8	99.7	119.3	107.2	29.5	10.4

Capital including Treasury intervention at the end of 2014 is 10.4b. Capital at the end of 2014 excluding Treasury intervention would be 28.9b. Do I hear someone starting a slow clap for Treasury's Intervention?[15] No wonder there are cries for a recap.

[15] A representative for A&E's Intervention asked us to emphasize that they are in no way affiliated with the US Treasury.

Another Backdoor Bailout: Rep & Warranty

Next, let's look at a very important secondary metric. We took a look at Historic Average Write-offs from 2002 through 2006; they fell within a 200m to 300m range. For this part of the analysis, we assume 300m is the annual realized credit write-off in a normalized environment. We also assume that not every defaulted loan from 05 to 07 included a Rep and Warranty violation. Many defaults were due to simple math. If a homeowner puts x% down and the house value declines by x% +500 basis points, the homeowner often walks. Based on this, an inflated non-recourse credit loss figure must be included.

We then researched the lawsuits brought against the TBTF originating banks and determined a 50% Rep & Warranty blended material breach rate was appropriate based on statistical analyses included in the suits (see example below from Nomura). We then stated that the historic average plus 50% of the remaining credit losses have no recourse to the originating bank. The remainder is a reasonable estimate of what Fannie should've been able to contractually recover from the TBTF banks. Finally, we added back the settlements to offset this amount.

SECURITIZATION	SAMPLE SIZE	NUMBER MATERIALLY DEFECTIVE	PERCENTAGE MATERIALLY DEFECTIVE
NAA 2005-AR6	131	61	47%
NHELI 2006-FM1	100	59	59%
NHELI 2006-HE3	99	50	55%
NHELI 2006-FM2	100	53	53%
NHELI 2007-1	98	46	47%
NHELI 2007-2	98	49	50%
NHELI 2007-3	97	44	45%
TOTAL	723[117]	362	50%

Not surprisingly, we calculate $50.2 Billion of estimated credit losses that should have been subject to R&W put back. These, however, were settled by the FHFA for $8.7 Billion….**which resulted in Fannie Mae eating $41.5 billion in TBTF credit losses** (our favorite is the confidential Wells Fargo deal which appears to have been settled for about once cent on the dollar). Hey, look everyone, it's another backdoor bailout for the TBTF banks! Yay!

	2007	2008	2009	2010	2011	2012	2013	2014	Total
Historic Average Writeoff (2002 to 2006)	(0.3)	(0.3)	(0.3)	(0.3)	(0.3)	(0.3)	(0.3)	(0.3)	(3.8)
Implied charge off due to Housing downturn plus R&W Violation	(1.7)	(6.7)	(32.2)	(19.7)	(15.7)	(13.2)	(6.1)	(4.9)	(100.5)
Estimated 50% of downturn defaults due to R&W Violation	(0.9)	(3.3)	(16.1)	(9.9)	(7.9)	(6.6)	(3.0)	(2.4)	(50.2)
Recoveries							2.0	6.8	8.7
Net loss shielded from banks through Fannie Capital	(0.9)	(3.3)	(16.1)	(9.9)	(7.9)	(6.6)	(1.1)	4.3	(41.5)

The Mighty Deferred Tax Asset (Oh Deloitte, Naughty Naughty Deloitte)

The most interesting portion of this entire analysis is the treatment of the Deferred Tax Asset. If Treasury through FHFA were to write up the Loan Loss Reserve, only 65% of the total amount would fall to Net Loss. The remaining 35% would go to create/increase the Deferred Tax Asset. This would serve as a bit of a hiccup in Treasury's plan to take down the GSEs. For example, the $200B figure that was consistently trumpeted by Treasury and the media would have required in excess of $300B of Loan Loss reserves because 35% would have gone to the DTA. $300B of Loan Loss reserves would have raised a few eyebrows. So how did Treasury solve this financial engineering problem? In 2008, they made a case to reserve against the DTA which maximized the shock factor of the inflated loan loss reserve.

As we discussed in paper 2, there's no specific measurement period surrounding an impairment to a Deferred Tax Asset. FAS 109 simply states the following:

> "All Available evidence, both positive and negative, is considered to determine whether, based on the weight of that evidence, a valuation allowance is needed for some portion or all of a deferred tax asset. Judgement must be used in considering the relative impact of negative and positive evidence. The weight given to the potential effect of negative and positive evidence should be commensurate with the extent to which it can be objectively verified. The more negative evidence that exists (a) the more positive evidence is necessary and (b) the more difficult it is to support a conclusion that a valuation allowance is not needed."

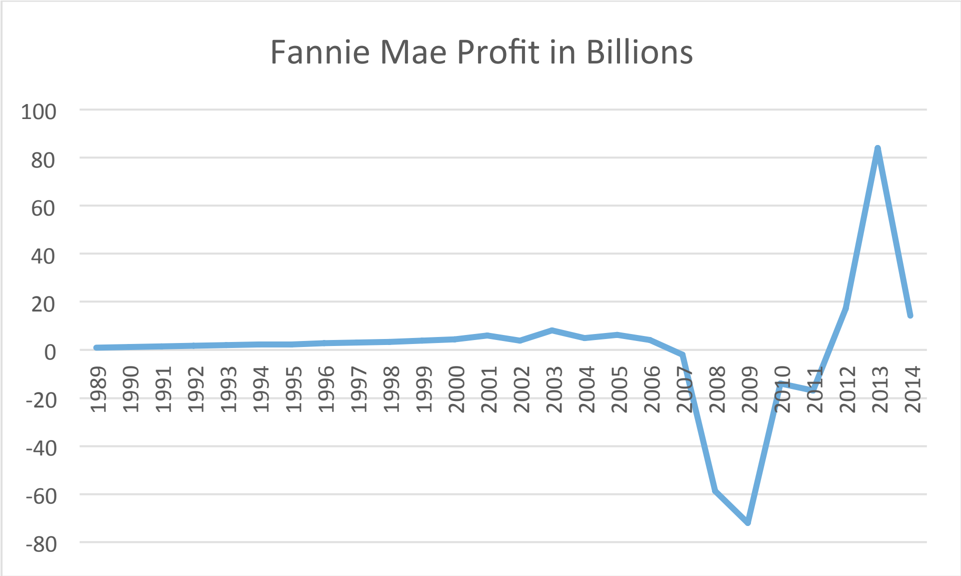
Keep in mind, the absolute key factor is positive net income. A Deferred Tax Asset has value when a company is profitable. As such, we believe that Deloitte not only misstated Fannie's financials, but exhibited gross negligence by ignoring simple, powerful historical fact when addressing the DTA.

Lets examine the 2008 10k language surrounding the DTA Reserve:

> "We evaluate our deferred tax assets for recoverability using a consistent approach that considers the relative impact of negative and positive evidence, including our historical profitability and projections of future taxable income. We are required to establish a valuation allowance for deferred tax assets and record a charge to income or stockholders' equity if we determine, based on available evidence at the time the determination is made, that it is more likely than not that some portion or all of the deferred tax assets will not be realized. In evaluating the need for a valuation allowance, we estimate future taxable income based on management approved business plans and ongoing tax planning strategies. ***This process involves significant management judgement*** about assumptions that are subject to change from period to period based on changes in tax laws or variances between our projected operating performance, our actual results and other factors. Accordingly, we have included the assessment of a deferred tax asset valuation allowance as a critical accounting policy."
>
> "As of September 30, 2008, we were in a cumulative book taxable loss position for more than a 12-quarter period. For purposes of establishing a deferred tax valuation allowance, this cumulative book taxable loss position is considered significant, objective evidence that we may not be able to realize some portion of our deferred tax assets in the future."
>
> "As of September 30th 2008, we concluded that it was more likely than not that we would not generate sufficient taxable income in the foreseeable future to realize all of our deferred tax assets. Our conclusion was based on our consideration of the relative weight of the available evidence, including the rapid deterioration of the market conditions discussed above, the uncertainty of future market conditions on our results of operations and ***significant uncertainty surrounding our future business model as a result of the placement of the company into conservatorship by the FHFA*** on September 6, 2008"

In common practice the profitability of an entity is reviewed over a three year period. A company such as Fannie Mae, which has been around since the 1930's, should be reviewed over a much longer period. The disclosure, however, stated that Fannie had a 12 month loss coupled with "Significant uncertainty surrounding our future business model as a result of the placement of the company into

Conservatorship." **This is a cherry picked method that should never have passed Deloitte's audit. To make matters even worse, they impaired 30.9b of the 34.8b DTA.** Let's put the historic profitability into perspective in a chart.



As you can see, every year in this graph until the worst housing crisis since the Great Depression, Fannie Mae was profitable. **To argue that after 12 months of GAAP losses, the company will never, ever, ever be profitable again is simply not reasonable. Deloitte has a lot of explaining (and restating) to do.**

Now that we addressed the wording around the original Impairment, let's see how the FHFA changed their tune when Treasury was salivating over a massive windfall.

> "We recognize deferred tax assets and liabilities for future tax consequences arising from differences between the carrying amounts of existing assets and liabilities under GAAP and their respective tax bases, and for net operating loss carryforwards and tax credit carryforwards. We evaluate the recoverability of our deferred tax assets as of the end of each quarter, weighting the positive and negative evidence, and are required to establish or maintain a valuation allowance for these assets if we determine that it is more likely than not that some or all of the deferred tax assets will not be realized. The weight given to the evidence is commensurate with the extent to which the evidence can be objectively verified. If negative evidence exists, positive evidence is necessary to support a conclusion that a valuation allowance is not needed."

"The positive evidence that weighed in favor of releasing the allowance as of March 31, 2013 and ultimately outweighed the negative evidence against releasing the allowance was as follows:

- Our profitability in 2012 and the first quarter of 2013 and our expectations regarding the sustainability of these profits;
- Our three-year cumulative income position as of March 31, 2013;
- The strong credit profile of the loans we have acquired since 2009;

- The significant size of our guarantee book of business and our contractual rights for future revenue from this book of business;
- Our taxable income for 2012 and our expectations regarding the likelihood of future taxable income; and
- That our net operating loss carryforwards would not expire until 2030 through 2031. We anticipated that we would utilize all of these carryforwards upon filing our 2013 federal income tax return."

"In addition, we transitioned from a 3 year cumulative loss position over the three years ended 12/31/12 to a 3 year cumulative income position over the three years ended 3/31/13. The change in these conditions during the first quarter of 2013 removed negative evidence that supported maintaining the valuation allowance against our net deferred tax assets as of 12/31/12."

The result was an almost complete reversal of <u>$58 Billion (fifty-eight billion) of Reserve</u> <u>paid straight to the US Treasury</u>. Let's analyze these items because the 10k language absolutely reeks of inconsistency.

First, they clearly stated in 2008 that the uncertainty of conservatorship resulted in the DTA reserve. Unfortunately for both Treasury and Deloitte, this uncertainty existed in 2013 when the DTA was reversed and continues to exist to this day. By that logic, either the Reserve should have never occurred or it should never have been reversed and paid to Treasury.

Second, they state that they lost money in the trailing 12 months in 2008, but then switch to a *3 year <u>cumulative</u> income* in 2013 (convenient). **The 3 year cumulative income math is a farce unless you include the massive DTA reversal in Q1 of 2013. In effect, they reversed the DTA reserve by stating that they were GAAP profitable, <u>but they weren't GAAP profitable without the DTA reversal (and additional reserve reversals).</u>** So q4 2012 and q1 2013 reversals made them transition to a 3 year cumulative income position…. but reversals shouldn't have been allowed until they transitioned into a 3 year cumulative income position in the first place.

How on earth could they claim what they claimed? Seriously, how how how how could they claim it?[16] Wikipedia refers to this as the chicken or the egg causality dilemma. Wikipedia: "The chicken or the egg causality dilemma is commonly stated as 'which came first, the chicken or the egg?' To ancient philosophers, the question about the first chicken or egg also evoked the questions of how life and the universe in general began… Cultural references to the chicken and egg intend to point out the futility of identifying the first case of a circular cause and consequence." **The 3 year cumulative GAAP income math is absolutely ridiculous.**

Third, they also state that contractually they have strong future revenue rights from their guarantee business…which they also had in 2008.

As plain as day, Deloitte allowed them to talk out of both sides of their mouth.

What should happen now?

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[16] And in the original Terminator, how does John Connor's dad travel back in time from the future to save him if his dad doesn't meet his mother until he travels back to save him?

All of these items add up to an obvious conclusion: Deloitte must restate. The Deferred Tax Asset Reserve should have never been booked in the first place. Using the uncertainty of conservatorship as a reason to impair while ignoring the previous 18 years of profitability is unreasonable and incorrect. On the flip side, ignoring the uncertainty of conservatorship in 2013 to reverse the reserve is cherry picking and also incorrect.

Treasury can't use the argument to its advantage on the front end and ignore its existence on the back end. Deloitte knew or should have known better…and they should be on the hook for the cost of a full restatement. In addition, all non-cash inflated reserves that were historically unnecessary must be reversed and pushed back into Net Income. Deloitte simply has no margin for error based on Treasury's imposed "Net Asset" trigger for borrowing funds.

Oh and as for Treasury's motive this time around (hint: it had everything to do with padding the general fund while conveniently providing debt ceiling negotiation breathing room)… [17]

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A Treasury Department official confirmed that the funds returned by Fannie and Freddie will be deposited into the general fund and will be factored into how long the department can continue to pay the government's bills before running up against the debt ceiling.

The $59 billion Fannie will send, combined with the $7 billion Freddie said it would pay the Treasury by June 30, would likely push back the date when the government will breach the debt ceiling until October, if it is not raised before then, the Bipartisan Policy Center said today.

For support documentation or inquiries, please contact us @gsemath08@gmail.com

[17] http://www.politico.com/story/2013/05/fannie-mae-to-send-treasury-big-payday-91128.html