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

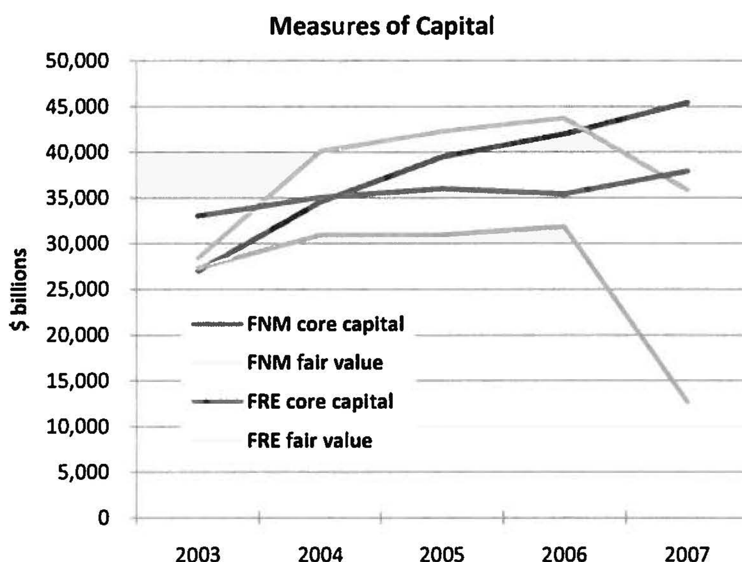
Any realistic assessment of Fannie Mae's capital position would show the company is currently insolvent. Accounting fraud has resulted in several asset categories (non-agency securities, deferred tax assets, low-income partnership investments) being overstated, while the guarantee obligation liability 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."[1]

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.



[1] 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,[2] 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.[3]

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:

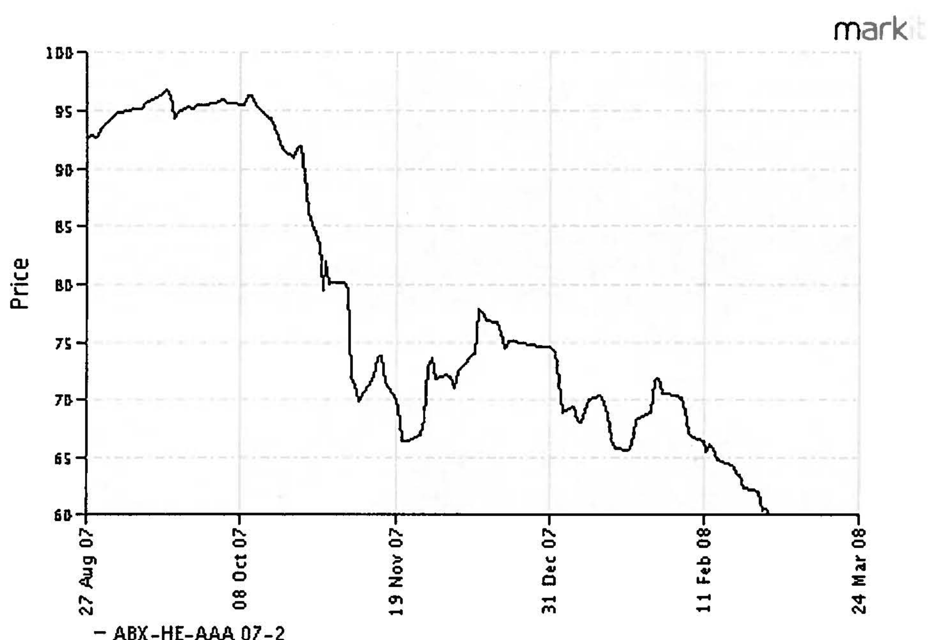
> Some observers of current market conditions have asserted that market pricing is irrational, and they have suggested that entities should instead default to a model-based measurement that is based on the economic "fundamentals" of

[2] "Swept Away" by Jonathan R. Laing, *Barron's*, May 17, 2004
[3] 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."[4] [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.[5] 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:

[4] http://www.aicpa.org/caq/download/WP_Measurements_of_FV_in_Illiquid_Markets.pdf

[5] 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.[6]

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.[7] 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

[6] http://www.morganstanley.com/about/press/articles/5779.html
[7] 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.[8]

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.[9] 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.

[8] http://www.sec.gov/Archives/edgar/data/892535/000119312508040737/d10k.htm, pp. 34-35
[9] 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."[10] 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."[11]

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.[12]

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.[13]

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

[10] http://www.sec.gov/Archives/edgar/data/310522/000095013308000795/w48295e10vk.htm, p. 58
[11] http://www.fanniemae.com/ir/pdf/sec/2008/2007_10K_investor_summary.pdf, p. 26
[12] http://www.ofheo.gov/media/pdf/FNMacctgattach5604.pdf
[13] 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."[14]

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."[15]

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.[16]

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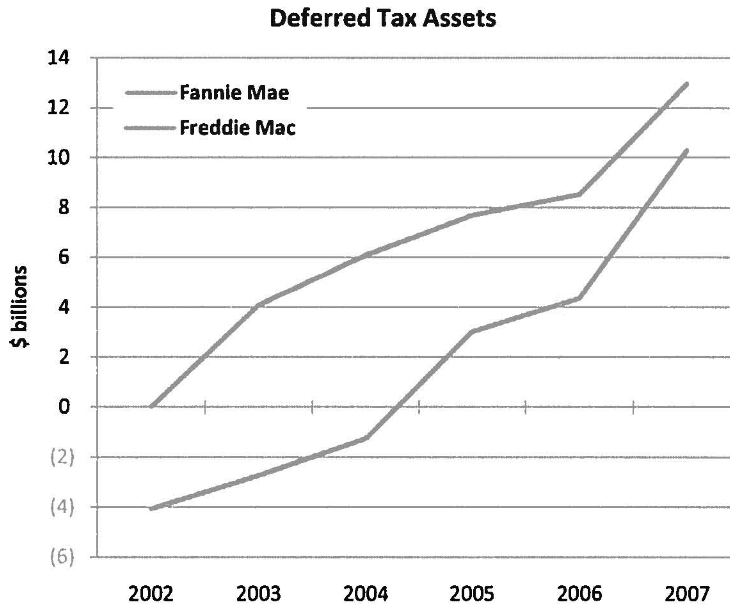
[14] "Freddie Mac: Disappointing 4Q07 Results from FRE" by Kenneth A. Posner and Vivian(Wei) Wang, Morgan Stanley, February 28, 2008

[15] http://www.freddiemac.com/investors/er/pdf/transcripts_022808.pdf, pp. 8-9

[16] "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."[17] 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).

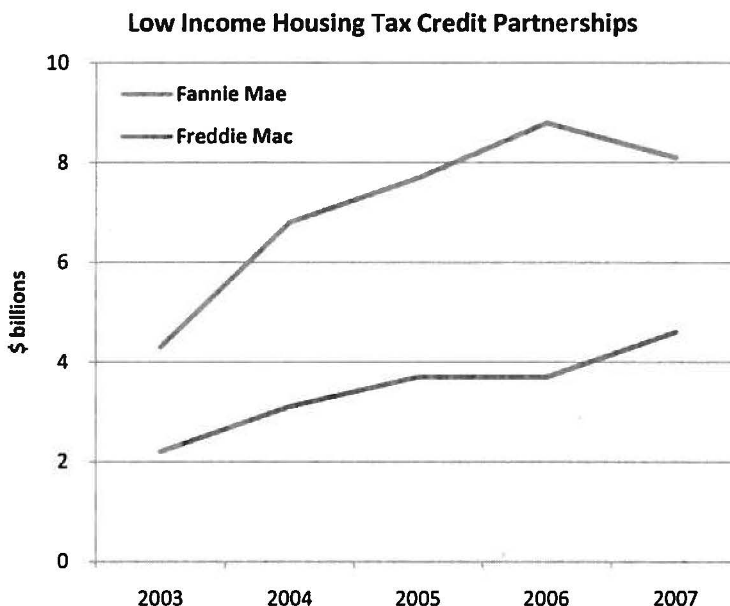
Given the inexorable five-year increase, it is clear that Fannie's past profitability has been insufficient to utilize the DTA. Despite reporting net income of over $23 billion in 2003 to 2006, the DTA has grown from nothing to $8.5 billion at the end of 2006. In 2007, with a net loss of $2.1 billion, 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

[17] 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.[18]

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.

[18] http://www.fanniemae.com/media/speeches/Goldman_conference_transcript.pdf, pp. 28-29

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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.