

responsible for the company's finance and risk management activities, strategic and business planning, financial reporting and accounting, and the management of Fannie's largest business, its portfolio of mortgage investments. Mr. Howard's detailed knowledge of Fannie's accounting, operations, and business risks—together with his experience at the company in the years during which the seeds of the 2008 mortgage crisis were sown—gives him a unique perspective on what occurred in the financial markets in general and with Fannie specifically in the period leading up to, during, and following the crisis. Mr. Howard's interest is in ensuring that the Court has a factually accurate understanding of the relevant details concerning the government's placement of Fannie Mae and Freddie Mac ("Freddie," and together with Fannie, "the Companies") into conservatorship, and the subsequent management and operation of that conservatorship.

**MR. HOWARD'S BRIEF IS RELEVANT TO THE DISPOSITION OF THE DISPUTE
AND WILL BE HELPFUL TO THE COURT**

This Court has the "inherent authority" to grant leave to permit participation by an *amicus curiae*. *Youming Jin v. Ministry of State Sec.*, 557 F. Supp. 2d 131, 136 (D.D.C. 2008). In determining whether to grant leave, the Court has "broad discretion," *Nat'l Ass'n of Home Builders v. U.S. Army Corps of Eng'rs*, 519 F. Supp. 2d 89, 93 (D.D.C. 2007), and leave is generally granted when "the information offered is timely and useful," *Ellsworth Assocs. v. U.S.*, 917 F. Supp. 841, 846 (D.D.C. 1996). Mr. Howard can assist the Court by offering a unique perspective, and information that is timely and useful. As a result, his brief "will assist the [Court] by presenting ideas, arguments, theories, insights, facts, or data that are not to be found in the parties' briefs." *Voices for Choices v. Ill. Bell Tel. Co.*, 339 F.3d 542, 545 (7th Cir. 2003).

CONCLUSION

For the foregoing reasons, Mr. Howard respectfully requests that this Court grant this Motion for Leave to file his Brief *Amicus Curiae* in Opposition to Defendants' Motion to Dismiss.

Respectfully submitted,

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Dated: February 2, 2016

CERTIFICATE OF SERVICE

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THE HONORABLE GREGORY M. SLEET
UNITED STATES DISTRICT JUDGE

EXHIBIT 1

**IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF DELAWARE**

DAVID JACOBS and GARY HINDES, on
behalf of themselves and all others similarly
situated, and derivatively on behalf of the
Federal National Mortgage Association and
Federal Home Loan Mortgage Corporation,

Plaintiffs,

v.

C.A. No. 15-708-GMS

THE FEDERAL HOUSING FINANCE
AGENCY, in its capacity as Conservator of
the Federal National Mortgage Association
and the Federal Home Loan Mortgage
Corporation, and THE UNITED STATES
DEPARTMENT OF THE TREASURY,

Defendants,

and

THE FEDERAL NATIONAL MORTGAGE
ASSOCIATION and THE FEDERAL HOME
LOAN MORTGAGE CORPORATION,

Nominal Defendants.

BRIEF OF AMICUS CURIAE IN OPPOSITION TO MOTION TO DISMISS

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Dated: February 2, 2016

TABLE OF CONTENTS

	Page(s)
INTRODUCTION AND SUMMARY OF THE ARGUMENT	1
ARGUMENT	3
I. THE GOVERNMENT’S NATIONALIZATION OF FANNIE AND FREDDIE WAS NOT A RESCUE, BUT A PLANNED TAKEOVER BY TREASURY FOR POLICY PURPOSES	3
II. A COMBINATION OF TEMPORARY AND ARTIFICIAL NON-CASH ACCOUNTING ENTRIES IMPOSED BY FHFA CAUSED FANNIE AND FREDDIE TO NEED TO DRAW \$187 BILLION IN UNNECESSARY SENIOR PREFERRED STOCK FROM TREASURY	12
III. TREASURY IMPOSED THE NET WORTH SWEEP IN AUGUST 2012 TO ENSURE THAT INCOME FROM REVERSALS OF FANNIE AND FREDDIE’S NON-CASH ACCOUNTING EXPENSES WOULD BE TRANSFERRED ENTIRELY TO TREASURY, PREVENTING THE COMPANIES FROM REBUILDING THEIR CAPITAL	15
CONCLUSION.....	17

Non-Party Timothy Howard was the Chief Financial Officer of Fannie Mae (“Fannie”) from February 1990 to January 2005. During that time, he was responsible for the company’s finance and risk management activities, strategic and business planning, financial reporting and accounting, and the management of Fannie’s largest business, its portfolio of mortgage investments. In 2013, Mr. Howard published a book on the financial crisis titled *The Mortgage Wars*.

Mr. Howard’s detailed knowledge of Fannie’s accounting, operations, and business risks—together with his experience at the company in the years during which the seeds of the 2008 mortgage crisis were sown—gives him a unique perspective on what occurred in the financial markets in general and with Fannie specifically in the period leading up to, during, and following the crisis. Much of what has been written and stated publicly about these events is incorrect, and can be readily disproven with verifiable facts that either are not widely known or have been ignored or misrepresented.

Mr. Howard’s interest is in ensuring that the Court has a factually accurate understanding of the relevant details concerning the government’s placement of Fannie Mae and Freddie Mac (“Freddie,” and together with Fannie, the “Companies”) into conservatorship, and the subsequent management and operation of that conservatorship.

INTRODUCTION AND SUMMARY OF THE ARGUMENT

Defendants’ motions to dismiss advance a false narrative that the United States Treasury (“Treasury”) rescued Fannie and Freddie at enormous risk to taxpayers, and that the \$187 billion in senior preferred stock forced upon the Companies was essential to save them from mandatory receivership and liquidation. As explained more fully below, this portrayal of Treasury acting as savior disintegrates in the face of indisputable facts.

The takeover of Fannie and Freddie was not a rescue. Unlike all commercial or investment bank interventions during the crisis, Treasury's decision to force the Companies into conservatorship was not a response to any imminent threat of failure. Rather, it was a calculated policy decision by Treasury, made at a time of Treasury's choosing and with ample advance planning. That decision—which resulted in the effective nationalization of Fannie and Freddie—was made without statutory authority and after Treasury overrode the Companies' own regulator, the Federal Housing Finance Agency ("FHFA"), which had deemed them to be in compliance with their capital standards and safety and soundness requirements.

Once in conservatorship, the Companies' respective management teams had no say on the terms under which they would receive capital. Treasury set those punitive terms on its own, involving Treasury-controlled FHFA only when required. The Preferred Stock Purchase Agreements (the "PSPAs") imposed upon the Companies required that any shortfalls in the Companies' book capital—no matter what their source or duration—be offset with "draws" of senior preferred stock that carried a perpetual dividend rate of at least 10 percent per annum after tax, and could never be repaid. The unprecedented non-repayment feature of the PSPAs gave Treasury and FHFA a powerful incentive to make accounting decisions for Fannie and Freddie that accelerated or greatly overstated their non-cash expenses after the conservatorship began, temporarily (and unnecessarily) ballooning the Companies' losses and creating a windfall of permanent dividend income for Treasury.

Through the end of 2011, Fannie and Freddie had enough business revenue (net interest income on loans held in portfolio, fees on guaranteed mortgage-backed securities plus other miscellaneous income) to cover all of their credit losses and administrative expenses. As a result, they remained comfortably solvent on an *operating* basis. But Treasury sought a different

outcome. From September 2008 through December 2011, Treasury and FHFA imposed more than \$320 billion in non-cash expenses on the Companies—exhausting their capital and forcing them to take \$187 billion in non-repayable senior preferred stock to cover \$151 billion in book losses and another \$36 billion in senior preferred stock dividend payments to Treasury.

Yet the Companies survived even this. Once no further non-cash expenses remained to be booked, Fannie and Freddie returned to profitability in the first quarter of 2012. Then, in early August 2012, each reported sufficient second quarter earnings to pay their senior preferred stock dividends and retain \$3.9 billion in capital. Less than two weeks later, Treasury and FHFA imposed the Third Amendment to the PSPA (which Treasury called the “Net Worth Sweep” in its press release), replacing the Companies’ quarterly dividend payment with the requirement that they remit all future earnings to Treasury. The purpose of the Net Worth Sweep was evident: to ensure that when the Companies’ mammoth non-cash expenses ceased or reversed themselves, the resulting earnings were sent to Treasury, rather than being retained by Fannie and Freddie to strengthen their capital cushions. The Net Worth Sweep was a deliberate expropriation of the Companies’ assets, and it was immensely beneficial to Treasury. From the time the Sweep was imposed in January 2013 through the end of 2014, Treasury pulled in over \$170 billion—some \$133 billion *more* than the \$37 billion the Companies would have owed absent the Sweep.

ARGUMENT

I. THE GOVERNMENT’S NATIONALIZATION OF FANNIE AND FREDDIE WAS NOT A RESCUE, BUT A PLANNED TAKEOVER BY TREASURY FOR POLICY PURPOSES.

Treasury’s actions to force Fannie and Freddie into conservatorship were fundamentally different from regulatory interventions in support of all other financial institutions during the 2008 financial crisis. All of the commercial and investment bank rescues—as well as that of

AIG—occurred in response to sudden and uncontrollable liquidity crises that had similar profiles: market perceptions of a sharp decline in the value of a company’s mortgage-related assets led to rapid outflows of consumer deposits, or an inability to roll over maturing short-term obligations. Depressed asset prices made it impossible for these lightly capitalized companies to replace lost deposits or maturing short-term debt by selling assets without taking losses that would have exhausted their capital. The Federal Reserve and Treasury were confronted with the need either to take immediate steps to save and preserve them—whether through massive provisions of liquidity, assisted mergers, asset guarantees or other measures—or to allow them to fail.

Fannie and Freddie faced no similar threats. As early as the winter of 2000, both companies had agreed with Treasury, and pledged publicly, to maintain sufficient liquidity to enable them to survive at least three months without access to the debt markets.¹ As a consequence of living up to this pledge, unlike all of the other companies rescued by the government during the financial crisis, neither Fannie nor Freddie ever experienced any imminent risk of insolvency because of difficulty rolling over maturing debt. Nor did they need to sell assets at depressed prices to survive. The Companies never experienced a *market* crisis.

Moreover, had Fannie or Freddie ever required temporary assistance from the government, there was a straightforward way such assistance could have been provided, at no risk to U.S. taxpayers. Former Federal Reserve Chairman Ben Bernanke describes this mechanism in his book, *The Courage To Act*: “To lend to Fannie and Freddie, which were not banks and thus not eligible to borrow at our regular discount window, we’d invoke yet another rarely used lending authority, this one under sections 13(13) of the Federal Reserve Act....

¹ Fannie Mae, 2000 *Annual Report*; Freddie Mac 2000 *Annual Report*.

Under 13(13), our loans must be collateralized by Treasury securities or securities guaranteed by an ‘agency’ such as Fannie and Freddie.”² As of August 2008, Fannie held over \$300 billion in “agency” mortgage-backed securities in its portfolio, while Freddie held over \$400 billion in similar securities.³ Had it become necessary, the Companies could have used those unencumbered assets to collateralize any conceivable amount of short-term borrowing from the Fed.

Treasury also had established a secured lending credit facility for each company, to serve as a liquidity backstop. Yet both Treasury and the Federal Reserve declined to make either lending capability available to Fannie or Freddie. In *The Courage To Act*, Bernanke is remarkably candid about his reason for dismissing the alternative of lending to the Companies: “I certainly did not want to do that. How ironic would it be for the Fed to help rescue [Fannie and Freddie] after all the years spent criticizing them?”⁴

That, in fact, was the reality: neither the Fed nor Treasury ever considered a true rescue of Fannie or Freddie. Instead, Treasury made a policy decision to take them over—against their will, without statutory authority, and at a time determined by Treasury Secretary Henry Paulson. As Paulson says in his book, *On The Brink*, he wanted to put the Companies into conservatorship before Lehman Brothers announced a “dreadful loss” for the second quarter of 2008.⁵

The seeds of the Fannie and Freddie takeovers were sown in the early 2000s. At that time, Treasury and the Federal Reserve had undertaken a series of actions, including a reduction in bank risk-based capital requirements, designed to promote the use of private-label securities—

² Ben S. Bernanke, *The Courage To Act: A Memoir of A Crisis and Its Aftermath* 234 (W.W. Norton, 2015) (“*The Courage To Act*”).

³ FNMA 10-Q (2008 Q3); FHLMC 10-Q (2008 Q3).

⁴ *The Courage To Act*, at 232.

⁵ Henry M. Paulson, *On The Brink: Inside the Race to Stop the Collapse of the Global Financial System*. 164 (Business Plus, 2013).

securities issued by entities other than Fannie, Freddie, or the Government National Mortgage Association—as an alternative to residential mortgage financing by those companies. Private-label issuance became the dominant form of mortgage securitization in 2004, but by late 2007 the unregulated private-label market had collapsed amidst an explosion of delinquencies and defaults. The result was a sharp fall-off in the availability of mortgage credit, to which Congress responded in February 2008 by nearly doubling the maximum dollar amount of individual mortgages Fannie and Freddie could finance. That gave the Companies access to the largest share of new residential mortgage loans in their history.

In the introduction to the 2013 edition of his book, Paulson states, “[f]rom my first days at Treasury, I had sought to reduce the role and strengthen the regulation of Fannie Mae and Freddie Mac, which owned or guaranteed about half of America’s residential mortgages.”⁶ After the collapse of the private-label securities market, however, Paulson saw that “[Fannie’s and Freddie’s] combined share of new mortgage activity had grown from 46 percent before the crisis to 76 percent.”⁷ Paulson told the Financial Crisis Inquiry Commission that Fannie and Freddie were “the only game in town” in early 2008, and that “[Fannie and Freddie], more than anyone, were the engine *we* needed to get through the problem.”⁸ The events described below make clear that when Paulson said “we” he meant the United States Treasury; by then a decision already had been made to ultimately take over the Companies for the exclusive benefit of the federal government and to the detriment of all other stakeholders.

On March 8, 2008, Jason Thomas, a senior White House official at the National Economic Council, sent a copy of a paper titled “Fannie Mae Insolvency and Its Consequences”

⁶ *Id.* at xix.

⁷ *Id.* at 127.

⁸ *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* 311 (Jan. 2011) (emphasis added).

to Robert Steel, Undersecretary for Domestic Finance at Treasury.⁹ This paper had been provided to the news publication *Barron's* as the basis for a negative article on Fannie published that same day.¹⁰ The paper and the article each opined that because of risky loan acquisitions and four accounting treatments the paper claimed were questionable—for (i) deferred tax assets, (ii) low-income housing tax credits, (iii) the valuation of Fannie's private-label security holdings and (iv) the valuation of its guaranty obligations for mortgage-backed securities—the company was in danger of failing and might have to be nationalized.

In an email message transmitting the paper to Steel, Thomas wrote: “Attached is a document used as the sourcing for today's *Barron's* article on the potential collapse of Fannie Mae. I send it only to help inform potential internal Treasury discussions about the potential costs and benefits of nationalization.”¹¹ This message reveals that the subject of Fannie nationalization had been raised at Treasury at least as early as March 2008. Moreover, the paper's prescription for a potential Fannie insolvency—writing down many of the company's assets and massively boosting its loss reserves—was a virtual blueprint for what Treasury and FHFA would do six months later.

On July 11, 2008, the *New York Times* published a front-page article saying the following: “Senior Bush administration officials are considering a plan to have the government take over one or both of [Fannie and Freddie] and place them in a conservatorship if their problems worsen.”¹² The source for this story was not identified. Shares of the Companies plunged, and in response Paulson publicly pledged support for them two days later, saying,

⁹ Email from J. Thomas to R. Steel of March 8, 2008, *available at* FCIC Resource Library.

¹⁰ *Id.*; J. Laing, *Is Fannie Mae the Next Government Bailout?*, *Barron's* (Mar. 10, 2008).

¹¹ *Id.*

¹² S. Laboton & S. Weisman, *U.S. Weighs Takeover of Two Mortgage Giants*, *N.Y. Times* (July 11, 2008).

“Fannie Mae and Freddie Mac play a central role in our housing finance system and must continue to do so in their current form as shareholder-owned companies.”¹³

In less than two weeks he said the precise opposite to a select group of Wall Street insiders. As reported by Bloomberg News, Paulson told a gathering of hedge fund managers at a private meeting at Eton Park Capital Management on July 21, 2008 that Treasury was considering a plan to put the Companies into conservatorship, which would effectively wipe out their common and preferred shareholders.¹⁴ Paulson does not mention this meeting in his book, and the government offers no explanation as to why the meeting took place or what its objective was. It appears, however, that the objective was to trigger selling in Fannie’s and Freddie’s equity and debt securities, contributing to the sense of market unease to which Treasury later would claim to be responding in taking over the Companies.

When the Housing and Economic Recovery Act (“HERA”) was enacted on July 30, it created a new regulator for Fannie and Freddie, the Federal Housing Finance Agency, and empowered it to place both companies into conservatorship or receivership. HERA’s legislative language, crafted and supported by Treasury, included a clause not present in any other regulatory statute: “The members of the board of directors of a regulated entity shall not be liable to the shareholders or creditors of the regulated entity for acquiescing in or consenting in good faith to the appointment of the agency [FHFA] as conservator or receiver for that regulated entity.”

This clause would come into play within a matter of weeks. When Paulson met with the directors of Fannie and Freddie to inform them of his intent to take over their companies, neither

¹³ *On The Brink*, at 149.

¹⁴ R. Teitelbaum, *How Paulson Gave Hedge Funds Advance Word of Fannie Rescue*, Bloomberg Business (Nov. 29, 2011).

met any of the twelve conditions for conservatorship spelled out in the newly passed legislation. Paulson did not seem to view this as an obstacle. As he explains in *On The Brink*, Paulson intended to rely on “the awesome power of the government and what it would mean for Ben [Bernanke] and me to sit across from the boards of Fannie Mae and Freddie Mac and tell them what we thought it was necessary for them to do.”¹⁵

Treasury lacked authority to put the Companies into conservatorship, yet Paulson was undeterred. Treasury’s dominance of FHFA’s decision-making comes through unmistakably in Paulson’s book: “FHFA had been balky all along. That was a big problem because only FHFA had the statutory power to put Fannie and Freddie into conservatorship. We had to convince its people that this was the right thing to do, while making sure to let them feel they were still in charge.”¹⁶

As late as August 22, 2008, FHFA had sent both Fannie and Freddie letters saying the Companies were safe and sound and exceeded their regulatory capital requirements.¹⁷ Paulson simply requested FHFA Director James Lockhart to change his agency’s posture on the Companies.¹⁸ Not two weeks after certifying the adequacy of the Companies’ capital, FHFA reversed course at Paulson’s urging. On September 4, 2008, FHFA sent each company a mid-year review letter, alleging weaknesses and making criticisms never before communicated to either one.¹⁹ And two days later, Paulson, Lockhart, and Bernanke met with the Companies’

¹⁵ *On The Brink*, at 167.

¹⁶ *Id.* at 5,6.

¹⁷ Letter from C. Dickerson to D. Mudd of Aug. 22, 2008; Letter from C. Dickerson to R. Syron of Aug. 22, 2008, *available at* FCIC Resource Library.

¹⁸ *On the Brink*, at 165.

¹⁹ Letter from C. Dickerson to D. Mudd of Sept. 4, 2008; Letter from C. Dickerson to R. Syron of Sept. 4, 2008, *available at* FCIC Resource Library.

CEOs and directors to tell them they had no choice but to agree to conservatorship.²⁰ At that time both companies exceeded their regulatory capital requirements—Fannie by \$9.4 billion and Freddie by \$2.7 billion.²¹

Unlike all real rescues during the financial crisis, New York Federal Reserve Bank President Timothy Geithner played no role in the takeovers of Fannie and Freddie. In his book *Stress Test*, Geithner writes: “I was in the Adirondacks over Labor Day weekend [2008], spending time with my family and trout fishing with Paul Volcker and Tim Collins . . . I felt a bit guilty that I had gone fishing, because Hank [Paulson] had asked me to come to Washington to help him plan a resolution for Fannie and Freddie. . . . But this was a Treasury operation, and I didn’t think Hank needed me in the war room.”²² Indeed Paulson did not.

As Paulson pressured the CEOs and directors of Fannie and Freddie to acquiesce to conservatorship, he deliberately withheld from them the terms that would be imposed in the aftermath. Paulson says in *On The Brink*: “The Fannie executives asked how much equity capital we planned to put in. How would we structure it? We wouldn’t say.”²³

Once Fannie and Freddie gave in to conservatorship—and with their management teams no longer having the ability to influence the terms of their purported rescues—Treasury and FHFA, as conservator of the Companies, entered into Preferred Stock Purchase Agreements for each. In these PSPAs, Treasury committed to purchase senior preferred stock from Fannie and Freddie when requested (or “drawn”) by them to maintain a positive net worth. The stock

²⁰ D. Solomon, S. Reddy, & S. Craig, *Mounting Woes Left Officials with Little Room to Maneuver*, Wall St. J. (Sept. 8, 2008).

²¹ News Release, *Fannie Mae Reports Second Quarter 2008 Results* (Aug. 8, 2008); News Release, *Freddie Mac Releases Second Quarter 2008 Financial Results* (Aug. 6, 2008).

²² Timothy F. Geithner, *Stress Test: Reflections on Financial Crises* 174 (Broadway Books, 2014).

²³ *On The Brink*, at 10.

entitled Treasury to dividends of 10 percent per annum if paid in cash or 12 percent if paid in kind (i.e., by taking more senior preferred stock, thus increasing Treasury's liquidation preference). In exchange for this commitment, Treasury received as a fee \$1.0 billion in senior preferred stock from each company, along with warrants to purchase 79.9 percent of Fannie and Freddie common stock at a nominal price and the right to charge a further "periodic commitment fee" in the future.

Fannie's and Freddie's PSPAs included one feature unique to these documents: all draws of senior preferred stock from Treasury were not repayable. Dividends on draws made at any time, and for any reason, had to be paid in perpetuity. We are unaware of any other regulator using non-repayable senior preferred stock as a vehicle for "assisting" an institution, or for any other purpose.

This unique non-repayment restriction, imposed on the Companies without their consent, served to transform temporary book losses at Fannie and Freddie into permanent cash revenues for Treasury. As conservator, FHFA had the ability to adopt accounting conventions that would either pull the Companies' non-cash expenses forward or allow them to be recorded based on estimates of future conditions. The terms of the PSPAs dictated that book losses created in this fashion had to be offset with senior preferred stock, and the non-repayment feature ensured that even if the losses were reversed—or turned out to be non-existent—Treasury still received a perpetual dividend equal to 10 percent of the highest cumulative loss at each company (or 12 percent if the dividends were paid in kind). This unprecedented non-repayment feature makes clear that Treasury and FHFA intended to engineer a massive concentration of Fannie's and Freddie's expenses as soon as the conservatorship was in place—and that is exactly what transpired.

II. A COMBINATION OF TEMPORARY AND ARTIFICIAL NON-CASH ACCOUNTING ENTRIES IMPOSED BY FHFA CAUSED FANNIE AND FREDDIE TO NEED TO DRAW \$187 BILLION IN UNNECESSARY SENIOR PREFERRED STOCK FROM TREASURY.

Treasury has systematically and grossly mischaracterized Fannie's and Freddie's credit risks and financial conditions leading up to the takeover. In *On The Brink*, Paulson says flatly: "Fannie and Freddie were the most egregious example of flawed policies that inflated the housing bubble and set off the financial crisis."²⁴

The reality was starkly different. At the time the Companies were forced into conservatorship, readily available mortgage performance data showed an average serious delinquency rate on single-family mortgages owned or guaranteed by Fannie and Freddie of 1.3%.²⁵ This was *half* the 2.6% serious delinquency rate on prime single-family mortgages reported by the Mortgage Bankers' Association ("MBA") for the industry—a figure that included Fannie and Freddie, meaning that the delinquency rate on loans made or held by others was approximately 3.5%. And the MBA's serious delinquency rate on subprime mortgages for the same period was 18.7%.²⁶ Contrary to Treasury's assertions, these empirical data show that Fannie and Freddie were not the riskiest, but the most disciplined sources of mortgage credit prior to the crisis.

Subsequent experience confirmed this. From 2008 through 2014, the average loss rate on residential mortgages owned or guaranteed by Fannie and Freddie was 0.45% per year, while the loss rate for residential mortgages owned by commercial banks over the same period was more

²⁴ *Id.* at xxxii.

²⁵ Fannie Mae *Monthly Summary*, Table 9 (Sept. 2008); Freddie Mac *Monthly Volume Summary*, Table 6 (Sept. 2008).

²⁶ Mortgage Bankers' Association *National Delinquency Survey* (Sept. 2008).

than triple that amount, at 1.43% per year.²⁷ And while estimates of loss rates on private-label mortgage-backed securities vary, they greatly exceed 2.0% per year.

Precisely because Fannie and Freddie had *not* been purchasing or guaranteeing the types of toxic mortgages that caused the housing boom and subsequent bust, their credit losses never rose so high as to threaten their solvency. Between 2008 and 2011, Fannie and Freddie suffered a combined \$101.4 billion in credit losses. During that same period their business revenues—net interest income plus guaranty fees and other miscellaneous income—were sufficient to cover both those credit losses and \$15.5 billion in administrative expenses.²⁸ On an *operating* basis, the Companies would have been able not only to maintain the \$84 billion of capital they held on June 30, 2008 (\$47 billion for Fannie and \$37 billion for Freddie), but also increase it.

Why, then, did Fannie and Freddie lose all of their capital *and* have to take \$187 billion in senior preferred stock from Treasury to cover \$151 billion in losses and \$36 billion in senior preferred stock dividend payments? The answer: Treasury, through FHFA, forced the Companies to incur an astounding \$326 billion in non-cash accounting charges, booked to their income statements after they were placed in conservatorship.

The plan for imposing these non-cash expenses had been detailed in the paper titled “Fannie Mae Insolvency and Its Consequences,” circulated within Treasury in March 2008. And the numbers were huge. From the third quarter of 2008 through the end of 2011, (i) \$124 billion was added to the Companies’ loan loss reserves; (ii) \$100 billion in deferred tax assets were written off; (iii) \$53 billion of the Companies’ non-agency mortgage securities were written

²⁷ FNMA 10-K (2009); FNMA 10-K (2011); FNMA 10-K (2014); FHLMC 10-K (2009); FHLMC 10-K (2011); FHLMC 10-K (2014); FDIC Statistics on Banking.

²⁸ FNMA 10-K (2009); FNMA 10-K (2011); FHLMC 10-K (2009); FHLMC 10-K (2011).

down, and (iv) \$49 billion in other non-cash expenses were incurred.²⁹ The vast majority of these accounting expenses were temporary, and many were based on estimates of future losses that ultimately would reverse and become income.

As soon as Fannie and Freddie were forced into conservatorship, FHFA set up a valuation reserve for their deferred tax assets, thereby effectively writing them off. This decision was based on the contention that the Companies would not have enough taxable income to realize the value of these assets, but the Companies still had positive operating results, so any shortfall in taxable income was a result of non-cash losses imposed by FHFA itself. The massive increase in Fannie's and Freddie's loss reserves dwarfed the reserve increases taken by commercial banks over the same period, notwithstanding that the Companies had delinquency and loss rates only about a third the size of the banks'. And the values of Fannie's and Freddie's securities and other assets were written down at a time when market illiquidity was at its peak, and prices at their lowest.

From all of this, the big winner was Treasury. By having FHFA run up Fannie's and Freddie's non-cash losses, Treasury created the impression that the \$187 billion in senior preferred stock the Companies were forced to draw was necessary to stave off "mandatory receivership and liquidation," and that these draws subjected taxpayers to "enormous risk". At the same time, Treasury generated for itself a perpetual income stream of \$18.7 billion per year, based on the combination of the massive temporary losses FHFA imposed on the Companies, the non-repayable senior preferred stock their PSPAs required them to take, and the ten percent per annum after-tax dividend they had to pay on the maximum dollar amount outstanding of that stock. Treasury, however, wanted still more.

²⁹ FNMA 10-K (2008); FNMA 10-K (2009); FNMA 10-K (2011); FHLMC 10-K (2008); FHLMC 10-K (2009); FHLMC 10-K (2011).

III. TREASURY IMPOSED THE NET WORTH SWEEP IN AUGUST 2012 TO ENSURE THAT INCOME FROM REVERSALS OF FANNIE AND FREDDIE'S NON-CASH ACCOUNTING EXPENSES WOULD BE TRANSFERRED ENTIRELY TO TREASURY, PREVENTING THE COMPANIES FROM REBUILDING THEIR CAPITAL.

Treasury's strategy of using non-cash accounting losses to eliminate Fannie and Freddie's capital and force them to draw billions in non-repayable senior preferred stock had one unavoidable consequence: as soon as all of those losses had been booked, the Companies would return to profitability. And when some of the losses reversed, the Companies would be *extremely* profitable.

By the end of 2011, a mammoth \$124 billion had been added to Fannie's and Freddie's loss reserves. Those reserves were available to absorb future credit losses, and in the first half of 2012 the Companies charged nearly all of their credit losses against their reserves, rather than against income. Without credit losses deducted from income, their net interest income and guaranty fees were sufficient to return them to stable profitability. In the first quarter of 2012 the Companies reported combined profits of \$3.3 billion, their first positive results since the second quarter of 2007.³⁰ Shortly thereafter, they reported \$8.1 billion in combined profits for the second quarter of 2012—enough to both pay their quarterly senior preferred stock dividends to Treasury *and* add \$3.6 billion to retained earnings.³¹ The second quarter of 2012 marked a clear turning point. With both companies able to use their ample loss reserves to absorb credit losses for at least the next few years, they were certain to be profitable enough to warrant release of the valuation reserves on their deferred tax assets, adding still further to their profits.

³⁰ FNMA 10-Q (2007 Q2); FNMA 10-Q (2012 Q1); FHLMC 10-Q (2007 Q2); FHLMC 10-Q (2012 Q1).

³¹ FNMA 10-Q (2012 Q2); FHLMC 10-Q (2012 Q2).

Treasury, of course, knew this, and it was no coincidence that Treasury and FHFA agreed to the Net Worth Sweep less than two weeks after Fannie and Freddie announced their second quarter earnings. Under the Sweep, the Companies were required to send all of their future profits to Treasury instead of paying a quarterly dividend. The express purpose of the Sweep was to ensure that when the effects of Fannie's and Freddie's earlier accounting-related write-downs and excessive loss reserving were reversed, it would be the Treasury, and not the Companies or their stockholders, that would benefit.

From the time the Net Worth Sweep was adopted through the end of 2014, Fannie and Freddie paid Treasury \$170.2 billion.³² Had the original dividend payment terms remained in effect, Treasury would have received only \$37.6 billion. The Companies would have retained the remaining \$132.6 billion, enabling them to improve their balance sheets and at the same time reassure all market participants (including the bondholders and stockholders of each company) that their futures were bright and that their conservatorships might soon end.

Initially, Treasury claimed that the Net Worth Sweep was essential to preventing Fannie and Freddie from entering "death spirals" of borrowing in order to continue to make their dividend payments. In their motions to dismiss, Defendants abandon this contention, and instead imply that the "rescues" of Fannie and Freddie were of such great value that the Net Worth Sweep is fair compensation for the services rendered: "Plaintiffs want to maintain those aspects of the [PSPAs] they like—*i.e.*, the unprecedented financial support from Treasury at a time when the Enterprises required billions of dollars in capital to avoid mandatory receivership and liquidation—and discard the parts they do not like—*i.e.*, the Third Amendment."³³

³² FNMA 10-K (2014); FHLMC 10-K (2014).

³³ *Motion to Dismiss by Defendants FHFA, Fannie Mae and Freddie Mac* (Filed Nov. 13, 2015).

Legal issues aside, there are fatal factual flaws to this narrative. As documented above, the takeover of Fannie and Freddie was *not* a rescue—it was nationalization, executed by Treasury for its own policy purposes. Fannie and Freddie did not request or require assistance at the time they were taken over, and had they ever needed any assistance the government could have provided it at no cost or risk to the taxpayer by making secured repayable loans to the Companies, fully collateralized by their holdings of agency mortgage-backed securities. Because the government made a conscious policy choice not to permit such assistance, it cannot now assert that the option it *did* pick—nationalizing the Companies against their will, without statutory authority and to Treasury’s sole financial benefit—at the same time subjected taxpayers to “enormous risk,” for which the government is owed the exorbitant compensation conveyed upon it by the Net Worth Sweep. If there truly ever was any risk to the government in assisting the Companies (and there was not) the government could have completely avoided that risk by making collateralized loans to them. The government cannot have it both ways.

CONCLUSION

For the foregoing reasons, Defendants’ motions to dismiss should be denied in their entirety.

Respectfully submitted,

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CERTIFICATE OF SERVICE

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