Nos. 19-422 & 19-563

In the Supreme Court of the United States

PATRICK J. COLLINS, ET AL., PETITIONERS

v.

STEVEN T. MNUCHIN, SECRETARY, U.S. DEPARTMENT OF TREASURY, ET AL.

STEVEN T. MNUCHIN, SECRETARY, U.S. DEPARTMENT OF TREASURY, ET AL., PETITIONERS

v.

PATRICK J. COLLINS, ET AL.

ON WRITS OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

BRIEF FOR TIMOTHY HOWARD AS *AMICUS CURIAE* SUPPORTING PETITIONERS IN NO. 19-422 AND RESPONDENTS IN NO. 19-563

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INTEREST OF *AMICUS CURIAE*[1]

Timothy Howard was the Chief Financial Officer of the Federal National Mortgage Association ("Fannie Mae" or "Fannie") from February 1990 to January 2005. During that time, he was responsible for Fannie's finance and risk management activities, strategic and business planning, financial reporting and accounting, and management of mortgage investments, Fannie's largest business. Mr. Howard wrote and published a book on the 2008 financial crisis titled *The Mortgage Wars* (McGraw-Hill) in 2013, and since 2016 has written articles and commentary in his blog *Howard on Mortgage Finance*, https://howardonmortgagefinance.com.

Mr. Howard's detailed knowledge of Fannie's accounting, operations, and business risks—together with his experience at the company when the seeds of the 2008 mortgage crisis were sown—gives him a unique perspective on what occurred in the financial markets generally, and at Fannie specifically, in the periods before, during, and after the crisis. Much of what has been written and stated about these events is incorrect and disproved with facts that either are

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[1] Pursuant to Rule 37.6, no counsel for any party authored this brief in whole or in part, and no party or counsel for a party made a monetary contribution intended to fund the preparation or submission of this brief. In addition to *amicus curiae* and his counsel, non-party Mason Capital Management LLC also made a monetary contribution for the preparation or submission of this brief. Counsel for the parties received timely notice of, and consented in writing to, this filing.

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 the Federal Home Loan Mortgage Corporation ("Freddie Mac" or "Freddie") (collectively, the "Companies") into conservatorship, and the management and operation of that conservatorship.

SUMMARY OF ARGUMENT

The Federal Parties' opening brief advances the narrative that the United States Department of the Treasury ("Treasury") rescued Fannie Mae and Freddie Mac at enormous risk to taxpayers, and that the $187 billion in senior preferred stock forced on the Companies was essential to save them from mandatory receivership and liquidation. *E.g.*, Br. 3, 5. This portrayal of Treasury acting as a savior is false.

In fact, the takeover of Fannie and Freddie was not a rescue. Unlike the commercial and investment bank interventions during the financial crisis, Treasury's decision to force the Companies into conservatorship was not a response to any imminent threat of failure. On the contrary, it was a calculated policy decision by Treasury, made at a time of Treasury's choosing, with ample and evident advance planning. That decision was made without statutory authority and after Treasury overrode the Companies' own regulator, the Federal Housing Finance Agency ("FHFA"), which had deemed them compliant 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 FHFA only when required. The Preferred Stock Purchase Agreements ("PSPAs") imposed on the Companies required that any shortfalls in their book capital—irrespective of their source or duration—would 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 fully 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. This temporarily (and unnecessarily) ballooned the Companies' losses and created a windfall of permanent dividend income for Treasury.

Through the end of 2011, Fannie and Freddie had enough business revenue (*e.g.,* net interest income on loans held in portfolio, fees on guaranteed mortgage-backed securities, and other miscellaneous income) to cover all of their credit losses and administrative expenses. As a result, the Companies 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.

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 of the Companies 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 that was immensely beneficial to Treasury. From the time it was imposed in January 2013 through the second quarter of 2016—the most recently reported quarter when this suit was first filed—Treasury pulled in \$192 billion: \$126 billion *more* than the \$66 billion the Companies would have owed absent the Net Worth Sweep. As a result of the Sweep, the Companies' regulatory, or core, capital—outstanding common and non-cumulative preferred stock, plus accumulated deficit—was a *negative* $186 billion at June 30, 2016, and still was a negative $170 billion at December 31, 2019. FNMA 10-Q (2016 Q2); FHLMC 10-Q (2016 Q2); FNMA 10-K (2019); FHLMC 10-K (2019).[2]

ARGUMENT

I. THE GOVERNMENT'S NATIONALIZATION OF THE COMPANIES WAS NOT A RESCUE, BUT A PLANNED TAKEOVER BY TREASURY FOR POLICY REASONS.

A. Fannie And Freddie Did Not Require A "Rescue" In 2008.

Treasury's actions to force Fannie and Freddie into conservatorship were fundamentally different from regulatory interventions in support of 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 either led to rapid outflows of consumer deposits or prevented the company from rolling over its 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

[2] For the Companies' SEC filings, see generally: https://fanniemae.gcs-web.com/financial-information/sec-filings; http://www.freddiemac.com/investors/financials/sec-filings.html.

exhausted their capital. The Federal Reserve and Treasury were confronted with the need either to take immediate steps to save and preserve these companies—whether through massive provisions of liquidity, assisted mergers, asset guarantees, or other measures—or to allow them to fail.

In contrast, 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. Fannie Mae, *2000 Annual Report;* Freddie Mac *2000 Annual Report*. As a consequence of fulfilling 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 it 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 section

> 13(13) of the Federal Reserve Act. . . . Under 13(13), our loans must be collateralized by Treasury securities or securities guaranteed by an 'agency' such as Fannie and Freddie.

Ben S. Bernanke, *The Courage to Act: A Memoir of a Crisis and Its Aftermath* 234 (W.W. Norton & Co. 2015) (*"The Courage to Act"*). 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. FNMA 10-Q (2008 Q3), FHLMC 10-Q (2008 Q3). If necessary, the Companies could have used those unencumbered assets to collateralize any conceivable amount of short-term borrowing from the Federal Reserve.

Treasury also had established a secured lending credit facility for each of the Companies, 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 his book, Chairman 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 the GSEs [Fannie and Freddie] after all the years spent criticizing them?" *The Courage to Act* 232.

B. The Conservatorship Of Fannie And Freddie Stemmed From A Policy Decision by Treasury.

Indeed, neither the Federal Reserve 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 he says in his book, he wanted to put the Companies into conservatorship before Lehman Brothers announced a "dreadful loss" for the second quarter of 2008. Henry M. Paulson, Jr., *On the Brink: Inside the Race to Stop the Collapse of the Global Financial System* 164 (Business Plus updated trade ed. 2013) ("*On the Brink*").

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—securities issued by entities other than Fannie, Freddie, or the Government National Mortgage Association—as an alternative to residential mortgage financing by those entities. 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, Secretary Paulson states: "From 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." *Id.* at xix. After the collapse of the private-label securities market, however, Secretary Paulson saw that the Companies' "combined share of new mortgage activity had grown from 46 percent before the crisis to 76 percent." *Id.* at 127. Secretary Paulson told the Financial Crisis Inquiry Commission that Fannie and Freddie were "the only game in town" in early 2008, and that they "more than anyone, were the engine *we* needed to get through the problem." *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), https:/www.govinfo.gov /content/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf (emphasis added) ("*Financial Crisis Inquiry Report"*). The events described below make clear that, by the term "we," Secretary Paulson meant Treasury. Early in 2008, he had already made the decision to 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" to Robert Steel, Undersecretary for Domestic Finance at Treasury. Email from J. Thomas to R. Steel (Mar. 8, 2008), FCIC Resource Library ("Thomas Email").[3] This paper had been provided to the news publication *Barron's* as the basis for a negative article on Fannie published that same day. *Id.;* J. Laing, *Is Fannie Mae the Next Government Bailout?*, Barron's (Mar. 10, 2008), https://www.wsj.com/articles/SB120493962895621231. 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 his email message transmitting the paper to Steel, Thomas wrote: "Attached is the 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." Thomas Email. 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

[3] *See* https://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2008-03-08_Treasury_Email_ from_Jason_Thomas_to_Steel_Re_Source_ document_for_Barrons_articl e_on_FNM.pdf.

company's assets and massively boosting its loss reserves—was a virtual blueprint for what Treasury and FHFA would actually do six months later.

Just days after the *Barron's* article, and on the eve of the announcement of the government-assisted acquisition of Bear Stearns by JP Morgan, Secretary Paulson overrode the objections of the Director of the Office of Federal Housing Enterprises Oversight ("OFHEO"), James Lockhart—who remained Director of FHFA when it replaced OFHEO in July of 2008—and allowed Fannie and Freddie to reduce their surplus capital percentages without any firm commitment from either company to raise additional capital. Director Lockhart expressed his disapproval in an e-mail written shortly after this agreement, saying: "The idea strikes me as perverse, and I assume it would seem perverse to the markets that a regulator would agree to allow a regulatee to increase its very high mortgage credit risk leverage (not to mention increasing interest rate risk) without any new capital." *Financial Crisis Inquiry Report* 315. Secretary Paulson's action was an unambiguous example of Treasury's dominance of FHFA. In addition, allowing Fannie and Freddie to reduce their capital and simultaneously increase their risk was so starkly contrary to Treasury's previous prescriptions for the Companies that it strongly suggests that Secretary Paulson already had begun to think of them as instruments of the government.

On July 11, 2008, the *New York Times* published a front-page article stating that "[s]enior 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." S. Labaton & S. Weisman, *U.S. Weighs Takeover of Two Mortgage Giants,* N.Y. Times (July 11, 2008), https://www.nytimes.com/2008/07/11/business/11fannie.html. The source for this story was not identified. Shares of the Companies plunged. In response, Secretary Paulson publicly pledged support for them two days later, saying, "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." *On the Brink* 149.

In less than two weeks, however, Secretary Paulson said the precise opposite to a select group of Wall Street insiders. As reported by *Bloomberg News*, Secretary Paulson told a group of investment managers at a private meeting on July 21, 2008 that Treasury was considering putting the Companies into conservatorship, which would effectively wipe out their common and preferred shareholders. R. Teitelbaum, *How Paulson Gave Hedge Funds Advance Word of Fannie Rescue,* Bloomberg Business (Nov. 29, 2011), https://www.bloomberg.com/news/articles/2011-11-29/how-henry-paulson-gave-hedge-funds-advance-word-of-2008-fannie-mae-rescue. The Secretary does not mention this meeting in his book, and the Federal Parties offer no explanation 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.

Nine days after Secretary Paulson's meeting, when Congress enacted the Housing and Economic Recovery Act ("HERA"), 12 U.S.C. §§ 4617 *et seq.,* on July 30, 2008, it created a new regulator for Fannie and Freddie—the FHFA—and empowered it to place both of the Companies into conservatorship or receivership. HERA's legislative language, crafted and supported by Treasury, included the following clause: "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." 12 U.S.C. § 4617(a)(6).

This clause would come into play within a matter of weeks. When Secretary Paulson met with the directors of Fannie and Freddie to inform them of his intent to take over the Companies, neither met any of the twelve conditions for conservatorship spelled out in HERA. *See id.* § 4617(a)(3). Secretary Paulson did not seem to view this as an obstacle. As he explains in *On the Brink,* Secretary 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." *On the Brink* 167.

Treasury lacked authority to put the Companies into conservatorship, yet Secretary

Paulson was undeterred. Treasury's dominance of FHFA's decision-making during this period comes through unmistakably in his 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." *Id.* 5-6.

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. Letters from C. Dickerson to D. Mudd and R. Syron (Aug. 22, 2008), FCIC Resource Library. [4] Secretary Paulson simply instructed Director Lockhart to change his agency's posture on the Companies. *On the Brink* 165. Not two weeks after certifying the adequacy of the Companies' capital, FHFA reversed course at Secretary 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. Letters from C. Dickerson to D. Mudd and R. Syron of Sept. 4, 2008, FCIC Resource Library.[5]

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[4] *See* https://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2008-08-22_Fannie_Mae_Letter_ from_Dickerson_to_Mudd_Re_Notice _of_Proposed_Capital_Classification_at_June_30_2008.pdf.

[5] *See* https://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2008-09-04%20FHFA%20 Dickerson%20ltr%20to%20Fannie%20Mae %20Mudd%20-%20Mid-Year%20letter.pdf.

Two days later, Secretary Paulson, Director Lockhart, and Chairman Bernanke met with the Companies' CEOs and directors to tell them they had no choice but to agree to conservatorship. D. Solomon, S. Reddy, & S. Craig, *Mounting Woes Left Officials with Little Room to Maneuver,* Wall St. J. (Sept. 8, 2008), https://www.wsj.com/articles/SB122083060663308415. At that time both of the Companies exceeded their regulatory capital requirements—Fannie by $9.4 billion and Freddie by $2.7 billion. News Release, *Fannie Mae Reports Second Quarter 2008 Results* (Aug. 8, 2008), https://www.fanniemae.com/newsroom/fannie-mae-news/fannie-mae-reports-second-quarter-2008-results; News Release, *Freddie Mac Releases Second Quarter 2008 Financial Results* (Aug. 6, 2008) (website unavailable).

The Federal Parties state in their petition for *certiorari* that "[t]he enterprises needed to raise more capital in order to stay in business—but private investors were unwilling to provide that capital." Pet. 3. The latter statement is false. On March 19, 2014, this *amicus* received an email from a senior executive of a major investment management firm[6] that said in part:

> Paulson is on record as saying that Morgan Stanley tried to raise capital in the summer of 2008 and found no takers. I would vehemently disagree with that. I vividly remember a call I did that

[6] The executive has not consented to the use of his or his firm's name in this brief.

> summer with Dan Simkiwicz and Taylor Wright (Treasury's bankers from MS) where I indicated a willingness to invest $5-10B [billion] in each company if the terms were right. Market chatter has led me to believe that—at a minimum—GSAM [Goldman Sachs Asset Management] and Fido [Fidelity Investments] were also constructive during those dark days.

Further, unlike all real rescues of financial institutions during the financial crisis, New York Federal Reserve Bank President Timothy Geithner appears to have played no role in the takeovers of Fannie and Freddie. In his book, Mr. 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.

Timothy F. Geithner, *Stress Test: Reflections on Financial Crises* 174 (Crown Publishers 2014). Indeed, Secretary Paulson did not need him in the war room.

Moreover, as Secretary 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. As he admits in his book: "The Fannie executives asked how much equity capital we planned to put in. How would we structure it? We wouldn't say." *On the Brink* 10.

C. Treasury And FHFA Used The Conservatorship To Lay The Groundwork For The Net Worth Sweep.

Once Fannie and Freddie surrendered to conservatorship—and with their management teams stripped of 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 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. This *amicus* knows of no 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 FORCED THE COMPANIES TO DRAW $187 BILLION IN SENIOR PREFERRED STOCK FROM TREASURY.

Treasury has systematically and grossly mischaracterized the Companies' lending practices and financial conditions leading up to the takeover. In *On the Brink*, Secretary 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." *Id.* at xxxii.

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%. Fannie Mae *Monthly Summary,* Table 9 (Sept. 2008), https://capmrkt.fanniemae.com /resources/file/ir/pdf/ monthly-summary/093008.pdf; Freddie Mac *Monthly Volume Summary,* Table 6 (Sept. 2008). 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 considerably higher, at approximately 3.5%. And the MBA's serious delinquency rate on subprime mortgages for the same period was an astounding 18.7%. Mortgage Bankers' Association *National Delinquency Survey* (Sept. 2008).

Contrary to Treasury's assertions, these empirical data show that Fannie and Freddie were not the riskiest, but in fact were the most disciplined, sources of mortgage credit prior to the financial crisis.

Further, from 2008 through 2012, when Fannie and Freddie returned to profitability, the average loss rate on residential mortgages owned or guaranteed by the Companies was 0.53% per year, while the loss rate for residential first mortgages owned by commercial banks over the same period was nearly triple that amount, at 1.42% per year. FNMA 10-K (2009); FNMA 10-K (2012); FHLMC 10-K (2009); FHLMC 10-K (2012); *see also FDIC Statistics on Banking*, https://www7.fdic.gov/sdi/main.asp?formname=standard. And while estimates of loss rates on private-label mortgage-backed securities vary, all 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, yet 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. FNMA 10-K (2009); FNMA 10-K (2011); FHLMC 10-K (2009); FHLMC 10-K (2011). 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 at Fannie and $37 billion at Freddie), but to *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? Because FHFA forced the Companies to incur an astounding $326 billion in non-cash accounting charges, booked to their income statements after they were placed into 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. 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 net 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. Fannie's and Freddie's loss reserves were hiked to levels that dwarfed the loss reserves of commercial banks during 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.

The actual numbers were huge. From the third quarter of 2008 through the end of 2011: (i) $100 billion in deferred tax asset reserves were set up; (ii) $124 billion was added to the Companies' loan loss reserves; (iii) $53 billion of their non-agency mortgage securities were written down; and (iv) $49 billion in other non-cash expenses were incurred. FNMA 10-K (2008); FNMA 10-K (2009); FNMA 10-K (2011); FHLMC 10-K (2008); FHLMC 10-K (2009); FHLMC 10-K (2011). The majority of these accounting expenses were either temporary or based on estimates of future losses that ultimately would reverse and become income.

The Companies' non-cash expenses turned their $84 billion in capital just prior to the conservatorships into draws of $187 billion in senior preferred stock at the end of 2011—covering $151 billion in non-cash losses put on their books by FHFA and the $36 billion in dividends they had to pay on that stock. The speed with which the $151 billion in losses were recouped, however, is irrefutable proof of their artificiality. From the time of Fannie's creation in 1938 and Freddie's in 1970, their cumulative combined earnings through June 2008 totaled less than $100 billion. Yet in just 18 months, from the fourth quarter of 2012 through the first quarter of 2014, the two companies earned—and paid to Treasury—$158 billion, more than half again what they had earned in their entire pre-crisis existence.[7] This was possible because, while economic

[7] News Release, *Fannie Mae Reports Net Income of $5.3 Billion and Comprehensive Income of $5.7 Billion for First Q1 2014* (May 8, 2014), https://www.fanniemae.com/newsroom/fannie-mae-news/fannie-mae-reports-net-income-53-billion-and-comprehensive

losses must be repaid with economic earnings, artificial losses can be repaid simply by reversing them, as occurred with Fannie and Freddie.

From all of this, the big winner was Treasury. By having FHFA run up the Companies' non-cash losses to astronomical levels, the Federal Parties created the impression that the $187 billion in senior preferred stock they 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 nearly $19 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. Its avarice culminated in the Net Worth Sweep.

-income-57-billion-q1-2014*;* News Release, *Freddie Mac Reports Net Income of $1.4 Billion, Comprehensive Income of $1.9 Billion for Second Quarter 2014* (Aug. 7, 2014), http://www.freddiemac.com/investors/financials/pdf/2014er-2q14_ release.pdf.

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

The Federal Parties' strategy of using non-cash accounting losses to eliminate the Companies' capital and force them to draw huge amounts of non-repayable senior preferred stock had two consequences: first, as soon as all of those losses had been booked, the Companies would return to profitability; then, when many of the losses reversed, the Companies would be *extremely* profitable.

At the end of 2011, the full amount of the mammoth $124 billion added to Fannie's and Freddie's loss reserves over the previous 3 ½ years was available to absorb future credit losses. And in the first half of 2012, the Companies charged nearly all of their credit losses against these reserves. With very few credit losses deducted from income, the Companies' guaranty fees and net interest income were sufficient to return them to stable profitability. In the first quarter of 2012 they reported combined profits of $3.3 billion, their first positive results since the second quarter of 2007. FNMA 10-Q (2007 Q2); FNMA 10-Q (2012 Q1); FHLMC 10-Q (2007 Q2); FHLMC 10-Q (2012 Q1). 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. FNMA 10-Q (2012 Q2); FHLMC 10-Q (2012 Q2). The second quarter of 2012 marked a clear turning point. With the 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.

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 Net Worth 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 Treasury, and not the Companies or their stockholders, that would benefit.

From the time the Net Worth Sweep was adopted through the second quarter of 2016, Fannie and Freddie paid Treasury $192 billion. FNMA 10-K (2014); FNMA 10-Q (2016 Q2); FHLMC 10-K (2014); FHLMC 10-Q (2016 Q2). Had the original dividend payment terms remained in effect, Treasury would have received only $66 billion. The Companies would have retained the remaining $126 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, the Federal Parties 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. After discovery in parallel litigation in the Court of Federal Claims revealed this explanation to be false, the Federal Parties then implied that the "rescues" of Fannie and Freddie were of such great value that the Net Worth Sweep was 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." Defendants' Motion to Dismiss 3, *Jacobs, et al. v. FHFA, et al.,* No. 1:15-cv-00708-GMS (D. Del. Nov. 13, 2015), ECF No. 18.

Legal issues aside, there are fatal factual flaws in this line of argument. 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. Further, 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 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" that justified the Net Worth Sweep. If there truly ever was any risk to the government in assisting the Companies (and there was not), collateralized loans were a means to avoid risk altogether. The government eschewed this solution in favor of the devious alternative that culminated in the Net Worth Sweep.

CONCLUSION

As requested by Plaintiffs, the Court should: (1) affirm the Fifth Circuit's statutory ruling and its ruling that FHFA is unconstitutionally structured; (2) reverse the Fifth Circuit's ruling on the appropriate remedy for Plaintiffs' constitutional claim; and (3) order that the Third Amendment be set aside.

Respectfully submitted.

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