

Memorandum

April 11, 2011

TO: Inspector General Eric Thorson
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Room 4436,
Washington, DC 20220

Senator Tim Johnson
Chairman
U.S. Senate Committee on Banking, Housing, and Urban Affairs
136 Hart Senate Office Building
Washington, DC 20510

Representative Spencer Bachus
Chairman
House Financial Services Committee
2246 Rayburn Building
Washington, DC 20515

FR: Ralph Nader
P.O. Box 19312
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RE: Need for an Inspector General Investigation of and Congressional hearings about Misleading Statements by high government officials about the financial health of Fannie Mae & Freddie Mac Prior to the Government imposed Conservatorship

I. BACKGROUND

Fannie Mae and Freddie Mac are government-sponsored enterprises (GSEs). Both companies were created by the federal government and both companies have federal government charters. These companies also have shareholders.

Shareholders in both companies purchased common stock and believed as shareholders they would share in the profits of the companies in which they invested and that as shareholders they would, with other shareholders, elect corporate directors and that those directors would oversee the management of the company. Shareholders also had legal rights to challenge management decisions through the courts and through proxy battles or by offering shareholder resolutions.

The Housing and Economic Recovery Act of 2008 authorized the government to place the GSEs in a conservatorship and replaced the existing weak GSE regulator, the Office of Federal Housing Enterprise Oversight (OFHEO), with the Federal Housing Finance Agency (FHFA).

On September 7, 2008, the FHFA established a conservatorship for Fannie Mae and Freddie Mac and took over the GSEs assets and assumed control of the GSEs. Common shareholders lost their voting rights, and dividends on preferred and common stock were suspended. Annual shareholder meetings were canceled.

Current Treasury Department and Congressional proposals regarding Fannie Mae and Freddie Mac have failed to consider the plight of common shareholders. Many prudent investors, including the undersigned, purchased Fannie Mae and Freddie Mac common stock because these stocks were considered safe investments. Shareholders who might otherwise have been apprehensive about keeping their Fannie Mae and Freddie Mac stock, even as the financial crisis was mushrooming, were led to believe these two prominent GSEs were financially sound. Even the most risk-averse, prudent investor would be comfortable relying on statements from knowledgeable high-ranking government officials who claimed Fannie Mae and Freddie Mac were rock-solid companies.

The following statements by high-ranking government officials would naturally lead a prudent shareholder to believe that Fannie Mae and Freddie Mac stock was a safe investment.

II. MISLEADING STATEMENTS BY HIGH-RANKING GOVERNMENT OFFICIALS

1. On July 10, 2008, OFHEO Director James B. Lockhart said:

“OFHEO has been monitoring and continues to monitor closely Fannie Mae, Freddie Mac and the mortgage and financial markets. As one would expect, we are carefully watching the Enterprises’ credit and capital positions.

As I have said before, they are adequately capitalized, holding capital well in excess of the OFHEO-directed requirement, which exceeds the statutory minimums. They have large liquidity portfolios, access to the debt market and over \$1.5 trillion in unpledged assets.”¹

2. On July 10, 2008 former Chair of the House Financial Services Committee Representative Barney Frank said that Fannie Mae and Freddie Mac are important financial institutions that are basically strong and are “well capitalized.”²

3. On July 11, 2008 Chuck Greener, Fannie Mae Senior Vice President said:

“OFHEO has reiterated that Fannie Mae is adequately capitalized, the highest capital

1. <http://www.fhfa.gov/webfiles/1503/71008Statement.pdf>.

2. US Frank: Fannie, Freddie Are “Very Important, Well Capitalized” By John Shaw, The Main Wire, July 10, 2008 Thursday 2:24 PM GM <http://www.marketnews.com>

designation given by our regulator. More broadly, Treasury Secretary Henry Paulson and leaders in Congress have also issued statements of support, for which we are appreciative.”³

4. On July 13, 2008 former Senator Christopher Dodd, who chaired the Senate Banking Committee said: Fannie and Freddie were in “good shape”.

“They have more than adequate capital, in fact more than the law requires,” Dodd, a Connecticut Democrat who is chairman of the Senate Banking Committee, said on CNN’s “Late Edition” today. “They have access to capital markets. They’re in good shape.” “To suggest somehow they’re in major trouble is not accurate,” Dodd said.⁴

5. On July 15, 2008 former Treasury Secretary Henry M. Paulson said:

“Our proposal⁵ was not prompted by any sudden deterioration in conditions at Fannie Mae or Freddie Mac. OFHEO have reaffirmed that both GSEs remain adequately capitalized.”⁶

6. On July 15, 2008 Senator Dodd also said:

In considering the state of our economy, in particularly turmoil in recent days, it is important to distinguish between fear and facts. In our markets today, far too many actions are being driven by fear and ignoring crucial facts.

One such fact is that Fannie Mae and Freddie Mac have core strengths that are helping them weather the stormy seas of today’s financial markets. They are adequately capitalized. They are able to act as the debt markets. They have solid portfolios with relatively few risky subprime mortgages. They are well-regulated and they have played a vital role in maintaining the flow of affordable mortgage credit, even during these volatile times.⁷

7. On July 16, 2008 Ben S. Bernanke, the Chairman of the Federal Reserve told the House Financial Services Committee:

“Let me just say a word about GSEs, because you raised that.

The GSEs are adequately capitalized. They are in no danger of failing.”⁸

8. On August 20, 2008 Associated Press reported the following from former Fannie Mae CEO

3. <http://www.fanniemae.com/newsreleases/2008/4422.jhtml>

4. July 13, 2008, Bloomberg – Fannie Mae, Freddie Mac Are in ‘Good Shape’ Dodd Says.

5. Treasury Secretary Henry M. Paulson Jr. was seeking permission from Congress to temporarily increase the amount the companies could borrow from the Treasury.

6. Testimony of Honorable Henry M. Paulson Secretary of the Treasury, Hearing: Recent Developments in U.S. Financial Markets and Regulatory Responses to Them. US Senate Committee on Banking, Housing and Urban Affairs, Tuesday, July 15, 2008.

7. Senate Committee on Banking, Housing and Urban Affairs, Hearing on the Federal Reserve’s Semiannual Monetary Policy Report to Congress, July 15, 2008

8. House Committee on Financial Services Hearing on Monetary Policy and the State of the U.S. Economy July 16, 2008.

Daniel Mudd:

“Fannie Mae’s chief executive sought to reassure investors that no [government] bailout is imminent. “They haven’t offered anything and we haven’t asked for anything,” Fannie Mae CEO Daniel Mudd said in a public radio interview Wednesday morning. “I don’t anticipate that they will do that.” Mudd said the company’s financial position “remains very strong,” and that he intends to remain the CEO.”⁹

Prudent shareholders, employees, pension and 401 (k) funds, mutual funds, and small banks have all been adversely affected because of their reliance on misleading statements about the financial strength of the GSEs by high-ranking government officials. The impact of the statements made by Mr. Mudd and Mr. Greener as representatives of Fannie Mae and the statements made by Mr. Lockhart, Mr. Bernanke and Mr. Paulson, as high-ranking government officials with substantial influence over these GSEs may well have been relied upon by investors and may have caused investors to suffer financial harm. The GSEs have a variety of characteristics that have given them special and unique quasi-governmental status.

Prior to FHFA’s establishment of the conservatorship, as Government Sponsored Enterprises Fannie Mae and Freddie Mac enjoyed a variety of privileges not available to other corporations. Thomas H. Stanton, author of: *Government-Sponsored Enterprises: Mercantilist Companies in the Modern World (AEI Studies on Financial Market Deregulation 2002)* and *A State of Risk: Will Government-Sponsored Enterprises Be the Next Financial Crisis? (HarperCollins 1991)* and

9. August 20, 2008, Associated Press Online, “Fannie Mae, Freddie Mac shares plummet” by Stephen Bernard and Alan Zibel.

* On Mar 11, 2011 Daniel Mudd, now Chief Executive Officer of Fortress Investment Group LLC, issued the following statement to Bloomberg News regarding the “Wells Notice” issued to him by the SEC:

“I have been informed that the SEC staff has sent my counsel a Wells Notice arising out of my service at Fannie Mae. In keeping with SEC procedures, I intend to submit a written response that will make clear why the SEC staff should not pursue any action in this matter.

“The disclosures and procedures that are the subject of the staff’s investigation were accurate and complete. These disclosures were previewed by federal regulators, and have been issued in the same form since the company went into government conservatorship.

“As the executive responsible for initially registering Fannie Mae with the SEC, and having led the company through the SEC-mandated restatement, I have the highest respect for the Commission. Nevertheless, I could not disagree more with this turn of events.”

* The Wells Notice. Rule 5(c) of the SEC’s Rules on Informal and Other Procedures states that “[u]pon request, the staff, in its discretion, may advise such persons [involved in preliminary or formal investigations] of the general nature of the investigation, including the indicated violations as they pertain to them, and the amount of time that may be available for preparing and submitting a statement prior to the presentation of a staff recommendation to the Commission for the commencement of an administrative or injunction proceeding.” 17 C.F.R. Section 202.5(c).

<http://www.sec.gov/divisions/enforce/enforcementmanual.pdf>

Professor David Reiss have assembled a variety of examples that illustrates this point.¹⁰

10 Examples of Special privileges afforded to GSEs:

- i. Fannie Mae and Freddie Mac could borrow money at a lower cost than private companies (they have access to agency credit). The combination of low borrowing costs and high leverage allowed greater growth.
- ii. Private-label firms could not compete head on with GSEs because their cost of capital was greater. Therefore, Fannie Mae and Freddie Mac could price their securities more attractively than private label issuers, and have nearly the entire prime, conforming market to themselves – a market in which they could effectively act as duopolists.
- iii. Fannie and Freddie were regulated partly by the U.S. Department of Housing and Urban Development (HUD) and partly by the Office of Federal Housing Enterprise Oversight (OFHEO). In addition to the weakness of this divided regulatory regime Fannie Mae and Freddie Mac were often inadequately regulated because their regulators lacked the legal authority and mandate to prevent the companies from making serious financial mistakes.
- iv. There was an implied guarantee of Fannie Mae's and Freddie Mac's obligations by the federal government. This made investors more willing to pay a premium for Fannie Mae's and Freddie Mac's securities over that which they would pay for the debt securities of other private companies.
- v. Fannie Mae and Freddie Mac were considered "Too Big to Fail," referring to the policy where a government bails out insolvent institutions instead of letting them go through normal channels, such as the kind of receivership that applies to commercial banks that are not considered "Too Big to Fail."
- vi. Unlike most other publicly traded corporations, Congress created Fannie Mae and Freddie Mac to achieve a public purpose, in addition to the traditional profit-maximization that private corporations seek.
- vii. Fannie Mae's and Freddie Mac's securities are exempt under the Securities Acts and are therefore not required to be registered with the SEC.
- viii. Fannie Mae and Freddie Mac are exempt from state and local income taxes.
- ix. Federal law preempts many state laws that otherwise might apply to Fannie Mae and Freddie Mac.
- x. The Secretary of the Treasury is authorized to purchase Fannie Mae and Freddie Mac debt.
- xi. Fiduciaries could invest in Fannie Mae and Freddie Mac obligations as if they were government securities.
- xii. Federal Reserve Banks were fiscal agents for Fannie Mae and Freddie Mac.
- xiii. Fannie Mae's and Freddie Mac's securities were eligible for unlimited investment by federally regulated lenders, including national banks, federal savings associations, and federal credit unions, in contrast to the restricted ability of those entities to invest in the obligations of other publicly traded corporations.
- xiv. Fannie Mae and Freddie Mac had lower capital requirements than other financial institutions (only required to hold 2.5% of their capital against mortgages retained in their portfolios and 0.45% against their mortgage-backed securities), amounting to leverage that is between twice and three times as high as regulators permit for other financial institutions. This greater leverage provided the potential for greater profits for Fannie Mae and Freddie

III. UNCERTAIN STATUS OF COMMON STOCKHOLDERS

Under the conservatorship, the government has received warrants to buy up to 79.9 percent of GSE common stock for \$0.00001 per share. The non-government common stockholders are, in essence, zombie stockholders with no rights and no remedies against the GSEs or the FHFA.¹¹ The government, however, would not want to own even 80 percent of the stock, because the government does not want the GSEs' assets and liabilities on the government's books. Consequently the shareholders are in a financial limbo.

IV. DELISTING

On June 16, 2010, the FHFA directed Fannie Mae and Freddie Mac to delist their common and preferred stock from the NYSE. The Exchange did not demand this move. Fannie Mae's stock price had dropped slightly below the \$1 per share threshold stipulated by NYSE rules, but the Big Board is quite flexible with time either to get back over \$1 or to allow companies to offer a reverse stock split. Freddie was over the \$1 level. The delisting took the shares down to the range of 30 cents, wiped out billions of dollars in shareholder value, and chased away many institutional holders.

FHFA Acting Director Edward J. DeMarco said: "A voluntary delisting at this time simply makes sense and fits with the goal of a conservatorship to preserve and conserve assets."¹²

On September 15, 2010, Acting Director DeMarco said:

"The statutory purpose of conservatorship is to preserve and conserve each company's

Mac shareholders but also made the companies more vulnerable to financial failure.

xv. Fannie Mae and Freddie Mac were exempt from certain privacy restrictions and creditworthiness requirements including the Gramm-Leach-Bliley financial privacy restrictions that apply to other financial firms.

xvi. GSEs held unique legal charters that created a barrier to protect against possibility that a new entrant would benefit from the same system of statutory privileges.

Examples from: THE FEDERAL GOVERNMENT'S IMPLIED GUARANTEE OF FANNIE MAE AND FREDDIE MAC'S OBLIGATIONS: UNCLE SAM WILL PICK UP THE TAB, Georgia Law Review Summer 2008 42 Ga. L. Rev. 1019 and Interview with Thomas H. Stanton, July 7, 2010.

11. See: 12 USC § 4617 (b) (2) (K) Other provisions. (i) Shareholders and creditors of failed regulated entity. Notwithstanding any other provision of law, the appointment of the Agency as receiver for a regulated entity pursuant to paragraph (2) or (4) of subsection (a) and its succession, by operation of law, to the rights, titles, powers, and privileges described in subsection (b)(2)(A) shall terminate all rights and claims that the stockholders and creditors of the regulated entity may have against the assets or charter of the regulated entity or the Agency arising as a result of their status as stockholders or creditors, except for their right to payment, resolution, or other satisfaction of their claims, as permitted under subsections (b)(9), (c), and (e).

12 FHFA News Release http://www.fhfa.gov/webfiles/15854/Delisting_6_16_10.pdf

assets and put them in a sound and solvent condition. The goals of conservatorship are to help restore confidence in the companies, enhance their capacity to fulfill their mission, and mitigate the systemic risk that contributed directly to instability in financial markets.”¹³

Acting Director DeMarco’s action in delisting Fannie Mae and Freddie Mac do not seem to comport with his understanding of the statutory purpose of the conservatorship.

V. GOVERNMENT TREATMENT OF (GSES) VS OTHER FINANCIALLY TROUBLED CORPORATIONS.

The federal government employed various rescue models to assist or bailout financially troubled corporations.

One model provided capital and credit lines to Bank of America, Citigroup, Morgan Stanley, J.P. Morgan Chase and AIG, leaving their shareholders beaten down but intact to start recovering value.

A second model dispatched General Motors into a well-orchestrated, bankruptcy process. While the bankruptcy court treated the common shareholders like flotsam and jetsam, GM emerged well subsidized and tax-privileged with a clean balance sheet under temporary ownership by the U.S. and Canadian governments and the United Auto Workers.

A third model placed Fannie Mae and Freddie Mac under an indeterminate conservatorship scheme that kept but abused its common shareholders, who had already lost up to 99% of their investment. Neither vanquished nor given an opportunity to recover, the institutional and individual shareholders are trapped in limbo.

The proposals being put forth by the Treasury Department and Congress do little to protect the already financially injured shareholders. An array of options put forth by former Treasury Secretary Paulson¹⁴

and the GAO¹⁵ are rarely mentioned by Treasury officials or members of Congress. A wide-ranging debate about the best approach to dealing with the full array of GSE stakeholders is in order. A September 9, 2009 Congressional Research Service Report suggested that Congress may consider the following options:

- Return Fannie Mae and Freddie Mac to their stockholders with little or no change

13. Statement of Edward J. DeMarco, Acting Director, Federal Housing Finance Agency, Before the U.S. House of Representatives Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises, September 15, 2010.

14. Remarks by Treasury Secretary Henry M. Paulson, Jr. on The Role of the GSEs in Supporting the Housing Recovery before the Economic Club of Washington, January 7, 2009.

15. FANNIE MAE AND FREDDIE MAC: Analysis of Options for Revising the Housing Enterprises’ Long-term Structures, September 2009. <http://www.gao.gov/new.items/d09782.pdf>

to their congressional charters;

- Eliminate their GSE status and convert Fannie Mae and Freddie Mac into private corporations;
- Eliminate their GSE status and convert Fannie Mae and Freddie Mac into a government agency; or
- Make supplementary changes to support the secondary mortgage market such as providing government reinsurance of MBS or encouraging the use of covered bonds.¹⁶

VI. THE IMPLIED GOVERNMENT GUARANTEE

A Congressional Research Service (CRS) Report for Congress states:

Through their charters, GSEs receive a number of privileges not granted to private sector financial firms. These privileges and the public-private (hybrid) nature of GSEs create the perception among investors that the federal government backs GSE obligations. To be clear, there is no explicit guarantee in law for GSE liabilities. In fact, the charter of each GSE requires that it inform investors that its securities are not government-backed. Nevertheless, there is a general presumption to the contrary, which Fannie Mae acknowledged in a letter to the Office of the Comptroller of the Currency:

Fannie Mae standard domestic obligations, like Treasuries, typically receive no rating on an issue-by-issue basis, because investors and rating agencies view the implied government backing of Fannie Mae as sufficient indication of the quality of Fannie Mae obligations.

This impression of federal backing has been encouraged by the federal government's past actions. For example, when the Farm Credit System was in crisis in the late 1980s, the federal government arranged a bailout.¹⁷

Professor David Reiss, notes:

Market players, the entities that buy and sell Fannie and Freddie securities, speak with one voice regarding the relationship between the federal government and Fannie and Freddie; the federal government does, indeed, extend an implied guarantee to Fannie's and Freddie's obligations. Market players put their money where their mouths are; they routinely purchase Fannie and Freddie obligations at prices just a bit higher than the prices they pay for Treasury securities. That is, market players perceive the risk of default of Fannie and Freddie obligations, notwithstanding the potential insolvency of either of those companies, as

16. CRS Report: Options To Restructure Fannie Mae and Freddie Mac, by N. Eric Weiss. September 9, 2009

17. Government-Sponsored Enterprises (GSEs): An Institutional Overview, by Kevin R. Kosar, Updated April 23, 2007.

nearly as unlikely as the risk of a default by the U.S. Government itself. The market comes to its conclusion by identifying a pattern amidst the strands of “ complex web of relationships and market signals that, in toto, result in what may be deemed to be a de facto guarantee of the GSE’s obligations.”¹⁸

The existence of an implied guarantee may not be legally enforceable, but, given the statements by high-ranking government officials about the financial health of Fannie and Freddie, the moral obligation to provide some minimum consideration to owners of common stock is clear. The Congressional Budget Office (CBO) noted the benefit of this implied guarantee:

Fannie Mae’s and Freddie Mac’s charters gave the GSEs advantages over other participants in the secondary market for conforming mortgages, including the perception of an implied federal guarantee on their obligations. Those advantages furnished the GSEs with market power—meaning that they could charge somewhat more for their guarantees than it cost to provide them, while still charging less than potential competitors that lacked those advantages. The GSEs’ most important advantage was the financial value of the implicit federal guarantee; that value has often been equated to a federal subsidy because it represents the cost to taxpayers of providing the guarantee. The subsidy lowered the cost to the GSEs of issuing debt and increased the value to investors of their guarantees on mortgage-backed securities.¹⁹

Fannie and Freddie Common shareholders should not be vanquished, but given a chance to recover some of value of their stock, just as the Citibank shareholders were allowed to participate in the recovery of Citibank stock. Investors of a variety of stripes, in part because of the reassuring statements made by high-ranking government officials, relied on the government to back-stop their investments in GSE stock.

VII. QUESTIONS

The actions of high-ranking government officials raise serious questions about the government-imposed conservatorship and its impact on GSE common shareholders. The Treasury Department Inspector General and Congressional Committees with appropriate jurisdiction are in the best position to review the concerns raised in this memorandum and conduct a thorough investigation of these matters. In fact, such a review is imperative, given the absence of legal rights and remedies available to the GSE shareholders for internal shareholder advocacy or external judicial determination. The following questions should guide the investigation of connection between the actions and statements of high-ranking government officials and the financial harm done to GSE shareholders:

1. Did high-ranking government officials erroneously, negligently, or intentionally make

18. THE FEDERAL GOVERNMENT’S IMPLIED GUARANTEE OF FANNIE MAE AND FREDDIE MAC’S OBLIGATIONS: UNCLE SAM WILL PICK UP THE TAB, Georgia Law Review Summer 2008 42 Ga. L. Rev. 1019.

19. Fannie Mae, Freddie Mac, and the Federal Role in the Secondary Mortgage Market, CBO Study, December 2010.

misleading statements concerning the financial condition of the GSEs?

2. Why did the federal government choose the path of conservatorship for these two GSEs rather than the model used for Citigroup and other financial institutions?
3. Why does housing finance reform require the liquidation or dissolution of Fannie Mae and Freddie Mac?
4. How did the Treasury Department arrive at the notion that recovery of taxpayer funds issued to Fannie Mae and Freddie Mac would not be full and complete?
5. How does the voluntary FHFA delisting of Fannie Mae and Freddie Mac stock, and the destruction of billions of dollars of shareholder value comport with preserving and conserving each company's assets and putting them in a sound and solvent condition?
6. How does delisting help restore public confidence in the companies, or enhance their capacity to fulfill their mission?
7. If the two companies should recover, does the FHFA intend to release Fannie Mae and Freddie Mac from conservatorship and relist their securities on the NYSE?
8. Why should Fannie Mae and Freddie Mac common stock owners be prohibited from filing suit against the GSE managers for making false or misleading statements concerning the financial condition of the GSEs?
9. Why wasn't this prohibition applied to other financially troubled institutions such as Citibank, and Bank of America, which were considered "Too Big to Fail", and which received government bailouts?
10. Did the Treasury Department limit its ownership of GSE common stock to 79.9 percent to avoid having the liabilities of the GSEs appear on the government books?
11. Does the Treasury Department have a moral obligation to provide GSE common stockholders with the legal rights they had before the conservatorship was established?
12. Has the Treasury Department made any assurances to foreign sovereign funds regarding the future structure of Fannie Mae or Freddie Mac?
13. Has the Treasury Department prepared any estimates of when or how Fannie Mae and Freddie Mac will become profitable?

14. Has the Treasury Department evaluated the long-term taxpayer cost of various re-structuring options put forward by the GAO?
15. Has the Treasury Department considered substantially reducing the 10 percent dividend paid by the GSEs to the federal government to increase the likelihood that the financial health of the GSEs could be restored?

I look forward to your response.

A handwritten signature in black ink, appearing to read "Ralph Nader". The signature is fluid and cursive, with the first name "Ralph" and last name "Nader" clearly distinguishable.

Ralph Nader