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FANNIE MAE AND FREDDIE MAC IN ADMINISTRATION

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Introduction

Fanny Mae was, until 6 September 2008, a publicly held company, the biggest corporation in the United States' \$3 TRILLION mortgage investment market and holds one quarter of this secondary mortgage market for US home loans .It is the second -largest issuer of debt in the US after the federal government. Which guarantees Fannie Mae to a total of \$2 trillion?

Freddie Mac, the Federal Home Loan Mortgage Corp made a loss of \$550 million for the third quarter of 2006, compared to a profit of \$880 million in 2005, blaming this loss on a decline in interest-rates. In 2003, Freddie Mac was penalised for understating earnings of \$5 billion in 2003 and paid \$125 million in penalties to its regulator, the Office of Federal Housing Oversight, to settle charges of accounting fraud. However, 6 September 2008, both Fannie Mae and Freddie Mac have been placed under administration by the US government and a new regulator, the Federal Housing Finance Agency, will have control and oversight of Fannie and Freddie, assuming the powers of their officers, director and shareholders. The Treasury will provide capital infusions for the two companies to ensure they remain solvent. The capital investment will have an upper limit of \$100 billion each for each company. Treasury said the \$100 billion figure did not reflect the companies' financial health, but instead shows "a strong commitment to [Fannie's and Freddie's] creditors and mortgage-backed security holders." Fannie and Freddie have together lost \$14 billion in 2008. As part of the government takeover, Fannie Chief Executive and Freddie's Chairman and Chief Executive will be dismissed. The US property market is in recession. Fannie and Freddie have not suddenly found themselves in financial straits and in 2003 both companies were found to be committing fraud.

Financial Irregularities in 2003

The corporation is alleged to have held back expenses at year end in order to keep profits steady as per forecasted figures and so achieve bonus compensation targets. It has manipulated its earnings per share ratio¹ since 1998. This was so that it could maintain stable earnings at the expense of accurate financial disclosure. It employed an improper reserve in accounting for the amortisation of deferred price adjustments under GAAP Accounting Rules and tolerated related internal control deficiencies. As far back as 1966, studies by Brief² demonstrated that cheating on the earnings ratio was a bad influence on resource allocation, prices and output, the business cycle and economic growth in general. This false accounting manipulated those investors who simply trusted and market by taking the earnings ratio as the main decision factor of sound investment, investing in Fannie Mae.

Fanny Mae's financial fraud, made public in 2003, was not an exception to the rule in the mortgage market in the US. The Federal Bureau of Investigation (FBI) reported in 2004 state that the whole US mortgage market is fraudulent.³ The FBI have investigated hundreds of mortgage frauds⁴ recently covering billions of US dollars which are defrauded , causing billions of dollars of losses to financial institutions.

¹ Earnings per share is found by dividing profit attributable to the ordinary shareholders by the number of ordinary shares in issue and the price/earnings ratio, the more important ratio, is calculated by dividing the share price by the earnings per share. This relates the company performance to external perception. Generally a high price/earnings ratio is a good indicator of market support. For companies quoted in the financial press as Fannie Mae often is, it is essential that the price/earnings ratio is consistent and comparable and any area that determines profit will have an effect on this ratio. That is why Fannie Mae decided to treat certain operative expenses in certain ways - to keep the p/e ratio "smooth". Alexander. D, (2000), 'Financial Reporting', London: Chapman & Hall.

The accounting technique of 'earnings smoothing' is common to many serious financial frauds. It was used at Microsoft systems Inc, Waste Management Inc, Enron Inc. It involves inflation of earnings per share, the key being that debt was under-reported and operating costs were also under-reported.

² Brief. R, (1966), 'The origin and evolution of nineteenth century asset accounting'. Butterworths.

³ Fleishman. S, (2004), 'Mortgage fraud concerns FBI', Washington Post, 18 September 2004.

⁴ US examples of mortgage fraud are (1) buying a house with a large mortgage at a greatly increased price from a partner, selling it back to him quickly for its real market price and leaving a large mortgage unpaid; (2) fictitious credit histories in order to obtain large mortgage; (3) forged loan documents; (4) mortgage foreclosure methods used to buy property in order to conceal the true buyer's name.

Such mortgage fraud is occurring in Charlotte, Washington, New York, Georgia, Missouri, California, Nevada and many other states and is therefore widespread;⁵

Unqualified Accounting Statements of the Auditor misled the market.

In clear violation of Accounting Standards, the auditors of Fannie Mae issued unqualified audit certificates⁶ since 1996 to 2003. The 2002 Sarbanes Oxley Act made drastic changes to corporate governance. The Chief Executive Officer must certify that each periodic financial report fully complies with the requirements of sections 13(a) and 15(a) of the Exchange Act and that the information in the report is fair and true in all material respects, of the financial conditions and results of the company.

There are now criminal sanctions for signing a false report. Violation of section 302 carries civil penalties to the Chief Executive Officer and violations to section 906, certifying accounts knowing it to be false, subjects him to a fine of up to one million US dollars or imprisonment for up to ten years, or both.⁷

Addressing the legal issues - market Response in 2003

The Federal Reserve's response to Fannie Mae's false accounting and fraud to 2003 was to refuse to promise to buy back open purchases of dated paper such as 10-year T Notes and the European Central Bank took all Fanny Mae debt from its reserve base. Fannie Mae's own Regulator, the Office of Federal Housing Enterprise Oversight has demanded that Fannie Mae must, from now maintain 30% more capital than the 2003 rules stipulated. In 2003, Fannie Mae's stock price decreased from \$128 before 2003

⁵ Frieden, T, (2004), 'FBI warns of mortgage fraud 'epidemic'. Seeks to head off 'next S & L crisis', Washington: CNN Law Centre. By 2004 all these states which suffered mortgage fraud had enacted new and amended legislation to stop anti-predatory lending home loan practices.

⁶ Financial Statements that are unqualified are normally relied on as showing a true and fair view of the financial position, performance and changes in financial position of an enterprise.

⁷ Robinson, J. K. , Lashway, S.T, (2003), ' The Sarbanes=Oxley Act of 2002: A brief Summary of the New Professional Responsibility Obligations for Security Obligations for Securities Attorneys, New Criminal Provisions, and Reforms to the Sentencing Guidelines', American Bar Association Section in Litigation, Spring 2003.

to \$70.10 on 6th November 2004⁸ when Fanny Mae redeemed \$350 million securities and the dollar fell.

Legislation to prevent predatory mortgage lending

When Fannie Mae's illegal securitisation came to light in 2003, it triggered a US consumer lending alert by the federal government, quickly followed by changes in legislation in various states. There was the amendment to the New Jersey Home Ownership Security Act 2002 in November 2003. A new section 279 amended the Act to eliminate 'covered loans' and to prohibit 'loan flipping', a fraud. The section also excluded escrows to pay for future taxes and insurance.⁹ The state of Massachusetts enacted legislation as a direct result of Fannie Mae fraud, namely, the Massachusetts Predatory Home Loan Practices Act 2003, to be applied to all loans closed on or after 7 November, 2004. The Act includes a prepayment penalty incurred in the refinancing of a loan and the Act stops the previous unfair terms of misleading advertising, unreasonable terms, fees and charges on all home mortgage loans. It also makes 'loan flipping' illegal and prohibits the financing of credit insurance. with compulsory mandatory reporting of payment history. The Act permits a court to rescind or bar a lender from collecting on, a home mortgage loan contract that violates the law. The Act prohibits the following terms and practices - no lending without home counselling; no lending without regard to repayment ability; limit on financing points and fees; limit on payment to contractors; no recommending default on existing debt; no evading the Act; no prepayment penalties; no increased default interest rate; no balloon payments; no call provision; no negative amortisation; no modification of deferral fees; no advance payments; no mandatory arbitration clauses. New York also

⁸ Quote.com, (2004), 'Fannie Mae Redemption', 2 November 2004, Washington: Quote.com.

⁹ Thacher Proffitt & Wood LLP, (2004), 'Consumer Lending Alert', June 2004.

has similar new legislation. The state of Maine now has new mortgage legislation Maine Truth in Lending Act 2004 with anti-predatory lending provisions. The state of Nebraska also reacted to the Fannie Mae fraud and made amendments to its Nebraska Mortgage Bankers Registration and Licensing Act. In January 2004, Oklahoma has in force a new anti -predatory lending law, the Oklahoma Anti-Predatory Lending Law. and New Jersey also made amendments to its New Jersey Home Ownership Security Act.

US Law relating to overseas financial banking business

The connection with the EU Basel Capital Accord, EU Market Abuse Directive, EU Prospectus Directive,¹⁰ money laundering and new US federal Regulation is absent for Thrift Cross-Border activities which include all manner of financial activities transferred to foreign countries. This poses high risk for such countries ' markets, even though foreign banks' jurisdiction are governed by the International Money Laundering Abatement and Financial Anti-Terrorism Act 2001, although some of the US savings and loans holding companies have European operations and are already protected under the Gramm-Leach-Bliley Act 1999, because they were formed before 1999 and the Act is not retrospective.

These 'thrifts' engage in offering clearing-house services through a foreign agency office, including global custody, settlement, securities lending , paying agent and CEDEL depository services; investing in foreign currency-dominated certificates of deposit and foreign debt instruments and providing foreign currency exchange forward contracts to commercial borrowers; foreign currency exchange services; making loans on the security of foreign real estate; re-insurance activities, provide

¹⁰ Revell. S, Jones. T, Kalderon. M, (2004), 'The Prospectus Directive and its implementation in the UK', London: Freshfields Bruckhaus Deringer, October 2004.

internal asset-management services to reduce tax, and establishing foreign real estate investment trusts! These thrifts are not subject to federal financial services regulation other than the 'thrift' regulator. The US with the Basel Committee, have developed specific rules for these 'thrifts' in the EU, such as the Joint Agency Statement on Parallel Banking Organisations ('thrifts') and the Office of Thrift Supervision (OTS) now has a role as a consolidated financial services regulator under European Union Directive 2002/87.¹¹ Since 2004, the United States has joint legislation with the European Union, partly governing the EU banking sector.¹² The Bank of England Financial Stability Report 2004 revealed that the US accounts for the largest single country exposure of UK -owned banks.

US 'thrifts' have, over many years, let into the global financial system trillions of dollars of unregulated financial products, most of which can be summarised as 'junk bonds'. The EU and the US now wish to call an amnesty on and start afresh with new regulations to be applied only to new products. This is the crux of the European Union's Basel II Accord and the United States's Depository Institution Management Interlock Act 2000 (DIMIA). Cross-border financial interaction with some form of security via capital requirements for all banks and non-bank institutions is now in place.

Use of international accounting standards.

The EU agreed to allow the US banks (and all other parties) to use their present accounting standards but restate the accounts to statements EQUIVALENT to the International Accounting Statements. No definition of the word "equivalent" has been

¹¹ Croke. J .J and Manbeck. P. C, (2004), 'Revisions to Proposed Basel Capital Adequacy Framework', The Banking Law Journal, New York: A. S. Pratt & Sons.

¹² There is at present \$1 trillion in the EU banking sector.

given. It was the use of GAAP Accounting standards which Fannie Mae used to manipulate its operating costs, profit and earnings per share until 2003.

US Accounting Standards Board

The Powers Report which was commissioned. soon after the Enron collapse in 2002 reported that Price Water-house Accountants had breached SEC requirements in giving a true and fait opinion on the exchange of Enron shares for the Special Purpose Entity's "put note"; had failed to treat the Special Purpose Entities as Enron assets and had treated a third-party debt as equity; had made insufficient and opaque disclosures to the SEC; had condoned the use of derivatives for hedging risk; had condoned disproportionate employee bonuses which had not gone through the proper procedure of Board approval and had left untangled the complicated incomprehensible financial transactions or securitisation and most alarmingly, had failed to see anything wrong in Enron's two year period of internet futures trading in volumes equivalent to the trading of a small Stock Exchange, without SEC approval or licence.

Securitization debt as used by Fannie Mae

Securitisation debt has a lower interest-rate cost (see Table 4 below) than say, corporate debt Securitized capital market debt is called "Commercial Paper". The Table below shows the short term attractiveness of securitisation compared to Ordinary bank rate; the small reductions in bank rates make for very substantial cash-flow differences when the securitisation involves billions of US dollars and is one

method of providing liquidity for companies not in a position to borrow, so preventing bankruptcy, although a company should be prudent enough not to take the high risks that securitisation entail.¹³

Table 4 -Securitized and ordinary commercial bank rates

<i>Commercial Paper-1 month</i>	6.2%	3.8%	1.7%	1.0%
<i>Commercial Paper -2mths</i>	6.3%	3.7%	1.8%	1.6%
<i>Commercial Paper - 3 mths</i>	6.3%	3.6%	1.7%	1.7%
<i>Prime Bank Rate</i>	9.2%	6.9%	4.7%	4.0%

Source: Bloomberg.com.

The US securitisation industry deals in trillions of dollars of securitisation each year, a very lucrative industry. The US Federal government has implemented the Sarbanes - Oxley Act 2002 demands transparency in the financial reports and could literally wipe out the securitisation industry, causing several states to enact laws that permit 'true sale' treatment without regard to the substance of the transaction.¹⁴ Fannie Mae engaged in high risk synthetic securitisation, the use of credit risk mitigation techniques, that is, collateral, guarantees and credit derivatives, for hedging the underlying exposure without collateral. The result of this alarmingly massive financial hedging/betting is that many states of the US speedily enacted new legislation against anti-predatory money lending. Recently Germany amended its Mortgage Bank Act to protect the Pfandbrief holder's rights in case of an issuer's insolvency; since Germany has 70% of the European covered bond market and some

¹³ Schwarcz. S, (2004), 'Securitisation post-Enron', Vol 25.No.5, Yeshiva :Cardozo Law Review

¹⁴ Delaware was the only US state to brazenly enact the Delaware Asset-Backed Securities Facilitation Act 2002, give Delaware the right to determine what constitutes a true sale in a securitisation transaction. The Act states that "any financial assets purported , in the transaction documents, to be transferred in a securitisation transaction "shall be deemed to no longer be the property, assets or rights of the transferor."

of the market share of US Treasury and Agency Paper which the Asian Central Banks no longer wanted. In deceit, Fannie Mae misused structured finance vehicles, designed to lower financing costs and spread investment risk, to carry out sham transactions and mislead investors, analysts and regulators about their true financial condition.

US Government Investigation into Fannie Mae discontinued in 2006

US Department of Justice (DOJ) discontinued its two-year investigation into Fannie Mae. In May, 2006, regulators at the US Securities and Exchange Commission (SEC) and the Office of Federal Housing Enterprise Oversight (OFHEO) announced that Fannie Mae had agreed to pay a \$400 million settlement in relation to violations of the reporting and accounting provisions of the Securities Exchange Act of 1934 and anti-fraud provisions of the Securities Act of 1933. Fannie Mae has agreed to implement corrective measures and pay a collective penalty of \$400 million dollars as part of settlements with OFHEO. This level of penalty signals that unsafe and unsound conditions cannot be tolerated at firms that have a public mission and enjoy public benefits. The agreements come after OFHEO released its Report of the Special Examination of Fannie Mae, detailing an unethical corporate culture where Fannie Mae employees manipulated accounting and earnings to trigger bonuses for senior executives from 1998 to 2004. OFHEO also directed that Fannie Mae limit the growth of its portfolio mortgage assets to the level of December 31, 2005. OFHEO's action was based on the ongoing internal controls, risk management and accounting deficiencies and the need for the Enterprise to provide OFHEO an acceptable business plan for managing its market activities. The OFHEO Report said that the image of Fannie Mae as one of the lowest-risk and 'best in class' institutions had been a façade.

In July 2008, the US government voted to rescue Fannie Mae and Freddie Mac¹⁵, both government-sponsored firms and some senators argued that the companies' executive pay should be frozen, especially because Freddie Mac 's Chairman and Chief Executive had been paid nearly twenty million dollars in compensation even though the mortgage company's shares had lost half its value and the mortgage market situation in the US is as follows:

Freddie Mac Primary Mortgage Market Survey®	Week (ending September 4, 2008)
30-Year Fixed Mortgages	6.35 %
15-Year Fixed Mortgages	5.90 %
5/1-Year Adjustable Rate Mortgages	5.97 %
1-Year Adjustable Rate Mortgages	5.15 %

Source: Federal Housing Finance Board

Even though Fannie Mae implemented new foreclosure rules¹⁶ to be instituted as from June 2008, its dire financial straits has cause the US government to announce on 5th September 2008, that it is taking over the running of Fannie Mae and Freddie Mac. This announcement was not a surprise to many investors who have long believed that ,because of Freddie Mac's legal charter, the U.S. government would prevent it from defaulting in a financial crisis¹⁷.

¹⁵ The Federal National Mortgage Association (Fannie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac) had debts of \$69 billion in 1980 and this had risen to \$700 billion in 1999; and \$7 trillion in 2008.

¹⁶ The new rule mandates five years must pass after a foreclosure before a borrower is eligible for a new Fannie Mae loan. Previously, DU would consider loans with foreclosures after two years. Now, the loan will receive a Refer or a Caution/IV if it hasn't been a full five years. Extenuating circumstances won't be considered unless it's been at least three years after the foreclosure, and the loan will have to be manually underwritten. Borrowers must wait for seven years before they are eligible for a cash-out refinance. After five years, the borrower would have a 10% down payment to be eligible for a purchase. After five years, the borrower must have a 680 or higher credit score.

¹⁷ Freddie Mac pays federal taxes but is exempt from state and local income taxes and has less stringent capital requirements than banks. Its cost of capital is low, or only slightly higher than long-term Treasuries. Freddie Mac, which is considered a pioneer in the secondary mortgage market, does not

US Sub-prime mortgage market position in 2007

From a deficit of 542 billion US dollars in 2003, the US had a retained mortgage portfolio of \$1000 billion plus debts to EU and Asian banks of \$800 billion and a sharp increase of hedge funds to US \$ 40 billion, a total of trillions as at September 2008.

Subprime Mortgages 2000-2003(Billions of US dollars)

Year	Subprime originations	Total originations	Subprime as a percent of total
2000	138.0	1,048.0	13.2
2001	173.0	2,100.0	8.2
2002	241.0	2,780.0	8.7
2003	332.0	3,760.0	8.8

Source: Mortgage Statistical Annual, March 2004.

The US also has \$ 210 billion in credit card loans¹⁸. With US business mostly equity based, compared to the equity and fixed income business base of Europe, there is not much competition between banks. The Federal Bureau of Investigation (FBI) reported in 2004 that the whole US mortgage market is fraudulent.¹⁹ The FBI have investigated hundreds of mortgage frauds²⁰ recently covering billions of US dollars which are defrauded , causing billions of dollars of losses to financial institutions.

originate mortgages, but buys them from commercial banks, mortgage banks, savings institutions and credit unions, supplying the housing industry with liquidity for new home sales.

¹⁸ Bank of England, (2004), 'The Financial Stability Conjecture and Outlook Report', p.28.

¹⁹ Fleishman. S, (2004), 'Mortgage fraud concerns FBI', Washington Post, 18 September 2004.

²⁰ US examples of mortgage fraud are (1) buying a house with a large mortgage at a greatly increased price from a partner, selling it back to him quickly for its real market price and leaving a large mortgage unpaid; (2) fictitious credit histories in order to obtain large mortgage; (3) forged loan documents; (4) mortgage foreclosure methods used to buy property in order to conceal the true buyer's name.

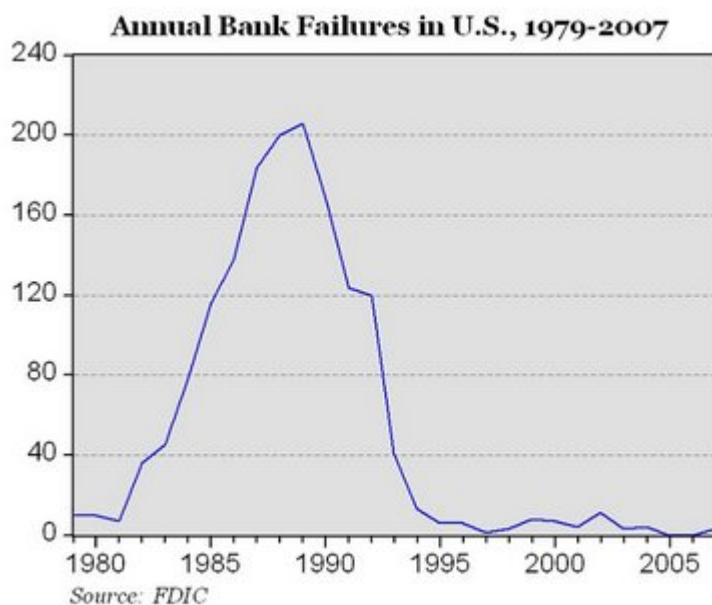
Such mortgage fraud is occurring in Charlotte, Washington, New York, Georgia, Missouri, California, Nevada and many other states and is therefore widespread.²¹

The US with the Basel Committee, have developed specific rules for these 'thrifts' in the EU, such as the Joint Agency Statement on Parallel Banking Organisations ('thrifts') and the Office of Thrift Supervision (OTS) now has a role as a consolidated financial services regulator under European Union Directive 2002/87.²² The United States now has joint legislation with the European Union, partly governing the EU banking sector.²³ . . The Bank of England Financial Stability Report 2004 revealed that the US accounts for the largest single country exposure of UK -owned banks. . US 'thrifts' have, over many years, let into the global financial system trillions of dollars of unregulated financial products, most of which can be summarised as 'junk bonds'. The EU and the US now wish to call an amnesty on and start afresh with new regulations to be applied only to new products. This is the crux of the European Union's Basel II Accord and the United States' Depository Institution Management Interlock Act 2000 (DIMIA). Cross-border financial interaction with some form of security via capital requirements for all banks and non-bank institutions are now in place.

²¹ Frieden. T, (2004), 'FBI warns of mortgage fraud 'epidemic'. Seeks to head off 'next S & L crisis', Washington: CNN Law Centre. By 2004 all these states which suffered mortgage fraud had enacted new and amended legislation to stop anti-predatory lending home loan practices.

²² Croke. J .J and Manbeck. P. C, (2004), 'Revisions to Proposed Basel Capital Adequacy Framework', The Banking Law Journal, New York: A. S. Pratt & Sons.

²³ There is at present \$1 trillion in the EU banking sector.

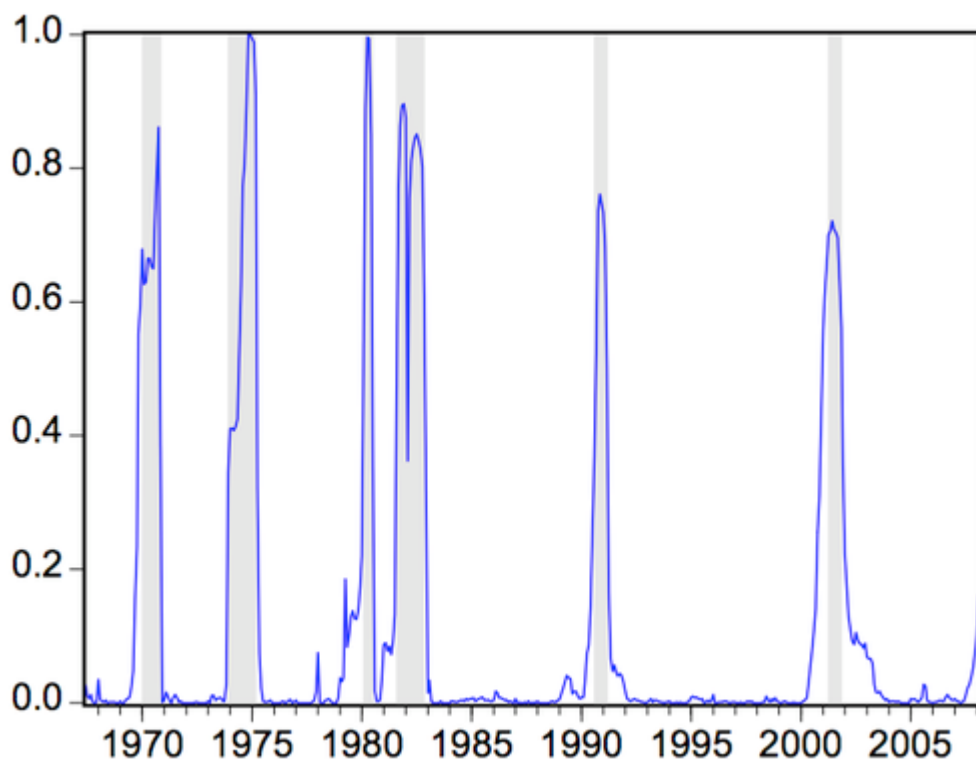


There have been significant collapses of many companies, namely: (i) New Century Financial Corp. was one of the United States largest sub-prime mortgage lenders, bankrupted following criminal investigation and violation of debt covenants with several lenders; (ii) Fremont General Corp. was down-graded and its share price fell after it sold its sub-prime lending business, having received a “cease-and-desist” order from the Federal Deposit Insurance Corporation; (iii) Share price of American Home Mortgage Investment (AHM) fell by 88% after the Melville (N.Y.) lender to homeowners with decent credit histories announced that it is facing serious liquidity issues and may be forced to close; (iv) Since January 2008, the U.S. stock markets have lost more than \$200 billion; (v) On 4 September 2008, Nevada regulators closed Silver State Bank, the 11th failed bank in 2008. In July, regulators took over IndyMac, which had \$19 billion and investment bank Bear Stearns Cos. Was taken over by JPMorgan Chase Bank.

Conclusion

All the signals are that the US is in economic recession.

Historical U.S. Recession Probabilities 1967 to 2005



Graph courtesy Google Images

US.STATUTES AND CONVENTIONS

Anti-Predatory Lending Act 2004 (Oklahoma)

Asset-backed Securities Facilitation Act 2002 (Delaware)

Basel Capital Accord (European Union)

Depository Institution Management Interlock Act 2000 (US)

Graham-Leach-Bliley Act 1999 (US)

Home Ownership Security Act 2003 (New Jersey)

International Money Laundering Abatement and Financial Anti-Terrorism Act 2001
(US)

Market Abuse Directive (EU)

Mortgage Bank Act 2004 (Germany)

Mortgage Bankers Registration and Licensing Act 2004 (Nebraska)

OECD Corporate Governance Convention 1998.

Predatory Home Loan Practices Act 2003 (Massachusetts)

Prospectus Directive (EU)

Sarbanes-Oxley Act 2002 (US)

Truth in Lending Act 2004 (Maine)

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