EXHIBIT 1

[EN BANC ORAL ARGUMENT SCHEDULED FOR MAY 24, 2017]

No. 15-1177

IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

PHH CORPORATION, et al.,
Petitioners,

v.

CONSUMER FINANCIAL PROTECTION BUREAU,
Respondent.

ON PETITION FOR REVIEW OF AN ORDER OF THE
CONSUMER FINANCIAL PROTECTION BUREAU

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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CERTIFICATE AS TO PARTIES, RULINGS, AND RELATED CASES

A. Parties and Amici

Except for the following, all parties, intervenors, and amici appearing in this Court are listed in the Opening En Banc Brief for Petitioners.

After this Court granted rehearing en banc, the following newly appeared as amici before this Court: The Cato Institute, RD Legal Funding, LLC, RD Legal Finance, LLC; RD Legal Partners, LP, Roni Dersovitz, and the States of Missouri, Alabama, Arizona, Arkansas, Georgia, Idaho, Indiana, Kansas, Louisiana, Nevada, Oklahoma, South Carolina, South Dakota, Texas, West Virginia, and Wisconsin.

The following have filed a notice of intent to participate as amicus: The Attorneys General of the States of Connecticut, Delaware, Hawaii, Illinois, Iowa, Maine, Maryland, Massachusetts, Mississippi, New Mexico, New York, North Carolina, Oregon, Rhode Island, Vermont and Washington, and the District of Columbia.

B. Ruling Under Review

This is a petition for review of a Final Order in *In the Matter of PHH Corporation*, Docket No. 2014-CFPB-0002 (June 4, 2015) [JA 1]. The Bureau's decision is unreported.

C. Related Cases

Counsel are unaware of any related cases within the meaning of Rule 28(a)(1)(C).

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GLOSSARY

CFPB	Consumer Financial Protection Bureau
FHFA	Federal Housing Finance Agency
FTC	Federal Trade Commission
HUD	Department of Housing and Urban Development

INTRODUCTION AND SUMMARY

The United States respectfully submits this brief as amicus curiae pursuant to Federal Rule of Appellate Procedure 29(a), in order to address the issues posed by the Court in its order granting rehearing en banc.

In 2010, Congress created the Consumer Financial Protection Bureau (CFPB) as part of the Dodd-Frank Act, giving the CFPB authority to enforce U.S. consumer-protection laws that had previously been administered by seven different government agencies, as well as new provisions added by Dodd-Frank itself. *See* 12 U.S.C. § 5581(b). The CFPB is headed by a single Director who is appointed by the President, with the advice and consent of the Senate, for a term of five years, *id.* § 5491(b), (c)(1), and who may be removed by the President only for "inefficiency, neglect of duty, or malfeasance in office," *id.* § 5491(c)(3).

The panel in this case held that this "for cause" removal provision violates the constitutional separation of powers. Op. 9-10. The panel explained—and neither party disputes—that, as a general matter, the President has "Article II authority to supervise, direct, and remove at will subordinate [principal] officers in the Executive Branch" in order to exercise his vested power and duty to faithfully execute the laws. Op. 4. The panel recognized as well that *Humphrey's Executor v. United States*, 295 U.S. 602, 629 (1935), established an exception to that rule, holding that Congress may "forbid [the] removal except for cause" of members of the Federal Trade

Commission (FTC)—a holding that has been understood to cover members of other multi-member regulatory commissions that share certain features and functions with the FTC. Op. 4.

The principal constitutional question in this case is whether the exception to the President's removal authority recognized in *Humphrey's Executor* should be extended by this Court beyond multi-member regulatory commissions to an agency headed by a single Director. While we do not agree with all of the reasoning in the panel's opinion, the United States agrees with the panel's conclusion that single-headed agencies are meaningfully different from the type of multi-member regulatory commission addressed in *Humphrey's Executor*.

The Supreme Court's analysis in *Humphrey's Executor* was premised on the nature of the FTC as a continuing deliberative body, composed of several members with staggered terms to maintain institutional expertise and promote a measure of stability that would not be immediately undermined by political vicissitudes. A single-headed agency, of course, lacks those critical structural attributes that have been thought to justify "independent" status for multi-member regulatory commissions. Moreover, because a single agency head is unchecked by the constraints of group decision-making among members appointed by different Presidents, there is a greater risk that an "independent" agency headed by a single person will engage in extreme departures from the President's executive policy. And as the panel recognized, while multi-member regulatory commissions sharing the characteristics of the FTC discussed in *Humphrey's Executor* have existed for over a century, limitations on the President's authority to remove a single agency head are a recent development to which the Executive Branch has consistently objected.

We therefore urge the Court to decline to extend the exception recognized in *Humphrey's Executor* in this case. In addition, in our view, the panel correctly applied severability principles and therefore properly struck down only the for-cause removal restrictions.

STATEMENT

Congress created the CFPB in 2010, as part of the Dodd-Frank Act, directing the Bureau to "seek to implement and, where applicable, enforce Federal consumer financial law" in order to ensure that "all consumers have access to markets for consumer financial products and services" and that the markets for such products and services are "fair, transparent, and competitive." 12 U.S.C. § 5511(a). The CFPB has authority to regulate the consumer-finance industry, including loans, credit cards, and other financial products and services offered to consumers. It has power to prescribe rules implementing consumer-protection laws; to conduct investigations of market actors; and to enforce consumer-protection laws in administrative proceedings and in federal court, including through civil monetary penalties. *See, e.g.*, *id.* §§ 5511(c), 5562, 5563, 5565. Congress transferred to the CFPB the authority to exercise functions that had previously been spread among seven different federal agencies. *Id.* § 5581(b). Although some of the powers transferred to the CFPB came from multi-member commissions whose members are not subject to removal at will by the President, functions at issue in this case were transferred from the Department of Housing and Urban Development (HUD), a Cabinet agency. The CFPB is also tasked with enforcing new statutory requirements related to consumer finance. *See, e.g.*, *id.* § 5531.

This case involves a petition for review of a CFPB order requiring PHH Corporation to pay $109 million in disgorgement. A panel of this Court vacated the order on several statutory and constitutional grounds.

The CFPB (acting through its own attorneys, *see* 12 U.S.C. § 5564(b)), sought rehearing. This Court invited the Solicitor General to respond to the rehearing petition. The brief of the United States supported rehearing en banc, and took issue with aspects of the panel's analysis. The brief did not take a position on the constitutionality of the CFPB's structure, but observed that the "conferral of broad policymaking and enforcement authority on a single person below the President, whom the President may not remove except for cause, . . . raises a significant constitutional question that the Supreme Court has not yet squarely confronted." U.S. Resp. Br. 2. The brief urged that the Court's analysis should focus on "preserving (or appropriately limiting) the powers and roles of each Branch," rather than on a particular structure's "impact on individual liberty as a freestanding basis for finding a separation-of-powers violation." *Id.* at 10, 12.[1]

This Court granted the petition for rehearing en banc, instructing the parties to address various specified issues.

ARGUMENT

I. *Humphrey's Executor* Upheld Removal Restrictions For Members Of Multi-Headed Commissions And Should Not Be Extended By This Court To The CFPB, Which Is Headed By A Single Director

A. Under the Constitution and Supreme Court precedent, the general rule is that the President must have authority to remove Executive Branch agency heads at will.

Article II of the Constitution provides that the "[t]he executive Power shall be vested" in the President, and that he shall "take Care that the Laws be faithfully executed." U.S. Const. art. II, § 1, cl. 1; *id.* art. II, § 3. These provisions reflect the Framers' intention to create a strong, unitary Executive. *See Myers v. United States*, 272

[1] The CFPB has authority to represent itself in federal district courts and courts of appeals, and typically does so. 12 U.S.C. § 5564(b). In one case filed against several federal agencies and departments, however, the Department of Justice represented all government defendants, including the CFPB. The government's district court briefs in that case argued that, based on the Supreme Court's decision in *Humphrey's Executor*, the CFPB's for-cause removal provision is consistent with the Constitution. *See State National Bank of Big Spring v. Mnuchin*, No. 1:12-cv-1032 (D.D.C.). After reviewing the panel's opinion here and further considering the issue, the Department has concluded that the better view is that the provision is unconstitutional. The Department is working with the CFPB to substitute the CFPB's own attorneys in that litigation.

U.S. 52, 116 (1926); *see also The Federalist No. 70*, at 472-73 (J. Cooke ed., 1961) (Hamilton). Of particular relevance here, "if any power whatsoever is in its nature Executive, it is the power of appointing, overseeing, and controlling those who execute the laws." *Free Enterprise Fund v. Public Co. Accounting Oversight Bd.*, 561 U.S. 477, 492 (2010) (quoting 1 Annals of Cong. 463 (1789) (Joseph Gales ed., 1834) (remarks of Madison)). "[A]s part of his executive power," the President "select[s] those who [are] to act for him under his direction in the execution of the laws." *Myers*, 272 U.S. at 117; *see also* U.S. Const. art. II, § 2, cl. 2. Just as the President's ability to "select[] . . . administrative officers is essential" to the exercise of "his executive power," so too is his ability to "remov[e] those for whom he cannot continue to be responsible." *Myers*, 272 U.S. at 117; *see also Bowsher v. Synar*, 478 U.S. 714, 726 (1986) ("Once an officer is appointed, it is only the authority that can remove him, and not the authority that appointed him, that he must fear and, in the performance of his functions, obey." (quotation marks omitted)).

Accordingly, "[s]ince 1789, the Constitution has been understood to empower the President to keep [executive] officers accountable—by removing them from office, if necessary." *Free Enterprise Fund*, 561 U.S. at 483. Indeed, the First Congress—many of whose members took part in the Constitution's framing—extensively debated the President's removal authority when creating the Department of Foreign Affairs (which later became the Department of State). "The view that 'prevailed' . . . was that the executive power included a power to oversee executive officers through removal; because that traditional power was not 'expressly taken away, it remained with the President.'" *Id.* at 492 (quoting Letter from James Madison to Thomas Jefferson (June 30, 1789), 16 *Documentary History of the First Federal Congress* 893 (2004)). This view "soon became the 'settled and well understood construction of the Constitution.'" *Id.* (quoting *Ex parte Hennen*, 38 U.S. (13 Pet.) 230, 259 (1839)).

Affirming this established understanding, the Supreme Court held in *Myers* that the President's executive power necessarily includes "the exclusive power of removal." *Myers*, 272 U.S. at 122. "[T]o hold otherwise," the Court explained, "would make it impossible for the President . . . to take care that the laws be faithfully executed." *Id.* at 164. The Court thus invalidated a statutory provision that "denied . . . the President" the "unrestricted power of removal" of officers appointed by the President with the advice and consent of the Senate. *Id.* at 176; *see also id.* at 107.

In sum, as the Supreme Court recently reaffirmed, the President's executive power "includes, as a general matter, the authority to remove those who assist him in carrying out his duties" to faithfully execute the laws. *Free Enterprise Fund*, 561 U.S. at 513-14. "Without such power, the President could not be held fully accountable" for how executive power is exercised, and "[s]uch diffusion of authority 'would greatly diminish the intended and necessary responsibility of the chief magistrate himself.'" *Id.* at 514 (quoting *The Federalist No. 70*, at 478).

Although the Supreme Court has upheld certain "limited restrictions" on the President's general removal power with respect to inferior officers, *Free Enterprise Fund*, 561 U.S. at 495, the Court has recognized only one such restriction with respect to principal officers who head agencies: the exception recognized in *Humphrey's Executor*. *See id.* at 492-95. As demonstrated below, that exception does not apply to the CFPB's Director, and it should not be so extended.

B. *Humphrey's Executor* created an exception to the general rule only for multi-member regulatory commissions.

In *Humphrey's Executor*, the Supreme Court upheld a provision of the Federal Trade Commission Act establishing that FTC commissioners could be removed only for "inefficiency, neglect of duty, or malfeasance in office." *Humphrey's Executor*, 295 U.S. at 620 (quoting 15 U.S.C. § 41 (1934)). The Court's conclusion rested on its view at the time that the FTC "cannot in any proper sense be characterized as an arm or an eye of the executive," but rather "acts in part quasi-legislatively and in part quasi-judicially." *Humphrey's Executor*, 295 U.S. at 628.[2]

[2] Since that time, the Supreme Court has observed that "the powers of the FTC at the time of *Humphrey's Executor* would at the present time be considered 'executive,' at least to some degree." *Morrison v. Olson*, 487 U.S. 654, 689 n.28 (1988).

That characterization of the FTC was based not only on its substantive functions, but also on its structural features as an "administrative body." *See Humphrey's Executor*, 295 U.S. at 628. The FTC had five members with staggered terms, and no more than three of them could be of the same political party. *See id.* at 619-20. The Court thus emphasized early in its opinion that the FTC was "called upon to exercise the trained judgment of a body of experts" and was "so arranged that the membership would not be subject to complete change at any one time." *See id.* at 624. Indeed, the direct relationship perceived between those structural features and the restriction on the President's removal power was underscored by the fact that they all were enacted in the same statutory section. 15 U.S.C. § 41 (1934), *quoted in Humphrey's Executor*, 295 U.S. at 620.

The holding in *Humphrey's Executor* has been understood to encompass other multi-member commissions with features and functions similar to those of the FTC. *See, e.g.*, *Wiener v. United States*, 357 U.S. 349, 355-56 (1958) (holding that "[t]he philosophy of *Humphrey's Executor*" precludes at-will removal of members of the War Claims Commission, a three-member body that was charged with adjudicating war-related compensation claims); *see also Free Enterprise Fund*, 561 U.S. at 483 ("In *Humphrey's Executor*, we held that Congress can, under certain circumstances, create independent agencies run by principal officers appointed by the President, whom the President may not remove at will but only for good cause." (citation omitted));

Morrison v. Olson, 487 U.S. 654, 724-25 (1988) (Scalia, J., dissenting) ("[R]emoval restrictions have been generally regarded as lawful for so-called 'independent regulatory agencies,' such as the Federal Trade Commission, the Interstate Commerce Commission, and the Consumer Product Safety Commission, which engage substantially in what has been called the 'quasi-legislative activity' of rulemaking . . . ." (citations omitted)).

As the panel noted, it is "not merely accidental or coincidental" that the "independent agencies" that were established and understood to be covered by *Humphrey's Executor* have been "multi-member" bodies. Op. 48. Rather, it has been generally recognized that the removal restriction is a concomitant of—indeed, "inextricably bound together" with—a continuing deliberative body. Op. 48-49 (citing various sources). Thus, as an extensive study of independent agencies conducted in 1977 by the Senate Committee on Governmental Affairs concluded, "[t]he size of the commission, the length of the terms, and the fact that they do not all lapse at one time are key elements of the independent structure." S. Comm. on Governmental Affairs, *Study on Federal Regulation*, S. Doc. No. 95-91, vol. 5, at 35 (1977). These features, typically accompanied by a limitation on the President's removal authority, were "the basic structural features which [had] marked every independent regulatory commission, beginning with the" Interstate Commerce

Commission in the 1880s. *Id.* at 36; *see also* Interstate Commerce Act, ch. 104, § 11, 24 Stat. 379, 383 (1887); Act of Mar. 2, 1889, ch. 382, § 6, 25 Stat. 855, 861-62.

The structure of multi-member agencies with staggered-term memberships was designed to promote long-term continuity and expertise, and that goal was thought to be furthered by restricting the President's power to remove the members of such agencies. As the 1977 Senate study observed, "regulatory policies would tend to be more permanent and consistent to the extent that they were not identified with any particular administration or party," and "[a]brupt change would therefore be minimized." *Study on Federal Regulation*, vol. 5, at 29-30; *see also* 51 Cong. Rec. 10,376 (1914) (contemplating that Federal Trade Commission "would have precedents and traditions and a continuous policy and would be free from the effect of . . . changing incumbency").

In addition, the structure of multi-member agencies was designed to facilitate deliberative group decision-making, and that goal too was thought to be furthered by removal restrictions. In fact, the Senate study concluded that the "[c]hief" consideration in determining whether to create an independent commission, rather than a standard executive agency, "is the relative importance to be attached to group decision-making." *Study on Federal Regulation*, vol. 5, at 79. Similarly, Professor Kenneth Culp Davis expressed the view that independent commissions are created primarily because they exercise adjudicative functions, and that these bodies should have multiple members "just as we want appellate courts to be made up of plural members, to protect against the idiosyncracies of a single individual." Kenneth Culp Davis, *Administrative Law of the Seventies* 15 (1976); *see also* Op. 45 (noting that "unlike single-Director independent agencies, multi-member independent agencies 'can foster more deliberative decision making'" (quoting Kirti Datla & Richard L. Revesz, *Deconstructing Independent Agencies (and Executive Agencies)*, 98 Cornell L. Rev. 769, 794 (2013)).

C. *Humphrey's Executor* should not be extended to the CFPB.

1. A single-headed independent agency is not covered by an essential aspect of the rationale underlying *Humphrey's Executor* and independent multi-member commissions. The CFPB lacks the structural features that the Supreme Court relied upon in part when characterizing the FTC as a "quasi-legislative," "quasi-judicial" "administrative body." *Humphrey's Executor*, 295 U.S. at 628. A multi-member commission with staggered-term memberships is established as "a body of experts" that by its nature operates in an interactive and deliberative manner, and is "so arranged that the membership would not be subject to complete change at any one time." *Id.* at 624. Restricting the President's power to remove the members of such commissions is thus thought to facilitate deliberative group decision-making and promote an inherent institutional continuity.

An agency headed by a single officer has none of those attributes. To the contrary, it embodies a quintessentially executive structure. "The insistence of the Framers upon unity in the Federal Executive—to ensure both vigor and accountability—is well known." *Printz v. United States*, 521 U.S. 898, 922 (1997); *see also Clinton v. Jones*, 520 U.S. 681, 712 (1997) (Breyer, J., concurring) (describing how the Founders "consciously decid[ed] to vest Executive authority in one person rather than several," in contrast with their vesting of legislative and judicial powers in multi-member bodies). It has long been recognized that "[d]ecision, activity, secre[c]y, and d[i]spatch will generally characterise the proceedings of one man in a much more eminent degree[] than the proceedings of a greater number." 3 Joseph Story, *Commentaries on the Constitution of the United States* § 1414, at 283 (1833). The Constitution itself specifies the official who must exercise that sort of executive power: the President, acting either personally or through subordinate officers who are accountable to him and whose actions he can control. The principles animating the exception in *Humphrey's Executor* do not apply when Congress carves off a portion of that quintessentially executive power and vests it in a single principal officer below the President who is not subject to the President's control.

Insofar as the Supreme Court has retreated from its rationale in *Humphrey's Executor* in sustaining the FTC structure as "quasi-legislative" and "quasi-judicial," it is particularly significant that the CFPB does not possess the structural features that characterized the FTC. As the Court acknowledged in *Morrison*, "it is hard to dispute that the powers of the FTC at the time of *Humphrey's Executor* would at the present time be considered 'executive,' at least to some degree." *Morrison*, 487 U.S. at 689 n.28. Consequently, it is imperative that an executive agency still seeking to be characterized as "quasi-legislative" or "quasi-judicial" under *Humphrey's Executor* at least have a multi-member structure, with its attributes of a deliberative body designed to have accumulated and collective insights and expertise as well as inherent institutional continuity. Indeed, given "[t]he difficulty of defining such categories of 'executive' or 'quasi-legislative' officials," *Morrison*, 487 U.S. at 689 n.28, extending the "limited" *Humphrey's Executor* exception for multi-member commissions to single agency heads could threaten to swallow the "general" rule of *Myers* and Article II. *See Free Enterprise Fund*, 561 U.S. at 495, 513.[3]

2. Moreover, a single-headed independent agency creates concerns regarding the dispersion of executive power that are greater than those created by a multi-member independent commission. Although the President's removal authority is identical in the two cases, a single-headed independent agency presents a greater risk

[3] Although *Morrison* upheld a "good cause" removal restriction for an independent counsel who was a "purely executive" official, the Court reasoned that the President's duty to faithfully execute the laws was not impermissibly impaired because the prosecutor was "an inferior officer … with limited jurisdiction and tenure and lacking policymaking or significant administrative authority." *Morrison*, 487 U.S. at 689-91. That holding obviously does not apply to any principal officer who heads an executive agency, especially the CFPB Director.

than a multi-member independent commission of taking actions or adopting policies inconsistent with the President's executive policy. That is so for two related reasons.

First, whereas a multi-headed commission generally must engage in at least some degree of deliberation and collaboration, which tend toward compromise, a single Director can decisively implement his own views and exercise discretion without these structural constraints. *See* Op. 46. It is for such reasons that the Framers adopted a strong, unitary Executive—headed by the President—rather than a weak, divided one. Vesting such power in a single person not answerable to the President constitutes a stark departure from that framework.

Second, the difference in decision-making is reinforced by the difference in the timing and composition of appointments to the two types of agencies. For a multi-headed commission with staggered terms, the President is generally assured to have an opportunity to appoint at least some of its members, and the bipartisan-membership requirement that is common for such commissions further increases the likelihood that at least some of the holdover members share the President's views. *See* Op. 58. By contrast, where a single Director has a term greater than four years (as is true for the CFPB), a President may never get to appoint the Director. *See id.* An agency where a President lacks control over both back-end removal and front-end appointment represents a further departure from the constitutional design.

To be sure, the frequency with which the threat of extreme departures from the President's executive policy materializes will depend on the particular circumstances, but the "added" risk of such departures "makes a difference." *See Free Enterprise Fund*, 561 U.S. at 495. Whereas the interference with executive power was mitigated in *Morrison* by the independent counsel's limited authority, and mitigated in *Humphrey's Executor* by the FTC's multi-member nature, the CFPB's interference with executive power is exacerbated by both its single-headed nature and its wide-ranging policy making and enforcement authority over private conduct.

3. Furthermore, unlike multi-member independent commissions, single-headed independent agencies are a relatively novel innovation. In the separation-of-powers context, "the lack of historical precedent" for a new structure is "[p]erhaps the most telling indication of [a] severe constitutional problem." *Free Enterprise Fund*, 561 U.S. at 505; *see also NLRB v. Noel Canning*, 134 S. Ct. 2550, 2559 (2014) ("'[L]ong settled and established practice is a consideration of great weight in a proper interpretation of constitutional provisions' regulating the relationship between Congress and the President." (quoting *The Pocket Veto Case*, 279 U.S. 655, 689 (1929))). In *Free Enterprise Fund*, for instance, because "historical practice had settled on one level of for-cause removal for a President to remove the head of an independent agency," Op. 42, the Court declined to extend *Humphrey's Executor* to a "novel structure": two layers of for-cause removal. *Free Enterprise Fund*, 561 U.S. at 496. The

Supreme Court has thus been reluctant to expand *Humphrey's Executor* to "new situation[s] not yet encountered by the Court." *Id.* at 483.

Here, as the panel explained, until relatively recently all independent agencies have been structured as multi-member commissions. Op. 27-35. Congress has created agencies with a single head subject to for-cause removal on only three other occasions.

First, in 1978, Congress established the Office of Special Counsel as an entity with a single head subject to removal only for cause. Op. 31. Among other functions, the Office of Special Counsel can seek corrective action through the Merit Systems Protection Board for violations of federal civil service personnel principles. The Office of Legal Counsel opposed the for-cause removal provision, Mem. Op. for the Gen. Counsel, Civil Serv. Comm'n, 2 Op. O.L.C. 120 (1978), and President Reagan vetoed subsequent legislation regarding the Office of Special Counsel, citing "serious constitutional concerns" about the agency's independent status. *See* Memorandum of Disapproval on a Bill Concerning Whistleblower Protection, 2 Pub. Papers 1391, 1392 (Oct. 26, 1988). As the panel noted, moreover, the Office's "narrow jurisdiction" over "government employers and employees" provides no historical support for creating a very different single-headed independent agency exercising general regulatory and enforcement power over private parties operating in a large sector of the economy, such as the CFPB. Op. 31-32.

Second, in 1994, Congress made the Social Security Administration a separate agency headed by a single Commissioner appointed for a term of six years and removable only for cause. Op. 30; *see also* 42 U.S.C. § 902(a). When appraising the bill, President Clinton issued a signing statement noting that "in the opinion of the Department of Justice, the provision that the President can remove the single Commissioner only for neglect of duty or malfeasance in office raises a significant constitutional question." Statement on Signing the Social Security Independence and Program Improvements Act of 1994, 2 Pub. Papers 1471, 1472 (Aug. 15, 1994). Moreover, as the panel recognized, the Social Security Administration overwhelmingly engages in "supervision of the adjudication of private claims for benefits," not in bringing enforcement actions against private citizens, which makes it an inapposite precedent for the CFPB. Op. 30-31.

Third, the Federal Housing Finance Agency (FHFA), which Congress created during the 2008 financial crisis to oversee Fannie Mae and Freddie Mac, is also headed by a single Director subject to removal only for cause. Op. 33. We are not aware of any Executive Branch comment on its single-director structure at the time of enactment of that emergency legislation. In any event, the FHFA is a safety and soundness regulator for specified government-sponsored enterprises, namely Fannie Mae and Freddie Mac—for which the agency has acted as conservator since its inception—as well as federal home loan banks. *Compare* 12 U.S.C. § 4502(20) (defining "regulated entit[ies]" within jurisdiction of FHFA), *with id.* § 5481(6) (defining "covered person" regulated by the CFPB as "any person that engages in offering or providing a consumer financial product or service").[4]

Thus, to date, the Supreme Court has sanctioned a limitation on the power to remove principal officers of the United States only for members of multi-member bodies. Neither history nor precedent suggests that *Humphrey's Executor* should be extended to the CFPB.

In sum, a removal restriction for the Director of the CFPB is an unwarranted limitation on the President's executive power. This Court should not extend the exception established by the Supreme Court in *Humphrey's Executor* to undermine the general constitutional rule that the President may remove principal officers at will.

II. The Panel Correctly Concluded That The For-Cause Removal Provision Is Severable From The Remainder Of The CFPB Statutory Scheme

The panel correctly concluded (Op. 65-69) that the proper remedy for the constitutional violation is to sever the provision limiting the President's authority to remove the CFPB's Director, not to declare the entire agency and its operations unconstitutional.

[4] The panel in this case appropriately did not address the application of its ruling to other agencies not before the Court.

This conclusion follows directly from the Supreme Court's decision in *Free Enterprise Fund*, which applied the familiar principle that, when "'confronting a constitutional flaw in a statute,'" courts generally "'try to limit the solution to the problem,' severing any 'problematic portions while leaving the remainder intact.'" *Free Enterprise Fund*, 561 U.S. at 508 (quoting *Ayotte v. Planned Parenthood of N. New England*, 546 U.S. 320, 328-29 (2006)). Even though Congress had not enacted a severability clause, the Court there held unconstitutional only the removal restrictions pertaining to members of the Public Company Accounting Oversight Board, and went on to hold that the proper remedy was to invalidate the removal restrictions, leaving the board members removable at will. *Id.* at 509. The Court reasoned that the Sarbanes-Oxley Act would "remain[] fully operative as a law with these tenure restrictions excised," and that no evidence suggested that Congress "would have preferred no Board at all to a Board whose members are removable at will." *Id.* (quotation marks omitted).

Similarly, in *Intercollegiate Broadcasting System, Inc. v. Copyright Royalty Board*, 684 F.3d 1332 (D.C. Cir. 2012), this Court held that copyright royalty judges, who are charged with setting royalty rates for digital transmissions of recorded music, were principal officers who had not been appointed by the President and confirmed by the Senate. The Court held that the proper remedy was to invalidate only a provision that limited the Librarian of Congress's ability to remove the judges. *Id.* at 1340-41. The

Court concluded that this remedy "eliminates the Appointments Clause violation and minimizes any collateral damage." *Id.* at 1340.

Here, as in those cases, severing the removal restriction is the proper remedy. Absent the for-cause removal provision, the Dodd-Frank Act and its CFPB-related provisions will remain "fully operative." *Free Enterprise Fund*, 561 U.S. at 509. And, as in *Free Enterprise Fund,* there is no evidence that Congress would have preferred no Bureau at all to a Bureau whose Director was removable at will. *See id.* Citing one legislator's statement that Congress sought to create a "completely independent" agency, PHH Br. 30, PHH speculates that Congress would have preferred to have no agency at all in the absence of a for-cause removal provision. But Congress never expressed this sentiment, and the Dodd-Frank Act's severability clause underscores that Congress would not have intended this result. 12 U.S.C. § 5302; *see Alaska Airlines, Inc. v. Brock*, 480 U.S. 678, 686 (1987) (noting that severability clause "creates a presumption that Congress did not intend the validity of the statute in question to depend on the validity of the constitutionally offensive provision," and "unless there is strong evidence that Congress intended otherwise, the objectionable provision can be excised from the remainder of the statute"). While it may be possible to conceive of other ways to remedy the constitutional violation, "[s]uch editorial freedom . . . belongs to the Legislature, not the Judiciary." *Free Enterprise Fund*, 561 U.S. at 510.

III. The Court Has Discretion To Reach The Constitutionality Of The Bureau's For-Cause Removal Provision, And May Appropriately Do So Here

We previously noted (U.S. Resp. Br. 12-14) that this Court may avoid deciding the separation-of-powers question in light of the panel's ruling on the statutory issues, which were the focus of the panel-stage briefing. The United States takes no position on the statutory issues in this case, but in the event that the ultimate resolution of those issues results in vacatur of the CFPB's order, it is within this Court's discretion to avoid ruling on the constitutional question. *See Northwest Austin Mun. Util. Dist. No. One v. Holder*, 557 U.S. 193, 205 (2009); *see also* Op. of Henderson, J., at 8. That said, as the case has now been set for plenary briefing and en banc argument on the separation-of-powers question, and as that question is likely to recur in pending and future cases, it would be appropriate for the Court to provide needed clarity by exercising its discretion to resolve the separation-of-powers issue now.

IV. The Court's Decision In *Lucia* Should Not Affect The Disposition Of This Case

This Court has granted rehearing en banc in *Lucia v. SEC,* 832 F.3d 277 (D.C. Cir. 2016), to consider whether administrative law judges of the Securities and Exchange Commission are officers of the United States within the meaning of the Appointments Clause. If the Court concludes that these administrative law judges are not officers, its holding will not affect the Court's treatment of the other issues in this case. If the Court reaches a different conclusion in *Lucia*, its decision need not bear on the proper disposition of this case. In addition to deciding the separation-of-powers question, the panel vacated the CFPB's order on due process and statutory grounds; a conclusion that the administrative law judge who heard PHH's case was unconstitutionally appointed could only provide an additional, independent ground for vacatur. If the CFPB pursues sanctions against PHH in new proceedings on remand, such proceedings will, of course, need to be consistent with the outcome in *Lucia*. That prospect should not affect this Court's determination whether to reach the separation-of-powers question at this time.

CONCLUSION

For the foregoing reasons, the for-cause removal provision should be invalidated and severed from the remainder of the Dodd-Frank Act.

Respectfully submitted,

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Acting Assistant Attorney General

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s/ Daniel Tenny
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MARCH 2017

CERTIFICATE OF COMPLIANCE

I hereby certify that this brief satisfies the type-volume requirements of Rule 29(a)(5). This brief contains 5,410 words.

s/ Daniel Tenny
Daniel Tenny

CERTIFICATE OF SERVICE

I hereby certify that on March 17, 2017, I filed and served the foregoing with the Clerk of the Court by causing a copy to be electronically filed via the appellate CM/ECF system. Participants in the case are registered CM/ECF users and will be served via the CM/ECF system. I also caused 30 paper copies of the brief to be hand delivered to the Court.

s/ Daniel Tenny
Daniel Tenny

EXHIBIT 2

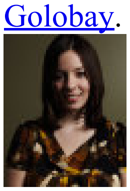
HOUSINGWIRE

www.housingwire.com/articles/lockhart-leave-fhfa-soon

Lockhart to Leave FHFA Soon

Diana Golobay
August 5, 2009

[Update 2: adds Lockhart's statement on his resignation, Williams' statement on DeMarco's appointment.] **Federal Housing Finance Agency** director James Lockhart said Thursday he will leave his post as head of the agency. *HousingWire*'s sources at a major regulator late Wednesday confirmed Lockhart would soon resign. In a statement issued hours later, Lockhart said Ed DeMarco will step into the role of acting director. DeMarco takes on the responsibility after serving the past year as chief operating officer and senior deputy director for housing mission and goals at FHFA. "This has been one of the most challenging and rewarding assignments of my career and I am very pleased with the work we have been able to accomplish through a very difficult period," Lockhart said. "As the housing market is starting to stabilize and the housing GSEs are strongly supporting the mortgage markets and other financial institutions, it is time for me to move on to the next chapter." At the FHFA, Lockhart regulated mortgage finance giants **Freddie Mac** (FRE) and **Fannie Mae** (FNM). He took the role more than a year ago when the Housing and Economic Recovery Act set up the FHFA. Fannie's CEO, Michael Williams, issued a statement Thursday thanking Lockhart for his support during Williams' recent transition to the role of Fannie CEO. "I congratulate Ed DeMarco on his appointment as the Acting Director of FHFA and look forward to working closely with him in the days ahead," Williams said. "Director DeMarco was instrumental in helping to develop and oversee Fannie Mae's participation in the [Making Home Affordable] program, and I look forward to his leadership as we continue to implement initiatives supporting foreclosure prevention and sustainable homeownership." Fannie and Freddie may soon face issues of their own, as **Moody's Investors Service** recently said the US government may begin to wind down their business within 18 months. Analysts at the rating agency pointed to quarterly losses at the government-sponsored enterprises ever since late 2007 to indicate a far less costly alternative would be for the government to resolve their business. **Write to** Diana Golobay.



Diana Golobay was a reporter with HousingWire through mid-2010, providing wide-ranging coverage of the U.S. financial crisis. She has since moved onto other roles as a writer and editor.

EXHIBIT 3

O R D E R

Pursuant to the Constitution and the laws of the United States, including section 4512(f) of title 12, United States Code, I hereby designate Edward J. DeMarco, Senior Deputy Director for Housing Mission and Goals and Chief Operating Officer, Federal Housing Finance Agency, as Acting Director of the Federal Housing Finance Agency, effective September 1, 2009.

THE WHITE HOUSE,

August 25, 2009.

EXHIBIT 4

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

July 31, 2012

Federal Housing Finance Agency
Office of the Director
400 7th Street S.W.
Washington, D.C. 20024

Dear Acting Director DeMarco,

I am writing in response to the decisions announced in your letter to Congress today. While I was encouraged that the Federal Housing Finance Agency (FHFA) is making progress on some initiatives we have discussed that will help the housing market recover, I am concerned by your continued opposition to allowing Fannie Mae and Freddie Mac (GSEs) to use targeted principal reduction in their loan modification programs.

FHFA is an independent federal agency, and I recognize that, as its Acting Director, you have the sole legal authority to make this decision. However, I do not believe it is the best decision for the country, because, as we have discussed many times, the use of targeted principal reduction by the GSEs would provide much needed help to a significant number of troubled homeowners, help repair the nation's housing market, and result in a net benefit to taxpayers.

Indeed, notwithstanding the selective numbers cited in your letter, FHFA's own analysis, which you have shared with us previously, has shown that permitting the GSEs to participate in the Principal Reduction Alternative program (HAMP-PRA) could help up to half a million homeowners and result in savings to the GSEs of $3.6 billion compared to standard GSE loan modifications. Furthermore, if the GSEs were to participate in HAMP-PRA, taxpayers would save as much as $1 billion on a net basis. In view of the clear benefits that the use of principal reduction by the GSEs would have for homeowners, the housing market, and taxpayers, I urge you to reconsider this decision.

I have asked Michael Stegman of my staff to restate in writing for you the case for principal reduction, consistent with FHFA's mandates as conservator and regulator of the GSEs, that the Treasury has made to you and your staff over the last several months. His memorandum is enclosed. Treasury stands ready to provide any additional analytical support to make a targeted principal reduction program at the GSEs successful.

We welcome the positive steps you announced today regarding further refinancing opportunities, providing clarity to lenders on legal exposures, aligning short sale practices, and putting foreclosed properties back on the market. All of these have the potential to help advance recovery of the housing market. As we have previously discussed, the impact of these steps will depend on the speed with which you act and the extent of the changes you make.

Five years into the housing crisis, millions of homeowners are still struggling to stay in their homes, and the legacy of the crisis continues to weigh on the market. You have the power to help more struggling homeowners and help heal the remaining damage from the housing crisis. I hope you will move to address these problems with a sense of urgency and force commensurate with the scale of the remaining challenges.

Sincerely,

Timothy F. Geithner

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

July 31, 2012

MEMORANDUM
TO: Acting Director Ed DeMarco
FROM: Michael Stegman, Counselor for Housing Finance Policy
RE: The Case for Principal Reduction

Secretary Geithner asked me to summarize below the case for using principal reduction in a targeted manner that the Treasury has made to you and your staff over the last several months.

Principal reduction benefits individual homeowners and the housing market as a whole.

The use of targeted principal reduction is beneficial for several reasons. It provides relief to a significant number of underwater troubled homeowners, helps repair the housing market and minimizes taxpayer losses. The basis for this judgment, which is consistent with Fannie Mae's study of Home Affordable Modification Program (HAMP) performance data and the behavior of private lenders and investors, is that a carefully designed, targeted program of principal reduction is effective in reducing the risk of re-default by borrowers who receive loan modifications.

In June 2010, Treasury introduced principal reduction as part of the Making Home Affordable program (HAMP-PRA) to help certain underwater borrowers who are struggling to avoid foreclosure and improve community and housing market stability. Under this program, financial incentives are paid to investors as a percentage of each dollar of principal reduction. Borrowers are eligible only if they face a financial hardship and demonstrate an ability to pay the modified mortgage amount. Moreover, participating servicers are encouraged to reduce principal only when the modification makes economic sense for the investor, taking into account the cost of modification and the risk (and potential cost) of foreclosure.

The available evidence on HAMP-PRA, as well as industry practice, indicates that targeted principal reduction makes economic sense for the holder of the credit risk, be it a bank holding the loan in portfolio, investors in private label securities, or Fannie Mae and Freddie Mac (GSEs) for loans they guarantee.

Fannie Mae, acting as Treasury's agent, analyzed HAMP modification performance data with and without principal reduction.[1] This analysis shows that six months following modification, controlling for loan and borrower characteristics, the re-default rate was lower for loans that were modified with principal reduction than the re-default rate for loans that were modified with

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[1] U.S. Department of the Treasury, The Effects of the Principal Reduction Alternative (PRA) on Re-default Rates in the Home Affordable Modification Program (HAMP): Early Results, July 2012. Summary of research performed by Fannie Mae.

comparable payment reductions but without principal forgiveness. This early positive difference in re-default rates in favor of principal reduction is expected to increase further as the loans age.

Fannie Mae's analysis suggests that using principal reduction to reduce the loan-to-value (LTV) ratio not only increases a borrower's *ability to pay*, but for these selected borrowers, it also increases the likelihood that they will *continue to pay*.

Principal reduction would provide additional benefits to households, communities, and taxpayers if Fannie Mae and Freddie Mac were to implement it as part of their modification programs.

Treasury believes that principal reduction is consistent with the Federal Housing Finance Agency's (FHFA) mandates as conservator and regulator of the GSEs because analysis shows it is economically beneficial to both the GSEs and taxpayers. Indeed, even FHFA's own analysis shows that permitting the GSEs to participate in a principal reduction program could help up to half a million homeowners and benefit the GSEs up to $3.6 billion and save taxpayers as much as $1 billion.

The 2008 law that created the FHFA as conservator and regulator of the GSEs gave the agency several responsibilities. One is to "preserve and conserve" the assets of the GSEs. A second is to help the housing market recover. Specifically, FHFA is to "ensure... that the operations and activities of each [GSE] foster liquid, efficient, competitive, and resilient national housing finance markets."[2]

In passing the Emergency Economic Stabilization Act of 2008 (EESA), Congress made it clear that FHFA's obligation to help the housing market heal involves helping homeowners avoid foreclosure. Under that law, FHFA is required to "implement a plan that seeks to maximize assistance for homeowners and use its authority to encourage the servicers of the underlying mortgages, and considering net present value to the taxpayer, to take advantage of... available programs to minimize foreclosures."

We believe that implementation of the principal reduction alternative under Treasury's mortgage modification program is not only consistent with FHFA's statutory responsibilities, but is also the most prudent way for FHFA to meet its obligations.

The targeted use of principal reduction will help preserve the assets of the GSEs, as well as minimize foreclosures and maximize assistance for homeowners. GSE loans represent more than half of the outstanding mortgages in the country. This means that the reach and impact of our housing programs depend to a significant degree on the participation of the GSEs. When the GSEs participate, as they have in the programs that give homeowners the chance to reduce their monthly mortgage payment, they have had a very substantial impact. When the GSEs do not participate, the impact of these programs is much more limited. Because of the importance of the GSEs to the housing market overall, FHFA's decision not to allow the GSEs to participate

[2] Federal Housing Finance Regulatory Reform Act of 2008, enacted as Division A of the Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654 (Jul. 30, 2008)

substantially limits the effectiveness of the programs. Recognizing this, we have tried to make it easier and more compelling for the GSEs to align their programs with those in the private mortgage market.

Specifically, Treasury supports the use of principal reduction not for Fannie Mae and Freddie Mac's entire portfolios, but on a loan-by-loan basis. Principal reduction should only be used when the modified loan has a positive net present value (NPV) that is *greater* than any other modification.

FHFA's original analysis of principal reduction was not performed in this manner, showing instead that HAMP-PRA, when applied to the entire GSE portfolio of underwater borrowers, would generate negative NPV results as compared to other modifications. This, of course, is not how the program was designed to work, so the finding was not relevant to an adequate assessment of its benefit. Once performed correctly on a loan-by-loan basis, principal reduction would apply in a limited number of cases and show a positive NPV result for both GSEs and taxpayers.

FHFA's corrected analysis showed the following:

- Almost a half-million troubled, underwater borrowers with Fannie Mae or Freddie Mac loans could benefit from principal reduction.

- Applying HAMP-PRA to this eligible universe with full participation would result in net savings to the GSEs of $3.6 billion compared to standard GSE loan modification processes.

- After deducting Treasury incentives of $2.7 billion, there would still be a net savings to taxpayers overall of up to approximately $1 billion.

FHFA also found that a significant share of the economic benefits to the GSEs from their participation in HAMP-PRA would come from borrowers who are more than 12 months delinquent. While these loans may have a lower probability of curing, each borrower who gets back on track as a result of receiving principal forgiveness generates disproportionately large savings to the GSEs. Moreover, borrowers only receive principal reduction once they have successfully returned to making on-time payments and completed a trial modification. Even if these longer-delinquent loans are not included in the program, by FHFA's estimate, there are still almost 300,000 loans that can participate in HAMP-PRA at zero cost to the taxpayer.

Finally, the number of troubled, underwater borrowers who will ultimately benefit from GSE participation in HAMP-PRA depends on overall take-up. But even if only a portion of those eligible are helped, it is very important for those homeowners where it means the difference between keeping and losing their homes.

Concerns about the cost and administrative burden to the GSEs of implementing principal reduction can be addressed with support offered by the Treasury Department.

FHFA has expressed concern that implementation of HAMP-PRA would be an administrative and financial burden on the GSEs and would divert management attention from higher priority objectives. Treasury has offered to help FHFA address that problem by paying the additional administrative costs required to implement HAMP-PRA. We also have offered to work with the GSEs to rearrange Treasury priorities for other HAMP-related administrative projects to free up both human and technical resources to help accelerate implementation of a principal reduction program.

Concern regarding strategic default has been carefully addressed in the design of HAMP-PRA.

Critics of principal reduction argue that large numbers of currently performing underwater borrowers would strategically default on their loans, in the hope of getting principal reduction, and potentially raise the future cost of mortgage credit.

We believe the design of HAMP addresses this concern. First, there are a series of eligibility requirements that a borrower must meet. In order to qualify for a modification of any kind, a borrower must have a demonstrated financial hardship and must be delinquent or at risk of imminent default and sign an affidavit attesting to an economic hardship. The NPV model discloses whether a modification with principal reduction is more cost-beneficial to the investor than a standard HAMP modification without principal reduction. In addition, the borrower's modified mortgage payment must meet certain debt-to-income criteria. In essence, a borrower who defaults cannot be certain that he or she will obtain a HAMP modification, much less a HAMP modification with principal reduction. Therefore, a borrower would take a substantial risk by deliberately defaulting: they would have to choose to damage their credit for years to come and perjure themselves on the chance that they would be found eligible for the program. For these reasons, we do not believe implementation of HAMP-PRA by the GSEs alongside other mortgage relief programs would negatively affect the future cost and availability of credit.

Nevertheless, we have indicated to FHFA our willingness for the GSEs to include an asset test or other type of hardship screen to maximize the likelihood that only borrowers with genuine hardships receive principal reduction.

Importantly, banks are using principal reduction on loans in their own portfolios. Even before Treasury announced tripling incentives to encourage participation in HAMP-PRA, the use of principal forgiveness was on the rise in non-GSE modifications. Private lenders (including many who are not party to the national foreclosure settlement) are providing substantial sums of principal reduction through HAMP-PRA for a very high percentage of eligible borrowers on their own portfolios. Thus, facing the very factors faced by FHFA, including the risk of strategic default, private lenders have determined that the judicious use of principal reduction makes financial sense.

A recent Fitch Ratings analysis of strategic default within principal forgiveness programs operated under the national mortgage settlement finds little evidence of strategic default.[3] FHFA is also working closely with the California and Nevada Hardest Hit Fund programs to implement limited principal reduction programs (one in connection with a refinancing under the GSEs' own Home Affordable Refinance Program) that suggest that strategic default concerns can be adequately addressed.

The attached table was excerpted from FHFA's June 25, 2012, analysis.

[3] Jon Prior, "Fitch Sees No Sign of Strategic Default for Rising Principal Reductions"; *Housing Wire* (July 9 2012), http://www.housingwire.com/news/fitch-sees-no-sign-strategic-default-rising-principal-reductions

Federal Housing Finance Agency

Model Results Selecting Optimal HAMP Modification Based on Net Present Value (NPV)

Standard HAMP Modifications versus Optimal HAMP Option ($ in billions; loan counts rounded to nearest thousand; totals may not add due to rounding)	**Expected Losses, No Modification**	**Reduction in Losses, Standard HAMP**	**Reduction in Losses, Optimal HAMP Modification**	**Enterprise Benefit, Optimal HAMP Modification vs. Standard HAMP**	**Treasury Subsidy**	**Taxpayer Benefit**
Eligible Pool # of Loans: 497,000 UPB: $99.3 billion	$45.0	$6.6	$10.2	$3.6	$2.7	$1.0
Assumption: 50 percent take-up # of Loans: 248,000 UPB: $49.7 billion	$22.5	$3.3	$5.1	$1.8	$1.3	$0.5

Notes:

- Each loan tested for maximum NPV based on HAMP-PRA, traditional HAMP, or no modification. Loan assigned to category yielding the highest NPV, per the model.
- Pre-modification DTIs adjusted to reflect DTI distribution of loans that received HAMP modifications (delinquent loans only).
- Model results are still just that – model results based on assumptions about behaviors for which we lack much historical data.

Source: Federal Housing Finance Agency – Meeting with Treasury Secretary Geithner – June 25, 2012

Definitions:
UPB – Unpaid principal balance
DTI – Debt-to-income ratio
Standard HAMP Mod – A HAMP modification that uses forbearance for underwater homeowners rather than principal reduction. The protocol is to reduce the rate to 2 percent, extend term out to 40 years, and forbear principal. The protocol stops at any point in the process as soon as the target DTI of 31 percent is reached.
Optimal HAMP Mod – A HAMP-PRA modification that uses principal reduction for underwater homeowners. The protocol is to reduce principal until the LTV is reduced to 115 percent, then follow the steps in the Standard HAMP modification. Again, the protocol stops at any point in the process as soon as the target DTI of 31 percent is reached.

EXHIBIT 5

Table 2: Dividends on Enterprise Draws from Treasury[1]
($ billions)

Quarter	Freddie Mac			Fannie Mae		
	Dividends Accrued	Date Paid	Cumulative Dividends Paid[2]	Dividends Accrued	Date Paid	Cumulative Dividends Paid[2]
2008 Q4	$0.167	12/31/2008	$0.173	$0.025	12/31/2008	$0.031
2009 Q1	0.370	3/31/2009	0.543	0.025	3/31/2009	0.056
2009 Q2	1.149	6/30/2009	1.692	0.409	6/30/2009	0.465
2009 Q3	1.294	9/30/2009	2.986	0.885	9/30/2009	1.350
2009 Q4	1.293	12/31/2009	4.278	1.150	12/31/2009	2.501
2010 Q1	1.293	3/31/2010	5.571	1.527	3/31/2010	4.028
2010 Q2	1.293	6/30/2010	6.863	1.909	6/30/2010	5.937
2010 Q3	1.560	9/30/2010	8.424	2.117	9/30/2010	8.055
2010 Q4	1.603	12/31/2010	10.027	2.153	12/31/2010	10.207
2011 Q1	1.605	3/31/2011	11.632	2.216	3/31/2011	12.424
2011 Q2	1.618	6/30/2011	13.249	2.281	6/30/2011	14.705
2011 Q3	1.618	9/30/2011	14.867	2.495	9/30/2011	17.199
2011 Q4	1.655	12/31/2011	16.522	2.621	12/31/2011	19.821
2012 Q1	1.808	3/31/2012	18.329	2.819	3/31/2012	22.639
2012 Q2	1.808	6/30/2012	20.137	2.931	6/30/2012	25.571
2012 Q3	1.808	9/28/2012	21.946	2.929	9/28/2012	28.499
2012 Q4	1.808	12/31/2012	23.754	2.929	12/31/2012	31.428
2013 Q1	5.826	3/29/2013	29.580	4.224	3/29/2013	35.652
2013 Q2	6.971	6/28/2013	36.552	59.368	6/28/2013	95.020
2013 Q3	4.357	9/30/2013	40.909	10.243	9/30/2013	105.263
2013 Q4	30.436	12/31/2013	71.345	8.617	12/31/2013	113.880
2014 Q1	10.435	3/31/2014	81.780	7.192	3/31/2014	121.072
2014 Q2	4.499	6/30/2014	86.279	5.692	6/30/2014	126.764
2014 Q3	1.890	9/30/2014	88.164	3.712	9/30/2014	130.469
2014 Q4	2.786	12/31/2014	90.955	3.999	12/31/2014	134.474

N/A = not applicable; TBD = to be determined but not later than 9/29/2017

[1] As set forth in the Third Amendment to the Amended and Restated Senior Preferred Stock Purchase Agreement, between January 1, 2013 and December 31, 2017, dividend amounts will be the Net Worth Amount at the end of the immediately preceding fiscal quarter minus the applicable capital reserve amount. The 2013 capital reserve amount of $3 billion will be reduced by $600 million each calendar year until it reaches zero on January 1, 2018.
[2] Dividends accrued may not add up to cumulative dividends due to rounding.

(Table continued on next page)

2015 Q1	0.851	3/31/2015	91.807	1.920	3/31/2015	136.394
2015 Q2	0.746	6/30/2015	92.552	1.796	6/30/2015	138.190
2015 Q3	3.913	9/30/2015	96.466	4.359	9/30/2015	142.549
2015 Q4	0.000	N/A	96.466	2.202	12/31/2015	144.751
2016 Q1	1.740	3/31/2016	98.206	2.859	3/31/2016	147.610
2016 Q2	0.000	N/A	98.206	0.919	6/30/2016	148.529
2016 Q3	0.933	9/30/2016	99.138	2.869	9/30/2016	151.398
2016 Q4	2.310	12/30/2016	101.448	2.976	12/30/2016	154.375
2017 Q1	4.476	3/31/2017	105.923	5.471	3/31/2017	159.846
2017 Q2	2.234	6/30/2017	108.158	2.779	6/30/2017	162.625
2017 Q3	1.985	9/29/2017	110.143	3.117	9/29/2017	165.742
Cumulative Dividends Paid by Both Enterprises[3]			**$275,885**			

Source: Freddie Mac and Fannie Mae
N/A = not applicable

[3] Cumulative dividends paid may not add up to cumulative dividends paid by both Enterprises due to rounding.

EXHIBIT 6

Table 1: Quarterly Draws on Treasury Commitments to Fannie Mae and Freddie Mac per the Senior Preferred Stock Purchase Agreements[1]
($ billions)

Quarter	Freddie Mac				Fannie Mae			
	Reported GAAP Net Worth	Requested Draw	Draw Date	Cumulative Enterprise Draws[2]	Reported GAAP Net Worth	Requested Draw	Draw Date	Cumulative Enterprise Draws[2]
2008 Q3	-$13.700	$13.800	11/24/2008	$13.800	$9.400	$0.000	N/A	$0.000
2008 Q4	-30.600	30.800	3/31/2009	44.600	-15.200	15.200	3/31/2009	15.200
2009 Q1	-6.000	6.100	6/30/2009	50.700	-18.900	19.000	6/30/2009	34.200
2009 Q2	8.200	0.000	N/A	50.700	-10.600	10.700	9/30/2009	44.900
2009 Q3	10.400	0.000	N/A	50.700	-15.000	15.000	12/31/2009	59.900
2009 Q4	4.400	0.000	3/31/2010	50.700	-15.300	15.300	3/31/2010	75.200
2010 Q1	-10.500	10.600	6/30/2010	61.300	-8.400	8.400	6/30/2010	83.600
2010 Q2	-1.700	1.800	9/30/2010	63.100	-1.400	1.500	9/30/2010	85.100
2010 Q3	-0.100	0.100	12/31/2010	63.200	-2.400	2.500	12/31/2010	87.600
2010 Q4	-0.400	0.500	3/31/2011	63.700	-2.500	2.600	3/31/2011	90.200
2011 Q1	1.200	0.000	6/30/2011	63.700	-8.400	8.500	6/30/2011	98.700
2011 Q2	-1.478	1.479	9/30/2011	65.179	-5.087	5.087	9/30/2011	103.787
2011 Q3	-5.991	5.992	12/31/2011	71.171	-7.791	7.791	12/31/2011	111.578
2011 Q4	-0.146	0.146	3/31/2012	71.317	-4.571	4.571	3/31/2012	116.149
2012 Q1	-0.019	0.019	6/30/2012	71.336	0.268	0.000	N/A	116.149
2012 Q2	1.086	0.000	N/A	71.336	2.770	0.000	N/A	116.149
2012 Q3	4.906	0.000	N/A	71.336	2.411	0.000	N/A	116.149
2012 Q4	8.826	0.000	N/A	71.336	7.224	0.000	N/A	116.149
2013 Q1	9.971	0.000	N/A	71.336	62.368	0.000	N/A	116.149
2013 Q2	7.357	0.000	N/A	71.336	13.243	0.000	N/A	116.149
2013 Q3	33.436	0.000	N/A	71.336	11.616	0.000	N/A	116.149
2013 Q4	12.835	0.000	N/A	71.336	9.591	0.000	N/A	116.149
2014 Q1	6.899	0.000	N/A	71.336	8.092	0.000	N/A	116.149
2014 Q2	4.290	0.000	N/A	71.336	6.112	0.000	N/A	116.149
2014 Q3	5.186	0.000	N/A	71.336	6.399	0.000	N/A	116.149

[1] Freddie Mac's draws have been based on reported GAAP stockholders' equity, while Fannie Mae's draws have been based on GAAP net worth. Both GAAP stockholders' equity and GAAP net worth are measures of the difference between an Enterprise's assets and liabilities. Both measures include realized and unrealized losses as of the reporting date. Losses ultimately realized in the future may differ from unrealized losses as of the reporting date.
[2] Excludes $1 billion in liquidation preference on the senior preferred stock position obtained by Treasury from each Enterprise upon initiation of the Senior Preferred Stock Purchase Agreement. The initial $1 billion is not a draw on the Treasury's commitment under the agreement.

(Table continued on next page)

2014 Q4	2.651	0.000	N/A	71.336	3.720	0.000	N/A	116.149
2015 Q1	2.546	0.000	N/A	71.336	3.596	0.000	N/A	116.149
2015 Q2	5.713	0.000	N/A	71.336	6.159	0.000	N/A	116.149
2015 Q3	1.299	0.000	N/A	71.336	4.002	0.000	N/A	116.149
2015 Q4	2.940	0.000	N/A	71.336	4.059	0.000	N/A	116.149
2016 Q1	1.000	0.000	N/A	71.336	2.119	0.000	N/A	116.149
2016 Q2	2.133	0.000	N/A	71.336	4.069	0.000	N/A	116.149
2016 Q3	3.510	0.000	N/A	71.336	4.200	0.000	N/A	116.149
2016 Q4	5.076	0.000	N/A	71.336	6.071	0.000	N/A	116.149
2017 Q1	2.834	0.000	N/A	71.336	3.379	0.000	N/A	116.149
2017 Q2	2.585	0.000	N/A	71.336	3.717	0.000	N/A	116.149
Total Cumulative Draws by Both Enterprises				**$187.485**				

Source: Freddie Mac and Fannie Mae **N/A = not applicable**

The full text of the Senior Preferred Stock Purchase Agreements and the amendments to those agreements are available online here. For Fannie Mae's quarterly and annual financial results, click here. For Freddie Mac's quarterly and annual financial results, click here.

EXHIBIT 7

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA

Case No. 17-cv-02185 (PJS/HB)

ATIF F. BHATTI, TYLER D. WHITNEY, and MICHAEL F. CARMODY,

Plaintiffs,

-vs-

THE FEDERAL HOUSING FINANCE AGENCY, MELVIN L. WATT, in his official capacity as Director of the Federal Housing Finance Agency, and THE DEPARTMENT OF THE TREASURY,

Defendants.

DECLARATION OF ATIF F. BHATTI

I, Atif F. Bhatti, declare as follows:

1. I am one of the Plaintiffs in the lawsuit captioned above.

2. I have first-hand knowledge of the facts in my declaration and could, and would, if called upon to do so, testify competently as to those facts.

3. I have continuously owned common shares of Fannie Mae stock since before this lawsuit was filed.

Pursuant to 28 U.S.C. § 1746, I declare under penalty of perjury that, to the best of my knowledge, the foregoing is true and correct. Executed on October 10, 2017.

s/Atif F. Bhatti
Atif F. Bhatti

EXHIBIT 8

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA

Case No. 17-cv-02185 (PJS/HB)

ATIF F. BHATTI, TYLER D. WHITNEY, and MICHAEL F. CARMODY,

Plaintiffs,

-vs-

THE FEDERAL HOUSING FINANCE AGENCY, MELVIN L. WATT, in his official capacity as Director of the Federal Housing Finance Agency, and THE DEPARTMENT OF THE TREASURY,

Defendants.

DECLARATION OF
TYLER D. WHITNEY

I, Tyler D. Whitney, declare as follows:

1. I am one of the Plaintiffs in the lawsuit captioned above.

2. I have first-hand knowledge of the facts in my declaration and could, and would, if called upon to do so, testify competently as to those facts.

3. I have continuously owned both common and preferred shares of Fannie Mae stock since before this lawsuit was filed.

Pursuant to 28 U.S.C. § 1746, I declare under penalty of perjury that, to the best of my knowledge, the foregoing is true and correct. Executed on October 11, 2017.

s/Tyler D. Whitney
Tyler D. Whitney

EXHIBIT 9

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA

Case No. 17-cv-02185 (PJS/HB)

ATIF F. BHATTI, TYLER D. WHITNEY, and MICHAEL F. CARMODY,

Plaintiffs,

-vs-

THE FEDERAL HOUSING FINANCE AGENCY, MELVIN L. WATT, in his official capacity as Director of the Federal Housing Finance Agency, and THE DEPARTMENT OF THE TREASURY,

Defendants.

DECLARATION OF MICHAEL F. CARMODY

I, Michael F. Carmody, declare as follows:

1. I am one of the Plaintiffs in the lawsuit captioned above.

2. I have first-hand knowledge of the facts in my declaration and could, and would, if called upon to do so, testify competently as to those facts.

3. I have continuously owned common shares of Fannie Mae stock since before this lawsuit was filed.

Pursuant to 28 U.S.C. § 1746, I declare under penalty of perjury that, to the best of my knowledge, the foregoing is true and correct. Executed on October 12, 2017.

s/Michael F. Carmody
Michael F. Carmody

EXHIBIT 10

VIEWPOINTS

MILKEN INSTITUTE
CENTER FOR FINANCIAL MARKETS

Why Housing Reform Still Matters

Michael Bright and Ed DeMarco

June 2016

The 2008 financial crisis left a lot of challenges in its wake. The events of that year led to years of stagnant growth, a painful process of global deleveraging, and the emergence of new banking regulatory regimes across the globe.

But at the epicenter of the crisis was the American housing market. And while America's housing finance system was fundamental to the financial crisis and the Great Recession, reform efforts have not altered America's mortgage market structure or housing access paradigms in a material way.

This work must get done. Eventually, legislators will have to resolve their differences to chart a modernized course for housing in our country. Reflecting upon the progress made and the failures endured in this effort since 2008, we have set ourselves to the task of outlining a framework meant to advance the public debate and help lawmakers create an achievable plan. Through a series of upcoming papers, our goal will be to not just foster debate but to push that debate toward resolution.

Before setting forth solutions, however, it is important to frame the issues and state why we should do this in the first place. In light of the growing chorus urging surrender and going back to the failed model of the past, our objective in this paper is to remind policymakers why housing finance reform is needed and help distinguish aspects of the current system that are worth preserving from those that should be scrapped.

Why Housing Finance Reform Is Needed, and What It Must Accomplish

Structural housing finance reform was never going to be an easy undertaking. But it can't be ignored. After years of debate, we understand that sensible reforms should seek to preserve the aspects of the old system that worked while ridding the system of its flaws. And we understand that transitioning to a new market infrastructure must be carried out without disruption—disruption that could upset mortgage availability in the near term or upset the processes and operations of the thousands of firms that make up the complex housing finance ecosystem.

So no, this was never going to be easy.

Still, nearly a decade after the financial crisis, housing finance is notable for its political and policy complexity as well as the passion that it stirs. Meaningful reform must be achieved, the vast majority of policymakers say, yet the decade anniversary of the conservatorships of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corp. (Freddie Mac) looms.

A home is the largest purchase most Americans will make in their lives. By some estimates, housing is the engine that propels nearly one-fifth of the American economy. Access to decent housing is crucial to a vibrant middle class. On top of all that, the system is enormously intricate; this is not your grandfather's housing market. No longer is the typical mortgage characterized by a 20 percent down payment and funded with community deposits from the local savings and loan. Today, the vast majority of America's mortgages come into existence via a complex financial infrastructure, not via local banks that simply take in deposits and lend them out. Instead we have a web of bank and non-bank lenders, bank and non-bank mortgage servicers, mortgage insurers, guaranteed securities, derivatives, credit investors, rate investors, and more that together connect savers across the globe with families across the country who seek to buy a house. All of this has led to structurally lower and less volatile interest rates. But it has also created complex terrain to navigate.

So here we are eight years after the financial crisis, with the two government-sponsored enterprises (GSEs) that sit at the heart of America's housing finance ecosystem—Fannie Mae and Freddie Mac—trapped in a state of legal limbo called conservatorship. The government life support given to them at the height of the financial crisis was meant to be temporary, followed by legislation replacing the toxic aspects of their activities and reforming our market structure. But a long-term decision about how to replace the life support with something better without disrupting the housing market requires political compromise and pragmatic thinking. Politically, members of Congress on both sides of the aisle will have to give on some issues to achieve an agreement. They will need to put ideology aside and ask, "Will this actually work?"

The challenge of finding sufficient political common ground to break the GSEs out of conservatorship has felt so daunting that it has led to doing nothing. But continued inaction is a de facto decision to stay with what we've got. Others have suggested we give up in a different way: return, hat in hand, to the old model that failed. These arguments are misguided and dangerous. Neither approach would address the failures of the past or the economic challenges of the present.

The former choice—remaining in conservatorship—would allow the entire housing system to rely almost entirely on the decisions of the Federal Housing Finance Agency (FHFA) director and the two CEOs he or she is meant to regulate. In the end, this "head in the sand" strategy is not a serious approach. Such a lack of legislative clarity turns market decisions, such as how to underwrite a loan or price its risk, into a bureaucratic exercise or worse. This is not the proper role for a regulatory agency. But until Congress acts, the FHFA is stuck in its role of regulator and conservator.

The latter idea—returning to the old model, in which the GSEs operate in a blessed state as government-sponsored enterprises that are tasked with a public mission but report to private shareholders, coupled with a management team incentivized to leverage all advantages not for the long-term health of the economy but instead for immediate financial gain—relies on the assumption that future congresses will also bail out Fannie and Freddie successor entities the next time there is a major market disruption. (And there will always be market disruptions.) This path, too, leaves the well-being of the housing market very much to chance.

As the events of 2008 demonstrated, the old model worked only because investors were confident that taxpayers stood behind the companies. If Fannie and Freddie were released from government control and, for all intents and purposes, returned to their pre-conservatorship quasi-private status, are we sure that a future Congress will inject emergency capital into them when they become insolvent or the mortgage-backed securities (MBS) market questions the strength of their guarantee?

Of course, the answer is no. Yet from Congress' perspective, as much as it may never want to vote for taxpayer life support again, the pressure to keep two dominant players operating could very well lead to another vote to allocate emergency capital into successor entities.

All of this begs the question: Where, exactly, do we go from here?

There are notable, impressive successes inside America's housing finance system. These must be preserved. Yet we must also reduce the likelihood that financial institutions will need emergency congressional action in the future. Additionally, incentives need to be properly structured and transparent, not comingled and opaque. Put another way, housing finance reform is about throwing out the dirty bathwater but keeping the baby. Fortunately, meaningful steps have already been taken, albeit slowly. And we are writing about these issues because it seems that meaningful policy debate in Washington may begin anew in 2017.

The Secondary Mortgage Market and Its Collapse

While the Bailey Brothers' Building and Loan from the classic movie *It's a Wonderful Life* renders a heartwarming picture of local housing finance, only remnants of that system remain today. At least since the savings and loan debacle in the 1980s, the U.S. housing finance system has been dominated by the secondary mortgage market, that is, the marketplace where lenders, bond investors, and the infrastructure of securitization meet.

In simple terms, the secondary market is where individual mortgages made across the country are bundled into large groups of mortgages, called pools, and sold to global investors in a structure called a mortgage-backed security. The process of pooling mortgages and issuing MBS is called securitization. This system can be very powerful and beneficial. Rather than relying on the availability and stability of local deposits at a savings (or building) and loan, the secondary market draws asset managers across the globe to invest in pools of hundreds or thousands of mortgages.

In this way, pension funds, college endowment funds, insurance companies, mutual funds, retirement savings plans, foreign central banks, foreign wealth funds, and other institutional money managers responsible for investing the savings of individuals and institutions provide the money a family needs to buy a house anywhere in America. Interestingly, these widely dispersed investors know very little about the risk characteristics of any individual borrower in their pool, nor do they know much about the condition of a particular house, the neighborhood in which it's located and the local economy. So why are they willing to fund these mortgages?

The answer lies in the structure and reliability of the secondary mortgage market and the institutions and legal arrangements at its center. In the run-up to the financial crisis, and still today, there are three distinct components that compose most of the secondary mortgage market and make this financial ecosystem possible.

First, in the government segment of the housing finance system, the Government National Mortgage Association, or Ginnie Mae, oversees the pooling of mortgages guaranteed by the Federal Housing Administration (FHA), the Department of Veterans Affairs (VA), and a few smaller federal housing programs. The Ginnie Mae label on a mortgage-backed security tells investors that the full faith and credit of the United States government guarantees that they will receive timely payment of principal and interest each month and that investors will not lose any principal as a result of borrower defaults on the underlying mortgages.

In this case, the risk is largely borne by the federal government through its FHA, VA, and other mortgage insurance programs. Loan originators and loan servicers retain some risk as well, and Ginnie Mae bears the ultimate risk if these private-sector entities fail to fulfill their responsibilities. Ginnie charges the homebuyer six basis points per year (or typically less than $1 per month) for this backstop guarantee. Today, Ginnie Mae MBS account for $1.5 trillion of the roughly $7 trillion in outstanding MBS, or more than 20 percent, which is a historic high.

Second, on the other end of the spectrum, in the purely private-label segment of the housing finance system, banks and other financial institutions (call them Wall Street firms if you must, although many are not located anywhere near New York) put together mortgage pools and sell the MBS to private investors. In this market segment, the nongovernment investors bear all the credit risk; that is, if borrowers default on their payments, investors suffer the loss. As a result, private-label MBS are broken into multiple subgroups, called tranches, which create a predetermined order for bearing credit losses. More subordinate tranches bear all the credit losses until they are wiped out, and then losses proceed to holders of more senior tranches of the pool.

In the decade or so leading up to the financial crisis, the private-label market (often referred to as the private-label securitization market, or PLS) exploded in size, often backed by subprime mortgages, which were underwritten according to nonstandard guidelines. To name a few, documentation of income or assets was frequently not required, there were very few antifraud controls, and whether prospective borrowers could repay a loan was seen as a secondary question at best. The PLS market fanned the flames of these problems, but the government-sponsored enterprises, worried about losing market share, were quick to follow.

The private-label market is also where so-called "jumbo loans" are securitized.[1] By 2006, private-label MBS accounted for about half of outstanding MBS, but today that portion is down to less than 10 percent. In fact, there has been almost no new issuance in this market since the crisis. The reason is that the crisis exposed several deep, structural flaws in the PLS market, including a lack of standardization in disclosures, opaque and nonstandard legal terms from one PLS to another, and no functioning mechanism to ensure that servicers who determined whether and how to modify loans and enforce contracts did so in the best interest of investors. The U.S. Treasury Department and other entities are working to address these flaws in an effort to build a more sustainable PLS market, but this market segment remains moribund.

Third, and the largest by far, is the GSE market segment, composed of loans bundled, securitized, and guaranteed by Fannie Mae and Freddie Mac.[2] Chartered by Congress, endowed with unique benefits unavailable to any other private firm, and tasked with developing a liquid and stable market in which non-FHA mortgages could be bought and sold, Fannie and Freddie grew into behemoths in both their market power and political influence.

The market interpreted this package of benefits, including the GSEs' federal charter and exemption from certain securities laws, as giving the two companies an implied government guarantee. In turn, these benefits and the associated implied guarantee allowed Fannie and Freddie to join Ginnie Mae in selling mortgage-backed securities in a forward market, called the "To Be Announced," or TBA, market. Being able to trade MBS in the TBA market allows for easy trading and hedging of mortgages around the globe as well as the standardization of underwriting. But in 2008, our reliance on these entities as a public/private duopoly was exposed as a Faustian bargain.

A hybrid between public mission and private ownership, Fannie and Freddie often reaped the best of both worlds. Operating with numerous public benefits, the companies and their shareholders operated with lower costs, much lower capital requirements, and far weaker regulation than any bank or savings and loan.[3] In the end, their unique structure of private shareholders, private-sector salaries and benefits, and an implicit public guarantee came to symbolize "Heads we win, tails the taxpayers lose."

In this market segment, Fannie and Freddie bought mortgages, packaged them into MBS, and guaranteed the MBS holders payment of principal and interest if any borrower defaulted on a loan. They

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1. Jumbo loans have a principal balance greater than the conforming loan limit, that is, the largest mortgage Fannie Mae and Freddie Mac may purchase. Currently, the conforming loan limit is $625,000 in high-cost areas and $417,000 across most of the rest of the country.
2. Fannie Mae and Freddie Mac are two among a handful of GSEs, financial institutions chartered by Congress but owned and operated by private shareholders. GSEs have a public mission stated in their charter and receive such benefits as preferential tax treatment and cheaper access to capital markets, which are unavailable to other private firms.
3. For example, their capital levels were extraordinarily low, at times less than 100 basis points.

charged borrowers a guarantee fee embedded in the interest rate—effectively an insurance premium—for bearing this risk. With nearly $5 trillion in MBS outstanding at the time of the crisis—50 percent of all U.S. mortgage debt—we can see in hindsight that this concentrated credit risk exposure was a systemic threat.

It was widely discussed before the crisis that this setup, combined with the two companies' importance to housing finance and their government support, meant that taxpayers, in all likelihood, "implicitly guaranteed" Fannie and Freddie MBS investors should the GSEs fail. While Congress routinely insisted that there was no government guarantee behind Fannie and Freddie, the market thought otherwise—and when the enterprises failed, that implicit guarantee was honored and became explicit. In the summer of 2008, Congress gave the Treasury Department unlimited authority to purchase Fannie and Freddie securities. The subsequent appointment of the FHFA as conservator backed by direct financial support from the Treasury protected the holders of Fannie and Freddie MBS.

Since the crisis, the private-label market mostly vanished, and Ginnie Mae, Fannie and Freddie have expanded their market shares. Despite Fannie and Freddie being on government life support, the conservatorship design supported by Treasury backstop financing enabled investors to continue buying their MBS, thereby ensuring ongoing liquidity in the U.S. mortgage market. Absent this life support, the country would have been without a viable secondary market to provide liquidity for new mortgages not backed by a government agency such as the FHA.

While there are other important considerations to the workings of this secondary market, two more background points—clear lessons from the financial crisis—are worth making here. First, to reap the benefits of a market like the one we have come to know, the mortgages in an MBS must be homogenous. That is, they need to share certain characteristics such as repayment term and whether the loan has a fixed or adjustable interest rate. Similar loans allow investors to analyze and estimate prepayment speeds, which affect MBS pricing. This is a critical component of how investors manage the interest rate risk of a long-term security with variable prepayment.

Second, Ginnie Mae, Fannie Mae, and Freddie Mac play an important role overseeing and enforcing certain contracts critical to the market's operations. Key among these are overseeing mortgage servicers on behalf of investors and taking appropriate remedial steps, including transferring mortgage servicing, in the event of problems. The private-label world, as we came to see in the crisis, lacks an effective mechanism for such oversight, which the Treasury Department and industry groups have wrestled with in recent years.

This brief review reminds us that the objective of strengthening the secondary market while avoiding future government bailouts means replacing what is broken in the Fannie/Freddie model. That includes the systemic risk caused by concentrating credit risk on two balance sheets. We also need to eliminate the features of their charters that concentrated risk and political power in two quasi-private companies. Not to be lost is the challenge and opportunity of strengthening the other two component parts of the secondary mortgage market—the government segment and the purely private segment—and modernizing critical infrastructures that support housing finance.

At the same time, we need to preserve the liquidity and capacity of an active, globally financed MBS market because it ensures lower mortgage rates and stable access to credit. And we need to better define the role of each segment of the housing market. The purely private, purely public, and hybrid parts of the system must operate as one ecosystem, not competitors in a race to the bottom.

What Has Transpired So Far?

From a public policy perspective, it makes sense to begin policy analysis by examining the purely governmental programs and institutions involved in housing finance, especially the Federal Housing Administration. Nonetheless, the Fannie/Freddie space of the secondary mortgage market is by far the largest component of the housing market. So we address its flaws here, and we will return to the FHA and other government programs in a later paper.

Since Fannie and Freddie were put on government life support in 2008, the question, "What do we do with them and the housing finance system next?" remains unanswered. But to be entirely pessimistic about policymakers' capacity to solve complex problems misses important points. Some helpful steps have been taken, and they are worth quickly reviewing.

The first of these policy initiatives occurred in 2012 with the introduction of the FHFA Strategic Plan for Enterprise Conservatorships[4] and its associated "annual scorecards." The scorecards set the FHFA's priority objectives for Fannie and Freddie to achieve over the subsequent calendar year.[5] The strategic plan and annual scorecards defined initiatives for Fannie and Freddie to modernize their operations and business practices while preparing the groundwork for a post-conservatorship secondary mortgage market. The two most significant results of these efforts are the development of credit risk-sharing, or credit-risk transfer (CRT) products that have helped shift risk away from Fannie and Freddie (and therefore taxpayers); and a common platform to replace each company's outdated, proprietary securitization infrastructure and technology.

Beginning here with CRT, credit-risk transfer transactions began small in 2013—the scorecard goal was just $30 billion in unpaid principal balance—but they have since become a substantive risk-shifting mechanism for the enterprises and, with a bit more work, can become a market asset class of their own. Credit-risk transfer accomplishes a number of key tasks on the reform agenda. CRT brings in market signals, ushers in private risk takers ahead of taxpayers, and focuses market practitioners on the development of models for continued improvement in mortgage credit risk management. In short, credit-risk transfer has helped form a foundation for a new mortgage credit market structure.[6] Importantly, we

4. Federal Housing Finance Agency, A Strategic Plan for Enterprise Conservatorships: The Next Chapter in a Story that Needs an Ending. February 21, 2012. The plan was written by one of the authors of this paper.
http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/20120221_StrategicPlanConservatorships_508.pdf
5. In 2014, current FHFA Director Melvin Watt restated the strategic goals in an updated plan. See Federal Housing Finance Agency, The 2014 Strategic Plan for the Conservatorships of Fannie Mae and Freddie Mac, May 13, 2014.
http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2014StrategicPlan05132014Final.pdf. The FHFA continues to publish annual scorecards prioritizing efforts and setting targets for meeting the strategic goals.
6. For additional background on the steps taken to date and those still needed to fully develop a market for mortgage credit risk, see Edward J. DeMarco, "(Re-) Creating a Market for Mortgage Credit Risk," October 28, 2015.
http://www.milkeninstitute.org/publications/view/748

also now know that the plumbing for credit-risk transfer works well—both "front end," in which terms are arranged before loans are sold to a GSE, and "back end," in which a GSE determines how and when to shed risk.

There is no doubt that the mortgage credit markets are slowly coming back to life. We should continue to foster this development by expanding the scope and depth of risk transfer and developing a legal and regulatory infrastructure that ensures transparency and investor protection. These steps are needed for credit risk investors to have confidence in this sector for the long haul and for the market to remain liquid during periods of economic difficulty. With a properly modernized architecture, these credit markets can be harnessed to measure and price credit risk, allocate credit, and insulate taxpayers in a targeted and effective way.

TABLE 1: Credit-Risk Transfer (CRT) Has Evolved Since 2012

Category 1: 'Back End' CRT – Transaction Structured and Arranged After GSEs Acquire Loans for Securitization

Structure	Particular Advantages	Possible Challenges
STACR – Structured Agency Credit Risk Securities	Scalable and repeatable. Market now knows the structure well.	Not REIT eligible. Relies on a strong, liquid market at time of issuance. GSEs at risk until bond is actually placed.
CAS – Connecticut Avenue Securities	Scalable and repeatable. Market now knows the structure well.	Not REIT eligible. Relies on a strong, liquid market at time of issuance. GSEs at risk until bond is actually placed.
ACIS – Agency Credit Insurance Structure	Insurance money is readily available.	Limited investor base, only insurers.
CIRT – Credit Insurance Risk Sharing	Insurance money is readily available.	Limited investor base, only insurers.

Category 2: 'Front End' CRT – Transaction Structured and Arranged Before GSEs Acquire Loans for Securitization

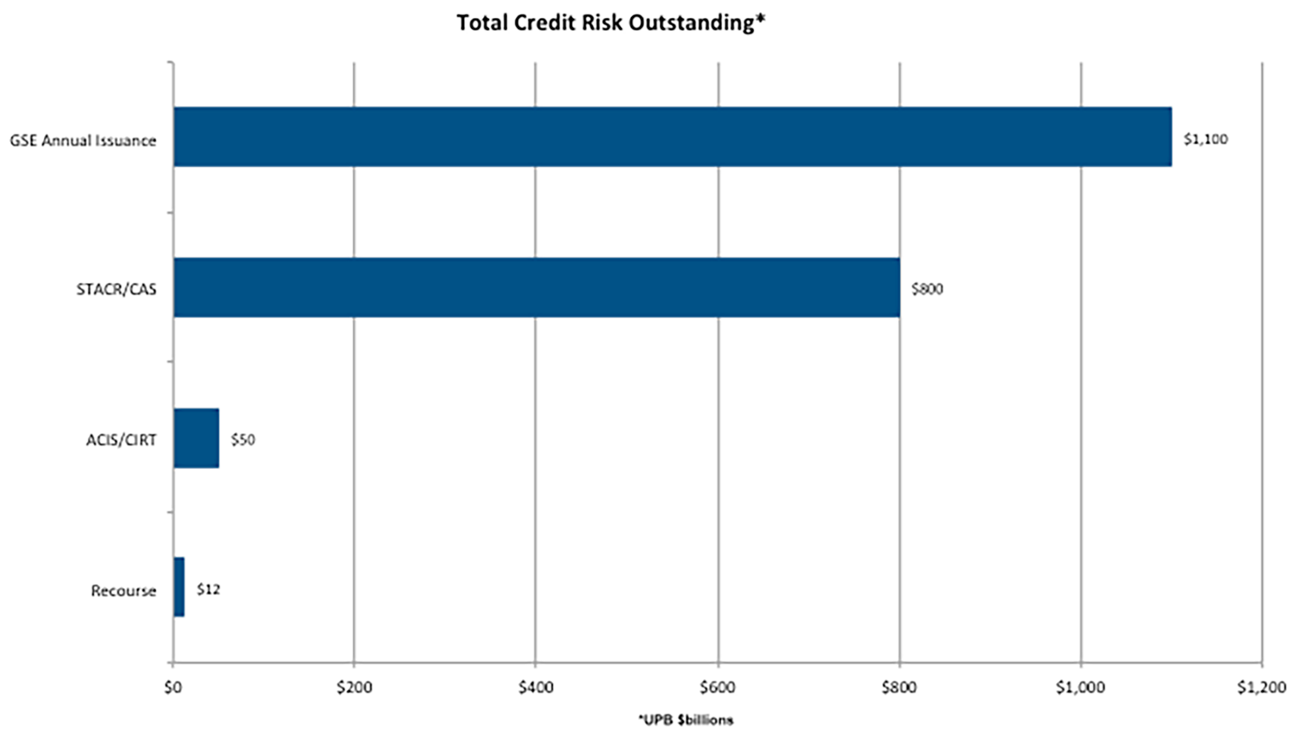
Structure	Particular Advantages	Possible Challenges
Syndication Transfer	GSEs never take on first-loss risk. Scalable. Fully collateralized.	Issuer, originator, and servicer retain no credit risk.
Recourse note held on book	Total alignment of incentives. Ability to lock in pricing for a longer period. Fully collateralized so no counterparty risk.	Thus far, only a few mortgage firms with comprehensive origination, servicing, and investment platforms can execute these transactions.
Deeper MI*	Mortgage Insurers have infrastructure in place. Leverage allows for competitive pricing.	Counterparty risk persists for the GSEs, as MIs are already their largest source of such risk.

*Note: As of December 2015, deeper MI, a conceptual tool, had not been tested or utilized.

TABLE 2: CRT Has Become a Permanent De-Risking Feature of the GSEs

2012	▪ Scorecard required the GSEs to "shrink enterprises dominant presence via credit risk transfer." Scorecard required some initial CRT transactions in 2012 and for GSEs to establish a timeline for growth.
2013	▪ Scorecard again required the GSEs to "shrink enterprises dominant presence" via "CRT structures that in aggregate were are least $30bn UPB" by the end of 2013.
2014	▪ Scorecard for the first time explicitly referenced STACR and CAS and required these deals to collectively reach $90bn of UPB in 2014.
2015	▪ Required overall CRT to be $150bn for Fannie, $120bn for Freddie. ▪ Also said, "GSEs must each utilize at least two types of risk transfer."

CHART 1: The System Is Making Progress



*Approximate
Source: SIFMA

In 2012, the FHFA announced that work would begin on a common securitization platform, that is, the systems technology that governs payments from borrowers to MBS investors. The agency had determined that neither Fannie nor Freddie had a securitization platform capable of being built on for the future. Moving from the outdated, proprietary securitization infrastructure each company used to a shared utility provides numerous benefits. Among them, it creates the opportunity to standardize disclosures, data terms, and even bond administration functions between the two entities.

We now know that many of the functions that underpin MBS securitization can be managed as a common utility, which is being called the CSP or CSS.[7] If done properly, a common platform for securitization could remove a significant barrier to entry for potential competitors. Unfortunately, thus far the focus of the CSP project has been the adoption of a single security for use by only the GSEs, and not as a means to allow new entrants into the market. However, despite this unfortunate dynamic, in the end we now know that the plumbing of the CSP could operate as a standalone market utility or, more promisingly, it could be folded into a government agency that provides the catastrophic guarantee for MBS (such as a Federal Mortgage Insurance Corp., a National Mortgage Reinsurance Corp., or simply Ginnie Mae).

Either way, both of these initiatives—the CRT and the CSP—are meaningful undertakings that faced skepticism in the beginning but are now largely recognized as worthwhile endeavors. These changes alone, so long as they are continued, help ensure that the post-conservatorship secondary market segment traditionally served by Fannie and Freddie will not look the same as it did before the crisis. Congress, for its part, has done more than immediately meets the eye as well. It is true that we have not had a Rose Garden signing ceremony for a major reform law. But progress has occurred. Consider that both the House and Senate committees of jurisdiction passed reform bills in 2013 and 2014. Alternative bills were also crafted in both chambers, and all were done with a great deal of thought applied to a highly complex topic. Passions sometimes flared as various approaches were offered. But such is to be expected when discussing legislation that will forever impact the market structure that enables Americans to purchase homes. It's clear, though, that both sides of the aisle and both chambers of Congress—with administration input—have nudged their way forward. In the end, we do not think political consensus is as far away as some would suggest.

To many Americans, owning a home is a quintessential element of the American dream. How the housing market should serve families is a question to be answered by our elected officials. Congress and the White House must and, in our view will, set the four corners of how the future secondary mortgage market will operate. After all, an act of law chartered the enterprises, and an act of law injected nearly $200 billion of taxpayer money into them to keep them solvent since 2008. An act of law will ultimately resolve the conservatorships and decide the secondary mortgage market's future structure and participants. To think that something of this magnitude should be done simply via regulatory action is, to us, an insult to Congress and the American democratic process.

7. On Oct. 7, 2013, the FHFA announced a joint venture between Fannie Mae and Freddie Mac to implement the CSP. The new entity was chartered as Common Securitization Solutions, LLC℠ (CSS). The idea of directing the enterprises to initiate joint work on a common securitization platform, or CSP, first appeared in the 2012 Strategic Plan for Enterprise Conservatorships, and the idea was subsequently developed in various FHFA white papers, speeches, and announcements. See http://www.fhfa.gov/PolicyProgramsResearch/Policy/Pages/Common-Securitization-Platform-Background.aspx.

We understand the difficulty, but this is a debate about the role of government and market forces in nearly one-fifth of the American economy. The responsibility for resolving this debate falls squarely on the shoulders of our elected officials. So we believe the debate will shift back toward legislators and the next administration. Here, for their consideration, we offer answers to two critical questions.

What Parts of the Currency Secondary Mortgage Markets Are Worth Preserving?

If reformers are to be guided by the principle "Don't throw the baby out with the bathwater," it is worth clearly identifying which is which.

There are many aspects of how the current model works that are worth keeping, and any reform plan should take care to not damage these. We believe there are three broad aspects of the current system that all parties want to preserve. One aspect concerns the investors—the suppliers of the money used to buy homes. The second aspect concerns the homebuyers and lenders—the parties who rely on that source of funds to make new mortgage loans. And the third aspect concerns the number and reliability of the pipes connecting borrowers and lenders to investors.

1. MAINTAINING A LIQUID MBS MARKET

In today's secondary mortgage market, there are $6.3 trillion in outstanding government and agency MBS, led by Fannie Mae ($2.8 trillion), Freddie Mac ($1.8 trillion), and Ginnie Mae ($1.7 trillion).[8] These securities trade in global capital markets. The vast scale and liquidity of these markets mean there is a reliable flow of money from around the globe to fund American home buying. As a result, homebuyers can obtain mortgage loans through the ups and downs of the economy. Indeed, mortgages remained available even as other parts of the credit markets endured considerable strains during the financial crisis. On the investors' side, a deep and liquid MBS market is certainly a characteristic of the current system to be maintained.

There are two aspects of this deep and liquid MBS market that warrant special mention.

a. The TBA Market

One of modern finance's more interesting and important innovations was the MBS futures market, referred to by traders and investors as the To Be Announced, or TBA market, as mentioned earlier. It enables mortgage lenders to lock in a forward price for mortgages, which, in turn, allows a homebuyer to lock in his or her interest rate in advance. Absent the TBA futures market (or some equivalent), customers may not know their interest rate until the day they close on a loan.

This market serves as a foundational pillar of the American home buying process and should be reformed but kept intact. It also provides the means for hedging a large portfolio of mortgages against fluctuations in interest rates, thereby allowing asset managers of various stripes to support homeownership via liquid investments. It is important to recognize that the TBA market has not emerged in non-

8. SIFMA, US Mortgage-Related Issuance and Outstanding. Feb. 18, 2016.

governmental asset-backed securitization. Its functioning rests on the elimination of credit risk to MBS investors due to either an explicit or implicit government guarantee combined with the government exempting the issuing agencies from certain securities laws.[9]

b. Standardization

MBS investors rely on a set of standards to ensure their ability to model and price these securities. The degree of standardization varies across the Ginnie Mae, Fannie and Freddie, and PLS segments of the MBS world. Where standards were weakest—the PLS market—is where the most severe problems arose during the crisis. The past several years have seen much effort to enhance standardization in all three market segments, and these efforts should continue.

Data standards—The FHFA directed that Fannie and Freddie release substantial amounts of historical loan-level data for analysis by market practitioners. In May 2010, the agency launched the Uniform Mortgage Data Program, in which Fannie and Freddie have been working with the industry standard-setting body to develop common data definitions and an industrywide method for electronic reporting of mortgage-related information. A mechanism for ensuring the continued standardization and public release of mortgage data going forward should be established, building on this recent effort.

Servicing standards—Two homeowners who experience similar life circumstances that lead to the inability to pay a mortgage should not be treated differently because one had servicing rights sold to a more responsive servicer than the other. It took years of effort in the wake of the financial crisis to develop more uniform mortgage servicing practices, particularly as they relate to working with delinquent borrowers. Investors need to know the servicing rules to estimate their potential costs and recoveries when a borrower defaults. In addition, since servicers are the agents for enforcing the mortgage contract, investors need to ensure not only that there are standards for servicing practices, but that those standards are enforced. Clearly, there is a need for effective management and oversight of servicers.

Security structure and disclosures—The more uniform the contractual terms from one MBS to another, the less security-by-security review investors must perform when deciding whether to make a purchase. So MBS uniformity adds liquidity, which ultimately lowers borrowing costs. A key FHFA scorecard goal today is moving Fannie and Freddie to a common security, thereby eliminating differences between the two that may hamper liquidity and lead to differential pricing between the companies' MBS. The Treasury and industry groups are also working on a more standardized security for the PLS market.

Beyond the terms of the security, standardization of the disclosures made to investors also enhance liquidity and investors' confidence in the expected performance of the underlying mortgages. Here again, the FHFA has been driving efforts to deepen and standardize disclosures between Fannie and Freddie MBS. A common security might also facilitate other firms' eventual entry into the securitization business

9. For more information on the TBA market, see James Vickery and Joshua Wright, *TBA Trading and Liquidity in the Agency MBS Market*, Federal Reserve Bank of New York Economic Policy Review, May 2013. https://www.newyorkfed.org/medialibrary/media/research/epr/2013/1212vick.pdf
and Center for American Progress, *The Importance of the To-Be-Announced, or TBA, Market,* https://cdn.americanprogress.org/wp-content/uploads/2013/10/HousingFinanceReform_4.pdf.

with a government guarantee, since the MBS issued by a new firm would trade in a common pool with existing assets rather than bearing a massive liquidity disadvantage.

2. MAINTAINING NATIONWIDE ACCESS TO THE SECONDARY MORTGAGE MARKET AT ALL TIMES

From the point of view of homebuyers and mortgage lenders, the secondary market needs to provide reliable access for all eligible borrowers and lenders, without regard to loan size, property location, and type or size of lender.

But achieving this equitable access can be challenging because many of the costs to underwrite a loan are fixed, which means they represent a higher percentage of the loan amount on smaller loans than on larger ones. Additionally, these incentives generally push lenders to focus on the loans that are easiest to make. As a result, communities with relatively few or low-priced houses (mostly rural and lower-income communities) often face origination costs that are higher as a share of loan value than more urban and well-off communities. A mortgage credit system that supports a consistent guarantee fee nationwide can provide lower-dollar-amount loans with equitable access to the secondary MBS market. Reform should ensure that these smaller and more challenging loans have equitable access.

3. COMPETING OUTLETS CONNECTING THE PRIMARY MARKET TO THE SECONDARY MARKET

While this element of maintaining a liquid MBS market might not draw universal agreement, in our view the mechanisms that connect the primary market (where lenders make loans to borrowers) and the secondary market (where global investors buy and sell MBS) should themselves be subject to competition. There are thousands of lenders and millions of borrowers out there. Forcing them into just one or two gatekeepers that control the securitization process (as we did with Fannie and Freddie) diminishes innovation and customer service while increasing systemic risk associated with the operational or financial failure of the gatekeeper.

If anything, it is remarkable that Fannie and Freddie still compete with each other for business while under government control. They should be lauded for continuing to innovate in developing tools and technologies to assist their seller servicers. But as we embrace the forces of competition, we should remember that in housing, such rivalry can cut both ways. We believe that competition should be segmented into areas that are beneficial and those that are damaging.

For example, proprietary data standards at Fannie and Freddie served to reduce data quality. They were not, or should not have been, a source of competitive advantage. Competition in pricing can be helpful if it reduces mortgage rates for consumers but harmful if it leads the firms to underprice risk. Moreover, insufficient competition can distort markets, such as in the old system in which Fannie and Freddie offered insurance premium (i.e., the guarantee fee) discounts to large-volume lenders that undermined overall underwriting quality. On the other hand, competing on customer service in working with seller servicers did and should continue to promote efficiency and better outcomes. The future secondary market should maintain incentives for participants to innovate in technology and infrastructure, to be as responsive as possible and increase the quality of their interactions with participants in the origination market. These "competitive" aspects of the old and current systems are worth preserving and enhancing—and apply to additional firms competing in the securitization market.

Finally, as noted above, having multiple firms participate in securitization ensures a buffer in case any of them fail. No individual firm should be so essential to the functioning of the market or the economy that it must be rescued from financial distress. A market structure that allows new participants to enter can address some of the systemic risk concerns arising from a world with just one or two securitization gatekeepers.

What Should a Reform Law Aim to Accomplish?

If the above is worth saving, what must we leave behind? That is, what change are we trying to bring about?

In our view, there are glaring needs. We believe the primary changes that housing finance reform must accomplish can broadly be bucketed into the following five categories:

(1) **ELIMINATE EMERGENCY BAILOUTS.**
(2) **BUILD SOME DEGREE OF CONSENSUS ON A MODERNIZED AFFORDABILITY AND ACCESS PARADIGM.**
(3) **BRING MARKET SIGNALS, PRIVATE CAPITAL, COMPETITION, AND INNOVATION BACK TO THE MARKET, BUT WITH STANDARDS AND GUARDRAILS.**
(4) **ELIMINATE HIDDEN OR IMPLIED GUARANTEES AND ALL VESTIGES OF THE CRONY CAPITALISM THAT CHARACTERIZE FANNIE AND FREDDIE'S CHARTERS.**
(5) **ALIGN INCENTIVES AS MUCH AS POSSIBLE THROUGHOUT THE MORTGAGE ECOSYSTEM.**

In short, we advocate preserving the business functions provided by Fannie and Freddie that work and are needed in the secondary market. But the inherent conflicts need to go, and we need to rely far more on normal market mechanisms to analyze, price, and distribute risk across a wide set of participants rather than concentrate that risk in one or two entities. That brings us to change No. 1.

(1) **ENSURE THAT WE HAVE NO MORE EMERGENCY BAILOUTS IN HOUSING**

The GSEs have been stuck in a state of limbo for the better part of a decade. That began with an emergency injection of capital in 2008, when Congress was forced to authorize the Treasury Department to do what many feared it would have to do in a crisis—use taxpayer money to make good on Fannie and Freddie's guarantees because shareholder capital was woefully inadequate. Without the bailout, Congress would have risked a collapse of the housing market (not to mention the U.S. economy and the global financial system).

First and foremost, housing reform must design a system that ensures this will never happen again. One-fifth of our economy cannot rely on emergency congressional action to help the secondary market remain solvent. That's not capitalism. We're pretty sure it's not socialism, either. It is crony capitalism. Labels aside, though, it's not a smart systemic design, and it is not good public policy. So at its core, reform needs to minimize the likelihood of a situation in which Congress must bail out enterprises that enrich themselves with federal benefits, then send the bill to taxpayers when they get into trouble.

Of course, the injection of capital into Fannie and Freddie isn't the only thing that happened in 2008. Other major financial firms failed and were shut down (e.g., Lehman Brothers) or were merged out of existence by the government (e.g., Washington Mutual). Hundreds of banks, ranging from the largest megabanks to hundreds of small community institutions, received TARP funds to shore up their precarious capital positions or to help stabilize the financial system.

But in the aftermath, at least a law was passed that was designed to reduce the chance that the nation would go through this again. Dodd-Frank is certainly not perfect, far from it, and it remains to be seen whether the resolution authority in Title 2 would suffice to prevent bailouts in a future systemic crisis. But a significant step was taken for banks, and the debate about breaking them up remains a major part of today's policy conversation.

For the GSEs, however, no such reform has occurred. Yet we hear a growing chorus demanding that the companies be released from conservatorship and returned to the status quo ante.

We believe that would be a grave mistake. In 2008, Congress had to rescue Fannie and Freddie MBS investors (and the companies' debt holders). We can't have a system "capitalized" by shareholders in two institutions that are too big, too important, and too entrenched to fail. The risk concentrated in these entities must be distributed across the financial system so that markets can better manage risk and absorb losses when misjudgments are made.

We also need to be honest about certain economic and political realities. We cannot envision a world where Congress would allow a collapse of the nation's housing market without a meaningful response that involves taxpayers. The economic damage and follow-on costs such a collapse could impose and the systemic implications for financial markets make congressional action almost certain. So taxpayers already own the tail risk (or catastrophic risk). This put option was provided to Fannie and Freddie largely for free. It represents a failure of the old system and it needs to end. More than that, policymakers should include automatic stabilizers in the new system to act as shock absorbers in extreme economic conditions. With those in place, market participants would have greater certainty heading into a crisis, muting volatility.

(2) BUILD CONCENSUS ON THE OBJECTIVES OF ACCESS AND AFFORDABILITY POLICY, AND MAKE THEM TRANSPARENT AND ACCOUNTABLE

Senate efforts to reshape the secondary market faltered in 2014 in no small part because some senators objected to changes made to the affordability paradigms that existed prior to conservatorship. As a reminder, the legislation would have replaced housing "goals"—the rules that govern what percentage of GSE guaranteed loans must be made to borrowers with low or very low incomes or who reside in low-income communities—with an off-budget, 10 basis point tax on mortgages flowing through the new system. This revenue would have directly funded homeownership and rental assistance programs.

Final negotiations never quite came to fruition, but the concept evolved into a "flex fee," with the tax increasing or decreasing depending on how much the private guarantors were servicing designated markets. While the idea received high marks for transparency and accountability, time ran out before the concept could be finalized.

So reform should answer these questions: What is the goal of our affordability and access paradigm? Where do market mechanisms fail to work, and why? How do we most efficiently and effectively target and achieve homeownership access goals? How can we create a system that ensures equitable access for all Americans? Are area median income targeted goals the best way, or is there a better approach? Since real estate conditions are typically governed by local economic conditions, sometimes with differing laws, what roles should state and local housing agencies take? Most importantly, does the new secondary market structure ensure access for all eligible borrowers and lenders, or are additional mandates needed?

There can be both economic and social benefits to forcing some cross-subsidization of homeownership, thus lowering access costs for borrowers who are typically shown to be higher-risk. We should look first to programs that offer the most accountability, transparency, and opportunity for congressional oversight. If such programs are not working as desired, it is incumbent upon our elected officials to correct their shortcomings (or eliminate them). In addition, if the public policy goal of promoting homeownership for these families is to encourage long-term wealth building, we should think harder about whether our current approaches achieve that outcome. (For example, we incentivize debt over equity accumulation in many ways, including through the mortgage interest deduction.)

The fact is, the country has a regrettable legacy of redlining and discrimination in housing finance, some of it officially sanctioned in the early years of the FHA program. This history has imposed long-term costs on the victims. Low-income communities, in addition, often feel trapped between no access to credit and predatory lending. We would benefit as a country if we could envision a housing policy that not only ensured nondiscriminatory treatment but cultivated opportunities for those who face homelessness or struggle to find an affordable rental or confront enormous obstacles to starting on the wealth-building path of homeownership. Surely, with new thinking, we can find a more efficient approach to promoting affordable housing than what we have now.

In our view, an example of misguided assistance is approving a mortgage for someone who lacks the basic preparation for the responsibilities of homeownership. A better long-term approach would entail helping such a person to get prepared. That can include financial counseling, programs designed to repair credit, assistance in establishing a household budget, and assisting with a savings plan focused not just on a down payment but to help the future homeowner build a rainy day fund. And we must recognize that we have a serious problem when almost a quarter of renter households spend more than half of their income on rent.[10]

10. http://blogs.wsj.com/economics/2016/06/22/middle-income-families-are-increasingly-losing-ground-on-affordability-despite-a-housing-recovery/.

Rather than maintain the standoff this type of policy discussion normally produces, we need to find new approaches. We submit that there may be room for agreement in the realms of using pre- and post-purchase counseling for first-time homebuyers; disbursing some funds to state and local entities that have proven successful as sustainable homeownership models; focusing on making rent more affordable; working with would-be homeowners to help them succeed, and making sure that access is maintained for low-dollar-amount loans and loans that require more underwriting resources but can be successful. Republican or Democrat, no one wants the taxpayer to support a system that only serves borrowers who would have received a loan anyway. We also do not want taxpayers to support a system focused on high-end rentals. We need a housing system that works for American households of all income levels. It starts with dialogue and openness to reform.

(3) BRING PRIVATE CAPITAL, COMPETITION, AND INNOVATION BACK TO THE MARKET, BUT WITH STANDARDS AND GUARDRAILS

The government today dominates the secondary mortgage market. It sets the rules, prices the risk, and determines what products are acceptable or otherwise. We have lost many of the market forces we rely on in the rest of our financial system. Taxpayers continue to provide almost all of the capital that supports the secondary mortgage market. Yet before advocating for, and moving back to, a more market-based system, we must come to grips with how that market system contributed to the financial crisis and ensure that our reforms recognize and account for those failings. Here again, we need to separate baby from bathwater.

We do not subscribe to one-sided views of the cause of the financial crisis. We believe that strenuous efforts by policymakers to promote homeownership—such as housing goals in 2004 that encouraged subprime lending—contributed to market innovations that failed spectacularly. What is most regrettable is that these failures inflicted enormous damage on vulnerable households the policies and programs were supposed to help.

Yet while responding to government incentives and encouragement, mortgage originators and secondary market participants also pursued their own self-interest and operated in a remarkably predatory manner that hid risks as those risks were shifted around the system. And whatever one thinks about the government's culpability in promoting risky mortgage lending, no one forced the managers of these businesses to abandon their fiduciary responsibilities or their common sense. The end result, of course, caused enormous damage to homeowners and neighborhoods, but also harmed MBS investors, including regular folks such as families saving for retirement or for their children's education.

So in returning to a more market-based system, the government has a role promoting both consumer and investor protection. In particular, this means ensuring that markets operate transparently and competitively and are accessible to all. It also means markets should evolve to meet new circumstances and be allowed to innovate to better meet consumer needs. The hard lessons of the financial crisis also should instill in us a measure of humility as to the efficacy of efforts to promote market outcomes that are incompatible with the dynamics of risk and reward. We should not ask private market participants to achieve social policy goals through a web of hidden subsidies and penalties. For starters, more transparency can be helpful.

The good news is we have already started down the road to such an outcome. Progress since 2013 in the credit-risk transfer market—the selling of mortgage credit risk away from Fannie and Freddie and back to private capital market—is the foundation. If reformers want to see more price signals to indicate where national mortgage rates should be, then the continued development of the credit-risk transfer market is essential. But its progress depends on the willingness of the FHFA (and Fannie and Freddie) to direct this risk away from taxpayers and back to market participants. Congress should make it clear that these programs are a permanent feature of the secondary mortgage market.

If government saw its role more as providing direct subsidies where needed and otherwise ensuring transparent and open markets supported by consumer and investor protections, the power of private markets to innovate and provide capital for housing would be unleashed. The root word of "capitalism," of course, is capital, and today's market relies largely on taxpayer capital, not private capital. But for now, with taxpayers guaranteeing roughly three of every four mortgages, the federal government is occupying the field. Market signals, innovation, and competition are stifled, precluding the full return of private capital to manage mortgage risk and heaping that risk on the backs of taxpayers.

(4) ELIMINATE HIDDEN OR IMPLIED GUARANTEES AND ALL VESTIGES OF THE CRONY CAPITALISM THAT CHARACTERIZES FANNIE AND FREDDIE'S CHARTERS

Of course, while market signals are important, housing is a critical human need, so it should come as no surprise that market failures, real or perceived, draw the government into this sphere. The FHA program is just one example. The mortgage interest tax deduction and GSE housing goals also reflect elected officials' judgment that the socially optimal amount of housing finance is greater than what a purely market-based system would provide.

FHA is funded by its users and has direct access to the Treasury Department for revenue, so losses that exceed the program's self-funding are transparently the responsibility of taxpayers. The program is managed by government officials who are paid at government pay scales, and the program is overseen by Congress.

As explained earlier, Fannie and Freddie operate in a different world. Pre-conservatorship, they were in a world of crony capitalism, privately owned but endowed with special privileges that enriched their operations. They regularly lobbied for more while fiercely protecting what they had. They were close to the government when it suited them (as when borrowing money in capital markets) and fully private when it didn't (compare, for example, the salaries of Fannie and Freddie CEOs to that of the FHA commissioner).[11]

11. In 2007, the year before the conservatorships, Fannie Mae's CEO took home $12 million and Freddie Mac's CEO received $18 million. The FHA commissioner earned less than $200,000.

It is not illogical to look at the 78-year history of Fannie Mae and the 46-year history of Freddie Mac and conclude that a) they advanced their public mission and made positive contributions to creating a stable and liquid secondary mortgage market and b) their operating structure was horrendous for the systemic risk it built up and the corrosive effect it had on the body politic.[12] The challenge of reform is to ensure a stable and liquid secondary market as well as the systematic removal of all vestiges of the flaws inherent in the heads-I-win-tails-the-taxpayers-lose structure.

That means no more implied guarantees, no more exclusive charters that erect barriers to entry while granting operating advantages that reinforce such barriers. That means the new secondary mortgage market institutions must be able to fail without throwing our housing finance system, and indeed the global financial system, into turmoil. That means the system must be transparent and all market participants must face the same capital and operating requirements.

(5) ALIGN INCENTIVES THROUGHOUT THE HOUSING SYSTEM

The lack of incentive alignment has been a significant failing of the old and current models. These misalignments came in all sorts of flavors: originators who had no skin in the game on mortgage performance; second-lien holders who serviced first liens owned by someone else; homeowners who used their houses as ATMs to take out equity through second mortgages and equity lines of credit; brokers who had incentives to help investors commit fraud and lenders who helped borrowers do the same; appraisers who lost their jobs if they didn't hit their numbers; servicing compensation rules that didn't help troubled borrowers when markets became unglued; no one helping homeowners understand the costs along with the benefits…. We could go on.

The bottom line is that mortgage credit risk should not be a "hot potato" passed from one institution to the next, where it is always someone else's problem (and ultimately becomes the responsibility of government). Lenders and secondary market firms can't be in the business of getting rich by handing the government the burden. GSEs can't be in the business of getting rich by gambling that the taxpayers give them a free put option. Shareholders can't be in the business of getting rich by knowing that the companies they own can never go under.

There is a way to help right these wrongs, and it involves aligning incentives. Reform should help everyone who operates in the mortgage ecosystem have a stake in its collective success. It should incentivize the buildup of equity, not just debt. It should put everyone's skin in the game—borrowers, servicers, lenders, guarantors, and the government.

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12. See, for example, Owen Ullman, "Crony Capitalism: American Style," *The International Economy*, July/August 1999. http://www.international-economy.com/TIE_JA99_Ullmann.pdf.

Consequences of Inaction

Before concluding, we should remind readers of some potential consequences of inaction. The 114th Congress has been largely absent from the debate about housing finance reform. With the notable exception of two laws that actually passed—one that restricted CEO compensation at Fannie Mae and Freddie Mac and one that placed limitations on the sale of Treasury-owned shares in the enterprises (the so-called "Jumpstart GSE Reform" bill)—little has occurred.

This was perhaps a consequence of "housing finance exhaustion" after the previous Congress saw two efforts stall after devoting much time and resources. Such exhaustion is understandable, but dangerous. It is fortunate that efforts to bring in market signals and unify the enterprises' securitization functions have continued during this time. But it should not be taken for granted that we will remain on this trajectory absent congressional oversight.

The first glaring consequence of inaction could be Fannie and Freddie's entrenchment into our economy in some barely evolved version of their old selves. Without more guidance from Congress, for example, the FHFA and the GSEs could very well choose to position themselves as the gatekeepers of mortgage credit for the entire market. We are concerned that congressional inaction could lead the enterprises to further embed themselves into the markets, not further move them and taxpayers out of harm's way. Unless lawmakers are involved, this will be left to chance.

Which brings us to the next risk of inaction: The FHFA was never envisioned as the permanent manager of the enterprises. It was meant to be their regulator. While the Housing and Economic Recovery Act of 2008 gave the FHFA more authority than the previous Fannie/ Freddie regulator (the Office of Federal Housing Enterprise Oversight) had, we could be on a march back to the days when Fannie and Freddie had more political influence than did their regulator. Politicizing FHFA leadership positions could, for example, easily neuter the agency and give the GSEs even more sway than they held in the 1990s. Such an outcome should terrify policymakers on all sides.

The current FHFA director and his predecessor (a co-author of this paper) have repeatedly spoken of the need for Congress to provide direction to the agency and, more importantly, to the entire market. As we noted earlier, we are talking about one-fifth of the American economy. Our elected representatives are responsible for crafting a vision for the future of housing markets and housing policy.

The third risk is that another economic downturn could lead to large losses at the enterprises, another round of taxpayer assistance, potential market disruptions, and legislation crafted in a crisis with decisions made in the heat of the moment. No one who cares about housing should want such an outcome, not even those who believe it would put the political wind at their backs. And besides, waiting for such a moment is a dangerous strategy, in part because…

…inaction could thwart the nascent development of the credit markets, which have shown signs of life in recent years. These markets have even begun developing modernized infrastructure to price, hedge, and manage mortgage credit risk.

What worries us most is that a lack of meaningful supervision by Congress creates a dynamic in which the players do not act with the good of the broader ecosystem in mind. It is not difficult to envision people fighting to protect their turf, allowing egos to drive decisions, and making speeches designed to provide political cover in the event of a capital shortfall rather than doing the hard work to structurally redirect risk away from the Treasury Department's backstop. All of this is corrosive to not only the functioning of the markets but to Congress' ability to monitor the functioning of our economy.

Incremental Administrative Steps While Reform Percolates

There are a series of steps that the FHFA and the GSEs should take while policymakers wrestle with the contours of long-term reform. The FHFA should continue to embrace various forms of credit-risk transfer to bring in private capital and identify price signals. The recent FHFA scorecard moves in this direction but could do so much more forcefully. It also builds on these efforts substantively by proposing that a formal request for information be disseminated to gather market feedback. We hope that the FHFA and market participants continue to advocate for risk transfer and, in particular, the kind that lessens dependence on Fannie and Freddie's GSE structure and is aimed more at long-term solutions. To us, if there is one incremental reform that is crucial to continuing the momentum we have, this is it.

Two other steps stand out. The common securitization platform should be broadened beyond Fannie and Freddie in anticipation of other issuers' accessing this platform in the future. And the conforming loan limit should not be allowed to increase. There is no justification for expanding GSE subsidies and taxpayer protection at the upper end of the price distribution as the market recovers and the enterprises remain supported by taxpayers.

What makes no sense to us whatsoever is the idea that the enterprises themselves should be returned to their prior role and structure. Prior to conservatorship, there was a long history of warnings from analysts that this GSE structure was bound to fail at taxpayer expense. With those forecasts realized, we should not fall back on that broken system just because achieving political consensus is hard and will need more time.

Conclusion

This initial paper in our series outlines the objectives of reform as we see them because we believe it is important to identify what we are trying to accomplish before we craft a comprehensive reform plan. We recognize that achieving these objectives will require hard work. We also recognize that they won't attract universal agreement, although we believe most of what we have set forth is closely aligned with objectives in many other reform proposals. We are also well aware that the system needs to get from point A to point B without disruption. Transition matters. Any reform legislation should allow for a sufficient transitional period.

We believe, however, that reform is possible. As we stated earlier, important steps have already been taken to move our housing finance system down this path.

There are going to be tradeoffs and compromises along the way. Some of these objectives may prove politically challenging at first. But lawmakers need to get serious about these issues, and they need to get going.

Next Steps

In forthcoming papers, we intend to define an approach consistent with the goals described here, addressing what we see as the three broad categories of housing finance reform that Congress must tackle. Specifically, we will present:

- A detailed proposal for a secondary mortgage market structure that enables capital markets to operate efficiently, safely, and soundly. This structure would replace the failed GSE structure while combining market mechanisms with appropriate government standard setting, oversight, and transparent support to ensure a deep and liquid market.
- A modernized framework for housing policy that would allow federal programs to address market failures, achieve socially and economically desirable outcomes, and innovate to deal with challenges families face finding affordable rental properties or reaching that first rung on the ladder of homeownership.
- An inventory of legal and institutional structures that support our housing finance system but are in great need of modernization. From appraisals to mortgage registries and beyond, we need legislative changes to bring important components of our housing finance system into the digital age.

About the Authors

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Ed DeMarco is a senior fellow in residence at the Milken Institute. Prior to that, he was a 28-year civil servant, culminating with his role as acting director of the Federal Housing Finance Agency from September 2009 to January 2014. There he dealt with the challenges of managing the mega-institutions Fannie Mae and Freddie Mac. DeMarco crafted the 2012 FHFA Strategic Plan for Enterprise Conservatorships and the associated scorecards and set into motion the credit-risk transfer and common securitization initiatives that underpin administrative efforts today.

About the Center for Financial Markets

Based in Washington, D.C., the Milken Institute Center for Financial Markets promotes financial market understanding and works to expand access to capital, strengthen—and deepen—financial markets, and develop innovative financial solutions to the most pressing global challenges.

About the Milken Institute

The Milken Institute is a nonprofit, nonpartisan think tank determined to increase global prosperity by advancing collaborative solutions that widen access to capital, create jobs, and improve health. We do this through independent, data-driven research, action-oriented meetings, and meaningful policy initiatives.

EXHIBIT 11

WHO WE ARE & WHAT WE DO

FHFA is working to strengthen and secure the United States secondary mortgage markets by providing effective supervision, sound research, reliable data, and relevant policies.

We are an independent regulatory agency responsible for the oversight of vital components of the secondary mortgage markets—the housing government sponsored enterprises of Fannie Mae, Freddie Mac and the Federal Home Loan Bank System. Combined these entities provide more than $5.8 trillion in funding for the U.S. mortgage markets and financial institutions. Additionally, FHFA is the conservator of Fannie Mae and Freddie Mac.

We are building a better secondary mortgage market for the future. FHFA is pursuing a series of initiatives and strategies to improve the future system of housing finance. One important initiative is the creation of a new Common Securitization Platform that will serve the dual purpose of modernizing current outdated infrastructures and provide the potential for other market participants to use the same infrastructure.

We work with those we regulate to preserve homeownership through the **Home Affordable Refinance Program** (HARP) and the **Home Affordable Modification Program** (HAMP). The programs provide real help to homeowners and communities - to date these programs have helped millions of Americans remain in their homes.

FHFA was created on July 30, 2008, when the President signed into law the **Housing and Economic Recovery Act of 2008**.

Our Mission

Ensure that the housing government sponsored enterprises operate in a safe and sound manner so that they serve as a reliable source of

Financial Stability Oversight Council

FHFA is a member agency of the **Financial Stability Oversight Council**. The Council is charged with identifying risks to the financial stability of the United States; promoting market discipline; and responding to emerging risks to the stability of the United States' financial system.

The other members of the Council are:

Board of Governors Federal Reserve System

Commodity Futures Trading Commission

Consumer Financial Protection Bureau

Federal Deposit Insurance Corporation

National Credit Union Administration

Office of the Comptroller of the Currency

Securities and Exchange Commission

Treasury Department

liquidity and funding for housing finance and community investment.

Our Vision

A reliable, stable, and liquid housing finance system.

Our Values

Respect - Respect each other, information and resources.

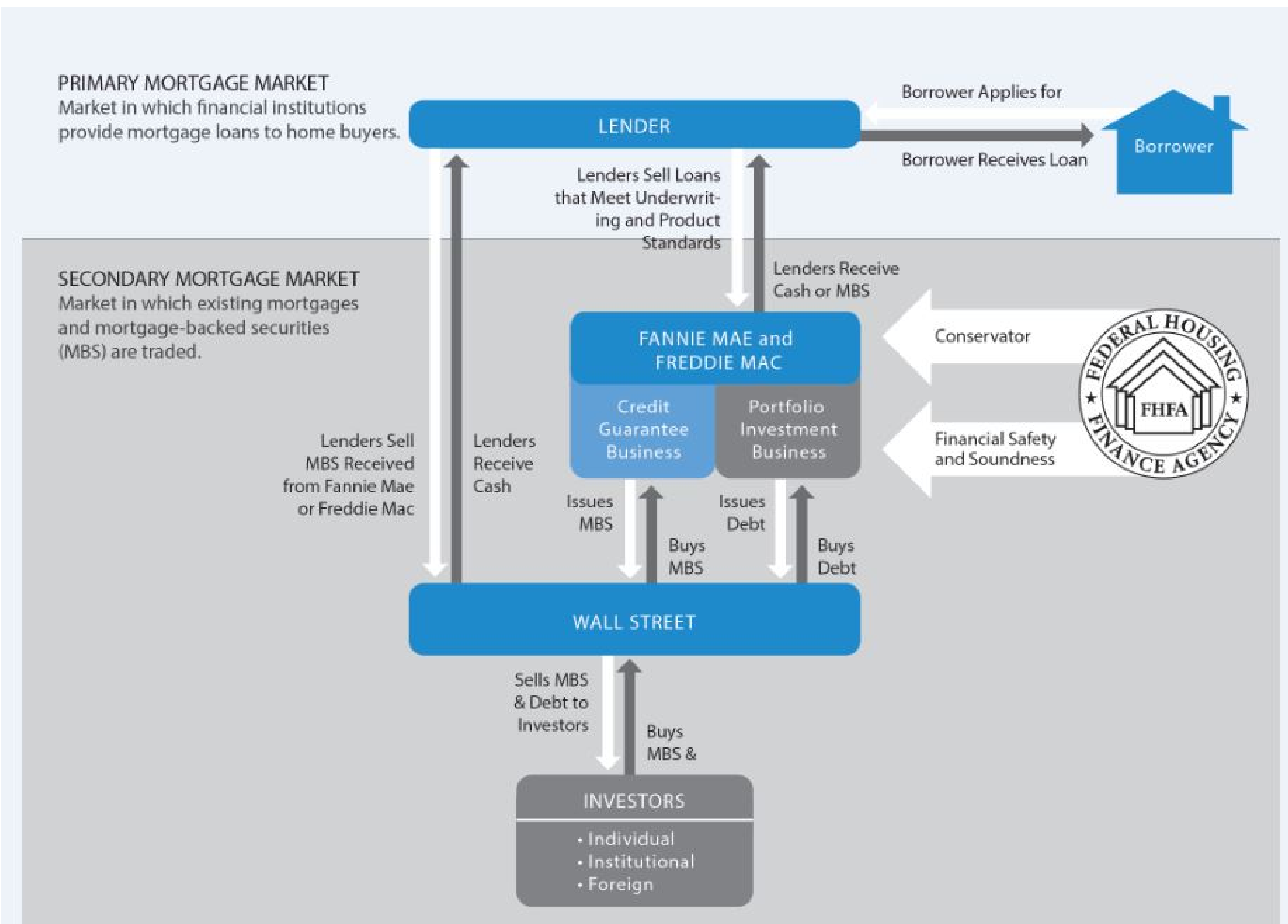
Excellence - Aspire to excel in every aspect of our work.

Integrity - Commit to the highest ethical and professional standards.

Diversity - Promote diversity in our employment and business practices, and those of our regulated entities.

Our Oversight Role

Fannie Mae & Freddie Mac



Federal Home Loan Bank System

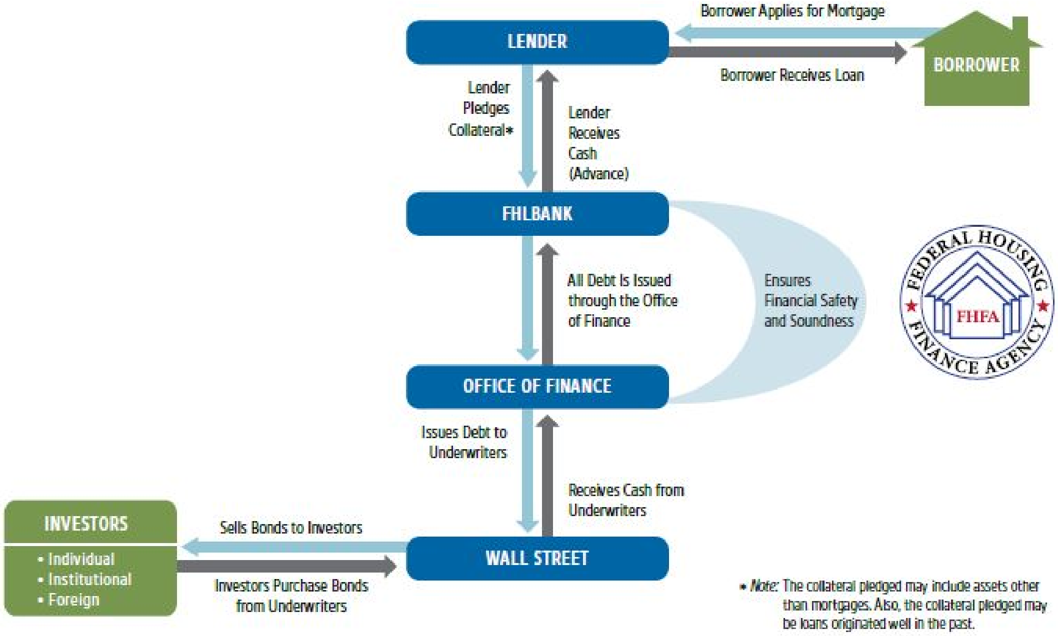

Borrower Applies for Mortgage
LENDER
BORROWER
Borrower Receives Loan
Lender Pledges Collateral*
Lender Receives Cash (Advance)
FHLBANK
All Debt Is Issued through the Office of Finance
Ensures Financial Safety and Soundness
OFFICE OF FINANCE
Issues Debt to Underwriters
Receives Cash from Underwriters
INVESTORS
• Individual
• Institutional
• Foreign
Sells Bonds to Investors
Investors Purchase Bonds from Underwriters
WALL STREET
* Note: The collateral pledged may include assets other than mortgages. Also, the collateral pledged may be loans originated well in the past.

EXHIBIT 12

IN THE UNITED STATES COURT OF FEDERAL CLAIMS

FAIRHOLME FUNDS, INC., *et al.*,	)	
Plaintiffs,	)	
	)	No. 13-465C
v.	)	(Judge Sweeney)
	)	
THE UNITED STATES,	)	
Defendant.	)	

DECLARATION OF MELVIN L. WATT

I, Melvin L. Watt, hereby declare, based on personal knowledge and/or information and belief as follows:

1. I am Director of the Federal Housing Finance Agency ("FHFA" or the "Conservator") and assumed office on January 6, 2014. Prior to assuming office as Director, I served as an elected Member of the United States House of Representatives from January 1993 until January 2014.

2. FHFA is an independent federal agency with regulatory authority over the Federal National Mortgage Association ("Fannie Mae"), the Federal Home Loan Mortgage Corporation ("Freddie Mac") (together, the "Enterprises") and the 12 Federal Home Loan Banks. Congress created FHFA in July 2008 in response to the housing and economic crisis with the goal of stabilizing the Enterprises and the national housing market. FHFA has served as the Conservator of the Enterprises since September 6, 2008.

3. I have reviewed Plaintiffs' Requests for Production. I have also reviewed the Declaration of Christopher H. Dickerson that will be contemporaneously filed in this case, and I share the concerns expressed about the potential disclosure of predecisional documents plaintiffs seek relating to ongoing and future operations of the conservatorships. The purpose of this

declaration is to set forth some of the significant ways in which Plaintiffs' discovery requests pursuant to the Court's February 26, 2014 Order would adversely impact the ability of FHFA to exercise its powers and functions as Conservator and adversely impact the financial markets. The disclosure of the information requested will have extraordinarily deleterious consequences on the Conservator's conduct of the ongoing and future operations of the conservatorships.

4. In my role as Director, I am responsible for making policy decisions on behalf of the Agency. As such, I am frequently involved in confidential internal deliberations regarding a wide range of policy matters relating to the management, supervision, operation and function of the Enterprises. These deliberations, which frequently concern how the conservatorships should proceed on a wide variety of fronts, embody issues at the heart of the Conservator's congressionally-defined missions.

5. I am aware that Plaintiffs' claims and allegations in this case challenge the Third Amendment to the Preferred Senior Stock Agreements ("PSPAs") between FHFA, on behalf of the Enterprises, and the U.S. Department of the Treasury. I am also aware of this Court's February 26, 2014 Discovery Order, and that on April 7, 2014 Plaintiffs served their First Set of Requests for Production.

6. Plaintiffs' discovery plan -- through document requests, interrogatories and deposing Agency officials -- seeks to obtain confidential, non-public information concerning a range of critical issues such as potential courses of action regarding the future of the conservatorships that relate directly to the Conservator's ongoing mission. Specifically, Plaintiffs' document requests 1 [to the extent it seeks documents relating to ongoing and future operations of the Enterprises], 6, 7, 8, 9 and 10 each seeks information that relates to ongoing or future conservatorship operations. The disclosure of such information, including information

relating to or considered in connection with past conservatorship decisions or relevant to the Conservator's conduct of the ongoing and future operations of the conservatorships, will affect the exercise of powers or functions of the Conservator in a number of ways.

7. The Conservator is charged with directing the largest conservatorships in U.S. history in support of the Nation's multi-trillion dollar mortgage finance system. The disclosure of any plans relating to ongoing and future operation of the conservatorships, including the projections of the future profitability of Fannie Mae and Freddie Mac (or lack thereof) under a range of economic, business and policy scenarios, can be anticipated to have a destabilizing effect on the Nation's housing market and economy.

8. The Enterprises provide critical liquidity to the national housing finance system. To discharge their missions, the Enterprises purchase residential mortgages originated by banks and other qualified lenders, which in turn use the proceeds from those sales to engage in further lending to homebuyers in the primary mortgage market. To finance their purchases of residential mortgages, the Enterprises borrow funds from investors by issuing debt securities, and they also bundle the mortgages into mortgage-backed securities that are in turn sold to investors. The prices at which the Enterprises can sell their debt securities and mortgage-backed securities to such investors are directly related to market perceptions of the Enterprises' financial viability. If the market perception is that the Enterprises are not financially viable, they will have greater difficulty selling their debt and mortgage-backed securities, leading to lower proceeds from such sales. As less capital becomes available to the Enterprises for their future operations, the Enterprises become less able to purchase mortgages from loan originators. That effect would in turn result in higher mortgage rates, reduced loan availability for homebuyers in the primary

market, or both, as loan originators find it more difficult to generate capital for further lending and reduce portfolio risk by re-selling their loans in the secondary market.

9. The disclosure of forward-looking, non-public financial projections could immediately alter market expectations and have a destabilizing impact on the housing market in both the short and long term. For example, disclosure of projections that suggested (or that market participants interpreted as suggesting) that the Enterprises' financial conditions were worse than previously assumed could, through the mechanism outlined above, increase current prices in the primary and secondary mortgage markets. Conversely, disclosure of projections that tended to suggest that the Enterprises' financial viability were enhanced relative to current market expectations could also impact the sales of the Enterprises' debt and mortgage-backed securities, and hence the rates available in the primary and secondary markets. In either case, disclosure of forward-looking, non-public information could result in an array of consequences such as sharp spikes or declines in the cost of obtaining credit for borrowers and large shifts in the demand for mortgage-backed securities. This result would undermine FHFA's ability to direct the conservatorships and detract from Congress's goal of maintaining stability in the federal housing markets. In sum, making available potentially market-moving information regarding projections of future profitability (responsive to document request 1) of the Enterprises, as well as how the conservatorships may end (responsive to document requests 6, 7, 8, 9 and 10), easily could set off a chain of volatile and unpredictable reactions in the financial markets that could not be contained.

10. The intention of the PSPAs was to instill market confidence in the Enterprises. Disclosure of confidential information relating to ongoing and future operations of the conservatorships, which was for internal use by FHFA, and not intended for public disclosure

and consumption, would directly undermine that goal and could induce precisely the market instability that FHFA was created to prevent.

11. Making available in this litigation the type of non-public and confidential information relating to the Conservator's conduct of the ongoing and future operations of the conservatorships could also adversely affect the Conservator's ability to operate the conservatorships because it would enable the Enterprises to gain access to confidential internal FHFA documents that were not intended to be shared with or reviewed by the Enterprises. It is essential for the Conservator to be able to restrict access to confidential agency documents that reflect internal policy deliberations, the disclosure of which would affect the Conservator's ability to direct the ongoing and future operations and activities of the Enterprises. A contrary result would greatly restrain the unfettered ability Congress conferred upon the Conservator to continue to develop and implement the most effective policy solutions for the wide array of operational and other challenges confronting the Enterprises.

12. Disclosure of documents relating to the future of the Enterprises, such as documents responsive to document requests 6 and 8 pertaining to a possible future wind down and termination of the conservatorships, could also severely affect employee stability at Fannie Mae and Freddie Mac, thereby compromising critical policy matters regarding the conservatorships. Between late 2011 and early 2012, voluntary departures from Freddie Mac reached 17% in the wake of different proposals to alter its compensation system. Disclosure of confidential information about the Enterprises' futures could lead to equivalent, or greater, departure levels.

13. Disclosure of information sought by Plaintiffs concerning a wide range of operational and other issues about which final decisions have not yet been made or implemented

fully, such as documents responsive to requests 8 and 10, would mislead the public and adversely affect market participants by disseminating raw data and information suggesting courses of action that may later be rejected or significantly altered. This would be extremely damaging because of the critical policy matters regarding the conservatorships currently under examination and evaluation. The release of documents that reflect prior thinking of Agency personnel concerning matters about which the Agency may follow a different course during my tenure as Director are likely to lead to the public and market participants second-guessing every decision, and will make any changes to Agency policy more difficult at both the deliberation and implementation stages. Thus, the disclosure of such documents and information would substantially impair my ability to direct the operations of the conservatorships in the manner I believe to be in the best interests of the conservatorships and the Agency. Accordingly, disclosure of deliberations of my immediate predecessor and during my tenure could have adverse impact to the Enterprises and market consequences.

14. In summary, any disclosure of information concerning the Conservator's future financial projections, strategic analyses, operational plans, and a broad range of related information responsive to requests 1, 6, 7, 8, 9 and 10 that relate to the Conservator's conduct of the ongoing and future operations of the conservatorships would affect the Conservator's ability to direct the Enterprises. Likewise, the potential negative impact on the Enterprises' financial health from disclosure of such confidential , nonpublic information would undermine the Conservator's ability to conserve and preserve the assets and property of the Enterprises and maintain stability in the housing finance market.

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct.

Executed this 29th day of May 2014 at Washington, D.C.

By: Melvin L. Watt
MELVIN L. WATT

EXHIBIT 13

Housing Share of GDP Expands

BY **DAVID LOGAN** *on* **JUNE 28, 2016** • (**0**)

With the release of the final estimates of first quarter 2016 GDP growth (revised up two-tenths to a 1.1% growth rate), housing's share of gross domestic product (GDP) ticked up slightly to 15.4%. The home building and remodeling component – residential fixed investment – as a share of GDP expanded to 3.4%.

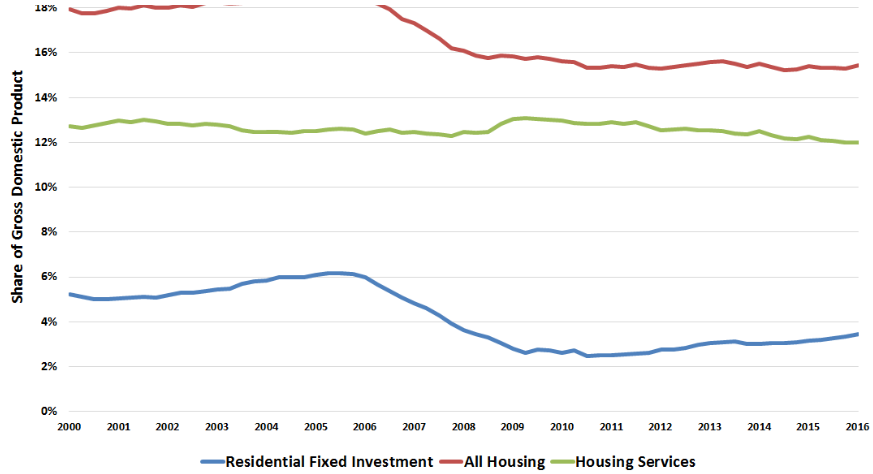
Housing-related activities contribute to GDP in two basic ways.

The first is through residential fixed investment (RFI). RFI is effectively the measure of the home building, multifamily development, and remodeling contributions to GDP. It includes construction of new single-family and multifamily structures, residential remodeling, production of manufactured homes and brokers' fees.

For the first quarter, RFI was 3.4% of the economy, reaching a $568 billion seasonally adjusted annual rate (SAAR) in inflation-adjusted 2009 dollars. This is the highest quarterly rate for RFI in more than eight years. The first quarter growth for RFI added 0.5 points to the headline GDP growth rate (i.e. GDP would have only expanded 0.6% absent the RFI contribution), the largest contribution since 2012.

The second impact of housing on GDP is the measure of housing services, which includes gross rents (including utilities) paid by renters, and owners' imputed rent (an estimate of how much it would cost to rent owner-occupied units) and utility payments. The inclusion of owners' imputed rent is necessary from a national income accounting approach, because without this measure, increases in homeownership would result in declines for GDP. For the first quarter, housing services was 12.0% of the economy or $1.98 trillion (SAAR).

Taken together, housing's share of GDP was 15.4% for the first quarter.



RFI has averaged 4.7% of GDP over the past 35 years while housing services have averaged 13.3%, for a combined 18% of GDP. These shares tend to vary over the business cycle; RFI and combined housing have grown by 31% and 17%, respectively, as a share of the economy since the end of the Great Recession.

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‹ Despite Upward Revision, Slower Growth Trend Continues

Pending Sales Pause ›

Tags: bureau of economic analysis , economic growth , gdp , gdp growth , gross domestic product , home building , housing , Housing Contribution , housing services , housing share of GDP , housing share of the economy , remodeling , residential fixed investment

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EXHIBIT 14

Fannie-Freddie Regulator Said to Plan to Stay On Under Trump

By **Joe Light**
December 15, 2016, 5:00 AM EST

- Mel Watt said to tell FHFA employees of plan to remain in job
- Republican efforts to reshape housing policy could be affected

When Barack Obama leaves office on Jan. 20, Democratic appointees across the government are expected to follow him out the door, to be replaced by officials chosen by Donald Trump <https://www.bloomberg.com/billionaires/id/1252249> . Not Mel Watt -- he isn’t planning to go anywhere.

As head of the little-known but powerful Federal Housing Finance Agency, Watt oversees Fannie Mae <https://www.bloomberg.com/quote/FNMA:US> and Freddie Mac <https://www.bloomberg.com/quote/FMCC:US> , the companies that underpin nearly half of U.S. mortgages. Watt has told employees and others close to him that he plans to stay at his post after Trump becomes president to serve out a term that doesn’t end until January 2019, according to people familiar with the matter who asked not to be named because the discussions were private.

Mel Watt Photographer: Andrew Harrer/Bloomberg

That could make Watt a potential hurdle to any plans Trump and the Republican-controlled Congress have to overhaul the system that finances the nation's housing market. Steven Mnuchin, Trump's nominee for Treasury Secretary, has already said that removing Fannie and Freddie from government control will be a top priority of the incoming administration.

Watt, through an FHFA spokesman, declined to comment.

Unique Role

Watt, a Democrat who was a member of Congress before taking the FHFA job in 2014, is in a unique role. Because the FHFA is an independent regulator, its leadership isn't supposed to be subject to the will of the president.

At the same time, the agency's decisions can have an almost unrivaled effect on a broad swath of the economy. It can affect mortgage rates by lowering or raising the fees Fannie and Freddie charge. It can also make loans easier or harder to get by changing the companies' credit standards.

For investors who own Fannie and Freddie shares, Watt's status could be a deciding factor in whether they get a financial windfall. The companies have been in U.S. conservatorship since they were bailed out during the 2008 financial crisis at an eventual cost of $187.5 billion. The companies have since paid Treasury dividends of more than $250 billion. Some private shareholders say the law gives the FHFA director the power to release them into the private market. If that happened, investors who bought when the companies seemed certain to be wound down could make billions of dollars.

"The agency is profoundly important," said Lisa Rice, executive vice president of the National Fair Housing Alliance, adding that she hopes and expects Watt to stay.

Watt's Approval

While Trump's team hasn't articulated a housing-finance agenda, FHFA's role rose to the fore late last month when Mnuchin said the incoming administration plans to free the companies from the government. To make such a move without legislation, the administration would likely need sign-off from Watt.

Watt has made statements suggesting he might be amenable to allowing the companies to retain more capital. The current bailout terms require them to send nearly all of their profits to Treasury, and by 2018 they will have no capital buffer to protect against losses. In February, he called the companies' shrinking buffers "the most serious risk and the one that has the most potential for escalating in the future."

At the same time, Watt has consistently said that housing-finance reform must be done through Congress, suggesting that he might not back any solution that Trump tries to push through on his own.

In May 2014, Watt said he believed FHFA had the authority to end the conservatorship, "but the alternatives would not be desirable alternatives." The agency's goals "are consistent with continuing the operation of Fannie and Freddie in the here and the now and we'll do that until there is legislation passed," he said at the time.

In November 2014, Watt told reporters that in the long-term he wouldn't rule out recapitalizing and releasing the companies and that the Treasury Department would have to start that conversation.

Congressional Input

Treasury is forbidden to sell its stakes in Fannie and Freddie without congressional approval until 2018 under the terms of legislation passed last year.

"Congress has made its position known clearly that if you're going to end the conservatorship, they want a voice in that decision," said Michael Stegman, who helped shape housing policy in the Obama White House and is now a fellow at the Bipartisan Policy Center in Washington.

Still, some groups have pushed for Watt and the administration to act without Congress.

"The best thing to do is to recap and release," said National Community Reinvestment Coalition President John Taylor, who argues that preserving the companies is necessary to protect their mandates to serve lower income borrowers and fund affordable housing.

Fannie and Freddie don't make mortgages. They buy them from lenders, wrap them into securities and make guarantees to investors in case of default. Through the first half of the year, they backed 43 percent of new mortgages, according to the Urban Institute's Housing Finance Policy Center.

Trump Pressure

It isn't yet clear whether Trump and the Republican Congress want Watt to leave and what leverage they could bring to bear to make it happen.

A recent court ruling said a president should be able to remove the director of the Consumer Financial Protection Bureau at will and said the FHFA has a similar governance structure. That decision is under appeal.

While Watt plans to stay, there are tactics lawmakers could use to make his life unpleasant, including frequent congressional hearings, investigations or other public conflicts. Watt turns 72 years old next year.

Before he started his five-year term in January 2014, many Republicans believed that Watt would tell Fannie and Freddie to lower credit standards, slash prices and take other steps that reflected his two-decade tenure in Congress as a North Carolina Democrat.

Instead, Watt has taken more measured steps, often frustrating members of both parties.

His predecessor refused requests to slash mortgage balances for borrowers who owed more than their homes were worth. This year, Watt released a program to reduce principal, but one that was much smaller than some advocates sought.

Replacement Unknown

The middle path taken by Watt could reduce the urgency among Republicans to seek a replacement, especially while Trump barrels through dozens of other confirmations, said Mark Calabria, director of financial regulation studies at the libertarian Cato Institute.

That doesn't mean advocates of more mortgage lending to low- and moderate-income borrowers aren't concerned. Taylor, of the National Community Reinvestment Coalition, said affordable housing advocates have encouraged Watt to stay.

Taylor said he hopes Watt increases the number of loans Fannie and Freddie back to low- and moderate-income borrowers and lowers their fees.

"We and others are worried about what the replacement would look like," he said.

EXHIBIT 15

HUD Chief: Obama Can't Fire FHFA's DeMarco

By **Rob Blackwell**
Pub ished August 03 2012, 11:48am EDT

More in **Secondary market, Law and regulation, Servicing**

President Obama disagrees with the Federa Housing Finance Agency's refusa to a ow principa reductions on mortgages but can do itt e to stop it, according to Housing and Urban Deve opment secretary Shaun Donovan.

Speaking with reporters on a conference ca ate in the week, Donovan acknow edged that many on the eft have been urging Obama to fire acting FHFA director Ed DeMarco since he announced Tuesday that Fannie Mae and Freddie Mac wou d not permit principa reductions as part of a government refinancing program. That is impossib e, Donovan said.

"He is a career emp oyee—some have ca ed for him to be fired. That is not authority that the president has," Donovan said.

The Obama administration had nominated Joseph Smith—now the $25 bi ion mortgage sett ement's monitor—to be head of FHFA, but Senate Repub icans opposed the appointment, Donovan said.

"We had a very strong nominee, very qua ified," said Donovan. "He was b ocked by the Senate."

Donovan's comments came the same day a consumer group announced it had co ected 25,000 signatures in the past day a one ca ing on the president to fire DeMarco. Rebui d the Dream said more than 117,000 peop e have signed a petition demanding DeMarco's ouster.

"Giving America's underwater homeowners some mortgage re ief wou d save our government $1 bi ion, keep hundreds of thousands of American fami ies out of forec osure and create more than a mi ion jobs, as homeowners start spending more money oca y," said Van Jones, president and co-founder of Rebui d the Dream. "Edward DeMarco is sing e-handed y standing in the way of a of this. The best thing President Obama can do for the economy right now is get rid of Ed DeMarco."

Donovan is technica y correct in saying that Obama cannot fire DeMarco over a po icy disagreement. Under the aw, the head of an agency can on y be dismissed "for cause," a standard DeMarco has not reached, according to Mark Ca abria, a former top Senate Banking Committee staffer and now director of financia regu ation studies at the Cato Institute. Even if he were removed as acting head and returned to his previous ro e as deputy director, however, it's unc ear who Obama cou d rep ace DeMarco with that wou d view the decision on principa reductions any different y.

"The president cannot fire DeMarco in terms of his being a government emp oyee," said Ca abria. "If DeMarco provided sufficient cause, he cou d probab y be removed but sti keep his former job as deputy director. The President wou d be imited, however, to appointing one of the other deputy directors as acting director."

Donovan reiterated that the administration strong y disagrees with DeMarco's move, and continues to hope he wi change his mind.

"We be ieve, the president be ieves, that the decision that Ed DeMarco made is wrong," Donovan said. "We've urged him to reconsider. There is c ear evidence at this point that principa reductions benefit not just homeowners and neighborhoods, but a so the economy."

He was seconded by Iowa attorney genera Tom Mi er, who said principa reductions have been effective in he ping homeowners as part of the mortgage sett ement with the top five servicers. He disputed DeMarco's fears that if Fannie and Freddie granted principa reductions, it wou d cause homeowners to strategica y defau t on their mortgages.

"I just be ieve so strong y that Ed DeMarco is wrong," said Mi er, noting that there have been 82,000 principa reductions as part of the sett ement. "There haven't been these defau ts. This is an ideo ogica worry."

The two officia s hosted the conference ca to discuss a new effort by HUD to reach out to borrowers that may benefit from the mortgage sett ement. They announced a new series of pub ic service announcements to be run nationwide as we as a dedicated site on HUD's website to he p homeowners find re evant information.

EXHIBIT 16

Document Not Intended for External Distribution

HOUSING FINANCE REFORM QUESTIONS AND ANSWERS

HARDEST QUESTIONS

1. ***Will the administration's plan raise mortgage rates?***
   - Any credible reform plan to address the irresponsible aspects of the pre-crisis housing market will make credit less easily available. We are coming out of a system in which institutions did not hold enough capital and priced guarantees at a level too low to cover their risk.
   - We will work to ensure, however, that reforms occur at a measured pace, allowing borrowers to adjust to the new market, preserving widespread access to affordable mortgages for creditworthy borrowers including lower-income Americans, and supporting, rather than threatening, the health of our nation's economic recovery.

2. ***How will your plan affect access to the 30-year fixed rate mortgage?***
   - Access to the 30-year fixed rate mortgage will be a key consideration in the long-term structure of housing finance. The 30-year fixed rate mortgage has provided homeowners with a simple and stable vehicle to finance their homes, and can protect American families from financial shocks.
   - The 30-year fixed-rate mortgage is a complex financial product that is not common in other countries around the world. Fannie Mae and Freddie Mac have helped promote the availability of the 30-year fixed-rate mortgage in the United States by guaranteeing the credit risk of mortgages. This has allowed mortgage investors to take only the interest rate risk of the mortgage-backed security. Without a guarantee, few investors would prefer to buy 30-year fixed rate mortgages, and, therefore, the ability for credit-worthy Americans to have access to that product may be greatly reduced.
   - Designing a new system for housing finance will require making difficult trade-offs. Some of these options for a future housing finance system reduce taxpayer risk by eliminating the role of the government beyond the FHA which would make the 30-year fixed more difficult to come by.

3. ***What specific analysis have you performed to support the statements in the paper and when can you share those with us?***
   - This is a really complicated issue as you know, and so we consulted with a wide range of stakeholders ranging from financial services providers to consumer groups and affordable housing advocates. In addition, within the Administration, we worked with HUD and NEC; the white paper reflects input from many different sources. Going forward, we would be happy to work with you in analyzing various factors that could facilitate the deliberation by Congress regarding policy choices.

4. ***How long will it take to unwind Fannie Mae and Freddie Mac? Why not unwind Fannie Mae and Freddie Mac at a faster pace? Why did you not come out with a specific proposal for pace of unwind?***
   - The pace will depend on market conditions. We cannot forget that while we have made important progress stabilizing the housing market, this critical sector of the economy remains fragile. Private capital has not yet fully returned to the market, and the government continues to play an outsized – though unfortunately necessary role – in ensuring the availability of mortgage credit.
   - Proposals that prematurely constrain Fannie Mae and Freddie Mac's ability to guarantee loans could limit the availability of mortgage credit, shock the economy, and expose taxpayers to greater losses on the loans already guaranteed by Fannie Mae and Freddie Mac.

5. ***How exactly will Treasury ensure that Fannie Mae and Freddie Mac will have sufficient capital to meet their obligations in 2013 when the caps are set? What are the specific steps that you will take?***
   - At the end of 2012, under the Preferred Stock Purchase Agreements (PSPAs) Fannie Mae and Freddie Mac entered into with Treasury, $275 billion of funding capacity will remain to fund any net worth deficits ($125 billion for Fannie Mae and $150 billion for Freddie Mac). Under the conservative baseline stress test forecasts conducted by FHFA, both Fannie Mae and Freddie Mac are expected to have positive net income in 2013. This will mean that Treasury is not expected to need to fund any operating losses at Fannie Mae and Freddie Mac after the expiration of the PSPA funding commitment.
   - To the extent that required dividend payments exceed net income, FHFA, as conservator, could consider not declaring dividends pursuant to the certificates of designation for the preferred shares, so that draws on the PSPAs are not used to pay dividends, preserving as much funding as possible to cover any unanticipated losses at Fannie Mae and Freddie Mac.
   - We expect that $275 billion, nearly twice the amount of net funding provided by Treasury to date, will provide a substantial cushion for any unexpected losses and should give market participants confidence about the government's commitment to these institutions.

6. ***Why increase pricing and not just reduce the conforming loan limit as some have suggested?***
   - There are many levers that could be used to reduce the footprint of Fannie Mae and Freddie Mac. Relying on any one has its downsides: relying on loan limits alone, for instance, would create too dramatic a shift in the availability of credit to those who suddenly fall outside of the reach of Fannie Mae and Freddie Mac.

7. ***What power does Treasury actually have over Fannie Mae and Freddie Mac?***
   - Treasury does not control Fannie Mae and Freddie Mac. Fannie Mae and Freddie Mac are under the conservatorship of their regulator, FHFA.
   - As a member of the Federal Housing Finance Oversight Board (FHFOB), the Secretaries of Treasury and HUD provide policy guidance and recommendations to FHFA on a range of matters related to Fannie Mae and Freddie Mac and the conservatorship of Fannie Mae and Freddie Mac.

8. ***Why does Treasury think it can compel independent agencies to follow its requests? Does this plan conflict with FHFA's statutory mission as conservator?***
   - Treasury cannot compel FHFA to act. The joint working group of FHFA and FHA will consider changes to pricing and other standards and will seek comment from the public. This working group will provide regular feedback to FHFOB and FSOC as reforms are implemented.
   - The Administration's plan is consistent with FHFA's statutory mission as conservator.

9. ***What exactly is the FHFOB and what is Treasury's role in the FHFOB?***
   - The Federal Housing Finance Oversight Board (FHFOB) was established by HERA to provide oversight and policy recommendations to the FHFA.
   - The FHFOB is comprised of the heads of four agencies, including the Secretary of the Treasury, the Secretary of HUD, the Chairman of the SEC, and the Director of the FHFA. The Director of the FHFA serves as the Chairperson of the FHFOB.
   - The FHFOB is responsible for advising the Director of the FHFA with respect to overall strategies and policies in carrying out his or her duties.

10. What parts of your plan require legislation?

- Without additional legislation, Treasury, in conjunction with other agencies, can make substantial progress towards responsibly reducing the size of the government's role in housing finance and implement critical reforms to the housing finance market.
- Dodd-Frank and HERA provide the Administration, FHFA, and other independent regulators the tools necessary to complete many critically important reforms in the near-term. Determining the long-term role for government will require serious dialogue with Congress about a difficult set of trade-offs. In all end states, legislation is required to change Fannie Mae and Freddie Mac's charters.

11. What is your timeline for legislation? Are you proposing legislative text?

- We would be happy to work with Congress to provide any support necessary to advance comprehensive housing reform legislation. We believe that we should move as quickly as is prudent to provide certainty to our housing finance system and our economy.

12. Since the Administration has no plan for Fannie Mae and Freddie Mac to emerge from conservatorship, why hasn't OMB added these entities to the budget as if their operations were conducted by a federal agency?

- The Budget maintains the existing non-budgetary presentation for Fannie Mae and Freddie Mac, as it does for the other GSEs. This is consistent with financial accounting standards that do not require consolidation if ownership control is temporary.
- All of the federal programs that provide direct support to Fannie Mae and Freddie Mac, including the Senior Preferred Stock Purchase Agreements (PSPAs), are shown on-budget.

13. How does OMB's estimate of Fannie and Freddie's deficit impact differ from CBO's approach?

- The 2012 Budget maintains the existing non-budgetary presentation for Fannie Mae and Freddie Mac. This is consistent with governmental financial accounting standards that do not require consolidation of an entity if ownership control is temporary, as it is for Fannie Mae and Freddie Mac during the period of their conservatorship. However, all of the federal programs that provide direct support to Fannie Mae and Freddie Mac, including the Senior Preferred Stock Purchase Agreements (PSPAs), are shown on-budget.
- As we understand it, CBO's estimates of the deficit impact of Fannie Mae and Freddie Mac are considerably higher than the Administration's because CBO defines the budget impact as capturing what a private entity would require as compensation for assuming Fannie Mae and Freddie Mac's commitments. The compensation is represented in CBO's description as the difference in market value between Fannie and Freddie's assets and their liabilities on a "risk adjusted" basis. This "risk premium" assigned by CBO does not constitute a federal outlay, and is not comparable to the budgetary estimates of Fannie Mae and Freddie Mac's costs included in the President's Budget. The Administration presents the budget impact as the estimated amount attributable to transactions between Treasury and Fannie Mae and Freddie Mac under the PSPAs.
- The Budget assumes that Treasury will make cumulative investments in Fannie Mae and Freddie Mac of $224 billion from FY2009 through FY2012, and receive dividends of $55 billion over the same period. These estimates are consistent with the "baseline" case in the range of potential draws announced by FHFA in October 2010. Starting in 2013, the Budget forecasts that Fannie Mae and Freddie Mac will have sufficient earnings to pay part but not all of the scheduled dividend payments. The Budget assumes additional net dividend receipts of $97 billion from FY2013-FY2021.

14. Would OMB's estimate of Fannie and Freddie's deficit impact differ from CBO's if Fannie and Freddie were treated as on balance sheet?

- It is our understanding that in an on-balance-sheet analysis, OMB's estimate of the Fannie Mae and Freddie Mac's deficit impact would likely continue to be lower than CBO's estimate because of different choices for calculating the discount rate. OMB would most likely use standard Credit Reform treatment, which does not allow for "market risk adjustment" of asset and investment values as conducted by CBO. The calculation of the "subsidy" provided by Fannie Mae and Freddie Mac is sensitive to the choice of discount rate. The subsidy is lower and possibly negative if a Treasury rate is used as the discount rate as required by Credit Reform treatment, rather than using a rate adjusted for market risk as is used by CBO.
- *Background on Credit Reform:*
  The Federal Credit Reform Act of 1990 (FCRA) (Title V of the Omnibus Budget Reconciliation Act of 1990, Pub. L. 101-508) was intended to improve the measurement of the budgetary costs of federal credit programs. Beginning in 1992, FCRA required the President's budget to use certain principles to reflect the cost of direct loan and loan-guarantee programs. Since under FCRA the budgetary treatment of a direct loan or loan guarantee must reflect the loan's "subsidy cost" (the net value of the loan's cash flows over the life of the loan, rather than in one year), the only amounts that are recorded in the Federal budget for purposes of calculating the deficit budget are subsidy cost budget authority and outlays.

15. Would the different budgetary treatment for Fannie and Freddie cause CBO and OMB to provide different scores for legislation that would affect those entities?

- We believe that CBO's current on-budget and the Administration's current non-budgetary treatments of Fannie Mae and Freddie Mac's costs in conservatorship potentially could result in legislative scoring differences. Given that we have proposed three different options for housing finance reform, we think that defining a specific budgetary treatment at this time for any particular reform structure would be misleading. As noted above, the Administration carefully considered whether Fannie Mae and Freddie Mac should be consolidated in the Government's financial statements and classified as budgetary entities. We may change our determination at a future date based on new information available at that time. The provisions of any legislation reforming Fannie Mae and Freddie Mac will be critical to determining whether such a change in treatment is necessary.

16. What steps are you going to take to promote a covered bond market?

- There are a number of ideas that could be considered by Congress in enacting housing finance reform – including covered bonds. Legislation could be helpful in promoting a covered bond market as an alternative funding mechanism for banks.

17. What can you say about the future of the To Be Announced (TBA) market?

- The TBA market provides or facilitates a variety of benefits to borrowers and lenders, including lower borrowing costs, the ability to "lock in" a mortgage rate prior to completing the purchase of a home, flexibility in refinancing, risk management, and the ability to pre-pay a mortgage at the borrowers' discretion. TBA trading greatly enhances secondary market liquidity and provides greater access to these markets for smaller lenders and community banks.
- The presence of a well-functioning TBA market will depend on the long-term path of reform. Without the presence of a guarantee, it is likely that liquidity in the TBA market would be substantially reduced.

18. ***What does the experience of the jumbo mortgage market tell us about whether a privatized mortgage market can serve the broader mortgage needs of America?***
    - The jumbo market has effectively served Americans whose loans fall outside of the conforming loan limits. It is important to keep in mind, however, that the jumbo market did benefit from the presence of the TBA market for mortgages guaranteed by Fannie Mae and Freddie Mac. Origination of Jumbos was often hedged through the TBA market.

19. ***The FHLBs have not required any bailouts. Why are any changes necessary?***
    - Like Fannie Mae and Freddie Mac, the Federal Home Loan Banks (FHLBs) are congressionally chartered government enterprises. Like Fannie Mae and Freddie Mac, they were allowed to run large investment portfolios by funding themselves with debt that the market apparently perceived had USG support.
    - FHLB advances allow member banks to take risks with such loans while shifting the cost of that risk to the FDIC and, therefore, indirectly to taxpayers.

20. ***The FHLB system current pays 20% of its profits to pay off the debt from the Savings and Loans financial crisis of the 1980s. These debt obligations (REFCORP bonds) are finally about to be fully repaid.***

    Question from the Right: ***Given the capital problems in some of the FHLBs that your White Paper highlights, can you allow the FHLBs to retain their profits without attempting to raise their effective taxes once the REFCORP obligations expire?***
    - Congress required the FHLB system to fund certain obligations related to the Savings and Loans crisis. The terms of that obligation were set in statute and were changed by statute. Changes that affect obligations imposed on FHLBs would have to originate in legislation and the Administration would work with the Congress to determine the best policy. I do think that the FHLB system could benefit from additional capital and that the various banks, 8 out of the 12 are under some sort of regulatory or voluntary plan with respect to capital, dividends or stock purchase, should continue to work with their regulator to increase their capital.

    Question from the Left: ***The FHLBs also pay 10% of their profits to support affordable housing programs in their community. Given the need for additional support for affordable housing programs do you support requiring the FHLBs to increase their contribution to affordable housing programs once the REFCORP obligations come off their books?***
    - Support for affordable housing programs is critically important, a point which the White Paper makes. We also believe that it should be conducted transparently, accounted for openly and done in a manner which balances many important objectives, including that of creating affordable rental housing. Whether we are appropriately funding affordable housing, and whether more of the funding should come from the FHLBs, are questions that I want to work with the Congress to answer.

21. ***Why is increased borrower equity being required at FHA and in a reformed housing finance system? Risky loan features during the bubble were not tied to low equity, but to poor underwriting, not escrowing for taxes and insurance, and payment shocks due to adjustable payments.***
    - Lower LTVs provide protection against home price depreciation, so equity is less quickly wiped out by drops in home values.
    - LTV should be just one of a number of factors lenders consider in evaluating borrowers in a reformed housing finance system. Other factors often include: (1) housing cost-to-income and overall debt-to-income ratios; (2) credit scores; (3) whether the loan has an adjustable interest rate

and when and how much payments may increase; (4) how much savings an owner has available for unexpected expenses; (5) whether the owner has received counseling; (6) the condition of the property and its major systems; and (7) the extent to which the owner's future housing expenses will exceed previous housing expenses.

22. ***How will proposed housing finance reforms address the racial wealth gap, and the severe losses in homeownership rates during the housing crisis that disproportionately impacted communities of color?***
    - Unsustainable loans during the housing bubble disproportionately hurt low-income and minority borrowers and communities. Implementation of Dodd-Frank Act reforms, including the establishment of qualified mortgage standards and the Bureau of Consumer Financial Protection, are important and integral early elements of housing finance reform to curb those abusive practices in the future.
    - Access to mortgage credit for all credit-worthy families and all communities is a critical element in any long-term housing finance system. Any adjustments made to mortgage standards will affect individual borrowers and communities in America differently. We believe that any changes to the system should be taken with sensitivity to the potentially disparate impacts those changes might have, appropriately balanced against systemic risk.
    - We will also ensure that housing finance providers comply with antidiscrimination laws. We will work with Congress to establish increased data transparency in the secondary market, to track where and to whom mortgage credit is flowing. This data will help ensure that all mortgage market participants are complying with antidiscrimination laws. And we will consider ways to ensure that secondary market securitizers and guarantors serve all communities, consistent with primary market providers and safety and soundness.

23. ***What role will FICO scoring play in any reforms of the housing finance system?***
    - A reformed housing finance system should have stronger underwriting standards. FICO scores are one of several factors lenders should consider to determine a borrower's creditworthiness. Because of Dodd-Frank reforms, and increased skin in the game by lenders, lenders should engage in a more robust analysis of borrower creditworthiness in a future housing finance system.

24. ***Aren't tax policy changes a better way to provide targeted and effective support for affordability and access?***
    - Tax policy changes were beyond the scope of the white paper. Moving forward, we will work with Congress to evaluate a range of proposals to achieve our goals of rebalancing support between homeownership and rental and providing targeted, transparent, and effective support..

25. ***10% down payment is not an effective means to reduce risk at the GSEs as they are unwound. It unnecessarily bloats FHA during the GSE wind down.***
    - Slowly increasing down payments over time at Fannie Mae and Freddie Mac is an important step to help reduce taxpayer risk and increasing system stability. As Fannie Mae and Freddie Mac's presence in the market contracts, the Administration will coordinate program changes at FHA to ensure that the private market – not FHA – picks up that new market share.

26. ***Do you support the Affordable Housing Trust and/or Capital Magnet Fund?***
    - The Affordable Housing Trust (AHT) and Capital Magnet Fund (CMF) were set up under HERA to provide rental housing assistance in the form of capital grants for the development of affordable rental housing and provide funds for CDFIs and other non-profit organizations for affordable housing.

- The Administration supports a dedicated, budget-neutral financing mechanism to support homeownership and rental housing objectives that current programs cannot adequately address, including the objectives of the AHT and CMF. This will ensure that USG support is explicit, and that taxpayers are not exposed to undue risk.
- The HERA trust funds, including the Affordable Housing Trust Fund and the Capital Magnet Fund, should be part of topics in the conversation between Congress and the Administration on housing finance reform.

27. ***What are your thoughts on legislation that would end HAMP early?***

Because of HAMP, struggling homeowners have more opportunities to stay in their homes than they would have two years ago.

- Over 600,000 borrowers have started permanent modifications. These borrowers are experiencing real savings, a median of $520, and are more likely to perform in their modifications. At the end of Dec. 85% of borrowers were still current.
- Hundreds of thousands of homeowners are still struggling to save their homes. HAMP provides critical opportunities for long term and sustainable modifications. The proprietary modifications, while improved, do not provide as deep payment reductions or borrower protections.
- HAMP provides a clear and transparent approach to modifications and mortgage assistance. This is critical for homeowners and counselors to ensure that homeowners are properly evaluated. Consider the infrastructure HAMP has in place to protect borrowers:
    - Requirement that all 60 day delinquent borrowers be evaluated for a mod that can provide median monthly savings of 37%.
    - A requirement that if not accepted into HAMP, borrowers must be provided a reason and considered for a proprietary modification.
    - An escalations process that can negotiate with the servicer on behalf of the borrower.
    - Sound dual track protections so borrowers are not simultaneously being foreclosed upon while in a trial HAMP modification.
- In addition, HAMP provides a comprehensive approach to assist struggling homeowners: a second lien program, short sale and foreclosure alternatives, unemployment assistance, and targeted assistance to hardest hit states.
- Termination of HAMP would increase the likelihood that we will return to environment where there was no servicer accountability, and great inconsistency in "work outs" and mortgage assistance offered.

28. ***What are you doing to address the foreclosure crisis? What is the status of the Administration's foreclosure task force?***

- The Administration's foreclosure task force, a group of eleven federal agencies, including Treasury, the Department of Justice (DOJ) and the state Attorneys General, are conducting ongoing investigations to review of foreclosure processing, loss mitigation, and disclosure at the nation's largest mortgage servicers.
- The foreclosure task force is working collaboratively to identify and fix the breakdowns in internal controls, documentation, and corporate governance practices associated with the mortgage servicing and foreclosure processes.
- The agencies participating in the task force share a common objective of holding servicers that engaged in any wrongdoing fully accountable for their actions. Because this is an ongoing investigation, it would not be appropriate to comment further at this time.
- Errors in foreclosure processing and improper loss mitigation practices must be corrected immediately. Servicers that acted improperly must be held accountable and the system must be reformed to prevent these problems from occurring again.

- That is why Treasury supports national, simplified servicing standards to eliminate conflicts of interest and provide clarity and consistency to borrowers and investors regarding their treatment by servicers, especially in the event of delinquency.

*****THE BELOW IS FOR BACKGROUND PURPOSES ONLY—IT IS NOT TO BE INCLUDED IN TESTIMONY**:**

Under the leadership of the Department of Justice, and with Treasury co-ordinating, a group of federal regulators and State Attorneys General has been reviewing issues in connection with loan modifications and foreclosures, and considering potential remedies. It is anticipated that this may lead to a negotiated settlement with the mortgage servicers. Talks with the servicers have not yet begun, though the states have prepared a draft term sheet. This draft term sheet is currently being revised to incorporate comments from federal agencies. At the request of the AGs, it has not yet been shared with OCC or the Fed. The size, structure and number of institutions covered by a potential settlement have not been finalized. At the same time, the OCC has prepared a draft consent order. The OCC has discussed this order with the banks and appears to be preparing to move forward shortly. Recent coverage on prospective settlement terms has increased urgency to finalize the term sheet and initiate discussion with the servicers.

29. Why are you punting on the end state after 2 years of work?

- We have provided a comprehensive and aggressive plan to reform the housing finance system. These steps are absolutely essential to reducing the role of government on the housing market, reducing taxpayer risk and bringing private capital back into the market.
- We need to be deliberate in our approach to further steps for reform given the fragility of the overall recovery and the housing market in particular. Determining the long-term role for government will require a serious dialogue with Congress about a difficult set of trade-offs between providing broad access to mortgages for American families, managing the risk to taxpayers, and maintaining a stable and healthy mortgage market.
- And while the discussion about end states is important, we must be careful not to let it keep us from the immediate task at hand: we need to scale back the role of government in the mortgage market, and promote the return of private capital to a healthier, more robust system.

30. How will your reforms help prevent further market concentration in a few financial institutions that are effectively TBTF and that exert anti-competitive pricing pressure on both the primary and secondary market? Won't the full privatization options unduly advantage large institutions?

- Potential impacts on consolidation in the financial system should be a consideration in determining the long-term structure of our nation's housing finance system. This should be part of the conversation that we have together as this Congress moves ahead with legislation.

31. In Option 2, how would the government backstop mechanism work during a crisis? How would you ensure that it is only scaled up during a true crisis and that its use is reduced when the crisis ends?

- One option is to prescribe a limit to the amount of mortgages that can be wrapped by a guarantee. The fee for this guarantee should be allowed to change depending on market conditions. In good economic times, the guarantee fee would be very high, but when the housing market deteriorates, it would be reduced.
- Alternatively, the cost of the guarantee could be fixed, but the amount of mortgage product that could be wrapped could vary depending on economic and housing conditions. In good economic

times, there would be only a small amount of mortgage product able to be wrapped, but in stressful times, this amount would increase

32. ***Does the Administration have a preferred option among those it has proposed? Do you favor a government guarantee?***
    - The Administration believes that the right course forward is one where the government facilitates access to mortgage credit for creditworthy Americans, but not at the cost of excessive taxpayer risk or financial instability.
    - We evaluate three proposals according to four key criteria: access to mortgage credit; incentives for investment in the housing sector; taxpayer protection; and financial and economic stability.
    - We ask Congress to work with us to determine the right balance of priorities for a new, predominantly private housing finance market as soon as possible.

33. ***What analysis have you done / what support do you have to show that the government can accurately price the guarantee fee in Option 3?***
    - Removing the conflicts of interests between private shareholders' profit motive and public mission would make and government reinsurer materially different from Fannie and Freddie.
    - If the government did misprice the reinsurance, the system could be built with a mechanism to ensure that actors who participate in the system pay for any losses, and not taxpayers.

34. ***Which options minimize systemic risk in the system? Specifically - To the extent that our largest financial institutions (and other very large or systemically significant firms) held or guaranteed any significant portion of the $5.5 trillion in mortgage loans currently financed through Fannie and Freddie, won't greater privatization escalate the problem of "too big to fail," especially given the importance of residential mortgage debt?***
    - There are ways to mitigate systemic risk in all three options and we should take those steps.

35. ***I recently read a report on Bloomberg that the FSOC is considering designating insurance companies. What is Bloomberg talking about, and why can't I have a copy if Bloomberg has it?***
    - I do not have the details of the Bloomberg report, and the FSOC has not publically released any report on this topic.
    - The public comment period just ended for FSOC's proposed rule for designating nonbank financial firms for heightened supervision by the Fed. As required by Dodd-Frank, and further explained in the proposed rule, the process for potential designation will be open and transparent, giving the institution both the opportunity to respond and the ability to seek review in court.
    - Congress charged FSOC with the task of considering risks to the financial system and fashioning appropriate responses, and determining whether certain institutions or market sectors pose a systemic risk to the economy generally. The FSOC takes this responsibility very seriously, and is working diligently to analyze and monitor any potential systemic risks.

36. ***How can the government justify spending $162 million defending Fannie Mae and Freddie Mac's top executives in civil lawsuits?***
    - FHFA, Fannie Mae and Freddie Mac's conservator and regulator, determined it had legal obligation to defend certain top executives in certain civil lawsuits.
    - As Acting Director DeMarco testified on February 15th, FHFA is legally obligated to cover the legal fees of certain officers of Fannie Mae and Freddie Mac in lawsuits over actions they took in performance of their official duties. Failing to cover their legal costs would only invite more lawsuits, and would likely increase ultimate cost to taxpayers.

37. ***Why is there any need at all for a government role in housing, given that other countries seem to get along fine without it?***
    - International comparisons are difficult to make. While it is true that many countries don't directly support their housing finance systems through guarantees on MBS, they may provide support for the housing system in different ways. For instance, in many European systems, banks provide mortgage credit, and receive support from the government. Discussion of what countries do and don't provide support for their mortgage markets is not as simple as many suggest.
    - It is also important to recognize that the US is one of the only countries in the world where the majority of mortgages are pre-payable, 30-year fixed-rate mortgages.

38. ***What do you think about the Canadian housing finance system? Didn't it rely on substantially less government support?***
    - About 70% of the Canadian mortgage market is funded by banks. Of the remaining 30% that is financed through the capital markets, most is explicitly guaranteed through a government-owned mortgage insurance company.
    - The Canadian system relies heavily on strict LTV restrictions to ensure stability.

39. ***Do you think the Danish mortgage system provides an attractive model for the US?***
    - The Danish mortgage market relies on heavily regulated mortgage banks who issue cover bonds. There are also additional strict LTV restrictions in the system.
    - The system is remarkably stable and consumers benefit from a high level of transparency, but it is important to remember that the government provides an implicit backstop for the mortgage banks.

HOUSING FINANCE FROM THE GREAT DEPRESSION TO THE GREAT RECESSION

Fundamental Flaws in the Housing Finance Market

What caused the crisis in the housing market?

- No single cause can fully explain the crisis. Misbehavior, misjudgments, and missed opportunities – on Wall Street, on Main Street, and in Washington – all came together to push the economy to the brink of collapse. Numerous structural flaws included:
  - Poor consumer protections allowed risky, low-quality mortgage products and predatory lending to proliferate.
  - An inadequate and outdated regulatory regime failed to keep the system in check.
  - A complex securitization chain lacked transparency, standardization, and accountability and allowed lenders to pass toxic product through the system without regard for its risk.
  - Inadequate capital in the system left financial institutions unprepared to absorb losses.
  - The servicing industry was ill-equipped to serve the needs of borrowers, lenders and investors once housing prices fell.

Were homeowners themselves to blame for the housing market collapse, because they took out loans they knew they couldn't afford and made speculative investments on their houses?

- There were many causes of the crisis and no one factor or player had full responsibility.
- Borrowers bear some responsibility for their decisions to take on more debt. Some consumers took out unsustainable mortgages and used their houses as ATMs to access cash. Other consumers were steered into higher cost products when they were eligible prime loans.

Is the Community Reinvestment Act (CRA) to blame for the collapse of Fannie and Freddie and the overall financial crisis?

- No. Claims that the CRA caused the housing crisis are not supported by fact.
- Loans originated by CRA lenders show evidence of less risky lending practices. CRA lenders offered low income areas a higher percentage of fixed rate mortgages (28%) as compared to independent mortgage companies (18.2%).
- Default rates on CRA loans were no higher than those on other similar loans that did not qualify for CRA. Studies indicate that loans made by CRA lenders within their assessment area were less likely to be in foreclosure than those made by independent mortgage companies.
- Loans and securities backed by CRA loans represented a very small percentage of the loans that were originated in the boom years. More than half of subprime loans were made by independent mortgage companies not subject to CRA and another 30% were made by affiliates of banks or thrifts that were not subject to CRA examination.
- CRA did not encourage lenders to buy subprime loans. According to economists at the Federal Reserve Board, in 2006, less than 2% of mortgage originations sold by independent mortgage companies were higher-priced, CRA-credit-eligible, and purchased by CRA-covered banks.
- CRA was enacted in 1977 and the last substantial administrative changes took effect in 1996. The major expansion of subprime and Alt-A lending did not begin until 2004.

The Failure of Fannie Mae and Freddie Mac

Did Fannie/Freddie cause the financial crisis by lowering their underwriting standards, allowing consumers to get loans they couldn't afford?

- No. Rather than leading the market into subprime and other risky mortgages, Fannie and Freddie followed the private sector. Initially, Fannie and Freddie continued to guarantee primarily highly-quality, fully-documented mortgages, while the private sector generated increasingly risky mortgages. But as their market share declined (from 70% in 2003 to 40% in 2006), Fannie and Freddie pursued riskier business to chase market share and profits, just as house prices were peaking.
  - *Increase in Alt-A loans in 2005-2007:* About 75% of Fannie Mae and Freddie Mac's current Alt-A loans in the GSE guarantee book were originated from 2005-2007. Only 24% came from 2004 or earlier. In particular, of Freddie Mac's current Alt-A, 27% and 31% were originated in 2006 and 2007, respectively.
  - *Higher LTV lending increased in 2007:* . Loans with LTV above 90% were 15% of all loans purchased in 2007, as compared to just 9% of loans purchased earlier in the decade. Loans of LTV at or below 80% were just 75% of 2007 originations, while they had comprised 86% of originations in 2003 and 2005
  - *Increase in share of loans with risky features in 2007:* The share of loans with risky features such as a combination of low FICO score and high LTVs, increased at Fannie Mae and Freddie Mac in 2007.

Were Fannie and Freddie's affordability goals a major cause of the financial crisis or of the failures of Fannie and Freddie?

- No. A combination of fundamental structural flaws – not the affordable housing goals – bears primary responsibility for both the losses at Fannie and Freddie and for the broader financial crisis.
- The mistakes that led to their losses closely mirrored mistakes in the private-label securities market, where affordability goals were a non-factor. Those mistakes include poor underwriting standards, underpriced risk, insufficient capital, and inadequate regulatory or investor oversight.
- Furthermore, GSE acquired loans had higher FICO scores and lower LTVs than the PLS backed loans:
  - *FICO scores are higher in GSE-purchased loans*: 84% of GSE loans had FICO above 660, compared to only 47% in PLS backed loans. Only 5% of GSE loans went to borrowers below 620 FICO, compared to 32% of PLS backed loans.
  - *LTVs are lower for GSE-purchased loans*: 82% of GSE loans had an LTV of 80% or lower, compared to 2/3rds of PLS backed loans.
- Delinquency rates and default were higher on many private-label securities and other loans held by banks and other private market institutions as compared to the loans held by Fannie Mae and Freddie Mac, including loans qualifying for the affordability goals.
  - Only 32% of seriously delinquent loans in Q1 2009 were attributed to mortgages insured or guaranteed by Fannie Mae, Freddie Mac and GNMA/FHA, despite the fact that these entities and agencies insured or guaranteed 67% of all outstanding mortgages.

Why was oversight of Fannie Mae and Freddie Mac so weak?

- Fannie Mae and Freddie Mac's previous regulator, The Office of Federal Housing Enterprise Oversight (OFHEO), did not have adequate enforcement authority to constrain risky behavior.

- Fannie Mae and Freddie Mac's aggressive lobbying efforts successfully defeated efforts to have them regulated more effectively.

Current State of the Housing Market

Why hasn't the Obama Administration done more to help the housing market recover?

- Since taking office in January 2009, the Obama Administration has helped stabilize the housing market and provide critical support for struggling homeowners. Without these initiatives, the downturn in the housing markets and the economy could have been far worse.
- To help stabilize the housing market, the Administration implemented a series of broad actions, including:
  - Supported the First Time Homebuyer Tax Credit, which has helped 2.5 million American families purchase homes.
  - Provided more than $5 billion in support for affordable rental housing through low income housing tax credit programs and $6.92 billion.
  - Support for the Neighborhood Stabilization Program to restore neighborhoods hardest hit by concentrated foreclosures.
  - Housing Finance Agencies Initiative to increase sustainable homeownership and rental resources.
  - Created the $7.6 billion HFA Hardest Hit Fund for innovative foreclosure prevention programs in the nation's hardest hit housing markets.
  - Supported home purchase and refinance activity through the FHA to provide access to affordable mortgage capital and help homeowners prevent foreclosures.

What are the signs of impact on the market of your housing initiatives:

- Over 9.5 million Americans have refinanced to lower payments.
- Refinance saving homeowners $150 on average a month, with aggregate savings of $28.5 billion since April 2009.
- Over 500,000 homeowners are in permanent modifications.
- Median HAMP payment reduction of over $500 per month.
- We are seeing positive structural change in the mortgage market as a result of HAMP.
- Hardest Hit Fund helping deliver help to states hardest hit by unemployment and home price declines.

What can you say about HAMP?

- To date, the Home Affordable Mortgage Program (HAMP) has achieved three critical goals: it has provided immediate relief to many struggling homeowners; it has used taxpayer resources efficiently; and it has helped transform the way the entire mortgage servicing industry operates
  - HAMP establishes a national, standardized modification program that is helping responsible, struggling borrowers across the country stay in their homes.
  - HAMP has fundamentally changed the paradigm of how servicers work with delinquent borrowers, shifting from a debt collection model to an underwriting model.
  - We continue to see challenges. Servicers were slow to implement HAMP, and must continue to increase the pace of permanent modifications. Recent improvements in the program have accelerated the pace of permanent modifications, and we are implementing adjustments to better address unemployment and negative equity.

- The HAMP solution still is the best option available to borrowers, and in light of the foreclosure irregularities it remains critically important that servicers focus on their efforts to evaluate borrowers for HAMP.

GSE sources of losses and post-conservatorship book of business

Note: The Conservator's report included numbers as of Q2 2010:

GSE losses since conservatorship are almost entirely attributable to loans that were originated and guaranteed before conservatorship and that remain obligations of the entities.

- The 2006, 2007, and 2008 vintages account for over 70% of all credit losses.
- Less than 1% of the post-conservatorship credit losses are a result of loans guaranteed in 2009 and 2010.

The FHFA Conservator's Report highlights that the bulk of capital reductions (over 70%) have come from Single Family guaranteed loans as of Q2 2010.

- Many commentators tend to point incorrectly to the retained portfolios as the cause of Fannie Mae and Freddie Mac's collapse; while the losses were significant and were indicative of the risks Fannie Mae and Freddie Mac took, the Investment/Capital Markets (Retained Portfolio) segment has only accounted for 9% of the cumulative losses
- The Single-Family Guarantee segment has been the largest contributor to capital reduction, accounting for 73% percent of capital reduction since the end of 2007.
- The Multifamily segment accounted for 5% of capital reduction

A disproportionally large amount of credit losses have come from loans in the guarantee book with risky characteristics

- During the housing bubble run-up Fannie Mae and Freddie Mac sought to preserve their market share by guaranteeing loans with riskier characteristics including Alt-A underwriting standards, interest only payments, and high loan to Value (LTV) ratios.
- Many of Fannie Mae and Freddie Mac's credit losses have been disproportionally concentrated in these buckets of loans with risky characteristics. For example, Alt-A represented about 10% of the amount outstanding (UPB) at each enterprise at the end of 2008, but have accounted for more than 35% of the credit losses for both entities since January 2008.

Under the supervisions of the FHFA, progress has been made on improving the credit quality of loans Fannie Mae and Freddie Mac guarantee

- Under the supervision of the FHFA, the credit quality of the post-conservatorship book of business improved dramatically versus pre-conservatorship:
  - Alt-A loans now account for 0% of the new book of business since conservatorship as compared to 22% for Fannie in 2006 and 22% for Freddie in 2007.
  - Low credit (<620 FICO) purchases are now only 1% as compared to 6% for both Fannie and Freddie in 2007.
  - Average FICO of new business improved from roughly 715 in 2006 to 750 or more for both Fannie and Freddie.

  - While >90% LTV mortgages are slightly up in 2010 from 2009, this is almost entirely related to HARP refis, which are a loss mitigation mechanism and actually reduces the risk of default.
- Additionally, guarantee fees have been increased and Fannie Mae and Freddie Mac have risk-adjusted their pricing.
- The new, higher credit quality book of business from 2009 has seen substantially lower cumulative default rates when adjusted for loan age

TOWARDS A NEW SYSTEM OF HOUSING FINANCE

Paving the Way for a Robust Private Mortgage Market

Winding down Fannie Mae and Freddie Mac on a responsible timeline

Explain "price Fannie Mae and Freddie Mac's guarantees as if they were held to the same capital standards as private banks or financial institutions"?

- Fannie Mae and Freddie Mac over time were required to hold far less capital then regulated private institutions. Since they did not have to maintain higher levels of capital, they could set the fee that they charged to guarantee mortgage-backed securities at artificially low levels.
- Fannie Mae and Freddie Mac are currently pricing as if they were required to hold their statutory capital minimum of 45 basis points. Fannie Mae and Freddie Mac will over time increase their pricing as if they had to hold 250-400 basis points of capital depending on the risk characteristics of the loans guaranteed, which is the level that other private banks would have to hold against the same risk. This will increase guarantee fees from approximately 25 basis points to approximately 70-100 basis points over time.

Is the plan for Fannie Mae and Freddie Mac to begin to re-build a capital base?

- No. Treasury will ensure that Fannie Mae and Freddie Mac have sufficient capital to meet their obligations, but Fannie Mae and Freddie Mac will not increase their capital as if they were being returned to their pre-conservatorship status.
- Treasury remains committed to protecting taxpayers and ensuring that future positive earnings of the Enterprises are returned to taxpayers.

What percentage of the market will no longer be covered when the temporary increases in conforming loan limits expire in October 2011? How much will their mortgage rates increase?

- Looking at the numbers from 2010, approximately 50,000 loans (less than 5% of total mortgage originations in 2010) were loans within the temporary conforming loan increase.
- It is likely that the private sector will have the ability to absorb this incremental supply through bank portfolio lending.

What is physically going to happen to the operations at Fannie Mae and Freddie Mac including the infrastructure, systems, and human capital? Is just letting these institutions wither away in the best interest of taxpayers?

- FHFA and the administration will seek to maximize taxpayer recovery in Fannie Mae and Freddie Mac. Where appropriate, FHFA and the administration will consider selling certain business lines and pieces of the infrastructure to private entities.

- However, it is likely that certain pieces of the operation will simply be wound down.
- We will continue to work with FHFA to ensure that talent is retained so that mortgage credit continues to flow during the transition, and that wind down is successful and supports taxpayers' interests.

If Fannie Mae and Freddie Mac have room under the retained portfolio ceilings, and if mortgages cheapen, will Fannie Mae and Freddie Mac be able to purchase MBS for their portfolios?

- The Administration will ensure that Fannie Mae and Freddie Mac's retained portfolios are wound down at a pace no less than 10 percent per year.
- Both Fannie Mae and Freddie Mac are ahead of this schedule and we support the efforts to continue to responsibly reduce the size of these portfolios.

Are there any conditions where the Administration would support a faster wind down of Fannie Mae and Freddie Mac's portfolios?

- There is no rigid set of conditions that will be used to increase the pace of the portfolio unwind. However, we will constantly monitor the market, and if there is an opportunity to increase the pace of the unwind that will not disrupt markets and is in taxpayers' best interest, we could consider increasing the pace of disposition.
- We recognize that a minimal retained portfolio supplies certain important functions, such as providing liquidity to small lenders through the cash window and providing the ability to purchase delinquent loans out of MBS pools.

What is the current size and composition of Fannie Mae and Freddie Mac retained portfolios?

- The current combined size of Fannie Mae and Freddie Mac's portfolios is $1.5 trillion. They consists of approximately $600 billion in agency MBS, $300 billion non-agency MBS, and $600 billion in mortgage whole loans.
- As the agency mortgages are paying down and the agencies continue to buy delinquent loans out of pools, the composition of the portfolios has been changing such that mortgage loans comprise a larger proportion and agency MBS a smaller proportion.

Fannie Mae and Freddie Mac hold a large percentage of REO on their balance sheets. What is your plan for removing those assets?

- We recognize that the housing market remains fragile and we will not pursue policies that threaten to disrupt the recovery. The pace of REO disposition should proceed in a fashion that would not overly disrupt the market, negatively affect house prices, and further destabilize communities.
- We will work with FHFA to consider all strategies for the disposition of these properties as long as those strategies maximize recovery for the taxpayer and do not disrupt the fragile housing market recovery.

<u>Returning FHA to its role as a targeted provider of credit</u>

Why is it necessary to make adjustments to FHA's single family business?

- This is necessary to bring private capital back into the mortgage market and reduce taxpayer exposure. As Fannie Mae and Freddie Mac increase their pricing, without corresponding changes at FHA, Fannie Mae and Freddie Mac's old business will flow to FHA rather than the private market as

FHA will become the cheapest source of mortgage financing in the market. This would actually result in increased risk for taxpayers and would not reduce the government's footprint.

- Our goal is to return FHA to its traditional role as a targeted provider of mortgage credit and to reduce taxpayer exposure.

But, FHA has not cost the taxpayers any money. Why are we concerned about scaling back their footprint?

- FHA currently has increased its market share to serve as a countercyclical source of credit in the housing downturn. Its current market share is 30% compared to a historic average closer to 10-15% and as low as 3% in 2006. The maximum FHA conforming loan limits were increased to $729,500, which represented a departure from FHA's traditional role as a targeted provider of mortgage credit and access to low and moderate income and first-time homebuyers.
- While FHA has not required a bailout, the agency is currently operating below its statutory minimum capital requirement. If there were another downward shock to house prices, it is possible that taxpayers would face losses on loans guaranteed by the FHA.

<u>FHLBs</u>

How would the advance restrictions affect the FHLB system?

- Advance restrictions would improve the stability of the FHLB system by preventing the system from becoming over exposed with respect to any one institution. During the lead up to the crisis, the FHLB system saw a significant increase in advances from some of the largest institutions, several of which were severely affected by the crisis.
- Depending on the size of the advance cap and the use of advances, it might affect a few of the largest financial institutions. Our intention is not affect small or medium sized financial institutions.

How would single district membership affect the FHLB system?

- Single district membership would address one of the significant weaknesses of the FHLB system, the collateral arbitrage between FHLB banks.
- Single district membership would have little effect on small or medium sized financial institutions, which are generally members of only one FHLB. It would require large financial institutions which are members of multiple banks, sometimes four or more, to choose a district. We would work with FHFA to ensure an orderly transition.

Won't a large covered bond market favor large financial institutions and encourage even greater concentration in the banking sector?

- We want to promote a deep and liquid private capital market for the availability of mortgage credit. We are open to alternative ways to encourage additional private capital into the market. It is premature to speculate what the effects of a potentially new market would be.

Restoring Trust and Integrity in the Broader Housing Market

Is your plan to "fix the flaws in the mortgage market" just to implement the Dodd-Frank Act? What's new here?

- The authorities and mandates handed down by Dodd-Frank are critical tools for bringing capital markets back into the housing finance system. They fix fundamental flaws in the housing finance system, including consumer and investor protection, conflicts of interest, and systemic risk oversight.
- The Administration has recommended important reforms for mortgage servicing, lien priority, disclosure, and to FHA and other government housing finance programs. These reforms include regulatory reforms, legislative proposals, and industry best practices.

Reliance on current law and independent agencies

Given her or his critical role in your plan, when will you appoint the FHFA's director?

- The President, with the advice and consent of the Senate, appoints the FHFA Director. Congress and the President direct the timing of any appointment. Acting Director Ed DeMarco has done well in reducing risk to the taxpayers and fulfilling his role as conservator.

Increasing transparency, standardization, and accountability in the securitization chain.

How does Treasury's plan interact with the Qualified Residential Mortgage (QRM) and Risk Retention rules mandated by Section 941 of Dodd-Frank? Will the rules apply to Fannie Mae and Freddie Mac? Will the Administration's recommendations change once these rules are promulgated?

- Reforming the securitization market and requiring "skin in the game" is critically important.
- The risk retention rulemaking process is still underway and because rules have not yet been issued, we are not able to comment or predict what those rules might look like or what effect the rules will have on housing finance reform or the economy generally.
- The Administration looks forward to working with Congress and the Section 941 rule writers to determine how the future reforms should incorporate the risk-retention rules once they are issued.

What were the conclusions of the Study mandated by Section 946 of Dodd-Frank on the Macroeconomic Effects of Risk Retention?

- The study concludes that risk retention can help reform the securitization market, protect the public and the economy against irresponsible lending practices, and facilitate economic growth by allowing for safe and sound credit formation for consumers, businesses, and homeowners, resulting in market participants pricing credit risk more accurately and allocating capital more efficiently.
- Risk retention alone cannot fix all of the flaws in the system, but it can help by aligning interests of participants in the securitization process and encouraging better underwriting standards. Dodd-Frank has a number of other reforms intended to address these and other problems that became apparent during the financial crisis.
- There are many choices in designing a risk retention framework. The study discusses some of these choices and puts forth principles to use in determining how such a framework could be set.

What is the timing of the Section 941 risk retention rules? What is Treasury's role in the rulemaking process? When will a Notice of Proposed Rulemaking (NPR) be released? Will there be an Advanced Notice of Proposed Rulemaking? Will you meet the April deadline?

- The Treasury Secretary, as Chairman of the FSOC, is the coordinator of the Section 941 rule writing process, but does not have rule writing authority.
- At this point, we are not able to give an indication the timing of the release of either the notice of proposed rules or the final rules. The rule writers are working diligently to find consensus on all relevant issues.
- While we cannot comment on timing of releases, there will be an NPR released with an adequate public comment period before any rules are finalized. We will welcome public comments at that time.

Regulatory Oversight

Why do we think the government is going to be more effective at regulating the housing market this time around?

- As a result of the reforms that will be implemented as part of Dodd-Frank and the additional reforms proposed in this plan, regulation will be consolidated in the hands of stronger regulators who have the ability to effectively oversee and monitor entities in the housing finance system.

How are you going to prevent predatory lending or liar loans and other consumer fraud?

- The Dodd-Frank Act created the CFPB both to defend consumers from predatory and deceptive lending and to ensure consumers are able to understand the risks and obligations inherent in their financial transactions.

Increased Capital

Won't larger capital requirements lead to slower loan growth in the near term and slower economic growth?

- Safety and soundness of the financial system is critical to promote our economy's vitality and its ability to take risk and promote innovation. Ultimately, we must strike an appropriate balance, instituting sufficient reforms to ensure a safe and sound system, while continuing to encourage innovation and sound investment.
- As the recent crisis demonstrated, excessive and reckless growth can be destabilizing for the entire economy and is not in the country's long-term interest.

How will the new framework put forth by the Basel Committee on Banking Supervision affect the Housing Finance Market? Does the Administration's plan take these changes into account?

- In July 2009, the BCBS strengthened supervisory standards and increased regulatory capital requirements for complex securitizations. The BCBS adopted several revisions to the regulatory framework known as Basel II to address some of the main problems highlighted by the recent financial crisis.

- On December 16, 2010, the BCBS announced stricter capital regulatory requirements for banks. These requirements are commonly known as Basel III. Basel III is intended to improve the banking sector's ability to absorb shocks arising from financial and economic stress.
- Basel III must be adopted by the individual regulators of each participating nation, and is by its own terms to be phased in beginning January 1, 2013. Basel III standards include requirements for banks to have: (i) heightened risk weight for some lower-rated and unrated securitization exposures; (ii) more conservative collateral haircuts for securitization collateral with respect to counterparty exposure; and (iii) additional specific risk haircuts for securitization exposures when calculating the capital requirement related to market risk.
- These reforms are consistent with the Administration's commitment to increasing capital in the housing finance system and ensuring that sufficient capital is held by the private sector against residential securitization exposures going forward.

Mortgage Servicing and Foreclosure

What does the Administration mean by national servicing standards and which ones would the Administration support?

- The Administration is leading a broader interagency process working to develop national servicing standards.
- The work on this process is underway, including study of measures that would align incentives and provide clarity and consistency to borrowers and investors regarding their treatment by servicers, especially in the event of delinquency.
- The Administration is also working with FHFA, in coordination with HUD and Ginnie Mae, to explore alternative compensation structures to align industry incentives and promote foreclosure alternatives when in the best interest of both the borrower and the credit guarantor.

Does the Administration support a fee-for-service model for servicer compensation?

- A fee-for-service compensation structure could help ensure servicers have the appropriate incentives to invest the time and effort to work with troubled borrowers to avoid default or foreclosure. The Administration is receptive to comments on whether there are other effective means of addressing these concerns as well.

How does the Administration specifically propose to deal with lien priority issues?

- Mortgage documents should require disclosure of second liens.
- In addition, mortgage documents should define the process for modifying a second lien in the event that the first lien becomes delinquent. This will prevent a second lien from standing in the way of a first lien modification and help prevent avoidable foreclosures.
- Finally, we could consider options for allowing primary mortgage holders to restrict, in certain circumstances, additional debt secured by the same property. This would require a legislative change.

A System with Transparent and Targeted Support for Access and Affordability

General access and affordability questions

How can the USG provide targeted support for "hard-to-reach" segments without increasing its risk exposure? Aren't the "hard-to-reach" segments the least creditworthy?

- Hard-to-reach segments can be served in a creditworthy and responsible manner.
- Many private mortgage lenders, FHA, State HFAs, nonprofits, and CDFIs have all provided responsible underwriting to hard-to-reach segments with low rates of loss.
- Many subprime borrowers could have qualified for prime loans but were subject to discriminatory pricing and predatory products. When given access to safe, stable, well-underwritten mortgages, hard-to-reach borrowers have consistently demonstrated an ability to meet their obligations.
- Private credit markets, particularly secondary markets, tend to systematically under serve certain market segments because (1) secondary markets favor standardization, volume and information, making it difficult to introduce new products designed to meet the needs of underserved markets; (2) less standardized products are more difficult to underwrite and securitize; (3) low-balance loans are less profitable to originate.
- With respect to multifamily rental housing, Fannie Mae successfully targeted properties the private secondary markets seldom reach, including buildings affordable to moderate income families and buildings with government subsidies. Fannie Mae's low rates of loss in its multifamily portfolio demonstrate that such segments can be served in a safe, sensible and efficient manner.

Shouldn't all high LTV lending be eliminated? Otherwise, we will just keep pushing homes on people who can't afford them and shouldn't be in them.

- It is essential that home owners have sufficient financial resources to contribute a down payment and carry monthly mortgage and other expenses. Homeownership is not right for everyone. But not all high LTV lending is risky and providing homeownership opportunities for credit-worthy families should remain an important policy goal.
- LTV ratios are only one factor in determining risk and should be considered as part of an overall risk profile. Appropriate borrower and loan characteristics can keep overall risk low even without a large down payment.
- We should empower consumers to avoid unfair practices and make fully informed decisions. Requiring lenders to verify borrower ability to pay will ensure that mortgages are more sustainable and affordable in a reformed housing finance system.

FHA single family reforms

Aren't higher down payments and premiums at FHA going to unfairly restrict access to mortgage loans for creditworthy borrowers in need? Isn't increased down-payment assistance a poor substitute for your proposed reduced role and higher cost of FHA?

- The Administration is committed to ensuring creditworthy first-time homebuyers and families with modest incomes can access a mortgage. Government has an important role to play in ensuring that capital is available to creditworthy borrowers in *all* communities, including rural areas, economically distressed regions, and low-income communities.
- It is important to balance two homeownership objectives: access and sustainability. Mortgage defaults and foreclosures are damaging to families and communities, as well as to mortgage lenders, investors and the FHA and the taxpayers that stand behind it.

- Strengthening FHA's capital reserve account is necessary to enable FHA to manage housing downturns and to protect taxpayers. Reforms to FHA will ensure that creditworthy borrowers with low- and moderate- incomes will continue to have access to mortgage credit.
- We believe that the private sector should take the lead role in supplying mortgage credit to all Americans. FHA should provide an upper limit on pricing and encourage the private sector to compete successfully, as it did in the 1990s. Changes at FHA are necessary to gradually shrink its market share and allow the private market to grow.
- We will seek ways to support down payment assistance, counseling and other mechanisms to allow creditworthy borrowers without access to personal or family wealth to become homeowners.

Multifamily/Rental reforms

Why should the USG provide any support to multifamily rental finance? Wasn't the lesson from the crisis that government involvement creates larger booms and busts and exposes taxpayers to too much risk?

- FHA, Fannie Mae and Freddie Mac have performed well with multifamily properties.
- Many renters face serious affordability challenges. Half of *all* renters spend more than 30% of their income on housing – the most common affordability benchmark -- and a quarter spend more than half. And for low-income renters, adequate and affordable homes are increasingly scarce; for every 100 extremely low-income American families, for example, only 32 adequate homes are affordable.
- Private credit markets have generally underserved multifamily rental properties that offer affordable rents, preferring to invest in high-end developments.
- Government involvement in multifamily rental finance will be targeted, transparent, and seek to put private capital in the first-loss position. It will focus on supporting affordable rental options to low- and moderate-income families, who face high rent burdens.

During transition, will Fannie and Freddie continue their multifamily business? Without Fannie and Freddie's support, won't rents increase to unaffordable levels for middle- and lower-income Americans? Will you institute any substantial federal support for multifamily rental markets?

- We will work with FHFA to ensure liquidity and steady financing remains available to the middle of the rental market, where housing is generally affordable to moderate-income families.
- As we wind down Fannie Mae and Freddie Mac, it will be critical to find ways to maintain liquidity in this segment of the market and to ensure that new sources of capital enter the market.
- FHA currently insures mortgages for multifamily rental properties, and will continue to do so. Furthermore, the Administration will explore ways to expand FHA's capacity to support multifamily markets.
- We will consider a range of reforms, such as risk-sharing with private lenders and developing programs dedicated to hard-to-reach property segments, including the smaller properties that contain one-third of all rental apartments.

How specifically do you plan to expand FHA's capacity in multi-family lending? What does your proposal for "FHA risk-sharing with private lenders" in multifamily housing mean specifically?

- FHA would benefit from reforms that incorporate current best practices in the multifamily finance industry. These include streamlined underwriting and approval processes that require private lenders to share losses on loans the FHA insures.
- New flexibilities related to internal infrastructure, processes and human capital development and retention would be required for FHA to have expanded capacity.

- There are a number of ways in which risk sharing can be implemented. Overall, risk sharing with private lenders would put the lender at risk for at least part of the losses in cases of default. Fannie Mae's current multifamily business uses risk sharing to align lenders' incentives with their own and could serve as a model for future FHA activities. We will consider using a version of Fannie Mae's designated underwriting system (DUS).

Won't an expanded FHA crowd out private capital? How is an expanded FHA consistent with the USG's desire to increase private capital in the housing finance system?

- Potential reforms to FHA could include risk-sharing with private lenders, which would draw in private capital.
- The private secondary market has not well served all segments of the multifamily market, most notably the small buildings (5 - 50 units) that contain one-third of all multifamily rental apartments. While encouraging private capital to engage in those markets remains important, we believe that FHA can help demonstrate how to serve those segments safely and profitably.

Why have you not proposed an expansion of the Low-Income Housing Tax Credit (LIHTC) to produce and preserve more affordable rental housing?

- Tax policy changes are beyond the scope of this white paper.

Doesn't increased support for rental housing disadvantage rural and suburban communities at the expense of urban areas?

- Support for rental housing is important in all communities, including urban, suburban, and rural communities. Wherever located, rental housing should provide families access to good jobs for parents and quality schools for children and contribute to community stability.
- Our proposal to support rental housing finance focuses on smaller multifamily properties for federal support. Smaller rental buildings are woven into the fabric of the suburban, rural and urban communities and are an important resource to working families.

Secondary market access

Why is secondary market access important?

- In a more privatized housing market, there is a risk that many communities may face contractions in mortgage credit. Underserved markets, including rural areas, economically distressed regions, and low- and moderate-income LMI borrowers and communities account for about one-half of all home purchase mortgages. LMI borrowers and communities alone account for over 40%.

Isn't your proposal to "make sure that secondary market participants reflect primary market activity" just Fannie/Freddie affordability goals by another name?

- No. Fannie Mae and Freddie Mac's affordability goals were poorly designed and implemented in some important ways.
    - *Mis-alignment with primary market*. Fannie Mae and Freddie Mac's goals were set as a share of their overall mortgage purchases, but did not reflect primary market lending activity, changing economic conditions, or even safe and sound lending practice. Future policy should better align activities in the primary and secondary markets, consistent with safety and soundness.
    - *Better targeting of underserved households and areas*. Fannie Mae and Freddie Mac's goals were insufficiently targeted. They did not reach all underserved market segments. They included middle-income communities and borrowers, and did not target rural communities.

  - *Consumer sustainability*. Prior to HERA, Fannie Mae and Freddie Mac were allowed to count certain mortgages that were unsustainable for consumers towards their goals targets.
- Establishing a system where the secondary market reflects primary market activity will help credit flow to all market segments and geographies Going forward, secondary market access should be better targeted and financially sustainable for families, communities, and for financial institutions, and be consistent with safety and soundness.
- Recognizing the dynamic interplay between the primary and secondary markets, we will work with Congress to determine the best measures to ensure that all creditworthy Americans in all communities are able to access mortgage credit in a reformed housing finance system.

Won't secondary market access cause rates to rise for middle-class families to subsidize people for whom homeownership isn't appropriate?

- No. Secondary market access does not imply unprofitable or unsafe lending. Homeownership is not right for everyone, but the secondary markets should serve creditworthy borrowers in all communities.
- The secondary market should support the full range of primary market activity. Because the secondary market would mirror the primary market, they should not distort underwriting standards or push inappropriate loans on would-be homeowners. In fact, secondary market access is an important tool to ensure that credit is flowing to middle- as well as low-income families in all communities, including rural and economically distressed areas.

How does the proposal address racial and ethnic discrimination in the housing finance system?

- We will work with Congress to require greater transparency in the mortgage market, requiring securitizers to disclose information on the credit, geographic and demographic characteristics of the underlying loans they support. This will make it easier to determine whether market participants are complying with their legal obligations, and also make clear to the public what communities these institutions are and are not serving.

Doesn't your proposal for more transparency and data disclosure by securitizers place an undue burden on the private sector and unnecessarily raise rates for all Americans?

- Securitizers should collect loan-level data as part of their due diligence and performance analysis. Better and more transparent data will help protect consumers while also improving market efficiency and accountability.
- Data disclosure can help the private sector identify new opportunities in markets it had previously overlooked. Data disclosure can help firms to improve metrics to assess the loan performance.

New dedicated funding for targeted affordable housing

Why should affordable housing programs receive a dedicated funding source?

- The scale of affordable housing needs will require more support from the federal government.
  - Half of all renters spend more than 30% of their income on housing – the most common affordability standard – and a quarter of all renters spend more than half.
  - The problems are most acute for low-income renters. For every 100 *very* low-income renters, only 60 adequate rental homes are affordable and there are only 32 such units for every 100 *extremely* low-income renters.
  - Increased down payment requirements in a reformed system may require more support for creditworthy borrowers to access mortgage credit.

Doesn't the federal government already have a large array of affordable rental and homeownership programs? Why should new programs be created and funded?

- Current policies and programs do not fully support a range of critical needs in affordable rental and homeownership, including:
    - Supply shortages in affordable rental housing for the lowest income families, similar to the Affordable Housing Trust Fund proposed to be capitalized in the President's 2012 Budget;
    - Access to down payment assistance and counseling for creditworthy borrowers in a form that does not expose them or financial institutions to excessive risk or cost;
    - Scaling up proven nonprofit partnerships that can attract much larger amounts of private capital; and
    - Overcoming market failures that make it hard to develop a secondary market for targeted affordable housing mortgages, such as that for small rental properties and location- and energy-efficient mortgages.
- New programs can better engage a range of partners with proven track records of success, including state housing finance agencies, non-profits, and CDFIs.
- To begin to re-balance support for homeownership and rental, greater support of renters and rental housing finance is appropriate.

Do you support the HERA affordable housing programs, including the Affordable Housing Trust Fund and the Capital Magnet Fund?

- The Administration's recommended uses of the dedicated funds are consistent with those of the HERA programs. The Affordable Housing Trust Fund primarily addresses the production and preservation of rental housing by the lowest-income families. The Capital Magnet Fund provides seed money that effective CDFIs and nonprofit organizations use for affordable housing that attracts substantial additional funds.

What funding sources is the Administration considering for its proposed set of affordable housing initiatives? How much funding would be involved?

- The Administration will work with Congress to determine appropriate amounts and sources for dedicated, budget-neutral financing mechanisms.

Shouldn't they be part of the regular appropriations process to be properly overseen by Congress? You are just trying to bypass proper government oversight of affordable housing, just like during the Fannie Mae/Freddie Mac goals era.

- Transparency in all affordable housing programs is an important component of reform.
- Congress will retain all oversight powers over any targeted homeownership and affordable rental programs which use dedicated funding sources.

<u>A RESPONSIBLE PATH FORWARD FOR REFORM: TRANSITION</u>

<u>Preferred Stock Purchase Agreements (PSPAs) Mechanics</u>

How does the Treasury financial commitment under the PSPAs work?

- Treasury's financial commitment will increase until December 31, 2012 to cover any future deficiency amounts (net losses requiring a Treasury draw) less whatever surplus remains by December 31, 2012.
- Treasury's financial commitment will not be reduced below $200 billion per institution.
- For example, if a GSE has cumulative deficiency amounts before December 31, 2012 of $50 billion, the cap would increase to $250 billion.
- However, the formula will also take account of any gains before December 31, 2012 as well. So if either GSE has a cumulative Deficiency Amount of $50 billion, but also has gains of $20 billion, the cap would increase only to $230 billion.
- In all cases, the cap cannot be lowered below $200 billion. So, for example, if either GSE had no losses and generated $50 billion of gains over the next three years, the cap would remain at $200 billion.
- The Q3 2010 draws of $0.1 billion for Freddie and $2.5 billion for Fannie increased the caps to $212.4 billion for both institutions.

Legacy Obligations

Message to the Market: Our support for Fannie Mae and Freddie Mac should be clear during this time of Transition

- The Administration will not pursue policies or reforms in a way that would threaten to disrupt the ability of Fannie Mae and Freddie Mac to honor their obligations.
- The 2009 amendments to the Preferred Stock Purchase Agreements should make it clear that the government will ensure that Fannie Mae and Freddie Mac have sufficient capital to perform under guarantees issued now or in the future and the ability to meet their debt obligations.
- As the market improves and Fannie Mae and Freddie Mac are wound down, it should be clear that the government is committed to ensuring that Fannie Mae and Freddie Mac have sufficient capital to perform under any guarantees issued now or in the future and the ability to meet any of their debt obligations. We believe that under our current funding arrangements, there is sufficient funding to ensure the orderly and deliberate wind down of Fannie Mae and Freddie Mac, as described in our plan.
- The structure of the PSPAs provides a substantial margin of solvency for Fannie Mae and Freddie Mac which allows them to meet their obligations even in substantially more adverse economic scenarios.

Fannie and Freddie employee retention and compensation

Why do you say that you are going to "reward" the current employees of Fannie and Freddie for a successful unwind?

- It is in the taxpayers' best interest that Fannie Mae and Freddie Mac have the ability to maintain the highest quality people and operations to effectively continue to support a stable housing market.
- The greatest risk to the taxpayer is in contracting the availability of new mortgage finance in such a way that would destabilize the market. A large departure of employees from Fannie Mae and Freddie Mac could potentially threaten the flow of mortgage credit.

Taxpayer Cost / Repayment

How much money are taxpayers are going to pour into these companies?

- The level of losses that Fannie Mae and Freddie Mac experience is highly dependent on the future path of house prices.
- In October, FHFA coordinated an independent stress test for both Fannie Mae and Freddie Mac to project forecasted draws from the Treasury / losses based on various inputs.
- FHFA has identified three scenarios (using Moody's house price paths): (1) Stronger Near-Term Recovery, (2) Current Baseline, and (3) Deeper Second Recession.
    - The cumulative draws from Treasury by 2013 are forecasted under those assumptions to be $221, $238, and $363 billion, of which $148 billion had been drawn as of Q2 2010.
    - Total draws (net of dividends), are forecasted to be $141, $154, and $259B, respectively.
    - Fannie Mae and Freddie Mac have drawn $153B from the Treasury as of Q3 2010 ($135B net of dividends).
    - So the additional draws (net of dividends) would be $6B under the recovery scenario, $19B under the base case, and $124B under the second recession scenario.

How many loans do Fannie Mae and Freddie Mac currently guarantee in their single family book? How do you view that number changing over time as pricing increases and these entities are wound down?

- Combined, Fannie Mae and Freddie Mac currently guarantee $4.4 trillion mortgages.
- The ultimate pace of Fannie Mae and Freddie Mac's unwind will be a function of market conditions and the ultimate recommendations to FHFA.

Why aren't you cutting Fannie and Freddie's excessively high 10 percent dividend rate on the PSPA? If it weren't for the dividend, those firms would be profitable.

- Treasury remains committed to protecting taxpayers and ensuring that future positive earnings of Fannie Mae and Freddie Mac are returned to taxpayers as compensation for their investment.
- According to the FHFA stress tests in the base case, the dividend payments will cover all positive earnings at Fannie Mae and Freddie Mac and return that money to taxpayers.

Why did you choose to waive the Periodic Commitment Fee? Isn't the Periodic Commitment Fee an opportunity to recoup some of the taxpayers' investments in Fannie Mae and Freddie Mac?

- Fannie Mae and Freddie Mac are currently required to pay a dividend equal to 10% of the taxpayers' total investment. According to the FHFA stress tests in the base case, both Fannie Mae and Freddie Mac are expected to require additional draws through the end of 2011 to cover net income losses and required dividend payments meaning that no excess income would be available for taxpayer recoupment.
- Given the size of the current draws from Fannie Mae and Freddie Mac, imposing the Periodic Commitment Fee would only lead to increased Treasury draws and not generate increased net proceeds for the taxpayer.

Why not merge the assets of Fannie and Freddie to cut costs for taxpayers?

- FHFA and the administration should consider managing certain assets of Fannie Mae and Freddie Mac jointly and outsourcing certain non-core operations functions in instances where that is in taxpayers' best interest.

- However, Fannie Mae and Freddie Mac have different systems and different risk management tools that aren't easily compatible. Undertaking a large scale project to consolidate all of the operations would take many years and result in large taxpayer expense.

OPTIONS FOR THE LONG-TERM STRUCTURE OF HOUSING FINANCE

How did you select these four criteria, access to mortgage credit, incentive for investment in housing, taxpayer protection, and financial and economic stability? Why not [x]?

- These four criteria take into account the fundamental choices we face when designing a new system and assessing its impact on borrowers, lenders, and taxpayers. They provide a clear yardstick upon which different choices can be assessed so that the benefits and drawbacks can be weighed carefully.
- However, all criteria should be considered, including [x] in any robust discussion about potential long-term solutions for our nation's housing finance system

Why did you include "access to mortgage credit" as a key principle for evaluating a future plan? You already stated that not everyone needs to own a home. Couldn't households rent instead of accessing a mortgage?

- While the Administration is committed to a more balanced approach toward both rental and home ownership, we will preserve the ownership option for a wide variety of households. Those households who have appropriate credit history and are in a financial position to purchase a home should have this option regardless of demographic or geographic location.
- Although not appropriate for all households, homeownership provides a means by which Americans can accumulate savings by building equity in their homes. Although we witnessed excessive "cashing-out" of this equity when some households used their homes as if they were piggybanks at the height of the bubble, responsible equity building can be a gateway to the middle class.

Why do we care about standardization in the mortgage market?

- A standardized mortgage market allows consumers to compare products easily across states, which is of particular advantage when moving homes.
- Additionally, as in most industries, there are advantages to uniformity, which could lower costs to consumers.
- There are instances where unique mortgage products are appropriate and sustainable for borrowers. Where appropriate, the non-standard nature of the mortgage should be clearly documented and communicated to the borrower, so that he or she can fully understand and agree that the mortgage product indeed suits his or her unique circumstances.

Why does government involvement in housing increase access to credit for many communities?

- By facilitating deep, liquid secondary markets, government involvement can expand the ability for small banks to sell their loans into the secondary market.
- Secondary markets and mechanisms for accessing them are particularly critical for small and community banks, who have more limited access to funding sources besides deposits.
- Without other mechanisms of access, small banks might be forced to rely on larger banks for secondary-market sources of funding, which would likely mean less attractive pricing for small banks and their communities.

Why does government support make investment in housing more attractive and distort credit markets?

- The presence of a government guarantee dramatically reduces the riskiness of the security to the end investor and increases the number of capital that investors are willing to devote to the sector. The guarantee both increases the amount of investors who are willing to participate in the market and the amount of capital that each investor devotes to the sector.

Why do you claim that government support can help promote financial stability? The US had Fannie Mae and Freddie Mac yet our housing boom and bust was more severe than that in most other country.

- Delinquency rates were much higher on mortgages originated outside of Fannie Mae and Freddie Mac, in the PLS market that did not have either government support or government supervision. Additionally, prices on agency mortgages were only minimally affected in the crisis, especially relative to the PLS market. Borrowers who qualified for mortgages that conformed to Fannie and Freddie's standards were able to access the market for mortgage credit through the entire crisis.
- Many of Fannie and Freddie's problems can be attributed to the fact that their government support was not transparent and was not priced.
- In "normal" times, the presence of a government guarantee prevents investors from engaging in fire sales of securities in the same way that the FDIC prevents runs on banks from depositors.
- In times of stress, the presence of the guarantee allows borrowers to continue to be able to access the secondary markets and have access to the credit that they need to sell their home and move or refinance their existing mortgage.

Why are we so concerned about access to mortgage credit in a crisis? Aren't the reforms we are implementing going to dramatically reduce the probability of future crises?

- The reforms we are implementing will create a more safe and sound system that substantially reduces the probability of a future crisis.
- This does not change, however, the fact that government should consider the value of having the tools necessary to minimize the impact of a future crisis should one result from unforeseen circumstances.

How much capital would move outside of the mortgage market and/or outside of the US if there were no guarantee in a future system?

- It is difficult to determine exactly how much capital would flow away from the domestic mortgage market. However, at a minimum, it's likely that several hundred billion dollars in investments in MBS from overseas investors would gradually flow into Treasuries.

<u>Option 1: FHA-only</u>

What approximate percentage of the market do you envision being covered by FHA in such a plan?

- The percentage of the market covered by FHA should be dictated by the types of borrowers who should be served, not by an abstract market share target.
- We look forward to working with Congress to develop policy to reduce the market share of FHA significantly from today's current unsustainable levels.

Why does Option 1 reduce the government's ability to effectively step in to ensure access during a crisis? The Federal Reserve played a stabilizing role during this last crisis. Couldn't they do the same in a future crisis?

- While the Federal Reserve, Treasury or other agency could step in and provide support during future crisis, there are several drawbacks to relying on such assistance in the future. Without a clear and transparent process established in advance, there is less certainty about how – if at all – support would be provided
- The associated moral hazard of ensuring government support without explicitly charging for it could result in the private sector taking on more risk than it should.

In Option 1, wouldn't the FHA drastically expand its market share if Fannie Mae and Freddie Mac were no longer an available option?

- In a privatized market with the government role limited to FHA, in order to prevent all mortgages going through FHA, strict limits would be necessary to ensure that FHA only provides loans to low and moderate income borrowers.
- By decreasing the conforming loan limit and increasing FHA guarantee fee pricing, the amount of market share that FHA will cover will decrease.

Can the government credibly avoid stepping in amid a true crisis? Won't the market still be left guessing if, when, and how the government might intervene under the "FHA only" model?

- Predetermined rules will be needed to govern when the government would and would not step in during a crisis to avoid excessive risk taking and moral hazard.
- Ensuring that the government takes no action over the course of many cycles is, however difficult to control and predict ex ante and should be taken into consideration when designing such predetermined rules and reforms.

Option 2: FHA with Additional Guarantee Mechanism to flex in times of stress

Are options 1 and 2 radically different?

- In Option 2, there would be an explicit mechanism to provide mortgage credit in a crisis. Option 1 does not have this.
- However, under normal economic conditions, Options 1 and 2 share many of the same benefits and drawbacks.

Why do we need a separate mechanism? Would FHA and the Federal Reserve alone have the capacity to respond with sufficient speed and force during a crisis to preserve access to mortgage credit for American families?

- While the FHA and Federal Reserve have played a significant role in backstopping the housing market during the recent crisis, they should not be counted upon in future crises.
- The Federal Reserve is limited in its capacity to provide a liquidity backstop for all asset classes. Additionally, if the Federal Reserve stepped in during every crisis, it could promote financial recklessness. FHA, while allowing a significant portion of Americans to access mortgages during the recent crisis, has taken on an unsustainably large market share, which the Administration is committed to reducing. If the FHA is allowed to increase its market share during every crisis, there should be proper structuring and pricing in advance to avoid greater taxpayer risk.

In Option 2, how would the government backstop mechanism work during a crisis? How would you ensure that it is only scaled up during a true crisis and that its use is reduced when the crisis ends?

- One option is to prescribe a limit to the amount of mortgages that can be wrapped by a guarantee. The fee for this guarantee should be allowed to change depending on market conditions. In good economic times, the guarantee fee would be very high, but when the housing market deteriorates, it would be reduced.
- Alternatively, the cost of the guarantee could be fixed, but the amount of mortgage product that could be wrapped could vary depending on economic and housing conditions. In good economic times, there would be only a small amount of mortgage product able to be wrapped, but in stressful times, this amount would increase.

How will you prevent a future Administration and Congress from changing the nature of the backstop so that it becomes a guarantee used extensively during all economic conditions?

- While this is a risk for any reforms put in place, there are methods that this Congress and Administration can put in place to structure a backstop that can weather political change.
- Other provisions could be considered to limit the ability of future regulators to interfere with the proper functioning of a backstop. They might include auction mechanisms for guarantees where the private market determines the appropriate price for a guarantee. Additionally, the amount of guarantee offered could change based upon certain economic indicators, to ensure that the guarantee properly adjusts for changing economic conditions.

<u>Option 3: Government Reinsurance with Private Mortgage Guarantors bearing significant first loss</u>

Won't the presence of a government reinsurer just institutionalize more bailouts and moral hazard?

- An actuarially fair fee in return for reinsurance gives the government the ability to charge for the risk that it takes prior to any crisis. It also provides a mechanism to recoup losses.
- A government reinsurance program would provide clearer "rules of the game" so stakeholders and investors are not stuck in a guessing game about if, when, and how the government might take action in future housing or financial crises.
- The fact that the government is in a very remote risk position through the structuring of reinsurance reduces moral hazard risk to taxpayers.

In the reinsurer option, won't there only be a handful of private mortgage guarantors that are all Too Big To Fail?

- It will be essential to ensure adequate capital standards and strong regulation of the private mortgage guarantors to protect taxpayers.
- Broad reinsurance will likely attract a larger pool of investors to the mortgage market, enough to support a number of private mortgage guarantors. If large number of mortgage guarantors take attritional risk, it will encourage competition, more appropriate and efficient pricing, and reduce the likelihood of "too big to fail" through competition.
- It is important to note that the government reinsurance would only cover the loan or security itself, and would not be available to the mortgage guarantor .

- Additionally, if any of these entities is designated by the FSOC as systemically significant, they will be regulated by the Federal Reserve, pursuant to Dodd-Frank.

How would a government reinsurance scheme be different from the old Fannie/Freddie system?

- A well-capitalized set of private mortgage guarantors would put substantially more private capital at risk of first loss in front of the taxpayer than Fannie and Freddie, who held insufficient capital. Instead of building capital reserves by retaining earnings, Fannie and Freddie disbursed their profits to managers and shareholders.
- An explicit guarantee would be more transparent.
- A priced guarantee with a put-back mechanism and a first-loss position would encourage robust underwriting.
- Removing the conflicts of interests between private shareholders' profit motive and public missions would make and government reinsurer materially different from Fannie and Freddie.

How will you prevent private mortgage guarantors from competing on market share and engaging in a "race to the bottom" with lower underwriting standards, especially over the course of multiple housing cycles?

- The fact that these institutions are the first to bear losses related to borrower delinquency or default gives them a strong incentive to maintain credit standards.
- The deterioration of underwriting standards in the recent crisis was caused by several factors that will no longer issues under this plan.
    - Mortgage guarantors would be wholly private entities, unable to use public resources to absorb losses.
    - Additionally, in the previous system many mortgage chain participants were able to pass all of the credit risk to the entity that purchased the loans. In this model, the mortgage guarantor would retain significant (and first) credit exposure.
- Stronger oversight will also help maintain robust credit standards through multiple economic ups and downs.
- The explicit credit risk associated with government reinsurance would also encourage federal policymakers to consider potential budgetary effects, and will encourage them to maintain rigorous oversight of the industry.

Where will the reinsurance fees go when they are collected?

- There are two leading options. Reinsurance fees could be returned to general revenue fund as is done by GNMA, or they could be placed into a separate trust fund, as the FDIC does with the Deposit Insurance Fund (DIF).

How is the reinsurer different than GNMA? Would the reinsurance be accomplished through GNMA?

- The function of the reinsurer is very similar to that of GNMA, and we could consider having GNMA become the reinsurer.

OTHER

Why doesn't this plan address concentration in the lending industry and how that affects access to affordable mortgage credit?

- The Administration supports drawing on competitive forces to lower consumer lending rates, whether through reduction of the governmental presence in the mortgage market or through ensuring competition among private mortgage guarantors.

Why didn't the Administration address the Mortgage Interest Deduction (MID) in the paper and will the President address it in his budget?

- We are not actively considering a change to the MID, and the Administration considers tax reform to be a separate issue. That said, we are taking a holistic view of housing finance reform, and all reasonable reforms will receive due consideration.

International comparisons

How do homeownership rates in the US compare with other countries?

- The US has average homeownership rates compared to other countries
- However, the US also has substantially greater access to mortgage credit, illustrating that there are other factors that influence homeownership rates.

How much securitization of mortgages is there in other countries?

- The US mortgage market is unique in its reliance on securitization as a funding source – 60% of outstanding mortgages in the US are funded by securitization
- The next biggest users of securitization are Australia, Canada, Spain, Netherlands, and the U.K., but MBS securities account for less than 30% of the mortgages outstanding in all these countries

FACTSHEET: HOUSING FINANCE REFORM BY THE NUMBERS

Fannie Mae and Freddie Mac

- Buy, bundle, and guarantee residential mortgages as mortgage-backed securities (MBS).
- Guarantee millions of loans, currently totaling $4.4 trillion as of December 2010.
- Traditionally guarantee about half of new mortgages, but their market share temporarily declined during the housing boom, as private-label securitization swelled.
- Hold investment portfolios of $1.49 trillion in mortgage-related loans and securities, about 20% of which in private-label MBS.
- Fund their investment portfolios with $1.522 trillion of debt at low interest rates because of the perception of USG support.
- Have traditionally drawn a large portion of their profits from their investment portfolios.
- Concentrate their activities in single-family mortgage loans, although also both securitize and invest in multifamily loans that finance rental housing.

The Federal Home Loan Bank system (FHLBs)

- A cooperative composed of 12 regional banks that are themselves owned cooperatively by private financial institutions domiciled in their individual districts.
- 600 members each, on average, from small community banks to large commercial banks.
- Currently $500 billion "advance" loans outstanding to members, collateralized by high-quality mortgage-related loans and securities.
- In the crisis, the FHLB advances ballooned to over $1 trillion, providing an important source of back-up funding to their members.
- Hold investment portfolios of about $330 billion in mortgage-related loans and securities.
- Fund their advances and investments with $814 billion of debt at an exceptionally low interest rate because of the apparent market perception of USG support (like Fannie and Freddie, the FHLBs are congressionally chartered).
- Allow members to take risks with mortgage loans while shifting the cost of that risk to taxpayers via the FDIC.

The Federal Housing Administration (FHA)

- Guarantees loans that are then bought and bundled as privately-issued securities, which are guaranteed as by Ginnie Mae (the Government National Mortgage Association).
- Traditionally focuses on first-time and lower-income homebuyers, in part through lower requirements for down payments than Fannie and Freddie.
- Guarantees millions of loans, currently totaling over $1 trillion.
- Traditionally guarantees only 10-15% of new mortgages, but the FHA's market share has swollen to nearly 30% during this housing crisis;
- Ginnie Mae also stamps MBS backed by loans guaranteed by the VA (about 15% of recent GNMA issuance) and the USDA (rural housing, under 10% in the last two years).

Multifamily / Rental Housing

- One-third of all Americans are renters – about 100 million people.

- Fannie Mae and Freddie Mac's market share in multifamily lending expanded from 40% in 2007 to 80% in 2009 as market conditions eroded and private lenders collapsed or withdrew.
- Fannie Mae and Freddie Mac's aggregate multifamily investment portfolios totaled $347 billion in mortgage-related loans and securities, about 70% of which in whole loans and 30% in mortgage-related securities (as of September 30, 2010).
- About $42 billion of multifamily loans are guaranteed by Fannie or Freddie but held by private investors.
- Risk Sharing: Fannie delegates underwriting but requires 33% risk retention of underwriters, while Freddie assumes all credit risk after detailed credit review.

Affordability & Access

- Over 40% of home purchases are by low/moderate-income families and communities.
- Almost 50 million renters now spend more than 30% of their income on rent (the most common benchmark for affordability); and one-fourth spend more than 50% of their income on rent – double the share in 1960.
- For every 100 *very* low-income renters, there are only 60 rental homes that are both adequate and affordable rental homes; for every 100 *extremely* low-income renter there are only 32 such units.

Housing Market: fragile but signs of stabilization

- House prices remain fragile as the FHFA purchase-only index remains below its November 2009 level after changing little in the fall of 2010.
- Low mortgage rates continue to keep affordability indices at record high levels.
- In 2010, single-family sales were at their lowest level since 1997. New and existing home sales increased in December, but remained below levels seen in 1H 2010.
- Inventory of existing homes has fallen to 8 months' supply, still double the pre-boom average.
- Mortgage delinquency rates have leveled off, but remain quite high, with over 9% of all mortgage loans delinquent in the third quarter of 2010 – about twice the historical average.
- New foreclosures have temporarily declined as lenders review internal procedures related to foreclosure processing, but the number of foreclosures currently in process is roughly equal to the number completed since 2009, and analysts predict that in the next several years, the total number of completed foreclosures may triple.
- Homeowners in HAMP permanent modifications perform well, with re-default rates below industry norms.

Concentration

- Currently, the top 5 mortgage originators control more than 60% of all origination. This is triple their market share in the early 1990's

EXHIBIT 17

POLITICO

'With every criticism, there's an opportunity to learn' said DeMarco (right). | JAY WESTCOTT/POLITICO

Housing head at home with criticism

By JOSEPH WILLIAMS | 10/26/2011 11:20 PM EDT

Depending on whom you ask, federal housing finance czar Edward DeMarco, described as the most powerful man in Washington housing policy, is preventing a desperately needed rebound of the national housing market — or is instituting long-overdue fiscal discipline to the government's role in the mortgage market.

Ask DeMarco — acting director of the Federal Housing Finance Agency, overseer of financially troubled, federally backed mortgage buyers Fannie Mae and Freddie Mac — and he insists he's just doing his job.

“I’m an independent regulator,” he told POLITICO in a recent interview. “I’m not trying to be a friend or foe to anyone.”

There’s little doubt he has few of the former and plenty of the latter.

Democrats, for example, have wanted him fired because he resisted proposals to use Fannie and Freddie as a lifeline for underwater homeowners by writing down or, in some cases, writing off billions in federally backed loans. Such a move would help bring the relief President Barack Obama has long promised to distressed homeowners but would also drench the mortgage giants — which have already soaked up $169 billion in taxpayer bailouts — in a fresh wave of red ink.

Writing to the White House earlier this month, House Democrats complained that DeMarco “still refuses to assert his authority and ease the restrictions” that would help a wide swath of desperate middle-class homeowners facing foreclosure. “Millions of people across the country are suffering, and we still don’t have a sufficient plan from FHFA to stem this crisis,” they wrote.

Republicans, on the other hand, were thwarted in their legislative attempts to wipe out Fannie and Freddie when the conservator sharply criticized a series of 15 bills filed earlier this year.

At the same time, DeMarco frustrated the banking industry by using his conservator powers to introduce sweeping reforms to make the mortgage industry more efficient and transparent — including plans to standardize credit and property appraisals, clarifying transactions involving complex mortgage-backed securities and pushing back hard against a proposal that would limit compensation to securities holders.

“I don’t think the industry views me as a particular friend,” DeMarco said.

With criticism coming from the left and the right — including a scathing Washington Post opinion piece by Lawrence Summers, formerly Obama’s top economic adviser — it would seem that job security would not be assured for DeMarco, whom Obama didn’t nominate and the Senate didn’t confirm for the top FHFA job. But as the head of an independent supervisory agency, he can’t be fired, and so far he’s reportedly resisted White House and Treasury Department pressure to step down.

But DeMarco insists he’s unfazed.

“With every criticism, there’s an opportunity to learn and assess how one is doing, and whether there are lessons to be learned from that,” he said. “I don’t drive what I do or what FHFA does by the criticism we’ve received, or the praise we get, for that matter.

“We learn from criticism. We appreciate praise. But we’re not guided by that.”

EXHIBIT 18

Rep. Frank joins calls for top Fa Freddie regulator to be replac

BY MIKE LILLIS - 03/11/12 10:28 PM EDT

Just In...

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INTERNATIONAL — 24M 24S AGO

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Fight over national monuments intensifies
ENERGY & ENVIRONMENT — 1H 11M AGO

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BLOG BRIEFING ROOM — 1H 14M AGO

VIEW ALL

Rep. Barney Frank has joined the growing chorus of Democrats calling for the removal of the nation's leading housing regulator.

The Massachusetts Democrat said Edward DeMarco, head of the federal agency that oversees Fannie Mae and Freddie Mac, has been "too rigid" in his approach to foreclosure prevention and should be replaced.

"He's been too rigid in refusing to help on foreclosures," Frank, the ranking member of the House Financial Services Committee, said Wednesday. "He's acting as if he was head of two private companies called Fannie and Freddie and not taking into account the impact this has on the economy, and I think he should be more cooperative with efforts to reduce foreclosures."

Asked if DeMarco should go, Frank said, "Yes. ... since he won't be more flexible, yes."

But Frank was also quick to concede that replacing DeMarco is no guarantee the Federal Housing Finance Agency (FHFA) would adopt the more aggressive foreclosure-prevention policies DeMarco's critics have urged.

Instead, because Senate Republicans would likely block any permanent replacement President Obama nominated, the White House would be required, by law, to seat one of DeMarco's top FHFA deputies – officials who support DeMarco's strategies, Frank said, and would likely continue the same foreclosure policies that have so angered Democrats and housing advocates.

"If they got rid of DeMarco they'd have to replace him with one of the other three [FHFA] division heads, who'd be the same as him," Frank said. "The president could only replace DeMarco with somebody who would be probably more rigid than DeMarco."

The whirlwind surrounding DeMarco and the FHFA has been swirling for months as millions of homeowners remain underwater, the housing market remains volatile and the Obama administration's efforts to provide relief have fallen far short of their targets.

As head of the FHFA — an independent agency created in 2008 to respond to the plunging housing market — DeMarco is charged with protecting the taxpayers, who bailed out Fannie and Freddie to the tune of roughly $160 billion. That part is not in dispute. Where DeMarco and his critics differ is how the FHFA can best accomplish that task — an argument that's recently revolved around the issue of principal write-downs.

DeMarco has said repeatedly that he has authority to reduce mortgage principal to prevent foreclosures, but won't use it because it's the least effective way to protect the taxpayer's investment in Fannie and Freddie. Instead, he's focused the FHFA's anti-foreclosure efforts on cutting interest rates, extending the length of loans and offering principal forbearance. Those strategies, he says, strike the proper balance between helping homeowners, protecting taxpayers and avoiding moral hazard.

"What FHFA has consistently found in its analysis is that ... those tools work better than ... [principal reduction] with regard to our fundamental mandate of conserving and preserving [Fannie and Freddie]," DeMarco told a Senate panel earlier this month.

Critics of that position, including a long list of Democrats and housing advocates, disagree, maintaining that FHFA should reduce principal balances for those homeowners threatened most by foreclosure. The resulting market stabilization, they argue, would also benefit Fannie and Freddie — and therefore the taxpayers DeMarco is charged with serving.

"It can't be that that [principal forgiveness] would never be right," Frank said. "He's in charge of the largest amount of residential property in America. It can't be in his interest in this crisis not to stabilize it [the housing market]."

Frank was quick to praise DeMarco's business acumen, saying he's done a "very good job" stabilizing Fannie and Freddie. But his unwillingness to prevent more foreclosures for the sake of the broader economy, Frank added, is a mistake.

"Since it's been in a conservatorship, we're not losing any money. The new loans they are making have been solid," Frank said. "He's done a very good job of running it, but he has been too rigid about the impact that it has on the economy."

Frank emphasized that the controversy surrounding DeMarco's approach to principal reduction is not a legal one.

"He has not tried to claim that he has no legal authority to do that," Frank said. "It's a policy choice and, I think, a mistaken one."

Democrats are pointing to reports indicating that private mortgage lenders are using principal reductions as a way to protect their investments. If that strategy is good enough for Wall Street, they ask, why not for Fannie and Freddie?

"They're finding it profitable on their own portfolios to do principal write-downs," a Senate Democratic staffer said Friday. "It doesn't make a damn bit of sense not to do any principal reductions [at FHFA]."

Edward Pinto, a fellow at the American Enterprise Institute (AEI) and formerly an executive vice president of Fannie Mae, had another take. He conceded private lenders are pursuing principal forgiveness, but usually only in cases when homeowners are hopelessly swamped as a result of taking out negative amortization and other exotic loans — arrangements Fannie and Freddie largely avoided, he said. With that in mind, Pinto said, DeMarco is correct to avoid principal reductions.

"His math and analysis is accurate," Pinto said. "It would be very expensive to do this [at FHFA]."

On Thursday, members of the Senate Banking Committee will examine that issue. The hearing, a joint effort between Banking's housing and securities subpanels, will feature testimony from FHFA's inspector general, as well as private lenders who are using principal forgiveness to protect investments.

Under the law, FHFA directors serve for five-year terms, while acting directors serve indefinitely, until a director is nominated and confirmed by the Senate.

Obama's one stab at filling the vacancy atop FHFA ended in failure. In November of 2010, the president tapped North Carolina Banking Commissioner Joseph Smith to head the agency, but Senate Republicans — notably Sen. Richard Shelby (Ala.), the ranking member of the Banking Committee — blocked the appointment.

Smith withdrew from the running two months later, and Obama has so far declined to nominate another figure.

The White House on Friday declined to comment for this story.

John Taylor, president and CEO of the National Community Reinvestment Coalition, a housing advocacy group, said it wouldn't benefit Obama to remove DeMarco until he's certain the replacement would focus more intently on foreclosure prevention.

"The process shouldn't just end up with the next in line [at FHFA]," Taylor said Friday. "He needs to get to the point where he's got somebody on the same team."

Some Democrats and advocates have urged Obama to replace DeMarco using a recess appointment, like the president did in January when he named Richard Cordray to head the new Consumer Financial Protection Bureau (CFPB).

But Frank said it’s unlikely Obama would take that controversial step twice.

"Having done the CFPB recess, he doesn't want to do another one," Frank said.

Meanwhile, some housing advocates fear the debate over FHFA's anti-foreclosure efforts could become overly political at the expense of struggling homeowners.

David Abromowitz, a housing lawyer and senior fellow at the Center for American Progress, said he's worried the foreclosure-prevention issue will "get sidetracked" by a "partisan fight over the powers of the president."

"If this becomes a question of whether Obama can or can't get an appointment versus [whether] FHFA is doing a good job," he said, "then we'll lose a window of time when we could be preventing foreclosures."

SHARE TWEET PLUS ONE

EXHIBIT 19

UNITED STATES DISTRICT COURT
DISTRICT OF COLUMBIA

In re Fannie Mae/Freddie Mac Senior Preferred Stock Purchase Agreement Class Action Litigations	**Misc. Action No. 13-mc-1288 (RLW)**
THIS DOCUMENT RELATES TO: **ALL CASES**	CLASS ACTION **CONSOLIDATED AMENDED CLASS ACTION AND DERIVATIVE COMPLAINT**

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Plaintiffs Melvin Bareiss, Joseph Cacciapalle, John Cane, Francis J. Dennis, Michelle M. Miller, Marneu Holdings, Co., United Equities Commodities, Co., and 111 John Realty Corp. (collectively "Plaintiffs"), by the undersigned attorneys, submit this Consolidated Amended Class Action and Derivative Complaint against the defendants named herein.

NATURE AND SUMMARY OF THE ACTION

1. This is a class action brought by Plaintiffs on behalf of themselves and several classes (the "Classes," as defined herein) of holders of preferred stock or common stock issued by either the Federal National Mortgage Association ("Fannie Mae" or "Fannie") or the Federal Home Loan Mortgage Corporation ("Freddie Mac" or "Freddie;" Fannie Mae and Freddie Mac together, the "Companies"), seeking damages and equitable relief, including rescission, for breach of contract and breach of the implied covenant of good faith and fair dealing, in connection with the Third Amendment to Amended and Restated Senior Preferred Stock Purchase Agreement, dated August 17, 2012 (the "Third Amendment"), between the Defendant United States Department of the Treasury ("Treasury") and the Defendant Federal Housing Finance Agency ("FHFA") in its capacity as conservator for Fannie Mae and Freddie Mac.

2. This is also a class action brought by Plaintiffs on behalf of themselves and a sub-class (the "Takings Class," as defined herein) of certain holders of preferred stock or common stock issued by either Fannie Mae or Freddie Mac, seeking just compensation for the taking of private property in violation of the Takings Clause and Due Process Clause of the United States Constitution.

3. This is also a derivative action brought by Plaintiffs on behalf of Fannie Mae, seeking damages and equitable relief, including rescission, for breach of fiduciary duty. Plaintiffs allege the following based upon personal knowledge as to themselves and their own

acts and upon information and belief as to all other matters. Plaintiffs' information and belief is based on, inter alia, the investigation of Plaintiffs' counsel.

4. Fannie Mae and Freddie Mac are government sponsored enterprises chartered by the U.S. Congress to facilitate liquidity and stability in the secondary market for home mortgages. While they are commonly referred to as "Government Sponsored Enterprises" or "GSEs," Fannie Mae and Freddie Mac are not government agencies. Instead, as private, for-profit corporations, the Companies have shareholders, directors, and officers like other non-governmental corporations, and their debt and equity securities have for years been privately owned and publicly traded, including by public pension funds, mutual funds, community banks, insurance companies, and myriad individual investors.

5. Although both Fannie and Freddie were chartered by the U.S. Congress, the federal government did not guarantee, directly or indirectly, their securities or other obligations. Fannie and Freddie were stockholder-owned corporations, and, before the 2008 financial crisis, their businesses were self-sustaining and funded exclusively with private capital.

6. To raise capital, the Companies issued several publicly traded securities including common stock and numerous classes of non-cumulative preferred stock ("Preferred Stock"). The Preferred Stock, which had the essential characteristics of a fixed income security, was long perceived to be a conservative investment paying modest but reliable rates of return and carrying high credit ratings. The common stock, in turn, participated in the earnings of the Companies for many years. By 2008, Fannie Mae and Freddie Mac were two of the largest privately owned financial institutions in the world, and had been consistently profitable for decades.

7. In July 2008, in response to the crisis in the residential housing and mortgage markets, Congress passed the Housing and Economic Recovery Act of 2008 ("HERA"), creating

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FHFA to oversee the operations of Fannie Mae and Freddie Mac. Congress empowered FHFA to serve as Conservator to the Companies when necessary to preserve their financial health. When acting as Conservator, FHFA is obligated to manage the Companies with the goal of putting them in a sound and solvent financial condition while preserving and conserving their assets. 12 U.S.C. § 4617(b)(2)(D). Congress also authorized Treasury to provide limited financial assistance to the Companies by purchasing securities issued by the Companies if it determined that such purchases would help stabilize financial markets, prevent disruptions in the mortgage markets, and protect taxpayers.

8. Just two months after HERA's enactment, on September 6, 2008, FHFA placed Fannie Mae and Freddie Mac into temporary conservatorship. The objective of the conservatorship was to stabilize the institutions so they could return to their normal business operations. Indeed, by statute, the purpose of appointing the conservator was "to preserve and conserve the [Companies'] assets and property and to put the [Companies] in a sound and solvent condition." HERA expressly grants FHFA, as Conservator, the power to take such action as may be necessary to put the Companies in a "sound and solvent condition" and that is appropriate to "carry on the business of the Companies" and "preserve and conserve the[ir] assets and property." FHFA itself vowed, at the time the Companies were placed into conservancy, that it was committed to operating the Companies "until they are stabilized" and that the conservatorship would be terminated upon successful completion of its plan to restore the Companies to "a safe and solvent condition." The public was entitled to rely on these official statements of the purposes of the conservatorship, and public trading in the Companies' stock was allowed to, and did, continue.

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9. In connection with the appointment of FHFA as Conservator, Fannie Mae and Freddie Mac each entered into a Senior Preferred Stock Purchase Agreement ("PSPA") with Treasury. Under these contracts, Treasury agreed to invest in a newly created class of securities in the Companies, known as Senior Preferred Stock ("Government Stock"), when and as necessary for the Companies to maintain a positive net worth. In return for its commitment to purchase Government Stock, Treasury received $1 billion of Government Stock in each Company as a commitment fee and warrants to acquire 79.9% of the common stock of the Companies at a nominal price. The Government Stock ranked senior in priority to all other series of Fannie Mae and Freddie Mac Preferred Stock, and would earn an annual dividend, paid quarterly, equal to 10% of the outstanding liquidation preference, i.e., the sum of the $1 billion commitment fee plus the total amount of Government Stock outstanding. The warrants to acquire a 79.9% ownership stake in the Companies gave Treasury a significant "long" position – over and above the substantial 10% coupon on its Government Stock – which, if exercised, could result in enormous profits to the government in the event the Companies returned to profitability.

10. Shortly after being placed into conservatorship, the Companies, under the control of FHFA, wrote down their assets significantly. FHFA caused the Companies to declare large non-cash losses in the value of deferred tax assets, and to take out large loss reserves on their balance sheets. These accounting adjustments reflected exceedingly negative views about the Companies' future financial prospects and temporarily decreased the Companies' operating capital and their net worth by hundreds of billions of dollars. To fill the holes in the Companies' balance sheets created by these significant write-downs, Treasury immediately began purchasing Government Stock. By mid-2012, Treasury had invested approximately $189 billion in Government Stock, the majority attributable to these accounting adjustments, and the remainder

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to repay Treasury the hefty 10% coupon on its outstanding Government Stock – dividends that had ballooned to approximately $19 billion annually, or nearly $5 billion quarterly.

11. Treasury made its investment in Fannie Mae and Freddie Mac pursuant to temporary authority established under Section 1117 of HERA. That authority expired on December 31, 2009. Before the authority expired, Treasury and FHFA made two substantive amendments to the PSPAs (neither of which are challenged in this lawsuit).

12. By the second quarter of 2012, both Fannie Mae and Freddie Mac had returned to profitability and were solvent. The Companies made a combined quarterly profit of $8.3 billion in the second quarter of 2012, or approximately 170% of the $5 billion quarterly dividend payable to Treasury on its Government Stock. Thus, by no later than the end of the second quarter of 2012, the Companies were generating sufficient profits to pay a dividend on the Preferred Stock, from available cash, to private investors. And once the 10% coupon on the Government Stock was paid in full, and the Companies' satisfied their contractual obligations to holders of the Preferred Stock, Treasury would also be entitled to dividends with respect to its ownership of 79.9% of the Companies' common stock (assuming exercise of Treasury's warrants).

13. Furthermore, as the housing market recovered, it became clear that the Companies' actual financial condition was never as bad as FHFA projected when it ordered the Companies to write down their balance sheets. For example, between 2008 and 2012, the Companies' actual realized loan losses were far less – by about $100 billion – than their anticipated losses. As their financial conditions have improved, the Companies have been able to reverse the earlier write-downs of their deferred tax assets and loss reserves. Significantly, the excessive write-downs were what caused Treasury to inject surplus funds into the Companies in

the first place, triggering billions of dollars of payments back to Treasury under the 10% coupon on Government Stock, which, in turn, required further draw downs on Treasury's funding commitment.

14. Consequently, by no later than the second quarter of 2012, Treasury was well-positioned to reap the fruits of its investment in Fannie Mae and Freddie Mac. As the housing recovery gained traction, the stream of profits on Treasury's investments in the Companies was projected to continue, and grow, in the coming years. Indeed, coupled with the expected reversal of loss reserves and the write-up in value of other assets, the Companies' net worth was poised to increase by several hundred billion dollars. Treasury was entitled to a substantial 10% coupon on its Government Stock (now payable out of the Companies' available cash), and to 79.9% of the Companies' profits going forward, subject to the Companies' fulfillment of their contractual obligations to the holders of their Preferred Stock. In addition, Treasury, through FHFA, as Conservator, could require Fannie Mae and Freddie Mac to begin repaying the principal of Treasury's investment in the Companies by redeeming Treasury's Government Stock.

15. Instead, Treasury insisted on all of the Companies' profits, forever. Accordingly, rather than exercising its right to purchase up to 79.9% of the Companies' common stock or taking steps to enable the Companies to redeem the Government Stock, FHFA, as Conservator, and Treasury acted together to ensure that Treasury would be the sole beneficiary, to the exclusion of all other shareholders, of the Companies as operating enterprises.

16. Specifically, FHFA and Treasury announced the "Third Amendment" to the PSPAs. The Third Amendment had devastating consequences for holders of the Preferred Stock and common stock. In place of the 10% coupon due on Treasury's Government Stock, the Third Amendment changed the PSPAs so as to entitle Treasury to a dividend of 100% of all current

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and future profits of the Companies. As a result of this purported "amendment" to the terms of the Companies' PSPAs with Treasury, Fannie Mae and Freddie Mac would be left with no funds to redeem Treasury's Government Stock or distribute to the holders of Preferred Stock or common stock, whether by dividend, redemption, or in a liquidation. Indeed, since the PSPAs provided that in the event of a liquidation of Fannie Mae or Freddie Mac, the Government would receive a liquidation preference that included the amount of any prior unpaid dividend, the Third Amendment guaranteed that even if the Companies were liquidated, Treasury would receive the full amount of their net worth in that liquidation.

17. The Third Amendment, which Fannie Mae, Freddie Mac, and the Government implemented without seeking or obtaining the consent of the holders of Preferred Stock or common stock as contractually required, sidestepped the rules of priority, eliminated the contractual rights of the Preferred Stock and common stock holders, and expropriated for the Government the economic value of these privately-held securities. As Treasury stated on the day of the announcement, the Third Amendment was intended to ensure that "every dollar of earnings that Fannie Mae and Freddie Mac generate will . . . benefit taxpayers."

18. Neither the Companies nor their private investors received any meaningful value in return for the Third Amendment. As noted above, under the Third Amendment, the amount of cash the Companies transfer to Treasury as a dividend does not reduce the amount of the Government Stock outstanding. Furthermore, the Companies have not been permitted to redeem Treasury's Government Stock. Thus, regardless of how much money the Companies send to Treasury, all of the Government Stock will remain outstanding, and Treasury will continue to take substantially all of the Companies' net worth, as long as they remain in business. The Third Amendment thus enriches the federal government through a self-dealing arrangement, and

destroys tens of billions of dollars of value in the Companies' Preferred Stock and common stock. Treasury and FHFA effectively nationalized two of the nation's biggest financial institutions, after they returned to profitability and while FHFA was supposed to be serving as their Conservator.

19. Treasury has reaped immense profits via the Third Amendment. On or about June 30, 2013, the Companies collectively paid Treasury a $66.3 billion dividend – more than fourteen times the $4.7 billion that Treasury would have received under the original 10% coupon on its Government Stock. Such large payments were not unexpected; shortly after the Third Amendment was executed, FHFA's Inspector General recognized that the new arrangement could result in an "extraordinary payment to Treasury." FHFA Office of Inspector General, Analysis of the 2012 Amendments to the Government Stock Purchase Agreements, at 15 (Mar. 20, 2013). Moreover, Treasury and FHFA maintain that this excess payment of $61.6 billion somehow does not represent a return on capital invested, and therefore do not take it into account as a repayment of funds that Treasury advanced to the Companies. Therefore, the liquidation preference of Treasury's Government Stock has not been reduced and stands at $189 billion (with approximately $117 billion attributable to Fannie Mae and $72 billion attributable to Freddie Mac) – i.e., the same amount as of the time of the Third Amendment. As a result of the Third Amendment, Treasury's annualized rate of return on its Government Stock for the quarter was a staggering 140%.

20. Moreover, the Companies have continued to report strong earnings and the payment of enormous dividends to Treasury for the second and third quarters of 2013. For example, for the most recent quarter the Companies reported $39.2 billion in combined profits and announced that they will collectively pay $39 billion in dividends to Treasury for the third

quarter of 2013 under the Third Amendment. Thus, by the end of this year, Fannie Mae will have paid an aggregate of approximately $113.9 billion in dividends to Treasury, and Freddie Mac will have paid approximately $71.345 billion – i.e., $9 million more than Freddie received from Treasury – for total dividend payments of $185.2 billion as of December 2013.

21. The statutes and regulations governing Treasury and FHFA did not authorize them to enter into the Third Amendment, and in fact, FHFA's actions were contrary to its statutory responsibility as Conservator to take those actions "necessary to put the [Companies] in a sound and solvent condition" and "appropriate to carry on the business of the [Companies] and preserve and conserve [their] assets and property." 12 U.S.C. § 4617(b)(2)(D).

22. The Third Amendment has stripped Fannie Mae and Freddie Mac of their ability to rebuild their capital reserves or to distribute dividends to Plaintiffs, the other members of the Classes, or other holders of Fannie Mae and Freddie Mac stock. Moreover, by appropriating the entirety of the Companies' net worth for the government's coffers on a quarterly basis, the Third Amendment has effectively eliminated the property and contractual rights of Plaintiffs and the Classes to receive their liquidation preference upon the dissolution, liquidation or winding up of Fannie Mae and Freddie Mac. FHFA and Treasury took away the Classes' rights:

- To receive dividend payments. Under the terms of the Preferred Stock certificates of designation and the Freddie Common Stock certificate of designation ("Certificates" or "Certificates of Designation"), Fannie Mae and Freddie Mac owed Plaintiffs and the other members of the Classes dividends, if declared, to the extent that the Companies earned profits above and beyond their requirement to pay the 10% dividend on the Treasury's Senior Preferred Stock. As of the second quarter of 2012, the quarters leading up to this filing, and for the foreseeable

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future, Fannie Mae and Freddie Mac's profits have exceeded or will likely exceed that threshold;

- To receive a liquidation distribution upon Fannie Mae and Freddie Mac's dissolution, liquidation or winding up, a right which was still worth a substantial amount of money even though it was junior to the liquidation preference of the Senior Preferred Stock; and
- To vote upon changes to the Preferred Stock or common stock that were materially adverse to stockholders.

23. Plaintiffs and the other members of the Classes paid valuable consideration in exchange for these contractual rights, and in doing so helped provide financial support for Fannie Mae and Freddie Mac's business both before and after the imposition of the conservatorship. Indeed, even after the imposition of the conservatorship, the contractual rights of Plaintiffs and the other members of the Classes had substantial market value – market value that swiftly dissipated in the wake of the Third Amendment.

24. The current projections for the Companies' continued profitability show that by the first quarter of 2014, they will be able not only to repay all of the money the Companies drew down from Treasury, but also to pay the requisite 10% annual dividend. But for the Third Amendment, Fannie Mae and Freddie Mac would be capable of paying billions in dollars in profits to the holders of their other Preferred Stock and their common stock, including the members of the Classes. Due to the Third Amendment, that money will all accrue to Treasury instead. Treasury will receive a massive surplus above and beyond its pre-Third Amendment contractual entitlements, and Plaintiffs and the other members of the Classes will receive nothing.

25. Entry into the Third Amendment by Treasury and FHFA, in its capacity as Conservator for Fannie Mae and Freddie Mac, was not an arm's length agreement, and was in breach of the express terms of the Certificates of the Preferred Stock and of Freddie Mac Common Stock, and in breach of the implied covenant of good faith and fair dealing inherent in such Certificates. This action seeks an award of compensatory damages for such breach to Plaintiffs and the other members of the Classes and/or equitable relief with respect to such breach, including rescission of the Third Amendment.

26. Entry into the Third Amendment by Treasury and FHFA also constituted an unlawful taking of private property under the Takings Clause and Due Process Clause of the United States Constitution. Even after the imposition of the conservatorship Plaintiffs and the Takings Class had a reasonable, investment-based expectation in the value of their dividend rights and liquidation preferences. Treasury and FHFA violated their property rights by effectively expropriating these contractual rights without any compensation whatsoever. This action seeks an award of just compensation to Plaintiffs and the other members of the Takings Class.

27. Moreover, Treasury, as *de facto* controlling stockholder of the Companies, stood on both sides of the decision to implement the Third Amendment. Although Treasury has gained, and will gain, enormous benefits from the Third Amendment, the Companies received nothing in return. As such, the Third Amendment was, and is, waste and not entirely fair to Fannie Mae, and constituted a breach of the fiduciary duties owed to Fannie Mae by FHFA and Treasury, as Fannie Mae's controlling stockholder. Furthermore, the Third Amendment was inconsistent and in conflict with FHFA's statutory responsibilities, as Conservator to the Companies, to put the Companies back into "a sound and solvent condition" and to "conserve

[their] assets and property." Accordingly, this action also seeks, derivatively on behalf of Fannie Mae, an award of compensatory damages and disgorgement for such breach and/or equitable relief with respect to such breach, including rescission of the Third Amendment.

JURISDICTION AND VENUE

28. This Court has subject matter jurisdiction over this action pursuant to 12 U.S.C. §§ 1452(c), 1723a(a) and 4617, and 28 U.S.C. §§ 1343(a)(3) and 1346(a)(2). In addition, this Court has subject matter jurisdiction under 28 U.S.C. § 1332(d)(2)(A) in that Plaintiffs and defendants are citizens of different states and the matter in controversy exceeds $5 million, exclusive of interest and costs. The Court also has subject matter jurisdiction over the state law claims asserted herein pursuant to 28 U.S.C. § 1367(a).

29. Venue is proper in this district under 28 U.S.C. §§ 1391(e)(1)(A) and (B), because this is an action against agencies of the United States; one or more of the Defendants reside in this district; and a substantial portion of the transactions and wrongs complained of herein, including the Defendants' primary participation in the wrongful acts detailed herein, occurred in this district. In addition, one or more of the Defendants maintains executive officers in this district, and Defendants have engaged in regular activities and conducted business here, which have had an effect in this district. Moreover, a substantial part of the events or omissions giving rise to this action occurred in this judicial district.

THE PARTIES

30. Plaintiff Melvin Bareiss is a citizen of the state of Kansas, and is a holder of Fannie Mae 8.25% Series T Preferred Stock. Mr. Bareiss purchased Fannie Mae Preferred Stock in May 2008, and has been a holder of Fannie Mae Preferred Stock continuously since then.

31. Plaintiff Joseph Cacciapalle is a citizen of the state of New Jersey, and is a holder of Fannie Mae 8.25% Series S Preferred Stock, Fannie Mae 8.25% Series T Preferred Stock, and

Freddie Mac 8.375% Series Z Preferred Stock. Mr. Cacciapalle purchased Fannie Mae Preferred Stock in January 2008, purchased Freddie Mac Preferred Stock in February 2008, and has been a holder of Fannie Mae Stock and Freddie Mac Preferred Stock continuously since then.

32. Plaintiff John Cane is a citizen of the state of Vermont, and is a holder of Fannie Mae Preferred 8.25% Series T Preferred Stock. Mr. Cane purchased Fannie Mae Preferred Stock in 2009, held Fannie Mae Preferred Stock as of August 17, 2012, and has been a holder of Fannie Mae Preferred Stock continuously since then.

33. Plaintiff Francis J. Dennis is a citizen of the state of New Jersey, and is a holder of Fannie Mae 8.25% Series S Preferred Stock and Fannie Mae 8.25% Series T Preferred Stock. Mr. Dennis purchased Fannie Mae Preferred Stock in May 2008, and has been a holder of Fannie Mae Preferred Stock continuously since then.

34. Plaintiff Michelle M. Miller is a citizen of the state of Missouri, and is a holder of Fannie Mae common stock and Freddie Mac common stock. Ms. Miller purchased Fannie Mae common stock in July 2010 and Freddie Mac common stock in October 2009, and has been a holder of Fannie Mae common stock and Freddie Mac common stock continuously since then.

35. Plaintiff Marneu Holdings, Co. is a New York general partnership, with offices in New York, N.Y. Its partners are New York citizens, such that it is also a New York citizen. Marneu Holdings, Co. is a holder of Fannie Mae 5.375% Series I Preferred Stock, Fannie Mae Variable Rate Series P Preferred Stock, Fannie Mae 4.75% Series M Preferred Stock, Fannie Mae 8.25% Series S Preferred Stock, Fannie Mae 5.375% Convertible Series 2004-1 Preferred Stock, Freddie Mac Fixed-to-Floating Rate Series Z Preferred Stock, and Freddie Mac 6.02% Series X Preferred Stock. Marneu Holdings, Co. purchased Fannie Mae Preferred Stock in

December 2009, and Freddie Mac Preferred Stock in October 2012, and has been a holder of Fannie Mae Preferred Stock and Freddie Mac Preferred Stock continuously since then.

36. Plaintiff 111 John Realty Corp. is a New York "S" corporation, with offices in New York, New York, and is therefore a citizen of the state of New York. 111 John Realty Corp. is a holder of Fannie Mae 8.25% Series S Preferred Stock. 111 John Realty Corp. purchased Fannie Mae Preferred Stock in September 2012, and has been a holder of Fannie Mae Preferred Stock continuously since then.

37. Plaintiff United Equities Commodities, Co. is a New York general partnership, with offices in New York, New York. Its partners are New York citizens, such that it is also a New York citizen. United Equities Commodities, Co. is a holder of Fannie Mae 8.25% Series T Preferred Stock and Freddie Mac Variable Rate Series M Preferred Stock. United Equities Commodities, Co. purchased Fannie Mae Preferred Stock in June 2011, and Freddie Mac Preferred Stock in October 2012, and has been a holder of Fannie Mae Preferred Stock and Freddie Mac Preferred Stock continuously since then.

38. Defendant FHFA, as Conservator of Fannie Mae, is an independent agency of the United States government with its headquarters located at Constitution Center, 400 7th Street, S.W., Washington, D.C. 20024, and therefore is a citizen of the District of Columbia. According to FHFA's strategic plan for fiscal years 2013-17, "[s]ince September 2008, FHFA has been the conservator of Fannie Mae and Freddie Mac… with responsibility of overseeing management and governance of the Enterprise[]."

39. Defendant Treasury is an executive agency of the United States government with its headquarters located at 1500 Pennsylvania Avenue, N.W., Washington, D.C. 20220, and

therefore is a citizen of the District of Columbia. The Department of the Treasury owns the Government Stock, and is a signatory to certain agreements central to this Complaint.

40. Defendant and nominal defendant Fannie Mae is a federally-chartered Government Sponsored Enterprise with its principal executive offices located at 3900 Wisconsin Avenue, N.W., Washington, D.C. 20016, and therefore is a citizen of the District of Columbia.

41. Defendant and nominal defendant Freddie Mac is a federally chartered Government Sponsored Enterprise with its principal executive offices located at 8200 Jones Branch Drive, McLean, Virginia, and is therefore a citizen of Virginia.

ADDITIONAL PARTIES

42. Plaintiff American European Insurance Company is a New Jersey corporation with offices in New York, New York, and is a holder of Fannie Mae 8.25% Series T Preferred Stock and Freddie Mac Variable Rate Series M Preferred Stock. American European Insurance Company held Fannie Mae Preferred Stock in May 2008 and Freddie Mac Preferred Stock in January 2001, and has been a holder of Fannie Mae Preferred Stock and Freddie Mac Preferred Stock continuously since then.

43. Plaintiff Barry P. Borodkin (acting individually and on behalf of his IRA and SEP IRA) is a citizen of the state of New York, and is a holder of Fannie Mae Variable Rate Series F Preferred Stock, Fannie Mae Variable Rate Series G Preferred Stock, Fannie Mae 5.81% Series H Preferred Stock, Fannie Mae 5.125% Series L Preferred Stock, Fannie Mae 4.75% Series M Preferred Stock, Fannie Mae 5.50% Series N Preferred Stock, Fannie Mae Variable Rate Series P Preferred Stock, Fannie Mae 6.75% Series Q Preferred Stock, Fannie Mae 7.625% Series R Preferred Stock, and Fannie Mae 8.25% Series S Preferred Stock and Fannie Mae 8.25% Series T Preferred Stock. Mr. Borodkin held Fannie Mae Preferred Stock prior to August 2012, and has been a holder of Fannie Mae Preferred Stock continuously since then.

44. Plaintiff Mary Meiya Liao is a citizen of the state of California, and is a holder of Fannie Mae 8.25% Series T. Preferred Stock. Ms. Liao purchased Fannie Mae Preferred Stock in May 2008, and has been a holder of Fannie Mae Preferred Stock continuously since then.

FACTS

I. BACKGROUND OF FANNIE MAE AND FREDDIE MAC

45. Fannie Mae and Freddie Mac are stockholder-owned corporations organized and existing under the Federal National Mortgage Act and the Federal Home Loan Corporation Act, respectively. Fannie Mae was established in 1938 as a federal agency to provide the mortgage market with supplemental liquidity, and was converted to a private corporation in 1968. Freddie Mac was created as an alternative to Fannie Mae to make the secondary mortgage market more competitive and efficient. Both Companies are Government Sponsored Enterprises, which are private corporations that Congress created to increase mortgage market liquidity. They seek to accomplish this by purchasing mortgages that private banks originate and bundling them into mortgage-related securities to be sold to investors. Through the creation of this secondary mortgage market, the Companies increase liquidity for private banks, which enables them to make additional loans to individuals for home purchases.

46. Notwithstanding their government charters, private shareholders owned Fannie Mae and Freddie Mac until 2007. Before 2007, the Companies were consistently profitable. In fact, prior to that time, the most recent full-year loss for Fannie Mae was in 1985, while Freddie Mac had never experienced an annual loss, according to the Companies' regulator.

II. FHFA PLACES THE COMPANIES INTO RECEIVERSHIP AND CAUSES THEM TO INITIATE MASSIVE WRITE-DOWNS

47. Beginning in 2006, an industry-wide financial crisis and nationwide declines in the housing market caused the Companies to suffer losses. As the Office of Federal Housing

Enterprise Oversight (the "OFHEO"), which was Fannie Mae and Freddie Mac's regulator at that time, stated in its 2008 annual report to Congress:

> In 2007, a confluence of factors – turmoil in the housing and mortgage markets, loss of liquidity in the credit marks, and volatility in the capital markets adversely impacted the financial performance of financial institutions . . . with significant exposure to mortgage markets. The Enterprises' financial results suffered along with the results of other financial institutions. Both Enterprises were unprofitable in 2007 – Freddie Mac's first annual net loss ever, and Fannie Mae's first since 1985.

48. Despite these losses, the OFHEO continued to assure the marketplace of the Companies' soundness. For example, in a March 19, 2008 statement, OFHEO director James Lockhart said that, "Fannie Mae and Freddie Mac have played a very important and beneficial role in the mortgage markets over the last year. Let me be clear – both companies have prudent cushions above the OFHEO-directed capital requirements and have increased their reserves. We believe they can play an even more positive role in providing the stability and liquidity the markets need right now." On that date, Lockhart also said that the idea of a bailout is "nonsense in my mind. The companies are safe and sound, and they will continue to be safe and sound." *As Crisis Grew, A Few Options Shrank To One*, N.Y. TIMES, Sept. 7, 2008. Similarly, on June 9, 2008, OFHEO published a news release stating that it classified Fannie Mae and Freddie Mac as "adequately capitalized as of March 31, 2008."

49. In July 2008, Congress enacted HERA, establishing FHFA to replace the OFHEO as the Companies' regulator, and granting Treasury temporary authority to assist the Companies through the purchase of securities. HERA provided a specific list of enumerated circumstances under which FHFA would have the power to place the Companies into conservatorship or receivership. HERA was passed not because Fannie Mae or Freddie Mac was deemed to be insolvent or operating unsafely at that time, but rather, to provide the struggling mortgage and financial markets with added confidence. As Treasury Secretary Henry Paulson testified to a

Congressional panel, "If you've got a bazooka, and people know you've got it, you may not have to take it out." *Paulson's Itchy Finger, on the Trigger of a Bazooka*, N.Y. TIMES, Sept. 9, 2008. Indeed, on July 10, 2008, Paulson and Federal Reserve Chairman Ben Bernanke both testified before the House Financial Services committee that Fannie Mae and Freddie Mac were adequately capitalized, and on July 10, 2008, the OFHEO issued a statement that, as of March 31, 2008, Fannie Mae and Freddie Mac were "holding capital well in excess of the OFHEO-directed requirement[.]"

50. Similarly, in support of HERA, Senator Isakson (R-GA) commented that:

> The bill we are doing tomorrow is not a bailout to Freddie Mac and Fannie Mae or the institutions that made bad loans. It is an infusion of confidence the financial markets need. Fannie and Freddie suffer by perception from the difficulties of our mortgage market. If anybody would take the time to go look at the default rates, for example, they would look at the loans Fannie Mae holds, and they are at 1.2 percent, well under what is considered a normal, good, healthy balance. The subprime market's defaults are in the 4 to 6 to 8-point range. That is causing the problem. That wasn't Fannie Mae paper, and it wasn't securitized by Fannie Mae. They have $50 billion in capital, when the requirement is to have $15 billion, so they are sound. But the financial markets, because of the collapse of the mortgage market, have gotten worse.

51. Nonetheless, on September 6, 2008, FHFA placed the Companies into conservatorship and, in a press release issued the next day, said that, "as the conservator, FHFA will assume the power of the Board and management." As the Conservator for the Companies, FHFA became responsible for "preserv[ing] and conserv[ing] [their] assets and property" and managing them in a manner that would restore them to a "sound and solvent condition." 12 U.S.C. § 4617(b)(2)(D). At the time, FHFA stated that the goal of this action was "to help restore confidence in Fannie Mae and Freddie Mac, enhance their capacity to fulfill their mission, and mitigate the systemic risk that has contributed directly to the instability in the current market." According to FHFA's press release, the conservatorship was "a statutory process designed to stabilize a troubled institution with the objective of returning the entities to

normal business operations. FHFA will act as the conservator to operate the Enterprises until they are stabilized." FHFA also issued a Fact Sheet indicating that, "[u]pon the [FHFA] Director's determination that the Conservator's plan to restore the Company to a safe and solvent condition has been completed successfully, the Director will issue an order terminating the conservatorship. At present, there is no exact time frame that can be given as to when this conservatorship may end."

52. The decision to place the Companies into conservatorship was driven not by analysis of the HERA statutory factors, but by broader macroeconomic and political concerns and the need to provide support for the struggling mortgage market. As the *New York Times* stated, the administration sought "to shrink drastically [Fannie Mae and Freddie Mac's] outsize influence on Wall Street and on Capitol Hill while at the same time counting on them to pull the nation out of its worst housing crisis in decades." *In Rescue To Stabilize Lending, U.S. Takes Over Mortgage Finance Titans*, N.Y. TIMES, Sept. 7, 2008. "In the end, [Secretary of the Treasury] Mr. Paulson's decision seems to have been a philosophical one, rather than one forced by imminent crisis. Of course, for stagecraft purposes, it was played as impending disaster." *Paulson's Itchy Finger, on the Trigger of a Bazooka*, N.Y. TIMES, Sept. 9, 2008.

53. Regarding the securities held by private investors, FHFA's director told investors that, among the "components of [the] conservatorship[,]" "the common stock and preferred stock dividends will be eliminated, but the common and all preferred stocks will continue to remain outstanding. Subordinated debt interest and principal payments will continue to be made." In another statement issued that same day, Treasury Secretary Paulson likewise made clear that, "conservatorship does not eliminate the outstanding preferred stock, but does place preferred shareholders second, after the common shareholders, in absorbing losses." And in a Form 8-K

filing issued by Freddie Mac on September 11, 2008, Freddie Mac stated that, “The holders of Freddie Mac’s existing common stock and preferred stock . . . will retain all their rights in the financial worth of those instruments, as such worth is determined by the market.” In a Form 8-K filing issued by Fannie Mae on September 11, 2008, Fannie Mae stated that:

> The Certificate of Designation for the Senior Preferred Stock provides that Fannie Mae may not, at any time, declare or pay dividends on, make distributions with respect to, or redeem, purchase or acquire, or make a liquidation payment with respect to, any common stock or other securities ranking junior to the Senior Preferred Stock **unless** (a) full cumulative dividends on the outstanding Senior Preferred Stock in respect of the then-current dividend period and all past dividend periods (including any unpaid dividends added to the liquidation preference) have been declared and paid in cash, and (b) all amounts required to be paid with the net proceeds of any issuance of capital stock for cash have been paid in cash. (emphasis added)

54. Thus, the conservatorship did not itself involve the appropriation of any Preferred Stock or common stock, amend any of the Certificates of Designation, or otherwise legally modify any contractual rights held by Plaintiffs or the other members of the Classes. Moreover, FHFA stated that it was critical to complete key regulations “so that any new investor will understand the investment proposition,” clearly implying that FHFA intended that private investors would continue to purchase Fannie Mae and Freddie Mac securities.

55. Treasury was authorized under HERA to strengthen the Companies’ balance sheets by purchasing their securities, within set time frames and consistent with prescribed statutory requirements. Beginning with HERA’s enactment in 2008 until the end of 2009, Congress authorized Treasury to “purchase any obligations and other securities issued by the [Companies] . . . on such terms and conditions as the Secretary may determine and in such amounts as the Secretary may determine.” 12 U.S.C. §§ 1455(l)(1)(A), 1719(g)(1)(A). To exercise this authority, the Secretary was required to determine that purchasing the Companies’ securities was “necessary to . . . provide stability to the financial markets; prevent disruptions in

the availability of mortgage finance; and protect the taxpayer." 12 U.S.C. §§ 1455(l)(1)(B), 1719(g)(1)(B). The Secretary was required to consider several factors in making these determinations:

> (i) [t]he need for preferences or priorities regarding payments to the Government; (ii) [l]imits on maturity or disposition of obligations or securities to be purchased; (iii) [t]he [Companies'] plan[s] for the orderly resumption of private market funding or capital market access; (iv) [t]he probability of the [Companies] fulfilling the terms of any such obligation or other security, including repayment; (v) [t]he need to maintain the [Companies'] status as private shareholder-owned compan[ies]; [and] (vi) Restrictions on the use of [the Companies'] resources, including limitations on the payment of dividends and executive compensation and any such other terms and conditions as appropriate for those purposes.

Id. §§ 1455(l)(1)(C), 1719(g)(1)(C).

56. Treasury used its temporary authority under HERA to enter into the PSPAs with FHFA, which acted on behalf of both Companies. The PSPAs are identical in all material respects. Under the PSPAs, Treasury purchased 1 million shares of Government Stock from each company in exchange for allowing the Companies to draw up to $100 billion each from Treasury. The Government Stock has a liquidation preference equal to $1 billion plus the sum of all draws by each company against Treasury's funding commitment. The Government Stock is also entitled to a cumulative dividend equal to 10% of the outstanding liquidation preference. If a company pays a dividend, the PSPAs require Treasury to be paid dividends declared in full, but not paid, for prior dividend periods, before any privately held securities may receive a dividend. Indeed, the PSPAs explicitly prohibit any shareholder other than Treasury from being paid any dividend without Treasury's consent. Further, if the Companies liquidate, no shareholder can recover anything before the Treasury recovers the full liquidation value of its shares. Treasury also has the right under the PSPAs to purchase up to 79.9% of the Companies' common stock at a nominal price.

57. On September 11, 2008, Fannie Mae filed with the U.S. Securities and Exchange Commission a Form 8-K disclosing further details regarding its conservatorship and the PSPA. Among other things, this Form 8-K stated that "FHFA, as Conservator, has the power to repudiate contracts entered into by Fannie Mae prior to the appointment of FHFA as Conservator if FHFA determines, in its sole discretion, that performance of the contract is burdensome and that repudiation of the contract promotes the orderly administration of Fannie Mae's affairs. FHFA's right to repudiate any contract must be exercised within a reasonable period of time after its appointment as Conservator." FHFA did not, either within a reasonable period of time after its appointment as Conservator or at any other time before August 17, 2012, purport to repudiate any of the contracts governing the Companies' Preferred Stock or common stock.

58. At the end of 2009, Treasury's statutory authority to purchase the Companies' securities expired. To enable Treasury to provide the Companies with liquidity beyond 2009, Treasury and FHFA amended the PSPAs twice. First, in May 2009, Treasury agreed to expand its funding commitment to $200 billion per company from $100 billion per company. Then, on December 24, 2009, just before the expiration of Treasury's temporary authority under HERA, it agreed to a funding commitment that would be sufficient to allow the Companies to satisfy their 2010, 2011, and 2012 capitalization requirements and a funding commitment up to a limit determined by an agreed-upon formula for subsequent years.

59. Before FHFA placed the Companies into conservatorship, Fannie Mae and Freddie Mac Preferred Stock enjoyed strong credit ratings, with all three major credit rating agencies assigning high investment-grade ratings on the Preferred Stock from the dates of issuance until 2008. Treasury and other federal agencies encouraged private entities to invest in

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the Companies, and banking regulators permitted banks to carry the Companies' Preferred Stock on their balance sheets at a lower risk weighting than other companies' preferred stock.

60. When the Companies entered conservatorship, FHFA suspended payment of dividends on all Preferred Stock and common stock, and the PSPAs explicitly prohibit payment of any such dividends without Treasury's consent. As a result, no dividends have been paid to the holders of the Companies' Preferred Stock and common stock since 2008.

61. Furthermore, after FHFA took control of the Companies, it decided that it did not expect them to be profitable, and that they would likely incur large losses in the coming years. FHFA therefore directed the Companies to book substantial loss reserves – recording loan losses before they were actually incurred – and required the Companies to eliminate from their balance sheets the value of non-cash deferred tax assets that would only be of use if the Companies became profitable.

62. These write-downs and accounting decisions directed by FHFA led to a circular payment obligation requiring the Companies to draw down Treasury's funding commitment, which, in turn, required the Companies to pay increased dividends to Treasury. Under the initial PSPAs, Treasury committed to make quarterly payments to the Companies in order to maintain a zero net worth. Each quarter, FHFA looked to the Companies' financial statements to determine if their liabilities exceeded their assets. If so, FHFA would request that Treasury draw down the Companies' funding commitment and provide funds equal to the net worth deficit. Because of the impact of the accounting adjustments directed by FHFA, the Companies had less capital, and therefore needed capital from Treasury both to operate and to pay the quarterly dividends due under the PSPAs. The Companies thus were required to draw additional funds from Treasury's funding commitment, thereby increasing the amount of Treasury's aggregate liquidation

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preference, and thus the amount of dividends payable to Treasury. Between 2008 and 2012, under the PSPAs, as amended, Treasury provided approximately $187 billion to the Companies.

63. Throughout this time, the Companies continued to be managed in conservatorship by FHFA. HERA empowered FHFA to force the Companies into receivership and to liquidate their assets under certain circumstances, 12 U.S.C. § 4617(b)(2)(E), but FHFA always has maintained that its relationship with the Companies is that of Conservator rather than liquidator. *See* News Release FHFA, *A Strategic Plan For Enterprise Conservatorships: The Next Chapter In A Story That Needs An Ending*, at 9 (Feb. 21, 2012) (asserting that "[w]ithout action by Congress, FHFA must continue to look to the existing statutory provisions that guide ***the conservatorships***.") (emphasis added).

III. THE COMPANIES RETURN TO PROFITABILITY

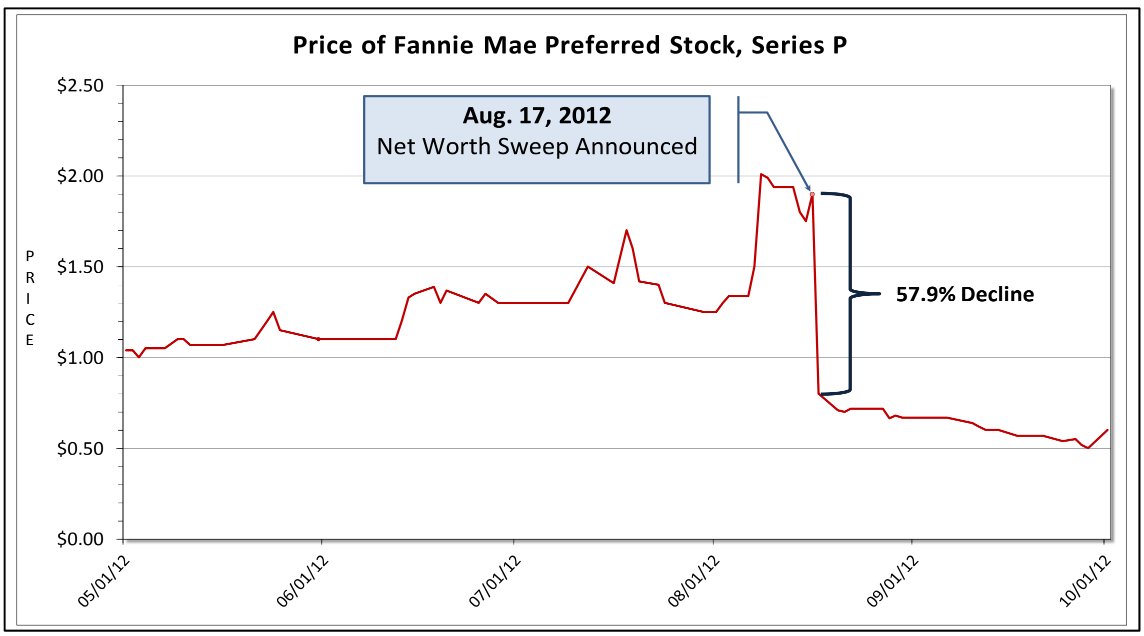
64. In 2012, it became clear that FHFA had overestimated the Companies' likely losses and underestimated the possibility of a return to profitability. For example, the Companies' actual loan losses were far less than anticipated. Between the beginning of 2007 and the second quarter of 2012, more than $234 billion had been set aside by the Company to absorb anticipated loan losses, whereas loan losses of just over $125 billion were actually recognized during that period, such that the projected losses had been overestimated by $109 billion.

65. Contrary to FHFA's 2008 projections, the Companies posted profits of more than $10 billion in the first two quarters of 2012. Even more importantly, the Companies disclosed that they expected to be consistently profitable for the foreseeable future, such that they would eventually be able to remove the valuation allowance against their deferred tax assets, worth approximately $100 billion.

66. Thus, the Companies were positioned to pay back the government for the support they had received, with money left over to provide a financial return to their private investors.

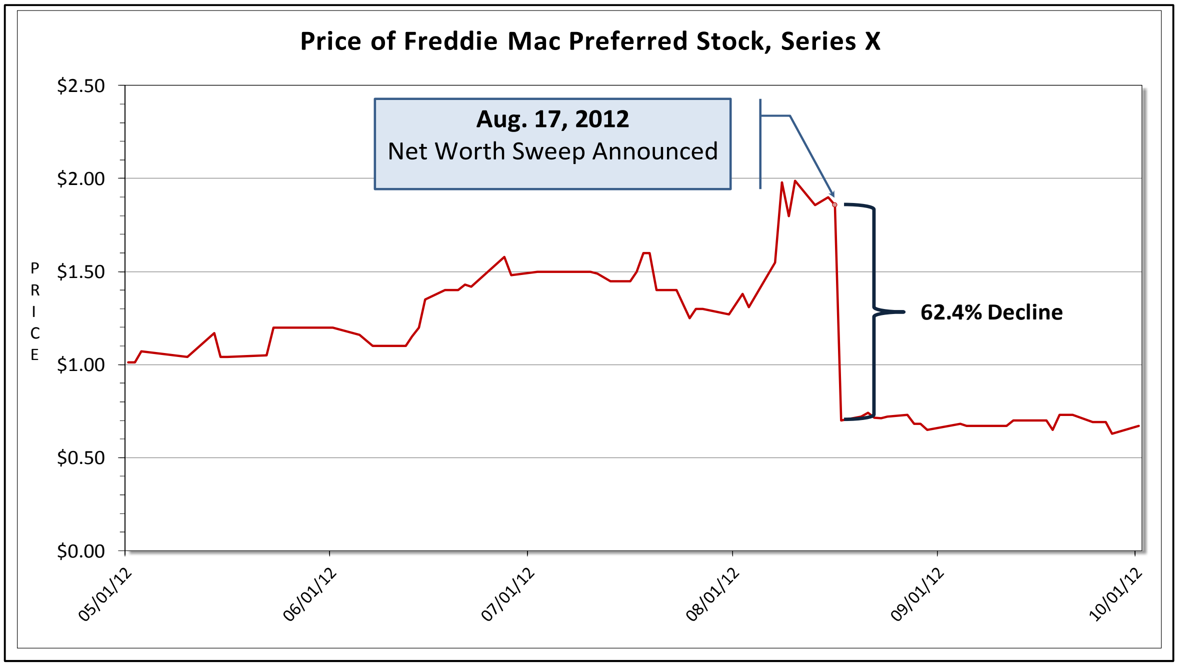
Yet instead of either allowing the Government Stock to be redeemed or compensating private investors for the excess value that the Companies were providing, Treasury and FHFA instead implemented the Third Amendment to ensure that private investors would be locked out of this recovery.

67. The return of Fannie Mae and Freddie Mac to profitability in 2012 led to a substantial increase in the trading prices of the Companies' Preferred Stock. In fact, the price of each series of Fannie Mae Preferred Stock increased between 67% and 115%, with an average of 83%, from May 1, 2012, to August 17, 2012, up until the time that Treasury issued a news release announcing the Third Amendment. The Series P Preferred Stock, for example, increased by 83% during that time period, only to decline significantly after the Third Amendment was announced:



68. Similarly, the price of each series of Freddie Mac Preferred Stock increased an average of 86% from May 1, 2012, to August 17, 2012. The Series X Preferred Stock, for

example, increased by 84% during that time period, but suffered a material decline after the Third Amendment was announced:



IV. THE THIRD AMENDMENT BARS THE COMPANIES' SHAREHOLDERS FROM PARTICIPATING IN THE COMPANIES' RETURN TO PROFITABILITY

69. With the Companies' return to consistent and record profitability, the holders of the Preferred Stock and common stock had reason to believe and expect that they would in time regain a return on their investment. They also had a reasonable expectation that the Companies would eventually be healthy enough to redeem the Government Stock, exit conservatorship, and be "return[ed] to normal business operations," as FHFA's director had vowed when the conservatorship was established.

70. These reasonable and realistic expectations of the holders of the Preferred Stock and common stock did not last long, however, due to the Government's own self-dealing rather than any change in the outlook for the housing market, broader economy, or the financial performance of the Companies.

71. As noted above, FHFA agreed to sweep all the Companies' profits to Treasury exactly when they had returned to stable profitability. At a dividend rate of 10%, Treasury's approximately $189 billion in outstanding Government Stock earns annual dividends of some $18.9 billion, payable in quarterly installments of approximately $4.7 billion. Thus, in any quarter in which the Companies' combined profits exceed $4.7 billion (or more precisely, any quarter in which Fannie Mae or Freddie Mac's profits exceed the dividend owed on their Government Stock), that value would inure to the benefit of the private shareholders ***but for the Third Amendment***. As FORTUNE magazine reported:

> Why did the Treasury enact the so-called Third Amendment that so radically altered the preferred-stock agreement? By mid-2012, Fannie and Freddie were beginning to generate what would become gigantic earnings as the housing market rebounded. If the original agreement remained in place, the GSEs would build far more than $100 billion in retained earnings, and hence fresh capital, in 2013 alone. That would exert pressure for Congress to allow Fannie and Freddie to pay back the government in full, and reemerge as private players. Timothy Geithner was strongly opposed to the rebirth of the old Fannie and Freddie. The "sweep clause" that grabbed the entire windfall in profits was specifically designed to ensure that Fannie and Freddie remained wards of the state that would eventually be liquidated.

What's Behind Perry Capital's Fannie and Freddie Gambit, FORTUNE, July 8, 2013.

72. In an August 17, 2012 press release announcing the modification of the PSPA, Treasury said that the changes would "help expedite the wind down of Fannie Mae and Freddie Mac, make sure that every dollar of earnings each firm generates is used to benefit taxpayers, and support the continued flow of mortgage credit during a responsible transition to a reformed housing finance market." It called the amendment a full income sweep of "every dollar of profit that [the] firm earns going forward," and that the amendment will fulfill the "commitment made in the Administration's 2011 White Paper that [Fannie Mae and Freddie Mac] will be wound down and will not be allowed to retain profits, rebuild capital, and return to the market in their prior form." This language was in stark contrast to their earlier representations that they sought

only to "stabilize" the Companies and return them "to normal business operations" (as well as the February 2, 2010 statement of Edward DeMarco, Acting Director of FHFA, that "[t]here are a variety of options available for post-conservatorship outcomes, but the only one that FHFA may implement today under existing laws is to reconstitute the two companies under their current charters.").

73. Treasury will receive a windfall in payments of dividends under the Third Amendment. In 2012, the Companies made combined profits of more than $28 billion. In the first quarter of 2013, they posted combined profits of approximately $15 billion, Fannie Mae added approximately $51 billion to its balance sheet by reversing write-downs of deferred tax assets, and Freddie Mac may soon be able to recognize tens of billions of dollars in deferred tax assets as well. At the end of the second quarter of 2013, the Third Amendment required the Companies to pay $66.3 billion to Treasury. At the end of the third quarter of 2013, the Third Amendment required the Companies to pay $39 billion to Treasury. In total, by the end of this year, Fannie Mae will have paid $113.9 billion in dividends to Treasury, and Freddie Mac will have paid $71.345 billion, *i.e.*, $9 million more than it received from the Government. Thus, by December 2013, the Companies' will have paid back a total of $185.3 billion in the form of dividends to Treasury, or within about $2 billion of the $187.5 billion they received from the government.

74. The President's proposed fiscal year 2014 budget estimates that Fannie Mae and Freddie Mac will together pay $238.5 billion in dividends to Treasury over the next ten years, far outstripping the government's investments. Even this figure likely underestimates the total value of the dividends that Treasury is likely to receive via the Third Amendment, since the budget was released before Fannie Mae announced its decision to release its deferred tax assets.

75. The Third Amendment is even capturing the Companies' recoveries on legal claims that preceded the conservatorships. For example, on October 1, 2013, Freddie Mac announced that it had entered into a $1.3 billion settlement with three financial institutions concerning Freddie Mac's claims relating to representations and warranties on loans that it had purchased, and that FHFA, as Freddie Mac's Conservator, had approved the settlement. The claims at issue involved loans that Freddie Mac purchased between 2000 and 2012, such that many of them preceded the conservatorship by years. Yet none of the funds recouped will go to benefit Freddie Mac shareholders. Rather, Freddie Mac's CEO stated that, "[w]ith these settlements, Freddie Mac is recouping funds effectively due to the nation's taxpayers."

76. Moreover, FHFA has announced other, similar settlements with financial institutions relating to breaches of representations and warranties on loans purchased by Fannie Mae and Freddie Mac well before the conservatorship. For example, on October 25, 2013, FHFA announced a $1.1 billion settlement, in its role as Conservator to Fannie Mae and Freddie Mac, with JP Morgan relating to claims that the bank repurchase breaching loans sold to Fannie and Freddie in the years leading up to the financial crisis. In addition, FHFA announced a separate $4 billion settlement with JP Morgan, also in FHFA's role as Conservator to the Companies, relating to claims that the bank violated the federal securities laws in the connection with the sales and securitizations of loans to the Companies from 2005 to 2007. Similarly, on May 28, 2013, FHFA announced a $3.5 billion settlement, in its role as Conservator to the Companies with Citigroup, covering claims of alleged violations of federal and state securities laws in connection with private-label residential mortgage-backed securities purchased by Fannie Mae and Freddie Mac. FHFA has announced similar settlements this year with General Electric ($549 million), UBS ($885 million) and Wells Fargo ($335 million). Most recently, on

December 2, 2013, it was announced that Bank of America agreed to pay Freddie Mac a total of $404 million to settle claims related to breaches of representations and warranties on approximately 716,000 single-family loans originated between 2000 and 2009 and sold to Freddie Mac.

77. In sum, the Government is now expropriating “every dollar of earnings that each firm earns” on a quarterly basis. This guarantees that there can never be a distribution to the holders of Preferred Stock or common stock no matter how much income the Companies earn and no matter how much their assets are worth in any liquidation. That is, the Preferred Stock and common stock holders’ stake in the Companies has been taken, in quarterly installments, since the moment the Third Amendment took effect, and this taking of their property will continue until the last dime has been extracted from the Companies if, and when, they are wound up.

78. Plaintiffs and other holders of the Preferred Stock and common stock had a reasonable, investment-backed expectation in the value of their right to a portion of the profits earned by the Companies and, thus, in the future dividends their stock would pay, if the Companies once again become profitable and restored to sound and solvent condition. Just as the Federal Government cannot seize corporate assets for a public purpose without paying just compensation, so too it cannot seize corporate stock to accomplish the same end.

V. THE THIRD AMENDMENT VIOLATED THE CONTRACTUAL RIGHTS OF HOLDERS OF THE COMPANIES’ PREFERRED STOCK AND COMMON STOCK

79. The Companies have issued common stock and several series of Preferred Stock that are, as a result of the PSPAs, subordinate to the Government Stock. Prior to September 6, 2008, Fannie Mae had issued common stock and several series of Preferred Stock, including:

FANNIE MAE STOCK

Security	CUSIP	Ticker Symbol
Common Stock	313 586 109	FNMA
5.25% Non-Cumulative Preferred Stock, Series D	313 586 505	FDDXD
5.10% Non-Cumulative Preferred Stock, Series E	313 586 604	FNMFM
Variable Rate Non-Cumulative Preferred Stock, Series F	313 586 703	FNMAP
Variable Rate Non-Cumulative Preferred Stock, Series G	313 586 802	FNMAO
5.81% Non-Cumulative Preferred Stock, Series H	313 586 885	FNMAM
5.375% Non-Cumulative Preferred Stock, Series I	313 586 877	FNMAG
5.125% Non-Cumulative Preferred Stock, Series L	313 586 844	FNMAN
4.75% Non-Cumulative Preferred Stock, Series M	313 586 836	FNMAL
5.50% Non-Cumulative Preferred Stock, Series N	313 586 828	FNMAK
Variable Rate Non-Cumulative Preferred Stock, Series O	313 586 794	FNMFN
5.375% Non-Cumulative Convertible Series 2004-1 Pref. Stock	313 586 810	FNMFO
Variable Rate Non-Cumulative Preferred Stock, Series P	313 586 786	FNMAH
6.75% Non-Cumulative Preferred Stock, Series Q	313 586 778	FNMAI
7.625% Non-Cumulative Preferred Stock, Series R	313 586 760	FNMAJ
Fixed-to-Floating Rate Non-Cumulative Preferred Stock, Series S	313 586 752	FNMAS
8.25% Non-Cumulative Preferred Stock, Series T	313 586 737	FNMAT

80. Likewise, prior to September 6, 2008, Freddie Mac had issued common stock and several series of Preferred Stock, including:

<u>FREDDIE MAC STOCK</u>

Security	**CUSIP**	**Ticker Symbol**
Common Stock	313 400 301	FMCC
5.1% Preferred Stock, due 12/31/2049	313 400 814	FREJO
5.3% Non-Cumulative Perpetual Preferred Stock	313 400 822	FREJP
5.81% Perpetual Preferred Stock	313 400 889	FREGP
Variable-Rate Preferred Stock, Series B	313 400 608	FMCCI
5% Preferred Stock, Series F	313 400 863	FMCKK
Variable-Rate Preferred Stock, Series G	313 400 848	FMCCG
5.1% Preferred Stock, Series H	313 400 855	FMCCH
5.79% Preferred Stock, Series K	313 400 830	FMCCK
Variable-Rate Preferred Stock, Series L	313 400 798	FMCCL
Variable-Rate Preferred Stock, Series M	313 400 780	FMCCM
Variable-Rate Preferred Stock, Series N	313 400 764	FMCCN
5.81% Preferred Stock, Series O	313 400 772	FMCCO
6% Preferred Stock, Series P	313 400 749	FMCCP
Variable-Rate, Series Q	313 400 756	FMCCJ
5.7% Preferred Stock, Series R	313 400 731	FMCKP
Variable-Rate, Series S	313 400 715	FMCCS

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6.42% Preferred Stock, Series T	313 400 699	FMCCT
5.9% Preferred Stock, Series U	313 400 681	FMCKO
5.57% Preferred Stock, Series V	313 400 673	FMCKM
5.66% Preferred Stock, Series W	313 400 665	FMCKN
6.02% Preferred Stock, Series X	313 400 657	FMCKL
6.55% Preferred Stock, Series Y	313 400 640	FMCKI
Fixed-to-Floating Rate Preferred Stock, Series Z	313 400 624	FMCKJ

81. This Preferred Stock and common stock, which was issued prior to the issuance of the Government Stock, is held by private investors such as pension funds, community banks, insurance companies, and individual investors. As of March 31, 2013, the Companies' outstanding Preferred Stock had an aggregate liquidation preference of $33 billion. Each class of Preferred Stock has its own contractual dividend rate and liquidation value.

82. Prior to September 8, 2008, each series of Fannie Mae Preferred Stock ranked on a parity with all other issued and outstanding series of Fannie Mae Preferred Stock as to the payment of dividends and the distribution of assets upon dissolution, liquidation or winding up of Fannie Mae, and each series of Freddie Mac Preferred Stock ranked on a parity with all other issued and outstanding series of Freddie Mac Preferred Stock as to the payment of dividends and the distribution of assets upon dissolution, liquidation, or winding up of Freddie Mac. In other words, each series of Fannie Mae and Freddie Mac Preferred Stock carried equal contractual rights to with regards to the dividends, and each series of Fannie Mae and Freddie Mac Preferred Stock carried equal liquidation preferences (or their respective pro rata portions thereof) upon dissolution, liquidation, or winding up of Fannie Mae and Freddie Mac. Prior to September 6,

2008, Fannie Mae and Freddie Mac each regularly declared and paid dividends on each series of their respective Preferred Stock.

83. Delaware law applies to Fannie Mae pursuant to Section 1.05 of its bylaws, which provides that "the corporation has elected to follow the applicable corporate governance practices and procedures of the Delaware General Corporation Law." Virginia law applies to Freddie Mac pursuant to Section 11.3 of its bylaws, which provides that, "[T]he Corporation shall follow the corporate governance practices and procedures of the law of the Commonwealth of Virginia[.]" Under both Delaware and Virginia law, preferred stock designations are deemed as amendments to a corporation's charter and are therefore generally reviewed as contractual in nature.

84. Thus, the Certificate of Designation for each series of Preferred Stock constitutes a contract with provisions governing the holders' dividend, liquidation rights and amendments to the terms of the Preferred Stock. These provisions are materially similar to, for example, the Certificate of Designation for Fannie Mae's Series T Preferred Stock, as described below:

> **1. Dividends.**
>
> (a) Holders of record of Series T Preferred Stock (each individually a "Holder," or collectively the "Holders") ***will be entitled to receive, ratably, when, as and if declared by the Board of Directors, in its sole discretion out of funds legally available therefore, non-cumulative cash dividends at [specified rate] per annum of the [specified] stated value . . . of Series T Preferred Stock.***
>
> * * *
>
> **4. Liquidation Rights.**
>
> (a) Upon any voluntary or involuntary dissolution, liquidation or winding up of Fannie Mae, after payment or provision for the liabilities of Fannie Mae and the expenses of such dissolution, liquidation or winding up, the Holders of outstanding shares of the Series T Preferred Stock ***will be entitled to receive out of the assets of Fannie Mae or proceeds thereof available for distribution to stockholders,*** before any payment or distribution of assets is made to holders of Fannie Mae's common stock (or any other stock of Fannie Mae ranking, as to the

distribution of assets upon dissolution, liquidation or winding up of Fannie Mae, junior to the Series T Preferred Stock), ***the amount of [the stated value] per share plus an amount . . . equal to the dividend (whether or not declared) for the then-current quarterly Dividend Period accrued to but excluding the date of such liquidation payment***, but without accumulation of unpaid dividends on the Series T Preferred Stock for prior Dividend Periods.

(b) If the assets of Fannie Mae available for distribution in such event are insufficient to pay in full the aggregate amount payable to Holders of Series T Preferred Stock and holders of all other classes or series of stock of Fannie Mae, if any, ranking, as to the distribution of assets upon dissolution, liquidation or winding up of Fannie Mae, on a parity with the Series T Preferred Stock, the assets will be distributed to the Holders of Series T Preferred Stock and holders of all such other stock pro rata, based on the full respective preferential amounts to which they are entitled (but without, in the case of any non-cumulative preferred stock, accumulation of unpaid dividends for prior Dividend Periods).

* * *

7. Voting Rights; Amendments.

* * *

(b) Without the consent of the Holders of Series T Preferred Stock, Fannie Mae will have the right to amend, alter, supplement or repeal any terms of this Certificate or the Series T Preferred Stock (1) to cure any ambiguity, or to cure, correct or supplement any provision contained in this Certificate of Designation that may be defective or inconsistent with any other provision herein or (2) to make any other provision with respect to matters or questions arising with respect to the Series T Preferred Stock that is not inconsistent with the provisions of this Certificate of Designation ***so long as such action does not materially and adversely affect the interests of the Holders of Series T Preferred Stock***; provided, however, that any increase in the amount of authorized or issued Series T Preferred Stock or the creation and issuance, or an increase in the authorized or issued amount, of any other class or series of stock of Fannie Mae, whether ranking prior to, on a parity with or junior to the Series T Preferred Stock, as to the payment of dividends or the distribution of assets upon dissolution, liquidation or winding up of Fannie Mae, or otherwise, will not be deemed to materially and adversely affect the interests of the Holders of Series T Preferred Stock.

(c) ***Except as set forth in paragraph (b) of this Section 7, the terms of this Certificate or the Series T Preferred Stock may be amended, altered, supplemented, or repealed only with the consent of the Holders of at least two-thirds of the shares of Series T Preferred Stock then outstanding,*** given in person or by proxy, either in writing or at a meeting of stockholders at which the Holders of Series T Preferred Stock shall vote separately as a class. On matters

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requiring their consent, Holders of Series T Preferred Stock will be entitled to one vote per share.[1]

85. The Certificate of Designation for the common stock issued by Freddie Mac also constitutes a contract with provisions governing the holders' dividend, liquidation rights and amendments to the terms of the common stock. These provisions provide, in pertinent part:

2. Dividends.

(a) The holders of outstanding shares of Common Stock shall be entitled to receive, ratably, dividends (in cash, stock or other property), when, as and if declared by the Board of Directors out of assets legally available therefor. The amount of dividends, if any, to be paid to holders of the outstanding Common Stock from time to time and the dates of payment shall be fixed by the Board of Directors of Freddie Mac (the "Board of Directors"). Each such dividend shall be paid to the holders of record of outstanding shares of the Common Stock as they appear in the books and records of Freddie Mac on such record date, not to be earlier than 45 days nor later than 10 days preceding the applicable dividend payment date, as shall be fixed in advance by the Board of Directors.

* * *

8. Liquidation Rights.

(a) Upon the dissolution, liquidation or winding up of Freddie Mac, after payment of or provision for the liabilities of Freddie Mac and the expenses of such dissolution, liquidation or winding up, and after any payment or distribution shall have been made on any other class or series of stock of Freddie Mac ranking prior to the Common Stock upon liquidation, the holders of the outstanding shares of the Common Stock shall be entitled to receive out of the assets of Freddie Mac available for distribution to stockholders, before any payment or distribution shall be made on any other class or series of stock of Freddie Mac ranking junior to the Common Stock upon liquidation, the amount of $0.21 per share, plus a sum equal to all dividends declared but unpaid on such shares to the date of final distribution. The holders of the outstanding shares of any class or series of stock of Freddie Mac ranking prior to, on a parity with or junior to the Common Stock upon liquidation shall also receive out of such assets payment of any corresponding preferential amount to which the holders of such stock may. by the terms thereof, be entitled. Thereafter, subject to the foregoing and to the provisions of paragraph (b) of this Section 8, the balance of any assets of Freddie Mac available for distribution to stockholders upon such dissolution, liquidation

[1] All emphasis added unless otherwise noted.

> or winding up shall be distributed to the holders of outstanding Common Stock in the aggregate.
>
> (b) Notwithstanding the foregoing, upon the dissolution, liquidation or winding up of Freddie Mac, the holders of shares of the Common Stock then outstanding shall not be entitled to be paid any amounts to which such holders are entitled pursuant to paragraph (a) of this Section 8 unless and until the holders of any classes or series of stock of Freddie Mac ranking prior upon liquidation to the Common Stock have been paid all amounts to which such classes or series of stock are entitled pursuant to their respective terms.
>
> * * *
>
> **10. Miscellaneous.**
>
> * * *
>
> (h)(ii) The affirmative vote by the holders of shares representing at least 66 2/3% of all of the shares of the Common Stock at the time outstanding and entitled to vote, voting together as a class, shall be necessary for authorizing, effecting or validating the amendment, alteration, supplementation or repeal of any of the provisions of this Certificate if such amendment, alteration, supplementation or repeal would materially and adversely affect the powers, preferences, rights, privileges, qualifications, limitations, restrictions, terms or conditions of the Common Stock.

86. Thus, the Classes had a right to exclude the Companies from destroying their dividend, liquidation and voting rights, as the Companies were contractually barred from amending the terms of the Preferred Stock or Freddie Mac common stock held by the Classes in a manner that had a material and adverse impact on stockholders, unless they first received the permission of two-thirds of the affected holders. The Companies neither sought nor obtained such permission before entering into the Third Amendment. There can be no doubt that the Third Amendment made “materially adverse” changes to rights of the holders of Preferred Stock and Freddie Mac common stock, such that it violated the Classes’ contractual rights. The only exception to this requirement was if Fannie Mae or Freddie Mac issued a new class or series of stock. In executing the Third Amendment, FHFA, Fannie Mae, and Freddie Mac have not purported to issue a new series of stock, and therefore the contractual provision against

amending the terms of the Preferred Stock and Freddie Mac common stock in a way that is materially adverse to stockholders has been violated. Indeed, if the Third Amendment in fact constituted the issuance of a new series of stock to the Treasury, then the Third Amendment was illegal, because the statutory authority allowing the Treasury to acquire new series of stock in Fannie Mae and Freddie Mac expired at the end of 2009. 12 U.S.C. §§ 1455(l)(4), 1719(g)(4).

87. Through the Third Amendment, Fannie Mae and Freddie Mac and their Conservator FHFA eliminated the Preferred Stockholders' and Freddie Mac common stockholders' contractual rights to receive dividends before the Government could receive any dividends in excess of its 10% cumulative dividend on the Government Stock, and to receive a pro rata distribution of any liquidation proceeds available after the Government received full recovery of the face amount of the Government Stock. Thus, the Third Amendment amended, altered, and repealed the terms of the Certificates of Designation, *e.g.*, the contractual terms governing the holders' rights to receive dividends and liquidation distributions, in a manner that materially and adversely affected – indeed, completely destroyed – the rights and interests of the holders of the Preferred Stock and Freddie Mac common stock.

88. In further breach of the terms of the Certificates of Designation, Fannie Mae and Freddie Mac and their Conservator FHFA did not seek or obtain the consent of two-thirds of the stockholders as required by the terms of the Certificates before amending, altering, and repealing the terms of the Certificates in a manner that materially and adversely affected the rights and interests of the holders of the Preferred Stock and Freddie Mac common stock.

89. Fannie Mae's and Freddie Mac's agreement to the Third Amendment did not purport to create and issue any other class or series of Fannie Mae or Freddie Mac stock, nor did it purport to be an increase in the authorized or issued amount of any other class or series of

Fannie Mae or Freddie Mac stock. Rather, the Third Amendment to which the Companies agreed in August 2012 was described simply as an amendment to the terms of the Government Stock that Fannie Mae and Freddie Mac had issued in September 2008. Accordingly, the amendment, alteration, and repeal of the terms of the Certificates via their agreement to the Third Amendment was not exempt from the two-thirds vote requirement set forth in the Certificates.

90. In addition to their explicit terms, inherent in the Certificates was an implied covenant by Fannie Mae and Freddie Mac to deal fairly with the holders of Preferred Stock and Freddie Mac common stock and to fulfill the issuers' contractual obligations in good faith, *e.g.*, an implied promise that Fannie Mae and Freddie Mac would not take actions that would make it impossible for the holders of the Preferred Stock and Freddie Mac common stock to realize any value from their dividend and liquidation rights.

91. Fannie Mae and Freddie Mac and their Conservator FHFA acted unfairly and in bad faith with respect to the holders of the Preferred Stock and Freddie Mac common stock and breached their implied covenant of good faith and fair dealing by agreeing to the Third Amendment, the purpose and effect of which was to make it impossible for the holders of the Preferred Stock and Freddie Mac common stock to realize any value from their dividend and liquidation rights, and thus to deny the holders of the Preferred Stock and Freddie Mac common stock the fruits of their agreements with Fannie Mae and Freddie Mac.

VI. THE THIRD AMENDMENT WAS INCONSISTENT AND IN CONFLICT WITH FHFA'S STATUTORY RESPONSIBILITIES AS A CONSERVATOR

92. The Third Amendment is wholly inconsistent with, and in manifest conflict with, FHFA's statutory responsibilities as Conservator of Fannie Mae and Freddie Mac. As Conservator, FHFA is obligated to "take such action as may be – (i) necessary to put the regulated entity in a sound and solvent condition; and (ii) appropriate to carry on the business of

the regulated entity and preserve and conserve the assets and property of the regulated entity.” 12 U.S.C. § 4617(b)(2)(D). As FHFA itself has acknowledged, the agency “has a statutory charge to work to restore a regulated entity in conservatorship to a sound and solvent condition . . . .” Conservatorship and Receivership, 76 Fed. Reg. 35,727 (June 20, 2011). Accordingly, “allowing capital distributions to deplete the entity’s conservatorship assets would be inconsistent with the agency’s statutory goals, as they would result in removing capital at a time when the Conservator is charged with rehabilitating the regulated entity.” *Id.* The Third Amendment’s quarterly sweep of all net profits thus clearly harms, rather than promotes, the soundness and solvency of the Companies by effectively preventing them from rebuilding their capital. Nor can distributing the entire net worth of the Companies to Treasury be reconciled with FHFA’s statutory obligation to preserve and conserve their assets and property. Indeed, Fannie Mae has identified the dividend obligations imposed by the Third Amendment as posing a “specific risk to [its] business” by prohibiting it from “build[ing] capital reserves.” Fannie Mae, Universal Debt Facility, Offering Circular, at 11 (May 14, 2013).

93. Furthermore, on information and belief, FHFA agreed to the Third Amendment at the insistence and under the direction and supervision of Treasury. Treasury, however, lacks the authority to impose such direction and supervision, and FHFA lacks the authority to submit to it. Indeed, HERA expressly provides that “[w]hen acting as conservator, . . . [FHFA] shall not be subject to the direction or supervision of any other agency of the United States . . . .” 12 U.S.C. § 4617(a)(7).

94. Statements by both FHFA and Treasury provide further confirmation that the Third Amendment is inconsistent with FHFA’s statutory powers and responsibilities as Conservator. Treasury, for example, stated the Third Amendment would “expedite the wind

down of Fannie Mae and Freddie Mac," and it emphasized that the "quarterly sweep of every dollar of profit that each firm earns going forward" would make "sure that every dollar of earnings that Fannie Mae and Freddie Mac generate will be used to benefit taxpayers." Press Release, U.S. Dep't of Treasury, *Treasury Department Announces Further Steps to Expedite Wind Down of Fannie Mae and Freddie Mac* (Aug. 17, 2012). Indeed, Treasury emphasized that the Third Amendment would ensure that the Companies "will be wound down and will not be allowed to retain profits, rebuild capital, and return to the market in their prior form." *Id.*

95. Likewise, FHFA Acting Director DeMarco stated that the Third Amendment reflected the agency's goal of "gradually contracting [the Companies'] operations." Edward J. DeMarco, Acting Director, FHFA, *Statement on Changes to Fannie Mae and Freddie Mac Preferred Stock Purchase Agreements*. DeMarco later informed a Senate Committee that the "recent changes to the [Purchase Agreements], replacing the 10 percent dividend with a net worth sweep, reinforce the notion that the [Companies] will not be building capital as a potential step to regaining their former corporate status." Edward J. DeMarco, Acting Director, FHFA, Statement Before the U.S. Senate Comm. on Banking, Housing and Urban Affairs, at 3 (Apr. 18, 2013). Likewise, in its 2012 report to Congress, FHFA explained that it had begun "prioritizing [its] actions to move the housing industry to a new state, one without Fannie Mae and Freddie Mac." FHFA, Report to Congress 2012, at 13 (June 13, 2013). Thus, according to FHFA, the Third Amendment "ensures all the [Companies'] earnings are used to benefit taxpayers" and "reinforces the fact that the [Companies] will not be building capital." *Id*. at 1, 13.

96. The incredibly negative impact of the Third Amendment on the Companies' balance sheets is demonstrated by Fannie Mae's results in the first quarter of this year. As explained above, at the end of the first quarter, Fannie Mae's net worth stood at $62.4 billion.

Under previous versions of the PSPAs, Fannie Mae would have been obligated to pay Treasury only $2.9 billion, and the balance – $59.5 billion – would have been credited to capital reserves. The Third Amendment, however, required Fannie Mae to pay Treasury $59.4 billion. This windfall was not unanticipated. Indeed, FHFA's Office of the Inspector General recognized that, as a result of the Third Amendment, reversal of the Companies' deferred tax valuation allowances could result in "an extraordinary payment to Treasury." FHFA Office of Inspector General, Analysis of the 2012 Amendments to the Government Stock Purchase Agreements, at 15 (Mar. 20, 2013).

97. FHFA has announced that, during the conservatorship, existing statutory and FHFA-directed regulatory capital requirements will not be binding on the Companies. And at the end of 2012, Fannie Mae had a deficit of core capital in relation to statutory minimum capital of $141.2 billion. This deficit decreased to $88.3 billion by the end of the first quarter of 2013. When adjusted for the $59.4 billion dividend payment to Treasury, however, Fannie Mae's core capital deficit jumped back up to $147.7 billion. Thus, because of the Third Amendment, Fannie Mae is now in a worse position with respect to its core capital than it was before the record profitability it achieved in the first quarter of this year.

98. Additionally, the dividend under the Government Stock must be paid to Treasury in cash, even though the net worth of the Companies may include non-cash assets, such as the deferred tax assets. As a result, the Companies have had to sell non-liquid assets or issue debt to pay the dividend, which has had the foreseeable effect of preventing them from maximizing the value of their assets. Borrowing money to pay a dividend on a paper profit is directly contrary to operating the Companies in a safe and sound manner and restoring them to financial health, as FHFA is statutorily required to do when it is acting as a conservator.

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99. Further, the Companies can never accumulate capital under the Third Amendment and can never redeem the Government Stock: so long as the Companies remain in operation, all of their net worth will be transferred to Treasury but the outstanding balance of the Government Stock will remain $189 billion. Under the Third Amendment, none of the Companies' assets can be used to provide value to holders of their Preferred Stock or common stock.

100. Accordingly, the Third Amendment is wholly inconsistent with, and presents a manifest conflict of interest with FHFA's statutorily prescribed powers, functions and responsibilities as Conservator to the Companies.

101. Indeed, several related individual actions have been commenced against Defendants by holders of Fannie Mae and Freddie Mac preferred and common stock asserting FHFA and Treasury acted beyond their statutory powers and functions in adopting the Third Amendment. These related actions, which are being coordinated and will be adjudicated concurrently with these consolidated actions, assert that (i) neither Treasury nor FHFA had authority to enter into the Third Amendment; and (ii) the Third Amendment was unlawful and should be set aside because the Treasury and FHFA acted arbitrarily and capriciously in entering into the Third Amendment. For example, the related actions allege that FHFA is without authority to wind down the Companies pursuant to the Net Worth Sweep, as well as that the Third Amendment created new securities, and Treasury's purchase of those securities violated that clearly demarcated limit on its authority. Moreover, the related actions allege that there is no public record or evidence that: (1) Treasury made the determinations or considered the factors that HERA requires before it executed the Third Amendment; (2) Treasury considered alternatives to the Third Amendment that would have been both consistent with its statutory obligations and less harmful to holders of the Companies' Preferred Stock and common stock,

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including refinancing the Government Stock or allowing the Companies to resume paying dividends to holders of their Preferred Stock and common stock; (3) FHFA considered whether the Third Amendment is compatible with its statutory obligations as the Companies' Conservator; (4) FHFA considered alternatives to the Third Amendment that would have been both consistent with its statutory obligations and less harmful to holders of the Companies' Preferred Stock and common stock, including refinancing the Government Stock or allowing the Companies to resume paying dividends to holders of their Preferred Stock and common stock; and (5) that either Treasury or FHFA considered whether the Third Amendment is consistent with their duties to holders of the Companies' Preferred Stock and common stock.

VII. BY ENTERING INTO THE THIRD AMENDMENT, FHFA AND TREASURY VIOLATED THEIR FIDUCIARY OBLIGATIONS TO FANNIE MAE AND ITS PRIVATE SHAREHOLDERS

102. Delaware law applies to Fannie Mae pursuant to Section 1.05 of its bylaws. Under Delaware law, officers and directors of a corporation owe that corporation and its shareholders fiduciary obligations of due care, good faith, loyalty, and candor, and are required to use their utmost ability to control and manage the corporation in a fair, just, honest, and equitable manner.

103. By reason of its purported conservatorship of Fannie Mae and because of its ability to control the business and corporate affairs of Fannie Mae, FHFA is a *de facto* officer or director of Fannie Mae, and therefore owed the Companies and their shareholders fiduciary obligations of due care, good faith, loyalty, and candor, and was and is required to use its utmost ability to control and manage Fannie Mae and Freddie Mac in a fair, just, honest, and equitable manner.

104. As disclosed in Fannie Mae's 2012 Form 10-K filing, "Upon its appointment, the conservator [FHFA] immediately succeeded to all rights, titles, powers and privileges of Fannie

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Mae, and of any shareholder, officer or director of Fannie Mae with respect to Fannie Mae and its assets, and succeeded to the title to the books, records and assets of any other legal custodian of Fannie Mae. As a result, our Board of Directors no longer had the power or duty to manage, direct or oversee our business and affairs." Fannie Mae's current directors "serve on behalf of the conservator and exercise their authority as directed by and with the approval, where required, of the conservator. FHFA has instructed Fannie Mae's directors to consult with it and obtain its written approval before taking action in a wide variety of areas, including but not limited to:

(a) Engaging in redemptions or repurchases of subordinated debt;

(b) Matters that relate to the Conservator's powers, Fannie Mae's conservatorship status, or the legal effect of the conservatorship on contracts;

(c) Agreements relating to litigation, claims, regulatory proceedings, or tax-related matters where the value of the claim exceeds a specified threshold;

(d) Actions that are likely to cause significant reputational risk;

(e) Establishing the annual operating budget; and

(f) Matters requiring the approval of or consultation with Treasury under the PSPAs.

105. While Fannie Mae's officers are under FHFA's control, in a February 2, 2010 letter to Congress, the Director of FHFA confirmed that "Like other corporate executives, the Enterprises' executive officers are subject to the legal responsibility to use sound and prudent business judgment in their stewardship of their companies," and that FHFA had charged the Companies' boards with "ensuring normal corporate governance practices and procedures are in place." FHFA was and is required to act in furtherance of the best interests of the Companies and their shareholders so as to benefit all shareholders equally and not in furtherance of the

personal interest or benefit of FHFA, Treasury, or the federal government. Because of its position of control and authority as the purported conservator of Fannie Mae and Freddie Mac, FHFA was able to and did, directly and/or indirectly, exercise control over the wrongful acts complained of herein.

106. Additionally, under Delaware law, a dominant or controlling shareholder owes fiduciary duties to the corporation and its minority shareholders, so long as that shareholder exercises actual control of corporate conduct. *Kahn v. Lynch Communication Systems, Inc.*, 638 A.2d 1110 (Del. 1994).

107. Treasury exercises *de facto* control over Fannie Mae, including through its Senior Preferred Stock, and warrants to purchase the Companies' common stock, as well as its control of the provision of funds to Fannie Mae. As controlling stockholder of Fannie Mae, Treasury owed fiduciary duties of due care, good faith, loyalty, and candor, to Fannie Mae and its stockholders. Because of Treasury's *de facto* position of control and authority over Fannie Mae, it stood on both sides of the decision to engage in the Third Amendment and it was able to and did, directly and/or indirectly, exercise control over the wrongful acts complained of herein.

108. The Third Amendment offered no benefits whatsoever to Fannie Mae or its minority shareholders. Rather, it was an egregiously self-dealing transaction, the benefits of which flowed entirely to the Treasury as Fannie Mae's controlling shareholder, and indirectly to FHFA through its status an agency of the federal government.

109. The Third Amendment was in no way an exercise of valid business judgment or deemed to be in the best interests of Fannie Mae. Indeed, it was specifically intended to ensure that Fannie Mae's shareholders could never again recover any value from their investments, and to ensure that the Company could not function as a private enterprise and would have to be

wound down. By preventing Fannie Mae from rebuilding capital or returning to the market, as Treasury stated in its press release, the purpose and effects of the Third Amendment ran directly contrary to FHFA's purported statutory mission to "put the regulated entity in a sound and solvent condition," "carry on the business of the regulated entity," and "preserve and conserve the assets and property of the regulated entity." 12 U.S.C. § 4617(b)(2)(D). As such, the Third Amendment was inconsistent and in manifest conflict with FHFA's statutory functions and responsibilities as Conservator to the Companies.

VIII. BY ENTERING INTO THE THIRD AMENDMENT, FHFA AND TREASURY TOOK THE VESTED PROPERTY RIGHTS OF PLAINTIFFS AND THE TAKINGS CLASS WITHOUT JUST COMPENSATION

110. In addition to violating the contractual rights of the Companies' shareholders, the Third Amendment also violated the Fifth Amendment by expropriating their interest in the Companies without just compensation. The Government cannot evade the requirements of the Fifth Amendment by imposing a conservatorship – indeed, FHFA as the Companies' Conservator was legally bound to protect the interests of all the shareholders of the Companies under its stewardship, not just the interests of its fellow Government agency.

111. The Government's unilateral imposition of the Third Amendment pursuant to FHFA's authority as Conservator of Fannie Mae and Freddie Mac cannot be characterized as "conserving" the Companies' assets or property. On the contrary, as Treasury announced, the Third Amendment's purpose was to advance the Government's public policy goals of "benefit[ing] taxpayers," "[s]upporting the continued flow of mortgage credit," and "winding down Fannie Mae and Freddie Mac" in a manner that ensured Fannie Mae and Freddie Mac would never "retain profits, rebuild capital, and return to the market in their prior form." *See* Press Release, U.S. Dep't of Treasury, *Treasury Department Announces Further Steps to Expedite Down of Fannie Mae and Freddie Mac* (Aug. 17, 2012).

112. Plaintiffs' ownership of Preferred Stock and common stock carries certain contractual and property rights, including, but not limited to, the right to receive a share of the Companies' future profits, in the form of dividend payments, and the right to receive a liquidation preference in accord with the liquidation schedule set forth in the Certificates of Designation or otherwise provided by the Companies' charter documents and applicable laws.

113. As holders of Preferred Stock and common stock, Plaintiffs and the Takings Class had a reasonable investment-backed expectation that their contractual rights as stockholders would be preserved, including their liquidation preferences and their rights to dividends. These contractual rights were important features of the Preferred Stock and common stock.

114. Plaintiffs' property interest in their Preferred Stock and common stock, including the dividend and liquidation rights inherent in such stock ownership, are constitutionally cognizable property rights protected by the Fifth Amendment.

115. The Government's imposition of the Third Amendment deprived Plaintiffs of their vested property rights by, among other things, expropriating for the Government the entire Preferred Stock and common stock holders' equity in the Companies, and by making it impossible for Plaintiffs and the Takings Class to realize any value from their contractual right to share in the Companies' future profits or from their liquidation preference.

116. In short, the Third Amendment is designed to raise general revenue for the Government at the expense of the holders of the Preferred Stock and common stock, and thereby imposes on holders of Preferred Stock and common stock a disproportionate burden that should be shared by the entire population.

<u>CLASS ACTION ALLEGATIONS</u>

117. With respect to Counts I and IV hereof, Plaintiffs bring this action on behalf of themselves and as a class action pursuant to Federal Rules of Civil Procedure 23(a) and 23(b) on

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behalf of a Class consisting of all persons and entities who held shares of Fannie Mae Preferred Stock and who were damaged thereby (the "Fannie Preferred Class"). Excluded from the Fannie Preferred Class are the Defendants.

118. With respect to Counts II and V hereof, Plaintiffs bring this action on behalf of themselves and as a class action pursuant to Federal Rules of Civil Procedure 23(a) and 23(b) on behalf of a Class consisting of all persons and entities who held shares of Freddie Mac Preferred Stock and who were damaged thereby (the "Freddie Preferred Class"). Excluded from the Freddie Preferred Class are the Defendants.

119. With respect to Counts III and VI hereof, Plaintiffs bring this action on behalf of themselves and as a class action pursuant to Federal Rules of Civil Procedure 23(a) and 23(b) on behalf of a Class consisting of all persons and entities who held shares of Freddie Mac common stock and who were damaged thereby (the "Freddie Common Class"). Excluded from the Freddie Common Class are the Defendants.

120. With respect to Count VIII hereof, Plaintiffs bring this action on behalf of themselves and as a class action pursuant to Federal Rules of Civil Procedure 23(a) and 23(b) on behalf of a Class consisting of all persons and entities who held shares of Fannie Mae Preferred Stock, Fannie Mae common stock, Freddie Mac Preferred Stock, and/or Freddie Mac common stock as of the Third Amendment and who suffered less than $10,000 damages thereby, measured individually and not in the aggregate (the "Takings Class"). Excluded from the Class are the Defendants.

121. The Fannie Preferred Class, Freddie Preferred Class, Freddie Common Class, and Takings Class are referred to herein as the "Classes."

122. The members of the Classes are so numerous that joinder of all members is impracticable. While the exact number of Class members is unknown to Plaintiffs at this time and can only be ascertained through appropriate discovery, Plaintiffs believe that there are at least thousands of members in the proposed Classes. As of August 17, 2012, and the date of the filing of this action, there were hundreds of millions of shares of Fannie Mae and Freddie Mac Preferred Stock and common stock outstanding. As of February 28, 2013, there were 1,158,077,970 shares of Fannie Mae common stock outstanding, and as of December 31, 2012, there were 556 million shares of Fannie Mae Preferred Stock outstanding. As of February 15, 2013, there were 650,038,674 shares of Freddie Mac common stock outstanding, and as of December 31, 2012, there were 464,170,000 shares of Freddie Mac Preferred Stock outstanding. Record owners and other members of the Classes may be identified from records maintained by Fannie Mae and Freddie Mac and/or their transfer agent and may be notified of the pendency of this action by mail, using the form of notice similar to that customarily used in securities class actions.

123. Plaintiffs' claims are typical of the claims of the other members of the Classes as all members of the Classes purchased or otherwise acquired Fannie Mae or Freddie Mac stock during the class period, and were similarly affected by Defendants' wrongful conduct that is complained of herein.

124. Plaintiffs will fairly and adequately protect the interests of the members of the Classes, and have retained counsel competent and experienced in class action, derivative, securities, and constitutional litigation. Plaintiffs have no interests that are adverse or antagonistic to the Classes.

125. A class action is superior to other available methods for the fair and efficient adjudication of this controversy. Because the damages suffered by individual members of the Classes may be relatively small, and because the damages suffered by individual members of the Takings Class are relatively small by definition, the expense and burden of individual litigation make it impracticable for Class members individually to seek redress for the wrongful conduct alleged herein.

126. Common questions of law and fact exist as to all members of the Classes and predominate over any questions solely affecting individual members of the Class. Among the questions of law and fact common to the Classes are:

a) Whether one or more Defendants breached the terms of the Certificates for the Preferred Stock and common stock and/or the implied covenant of good faith and fair dealing inherent in those Certificates;

b) Whether Treasury breached its fiduciary duties to Fannie Mae and its shareholders;

c) Whether Treasury's and FHFA's conduct in entering into the Third Amendment violated the Takings Clause of the U.S. Constitution; and

d) Whether the members of the Classes are entitled to injunctive relief, including rescission, and/or one or more Defendants are liable for damages to the members of the Classes, and the proper measure thereof, for breaches of contract, the implied covenant of good faith and fair dealing, and/or breach of fiduciary duty.

127. The prosecution of separate actions by individual Class members would create the risk of inconsistent or varying adjudications with respect to the individual Class members, which would establish incompatible standards of conduct for Defendants, or adjudications with respect to individual Class members that would, as a practical matter, be dispositive of the interests of the other members not parties to the adjudications or substantially impair their ability to protect their interests.

128. Defendants have acted on grounds generally applicable to the Classes with respect to the matters complained of herein, thereby making appropriate the relief sought herein with respect to the Classes as a whole.

DEMAND IS EXCUSED DUE TO THE
<u>FHFA'S MANIFEST CONFLICT OF INTEREST</u>

129. With respect to Count VII hereof, Plaintiffs bring action derivatively on behalf of and for the benefit of Fannie Mae to redress injuries suffered by Fannie Mae as a direct and proximate result of the breaches of fiduciary duty alleged herein. For purposes of Count VII, Fannie Mae is named as a nominal defendant in a derivative capacity.

130. Plaintiffs are holders of Fannie Mae Preferred Stock and common stock, and were holders such securities prior to September 6, 2008, including prior to and on August 17, 2012, and have been holders of said securities continuously since then. Plaintiffs have retained counsel that is competent and experienced in class action, derivative and securities litigation.

131. Plaintiffs intend to retain their shares of Preferred Stock and common stock throughout the duration of this litigation.

132. The breaches of fiduciary duty complained of herein subject, and will persist in subjecting, Fannie Mae to continuing harm because the adverse consequences of the injurious actions are still in effect and ongoing.

133. To the extent any demand requirement with respect to Fannie Mae's Board of Directors would otherwise be applicable in this context, such demand is excused and Plaintiffs are entitled to pursue the derivative claim alleged herein as a result of FHFA's domination of the Board. Fannie Mae's 2012 Form 10-K discloses that "[o]ur directors do not have any fiduciary duties to any person or entity except to the conservator and, accordingly, are not obligated to consider the interests of the company, the holders of our equity or debt securities or the holders

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of Fannie Mae MBS unless specifically directed to do so by the conservator." Fannie Mae's Board of Directors is prohibited from taking action on "matters that relate to the conservator's powers" or "the legal effect of the conservatorship on contracts," such as this litigation, without prior written approval of FHFA.

134. To the extent any demand requirement with respect to FHFA would otherwise be applicable in this context, such demand is excused and Plaintiffs are entitled to pursue the derivative claim alleged herein as a result of FHFA's manifest conflict of interest.

135. Treasury exercises *de facto* control over Fannie Mae, including through its Senior Preferred Stock and warrants to purchase Fannie Mae common stock, as well as its control of the provision of funds to Fannie Mae. The Secretary of the Treasury also sits on FHFA Oversight Board. With such *de facto* power over the Companies' strategies and operations, the Treasury is in a position to, and does, direct FHFA with respect to determinations affecting the Companies and their stockholders.

136. FHFA is interested in and benefits from the Third Amendment as an agency of the federal government, and cannot reasonably be expected to initiate litigation for the breaches of fiduciary duty alleged herein, which would be asserted against itself and the Treasury, Fannie Mae's controlling stockholder. Indeed, Treasury and FHFA face a substantial threat of liability with respect to the breach of fiduciary duty claim.

137. Notwithstanding its fiduciary duties to Fannie Mae and its stockholders, FHFA has expressly acknowledged that it does not act with the interests of Fannie Mae shareholders in mind. Indeed, Fannie Mae's 2008 Form 10-K filing frankly disclosed that, since the imposition of the conservatorship, the company was "[n]o longer managed with a strategy to maximize common shareholder returns."

138. Accordingly, FHFA has a manifest conflict of interest that makes it incapable of pursing the derivative claim for breach of fiduciary duty alleged herein. Given Treasury's *de facto* controlling stockholder status and FHFA's close relationship to Treasury in connection with Fannie Mae matters, a derivative action offers the only reasonable avenue for the pursuit of the breach of fiduciary duty claim.

CAUSES OF ACTION

COUNT I

BREACH OF CONTRACT – FANNIE MAE PREFERRED STOCK
(Against Fannie Mae and FHFA)

139. Plaintiffs incorporate by reference and reallege each and every allegation set forth above, as though fully set forth herein.

140. The Certificates for the Fannie Mae Preferred Stock were and are, for all purposes relevant hereto, contracts between the members of the Fannie Preferred Class and Fannie Mae.

141. The Certificates for the Fannie Mae Preferred Stock provide for contractually-specified dividend rights and liquidation preferences for the holders of Preferred Stock.

142. As Fannie Mae's Conservator, FHFA also became obligated to act consistently with Fannie Mae and Freddie Mac's responsibilities under the Certificates.

143. By entering into the Third Amendment so as to effectively deprive Plaintiffs and the other members of the Fannie Preferred Class of any possibility of receiving dividends or a liquidation preference, Fannie Mae, acting through FHFA, breached the terms of the Certificates for the Fannie Mae Preferred Stock. The Third Amendment amends, alters, supplements or repeals the contractually-specified dividend rights and liquidation preferences of the holders of Fannie Mae Preferred Stock in a manner that materially affects the interests of the holders of Fannie Mae Preferred Stock without the required consent.

144. Plaintiffs and the other members of the Fannie Preferred Class suffered damages as a direct and proximate result of the forgoing breach of contact.

COUNT II

BREACH OF CONTRACT – FREDDIE MAC PREFERRED STOCK
(Against Freddie Mac and FHFA)

145. Plaintiffs incorporate by reference and reallege each and every allegation set forth above, as though fully set forth herein.

146. The Certificates for the Freddie Mac Preferred Stock were and are, for all purposes relevant hereto, contracts between the members of the Freddie Preferred Class and Freddie Mac.

147. The Certificates for the Freddie Mac Preferred Stock provide for contractually-specified dividend rights and liquidation preferences for the holders of Freddie Mac Preferred Stock.

148. As Freddie Mac's Conservator, FHFA also became obligated to act consistently with Freddie Mac's responsibilities under the Certificates.

149. By entering into the Third Amendment so as to effectively deprive Plaintiffs and the other members of the Freddie Preferred Class of any possibility of receiving dividends or a liquidation preference, the Companies, acting through FHFA, breached the terms of the Certificates for the Freddie Mac Preferred Stock. The Third Amendment amends, alters, supplements or repeals the contractually-specified dividend rights and liquidation preferences of the holders of Freddie Mac Preferred Stock in a manner that materially affects the interests of the holders of Freddie Mac Preferred Stock without the required consent.

150. Plaintiffs and the other members of the Freddie Preferred Class suffered damages as a direct and proximate result of the forgoing breach of contact.

COUNT III

BREACH OF CONTRACT – FREDDIE MAC COMMON STOCK
(Against Freddie Mac and FHFA)

151. Plaintiffs incorporate by reference and reallege each and every allegation set forth above, as though fully set forth herein.

152. The Certificate for the Freddie Mac common stock was and is, for all purposes relevant hereto, a contract between the members of the Freddie Common Class and Freddie Mac.

153. The Certificate for the Freddie Mac common stock provides for contractually-specified dividend rights and liquidation preferences for the holders of Freddie Mac common stock.

154. As Freddie Mac's Conservator, FHFA also became obligated to act consistently with Freddie Mac's responsibilities under the Certificate.

155. By entering into the Third Amendment so as to effectively deprive Plaintiffs and the other members of the Freddie Common Class of any possibility of receiving dividends or a liquidation preference, Freddie Mac, acting through FHFA, breached the terms of the Certificate for the Freddie Mac common stock. The Third Amendment amends, alters, supplements or repeals the contractually-specified dividend rights and liquidation preferences of the holders of Freddie Mac common stock in a manner that materially affects the interests of the holders of Freddie Mac common stock without the required consent.

156. Plaintiffs and the other members of the Freddie Common Class suffered damages as a direct and proximate result of the forgoing breach of contact.

COUNT IV

BREACH OF THE IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING

FANNIE MAE PREFERRED STOCK (Against Fannie Mae and FHFA)

157. Plaintiffs incorporate by reference and reallege each and every allegation set forth above, as though fully set forth herein.

158. The Certificates for Fannie Mae Preferred Stock were and are, for all purposes relevant hereto, contracts between the members of the Fannie Preferred Class and Fannie Mae.

159. Inherent in these contracts was, and is, an implied covenant of good faith and fair dealing, requiring Fannie Mae to deal fairly with Plaintiffs and the other members of the Fannie Preferred Class, to fulfill their obligations to Plaintiffs and the Fannie Preferred Class in good faith, and not to deprive Plaintiffs and the Fannie Preferred Class of the fruits of their bargain.

160. As Fannie Mae's Conservator, FHFA also became obligated to act consistently with Fannie Mae's responsibilities under the implied covenant of good faith and fair dealing.

161. By entering into the Third Amendment with the purpose of effectively depriving Plaintiffs and the other members of the Fannie Preferred Class of any possibility of receiving dividends or a liquidation preference, Fannie Mae, acting through FHFA, breached the implied covenant of good faith and fair dealing inherent in the Certificates for the Preferred Stock. Through the implied covenant of good faith and fair dealing, Fannie Mae, acting through FHFA, was obligated not to eliminate the rights and interests of the Fannie Preferred Class in receiving dividends or a liquidation preference. In effectively eliminating such rights and interests entirely through the Third Amendment, Fannie Mae, acting through FHFA, acted arbitrarily and unreasonably and not in good faith or with fair dealing toward the members of the Fannie Preferred Class.

162. Plaintiffs and the other members of the Fannie Preferred Class suffered damages as a direct and proximate result of the forgoing breach of the implied covenant of good faith and fair dealing.

COUNT V

BREACH OF THE IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING

FREDDIE MAC PREFERRED STOCK (Against Freddie Mac and FHFA)

163. Plaintiffs incorporate by reference and reallege each and every allegation set forth above, as though fully set forth herein.

164. The Certificates for Freddie Mac Preferred Stock were and are, for all purposes relevant hereto, contracts between the members of the Freddie Preferred Class and Freddie Mac.

165. Inherent in these contracts was, and is, an implied covenant of good faith and fair dealing, requiring Freddie Mac to deal fairly with Plaintiffs and the other members of the Freddie Preferred Class, to fulfill their obligations to Plaintiffs and the Freddie Preferred Class in good faith, and not to deprive Plaintiffs and the Freddie Preferred Class of the fruits of their bargain.

166. As Freddie Mac's Conservator, FHFA also became obligated to act consistently with Freddie Mac's responsibilities under the implied covenant of good faith and fair dealing.

167. By entering into the Third Amendment with the purpose of effectively depriving Plaintiffs and the other members of the Freddie Preferred Class of any possibility of receiving dividends or a liquidation preference, Freddie Mac, acting through FHFA, breached the implied covenant of good faith and fair dealing inherent in the Certificates for the Freddie Mac Preferred Stock. Through the implied covenant of good faith and fair dealing, Freddie Mac, acting through FHFA, was obligated not to eliminate the rights and interests of the Freddie Preferred Class in receiving dividends or a liquidation preference. In effectively eliminating such rights and

interests entirely through the Third Amendment, Freddie Mac, acting through FHFA, acted arbitrarily and unreasonably and not in good faith or with fair dealing toward the members of the Freddie Preferred Class.

168. Plaintiffs and the other members of the Freddie Preferred Class suffered damages as a direct and proximate result of the forgoing breach of the implied covenant of good faith and fair dealing.

COUNT VI

BREACH OF THE IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING

FREDDIE MAC COMMON STOCK (Against Freddie Mac and FHFA)

169. Plaintiffs incorporate by reference and reallege each and every allegation set forth above, as though fully set forth herein.

170. The Certificate for Freddie Mac common stock was and is, for all purposes relevant hereto, a contract between the members of the Freddie Common Class and Freddie Mac.

171. Inherent in this contract was, and is, an implied covenant of good faith and fair dealing, requiring Freddie Mac to deal fairly with Plaintiffs and the other members of the Freddie Common Class, to fulfill their obligations to Plaintiffs and the Freddie Common Class in good faith, and not to deprive Plaintiffs and the Freddie Common Class of the fruits of their bargain.

172. As Freddie Mac's Conservator, FHFA also became obligated to act consistently with Freddie Mac's responsibilities under the implied covenant of good faith and fair dealing.

173. By entering into the Third Amendment with the purpose of effectively depriving Plaintiffs and the other members of the Freddie Common Class of any possibility of receiving dividends or a liquidation preference, Freddie Mac, acting through FHFA, breached the implied covenant of good faith and fair dealing inherent in the Certificate for the Freddie Mac common

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stock. Through the implied covenant of good faith and fair dealing, Freddie Mac, acting through FHFA, was obligated not to eliminate the rights and interests of the Freddie Common Class in receiving dividends or a liquidation preference. In effectively eliminating such rights and interests entirely through the Third Amendment, Freddie Mac, acting through FHFA, acted arbitrarily and unreasonably and not in good faith or with fair dealing toward the members of the Freddie Common Class.

174. Plaintiffs and the other members of the Freddie Common Class suffered damages as a direct and proximate result of the forgoing breach of the implied covenant of good faith and fair dealing.

COUNT VII

BREACH OF FIDUCIARY DUTY

FANNIE MAE
(Against Treasury and FHFA)

175. Plaintiffs incorporate by reference and reallege each and every allegation set forth above, as though fully set forth herein.

176. By imposing a conservatorship over Fannie Mae, through which FHFA assumed the powers of its officers and directors, FHFA assumed fiduciary duties of due care, good faith, loyalty, and candor, to Fannie Mae and its stockholders, including Plaintiffs and the other members of the Fannie Preferred Class, and was and is required to use its utmost ability to control and manage Fannie Mae in a fair, just, honest, and equitable manner. FHFA was and is required to act in furtherance of the best interests of Fannie Mae and its shareholders so as to benefit all shareholders equally and not in furtherance of the personal interest or benefit of FHFA, Treasury, or the federal government.

177. Treasury exercises *de facto* control over Fannie Mae, including through its Senior Preferred Stock and warrants to purchase Fannie Mae common stock, as well as its control of the provision of funds to Fannie Mae. As controlling stockholder of Fannie Mae, Treasury owed fiduciary duties of due care, good faith, loyalty, and candor, to Fannie Mae and its other stockholders.

178. The Third Amendment constituted a self-dealing transaction. Treasury, as controlling stockholder of Fannie Mae, stood on both sides of the decision to implement the Third Amendment, to the benefit of Treasury and the detriment of Fannie Mae and its stockholders other than Treasury. Moreover, as an agency of the federal government, FHFA was interested in and benefited from the Third Amendment.

179. Through the Third Amendment, FHFA and Treasury breached their fiduciary duties to Fannie Mae. The Third Amendment was not entirely fair to Fannie Mae, as it was neither the product of a fair process nor reflected a fair price. Indeed, the Third Amendment, which effectively delivers all of Fannie Mae's profits to Treasury in perpetuity, was granted to benefit the Treasury, with no benefit to Fannie Mae in return.

180. The Third Amendment was neither entirely nor intrinsically fair, nor did it further any valid business purpose of Fannie Mae, nor did it reflect a good faith business judgment as to what was in the best interests of Fannie Mae or its shareholders.

181. The Third Amendment constituted waste and a gross abuse of discretion.

182. As a direct and proximate result of the foregoing breach of fiduciary duty, Fannie Mae suffered damages.

COUNT VIII

JUST COMPENSATION UNDER THE FIFTH AMENDMENT
(Against FHFA and Treasury)

183. Plaintiffs incorporate by reference and reallege each and every allegation set forth above, as though fully set forth herein.

184. Through the conduct alleged herein, FHFA and Treasury destroyed the rights and value of the property interests associated with the Preferred Stock and common stock of the Companies held by the Takings Class, without just compensation, and nullified the Takings Class' reasonable, investment-backed expectations, and violated the fundamental principles of the Due Process and Takings Clauses of the United States Constitution.

185. The Fifth Amendment provides that no person shall, "be deprived of life, liberty or property, without due process of law; nor shall private property be taken for public use, without just compensation."

186. FHFA and Treasury violated the statutory, contractual, and Constitutional rights of the Takings Class in taking private property as alleged herein without providing just compensation. FHFA and Treasury took and/or exacted the property and legally cognizable property rights of the Companies' shareholders by, among other things, (1) improperly taking all of the net worth of the Companies; and (2) by improperly imposing the stock agreements and conservatorships over the Companies.

187. By imposing the Third Amendment, FHFA and Treasury took the Takings Class' vested, legally cognizable property rights without just compensation, as alleged herein. FHFA and Treasury entered into an agreement with each other to take "every dollar of earnings each firm generates . . . to benefit taxpayers." One federal agency – FHFA, which was supposedly acting as Conservator for the Companies – struck a deal with another federal agency – Treasury

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– to effectively confiscate the Preferred Stock and common stock held by private investors in Fannie Mae and Freddie Mac, with *all* future earnings of the Companies to be paid to Treasury in the form of quarterly dividends.

188. The Takings Class had both a legally cognizable property interest and a reasonable, investment-backed expectation in their Preferred Stock and in the share of the Companies' future earnings to which they and other holders of Preferred Stock and common stock were contractually entitled.

189. The Takings Class also had both a legally cognizable property interest and a reasonable, investment-backed expectation in the liquidation rights to which such Preferred Stock and common stock were contractually entitled in the event that Fannie Mae and Freddie Mac were dissolved or liquidated.

190. By imposing the Third Amendment, Defendants took the Takings Class' vested, legally cognizable property rights and destroyed their reasonable, investment-backed expectations without paying just compensation.

191. As a result of the Third Amendment, the Takings Class has been deprived of all economically beneficial uses of its Preferred Stock in Fannie Mae and Freddie Mac.

192. The Takings Class is entitled to just compensation for FHFA and Treasury's taking of property.

PRAYER FOR RELIEF

WHEREFORE, Plaintiffs prays for relief and judgment, as follows:

1. Certifying that this action is a proper class action under Rule 23(a) and (b)(3) of the Federal Rules of Civil Procedure on behalf of the Classes defined herein;

2. Declaring that this action is a proper derivative action and that presuit demand is excused;

3. Declaring that the Third Amendment was neither entirely nor intrinsically fair to Fannie Mae, did not further any valid business purpose of Fannie Mae, did not reflect a good faith business judgment as to what was in the best interests of Fannie Mae or its shareholders, and constituted waste and a gross abuse of discretion;

4. Declaring that, through the Third Amendment, Defendants FHFA and Treasury breached their respective fiduciary duties to Fannie Mae;

5. Awarding compensatory damages and disgorgement in favor of Fannie Mae against Defendants FHFA and Treasury, jointly and severally, as a result of such defendants' breach of their respective fiduciary duties, in an amount to be proven at trial, including interest thereon;

6. Declaring that Defendants breached the terms of the certificates of designation and the implied covenant of good faith and fair dealing;

7. Awarding Plaintiffs and the Classes the amount of damages they sustained as a result of Defendants' breaches of contract or breaches of the implied covenant of good faith and fair dealing;

8. Granting appropriate equitable and injunctive relief to remedy Defendants' breaches of contract, and breaches of the implied covenant of good faith and fair dealing, including rescission of the Third Amendment;

9. Declaring that, by entering into the Third Amendment, FHFA and Treasury have illegally taken the private property of the Takings Class without just compensation;

10. Awarding the Takings Class the amount of just compensation that will adequately compensate it for the taking of its property;

11. Awarding Plaintiffs their reasonable costs and expenses incurred in this action, including counsel fees and expert fees; and

12. Such other and further relief as the Court may deem just and proper.

JURY TRIAL DEMANDED

Plaintiffs hereby demand a trial by jury.

Dated: December 3, 2013

Respectfully Submitted,

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Additional Counsel for Plaintiffs

VERIFICATION

I, Joseph Cacciapalle, hereby verify that I have authorized the filing of the attached Consolidated Amended Class Action Complaint, that I have reviewed the Consolidated Amended Class Action Complaint and that the facts therein are true and correct to the best of my knowledge, information and belief.

I declare under penalty of perjury that the foregoing is true and correct.

DATE: 12 - 2 - 2013

Joseph Cacciapalle

Joseph Cacciapalle

VERIFICATION

I, Melvin Bareiss, hereby verify that I have authorized the filing of the attached Consolidated Amended Class Action and Derivative Complaint, that I have reviewed the Consolidated Amended Class Action and Derivative Complaint and that the facts therein are true and correct to the best of my knowledge, information and belief.

I declare under penalty of perjury that the foregoing is true and correct.

DATE: 12/3/2013

Melvin Bareiss

EXHIBIT 20

UNITED STATES DISTRICT COURT
DISTRICT OF COLUMBIA

In re Fannie Mae/Freddie Mac Senior Preferred Stock Purchase Agreement Class Action Litigations **THIS DOCUMENT RELATES TO:** **ALL ACTIONS**	**Misc. Action No. 13-mc-1288 (RCL)** **DERIVATIVE COMPLAINT**

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Plaintiffs American European Insurance Company ("AEIC"), Joseph Cacciapalle ("Cacciapalle") and Michelle M. Miller ("Miller" and collectively with AEIC and Cacciapalle, "Plaintiffs"), by the undersigned attorneys, submit this Derivative Complaint against defendants United States Department of the Treasury ("Treasury") and Federal Housing Finance Agency ("FHFA," and together with Treasury, "Defendants").

NATURE AND SUMMARY OF THE ACTION

1. This is a derivative action brought by Plaintiffs on behalf of the Federal Home Loan Mortgage Corporation ("Freddie Mac" or "Freddie"), seeking damages for breach of fiduciary duty in connection with the Third Amendment to the Amended and Restated Senior Preferred Stock Purchase Agreement, dated August 17, 2012 (the "Third Amendment"), between Defendant Treasury and Defendant FHFA in its capacity as conservator for Freddie Mac.

2. Plaintiffs allege the following based upon personal knowledge as to themselves and their own acts and upon information and belief as to all other matters. Plaintiffs' information and belief is based on, *inter alia*, the investigation of Plaintiffs' counsel.

3. Freddie Mac and the Federal National Mortgage Association ("Fannie Mae" or "Fannie") are government sponsored enterprises chartered by the U.S. Congress to facilitate liquidity and stability in the secondary market for home mortgages. While they are commonly referred to as "Government Sponsored Enterprises" or "GSEs," Freddie Mac and Fannie Mae (together, the "Companies") are not government agencies. Instead, as private, for-profit corporations, the Companies have shareholders, directors, and officers like other non-governmental corporations, and their debt and equity securities have for years been privately owned and publicly traded, including by public pension funds, mutual funds, community banks, insurance companies, and myriad individual investors.

4. Although Freddie Mac was chartered by the U.S. Congress, the federal government did not guarantee, directly or indirectly, its securities or other obligations. Freddie Mac was a stockholder-owned corporation, and, before the 2008 financial crisis, its business was self-sustaining and funded exclusively with private capital.

5. To raise capital Freddie Mac issued several publicly traded securities including common stock and numerous classes of non-cumulative preferred stock ("Preferred Stock"). The Preferred Stock, which had the essential characteristics of a fixed income security, was long perceived to be a conservative investment paying modest but reliable rates of return and carrying high credit ratings. The common stock, in turn, participated in the earnings of Freddie Mac for many years. By 2008, Freddie Mac was one of the largest privately owned financial institutions in the world, and had been consistently profitable for decades.

6. In July 2008, in response to the crisis in the residential housing and mortgage markets, Congress passed the Housing and Economic Recovery Act of 2008 ("HERA"), creating FHFA to oversee the operations of Freddie Mac and Fannie Mae. Congress empowered FHFA to serve as Conservator to the Companies when necessary to preserve their financial health. When acting as Conservator, FHFA is obligated to manage the Companies with the goal of putting them in a sound and solvent financial condition while preserving and conserving their assets. 12 U.S.C. § 4617(b)(2)(D). Congress also authorized Treasury to provide limited financial assistance to the Companies by purchasing securities issued by the Companies if it determined that such purchases would help stabilize financial markets, prevent disruptions in the mortgage markets, and protect taxpayers.

7. Just two months after HERA's enactment, on September 6, 2008, FHFA placed Freddie Mac and Fannie Mae into temporary conservatorship. The objective of the

conservatorship was to stabilize the institutions so they could return to their normal business operations. Indeed, by statute, the purpose of appointing the conservator was "to preserve and conserve the [Companies'] assets and property and to put the [Companies] in a sound and solvent condition." HERA expressly grants FHFA, as Conservator, the power to take such action as may be necessary to put the Companies in a "sound and solvent condition" and that is appropriate to "carry on the business of the Companies" and "preserve and conserve the[ir] assets and property." FHFA itself vowed, at the time the Companies were placed into conservancy, that it was committed to operating the Companies "until they are stabilized" and that the conservatorship would be terminated upon successful completion of its plan to restore the Companies to "a safe and solvent condition." The public was entitled to rely on these official statements of the purposes of the conservatorship, and public trading in the Companies' stock was allowed to, and did, continue.

8. In connection with the appointment of FHFA as Conservator, Freddie Mac and Fannie Mae each entered into a Senior Preferred Stock Purchase Agreement ("PSPA") with Treasury. Under these contracts, Treasury agreed to invest in a newly created class of securities in the Companies, known as Senior Preferred Stock ("Government Stock"), when and as necessary for the Companies to maintain a positive net worth. In return for its commitment to purchase Government Stock, Treasury received $1 billion of Government Stock in each company as a commitment fee and warrants to acquire 79.9% of the common stock of the Companies at a nominal price. The Government Stock ranked senior in priority to all other series of Freddie Mac and Fannie Mae Preferred Stock, and would earn an annual dividend, paid quarterly, equal to 10% of the outstanding liquidation preference, *i.e.*, the sum of the $1 billion commitment fee plus the total amount of Government Stock outstanding. The warrants to

acquire a 79.9% ownership stake in the Companies gave Treasury a significant "long" position – over and above the substantial 10% coupon on its Government Stock – which, if exercised, could result in enormous profits to the government in the event the Companies returned to profitability.

9. Shortly after being placed into conservatorship, Freddie Mac, under the control of FHFA, wrote down its assets significantly. FHFA caused Freddie Mac to declare large non-cash losses in the value of deferred tax assets, and to take out large loss reserves on its balance sheets. For example, in 2008, Freddie Mac wrote down the valuation of its deferred tax assets by $40.2 billion, and made a $16.4 billion provision for credit losses. To fill the holes in Freddie Mac's balance sheet created by these significant write-downs, Treasury immediately began purchasing Government Stock. By mid-2012, Freddie Mac had made aggregate Treasury draws of $71.3 billion, and had paid aggregate cash dividends to Treasury of $20.1 billion.

10. Treasury made its investment in Freddie Mac and Fannie Mae pursuant to temporary authority established under Section 1117 of HERA. That authority expired on December 31, 2009. Before the authority expired, Treasury and FHFA made two substantive amendments to the PSPAs (neither of which are challenged in this lawsuit).

11. By the second quarter of 2012, Freddie Mac had returned to profitability and was solvent. Freddie Mac made a quarterly profit of $2.8 billion in the second quarter of 2012, or approximately 150% of the $1.8 billion quarterly dividend payable to Treasury on its Government Stock. Consequently, by no later than the second quarter of 2012, Treasury was well-positioned to reap the fruits of its investment in Freddie Mac. Treasury was entitled to a substantial 10% coupon on its Government Stock, and to 79.9% of Freddie Mac's profits going forward, subject to Freddie Mac's fulfillment of its contractual obligations to the holders of its Preferred Stock. In addition, Treasury, through FHFA as Conservator, could require Freddie

Mac to begin repaying the principal of Treasury's investment by redeeming Treasury's Government Stock.

12. Instead, Treasury insisted on all of Freddie Mac's profits in perpetuity. Accordingly, rather than exercising its right to purchase up to 79.9% of Freddie Mac's common stock or taking steps to enable Freddie Mac to redeem the Government Stock, FHFA, as Conservator, and Treasury acted together to ensure that Treasury would be the sole beneficiary, to the exclusion of all other stockholders, of Freddie Mac as an operating enterprise.

13. Specifically, FHFA and Treasury announced the "Third Amendment" to the PSPAs. The Third Amendment had devastating consequences for holders of the Preferred Stock and common stock. In place of the 10% coupon due on Treasury's Government Stock, the Third Amendment changed the PSPAs to entitle Treasury to a dividend of 100% of all current and future profits of the Companies. As a result of this purported "amendment" to the terms of the Companies' PSPAs with Treasury, Freddie Mac would be left with no funds to redeem Treasury's Government Stock or rebuild its capital.

14. Freddie Mac did not receive any meaningful value in return for the Third Amendment. As noted above, under the Third Amendment, the amount of cash Freddie Mac transfers to Treasury as a dividend does not reduce the amount of the Government Stock outstanding. Furthermore, Freddie Mac has not been permitted to redeem Treasury's Government Stock. Thus, regardless of how much money Freddie Mac sends to Treasury, all of the Government Stock will remain outstanding, and Treasury will continue to take substantially all of Freddie Mac's net worth, as long as it remains in business. The Third Amendment and its "Net Worth Sweep" thus enriches the federal government through a self-dealing arrangement.

Treasury and FHFA effectively nationalized one of the nation's largest financial institutions after it returned to profitability and while FHFA was supposed to be serving as its Conservator.

15. Each of the Companies has now repaid Treasury for its investment. As of June 2014, Freddie Mac has paid Treasury total cash dividends of $86.3 billion, exceeding its cumulative cash draws of $71.3 billion, and Fannie Mae had paid total dividends of $126.8 billion in comparison to $116.1 billion in draw requests. However, Treasury and FHFA propose that these dividend payments do not represent a return on capital invested, and do not account for them as a repayment of funds that Treasury advanced to Freddie Mac. Therefore, the liquidation preference of Treasury's Government Stock has not been reduced and stands at approximately $72.3 billion – *i.e.*, the same amount as of the time of the Third Amendment.

16. Treasury, as *de facto* controlling stockholder of Freddie Mac, stood on both sides of the decision to implement the Third Amendment. Although Treasury has gained, and will gain, enormous benefits from the Third Amendment, Freddie Mac received nothing in return. As such, the Third Amendment was, and is, waste and not entirely fair to Freddie Mac, and constituted a breach of the fiduciary duties owed to Freddie Mac by FHFA and Treasury, as Freddie Mac's controlling stockholder. Furthermore, the Third Amendment was inconsistent and in conflict with FHFA's statutory responsibilities, as Conservator to Freddie Mac, to put Freddie Mac back into "a sound and solvent condition" and to "conserve its assets and property." Accordingly, this action seeks, derivatively on behalf of Freddie Mac, an award of compensatory damages and disgorgement for such breach.

JURISDICTION AND VENUE

17. This Court has subject matter jurisdiction over this action pursuant to 12 U.S.C. §§ 1452(c), 1723a(a) and 4617. In addition, this Court has subject matter jurisdiction under 28

U.S.C. § 1332(d)(2)(A) in that Plaintiffs and defendants are citizens of different states and the matter in controversy exceeds $5 million, exclusive of interest and costs.

18. Venue is proper in this district under 28 U.S.C. §§ 1391(e)(1)(A) and (B), because this is an action against agencies of the United States; one or more of the Defendants reside in this district; and a substantial portion of the transactions and wrongs complained of herein, including the Defendants' primary participation in the wrongful acts detailed herein, occurred in this district. In addition, one or more of the Defendants maintains executive offices in this district, and Defendants have engaged in regular activities and conducted business here, which have had an effect in this district. Moreover, a substantial part of the events or omissions giving rise to this action occurred in this judicial district.

THE PARTIES

19. Plaintiff AEIC is a New Jersey corporation with offices in New York, New York, and is a holder of Freddie Mac Variable Rate Series M Preferred Stock. AEIC purchased Freddie Mac Preferred Stock in January 2001, and has been a holder of Freddie Mac Preferred Stock continuously since then.

20. Plaintiff Joseph Cacciapalle is a citizen of the state of New Jersey, and is a holder of Freddie Mac 8.375% Series Z Preferred Stock. Mr. Cacciapalle purchased Freddie Mac Preferred Stock in February 2008, and has been a holder of Freddie Mac Preferred Stock continuously since then.

21. Plaintiff Michelle M. Miller is a citizen of the state of Missouri, and is a holder of Freddie Mac common stock. Ms. Miller purchased Freddie Mac common stock in October 2009, and has been a holder of Freddie Mac common stock continuously since then.

22. Defendant FHFA, as Conservator of Freddie Mac, is an independent agency of the United States government with its headquarters located at Constitution Center, 400 7th Street,

S.W., Washington, D.C. 20024, and therefore is a citizen of the District of Columbia. According to FHFA's strategic plan for fiscal years 2013-17, "[s]ince September 2008, FHFA has been the conservator of Fannie Mae and Freddie Mac . . . with responsibility of overseeing management and governance of the Enterprises."

23. Defendant Treasury is an executive agency of the United States government with its headquarters located at 1500 Pennsylvania Avenue, N.W., Washington, D.C. 20220, and therefore is a citizen of the District of Columbia. The Department of the Treasury owns the Government Stock, and is a signatory to certain agreements central to this Complaint.

24. Nominal defendant Freddie Mac is a federally chartered Government Sponsored Enterprise with its principal executive offices located at 8200 Jones Branch Drive, McLean, Virginia 22102, and is therefore a citizen of Virginia.

FACTS

I. BACKGROUND OF FREDDIE MAC

25. Freddie Mac is a stockholder-owned corporation organized and existing under the Federal Home Loan Mortgage Corporation Act. Freddie Mac was created as an alternative to Fannie Mae to make the secondary mortgage market more competitive and efficient. Freddie Mac is a Government Sponsored Enterprise, which is a private corporation that Congress created to increase mortgage market liquidity. It seeks to accomplish this by purchasing mortgages that private banks originate and bundling them into mortgage-related securities to be sold to investors. Through the creation of this secondary mortgage market, Freddie Mac increased liquidity for private banks, which enables it to make additional loans to individuals for home purchases.

26. Notwithstanding their government charters, private shareholders owned Freddie Mac and Fannie Mae until 2007. Before 2007, the Companies were consistently profitable. In

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fact, prior to that time, Freddie Mac had never experienced an annual loss, according to the Companies' regulator.

II. FHFA PLACES THE COMPANIES INTO RECEIVERSHIP AND CAUSES THEM TO INITIATE MASSIVE WRITE-DOWNS

27. Beginning in 2006, an industry-wide financial crisis and nationwide declines in the housing market caused the Companies to suffer losses. As the Office of Federal Housing Enterprise Oversight (the "OFHEO"), which was Freddie Mac and Fannie Mae's regulator at that time, stated in its 2008 annual report to Congress:

> In 2007, a confluence of factors – turmoil in the housing and mortgage markets, loss of liquidity in the credit marks, and volatility in the capital markets adversely impacted the financial performance of financial institutions . . . with significant exposure to mortgage markets. The Enterprises' financial results suffered along with the results of other financial institutions. Both Enterprises were unprofitable in 2007 – Freddie Mac's first annual net loss ever, and Fannie Mae's first since 1985.

28. Despite these losses, the OFHEO continued to assure the marketplace of the Companies' soundness. For example, in a March 19, 2008 statement, OFHEO director James Lockhart said that, "Fannie Mae and Freddie Mac have played a very important and beneficial role in the mortgage markets over the last year. Let me be clear – both companies have prudent cushions above the OFHEO-directed capital requirements and have increased their reserves. We believe they can play an even more positive role in providing the stability and liquidity the markets need right now." On that date, Lockhart also said that the idea of a bailout is "nonsense in my mind. The companies are safe and sound, and they will continue to be safe and sound." *As Crisis Grew, A Few Options Shrank To One*, N.Y. TIMES, Sept. 7, 2008. Similarly, on June 9, 2008, OFHEO published a news release stating that it classified Freddie Mac and Fannie Mae as "adequately capitalized as of March 31, 2008."

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29. In July 2008, Congress enacted HERA, establishing FHFA to replace the OFHEO as the Companies' regulator, and granting Treasury temporary authority to assist the Companies through the purchase of securities. HERA provided a specific list of enumerated circumstances under which FHFA would have the power to place the Companies into conservatorship or receivership. HERA was passed not because Freddie Mac or Fannie Mae was deemed to be insolvent or operating unsafely at that time, but rather, to provide the struggling mortgage and financial markets with added confidence. As Treasury Secretary Henry Paulson testified to a Congressional panel, "If you've got a bazooka, and people know you've got it, you may not have to take it out." *Paulson's Itchy Finger, on the Trigger of a Bazooka*, N.Y. TIMES, Sept. 9, 2008. Indeed, on July 10, 2008, Paulson and Federal Reserve Chairman Ben Bernanke both testified before the House Financial Services committee that Freddie Mac and Fannie Mae were adequately capitalized, and on July 10, 2008, the OFHEO issued a statement that, as of March 31, 2008, Freddie Mac and Fannie Mae were "holding capital well in excess of the OFHEO-directed requirement[.]"

30. Similarly, in support of HERA, Senator Johnny Isakson (R-GA) commented that:

> The bill we are doing tomorrow is not a bailout to Freddie Mac and Fannie Mae or the institutions that made bad loans. It is an infusion of confidence the financial markets need. Fannie and Freddie suffer by perception from the difficulties of our mortgage market. If anybody would take the time to go look at the default rates, for example, they would look at the loans Fannie Mae holds, and they are at 1.2 percent, well under what is considered a normal, good, healthy balance. The subprime market's defaults are in the 4 to 6 to 8-point range. That is causing the problem. That wasn't Fannie Mae paper, and it wasn't securitized by Fannie Mae. They have $50 billion in capital, when the requirement is to have $15 billion, so they are sound. But the financial markets, because of the collapse of the mortgage market, have gotten worse.

31. Nonetheless, on September 6, 2008, FHFA placed the Companies into conservatorship and, in a press release issued the next day, said that, "as the conservator, FHFA will assume the power of the Board and management." As the Conservator for the Companies,

FHFA became responsible for "preserv[ing] and conserv[ing] [their] assets and property" and managing them in a manner that would restore them to a "sound and solvent condition." 12 U.S.C. § 4617(b)(2)(D). At the time, FHFA stated that the goal of this action was "to help restore confidence in Fannie Mae and Freddie Mac, enhance their capacity to fulfill their mission, and mitigate the systemic risk that has contributed directly to the instability in the current market." According to FHFA's press release, the conservatorship was "a statutory process designed to stabilize a troubled institution with the objective of returning the entities to normal business operations. FHFA will act as the conservator to operate the Enterprises until they are stabilized." FHFA also issued a Fact Sheet indicating that, "[u]pon the [FHFA] Director's determination that the Conservator's plan to restore the Company to a safe and solvent condition has been completed successfully, the Director will issue an order terminating the conservatorship. At present, there is no exact time frame that can be given as to when this conservatorship may end."

32. The decision to place the Companies into conservatorship was driven not by analysis of the HERA statutory factors, but by broader macroeconomic and political concerns and the need to provide support for the struggling mortgage market. As *The New York Times* stated, the administration sought "to shrink drastically [Freddie Mac and Fannie Mae's] outsize influence on Wall Street and on Capitol Hill while at the same time counting on them to pull the nation out of its worst housing crisis in decades." *In Rescue To Stabilize Lending, U.S. Takes Over Mortgage Finance Titans*, N.Y. TIMES, Sept. 7, 2008. "In the end, [Secretary of the Treasury] Mr. Paulson's decision seems to have been a philosophical one, rather than one forced by imminent crisis. Of course, for stagecraft purposes, it was played as impending disaster." *Paulson's Itchy Finger, on the Trigger of a Bazooka*, N.Y. TIMES, Sept. 9, 2008.

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33. Treasury was authorized under HERA to strengthen the Companies' balance sheets by purchasing their securities, within set time frames and consistent with prescribed statutory requirements. Beginning with HERA's enactment in 2008 until the end of 2009, Congress authorized Treasury to "purchase any obligations and other securities issued by the [Companies] . . . on such terms and conditions as the Secretary may determine and in such amounts as the Secretary may determine." 12 U.S.C. §§ 1455(l)(1)(A), 1719(g)(1)(A). To exercise this authority, the Secretary was required to determine that purchasing the Companies' securities was "necessary to . . . provide stability to the financial markets; prevent disruptions in the availability of mortgage finance; and protect the taxpayer." 12 U.S.C. §§ 1455(l)(1)(B), 1719(g)(1)(B). The Secretary was required to consider several factors in making these determinations:

> (i) [t]he need for preferences or priorities regarding payments to the Government; (ii) [l]imits on maturity or disposition of obligations or securities to be purchased; (iii) [t]he [Companies'] plan[s] for the orderly resumption of private market funding or capital market access; (iv) [t]he probability of the [Companies] fulfilling the terms of any such obligation or other security, including repayment; (v) [t]he need to maintain the [Companies'] status as private shareholder-owned compan[ies]; [and] (vi) Restrictions on the use of [the Companies'] resources, including limitations on the payment of dividends and executive compensation and any such other terms and conditions as appropriate for those purposes.

Id. §§ 1455(l)(1)(C), 1719(g)(1)(C).

34. Treasury used its temporary authority under HERA to enter into the PSPAs with FHFA, which acted on behalf of both Companies. The PSPAs are identical in all material respects. Under the PSPAs, Treasury purchased one million shares of Government Stock from each Company in exchange for allowing the Companies to draw up to $100 billion each from Treasury. The Government Stock has a liquidation preference equal to $1 billion plus the sum of all draws by each company against Treasury's funding commitment. The Government Stock is

also entitled to a cumulative dividend equal to 10% of the outstanding liquidation preference. If a company pays a dividend, the PSPAs require Treasury to be paid dividends declared in full, but not paid, for prior dividend periods, before any privately held securities may receive a dividend. Indeed, the PSPAs explicitly prohibit any shareholder other than Treasury from being paid any dividend without Treasury's consent. Further, if the Companies liquidate, no shareholder can recover anything before the Treasury recovers the full liquidation value of its shares. Treasury also has the right under the PSPAs to purchase up to 79.9% of the Companies' common stock at a nominal price.

35. At the end of 2009, Treasury's statutory authority to purchase the Companies' securities expired. To enable Treasury to provide the Companies with liquidity beyond 2009, Treasury and FHFA amended the PSPAs twice. First, in May 2009, Treasury agreed to expand its funding commitment to $200 billion per company from $100 billion per company. Then, on December 24, 2009, just before the expiration of Treasury's temporary authority under HERA, it agreed to a funding commitment that would be sufficient to allow the Companies to satisfy their 2010, 2011, and 2012 capitalization requirements and a funding commitment up to a limit determined by an agreed-upon formula for subsequent years.

36. After FHFA took control of the Companies, it decided that it did not expect them to be profitable, and that they would likely incur large losses in the coming years. FHFA therefore directed the Companies to book substantial loss reserves – recording loan losses before they were actually incurred – and required the Companies to eliminate from their balance sheets the value of non-cash deferred tax assets that would only be of use if the Companies became profitable.

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37. These write-downs and accounting decisions directed by FHFA led to a circular payment obligation requiring the Companies to draw down Treasury's funding commitment, which, in turn, required the Companies to pay increased dividends to Treasury. Under the initial PSPAs, Treasury committed to make quarterly payments to the Companies in order to maintain a zero net worth. Each quarter, FHFA looked to the Companies' financial statements to determine if their liabilities exceeded their assets. If so, FHFA would request that Treasury draw down the Companies' funding commitment and provide funds equal to the net worth deficit. Because of the impact of the accounting adjustments directed by FHFA, the Companies had less capital, and therefore needed capital from Treasury both to operate and to pay the quarterly dividends due under the PSPAs. The Companies thus were required to draw additional funds from Treasury's funding commitment, thereby increasing the amount of Treasury's aggregate liquidation preference, and thus the amount of dividends payable to Treasury. Between 2008 and 2012, under the PSPAs, as amended, Treasury provided approximately $71.3 billion to Freddie Mac.

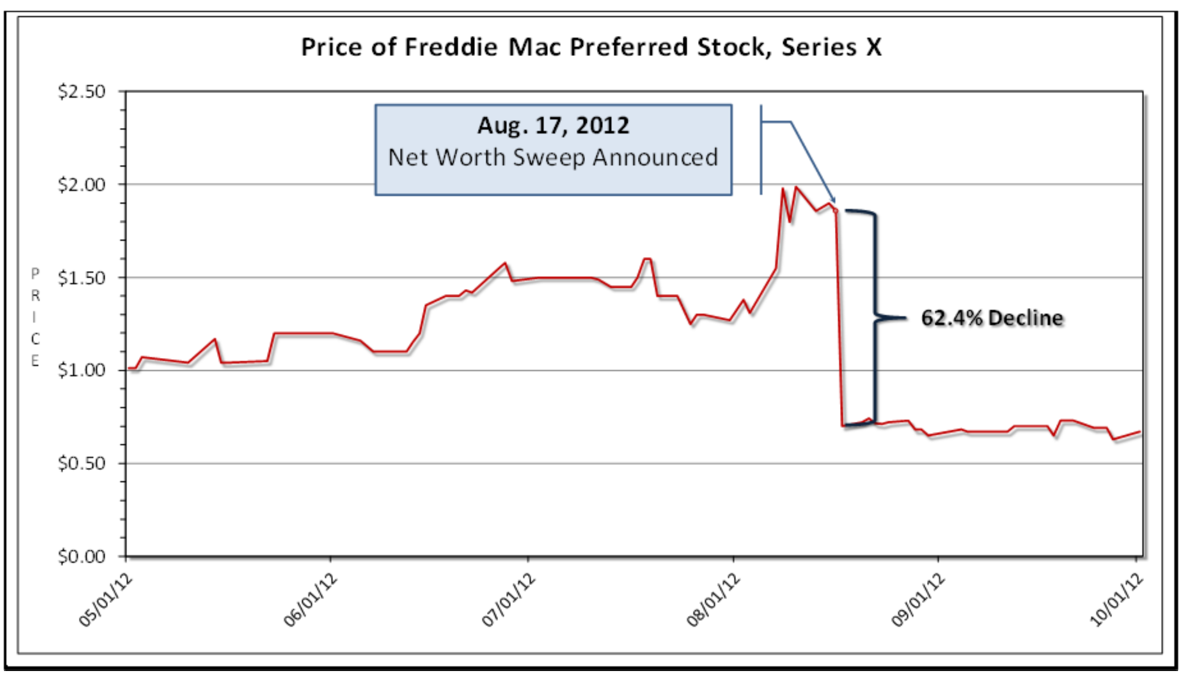
38. Throughout this time, the Companies continued to be managed in conservatorship by FHFA. HERA empowered FHFA to force the Companies into receivership and to liquidate their assets under certain circumstances, 12 U.S.C. § 4617(b)(2)(E), but FHFA always has maintained that its relationship with the Companies is that of Conservator rather than liquidator. *See* FHFA News Release, *A Strategic Plan For Enterprise Conservatorships: The Next Chapter In A Story That Needs An Ending*, at 9 (Feb. 21, 2012) (asserting that "[w]ithout action by Congress, FHFA must continue to look to the existing statutory provisions that guide ***the conservatorships***.") (emphasis added).

III. FREDDIE MAC RETURNS TO PROFITABILITY

39. In 2012, Freddie Mac returned to profitability, recording comprehensive income of $4.6 billion for the six-month period ending June 30, 2012. Its Treasury draw in the first

quarter of the year was only $19 million, and since Freddie Mac's net worth was positive during the second quarter, there was no need for it to draw upon additional Treasury funding for that quarter. Moreover, Freddie Mac's dividend payments to Treasury during the first six months of the year were only $3.6 billion. Thus, Freddie Mac had approximately one billion dollars with which to begin rebuilding its capital base, repaying the government for its financial support, or providing a financial return to its private investors. Yet instead of allowing any of these options to proceed, Treasury and FHFA instead implemented the Third Amendment to ensure that Freddie Mac could not benefit from its recovery.

40. The return of Freddie Mac to profitability in 2012 led to a substantial increase in the trading prices of its Preferred Stock. The price of each series of Freddie Mac Preferred Stock increased an average of 86% from May 1, 2012, to August 17, 2012. The Series X Preferred Stock, for example, increased by 84% during that time period, but suffered a material decline after the Third Amendment was announced:



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IV. THE THIRD AMENDMENT BARS FREDDIE MAC FROM BENEFITING FROM THE COMPANY'S RETURN TO PROFITABILITY

41. As noted above, FHFA agreed to sweep all of Freddie Mac's profits to Treasury exactly when it had returned to profitability. At a dividend rate of 10%, Treasury's approximately $72.3 billion in outstanding Government Stock earns annual dividends of some $7.2 billion, payable in quarterly installments of approximately $1.8 billion. Thus, in any quarter in which Freddie Mac's combined profits exceed $1.8 billion (or more precisely, any quarter in which Freddie Mac's profits exceed the dividend owed on its Government Stock), that value would inure to the benefit of the company ***but for the Third Amendment***. As FORTUNE magazine reported:

> Why did the Treasury enact the so-called Third Amendment that so radically altered the preferred-stock agreement? By mid-2012, Fannie and Freddie were beginning to generate what would become gigantic earnings as the housing market rebounded. If the original agreement remained in place, the GSEs would build far more than $100 billion in retained earnings, and hence fresh capital, in 2013 alone. That would exert pressure for Congress to allow Fannie and Freddie to pay back the government in full, and reemerge as private players. Timothy Geithner was strongly opposed to the rebirth of the old Fannie and Freddie. The "sweep clause" that grabbed the entire windfall in profits was specifically designed to ensure that Fannie and Freddie remained wards of the state that would eventually be liquidated.

What's Behind Perry Capital's Fannie and Freddie Gambit, FORTUNE, July 8, 2013.

42. In an August 17, 2012 press release announcing the modification of the PSPAs, Treasury said that the changes would "help expedite the wind down of Fannie Mae and Freddie Mac, make sure that every dollar of earnings each firm generates is used to benefit taxpayers, and support the continued flow of mortgage credit during a responsible transition to a reformed housing finance market." It called the amendment a full income sweep of "every dollar of profit that [the] firm earns going forward," and that the amendment will fulfill the "commitment made in the Administration's 2011 White Paper that [Freddie Mac and Fannie Mae] will be wound

down and will not be allowed to retain profits, rebuild capital, and return to the market in their prior form." This language was in stark contrast to their earlier representations that they sought only to "stabilize" the Companies and return them "to normal business operations" (as well as the February 2, 2010 statement of Edward DeMarco, Acting Director of FHFA, that "[t]here are a variety of options available for post-conservatorship outcomes, but the only one that FHFA may implement today under existing laws is to reconstitute the two companies under their current charters.").

43. The "Net Worth Sweep" is especially significant because Freddie Mac expects that it will be consistently profitable in the future. Freddie Mac had certain tax credits that it could only use if it generated taxable profits. When the company did not expect to be profitable, it maintained a valuation allowance against its net deferred tax assets. In the third quarter of 2013, however, Freddie Mac decided that the positive evidence that it would be sufficiently profitable to make use of the deferred tax assets outweighed the negative evidence. As a result, Freddie Mac recorded a $23.9 billion income tax benefit. But due to the Third Amendment, this benefit accrued directly to the Treasury. Because the income tax benefit increased Freddie Mac's net worth, it increased the amount of the dividend that Freddie Mac owed under the Third Amendment, such that Freddie Mac was required to make an enormous $30.4 billion dividend payment at the end of the year.

44. Treasury has received a windfall in payments of dividends under the Third Amendment. As of the date of filing of this Complaint, the Companies have together paid $213.1 billion to Treasury, exceeding their collective Treasury draws by $25.7 billion. Freddie Mac has now been profitable for ten consecutive quarters (and Fannie Mae for nine), but the Companies are not permitted to share in their own profits.

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45. The President's proposed fiscal year 2015 budget estimates that Freddie Mac and Fannie Mae will together pay $181.5 billion in dividends to Treasury over the next ten years (*i.e.*, fiscal 2014 to 2024), far outstripping the government's investments. According to the President's proposed budget, "[t]he cumulative budgetary impact of the PSPA agreements from the first PSPA purchase through FY 2024 is estimated to be a net return to taxpayers of $179.2 billion."

46. The Third Amendment is even capturing the Companies' recoveries on legal claims that preceded the conservatorships. For example, on October 1, 2013, Freddie Mac announced that it had entered into a $1.3 billion settlement with three financial institutions concerning Freddie Mac's claims relating to representations and warranties on loans that it had purchased, and that FHFA, as Freddie Mac's Conservator, had approved the settlement. The claims at issue involved loans that Freddie Mac purchased between 2000 and 2012, such that many of them preceded the conservatorship by years. Yet none of the funds recouped will benefit Freddie Mac. Rather, Freddie Mac's Chief Executive Officer stated that, "[w]ith these settlements, Freddie Mac is recouping funds effectively due to the nation's taxpayers."

47. Moreover, FHFA has announced other, similar settlements with financial institutions relating to breaches of representations and warranties, securities law violations, and common law fraud with respect to mortgage loans or mortgage-backed securities ("MBS") purchased by Freddie Mac and Fannie Mae well before the conservatorship. For example, on October 25, 2013, FHFA announced a $1.1 billion settlement in its role as Conservator to Freddie Mac and Fannie Mae, with JP Morgan relating to claims that the bank repurchase breaching loans sold to Fannie and Freddie in the years leading up to the financial crisis. In addition, FHFA announced a separate $4 billion settlement with JP Morgan, also in FHFA's role

as Conservator to the Companies, relating to claims that the bank violated the federal securities laws in connection with the sales and securitizations of loans to the Companies from 2005 to 2007. Similarly, on May 28, 2013, FHFA announced a $3.5 billion settlement, in its role as Conservator to the Companies with Citigroup, covering claims of alleged violations of federal and state securities laws in connection with private-label residential mortgage-backed securities purchased by Freddie Mac and Fannie Mae. FHFA announced similar settlements last year with UBS ($885 million), General Electric ($549 million), Bank of America ($404 million), and Wells Fargo ($335 million). This year, FHFA has already announced settlements, in its role as Conservator to the Companies, totaling approximately $9.7 billion with Bank of America ($9.33 billion aggregate payment), Barclays Bank PLC ($280 million) and RBS Securities ($99.5 million) which cover private-label MBS purchased by the Companies from 2005 to 2007.

V. THE THIRD AMENDMENT HARMS FREDDIE MAC BY PREVENTING IT FROM REBUILDING CAPITAL

48. FHFA has acknowledged that the agency "has a statutory charge to work to restore a regulated entity in conservatorship to a sound and solvent condition . . . ." Conservatorship and Receivership, 76 Fed. Reg. 35,727 (June 20, 2011). Accordingly, "allowing capital distributions to deplete the entity's conservatorship assets would be inconsistent with the agency's statutory goals, as they would result in removing capital at a time when the Conservator is charged with rehabilitating the regulated entity." *Id*. The Third Amendment's quarterly sweep of all net profits clearly harms, rather than promotes, Freddie Mac's soundness and solvency by effectively preventing it from rebuilding its capital.

49. Furthermore, statements by both FHFA and Treasury confirm that the Third Amendment is intended not merely to prevent Freddie Mac from rebuilding its capital, but to facilitate the company's eventual elimination. Treasury, for example, stated the Third

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Amendment would "expedite the wind down of Fannie Mae and Freddie Mac," and it emphasized that the "quarterly sweep of every dollar of profit that each firm earns going forward" would make "sure that every dollar of earnings that Fannie Mae and Freddie Mac generate will be used to benefit taxpayers." Press Release, U.S. Dep't of Treasury, *Treasury Department Announces Further Steps to Expedite Wind Down of Fannie Mae and Freddie Mac* (Aug. 17, 2012). Indeed, Treasury emphasized that the Third Amendment would ensure that the Companies "will be wound down and will not be allowed to retain profits, rebuild capital, and return to the market in their prior form." *Id.*

50. Likewise, FHFA Acting Director DeMarco stated that the Third Amendment reflected the agency's goal of "gradually contracting [the Companies'] operations." Edward J. DeMarco, Acting Director, FHFA, *Statement on Changes to Fannie Mae and Freddie Mac Preferred Stock Purchase Agreements*. DeMarco later informed a Senate Committee that the "recent changes to the [Purchase Agreements], replacing the 10 percent dividend with a net worth sweep, reinforce the notion that the [Companies] will not be building capital as a potential step to regaining their former corporate status." Edward J. DeMarco, Acting Director, FHFA, Statement Before the U.S. Senate Comm. on Banking, Housing and Urban Affairs, at 3 (Apr. 18, 2013). Likewise, in its 2012 report to Congress, FHFA explained that it had begun "prioritizing [its] actions to move the housing industry to a new state, one without Fannie Mae and Freddie Mac." FHFA, Report to Congress 2012, at 13 (June 13, 2013). Thus, according to FHFA, the Third Amendment "ensures all the [Companies'] earnings are used to benefit taxpayers" and "reinforces the fact that the [Companies] will not be building capital." *Id*. at 1, 13.

51. Additionally, the dividend under the Government Stock must be paid to Treasury in cash, even though Freddie Mac's net worth may include non-cash assets, such as deferred tax

assets. As a result, Freddie Mac has had to sell non-liquid assets or issue debt to pay the dividend, which has had the foreseeable effect of preventing it from maximizing the value of its assets. Borrowing money to pay a dividend on a paper profit is directly contrary to operating Freddie Mac in a safe and sound manner and restoring it to financial health, as FHFA is statutorily required to do when it is acting as a conservator.

52. Further, Freddie Mac can never accumulate capital under the Third Amendment and can never redeem the Government Stock: so long as the Companies remain in operation, all of its net worth will be transferred to Treasury but the outstanding balance of the Government Stock will remain $72.3 billion.

VI. BY ENTERING INTO THE THIRD AMENDMENT, FHFA AND TREASURY VIOLATED THEIR FIDUCIARY OBLIGATIONS TO FREDDIE MAC

53. Virginia law applies to Freddie Mac pursuant to Section 11.3 of its bylaws. Under Virginia law, officers and directors of a corporation owe that corporation and its shareholders fiduciary obligations to exercise the utmost good faith in their dealings with the corporation, not to place themselves in any position where their individual interests clash with their duty to the corporation, and not to use their position to acquire personal advantage or profit.

54. By reason of its purported conservatorship of Freddie Mac and because of its ability to control the business and corporate affairs of Freddie Mac, FHFA is a *de facto* officer or director of Freddie Mac and, therefore, owed Freddie Mac fiduciary obligations to exercise the utmost good faith in its dealings with the company.

55. As disclosed in Freddie Mac's 2013 Form 10-K filing, "Upon its appointment, FHFA, as Conservator, immediately succeeded to all rights, titles, powers and privileges of Freddie Mac, and of any stockholder, officer or director of Freddie Mac with respect to Freddie Mac and its assets. . . . We conduct our business subject to the direction of FHFA as our

Conservator. . . . The Conservator continues to determine, and direct the effects of the Board of Directors and management to address, the strategic direction for the company. While the Conservator has delegated certain authority to management to conduct business operations, many management decisions are subject to review and approval by FHFA and Treasury. In addition, management frequently receives directions from FHFA on various matters involving day-to-day operations."

56. Freddie Mac's current directors "serve on behalf of, and exercise authority as directed by, the Conservator." FHFA has instructed Freddie Mac's directors to consult with it and obtain its written approval before taking action in a wide variety of areas, including but not limited to:

(a) Engaging in redemptions or repurchases of subordinated debt;

(b) Matters that relate to the Conservator's powers, Freddie Mac's conservatorship status, or the legal effect of the conservatorship on contracts;

(c) Agreements relating to litigation, claims, regulatory proceedings, or tax-related matters where the value of the claim exceeds a specified threshold;

(d) Actions that are likely to cause significant reputational risk;

(e) Establishing the annual operating budget; and

(f) Matters requiring the approval of or consultation with Treasury under the PSPAs.

57. While Freddie Mac's officers are under FHFA's control, in a February 2, 2010 letter to Congress, the Director of FHFA confirmed that "Like other corporate executives, the Enterprises' executive officers are subject to the legal responsibility to use sound and prudent business judgment in their stewardship of their companies," and that FHFA had charged the Companies' boards with "ensuring normal corporate governance practices and procedures are in

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place." FHFA was and is required to act in furtherance of the best interests of the Companies and not in furtherance of the personal interest or benefit of FHFA, Treasury, or the federal government. Because of its position of control and authority as the conservator of Freddie Mac, FHFA was able to and did, directly and/or indirectly, exercise control over the wrongful acts complained of herein.

58. Additionally, under Virginia law, dominant or controlling stockholders also owe fiduciary duties, and must exercise good faith and care in their dealings with the corporation. Any disposition of the corporation or its assets to deprive the minority holders of their just share of it or to gain for themselves at the expense of the holders of the minority of the stock is a breach of their duties and of trust. It is the fact of control held and exercised of the common property, not the particular means by which or manner in which the control is exercised, that creates the fiduciary obligation. *See Parsch v. Massey*, No. 04-193, 2009 WL 7416040, at *11 (Va. Cit. Ct. Nov. 5, 2009).

59. Treasury exercises *de facto* control over Freddie Mac, including through its Senior Preferred Stock, and warrants to purchase the Companies' common stock, as well as its control of the provision of funds to Freddie Mac. Freddie Mac's 2012 Form 10-K admits that "Treasury has significant rights and powers with respect to our company as a result of the Purchase Agreement," and that Freddie Mac is "dependent upon the continued support of Treasury" in order to keep operating its business. Without the prior written consent of Treasury, Freddie Mac may not, *inter alia*:

(a) Declare or pay any dividend;

(b) Redeem, purchase, retire, or otherwise acquire any Freddie Mac equity securities;

(c) Sell or issue any Freddie Mac equity securities;

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(d) Seek to terminate the conservatorship; or

(e) Enter into a corporate reorganization, recapitalization, merger, acquisition, or similar event.

60. In addition, Treasury's warrants to purchase 79.9% of Freddie Mac's common stock provide Treasury with the effective ability to decide any vote that is presented to Freddie Mac stockholders. Freddie Mac's 2012 Form 10-K states that, "Treasury has the ability to acquire almost 80% of our common stock for nominal consideration by exercising the warrant we issued to it pursuant to the Purchase Agreement. Consequently, the company could effectively remain under the control of the U.S. government even if the conservatorship were ended and the voting rights of common stockholders restored." Due to Treasury's warrants, "existing common stockholders have no assurance that, as a group, they will be able to control the election of our directors or the outcome of any other vote after the time, if any, that the conservatorship ends."

61. The administrative record produced by Defendants in a related litigation indicates that the structure of the Third Amendment's Net Worth Sweep originated with Treasury, and characterize the Net Worth Sweep as "Treasury's PSPA Modification Proposal."

62. As controlling stockholder of Freddie Mac, Treasury owed fiduciary duties of due care, good faith, loyalty, and candor, to Freddie Mac. Because of Treasury's *de facto* position of control and authority over Freddie Mac, it stood on both sides of the decision to engage in the Third Amendment and it was able to and did, directly and/or indirectly, exercise control over the wrongful acts complained of herein.

63. The Third Amendment offered no benefits whatsoever to Freddie Mac. Rather, it was an egregiously self-dealing transaction, the benefits of which flowed entirely to the Treasury

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as Freddie Mac's controlling stockholder, and indirectly to FHFA through its status as an agency of the federal government.

64. The Third Amendment was in no way an exercise of valid business judgment or deemed to be in the best interests of Freddie Mac. Indeed, it was specifically intended to ensure that the Company could not function as a private enterprise and would have to be wound down. By preventing Freddie Mac from rebuilding capital or returning to the market, as Treasury stated in its press release, the purpose and effects of the Third Amendment ran directly contrary to FHFA's purported statutory mission to "put the regulated entity in a sound and solvent condition," "carry on the business of the regulated entity," and "preserve and conserve the assets and property of the regulated entity." 12 U.S.C. § 4617(b)(2)(D). As such, the Third Amendment was inconsistent and in manifest conflict with FHFA's statutory functions and responsibilities as Conservator to the Companies.

PLAINTIFFS HAVE SATISFIED THE DEMAND REQUIREMENT

65. Plaintiffs bring this action derivatively on behalf of and for the benefit of Freddie Mac to redress injuries suffered by Freddie Mac as a direct and proximate result of the breaches of fiduciary duty alleged herein. Freddie Mac is named as a nominal defendant in a derivative capacity.

66. Plaintiffs AEIC, Cacciapalle and Miller are holders of Freddie Mac Preferred Stock and common stock, respectively. Plaintiff AEIC was a holder of Freddie Mac Preferred Stock prior to September 6, 2008, including prior to and on August 17, 2012, and has been a holder of said securities continuously since then. Plaintiff Cacciapalle was a holder of Freddie Mac Preferred Stock prior to September 6, 2008, including prior to and on August 17, 2012, and has been a holder of said securities continuously since then. Plaintiff Miller was a holder of Freddie Mac common stock prior to and on August 17, 2012, and has been a holder of said

securities continuously since then. Plaintiffs have retained counsel that is competent and experienced in derivative litigation.

67. Plaintiffs AEIC, Cacciapalle and Miller intend to retain their shares of Preferred Stock and common stock, respectively, throughout the duration of this litigation.

68. The breaches of fiduciary duties complained of herein subject, and will persist in subjecting, Freddie Mac to continuing harm because the adverse consequences of the injurious actions are still in effect and ongoing.

69. Va Code Ann. 13.1-672.1 provides that "[n]o shareholder may commence a derivative proceeding until: (1) A written demand has been made on the corporation to take suitable action; and (2) Ninety days have expired from the date delivery of the demand was made[.]"

70. On January 6 and 7, 2014, Plaintiffs each sent a letter to Freddie Mac regarding the Third Amendment and the matters at issue in this Complaint, demanding that the Board of Directors of Freddie Mac and/or FHFA commence a civil action against FHFA and Treasury to recover for the benefit of Freddie Mac all damages that Freddie Mac has suffered as a result of FHFA and Treasury's breaches of their respective fiduciary duties, and commence a civil action for a declaration that the Third Amendment is null and void. Copies of these letters are attached to this Complaint as Exhibits A, B and C.

71. On April 9, 2014, FHFA rejected Plaintiffs' demands, stating that, "the conservator does not intend to authorize Freddie Mac or its directors or officers on behalf of Freddie Mac to take the actions that the Letter demands." Copies of the letters that FHFA sent to Plaintiffs rejecting Plaintiffs' demands are attached to this Complaint as Exhibits D, E, and F.

CAUSES OF ACTION

BREACH OF FIDUCIARY DUTY
(Against Treasury and FHFA)

72. Plaintiffs incorporate by reference and reallege each and every allegation set forth above, as though fully set forth herein.

73. By imposing a conservatorship over Freddie Mac, through which FHFA assumed the powers of its officers and directors, FHFA assumed fiduciary duties of due care, good faith, loyalty, and candor, to Freddie Mac, and was and is required to use its utmost ability to control and manage Freddie Mac in a fair, just, honest, and equitable manner. FHFA was and is required to act in furtherance of the best interests of Freddie Mac and its stockholders so as to benefit all stockholders equally and not in furtherance of the personal interest or benefit of FHFA, Treasury, or the federal government.

74. Treasury exercises *de facto* control over Freddie Mac, including through its Senior Preferred Stock and warrants to purchase Freddie Mac common stock, as well as its control of the provision of funds to Freddie Mac. As controlling stockholder of Freddie Mac, Treasury owed fiduciary duties of due care, good faith, loyalty, and candor, to Freddie Mac.

75. The Third Amendment constituted a self-dealing transaction. Treasury, as controlling stockholder of Freddie Mac, stood on both sides of the decision to implement the Third Amendment, to the benefit of Treasury and the detriment of Freddie Mac and its stockholders other than Treasury. Moreover, as an agency of the federal government, FHFA was interested in and benefited from the Third Amendment.

76. Through the Third Amendment, FHFA and Treasury breached their fiduciary duties to Freddie Mac. The Third Amendment was not entirely fair to Freddie Mac, as it was neither the product of a fair process nor reflected a fair price. Indeed, the Third Amendment,

which effectively delivers all of Freddie Mac's profits to Treasury in perpetuity, was granted to benefit the Treasury, with no benefit to Freddie Mac in return.

77. The Third Amendment was neither entirely nor intrinsically fair, nor did it further any valid business purpose of Freddie Mac, nor did it reflect a good faith business judgment as to what was in the best interests of Freddie Mac.

78. The Third Amendment constituted waste and a gross abuse of discretion.

79. As a direct and proximate result of the foregoing breach of fiduciary duty, Freddie Mac suffered damages.

PRAYER FOR RELIEF

WHEREFORE, Plaintiffs pray for relief and judgment, as follows:

1. Declaring that this action is a proper derivative action and that the presuit demand requirement has been satisfied;

2. Declaring that the Third Amendment was neither entirely nor intrinsically fair to Freddie Mac, did not further any valid business purpose of Freddie Mac, did not reflect a good faith business judgment as to what was in the best interests of Freddie Mac, and constituted waste and a gross abuse of discretion;

3. Declaring that, through the Third Amendment, Defendants FHFA and Treasury breached their respective fiduciary duties to Freddie Mac;

4. Awarding compensatory damages and disgorgement in favor of Freddie Mac against Defendants FHFA and Treasury, jointly and severally, as a result of such defendants' breach of their respective fiduciary duties, in an amount to be proven at trial, including pre-judgment and post-judgment interest thereon;

5. Awarding Plaintiffs their reasonable costs and expenses incurred in this action, including counsel fees and expert fees; and

6. Such other and further relief as the Court may deem just and proper.

JURY TRIAL DEMANDED

Plaintiffs hereby demand a trial by jury.

Dated: July 30, 2014

Respectfully Submitted,

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Additional Counsel for Plaintiffs

VERIFICATION

I, Steve Klein, Treasurer of American European Insurance Company, hereby verify that I have authorized the filing of the attached Derivative Complaint, that I have reviewed the Derivative Complaint and that the facts therein are true and correct to the best of my knowledge, information and belief.

I declare under penalty of perjury that the foregoing is true and correct.

DATE: 7/21/2014

Steve Klein

Steve Klein

VERIFICATION

I, Joseph Cacciapalle, hereby verify that I have authorized the filing of the attached Derivative Complaint, that I have reviewed the Derivative Complaint and that the facts therein are true and correct to the best of my knowledge, information and belief.

I declare under penalty of perjury that the foregoing is true and correct.

DATE: 7/25/14

Joseph Cacciapalle

Joseph Cacciapalle

VERIFICATION

I, Michelle M. Miller, hereby verify that I have authorized the filing of the attached Derivative Complaint, that I have reviewed the Derivative Complaint and that the facts therein are true and correct to the best of my knowledge, information and belief.

I declare under penalty of perjury that the foregoing is true and correct.

DATE: 7/23/14

Michelle M. Miller

EXHIBIT 21

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF IOWA
CEDAR RAPIDS DIVISION

THOMAS SAXTON, IDA SAXTON,
BRADLEY PAYNTER,

Plaintiffs,

vs.

THE FEDERAL HOUSING FINANCE AGENCY, in its capacity as Conservator of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, MELVIN L. WATT, in his official capacity as Director of the Federal Housing Finance Agency, and THE DEPARTMENT OF THE TREASURY,

Defendants.

Civil Action No. 1:15-cv-00047

ORDER

This matter comes before the Court on the Unopposed Motion to Unseal Plaintiffs' Amended Complaint (docket number 84) filed by the Plaintiffs on June 23, 2016. Plaintiffs' move the Court to unseal their Amended Complaint, which was originally filed under seal, as it contains certain information subject to a Protective Order in a pending United States Court of Federal Claims case, *Fairholme Funds, Inc. v. United States*, No. 13-465C. [R. 47 at 1]. Since the filing of the Amended Complaint, the "protected information" designation has been removed from the information referenced in the Amended Complaint that previously was subject to the *Fairholme* protective order. Further, counsel for Defendants and counsel for the parties who produced the information at issue in the *Fairholme* case all have consented to the unsealing of the Amended Complaint. Accordingly, for the reasons stated in the motion, the Court finds the motion should be granted.

ORDER

IT IS THEREFORE ORDERED that the Motion to Unseal Plaintiff's Amended Complaint (docket number 84) filed by Plaintiffs is **GRANTED.**

DATED this 24th day of June, 2016.

JON STUART SCOLES
CHIEF MAGISTRATE JUDGE
NORTHERN DISTRICT OF IOWA

**IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF IOWA
CEDAR RAPIDS DIVISION**

THOMAS SAXTON, IDA SAXTON, BRADLEY PAYNTER, Plaintiffs, vs. THE FEDERAL HOUSING FINANCE AGENCY, in its capacity as Conservator of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, MELVIN L. WATT, in his official capacity as Director of the Federal Housing Finance Agency, and THE DEPARTMENT OF THE TREASURY, Defendants.	No. 1:15-cv-00047 **PLAINTIFFS' AMENDED COMPLAINT FOR DECLARATORY AND INJUNCTIVE RELIEF AND DAMAGES** **[FILED UNDER SEAL]**

Thomas Saxton, Ida Saxton, and Bradley Paynter, by and through their undersigned counsel, hereby allege as follows:

I. INTRODUCTION

1. In August 2012, at a time when the housing market was recovering from the financial crisis and the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (respectively, "Fannie" and "Freddie," and, together, the "Companies") had returned to stable profitability, the federal government took for itself the entire value of the rights held by Plaintiffs and Fannie's and Freddie's other private shareholders by forcing these private, shareholder-owned Companies to turn over **all** of their profits to the federal government on a quarterly basis **forever**—an action the government called the "Net Worth Sweep." Plaintiffs

bring this action to put a stop to the federal government's naked and unauthorized expropriation of their property rights.

2. Fannie and Freddie are two of the largest privately owned financial institutions in the world. They insure trillions of dollars of mortgages and provide essential liquidity to the residential mortgage market. The Companies operate for profit, and their debt and equity securities are privately owned and publicly traded. The Companies' shareholders include community banks, charitable foundations, mutual funds, insurance companies, pension funds, and countless individuals, including Plaintiffs.

3. Throughout the financial crisis, Fannie and Freddie were capable of meeting all of their obligations to insureds and creditors and were capable of absorbing any losses that they might reasonably incur as a result of the downturn in the financial markets. As mortgage insurers, Fannie and Freddie are designed to generate ample cash to cover their operating expenses—and indeed this was the case for the Companies throughout the financial crisis. In contrast to the nation's largest banks, the Companies took a relatively conservative approach to investing in mortgages during the national run up in home prices from 2004 to 2007. As a result, the Companies (i) experienced substantially lower mark-to-market credit losses during the financial crisis than other mortgage insurers, (ii) were never in financial distress, and (iii) remained in a comparatively strong financial condition. Indeed, the Companies' ability to pay any outstanding claims—a fundamental principle for all insurers—was never in doubt. Despite the Companies' relative financial health, the Department of the Treasury ("Treasury") implemented a deliberate strategy to seize the Companies and operate them for the exclusive benefit of the federal government.

4. At Treasury's urging, in July 2008, Congress enacted the Housing and Economic Recovery Act of 2008 ("HERA"). HERA created the Federal Housing Finance Agency ("FHFA") (Treasury and FHFA are sometimes collectively referred to herein as the "Agencies") to replace Fannie's and Freddie's prior regulator and authorized FHFA to appoint itself as conservator or receiver of the Companies in certain statutorily specified circumstances. As conservator, HERA charges FHFA to rehabilitate Fannie and Freddie by taking action to put the Companies in a sound and solvent condition while preserving and conserving their assets. Only as receiver does HERA authorize FHFA to wind up the affairs of Fannie and Freddie and liquidate them. HERA's distinctions between the authorities granted to conservators and receivers are consistent with longstanding laws and practices of financial regulation.

5. HERA also granted Treasury temporary authority to invest in the Companies' stock until December 31, 2009. Congress made clear that in exercising this authority Treasury was required to consider the need for Fannie and Freddie to remain private, shareholder-owned companies.

6. These limitations on FHFA's and Treasury's authority make clear that Congress did not intend for the Agencies to operate Fannie and Freddie in perpetuity, and certainly not for the exclusive financial benefit of the federal government.

7. On September 6, 2008—despite both Agencies' prior public statements assuring investors that the Companies were in sound financial shape—FHFA, at Treasury's urging, abruptly forced Fannie and Freddie into conservatorship. Under HERA, and as acknowledged by FHFA at the time, the purpose of the conservatorship was to restore confidence in and stabilize the Companies with the objective of returning them to normal business operations. As FHFA confirmed in its public statements, conservatorship is necessarily temporary, and FHFA may

only act as conservator for the Companies until they are stabilized. At the time, neither of the Companies was experiencing a liquidity crisis, nor did they suffer from a short-term fall in operating revenue. Moreover, the Companies had access to separate credit facilities at the Federal Reserve and at the Treasury, and the Companies held hundreds of billions of dollars in unencumbered assets that could be pledged as collateral if necessary. Nevertheless, Treasury instead coerced the Companies into conservatorship to further the government's unspoken policy objectives. Indeed, a receivership that sold all of the Companies' assets and liabilities would have more economic value to the private shareholders than the conservatorship as it was structured and operated in practice. And in any event, Treasury had definitively concluded that the Companies would not be placed into receivership at that time.

8. Immediately after the Companies were forced into conservatorship, Treasury exercised its temporary authority under HERA to enter into agreements with FHFA to purchase securities of Fannie and Freddie ("Preferred Stock Purchase Agreements" or "PSPAs"). Under these PSPAs, Treasury committed to purchase a newly created class of securities in the Companies, known as Senior Preferred Stock ("Government Stock"). In return for its commitment to purchase Government Stock, Treasury received $1 billion of Government Stock in each Company and warrants to acquire 79.9% of the common stock of the Companies at a nominal price.

9. The Government Stock entitled Treasury to dividends at an annualized rate of 10% if paid in cash or 12% if paid in kind. The Government Stock was entitled to receive cash dividends from the Companies only to the extent declared by the Board of Directors "in its sole discretion, from funds legally available therefor." If the Companies did not wish to—or legally could not—pay a cash dividend, the unpaid dividends on the Government Stock could be

capitalized (or paid "in kind") by increasing the liquidation preference of the outstanding Government Stock—an option Treasury publicly acknowledged in the fact sheet it released upon entry into the PSPAs. Therefore, the Companies were *never* required to pay cash dividends on Government Stock. There was *never* any threat that the Companies would become insolvent by virtue of making cash dividend payments, both because dividends could be paid with stock and because state law prohibits the payment of dividends if it would render a company insolvent. Indeed, unlike most preferred stock that imposes temporal limits on a company's ability to exercise a payment in kind option, the PSPAs specifically allowed the Companies to utilize this mechanism throughout the life of the agreement, thereby foreclosing any possibility that they would exhaust Treasury's funding commitment because of a need to make a dividend payment to Treasury.

10. The Government Stock diluted, but did not eliminate, the economic interests of the Companies' private shareholders. The warrants to purchase 79.9% of the Companies' common stock gave Treasury "upside" via economic participation in the Companies' profitability, but this upside would be *shared* with preferred shareholders (who had to be paid before any payment could be made on common stock purchased with Treasury's warrants) and common shareholders (who retained rights to 20.1% of the Companies' residual value). James Lockhart, the Director of FHFA, accordingly assured Congress shortly after imposition of the conservatorship that Fannie's and Freddie's "shareholders are still in place; both the preferred and common shareholders have an economic interest in the companies" and that "going forward there may be some value" in that interest.

11. Under FHFA's supervision—and, on information and belief, at the insistence and direction of Treasury—the Companies were forced to excessively write down the value of their

assets, primarily due to FHFA's wildly pessimistic assumptions about potential future losses. Despite the Companies' concerns, FHFA caused the Companies to incur substantial non-cash accounting losses in the form of loan loss provisions. To be clear, tens of billions of dollars of these provisions—recognized by the Companies as expenses—were completely unnecessary since the potential loan losses never materialized into actual losses. Nonetheless, by June 2012, the Agencies had forced Fannie and Freddie to issue $161 billion in Government Stock to make up for the balance-sheet deficits caused by the Agencies' unrealistic and overly pessimistic accounting decisions, even though there was no indication that the Companies' actual cash expenses could not be met by their cash receipts. The Companies were further forced to issue an additional $26 billion of Government Stock so that Fannie and Freddie would be able to pay *cash* dividends to Treasury even though, as explained above, the Companies were never required to pay cash dividends. Finally, because (i) the Companies were forced to issue Government Stock to Treasury that they did not need to continue operations and (ii) the structure of Treasury's financial support did not permit the Companies to repay and redeem the Government Stock outstanding, the amount of the dividends owed on the Government Stock was artificially—and permanently—inflated.

12. As a result of these transactions, Treasury amassed a total of $189 billion in Government Stock. But based on the Companies' performance in the second quarter of 2012, it was apparent that there was still value in the Companies' private shares. Treasury's attempt to drown the Companies by extending a *concrete* "life preserver" had failed. By that time, the Companies were thriving and paying 10% annualized cash dividends on the Government Stock without drawing additional capital from Treasury. And based on the improving housing market and the high quality of the newer loans backed by the Companies, it was apparent that they had

returned to stable profitability. This return to profitability made it inevitable that the Companies would be reversing many of the non-cash accounting losses they had incurred under FHFA's supervision, and the reversal of those paper losses would result in massive profits. Indeed, the Agencies had specific information from the Companies demonstrating that such reversals would take place soon. Given this information and the broad-based recovery in the housing industry that had occurred by the middle of 2012, the Agencies fully understood that the Companies were on the precipice of generating huge profits, far in excess of the dividends owed on the Government Stock. Moreover, when the Net Worth Sweep was suddenly imposed on the Companies in August 2012, the financial crisis had clearly passed and there was absolutely no need for "drastic emergency action" by the Agencies.

13. Treasury, however, was not content to share the value of the Companies with private shareholders and was committed to ensuring that the Companies were operated for the exclusive benefit of the federal government. Indeed, unbeknownst to the public, Treasury had secretly resolved "to ensure existing common equity holders will not have access to any positive earnings from the [Companies] in the future." By the middle of 2012, however, it was apparent that even the large amount of Government Stock outstanding—the proverbial "concrete life preserver"—would not achieve this unlawful policy goal for Treasury.

14. Therefore, on August 17, 2012, just days after the Companies announced their robust second quarter earnings, the Agencies unilaterally imposed the Net Worth Sweep to expropriate for the federal government the value of Fannie and Freddie shares held by private investors. Treasury itself said that the Net Worth Sweep was intended to ensure that "every dollar of earnings that Fannie Mae and Freddie Mac generate will benefit taxpayers." With the stroke of a pen, the Agencies had nationalized the Companies and taken all the value of the

Companies for the government, thereby depriving the private shareholders of all their economic rights, well in excess of the authority granted to the FHFA as conservator. The Companies received no incremental investment by Treasury or other meaningful consideration in return for the Net Worth Sweep. All of this was in blatant violation "the path laid out under HERA," which, as even Treasury acknowledged internally, was for Fannie and Freddie to "becom[e] adequately capitalized" and "exit conservatorship as private companies."

15. In attempting to defend the Agencies' naked expropriation of private property rights against claims by injured shareholders, the government has insisted that the Net Worth Sweep was necessary to prevent the Companies from entering a "death spiral" due to their existing dividend obligations to Treasury. This argument is facially implausible for at least two reasons: first, the timing of the Net Worth Sweep belies this explanation. The Agencies did not impose the Net Worth Sweep at a time when Fannie and Freddie were struggling to earn enough money to pay cash dividends to Treasury, but rather imposed it mere days after the Companies announced that they had earned several billion dollars more than necessary to make such payments. What is more, these earnings, coupled with an improving housing market and the improving quality of loans guaranteed by Fannie and Freddie, made clear that the Companies would soon be considering reversal of the non-cash accounting losses they had been forced to take while in conservatorship, which would generate extraordinary gains commensurate with those losses. Second, Treasury's Government Stock certificates never could cause the Companies to enter a death spiral, because by their plain terms they provided a mechanism for Fannie and Freddie to pay dividends in-kind rather than in cash.

16. In light of these facts, there were only two possible explanations for the death-spiral rationale: incompetence on the part of the Agencies at the time of the Net Worth Sweep or

inaccuracy in describing the Agencies' reasons for taking action. Discovery in the Court of Federal Claims has ruled out incompetence. Indeed, that discovery has made clear that the reason the Net Worth Sweep was adopted when it was is precisely the *opposite* of a concern that the Companies' earnings were going to be too low. Rather, the concern was that the Companies' earnings would be *too high* and thus would complicate the Agencies' plans to keep Fannie and Freddie in perpetual conservatorship and to prevent their private shareholders from seeing any return on their investments.

17. There is a wealth of evidence that supports this conclusion, and much of it is detailed below. But the most striking evidence relates to a meeting that occurred on August 9, 2012, between senior Treasury officials, including Under Secretary Mary Miller, and Fannie's executive management team. The Agencies knew in advance of that meeting that the company was likely entering a period of "golden years" of earnings. Indeed, in July 2012 the minutes of a Fannie executive management meeting during which that precise sentiment was expressed were circulated broadly within FHFA, including to Acting Director Edward DeMarco. Projections attached to those minutes showed that Fannie expected that its dividend payments to Treasury would exceed its draws under the PSPAs by 2020 and, more importantly for the "death spiral" narrative, that over $115 billion of Treasury's commitment would remain after 2022.

18. Fannie's projections did not account for reversal of the Company's massive deferred tax assets valuation allowance. That item alone would add over $50 **billion** dollars to Fannie's balance sheet. Treasury was keenly aware of this impending addition to earnings. Indeed, by late May 2012 Treasury was discussing with its consultant the topic of returning the deferred tax asset to Fannie's and Freddie's balance sheets, and a key item on Treasury's agenda for the August 9 meeting was how quickly Fannie forecasted releasing its reserves. At the

August 9 meeting, in addition to being presented with projections similar to those provided to FHFA in July, Treasury was given very specific information about the Company's deferred tax assets: Fannie CFO Susan McFarland has testified that she told Under Secretary Miller that release of the valuation allowance likely would happen in mid-2013 and that it likely would be in the range of $50 billion—a prediction that proved remarkably accurate. It thus is no surprise that Ms. McFarland also has testified that she did not think that Fannie was in a death spiral in mid-August 2012.

19. The Net Worth Sweep was imposed only days after Treasury's meeting with Fannie—and email traffic indicates that Treasury was making a "renewed push" to finalize the Net Worth Sweep that very day. In light of all of this, it is wholly implausible for the Agencies to claim that there was any imminent concern of a "death spiral." Indeed, in an internal document authored the day before the sweep, Treasury specifically identified the Companies' improving operating performance and the potential for near-term earnings to *exceed* the 10% dividend as reasons for imposing the Net Worth Sweep.

20. Treasury's knowledge of Fannie's expectations for its deferred tax assets also wholly discredits the declaration FHFA submitted to the public record in another district court asserting that "neither the Conservator nor Treasury envisioned at the time of the Third Amendment that Fannie Mae's valuation allowance on its deferred tax assets would be reversed in early 2013, resulting in a sudden and substantial increase in Fannie Mae's net worth, which was paid to Treasury in mid-2013 by virtue of the net worth dividend." That declaration was signed under penalty of perjury by Mario Ugoletti, who participated in the creation and implementation of the PSPAs while at Treasury, later moved to FHFA, and at the time of the Net Worth Sweep served as the principal liaison with Treasury concerning the PSPAs. And in his

deposition, Mr. Ugoletti expressly disclaimed any knowledge of Treasury's understanding of the deferred tax asset issue, and he also denied knowing what anyone else at FHFA thought about the issue.

21. The Net Worth Sweep has resulted in a massive and unprecedented financial windfall for the federal government. From the fourth quarter of 2012, the first fiscal quarter subject to the Net Worth Sweep, through the second quarter of 2015, the most recently completed fiscal quarter, Fannie and Freddie generated nearly $180 billion in net income. But rather than using those profits to prudently build capital reserves and prepare to exit conservatorship, Fannie and Freddie instead have been forced to pay $186 billion in "dividends" to the federal government under the Net Worth Sweep (funded by that net income and draining prior retained earnings)—nearly $130 billion more than the government would have received under the original PSPAs. Adding Net Worth Sweep dividends to the dividends Fannie and Freddie had already paid, Treasury has now recouped $54 billion *more* than it invested in the Companies. Yet, according to Treasury, the amount of outstanding Government Stock remains firmly fixed at $189 billion, and Treasury continues to insist that it has the right to all of Fannie's and Freddie's future earnings *in perpetuity*. At the time of the Net Worth Sweep, the Agencies knew that it would result in a massive financial windfall.

22. The Net Worth Sweep blatantly transgresses the limits Congress placed on FHFA's and Treasury's authority. As conservator of Fannie and Freddie, FHFA is charged with rehabilitating the Companies with a view to returning them to private control. The Net Worth Sweep guarantees that this can *never* be accomplished. Indeed, contrary to its statutory requirements and statements that it made when the conservatorship was initiated, FHFA has now indicated that it will operate Fannie and Freddie for the exclusive benefit of the government until

Congress passes housing finance legislation. Holding the Companies hostage in a perpetual conservatorship while awaiting potential legislative action was never an option for FHFA contemplated under HERA. And Treasury's decision to exchange its existing equity stake in the Companies for the new and different equity stake granted to it by the Net Worth Sweep years *after* its temporary authority to acquire the Companies' stock had expired is a direct affront to HERA's plain requirements. What is more, on information and belief Treasury compelled FHFA to agree to the Net Worth Sweep despite Congress's express direction that FHFA exercise its conservatorship authority independently.

23. By entering the Net Worth Sweep, FHFA violated HERA in at least five ways. First, FHFA failed to act as a "conservator"—indeed it has acted as an anti-conservator—because conservators are not allowed to use the companies under their care as ATM machines. Second, FHFA is required to put Fannie and Freddie in a sound and solvent condition, but the Net Worth Sweep forces the Companies to operate on the edge of insolvency by stripping the capital out of the Companies on a quarterly basis. Third, FHFA is required to conserve and preserve Fannie's and Freddie's assets, but the Net Worth Sweep requires the dissipation of assets by forcing the Companies to pay their net worth to Treasury on a quarterly basis. Fourth, FHFA is charged with rehabilitating Fannie and Freddie and seeking to return them to private control, but the Net Worth Sweep is designed to make any such outcome impossible. Finally, FHFA as conservator cannot be subject to the direction and supervision of any other government agency, but, on information and belief, FHFA entered the Net Worth Sweep at the direction and supervision of Treasury.

24. Treasury's violation of HERA is straightforward: the Net Worth Sweep, by changing the fundamental economic characteristics of Treasury's investment, created new

securities, and HERA explicitly prohibited Treasury from acquiring Fannie and Freddie securities in 2012.

25. This Court must set aside the Net Worth Sweep and restore to Plaintiffs the property rights the federal government has unlawfully expropriated for itself.

II. JURISDICTION AND VENUE

26. Counts I–III of this action arise under the Administrative Procedure Act ("APA"), 5 U.S.C. §§ 551–706, and/or the Housing and Economic Recovery Act of 2008 ("HERA"), PUB. L. NO. 110-289, 122 Stat. 2654 (2008) (codified at 12 U.S.C. §§ 1455, 1719, 4617). The Court has subject-matter jurisdiction over these claims under 28 U.S.C. § 1331. The Court is authorized to issue the non-monetary relief sought with respect to these claims pursuant to 5 U.S.C. §§ 702, 705, and 706. The Court has subject matter jurisdiction over Counts IV-V under 28 U.S.C. § 1367.

27. The Court also has subject matter jurisdiction over Counts IV-V under 12 U.S.C. §§ 1452(c), 1723a(a), and 4617(b)(2)(A).

28. Venue is proper in this Court under 28 U.S.C. § 1391(e)(1)(C) because this is an action against officers and agencies of the United States, Plaintiffs Thomas and Ida Saxton reside in this judicial district, and no real property is involved in the action.

III. PARTIES

29. Plaintiffs Thomas and Ida Saxton are citizens of the United States and residents and citizens of the State of Iowa. The Saxtons reside in Cedar Rapids, Iowa, in Linn County.

30. Plaintiff Bradley Paynter is a citizen of the United States and a resident and citizen of the State of Washington.

31. Defendant FHFA is, and was at all relevant times, an independent agency of the United States Government subject to the APA. *See* 5 U.S.C. § 551(1). FHFA was created on July 30, 2008, pursuant to HERA. FHFA is located at Constitution Center, 400 7th Street, S.W., Washington, D.C. 20024.

32. Defendant Melvin L. Watt is the Director of FHFA. His official address is Constitution Center, 400 7th Street, S.W., Washington, D.C. 20024. He is being sued in his official capacity. In that capacity, Director Watt has overall responsibility for the operation and management of FHFA. Director Watt, in his official capacity, is therefore responsible for the conduct of FHFA that is the subject of this Complaint and for the related acts and omissions alleged herein.

33. Defendant Department of the Treasury is, and was at all times relevant hereto, an executive agency of the United States Government subject to the APA. *See* 5 U.S.C. § 551(1). Treasury is located at 1500 Pennsylvania Avenue, N.W., Washington, D.C. 20220.

IV.
FACTUAL ALLEGATIONS

Fannie and Freddie

34. Fannie is a for-profit, stockholder-owned corporation organized and existing under the Federal National Mortgage Act. Freddie is a for-profit, stockholder-owned corporation organized and existing under the Federal Home Loan Corporation Act. The Companies' business includes purchasing and guaranteeing mortgages originated by private banks and bundling the mortgages into mortgage-related securities that can be sold to investors.

35. Fannie and Freddie are owned by private shareholders and their securities are publicly traded. Fannie was chartered by Congress in 1938 and originally operated as an agency

of the Federal Government. In 1968, Congress reorganized Fannie into a for-profit corporation owned by private shareholders. Freddie was established by Congress in 1970 as a wholly-owned subsidiary of the Federal Home Loan Bank System. In 1989, Congress reorganized Freddie into a for-profit corporation owned by private shareholders.

36. Before being forced into conservatorship, both Fannie and Freddie had issued common stock and several series of preferred stock. The several series of preferred stock of the Companies are in parity with each other with respect to dividend payments and liquidation preference, but they have priority over the Companies' common stock for these purposes. In essence, before common shareholders can be paid a dividend, dividends must be paid to the holders of preferred stock. And in a liquidation, the holders of preferred stock must receive the full par value of their stock before the common shareholders receive any value. The common stock is entitled to the residual economic value of the firms.

37. Plaintiff Thomas Saxton owns shares in the Z series of Freddie preferred stock. Plaintiffs Thomas and Ida Saxton also own shares of Freddie common stock, both individually and jointly. The Saxtons first acquired shares of Freddie common stock in 2008, before imposition of the conservatorship, and they have owned common shares continuously since that time.

38. Plaintiff Bradley Paynter owns shares of Fannie common stock. His parents, who reside in Cedar Rapids, Iowa, purchased the shares for him as a gift in 1996. Mr. Paynter has owned the stock since that time. He lived in Iowa until 2014, when he moved to the State of Washington.

39. Prior to 2007, Fannie and Freddie were consistently profitable. In fact, Fannie had not reported a full-year loss since 1985, and Freddie had never reported a full-year loss since

becoming owned by private shareholders. In addition, both Companies regularly declared and paid dividends on their preferred and common stock.

Fannie and Freddie Are Forced into Conservatorship

40. The Companies were well-positioned to weather the decline in home prices and financial turmoil of 2007 and 2008. While banks and other financial institutions involved in the mortgage markets had heavily invested in increasingly risky mortgages in the years leading up to the financial crisis, Fannie and Freddie had taken a more conservative approach that meant that the mortgages that they insured were far safer than those insured by the nation's largest banks. And although both Companies recorded losses in 2007 and the first two quarters of 2008—losses that largely reflected a decline in the market value of their holdings caused by declining home prices—both Companies continued to generate enough cash to easily pay their debts and retained billions of dollars of capital that could be used to cover any future losses. Neither Company was in danger of insolvency. Indeed, during the summer of 2008, both Treasury Secretary Henry Paulson and FHFA Director Lockhart publicly stated that Fannie and Freddie were financially healthy.

41. Despite (or perhaps because of) the Companies' comparatively strong financial position amidst the crisis, Treasury initiated a long-term policy of seeking to seize control of Fannie and Freddie and operate them for the exclusive benefit of the federal government. To that end, during the summer of 2008, Treasury officials promoted short-selling of the Companies' stock by leaking word to the press that Treasury might seek to place the Companies into conservatorship. On July 21, 2008, Treasury Secretary Paulson personally delivered a similar message to a select group of hedge fund managers during a private meeting at Eton Park Capital Management. Although at odds with Treasury's on-the-record statements to the press, the leaks

and tips had the intended effect of driving down the Companies' stock prices and creating a misperception among investors that the Companies were in financial distress.

42. Also during the summer of 2008, Treasury pressed Congress to pass what became the Housing and Economic Recovery Act of 2008 ("HERA"). HERA created FHFA (which succeeded to the regulatory authority over Fannie and Freddie previously held by the Office of Federal Housing Enterprise Oversight) and authorized FHFA, under certain statutorily prescribed and circumscribed conditions, to place the Companies into either conservatorship or receivership.

43. In authorizing FHFA to act as conservator under specified circumstances, Congress took FHFA's conservatorship mission verbatim from the Federal Deposit Insurance Act ("FDIA"), *see* 12 U.S.C. § 1821(d)(2)(D), which itself incorporated a long history of financial supervision and rehabilitation of troubled entities under common law. HERA and the FDIA, as well as the common law concept on which both statutes draw, treat conservatorship as a process designed to stabilize a troubled institution with the objective of returning it to normal business operations. Like any conservator, when FHFA acts as a conservator under HERA it has a fiduciary duty to safeguard the interests of the Companies and their shareholders.

44. According to HERA, FHFA "may, as conservator, take such action as may be—(i) necessary to put the regulated entity in a sound and solvent condition, and (ii) appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity." 12 U.S.C. § 4617(b)(2)(D). Thus, as FHFA has acknowledged, "[t]he purpose of conservatorship is to preserve and conserve each company's assets and property and to put the companies in a sound and solvent condition" and "[t]o fulfill the statutory mandate of conservator, FHFA must follow governance and risk management practices associated with

private-sector disciplines." FHFA, REPORT TO CONGRESS 2009 at i, 99 (May 25, 2010). And Mr. Ugoletti has testified that preserving and conserving the assets of Fannie and Freddie is "a fundamental part of conservatorship."

45. As FHFA has acknowledged, HERA requires and mandates FHFA as conservator to preserve and conserve Fannie's and Freddie's assets and to restore them to a sound and solvent condition. FHFA 2009 Annual Report to Congress at 99 (May 25, 2010), http://goo.gl/YOOgzC ("The statutory role of FHFA as conservator requires FHFA to take actions to preserve and conserve the assets of the Enterprises and restore them to safety and soundness."); FHFA Strategic Plan at 7 (Feb. 21, 2012), http://goo.gl/uXreKX. ("FHFA has reported on numerous occasions that, with taxpayers providing the capital supporting Enterprise operations, this 'preserve and conserve' mandate directs FHFA to minimize losses on behalf of taxpayers.").

46. Under HERA, conservatorship is a status distinct from receivership, with very different purposes, responsibilities, and restrictions. When acting as a receiver, but *not* when acting as a conservator, FHFA is authorized and obliged to "place the regulated entity in liquidation and proceed to realize upon the assets of the regulated entity." *Id.* § 4617(b)(2)(E). The only "post-conservatorship outcome[ ] . . . that FHFA may implement today under existing law," by contrast, "is to reconstitute [Fannie and Freddie] under their current charters." Letter from Edward J. DeMarco, Acting Director, FHFA, to Chairmen and Ranking Members of the Senate Committee on Banking, Housing, and Urban Affairs and to the House Committee on Financial Services 7 (Feb. 2, 2010). In other words, receivership is aimed at winding down an entity's affairs and liquidating its assets, while conservatorship aims to rehabilitate it and return

it to normal operation. This distinction between the purposes and authorities of a receiver and a conservator is a well-established tenet of financial regulation.

47. In promulgating regulations governing its operations as conservator or receiver of the Companies, FHFA specifically acknowledged the distinctions in its statutory responsibilities as conservator and as receiver: “A conservator’s goal is to continue the operations of a regulated entity, rehabilitate it and return it to a safe, sound and solvent condition.” Conservatorship and Receivership, 76 Fed. Reg. 35,724, 35,730 (June 20, 2011). In contrast, when FHFA acts as a receiver, the regulation specifically provides that “[t]he Agency, as receiver, *shall* place the regulated entity in liquidation . . . .” 12 C.F.R. § 1237.3(b) (emphasis added).

48. On September 6, 2008, FHFA—under significant pressure from Treasury—directed the Companies’ boards to consent to conservatorship. Given that the Companies were not in financial distress and were in no danger of defaulting on their debts, the Companies’ directors were confronted with a Hobson’s choice: face intense scrutiny from federal agencies for rejecting conservatorship or submit to the demands of Treasury and FHFA. The Agencies ultimately obtained the Companies’ consent by threatening to seize them if they did not acquiesce and by informing them that the Agencies had already selected new CEOs and had teams ready to move in and take control.

49. In publicly announcing the conservatorship, FHFA committed itself to operate Fannie and Freddie as a fiduciary until they are stabilized. As FHFA acknowledged, the Companies’ common stock remains outstanding during conservatorship and “continue[s] to trade,” *FHFA Fact Sheet, Questions and Answers on Conservatorship* 3, https://goo.gl/DV4nAt, and Fannie’s and Freddie’s stockholders “continue to retain all rights in the stock’s financial worth,” *id.* Director Lockhart testified before Congress that Fannie’s and Freddie’s “shareholders

are still in place; both the preferred and common shareholders have an economic interest in the companies" and that "going forward there may be some value" in that interest. Sept. 25, 2008, Hearing, U.S. House of Representatives, Committee on Financial Servs, H.R. Hrg. 110-142 at 29-30, 34.

50. FHFA also emphasized that the conservatorship was temporary: "Upon the Director's determination that the Conservator's plan to restore the [Companies] to a safe and solvent condition has been completed successfully, the Director will issue an order terminating the conservatorship." *FHFA Fact Sheet, Questions and Answers on Conservatorship* 2. Investors were entitled to rely on these official statements of the purposes of the conservatorship, and public trading in Fannie's and Freddie's stock was permitted to, and did, continue.

51. In short, the Companies were not in financial distress when they were forced into conservatorship. The Companies' boards permitted conservatorship based on the understanding that, like any other conservator, FHFA would operate the Companies as a fiduciary with the goal of preserving and conserving their assets and managing them in a safe and solvent manner. And in publicly announcing the conservatorships, FHFA confirmed that the Companies' private shareholders continued to hold a residual economic interest that would have value if the Companies generated profits in the future.

FHFA and Treasury Enter into the Purchase Agreements

52. On September 7, 2008, Treasury and FHFA, acting in its capacity as conservator of Fannie and Freddie, entered into the Preferred Stock Purchase Agreements.

53. In entering into the Purchase Agreements, Treasury exercised its temporary authority under HERA to purchase securities issued by the Companies. *See* 12 U.S.C. §§ 1455(*l*), 1719(g). To exercise that authority, the Secretary of the Treasury ("Secretary") was required to

determine that purchasing the Companies' securities was "necessary . . . to provide stability to the financial markets; . . . prevent disruptions in the availability of mortgage finance; and . . . protect the taxpayer." 12 U.S.C. §§ 1455(*l*)(1)(B), 1719(g)(1)(B). In making those determinations, the Secretary was required to consider six factors:

> (i) The need for preferences or priorities regarding payments to the Government.
> (ii) Limits on maturity or disposition of obligations or securities to be purchased.
> (iii) *The [Companies'] plan[s] for the orderly resumption of private market funding or capital market access*.
> (iv) The probability of the [Companies] fulfilling the terms of any such obligation or other security, including repayment.
> (v) *The need to maintain the [Companies'] status as . . . private shareholder-owned compan[ies]*.
> (vi) Restrictions on the use of [the Companies'] resources, including limitations on the payment of dividends and executive compensation and any such other terms and conditions as appropriate for those purposes.

Id. §§ 1455(*l*)(1)(C), 1719(g)(1)(C) (emphasis added).

54. HERA's legislative history underscores the temporary nature of Treasury's authority to purchase Fannie and Freddie securities. Secretary Paulson testified to Congress that HERA would give "Treasury an 18-month *temporary* authority to purchase—only if necessary—equity in either of these two [Companies]." *Recent Developments in U.S. Financial Markets and Regulatory Responses to Them: Hearing before the Comm. on Banking, Housing and Urban Dev.*, 100th Cong. (2008) (statement of Henry M. Paulson, Secretary, Dep't of the Treasury) at 5 (emphasis added). In response to questioning from Senator Shelby, Secretary Paulson reiterated that Treasury's authority to purchase Fannie and Freddie stock was intended to be a "short-term" solution that would expire at "the end of 2009." *Id.* at 11–12.

55. Treasury's authority under HERA to purchase the Companies' securities expired on December 31, 2009. *See id.* §§ 1455(*l*)(4), 1719(g)(4).

56. Treasury's PSPAs with Fannie and Freddie are materially identical. Under the original unamended agreements, Treasury committed to provide up to $100 billion to each Company to ensure that it maintained a positive net worth. In particular, for quarters in which either Company's liabilities exceed its assets under Generally Accepted Accounting Principles, the PSPAs authorize Fannie and Freddie to draw upon Treasury's commitment in an amount equal to the difference between its liabilities and assets.

57. In return for its funding commitment, Treasury received 1 million shares of Government Stock in each Company and warrants to purchase 79.9% of the common stock of each Company at a nominal price. Exercising these warrants would entitle Treasury to up to 79.9% of all future profits of the Companies, subject to the Companies' obligation to satisfy their dividend obligations with respect to the preferred stock and to share the remaining 20.1% of those profits with private common shareholders. As Treasury noted in entering the PSPAs, the warrants "provide potential future upside to the taxpayers." Action Memorandum for Secretary Paulson (Sept. 7, 2008).

58. Treasury's Government Stock in each Company had an initial liquidation preference of $1 billion. This liquidation preference increases by one dollar for each dollar the Companies receive from Treasury pursuant to the PSPAs. In the event the Companies liquidate, Treasury is entitled to recover the full liquidation value of its shares before any other shareholder may recover anything.

59. In addition to the liquidation preference, the original unamended PSPAs provided for Treasury to receive either a cumulative cash dividend equal to 10% of the value of the outstanding liquidation preference or a stock dividend. If the Companies decided not to pay the dividend in cash, the value of the dividend would be added to the liquidation preference—

effectively amounting to an in-kind dividend payment of additional Government Stock. After an in-kind dividend payment, the dividend rate would increase to 12% until such time as full cumulative dividends were paid in cash, at which time the rate would return to 10%. The plain terms of the PSPAs thus make clear that Fannie and Freddie never were required to pay a cash dividend to Treasury but rather had the discretion to pay dividends in kind.

60. The Agencies have repeatedly acknowledged the payment-in-kind option. For example, upon entering the PSPAs Treasury released a fact sheet stating that, "[t]he senior preferred stock shall accrue dividends at 10% per year. The rate shall increase to 12% if, in any quarter, the dividends are not paid in cash . . . ." U.S. TREASURY DEP'T OFFICE OF PUB. AFFAIRS, FACT SHEET: TREASURY SENIOR PREFERRED STOCK PURCHASE AGREEMENT (Sept. 7, 2008), https://goo.gl/ynb3TC. Internal communications likewise acknowledged the payment-in-kind option. In an October 2008 email to Treasury and FHFA officials, for example, a Treasury consultant asked whether Fannie and Freddie "intend[ed] to pay cash at 10 percent or accrue at 12 percent as a matter of policy." And in a June 2012 presentation to the Securities and Exchange Commission, Treasury stated that the dividend rate of the PSPAs would be 12% "if elected to be paid in kind." Treasury Presentation to SEC, GSE Preferred Stock Purchase Agreements (PSPA), Overview and Key Considerations at 9, June 13, 2012. Moreover, there was never any risk that payment of dividends would render the Companies insolvent since it would have been illegal for either Company to pay a dividend that would render it insolvent.

61. Numerous additional materials prove beyond a shadow of a doubt that the Agencies recognized that the PSPAs were designed to allow the payment of dividends in kind rather than in cash. To take just two examples, in an October 2008 email to Mario Ugoletti—who was then a Treasury official, but later moved to FHFA and was a key point of contact with

Treasury in the development of the Net Worth Sweep—another Treasury official indicated that the agency's consultant wanted to know "whether we expect [Fannie and Freddie] to pay the preferred stock dividends in cash or to just accrue the payments." Mr. Ugoletti did not forget about this feature of the PSPAs when he moved to FHFA. Indeed, he described the "payment-in-kind" option as part of the pre-Net Worth Sweep dividend structure during a deposition in May 2015. Second, a document attached to a September 16, 2008 email between FHFA officials expressly states that PSPA dividends may be "paid in-kind." Fannie's and Freddie's CFOs also were aware of the payment-in-kind option.

62. An in-kind dividend payment would not decrease Treasury's funding commitment because only when the Companies receive "funding under the Commitment" does its size decrease. Fannie and Freddie Amended and Restated Senior Preferred Stock Purchase Agreements ("PSPA") § 1. Thus, as the Congressional Research Service has acknowledged, under the PSPAs' original terms the Companies could "pay a 12% annual senior preferred stock dividend indefinitely." N. ERIC WEISS, CONG. RESEARCH SERV., RL34661, FANNIE MAE'S AND FREDDIE MAC'S FINANCIAL PROBLEMS (Aug. 10, 2012). In other words, because of the payment-in-kind option, there was no risk—none whatsoever—that the PSPAs would force Fannie and Freddie to exhaust Treasury's funding commitment to facilitate the payment of dividends.

63. Finally, the PSPAs provided for the Companies to pay Treasury a quarterly periodic commitment fee "intended to fully compensate [Treasury] for the support provided by the ongoing Commitment." PSPA § 3.2(a). The periodic commitment fee was to be set for five-year periods by agreement of the Companies and Treasury, but Treasury had the option to waive it for up to a year at a time. Treasury has exercised this option and has never received a periodic commitment fee under the PSPAs.

64. The PSPAs and the Government Stock Certificates explicitly contemplate that the Companies could pay down the liquidation preference and that when it is paid down "in full, such [Government Stock] shares shall be deemed to have been redeemed." Certificate §§ 3(c), 4(c). Indeed, the PSPAs were "structure[d]" to "enhance the probability of both Fannie Mae and Freddie Mac ultimately repaying amounts owed." Action Memorandum for Secretary Paulson (Sept. 7, 2008).

65. The PSPAs prohibit Fannie and Freddie from declaring and paying dividends on any securities junior to Treasury's Government Stock unless full cumulative dividends have been paid to Treasury on its Government Stock for the then-current and all past dividend periods.

66. In approving the exercise of Treasury's temporary authority under HERA to purchase securities of the Companies, Treasury Secretary Paulson determined (1) "[u]nder conservatorship, Fannie Mae and Freddie Mac will continue to operate as going concerns"; (2) "Fannie Mae and Freddie Mac may emerge from conservatorship to resume independent operations"; and (3) "[c]onservatorship preserves the status and claims of the preferred and common shareholders." Action Memorandum for Secretary Paulson (Sept. 7, 2008).

Treasury and FHFA Amend the Purchase Agreements
To Increase Treasury's Funding Commitment

67. On May 6, 2009, the Agencies amended the terms of the Purchase Agreements to increase Treasury's funding commitment to both Fannie and Freddie. In particular, under the amendment Treasury's total commitment to each Company increased from $100 billion to $200 billion.

68. On December 24, 2009—one week before Treasury's temporary authority under HERA expired—the Agencies again amended the terms of Treasury's funding commitment. Instead of setting that commitment at a specific dollar amount, the second amendment

established a formula to allow Treasury's total commitment to each Company to exceed (but not fall below) $200 billion depending upon any deficiencies experienced in 2010, 2011, and 2012, and any surplus existing as of December 31, 2012.

69. Treasury's authority under HERA then expired on December 31, 2009. As Treasury acknowledged, expiration of this authority meant that its "ability to make further changes to the PSPAs . . . [was] constrained." Action Memorandum for Secretary Geithner at 3 (Dec. 22, 2009).

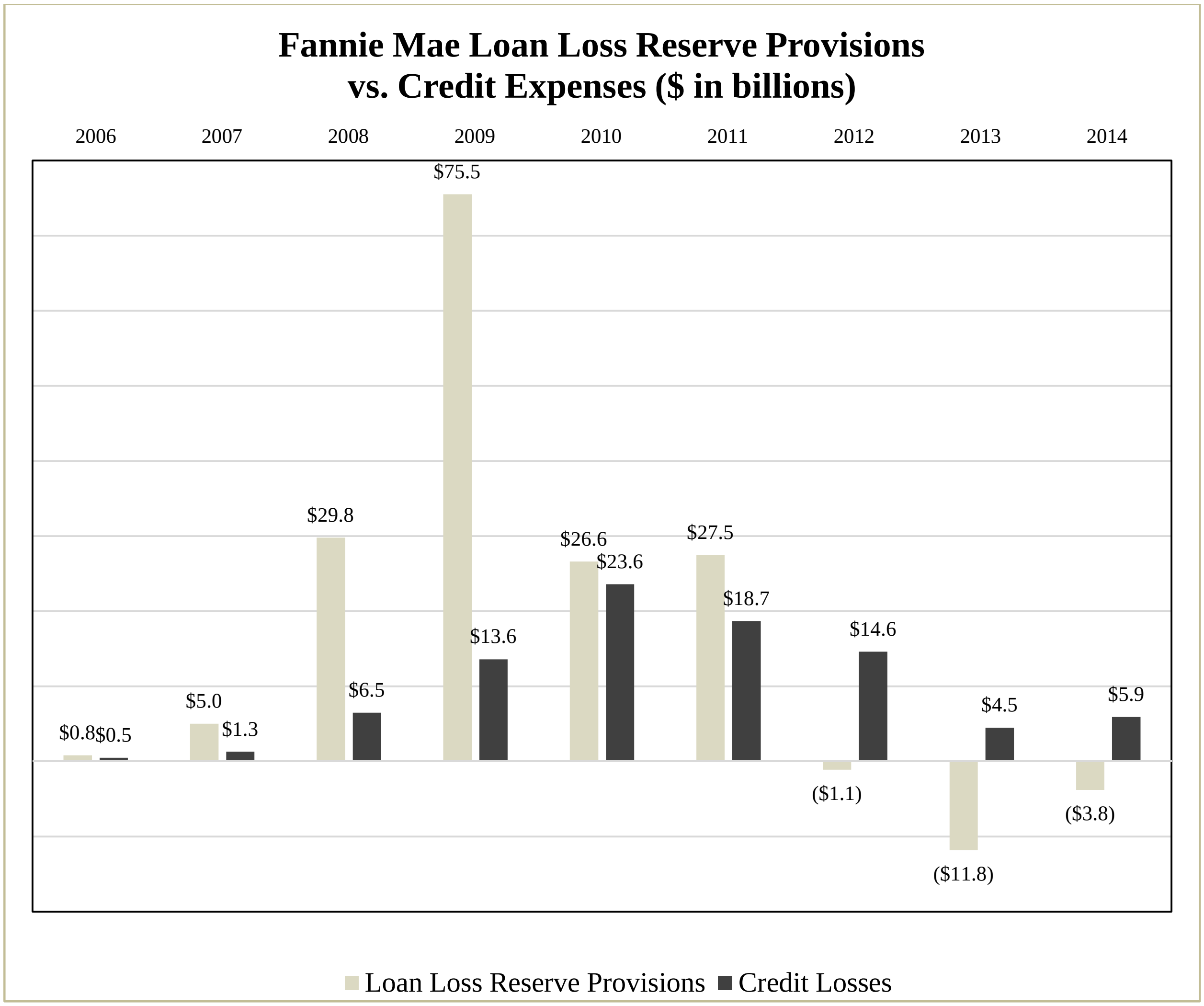
The Agencies Force Accounting Changes To Increase
<u>the Companies' Draws From Treasury</u>

70. Beginning in the third quarter of 2008—when FHFA took control of the Companies as conservator—the conservator began to make overly pessimistic and unrealistic assumptions about the Companies' future financial prospects. Those assumptions triggered adjustments to the Companies' balance sheets, most notably write-downs of significant tax assets and the establishment of large loan loss reserves, which caused the Companies to report non-cash losses. Although reflecting nothing more than accounting assumptions about the Companies' future prospects and having no effect on the cash flow the Companies were generating, these non-cash losses temporarily decreased the Companies' reported net worth by hundreds of billions of dollars. For example, in the first year and a half after imposition of the conservatorship, Fannie reported $127 billion in losses, but only $16 billion of that amount reflected actual credit-related losses. Upon information and belief, FHFA directed Fannie and Freddie to record these excessive non-cash losses at the insistence of Treasury, which resulted in excessive purchases of Government Stock by Treasury.

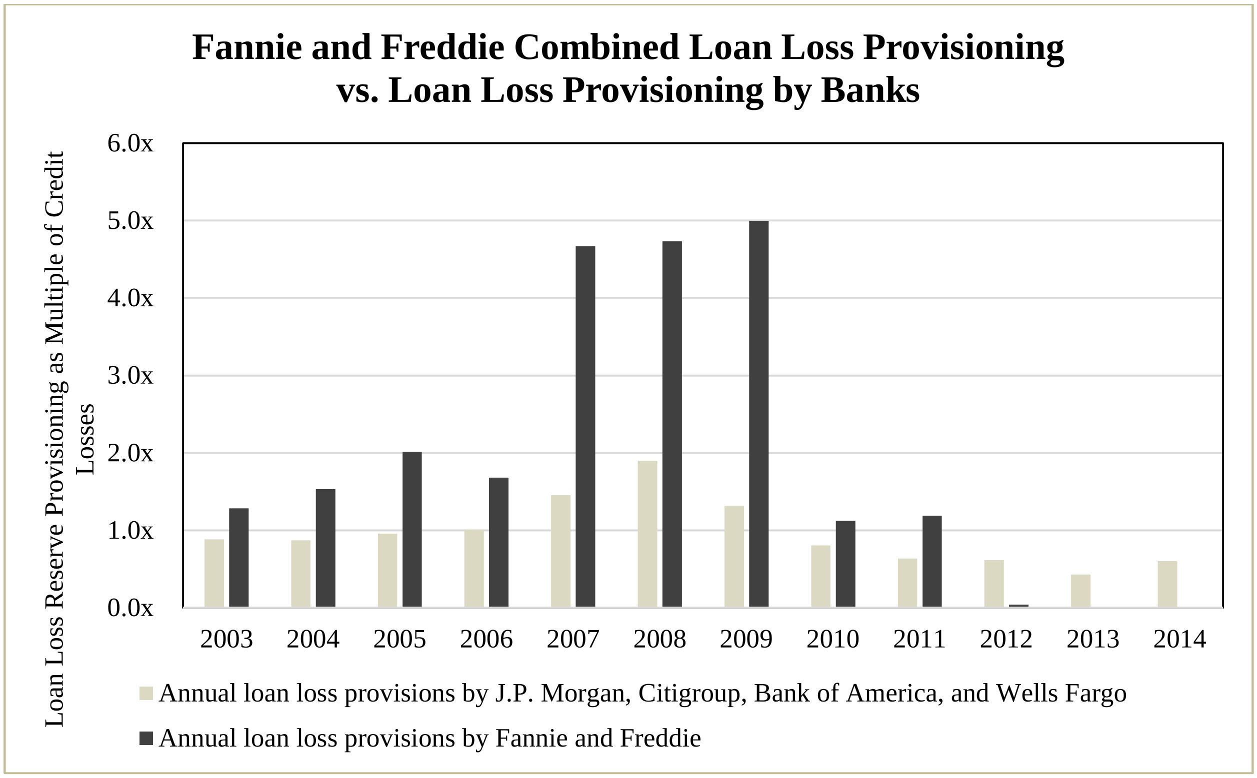
71. By the end of 2011, the Companies' reported net worth had fallen by $100 billion as a result of the decision made shortly after imposition of the conservatorship to write down the

value of their deferred tax assets. A deferred tax asset is an asset that may be used to offset future tax liability. Under Generally Accepted Accounting Principles, if a company determines that it is unlikely that some or all of a deferred tax asset will be used, the company must establish a "valuation allowance" in the amount that is unlikely to be used. In other words, a company must write down a deferred tax asset if it is unlikely to be used to offset future taxable profits. Shortly after FHFA took control of the Companies, FHFA made the implausible assumption that the Companies would *never again* generate taxable income and that their deferred tax assets were therefore worthless. That flawed decision dramatically reduced the Companies' reported net worth.

72. The decision to designate excessive loan loss reserves was another important factor in the artificial decline in the Companies' reported net worth during the early years of conservatorship. Loan loss reserves are an entry on the Companies' balance sheets that reduces their reported net worth to reflect anticipated losses on the mortgages they own. Beginning when FHFA took control of the Companies in the third quarter of 2008 and continuing through 2009, the Companies were forced to provision additional loan loss reserves far in excess of the credit losses they were actually experiencing. The extent to which excess loan loss reserve provisioning reduced the Companies' net worth is dramatically illustrated by the following chart, which compares Fannie's loan loss reserve provisioning to its actual credit losses for 2006 through 2014. As the chart shows, FHFA caused Fannie to make grossly excessive loan loss reserve provisions in 2008 and 2009. The excessive nature of these loan loss provisions was readily apparent by 2012, and the inevitable reversals would flow through to income on Fannie's balance sheet.



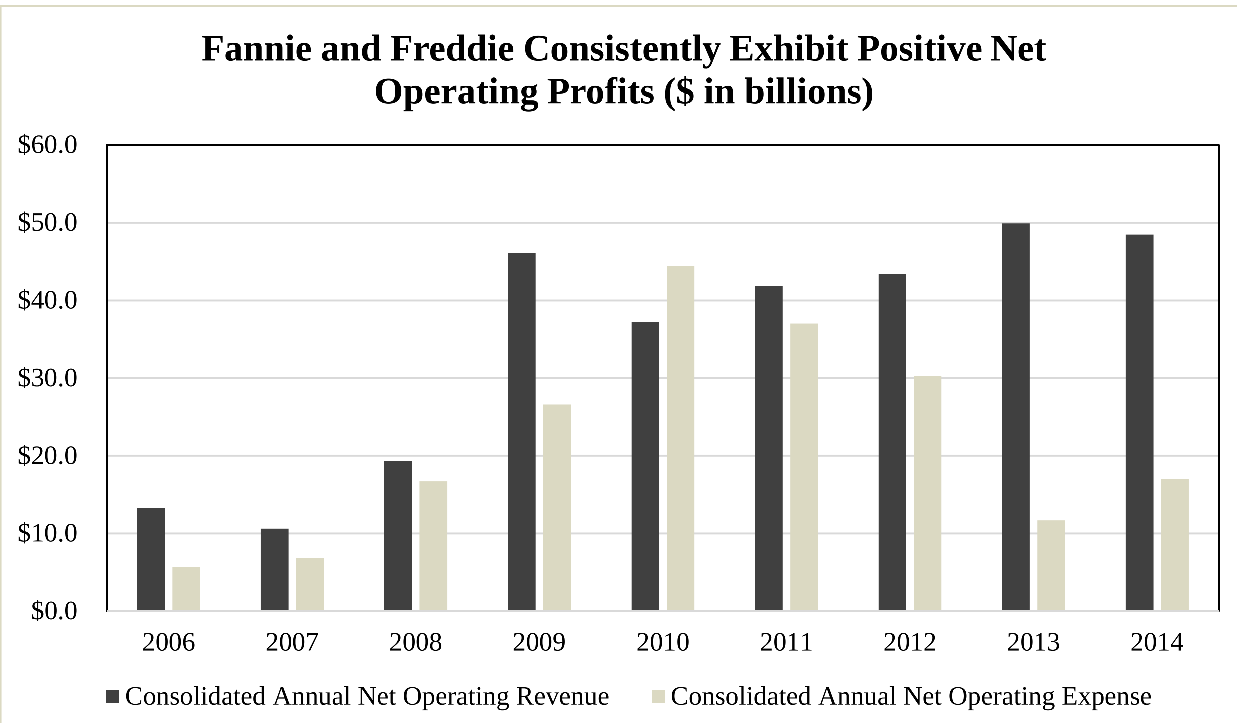
73. Despite the fact that the Companies' mortgage portfolios were safer than the similar portfolios held by banks involved in the mortgage business, banks were much more accurate—and far less aggressive—in reducing their net worth to reflect expected loan losses. The following chart illustrates this fact:



74. To date, the Companies have drawn a total of $187 billion from Treasury, in large part to fill the holes in the Companies' balance sheets created by these non-cash losses. Including Treasury's initial $1 billion liquidation preference in each Company, Treasury's liquidation preference for its Government Stock amounts to approximately $117 billion for Fannie and approximately $72 billion for Freddie. Approximately $26 billion of these combined amounts were drawn simply to pay the 10% dividend payments owed to Treasury. (In other words, FHFA requested draws to pay Treasury this $26 billion in cash rather than electing to pay the dividends in kind. Had the dividends been paid in kind, FHFA would not have had to draw from—and, consequently, reduce the remaining size of—Treasury's commitment to pay them.) Thus, Treasury actually "invested" approximately $161 billion in the Companies, primarily reflecting temporary changes in the valuation estimates of assets and liabilities.

The Companies Return to Profitability and Stability

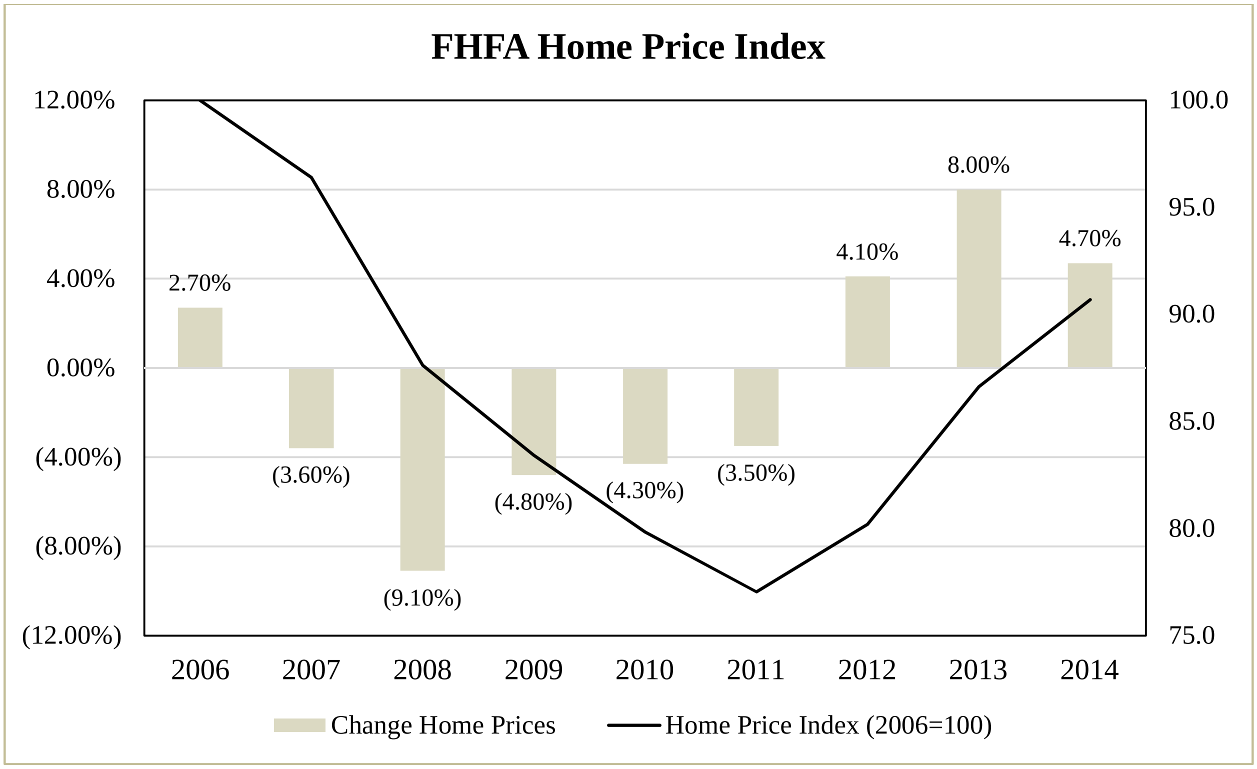
75. As explained above, the "losses" Fannie and Freddie experienced under conservatorship were driven primarily by temporary and overly pessimistic accounting decisions, not by an imbalance in operative expenses and revenues. Indeed, although they had reported significant declines in their net worth as a result of highly questionable accounting decisions, even in the early years of conservatorship they had continued to generate enough cash to cover their expenses. As the following chart illustrates, the Companies' annual net operating revenue has exceeded their net operating expenses in every year during the conservatorships except 2010, and their actual losses were never so severe that they would have had a negative net worth but for the excessively pessimistic treatment of deferred tax assets and loan loss reserves:



76. By 2012, Fannie and Freddie began generating consistent profits notwithstanding the anchor of their overstated loss reserves and the write-down of their deferred tax assets. Fannie has not drawn on Treasury's commitment since the fourth quarter of 2011, and Freddie

has not drawn on Treasury's commitment since the first quarter of 2012. In fact, in the first two quarters of 2012, the Companies posted sizable profits totaling more than $11 billion.

77. By 2012, the Companies were well-positioned to continue generating profits for the foreseeable future. Fannie's and Freddie's financial results are strongly influenced by home prices. And as FHFA's own Home Price Index shows, the market reached its bottom in 2011:



78. The improving housing market was coupled with stricter underwriting standards at Fannie and Freddie. As a result—and as the Agencies knew—Fannie- and Freddie-backed loans issued after 2008 had dramatically lower serious delinquency rates than loans issued between 2005 and 2008. The strong quality of these newer "vintages" of loans boded well for Fannie's and Freddie's future financial prospects. Together, the Companies' return to profitability and the stable recovery of the housing market showed in early 2012 that the Companies could in time redeem Treasury's Government Stock and provide a return on

investment to owners of their preferred and common stock. Indeed, a presentation sent to senior Treasury officials in February 2012 indicated that "Fannie and Freddie could have the earnings power to provide taxpayers with enough value to repay Treasury's net cash investments in the two entities."

79. Furthermore, as a result of Fannie's and Freddie's return to sustained profitability, it was clear that the overly pessimistic accounting decisions weighing down the Companies' balance sheets would have to be reversed. Indeed, by early August 2012, the Agencies knew that Fannie and Freddie were poised to generate massive profits well in excess of the Companies' dividend obligations to Treasury—profits that would make the $11 billion the Companies generated in the first half of 2012 look small by comparison.

80. A principal driver of these outsized profits would be the release of the Companies' deferred tax assets valuation allowances. By mid-2012, Fannie and Freddie had combined deferred tax assets valuation allowances of nearly $100 billion. Under relevant accounting rules, those valuation allowances would have to be reversed if the Companies determined that it was more likely than not that they would generate taxable income and therefore be able to use their deferred tax assets. In 2011, it was known within Fannie that the valuation allowance would be reversed; the question was the timing. The Treasury Department was intimately familiar with these issues, having seen such a reversal in February 2012 in connection with its massive investment in AIG.

81. Indeed, it should have been apparent to the Agencies by late 2011 that Fannie and Freddie would soon be in a position to reverse the valuation allowances for their deferred tax assets. In November 2011, Treasury consultant Grant Thornton prepared projections based on September 2011 data reporting combined profits of over $20 billion in 2014, with annual profits

then gradually declining to a long-term figure of about $13.5 billion. Profits of this magnitude necessarily would have led to the reversal of the valuation allowances. And Treasury took notice. The agenda for a May 29, 2012 meeting indicates that by that time Treasury and Grant Thornton were discussing "[r]eturning the deferred tax asset to the GSE balance sheets." And hand-written notes on a Grant Thornton document displaying Freddie's results through the first quarter of 2012 anticipate that Freddie could release its valuation allowance "probably [in] 2013, 2014."

82. The manager of Grant Thornton's valuation services to Treasury, Anne Eberhardt, admitted in a deposition that the projections based on September 2011 data were no longer valid 11 months later, and Fannie's CFO, Susan McFarland, has testified that it was particularly important to have fresh financial forecasts at that time. Mr. Ugoletti and Ms. Eberhardt also have testified to the importance of using up-to-date financial information, and Mr. DeMarco testified that FHFA as conservator was "constantly responding to a changing economic environment." And as Mr. DeMarco also testified, one change that took place between September 2011 and mid-August 2012 "was strengthening in the housing market." Thus, by August 2012, it was apparent that the outdated Grant Thornton projections drastically *underestimated* Fannie's and Freddie's earning capacity. (Mr. Ugoletti also has admitted that FHFA's own projections consistently were overly pessimistic leading up to August 2012.) Treasury and FHFA knew this, and they knew that reversal of the deferred tax asset valuation allowances was imminent. This fact came into sharp focus on August 9, 2012. On that date, Under Secretary of the Treasury for Domestic Finance Mary Miller and other senior Treasury officials had meetings with the senior executives of both Fannie and Freddie. During the meeting with Fannie's management, Treasury was presented with projections showing the Company earning an average of more than $11

billion per year from 2012 through 2022 and having over $116 billion left of Treasury's funding commitment at the end of that time period. Those projections are reproduced below:

Annual Detail of Cumulative Dividends and SPSPA Draws

Fannie Mae

($ in Billions)	2008-2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Comprehensive Income		11.6	7.5	11.0	12.5	13.9	13.2	12.2	11.4	10.9	10.5	10.5
Preferred Dividend Payment	19.8	11.6	11.8	12.1	12.2	12.2	12.2	12.2	12.2	12.2	12.3	12.5
Residual Equity	0.0	0.0	0.0	0.0	0.2	1.8	2.8	2.7	1.9	0.5	0.0	0.0
Cumulative Dividends	19.8	31.4	43.2	55.3	67.6	79.8	92.1	104.3	116.6	128.8	141.1	153.6
Cumulative SPSPA Draws	(116.1)	(116.1)	(119.0)	(121.2)	(121.5)	(121.5)	(121.5)	(121.5)	(121.5)	(121.5)	(122.9)	(124.8)
Cumulative Dividends Less Draws	(96.3)	(84.7)	(75.8)	(65.9)	(53.9)	(41.7)	(29.4)	(17.2)	(4.9)	7.3	18.3	28.8
SPSPA Funding Cap	240.9	240.9	240.9	240.9	240.9	240.9	240.9	240.9	240.9	240.9	240.9	240.9
Remaining Funding under SPSPA	124.8	124.8	122.0	119.7	119.5	119.5	119.5	119.5	119.5	119.5	118.1	116.1

Note: 2012-2016 figures from Fannie Mae July BOD corporate forecast. 2017-2022 figures are based on simplifying assumptions derived from trends observed within the 2012-2016 horizon.

Freddie Mac

($ in Billions)	2008-2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Comprehensive Income		11.6	7.5	8.2	8.6	9.0	8.7	8.3	7.7	7.1	6.7	6.5
Preferred Dividend Payment	16.3	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4
Residual Equity	0.0	0.0	0.4	1.7	3.5	5.6	6.9	7.9	8.1	7.9	7.2	6.3
Cumulative Dividends	16.3	23.7	31.1	38.4	45.8	53.2	60.6	68.0	75.4	82.8	90.2	97.6
Cumulative SPSPA Draws	(72.2)	(116.1)	(73.0)	(73.0)	(73.0)	(73.0)	(73.0)	(73.0)	(73.0)	(73.0)	(73.0)	(73.0)
Cumulative Dividends Less Draws	(55.9)	(92.4)	(41.9)	(34.5)	(27.1)	(19.7)	(12.3)	(4.9)	2.5	9.9	17.3	24.7
SPSPA Funding Cap	220.5	221.3	221.3	221.3	221.3	221.3	221.3	221.3	221.3	221.3	221.3	221.3
Remaining Funding under SPSPA	148.3	105.2	148.3	148.3	148.3	148.3	148.3	148.3	148.3	148.3	148.3	148.3

Note: 2012-2022 figures are based on simplifying assumptions derived from Fannie Mae forecast trends and observed relationships between key Fannie Mae and Freddie Mac performance metrics. Reported 2011 results re-aligned as necessary to correspond to Fannie Mae management reporting.

Note: Numbers may not fool due to rounding

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83. Furthermore, Treasury learned that Fannie's near-term earnings likely would be even higher than those in the projections due to the release of the Companies' deferred tax assets valuation allowance. One of Treasury's top agenda items heading into the meetings with Fannie was "how quickly [the Company] forecast[s] releasing credit reserves." And during the August 9 meeting, Fannie CFO Susan McFarland informed Treasury that the criteria for reversing the deferred tax assets valuation allowance could be met in the not-so-distant future. And when asked for more specifics by Under Secretary Miller, Ms. McFarland stated that the reversal would be probably in the 50-billion-dollar range and probably sometime mid-2013, an assessment that proved remarkably accurate.

84. FHFA was in possession of similar information. On July 13, 2012, Bradford Martin, Principal Advisor in the Office of Conservatorship Operations, broadly circulated within FHFA minutes from a July 9, 2012 Fannie executive management meeting. The recipients of the email included Acting Director DeMarco and Mr. Ugoletti. The minutes stated that Fannie Treasurer David Benson "referred to the next 8 years as likely to be 'the golden years of GSE earnings.' " Projections substantially similar to those shared with Treasury on August 9 were attached to the email containing the minutes, as demonstrated by the following slide:

Verification and Review in Progress

DRAFT

Annual view of net "repayment" to the US Government

Fannie Mae

($ in billions)	2008-2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Comprehensive Income		11.2	7.4	11.0	12.4	13.8	12.9	12.2	11.6	11.2	10.9	11.2
Preferred Dividend Payment	19.8	11.6	11.8	12.1	12.2	12.2	12.1	12.1	12.1	12.1	12.2	12.2
Residual Equity	0.0	0.0	0.0	0.0	0.2	1.8	2.5	2.5	2.0	1.0	0.0	0.0
Cumulative Dividends	19.8	31.4	43.2	55.3	67.6	79.8	92.0	104.1	116.3	128.4	140.6	152.8
Cumulative Infusion	(116.1)	(116.1)	(119.0)	(121.2)	(121.5)	(121.5)	(121.5)	(121.5)	(121.5)	(121.5)	(121.7)	(122.7)
Net "Repayment" to Gov't	*(96.3)*	*(84.7)*	*(75.8)*	*(65.9)*	*(53.9)*	*(41.7)*	*(29.5)*	*(17.4)*	*(5.2)*	*6.9*	*18.9*	*30.1*
SPSPA Funding Cap	240.9	240.9	240.9	240.9	240.9	240.9	240.9	240.9	240.9	240.9	240.9	240.9
Remaining Funding under SPSPA	124.8	124.8	122.0	119.7	119.5	119.5	119.5	119.5	119.5	119.5	119.3	118.3

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Combined GSE "repayment" could occur in 2020

Freddie Mac

($ in billions)	2008-2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Comprehensive Income		7.3	8.1	8.9	9.4	9.8	10.2	9.8	9.4	9.1	8.9	9.0
Preferred Dividend Payment	16.3	7.2	7.2	7.2	7.2	7.2	7.2	7.2	7.2	7.2	7.2	7.2
Residual Equity	0.0	3.1	4.5	6.6	9.2	12.2	15.2	17.7	19.9	21.8	23.4	25.2
Cumulative Dividends	16.3	23.5	30.8	38.0	45.2	52.5	59.7	66.9	74.1	81.4	88.6	95.8
Cumulative Infusion	(72.2)	(72.3)	(72.3)	(72.3)	(72.3)	(72.3)	(72.3)	(72.3)	(72.3)	(72.3)	(72.3)	(72.3)
Net "Repayment" to Gov't	*(55.9)*	*(48.8)*	*(41.6)*	*(34.3)*	*(27.1)*	*(19.9)*	*(12.6)*	*(5.4)*	*1.8*	*9.1*	*16.3*	*23.5*
SPSPA Funding Cap	220.5	220.6	220.6	220.6	220.6	220.6	220.6	220.6	220.6	220.6	220.6	220.6
Remaining Funding under SPSPA	148.3	148.3	148.3	148.3	148.3	148.3	148.3	148.3	148.3	148.3	148.3	148.3

Our approach is analogous to analyses by Moody's, OMB, and Millstein.

Note: Numbers may not foot due to rounding

Confidential – Restricted 14 FannieMae

85. Those projections expressly stated the assumption that Fannie would not be paying taxes because it would be using its deferred tax assets—and if Fannie was expecting to use its deferred tax assets, it would have to release the valuation allowance it had established for them. FHFA knew this; indeed, FHFA accountants were monitoring the Companies' deferred tax assets situation, and FHFA knew that the Companies' audit committees were assessing the status of the valuation allowances on a quarterly basis. In addition, Ms. McFarland testified that in July 2012 she would have mentioned the potential release of the valuation allowance at a Fannie executive committee meeting attended by at least one FHFA official and that FHFA was on notice of her August 9, 2012 statement to Under Secretary Miller regarding the potential release of the valuation allowance before the Agencies entered the third amendment to the PSPAs on August 17, 2012. While Mr. Ugoletti stated in a declaration in the United States District Court

for the District of Columbia that "neither the Conservator nor Treasury envisioned at the time of the Third Amendment that Fannie Mae's valuation allowance on its deferred tax assets would be reversed in early 2013," his deposition testimony reveals that he had no basis for making that statement: "I don't know who else in FHFA or what they knew about the potential for that [i.e., that the deferred tax assets might be written back up in 2013], but . . . our accountants were monitoring this situation, they were monitoring . . . whether to revalue, they had to do it all the time, revalue or not revalue, and I do not recall knowing about that this was going to be an issue until really '13 when it became imminent that, oh, this has to happen now, and I don't know what anybody else thought about it." And when asked whether he knew "what Treasury thought about it," he answered, "I do not."

86. By August 2012 the Agencies also knew that the Companies' provisioning for loan loss reserves far exceeded their actual losses. These excess loss reserves artificially depressed the Companies' net worth, and reversing them would increase the Companies' net worth accordingly. Indeed, on July 19, 2012, a Treasury official observed that the release of loan loss reserves could "increase the [Companies'] net [worth] substantially." And the Agencies were focused on this issue. Again, a briefing memorandum prepared for Under Secretary Miller in advance of the August 9, 2012 meetings with Fannie and Freddie executives indicates that a key question Treasury had for the Companies was "how quickly they forecast releasing credit reserves." And a handwritten note on a presentation from the August 9 meeting with Freddie says to "expect material release of loan loss reserves in the future." FHFA also knew that loan loss reserve releases would boost the Companies' profits going forward, a fact dramatically illustrated by a July 2012 FHFA presentation showing that starting in 2008 the Companies had set aside loan loss reserves far in excess of their actual losses.

87. In sum, by August 2012 the Agencies knew that Fannie and Freddie were poised to add tens of billions of dollars of deferred tax assets to their balance sheets and to reverse billions of dollars of loan loss reserves. These inevitable accounting decisions, coupled with Fannie's and Freddie's strong earnings from their day-to-day operations, meant that Fannie and Freddie would generate earnings well in excess of the Companies' dividend obligations to Treasury.

88. In addition to the release of deferred tax assets valuation allowances and loan loss reserves, Fannie and Freddie also had sizeable assets in the form of claims and suits brought by FHFA as conservator relating to securities law violations and fraud in the sale of private-label securities to Fannie and Freddie between 2005 and 2007. In 2013 and 2014, the Companies recovered over $18 billion from financial institutions via settlements of such claims and suits. The Companies, FHFA, and Treasury knew in August 2012 that the Companies would reap substantial profits from such settlements.

FHFA and Treasury Amend the PSPAs
To Expropriate the Companies' Net Worth

89. On August 17, 2012, within days after the Companies had announced their return to profitability and just as it was becoming clear that they had regained the earnings power to redeem Treasury's Government Stock and exit conservatorship, the Agencies unilaterally amended the PSPAs for a third time. At the time that this third amendment was under consideration, Fannie and Freddie were experiencing a dramatic turnaround in their profitability. Due to rising house prices and reductions in credit losses, in early August 2012 the Companies reported significant income for the second quarter 2012 and neither required a draw from Treasury under the PSPAs. What is more, the Agencies knew that Fannie and Freddie were poised to generate massive profits from the reversal of overly pessimistic accounting decisions

made in the early years of the conservatorships. But rather than fulfilling its statutory responsibility as conservator to return the Companies to sound and solvent business operations and, ultimately, to private control, FHFA entered into the Net Worth Sweep with Treasury, which expropriates all of the Companies' substantial profits and prevents them from ever exiting government control.

90. The timing of the Net Worth Sweep was driven by the Companies' return to profitability. Given that return to profitability, there was no imminent risk that Fannie and Freddie would be depleting Treasury's funding commitment—that risk likely was at its lowest point since the start of the conservatorships. Instead, the "risk"—indeed, the expectation—was that Fannie and Freddie were poised to recognize extraordinary profits that would allow them to begin rebuilding their capital levels and position themselves to exit conservatorship and deliver value to their private shareholders. This understanding is supported by the testimony of Ms. McFarland, Fannie's CFO at the time. She believed that the Agencies imposed the Net Worth Sweep in response what she told Treasury on August 9, and she thought its purpose "was probably a desire not to allow capital to build up within the enterprises and not to allow the enterprises to recapitalize themselves." According to Ms. McFarland, Fannie "didn't believe that Treasury would be too fond of a significant amount of capital buildup inside the enterprises."

91. But notwithstanding their statutory duties, FHFA and Treasury had decided that Fannie and Freddie would *not* be allowed to exit conservatorship in their current form. Allowing Fannie and Freddie to rebuild their capital levels, however, would make that decision more difficult to maintain. It is thus not surprising that FHFA perceived a "renewed push" from Treasury to implement the Net Worth Sweep on August 9, 2012, nor that in a document prepared for internal consumption and dated August 16, 2012 Treasury listed the Companies' "improving

operating performance" and the "potential for near-term earnings to exceed the 10% dividend" as reasons for the timing of the Net Worth Sweep.

92. White House officials supported the Net Worth Sweep and its goals to prevent Fannie and Freddie from building capital and to prevent private shareholders from benefiting from the Companies' return to profitability. James Parrott, a White House economic advisor, communicated with Treasury about the Net Worth Sweep during its development. In an email to a Treasury official on the day the Net Worth Sweep was announced, Mr. Parrott stated that "we've closed off [the] possibility that [Fannie and Freddie] ever[] go (pretend) private again." That same day, Mr. Parrott received an email from a market analyst stating that the Net Worth Sweep "should lay to rest permanently the idea that the outstanding privately held pref[ferred stock] will ever get turned back on." He forwarded the email to Treasury officials and commented that "all the investors will get this very quickly." Thus, Mr. Ugoletti was not surprised "that the preferred stock got hammered the day the Net Worth Sweep was announced." Mr. Parrott, who has left the Administration and is now with the Urban Institute, recently told the Economist that "[i]n the aftermath of the crisis there was widespread agreement that [Fannie and Freddie] needed to be replaced or overhauled." *A Funny Form of Conservation*, THE ECONOMIST, Nov. 21, 2015, *available at* http:goo.gl/gJVJrN. The Net Worth Sweep ensured that the Companies' return to profitability did not threaten this goal.

93. As Treasury stated when the Net Worth Sweep was announced, the dividend sweep of all of the Companies' net worth requires that "every dollar of earnings that Fannie Mae and Freddie Mac generate will be used to benefit taxpayers." Press Release, U.S. Dep't of the Treasury, Treasury Department Announces Further Steps to Expedite Wind Down of Fannie Mae and Freddie Mac (Aug. 17, 2012). The Net Worth Sweep, in short, effectively nationalized

the Companies and confiscated the existing and potential value of all privately held equity interests, including the stock held by Plaintiffs.

94. As a Staff Report from the Federal Reserve Bank of New York recently acknowledged, the Net Worth Sweep "effectively narrows the difference between conservatorship and nationalization, by transferring essentially all profits and losses from the firms to the Treasury." W. Scott Frame, et al., *The Rescue of Fannie Mae and Freddie Mac* at 21, FEDERAL RESERVE BANK OF NEW YORK STAFF REPORTS, no. 719 (Mar. 2015). The Economist stated the obvious in reporting that the Net Worth Sweep "squashe[d] hopes that [Fannie and Freddie] may ever be private again" and, as a result, "the companies' status as public utilities . . . appear[ed] crystal clear." Fannie Mae and Freddie Mac, *Back to Black*, THE ECONOMIST, Aug. 25, 2012, *available at* http:goo.gl/1PHMs.

95. As a result of the Net Worth Sweep, it is clear that FHFA will not allow Fannie and Freddie to exit conservatorship but rather will continue to operate them essentially as wards of the state, unless and until Congress takes action. Indeed, as of this writing FHFA's website states that "FHFA will continue to carry out its responsibilities as Conservator" until "Congress determines the future of Fannie Mae and Freddie Mac and the housing finance market." FHFA as Conservator of Fannie Mae and Freddie Mac, http://goo.gl/PjyPZb. This is consistent with the testimony of former Acting Director DeMarco, who stated that he had no intention of returning Fannie and Freddie to private control under charters he perceived to be "flawed." Mr. Ugoletti also testified that FHFA's objective "was not for Fannie and Freddie Mac to emerge from conservatorship." HERA does not contemplate that FHFA will operate a perpetual conservatorship that is entirely contingent on the hope of unspecified legislative action at some point in the future.

96. The Net Worth Sweep fundamentally changed the nature of Treasury's investment in the Companies. Instead of quarterly dividend payments at an annual rate of 10% (if paid in cash) or 12% (if paid in kind) of the total amount of Treasury's liquidation preference, the Net Worth Sweep entitles Treasury to quarterly payments of *all—100%*—of the Companies' existing net worth and future profits. Beginning January 1, 2013, the Companies have been required to pay Treasury a quarterly dividend equal to their *entire net worth*, minus a capital reserve amount that starts at $3 billion and decreases to $0 by January 1, 2018.

97. The Net Worth Sweep is extraordinary because it makes the Companies unique in financial regulation. Other financial institutions are required to retain minimum levels of capital that ensure that they can withstand the vicissitudes of the economic cycle and are prohibited from paying dividends when they are not adequately capitalized. The Companies, in contrast, are not allowed to retain capital but instead must pay their entire net worth over to Treasury as a quarterly dividend. The effect of the Net Worth Sweep is thus to force the Companies to operate in perpetuity on the brink of insolvency in a manner that federal regulators in other contexts understand to be fundamentally unsafe and unsound.

98. Forcing the Companies to operate in this inherently unsafe and unsound condition also has deleterious effects on their borrowing costs, which is a major expense for both Companies. As former Acting Director DeMarco has admitted, if the Companies are highly leveraged and have a relatively small amount of capital then, all other things being equal, their cost of borrowing will be higher.

99. The Companies did not receive any meaningful consideration for agreeing to the Net Worth Sweep. Because the Companies always had the option to pay dividends "in kind" at a 12% interest rate, the Net Worth Sweep did not provide the Companies with any additional

flexibility or benefit. Rather than accruing a dividend at 12% (which never had to be paid in cash), FHFA unlawfully agreed to make a payment of substantially all the Companies' net worth each quarter.

100. The Net Worth Sweep also provides that the Companies will not have to pay a periodic commitment fee under the PSPAs while the Net Worth Sweep is in effect. But Treasury had consistently waived the periodic commitment fee before the Net Worth Sweep, and it could only set the amount of such a fee with the agreement of the Companies and at a market rate. And that rate likely would have been, at most, a modest fraction of the outstanding amount of Treasury's commitment. This is how Freddie forecasted its "sensitivity" to imposition of a periodic commitment fee: "Our sensitivity to a commitment fee based on remaining commitment available beginning in 2013 of $149 billion shows that a 25 bps fee results in a $0.4 billion annual impact on Stockholders' Equity." Further, the purpose of the fee was to compensate Treasury for its ongoing support in the form of the commitment to invest in the Companies' Government Stock. By the time of the Net Worth Sweep, the 10 percent return on the Government Stock and the warrants for 79.9 percent of the common stock provided a more than adequate return on the government's stand-by commitment, and thus any additional fee would have been inappropriate. In August of 2012, the Companies had returned to stable profitability and were no longer drawing from Treasury's commitment. Given the Companies' return to profitability, the market rate for the periodic commitment fee in 2012, 2013, and 2014 would have been zero. And, of course, by the time of the Net Worth Sweep Treasury's temporary authority to purchase the Companies' securities had already expired, making any further purchases contrary to law. Finally, even if a market-rate fee had been agreed between Treasury and FHFA and imposed pursuant to the PSPA, the Companies had sufficient market power to

pass the entire amount of this fee through to their customers—as the Companies do for other operating and financing costs—without affecting profitability or the value of the Companies' equity securities.

101. For the foregoing reasons, Mr. Ugoletti's statement, in his declaration to the District Court for the District of Columbia, that the value of the periodic commitment fee was "incalculably large" is wholly inaccurate. Indeed, Mr. Ugoletti subsequently testified that he is neither "an expert on periodic commitment fees," nor "in the business of calculating" such fees, that he could not recall discussing his idea that the value of the fee was incalculably large with anyone at FHFA or Treasury, that he did not know whether anybody shared that view, and that he did not know whether anyone at FHFA or Treasury ever tried to calculate the value of the periodic commitment fee. Mr. DeMarco also testified that he could not recall anyone at FHFA attempting to quantify what the periodic commitment fee would have been in the absence of the Net Worth Sweep.

102. As the Agencies anticipated, Fannie and Freddie have been extraordinarily profitable since the imposition of the Net Worth Sweep. From the third quarter of 2012 through the third quarter of 2015, Fannie and Freddie have reported total net income of $116 billion and $68 billion, respectively.

103. As the Agencies also anticipated, Fannie's 2013 net income included the release of over $50 billion of the company's deferred tax assets valuation allowance. The release of this valuation allowance underscores Fannie's financial strength, as it demonstrates Fannie's expectation that it will generate sizable taxable income moving forward. Fannie relied on the following evidence of future profitability in support of the release of its valuation allowance:

- Its profitability in 2012 and the first quarter of 2013 and expectations regarding the sustainability of these profits;

- Its three-year cumulative income position as of March 31, 2013;
- The strong credit profile of the loans it had acquired since 2009;
- The significant size of its guaranty book of business and its contractual rights for future revenue from this book of business;
- Its taxable income for 2012 and its expectations regarding the likelihood of future taxable income; and
- That its net operating loss carryforwards will not expire until 2030 through 2031 and its expectation that it would utilize all of these carryforwards within the next few years.

104. Freddie's 2013 earnings also reflect the Company's decision to release a sizeable (in excess of $20 billion) deferred tax assets valuation allowance. Freddie relied on the following evidence in support of its release of its valuation allowance:

- Its three-year cumulative income position as of September 30, 2013;
- The strong positive trend in its financial performance over the preceding six quarters, including the quarter ended September 30, 2013;
- The 2012 taxable income reported in its federal tax return which was filed in the quarter ended September 30, 2013;
- Its forecasted 2013 and future period taxable income;
- Its net operating loss carryforwards do not begin to expire until 2030; and
- The continuing positive trend in the housing market.

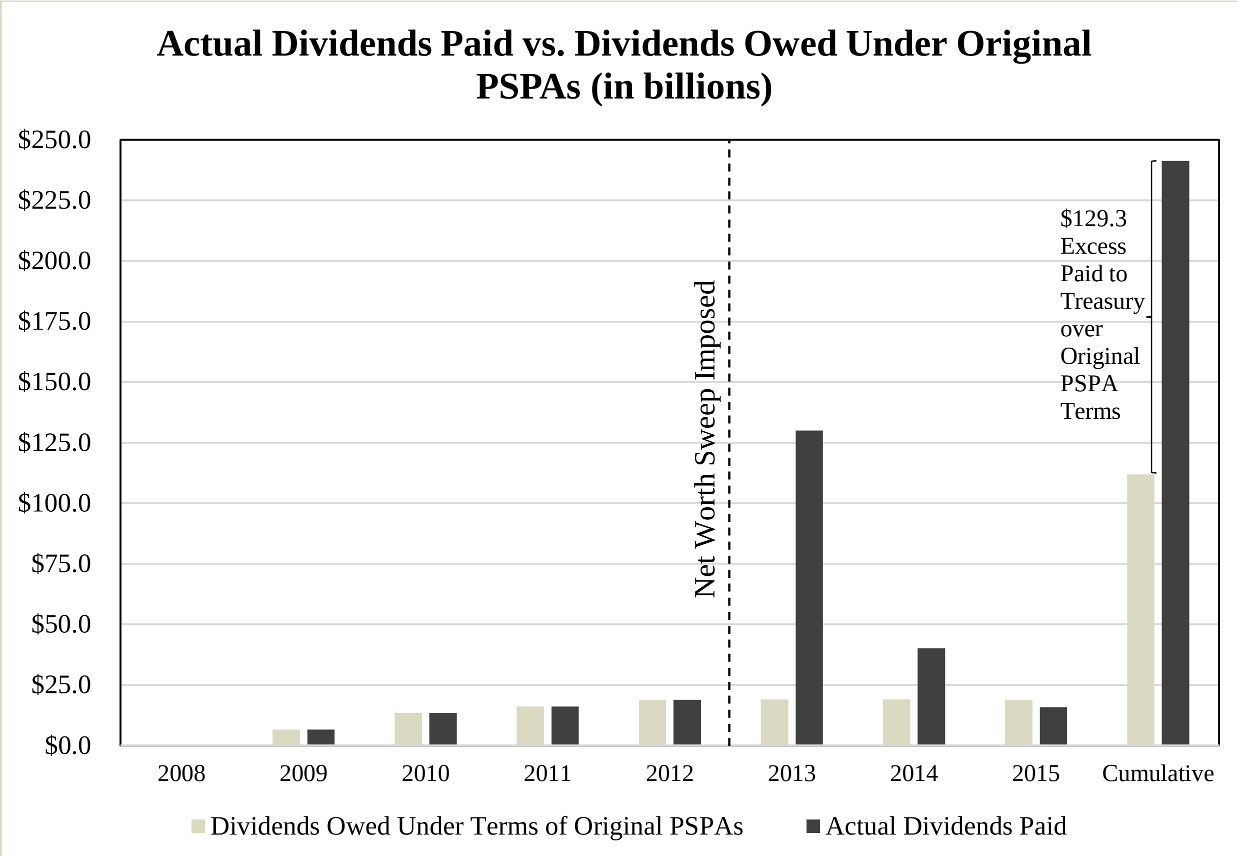
105. The Net Worth Sweep has proven to be immensely profitable for the federal government. The table below lists only the dividends Fannie and Freddie have paid under the Net Worth Sweep, and it does not include dividends paid before that time[1]:

[1] The Q4 2015 dividend amount has been established by the Q3 results, although it is not expected to be paid until late December. It is included in the table and in other calculations in the Complaint relating to dividend payments under the PSPAs.

Dividend Payments Under the Net Worth Sweep
(in billions)

		Fannie	Freddie	Combined
2013	Q1	**$4.2**	**$5.8**	**$10.0**
	Q2	**$59.4**	**$7.0**	**$66.4**
	Q3	**$10.2**	**$4.4**	**$14.6**
	Q4	**$8.6**	**$30.4**	**$39.0**
2014	Q1	**$7.2**	**$10.4**	**$17.6**
	Q2	**$5.7**	**$4.5**	**$10.2**
	Q3	**$3.7**	**$1.9**	**$5.6**
	Q4	**$4.0**	**$2.8**	**$6.8**
2015	Q1	**$1.9**	**$0.9**	**$2.8**
	Q2	**$1.8**	**$0.7**	**$2.5**
	Q3	**$4.4**	**$3.9**	**$8.3**
	Q4	**$2.2**	**$0.0**	**$2.2**
Total		**$113.3**	**$72.7**	**$186.0**

106. As the above chart shows, the Companies have paid Treasury $186 billion in "dividends" under the Net Worth Sweep. Had they instead been paying 10% cash dividends, they would have paid Treasury approximately $57 billion. The following chart shows how imposition of the Net Worth Sweep dramatically increased the size of the Companies' dividend payments to Treasury:



107. The Net Worth Sweep has thus unlawfully usurped nearly $130 billion from the Companies and sent it all into Treasury's coffers. As explained above, the Agencies knew that the Net Worth Sweep would result in a massive financial windfall for the federal government.

108. The Net Worth Sweep is squarely contrary to FHFA's statutory responsibilities as conservator of Fannie and Freddie. As conservator FHFA is obligated to "take such action as may be—(i) necessary to put the regulated entity in a sound and solvent condition; and (ii) appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity." 12 U.S.C. § 4617(b)(2)(D). As FHFA itself has acknowledged, the agency "has a statutory charge to work to restore a regulated entity in conservatorship to a sound and solvent condition . . . ." 76 Fed. Reg. at 35,727. Accordingly, "allowing capital distributions to deplete the entity's conservatorship assets would be

inconsistent with the agency's statutory goals, as they would result in removing capital at a time when the Conservator is charged with rehabilitating the regulated entity." *Id.* Thus, FHFA's own regulations generally prohibit Fannie and Freddie from making a "capital distribution while in conservatorship," subject to certain exceptions. 12 C.F.R. § 1237.12(a). Indeed, rather than putting Fannie and Freddie in sound and solvent condition, the Net Worth Sweep's reduction and eventual elimination of the Companies' capital reserves *increases* the likelihood of additional Treasury investment in the Companies.

109. But for the Net Worth Sweep Fannie and Freddie would have nearly $130 billion of additional capital to cushion them from any future downturn in the housing market and to reassure debtholders of the soundness of their investments. Instead, because of the Net Worth Sweep, the Companies are required to operate at the edge of insolvency, making them fundamentally unsafe and unsound and more likely to require an additional government bailout in the future.

110. The Net Worth Sweep's quarterly sweep of all net profits thus plainly harms, rather than promotes, the soundness and solvency of the Companies by effectively prohibiting them from rebuilding their capital. Nor can distributing the entire net worth of the Companies to Treasury be reconciled with FHFA's statutory obligation to preserve and conserve their assets and property. Indeed, Fannie has identified the dividend obligations imposed by the Net Worth Sweep as posing a "specific risk to [its] business" by prohibiting it from "build[ing] capital reserves." FANNIE MAE, UNIVERSAL DEBT FACILITY, OFFERING CIRCULAR (May 14, 2013).

111. FHFA fully understood that stripping capital out of a financial institution is the antithesis of operating it in a sound manner. Indeed, former Acting Director DeMarco has testified that capital levels are "a key component of the safety and soundness of a regulated

financial institution" and that, as a general matter, he thought that there should be more capital in the Companies to increase their safety and soundness. This recognition of the importance of capital levels is further demonstrated by an event that took place shortly after the Net Worth Sweep was announced. Fannie initially determined that the Company should reverse its deferred tax assets valuation allowance as of December 31, 2012. Doing so, however, would reduce the amount of Treasury's remaining funding commitment under the formula established by the second amendment to the PSPAs. FHFA strongly opposed this reduction of the funding commitment, which it viewed as a form of capital available to the Companies: "Capital is key driver for composite rating of critical concerns. The reduction in capital capacity from the U.S. Treasury and the SPSA agreements places undue risk on the future of Fannie Mae in conservatorship." Indeed, FHFA threatened Fannie that "if the amount of funds available under the agreement was reduced as a result of our releasing the valuation allowance in the fourth quarter of 2012, they would need to ensure the preservation of our remaining capital and undertake regulatory actions that could severely restrict our operations, increase our costs, or otherwise substantially limit or change our business in order to ensure the continued safety and soundness of our operations." As a result of this pressure from FHFA, Fannie reconsidered its decision and waited until the following quarter to release its valuation allowance, when the release would no longer affect the size of Treasury's funding commitment under the PSPAs. Waiting this extra quarter preserved approximately $34 billion of Treasury's funding commitment. The Net Worth Sweep, by contrast, has *reduced* the capital available to Fannie by a much larger amount—nearly $130 billion, to date.

112. Furthermore, on information and belief, FHFA agreed to the Net Worth Sweep only at the insistence and under the direction and supervision of Treasury. The Net Worth Sweep

was a Treasury initiative and reflected the culmination of Treasury's long-term plan to seize the Companies and see that they were operated for the exclusive benefit of the federal government. It was Treasury that informed the Companies just days before the Net Worth Sweep that it was forthcoming, and a meeting addressing the Net Worth Sweep was held at Treasury during which a senior Treasury official announced the changes. Secretary Geithner apparently believed that even before the Net Worth Sweep "we had already effectively nationalized the GSEs . . ., and could decide how to carve up, dismember, sell or restructure those institutions." Plaintiff's Corrected Post-Trial Proposed Findings of Fact 26.2.1(a), *Starr Int'l Co. v. United States*, No. 1:11-cv-779-TCW (Fed. Cl. March 2, 2015), ECF No. 430. And Treasury officials intimately involved in the development of the Net Worth Sweep testified that they could not recall Treasury making any backup or contingency plans to prepare for any possibility that FHFA would reject the Net Worth Sweep proposal.

113. The Net Worth Sweep is just one example of the significant influence Treasury has exerted over FHFA from the beginning of the conservatorship. Indeed, Secretary Paulson has written that "seizing control" of Fannie and Freddie, an action that is statutorily reserved to FHFA, was an action "I took." HENRY M. PAULSON, JR., ON THE BRINK xiv (2d ed. 2013). Similarly, Congressional Budget Office Assistant Director for Financial Analysis Deborah Lucas told Congress that the Companies are subject to "ownership and control by the Treasury." *Fannie Mae, Freddie Mac & FHA: Taxpayer Exposure in the Housing Markets: Hearing Before the H. Comm. on the Budget*, 112th Cong. 15 (2011).

114. The Net Worth Sweep is merely one element of Treasury's broader plan to transform the housing finance market and to eliminate Fannie and Freddie. Other elements of that plan include the development of a single securitization utility to be used by both Fannie and

Freddie—and by other entities once Fannie and Freddie are eliminated. FHFA has made the development of such a utility a key initiative of the conservatorships, providing further evidence that FHFA is operating according to Treasury's playbook.

115. Treasury, however, lacks the authority to impose such direction and supervision, and FHFA lacks the authority to submit to it. HERA expressly provides that "[w]hen acting as conservator, . . . [FHFA] shall not be subject to the direction or supervision of any other agency of the United States . . . ." 12 U.S.C. § 4617(a)(7).

116. Contrary to statutory authority, both Treasury and FHFA understood the Net Worth Sweep to be a step toward the liquidation, not the rehabilitation, of the Companies. This was in stark contrast to FHFA's then-Acting Director's statement two years earlier that, absent legislative action, "the only [post-conservatorship option] that FHFA may implement today under existing law is to reconstitute [Fannie and Freddie] under their current charters." February 2, 2010 Letter of Acting Director DeMarco to Chairmen and Ranking Members of the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services. Communications between FHFA and Treasury, however, indicate that by January 2012 the Agencies shared common goals that included providing the public and financial markets with a clear plan to wind down Fannie and Freddie.

117. Statements by both FHFA and Treasury provide further confirmation that the Net Worth Sweep violates FHFA's statutory restrictions as conservator. Treasury, for example, said the Net Worth Sweep would "expedite the wind down of Fannie Mae and Freddie Mac," and it emphasized that the "quarterly sweep of every dollar of profit that each firm earns going forward" would make "sure that every dollar of earnings that Fannie Mae and Freddie Mac generate will be used to benefit taxpayers." Press Release, U.S. Dep't of the Treasury, Treasury

Department Announces Further Steps to Expedite Wind Down of Fannie Mae and Freddie Mac (Aug. 17, 2012). Indeed, Treasury emphasized that the Net Worth Sweep would ensure that the Companies "will be wound down and will not be allowed to retain profits, rebuild capital, and return to the market in their prior form." *Id*.

118. Unbeknownst to the public, as early as December 2010, an internal Treasury memorandum acknowledged the "Administration's commitment to ensure existing common equity holders will not have access to any positive earnings from the [Companies] in the future." Action Memorandum for Secretary Geithner (Dec. 20, 2010). Just weeks later, however, in another internal document the author of this memorandum acknowledged that "the path laid out under HERA and the Paulson Treasury when [the Companies] were put into conservatorship in September 2008" was for Fannie and Freddie to "becom[e] adequately capitalized" and "exit conservatorship as private companies" with "existing common shareholders" being "substantially diluted"—but not eliminated. Memorandum from Jeffery A. Goldstein, Undersecretry of Domestic Finance, to Timothy Geithner, United States Secretary of the Treasury at 4 (Jan. 4, 2011). The memorandum also acknowledged that any threat to Treasury's funding commitment from dividend payments potentially could be addressed by "converting [Treasury's] preferred stock into common or cutting or deferring payment of the dividend (under legal review)." *Id.* In other words, the problem Treasury was purportedly trying to solve with the Net Worth Sweep, a cash dividend too high to be serviced by earnings, could be addressed by other means already known to Treasury, such as cutting or deferring payment of the dividend.

119. Furthermore, as explained above, because of the payment-in-kind option available to FHFA and the Companies, the purported "circular dividend" problem was entirely illusory. Indeed, Jeff Foster, one of the architects of the Net Worth Sweep at Treasury, has testified that

he could not identify any "problems of the circularity [in dividend payments that] would have remained had the [payment-in-kind] option been adopted." Furthermore, another option was floated that would have preserved Treasury's funding commitment—only having a net worth sweep dividend kick in if Treasury's funding commitment was drawn down to $100 billion or less. Nevertheless, in 2012 the Agencies implemented the Administration's secret and unauthorized commitment to wipe out private shareholders by having the Companies enter into the Net Worth Sweep.

120. FHFA Acting Director Edward DeMarco informed a Senate Committee that the "recent changes to the PSPAs, replacing the 10 percent dividend with a net worth sweep, reinforce the notion that the [Companies] will not be building capital as a potential step to regaining their former corporate status." Edward J. DeMarco, Acting Director, FHFA, Statement Before the U.S. Sen. Comm. on Banking & Urban Affairs 3 (Apr. 18, 2013). In its 2012 report to Congress, FHFA explained that it had begun "prioritizing [its] actions to move the housing industry to a new state, one without Fannie Mae and Freddie Mac." FHFA, 2012 REP. at 13. Thus, according to FHFA, the Net Worth Sweep "ensures all the [Companies'] earnings are used to benefit taxpayers" and "reinforces the fact that the [Companies] will not be building capital." *Id.* at 1, 13. In short, the Net Worth Sweep plainly is central to the FHFA's new plan to "wind[] up the affairs of Fannie and Freddie," Remarks of Edward J. DeMarco, Getting Our House in Order at 6 (Wash., D.C., Oct. 24, 2013), and thus cannot be reconciled with the agency's statutory obligations as conservator of Fannie and Freddie.

121. While purportedly waiting for Congress to initiate potential legislative action on Fannie and Freddie, FHFA has resolved to operate the Companies for the exclusive benefit of the federal government rather than for the benefit of the Companies themselves and their private

stakeholders. The Net Worth Sweep is only the most blatant manifestation of this egregious decision, which is reflected in numerous additional FHFA statements and actions. In short, while HERA directs FHFA to operate the Companies in a manner that rebuilds their capital and returns them to private control, FHFA has resolved to operate Fannie and Freddie with a view toward "minimiz[ing] losses on behalf of taxpayers," FHFA, A STRATEGIC PLAN FOR ENTERPRISE CONSERVATORSHIPS: THE NEXT CHAPTER IN A STORY THAT NEEDS AN ENDING 7 (Feb. 21, 2012)—a goal that ignores a simple reality: no such losses have been incurred, and Treasury has currently realized an approximately $54 billion profit. Indeed, FHFA has made clear that its "overriding objectives" are to operate Fannie and Freddie to serve the federal government's policy goals of "[g]etting the most value for taxpayers and bringing stability and liquidity to housing finance . . . ." *Id*. at 21. Director Watt summed up the situation succinctly when stating that he does not "lay awake at night worrying about what's fair to the shareholders" but rather focuses on "what is responsible for the taxpayers." Nick Timiraos, *FHFA's Watt 'Comfortable' with U.S. Sweep of Fannie, Freddie Profits*, WALL STREET JOURNAL MONEY BEAT BLOG (May 16, 2014, 3:40 PM), http://goo.gl/Tltl0U.

122. The dramatically negative impact of the Net Worth Sweep on the Companies' balance sheets is demonstrated by Fannie's results in the first quarter of 2013. At the end of the first quarter Fannie's net worth stood at $62.4 billion. Under the prior versions of the PSPAs, if Fannie chose to declare a cash dividend it would have been obligated to pay Treasury a dividend of only $2.9 billion, and the balance—$59.5 billion—would have been credited to its capital. The Net Worth Sweep, however, required Fannie to pay Treasury $59.4 billion.

123. Contrary to FHFA's statutory authority, FHFA has ensured that the Companies cannot operate independently and must be wards of the federal government. FHFA has

announced that, during the conservatorship, existing statutory and FHFA-directed regulatory capital requirements will not be binding on the Companies. And at the end of 2012, Fannie had a deficit of core capital in relation to statutory minimum capital of $141.2 billion. This deficit decreased to $88.3 billion by the end of the first quarter of 2013. When adjusted for the $59.4 billion dividend payment to Treasury, however, Fannie's core capital deficit jumped back up to $147.7 billion. Thus, because of the Net Worth Sweep, Fannie was in a ***worse*** position with respect to its core capital than it was before the record-breaking profitability it achieved in the first quarter of 2013.

124. Furthermore, under FHFA's conservatorship Fannie and Freddie have elected to pay Treasury its dividend in cash, even though their net worth includes changes in both cash and non-cash assets. In the first quarter of 2013, for example, over $50 billion of Fannie's profitability resulted from the release of the Company's deferred tax assets valuation allowance—the same non-cash asset that previously created massive paper losses for the Company. As a result, Fannie was required to "fund [its] second quarter dividend payment of $59.4 billion primarily through the issuance of debt securities." Fannie, 2013 First Quarter Report, at 42.

125. Borrowing money to pay an enormous dividend on a non-cash profit (due to an accounting reversal) is without precedent in a conservatorship. It also is clearly contrary to FHFA's statutory obligations as conservator, as FHFA is operating the Companies in an inherently unsafe and unsound manner and hindering the ability of the Companies to restore their financial health so that they can be returned to normal business operations.

126. The Net Worth Sweep has become a major revenue source for the United States Government at the expense of Plaintiffs and other private shareholders. For example, the federal

government's record-breaking $53.2 billion surplus for the month of December 2013 was driven in large part by the $39 billion swept from Fannie and Freddie.

127. As previously noted, Treasury's temporary statutory authority to purchase the securities of the Companies was conditioned on its consideration of certain statutory factors, including "the need to maintain the [Companies'] status as . . . private shareholder-owned compan[ies]" and the Companies' plans "for the orderly resumption of private market funding or capital market access." *See* 12 U.S.C. §§ 1455(*l*)(1)(C), 1719(g)(1)(C). There is no public record that Treasury considered these factors before executing the Net Worth Sweep, and Treasury has asserted that it did not need to consider them. Indeed, the terms of the Net Worth Sweep requiring the quarterly payment of all profits and the winding down of the Companies' operations are wholly inconsistent with these factors. There is also no evidence that Treasury adequately considered alternatives to the Net Worth Sweep that would have been consistent with its statutory obligations, less harmful to Plaintiffs and other private shareholders, and more likely to ensure the Companies' future solvency. Finally, there is no evidence that Treasury fulfilled the statutory requirement to report exercises of its temporary purchase authority to Congress upon entering the Net Worth Sweep. *See* 12 U.S.C. §§ 1455(*l*)(1)(D); 1719(g)(1)(D).

128. FHFA made no public record of its contemporaneous decision-making processes in agreeing to the Net Worth Sweep. There is no public record that FHFA adequately considered whether the Net Worth Sweep is consistent with its statutory obligations as conservator of the Companies. Treasury's stated purpose of winding down the Companies, which necessarily involves liquidating their assets and property, is incompatible on its face with FHFA's charge to put the Companies back into "a sound and solvent condition" and to "conserve [their] assets and property." There is also no evidence that FHFA adequately considered alternatives to the Net

Worth Sweep that would have been both consistent with its statutory obligations and less harmful to private shareholders. Instead, there are statements by FHFA—including in its own Strategic Plan for the Companies—that the role of the conservator was to "minimize taxpayer losses" rather than protect and conserve the Companies.

129. Finally, there is no public record that either government agency—Treasury or FHFA—considered whether the Net Worth Sweep is consistent with the contractual and fiduciary duties to private shareholders. And the Net Worth Sweep is wholly inconsistent with those duties.

Dividend Payments Under the Purchase Agreements

130. Fannie has drawn $116.1 billion from Treasury under the PSPAs, while Fannie's purported dividends to Treasury under the PSPAs total $144.7 billion. Freddie has drawn $71.3 billion from Treasury under the PSPAs, while Freddie's purported dividends to Treasury under the PSPAs total $96.5 billion. Combined, Fannie and Freddie have paid Treasury approximately $54 billion more than they have received.

131. Yet, under the Net Worth Sweep, these purported dividend payments do not operate to pay down the liquidation preference or otherwise redeem any of Treasury's Government Stock. The liquidation preference of Treasury's Government Stock in the Companies purportedly remains at approximately $189 billion (due to the Companies' draws and the $1 billion initial valuation of Treasury's Government Stock in each) and will remain at that amount regardless of how many billions of dollars the Companies pay to Treasury in dividends going forward. The Government's rate of return is infinite, like that of a common equity holder.

132. Indeed, the fundamental nature of the change in Treasury's investment resulting from the Net Worth Sweep is illustrated by the facts that Treasury is now effectively Fannie's

and Freddie's *sole* equity shareholder and that Treasury's securities in the Companies are now effectively equivalent to 100% of the Companies' common stock. After giving effect to the Net Worth Sweep, Treasury has both the right to receive all profits of the Companies as well as control over the manner in which the Companies conduct business. Accordingly, following the Net Worth Sweep, Treasury's Government Stock should be characterized in a manner consistent with its economic fundamentals as 100% of the Companies' common stock. Indeed, the Government Stock must be deemed as common or voided altogether because, by definition, preferred stock must have preferences over other classes of stock. *See* 8 DEL. CODE tit. 8, § 151(c); VA. CODE § 13.1-638(C)(4). After the Net Worth Sweep, of course, the economic rights of other classes of Fannie and Freddie stock have been effectively eliminated, leaving nothing for the Government Stock to have preference over. The Government Stock simply takes *everything*.

133. That FHFA and Treasury continue to label the Government Stock as a preferred equity security is not controlling, particularly in light of the fact that the Net Worth Sweep was not an arms-length business transaction. Rather it was a self-dealing arrangement between two agencies of the federal government for the benefit of the federal government and, upon information and belief, one of those agencies (FHFA) was acting at the direction of the other (Treasury). Moreover, as explained above, statements by Treasury and FHFA make clear that the Net Worth Sweep was designed with the intent to grant the federal government the right to all of Fannie's and Freddie's future profits and to ensure that the Companies will remain under the control of the federal government and not return to the control of their private shareholders.

CLAIMS FOR RELIEF
COUNT I

FHFA's Conduct Exceeded Its Statutory Authority As Conservator

134. Plaintiffs incorporate by reference the allegations of the preceding paragraphs.

135. The APA requires the Court to "hold unlawful and set aside agency action, findings, and conclusions" that are "in excess of statutory jurisdiction, authority, or limitations" or that are "without observance of procedure required by law." 5 U.S.C. § 706(2)(C), (D). In addition to the limitations established under the APA, FHFA's authority as conservator of the Companies is strictly limited by statute. *See* 12 U.S.C. § 4617(b)(2)(D).

136. The Net Worth Sweep is inimical to the very definition of what it means to be a conservator, which is a term with a well-established meaning in financial regulation. A conservator is charged with seeking to rehabilitate the company under its control, not to operate the company for its own benefit while stripping it of its assets.

137. The Net Worth Sweep is in direct contravention of the statutory command that FHFA as conservator must undertake those actions "necessary to put the [Companies] in a sound and solvent condition" and "appropriate to carry on the business of the [Companies] and preserve and conserve [their] assets and property." 12 U.S.C. § 4617(b)(2)(D). Indeed, rather than seeking to put the Companies in a "sound and solvent" condition and to preserve and conserve the Companies' assets and property, FHFA has expropriated the Companies' entire net worth for the benefit of the federal government, to the detriment of the Companies and private shareholders such as Plaintiffs.

138. Furthermore, FHFA's purpose as conservator is to seek to rehabilitate Fannie and Freddie, but the Net Worth Sweep makes such rehabilitation impossible. Rather, the Net Worth Sweep makes clear that FHFA and Treasury intend to keep Fannie and Freddie in

conservatorship indefinitely, operating them for the sole benefit of the federal government, unless Congress passes legislation resolving the situation.

139. On information and belief, FHFA agreed to the Net Worth Sweep only at the insistence and under the direction and supervision of Treasury. But because HERA mandates that FHFA perform its duties as conservator independent of the "direction or supervision of any other agency," 12 U.S.C. § 4617(a)(7), FHFA was not authorized to subject itself to Treasury's will.

140. FHFA also acted beyond its authority by re-interpreting its statutory duty as a conservator under HERA to be a duty to taxpayers only and by resolving to hold Fannie and Freddie in a perpetual conservatorship to be operated for the benefit of the federal government.

141. FHFA's conduct was therefore outside of FHFA's authority under HERA and "in excess of statutory . . . authority" and "without observance of procedure required by law," and Plaintiffs are therefore entitled to relief against FHFA pursuant to 5 U.S.C. §§ 702, 706(2)(C), (D).

COUNT II

Treasury's Conduct Exceeded Its Statutory Authority

142. Plaintiffs incorporate by reference the allegations of the preceding paragraphs.

143. The APA requires the Court to "hold unlawful and set aside agency action, findings, and conclusions" that are "in excess of statutory jurisdiction, authority, or limitations" or that are "without observance of procedure required by law." 5 U.S.C. § 706(2)(C), (D).Treasury's statutory authority to purchase securities issued by the Companies expired on December 31, 2009. 12 U.S.C. §§ 1455(*l*)(4), 1719(g)(4). The Net Worth Sweep, which was executed on August 17, 2012, contravenes this unambiguous limit on Treasury's authority.

144. The Net Worth Sweep created an entirely new security. Under the original Purchase Agreements, Treasury purchased Government Stock that entitled it to a 10% cash or 12% in-kind quarterly dividend on an amount equal to the aggregate liquidation preference of the Government Stock. The Government Stock was a fixed return security not otherwise entitled to participate in the unlimited upside of the Companies' earnings. By contrast, the Net Worth Sweep entitles Treasury to a quarterly distribution of *all* of the Companies' earnings for as long as they remain in operation. The Net Worth Sweep thus effected a wholesale change to the nature of Treasury's securities after its statutory authority to purchase new securities had expired, and it converted Treasury's Government Stock into new securities that nationalize the Companies and entitle Treasury to 100% of their net worth as if Treasury were the outright owner of all common and preferred stock in the Companies. Treasury cannot evade this clear statutory restriction on its authority to purchase securities of the Companies by the simple expedient of calling these new securities an "amendment" to the old securities. As former Acting Director DeMarco has testified, the Net Worth Sweep amounted to "an *exchange* [of] one set of compensation to Treasury for another one." DeMarco Tr. at 328 (emphasis added).

145. In addition, before exercising its temporary authority to purchase securities, Treasury is required to "determine that such actions are necessary to . . . (i) provide stability to the financial markets; (ii) prevent disruptions in the availability of mortgage finance; and (iii) protect the taxpayer." 12 U.S.C. § 1719(g)(1)(B). In making the statutorily required determinations, Treasury must consider such factors as "the [Companies'] plan[s] for the orderly resumption of private market funding or capital market access" and "the need to maintain the [Companies'] status as . . . private shareholder-owned compan[ies]," among other factors. *Id*. § 1719(g)(1)(C)(iii), (v).

146. These statutory criteria must apply to any and all "amendments" to the Purchase Agreements. Were it otherwise, Treasury could fundamentally alter its investments in the Companies at any time, including after its investment authority has expired and effectively turn Treasury's limited, temporary grant of authority to purchase the Companies' securities under certain conditions, into an unconstrained and permanent authority and subvert the statutory limitations imposed by Congress.

147. As far as the public record discloses, Treasury did not make any of the required determinations or consider any of the necessary factors before imposing the Net Worth Sweep. It therefore exceeded its statutory authority.

148. The Net Worth Sweep is beyond Treasury's authority because it is not compatible with due consideration of factors that Treasury must consider before purchasing the Companies' securities or amending its agreements to purchase such securities. The Net Worth Sweep destroys the value of the Companies' private stock. The Net Worth Sweep is therefore wholly incompatible with "the need to maintain the [Companies'] status as . . . private shareholder-owned compan[ies]" and with the "orderly resumption of private market funding or capital market access."

149. On information and belief, FHFA agreed to the Net Worth Sweep only at the insistence and under the direction and supervision of Treasury. But because HERA mandates that FHFA "shall not be subject to the direction or supervision of any other agency" when performing its duties as conservator for the Companies, 12 U.S.C. § 4617(a)(7), Treasury acted in excess of its authority in imposing its will on FHFA.

150. Treasury's conduct was therefore outside of Treasury's authority under HERA and "in excess of statutory . . . authority" and "without observance of procedure required by

law," and Plaintiffs are therefore entitled to relief against Treasury pursuant to 5 U.S.C. §§ 702, 706(2)(C), (D).

COUNT III

Treasury's Conduct Was Arbitrary and Capricious

151. Plaintiffs incorporate by reference the allegations of the preceding paragraphs.

152. The APA requires the Court to "hold unlawful and set aside agency action, findings, and conclusions" that are "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. § 706(2)(A). This means, among other things, that agency action is unlawful unless it is the product of "reasoned decisionmaking" that considers every responsible alternative. *Motor Vehicle Mfrs. Ass'n*, 463 U.S. at 52. Decisionmaking that relies on inadequate evidence or that results in inconsistent or contradictory conclusions cannot satisfy that standard.

153. Before Treasury exercises its temporary authority to purchase the Companies' securities, it is required to determine that the financial support is necessary to "provide stability to the financial markets," "prevent disruptions in the availability of mortgage finance," and "protect the taxpayer." 12 U.S.C. §§ 1455(*l*)(1)(B), 1719(g)(1)(B). In making these determinations, Treasury is further required to "take into consideration" several factors, including the "plan for the orderly resumption of private market funding or capital market access," and the "need to maintain [the] status [of Fannie and Freddie] as . . . private shareholder-owned compan[ies]." *Id.* §§ 1455(*l*)(1)(C); 1719(g)(1)(C).

154. These statutory criteria plainly apply to any and all "amendments" of the Purchase Agreements. Were it otherwise, Treasury could fundamentally alter its investments in the Companies at any time, including after its investment authority has expired and effectively turn

Treasury's limited, temporary grant of authority to purchase the Companies' securities under certain conditions, into an unconstrained and permanent authority and subvert the statutory limitations imposed by Congress.

155. There is no evidence in the public record that Treasury made the required determinations or considered the necessary factors before imposing the Net Worth Sweep. Indeed, the available evidence reveals that none of the necessary conditions was satisfied. Further, Treasury also has not explained whether it considered alternatives to the Net Worth Sweep that would have been both consistent with its statutory obligations and less harmful to Plaintiffs and other private shareholders. Treasury has thus arbitrarily and capriciously failed to provide a reasoned explanation for its conduct, which results in the Government's expropriation of all private shareholder value in the Companies' preferred and common stock.

156. Treasury also arbitrarily and capriciously failed to consider alternatives to the Net Worth Sweep that would have better promoted stability in the mortgage markets by leaving the Companies on a sound financial footing. The Net Worth Sweep undermines the Companies' financial health by preventing them from building up cash reserves in one quarter that can be used to service debt in another quarter. Yet there is no evidence in the public record that Treasury considered alternatives to the Net Worth Sweep that would have provided greater assurance to investors that the Companies will be able to service their debts in the future.

157. Treasury also acted in an arbitrary and capricious manner by failing to consider whether the Net Worth Sweep is consistent with its fiduciary duties to minority shareholders as the Companies' dominant shareholder.

158. Treasury also acted arbitrarily and capriciously by relying on outdated and demonstrably inaccurate projections of Fannie's and Freddie's future financial performance

while ignoring or failing adequately to account for more timely and accurate information on that subject.

159. Under applicable state law governing shareholders' relationship with Fannie and with Freddie, a corporation's dominant shareholders owe fiduciary duties to minority shareholders.

160. Treasury is the dominant shareholder and de facto controlling entity of the Companies. For example, Treasury serves as the Companies' only permitted source of capital, and Treasury must give permission to the Companies before they can issue other equity securities and before they can sell assets valued above $250 million. Treasury also is able to influence or control the actions of FHFA as conservator and the length and nature of the conservatorship.

161. The Net Worth Sweep effectively transfers the value of the preferred and common stock from Plaintiffs and other private holders to the Companies' dominant shareholder. And as Treasury admits, the Net Worth Sweep's express purpose is to wind down the Companies' operations. Treasury's actions in preventing Plaintiffs and other minority shareholders from receiving any dividends or value from their stock, combined with Treasury's intent to wind down the Companies, render the private stock devoid of any value or prospect of return.

162. Treasury's conduct was therefore arbitrary and capricious, and Plaintiffs are therefore entitled to relief under 5 U.S.C. §§ 702, 706(2)(A).

COUNT IV

Breach of Contract Against FHFA as Conservator of Fannie and Freddie

163. Plaintiffs incorporate by reference the allegations of the preceding paragraphs.

164. Holders of the Companies' preferred and common stock have certain contractual rights. Preferred stockholders are entitled to a contractually specified, non-cumulative dividend and to a contractually specified liquidation preference. The dividend and liquidation rights of private preferred shareholders are prior to those of common shareholders. The Companies may not pay dividends or make distributions on account of its common stock in any quarter where dividends on preferred stock is not paid in full. Common shareholders are entitled to be paid dividends in parity with other common shareholders, and upon liquidation they are entitled to a share of the residual economic value of the firm after payment of debtholders and equity holders senior in priority to common stock.

165. By entering the Net Worth Sweep, FHFA, as conservator for Fannie and Freddie, breached the Companies' obligations to Plaintiffs by nullifying entirely Plaintiffs' contractual rights as holders of the Companies' stock. Thus, in addition to exceeding its authority as conservator under HERA, FHFA's agreement to the Net Worth Sweep breached or repudiated Fannie's and Freddie's contracts with Plaintiffs and other private shareholders.

166. Again, the Net Worth Sweep replaced the 10% dividend (if paid in cash) on Treasury's Government Stock with a perpetual requirement that the Companies pay their entire net worth to Treasury. Amounts in excess of the 10% cash dividend on the Government Stock would otherwise be available to pay dividends to private shareholders. The Net Worth Sweep thus strips the Companies of their ability to generate and retain funds to distribute as dividends to holders of preferred and common stock.

167. By essentially expropriating the entirety of the Companies' net worth for the government, the Net Worth Sweep also nullified entirely the contractual right of Plaintiffs and

other holders of common and preferred stock to receive a payment upon the dissolution, liquidation, or winding up Fannie and Freddie.

168. In short, the Net Worth Sweep effectively eliminated all equity interests in the Companies other than Treasury's Government Stock.

169. The Companies—and thus FHFA when acting as conservator for the Companies—is contractually prohibited from unilaterally changing the terms of preferred stock to materially and adversely the rights of preferred shareholders. The Net Worth Sweep violates this prohibition by effectively eliminating the dividend and liquidation preference rights associated with the Companies' preferred stock.

170. No provision of Plaintiffs' contracts with the Companies reserves to Fannie and Freddie any right to *repudiate* or *nullify entirely* the Companies' contractual obligations to Plaintiffs and other private shareholders by granting rights to another class of the Companies' stock.

171. Furthermore, the Net Worth Sweep effectively transformed Treasury's Government Stock into 100% of the Company's common stock by granting Treasury the right to 100% of the Company's net worth. The entitlement to receive all residual profit is the key attribute of common stock. Paying dividends on this newly created common stock without first paying dividends to Plaintiffs and other holders of preferred stock violates those shareholders' contractual right to be paid a dividend in full in any quarter where the Companies pay a dividend on common stock. It also violates the rights of other common shareholders to share in common stock dividend distributions.

172. FHFA has therefore both exceeded its statutory authority under HERA and breached the Companies' contracts with Plaintiffs and other private shareholders.

COUNT V

Breach of Implied Covenant of Good Faith and Fair Dealing Against FHFA as Conservator of Fannie and Freddie

173. Plaintiffs incorporate by reference the allegations of the preceding paragraphs.

174. Implicit in every contract is a covenant of good faith and fair dealing. The implied covenant requires a party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits of the bargain.

175. Holders of the Companies' preferred and common stock have certain contractual rights. Preferred stockholders are entitled to a contractually specified, non-cumulative dividend and to a contractually specified liquidation preference. The dividend and liquidation rights of private preferred shareholder are prior to those of common shareholders. The Companies may not pay dividends or make distributions on account of its common stock in any quarter where dividends on preferred stock is not paid in full. Common shareholders are entitled to be paid dividends in parity with other common shareholders, and upon liquidation they are entitled to a share of the residual economic value of the firm after payment of debtholders and equity holders senior in priority to common stock.

176. FHFA's agreement to the Net Worth Sweep has arbitrarily and unreasonably prevented Plaintiffs and other private shareholders from receiving any of the fruits of their investment. Again, the Net Worth Sweep replaced the 10% dividend on Treasury's Government Stock with a perpetual requirement that the Companies pay their entire net worth to Treasury. The Net Worth Sweep thus strips the Companies of their ability to generate and retain funds to distribute as dividends to Plaintiffs and other holders of preferred and common stock.

177. The Net Worth Sweep also (a) subverts the priority rights of preferred shareholders by effectively transforming Treasury's Government Stock into common stock and requiring the Companies to pay dividends on that common stock without first paying dividends on preferred stock, and (b) effectively replaces the Companies existing common stock with Treasury's Government Stock.

178. By essentially expropriating the entirety of the Companies' net worth for the government, the Net Worth Sweep also nullified entirely the contractual right of Plaintiffs and other holders of common and preferred stock to receive a payment upon the dissolution, liquidation, or winding up of Fannie and Freddie.

179. No provision of Plaintiffs' contracts with Fannie and Freddie reserves to the Companies any right to *repudiate* or *nullify entirely* the Companies' contractual obligations to Plaintiffs and other private shareholders by granting rights to another class of the Companies' stock.

180. In sum, the Net Worth Sweep repudiates and nullifies entirely the scope, purpose, and terms of the contracts governing the relationships between Fannie and Freddie and their preferred and common shareholders.

181. FHFA has therefore both exceeded its statutory authority under HERA and breached the implied covenant of good faith and fair dealing.

PRAYER FOR RELIEF

182. WHEREFORE, Plaintiffs pray for an order and judgment:

a. Declaring that the Net Worth Sweep, and its adoption, are not in accordance with and violate HERA within the meaning of 5 U.S.C. § 706(2)(C), and that

Treasury acted arbitrarily and capriciously within the meaning of 5 U.S.C. § 706(2)(A) by executing the Net Worth Sweep;

b. Enjoining Treasury and its officers, employees, and agents to return to Fannie and Freddie all dividend payments made pursuant to the Net Worth Sweep or, alternatively, recharacterizing such payments as a pay down of the liquidation preference and a corresponding redemption of Treasury's Government Stock rather than mere dividends;

c. Vacating and setting aside the Net Worth Sweep, including its provision sweeping all of the Companies' net worth to Treasury every quarter;

d. Enjoining FHFA and its officers, employees, and agents from implementing, applying, or taking any action whatsoever pursuant to the Net Worth Sweep;

e. Enjoining Treasury and its officers, employees, and agents from implementing, applying, or taking any action whatsoever pursuant to the Net Worth Sweep;

f. Enjoining FHFA and its officers, employees, and agents from acting at the instruction of Treasury or any other agency of the government and from re-interpreting the duties of FHFA as conservator under HERA;

g. Awarding Plaintiffs damages resulting from FHFA's breach of contract and breach of the implied covenant of good faith and fair dealing, including without limitation contractually-due dividends on the preferred and common stock for each quarter when a dividend based on the net worth of the Companies was paid to Treasury;

h. Awarding Plaintiffs their reasonable costs, including attorneys' fees, incurred in bringing this action; and

i. Granting such other and further relief as this Court deems just and proper.

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