U.S. Treasury – KPMG Comments on Fannie Mae Liquidity Commitment Calculations Performed by Grant Thornton (GT)

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1. How can the numbers for all three cases be reconciled with the cumulative draw downs for 2011-2014 in the FHFA press release? If the differences are due to different versions of the FNM projections, would the final LC and SPS reports submitted to KPMG be based on the same (final) set of FNM projections as the FHFA release?
   ANSWER: In the forecasts we received from Fannie Mae, the drawdowns are exactly as shown in the FHFA report once the fiscal year is taken into account (see the chart to the right). We changed our report with the news that Fannie Mae revised its Q3 draw down to $7.8 billion from $10.1 billion forecasted in the base case, $16.6 billion in the stress case, and $9.6 billion in the optimistic case. We do not expect to receive additional schedules from Fannie Mae to support these figures.

Scenario	Per FHFA Report	Q4 2011	Q1 2015
Stress	219	218.3	219.4
Base	150	149.4	150.0
Optimistic	145	143.7	145.4

2. Apart from the probabilities on page 3 in the LC report, which seem to be focused on the likelihood that the economy would perform better or worse relative to each scenario, does Moody's provide any other probabilities that would allow calculating an expected LC value (i.e. weighting the liquidity payments across all three scenarios)?
   ANSWER: We are not aware of any additional probabilities that Moody's provides. Our rationale for not placing weights on the scenarios was also based on discussions with the forecasting staff, as well as our observations that the stress case scenarios we have seen in the past have far exceeded actual losses.

3. Page 3: Are the historically high credit losses projected through 2013, representative of the trough ending in 2012 – would this be a reasonable time frame for all related losses to be "all in" related to the trough?
   ANSWER: The high credit losses through 2013 represent the losses related to the 2005 to 2008 vintage loans, which are projected to comprise an ever small portion of the credit book.

4. Page 3: Are the probabilities related to the scenarios correct as listed in the 3rd paragraph?
   ANSWER: Yes.

5. Page 9: Paragraph 5 discusses a peak-to-trough decline of 25-35%. Where is the market currently in terms of this drop?
   ANSWER: The specific figure isn't given in the report we received that provides this particular statistic; however, according to the June 30, 2011 Credit Supplement, the sum of all the data points available (2007 through Q2 of 2011), is -22.5 percent, based on the Fannie Mae Home Price Index. The comparable position according to the S&P / Case-Shiller index was -37.6 percent, which shows the trough beginning in 2006.

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6. Is it possible to see a quantified result of the backtesting done and any refinements to the methodology which were a result of said backtesting?
ANSWER: We are unable to provide the data without violating our non-disclosure agreement with Fannie Mae. As with Freddie Mac, we compared each of the forecasts we have received against actual performance for 2009 and 2010. Because of the accounting change in 2010 to consolidate the off-balance sheet trusts onto the balance sheet, the 2009 and 2010 forecasts are not strictly comparable, and Fannie Mae cautioned us that drawing conclusions across the different periods would not be appropriate. However, we observed that actual net losses were typically lower than predicted in the optimistic and base cases (which were similar to each other) and far lower than forecasted in the stress cases.

7. What is the significance of the second paragraph on page 8 in the Fannie LC report? Is the reference to "liquidity preference" meant to be "liquidation preference"?
ANSWER: This is part of the description of the Senior Preferred Stock purchase transaction. It contains language very similar to that found in Fannie Mae's 10-K. "Liquidity preference" and "liquidation preference" are used interchangeably.

FNM LC Exhibits 2011 11 28.xlsx

LC Ex 1, 2, 3

1. "Income from Partnerships" jumps to $231 million in 2015, and stays at that level, even though historically for 2011-2014 it is below $2 million on average.
ANSWER: This figure was informed by our discussions with Fannie Mae's forecasting staff.

2. Did Fannie Mae provide any reason for setting OTTI to 0 after 2012?
ANSWER: OTTI wasn't a significant figure in the two periods for which Fannie Mae provided forecast data. Fannie Mae did not give a reason other than to note that they are not currently taking much OTTI, and any accretion has been built into their forecasts.

3. "Fee and Other Income" is assumed to grow at 4.8%. Did Fannie Mae provide any additional support for that growth rate? What might be some of the reasons supporting that assumption. The Freddie LC report assumes that "Net non-interest income (loss)" would decline at 3%. Are these two income components comparable across the two GSEs? If yes, do you have a sense for what may be driving the drastically opposite outlook of each GSE in terms of that income component?
ANSWER: The growth rate in Fee and Other Income was an average growth rate in this category of miscellaneous income categories that Fannie Mae forecasted through 2015. The valuation model is fairly insensitive to the growth rate in this category. The two figures are not comparable across the GSEs. Fannie Mae's forecasts contain different income categories.

4. Draw downs at 9/30/2010 are hard coded at 85,100. Is that the net result after subtracting $1B (Note: this question may superseded by the response to the question we raised for the Freddie LC report).
ANSWER: Yes.

LC Ex 1a, 2a, 3a

5. In the Net Income module, mortgage assets fall below the 250B floor, does the PSPA allow exceptions for mortgage assets to drop below $250B?
ANSWER: These figures were provided to us by Fannie Mae. Paragraph 5.7 of the PSPA provides for the reduction of the mortgage assets but provides the $250 billion figure a floor below which the Company will not be required to drop.

5.7. *Mortgage Assets.* Seller shall not own, as of any applicable date, Mortgage Assets in excess of (i) on December 31, 2009, $850 billion, or (ii) on December 31 of each year thereafter, 90.0% of the aggregate amount of Mortgage Assets of Seller as of December 31 of the immediately preceding calendar year; provided, that in no event shall Seller be required under this Section 5.7 to own less than $250 billion in Mortgage Assets.

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6. In the Net Income module, several of the date series used have hardcoded values through 2025. Did Fannie Mae provide forecasts beyond 2015?
   ANSWER: Yes.

7. What is the rationale for creating the "Other Components of Economic NIM" series? Did Fannie Mae provide that separately in their forecasts? That income component is assumed to decline at 5%, is that a reflection of income that is not sustainable in the longer term?
   ANSWER: Correct. This figure was implicit in the more granular detail that Fannie Mae provided to us.

LC Ex 1b, 2b, 3b

8. Why does the credit book stay constant in the Credit Losses module, while the Guaranty Book gradually declines in the net Income module? What would be the portfolio component included in the Guaranty Book that would not require any credit loss provisions?
   ANSWER: The credit book was presented incorrectly in the exhibit for the forecast period (2011-15), but this has no effect on the calculation of the liquidity commitment or on the value o the senior preferred shares. We have updated the schedules to reflect the correct presentation of the credit book.

9. The Credit Loss provision rates of 2014 and 2015 are well below the longer term provision rates of 12.5 bps. Did Fannie Mae provide any additional details to support these rates for 2014 and 2015? As modeled, Loss provision rates jump between 2015 and 2016. Under the Stress case, the credit loss provision rate is a negative 16bps, while all other loss provision rates are positive. For 2014 and 2015, Loss Provision rates are lower under the Base Scenario when compared to the Optimistic scenario.
   ANSWER: These figures were taken from schedules provided to us by Fannie Mae's forecasting staff. The unexpectedly low credit loss provision figures were the result of changes in the incremental allowance, which offset the projected allowance for loan reserves as home prices begin to recover.

10. The Freddie LC report uses 12bps for long terms Credit Losses, and the Fannie uses 12.5bps. Is the long terms profile of Fannie Mae's portfolio riskier to warrant the additional 0.5bps bump up in the loss provision rate?
    ANSWER: Yes. Fannie Mae's serious delinquency rate is higher than Freddie Mac's.

LC Table 2

11. "LC Table 2" under the Stress case contains negative credit related expenses for 2014 and 2015? What do these represent?
    ANSWER: Please see the answer to question 9 above.

12. More generally, when comparing the Optimistic to the Base should one expect to see higher GAAP income and lower losses each year under the Optimistic Scenario, and similarly for the comparison of Base to Stress Scenarios?
ANSWER: The main driver of the different income results across the three scenarios is income from the mortgage assets. Under the stress scenario, the mortgage portfolio -- which the forecasting team at Fannie Mae gave to us through the year 2025 -- was larger for the stress case compared to the base case, which was itself larger than that of the optimistic case. The larger portfolio contributed the higher interest income.

13. Related to Q11, if the Income or Loss provision components do not rank order across scenarios (in the sense of higher income and lower losses being associated with more favorable conditions), should "Net comprehensive income (loss)"? Specifically, would one expect to see higher "Net Comprehensive Income (loss)" under more favorable conditions (i.e. when comparing Optimistic to Base, and Base to Stress)?
ANSWER: Please see the answer to question 12 above. With the exception of "Other non-interest expenses," the remaining components of Net Comprehensive Income (Loss) are stable across the three scenarios.

SPS FNM Report

Do the risk profiles of the two GSEs continue to support using the same set of discount rates for both?

ANSWER: Yes. The political environment and risks faced by both GSEs is the same. All indications are that the GSEs are receiving the same policy treatment from FHFA while in conservatorship, and both face the same risks with respect to exit from conservatorship and sustainability of the dividends. We note that Freddie Mac has lower forecasted credit losses, but neither entity will be able to pay the 10 percent dividend out of operating income.

We also looked at the preferred share prices for both entities, which are the closest comparable instruments. We determined there was not a meaningful difference in the implied recovery values between Fannie Mae and Freddie Mac.

We considered your question and determined that there was not sufficient market information or definitive policy guidance to treat the risk of repayment differently for Fannie Mae and Freddie Mac.