Memorandum

Date: March 25, 2013

To: [redacted]

From:

Subject:

[redacted]

[redacted]

Deferred Tax Presentation

March 14, 2013

PRE-DECISION DISCUSSION DRAFT
Federal Housing Finance Agency

3/25/2013 8:32:53 AM

Key Factors in FHFA's Deferred Tax Review

- Several discussions have taken place with the SEC, FHFA, Fannie Mae management, and the external auditors. Guidance provided by the SEC indicated that release of the DTA in the future is not unreasonable and it would be appropriate to disclose management's analysis in the fourth quarter. The FHFA interpretation is the SEC believes that not releasing the reserve was more supportable than release, under the facts and circumstances presented.
- 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. We have seen the adverse market reaction to the SPSA agreements – initial $100 billion was not sufficient – revised twice in 2009 because market became concerned with the capacity/funding stability – for the past three years Fannie Mae operated with unlimited capital support from Treasury – this is no longer the case. The SPSA limits capital accumulation.

Key Factors Continued

- The Treasury Credit Facility cannot be recreated under current legislative authority. The authority for that facility expired. Treasury cannot add any additional support to the SPSAs; the last time they could have done that was before the end of 2009.
- Access to discount window is more challenging than in 2008.
- The impact of the Fed's 2012 stabilization efforts has kept interest rates abnormally low – how will this impact house prices once Fed intervention ceases? House prices have a significant impact on credit loss. Interest rates will affect portfolio runoff (which also has an impact on credit).
- Objective evidence exists that Congress and Treasury are inclined to use Fannie Mae as a vehicle to accomplish national objectives that may be in conflict with tax asset realization (disallowance of LIHTC monetization in 2009). Congress has used the earnings potential of the company to fund other federal objectives. In 2012, Fannie Mae was obligated to remit 10 basis points of its guarantee income to Treasury as part of funding a federal payroll tax reduction. Legislation is pending for 2013 to extend the g-fee remittance.

Key Factors Continued

FHFA

- There is significant uncertainty as to whether Fannie Mae will continue to exist, whether and when it will emerge from conservatorship, and the nature of any changes that may occur to the business structure. FHFA, as Conservator, currently imposes constraints on its business activities. FHFA will require Fannie Mae to further curtail their current and future business activities and reduce the risk in the existing book commensurate with sharply reduced capital levels. Any capital constrained entity would be required to limit new business, improve risk adjusted returns, and initiate actions to preserve the franchise value – this will change the business model. While Fannie Mae did not consider this as part of their accounting analysis, we believe it is a key factor that could cause a material impact to the business and forecast.

Key Factors Continued

- At December 31, 2012, Fannie's total book of business stood at $3.19 trillion ($633B mortgage portfolio, $2,557B outstanding guarantees). Fair value of net assets was a negative $70.3 billion. Release of the valuation allowance at December 31, 2012 reduces the amount of the available capital support under the SPSA by $33.9 billion or 30% (from $117.8 billion to $83.9 billion).
- This reduction in supporting capital will materially increase Fannie Mae's implied operating leverage and attendant risk profile. Release of the valuation allowance will elevate balance sheet operating leverage by 26%, from 17.9 to 22.5. Corresponding total book-of-business leverage will increase by about 23%.

Key Factors Continued

Comparative Fannie Mae Risk Profiles - Impact of Q4 2012 DTA Recognition

		No DTA Release	With DTA Release	Change in Leverage
Q4 2012 Supporting Capital				
PSPA Equity Buffer		$ 3.0	$ 3.0	
Loss Reserves		$ 59.2	$ 59.2	
Available Treasury Capital Draw		$ 117.8	$ 83.9	
Total Supporting Capital =		**$ 180.0**	**$ 146.1**	
Q4 2012 Balance Sheet				
Cash, Cash Equivalents, Fed Funds	$ 121.5			
Mortgage Loans	$ 305.0			
Mortgage Securities:	$ 269.9			
Unfunded Consolidated Assets	$ 2,478.0			
Other Assets	$ 47.6			
No DTA Release Total Assets	**$ 3,222.0**			
Deferred Tax Asset	$ 58.0			
With DTA Release Total Assets	**$ 3,280.0**			
Balance Sheet Operating Leverage =		**17.9:1**	**22.5:1**	**26%**
Q4 2012 Total Book of Business				
Gross Mortgage Portfolio	$ 633.1			
Off Balance Sheet MBS & Guarantees	$ 2,557.3			
	$ 3,190.4			
Book of Business Operating Leverage =		**17.7:1**	**21.8:1**	**23%**

Key Factors Continued

- With monthly MBS liquidations running close to $80 billion, monthly MBS issuance needs to fall to under $30 billion in order to roughly maintain the same operating leverage.
- It is premature to base the earnings capacity turnaround on projections and models that changed dramatically from the third quarter 2012 to the fourth quarter 2012. Historical forecasts have proved to be highly uncertain and unreliable. Additional time to confirm recent modeled results is needed and consistent with Fannie Mae's draft accounting policy.

Key Factors Continued

FHFA

- Accounting guidance states, "As information about an entity's current financial position and its results of operations for the current and preceding years ordinarily is readily available, what has already occurred, and thus can be objectively verified, carries more weight than projections of future taxable income. Further, a cumulative loss in recent years is a significant piece of negative evidence that is difficult to overcome". As of year-end 2012, the company remains in a three-year cumulative loss position. The strength of the arguments that rely on one year turnaround is not sufficient to overcome this key fact.

Key Factors Continued

- The future impact of the sequester and changes from the 2013 scorecard, including the implementation of a joint venture and the requirements to contract the three business segments, are not adequately accounted for within the analysis and raise risks that need to be addressed.
- Projections for future income and taxable income rely on recent and significant changes, including a large reduction in the allowance (not sustainable) and an increase in HPI, which remains a yet unproven trend.

From the Fannie Mae 3Q2012 10Q

"Uncertainty Regarding our Future Status. There is significant uncertainty regarding the future of our company, including how long the company will continue to be in its current form, the extent of our role in the market, what form we will have, and what ownership interest, if any, our current common and preferred stockholders will hold in us after the conservatorship is terminated. We expect this uncertainty to continue. In February 2011, Treasury and the Department of Housing and Urban Development ("HUD") released a report to Congress on reforming America's housing finance market. The report states that the Administration will work with FHFA to determine the best way to responsibly wind down both Fannie Mae and Freddie Mac. The report emphasizes the importance of providing the necessary financial support to Fannie Mae and Freddie Mac during the transition period."

From the Fannie Mae 3Q2012 10Q

In February 2012, Treasury Secretary Geithner stated that the Administration intended to release new details around approaches to housing finance reform, including winding down Fannie Mae and Freddie Mac, and to work with congressional leaders to explore options for legislation, but that he does not expect housing finance reform legislation to be enacted in 2012.

Incoming Secretary Lew's remarks confirmed the wind-down scenario for the Enterprises.

In sum, there continues to be uncertainty regarding the future of our company, including how long the company will continue to exist in its current form, the extent of our role in the market, what form we will have, and what ownership interest, if any, our current common and preferred stockholders will hold in us after the conservatorship is terminated.

From the Fannie Mae 3Q2012 10Q

- The conservatorship has no specified termination date and there continues to be uncertainty regarding the future of our company, including how long the company will continue to exist in its current form, the extent of our role in the market, what form we will have, and what ownership interest, if any, our current common and preferred stockholders will hold in us after the conservatorship is terminated.
- Our business activities are significantly affected by the conservatorship and the senior preferred stock purchase agreement. We are currently under the control of our conservator, FHFA, and we do not know when or how the conservatorship will be terminated. In its strategic plan for fiscal years 2013-2017 released in October 2012, FHFA stated that '[g]iven the Enterprises' current financial condition and the terms of the U.S. Department of Treasury's financial support agreements, the Enterprises are unlikely to earn their way back to a condition that allows them to emerge from conservatorship.'"

Expectations for Fannie Mae's Assessment

- Comprehensive policies and procedures need to be in place to support the Enterprise, including those supporting accounting decisions.
- Policies and procedures need to be approved and implemented in a safe and sound manner.
- Forecasting assumptions need to be consistent, reasonable and properly supported.
- The use of modeling as a management tool needs to be well controlled.
- Supporting analysis for policy decisions needs to be balanced and fully documented.
- Ensure findings and comments from internal audit and other internal/external reviewers are incorporated into the decision-making process.