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[A WHITE PAPER ANALYSIS OF THE TREASURY TAKEOVER OF FANNIE MAE]

A White Paper Analysis of the Treasury Takeover of Fannie Mae

Executive Summary: **Fannie Mae was taken over by the U.S. Treasury on September 6, 2008. Such a complete takeover of a company with private stock ownership is an action that had never been taken by the Federal government before. It was a controversial move made at the time when financial markets were experiencing a panic. Yet, the question remains was this takeover necessary?**

This white paper reviews Fannie's Mae financial statements to understand the financial viability of the company during the period from 2007 to 2014. A number of financial indicators and documents provide evidence that Fannie Mae was not in the dire straits reported as the justification for the takeover. It is likely that Fannie Mae could have survived the financial crisis without the intervention of the Treasury.

The U.S. Treasury has controlled Fannie Mae since 2008 through the Federal Housing Finance Agency. Today Fannie Mae is a cash generating machine that sends billions of dollars in quarterly dividends to the Treasury. These business-generated cash flows provide the Treasury with monies to fund Congressional appropriations and delay the harsh reality of asking Congress for an increase in the legal debt limit which is a controversy in itself. Because of the terms of the takeover, Treasury can increase its dividend payments by simply making a managerial decision to increase their investment in Fannie Mae and thus increase its cash dividend payments.

Without complete funding for appropriations, the Administration can use the cash dividends along with other available revenues to fund appropriations it deems the most important to its interests and concerns. The result is that not all appropriations passed by Congress will be equally funded. Thus, without complete funding, such as obtained with an increase in the debt limit, certain Congressional priorities wind up curtailed. The cash dividends from Fannie Mae help support this thwarting of Congressional actions.

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Introduction:

On a balance sheet and income statement, dollar totals can be based on exact amounts such as the cash in a bank. Other totals can be based on management assumptions, i.e., guesses, such as the depreciation expense write offs. Higher management's assumptions can result in enormous changes in a company's prospects as viewed by investors. In recent court cases, corporate managers have biased their assumptions, in order to gain unfair advantages, to such a level that they have been accused of fraudulent behavior.

There are significant financial variations affecting the income statement and balance sheet that are singly based on the assumptions of managers. Here are some examples.

- Securities held to maturity and those held for sale recognize gains and losses at different times and that timing difference is determined by management's assumptions.
- At one time, a company's net loss could result in the recognition of an asset and the reduction of the loss. The asset was a reduction in future tax payments due to the managerial decision that there would be a profit in the future. Consequently, the loss resulted in a future tax savings and recognition of an immediate asset along with a decrease in the loss.
- The future loss on debt is determined by assumptions about collections. Lower future loss expectations result in a higher current income.
- Mark to market valuation allows managers to set prices on securities with limited market trading. Such assumptions allow for the immediate recognition of a gain or loss.

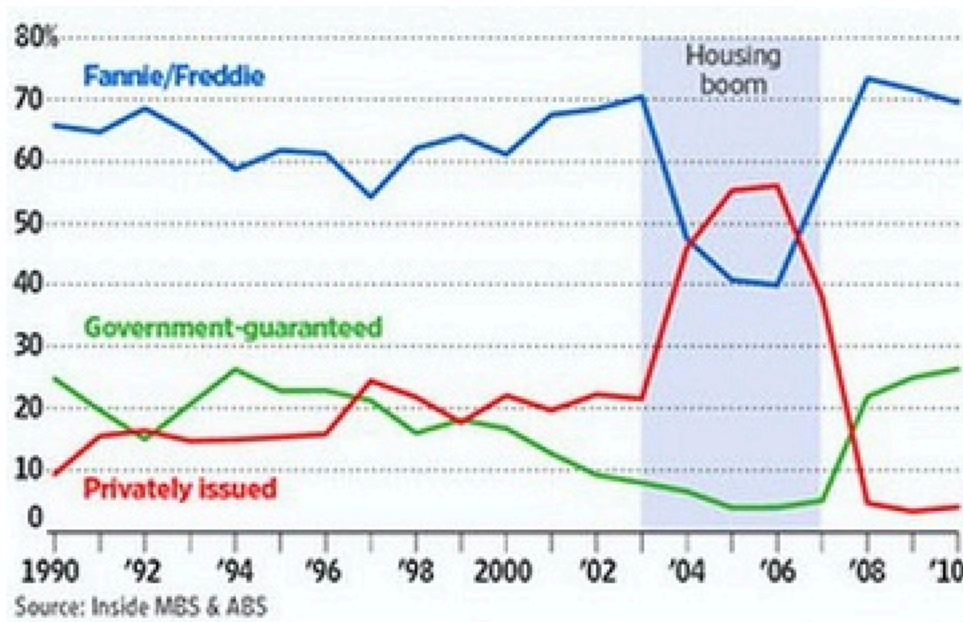
This report analyzes how management assumptions were used to change the financial reports of Fannie Mae during the period from September 2007 through December 2014. An analysis of the financial situation facing Fannie Mae during this period is used to determine if it was really necessary for the Treasury to take over Fannie Mae. The report identifies concerns about the way Fannie Mae's cash flow into the Treasury is being used with a "pick and choose" approach to funding Congressional appropriations.

Fannie Mae

The Federal National Mortgage Association ("Fannie Mae") is an organization that came out of the Great Depression as a means to support the mortgage industry by buying up loans and providing more liquidity to lenders for making new loans. Fannie Mae is a government-

sponsored enterprise (GSE), but its stock has been publicly traded since 1968. At year-end 2007, prior to the takeover, the total stockholders' equity was $44,011M.[1]

As the mortgage market began to change and be dominated by investment banks, there was an industry wide drop in mortgage underwriting requirements for obtaining loans. The next two charts show these changes as privately-issued mortgages and subprime loans dominated lending.



Eventually many risky loans were made and consequently many borrowers could not pay their mortgages and foreclosures skyrocketed as the mortgage market started to unravel.[2] Privately issued subprime serious delinquency rates hit 30.6% compared to Fannie Mae's 5.4% and Freddie Mac's 3.9%.

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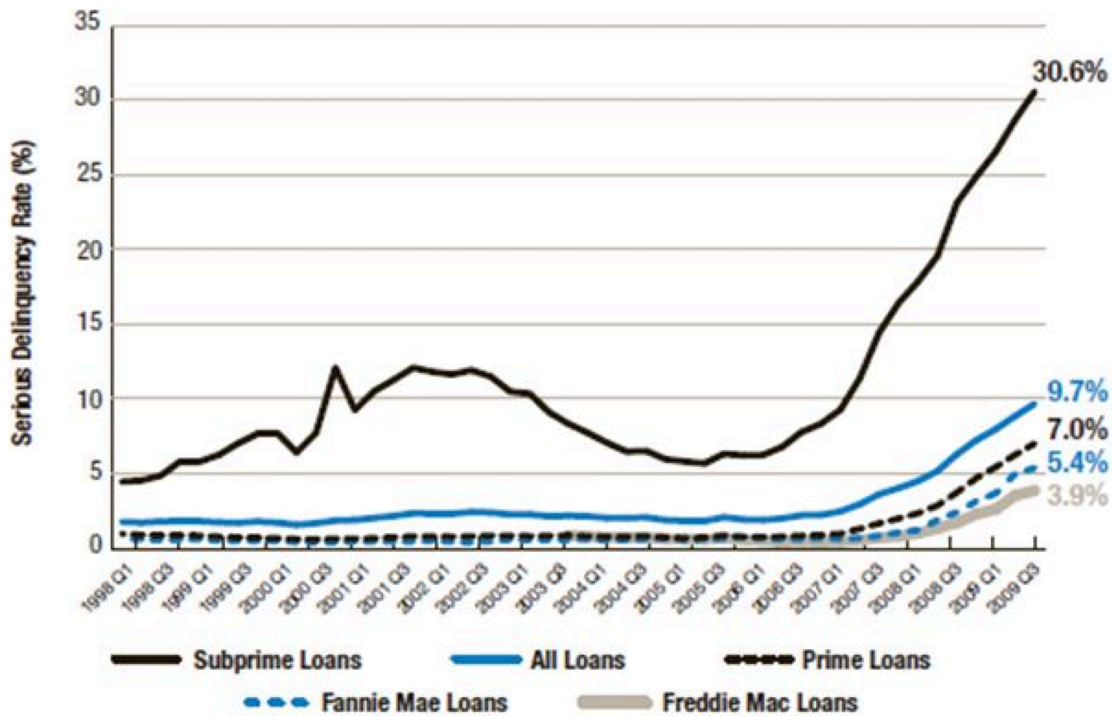
[1]10-K Annual Report, 2007, p. 46

[2]This was the result of two factors. The first of which was the spiking unemployment rate. The second was the omission of equity requirement and credit enhancement for non-GSE loans. Other entities do not have the same level of regulation required of the GSEs resulting in far fewer safeguards against default.



Source: Mortgage Bankers Association

In 2008, there was a wide level of confusion as to actual financial situation facing Fannie Mae. For example, on **August 22, 2008**, the Federal Housing Finance Agency informed Daniel Mudd (President and CEO) that Fannie Mae was "adequately capitalized under regulations based on certified information that was considered true and correct." [3] Then on **September 6, 2008**, Fannie Mae was placed into conservatorship. This represents a truly stunning change within a few days. By September, the market value of the Fannie Mae's common shares had plummeted, and in 2010 the stock would be delisted from the New York Stock Exchange.

The question that needs to be raised is: "Was this necessary?"

Fannie Mae's Operations

In 2007 and 2008, Fannie Mae was a "going concern." Also in 2007 and 2008, there was no specific guidance in GAAP about managements' responsibility to provide disclosures about the organization's ability to continue as a going concern.[4] Consequently, for managers there was a

[3] Financial Crisis Inquiry Commission (2011) *The Financial Crisis Inquiry Report: The Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*. Public Affairs: New York. p. 318.

[4] Today, management disclosures are required when there is substantial doubt about an entity's ability to continue as a going concern within the next financial year or when substantial doubt is alleviated as a result of consideration of management's plans. FASB Presentation of Financial Statements—Going Concern (Subtopic 205-40) *Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*, Accounting Standards Update

level of leeway in making a going concern determination, but as will be seen, not for the auditors.

In accounting terms, being a “going concern” means an organization will be able to meet its financial obligations usually within a year of the issuance of its financial statements. Factors that question that ability are events such as the following:

- Negative financial trends (e.g., recurring operating losses, working capital deficiencies, negative cash flow from operations, and other adverse important financial ratios);
- Other indications of possible financial difficulties (e.g., default on loans, dividend payments in arrears, denial of trade credit from suppliers, need to restructure debt to avoid default, noncompliance with statutory capital requirements, and a need to obtain new sources of financing methods or the disposal of substantial assets);
- Internal matters (e.g., work stoppages or other labor difficulties, substantial dependence on income from a particular project, unprofitable long-term contracts, and a need to significantly revise standard operations); and
- External matters (legal proceedings, legislation, or other matters that may jeopardize an entity’s ability to operate, loss of an important franchise, patent, or license, loss of a principal customer or supplier, and an uninsured or underinsured catastrophe).[5]

If the auditor concludes there is substantial doubt, the auditor should (1) consider the adequacy of disclosure about the company's possible inability to continue as a going concern for a reasonable period of time, and (2) include an explanatory paragraph (following the opinion paragraph) in the audit report to reflect the auditor's conclusion. If the auditor concludes that substantial doubt does not exist, the auditor should consider the need for disclosure.[6]

Financial Trends at Fannie Mae

As stated above, operating losses, working capital deficiencies, and negative cash flow from operations all indicate a corporation is in distress and may not be a going concern. A review of those financial areas for Fannie Mae help to identify the distress the company was facing at the time it was taken over.

Cash Flow:

Financial Accounting Standards Board.

[5]WoltersKluwer CCH (2014) GAAP Update Service, *Accounting Standards Update (ASU) No. 2014-15, Presentation of Financial Statements (ASC 205-40): Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern*. (October) Vol 14 (19): 3.

[6]PCAOB (2012) Standing Advisory Group Meeting, *Going Concern*. (May 17) p. 3.

No matter whether an organization has an income or a loss, without an adequate cash flow a company cannot meet its financial obligations as they come due. Once this occurs, questions arise about the ability of the company to continue as a going concern. The concept of cash flows is similar to cash in a checkbook at the beginning and end of a year. If an individual can see ahead of time that they are going to run out of cash, they will ask for a loan from the bank, but they are not going to ask for it unless they really need it. No one wants to pay interest on borrowings that they do not need. For business organizations, the Statement of Cash Flow is the annual financial report which provides information on changes in cash inflows and outflows. After the end of the year, it shows where the company generated its cash, be it from operations, borrowing, or asset sales.

For Fannie Mae, the ending balances from the Statement of Cash Flow for the years 2007 through 2014 are shown in Figure 1.[7] The ending balances shown in the 10-Ks have been adjusted to take out the effect of cash injections from Treasury[8] and cash withdrawals through dividend payments to Treasury.[9] It should be noted in Figure 2 that the only years when Fannie Mae showed negative cash generation was 2009 and 2010 and not in 2008 when it was taken over by the Treasury.[10] In reviewing the Statement of Cash Flows for 2009, it can be seen that there were two cash outflows that were extremely large and both decreased by more than $100B in 2010. These two items are “Purchases of Loans Held for Sale” and “Purchases of Available-for-Sale Securities.” In millions, the outflows were $109,684 and $165,103, respectively. Part of the $165,103 outflow was due to “advances to lenders.” Without these outflows, Fannie Mae would have not had a deficit in its 2009 cash position. It is also important to note that during 2009 and 2010, Fannie Mae continued to purchase loans from originating institutions that exceeded the sale of mortgage backed securities (MBS). For Fannie Mae, 2009 was an anomaly as the Treasury created a significant outflow of cash resources into the accounts of private investment bankers who had liquidity problems and were able to sell their toxic mortgages to Fannie Mae as ordered by the Treasury.[11]

This means that they did not burn cash, they simple turned cash into assets available for future sale. See “Purchases of loans held for sale under CF from operations. 110b in 2009. Under non cash activities in the CF statement it shows 119b of securitization related MBS held for sale. This disclosure changed in 2010 but it clearly shows cash out for 110b with no asset increase. In 2007, 2008, 2011, 2012, 2013, and 2014, Fannie Mae did not need any additional cash injections. In 2009 and 2010 the only short fall occurred due to increased purchasing of

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[7]Fannie Mae’s 10-Ks from the years 2007 to 2014.

[8]On Fannie Mae’s Consolidated Statement of Cash Flows, this is called “Proceeds from senior preferred stock purchase agreement with Treasury.”

[9]On Fannie Mae’s Consolidated Statement of Cash Flows, this is called “Payments of cash dividends on senior preferred stock to Treasury.”

[10]At that time, Treasury would not provide financial support unless it received equity ownership in Fannie Mae.

[11]2008 Blog Report from MyBudget360: “There is a report out by Bloomberg and now being reported by CBS MarkeWatch that Federal regulators are going to order Fannie Mae and Freddie Mac to start buying $40 billion a month in troubled mortgages each month.” <http://www.mybudget360.com/freddie-and-fannie-to-buy-40-billion-a-month-in-toxic-sub-prime-and-alt-a-mortgages/> and <http://www.bloomberg.com/apps/news?sid=aDjJYMSphyM0&pid=newsarchive> Accessed September 19, 2015.

loans from originating banks and holding the loans on its balance sheet. Its operations provided enough cash to cover its cash outflows. Yet, the Treasury continued to make cash injections into Fannie Mae. It is interesting to speculate as to why these injections continued.

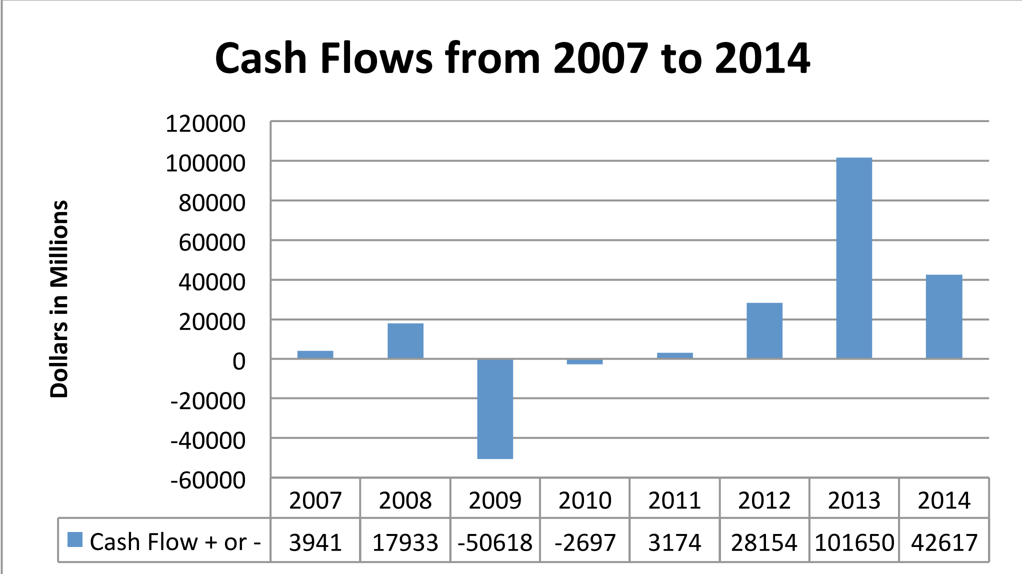

Figure 1. The Cash Flows from Fannie Mae beginning in 2007 and proceeding to 2014 without the effect of the cash inflows from Treasury payments and preferred stock dividend payments (in millions).

Table 1 shows the Treasury cash injections and cash withdrawals as dividends.

Year	Cash Inflow from Treasury as increases in equity investment	Cash Outflow as dividends to Treasury
2007	0	0
2008	0	0
2009	$59,900	$2,470
2010	$27,700	$7,706
2011	$23,978	$9,613
2012	$4,571	$11,608
2013	0	$82,452
2014	0	$20,594
Totals	**$116,149**	**$134,443**

Table 1. Cash injections and cash withdrawals from Treasury (in millions).

Table 1 shows that as of 2014, the Treasury has withdrawn more cash from Fannie Mae than it has injected to the tune of around $18B. Up until 2012, when the stock agreement between Fannie Mae and the Treasury was revised, Fannie Mae had been borrowing cash from the Treasury in order to make its required ten percent dividend payment to Treasury. The re-written agreement in 2012 curtails the borrowing but requires Fannie Mae to pay out its capital, above a specific buffer, to Treasury.

These withdraws are ongoing as Treasury continues to be paid cash dividends on its preferred stock holdings in Fannie Mae according to the contract terms of the takeover. A question that needs to be asked: Are the withdrawals affecting the "hard" capital (separate from accrual effects) that Fannie should maintain in case of another collapse in the housing market? Is it affecting working capital?

Working Capital

A positive working capital is important for an organization to maintain in order to be able to pay its short-term liabilities. The Small Business Administration defines working capital as:

> *Working capital is defined as the difference between current assets and current liabilities. Current assets are the most liquid of your assets, meaning they are cash or can be quickly converted to cash. Current liabilities are any obligations due within one year. Working capital measures what is leftover once you subtract your current liabilities from your current assets, and can be a positive or negative amount. The working capital is available to pay your company's current debts, and represents the cushion or margin of protection you can give your short-term creditors.*[12]

In Table 2, it can be seen that Fannie Mae had a positive working capital until 2010 when a negative working capital position started which has continued through 2014. Fannie Mae had a positive working capital in 2008 when it was taken over by the Treasury as well as in 2009. It should be noted that dividend payments on preferred stock to the Treasury began in March 2009 and in 2010, after which the organization started to recognize a deficit in its working capital. The largest deficit in working capital occurred in 2014, after a huge dividend payment of $20,594 (in millions) had been made to Treasury in 2013.

Year:	2007	2008	2009	2010	2011	2012	2013	2014
Current Assets*	$357,513	$357,294	$349,667	$151,248	$151,780	$103,876	$68,939^	$62,939
Current Liabilities**	$240,803	$337,015	$205,417	$171,059	$164,373	$120,019	$85,002	116,804
Working Capital (deficit)	$116,710	$20,279	$144,250	($19,811)	($12,593)	($16,143)	($16,063)	($53,865)

*total investment in securities, does not include accrued interest receivable. Inclusion of accrued interest would not change the deficit trend in working capital.

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[12]U.S. Small Business Administration. <https://www.sba.gov/content/working-capital> Accessed August 28, 2015.

**includes accrued interest payable, federal funds under agreements to repurchase, and short-term debt. The variation in current liabilities is largely due to changes in the short term debt.
^compared with 2012, the large decrease in current assets in 2013 was due to a decrease in restricted cash from a "decrease in unscheduled payments received due to lower payoff volumes"; and available for sale securities.

Table 2. Working Capital for Fannie Mae (in millions): Source 10-K Report

Again, the data indicates that there was no problem generating enough working capital until 2010, two years after the takeover.

Deferred Tax Assets:

Table 3 shows the changes in Fannie Mae deferred tax asset account from 2007 to 2014. Such changes do not affect cash or working capital. They are basically bookkeeping entries based on managerial decisions.

The generation of deferred tax assets and liabilities arise from differences in income reported in a company's annual report and its tax returns as noted in the following description.

> *Deferred tax assets (DTAs) arise when reported income on a financial statement is less than taxable income. DTAs are, in a sense, like pre-paid taxes and represent expected reductions of future reported taxes. Deferred tax liabilities (DTLs), on the other hand, arise when reported income is greater than taxable income. DTLs represent the expected amount of additional reported taxes to be paid. These items are a result of differences between GAAP accrual accounting and tax policy. Examples of DTAs include: product warranty reserves, tax loss carry-forwards, and future pension and postretirement benefit payments. Examples of DTLs include: accelerated depreciation payments and nondeductible intangibles.*[13]

The write off of any asset results in loss to the company and decreases its net income. Assume inventory assets are written off. It is clear that such an event creates a reduction in net income, but there is no effect on cash flow. Income and cash balances are two different animals.

In the past, other companies have written off their deferred tax assets. The case of Bethlehem Steel Corporation serves as an example. In July 2001, Bethlehem reported a $1.13 billion second-quarter loss, the bulk of it a $1 billion "unusual noncash" charge against earnings to write off the value of a deferred tax asset because the company thought it would not have profits going forward and therefore not have to pay taxes. They were correct. Three months later, Bethlehem filed for Chapter 11 bankruptcy reorganization. The following statement appeared in Bethlehem Steel Corporation's 2002 10-K annual report.

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[13] Deferred Tax Assets and Liabilities – Invested Capital Adjustment <https://www.newconstructs.com/deferred-tax-assets-and-liabilities> Accessed August 20, 2015.

> *In the absence of specific favorable factors, application of FASB Statement No. 109, issued in 1992, and its subsequent interpretations require a 100% valuation allowance for any deferred tax asset when a company has cumulative financial accounting losses, excluding unusual items, over several years. Accordingly, during 2001, after consideration of these factors, we provided a 100% valuation allowance for our deferred tax asset increasing our non-cash provision for income taxes for 2001 by $985 million.* (Bethlehem Steel Corporation, 10-K Report, 2002 p.18)

The write off of deferred tax assets is a management decision based on management's view of the future. Such a decision includes a question as to whether a firm can continue as a going concern. A decision to write off deferred tax assets would be made in only dire circumstances followed by an expected bankruptcy filing. These management actions also require additional disclosures in the auditor's opinion. In the auditor's opinion for Bethlehem, the auditor's question the ability of Bethlehem to continue as a going concern.

> **Excerpt from the Report of the Independent Auditors, Paragraph Two, Opinion from PriceWaterhouse Coopers, January 30, 2002.**
>
> *The accompanying consolidated financial statements have been prepared assuming that Bethlehem will continue as a going concern, which contemplates continuity of the company's operations and realization of its assets and payments of its liabilities in the ordinary course of business. As more fully described in the notes to the consolidated financial statements, on October 15, 2001, Bethlehem filed a voluntary petition for reorganization under Chapter 11 of the United States Bankruptcy Code.* ***The uncertainties inherent in the bankruptcy process and the company's recurring losses from operations raise substantial doubt about Bethlehem's ability to continue as a going concern.*** (Bethlehem Steel Corporation, 10-K, 2002 F-5).

The impetus for a write off of deferred tax assets is a basic "Yea" or "Na" from managers. The decision to write off deferred tax assets is done because it is anticipated that the company will not have profits in the foreseeable future. But the decision to write off deferred tax assets can be done for other underlying reasons that are cloaked under a "never have profits again" argument. Managers may decide to use a "big bath" approach to write-off deferred taxes and cloak it under a "we will never have profits" theory. With the big bath approach, managers make a large net loss, larger. The reasoning is that if we are going into the hole, why not make it a bigger hole because the following year it will look like we are doing better, even if we are not.

With Fannie Mae, the write off occurred just after the takeover (September 2008) and increased the annual net loss, just as had occurred with Bethlehem Steel. The implications of the write off are significant. The significance is that Fannie Mae's ability to be a going concern is questioned just as it was for Bethlehem Steel.

Deferred tax assets are subject to periodic impairment tests by the auditors.

> *Reduce deferred tax assets by a valuation allowance if, based on the weight of available evidence, it is more likely than not (a* ***likelihood*** *of more than 50 percent) that some portion or all of the* ***deferred tax assets will not be realized****. The valuation allowance shall be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized.*[14]

The auditors did not make any notations about the **likelihood of deferred taxes will not be realized** in their audit opinion. It is worth noting that Fannie Mae's auditors (Deloitte & Touche) did not include a paragraph in their 2007 or 2008 opinion about Fannie Mae's ability to continue as a going concern. The auditors did not see this as an issue otherwise they would have noted it in their opinion.

Yet, in the notes to the 2009 financial statements made by Fannie Mae's managers took a different view and provided the following explanation about the write-off of deferred tax assets.

> *As of September 30, 2008, we concluded that it was more likely than not that we would not generate sufficient taxable income* ***in the foreseeable future*** *to realize all of our deferred tax assets. Our conclusion was based on our consideration of the relative weight of the available evidence, including the rapid deterioration of market conditions discussed above, the uncertainty of future market conditions on our results of operations and significant uncertainty surrounding our future business model as a result of the placement of the company into conservatorship by FHFA on September 6, 2008. This negative evidence was the basis for the establishment of the partial deferred tax valuation allowance during 2008***.***
>
> *We evaluate our deferred tax assets for recoverability using a consistent approach that considers the relative impact of negative and positive evidence, including our historical profitability and projections of future taxable income. We are required to establish a valuation allowance for deferred tax assets and* ***record a charge to income*** *or stockholders' equity if we determine, based on available evidence at the time the determination is made, that it is more likely than not that some portion or all of the deferred tax assets will not be realized. In evaluating the need for a valuation allowance, we estimate future taxable income based on management-approved business plans and ongoing tax planning strategies. This process involves* ***significant management judgment*** *about assumptions that are subject to change from period to period based on changes in tax laws or variances between our projected operating performance, our actual results and other*

[14]Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) topic 740-10-30, *Income Taxes,* (Norwalk, CT: Financial Accounting Standards Board, 2011).

factors. Accordingly, we have included the assessment of a deferred tax asset valuation allowance as a critical accounting policy (Fannie Mae 10-K 2009).

Table 3 shows the increases and decreases in Deferred Tax Account in relationship to the deferred tax asset valuation account, total assets, net income (loss) and cash flow for an eight-year period.

Year:	2007	2008	2009	2010	2011	2012	2013	2014
Net Deferred Tax Assets	$12,967*	$3,926*	$909*	$754*	$433	$(509)	$47,560*	$42,206*
Valuation Allowance for Deferred Tax Assets	0	$30,825	$52,737	$56,314	$64,080	$58,851	$525	$150
Total Assets	$879,389	$912,404	$869,141	$3,221,972	$3,211,484	$3,222,422	$3,270,108	3,248,176
Net Income (Loss)	($2,050)	($58,728)	($72,022)	($14,018)	($16,855)	$17,220	$83,982	$14,209
Cash Flow ^	$3,941	$17,933	($50,618)	($2,697)	$3,174	$28,154	$101,650	$42,618

*Consolidated Balance Sheet, Notes to Consolidated Financial Statements, see Income Tax Note

**None recorded on the Consolidated Balance Sheet as the deferred tax assets were written off with a valuation allowance (Note 10, Income Taxes) which indicates there will be no net income in the foreseeable future.

^Cash flow without the "Treasury effect" of cash injections and withdrawals to and from Fannie Mae.

Table 3. The Relationship of the Deferred Tax Asset account to other financial data. (in millions). Source: 10-K filings.

The changes that increased the balance in the valuation account were determined by Fannie's managers and the consequent of their decisions caused the net income to generate a net loss until that managerial decision was reversed in 2012. The valuation account was essentially done away with in 2013 as Fannie Mae became profitable again. Figure 2 shows the relationship between the changes in the valuation account for deferred tax assets and the net income over the eight-year period. It is interesting to note how they mirror each other in opposite directions.

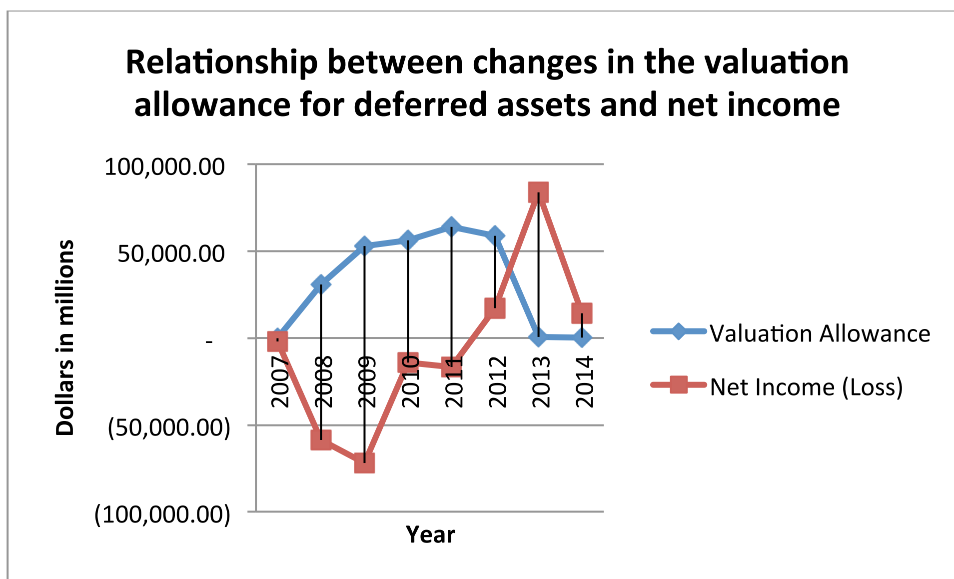

Figure 2. The chart shows the relationship between the deferred tax valuation account, and net income. The increases in the valuation account and the decrease net income mirror each other in opposite directions. (Over the eight-year period, the Pearson correlation coefficient between the valuation account and net income is .723 indicating a relatively high correlation at the .05 level of significance.)

In 2008 when Fannie was taken over by the Treasury, it had a positive cash flow. It did not need cash to meet its obligations. There appears to have been no financial reason to essentially write off the deferred tax asset in 2009 or generate the going concern implications from such a write-off. Three years after the deferred tax asset was written down, in 2012, a net income was earned. Three years is not the "foreseeable future." During the time period under review, Fannie Mae was a going concern, and it was not going bankrupt. The low point for Fannie Mae was when it had a negative cash flow in 2009 largely caused by Treasury requirement to purchase the toxic assets from investment banks. This was not similar to the dire circumstances faced by Bethlehem Steel.

Fannie Mae did have a net loss on its financial statements from 2007 to 2011 as shown in Table 2, but part of that loss was due to the effect of accounting accruals, such as the deferred tax asset write off (increase in valuation account), that did not affect the cash flow or the working capital. Businesses are concerned about their ability to meet their financial obligations. Cash flow and working capital provide a better indication of that ability than the net income…positive or negative.

It appears the decision to write off the deferred tax assets was a political decision to show the need for the Treasury's financial support and to justify a takeover. As the net loss was increased by the write off of deferred tax assets, it showed the world that the Treasury needed to be there to support Fannie Mae. This decision was made when the housing market appeared

to be collapsing and financial institutions needed to see strong government actions to prevent a panic.[15] The Treasury demonstrated that it was in charge by taking over Fannie Mae.

Independence of Fannie Mae

The Housing and Economic Recovery Act was passed in July 2008, and it gave the newly formed Federal Housing Finance Agency (FHFA) control over Fannie Mae. As the conservator, the FHFA assumed all the power of the Board and management.

The Treasury demanded three things in exchange for its financial support through the FHFA: (1) Fannie Mae would go into conservatorship – meaning they could continue to operate, but only with the Treasury's support; (2) Fannie Mae would give the Treasury preferred stock with a 10% dividend; and (3) warrants would be issued to the Treasury for up to 79% ownership interest. The warrants had an exercise price of one-thousandth of a U.S. cent ($0.00001) per share, and with a life of twenty years

The Fannie Mae's Board had no choice. They agreed to the terms and were fired.

Fannie Mae, as a GSE, had little or no independence from the U.S. Congress which allowed Treasury to exercise massive influence over Fannie Mae. The Board could not exercise any independent action and was forced into following risky loan policies and eventually into resigning. Once Fannie was controlled by the government, it was easy to make changes in the original contract terms to follow any path the Treasury wanted. Essentially, the Treasury was negotiating with itself through the FHFA. There were no arm's length negotiations. One such interpretation of the contract was that Fannie Mae would pay out all accrued net income under the terms of the agreement, but repayment would not reduce the debt owed to Treasury.

Clearly this is an example of undue influence of one government agency over another because Fannie Mae had lost all its independence and rights as a stockholder-owned corporation. Up to the present time period, Fannie Mae is operating under government control. Its management is run by the Treasury through the FHFA. The management decisions and the organization's media disclosures about its financial status since 2008 have to be viewed from the perspective that such information is oriented toward the making oversight by the government appear to be the best choice.

Why Kill a Cash Cow?

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[15] *The move failed to stanch a spreading panic in the financial world. In fact, some analysts say, the takeover accelerated the hysteria by signaling that no company, no matter how large, was strong enough to withstand the losses stemming from troubled loans. Within weeks, Lehman Brothers was forced to declare bankruptcy, Merrill Lynch was pushed into the arms of Bank of America, and the government stepped in to bail out the insurance giant the American International Group.* Charles Duhigg (2008) Pressured to Take More Risk, Fannie Reached the Tipping Point, *New York Times* (October 5). < http://www.nytimes.com/2008/10/05/business/05fannie.html?hp&_r=0> Accessed September 1, 2015

In February 2014, the Committee for a Responsible Federal Budget noted that the Federal deficit was reduced by dividends from Fannie Mae and Freddie Mac:

> *Unexpectedly good returns from Fannie Mae and Freddie Mac, which return excess profits to the Treasury, resulted in an $88 billion gain.*[16]

The Congressional Research Service recognized the significance of these dividends on the ability of the Treasury to avoid reaching the debt limit.

> *Special dividends from mortgage giants Fannie Mae and Freddie Mac also extended the U.S. Treasury's ability to meet federal obligations.*[17]

Fannie Mae is providing a good series of cash dividend payments to the Treasury, and this stream will continue as long as the conservatorship continues. Without dividend payments from Fannie to the Treasury the nation's debt limit would be reached earlier and the Treasury would have to request a Congressional increase in the debt limit. In the past, the request for an increase in the debt limit has created a road block between Congress and the Executive Branch. For that reason, there is a motivation to keep Fannie Mae under the Treasury's control.

Fannie Mae is providing a significant source of funding to the Treasury as it tries to fund the Federal Budget requirements. The interesting feature of these payouts is that the Treasury can increase its payment by simply increasing Fannie Mae's net worth. The dividends are tied to Fannie Mae's net worth. Recently, Fannie Mae's net worth has increased due to a management decision to accrue its deferred tax assets…the ones that were written off earlier because in the "foreseeable future" there would be no net income. Now they are reversing the effect from 2009 and increasing Fannie Mae's net worth and the Treasury's dividend payments.

Prior to 2008, there was no commercial business funding of the Federal Budget. Today the question needs to be considered as to whether this practice of receiving cash from "government businesses" will stop or be expanded by the Executive Branch.

Separation of Powers Under the Constitution

Congress has the "power of the purse." Congress provides operational appropriations to the Executive and Judicial branches of government. This is a founding principle underlying our system of governmental checks and balances that have existed since the founding of the Republic.

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[16]Committee for a Responsible Federal Budget. February 6, 2014 <http://crfb.org/blogs/why-did-deficit-fall-2014> Accessed August 30, 2015.

[17]Andrew Austin (2015) Congressional Research Service, *The Debt Limit Since 2011*, (March 26) p. 12. <https://www.fas.org/sgp/crs/misc/R43389.pdf.> Accessed August 30, 2015. It should be noted that the debt limit increased from $9,815B in September 29, 2007 to $17,212B on February 7, 2014. The national debt increased $6,579B during that period.

It is noted in Article I, Section 9, Clause 7 of the Constitution:

> *No money shall be drawn from the Treasury, but in consequence of appropriations made by law.*

The appropriation clause was written to give Congress exclusive control over spending by the Executive Branch as well as ensuring that democratically elected representatives would be able to have a check on the Executive Branch. This concept is intrinsic to the system of checks and balances in our government.

The Constitution holds the Executive Branch will conduct its affairs based on spending bill appropriations made by Congress.[18] Once an appropriation is approved by legislators, the cash for making the expenditures under the appropriation will come from tax revenues s or issuing debt, i.e. Treasury. So the appropriation and the monies to support those appropriations are not provided at the same time.

A Cash Shortage: What Happens? If funds are inadequate to support federal expenditures, for example when Congress withholds funding by not increasing the legal debt limit, it is an indication that Congress wants to exercise the power of the purse. As the Executive Branch continues to pay for expenditures when funding is withheld or unavailable, the Executive Branch diminishes the power of the purse that Congress exercises. With shortages in funding, the Executive Branch can pick and choose which programs to fund using its own set of objectives. In order for the Executive Branch to take these actions, it needs cash that it cannot get through additional Treasury borrowing. One new source of that cash comes from Fannie Mae.

With the cash generated by Fannie Mae, the Executive Branch is able to use non-governmental monies to finance Congressional appropriations. Technically, the Executive Branch has side stepped the basic principles in the Constitution that allows elected representatives to decide the country's program needs. Government expenditures begin to be selected by the Executive Branch according to its priorities, with some monies coming from a commercial business operation. The result is that the Executive Branch does not have to fund appropriations as intended by Congress, when there is a shortfall in funding.

The initial confiscation of Fannie Mae's assets by Treasury resulted in a cash windfall that was used to fund certain Congressional appropriations.[19] In addition, the Treasury has been able to increases it dividend returns by simply making managerial changes to Fannie Mae's financial statements. Without Fannie Mae's cash, Treasury would need to go to Congress and ask for an increase in the debt limit more quickly to fund a deficit. Anytime the Executive Branch is unable

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[18]An appropriation is the legal authorization to make an expenditure, but it is not actually the setting aside of any cash. It is only the authorization. The finding of cash to pay for expenditure arises from revenues the government collects through taxes, penalties, and fees, for example.

[19]The exact expenditures for which Fannie Mae's cash is being used are unknown. It is impossible to determine if Executive Branch favored, government programs are being funded with the billions received from Fannie Mae while funding for other less-favored programs, by the Executive Branch, are curtailed.

to get an increase in the legal debt limit and borrow money, it searches for other ways to fund programs it considers essential. For example, FHFA can encourage Fannie Mae to borrow monies that are paid to the Treasury in the form of dividends. Congress did not have to approve an increase in the debt limit. These tactics, depending on the timing of their implementation, may even get around the revenues forecasts from the Congressional Budget Office. The bottom line is that Fannie Mae's dividends paid to the Treasury help to delay the day the Treasury needs to ask for an increase in the debt limit.

When government funding for appropriations is limited, an uneven funding of appropriations is likely. This means the objectives of Congress may not be met as the Executive Branch chooses which programs to completely fund. With Fannie Mae, the Executive Branch has demonstrated that it has the ability to set up its own cash-generating business operation and easily increase its cash receipts in the middle of a budget period. Over time, if such business operations expand, Congressional objectives may become more disconnected from the objectives of the Executive Branch. This occurs because the programs Congress wants to support through its appropriation bills may not be the same ones that the Executive Branch wants to fund with the cash it has available from its own sources of revenue.[20]

These funding developments are a disturbing trend in which one branch of government is able to curtail another branch's constitutional priorities. As no one has been called to account for such cash generation methods used by the Executive Branch, it is likely that such techniques will expand in the future

Conclusion

Fannie Mae could have survived the financial crisis of 2007-2008 without the intervention of the Treasury. The financial data indicates that Fannie was a going concern at the time the conservatorship began in September 2008. The reason for the takeover was that a financial panic had gripped the financial markets, not that the entities needed any sort of financial assistance to weather the storm. In order to alleviate everyone's fears, the government had to take high profile measures to settle the markets. The U.S. Treasury decided that one such step was to nationalize Fannie Mae.

Today, Fannie Mae serves as cash-generating, petty cash machine for the Treasury that allows the Treasury more flexibility in requesting increases in the debt limit as well as providing discretionary spending authority. For the Administration, Fannie's cash can provide a means to

[20]Further along these lines, there has been approximately $150B paid in fines and penalties related to unscrupulous commercial bank activities during the same financial crisis that saw the takeover of Fannie Mae. What has been done with that $150B? The bulk of these monies have been deposited into the Treasury. Those windfall funds would not normally be part of annual budget forecasts and are probably being used to fund programs considered by the Executive Branch as "important" or as explained to taxpayers and the press as "deficit reduction." From a transparency view, it is unknown how these funds are being used. J.W. Schoen (2015). 7 years on from crisis, $150 billion in bank fines and penalties (April 30). CNBC.com <http://www.cnbc.com/2015/04/30/7-years-on-from-crisis-150-billion-in-bank-fines-and-penalties.html> Accessed September 19, 2015.

fund appropriations that are of particular interest to the Administration, and there is no guarantee those are the same programs for which Congress has established a priority.