This 3DAdvisors Report Covers:	
	Insider Trading: Insider Trading Behavior
✓	**Accounting**: Quality of Earnings Issues
✓	**Governance:** Corporate Governance Issues

GMAC Takes on More Risk in Mortgage Portfolio
General Motors Corporation (NYSE:GM) Update

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General Motors Corporation provides automotive-related products and services by primarily designing, manufacturing and marketing vehicles, as well as providing communications services and financial services. The company operates in two segments, Automotive, Communications Services and Other Operations, and Financing and Insurance Operations.

Summary of 3DAdvisors Findings for GM

- **Accounting:** GMAC takes on increasing risk in mortgage portfolio
- **Governance:** GMAC's fading disclosure of "Loans Held for Investment"
- **Accounting:** Mortgage Servicing Rights show further impairment
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Discussion of 3DAdvisors Findings

Accounting: GMAC takes on more risk in mortgage portfolio

With a company the size of GM, it is easy for items to get lost in the shuffle. Clearly, this is not the case with the Company's much-followed pension issues, which we touched on in our November 13, 2002 report. Another item that has our attention, which seems to have escaped detection, is the fact that certain GMAC mortgage loan operations are causing the Company to take on rapidly increasing amounts of risk as it attempts to find other areas to supplant income lost in its conventional car loan business.

As GM's access to capital has tightened, the GMAC subsidiary has resorted to holding a rapidly increasing portion of its total portfolio as loans for investment as opposed to securitizing them in the conventional fashion. These "Loans Held for Investment" carry extra risk as the Company bears all of the risk of credit loss throughout the holding period of the loans involved. Companies typically sell these loans to mitigate portions of such risk.

The growth in this category has become exponential. From somewhat meager beginnings of just $1.4 billion at Y/E 2001, Loans Held for Investment swelled to $3.4 billion by Y/E 2001. By Q3 2002, the category had jumped to $12.2 billion. By Y/E 2002, they had exploded to $20.6 billion.

We don't have to explain the risk in holding loans as opposed to selling them. Few industry peers choose such a strategy as aggressively as GMAC has. Indeed, Countrywide Financial, a player in the mortgage market with a larger loan servicing portfolio than GMAC, carries only $5 billion in Loans Held for Investment.

So why is GMAC pursuing this strategy? Our evidence supports a theory that would suggest that the Company has been increasing its concentration of sub-prime, and otherwise non-conventional loans in a drive to increase income. Indeed, past disclosures have indicated that sub-prime loans have contributed to at least the early growth in Loans Held for Investment. In 2002, GMAC indicated that the year's $1.1 billion increase in Loans Held for Investment was "primarily attributed to the origination of sub-prime adjustable rate mortgages." In that same year the Company had transferred $1.7 million of these sub-prime adjustable rate loans to Loans for Investment from Loans or Sale. Industry sources tell us that these are particularly risky loans as sub-prime adjustable rate mortgagees are the first to walk from their loans should a period of rising interest rates significantly increase their monthly payments.

Back in 2000, an even more interesting disclosure had indicated that, when Loans for Investment jumped to $1.9 billion (from $1.4 billion the prior year), the increases were driven by on the reclassification of $200 million non-performing assets to Loans Held for Investment plus another $90 million on a Mexican portfolio acquisition.

But that was then, and a lot has changed since Y/E 2001, when this loan category stood at $3.4 billion. In one year, GMAC has increased its Loans Held for Investment to $20.6 billion, or about 5% of its entire loan portfolio.

It would seem that GMAC is holding onto more loans because they cannot be sold as readily as more conventional loans. The Company however, seems to want us to think otherwise.

Governance: GMAC's fading disclosure of Loans Held for Investment

When GMAC first started holding loans for investment, the company had provided the only clues (shown above) as to some of the components of that category. More importantly, the Company had been providing updates on the increases in this category with each "Q" as well. Things began changing however, in late 2002. Gone were references to sub-prime loans or non-performing assets. These were replaced by disclosures that would lead the reader to interpret their existence to be for reasons other than the possibility that these were loans that could not be efficiently sold. For example, take a look at what the company had to say about these in the 2002 Q3 "Q":

"Mortgage loans held for investment totaled $12,196 million at September 30, 2002, $8,812 million above the balance at December 31, 2001. The increase was primarily attributed to approximately $8.9 billion of mortgage loans held for

investment which were originated and securitized during 2002 but which remain on the balance sheet as collateral for a borrowing arrangement."

At first glance, this would indicate that the cause for the entire increase in these loans lies in the fact that these loans were being held for collateral. But wait a minute! Evidence suggests that these loans are not conventional and, more than likely, could not be sold under conventional securitization programs. That being the case the next logical step, for GMAC, would be to borrow against those loans, using them as collateral, in efforts to replace the funding opportunities lost in the absence of their outright sales.

In the next period (Q4, 2002), GMAC's disclosure concerning these loans is contained in the following statement in its 10K:

"The Company periodically acquires or originates certain loans held for investment purposes. Additionally, certain loans held as collateral for securitization transactions (treated as financings) are also classified as mortgage loans held for investment. The Company has the intent and ability to hold these loans for the foreseeable future. The Company bears all or a material portion of the risk of credit loss on mortgage loans held for investment throughout the holding period of the loan."

With the huge jump, during Q4, in these loans for investment, to $20.6 billion, or over $8 billion during the quarter, we were anxious to see how much further growth may have occurred in them in Q1 of 2003. In checking, we were rather amazed to see that all reference to Loans Held for Investment had been dropped from the 10Q. Not a single reference, and this after showing detail relating to these loans in each "Q" going back to the beginning of their existence.

So, this category continues to increase significantly without the Company making any disclosure as to whether this is a change in investment strategy and what the rationale for the change is. Not only has the Company chosen not to provide detail as to why loans in this fast-growing category loans cannot be sold conventionally, it has now dropped all disclosure related to their existence. We think this represents a significant disclosure gap that will eventually need to be closed.

We maintain our posture on this as stated in our January 2, 2003 report. Since these Loans are Held for Investment, they do not have to be "marked to market" as they would have if they were "Held for Sale". Since we suspect that there is a strong component of sub-prime and non-conventional loans in this category, utilizing this strategy allows for the Company to delay hits to earnings should these loans fall behind.

Accounting: Mortgage Servicing Rights show further impairment

It appears that GMAC, in its push to rapidly grow its mortgage-based business, is dealing with risk profiles that are much different from its traditional businesses. It seems that the Company is both originating and buying a rapidly-growing amount of sub-prime and/or non-conforming loans but may not have the same expertise in the mortgage market that it traditionally has enjoyed in the auto loan market. These new risks go beyond the composition of the Company's Loans Held for Investment and include problems with the valuation of GMAC's large Mortgage Servicing asset.

As we reported earlier, GMAC incurred impairment charges, in 2001, related to its Mortgage Servicing Rights (MSR's) of $1.16 billion. The loss in these MSRs' reflects early prepayments of mortgages where the Company's expected cash flow, with regards to Mortgage Servicing Income, became impaired. After the impairment charge, GMAC continued to carry its remaining MSR's on the books for $4.8 million at Y/E end 2002. At the time, we had become a bit suspicious of this number since the Company, in 2002, "increased its reliance on its own Mortgage Servicing Rights cash flow history for certain assumptions" in the valuation of MSR's on its books. In the past, it had been basing fair value estimates of its MSR's "based upon assumptions derived from similar transactions which occur in the marketplace." This shift, to internal valuation methods, from outside market-related sources, concerned us.

Our suspicions materialized at the end of 2002 when GMAC again wrote down its MSR asset. This time the charge was $2.3 billion, far larger than the $1.16 billion charge of the previous year. This lowered GMAC's MSR asset value, on the books, from $4.84 billion to $2.68 billion.

So again, GMAC has significantly missed the mark on assessing the value of its MSR asset. Additionally, the Company has started using the "natural hedge" argument, made popular by Countrywide Financial's Angelo Mozilo. This argument attempts to downplay the significance of mortgage prepayment-related cash flow reductions because they tend to be replaced by new loan originations.

<u>Accounting: Fin 46 may force certain reconsolidations</u>

In January 2003, FASB issued Interpretation No. 46 (FIN 46) – Consolidation of Variable Interest Entities. Simply put, this rule requires re-consolidation certain off balance sheet entities, defined as Variable Interest Entities.

It seems likely that both GM, and GMAC will be required to consolidate a number of their off balance sheet entities that may be deemed the Variable Interest type. Assuming consolidation, the Company could be required to include, in its books, an additional $15.1 billion in assets and associated liabilities. Associated potential loss exposure to this which has been off-the books, would be $5.5 billion.