

The **GSE** REPORT™

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Major Events

Federal banking regulators approve a long-awaited final rule that lowers the risk-weighting of AAA and AA-rated mortgage-backed securities (MBS) and asset-backed securities (ABS) to match the risk-weighting of MBS issued by the GSEs

Currently, Fannie & Freddie's MBS have a 20% risk-weight, while privately issued MBS rated AAA and AA have a less advantageous 50% risk-weight. The new guidelines will place all securities rated AAA and AA on a level playing field with Fannie & Freddie – all at a 20% risk-weight, making private MBS a more attractive investment for banks

- The federal banking regulators (OCC, Federal Reserve, FDIC, and OTS) published a long-awaited final rule on recourse and residuals that would lower the risk-weighting of all AAA and AA-rated mortgage-backed and asset-backed securities to 20%, which puts them on par with Fannie and Freddie's MBS. This change is expected to make private label residential and commercial MBS more attractive investments for banks. The new capital standard for recourse transactions goes into effect on January 1, 2002 for transactions that settle on or after that date. For residuals and recourse arrangements already on the books, there is a one-year transition period before the new capital requirements become effective. Banks that enter transactions before January 1 may elect early adoption as of November 29 of "any provision of the final rule that results in a reduced capital requirement," the regulators said. The rule was published in the *Federal Register* on November 29. (*National Mortgage News Daily Web site*, 11/29/01; *Federal Register*, pages 19614-59667, 11/29/01)

Fannie & Freddie were opposed

- As noted in the July 7, 2000 *GSE Report*, Erick Bergquist with the *American Banker* reported that Fannie and Freddie were "up in arms" over the proposed rule. Prior to this new final rule, Fannie and Freddie's lower risk-weighting long supplied a strong incentive to buy their securities instead of privately issued MBS. (*American Banker*, Erick Bergquist, 6/30/00)
- As noted in previous *GSE Reports*, several financial services trade groups sent a joint letter to the Fed supporting the proposal of lowering the risk-weighting of all investment grade private institutions to the same 20% risk-weighting as Fannie and Freddie. The Financial Services Roundtable, America's Community Bankers, American Bankers Association, Consumer Mortgage Coalition, Mortgage Insurance Companies of America, and the National Home Equity Mortgage Association signed the letter. (*Joint Bank Trade Letter to Federal Reserve Board*, 5/11/99) The Mortgage Bankers Association also sent a letter to the Fed in support of revising the risk weightings. (*MBA Executive Vice President Paul Reid letter to the Federal Reserve Board*, 5/24/99)

GSEs' rapid growth and expanding debt could harm consumers if left unchecked, according to a study by the Mercatus Center at George Mason University

GSEs' rapid growth due to their special government benefits (subsidies)

GSEs' subsidies estimated at \$8.5 billion last year - subsidies reinforce the perception that the federal government would bail out the GSEs

GSEs have a strong incentive to increase their outstanding debt

Fannie & Freddie's superior financial returns are partly due to their increasingly risky business strategies

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Failure or even serious impairment of any of the GSEs could pose system risks to US mortgage markets and broader financial system

GSEs' competitors' concerns about GSEs may be well founded – regulatory oversight needed because GSE debt represents a potential liability to the federal government and to protect private competitors from undue expansion by the GSEs

Recommends policymakers consider other alternatives, including privatization of GSEs

Study claims GSEs' rapid growth and expanding debt could harm consumers

- While Fannie, Freddie, and the Federal Home Loan Bank System have contributed to one of the most dynamic mortgage markets in the world, their growing debt and their expanding scope could harm consumers, according to a new study by Mercatus Center Research Fellow Jay Cochran, III and Marymount University Assistant Professor Catherine England. (*Mercatus Center press release*, 11/15/01)
- Wendy Gramm, former chairman of the Commodity Futures Trading Commission and wife of Senator Phil Gramm (R-TX), heads the Mercatus Center. (*Market News International*, 11/15/01)

GSEs are growing faster than the mortgage market

- The Mercatus Center study, "*Neither Fish Nor Fowl: An Overview of the Big Three Government Sponsored Enterprises in the US Housing Finance Markets*," estimated that from 1995 to 2000, growth of the U.S. mortgage market averaged just 8.2 percent annually, while growth of the GSEs was at least double, and in some cases, triple that amount. (*Mercatus Center press release*, 11/15/01)

GSEs' rapid growth due to their special government benefits (subsidies)

- The GSEs' rapid growth is due in large part to the special privileges conferred on them by their congressional GSE charters, including their tax-exempt status and favorable treatment by banks and regulators. For example, since the GSEs are exempt from the Security and Exchange Commission's

registration and disclosure requirements -- which are applied to privately issued debt -- Fannie and Freddie saved an estimated \$176 million in 2000 and the FHLB System saved about \$60 million. (*Mercatus Center press release*, 11/15/01)

- The study refers to the benefits the GSEs receive not as subsidies but as “charter-conferred benefits or privileges.” The study said this language is more cumbersome but more precisely defines the GSEs’ relationship to the government and the source of their competitive advantage. (*Dow Jones Newswire*, John Connor, 11/15/01)

GSEs received \$8.5 billion in government benefits last year

- The study “conservatively” estimates the value of the GSEs’ charter benefits and funding advantages for all three GSEs to have grown from \$3.5 billion in 1994 to \$8.5 billion in 2000, representing a compound growth rate of more than 15 percent per year. (*Mercatus Study*, “*Neither Fish nor Fowl: An Overview of the Big-Three Government Sponsored Enterprises in the US Housing Finance Markets*,” Jay Cochran, III and Catherine England, 11/01; *Mercatus Center press release*, 11/15/01)
- Over the period 1994 to 2000, almost 80 percent of the value of the GSEs’ benefits came from the GSEs’ funding advantage. The study estimated that the GSEs enjoyed a cumulative funding cost advantage by virtue of their ability to borrow at lower rates than fully private firms of \$6.8 billion last year (\$2.6 billion for Fannie; \$1.9 billion for Freddie; and \$2.3 billion for the FHLBank System). The study also noted that although the GSEs have never used their lines of credit to the Treasury (\$2.25 billion each for Fannie and Freddie and \$4 billion for the FHLBank System) the mere existence of these lines of credit reinforces the notion of an implied government guarantee of GSE-issued debt. (*Dow Jones Newswire*, John Connor, 11/15/01; *Mercatus Study*, Cochran and England, 11/01)

GSEs’ benefits (government subsidies) reinforce the perception that the federal government would bail them out – Recommends Congress consider privatization

- “These privileges do more than just give the GSEs a funding cost advantage, they also reinforce the perception of a federal guarantee on GSE debt obligations,” said Cochran. “In order to avoid a federal bailout like the one we saw with the savings and loan industry, policymakers may want to consider a variety of alternatives, including privatization of one or more of the GSEs.” (*Mercatus Center press release*, 11/15/01) “The possibility of privatizing one or more of the housing GSEs should be considered.” (*Mercatus Study*, Cochran and England, 11/01)

GSEs have a strong incentive to increase their outstanding debt

- According to the study, the perception in the financial markets that the US government stands behind the GSEs’ debt may grow stronger as that debt increases. The GSEs “have a strong incentive to increase their outstanding debt,” because “it is by financing growth with new debt that the GSEs are best able to exploit their funding advantage,” the study said. From 1995 to 2000, Fannie’s outstanding debt more than doubled, while Freddie’s increased by more than 3.5 times, and the FHLBanks’ increased by 2.4 times, according to the study. (*Dow Jones Newswire*, John Connor, 11/15/01)
- “...there is the potential risk to taxpayers represented by the growing stock of GSE debt. Although the housing GSEs have been financially healthy during recent years that has not always been the case. Their fortunes may change in the future. Should any of the housing GSEs encounter financial

hardship, it is unlikely they would reduce their outstanding debt as problems mount.” (*Mercatus Study*, Cochran and England, 11/01)

Fannie & Freddie’s superior financial returns are partly due to their increasingly risky business strategies

- Fannie and Freddie’s superior financial returns arise from at least three different sources. “First charter-conferred benefits lower the GSEs’ operating costs. Second, the GSEs have been willing to use debt in funding their operations. Finally, Fannie Mae and Freddie Mac have pursued increasingly risky business strategies.”
- “The housing GSEs’ increased willingness to hold mortgages in their portfolios has also contributed to their recent exemplary financial performance. By holding mortgages rather than securitizing and selling them to investors, however, Fannie Mae and Freddie Mac, in particular, concentrate interest rate risk back onto their own balance sheets rather than using the secondary markets to disperse that risk. The ultimate success of this strategy will depend on borrowers’ keeping their mortgage payments current and on the GSEs’ keeping interest earnings matched to their interest expenses.” (*Mercatus Study*, Cochran and England, 11/01)

GSEs produced “a small margin of benefits in excess of costs” since 1995

- While the value of the GSEs’ charters has grown at a 15 percent annual rate from 1994-2000, the study estimated that the GSEs produced “a small margin of benefits in excess of costs” since 1995, ranging from \$1.8 billion in 1997 to \$10.1 billion in 1998. (*National Mortgage News Daily Web site*, 11/16/01; *Market News International*, 11/15/01; *Mercatus Center press release*, 11/15/01) The estimates were based on conservative assumptions and did not take into account all factors, including some charter-conferred privileges as well as secondary consequences of the GSEs’ activities in housing finance. (*Mercatus Center press release*, 11/15/01)
- “The three GSEs certainly have delivered benefits to both homebuyers and to lenders. They helped pioneer long-term amortized mortgages, and because they created a secondary mortgage market, loan contracts have been standardized and transaction costs have been reduced throughout the life of the loan,” England said. “However, the net benefits of the GSEs could be fleeting in the event of a severe economic downturn, especially given the small margins of GSE benefit over cost.” (*Mercatus Center press release*, 11/15/01)

GSEs’ activities affected 63% of the total mortgage market yet the growth of the GSEs is “unchecked by government officials” –GSEs could pose system risks to US mortgage markets and broader financial system

- The study found that at the end of last year, Fannie and Freddie either owned directly or sponsored securities backed by \$2.9 trillion of the \$5.2 trillion in home mortgages in the US. “Their activities thus affected 55% of the total mortgage market,” said the study. Combined, Fannie and Freddie’s activities supported approximately 75% of the conventional/conforming mortgage market as of year-end 2000. Taking into account the FHLBanks’ activities in purchasing mortgages and providing advances to members, the total figure for the GSEs’ activities rises by \$454 billion to \$3.3 trillion for 2000. In sum, the housing GSEs affected 63% of the US residential mortgage markets during 2000. The study noted, however that the rapid growth of the GSEs “has been unchecked by government officials,” and added that “it is widely accepted that the failure, or even the serious impairment, of any

of the GSEs could pose system risks to the US mortgage markets and indeed to the broader financial system if banks' investments in GSEs debt lost substantial value." (*Dow Jones Newswire*, John Connor, 11/15/01)

GSEs' competitors' concerns about the GSEs may be well founded – regulatory oversight needed

- The study noted that financial institutions with which the GSEs compete have objected to the GSEs' rapid expansion. "For their exceptional growth rates to continue, the GSEs must seek new opportunities, as their existing businesses will soon be limited by the slower growth rate of the mortgage markets generally. Expansion of the housing GSEs into other markets must almost certainly squeeze other providers. If the past is indicative of the future in this regard, the GSEs competitors' concerns may be well founded."
- The federal government regulates the GSEs for two reasons. "First, GSE debt represents a potential liability to the federal government...Federal supervision is also needed to protect private competitors from undue expansion by the GSEs. Their relationship to the federal government can give GSEs a competitive advantage, enabling them to crowd out private firms especially when the GSEs are allowed to move into new, already-occupied market segments. Because market discipline of the GSEs in terms of risk-taking and competitive inroads may be mute, and in some cases reversed altogether, regulatory oversight is required." (*Mercatus Study*, Cochran and England, 11/01)

GSEs should undergo close scrutiny by the government and the market

- "In sum, the GSEs are not fully responsive to market forces or to government control. To the extent GSEs' cost structures do not reflect market-driven costs and their operating venues are protected from competitive encroachment, GSEs face muted market discipline. Nor are the GSEs government agencies and thus subject to the budgeting process and other institutional controls. Government oversight of the GSEs is thus limited. Being neither fish nor fowl—neither fully private nor fully public enterprises—prudence and rational public policy dictate that the GSEs undergo regular, close scrutiny by both government and market participants." (*Mercatus Study*, Cochran and England, 11/01)
- "As their expansions near the limits of the U.S. mortgage markets, policymakers will be forced to confront some basic policy questions in connection with the GSEs.... In the pursuit of higher returns, have the GSEs concentrated rather than dispersed mortgage lending risks?" (*Mercatus Study*, Cochran and England, 11/01)

Other areas for further research on the GSEs

- The Mercatus study recommended further research on the GSEs including: (1) costs and benefits involved in GSE charter expansions; (2) effects of GSE activities on housing prices; (3) whether the GSEs can create money or credit; (4) how GSE debt as a benchmark would affect the financial markets; (5) what are the systemic consequences of a GSE failure; and (6) how would mortgage markets change if the GSEs were privatized. (*Mercatus Study*, Cochran and England, 11/01)

GSEs' comments on the study

- “We haven’t had a chance to review the study in detail,” Fannie spokeswoman Janice Daue said. “However, we will be engaging with the authors on the merit.” (*Washington Post*, Kathleen Day, 11/16/01)
- A Freddie spokeswoman said she hadn’t seen the study but stated that “it appears to be more of the same,” (i.e., another in a series of studies critical of Fannie and Freddie), and cited other studies by economists showing that the benefits generated by the GSEs exceeded their funding advantage. (*Dow Jones Newswire*, John Connor, 11/15/01) Freddie spokeswoman Sharon McHale said the GSE is “pleased that the study recognized the benefits” the two GSEs pass on to consumers. She challenged the study’s concern that the GSEs’ financial health could be jeopardized by an economic downturn because she claimed the GSE has strong risk management practices. (*Washington Post*, Kathleen Day, 11/16/01) “There are always these very academic reports that don’t reflect what goes on in the real world,” McHale said. “It’s quite clear that Freddie Mac and Fannie Mae do bring significant benefits to mortgage borrowers – not only in lower rates, but in technological innovations as well.” (*Real Estate Finance Today*, Mike Sorohan, 12/3/01)
- A spokeswoman for the Council of Federal Home Loan Banks said she hasn’t seen the study, but commented that the housing industry has been one of the real stabilizing effects on the economy. (*Dow Jones Newswire*, John Connor, 11/15/01)

Support for the “Ginnie Mae Choice” proposal continues to grow

Vice Chairman of the House Financial Services Committee, Congressman Mark Green (R-WI), releases a study finding that the proposal would provide substantial benefits to borrowers and help the US housing market

“This will help consumers and help re-energize the economy,” said Congressman Green

“Ginnie Mae Choice” supporters say the proposal will lower costs to consumers, increase revenue to the federal government, and create competition for Fannie & Freddie

New co-sponsors have been added to the “Ginnie Mae Choice” bill

- Senator Wayne Allard (R-CO) and Congresswoman Marge Roukema (R-NJ) introduced separate “Ginnie Mae Choice” bills on November 1 that would allow Ginnie Mae to securitize privately insured mortgage loans for the first time and allow Ginnie Mae to compete with Fannie and Freddie in the secondary mortgage market. (*Reuters*, Mark Felsenthal, 12/3/01)
- Congressman Mark Green released a study on December 4 that supports giving Ginnie Mae a broader role in US mortgage markets. Congressman Green said the extension of Ginnie Mae’s financial guarantee to some mortgages in the private sector would help the US housing market and improve the slumping economy. “This will help consumers and help re-energize the economy,” Congressman Green told *Reuters*. “Having additional options and enhanced competition will help everyone,” Green said. (*Reuters*, Mark Felsenthal, 12/3/01) “This plan will give our housing market a much-needed

shot in the arm during the critical juncture when our economy is slowing down,” said Congressman Green. (*American Banker*, 12/5/01)

- Congressman Green is among four House co-sponsors of the Ginnie Mae Choice bill, introduced by Congresswoman Roukema. (*Reuters*, Mark Felsenthal, 12/3/01) Other co-sponsors include: Congressman James Maloney (D-CT); Congressman Gary Miller (R-CA) and Congressman Chris Shays (R-CT). (*Thomas Web site*, <http://thomas.loc.gov>, 12/7/01)
- The study claims the bill would “expand the market for low down payment mortgages by increasing competition and providing additional choices for consumers.” The study further claims Ginnie Mae Choice would make mortgages more available to borrowers with blemished credit. The authors of the study are Ann Schnare, chairman of the Center for Housing Policy and Susan Woodward, a former economist at the Securities and Exchange Commission. (*Bloomberg*, Rob Wells, 12/3/01)
- The study also found that the Federal Housing Administration and Ginnie Mae would reap net income gains of more than \$200 million annually from the proposal. Schnare said more than 90% of the program’s default losses would be absorbed by private mortgage insurers. “FHA will benefit further through the introduction of private-sector risk management technology to its entire program,” Schnare said. “Currently, FHA suffers default rates two and three times those of the private sector and these tools will bring those numbers more into line,” Schnare added. “More underwriting systems that score credit risk will be introduced into the system, meaning more opportunities for consumers to get loans approved,” Woodward said. (*National Mortgage News Daily Web site*, 12/4/01; *Inman News Feature*, 12/5/01)

Fannie’s comments about the proposal

- Fannie spokesman Robert McCarson stated, “Not one single loan described in the proposal would be a loan that already couldn’t be approved by Fannie Mae, Freddie Mac and the FHA.” The report said the program would handle approximately \$30 billion in loans a year, attracting about five percent of loans currently handled by Fannie and Freddie. (*Bloomberg*, Rob Wells, 12/3/01)

Congressman Ney expresses concern about the proposal

- In a statement in the *Congressional Record* on November 13, Congressman Robert Ney (R-OH) expressed concerns about the Ginnie Mae Choice bill because he believes the bill would raise taxpayer risk. He is concerned that the bill would expand the express government backing of Ginnie Mae into the conventional home loan market and place taxpayers at a greater risk of assuming more default risk. He said he is concerned that the bill “is an unnecessary expansion of a federal government guarantee that inappropriately puts American taxpayers at risk.” (*Congressional Record*, pages E2055-2056, 11/13/01)

The conforming loan limit [the limit on the amount Fannie & Freddie can purchase] increases to \$300,700 in 2002, a 9.3% increase

Between 1996 and 2002 the loan limit has increased 45.3%

There are questions as to whether the increase is justified given the GSEs' mission to improve housing affordability in underserved areas

The increase will reduce the size of the jumbo market, increase prepayment speeds, and may increase "adverse selection" in the to-be-announced (TBA) market

Analyst believes this will potentially put pressure on the GSEs to provide more detailed loan balance information on their pools

[Editorial Note: It is likely Fannie & Freddie will continue to purchase loans that are greater than the new conforming loan limit]

- Beginning January 1, 2002, Fannie and Freddie can buy single-family mortgages up to \$300,700 in the 48 contiguous states, a 9.3% increase from the current limit of \$275,000. The change means that between 1996 and 2002 the loan limit has increased 45.3%. Limits in Hawaii, Alaska, Guam, and the US Virgin Islands will increase to \$451,050, from \$412,500 (50% higher than the rest of the country). (*National Mortgage News Daily Web site*, 11/28/01; *Wall Street Journal*, Patrick Barta, 11/29/01) The Federal Housing Finance Board calculates the loan limit every year to reflect the increase in average home prices each October from the year before. This method of calculating the annual change in the loan limit is set forth in the Federal Housing Enterprises Safety and Soundness Act of 1992. According to the FHFB, the average price for homes rose 9.4% in the past year. (*Wall Street Journal*, Patrick Barta, 11/29/01; *Business Wire*, 11/28/01) By law Fannie and Freddie set their own mortgage limits, but the rate of increase cannot be larger than the annual percentage increase in house prices. (*Dow Jones Newswire*, Jennifer Corbett Dooren, 11/28/01)
- Loans that qualify to be purchased by Fannie and Freddie are referred to as "conforming" in the mortgage business, while those above the limit are referred to as "jumbos." Fannie and Freddie cannot purchase mortgage loans above the conforming loan limit. Conforming loans generally carry interest rates that are one-quarter to one-half percentage points lower than jumbo loans. (*Dow Jones Newswire*, Jennifer Corbett Dooren, 11/28/01; *Wall Street Journal*, Patrick Barta, 11/29/01) **Despite the savings, however, economists agree that the higher loan limit probably won't produce many new buyers because people in the \$275,000-\$300,000 range were just as likely to go ahead with their purchases at the higher rate.** (*Future Banker*, Lew Sichelman, 12/3/01) **"There will be more credit at a lower cost for borrowers and that should help support volumes and housing demands, said Mark Zandi, chief economist at Economy.com. "But the impact should be small because that part of the market was already very well served by nonconforming [non GSE] lenders."** (*Real Estate Finance Today*, Michael Murray, 12/3/01) Orawin Velz, senior economist at Fannie said: "The most significant impact the increase will have on households is that it will allow more people to buy more-expensive homes without increasing their monthly mortgage payment.

Those who already have that kind of mortgage can refinance and move away from jumbo loans to conforming.” (*American Banker*, Tommy Fernandez, 12/10/01)

- Fannie and Freddie also announced that the limits on multi-family loans will increase next year. The limit on two-family units will be \$384,900 (up from \$251,950) and the limit on three-family units will be \$465,200 (up from \$425,400). The limit on four-family units will be \$578,150 (up from \$528,700). The limit for second mortgages will be \$150,350. The limit for second mortgages in Alaska, Hawaii, Guam, and the US Virgin Islands will be \$225,525. (*Dow Jones Newswire*, Jennifer Corbett Dooren, 11/28/01)

Conventional Single-Family Loan Limit Increases 1996-2002

Year	Loan Limit	Change from Previous Year
2002	\$307,700	9.35%
2001	\$275,000	8.83%
2000	\$252,700	5.29%
1999	\$240,000	5.66%
1998	\$227,150	5.85%
1997	\$214,600	3.67%
1996	\$207,000	na

(Source: *National Mortgage News*, 12/3/01)

California brokers are lobbying to increase the conforming loan limit even more

- California brokers have been lobbying heavily to qualify for the same loan terms as Hawaii, Alaska, Guam, and the US Virgin Islands. “Clearly the increase is welcome,” says Robert Bailey, incoming president of the California Association of Realtors. “But it doesn’t deal with the underlying [issue] of parity between California, Hawaii and Alaska.” “The same reason they increased the limits [in Hawaii, Alaska and the US Virgin Islands] that’s the situation we’re now facing in California,” he said. (*Wall Street Journal*, Patrick Barta, 11/29/01)

Is the increase justified given the GSEs’ mission?

- **Critics are likely to argue that Fannie and Freddie should focus more of their efforts on serving lower-income families. In cities where the median home price is below \$100,000, a home selling for \$300,000 is generally within reach of only the highest-income residents. That means Fannie and Freddie will now “be able to move more aggressively into the higher ends of the markets in those cities,” said Bert Ely, a banking consultant.** (*Wall Street Journal*, Patrick Barta, 11/29/01)
- **There are questions over whether the increase is justified, given the GSEs’ charter mission to improve housing affordability in underserved areas. Michael DiResto, a spokesman for Congressman Richard Baker (R-LA) said the increase is a good thing for high-end homebuyers, but the argument that such increases are a good thing for lower-income homebuyers “just doesn’t compute,” he said. “I wish someday to be able to afford a house that qualifies at this new loan limit,” DiResto said. “There just doesn’t seem to be a whole heck of a lot of help for**

low- to moderate-income homebuyers – the presumed beneficiaries of Fannie’s and Freddie’s benevolence.” (*American Banker*, Tommy Fernandez, 12/10/01)

The loan limit increase will reduce the size of the jumbo market, increase prepayment speeds, and may lead to increasing “adverse selection” in the to-be-announced market

- The increase in the conforming loan limit is expected to reduce the upcoming supply of jumbo mortgage loans, and prepayment speeds on jumbo loans originated before the mid-1990’s should increase, Art Frank, director of fixed income research at Nomura Securities International Inc. said. “It is going to allow for a commensurately smaller issuance in jumbos and bigger issuance in Agencies especially in the first quarter of next year,” said one MBS analyst. “It just continues the inexorable squeezing out of the prime label market.” Frank said that aside from slightly increasing agency market share at the expense of jumbos in 2002 and increasing the average loan size in agency 2002 pools, it would also make 1994 to 1997 premium jumbos “a little more callable as many of those loans have remaining balances in the high 200’s and can now refi into conforming at 3/8% lower rates.”
- *Real Estate Finance Today* reported that the increase in the conforming loan limits will have a substantial impact on prepayments of certain jumbo loans originated in 2000, according to industry observers. “We believe it will accelerate the trend of converging prepayments between the agency and non-agency sectors,” said Dale Westoff, a senior analyst for Bear Stearns. “Early indications from the refinancing wave suggest that there has been almost complete convergence between the true to-be-announced sector and jumbo prepayments.” The loan limit increase is expected to put additional upward pressure on prepayment speeds in selected sectors of the jumbo market. Overall, the agencies will capture approximately 12 percent of non-agency production with the loan-limit increase, analysts said. Currently, about 11.3 percent of 2000-vintage jumbos are at or under the GSE loan size limit. As of next January, the percentage will jump to 26.5 percent, according to Westoff. The most affected categories of jumbos are those originated in 1999, followed by 1998. (*Real Estate Finance Today*, Chris De Reza, 12/10/01)
- However, some experts believe that although the GSE larger loan sizes would shrink the jumbo market somewhat, it would not have that much of an impact, since this sector is skewed towards super-large loans. The average loan in the jumbo market is about \$400,000. With the increase, about 10% of jumbo borrowers, those in the \$275,000 to \$300,000 range, were added to those qualified to refinance into a conventional conforming loan. This would not make that much of a difference on prepayment speeds, analysts said. (*Asset Securitization Report*, Karen Sibayan, 12/3/01)
- Analysts also believe that the higher limits would adversely affect the business of leading prime lenders such as GMAC-RFC, Wells Fargo, Chase, Bank of America, Countrywide and Cendant. Given the competitiveness of the market, the difficulty in hedging servicing portfolios and market conditions in late 2001 where there has been a drastic shift from rapidly falling to rapidly increasing interest rates, the loan limit increase will be a very significant competitive challenge for prime players. (*Asset Securitization Report*, Karen Sibayan, 12/3/01; *Dow Jones Newswire*, 11/28/01) Gary Gordon, a managing director in specialty finance research at UBS Warburg said the loan limits will enable Fannie and Freddie to take some business away from jumbo lenders in the near term, “we should recognize that this isn’t a crisis” for the jumbo lenders. “This is a good year” for the GSEs, he said, but “there will be bad years.” (*American Banker*, Tommy Fernandez, 12/10/01)

- A short-term impact from the increase in conforming loan limits would be the increase in the percentage of mortgage loans from California in a lot of private deals. “As California real estate continues to outpace the market, it would be more difficult to have a conforming balance loan in this region as opposed to parts of the midwest where the average home price is about \$150,000,” said an MBS analyst. This could become a problem because when investors examine the collateral of a deal, they would want to know how much California exposure is in there partly due to diversification of risk issues. This is especially important for those buyers of subordinate tranches who would probably not agree to a collateral concentration in a particular region larger than 35%. “The higher-cost areas are going to increasingly populate jumbo deals,” said the MBS analyst. “Investors are going to have to price that accordingly, which would also negatively impact the jumbo market.” (*Asset Securitization Report*, Karen Sibayan, 12/3/01)
- The increase in the conventional loan balances also may lead to increasing “adverse selection” in the to-be-announced, or TBA, market, said David Montano, an MBS analyst at Credit Suisse First Boston. Montano said that means the differential in prepayment speeds between TBAs and the entire mortgage universe (the cohort) is expected to continue to increase. With average loan balances increasing very rapidly, newer production has much higher average loan balances than moderately seasoned paper. Also, within the same pools there may now be a wider dispersion of loans, ranging from \$100,000 to \$300,000, each loan size having different prepayment characteristics. The cohort as a whole will reflect the weighted average prepayment, which is composed mostly of smaller loans. The TBA deliverable pools, on the other hand, are composed of the larger loans that will prepay much faster. This is why the differential in average loan balance between what is TBA deliverable and what is the cohort as a whole can be larger now that the loan limits have increased. Montano believes this will potentially put more pressure on the GSEs to provide more detailed loan balance information on their pools. Currently, information on average loan balances is available but this is not always useful because the distribution of loan balances is not completely disclosed. The number of large loans in the pools is unknown. This would help clarify the pricing on deals because otherwise, without disclosure, everything is going to be priced to the worst case. (*Asset Securitization Report*, Karen Sibayan, 12/3/01; *Dow Jones Newswire*, 11/28/01)

It is likely Fannie & Freddie will purchase loans even greater than the new increased conforming loan limits

- As reported in previous *GSE Reports*, **in a speech before the Merrill Lynch Investor Conference, Fannie’s Chairman Franklin Raines stated that Fannie and Freddie are expanding into jumbo loans (those over the conforming limit, which by law cannot be bought by Fannie and Freddie).** Here’s how Fannie is using a “back door” into jumbos: Raines noted that “clever” lenders are breaking jumbo loans into two components and are structuring the jumbo debt amount into a first lien that is below the \$240,000 GSE cap [1999 conforming loan cap], with the remainder of the loan amount secured by a second mortgage. (*National Mortgage News*, 10/4/99)

Comptroller of the Currency John D. Hawke, Jr. claims the Gramm-Leach-Bliley Act expanded another GSE [FHLBank System] that “clearly had outlived its original purpose”

- Speaking at an American Enterprise Institute roundtable discussion on the Gramm-Leach-Bliley Act of 1999, Comptroller of the Currency John Hawke Jr. included comments on the FHLBank System, which the law helped by expanding the types of loans that banks and thrifts may pledge as collateral for advances from the system. The bill “expanded another government-sponsored enterprise [FHLBank System] that clearly had outlived its original purpose,” Hawke said. “Euthanasia was a better approach.” (*American Banker*, Barbara A. Rehm, Rob Blackwell, Nicole Duran, and Rob Garver, 11/19/01)

Nominee for FHFB Chairman - Shirlee Bowne - withdraws her nomination just two days prior to her confirmation hearing

FHFB – the Federal Housing Finance Board – regulates the FHLBank System

Senate confirms remaining three nominees for FHFB

FHFB will have a full five-person board for the first time in eight years

Senate Banking Committee Chairman Paul Sarbanes (D-MD) and Ranking Member Phil Gramm (R-TX) question the FHLBank Presidents’ salaries

- Shirlee Bowne, President Bush’s nominee to chair the FHFB, sent a letter to President Bush on November 13 asking that her nomination be withdrawn. The letter was sent two days prior to the Senate Banking Committee’s hearing on Bowne’s nomination. President Bush had selected Bowne to succeed acting FHFB Chairman Timothy O’Neill. John Connor with *Dow Jones Newswire* reported that Bowne, in a telephone interview, said there had been “a misunderstanding” when she was offered the position. She said she believed she was being offered a full seven-year term, but the term that was being offered would have been only about 27 months. After considering various factors, including the cost of government service, Bowne said she concluded that the shorter term wouldn’t work for her. “I felt I’d go in as a lame duck with that,” she said. “It was a difficult decision for me,” she said. “I’d love to do the job. I am very sorry it didn’t work out.” (*Dow Jones Newswire*, John Connor, 11/13/01) The White House assured her that she would be reappointed in 2004, but because that will be a presidential election year, Senate action on her nomination would be unlikely, she said. “I understood I could be reappointed, but I wasn’t sure a confirmation hearing could be held.” (*American Banker*, Rob Blackwell, 11/16/01)
- According to the *American Banker*, the move threw into doubt the FHFB’s immediate future. Acting FHFB Chairman J. Timothy O’Neill, who has lobbied hard to keep his position, may now be back in the running to remain. (*American Banker*, Rob Blackwell, 11/14/01) O’Neill has served on the FHFB for over six years. Even though his term has expired, he can continue to serve on the board until his successor is confirmed by the Senate. (*National Mortgage News Daily Web site*, 11/14/01) Sources say the White House still has not decided whom to appoint as chairman. (*American Banker*, Rob Blackwell and Michele Heller, 12/3/01)

Senate confirms remaining three nominees for FHFB

- Although, Shirlee Bowne withdrew her nomination for the FHFB, the Senate Banking Committee continued with its scheduled November 15 hearing to consider the nomination of the remaining three FHFB nominees – Allan Mendelowitz, Franz Leichter and John Thomas Korsmo. Mendelowitz and Leichter are current FHFB members, while Korsmo is a new nominee. Mendelowitz, a Democrat, served since October 1999 as executive director of the U.S. Trade Deficit Review Commission. Leichter, a former Democratic state senator in New York, was a practicing attorney in New York with the law firm of Walter, Conston, Alexander, and Green, P.C. Korsmo, a Republican, is president of a consulting firm and a partner in the real estate law firm, Korsmo and Wheeler. The Senate Banking Committee on November 27 approved the nominations of the three FHFB nominees. (*BNA Daily Report for Executives*, 11/28/01)
- The full Senate on November 29 confirmed the nominees without objections. (*Reuters*, 11/29/01) However, the three FHFB nominees were held up briefly. The delay started the week of November 26, when Senator Byron Dorgan (D-ND) allegedly put a hold on the nomination of Korsmo, a fellow North Dakotan. Sources were not clear of Senator Dorgan's objection. Senator Robert Bennett (R-UT) also placed holds on the nominations of Mendelowitz and Leichter, whose recess appointments were scheduled to expire by year-end. Senator Bennett said their nominations would not be released until the hold on Korsmo was released. Senator Dorgan released his hold on Korsmo's nomination late on November 29, which cleared the way for all three nominees to be confirmed. (*American Banker*, Rob Blackwell and Michele Heller, 12/3/01) Mendelowitz and Leichter have been serving on the FHFB thanks to recess appointments by former President Bill Clinton. Re-nominated by President Bush, Leichter's term expires February 27, 2006 and Mendelowitz's term expires February 27, 2007. Korsmo's term expires February 27, 2002. Once the newly confirmed nominees are sworn in, the FHFB will have a full contingent of five board members for the first time in eight years. (*National Mortgage News Daily Web site*, 11/30/01)

Senator Sarbanes and Senator Gramm question the FHLBank President's salaries

- During the November 15 confirmation hearing, Senate Banking Committee Chairman Paul Sarbanes (D-MD) raised concerns about the salaries of FHLBank presidents and of the bank's supervisors at the FHFB. FHLBank presidents' salaries increased by 43% one year after Congress repealed a requirement that the FHFB approve salary increases. "I think this is an issue we have to revisit," Senator Sarbanes said. He asked the FHFB nominees to review the salaries. (*National Mortgage News Daily Web site*, 11/15/01) The pay scale "is a problem, because the Finance Board has set salaries significantly higher than the other bank regulatory agencies," Senator Sarbanes said. "How do we justify this disparity?" (*American Banker*, Rob Blackwell, 11/16/01)
- Senator Phil Gramm (R-TX) noted that the 12 FHLBank presidents make \$500,000-\$600,000, which is much higher than the salaries of the Federal Reserve Bank presidents. Regional presidents in the Federal Reserve System earned an average of \$219,000 last year. "I don't think those salaries can be justified," Senator Gramm said. (*National Mortgage News Daily Web site*, 11/15/01; *Dow Jones Newswire*, Joseph Rebello, 11/15/01) "I think it creates a very real problem when you have people working who are regional presidents of Federal Reserve banks, and they are making a third of what

your people are making in what would be a parallel job.” (*American Banker*, Rob Blackwell, 11/16/01)

- Senator Gramm said he would vote in favor of the nominees, but the time had come for a “comprehensive review” of the FHFB, the FHLBank system and its mission. (*National Mortgage News Daily Web site*, 11/15/01; *Dow Jones Newswire*, Joseph Rebello, 11/15/01) He questioned the need for the FHFB, given the success of other GSEs such as Fannie and Freddie. “With the great success...of Freddie and Fannie and their growth for the last 25 years, I’m not sure what the Federal Housing Finance Board does,” he said. “I think we’ve got to take a long, sober look at exactly what this government agency is doing, what its mission is, whose interests it is serving,” Senator Gramm said. (*Dow Jones Newswire*, Joseph Rebello, 11/15/01) “I think this is a renegade agency. Under Chairman Bruce Morrison [led the FHFB from 1995 to 2000], they took actions in my opinion that are absolutely indefensible,” Senator Gramm said. (*American Banker*, Rob Blackwell, 11/16/01)
- Senator Gramm warned the nominees that if they were seeking their fifteen minutes of fame by serving on the FHFB, they were in the wrong place. “The only way you are ever going to get your name in the paper as a member of the Federal Housing Finance Board is to screw something up,” he said. “No one is going to write an article in *The New York Times* talking about what a great job you are doing on the board.” (*American Banker*, Barbara Rehm, Rob Blackwell, Nicole Duran, and Rob Garver, 11/19/01)

National Mortgage News provided the following chart in its November 26, 2001 edition on the FHLBank Presidents’ salaries:

FHLBank Presidents and their Salaries						
Executives See Paychecks Rise 16%-150% Year-to-Year						
	FHLBank	'00 Salary	'99 Salary	Total Comp. '00	Total Comp. '99	% Chg in Total Comp.
Michael A. Jessee	Boston	\$400,000	\$335,600	\$721,269	\$457,859	58%
Alfred A. DelliBovi	New York	\$425,000	\$345,000	\$691,835	\$454,261	52%
James D. Roy	Pittsburgh	\$400,000	\$337,296	\$530,813	\$456,631	16%
Raymond A. Christman	Atlanta	\$360,000	\$162,500	\$543,050	\$216,806	150%
Charles L. Thiemann	Cincinnati	\$435,000	\$345,000	\$748,752	\$457,402	64%
Martin L. Heger	Indianapolis	\$379,600	\$312,338	\$600,293	\$439,430	37%
Alex J. Pollock	Chicago	\$500,000	\$397,500	\$780,000	\$531,000	47%
Patrick J. Conway	Des Moines	\$331,667	\$169,869	\$456,094	\$261,791	74%
Terry Smith	Dallas	\$282,408	N/A	\$468,204	N/A	N/A
Frank A. Lowman	Topeka	\$360,000	\$287,750	\$515,778	\$408,271	26%
Dean M. Schultz	San Francisco	\$420,000	\$360,000	\$664,811	\$487,578	36%
Norman B. Rice	Seattle	\$325,000	\$270,833	\$385,700	\$329,452	17%

Source: *National Mortgage News/FHLB Reports* (*National Mortgage News*, 11/26/01)

Nominees are unable to justify the salaries

- The FHFb nominees told lawmakers they could offer no defense for the salaries of some members of the FHFb's own staff, the highest paid of whom earns \$230,628 a year. They also offered no defense for the compensation of the FHLBank presidents. "We as an agency would have a very hard time justifying compensation, going forward, that significantly exceeds those of other government agencies," said Mendelowitz. He said the FHFb would look "very carefully" at the matter. Korsmo said he was surprised to discover how underpaid he was compared to the FHLBank presidents. "I was surprised when I got there to find I was one of the lowest-paid guys in the system," he said. FHLBank presidents earn \$500,000-\$600,000 in total compensation on average, compared to \$125,700 in annual compensation for FHFb members. (*Dow Jones Newswire*, Joseph Rebello, 11/15/01)

FHFb extends its comment period on multi-district FHLBank membership

Lawmakers ask FHFb nominees about multi-district FHLBank membership

Five financial trade groups announce a January forum to discuss the issue

- The FHFb extended the public comment period on the issue of multiple FHLBank memberships from January 2, 2002 to March 4, 2002. (*Federal Register*, page 63007, 12/4/01) On October 3, 2001, the FHFb published a solicitation for comments on the issue of multiple memberships in FHLBanks, particularly the ramifications it could have for the FHLBank System. The notice solicits public comment on a series of policy questions relating to whether single financial institutions should be allowed to become members of more than one FHLBank at the same time, particularly in cases where a member of one FHLBank district acquires a member institution in a different FHLBank district. (*FHFb press release*, 9/26/01; *Federal Register*, pages 50366-50375, 10/3/01)
- As noted in previous *GSE Reports*, the FHFb has three applications where members of one FHLBank have acquired a thrift in another FHLBank district and would like to assume the acquired institution's membership in the FHLBank: (1) Washington Mutual Bank, Stockton, CA (a member of the San Francisco FHLBank) acquired Bank United in Texas and wants to become a member of the Dallas FHLBank; (2) Fleet National Bank, Boston, MA (a member of the Boston FHLBank) acquired Summit Bank and wants to become a member of the New York FHLBank; and (3) Charter One, Cleveland, OH (a member of the Cincinnati FHLBank) acquired Alliance Bancorp and wants to become a member of the Chicago FHLBank.
- Members of the New York and New Jersey congressional delegations have been urging the FHFb to allow WaMu and Fleet to become members of the FHLBank of New York. The lawmakers are concerned that the affordable housing resources provided by Dime and Summit would flow into the San Francisco and Boston FHLBank districts, unless the FHFb allows multi-district memberships. **The lawmakers acknowledged that the FHFb recently issued a solicitation for public comment on multi-district memberships, but they claimed the issue can't wait that long.** "To protect our community lending resources while the time-consuming and complex rule making process can be completed, we request that the Board conditionally approve multi-district membership on a case-by-case basis," wrote Senators Jon Corzine (D-NJ), Robert Torricelli (D-NJ), Hillary Rodham Clinton

(D-NY) and Charles Schumer (D-NY) in a letter to the FHFB. Thirteen members of the House Financial Services Committee signed a similar letter. (*National Mortgage News Daily Website*, 10/19/01)

- According to *National Mortgage News*, at the November 15 confirmation hearing for FHFB nominees, Senator Sarbanes said he was opposed to granting a special waiver for WaMu. He is concerned about the affordable housing funds but believes it can be resolved in some other way than approving a multi-district membership. “It is not quite clear to me why this should be used to make a fundamental change in the [FHLBank] System,” Senator Sarbanes said. Supporters of WaMu’s membership in the New York FHLBank are asking for “extraordinary action,” FHFB member (and nominee) Allan Mendelowitz said, “A case has not been made yet.” (*National Mortgage News Daily Web site*, 11/15/01; *National Mortgage News*, Brian Collins, 11/26/01)
- Senator Corzine, who had earlier signed a letter urging the FHFB to allow WaMu and Fleet to become members of the FHLBank of New York, indicated his willingness to discuss alternative solutions. This problem can be dealt with either by “multidistrict membership or some other solution that I would be more than happy to work [on]” with the FHFB, Senator Corzine said at the confirmation hearing. (*National Mortgage News Daily Web site*, 11/15/01; *National Mortgage News*, Brian Collins, 11/26/01)

FHFB cancels November 14 open meeting to discuss the issue – Supporters and opponents of multi-district FHLBank memberships express their opinions

- According to Rob Blackwell with the *American Banker*, FHLBank of New York President Alfred DelliBovi warned the FHFB on November 13 that denying WaMu temporary membership in the FHLBank of New York would impede New York’s economic recovery, but sources said he faces an uphill battle. “There will be serious undermining of the affordable-housing program,” DelliBovi said. “It would amount to a cut of 20%, and this at a time, after the catastrophic job losses as a result of the attack on the World Trade Center, when there is a critical need for affordable housing. I’m asking the Finance Board to do a very simple thing. This is the right thing to do.”
- Blackwell noted that the FHFB’s cancellation of a November 14 meeting may be a sign DelliBovi’s request “is falling on deaf ears.” The official reason for the cancellation was to provide time for two acting board members to prepare for their November 15 confirmation hearings, although sources speculated that FHFB Chairman O’Neill delayed the meeting because he lacked the votes to push through a waiver. [The FHFB then subsequently rescheduled its November 14 open board meeting to November 28, then December 5, and finally to December 11. (*Federal Register*, page 57967, 11/19/01; page 59595, 11/29/01; page 63545, 12/7/01)]
- Critics oppose the waiver, saying it could open the door to permanent multiple memberships and have broad consequences for the system. “If the Finance Board acts on the pending petitions, it prejudices the outcome,” wrote Herbert M. Sandler, chairman and chief executive officer of World Savings Bank in a letter to the FHFB. “And a few privileged institutions will achieve an unfair, and possibly permanent, competitive advantage over the thousands of other financial institutions that are members of the system. The Finance Board should take the time to examine what will be best for the system, which it cannot do if it must grant favored treatment immediately to a select few.”

- DelliBovi dismissed those complaints as groundless and accused opponents of playing politics while New York is struggling. “It is just bizarre and irrational that New York workers are going to be hurt because one of Wamu’s competitors is afraid that Wamu will have some advantage in the marketplace,” he said. (*American Banker*, Rob Blackwell, 11/14/01)

Five financial trade groups announce a January forum to discuss the issue

- Five financial trade groups are holding a forum on January 10-11 to discuss the implications of FHLBank multi-district memberships. America’s Community Bankers, the American Bankers Association, the Council of FHLBanks, the Financial Services Roundtable, and the Independent Community Bankers of America will host the forum. “The conference is designed to help move forward the development of joint policy recommendations on multidistrict membership to the Federal Housing Finance Board,” the groups said in a press release. (*American Banker*, Rob Blackwell, 11/28/01)

Fannie Mae and Freddie Mac

AA-rated mortgage insurance companies appeal to Office of Management and Budget (OMB) to change OFHEO’s risk-based capital rule for Fannie & Freddie

The OFHEO rule is currently under review at OMB

New Deputy Director at OFHEO claims the regulator has “teeth”

OFHEO – the Office of Federal Housing Enterprise Oversight – is Fannie & Freddie’s safety and soundness regulator

- OFHEO is planning to amend its risk-based capital rule covering Fannie and Freddie, which was issued this summer after several years of rule-making. OFHEO said the amendments will “modify provisions relating to counterparty haircuts, modeling of multifamily loans, and refunding and to make several technical adjustments and enhancements,” according to a notice published in the *Federal Register*. The agency said it plans to issue a notice of proposed rulemaking this month. (*Dow Jones Newswire*, John Connor, 12/3/01) The revised rule is currently under review at the OMB. Once the OMB clears the rule, it will be issued for a 30-day comment period. (*National Mortgage News Daily Web site*, 12/7/01)
- AA-rated mortgage insurers and several trade associations asked the OMB to modify OFHEO’s capital rule. The OFHEO proposed amended rule would reportedly reduce the capital differential between AAA-rated and AA-rated mortgage insurers, but not eliminate it. Currently, under OFHEO’s risk-based capital rule, Fannie and Freddie are required to hold more capital against mortgages insured by AA-rated firms than AAA-rated firms. Currently two mortgage insurers – GE Mortgage Insurance Corp. and United Guaranty Corp. – hold AAA-ratings. The other five mortgage insurers – Radian Group Inc., the PMI Group, Inc., MGIC Mortgage Insurance, Triad Guaranty Inc. and Republic Mortgage Insurance – have AA-ratings. Once the rule is implemented (September 13, 2002), Fannie

and Freddie would be required to take a “haircut” of 5% on exposure insured by a AAA-rated company and a 15% discount for AA-rated firms. (*American Banker*, Robert Julavits, 7/23/01) The five AA-rated mortgage insurers and Fannie and Freddie have requested the rule to be revised. (*National Mortgage News*, Brian Collins and Paul Muolo, 10/15/01)

- In a letter to OMB, the AA-rated mortgage insurers and several trade associations claim that requiring Fannie and Freddie to hold more capital if they rely on AA-rated companies will give the two AAA-rated companies an “unwarranted” competitive advantage. “We urge OMB to support equal capital treatment for mortgage insurers approved to do business with the housing GSEs in OFHEO’s risk-based capital regulation,” the December 6 letter to OMB Director Mitchell Daniels Jr. said. The American Insurance Association, Credit Union National Association, Mortgage Bankers Association, National Association of Home Builders, the National Association of Realtors, and the four AA-rated mortgage insurers signed the letter. (*National Mortgage News Daily Web site*, 12/7/01)

New Deputy Director at OFHEO claims the regulator has “teeth”

- In an October 31 interview with the *American Banker*, the Deputy Director of OFHEO Jimmy Barton claimed OFHEO “has teeth.” Barton, a former chief national bank examiner joined OFHEO in mid-July, as the second highest official at the agency. Barton is responsible for implementing and enforcing OFHEO’s risk-based capital rule for Fannie and Freddie. “I think it will be a great challenge,” he stated. “These are very complex enterprises.” Barton claims he is “tough, but very fair.” Barton spent 27 years as a bank supervisor with the OCC, including his last three years as chief national bank examiner. From 1997 until his new position at OFHEO, he worked with KPMG and the International Monetary Fund. Recently OFHEO successfully pushed for a 23% budget increase. “We do have teeth,” Barton said. The article reported, “Still, it is not clear that he plans to use them.” (*American Banker*, Tommy Fernandez, 11/20/01)

Fannie & Freddie’s cherry picking for better quality subprime loans may be partly to blame for the relatively weak credit quality of subprime loans securitized in 2000

- Henry Engelken with Moody’s Investors Service stated that subprime pools that were securitized in 2000 have a serious delinquency rate 32% higher than the average for pools originated between 1995 and 2000. Loanperformance, a company formerly known as Mortgage Information Corporation, also cited a historically high number of early defaults among loans originated last year. Subprime loans originated in 2000 “are under-performing 1999 production by 24%,” the company said in a recent newsletter.
- Competition among originators as lending volume declined and interest rates rose has been blamed for the weak credit quality of year 2000 loans. Another factor, Mr. Engelken claimed, is that Fannie and Freddie may have started cherry-picking the better quality subprime loans for their own portfolios. (*National Mortgage News*, Ted Cornwell, 10/29/01)

Mortgage Insurer thinks Fannie & Freddie's automated underwriting systems are partly to blame for rising delinquencies at the company

- MGIC Investment Corp. thinks Fannie and Freddie's automated underwriting systems are partly to blame for its rising delinquencies. When MGIC recently announced its third quarter earnings, MGIC President Curt Culver cited three reasons for rising delinquencies at the company, including a GSE automated underwriting related problem. "In particular we're seeing more delinquencies on loans in which the borrower had total debt ratios in excess of 45% and credit scores below 700, and yet the loans are being approved by the agencies' automated underwriting systems," Mr. Culver said.
- A MGIC spokesman clarified that GSE automated underwriting related problems "is the smallest" of the three reasons for rising delinquencies. "The effect is small but Curt felt it should be mentioned," the spokesman said. Other reasons cited were the "normal aging" of its portfolio and MGIC's growing book of business involving bulk insurance, which is geared toward non-conforming loans.
- The MGIC spokesman said the company is discussing the issue with the GSEs. "We want to be able to price these loans better," he said. The spokesman noted that when MGIC agrees to insure a mortgage that has been run through Fannie or Freddie's automated underwriting system it does not, in many cases, re-underwrite the loans through its own automated underwriting system. "We delegate the underwriting to their systems," he said.
- Fannie and Freddie said they do not see any problems with loans approved through their automated underwriting systems. The loans approved by Fannie's automated underwriting system "are the best performing loans in our portfolio," said a spokesman for Fannie. "We have not yet seen any rise in delinquencies." A Freddie spokesman stated that loans approved through their automated underwriting system "consistently have lower delinquency than comparable loans" that are not run through their automated underwriting system. "We have not seen any increase in delinquencies at all. (*National Mortgage News*, Paul Muolo, 10/29/01)

Fannie & Freddie "wrap" a number of subprime deals

- Fannie has issued its guarantee or "wrap" on subprime mortgage securitizations, but is reluctant to discuss it for competitive reasons. "We are being responsive to our lenders and if they want to do a wrap we have done that," said Fannie spokeswoman Janice Daue. Fannie has purchased or guaranteed \$8 billion in subprime loans under its expanded approval program that it rolled out in January 2001. Daue said that the wrap transactions make up a "small fraction of the \$8 billion." Freddie has issued its wrap on \$19 billion of subprime transactions over the past four years. (*National Mortgage News Daily Web site*, 12/6/01)

Fannie & Freddie differ on whether the mortgage market will grow next year

- Fannie predicts that industry-wide mortgage originations will increase from nearly \$1.9 trillion this year to more than \$2 trillion next year, according to Mary Lou Christy, Fannie's vice president in charge of investor relations. However, Freddie's deputy chief economist Frank Nothaft, said Freddie predicts 2001 originations at approximately \$1.8 trillion, and next year's at a lower \$1.5 trillion.

- Keith Gumbinger, vice president at research company HSH Associates is also skeptical that 2002 will be better than 2001. “The planets were definitely in alignment this year for the mortgage industry, he stated. “It stands to reason that with so much activity this year in purchases and refinances, it will be very difficult to top this year’s numbers. He believes that Nothhaft’s predictions are in line with those of other economists and industry observers in recent months.
- Fannie’s predictions are based on the assumption that interest rates will remain near the current levels for much of the next year. Christy estimated that over 70% of the industry’s current outstanding loans are still eligible for refinancing. Gumbinger, however, says the recent rate increases call such optimism into question. Such increases are “enough to put some folks on the sidelines...Unless we see a return to much lower rates, refinancing might be scaled back to a large degree.” Rates may continue to increase over the next few months once many of the government’s efforts to stimulate the economy take effect, he added. (*American Banker*, Tommy Fernandez, 11/27/01)

“Should Fannie and Freddie fear Ginnie Mae ‘Choice’ proposal?” asks Paul Muolo with *Mortgage Servicing News*

- “Ginnie Mae Choice” bills were introduced on November 1, which would allow Ginnie Mae to securitize privately insured mortgage loans for the first time and would allow Ginnie Mae to compete with Fannie and Freddie in the secondary mortgage market. [See earlier story in this *GSE Report*.]
- Paul Muolo with *Mortgage Servicing News* provided the following comments about the “Choice” proposals: “In theory, Fannie and Freddie could lose business to Choice...Since it exists only on paper, and in the minds of its private-sector backers...it’s hard to tell.” Muolo contended that the “Choice” product would need to be marketed aggressively to the mortgage industry to be successful. Muolo stated, “Do you see ‘GNMA Choice’ being actively marketed to mortgage lenders looking for ‘another’ choice besides Fannie and Freddie? Don't bet on it.”
- Muolo further argued, “I'm sure the attitude will be: if we build it, they will come. Life doesn't always work that way... If Choice is a real threat to the future of the GSEs, it would be reflected in the stock price of Fannie and Freddie. If anything, the share price for the two is now approaching their 52-week highs.” In his opinion, although some thought the FHLBanks’ Mortgage Partnership Finance (MPF) program would be a threat to Fannie and Freddie, he argued that the program “is hardly making a dent in GSE earnings or purchase volumes.”
- Muolo believes that GSE critics do not believe that the Bush administration will act to contain Fannie and Freddie’s alleged “charter creep” due to the focus on military action in Afghanistan. Muolo concluded, “With the economy in the tank and the recession turning uglier, will the Bush administration dare toy with Fannie and Freddie? No way.” (*Mortgage Servicing News*, Paul Muolo, December 2001/January 2002)

Fannie & Freddie are purchasing loans with Radian Guaranty's alternative title insurance product

American Land Title Association sues Radian to stop the mortgage insurance company from marketing the product

Standard and Poor's and Fitch are accepting Radian Lien Protection in lieu of title insurance in rated transactions

- The American Land Title Association (ALTA) sued Radian Guaranty to stop the mortgage insurance company from marketing an alternative title insurance product it calls Radian Lien Protection. ALTA is concerned that Radian's product is being represented as a title insurance product when it is really a form of mortgage insurance. ALTA claims that the Philadelphia-based company is not licensed to sell a title insurance product in California and the trade group is asking the Orange County, CA Superior Court to stop the "unlawful" sales of the product. The complaint also alleges that Radian has "falsely advertised" the product and asks the court to require Radian to replace its product with standard title insurance policies. The Radian product does not offer the benefits of traditional title insurance, according to ALTA executive vice president Jim Maher. Radian general counsel Howard Yaruss said ALTA's claims have "absolutely no foundation whatsoever." He said that product is a form of mortgage insurance that lenders can use as a substitute for title insurance. "It is not title insurance. We never said it is title insurance," Mr. Yaruss said. (*National Mortgage News Daily Web site*, 11/21/01)
- Radian president and chief operating officer Roy Kasmar noted that Radian Lien Protection is a form of mortgage pool insurance that replaces the lender title insurance when a borrower refinances a first or second mortgage. Radian Guaranty also provides closing services for lenders using this product through an affiliate, ExpressClose.com. "Because it is efficient, effective, and half the cost to the borrower, it is unquestionably competition for the title insurance industry," Kasmar said. "We are quite confident that our ability to provide this product is legal." Kasmar noted that traditional title insurance costs \$650 compared to \$275 for Radian's product. However, Radian Lien Protection is not a substitute for the owner's title insurance policy and it is not designed for purchase mortgages transactions. (*National Mortgage News Daily Web site*, 10/24/01; *National Mortgage News*, 10/29/01) "Our policy is not title insurance; it is a cheaper, faster, and more focused alternative." (*Howard S. Yaruss, General Counsel, Radian Group Letter to the Editor, American Banker*, 11/16/01)
- Fannie and Freddie have been purchasing loans with Radian Lien Protection on a negotiated basis. (*National Mortgage News*, 10/29/01)

Ratings agencies are accepting Radian Lien Protection in lieu of title insurance in rated transactions

- Fitch announced that it will accept the use of Radian Lien Protection in rated securities. The product "will be used in mortgage-backed securitizations and will provide protection from borrower's default for a broad range of losses, including losses due to undisclosed liens," Fitch said. Standard and Poor's also accepts Radian Lien Protection in lieu of title insurance in rated transactions. (*National Mortgage News Daily Web site*, 11/20/01)

GSE debt news:

- (1) Fannie & Freddie's debt issuance surges during the first nine months of 2001**
- (2) Federal Reserve Bank of New York is considering alternatives to Treasuries for its System Open Market Account**
- (3) Pension funds are looking for an alternative benchmark discount rate as 30-year Treasuries vanish (Merrill Lynch analysts believe there could be "Congressional resistance to designating GSEs as the pension benchmark")**
- (4) Freddie may publish a precise calendar for its euro debt issuance program in 2003**
- (5) Fitch rates Fannie & Freddie's long-term debt "AAA" based in part on Fannie & Freddie's GSE status**
- (6) Fannie completes its first year of sub debt sales**

Background on GSE debt and the supply of Treasuries

- Over the past few years, as the US was running budget surpluses, and the national debt was being paid down, the supply of Treasury securities shrunk. Investors, traders, borrowers, and even the US Federal Reserve were being forced to find new benchmark securities to replace the shrinking number of Treasuries. Among possible alternatives as a benchmark were the debt securities of Fannie and Freddie. Investors viewed them as "almost" as good as US Treasuries because of the implicit government guarantee of Fannie and Freddie's securities. Fannie and Freddie began bond issuance programs (Fannie – Benchmark bond program; Freddie- Reference bond program) to mirror traditional Treasury operations in size and regularity as an alternative benchmark.
- After the September 11 attacks, many economists expected the US to run a deficit and Treasuries would become more available. The economy was unstable even before the attacks, which resulted in boosting US spending on rebuilding and defense. Now, "it's extremely doubtful the US will be running a surplus for the upcoming fiscal year, and probably will run a deficit," said Gerald Lucas, Senior Government Strategist at Merrill Lynch. "Treasury supply will not be decreasing any more." (*Reuters English News Service, 10/3/01*)
- On October 31, however, the Treasury Department announced that it would stop selling 30-year bonds (the "long bonds"), saying the one-time benchmark for measuring other debt was no longer needed to meet the government's financing needs. It is unclear at this point what instrument, longtime users of the long-bonds will use to manage longer duration needs given an end to Treasury's 30-bond issuance. Alternatives to long-term Treasuries include: (1) bonds issued by agencies (Fannie and Freddie); (2) derivatives tied to the swaps market; (3) high-grade corporate bonds; or (4) 10-year Treasuries.

Fannie & Freddie's debt issuance surges during the first nine months of 2001

- Long-term federal agency debt more than doubled during the first nine months of this year, according to the Bond Market Association. "Agencies" is a category which includes the following bond issuers: Fannie, Freddie, the FHLBank System, Sallie Mae, and the Tennessee Valley Authority. Long-term agency debt issuance totaled \$660.8 billion, up from \$319.5 billion issued during the same period last year. Fannie and Freddie together accounted for nearly 60% of long-term federal agency debt issuance. Fannie's long-term debt issuance for the first nine months of the year was \$175 billion, up almost \$100 billion from the same period last year. Freddie's long-term debt issuance was \$168.8

billion for the first nine months of the year, compared to \$65.4 billion for the same period last year. The Bond Market Association also reported that Fannie and Freddie continued to increase their retained mortgage portfolios.

- Short-term federal agency debt outstanding increased 2.7% to \$749.9 billion at the end of September, compared to \$730.5 billion at the end of June. Short-term agency debt outstanding increased across most federal agencies with the exception of the FHLBank System and Sallie Mae. The FHLBank's debt outstanding fell to \$166 billion as of September 30, from \$175 billion at the end of June. The FHLBank System issued \$275.6 billion in long-term debt for the first nine months of the year, compared to \$148.6 billion during the same period last year. Average daily volume of agency securities by primary dealers totaled \$89.3 billion during the first nine months of the year, a 24.2% increase over the \$72.0 billion average daily trading volume in the same period last year. (*Dow Jones Newswire*, John Connor, 11/16/01; *National Mortgage News Daily Web site*, 11/20/01; Bond Market Association press release, 11/20/01)

Federal Reserve Bank of New York is continuing to look at alternatives to Treasurys for its System Open Market Account

- The Federal Reserve Bank of New York is continuing to look at alternatives to Treasurys for its System Open Market Account, Dino Kos, head of the New York Fed system open market desk, said on December 6. Among the alternatives are foreign sovereign debt, Ginnie Mae securities, and an auction/credit facility to add liquidity to the banking system. Kos also said the Fed is considering other alternatives. Part of the need for such alternatives is that the Fed's holdings of the most liquid on-the-run Treasurys is expected to continue shrinking. (*Dow Jones Newswire*, Steven Vames, 12/6/01)

Pension funds are looking for an alternative benchmark discount rate as 30-year Treasurys vanish (Merrill Lynch analysts believe there could be "Congressional resistance to designating GSES as the pension benchmark")

- Reacting to Treasury's October 31 announcement that it would no longer sell 30-year bonds, the pension fund industry is accelerating its campaign for an alternative long-term rate against which funds value their obligations. The Employee Retirement Security Act of 1974 (ERISA) requires that private pension funds (but not public) use the four-year weighted average of 30-year Treasury bond yields as the discount rate when calculating future liabilities for defined benefit plans. Even prior to Treasury's announcement to cancel long bond issuance, the American Benefits Council (a lobbying group that advocates employer-sponsored benefit programs), argued that the 30-year Treasury yield was too low. As a result of the low yield, employers need to invest more money to meet defined benefits in the future.
- The ABC recommended a three-year period in which employers would have the option of substituting a higher rate to discount their future pension obligations. The ABC referred to Moody's Aa corporate bond index (or a comparable rate) as a more accurate rate for use in liability and funding determinations. "This is a short-term recommendation from the Council until the industry reaches consensus upon an appropriate long-term discount rate," said James Delaplaine, vice president of retirement policy at ABC. Pension fund consultant Watson Wyatt & Co. supports the use of Aa corporate rate. However, analysts at Merrill Lynch believe the 30-year swaps rate to be a better

discount rate and think Congress is unlikely to sanction the use of a corporate bond index, as the higher rate could leave the pensions underfunded, which in turn could result in the government guarantors bailing out funds. The Merrill Lynch analysts suggest that long-term agency debt issued by the GSEs could offer an alternative, but they also noted that the regulatory issues and political noise surrounding the GSEs could potentially bring “Congressional resistance to designating GSEs as the pension benchmark.” That leaves the 30-year swap rate “as the most likely candidate to be the next ERISA discount rate,” said the Merrill analysts. “Given the minimal credit risk embedded in swaps and diversified basket underlying LIBOR, we think that Congress should designate 30-year swaps as the next ERISA discount rate,” the analysts added. (*Dow Jones Newswire*, Michael Mackenzie, 11/9/01)

Freddie may publish a precise calendar for its euro debt issuance program in 2003

- Freddie may begin publishing a precise calendar for its euro debt issuance program in 2003, with dates for pricing and settlement, Jerome Lienhard, Senior Vice President for Global Debt Funding at Freddie told *Dow Jones Newswire*. Lienhard explained that one reason why the euro calendar is not as precise as its dollar counterpart is purely logistical and due to the profusion of public holidays across Europe. Lienhard noted that although Freddie has been unable to achieve as cheap a cost of funding in euros as it has in dollars, this has not been an issue for the borrower. “I constantly get this question: didn’t this cost you more? I think that misses the whole point,” Lienhard stated, which is “the access that we see and the potential for growth the euro market has.” Lienhard added, “We think the potential is enormous and it’s unignorable.” (*Dow Jones Capital Markets Report*, Richard Barley, 11/30/01)

Fitch rates Fannie and Freddie’s long-term debt “AAA” based in part on Fannie & Freddie’s GSE status

- Fitch assigned AAA ratings to Fannie and Freddie’s long-term senior unsecured debt. Fitch also assigned AA ratings to Fannie and Freddie’s subordinated debt obligations and preferred stock. Fitch also gave Fannie and Freddie its highest short-term rating of F1+. Fitch said its AAA long-term and F1+ short-term ratings reflect not only the GSE status of the two companies and their strong operating platforms, but their importance to the housing market. Because of Fannie and Freddie’s “sizable role” in the US government’s housing policy and its “prominent position” within the global financial system, Fitch said it believed that the government would take significant steps to provide support to their operations and senior obligations in the event the agencies encountered difficulties. (*Dow Jones Newswire*, Joe Niedzielski, 11/15/01)

Fannie completes its first year of sub debt sales

- Fannie sold its fourth and final subordinated debt offering for 2001 in its first-year of the program. With the latest \$1 billion offering, Fannie has now issued \$5 billion of the subordinated securities and expects to issue up to \$12 billion to \$15 billion of these notes over a three-year period. Fannie said it will sell subordinated notes at least semi-annually starting next year and may expand the program to include maturities other than five- and ten-year notes. (*Reuters*, Lynn Adler, 12/5/01)

Banc of America Securities recommends Fannie & Freddie’s stock in their 10 best stock list

- Fannie and Freddie are two of the top 10 stocks recommended by Banc of America Securities analysts for institutional investors. John Skeen, chief investment officer of Banc of America Securities,

included Fannie and Freddie in his latest “Fresh Money Focus List” of stocks to reflect what he believes are the 10 best stocks in which to allocate new money by institutional investors in the current market. The two GSEs' stocks are also among Banc of America Securities' nine “top defensive picks” in the finance sector. (*National Mortgage News Daily Web site*, 11/27/01)

GSE analyst leaves Salomon Smith Barney – the firm suspends coverage on the mortgage sector

- Salomon Smith Barney analyst Thomas O'Donnell who covers Fannie, Freddie and other mortgage-related stocks, has left the company unexpectedly. O'Donnell ranked as a top analyst in mortgage finance. Salomon Smith Barney also abruptly suspended coverage of the entire mortgage sector. A spokeswoman for Salomon offered no guidance on why the company had suspended coverage of mortgage-related stocks. She would only say that coverage had stopped and that it was too early to say whether or not the move would be temporary. (*National Mortgage News Daily Web site*, 11/19/01; *National Mortgage News*, 11/26/01)

Fannie Mae

Goldman Sach analyst says Fannie's balance sheet is showing an imbalance in Fannie's assets and liabilities, that requires a costly fix

However, the analyst later notes that the increase in mortgage rates in recent weeks may have corrected the problem

- In a November 16 report, Goldman Sachs analyst Howard Shapiro warned about the duration gap of Fannie's mortgage portfolio. A duration gap compares the average life of a portfolio's assets against its liabilities, or debt. A positive gap indicates that the portfolio's assets have longer maturity periods than the liabilities, which means the company will collect income longer than paying on debt. A negative gap indicates that assets will mature before liabilities, which would leave the portfolio holder paying debts for a time without offsetting income. (*American Banker*, Tommy Fernandez, 11/29/01)
- Fannie's duration gap for October fell to negative 10-months, considerably outside its target range of plus or minus six months. That means that the average duration of the mortgages Fannie has on its books is 10 months less than the average duration of its debt outstanding. A strongly negative duration gap could produce future loses for Fannie because it suggests that a greater portion of its assets (mortgages) is likely to be refinanced relative to its liabilities, or debt. This scenario results in Fannie having to pay higher debt-interest payments while receiving less cash flow from its assets. (*Wall Street Journal*, Tyler Lifton, 11/26/01)
- According to Shapiro, the gap is the biggest risk imbalance on Fannie's books since 1998. Shapiro noted that “portfolio rebalancing can eliminate the gap, but there are costs.” He said that Fannie has two ways to rebalance its portfolio: purchase longer duration mortgages while shortening the average duration of its debt by issuing more securities with shorter-duration maturities or adjust its net-duration exposure through derivatives, but these can be costly. Shapiro speculated that Fannie would

use both. “Buying offsetting derivatives is a true expense - and going forward the interest margin will likely be lower than otherwise it would have been,” he wrote. (*Wall Street Journal*, Tyler Lifton, 11/26/01; *American Banker*, Tommy Fernandez, 11/29/01) Still, Shapiro believed that the impact of the negative duration gap on bottom-line earnings at Fannie would be minimal. (*Wall Street Journal*, Tyler Lifton, 11/26/01)

- Other analysts were less concerned about Fannie’s duration gap. Gary Gordon, a managing director at UBS Warburg, said that the duration gap has limitations as a measurement of portfolio health. Fannie calculates the duration gap for a specific day - the last business day of the month - to get a snapshot of the portfolio, Gordon said. Fannie’s latest snapshot was taken October 31, the day the Treasury Department suspended issuance of the 30-year bond. The price of the 10-year Treasury bond rallied in reaction, severely cutting its yield. Consequently, mortgage rates, which are tied to 10-year yields, dropped. Gordon said that Fannie had to estimate a duration figure on a market situation that has already changed considerably in the subsequent three weeks. “I’ll bet that if rates don’t change very much the November duration gap will come closer to zero - maybe plus or minus a few months, but far from” the October gap, he said. (*American Banker*, Tommy Fernandez, 11/29/01)
- Morgan Stanley Dean Witter & Co. analyst Kenneth Posner said that the recent rise in interest rates should naturally improve the gap. “Because of the negative gap the economic value of the portfolio should increase when interest rates rise,” he said. “In my estimation [this is] a total nonissue.” (*American Banker*, Tommy Fernandez, 11/29/01)
- In a subsequent article, it was reported that Shapiro believes that the rise in mortgage rates in recent weeks as Treasury prices fell may have helped to bring Fannie’s duration gap back into line. By driving mortgage rates higher, this would have increased the average duration of Fannie’s mortgage portfolio and reduce the risk of prepayments. “With the bond market selloff that we’ve had, Fannie Mae’s duration gap has very likely changed from negative to positive because mortgage durations have lengthened so much,” said Shapiro. “So the problem has essentially self corrected.” Shapiro added, “The duration gap issue is a theoretical problem... Without any fixing, and without any changes in the broader market, it would put Fannie Mae at earnings risk.” However, “The broader market has changed,” in recent weeks. (*Dow Jones Newswire*, Tyler Lifton, 11/27/01)
- OFHEO said it was unconcerned about the duration gap. “Fannie Mae is altering its risk positions and taking actions that are prudent and should lead to more normalized numbers being reported for November,” OFHEO Director Armando Falcon said. (*American Banker*, Tommy Fernandez, 11/29/01)

Fannie expands its technology for multi-family market

- Proacsys LLC announced that Fannie will use its Metasystem technology to provide multi-family lenders with technology to deliver credit and collateral documents. The technology will enable Fannie’s lenders to deliver each loan to Fannie in electronic form via a Web site developed and hosted by Proacsys. Fannie will also use the workflow capabilities of the Metasystem product to automate a number of its post-purchase activities using the Web-delivered documents. (*National Mortgage News Daily Web site*, 11/27/01)

Fannie appoints Jeff Hayward to senior vice president and names seven new vice presidents

- Fannie announced that its Board of Directors appointed Jeff Hayward to senior vice president – single-family business. The GSE also named Brian Cobb, vice president for enterprise systems and operations; Janet Doss, vice president for single-family business; Clare Evans, vice president for enterprise systems and operations; Kieran Gifford, vice president for credit policy; Denise Grant, vice president and assistant to the chairman; Clarence Hill, vice president for enterprise systems and operations; and Karen Pallotta, vice president for single-family business. (*Fannie press release, 11/20/01*)

Freddie Mac

Freddie plans to expand further into subprime

Freddie plans to begin purchasing subprime loans on a flow basis next year

Freddie is modifying its automated underwriting system to accept more borrowers with blemished credit to further expand into the subprime market

- According to Erick Bergquist with the *American Banker*, Freddie “is poised to become a bigger player in the subprime market next year.” Freddie plans to increase its bulk purchases of newly originated subprime loans and expand its list of subprime lender partners with which it does substantial business. Freddie is also modifying its automated underwriting system, Loan Prospector, to accept more loans from marginal borrowers. (*American Banker*, Erick Bergquist, 12/7/01)
- “We are going to be a player in the marketplace for newly originated subprime mortgages,” said David Andrukonis, Freddie’s senior vice president and chief credit officer of single-family capital deployment. (*American Banker*, Erick Bergquist, 12/7/01)
- Freddie is preparing to expand further into the subprime mortgage market some time next year by purchasing loans on a flow basis, according to Freddie’s Chairman Leland Brendsel. Brendsel told *MortgageWire* that Freddie will continue to take a measured and prudent approach to the subprime market, but it is time to take the “next step.” For several years, Freddie has been partnering with subprime lenders, such as Option One Mortgage Corp., reviewing their loans for securitizations and then guaranteeing the investment-grade tranches (rated AAA to BBB). (Freddie wrapped a recent Option One home-equity deal. See information at the end of this section.) This cautious approach has allowed Freddie to get firsthand performance data on subprime loans while taking very little risk, since the originator or other investors take the first-loss risk. (See earlier story in this *GSE Report* on Fannie & Freddie’s “wrapping” of subprime deals.) Based on this data, Freddie feels more comfortable starting a subprime purchasing program. Brendsel noted that subprime purchases would not be a significant percentage of Freddie’s loan volume next year. (*National Mortgage New Daily Web site*, 12/4/01)

- Andrukonis said Freddie plans to increase its bulk purchases of newly originated loans next year at a “good steady clip,” to \$10 billion, which would represent a 10% to 15% increase from the expected volume this year. The loans will be B and C grade and have Fair, Isaac & Co. (FICO) credit scores in the mid-500s to mid-600s, he said — significantly below the 700-plus scores Freddie is familiar with from its conventional purchases. Freddie also buys newly originated A- loans and seasoned loans from subprime lenders, he said. (*American Banker*, Erick Bergquist, 12/7/01)
- Bergquist noted that some regulatory and political watchdogs, fearing increased taxpayer exposure to the higher-risk subprime market, may be critical of Freddie’s expansion into the subprime market. Tensions may also increase among those interested in containing the GSEs’ expansion into the private sector. Andrukonis said the GSE is comfortable with the increased credit risk exposure from expanding further into the subprime market. He claimed that the GSE has studied the performance of subprime loans since 1996, and has approached the market very conservatively. Freddie also credit enhances the bulk packages with private mortgage insurance to mitigate the risk it is taking on, he said. “We’ve learned a lot. We’ve been doing it for five years, and we’ve built a very good scorecard and developed strong relationships with very good originators.” (*American Banker*, Erick Bergquist, 12/7/01)
- Freddie also plans increasing the number of subprime lenders with which it does substantial business. The GSE currently does business with a number of subprime lenders, but it works primarily with Option One Mortgage Corp. of Irvine, Calif., and Lehman Brothers. Andrukonis said that list could grow to six or more. (*American Banker*, Erick Bergquist, 12/7/01)

Freddie is modifying its automated underwriting system to accept more borrowers with blemished credit

- Freddie plans to modify its Loan Prospector automated underwriting system to accept more borrowers with blemished credit before the end of November, a spokeswoman for the GSE said. Freddie hopes the modifications will increase the number of prime loans it accepts through the system by 6%, to 330,000 a year, the spokeswoman said. (*American Banker*, Erick Bergquist, 12/7/01)
- According to Kenneth Harney with the *Washington Post*, Freddie’s modifications would provide lower interest rates and fees to an estimated 250,000 additional loan applicants annually over the next four years. Harney explains that Freddie’s underwriting system allows lenders to submit borrowers’ applications for a credit evaluation. An “accept” or “accept-plus” decision tells a loan officer that Freddie would buy the closed mortgage at its best currently posted rates and terms. A “caution” tells the lender that Freddie sees the borrower as higher risk -- requiring a higher interest rate or extra fees on the loan -- or a re-submission after the borrower's credit profile has been improved. The rate and fee differentials between “accepts” and “cautions” run from a quarter-percentage point to more than one percentage point. In a 7 percent market, for example, an application that gets an “accept” decision might get a 7 percent rate, but a “caution” could get an 8 percent effective rate including fees.
- The Loan Prospector system currently “accepts” about 75 percent of the loans it evaluates. Under the modifications, the “accept” rate would increase to 80 percent. The additional 5 percentage points -- about 1 million applicants over four years -- would reportedly qualify for the standard rates.

- “We feel we now know which ‘dents’ and ‘dings’ really matter” and “how to weight them” in forecasting future risks of nonpayment, said a Freddie official. The official said the estimated million additional “accepts” expected in the next four years may not all translate into actual loans bought by the GSE. (*Washington Post*, Kenneth Harney, 11/17/01)

Freddie wraps Option One home-equity deal

- Option One Mortgage sold a total of \$2.9 billion of conforming and non-conforming home equity loan-backed paper through joint lead managers Banc of America Securities and Greenwich Capital Markets. The offering featured \$2.54 billion FSPC Freddie Mac-wrapped T-36 series paper, with a 3.12 year average life, which priced at 15 basis points over one-month Libor. Also, \$409.5 million of un-wrapped 2.84 year senior notes priced at 30 basis points over one-month Libor. (*Asset Securitization Report*, Kevin Donovan, 10/15/01)

Freddie believes its effort to pitch its technology to wholesale and correspondent lenders has been successful

- Tommy Fernandez with the *American Banker* reported that Freddie’s year-old effort to pitch its origination technology to wholesale and correspondent lenders is paying off, according to Tricia McClung, Freddie’s vice president in charge of its automated underwriting system (Loan Prospector). McClung said the GSE’s effort to encourage mortgage brokers to use products like the Loan Prospector automated underwriting system has been successful. The GSE is also developing a Web site to give brokers access to a network of mortgage-related product vendors, she said.
- McClung said Freddie did not anticipate that the new campaign would significantly increase its loan purchase volume, because few wholesalers, and no correspondents, sell loans directly to Freddie. However, by improving the technology resources of wholesalers and correspondents, McClung believes it can remove “bottlenecks” resulting from the use of multiple automated software systems.
- In general, the software systems of wholesalers and correspondents now lag those of brokers, she said. “Many correspondents are using an older system” that forces them to input loan information received from their brokers manually, she said. “It’s a bit more of a technology hurdle.”
- Some lenders view Freddie’s push to encourage more industry players to use its software as a threat to their business and are concerned that the proliferation of Freddie’s technology would hurt the acceptance of their own private systems, and that wholesalers with new technology may seek business with banks they were not equipped to work with before. However, a few large lenders have welcomed Freddie’s efforts. Lisa Aldridge, a Charlotte, N.C.-based wholesale lending account executive with Wells Fargo & Co., says initially the company “fought this as much as we could,” because it felt “this was taking away a lot of the control and decision power from us,” she said. Working with Freddie, however, has helped Wells become more competitive in the wholesale loan market, she said. “We just could not afford not to do it.” (*American Banker*, Tommy Fernandez, 11/15/01)

Federal Home Loan Banks

FHFB to issue a proposed rule on FHLBank stock offerings to members

- The FHFB announced that it intends to issue a proposed rule to set forth the process and manner by which a FHLBank may offer capital stock in general solicitation to its members. The rule establishes filing, content and distribution requirements for such general solicitations, and requires disclosure to be consistent with corresponding requirements contained in the Securities and Exchange Commission's Regulations S-K and S-X. The FHFB said a notice of proposed rule-making would be issued in December, with a comment period ending in February. (*Dow Jones Newswire*, John Connor, 12/3/01; *Federal Register*, pages 62680-62683, 12/3/01)

FHLBank System continues to grow, however, FHLBank earnings drop

- The FHLBank System continues to grow, with increases in membership, assets, loans, investments, debt outstanding, and overnight discount note borrowing (in aggregate issuance reached \$2.8 trillion during the first nine months of 2001). According to its new financial report for the quarter ending September 30, the FHLBank System has 7,897 financial institution members, a net increase of 120 since the end of last year. (*Dow Jones Newswire*, John Connor, 11/16/01)
- Total assets of the FHLBanks were \$691.2 billion as of September 30, \$37.5 billion above total assets at the end of last year, while advances to member institutions were \$466.8 billion as of September 30, up \$28.9 billion from the end of last year. Investments held by FHLBanks totaled \$193.7 billion as of September 30, up from \$186.4 billion at the end of last year, with holdings of mortgage-backed securities rising to \$85.4 billion as of September 30 from \$81.3 billion as of December 31, 2000. (*Dow Jones Newswire*, John Connor, 11/16/01)
- System consolidated debt obligations outstanding increased to \$611.3 billion as of September 30, from \$591.6 billion at the end of last year. The daily rolling over of FHLBank System discount notes "led to aggregate issuance of overnight discount notes of \$2.8 trillion during the first nine months of 2001," compared to \$2.4 trillion during the first nine months of 2000. (*Dow Jones Newswire*, John Connor, 11/16/01)
- Total operating expenses for the FHLBanks for the third quarter of 2001 were \$90 million, up \$12 million from the third quarter of last year. Total operating expenses for the FHLBanks for the first nine months of 2001 were \$265 million, up \$29 million from the first nine months of last year. The report attributed the increase in operating expenses primarily to salaries and employee benefits. (*Dow Jones Newswire*, John Connor, 11/16/01)
- The FHLBanks reported a 23.5% drop in earnings in the third quarter, compared with last year, earning \$440 million in the third quarter, down \$135 million from last year. The net interest income before loan loss provision decreased by \$73 million because of the declining net interest margin. "In addition, other income decreased by \$81 million and other expense increased by \$16 million." The report said the \$81 million decrease in other income is primarily related to FAS 133, and resulted in an unrealized gain on securities held at fair value of \$183 million, and a net loss on derivatives and

hedging activities of \$297 million for the first nine months of 2001.” (*Dow Jones Newswire*, John Connor, 11/16/01; *National Mortgage News Daily Web site*, 11/19/01)

- Mortgage loans were \$22.6 billion as of September 30, up \$6.5 billion or 40.2% from the end of last year’s level of \$16.1 billion, and up \$7.9 billion or 54.3% from the September 30, 2000 level of \$14.7 billion. The increase in mortgage loans relates to the expansion of the member mortgage asset programs established by the FHLBanks. (*Dow Jones Newswire*, John Connor, 11/16/01)

Ginnie Mae

Mortgage Bankers Association releases economic stimulus plan that would generate \$58 billion in economic stimulus with no new spending

One of the proposals is keeping the Ginnie Mae guarantee fees at the current level and eliminating the 50 percent increase scheduled to become effective in October 2004

HUD Secretary Mel Martinez praised the MBA’s economic stimulus plan and said he would work with the MBA to gain Capitol Hill and Bush administration support

- The MBA released its priority policy recommendations to stimulate the US economy through housing, which the MBA estimates would generate \$58 billion in economic stimulus with no new spending. The package calls for among other things, repealing the 50% increase in the Ginnie Mae guarantee fee that is scheduled for October 2004. According to the MBA, the guarantee fee increase “amounts to a tax on homeownership” that should be eliminated. Keeping the Ginnie Mae guarantee fee at its current level will save borrowers \$30 million in the first year and \$150 million over five years, according to the MBA. HUD Secretary Mel Martinez praised the MBA’s economic stimulus plan and said he would work with the MBA to gain Capitol Hill and Bush administration support. Ginnie Mae President Ronald Rosenfeld said he would work toward rolling back the Ginnie Mae fee increase. (*National Mortgage News*, Lew Sichelman, 10/22/01; *Real Estate Finance Today*, Mike Sorohan, 10/22/01; *MBA press release*, 10/16/01)

Farmer Mac

Farmer Mac sets new earnings records

- Farmer Mac announced diluted operating earnings per share of \$0.42 for third quarter 2001, a new record and a 75 percent increase over third quarter 2000 diluted earnings per share of \$0.24. Operating income was \$5.0 million for the quarter and \$12.3 million year-to-date, compared to \$2.7 million and \$7.6 million for the same periods in 2000. Operating income, revenues, and earnings per share are measures that exclude the cumulative effect of the change in accounting principles recognized on January 1, 2001 under FAS 133. Net income for the third quarter 2001, including the cumulative and ongoing effects of FAS 133 during the quarter, was \$4.9 million or \$0.41 per share.
- Outstanding loan volume at the end of the third quarter was 37 percent higher than a year earlier, far eclipsing the rate of growth for agricultural debt. With \$4 billion in loans and guarantees in the third quarter, Farmer Mac still accounts for a relatively small proportion of the nearly \$100 billion of agricultural real estate loans outstanding. However, Farmer Mac's share is higher when measured against other institutional lenders, according to USDA data. According to the USDA, some \$75 billion of farmland debt was held by institutions such as banks, insurance companies, and the Farm Credit System as of last February – which would put Farmer Mac's market share at just over 5% of agricultural loans held by institutions. A year earlier, Farmer Mac's portfolio was just shy of \$3 million. (*National Mortgage News*, 10/29/01; *Farmer Mac press release*, 10/18/01)

Postal Service

Senate includes \$600 million for the Postal Service for mail sanitization in its Defense Department Appropriations bill

- The Senate passed its version of the Defense Department Appropriations bill on December 7, after Democrats dropped their plans to add homeland security spending and adopted a smaller substitute instead. Senate Democrats abandoned their effort to add an additional \$15 billion for domestic security to the bill. When procedural votes made clear that the Republicans would be able to block the Democrats' \$15 billion emergency spending add-on, the Democrats settled for a compromise, which shifted billions from military operations into bio-terrorism preparedness, homeland defense and New York's reconstruction in the bill's allocation of \$20 billion in already enacted supplemental spending. Some of the key parts of Senate Appropriations Committee Robert Byrd's (D-WV) original homeland defense proposal were included in the \$8.5 billion portion devoted to terrorism preparedness. The spending includes \$600 million for the US Postal Service. (*CQ Daily Monitor*, 12/10/01; *BNA Daily Report for Executives*, Cheryl Bolen, 12/11/01) [The version, which passed in the Senate Appropriations Committee, included \$875 million for the Postal Service.]
- The Defense Department Appropriations bill will now be decided in conference to work out differences between the House and Senate-passed versions.

- On November 27, the House Rules Committee voted against including an amendment to the Defense Department Appropriations bill that would have provided the Postal Service \$500 million for mail sanitation equipment. The amendment, introduced by Congressman David Obey (D-WI), was defeated 8-2. (*PostalWatch.org Web site*, 11/28/01)

Postal Service recently asked Congress for a \$5 billion financial bailout

- The money approved by the Senate is far less than the nearly \$5 billion the Postal Service had requested earlier. Postmaster General John Potter, testifying before the Senate Appropriations Treasury and General Government Subcommittee on November 8, told lawmakers that the Postal Service needed an immediate \$2 billion to cover lost revenues from the September 11 terrorist attacks and \$3 billion in costs for equipment to sanitize the mail. (*BNA Daily Report for Executives*, Derrick Cain, 11/9/01)
- According to Tony Pugh with *Knight-Ridder*, the problem with the Postal Service’s request for \$3 billion or more to sanitize mail is that the Postal Service hasn’t really explained, even to Congress, how it would decontaminate mail, how soon it could be done, what it would ultimately cost, which of the Postal Service’s 800,000 workers would be protected and whether new decontamination processes will further slow delivery of mail. Moreover, the Postal Service has a special burden when contending against other industries and agencies for post-terrorist emergency federal aid: Under the 1970 Postal Reorganization Act, the Postal Service is supposed to be self-sustaining. Congress doesn’t have to help. (*Knight Ridder/Tribune Business News*, Tony Pugh, 11/28/01)
- President Bush already approved \$175 million to immediately improve Postal Service safety. The administration says the \$175 million should be sufficient for now. (*Dow Jones Newswire*, Jennifer Corbett Dooren, 11/8/01, Alex Keto, 11/8/01)

Government watchdog group lambastes postal bailout and bonuses to postal executives

Postal Service announces \$124.5 million in executive bonuses, while losing \$1.68 billion

“...taking bonuses while they are riding a \$1.7 billion loss and panhandling for a taxpayer bailout is unconscionable,” stated Citizens Against Government Waste Vice President Leslie K. Paige

***Boston Herald* editorial says it’s a “no-brainer” to prohibit the Postal Service from paying bonuses in years where it runs a deficit**

Postal Service announces it will pay out bonuses, while it lost \$1.68 billion in fiscal 2001

- The Postal Service will pay out \$124.5 million in bonuses to executives, managers, supervisors and postmasters for meeting performance goals in fiscal 2001, postal officials announced on December 4. Approximately 61% of the 85,000 Postal Career Executive Schedule managers – the equivalent of Senior Executive Service members – have met their goals for the year.
- The Postal Service also announced that the agency lost \$1.68 billion in fiscal 2001, \$1.2 billion more than anticipated. Postal Service Chief Financial Officer Richard Strasser blamed the additional losses on three factors: (1) the delay in implementing the most recent rate hike; (2) the

recession; and (3) the September 11 attacks. Between September 11 and the end of the fiscal year on September 30, mail volume dropped by 800 million pieces, costing the agency between \$250 million and \$300 million in revenue. (*GovExec.com*, 12/4/01)

Postal service wants to expedite a rate increase

- The Postal Service wants to accelerate implementation of a pending postal-rate increase that it requested in September. The agency's board of governors said at the time that it would seek an increase in the price of first-class stamps by three cents to 37 cents. Strasser told reporters on December 4 that the board is seeking to accelerate the process for reviewing its rate-increase proposal, with a goal of implementing it in June. Normally, the requests take about a year to be implemented. (*Wall Street Journal*, Kathy Chen, 12/5/01)

CAGW lambastes postal bailout and executive bonuses

- The Council for Citizens Against Government Waste (CCAGW) lambasted Senate Appropriations Committee Chairman Robert Byrd's (D-WV) decision to give the U.S. Postal Service (USPS) \$875 million in bailout money without requiring it to initiate long-overdue reform measures.
- CCAGW also blasted the USPS for paying out bonuses. Though the *Washington Post* reported that executive bonuses for 2001 would be \$124.5 million, the actual number according to CCAGW is \$164.1 million. "It doesn't surprise me that there are already conflicting numbers out there. Postal managers are clearly mathematically challenged. Either way, taking bonuses while they are riding a \$1.7 billion loss and panhandling for a taxpayer bailout is unconscionable," stated CAGW Vice President Leslie K. Paige.
- "The USPS is seeking billions in government handouts this year without first committing to reform and streamlining," Paige said. "This agency was hemorrhaging cash this year even before September 11 and the anthrax mailings."
- "In fact, many of the postal service's recent expenditures merit scrutiny by Congress in light of the troubling testimony postal management gave before the U.S. Senate on November 8," Paige said. "Aside from the \$1.6 billion lost to waste, fraud, and mismanagement already documented by the USPS Office of Inspector General, it is difficult to reconcile the postal service's bailout requests with its new slick, multi-million television advertising campaign. Also troubling is that postal management has yet to offer a single substantive proposal to streamline its operations, reduce unnecessary costs, institute a hard hiring freeze, or eliminate money-losing ventures."
- "These folks simply do not get it. This is not the first time they have chosen to reward themselves with hundreds of millions of dollars in executive bonuses while operating in the red," Paige added. "Between 1996 and 2000, the USPS gave out more than \$1.4 billion in bonuses, including \$284 million last year, when it lost money."
- "There will never be reform at USPS until someone ties government dollars to new management," Paige concluded. "The current crew has presided over a financial debacle while avoiding hard choices and rejecting any serious change." (*CAGW press release*, 12/5/01)

- Earlier this year, Congressman Walter Jones (R-NC) introduced a sense of the House resolution to prohibit the distribution of any bonuses in years when the USPS operates at a deficit, a measure CCAGW supported. (*CAGW press release*, 12/3/01)

Boston Herald editorial

- A *Boston Herald* editorial says postal customers and taxpayers should be “outraged” that the Postal Service is distributing executive bonuses while expecting a \$1.7 billion loss this year. The editorial notes that the management-level employees receive the bonuses, while employees that face real risks from anthrax are not part of the bonus program. The Postal Service “continues to operate not as a business but as a government behemoth. Profit and loss are irrelevant as long as it has a monopoly on the delivery of first-class mail and regular opportunities to raid the Treasury.” The editorial calls Congressman Walter Jones’ resolution to prohibit the Postal Service from distributing bonuses when it runs a deficit “truly a no-brainer.” (*Boston Herald*, 12/8/01)

Postal Service defends its bonuses

- Deputy Postmaster General John Nolan and Richard Strasser, the agency’s chief financial officer, told reporters that the Postal Service is legally obligated to make the payments to postmasters, supervisors and other senior managers. Five years ago those groups agreed to forgo regular pay increases in return for what the agency calls a “pay for performance” system, they said. “Are we being overly generous? No. They’ve earned it,” Nolan said. (*Denver Post*, Bill McAllister, 12/5/01)

Fordham University Economics Professor has a plan for privatizing the Postal Service and strengthening its regulator as an alternative to a Congressional bailout

- CNNfn Anchor Jack Cafferty interviewed Rick Geddes, Economics Professor at Fordham University on CNN Money Morning on November 12. Cafferty noted that after losing millions of dollars, the US Postal Service is seeking bailout money from Congress. Cafferty noted that Professor Geddes might have a better way to address the skyrocketing deficits of the Postal Service. Professor Geddes claimed that privatizing the Postal Service might be “a very good first step” in reforming the Postal Service and “would be a big improvement over what we have now.”
- Geddes claimed that the ownership of the Postal Service could be changed so that it’s a publicly traded private company and issue stock in an initial public offering. He noted that Germany and Holland have already privatized their Postal Services and it “works quite well.” The postal services in these two countries are privately owned but they are still required to provide services to all addresses.
- Geddes also recommended changing the structure of the regulation of the Postal Service to give its current regulator – the Postal Rate Commission – enhanced powers. He feels that the regulator doesn’t have sufficient strength or legal authority to thoroughly control the Postal Service. Geddes acknowledged that there could be “substantial resistance” to the idea of privatizing the Postal Service. (*CNN Money Morning*, *CNNfn*, Transcript, 11/12/01)

Citizens Against Government Waste says the Postal Service is using September 11 “as a cover to bail themselves out of big deficits on the taxpayers' tab”

- After September 11, the special interests have come out of the Washington woodwork to ask for every conceivable subsidy, loan, or tax break. “For taking advantage of a national tragedy to lobby for handouts, and attempting to divert crucial resources from national defense during a time of crisis, CAGW names the Beltway Special Interests Porkers of the Month for November.”
- CAGW says the first two culprits are two quasi-government agencies, Amtrak and the U.S. Postal Service (USPS). “Both were wrought with waste well before 9/11, and both see in the terrorism bailouts a chance to get into the black and forestall real reform... The Postal Service has also seen 9/11 as a cover to bail themselves out of big deficits on the taxpayers' tab. The government monopoly has asked for \$5 billion in emergency payouts, a sum large enough to cover new security needs and erase most of its pre-9/11 loss of \$1.65 billion. This new request is particularly vexing, coming as it does, from an agency with more than \$1.4 billion in waste and mismanagement as identified by its own inspector general. By forgoing the \$197 million it paid in corporate executive bonuses last year, USPS could easily afford the \$40 million it is going to cost to sanitize the mail. Instead, USPS is seeking not only a bailout, but to raise first class mail rates by another three cents, ignoring the real causes of its financial deficits. (*PR Newswire*, 11/9/01)

American Business Media President/CEO hopes the Postal Service's request for billions of dollars from Congress will put the Postal Service's recent rate hike on hold

- American Business Media President/CEO Gordon Hughes was pleased that the Postmaster General recently asked Congress for a \$5 billion financial bailout to recoup financial losses brought on by the September 11 attacks and the anthrax scare. “This is great,” said Hughes when he heard the news. “We asked and the USPS [United States Postal Service] delivered.” The ABM/Magazine Publishers of America (MPA) coalition recently increased their lobbying efforts to “push hard” for an ample Postal Service bailout. “When we learned [US Postmaster General John Potter] was asking for a mere \$650 million in aid [post –anthrax attacks], we immediately made our case for more,” Hughes stated. “Our bottom line was in the billions and it looks as if we got it.” Without significant help from Congress, ABM counsel David Straus recently warned members there was a “very real” chance than an already overburdened USPS (\$3 billion in debt for 2001) could increase rates 20% - well above the proposed 10% mark for 2003 and much sooner too (up to September next year from January 2003). (*Phillips Business Information, Inc. MIN'S B-TO-B*, 11/12/01)

Direct Marketing Association would like the Postal Service to request \$6 billion from Congress

- The Direct Marketing Association recommends the Postal Service ask Congress for \$6 billion, said H. Robert Wientzen, president-CEO of the DMA. “We've continued to support the idea that the Postal Service should be compensated not just for the direct costs of the terrorist attacks but for the business losses that have resulted,” he said. The DMA hopes that Congress grants the request before it recesses for the holidays. The DMA recently formed a task force to work on Postal-related issues and is

currently seeking CEOs of companies with significant mailing operations to join the task force.
(*Crain Communications*, Philip B. Clark, 11/26/01)

***Washington Post* reports that the anthrax scare has highlighted the Postal Service's longtime problems**

- A *Washington Post* article noted that mail volume has dropped by seven percent since the September 11 terrorist attacks, declines not seen since the Great Depression. It has lost \$634 million in revenue since September 11 and projects \$2 billion in losses this fiscal year - on top of \$3 billion in expenses to buy devices to detect and kill anthrax spores.
- Senate leaders plan to ask for \$1 billion to help the Postal Service in the short-term, not the \$5 billion requested by the Postal Service. However, White House officials have said the \$175 million President Bush gave the Postal Service out of the \$40 billion emergency fund Congress approved is sufficient for the Postal Service this year. President Bush has threatened to veto any emergency spending beyond the \$40 million. Even if the Postal Service receives a financial boost that may not be enough. "The Postal Service has been notoriously unable to respond nimbly to economic swings. Relations with its labor force have become synonymous with dysfunction," reported the *Washington Post*.
- "The issue has always been, is the Postal Service going to become an efficient businesslike entity or is it going to be an inefficient government entity?" said Postal Rate Commission analyst Robert Cohen, noting that if the Postal Service, which has \$5.4 billion in cumulative losses, were a private firm, it would be bankrupt.
- Congressman John McHugh (R-NY), who has worked on Postal Service reform bills for the last several years, hopes a legislative solution will be considered next year. He agreed that the current crisis has made reform all the more urgent. "McHugh's bottom line is, as we talk about helping out the Postal Service with taxpayers' monies, we need to recognize this is a sinking ship," said Congressman McHugh's chief of staff, Robert Traub. "We can't just send taxpayer money down on a sinking ship. We have to shore it up, too. They're going to burn through whatever money we send them without some ability to adapt and change with the marketplace they operate in." (*Washington Post*, Ellen Nakashima and Andrew DeMillo, 11/27/01)

***Washington Times* op-ed by Edward Hudgins at the Cato Institute says a financial bailout could delay the inevitable privatization of the Postal Service**

- Edward Hudgins, director of regulatory studies at the Cato Institute wrote a commentary in the November 21 *Washington Times* on the Postal Service. Hudgins noted that Postmaster General John Potter is asking Congress for \$5 billion to help the Postal Service recover from the September 11 attacks and the anthrax scare. Hudgins wrote, "But the USPS is unlikely to recover from the downward financial spiral it was in before the September 11 attacks, and a bailout could delay the inevitable privatization that would help postal customers and the American economy." Hudgins wonders why taxpayers rather than customers should pick up the tab for protection of the US mail. "The argument is that the Postal Service is a government monopoly...so they should protect the mail.

But the argument ignores the situation of the USPS that predates the attacks, and the need for the bailout points to the USPS problems that must be addressed.”

- If American policymakers “insist on handing tax dollars to the US Postal Service, they should do so as part of a long-term plan to reorganize the USPS, to place it in private hands, and to remove its monopoly protection. Such an outcome will probably occur in any case. But the transition will be far smoother for postal workers, for managers, for postal customers, and for taxpayers if the need to deal with these terrible attacks is used as an opportunity to do the right thing.” (*Washington Times* commentary, Edward Hudgins, 11/21/01)

***Wall Street Journal* commentary says, “Let the Private Sector Go Postal”**

Commentary says the Postal Service should be opened up to competition

- Brendan Minter, assistant editor of *OpinionJournal.com*, wrote a November 23 commentary for the *Wall Street Journal* on the Postal Service’s request for a financial bailout. “In the war on terrorism the first thing the post office needs to do is surrender -- to market forces. The anthrax scare has only underscored what we’ve known for a long time: The US Postal Service is no longer the efficient and secure organization it needs to be.” Minter noted that Postmaster General John Potter’s solution for his organization’s failings is a multi-billion bailout. “But before Congress drops any checks in the mail, Mr. Potter should account for the practices that have led to so much red ink.”
- Minter added, “There’s a reason Mr. Potter...rounds to the half billion when asking Congress for money. The Postal Service doesn’t have a handle on its finances. Though the post office claims to use generally accepted accounting principles, Mr. [PostalWatch Executive Director Rick] Merritt...says that’s not always the case.”
- “The Postal Service is a bloated bureaucracy. Real reform will only come when it loses its monopoly and is forced to make hard decisions. Those reforms would include closing down inefficient offices and downsizing some of its 850,000 employees - both tricky propositions today.”
- “Supporters of the current system will claim no company can make a profit in the postal market and that universal service requires a monopoly. This simply isn’t true. Even with all its inefficiencies the post office has occasionally turned a profit. Surely a lean competitor could do better. And the post office would have plenty of competitors, particularly if sorting, bulk transport and delivering that ‘last mile’ were opened up to competition. An assortment of companies could then duke it out in those areas where they have a competitive advantage. Such reforms will make the post office more efficient, safe, and profitable. That’s the best way to ensure delivery really does continue through the rain, snow and dark of night, as well as during bio scares.” (*Wall Street Journal* commentary, Brendan Minter, 11/23/01)

***Investor's Business Daily* editorial hopes the Postal Service's financial losses will bring some necessary changes**

- “Snow and rain might not stop the delivery of mail. A flood of red ink, however, may bring some necessary change,” reported the *Investor's Business Daily*. The article noted that the Postal Service reported \$1.7 billion loss in the fiscal year, while Postmaster General John Potter requested \$5 billion from Congress. “Suddenly, the price of mailing a letter goes up with an official rate hike. If the government bails out the post office, taxpayers will be paying twice to mail a letter. The first expense comes when they buy the stamp. The second comes when they have to make up the 2001 shortfall as well as the \$199 million loss from the year before.”
- The article continued, “If the USPS is to operate like the successful business it supposedly aspires to be, then it needs to learn how to cut costs.” The Postal Service is blaming its problems on the effects of the September 11 attacks and anthrax issue. “But that’s not the root of its problems, which are systemic. A \$135 billion loss was projected for the current fiscal year even before the terrorists struck. In many ways, the post office is the author of its own hardships. Its history as a government-protected monopoly has fostered inefficiency...Government bailouts won’t lead to the reform needed to make the USPS profitable and independent of public money...If the losses are to stop, the Postal Service first has to quit acting like it’s still a branch of government. Then it must begin to take the business of business seriously.” (*Investor's Business Daily*, 12/6/01)

***Wall Street Journal* and *Christian Science Monitor* articles say efforts toward Postal Service privatization may be waning**

- A *Wall Street Journal* article by Yochi Dreazen and Andrew Caffrey reported that over the past 25 years, economies around the world are moving away from government and toward market competition of what once were deemed “public services.” However, even before the September 11 terrorist attacks, the beginnings of a “backlash were stirring.” The article noted that “Since September 11, the forward march of the market is stalling and, in some places, shifting into reverse...The price of security...may be tolerating more of the inefficiency of government and settling for slightly slower economic growth.”
- “To believers in the market, the US Postal Service exemplifies the shortcomings of a government monopoly, and there has been mounting interest in privatizing it.” The article noted that one month before the anthrax letters appeared on Capitol Hill, Congressman Dana Rohrabacher (R-CA) approached the Bush administration with a plan to transfer the post office’s assets to its 800,000 employees and require the Postal Service to compete with the private sector. William Henderson, a former postmaster general from 1998 to 2001, endorsed a similar plan on September 2. “But with postal workers on the front line of the war against terrorism and the postal service seeking new taxpayer subsidies, the plan is all but dead.” Congressman Rohrabacher stated, “It’s pretty clear that it would be much, much more difficult to do something as big as privatizing the postal service.” (*Wall Street Journal*, Yochi Dreazen and Andrew Caffrey 11/19/01)
- A *Christian Science Monitor* article noted that since September 11, efforts to privatize everything from Amtrak to the Postal Service are on hold. “In general, the enthusiasm for privatization across the board is waning,” said Don Kettl, a University of Wisconsin political scientist who has written extensively on privatization. “And September 11 has reminded us that more than profits and markets matter to us.” The Postal Service’s financial struggles encouraged some talk of privatization prior to the September 11 attacks. “But now, even as its debt grows, there is less discussion of any such

change - and a recent Gallup survey showing more than 70 percent of Americans approve of the way the Postal Service is handling its duties is another disincentive for privatization.” The stream of government bailouts that industries are seeking makes privatization less appealing, Kettle said. “Why privatize the Postal Service, when they are just going to end up asking for federal money...anyway?”

- “The question now is whether the privatization debate has fundamentally changed, or only temporarily slowed as the nation responds to a crisis,” the article reported. (*Dante Chinni Special to the Christian Science Monitor*, 11/26/01)

President Bush announces Postal Rate Commission nominations

- President Bush announced on November 30 his intention to nominate Tony Hammond to be a Commissioner of the Postal Rate Commission for the remainder of a six-year term expiring October 14, 2004. Hammond is currently the owner and managing member of T. Hammond Company, in Arlington, VA. He held various positions at the Republican National Committee from 1994 to 1999, including Political Director. Hammond was Director of the Missouri Republican Party from 1990 to 1994, and the Legislative Director for Congressman Gene Taylor from 1979 until 1989.
- President Bush also intends to designate George A. Omas to be Chairman of the Postal Rate Commission. Omas is currently the Vice Chairman of the Postal Rate Commission and has been a member since his confirmation in 1997. (*White House press release*, 11/30/01)

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Canfield & Associates, Inc.
801 Pennsylvania Ave., NW, Suite 625
Washington, DC 20004
Phone: (202) 661-2100
Fax: (202) 661-2101
www.canfieldassoc.com