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The **GSE** REPORT™

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- Federal Reserve Bank of Atlanta releases two studies on the GSEs ([p. 15](#))
 - One study examines the federal subsidies that the GSEs receive, noting that there are costs associated with GSE subsidies
 - The study finds among other things:
 - (1) GSEs are large and highly leveraged institutions (more leveraged than the thrift industry)
 - (2) Although the GSEs receive an implicit subsidy, it is still a subsidy
 - (3) Fannie & Freddie are very profitable (particularly compared to commercial banks) which lends credibility to claims that the GSEs are retaining part of their federal subsidies
 - (4) GSEs’ implicit government guarantee may increase risk taking
 - Second study compares Fannie & Freddie’s voluntary risk management initiatives to current banking standards
 - Study finds that the GSEs’ initiatives could be made more effective
 - Unlike banking standards, the GSEs’ initiatives are voluntary and the GSEs can suspend them without any supervisory consequences
- President of the Wisconsin chapter of the Appraisal Institute wants his trade group to seek a congressional end to federal subsidies given to Fannie & Freddie ([p. 18](#))
- Analyst report finds that Fannie & Freddie face competitive risks ([p. 19](#))
 - Fannie & Freddie face “threats of competitive insurgence that are credible, real, and supported by an increasing number of mortgage industry participants”

Fannie Mae and Freddie Mac

- OFHEO issues a correcting amendment to its controversial risk-based capital rule for Fannie & Freddie ([p. 20](#))
 - Merrill Lynch & Co. director says it is unlikely that the rule will become enforceable in its current form
- Fannie & Freddie spent several million dollars on lobbying last year ([p. 21](#))
 - Consumer advocate Ralph Nader stated in June 30, 1999 testimony before the House Budget Committee that some of the GSEs' government subsidies – intended to lower the costs for home buyers – are being diverted to build political and lobbying efforts “designed to make it difficult, if not impossible, for the Congress to provide (or the public to demand) proper oversight or regulatory improvements which would protect the public, increase support for affordable housing or ensure open competition in the mortgage market.”
- *Washington Business Journal* ranks Fannie & Freddie as the top two largest charitable contributors in the Washington, DC area ([p. 21](#))
 - [Editorial Note: While Fannie & Freddie are the largest public companies in the Washington, DC area, they do not pay state and local corporate income taxes by virtue of their GSE status. The GAO estimated that in 1995, Fannie & Freddie's exemption from state and local income taxes was worth approximately \$300 million a year (several million dollars more than their charitable contributions).]
- Fannie & Freddie rank higher in the 2001 Fortune 500 listing – Fannie ranks 20; Freddie ranks 41 ([p. 22](#))

Fannie Mae

- Fannie tries to seek a last-minute exemption from an anti-predatory lending bill in Georgia ([p. 22](#))
 - Bruce Marks, president of Neighborhood Assistance Corp. of America, states, “Like Enron, they [Fannie] want to control every aspect of the market from pricing to supply, but they want to avoid scrutiny.”
- Fannie to offer real-time pricing for lenders selling mortgages to Fannie for cash ([p. 22](#))
- Dexma connects lenders to Fannie's Casefile Data Services ([p. 23](#))
- Fannie further expands its political reach by including Federal and State officeholders in its press conferences and press releases and increasingly using its Partnership Offices in press events ([p. 23](#))
 - Fannie has 51 Partnership Offices open across the country - Fannie opens a new Partnership Office in Wilmington, DE
 - Fannie “wins the gratitude of politicians by staging local events with them, often to ‘announce’ its plans to buy local mortgages...It's almost as if Ford or Microsoft could allow politicians to gain some credit with voters for every Escort or Windows package sold in their district.” - *Wall Street Journal*, Nicholas Kulish & Jacob M. Schlesinger, 7/25/01

Freddie Mac

- Freddie expects to securitize \$10-\$15 billion in subprime loans this year ([p. 26](#))
- Freddie acquires data center in Northern, VA ([p. 26](#))

Federal Home Loan Banks

- Federal Housing Finance Board (FHFB) approves the FHLBank of Atlanta's capital plan (second FHLBank to be approved) ([p. 27](#))
 - FHFB holds public hearing on the FHLBank System's capital plans
 - FHFB regulates the FHLBank System
- FHLBank System's Mortgage Partnership Finance (MPF) and Mortgage Purchase Program (MPP) are growing ([p. 28](#))
 - Seattle FHLBank would like to increase member participation in MPP and supports a stock-purchase requirement on MPP-participating institutions
 - FHLBank of Chicago believes the MPF program will be hurt if the FHLBanks' capital plans are required to include an activity-based stock purchase requirement
 - The capital plans of the FHLBanks of Seattle and Atlanta, which have been approved by the FHFB, include stock purchase requirements
 - MPF and MPP are competitors to Fannie & Freddie in the secondary mortgage market
- Independent Community Bankers of America (ICBA) opposes multi-district FHLBank membership ([p. 30](#))
 - FHFB Chairman John Korsmo hopes for a vote by FHFB board members on multi-district memberships before the end of the year
- FHLBanks had \$600.7 billion of notional amount derivatives at the end of 2001 ([p. 31](#))
- FHFB approves streamlining of its affordable housing program ([p. 31](#))
- FHFB issues final rule reducing the amount of “in person” Office of Finance board of directors meetings per year ([p. 32](#))

Farm Credit System

- Farm Credit Administration (FCA) approves final rule allowing a Farm Credit System institution to terminate its Farm Credit System charter and become a financial institution ([p. 32](#))
- FCA approves final rule removing regulatory barriers to electronic commerce and allows System institutions to communicate electronically with shareholders ([p. 33](#))

Postal Service

- *Wall Street Journal* criticizes Postal Service's transformation plan to turn itself into a Commercial Government Enterprise (CGE) ([p. 33](#))
 - The CGE is modeled after Fannie & Freddie and would keep the Postal Service as a government owned entity, but one that enjoys some of the operational and financial flexibility found in the private sector
 - *Journal* calls the CGE an "oxymoron" that would "combine the benefits of a private business with the special privileges of a government"
 - "So long as America insists on retaining universal service and rules out privatization, the U.S. mail is going to have cost problems. But that's an argument for the Postal Service doing its original mission better, not for letting it monopolize more of the efficient private economy."
- Computer and Communications Industry and Citizens Against Government Waste (CAGW) criticize the Postal Service's e-commerce initiatives ([p. 34](#))
 - Free Congress Foundation criticizes the Postal Service's "abysmal" privacy record
- *Atlanta Journal and Constitution* editorial says that until a Postal Service reform plan is presented that "addresses how to trim the Postal Service's 850,000 work force, remove antiquated labor rules and close facilities, the proposals and deliberations will be nothing more than rearranging the deck chairs on the Titanic" ([p. 36](#))
- Postal Service Board of Governors officially approves increase in postage rates to take effect on June 30 ([p. 36](#))
 - The cost of a first-class stamp will increase from 34 to 37 cents
- Postal Service had a \$303 million net loss in the second quarter ([p. 37](#))

Major Events

Fannie buys back mortgage-backed securities (MBS) for the first time

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Investors and lawmakers say Fannie abused its status as a GSE by failing to clearly disclose the buy backs

Buy back renews calls for Fannie & Freddie to be subject to SEC disclosure requirements – Fannie & Freddie are the only two publicly traded Fortune 500 companies not subject to SEC disclosure and registration rules

Buy back prompts an inquiry by the Bond Market Association

Investors complain to the Office of Federal Housing Enterprise Oversight (OFHEO) – Fannie & Freddie’s safety and soundness regulator – OFHEO says it will review the buy backs

Investors complain to Capital Markets Subcommittee Chairman Richard Baker (R-LA) – his staff is gathering information

Fannie claims it notified OFHEO *before* the buy back – a day later, Fannie and OFHEO state that Fannie notified OFHEO *after* the buy back

After heated criticism, Fannie rescinds the MBS buy back and says it will not conduct any further MBS buy backs

Timeline:

March – Fannie buys back an estimated \$1.5 billion of outstanding MBS issued before 1993

April 5 – Becomes widely known that Fannie exercised the buy backs – Investors are upset

April 5 -11

Investors complain to lawmakers and OFHEO

Lawmakers renew call for subjecting Fannie & Freddie to SEC requirements

OFHEO begins gathering information

Bond Market Association starts inquiry

April 10 – Fannie discloses buy back rules on its Web site

April 10 – Fannie says it reserves the right to buy back even more MBS

April 10 – Fannie claims it notified OFHEO before the buy back

April 11 – Fannie and OFHEO claim Fannie notified OFHEO after the buy back

April 12 – Fannie rescinds MBS buy back and says it will not conduct any further MBS buy backs

Fannie bought back an estimated \$1.5 billion of outstanding MBS

- For the first time in its history, Fannie exercised its right to call certain mortgage-backed securities (MBS), which Fannie referred to as a “cleanup call.” In March, Fannie bought back an estimated \$1.5 billion of outstanding MBS issued before 1993. (*Dow Jones Newswire*, Joy C. Shaw, 4/5/02; Julie Haviv, 4/9/02) The move was estimated to cause investors to lose an estimated \$130 million in March. Investors stand to lose an additional \$700 million as prices fall, reflecting the threat of more debt redemptions, according to estimates by Lehman Brothers. (*Bloomberg*, Al Yoon, 4/10/02) The call spurred losses for participants in the market because the repurchase price was several dollars

lower than the levels where those MBS were trading and also because of the early payments on the MBS, according to analysts. (*Dow Jones Newswire*, Julie Haviv, 4/9/02) On April 5, Fannie confirmed that it had exercised its buy back rights for the first time in the month of March. (*Dow Jones Newswire*, Rebecca Christie, 4/10/02)

- Fannie's call back was estimated to cost investors at least \$100 million, according to analysts. "You can assume that if someone loses \$100 million on this MBS move that someone else (Fannie) stands to gain \$100 million," one investment banker said. A Fannie spokesman said the underlying mortgages eventually will be transferred to Fannie's retained portfolio. He had no estimate on how much the call would benefit Fannie. (*National Mortgage News*, Bonnie Sinnock, 4/15/02)

Fannie claims it disclosed the right to exercise buy backs in its prospectuses

- While the actual buy backs became widely known on April 5, the right for Fannie to exercise them was disclosed in the prospectuses of Fannie MBS, according to a Fannie spokesman. (*Dow Jones Newswire*, Joy C. Shaw, 4/5/02) Fannie said the buy backs, while rarely invoked, are clearly spelled out in its investment prospectuses. "We always have the option to do it. It's always been disclosed," said a Fannie spokesman. (*Reuters*, Richard Leong, 4/8/02) Fannie's spokesman Robert McCarson said Fannie disclosed its option to repurchase the securities when they were sold, mostly in the late 1980s and early 1990s. "There is an obligation for the investor to read the prospectus and understand the risks of the security they are investing in," said McCarson. (*Bloomberg*, Al Yoon, 4/10/02)
- **Many market participants did not even know about Fannie's cleanup calls until what one called "unbelievably high" prepayment speeds for the month of March were posted on April 5. "I thought to myself, this must be a mistake," said one MBS researcher upon examining the data.** (*Investment Dealer's Digest*, Adam Tempkin, 4/15/02)
- The prospectuses allowed Fannie to call MBS issued before 1993, if the outstanding balance of these securities fell to 10% or less of the original balance. In an internal Fannie memo, obtained by *Dow Jones Newswire*, Fannie said it is "exercising its call rights at this time for a variety of purposes, including but not limited to a reduction of the number of MBS pools that are almost completely paid off and the administrative burdens involved with maintaining such MBS pools." The Fannie spokesman said Fannie didn't exercise these calls earlier because the GSE only recently acquired the "operation ability" to identify these small, seasoned mortgage pools. He said Fannie would exercise its cleanup call options in the future when market conditions allow, and Fannie would hold the whole loans stemming from the called securities in its portfolio until the loans were retired. Investors holding those called MBS would receive the unpaid principal balance on the securities, plus one month's accrued interest, in the same fashion as if the mortgage loans backing MBS had been paid off, Fannie said. (*Dow Jones Newswire*, Joy C. Shaw, 4/5/02)
- A Fannie spokesman said it bought back these loan pools because it was expensive to service and track them. Some of these pool balances contain only one loan outstanding or are currently worth as low as \$500. "It's a cost-cutting measure," the spokesman said. Previously Fannie did not exercise the buy back option because it was difficult to track older mortgage bonds. But Fannie earlier this year installed new software programs that made it easier to identify these low-balance loan pools, the Fannie spokesman said. (*Reuters*, Richard Leong, 4/8/02)
- Fannie's spokesman Robert McCarson said Fannie did not warn investors of its buy backs because "it would have been the functional equivalent of doing what we did." However, Fannie did signal in its March 2002 prospectus that it might be a good idea to review the rules governing outstanding

securities, he said. Investors should have been more fully aware of the characteristics of the securities, which have always been stated up front, he said. "It was disclosed to investors in the prospectus as a possibility. People bought an instrument with an embedded option and that option was exercised," he said. (*Dow Jones Newswire*, Rebecca Christie, 4/10/02)

- **Investors, however, said that the information on Fannie's call was in the firm's pre-1993 documents. But Fannie's Web site did not even have any documents pre-1994. So investors, in effect, did not have access to the documents where this call provision was actually allowed.** (*Asset Securitization Report*, 4/22/02)

Fannie claims it notified OFHEO prior to the buy back – a day later, Fannie and OFHEO stated Fannie notified OFHEO after the buy back

- **Fannie maintained that it checked with OFHEO prior to using its first-ever cleanup call. A Fannie spokeswoman said on April 10 that Fannie checked with OFHEO before it took action in March and that Fannie has continued to communicate with OFHEO.** (*Dow Jones Newswire*, Dawn Kopecki, 4/10/02)
- **"Fannie Mae and Freddie Mac are not required to seek OFHEO's pre-approval to exercise their call rights and we were not informed of Fannie Mae's intention to call their MBS before they acted," said OFHEO Director Armando Falcon. "We are gathering all the relevant facts related to this matter."** (*Dow Jones Newswire*, Dawn Kopecki, 4/11/02)
- **Fannie and OFHEO stated on April 11 that Fannie first contacted OFHEO on April 8 after Fannie had conducted its first-ever cleanup call of MBS. OFHEO knew about the possibility of the cleanup call because of its general oversight practices, said OFHEO spokeswoman Stefanie Mullin. However, Fannie did not check in with OFHEO until April 8, after the cleanup call was disclosed.** Fannie acknowledged the April 8 contact with OFHEO on April 11. It said that its April 10 statement that it talked to OFHEO last month before the cleanup call was due to internal miscommunication. (*Dow Jones Newswire*, Rebecca Christie, 4/11/02)

Investors and lawmakers say Fannie abused its status as a GSE by failing to disclose the buy backs

- **Investors and lawmakers claimed Fannie abused its status as a GSE by failing to disclose the buy backs, reported Al Yoon with *Bloomberg*. The buy back renewed calls by some lawmakers to subject Fannie and Freddie to SEC requirements.** (*Bloomberg*, Al Yoon, 4/10/02)

Lawmakers renews calls for Fannie & Freddie to be subject to SEC requirements

- **"Fannie Mae needs to be closely looked at," said Congressman Christopher Shays (R-CT). Congressmen Shays and Edward Markey (D-MA) introduced a bill (HR 4071) on March 20 that would repeal Fannie and Freddie's exemption from SEC registration requirements. The buy backs are an example of how Fannie "basically operates with some impunity," said Congressman Shays. "I think people realize it's a gorilla in a china shop."** (*Bloomberg*, Al Yoon, 4/10/02)
- **"It sounds like a tacit acknowledgement that there may have been some disclosure problems," said Jeff Duncan, an aide to Congressman Markey, after Fannie announced it was rescinding its buy back. "Perhaps if they had registered with the SEC, they wouldn't have gotten into this mess," Duncan said.** (*Bloomberg*, Liz Goldenberg and Al Yoon, 4/12/02)

Investors complain to OFHEO

- **OFHEO said it received two dozen complaints about Fannie's buy backs.** (*Reuters*, Richard Leong, 4/15/02) **"We forwarded all the letters and substance of the phone calls to our general counsel's office for review,"** said OFHEO spokeswoman Stefanie Mullin. **"We're not sure what action, if any, we'll take at this point. I think that there was definitely concern that they were caught by surprise."** (*Dow Jones Newswire*, Dawn Kopecki, 4/10/02)

Investors complain to Capital Markets Subcommittee Chairman Richard Baker (R-LA)

- **Congressman Baker received a letter from an investor that said, "this is theft by a so-called 'government agency.'" Congressman Baker's office, which received several complaints about the buybacks, released the letter to the press. "We will examine the market implications of this,"** Congressman Baker stated. **He added that his staff is gathering information on the buy backs. He said his subcommittee plans to hold another round of hearings this year on the GSEs. Topics could include the Shays-Markey bill and the Bush Administration's views of the GSEs.** (*Bloomberg*, Al Yoon, 4/10/02)

Buy back prompts an inquiry by the Bond Market Association

- **The buy back prompted an inquiry by the Bond Market Association (BMA).** The BMA is seeking information from Fannie about the rationale for the call, according to an official, who said the unpredictability of the transaction was a concern of investors. **"Predictability is always an issue and important to the industry,"** said Laura Marcano, assistant general counsel for the BMA. **"This is an issue that caused our members to pick up the phone and call us."** (*Dow Jones Newswire*, Julie Haviv, 4/9/02)
- **Myra Danridge, a spokesman for the BMA, said that the BMA would like to "better understand how this exercise operates within existing governing transaction and disclosure documentation. Pending receipt of such information, as well as additional discussions with our members, we will determine which steps, if any, to take. We will at a minimum send a letter to Fannie Mae, requesting additional information or clarification in expressing our concerns, if any. We will make this correspondence public once we submit it."** (*Bloomberg News*, Liz Goldenberg, 4/9/02)

American Enterprise Institute's Peter Wallison said the issue is Fannie's disclosures, which are not subject to SEC requirements

- **AEI's Resident Fellow Peter Wallison said some investors complained that Fannie's buy back caught them by surprise because Fannie didn't fully disclose their right to call the securities. Fannie said the option was disclosed. "The main issue that it raises is a question of disclosure. There is legislation introduced in Congress that would require Fannie and Freddie to file" documents with the SEC for all debt sales, he said. There was "not full and complete disclosure of the fact that Fannie was able to call these securities. As a result, those who purchased the securities lost a great deal of money,"** Wallison said. **This "goes directly to the issue of whether Fannie and Freddie are adequately disclosing information and whether they should be required to file registration statements and prospectuses with the SEC."** (*Bloomberg News*, Liz Goldenberg, 4/9/02)
- Wallison added, **"If you had your lawyer review these things every time you bought securities, it would be a 'possibility' that you would have known about the call option, but to do that you would have to have a master trust indenture first. That is different from what the SEC requires, which is the document used to sell the security, it describes the security,"** he said. **"The dealers may not even have known, if they don't look at the master indenture document either. They are just salesman. Someone has to put out in the public where people can see it, the terms of these instruments,"** Wallison said.

“Ultimately that is the responsibility of the issuer. Also, it may be the dealers have some legal liability here for not disclosing it to the buyers. The initial obligation for disclosure, however, is on the issuer of the securities,” he said. (*Bloomberg News*, Liz Goldenberg, 4/9/02)

Freddie and Ginnie Mae do not have the same call options

- Freddie and Ginnie Mae do not have the same call options like Fannie, analysts said. “We don’t have the same clean-up provision as Fannie Mae,” a Freddie spokeswoman said. (*Reuters*, Richard Leong, 4/8/02) “The important distinction that needs to be made is that our call provisions are completely different than Fannie Mae’s,” said Freddie spokeswoman Sharon McHale. “We don’t have call provisions on our mortgage-backed securities.” However, Freddie does have the right to recall a handful of structured finance securities issued in the 1980s. However, McHale said the option differs from Fannie in that the holder of the security would realize any financial gain. “So it’s a night-and-day differentiation between us and Fannie,” she said. (*Dow Jones Newswire*, Dawn Kopecki, 4/11/02)

Investors’ comments about the buy backs

- **MBS market participants said Fannie’s buy backs seriously disrupted the secondary mortgage market.** MBS participants said Fannie’s buy backs threw the secondary market for higher coupon and seasoned collateral into utter disarray. **“We’ve been at a complete standstill for the whole week because of this,” said one MBS trader who requested anonymity.** He noted that there was almost total unwillingness for mortgage desks to bid on premium highly seasoned Fannie and Freddie paper during the week of April 8. Some investors were burned because they suddenly had their MBS investments returned to them through Fannie’s call and had to re-invest the money, sometimes at a loss because of lower interest rates. These players now fear that Fannie’s call will not be a one-time event, and that further calls may threaten their portfolios. “If Fannie doesn’t change its position and indicate that it’s a one-time event, this will be something of an analytic mess,” said another MBS market official. (*Investment Dealer’s Digest*, Adam Tempkin, 4/15/02)
- **“I along with our customers were shocked by the sudden decision by Fannie Mae to exercise these cleanup calls,” said Rob Fine, president at Descap Securities, a New-York based institutional bond broker-dealer. “I’m disappointed that investors were not well warned in advance.”** (*Reuters*, Richard Leong, 4/10/02)
- **“This is an extremely disruptive event,” said Andrew Kowalczyk, president and chief executive officer at AK Capital LLC, a broker dealer who lost money on the repurchase.** “There is no one who could say they saw this coming.” He added, “I’ve been contacted by over 10 people who lost 10 percent to 20 percent of their principal...Their year has been ruined.” (*Bloomberg*, Al Yoon, 4/10/02) **Kowalczyk said Fannie “stretched the bounds of fair play”** by going out of its way in its latest prospectus to say that bonds placed in new mega pools are subject to the pre-1993 10% call, not the post-1993 1% call. “They have securitized these pools into megas up until last month, and they charged people last month for new 30-year securities and called them away the following month,” he said. “Fannie Mae may have been planning this. They had this in the planning stage. And a month later, they called this security.” (*Dow Jones Newswire*, Rebecca Christie and Julie Haviv, 4/10/02)
- “It was a surprise to the market because the market was lazy and never looked at their prospectuses,” said Gerald Lucas, senior government bond strategist at Merrill Lynch. **“It left a bad taste in a lot of investors’ mouths, and it’s introduced a little uncertainty.”** (*Dow Jones Newswire*, Rebecca Christie, Julie Haviv, 4/10/02)

- Mitch Flack, portfolio manager and mortgage specialist at Metropolitan West Asset Management stated, “There’s quite a bit of confusion now in the marketplace. Specifically, there’s no longer clarity as to which pools may or may not get called.” Because pools included in other securities, such as collateralized mortgage obligations, are not subject to the call, “you have pools that look like they should’ve been called but weren’t called. That’s basically a lack of information and clarity because now there’s uncertainty as to whether a pool should be called going forward.” “Freddie Mac and Ginnie Mae don’t have those calls at the pool level. Now Fannie Mae has done something different from Freddie Mac. If Fannie Mae pools start to trade more poorly, Fannie Mae may begin to suffer in price relative to the other agencies.” He added, “They certainly made a decision based on current income rather than potential future expense. **They had every right to do what they did, but on the other hand, they did something that was certainly a surprise to the market, and they have to recognize that there are alternatives to Fannie Mae securities.**” (*Bloomberg News*, Elizabeth Stanton, 4/9/02) Flack said investors didn’t expect Fannie to call these bonds in part because Fannie had not opted to call them in the past. Also, Fannie’s competitors – Freddie and Ginnie Mae – do not have the same call option. As a result, Flack said, “it was largely assumed that Fannie Mae would avoid calling these to not leave a bad taste with investors.” (*Bloomberg News*, Elizabeth Stanton, 4/12/02)
- The fallout from calling the bonds early could change how some of the \$1.3 trillion in mortgage securities guaranteed by Fannie could be valued, according to Dave Geller, a mortgage-backed trader at William R. Hough & Co. in St. Petersburg, FL. **“We’ve got investors that lost a ton of money because of this,” said Geller. “Everyone was blindsided by it.” Geller and other mortgage bond players claimed that the risks of early calls backs for these older mortgage bonds were not clearly spelled out in available reference sources, and only became aware of Fannie’s buyback after its monthly prepayment data on the bonds were released on April 5.** (*Reuters*, Richard Leong, 4/8/02)
- **“It’s unfortunate that Fannie Mae made sort of a sudden move,” said Andrew Davidson, president of Andrew Davidson and Co., Inc., a securities valuation modeling expert. “What may have been value maximizing for them may not have been the best thing for the mortgage market.”** (*National Mortgage News*, Bonnie Sinnock, 4/15/02)
- One bond fund manager who declined to be identified, said he lost \$10 on each \$1000 mortgage bond that Fannie recalled in March. (*Reuters*, Richard Leong, 4/8/02)
- The controversy surrounding Fannie’s buy back reminded bond dealers’ of their frustration with the way the Treasury Department discontinued the 30-year bond last fall, a move that had been long discussed but was carried out without any advance notice of its timing. Analysts said Fannie doesn’t have as strong a need to be as consistent. While the GSE has increased its predictability in recent years to create a smoother market for its securities, it still doesn’t face the same pressures as Treasury. “I wouldn’t say that they are on par with Treasury in terms of predictability, nor would you expect them to be,” said Stephen Stanley, senior market economist at Greenwich Capital Markets. “They’re also a private company, so they don’t have the same pressure to cater to the public interest.” **However, one mortgage analyst that requested anonymity said Fannie’s implicit government guarantee should hold it to a higher standard than other private companies. The analyst said it seemed dicey for Fannie to say it is there for homeowners and gets government benefits, but also reserves the right to exercise its fine print without warning. “It’s hard to make the case for what they did here,” the analyst said.** (*Dow Jones Newswire*, Rebecca Christie and Julie Haviv, 4/10/02)

- **A number of market participants said they did not want to be quoted for attribution due to the heavy politics surrounding the GSEs. (*National Mortgage News*, Bonnie Sinnock, 4/15/02)**

Fannie posts its buy back rules on its Web site and says to expect more buy backs

- Fannie posted documentation on its “cleanup” call rules on its Web site on April 10. “We made a decision yesterday (April 9) that in the spirit of using the Web to make this information even more accessible than it already was, that we are going to publish this,” said McCarson. Fannie’s new posting included a fact sheet on cleanup call rules, as well as the prospectus language covering all securities from the program’s origin in 1981 until 1993, when the call option on new MBS was revised to a 1% threshold from the 10% threshold. While public, this information was not previously available on the Web, although more recent information has been. The rules were revised again in March 2002 to allow Fannie to call securities if only one loan remains outstanding. (*Dow Jones Newswire*, Rebecca Christie, 4/10/02; *Dow Jones Newswire*, Julie Haviv, 4/11/02)
- It was reported on April 10 that Fannie said it was also reserving the right to buy back more of its bonds if market conditions are favorable. As much as \$8 billion in securities issued before 1993 are eligible, according to market analysts. “We will monitor market conditions and if it’s appropriate will take steps that are consistent with a prudent management of the portfolio,” said Fannie’s spokesman Robert McCarson, adding that nothing was scheduled in the near-term. “According to Fannie, they are going to exercise these options regularly in the future,” said one agency analyst who asked not to be identified. (*Dow Jones Newswire*, Dawn Kopecki, 4/10/02, 4/11/02)

OFHEO advises Freddie to also post its buy back rules on its Web site

- OFHEO advised Freddie on April 11 to publicly post its buy back rules, in light of the controversy surrounding Fannie’s recent buy backs. “We have advised Freddie Mac that it would be appropriate to post their call provisions on their Web site,” OFHEO Director Armando Falcon said. Freddie does plan to post its call provisions on its Web site. (*Dow Jones Newswire*, Dawn Kopecki, 4/11/02)

After heated criticism, Fannie rescinds the buy back and says it will not conduct any further MBS buy backs

- **Fannie announced late on April 12 that it was rescinding all of its April 4, 2002 MBS “cleanup calls” and said it would not exercise any further cleanup calls. The about-face was a major embarrassment for Fannie, which earlier in the week, had warned investors to expect more cleanup calls in the future.** In addition to rescinding the April 4 redemption, Fannie said it would not exercise any further MBS cleanup calls, though it retained its rights to call certain debt instruments, such as callable debt, that it uses to manage interest-rate risk. (*Wall Street Journal*, Patrick Barta, 4/15/02)
- “Fannie Mae’s exercise of a cleanup call on our older MBS was a business decision,” said Freddie Executive Vice President and Chief Financial Officer Timothy Howard. “However, the benefit arising from that decision has clearly been outweighed by concerns investors have raised and the market confusion that has been caused,” Howard said. “Therefore, we are rescinding these cleanup calls, and will eliminate the cleanup call provision on all our MBS.” The rescission represents an about-face by Fannie, spurred, according to Fannie’s Howard by the concerns of customers. It became clear to top Fannie officials that the administrative efficiencies and savings associated with the cleanup call weren’t worth the heat the company was taking on the buy backs. (*Dow Jones Newswire*, John Connor, 4/12/02)

- “The announcement today means revised factors will be released for all MBS covered by the April 4, 2002, cleanup call, and for all Megas, REMICs and Stripped MBS payable on the 25th day of the month that include, in whole or in part, any MBS that were included in the rescinded call,” Fannie said. “We will be working with the Federal Reserve to ensure correct principal and interest remittances are distributed in the April 25 disbursement,” Fannie said. “The revised factors will be available at 4:30 p.m. on April 17.” Fannie said the rescission will also include MBS contained, in whole or in part, in REMICs payable on the 18th day of the month. It said the April 18 payments will be made based on the factors released April 4. “However, future payments on these REMICs will be adjusted in accordance with industry practice to fully reflect the cleanup call rescission. (*Dow Jones Newswire*, John Connor, 4/12/02)

Comments about Fannie’s rescission

- **“David beats Goliath,” said Andrew Kowalczyk, president and chief executive officer at AK Capital LLC, a broker-dealer that owned some of Fannie’s older MBS bonds.** (*Bloomberg*, Liz Goldenberg and Al Yoon, 4/12/02)
- **“This was a nasty move. This was a huge disrespect to its investors,” said James Midanek, director of fixed income at Turner Investment Partners in Walnut Creek, CA, who manages \$650 million in bonds.** (*Reuters*, Richard Leong, 4/15/02)
- The MBS market started to reevaluate premium securities on April 12 in the wake of Fannie’s surprise announcement that it was rescinding all of its April 4 “cleanup calls.” There will now be some really angry sellers and happy buyers of premium Fannie Mae mortgage-backed securities, said James Nimberg, mortgage strategist at Credit Suisse First Boston. “It’s a total capitulation on Fannie Mae’s part,” he added. After the calls became known on April 12, some investors sold seasoned Fannie premium securities at lower prices, taking into account the faster prepayment speeds that the calls would have endangered. “We told people not to trade,” Nimberg said. “And there were many ways to get around the cleanup calls like REMICS, but some people sold anyway.” Amitabh Arora, prepayment analyst at Lehman Brothers, was also surprised by Fannie’s rescission. **“Fannie Mae got a lot of heat from investors, even though it was within Fannie Mae’s legal rights to do it, but the way it was done wasn’t appropriate to investors,” he said. “I am completely taken aback by this development.”** Arora believed Fannie might have felt the timing was bad and that it would have hurt them in the long run because the call risk would drive down the value of Fannie’s MBS. **He also thought that with so much political scrutiny, Fannie probably felt the reversal would mute critics.** (*Dow Jones Newswire*, Julie Haviv and Joy C. Shaw, 4/12/02)
- Some investors sold seasoned premium securities at lower prices the week of April 8 and now are unhappy with Fannie’s sudden 180-degree turnaround. **“There are few winners out of this whole episode, perhaps only the holders of seasoned or low loan-count premium pools, who did nothing last week,”** said Charles Smart, senior vice president at First Tennessee Capital Markets, Memphis. **“Fannie Mae certainly didn’t cover itself with glory, looking sneaky and uncommunicative to some, then indecisive by reversing course after a week of market turmoil,”** Smart added. **“In an attempt to bend over backwards to placate the markets, Fannie Mae has given up the future opportunity to cleanup some real administrative costs,”** he said. (*Dow Jones Newswire*, Julie Haviv, 4/15/02)
- **“The call feature was not highly visible like corporate and municipal bonds with bondholders,”** said Rob Fine, president at Descap Securities, a New-York based institutional bond broker-

dealer. “I feel very comfortable that Fannie Mae did the right thing,” he said regarding Fannie’s rescission. (Reuters, Richard Leong, 4/15/02)

- **“What concerned me the most was the confusion,” said Mitch Flack, portfolio manager and mortgage specialist at Metropolitan West Asset Management. Now investors will “be able to move on and invest in Fannie Mae securities as they have in the past,” he said. For Fannie “to have corrected it so quickly is to their benefit.” (Bloomberg, Liz Goldenberg and Al Yoon, 4/12/02)**
- **One MBS strategist said Fannie was not even being truthful when it said (as part of its release announcing the elimination of the cleanup call), “On April 4, 2002, Fannie Mae announced a plan to exercise a cleanup call of MBS totaling approximately \$1.5 billion of unpaid principal.” “They said they announced a call. That’s not accurate,” said one strategist. “They never announced anything. They merely announced the factors and everybody else sort of figured it out. Somebody in Fannie Mae acknowledged it off the record but they didn’t put up anything on their Web site until Thursday April 11 at 7:15 a.m.” (Asset Securitization Report, Karen Sibayan, 4/22/02)**
- **Mortgage-industry experts said Fannie appeared to have underestimated the fallout from its actions, and some bond buyers said they suspected the company was worried about losing business. “If there were even the slightest backlash, Fannie could have lost some of its market share” to Freddie, said Laurence Penn, managing director of Ellington Management Group, an investment management company in Greenwich, CT, and buyer of Fannie securities. He added that some bond dealers had begun alerting customers when they had bond sales that didn’t include Fannie securities, presumably because they thought investors would be more attracted to such sales. (Wall Street Journal, Patrick Barta, 4/15/02)**
- **One veteran investment banker said Fannie's decision to buy back the MBS “started a riot.” He added that, “This just goes to show that Fannie is trying to make a buck anywhere it can.” He also raised the issue that bond investors might have raised a legal challenge to the cleanup call.” A senior mortgage market observer said that he believes Fannie’s decision shows that “politics won” over the cost savings the GSE would have obtained. He believes the issue was particularly sensitive given complaints to politicians and a recent pressure for the GSE to disclose more in its securities transactions. (National Mortgage News Daily Web site, 4/15/02)**
- **Fannie enjoys low borrowing costs as a GSE and “can afford to be generous” to investors who had complained, said James Cusser, who manages \$1.1 billion in fixed-income assets at Waddell & Reed in Overland Park, KS. “It’s easy virtue,” Cusser said. “I can’t think of another reason they’d do something against their financial self-interest.” (Bloomberg, Rob Wells, 4/15/02)**
- **“They cut their losses for fear the controversy would help move this [SEC] legislation forward,” said FM Watch executive director Michael House. “This clearly shows the need for effective oversight, which only the SEC can provide.” (Bloomberg, Rob Wells, 4/15/02)**

OFHEO’s comments on the rescission

- **OFHEO applauded the rescission. “We support this move,” said OFHEO spokeswoman Stefanie Mullin. She declined to discuss the conversations OFHEO had with Fannie over the buy back issue. OFHEO is completing its review of the mortgage bond repurchases. (Bloomberg, Liz Goldenberg and Al Yoon, 4/12/02)**

BMA's comments on the rescission

- “We are very pleased and appreciative of Fannie Mae’s responsiveness on this issue, which was of significant concern to market participants,” said Laura Marcano, BMA’s assistant general counsel. (*Reuters*, Richard Leong, 4/15/02)

OFHEO announces comprehensive review of Fannie & Freddie’s financial disclosures to compare with other publicly traded companies

Review will be conducted with the assistance of the SEC

Fannie & Freddie are the only two publicly traded Fortune 500 companies not subject to SEC disclosure and registration rules

Congressmen Chris Shays (R-CT) and Edward Markey (D-MA) have introduced a bill (HR 4071) that would repeal Fannie & Freddie’s exemption from SEC requirements

- OFHEO Director Armando Falcon said OFHEO will conduct a comprehensive review of the financial disclosure policies and practices of Fannie and Freddie, with the assistance of the SEC. OFHEO will compare the disclosure policies and practices of Fannie and Freddie against those of other publicly traded companies to ensure the GSEs’ practices “are at least comparable, if not better, where appropriate,” said Falcon. (*OFHEO press release*, 4/8/02)
- “Upon our request, the Securities and Exchange Commission (SEC) has agreed to make its staff available to OFHEO to provide technical assistance to us in our analysis of the disclosures currently made by Fannie Mae and Freddie Mac,” said Falcon. “I appreciate having the SEC staff’s assistance.” (*OFHEO press release*, 4/8/02) An OFHEO spokeswoman said the agency is tapping the SEC’s “accounting and legal expertise” and did not know how many people would be working on the effort at this time. (*National Mortgage News*, 4/15/02)
- OFHEO’s review of the GSEs’ financial disclosures is part of a regulatory infrastructure project begun well over a year ago. At the conclusion of this disclosure review, OFHEO will determine what action, if any, is appropriate. The options available to OFHEO range from issuing a report to establishing standards through a formal rulemaking process. (*OFHEO press release*, 4/8/02) “We are not going into this with any strong preconceived notion about what we might do,” Falcon said. (*New York Times*, Kenneth Gilpin, 4/9/02) The review is expected to be completed by early September. (*New York Times*, Kenneth Gilpin, 4/9/02) OFHEO’s general counsel Alfred Pollard is spearheading the effort. (*National Mortgage News*, 4/15/02)
- Fannie and Freddie’s exemption from SEC securities laws has recently come under fire. Congressmen Shays and Markey introduced a bill (HR 4071) on March 20 that would repeal Fannie and Freddie’s exemption from SEC registration requirements. (*National Mortgage News Daily Web site*, 3/21/02) Soon after, Fannie and Freddie agreed to make additional disclosures about their derivatives and more information about insider transactions by their executives. [See April 5, 2002 *GSE Report* for more information.]
- OFHEO also plans to release by the end of June, its first test run of Fannie and Freddie’s new risk-based capital standards. OFHEO is expected to release its annual report to Congress on June 15 and is on schedule to release a systemic risk study of Fannie and Freddie. (*Dow Jones Newswire*, Dawn Kopecki, 4/8/02)

SEC and White House response

- A SEC spokeswoman played down the agency's involvement in the review of Fannie and Freddie, saying the SEC often provides similar assistance to other agencies. She added that the review doesn't change the SEC's recent comments about the GSEs. In remarks to lawmakers on March 20, SEC Chairman Harvey Pitt suggested he believed Fannie and Freddie should be held to the same disclosure rules as other companies. However, the SEC later clarified that statement by saying, "neither Chairman Pitt nor the commission is advocating any change in the legal status of the GSEs." (*Wall Street Journal*, Patrick Barta, 4/9/02) [See April 5, 2002 *GSE Report* for more information about Chairman Pitt's comments.]
- **The White House hasn't officially ruled one way or the other on the issue, either endorsing nor dismissing proposals to repeal Fannie and Freddie's SEC exemption "The administration has not taken a specific position, but we believe disclosure is important for all companies," including GSEs, said a White House spokeswoman.** (*Dow Jones Newswire*, Dawn Kopecki, 4/5/02)

Fannie & Freddie could improve their disclosures

- Goldman Sachs said in an April 8 research report that while it welcomes Fannie and Freddie's recent disclosures about derivatives, it would like to see more information about potential credit losses under a variety of economic scenarios, as well as more details about derivatives counterparties and the GSEs' subprime loans. (*Wall Street Journal*, Patrick Barta, 4/9/02)

Fannie & Freddie's comments

- "We look forward to these discussions," said Fannie spokeswoman Janice Daue. "Our daily access to the capital markets demands that we meet or exceed the expectations of investors around the world for transparency and disclosure." (*New York Times*, Kenneth N. Gilpin, 4/9/02) Fannie spokesman Robert McCarson said, "We welcome OFHEO's announcement of its review of our financial disclosures. Cutting-edge transparency and disclosure have always been important to Fannie Mae." (*American Banker*, Tommy Fernandez, 4/10/02)
- At the Mortgage Bankers Association of America's National Secondary Market Conference in Chicago on April 8, Freddie's Executive Vice President Paul Peterson discussed OFHEO's review plans and the Shays-Markey SEC bill. "We voluntarily do all the disclosures" required by law, Peterson said. "The only thing you would get by asking us to be subject to SEC disclosures, especially since we'd have to pay the fees associated, would be increased cost." (*American Banker*, Tommy Fernandez, 4/10/02) Sharon McHale, a spokeswoman for Freddie said, "With the exception of Fannie Mae, our financial disclosures already exceed those of other financial institutions. The results of the review will be a verification of that fact." (*New York Times*, Kenneth N. Gilpin, 4/9/02) McHale said Freddie was "very happy" with OFHEO's review plans. "It has been recognized by others that we already meet or exceed SEC requirements," she said. "We're confident that the conclusion will be exactly that: that we exceed the disclosure requirements." (*American Banker*, Tommy Fernandez, 4/10/02)

Fannie & Freddie should be subject to SEC disclosures

- **Financial consultant Bert Ely said that "what OFHEO is trying to do is preserve turf." He said OFHEO is moving "in the right direction, but the best solution is the Shays-Markey bill, which would just bring Fannie and Freddie under SEC jurisdiction. The real expertise and enforcement power lie with the SEC. There is always a concern that OFHEO is far more**

deferential to Fannie and Freddie than a regulator who has thousands of charges.” (*American Banker*, Tommy Fernandez, 4/10/02)

Federal Reserve Bank of Atlanta releases two studies on the GSEs

One study examines the federal subsidies that the GSEs receive, noting that there are costs associated with GSE subsidies

The study finds among other things:

- (1) GSEs are large and highly leveraged institutions (more leveraged than the thrift industry)**
- (2) Although the GSEs receive an implicit subsidy, it is still a subsidy**
- (3) Fannie & Freddie are very profitable (particularly compared to commercial banks) which lends credibility to claims that the GSEs are retaining part of their federal subsidies**
- (4) GSEs’ implicit government guarantee may increase risk taking**

Second study compares Fannie & Freddie’s voluntary risk management initiatives to current banking standards

Study finds that the GSEs’ initiatives could be made more effective

Unlike banking standards, the GSEs’ initiatives are voluntary and the GSEs can suspend them without any supervisory consequences

- The FRB of Atlanta released two studies on the GSEs in its First Quarter 2002 *Economic Review*. The studies were authored by W. Scott Frame, financial economist and assistant policy adviser, and Larry D. Wall, financial economist and policy adviser in the Atlanta Fed’s research department. (*Economic Review, Federal Reserve Bank of Atlanta, First Quarter 2002*)

I. Subsidies to the GSEs – “Financing Housing through Government-Sponsored Enterprises”

Summary

- The study noted that Fannie, Freddie, and the FHLBanks were created to improve the availability of home mortgage financing by supplementing local funding. However, today’s more evolved financial markets enable retail lenders to tap national markets. Thus, the main contribution of the three housing GSEs has become providing homebuyers an interest rate subsidy that is made possible by the GSEs’ special relationship with the federal government. (Summary of *Economic Review Paper, “Financing Housing through Government-Sponsored Enterprises,”* W. Scott Frame and Larry D. Wall, First Quarter 2002)
- The study examined the economic issues arising from such subsidies via the housing GSEs. The authors first reviewed the benefits and costs of subsidizing housing finance and then provided background information about the housing GSEs and their relationship to the federal government. The GSEs’ importance to the financial markets, coupled with their special relationship with the government, raises concerns about the potential for moral hazard and the problems that would arise if a housing GSE became financially distressed or insolvent. The study then focused on two public policy debates that have been sparked by this special relationship. The first is whether the housing GSEs are efficient mechanisms for subsidizing housing. The second relates to the housing GSEs’ safety and soundness and questions whether implicit guarantees of their liabilities are the best way to subsidize them. (Summary of *Economic Review Paper, “Financing Housing through Government-*

Sponsored Enterprises,” Federal Reserve Bank of Atlanta, *Economic Review*, First Quarter 2002, W. Scott Frame and Larry D. Wall)

GSE subsidies provide benefits but also impose costs

- The study noted that the subsidies provided to the GSEs benefit mortgage borrowers, but they also impose costs on other parts of the economy and may have unintended consequences. “The reduction in the cost of housing leads to increased investment in housing, and the increased investment manifests itself both in higher home ownership rates and more expensive homes.” An increase in home ownership may provide social benefits, but they also increase the cost of homes for several reasons. An “unavoidable consequence of subsidizing housing is that it raises the cost of other types of consumption and investment...Also, individuals who perceive investment in housing as a substitute for other types of savings may invest less in financial assets such as stocks and bonds. Part of the cost of subsidizing housing may also be paid in the form of less business investment and reduced international competitiveness.” The study observed, “Thus subsidizing housing does have the intended effect of increasing the investment in housing. But economic theory is clear that the housing subsidy must come at the expense of economic activities that are not subsidized.” (*Financing Housing through Government-Sponsored Enterprises,*” W. Scott Frame and Larry D. Wall, Federal Reserve Bank of Atlanta, *Economic Review*, First Quarter 2002)

GSEs are large and highly leveraged institutions (more leveraged than the thrift industry)

- As of year 2000, Fannie and Freddie together held \$1.1 trillion in total assets and had net mortgage-backed securities outstanding totaling another \$1.3 trillion. The Congressional Budget Office reported that as of year-end 2000, Fannie and Freddie held or guaranteed 39% of all residential mortgages, 48% of all single-family conforming mortgages, and 70% of all fixed-rate conforming mortgages.
- Fannie, Freddie, and the FHLBanks are highly leveraged financial institutions that fund their portfolios primarily by issuing debt. As of December 31, 2000, the three GSEs’ \$1.7 trillion in outstanding debt is roughly the size of the municipal bond market (\$1.6 trillion) and more than half the size of the \$3 trillion of outstanding privately held Treasury debt. In year 2000 leverage ratios (total equity to total assets), the FHLB System was at 4.78%, Freddie was at 3.23%, and Fannie was at 3.09%. At the same time, the thrift industry had a combined leverage ratio of 8.45%. (*Financing Housing through Government-Sponsored Enterprises,*” W. Scott Frame and Larry D. Wall, Federal Reserve Bank of Atlanta, *Economic Review*, First Quarter 2002)

Although the GSEs receive an implicit subsidy, it is still a subsidy

- “While the housing GSEs do not receive appropriated funds to carry out their public missions, Congress has bestowed numerous benefits upon them that result in lower costs. These benefits represent a subsidy because fully private firms would be willing to pay the federal government for similar privileges.” The study explained that “providing an implicit guarantee is like agreeing to co-sign a loan. A parent who co-signs a loan for an adult child is conveying a valuable benefit to the child in that the loan is made on terms that would not be available absent the parent’s co-signing. The parent can provide this benefit without an actual outlay of funds provided the child pays on time, but if the borrower cannot pay, the guarantee may turn out to be very expensive.” (*Financing Housing through Government-Sponsored Enterprises,*” W. Scott Frame and Larry D. Wall, Federal Reserve Bank of Atlanta, *Economic Review*, First Quarter 2002)

Fannie & Freddie are very profitable (particularly compared to commercial banks) which lends credibility to claims that the GSEs are retaining part of their federal subsidies

- Fannie and Freddie are very profitable financial institutions. For 2000, return on equity (ROE) was 25.6% for Fannie and 22.8% for Freddie. In contrast, the combined ROE in 2000 for all FDIC-insured commercial banks was 14%. “Such figures lend some credence to claims that these institutions are retaining part of their federal subsidy.” Providing subsidies through a GSE rather than directly to home buyers, raises the potential for the GSEs to retain part of their subsidy. In a 2001 study, the CBO estimated that for 2000 the housing GSEs passed along only about half their cost savings to homebuyers.

Implicit guarantee may increase risk taking

- “The housing GSEs receive a large part of their federal subsidy through the market’s perception of an implicit guarantee of their debt. It is well understood that such guarantees create an incentive to increase risk taking.” The report noted, “providing an implicit guarantee to cover debt obligations may increase risk-taking incentives if the GSE becomes financially distressed. Thus, the provision of the guarantee needs to be accompanied with costly government supervision.” (*Financing Housing through Government-Sponsored Enterprises*,” W. Scott Frame and Larry D. Wall, Federal Reserve Bank of Atlanta, *Economic Review*, First Quarter 2002)

II. Comparison of Fannie & Freddie’s voluntary risk management initiatives to current banking standards - “Fannie Mae’s and Freddie Mac’s Voluntary Initiatives: Lessons from Banking”

Summary

- Frame and Wall’s second study examined Fannie and Freddie’s voluntary initiatives intended to enhance their risk disclosures and safety and soundness. In October 2000 Fannie and Freddie announced six voluntary risk management initiatives. One initiative would enhance market discipline by having the GSEs issue subordinated debt. A second would increase liquidity by having the GSEs maintain a liquid securities portfolio. The other four initiatives would increase transparency by having the GSEs disclose their credit losses under certain scenarios, disclose their interest rate losses under certain scenarios, obtain a credit rating for the government’s exposure to loss, and disclose whether the GSEs comply with certain capital adequacy standards.
- The study compared the GSEs’ initiatives with current banking standards. The analysis suggested that the GSEs’ initiatives are beneficial but could be made more effective. The authors pointed out that the contribution of the subordinated debt initiative to enhanced disclosure depends largely on whether investors believe the implicit guarantee extends to subordinated debtholders. The need for the liquidity initiative has not been established, the authors concluded, and can be criticized as allowing the GSEs to earn a credit spread. The most important of the disclosure initiatives, the one for interest rate risk, provides some new information but could be more informative if it summarized a wider set of interest rate scenarios. (Summary of *Economic Review Paper, “Fannie Mae’s and Freddie Mac’s Voluntary Initiatives: Lessons from Banking*,” Federal Reserve Bank of Atlanta, *Economic Review*, First Quarter 2002, W. Scott Frame and Larry D. Wall)

Unlike banking standards, the GSEs’ initiatives are voluntary and the GSEs can suspend them without any supervisory consequences

- “One important distinction applies to all of the [GSEs’] initiatives relative to banking standards. That is, once bank supervisors implement a requirement, individual institutions cannot suspend compliance without supervisory approval. By contrast, Fannie Mae or Freddie Mac could modify or suspend any

part of their initiatives, for any reason, without any supervisory consequences precisely because the initiatives are voluntary.” (“*Fannie Mae’s and Freddie Mac’s Voluntary Initiatives: Lessons from Banking*,” Federal Reserve Bank of Atlanta, *Economic Review*, First Quarter 2002, W. Scott Frame and Larry D. Wall)

President of the Wisconsin chapter of the Appraisal Institute wants his trade group to seek a congressional end to federal subsidies given to Fannie & Freddie

- Elm Grove, WI appraiser Donald J. Moore, President of the Appraisal Institute’s Wisconsin chapter, wants his trade group to seek a congressional end to federal subsidies given to Fannie and Freddie, which he thinks are too powerful for the public good. He has his state board’s authorization to present the issue at the trade group’s regional convention in June and, if approved, to the national convention in July.

- **“Fannie Mae and Freddie Mac have allowed a corrupt system to develop,”** Moore charged, explaining:

“House price should be independently collaborated, by neutral professionals like us, with no financial interest in the deal. But Fannie and Freddie have allowed the appraisal process to be controlled by parties with a vested interest in the outcome.” Now, he suspects Fannie and Freddie want to eliminate appraisers entirely. Both GSEs use automated valuation methods in lieu of full appraisals on some deals considered very low risk, charging \$50 to \$200 for the waiver.”

“For \$200, Moore noted, you could pay for a typical appraisal. “For the last 40 years, appraisers have been looking at every housing transaction. That has prevented fraud,” Moore said. **“When you eliminate this oversight, and people know there’ll only be a little computerized check on the market, maybe they’ll throw in the boat and some other undisclosed personal property into the mix.”**

Automated valuations are “an invitation to fraud,” Moore said. (*Milwaukee Journal Sentinel*, 4/14/02)

Other appraisers are upset with GSEs’ waiving of appraisals

- As noted in the January 4, 2002 *GSE Report*, appraisers are upset with Fannie’s pilot program which in some cases totally eliminates the need for any form of appraisal on home purchases and refinancings in exchange for lenders paying a \$50 waiver fee. **Frank K. Gregoire, chairman of the Appraisal Committee of the National Association of Realtors, calls the idea “radical” and worrisome. “People seem to have forgotten the lessons of the savings and loan crisis of the 1980s,”** said Gregoire. According to columnist Kenneth Harney, during the savings and loan crisis, thrift institutions racked up multi-billion dollar losses on the basis of inaccurate or fraudulent property appraisals.
- **Patrick Turner, a professional real estate appraiser in Richmond, VA, called Fannie's pilot program “ridiculous” and “dangerous.” “Common sense will tell you,”** said Turner, **“that you can't know what a house is worth”** without some form of appraisal. He cited the example of a home he examined that appeared normal from the outside, but had multiple building code violations including no enclosed bathroom in the entire house. **“[Fannie Mae is] trying to pull rabbits out of hats”** by eliminating appraisals, said Turner, but **“they're going to hurt the**

consumer and hurt themselves.” Homebuyers need professional appraisals, said Turner, “so that they've got an independent judgment that what they're paying [for the property] is the correct price.” (*Realty Times*, Kenneth Harney, 12/14/01; *Washington Post*, Kenneth Harney, 1/6/02)

- As noted in the August 10, 2001 *GSE Report*, many of the nation’s 85,000 appraisers worry that automated appraisal systems, in many cases provided by Fannie and Freddie, are not always accurate and could put them out of business, according to Patrick Barta with the *Wall Street Journal*. “We’re risking catastrophic losses in the residential real-estate market” if the automated appraisal systems turn out to be inaccurate on a widescale, warned Don Kelly, a spokesman for the Appraisal Institute. The appraisers also view the systems as the latest effort by Fannie and Freddie to expand into areas of the mortgage market that they don’t already dominate. Fannie and Freddie “have just found another way to make a buck,” said Joseph Murin, CEO of Lender’s Service. (*Wall Street Journal*, Patrick Barta, 7/20/01)
- Appraisers raised concerns about Freddie’s announcement in April 2001 about its appraisal waiver pilot program. In a May 10, 2001 letter to Freddie’s President Leland Brendsel, AFL-CIO President Michael Goodwin wrote, “many of our members do not have a comfort level with these policy changes.” The letter stated that the 13 million-member AFL-CIO was unhappy with the change, not only because the union represents appraisers but also because it holds substantial amounts of Freddie’s debt. “Please note that many affiliated unions of the AFL-CIO collectively manage pension fund assets of over 1.3 trillion dollars, of which 40% is invested in mortgage financing in Freddie Mac, Fannie Mae or Ginnie Mae,” the letter said. While Freddie called the change consumer-friendly, Goodwin noted in the letter that consumers would prefer accuracy over speed “when valuing the largest single investment most individuals and families will make in their lifetime.” (*Dow Jones Newswire*, Christine Richard, 7/20/01)

Analyst report finds that Fannie & Freddie face competitive risks

Fannie & Freddie face “threats of competitive insurgence that are credible, real, and supported by an increasing number of mortgage industry participants”

- Fannie and Freddie face “threats of competitive insurgence that are credible, real, and supported by an increasing number of mortgage industry participants,” according to an April 11 research report by Fox-Pitt, Kelton. According to John Connor with *Dow Jones Newswire*, the report said Fannie and Freddie have been seen favorably on Wall Street over the past decade, but that the GSEs have built their significant track records of growth and profitability in large part on competitive advantages that have all but eliminated direct competition. The Fox-Pitt, Kelton report, “*GSE Competition--A Bigger Issue Than Investors May Realize*,” was prepared by Chad Yonker, Hermant Hirani, and Chris Buonafede.
- “We believe the time of Fannie Mae and Freddie Mac operating in an environment void of competition has come to a close,” the report said. While the question of competition has gone largely unnoticed by investors, it could be the most significant issue faced by the two GSEs in the next five years. The FHLBank System’s mortgage-purchase programs (MPF and MPP) have the potential to undermine Fannie and Freddie’s duopoly status within the conventional mortgage market, the report said. The report noted, “the success of these programs could result in a meaningful loss of market share for Fannie Mae and Freddie Mac over the intermediate term, calling into question the viability of longer-term growth forecasts.”

- The report added, “We believe the emergence of the Federal Home Loan Banks as GSE competitors in the secondary mortgage market could have a significant detrimental impact on the earnings and market share growth rate of Fannie Mae and Freddie Mac over the next five years.” While the FHLBank programs are not free of drawbacks, noted the report, the concerns that may be restraining lenders from more aggressively selling loans to these programs can be overcome over time.
- The report further noted, “In addition to the competitive threat posed by the FHLBs, the Bush administration, members of Congress, and private market participants continue to look for additional means to increase competition in the secondary mortgage purchase market.” The report said the Administration “is keenly sensitive to the potential risks that Fannie Mae and Freddie Mac pose to the federal government,” and that mortgage lenders desire want more competition in the secondary mortgage market. (*Dow Jones Newswire*, John Connor, 4/12/02)

Fannie Mae and Freddie Mac

OFHEO issues a correcting amendment to its controversial risk-based capital rule for Fannie & Freddie

Merrill Lynch & Co. director says it is unlikely that the rule will become enforceable in its current form

- OFHEO issued corrections to its controversial risk-based capital rule for Fannie and Freddie on April 19 in the *Federal Register*. There are two errors in the Code of Federal Regulations that OFHEO said needed to be corrected; one section needed to be removed and a second section needed to be revised to reflect the appropriate cross reference. (*Federal Register*, pages 19321-19322, 4/19/02)
- A report by Merrill Lynch & Co. director Kurt van Kuller - “Trends in SF Bond Calls, Structures & Pricing” - said that the risk-based capital regulations are unlikely to become enforceable in their present form. “We suspect these capital regs will be revised to what we believe are more reasonable standards before they become effective Sept. 13, 2002,” he wrote. (*Bond Buyer*, Matthew Vadum, 4/17/02)

Background on the risk-based capital rule

- The risk-based capital rule - mandated by Congress in the 1992 act - establishes the level of capital Fannie and Freddie must maintain to survive a 10-year “stress test.” OFHEO’s risk-based capital rule was originally due December 1, 1994. The rule became effective once it was published in the *Federal Register* on September 13, 2001, however the rule is not enforceable until one year after publication (September 13, 2002). (*Federal Register*, pages 47730-47875, 9/13/01)
- OFHEO announced a final amendment to its risk-based capital rule on March 15, 2002 that among other things modified provisions related to counter-party haircuts. (*Federal Register*, pages 11850-11872, 3/15/02) The amendment did not change the date that the risk-based capital rule becomes enforceable. However, a trial run of OFHEO’s public test of the risk-based model using fourth quarter results – which would have been announced in early 2002 – was delayed as a result of the proposed revisions. Originally, OFHEO was supposed to run the model using fourth-quarter 2001 numbers and release the results in February 2002. OFHEO will now use first quarter 2002 numbers and release the results in June 2002. (*National Mortgage News*, 12/17/01) OFHEO expects to publish the test run of

the rule in early June, not for enforcement purposes but for transparency according to OFHEO Deputy Director Jimmy Barton. OFHEO will publish an enforceable capital classification of Fannie and Freddie after September 13, 2002. (*Speech of OFHEO Deputy Director Jimmy Barton before America's Community Bankers conference, 2/11/02*)

Fannie & Freddie spent several million dollars on lobbying last year

Consumer advocate Ralph Nader stated in June 30, 1999 testimony before the House Budget Committee that some of the GSEs' government subsidies – intended to lower the costs for home buyers – are being diverted to build political and lobbying efforts “designed to make it difficult, if not impossible, for the Congress to provide (or the public to demand) proper oversight or regulatory improvements which would protect the public, increase support for affordable housing or ensure open competition in the mortgage market.”

- In the second-half of 2001, Fannie spent \$3.57 million on lobbying, according to records with the Secretary of the Senate's office, as reported by *National Mortgage News*. In the first-half Fannie spent \$3 million, bringing its full-year total to \$6.57 million. Two years ago, Fannie spent about \$6 million in lobbying. Fannie noted that FM Watch spent \$2.8 million on lobbying in 2001. (*National Mortgage News Daily – Weekend Edition, Web site, Paul Muolo, 4/13-14/02*)
- FM Watch noted that *National Mortgage News'* estimate of Fannie's lobbying costs was too favorable to Fannie. FM Watch spokeswoman Beneva Schulte explained that Fannie's lobbying costs for 2001 (\$6.57 million) excluded what Fannie is paying its in-house lobbying staff. According to Senate records, Fannie employs nine in-house lobbyists: Arne Christenson, Duane Duncan, Nate Gatten, John Hines, Carmen Lowrey, Robert Maloney, William Maloni, Rich Maurano, and Laura Van Etten. *National Mortgage News* did not know the salaries of these individuals, but thought \$125,000 (on average) seemed like a good salary estimate, which would add another \$1.25 million to Fannie's lobbying costs. (*National Mortgage News Daily Weekend Edition, Web site, Paul Muolo, 4/20-21/02*)

Washington Business Journal ranks Fannie & Freddie as the top two largest charitable contributors in the Washington, DC area

[Editorial Note: While Fannie & Freddie are the largest public companies in the Washington, DC area, they do not pay state and local corporate income taxes by virtue of their GSE status. The GAO estimated that in 1995, Fannie & Freddie's exemption from state and local income taxes was worth approximately \$300 million a year (several million dollars more than their charitable contributions).]

- The *Washington Business Journal* ranked Fannie #1 and Freddie #2 in its listing of the top charitable contributors in the Washington, DC area. The Fannie Mae Foundation contributed \$27.1 million; Freddie contributed \$13.8 million. (*Washington Post, Jacqueline Salmon, 3/28/02*)
- **[According to the GAO, “if the enterprises had paid state and local corporate income taxes at an average rate of 8 percent in 1995 and if no other costs, capital levels, or operating strategies had changed, we [the GAO] estimated that this would have resulted in a combined increase in expenses for the enterprises in the range of \$367 million to \$256 million, again depending upon the enterprises' treatment of the increases in their federal tax returns.” (*Housing Enterprises, Potential Impacts of Severing Government Sponsorship, GAO, GAO/GGD-96-120, May 1996*)]**

Fannie & Freddie rank higher in the 2001 Fortune 500 listing – Fannie ranks 20; Freddie ranks 41

- Fortune magazine’s ranking of the nation’s largest companies compiled by *Fortune* magazine on the basis of 2001 revenue:

Company – 2001 Ranking	2000 Ranking	Revenue (\$ in millions)
20. Fannie Mae	26	\$50.803
41. Freddie Mac	50	\$35.523

(Associated Press, 4/1/02; *Fortune* magazine, <http://www.fortune.com/lists/F500/index.html>)

Fannie Mae

Fannie tries to seek a last-minute exemption from an anti-predatory lending bill in Georgia

Bruce Marks, president of Neighborhood Assistance Corp. of America, states, “Like Enron, they [Fannie] want to control every aspect of the market from pricing to supply, but they want to avoid scrutiny.”

- It appears that Fannie is no longer seeking a last-minute exemption from an anti-predatory-lending bill that some Georgia legislators are trying to pass in the final days of the session, according to *National Mortgage News*. In an April 4 letter to Georgia Governor Ray Barnes, Fannie asked for an exemption that “will insure that Fannie Mae can continue to advance market-based solutions to the problem of predatory lending, which we believe is the most effective method of addressing this problem.” Fannie’s spokeswoman Janice Daue said the use of the word “exemption” was “inappropriate” and that Fannie has clarified its position in another letter. “We are not asking for an exemption,” Daue said. She added, however, that Fannie wants to encourage state and local lawmakers to take advantage of Fannie’s anti-predatory-lending guidelines, which are binding on lenders who sell loans to Fannie. Community activists such as Bruce Marks, president of Neighborhood Assistance Corp. of America, feared that Fannie’s lobbying could scuttle the Georgia bill or create a huge loophole. “Fannie Mae is to the mortgage industry what Enron was to the energy industry,” Marks said. “Like Enron, they want to control every aspect of the market from pricing to supply, but they want to avoid scrutiny.” Bill Brennan of the Atlanta Legal Aid Society complained that Fannie is very secretive about its subprime business. “The inference that a lot of people are drawing is that they are getting into abusive lending,” Brennan said. “They should start explaining whose loans they are buying and reveal that. Then you can come to Georgia and ask for an exemption.”
- The reaction to the exemption request caused Fannie to quickly back down. Fannie restated its position in another letter to Governor Barnes. “Fannie Mae does not seek an exemption from coverage. It is our intent to support efforts by you and the legislature to combat predatory lending in Georgia,” the April 6 letter said. (*National Mortgage News Daily Web site*, 4/8/02; *National Mortgage News*, 3/15/02)

Fannie to offer real-time pricing for lenders selling mortgages to Fannie for cash

- Mortgage lenders will soon be able to commit to sell individual loans to Fannie through the company’s eCommitting application. The new Web-based tool provides lenders with enhanced capabilities to obtain Fannie’s commitment to purchase their mortgage loans using one connection,

which is accessed through the company's business-to-business Web site, www.efanniemae.com. This new tool, which is currently in a pilot program, will replace Desktop Trader for lenders who want to sell loans for cash to Fannie. It will be more broadly available in May. The announcement was made today during the Mortgage Bankers Association of America's National Secondary Marketing Conference.

- With eCommitting, lenders selling their loans for cash will benefit from quick access to many of Fannie's products, and real-time access to live pricing. The eCommitting tool will also help lenders facilitate better pipeline management and execution practices through flexible commitment periods. Before eCommitting, lenders were bound by strict pricing periods, but now lenders using eCommitting are able to choose pricing periods from 1 to 90 days. Additionally, because eCommitting accommodates a wide variety of Fannie's mortgage products, it will minimize the manual handling of commitments. (*Fannie press release, 4/9/02*)

Dexma connects lenders to Fannie's Casefile Data Services

- Dexma Corp. announced that its Loan Pump product will synchronize a lender's loan application system with Fannie's Casefile Data Services, an automated mechanism that allows lenders to customize and automatically transfer loan data from Fannie's environment to their own. Dexma unveiled its new product at the MBA's National Technology in Mortgage Lending Conference.
- Dexma believes the main advantage of Loan Pump is that it provides an immediate integration solution that eliminates re-keying or manual data transfers from Fannie's suite of products, the company said. "Our goal is to build an end-to-end online mortgage process that helps lenders conduct business as efficiently as possible," said Stephen Mase, President of Dexma. (*National Mortgage News, 3/25/02*)

Fannie further expands its political reach by including Federal and State officeholders in its press conferences and press releases and increasingly using its Partnership Offices in press events

Fannie has 51 Partnership Offices open across the country – Fannie opens a new Partnership Office in Northern, VA

Fannie "wins the gratitude of politicians by staging local events with them, often to 'announce' its plans to buy local mortgages...It's almost as if Ford or Microsoft could allow politicians to gain some credit with voters for every Escort or Windows package sold in their district." – *Wall Street Journal*, Nicholas Kulish & Jacob M. Schlesinger, 7/5/01

Fannie has 51 partnership offices

- According to Fannie's Web site, the company has 51 partnership offices open across the country (http://www.fanniemae.com/contact/partnership_offices.html) 4/16/02).

Congressman Jim Moran (D-VA) and Fairfax County Board of Supervisors Katherine Hanley – New Partnership Office in Northern Virginia

- Fannie joined with the above officials in announcing a home ownership initiative for Northern Virginia families. In addition, Fannie announced the grand opening of the company's Northern Virginia partnership office, located in the Ballston area of Arlington. (*Fannie press release, 2/26/02*)

Speaker of the House Dennis Hastert (R-IL)

- Fannie joined with Speaker Hastert to break ground for Heritage Woods of Batavia Supportive Living Facility. (*Fannie press release, 4/12/02*)

Senator Conrad Burns (R-MT)

- Fannie joined Senator Burns in announcing a local seminar for housing professionals on reverse mortgages. (*Fannie press release, 4/2/02*)

Congressman Jerry Kleczka (D-WI) and Milwaukee, WI Mayor John Norquist

- Fannie joined the above named officials to announce a \$1 million affordable homeownership pilot for Woodlands Condominium buyers. (*Fannie press release, 4/15/02*)

Congresswoman Sue Myrick (R-NC), Congressman Mel Watt (D-NC) and Charlotte, NC Mayor Patrick McCrory

- Fannie joined the above named officials to celebrate a \$1 million grant from HUD to support a partnership with the Charlotte Housing Authority and SocialServe.com – a nonprofit technology provider providing an interactive Web site for area low-income families. (*Fannie press release, 4/12/02*)

Congressman Gil Gutnecht (R-MN) and Northfield, MN Mayor Keith Covey

- Fannie joined the above named officials to announce a \$2 million loan through Fannie's American Communities Fund to increase affordable housing in Northfield. The loan to the Northfield Housing and Redevelopment Authority will support the Cannon River Community Land Trust. The Land Trust will enable buyers to purchase a home without having to buy the land beneath the home. (*Fannie press release, 4/12/02*)

Congressman Ernie Fletcher (R-KY) and Lexington, KY Mayor Pam Miller

- Fannie joined with the above named officials to announce a \$2 million mortgage initiative called "Urban Community Out Reach." (*Fannie press release, 4/8/02*)

Congressman Mel Watt (D-NC) and several Charlotte City Council Members

- Fannie joined the above officials to announce the grand opening of the Gables of Windgate, a 29-home development in City West. (*Fannie press release, 4/5/02*)

Congressman Spencer Bachus (R-AL), Congressman Earl Hilliard (D-AL), and Birmingham, AL Mayor Bernard Kincaid

- Fannie joined the above named officials to announce a \$1 million down payment and closing cost assistance program. (*Fannie press release, 4/2/02*)

Congressman Jay Inslee (D-WA), King County Executive Ron Simons, and Snohomish County Executive Bob Drewel

- Fannie joined the above named officials to announce that the Northshore School District would be offering an assisted housing benefit to its employers. The program is a collaboration among HomeStreet Bank, HomeSight, King and Snohomish Counties, the Housing Authority of Snohomish County, and Fannie. (*Fannie press release, 3/26/02*)

Congresswoman Marcy Kaptur (D-OH) and Toledo, OH Mayor Jack Ford

- Fannie joined the above officials to announce a new affordable lending initiative, Community Solutions, designed for firefighters, police officers and teachers. (*Fannie press release, 3/25/02*)

Congressman Dave Camp (R-MI) and Mt. Pleasant, MI Mayor Michael Pittsley

- Fannie joined the above officials to announce a new \$5 million mortgage financing initiative for Isabella Reservation homebuyers. (*Fannie press release, 3/22/02*)

Congressman Tim Roemer (D-IN) and Michigan City, IN Mayor Sheila Brillson

- Fannie joined the above officials to welcome a Section 8 recipient into a new home through the Michigan City Housing Authority Section 8 to Homeownership Program of Michigan City. (*Fannie press release, 3/11/02*)

Congresswoman Barbara Lee (D-CA) and Oakland, CA Mayor Jerry Brown

- Fannie joined the above officials to report on the progress of a neighborhood revitalization effort for West Oakland. (*Fannie press release, 3/11/02*)

Congressman Greg Ganske (R-IA) and Des Moines, IA Mayor Preston Daniels

- Fannie joined the above officials to announce a \$3 million anti-predatory lending initiative. (*Fannie press release, 2/22/02*)

Congresswoman Heather Wilson (R-NM)

- Fannie joined with Congresswoman Wilson to announce Section 8 homeownership initiative. (*Fannie press release, 4/12/02*)

Congressman Lee Terry (R-NE)

- Fannie joined with Congressman Terry in convening an anti-predatory lending roundtable with local housing partners. (*Fannie press release, 4/10/02*)

Congresswoman Grace Napolitano (D-CA)

- Fannie joined with Congresswoman Napolitano and CitiMortgage to announce a new partnership to provide \$1 billion in affordable mortgage lending to Southern California families. (*Fannie press release, 4/5/02*)

Congressman Ed Pastor (D-AZ)

- Fannie joined with Congressman Pastor in breaking ground for an affordable housing apartment building for seniors. (*Fannie press release, 4/2/02*)

Congresswoman Jan Schakowsky (D-IL)

- Fannie joined with Congresswoman Schakowsky and representatives from the Community and Economic Development Association of Cook County to announce a \$5 million anti-predatory lending refinance initiative in Cook County. (*Fannie press release, 3/26/02*)

Congressman Robert Andrews (D-NJ)

- Fannie joined with Congressman Andrews to announce a faith-based initiative for New Jersey area families. (*Fannie press release, 3/18/02*)

Congresswoman Maxine Waters (D-CA)

- Fannie joined with Congresswoman Waters to announce Fannie's products, eZ Access Pilot and Timely Payments Rewards. (*Fannie press release, 3/8/02*)

Delegate Donna Christian-Christensen (D-VI)

- Fannie joined with Delegate Christian-Christensen to recognize Banco Popular as the largest mortgage loan deliverer to Fannie in the Virgin Islands. (*Fannie press release, 2/21/02*)

Other local officials with whom Fannie held press opportunities:

Fannie also held press opportunities with the following public officials:

- (1) Miami, FL Mayor Manuel Diaz (*Fannie press release, 4/5/02*)
- (2) Allegheny County Chief Executive Jim Roddey and Pittsburgh, PA Mayor Tom Murphy (*Fannie press release, 4/1/02*)
- (3) Memphis, TN Mayor Willie Herenton (*Fannie press release, 3/26/02, 2/20/02*)
- (4) Washington, DC Councilmember Adrian Fenty (*Fannie press release, 3/12/02*)
- (5) Rockford, IL Mayor Doug Scott (*Fannie press release, 2/21/02*)

Freddie Mac

Freddie expects to securitize \$10-\$15 billion in subprime loans this year

- Freddie expects to securitize \$10 billion-\$15 billion in subprime loans this year, following better-than-expected volume in 2001. A Freddie spokeswoman said the \$10 billion to \$15 billion range is dependent on market conditions, but it would be “a ramp up for us given it will be a smaller market than last year.” Spokeswoman Sharon McHale said Freddie securitized \$9 billion in subprime product last year.
- Fannie securitized \$13.3 billion in subprime loans last year, including \$10 billion from its expanded approval program, which has 200 participating lenders. A spokeswoman said Fannie has not publicly released any projections regarding its subprime business. (*National Mortgage News, 4/8/02*)

Freddie acquires data center in Northern, VA

- Freddie has acquired 544 Herndon Parkway, an 110,000 square-foot data center in Herndon, VA. (*Real Estate Finance and Investment, 2/18/02*)

Federal Home Loan Banks

Federal Housing Finance Board (FHFB) approves the FHLBank of Atlanta's capital plan (second FHLBank to be approved)

FHFB holds public hearing on the FHLBank System's capital plans

FHFB regulates the FHLBank System

- The FHFB approved on April 10 the capital plan of the FHLBank of Atlanta, the second capital plan approved by the FHFB. Consideration of the plan was moved up from the FHFB's May 8 meeting. (*FHFB press release, 4/10/02*) "It is my goal to move expeditiously in the approval process of all the capital plans," said FHFB Chairman John T. Korsmo. (*FHFB press release, 4/10/02*)
- The FHLBank of Atlanta's capital plan authorizes Class B stock (redeemable on five years' written notice), with two subclasses: Class B(1) stock, held by a member to comply with its membership stock requirement (initially estimated at .15% of total assets with a cap of \$25 million), and Class B(2) stock, held by a member to comply with its activity-based stock requirement (initially estimated at 4.75% of outstanding advances and other activities). Both subclasses will receive the same dividend rate. The FHLBank of Atlanta's capital plan is available at www.fhlbatl.com. (*FHFB press release, 4/10/02*)
- The FHFB determined that the FHLBank of Atlanta's capital plan meets all statutory and regulatory requirements regarding capital structure and does not compromise that Bank's safety and soundness or that of the FHLBank System. As is the case for all the FHLBanks, the FHLBank of Atlanta was required to obtain FHFB approval of its internal market risk model and risk assessment procedures and controls prior to implementing its plan, which it expects to do in the first half of 2003. (*FHFB press release, 4/10/02*)
- Also, an action by FHFB staff has cleared the way for the FHLBank of Seattle to implement its capital plan by its target date of June 30, 2002. Managing Director James L. Bothwell on April 9 informed the Seattle FHLBank that FHFB staff had completed a review of its risk assessment procedures and controls and internal risk model. The FHFB approved the Seattle FHLBank's capital plan at its March 13 meeting, subject to this review. The FHFB will consider the remaining 10 FHLBank capital plans for approval at its May 8, June 12 and July 10 meetings. (*FHFB press release, 4/10/02*) The FHFB will consider proposals from the FHLBanks of Pittsburgh and Boston at its May 8 meeting. (*BNA Daily Report for Executives, 4/15/02*)
- The Gramm-Leach-Bliley Act (GLB), signed into law on November 12, 1999, amended the provisions of the FHLBank Act that relate to the capital structure of the FHLBanks. The law mandated the replacement of the existing subscription capital structure with a modern capital structure, with risk-based and leverage capital requirements that are similar to those of depository institutions. (*FHFB press release, 3/13/02*) As required by GLB, all of the FHLBanks submitted proposed capital structure plans to the FHFB by October 29, 2001. Each FHLBank must obtain FHFB approval of its internal risk model and risk assessment procedures and controls prior to implementing its capital plan. (*FHFB press release, 2/13/02*)

FHFB holds public hearing on the FHLBank System's capital plans

- The FHFB held a public hearing April 11 to hear testimony from FHLBanks on their capital plans. (FHFB press release, 4/10/02)

FHLBank System's Mortgage Partnership Finance (MPF) and Mortgage Purchase Program (MPP) are growing

Seattle FHLBank would like to increase member participation in MPP and supports a stock-purchase requirement on MPP-participating institutions

FHLBank of Chicago believes the MPF program will be hurt if the FHLBanks' capital plans are required to include an activity-based stock purchase requirement

The capital plans of the FHLBanks of Seattle and Atlanta, which have been approved by the FHFB, include stock purchase requirements

MPF and MPP are competitors to Fannie & Freddie in the secondary mortgage market

- The FHLBank System's annual report noted that the newly started MPP program, run individually by the FHLBanks of Seattle, Indianapolis, and Cincinnati, generated \$2.7 billion in loans in 2001. The Seattle FHLBank had \$1.7 billion in MPP loans outstanding as of December 31, followed by the Cincinnati FHLBank with \$566 million in loans and the Indianapolis FHLBank with \$366 million in loans. By the end of this year, the three FHLBanks expect to have \$9.5 billion of loans on their books, according to Indianapolis FHLBank spokeswoman Beth Neillist. Meanwhile, the MPF program, started by the FHLBank of Chicago, had \$19.5 billion in originations as well as \$8 billion in repayments and prepayments. (*National Mortgage News*, Brian Collins, 4/8/02)
- Tommy Fernandez with the *American Banker* reported that members of the Bush Administration have looked at the FHLBank of Chicago's MPF program as a potential competitor to Fannie and Freddie. "That day is still a long way off, but there are small signs that progress is being made," reported Fernandez. **He noted that the MPF program is still far behind Fannie and Freddie in terms of volume of loans purchased, however, there are indications that it has gained at least symbolic prominence over the last few years.** For example, at the recent Mortgage Bankers Association's annual secondary market conference, FHLBank of Chicago President Alex Pollock was seated for the first time on a panel with Fannie's Vice Chairwoman Jamie Gorelick, Freddie's Executive Vice President Paul Peterson and Ginnie Mae President Ronald Rosenbaum. Pollock does not believe the MPF program's size works against it. "People tell me 'Look how much smaller you are,' but the fact is, that doesn't matter," he said at the conference. **"Where competition takes place is the next deal. Once they are active in MPF, (lenders) will get a better deal than from Fannie and Freddie."** (*American Banker*, Tommy Fernandez, 4/11/02)
- **Terry Buhler, the vice president in charge of secondary market activity for AnchorBank of Madison, WI, said the MPF program is "obviously a viable alternative" in the secondary market. Buhler said MPF is "very good" for small and midsize thrifts, because it allows them to retain their own servicing "at a good price."** Giving small financial institutions the chance to retain their servicing "is a big deal," he said. Before the MPF program was developed, such lenders had to sell their servicing with the rest of the mortgage to aggregators or the GSEs, so the servicing, and the customer relationships that went with it, were taken "out of the community," he said. (*American Banker*, Tommy Fernandez, 4/11/02)

- **One MBA conference attendee, who requested anonymity, said that the market is paying more attention to alternatives to Fannie and Freddie, like the MPF program and Ginnie Mae because Ginnie and the FHLBanks are perceived to be passing on their cost advantages to U.S. consumers, and because they “are marketing themselves as GSEs that haven’t stepped over their charters” by moving closer to the business lines that mortgage companies perceive as their own terrain, the attendee said. (*American Banker*, Tommy Fernandez, 4/11/02)**

Seattle FHLBank would like to increase member participation in MPP and supports a stock-purchase requirement on MPP-participating institutions

- The FHLBank of Seattle would like to increase its member participation in MPP. While the Seattle FHLBank purchased \$1.7 billion in MPP loans last year, those loans came from only four member institutions. “Our current focus right now is membership penetration,” said Cindy Chirot, executive vice president and chief operating officer of the Seattle FHLBank. Outreach efforts have increased the number of MPP-approved institutions to 18. Chirot said the outreach effort has been directed to members of all sizes. “But obviously there is a lot of value to the midsize and smaller members who are not well served by the secondary market.” (*National Mortgage News*, 4/15/02)
- MPP is structured so that each of the three FHLBanks can provide local service and local pricing. “In terms of structure,” said Cindy Chirot, executive vice president and chief operating officer of the Seattle FHLBank, “that is the one thing that is different” between MPP and MPF. Another difference is that the Seattle FHLBank intends to impose a stock purchase requirement on MPP-participating institutions this summer, while the Chicago FHLBank believes a stock purchase requirement is unnecessary and will make the MPF program less attractive. (*National Mortgage News*, 4/15/02)

FHLBank of Chicago believes stock-purchase requirement would harm MPF

- Imposing a stock-purchase requirement on the MPF program would place it at a competitive disadvantage to Fannie and Freddie, according to FHLBank President Alex Pollock. “The continued growth of the MPF program would be extremely, adversely affected if we try to create mandatory stock purchases to go with MPF transactions,” Pollock testified at the March 11 FHFBS public hearing on the FHLBanks’ capital plans. He warned the FHFBS that a stock requirement would persuade members to back away from the MPF program and sell their loans to Fannie and Freddie. The FHFBS has approved capital plans for the FHLBanks of Seattle and Atlanta, which both have stock requirements for secondary market programs. (*National Mortgage News*, 4/15/02)
- As noted in the March 15, 2002 *GSE Report*, the America’s Community Bankers (ACB) and 17 state banking trade groups urged the FHFBS to require all FHLBank capital plans to include an activity-based stock purchase requirement. (*ACB press release*, 3/8/02; *ACB and state banking trade groups letter to the FHFBS Chairman John T. Korsmo*, 3/8/02)

Independent Community Bankers of America (ICBA) opposes multi-district FHLBank membership

FHFB Chairman John Korsmo hopes for a vote by FHFB board members on multi-district memberships before the end of the year

- The ICBA opposes permitting a single depository institution to belong to more than one FHLBank (multi-district membership). In an April 5 letter to the FHFB, the ICBA expressed concerns that multi-district membership could lead to consolidation of the FHLBank System and loss of its regional structure, which community banks highly value. ICBA told the FHFB that the FHLBank System has worked well and the reasons to change the system's membership rules to permit multi-district membership are not sufficiently compelling. The risks of not "getting right" the numerous issues that would have to be addressed are too great. These issues include:
 - How collateral will be pledged and monitored; what member stock purchase requirements will be and in which FHLBanks;
 - How voting rights will be handled across the system; and
 - What controls will be established to prevent large members with multiple memberships from leveraging the FHLBanks against each other-such as for lower rates or lenient collateral policies-to the system's detriment as a whole.
- "The system is working well in an environment without multi-district membership," wrote A. Pierce Stone, ICBA chairman and the chairman, president and CEO of Virginia Community Bank, Louisa, VA. "It should not be jeopardized by the great uncertainty of how or if these key issues can be satisfactorily resolved." Also, ICBA advised the FHFB that concentration in the borrowing of advances by the largest FHLBank members is an emerging issue and that it should be addressed now, before a serious safety and soundness problem arises. (*ICBA press release, 4/8/02*)
- The ICBA letter was in response to the FHFB's comment solicitation on the issue. (*BNA Daily Report for Executives, Marcia Kass, 4/9/02*) The FHFB requested comments on October 3, 2001, with a January 2, 2002 deadline, which was extended to March 4, 2002. (*Federal Register, page 63007, 12/4/01; FHFB press release, 9/26/01; Federal Register, pages 50366-50375, 10/3/01*) The FHFB received more than 150 comment letters by the March 4 deadline, most of which were cautiously supportive of multi-district membership. (*American Banker, Nicole Duran, 3/13/02; BNA Daily Report for Executives, Marcia Kass, 4/9/02*) [See March 15, 2002 *GSE Report* for summaries of many of the comment letters.] On March 4, the ICBA filed a comment letter with the FHFB with its initial views on multi-district membership but postponed a more detailed letter until after its board of directors meeting. On March 10, the ICBA's Board of Directors voted to oppose multi-district membership. (*BNA Daily Report for Executives, Marcia Kass, 4/9/02*)
- Although the FHFB has never approved a bank for multi-district FHLBank membership, more than 100 bank holding companies have financial institutions in more than one of the 12 FHLBank System districts, and nearly 200 members of the FHLBank System have branches extending beyond district lines, according to Scott Smith, acting director of the FHFB's Office of Policy Research and Analysis. (*BNA Daily Report for Executives, Richard Cowden, 3/7/02*) **FHFB Chairman John Korsmo said his intention is that FHFB board members vote before the end of this year on the question of multi-district memberships within the FHLBank System.** (*Dow Jones Newswire, John Connor, 3/12/02*) He told members of the ACB that his reading of the statute that created the FHLBank

System does not give the FHFBS clear authority to allow a single thrift or bank to become a member of two or more FHLBanks. He does not, however, have a closed mind. He said the FHFBS may hold public hearings on multi-district memberships and may hire its own attorney to advise the FHFBS on the issue. (*National Mortgage News*, 3/18/02)

FHLBanks had \$600.7 billion of notional amount derivatives at the end of 2001

- The FHLBanks had \$600.7 billion of total notional amount of interest-rate exchange agreements outstanding at the end of 2001, compared with \$565.7 billion in 2000, according to a FHLBank financial report. The report said the FHLBanks had about 25 counterparties for interest-rate exchange agreements. “Most are derivative dealers and major domestic and international banks, some of which may be affiliated with underwriters of consolidated obligation and members,” it said. “Most of the counterparties are rated AA/Aa or higher.” The report noted, “The notional amount serves as a factor for determining periodic interest payments or cash flows received and paid, and does not represent actual amounts exchanged for the FHLBanks’ exposure to credit and market risk.” The report added, “The amount potentially subject to credit loss is much less. Notional values are not meaningful measures of risks associated with derivatives. The risk of derivatives can only be measured meaningfully on a portfolio basis, taking into account the derivatives, the item being hedged, and any offsets between them.” (*Dow Jones Newswire*, John Connor, 4/2/02)

FHFBS approves streamlining of its affordable housing program

- The FHFBS approved April 10 a final rule to streamline the FHLBank System’s Affordable Housing Program (AHP), to implement several changes requested by the FHLBanks and users of the program. The changes provide more flexibility for the FHLBanks in administering the program, especially in the areas of scoring applications, the allocation and use of AHP funds, and post-completion project modifications and reviews. The final rule was published in the April 17 *Federal Register*.
- “The Federal Home Loan Banks asked for more flexibility so they could put their affordable housing money to work in the best way possible,” said FHFBS Chairman John Korsmo. The AHP provides direct subsidies or loans at subsidized rates to FHLBank System members to finance the purchase, construction, or rehabilitation of affordable housing for very-low, low, and moderate-income households. The FHLBank System contributes the greater of 10 percent of annual net earnings or \$100 million per year to the AHP, which operates as a series of 12 FHLBank district-wide competitions. The FHLBanks’ total AHP contribution for 2002 is \$239 million.
- Major changes in the final rule include:
 - Making the requirements for approval of post-completion project modifications the same as those for pre-completion modifications;
 - Permitting the use of repaid direct subsidies from a project to help another eligible household buy or rehabilitate a home in the same project;
 - Allowing an FHLBank to allocate a portion of its subsequent year’s required AHP contribution to the current year’s competitive application program;
 - Allowing the FHLBanks to award scoring points to projects using Federal government properties or non-Federal properties conveyed for significantly below market value;
 - Adding the Federal Financial Institutions Examination Council (FFIEC) as a source of area median income data;

- Removing the requirement that the amount of AHP subsidies offered by a FHLBank must be comparable in each funding period;
 - Removing the requirement that FHLBanks must determine a project's feasibility before scoring the application, and allowing the FHLBanks up to one year and 120 days after completion of a rental project to review initial project compliance documentation.
- The final rule, which follows a proposed rule published for comment on December 27, 2001, will take effect May 17, 2002. (*FHFB press release*, 4/10/02; *Federal Register*, pages 18796-18805, 4/17/02)

FHFB issues final rule reducing the amount of “in person” Office of Finance board of directors meetings per year

- The FHFB issued its final rule reducing the minimum number of “in person” Office of Finance board of directors meetings per year. The board of directors of the FHLBank System's Office of Finance won't have to meet “in person” any more than six times a year (previous minimum standard was nine times per year). In considering the reduction, the FHFB surveyed 12 bank holding companies, four thrift holding companies, and Fannie and Freddie to determine how often the board of directors should meet each year. The board of the Office of Finance is comprised of three part-time members. The final rule, published in the April 17 *Federal Register*, becomes effective on May 17, 2002. (*Dow Jones Newswire*, John Connor, 2/13/02; *Federal Register*, pages 18806-18807, 4/17/02)

Farm Credit System

Farm Credit Administration (FCA) approves final rule allowing a Farm Credit System institution to terminate its Farm Credit System charter and become a financial institution

- The FCA Board approved a final rule at its March 21 Board meeting which allows a System institution to terminate its FCS charter and become a bank, a savings and loan association, or other financial institution under Federal or state chartering authority. (*BNA Daily Report for Executives*, 4/8/02) The final rule was published in the April 8 *Federal Register* and will become effective 30 days after publication in the *Federal Register* during which either one or both houses of Congress are in session. The FCA will publish a notice of the effective date in the *Federal Register*. (*Federal Register*, pages 17907-17917, 4/8/02)
- The final rule amends existing regulations, in effect since 1991, so they apply to all System banks and associations, according to the FCA. The current rule excludes large banks and associations whose investment in its affiliated bank is greater than 25% of the bank's loans. FCS institutions were given authority to terminate System status by the Agricultural Credit Act of 1987. The rule provides clear procedures for termination of FCS status and ensures that all stockholders are treated fairly and equitably and that disclosure materials are easy to read and understand. The rule also ensures that non-terminating System institutions can continue to serve the credit needs of farmers, ranchers, and cooperatives. (*BNA Daily Report for Executives*, 4/8/02)

FCA approves final rule removing regulatory barriers to electronic commerce and allows System institutions to communicate electronically with shareholders

- The FCA Board approved a final rule at its March 21 Board meeting which removes regulatory barriers to electronic commerce and allows System institutions to communicate electronically with shareholders. (*BNA Daily Report for Executives*, 4/8/02) The final rule was published in the April 8 *Federal Register* and will become effective 30 days after publication in the *Federal Register* during which either one or both houses of Congress are in session. The FCA will publish a notice of the effective date in the *Federal Register*. (*Federal Register*, pages 16627-16634, 4/8/02)
- The rule is intended to create a flexible regulatory environment for the safe and sound use of technologies by System institutions and their shareholders. The rule explained that System institutions may communicate electronically with their shareholders, use e-signatures, and maintain electronic records, according to the FCA. The rule also amended an existing regulation to specifically allow FCS institutions to issue annual and quarterly reports electronically, with the consent of all parties. The regulation requires System boards and management to adopt e-commerce policies and procedures to ensure the institution's safety and soundness. (*BNA*, 4/8/02)

Postal Service

***Wall Street Journal* criticizes Postal Service's transformation plan to turn itself into a Commercial Government Enterprise (CGE)**

The CGE is modeled after Fannie & Freddie and would keep the Postal Service as a government owned entity, but one that enjoys some of the operational and financial flexibility found in the private sector

***Journal* calls the CGE an "oxymoron" that would "combine the benefits of a private business with the special privileges of a government"**

"So long as America insists on retaining universal service and rules out privatization, the U.S. mail is going to have cost problems. But that's an argument for the Postal Service doing its original mission better, not for letting it monopolize more of the efficient private economy."

Background on Transformation Plan:

- The USPS announced details of a "transformation plan" on April 5. The "transformation plan" is a proposed new business model that would preserve universal mail delivery and strengthen the mail system. (*USPS press release, Postal Service Vows to Save Universal Mail Delivery – Proposes New Business Model*, 3/5/02) The transformation plan outlines three alternative business models: (1) restructuring the USPS as a traditional government agency; (2) transforming the USPS into a commercial government enterprise; (3) creating a privatized corporation. Each would require structural legislative reform. (*USPS press release, PMG Unveils USPS Transformation Plan today at the National Press Club*, 4/5/02) **The transformation plan recommends a "middle ground" approach as the most appropriate modeled on Fannie and Freddie.** (*White House Bulletin*, 4/5/02) The new model, called a Commercial Government Enterprise (CGE), would create a government owned entity, but one that enjoys some of the operational and financial flexibility found in the private sector. Under the CGE, USPS claims it would set rates more predictably, be able to retain earnings, work under private sector labor laws and, depending on future legislation, could even

pay taxes or dividends to the government. (*USPS press release, Postal Service Vows to Save Universal Mail Delivery – Proposes New Business Model, 3/5/02*)

Wall Street Journal editorial

- In a April 10 editorial, the *Wall Street Journal* noted that “Postmaster General John E. Potter says he has an offer America can't refuse: Let the U.S. Postal Service compete like a private business, and he'll improve delivery and ensure its viability for decades to come. Where have we heard that one before?”
- The *Journal* noted, “Beware of bureaucracies bearing such gifts. Making the Postal Service more like Wal-Mart might sound like a good idea. That's what some of us have been urging for years...The problem now is that Mr. Potter doesn't want a real Wal-Mart. He's proposing something called a ‘Commercial Government Enterprise,’ an oxymoron if we've ever heard one. He wants the post office to combine the benefits of a private business with the special privileges of a government monopoly.”
- Some private companies are already facing unfair competitive pressure from the Postal Service. “If the Postal Service were truly private and competing on the same footing with everyone else, that would be one thing. But it now enjoys a number of plum advantages, including its exemption from taxes, antitrust suits and much labor law. Not to mention the huge cash flow that its monopoly on letters provides, which could allow it to undercut private competitors on price...Even if traditional post office functions could be separated from these new enterprises, the joint common costs -- such as its 38,000 branch offices -- would still act as a tremendous subsidy.”
- The Postal Service has a difficult time just handling the business it already has. A GAO report found the Postal Service's financial outlook “increasingly dire,” the result of “continuing deficits, severe cash-flow pressures, rising debt, and liabilities that exceed its assets.” Last year that translated into a \$1.7 billion loss. “It's true that some of these costs are inherent in the Post Office's mandate, which is to ensure that every American in the United States has mail delivery. But the fundamental obstacle to reform remains a unionized work force of nearly 800,000 people and a highly politicized management that makes privatization impossible; Congressmen and Senators are also more interested in protecting jobs in some mail processing center than in productivity and reform.”
- The *Journal* concluded, “So long as America insists on retaining universal service and rules out privatization, the U.S. mail is going to have cost problems. But that's an argument for the Postal Service doing its original mission better, not for letting it monopolize more of the efficient private economy.” (*Wall Street Journal* editorial, 4/10/02)

Computer and Communications Industry and Citizens Against Government Waste (CAGW) criticize the Postal Service's e-commerce initiatives

Free Congress Foundation criticizes the Postal Service's “abysmal” privacy record

- The Postal Service's Transformation Plan was criticized by some technology advocates for its efforts to expand services onto the Internet. Several advocacy groups voiced concerns about the USPS's direction in its Transformation Plan for failing to address the core issue it faces -- increasing revenue shortfalls -- and for failing to suggest effective solutions.
- Several groups, particularly the Computer and Communications Industry Association (CCIA), criticized the Postal Service's e-commerce initiatives. The Postal Service's e-commerce programs put

similar private industry programs in competition with a government-subsidized monopoly that doesn't have to face the same business concerns as private enterprise. "The USPS entrance into these markets is unfair to private companies and detrimental to competition and innovation," CCIA President Ed Black said, emphasizing that e-commerce was not e-government. "The USPS has a multitude of advantages that the private sector cannot compete with -- taxpayer subsidies, the government-sponsored postal monopoly and its own law enforcement mechanism." The e-commerce projects already are creating revenue losses for the Postal Service, CCIA said.

- CAGW Vice President Leslie Paige said the Postal Service should end programs that aren't critical to its core mission, including all e-commerce programs, advertising and merchandising. "Officials must pull the plug on all noncore businesses, eliminate all nonessential activities like advertising and retail, and root out wasteful practices," she said.
- The Postal Service made only general reference to its e-commerce activities in its Transformation Plan. The plan, which focused more on strategy than on specific details and programs, didn't provide details on its e-commerce programs. However, the USPS plan did say it had "recently explored initiatives in the e-commerce area and is evaluating and reviewing each initiative for its growth potential and relevance in the marketplace."
- The CCIA said the USPS currently operates several e-commerce activities, including: (1) Electronic bill payment. (2) USPS electronic postmark in which a trusted time and date stamp is applied to an electronic document or file. (3) Post Electronic Courier Service [PosteCS], an Internet-based message delivery service that provides confidentiality, privacy and integrity to electronic messages by offering an official electronic postmark. (4) NetPost Mailing Online, which allows mailers to submit documents and correspondence electronically to the USPS for delivery through standard mail delivery. (5) NetPost CardStore, which lets users create greeting cards online to be mailed the next business day. That service also allows image downloading. (6) NetPost.Certified, which provides a service to government agencies similar to the USPS electronic postmark. (7) Identity validation, which facilitates the use of digital signatures for online transactions. The USPS also is developing an online version of its movers guide (MoversGuide.com,) electronic addressing that would link an e-mail address to a physical mailbox, and secure electronic mail boxes. CCIA said most of those services compete with some private sector enterprises.
- More needs to be known about the Postal Service's venture into e-commerce and its effectiveness, the advocacy groups said. A General Accounting Office (GAO) report late last year said USPS spent \$11.5 million to develop online bill payment services, but took in only \$1.1 million. The GAO said e-commerce revenue for 2001 was well below USPS expectations -- it had anticipated \$104 million in revenue but took in less than 1% of that amount. The GAO said USPS was "cross-subsidizing" its e-commerce program with revenue from its other money streams. The Postal Rate Commission's Office of the Consumer Advocate also raised questions about the "nonpostal" programs and recommended that a full audit be conducted to account for costs and revenues of those programs, including e-commerce.
- The Postal Service must deal with privacy issues, the Free Congress Foundation Center for Technology Policy (CTP) said. The Postal Service has an "abysmal" privacy record that stems from its "Under the Eagle Eye" enforcement programs, which CTP said tracked mail of "innocent customers with no suspicion of criminal activity." The National Change of Address Database is a "terrible miscarriage of privacy that facilitates marketing abuse and identity fraud," CTP said. In its

plan, the Postal Service said it should work to improve the accuracy and security of address information in its databases. (*Washington Internet Daily*, Terry Lane, 4/8/02)

***Atlanta Journal and Constitution* editorial says that until a Postal Service reform plan is presented that “addresses how to trim the Postal Service's 850,000 work force, remove antiquated labor rules and close facilities, the proposals and deliberations will be nothing more than rearranging the deck chairs on the Titanic”**

- An April 5 *Atlanta Journal and Constitution* editorial on the Postal Service, noted that if the Postal Service were a completely independent private company, it would most likely be headed towards bankruptcy court. This will be the third year in a row that the Postal Service loses money. “But the Postal Service is not a private company. It is a creation of Congress, and unfortunately for the Postal Service and its customers, Congress is the biggest obstacle to real reform. Even though the USPS now operates under a separate board of governors and is supposed to be self-supporting, political considerations still hobble its operations.”
- “For example, Congress prevents the Postal Service from closing or consolidating any of its 38,000 post offices, though two-thirds of them are not profitable. Every time some small community howls that its post office is scheduled to close, its congressional representative steps in and prohibits the closing. Congress has also strapped the Postal Service with binding arbitration with its unions. The result is a backlog of 100,000 complaints and a brick wall blocking the way to innovation and improved productivity.” The Postal Service also runs under a business model that “is badly out of date.”
- Of the three reform proposals submitted by the Postal Service in its Transformation Plan pending before Congress, “one is likely to garner the most attention --- a proposal to free USPS from its statutory limitation against earning a profit. This might give it some incentive to increase productivity, since managers and employees would share in the profits. This choice also envisions quickening the rate-increase process, as the lengthy yearlong process does not allow the Postal Service to respond quickly to the marketplace.”
- “However, until a plan is presented that addresses how to trim the Postal Service's 850,000 work force, remove antiquated labor rules and close facilities, the proposals and deliberations will be nothing more than rearranging the deck chairs on the Titanic.” (*The Atlanta Journal and Constitution*, Editorial, 4/5/02)

Postal Service Board of Governors officially approves increase in postage rates to take effect on June 30

The cost of a first-class stamp will increase from 34 to 37 cents

- On April 9, the Postal Service Board of Governors approved an increase in postage rates effective June 30, 2002. The Board of Governors voted unanimously to accept the Postal Rate Commission’s increase recommendation. The Postal Service hopes the rate increase will help offset expected losses for FY 2002 – projected to be approximately \$1 billion. The USPS lost \$1.5 billion in FY 2001. (*BNA Daily Report for Executives*, Derrick Cain, 4/10/02)
- “This rate change came through an unprecedented settlement between the Postal Service and the mailing industry which allowed the PRC to expedite the case and the new rates to be implemented

earlier than they normally would have,” said Robert F. Rider, chairman of the Postal Service’s Board of Governors. “The settlement agreement with the industry was in recognition of the urgent financial needs of the Postal Service in light of the terrorist attacks and the downturn in the economy.” (*BNA Daily Report for Executives*, Derrick Cain, 4/10/02)

- As noted in the April 5, *GSE Report*, the independent Postal Rate Commission approved an unusual settlement on March 22 that allowed postal rates to increase as early as June 30. The USPS joined with mailer groups, postal employee organizations, competitors, and the Office of Consumer Advocate that represents the interests of the general public in a proposal that will increase rates by 7.7 percent. As part of the settlement, the USPS agreed to a schedule that would defer any additional increases until late summer of 2003. (*Postal Rate Commission press release*, 3/22/02) The Commission voted 3-0 to increase the postage rates. (*BNA Daily Report for Executives*, Derrick Cain, 3/25/02)
- The rates for First-Class one-ounce letters will increase by 3 cents, to 37 cents. The post card rate increases two cents to 23 cents. (*Postal Rate Commission press release*, 3/22/02) The rate for First-Class two-ounce letters will increase by 3 cents, to 60 cents. Priority mail (one pound) will increase from \$3.50 to \$3.85; priority mail (distant five pound, 2,000 miles) will increase from \$7.70 to \$12.15; Express mail (8 ounces. P.O. to addressee) will increase from \$12.45 to \$13.65; Express mail (2 lb. P.O. to addressee) will increase from \$16.25 to \$17.85; Parcel post, inter BMC (2 lb., Zone 5) will increase from \$3.45 to \$4.14; certified mail will increase from \$2.10 to \$2.30; and Return receipt, original signature will increase from \$1.50 to \$1.75. (*BNA Daily Report for Executives*, Derrick Cain, 3/25/02)
- This is the first time a postal rate case has been resolved through settlement. Normally, the numerous conflicting interests engage in complex litigation to determine whether rate increases are justified. Federal law requires the Postal Service to break even from operations. It is expected that next year the Service will need almost \$75 billion in postage revenue. (*Postal Rate Commission press release*, 3/22/02)

Postal Service had a \$303 million net loss in the second quarter

- The Postal Service had a \$303 million net loss in the second quarter, \$123 million more than planned, according to the Postal Service’s Chief Financial Officer and Executive Vice President Richard Strasser, Jr. Strasser said the Postal Service expects continuing loss in volume during the third quarter, which ends May 22. He said the Postal Service could lose as much as \$800 million in the third quarter if the economy fails to improve enough to increase mail volume. The Postal Service lost \$1.7 billion in FY 2001. (*DM News*, Melissa Campanelli, 4/10/02)

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