

The **GSE** REPORT TM

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Major Events

OFHEO issues proposed technical and correcting amendment to its risk-based capital rule for Fannie & Freddie

Congressman Richard Baker (R-LA) believes OFHEO is proposing a “substantive change” to the risk-based capital rule

Congressman Baker requests additional time for public comment on the proposal and requests more data from OFHEO on the impact of OFHEO’s proposed changes

In related news, after more than eight years, OFHEO’s risk-based capital rule became enforceable (September 13)

- Fannie and Freddie’s safety and soundness regulator - OFHEO - issued a proposed rule, which OFHEO claimed makes technical and correcting changes to its risk-based capital rule and updates the treatment of Financial Accounting Standard 133 (FAS 133) in the rule for Fannie and Freddie. The deadline for comments on the proposed amendments to the risk-based capital rule is September 23, 2002. OFHEO said it does not believe the proposed amendments will “generate significant commentary, as all of the proposed amendments are technical in nature and address provisions of the [risk-based capital] Rule that are out-of-date, incorrect or contain typographical errors.” OFHEO further noted that “most of the amendments do not materially impact the risk-based capital requirement” for Fannie and Freddie “and would improve the accuracy of the calculation of the risk-based capital requirement” for Fannie and Freddie. OFHEO “determined that the ten-day comment period provides sufficient opportunity for public response. (*Federal Register*, 9/12/02, pages 57760-57767; *OFHEO press release*, 9/12/02)
- In a September 12 letter to OFHEO Director Armando Falcon, Capital Markets Subcommittee Chairman Richard Baker (R-LA) said he believes OFHEO is proposing a “substantive change” to the risk-based capital rule and he requested more information from OFHEO and a longer public comment period to respond to OFHEO’s proposed change in treatment of FAS 133 in the rule. Congressman Baker noted that OFHEO’s proposed changes include 11 technical corrections and updates the treatment of FAS 133 in the risk-based capital rule. Congressman Baker wrote, **“I have no concerns with the technical corrections, since they would enhance the accuracy of the risk-based capital calculations. However, the need for urgency to modify the rule is not clear.”**
- Congressman Baker noted that because OFHEO’s proposed FAS 133 change impacts the risk-based capital requirement **“in any particular quarter,”** it should be considered a “substantive change.” He noted that OFHEO’s figures **“show that the proposed FAS 133 change, if applied in the first quarter 2002, would have increased Freddie Mac’s risk-based capital requirement by \$1.652 billion and Fannie Mae’s requirement by \$121 million, if the adjustments had been made at that time. A 29% increase in Freddie Mac’s risk-based capital requirement is a significant impact.”**
- Congressman Baker further noted that OFHEO’s proposal also stated: “FAS 133 requires that many previously off-balance sheet derivative positions be reflected on the balance sheet at their fair values” and that OFHEO’s rule encourages Fannie and Freddie to purchase large volumes of financial derivatives to hedge interest rate risk and minimize risk-based capital requirements. **“Given the extensive use of derivatives by the enterprises, changing the treatment of FAS 133 in the risk-based capital rule is a substantive, if not fundamental, change.”**

- He further noted that according to statute, OFHEO's rule contains a 30% add-on to the risk-based capital requirement's stress test to cover management and operations risk. "Under OFHEO's proposal, will FAS 133 adjustments occur before or after the 30% amount is added?" he questioned.
- Congressman Baker believes that the 10-day comment period proposed by OFHEO for the 11 technical corrections "seems appropriate." "However, because the proposed FAS 133 change is not technical and the third quarter 2002 ends shortly, I believe OFHEO should provide a longer period of time for public comment...To determine, at this late date, that the risk-based capital rule would result in capital calculations that are not consistent with total capital as required under the 1992 Act raises serious questions."
- "[I]n order to better assess the impact of FAS 133," Congressman Baker requested that OFHEO provide him – no later than September 20 - "the risk-based capital calculations for the enterprises based on September 30, 2002, financial data, calculated with and without the proposed FAS 133 change." Copies of the letter were also sent to the Ranking Member on the Capital Markets Subcommittee Paul Kanjorski (D-PA) and Treasury Under Secretary Peter Fisher. (*Congressman Baker's letter to OFHEO Director Armando Falcon, 9/12/02*)
- An OFHEO spokeswoman said the agency is reviewing Congressman Baker's letter and will issue a response soon. She further noted that OFHEO discussed the changes with the Office of Management and Budget and "no one raised" an objection. (*National Mortgage News Daily Web site, 9/16/02*)

Background on OFHEO's risk-based capital rule:

- OFHEO's risk-based capital rule establishes the level of capital Fannie and Freddie must maintain to survive a 10-year "stress test." The rule was originally due December 1, 1994. After taking eight and a half years, OFHEO finally issued the rule on September 13, 2001, however the rule did not become enforceable until one year later (September 13, 2002). Then just three months after OFHEO published the rule that took more than eight years to produce, OFHEO announced proposed changes to the rule on December 18, 2001 with a brief public comment period. OFHEO announced the final amendment to its risk-based capital rule on March 15, 2002, which remained essentially the same as the original December 18, 2001 proposed changes.
- The amended March 15, 2002 version, among other things modified provisions related to counter-party haircuts, the treatment of multifamily loans, funding costs, and a series of technical and clarifying changes. The amendment did not change the date that the risk-based capital rule became enforceable. During a July 23, 2002 Capital Markets Subcommittee hearing, however, Capital Markets Subcommittee Chairman Richard Baker (R-LA) raised concerns that the risk-based capital rule was changed so that Fannie and Freddie would receive more favorable results and he questioned political involvement in the changing of the rule. Data was released at the hearing which showed that Fannie would have failed an early version of OFHEO's risk-based capital rule before changes were made
- Although the regulation is considered enforceable September 13, 2002, there will be no immediate impact and OFHEO will publish the first enforceable data by the end of the year, using third quarter 2002 data. (*Dow Jones Newswire, John Connor, 9/13/02*) Until then, Fannie and Freddie will be subject only to minimum capital requirements.

Congressman Richard Baker asks FHFB about the FHLBank System's use of derivative hedging with Fannie or Freddie

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

- *Inside Mortgage Finance's* new publication, *Inside the GSEs*, reported that in an August 27 letter to FHFB Chairman John Korsmo, Congressman Baker asked the FHFB to provide detailed information on whether the FHLBanks are participating in hedging activities with Fannie or Freddie. Congressman Baker said he had learned that “at least one of these GSEs engages in interest rate hedging activity with [the] Federal Home Loan Banks as counterparties” and noted that such an arrangement raises the question of whether the GSEs' use of derivatives “is actually reducing the risk exposure of taxpayers.” (*Inside the GSEs*, 9/11/02)

Fannie & Freddie disclose less information on their mortgage-backed securities (MBS) than private sector issuers of MBS, reports the *American Banker*

Critics of Fannie & Freddie claim that the GSEs know more about their mortgage bonds than everyone else in the market and are using this information to buy pools containing the best loans for their own investment portfolios

- **The GSEs are not required to disclose as much information about their mortgage-backed securities as private issuers, which critics claim gives the GSEs an unfair edge, reported Tommy Fernandez with the *American Banker*. A July 17 Merrill Lynch & Co. report noted that Fannie and Freddie do not disclose five loan-pool characteristics that are disclosed by Wells Fargo & Co., including the loan purpose, documentation levels, loan-to-value average distribution, credit score average distribution, and delinquency history.**
- The Securities and Exchange Commission, Treasury Department, and the Office of Federal Housing Enterprise Oversight are producing a joint study examining among other things, the promotion of a more level-playing field with respect to initial offering disclosures between GSEs and non-GSE MBS issuers. [The joint study is expected to be completed by year-end and is expected to examine allegations that Fannie and Freddie “cherry pick” the best MBS for their portfolios.]
- Fannie and Freddie argue that investors do not need as much detail, because unlike private-sector companies the GSEs guarantee the quality of the loans backing the mortgage pools. Arne Christenson, Fannie's senior vice president of regulatory policy, said, “Investors have different risks for the different securities and thus want to know different information. Our securities...are traded in a TBA [to be announced] market, which calls for liquidity and limited disclosure.” Freddie's General Counsel Peter Mahoney claimed that in the TBA market, “investors trade on only a small number of attributes.” Andy McCormick, Fannie's senior vice president for portfolio management, acknowledged that participants in the resale market want more information, but the GSEs must weigh that against the market's need for liquidity. Christenson observed, “between disclosure and liquidity, there always has been a little bit of a tradeoff. The more information you provide, the more risk you run of fragmenting the market. Each bond, with more disclosure, runs the risk of becoming a ‘story’ bond.”
- **However private label issuers disclose more information. “Purchasers of private-label mortgage-backed securities get more loan-level information than purchasers of GSE MBS, enabling them to better establish the price they are willing to pay,” said American Enterprise Institute (AEI) Resident Fellow Peter Wallison. Critics of Fannie and Freddie claim therefore that the GSEs know more about their mortgage bonds than everyone else in the market and are using this information to buy pools**

containing the best loans -- those least likely to prepay -- for their own investment portfolios. “The GSEs have a lot of information about the underlying mortgages,” said Wallison. “So the GSEs can theoretically pay less for the MBS they buy.”

- Fannie and Freddie claim they have a firm ‘Chinese Wall’ separating the employees who put together the loan pools from those who buy mortgage bonds for the GSEs’ portfolios. **“Fannie and Freddie insist they have this Chinese Wall,” one industry said, speaking on condition of anonymity. “We have to take their word for it” but “if it doesn’t provide them an advantage, why not just share it with everybody?”** Wallison said that because of recent accounting scandals, investors “now understand the quality of the Chinese Walls that supposedly existed in the Wall Street securities firms and should take these GSE statements with a certain degree of skepticism.”
- Both GSEs said the tight bid-ask spreads for their securities indicate that investors are comfortable with the current disclosure. Srinivas Modukuri, a mortgage market strategist at Lehman Brothers, concurred. “I don't think more disclosure would hurt the mortgage market, but not having more disclosure isn't hurting anybody either.” (*American Banker*, Tommy Fernandez, 8/23/02)

Competition from the FHLBanks is having a “noticeable impact” on Fannie & Freddie, reports Fox-Pitt, Kelton

Freddie begins program that is similar to the FHLBanks’ mortgage purchase programs

“[T]he existence of the FHLB programs is having a meaningful impact on Freddie Mac’s [and Fannie Mae’s] business and profitability model,” notes Fox-Pitt, Kelton analyst Chris Buonafede

UBS Warburg says the FHLBanks must be radically restructured before they could become serious competitors to Fannie & Freddie

- A report by investment firm Fox-Pitt, Kelton Inc., “*GSE Competition – An Update: Beginning to Have a Noticeable Impact*,” noted that Fannie and Freddie are facing increasing competition from the FHLBanks. *American Banker’s* Tommy Fernandez and *Inside Mortgage Finance’s* new publication *Inside the GSEs* discussed the report in recent articles. The report was written by Fox-Pitt analysts Chris Buonafede and Hemant Hirani.
- The Fox-Pitt Kelton report noted that FHLBank competition is having a “noticeable impact” on Fannie and Freddie. As evidence, the report noted that Freddie began a loan purchase agreement with an unnamed “major lender” in the second quarter of this year that resembles two FHLBank programs. “Freddie Mac’s actions confirm that the competitive threat posed ... is meaningful,” said the report. (*American Banker*, Tommy Fernandez, 9/9/02) Fox-Pitt calls Freddie’s deal “a negative for Freddie Mac” that could erode the GSEs’ guarantee fee business. (*Inside the GSEs*, 9/11/02)
- Under the two FHLBank programs - the Mortgage Partnership Finance (MPF) and Mortgage Purchase (MPP) Program - FHLBanks purchase loans from banks and manage the interest rate, funding, and prepayment risks, similar to Fannie and Freddie. Unlike Fannie and Freddie, however, the FHLBanks do not assume the credit risk, which means lenders do not have to pay the guaranty fees that Fannie and Freddie charge. (*American Banker*, Tommy Fernandez, 9/9/02)
- Under Freddie’s new program, loans sold by the “major lender” are periodically compared with a reference pool of loans sold by other lenders. If the credit performance exceeds that of the reference pool, Freddie pays the lender. If it is worse, then the company pays Freddie. The agreement involves \$1.5 billion of loans,

which the report considered “negligible” given Freddie’s size, but “indicates that the existence of the FHLB programs is having a meaningful impact on Freddie Mac’s [and Fannie Mae’s] business and profitability model,” Buonafede said. The short-term effect will be “minimal,” but Fox-Pitt predicted the emergence of formidable competition could potentially slow the rise of Fannie and Freddie’s share of the conforming mortgage market and consequently hurt earnings growth. (*American Banker*, Tommy Fernandez, 9/9/02)

- Both the *American Banker* and *Inside the GSEs* noted that the FHLBanks’ market share is still very low compared to Fannie and Freddie. (*American Banker*, Tommy Fernandez, 9/9/02; *Inside the GSEs*, 9/11/02) Since 1997, the two FHLBank programs have bought \$38.1 billion of loans, or just 1.13% of the market. Fannie bought \$148 billion of mortgages and Freddie \$106 billion during just the first six months of this year. Buonafede said that the presence of even a small player is important because it gives lenders more leverage when dealing with Fannie and Freddie. **“By having an additional avenue to sell loans into the secondary market, the bargaining power of lenders - both large and small - increases relative to the GSEs,” the report said.** “This may force the GSEs to either retaliate, which may adversely impact their profitability, or suffer a loss of market share, which may adversely impact their growth prospects.” (*American Banker*, Tommy Fernandez, 9/9/02)

UBS Warburg says the FHLBanks do not pose a threat to Fannie & Freddie

- The FHLBanks’ mortgage purchase programs do not pose a threat to Fannie and Freddie, according to Gary Gordon, a managing director at UBS Warburg LLC. “It appears to us that the FHLBs can only become truly viable competitors to Fannie Mae and Freddie Mac if they are converted into a capital and operating structure at least very similar to Fannie and Freddie – with one management team and permanent capital,” he noted. The FHLBanks could become serious competitors to Fannie and Freddie over time, “But we believe it would require a radical restructuring of the FHLBs themselves, in effect turning them into a clone of Fannie and Freddie... Without that restructuring, we expect MPF to remain a small competitor.” (*American Banker*, Tommy Fernandez, 9/16/02)

FHLBank of Chicago MPF program growing

- Although the FHLBank System’s second quarter earnings dropped \$419 million on derivatives and other hedging activities during the months ending June 30, the FHLBank of Chicago reported in its 2002 semi-annual report that its net income increased due to the growth in its MPF program. Nationwide, total outstanding loans were \$30.6 billion, up 5.8% billion from year-end, producing an annualized growth rate of 47%. Most of the increase was attributable to growth in the portfolio of conventional loans, which grew at an annualized rate of 83% during the same period. Nationwide, participating institutions rose to 345 members. In Chicago, participating institutions increased to 1414 and loans outstanding grew to \$20.6 billion. The FHLBank of Chicago also noted that net income after REFCORP was \$89.0 million, up 55.7% from \$57.2 million for the first half of 2001. (*FHLBank of Chicago 2002 semi-annual report*)

Senate Banking Committee approves bill containing a provision repealing the 50% increase in the Ginnie Mae guarantee fee

Senator Jack Reed (D-RI) says an increase in the Ginnie Mae guarantee fee would hamper first-time homebuyers

Mortgage Bankers Association supports the repeal provision

- The Senate Banking Committee unanimously approved September 12 a bill to reauthorize a law simplifying Federal Housing Administration downpayments (S. 2239 – FHA Downpayment Simplification Act of 2002). The Senate Banking Committee also approved by voice vote an amendment to S. 2239 to repeal a scheduled increase in the guarantee fee charged by Ginnie Mae for guarantee of mortgage-backed securities

from 6 to 9 basis points. The increase would have gone into effect in FY 2004. Senator Reed, the amendment's author, said Ginnie Mae has more money than it needs and that an increase would hamper first-time homebuyers. (*BNA Daily Report for Executives*, Marcia Kass, 9/13/02) The amendment was co-sponsored by Senators Tim Johnson (D-SD) and Wayne Allard (R-CO). (*MBA press release*, 9/13/02)

- The MBA applauded the Senate Banking Committee for its vote September 12 to bring S. 2239 to the Senate floor. (*MBA press release*, 9/12/02) The MBA supports the provision repealing the Ginnie Mae guarantee fee increase. (*MBA press release*, 6/18/02) The increase in the Ginnie Mae guarantee fee - included in the 1998 Higher Education Act - raises the annual fee that Ginnie Mae charges on mortgage loans from 6 basis points to 9 basis points, for loans made after October 1, 2004. The revenue from that increase will be used to increase the level of Federal receipts produced by Ginnie Mae. The MBA estimated this increase would cost \$30 million or more a year and would penalize families that are in need of government programs to buy a home. In addition, the MBA noted there is no financial basis for a guarantee fee increase because Ginnie Mae is currently operating at a profit. (*MBA press release*, 3/18/02)
- The Housing Affordability for America Act (HR 3995), which includes the Ginnie Mae provision, introduced by Congresswoman Marge Roukema (R-NJ) was reported out of the House Financial Services Committee in July, but has yet to be scheduled for a floor vote. (*MBA press release*, 9/12/02)

House Capital Markets Subcommittee asks SEC for information on its investigation into short sales of Farmer Mac's stock

- The House Capital Markets Subcommittee asked the SEC about its progress on its investigation into the trading activity of Farmer Mac securities, reported Tyler Lifton with *Dow Jones Newswire* and Al Yoon with *Bloomberg News*. In a September 11 letter to SEC Chairman Harvey Pitt, Capital Markets Subcommittee Chairman Richard Baker (R-LA) and Ranking Member Paul Kanjorski (D-PA) asked the SEC to "advise us of its progress and its conclusions" in the investigation of short selling in Farmer Mac shares and bonds.
- During the second quarter, Farmer Mac's share price plummeted, which the GSE blamed on short-sellers. Farmer Mac said research reports by Gotham Partners Management and articles in the *New York Times* prompted Farmer Mac's drop in stock price. Farmer Mac is also the subject of a General Accounting Office (GAO) investigation into its finances. "We strongly believe that certain short sellers have engaged in activities that have violated the securities laws with respect to Farmer Mac shares over the past several months," a Farmer Mac spokeswoman said. "These improper activities have included, among other things, the broad dissemination of misinformation through a variety of channels, including selected media, and manipulation of both the equity and debt markets to depress the price of Farmer Mac's shares," she said. Because of this, "Farmer Mac notified the SEC and asked the commission to look into the possibility of wrongdoing by short sellers," she added. Farmer Mac has also asked the New York Stock Exchange to investigate trading of its stock.
- Congressmen Baker and Kanjorski noted in their SEC letter that the number of short sales of Farmer Mac's equity and debt securities increased noticeably beginning earlier this year and that the equity and debt securities "are the primary funding source for the conduct of Farmer Mac's statutory obligation to provide a secondary market for agricultural mortgage loans." The letter further noted that "officials at Farmer Mac have concluded as a result of certain circumstances related to this short-selling effort that violations of Federal securities laws might have occurred." The Congressmen said they "have every confidence that the Division of Enforcement is moving with diligence to give careful and thorough scrutiny" to Farmer Mac's claims that shorter sellers have manipulated its stocks and bonds.

- A SEC spokesman would neither confirm nor deny any existence of an investigation. (*Dow Jones Newswire*, Tyler Lifton, 9/12/02; *Bloomberg News*, Al Yoon, 9/12/02)

Senate Banking Committee to hold September 17 hearing to discuss subjecting the financial disclosures of the Tennessee Valley Authority (TVA) to SEC requirements

Senator Jim Bunning (R-KY) wants the SEC to regulate TVA's bonds

- The Senate Banking Committee scheduled a September 17 hearing to discuss TVA's financial disclosures. The Senate Banking Committee noted that the TVA is owned by the U.S. Government and has no public shareholders. TVA's annual revenues are approximately \$7 billion. The Committee noted that the TVA uses debt financing and has approximately \$25 billion of debt outstanding and that approximately 200,000 individuals and institutions hold TVA's debt. TVA is not required by federal law to make certain disclosures or to comply with the Securities Act of 1933 and the Securities Exchange Act of 1934. TVA voluntarily publishes press releases, annual and quarterly reports and offering circulars for the benefit of investors, including financial statements certified by PriceWaterhouseCoopers. (*Senate Banking Committee press release*, 9/13/02)
- At the Senate Banking Committee mark-up of S. 2673 on June 18 (the Public Company Accounting Reform and Investor Protection Act of 2002), Senator Bunning sought to file an amendment to subject the TVA to the Securities Exchange Act of 1934. However, according to Senate Banking Committee spokesman Jesse Jacobs, Senate Banking Committee Chairman Paul Sarbanes (D-MD) suggested Senator Bunning withdraw the amendment in return for a hearing on the issue. (*BNA Daily Report for Executives*, 9/16/02; *Senate Banking Committee press release*, 9/13/02) At the June 18 mark-up Senator Bunning said he would like the TVA to be brought under US securities laws, requiring it to file quarterly and annual reports with the SEC. "We don't need an Enron in the middle of Tennessee Valley," Senator Bunning said. Senator Bunning also noted, "credit agencies assume the government will not let TVA fail, but what if it does?" The TVA has no oversight authority except by Congress, Senator Bunning complained. (*Dow Jones Newswire*, Judith Burns, 6/21/02)
- TVA officials do not think SEC oversight is needed because the company files quarterly and annual reports to Congress and is audited annually by PriceWaterhouseCoopers LLC. And an independent inspector general and the General Accounting Office provide further oversight, a spokesman said. "We believe the investing public is protected," said TVA spokesman John Moulton. SEC spokeswoman Christi Harlan declined to comment. (*Dow Jones Newswire*, Judith Burns, 6/21/02)
- Scheduled to testify at the September 17 hearing are:
 - Ms. Skila Harris, Director, Tennessee Valley Authority;
 - Ms. Nancy P. Dorn, Deputy Director, Office of Management and Budget;
 - Mr. Alan L. Beller, Director, Division of Corporate Finance, Securities and Exchange Commission;
 - Mr. Craven Crowell, Chairman, CGW Group, and former Chairman, Tennessee Valley Authority;
 - Professor Alan G. Pulsipher, Executive Director and Marathon Oil Company Professor of Energy Policy in the Center for Energy Studies, Louisiana State University; and
 - Mr. Daniel T. Gates, Managing Director, Moody's Investor Service (*Senate Banking Committee press release*, 9/13/02)

All GSEs

OFHEO and FHFB pay some of the highest salaries for financial regulators, according to the *American Banker*

- The *American Banker* surveyed the employee salaries of federal financial regulators at seven agencies (NCUA, FDIC, FHFB, FRB, OCC, OFHEO, OTS) and the 12 Federal Reserve Banks. The numbers “raise questions about whether the pay scale for financial regulators is out of whack,” reported Rob Blackwell with the *American Banker*. **Among the “surprising findings was that two of the smallest financial services regulatory agencies – the National Credit Union Administration and the Federal Housing Finance Board – pay some of the highest salaries.”** The article noted that seven of the 20 highest-paid regulators work for these two agencies; the rest are either Fed employees or the presidents of some of the 12 Federal Reserve banks. The numbers also showed that some of the smallest agencies had higher percentages of employees making more than \$100,000 a year than their larger counterparts. OFHEO pays 63% of its employees above \$100,000 and 46% of the FHFB’s employees are above that limit. In contrast, the FDIC pays 33% of its employees above \$100,000, and the OCC, the Fed, and the OTS pay between 27% and 29% of their employees above \$100,000. The article listed the top 20 salaries of all seven agencies, including the FHFB and OFHEO as well as a list of the 50 highest paid senior executives in the financial regulatory industry.
- A spokesman for the FHFB acknowledged the high salaries and noted that it was part of the reason for a recent reorganization at the agency. [See August 23, 2002 *GSE Report* for more information on the reorganization.] Their highest paid employee, James Bothwell, the FHFB’s managing director was ousted as part of the recent reorganization. The FHFB spokesman noted that the higher salaries at the FHFB helped lure two top executives away from the FDIC, who are now the backbone of the FHFB.
- An OFHOE spokeswoman noted that it was formed only ten years ago and needed to hire experienced personnel to regulate Fannie and Freddie. Several observers, however, were surprised to find that among the heads of the seven financial services regulatory agencies, only Federal Reserve Board Chairman Alan Greenspan (\$166,700 annual salary) makes more than OFHEO Director Armando Falcon Jr. (\$150,000 annual salary). The article noted that the chiefs and board members of most agencies are not among the most highly paid regulators, because their salaries are fixed by statute. (*American Banker*, Rob Blackwell, 8/27/02)

Fannie Mae and Freddie Mac

It is not clear that Fannie & Freddie have done any better in promoting homeownership than various European states have done without the benefit of similar GSEs, reports the *Financial Times*

Competition for Fannie & Freddie from the FHLBanks may improve US housing

- **As criticisms increase against the GSEs, “it is also not clear that Freddie and Fannie have done any better in their main mission – promoting homeowners – than various European states have done without the benefit of similar organizations,” reported Norma Cohen with the *Financial Times*.** In the US, homeownership is approximately 67% of households, similar to the level in the UK. In four European countries – Ireland, Greece, Spain and Luxembourg – homeownership is higher, with Ireland and Spain the highest at 80% each, and the European average is just a few percentage points below that of the US. “So does the US really need Fannie and Freddie?,” asked Cohen.

- Freddie’s Chairman Leland Brendsel dismisses criticisms of his company as complaining from private sector lenders. Brendsel noted that borrowers whose mortgages cannot be purchased by Fannie or Freddie typically pay at least 30 to 50 basis points more in interest charges, so “their presence means that lenders have a hard time charging more for mortgages,” he said. Brendsel believes that without Freddie, homebuyers would be stuck with floating rate mortgages and be at the mercy of US monetary policy.
- The real issue, according to Chris Buonafede, securities analyst at Fox-Pitt, Kelton, is that both Fannie and Freddie have an ownership structure that is ideologically inconsistent. “They are shareholder-owned companies whose risks lie with the US government.” Fannie and Freddie are growing larger, making them even more difficult to contain. “Once the toothpaste is out of the tube you can’t put it back. And the tube is getting bigger,” he said. Buonafede said that for the first time in their history, both Fannie and Freddie are facing genuine competition – not from the private sector – but from the 12 FHLBanks. While small, the FHLBanks are showing signs of quickly mastering some of Fannie and Freddie’s own techniques. “Although this new-found competition may not sit well ideologically with the two companies’ fiercest critics, US housing markets may wind up in even better shape than they are now,” reported Cohen. (*Financial Times*, Norma Cohen, 8/23/02)

Fannie & Freddie plan to stay in the subprime market

- Fannie & Freddie plan to stay in the subprime market, notwithstanding the economy, reported *Equity* magazine’s Neil Morse. The GSEs’ expansion into the subprime market “is motivated by the ever-pressing need to produce profit, but insiders at the two GSEs insist the larger appetite does not mean they have lowered their quality standards.” Freddie expects to securitize \$10 billion to \$15 billion in subprime loans this year. Fannie’s purchases in 2001 totaled \$9.5 billion with \$3.6 billion in structured transactions. “The amounts, small to some, are scary to others.”
- Richard Cooperstein, Freddie’s Vice President, Capital Deployment – Structured Transactions, said source is a critical criterion and that Freddie frowns on lenders who originate both conventional and non-conforming loans and believes that no well-run company can run their A-business and subprime business out of the same shop. Cooperstein said Freddie’s outlook for subprime is “quite positive,” despite some concerns about how such loans may perform in a weakened economy. “It has held up well,” he reported, “Which firmed our resolve to continue to expand in this market.”
- Thomas Lund, Fannie’s Senior Vice President of Investments, said Fannie is pursuing more non-prime business to some extent because of criticisms that “we don’t do enough” for needy borrowers. Both Lund and Cooperstein argued that their automated underwriting systems assure they will not incur unacceptable risk in expanding into lower-quality loans. (*Equity magazine*, Neil Morse, 7/02)

Fannie & Freddie together earned almost as much as the entire thrift industry in the second quarter

- In the second quarter the entire thrift industry earned \$2.86 billion while Fannie and Freddie together earned \$2.57 billion. (*National Mortgage News Daily Briefing-Weekend Edition*, 8/31/02-9/1/02)

Fannie & Freddie argue that a Financial Standards Accounting Board (FASB) proposal would harm their MBS business

- Fannie and Freddie criticized the treatment of their MBS under a FASB proposal on consolidation of special-purpose entities and are concerned that it would cause consolidation and require them to hold substantially more capital against their guaranteed MBS. According to *National Mortgage News*, the proposal “is designed to prevent the Enrons of the world from concealing debt obligations in off-balance

sheet entities.” Fannie and Freddie argued that under two-prongs of FASB’s three-prong test -- guaranteeing timely payment of interest and principal on MBS and setting servicing fees -- they do not have a controlling interest in MBS trusts. In order to avoid consolidation, Fannie and Freddie must convince FASB that their servicing fees are “market-based” or persuade FASB to change its definition of market-based fees. (*National Mortgage News Daily Web site*, 9/9/02; *National Mortgage News*, 9/16/02)

Study for the Millennial Housing Commission recommends a risksharing partnership between FHA and the GSEs

Partnership would be aimed at the subprime market as a possible model that might help FHA address its weaknesses

- The Millennial Housing Commission released a June 2002 study, “*Single-Family Risksharing: A New Evaluation of its Potential as a Tool for FHA*,” by consultant Sarah Rosen Wartell. Wartell, a visiting scholar at Georgetown University Law Center, held a number of positions at the FHA from 1993 to 1998. From 1998-2000, she held a number of posts at the White House’s National Economic Council. According to Wartell, the Millennial Housing Commission has made a revitalized FHA one of the centerpieces of its prescription for housing policy for the next decade. The Commission proposed that FHA be reorganized as a government corporation and find new ways to do business, including through the exploration of single-family risksharing partnerships. The Wartell study was presented for the Commission, however, the views expressed are the author’s alone and should not be attributed to the Commission.
- “FHA’s future is a source of concern,” wrote Wartell. Her paper detailed the significant challenges that FHA faces and whether FHA has the tools and the capacity to manage the increasing risks in its portfolio. The paper noted that with its current weaknesses, FHA is “unable to fulfill its mission of responding to emerging needs in affordable and subprime lending.” FHA risksharing partnerships may help FHA address its weaknesses. Wartell, however, cautioned that there are potential benefits and dangers of risksharing. Wartell described four possible risksharing models that might help FHA address its weaknesses including: (1) risksharing between FHA and a mortgage insurer; (2) risksharing between FHA and a state mortgage insurance fund; (3) risksharing between FHA and a non-profit intermediary; and (4) risksharing between FHA and a GSE.
- The risksharing partnership between FHA and a GSE could be made with either Fannie or Freddie, or a similar arrangement with the FHLBanks might be considered. The paper noted that while FHA and the GSEs might share risk for various purposes, the risksharing example provided in the paper would be aimed specifically at the subprime market. “FHA would rely on the GSE to bring its superlative systems and analytical capacity to assist in serving subprime borrowers, who represent a level of risk that the GSE may not feel comfortable undertaking on its own. The goal of the partnership would be to offer products that provide price competition and transparency to the subprime market, through a delivery system committed to responsible lending practices.” Wartell noted, however, that “Giving the GSEs a role in the risksharing with FHA for any market would be controversial.” She noted, “It is possible that a similar project aimed at subprime lending could be launched with other partners instead, like MIs [mortgage insurers]; however, the GSEs bring certain advantages that make them especially well suited to helping FHA in higher risk markets.”
- The paper noted, “It is beyond the scope of this paper to debate whether risksharing with FHA is an appropriate role for the GSEs. In prior years, when discussion of FHA-GSE risksharing was broached, some argued that it would cause the GSEs to exceed their charter authority or appropriate market role. Suffice to say here that the GSEs are required by their charters to achieve certain public purposes and they are looking to find ways to expand their reach and serve more underserved borrowers. They will find it a

challenge, however, to manage the increased risk of the subprime market, while protecting their safety and soundness. Risksharing partnerships with FHA may be attractive to the GSEs, as a way of limiting their risk exposure as they expand into higher risk markets.” (*“Single-Family Risksharing: A New Evaluation of its Potential as a Tool for FHA,”* June 2002, Sarah Rosen Wartell for the Millennial Housing Commission)

Background on the Millennial Housing Commission

- The Millennial Housing Commission, created by Congress, was formed in January 2001, to develop legislative and regulatory recommendations to address America’s “housing crisis.” The formation of the Commission was authorized in the FY2000 VA, HUD Appropriations bill passed in September 2000. The Commission is composed of 22 members that were selected by the Chairman and Ranking Members of the House and Senate Appropriations Committee and the House and Senate Banking Committee and the relevant subcommittees of those panels with jurisdiction over housing. The Commission was tasked with producing a report to Congress by May 30, 2002. The Commission terminates on August 30, 2002. The Commission co-chairs are Susan Molinari and Richard Ravitch. Molinari is President & CEO of the Washington Group. Ravitch is a Principal in Ravitch Rice & Co., LLC and Chair of Aquarius Management Corporation. (*Millennial Housing Commission Web site, www.mhc.gov*) [Editorial Note: According to documents filed with the Secretary of the Senate on February 14, 2002, the Washington Group and Susan Molinari are registered to lobby for Freddie Mac.]

OFHEO releases paper on the financial performance of Fannie & Freddie in 2001

Fannie & Freddie’s purchase of single-family and multifamily mortgages increase to record levels

Percentage of loans Fannie & Freddie purchase that are run through their automated underwriting systems prior to purchase increased

Fannie & Freddie continue to purchase record shares of their own MBS for their portfolios and are purchasing each other’s MBS for their own portfolios

Fannie & Freddie’s purchase of single-family mortgages increased to record levels

- Purchases by Fannie and Freddie of single-family mortgages reached an all time high of \$961 billion in 2001. Collectively, Fannie and Freddie purchased before the end of the year some 40% of the single-family conventional mortgages originated in 2001, up from about 30% in 2000. Total purchases, including loans originated in prior years, amounted to 46% of 2001 originations. Fannie purchased \$568 billion in single-family loans in 2001 and Freddie purchased \$393 billion. Both totals were well over twice the amount each GSE purchased in 2000 and represented each GSEs’ highest volumes ever by a large margin.
- The refinance share of single-family mortgages purchased by Fannie and Freddie increased sharply in 2001. Of the loans purchased by Fannie and Freddie, more than 60% were refinanced loans, compared with less than one-third in 2000. The average LTV ratio of single-family mortgages purchased by Fannie and Freddie decreased. Adjustable-rate loans comprised a smaller share of each GSEs’ single-family purchases in 2001. The ARM share of Fannie’s purchases dropped from 16% in 2000 to 5%, while Freddie’s ARM share purchases fell from about 13% to less than 6%.

Fannie & Freddie maintain their presence in the subprime and Alternative A markets

- Freddie purchased \$9 billion of subprime mortgages, down from \$18.6 billion in 2000. Fannie does not release comparable data. Fannie and Freddie purchased approximately \$15 billion of low-documentation loans. Fannie purchased \$9.7 billion of Expanded Approval/Timely Payment Reward Mortgages.

Percentage of loans Fannie & Freddie purchase that are run through their automated underwriting systems prior to purchase increased

- During 2001, 62% of Freddie's single-family purchase volume was evaluated prior to purchase using Freddie's Loan Prospector automated underwriting system, compared with 56% in 2000. In 2001, Fannie processed 59% of its single-family purchases through Fannie's Desktop Underwriter. That represented 59% of 2001's business, up from 56% in 2000.

Fannie & Freddie's purchases of multifamily mortgages increased

- Fannie and Freddie's combined purchases of multifamily mortgages increased sharply in 2001. Purchases by Fannie exceeded \$19 billion, the largest annual volume ever, and almost twice the level purchased in 2000. Purchases by Freddie increased more than 50% to an annual high of \$9.5 billion. As of year-end 2001, Fannie and Freddie collectively owned (held in portfolio) \$33 billion of multifamily mortgages and guaranteed an additional \$52 billion of such mortgages.

Fannie & Freddie's volume of MBS and REMIC issuances increased

- Fannie and Freddie issued a record volume of MBS in 2001. Fannie's issuance increased 150% to an annual high of \$515 billion, which exceeded issuances for the two preceding years combined. Freddie's MBS issuances rose to \$387 billion in 2001, an increase of 134%. Fannie and Freddie's REMIC programs also grew significantly. Freddie's new issue volume of REMICs increased four-fold in 2001, reaching \$192.4 billion, its largest annual volume ever, while Fannie issuances rose by approximately \$100 billion to \$139.4 billion, its highest annual volume since 1993.

Fannie & Freddie's mortgage debt outstanding increased – Fannie & Freddie continue to purchase record shares of their own MBS for their portfolios and are purchasing each other's MBS for their own portfolios

- Fannie and Freddie's share of mortgage debt outstanding increased in 2001. Fannie's mortgage portfolio liquidation rate was 25% in 2001, compared with 10% in 2000. Freddie's mortgage portfolio liquidation rate increased to 28% in 2001 from 12% in 2000. Fannie and Freddie both continued to purchase sizable volumes of their MBS for their asset portfolios. Fannie purchased \$180 billion of its MBS in 2001, compared with \$105 billion in 2000, while Freddie's purchases of its MBS increased from \$59 billion in 2000 to \$158 billion in 2001.
- Fannie and Freddie also purchased significant shares of each other's MBS. The report showed that at year-end, 14% of Freddie's retained mortgage portfolio (\$70 billion) was invested in Fannie's MBS, while about 6% of Fannie's retained mortgage portfolio included Freddie's MBS. OFHEO found that Fannie held \$42.9 billion of Freddie's MBS, up from \$33.3 billion at the end of 2000, while Freddie's holdings of Fannie's MBS increased from \$28.3 billion to \$70 billion over last year. The research firm, Federal Financial Analytics, believes the number on GSE cross-ownership of MBS "raise further questions about concentration of risks and the true liquidity of the secondary market." Sources said that OFHEO has no immediate concerns about the GSE cross-ownership. (*National Mortgage News Daily Web site*, 9/11/02; *National Mortgage News*, Paul Muolo, 9/16/02; *Inside Mortgage Finance*, 9/11/02)
- Fannie and Freddie increased their combined debt outstanding by 24% to \$1.3 trillion in 2001, using the funds to finance the rapid growth in their retained mortgage portfolios.

Fannie & Freddie's profits continued to set records

- Fannie and Freddie's financial performance set new records across the board in 2001. Fannie's operating net income rose 21% to \$5.4 billion, while Freddie's rose 24% to \$3.2 billion. Over the past decade, Fannie's earnings have almost tripled and Freddie's have more than quadrupled. That strong profit growth has enabled Fannie and Freddie to sustain high rates of return on equity. Last year, Fannie's adjusted ROE

was 25.4%, the highest level since 1992, while Freddie's adjusted ROE was 23.1%. Total revenues increased significantly in 2001 – 21% for Fannie and 31% for Freddie.

Fannie & Freddie's guarantee fee income increased

- The combined guarantee fee income of Fannie and Freddie increased 8.5% in 2001, despite a decline in their average guarantee fee rates. Fannie's average guarantee fee rate fell to 19.0 basis points in 2001, down from 19.5 basis points in 2000. Freddie's average guarantee fee rate fell for the seventh consecutive year, dropping 0.6 basis points in 2001 to 18.7 basis points. Fannie and Freddie's average guarantee fee rate has fallen more than 23% since 1994.

Fannie & Freddie non-interest income increased

- Other non-interest income of Fannie and Freddie include fees earned for automated underwriting services, multifamily fees, fees earned from resecuritization activity, and gains and losses from certain hedging transactions. Freddie's net non-interest income totaled \$273 million in 2001, compared to \$130 million in 2000. That increase primarily reflects a \$115 million increase in securitization fees. Fannie recorded \$151 million of fees and other income in 2001, up from a \$44 million expense in 2000. That \$195 million increase was due primarily to a \$146 million in technology and transaction fees resulting largely from greater usage of Fannie's automated underwriting system (Desktop Underwriter), and the absence of a hedging loss that occurred in early 2000.

Credit losses declined, while delinquencies rates modestly increased

- Fannie and Freddie reduced their credit losses for the fourth consecutive year in 2001. Credit losses for Fannie fell 9% to \$81 million, or 0.0006% of Fannie's average total mortgage portfolio. Freddie's credit losses fell by 29% to \$67 million, or 0.0007% of its average total mortgage portfolio. The weakened US economy caused delinquency rates on single-family mortgages owned or securitized by Fannie and Freddie to increase modestly. The proportion of delinquent single-family loans at Fannie rose for the first time since 1997, increasing from 0.45% at year-end 2000 to 0.49% at the end of 2001. After falling for five consecutive years, Freddie's single-family delinquency rate increased from 0.37% at year-end 2000 to 0.41% at the end of 2001.

Combined non-mortgage investments of Fannie & Freddie increased

- The combined non-mortgage investments of Fannie and Freddie rose 14% from the fourth quarter of 2000 to the fourth quarter of 2001. Fannie's non-mortgage investments were down 3% to \$54 billion in the fourth quarter 2001. At the end of the fourth quarter, non-mortgage investments accounted for about 7% of Fannie's average investment assets, down from about 9% in the fourth quarter of 2000. Freddie's non-mortgage investments increased to \$92 billion in the fourth quarter 2001, an increase of 27% over the 2000 comparable period. Non-mortgage investments' relative share of Freddie's average earning assets was 16% in the fourth quarter 2001, a level similar to fourth quarter 2000.

Fannie & Freddie increased their core capital; market capitalization declined

- Fannie and Freddie increased their combined core capital by \$9.3 billion to \$44.5 billion in 2001. Fannie's core capital increased from \$20.8 billion at the end of 2000 to \$25.2 billion at the end of 2001, an increase of 21%. Freddie's core capital increased more than 34% in 2001 to \$19.3 billion, aided by the issuance of \$1.4 billion of preferred stock. Fannie and Freddie each experienced a modest decline in its market capitalization in 2001. Fannie's market capitalization decreased 8.5% at year-end 2001 to \$79 billion. Freddie's market capitalization fell by about 5% to \$45 billion.
- (Source: Unless otherwise indicated - *OFHEO annual research paper, "Mortgage Markets and the Enterprises in 2001,"* August 2002; *OFHEO press release, 9/6/02*)

Forbes ranks Fannie number eight and Freddie number 24 in its annual Global 500 list

- *Forbes'* Global 500 list which ranks publicly traded companies based on their sales, profits, assets and market value, ranked Fannie number eight and Freddie number 24. In 2001, Fannie earned more than \$50 billion in revenues and had nearly \$800 billion in assets. Freddie earned more than \$36 billion last year in revenues and had more than \$600 billion in assets. (*Inman News Feature, Forbes.com*)

Rank	Sales Rank	Company/Industry	Country	Revs (\$mil)	% Change	Net Inc (\$mil)	% Change	Assets (\$mil)	Market Cap (\$mil)	PE
8	7	Fannie Mae/finance	US	50,803	15	6,067	37	799,791	76,690	13
24	94	Freddie Mac/finance	US	36,173	21	5,373	72	617,340	45,609	13

(*Forbes.com, <http://www.forbes.com/global/2002/0722/global.html>*)

Group of prominent scholars – the Shadow Financial Regulatory Committee - will discuss GSE legislation at September 23 briefing

- The Shadow Financial Regulatory Committee is holding a luncheon and press briefing on September 23 that among other things will highlight proposed legislation for GSEs. The Shadow Committee, an independent committee sponsored by the American Enterprise Institute (AEI), is comprised of the following prominent scholars: George Kaufman, CoChair, Loyola University, Chicago; Robert Litan, CoChair, Brookings Institution; George Benston, Emory University; Marshall Blume, University of Pennsylvania; Charles Calomiris, AEI and Columbia University; Franklin Edwards, Columbia University; Scott Harrington, University of South Carolina; Richard Herring, University of Pennsylvania; Paul Horvitz, University of Houston; Hal Scott, Harvard Law School; Kenneth Scott, Stanford University; and Peter Wallison, AEI. (*AEI Invitation for September 23 briefing, www.aei.org/inv020923.htm*)

GSE debt news:

- (1) **October 2001 study published in Federal Reserve Bank of Cleveland publication, notes that as the federal debt declines, investors are turning to GSE debt as a close substitute**
- (2) **GSE long-term debt increases during first half of 2002; short-term debt decreases**
- (3) **Freddie lowers its five, 10-year debt sale minimums for 2003**

Background on GSE debt and the supply of Treasurys

- Over the past few years, as the US was running budget surpluses, and the national debt was being paid down, the supply of Treasury securities shrunk. Investors, traders, borrowers, and even the US Federal Reserve were being forced to find new benchmark securities to replace the shrinking number of Treasurys. Among possible alternatives as a benchmark were: (1) the debt securities of Fannie and Freddie; (2) derivatives tied to the swaps market; or (3) high-grade corporate bonds. Investors view the debt securities of Fannie and Freddie as “almost” as good as US Treasurys because of the implicit government guarantee of Fannie and Freddie’s securities. Fannie and Freddie began bond issuance programs (Fannie – Benchmark bond program; Freddie- Reference bond program) to mirror traditional Treasury operations in size and regularity as an alternative benchmark. Given the expected budget deficits in the next few years, the search for alternative benchmark investments may be lessened.

October 2001 study published in Federal Reserve Bank of Cleveland publication, notes that as the federal debt declines, investors are turning to GSE debt as a close substitute

- The Federal Reserve Bank of Cleveland's recent "*Journal of Money, Credit, and Banking*" contained a study entitled "*GSE Debt and the Decline in the Treasury Debt Market*" by Brent Ambrose, University of Kentucky and Tao-Hsien (Dolly) King, University of Wisconsin-Milwaukee. The paper was presented at the October 2001 Federal Reserve Bank of Cleveland's conference.
- **The paper noted that as a result of the economic expansion during the late 1990s, the size of the federal debt has declined significantly, reducing the amount of Treasury debt, while growth in federal agency debt has been remarkable.** Since 1996, the gross federal debt held by the public decreased by 9.6% to approximately \$3.4 trillion at the end of 2000. Economic projections indicate that the federal debt as a percentage of GDP may fall from 41% in 1999 to 6% in 2009. During the period of 1996 and 2000 when the federal debt declined 9.6%, total borrowing by the GSEs increased 76% from \$896 billion to \$1.7 trillion. **The authors noted, "As Congressionally chartered institutions, the GSEs enjoy several benefits unavailable to other private corporations" and that Fannie, Freddie, and the FHLBanks "have used these benefits to effectively dominate the residential mortgage market and their significant growth has attracted considerable criticism in recent years."** The authors explained, "Given the relative size of the GSEs, the impact that they have on financial markets, and the growth trajectory of their outstanding debt, understanding the impact of the decline in federal debt outstanding on the GSE debt market is of critical importance to policymakers involved in the debate regarding the costs and benefits of the GSEs' Congressional charter." ("*GSE Debt and the Decline in the Treasury Debt Market*," Brent Ambrose and Tao-Hsien (Dolly) King, "Journal of Money, Credit and Banking," Volume 34; Number 3, Part 2, August 2002)
- **The paper noted that GSE debt enjoys many advantages also associated with Treasuries and the "close relationship that exists between the GSEs and the federal government has created the perception of an 'implicit' guarantee by the federal government on GSE debt."** The paper separated the liquidity effect of GSE benchmark creation from the substitution effect resulting from the reduction in the Treasury debt market because it is "unclear the extent to which the advantage enjoyed by the GSEs is a result of the management ability (creating benchmark securities) or simply reflects the natural substitution of GSE debt for Treasury debt as the size of the Treasury market declines." ("*GSE Debt and the Decline in the Treasury Debt Market*," Brent Ambrose and Tao-Hsien (Dolly) King, "Journal of Money, Credit and Banking," Volume 34; Number 3, Part 2, August 2002)
- The paper found an overall reduction in yield spreads over time for debt issued by Fannie, Freddie, and the FHLBanks, indicating greater liquidity in the agency debt market. In general, the study confirmed that Fannie and FHLBank yields are positively related to the change in the overall level of Treasury debt outstanding and there is some evidence that the yield differentials between seasoned and newly issued Fannie bonds are positively priced and are smaller as the level of Treasury debt decreases. The study noted, "Given that we do not find a significant relationship between changes in the level of GSE debt and GSE yield spreads, our results do not support the hypothesis that the GSE benchmark programs have increased liquidity. Thus, our results support the hypothesis that as the federal debt contracts, investors are turning to GSE debt as a close substitute." ("*GSE Debt and the Decline in the Treasury Debt Market*," Brent Ambrose and Tao-Hsien (Dolly) King, "Journal of Money, Credit and Banking," Volume 34; Number 3, Part 2, August 2002)
- The paper examined whether Fannie and Freddie's debt issues could provide a suitable replacement for Treasuries as alternative benchmark securities. Overall, the paper's result suggested that agency debt might make suitable benchmark securities if the special status and privileges afforded these GSEs are eliminated.

(“Journal of Money, Credit and Banking,” Volume 34; Number 3, Part 2, August 2002; *Introduction*, Joseph Haubrich and James Thomson)

GSE long-term debt increases during first half of 2002; short-term debt decreases

- Federal agencies increased long-term new issue volume during the first half of 2002, to \$453.7 billion, according to a report by the Bond Market Association, up 6.7% percent from the \$425.3 billion issued during the same period last year. Long-term issuance by all the federal agencies increased, with the exception of Fannie, whose issuance decreased 9.2%.

Long-term federal agency debt issuance:

\$ billions	2001	2001: Q2	2002: Q2	YTD-to-YTD %Change	YTD-to-YTD \$Change
FHLB	383.0	165.2	169.7	2.7%	4.5
Freddie Mac	235.2	111.1	141.3	27.2%	30.2
Fannie Mae	249.4	123.3	112.0	-9.2%	(11.3)
Sallie Mae	19.5	9.0	11.3	25.6%	2.3
Farm Credit System	31.0	15.5	18.1	16.8%	2.6
Tennessee Valley Authority	3.4	1.2	1.3	8.3%	0.1
Totals	921.5	425.3	453.7	6.7%	28.4

Source: *Research Quarterly, Bond Market Association, August 2002*

- Short-term federal agency debt outstanding decreased 4%, to \$651.9 billion as of June 30, 2002, down from \$678.8 billion outstanding at the end of March. Short-term debt outstanding of the FHLBanks, Fannie, and the TVA increased, while Freddie, Sallie and the Farm Credit System decreased their short-term debt outstanding.

Short-term federal agency debt issuance:

\$ billions	6/30/01	3/31/02	6/30/02	% Change *	\$Change *
FHLB	175.0	128.3	134.3	4.7%	6.0
Freddie Mac	195.4	212.5	180.3	-15.2%	(32.2)
Fannie Mae	288.0	270.7	274.8	1.5%	4.1
Sallie Mae	35.2	30.7	29.2	-4.9%	(1.5)
Farm Credit System	34.5	34.8	31.1	-10.6%	(3.7)
Tennessee Valley Authority	2.4	1.8	2.2	22.2%	0.4
Totals	730.5	678.8	651.9	-4.0%	(26.9)

* Percentage and amount change between 6/30/02 and 3/31/02

Source: *Research Quarterly, Bond Market Association, August 2002*

- New issue activity of agency MBS increased to \$637.6 billion in the first half of the year, up 38.8% versus the \$459.5 billion issued during the same period last year. However, issuance was down on a quarter-to-quarter basis.

- Fannie, Freddie, and Ginnie Mae increased new issuance during the first half of the year. Agency MBS issuance increased to \$637.6 billion in the first half of the year, up 38.8% versus the \$459.5 billion issued during the same time last year. However, issuance was down on a quarter-to-quarter basis. MBS new issue volume totaled \$277.4 billion in the second quarter, down 4.9% from the second quarter of 2001 and down 23% from the first quarter of 2002. Fannie's issuance increased to \$311.0 billion in the first half of 2002, up 37.2 % from the \$226.7 billion issued during the same period last year. New issue volume by Freddie totaled \$240.4 billion in the first half of 2002, up 52.8% issued in the same period last year. Ginnie Mae's issuance increased 14.2%, to \$86.2 billion in the first half of the year, up from the \$75.5 billion issued during the same time last year.
- Issuance of agency collateralized mortgage obligations (CMO) increased to \$241.0 billion in the first half of 2002, more than double the \$111.5 billion issued during the first half of 2001. Freddie's total CMO issuance of \$148.7 billion in the first half of 2002, was up from the \$71.9 billion issued during the same period last year. Fannie's CMO issuance increased to \$58.4 billion in the first half of the year, up from the \$22.2 billion issued during first-half 2001. Issuance of Ginnie Mae CMOs was also up, totaling \$33.9 billion in the first half of 2002, almost double the \$17.4 billion issued one year ago. (*Research Quarterly, Bond Market Association, August 2002*)

Freddie lowers its five, 10-year debt sale minimums for 2003

- Freddie reduced the minimum size on the five- and 10-year Reference Notes it will sell in 2003 by a quarter to \$3 billion. Freddie also cut 30-year sales from its 2003 calendar. The "long-dated" issues may still be sold "according to market conditions and with advance notice," the company announced. Freddie also halved the minimum it would sell in a "reopening" or new sale of an existing issue, of five- and 10-year notes to \$1 billion. The minimum reopening of EuroReference Notes was trimmed to 1.5 billion euros from 2 billion euros. Total sale of its Reference Notes should fall between \$60 billion and \$80 billion in 2003, some 20% to 25% less than in 2002, said Jerome Lienhard, a senior vice president of investment funding at Freddie. (*Bloomberg News, Al Yoon, 9/9/02*)

HUD announces that it has established utility allowances for use by Fannie & Freddie in meeting HUD's affordable housing goals for the GSEs

- HUD announced that it has established monthly utility allowances in accordance with the Secretary's authority to regulate Fannie and Freddie. These allowances are used to determine whether rental units financed by Fannie and Freddie's mortgage purchases are affordable and may count toward the achievement of the income-based housing goals established by HUD. For these purposes, the allowances will be added to the contract rent for rental units in which: (1) tenant income is not available; (2) contract rent does not include the cost of utilities; and (3) the GSE does not use the HUD Section 8 utility allowance. Fannie and Freddie were advised by a May 9, 2002 letter that these allowances were to be published in the *Federal Register* and that they would become effective on July 1, 2002, but could be implemented sooner at each GSE's option. (*Federal Register, pages 56472-56473, 9/3/03*)

OFHEO's clarifying regulation to promote transparency and public awareness of supervisory standards for Fannie & Freddie is published in the *Federal Register*

- As noted in the August 23, 2002 *GSE Report*, OFHEO August 22 released a final safety and soundness regulation to promote transparency and public awareness of the supervisory standards for Fannie and Freddie. The safety and soundness regulation, a component of OFHEO's Regulatory Infrastructure Project begun in July 2000, was proposed for public comment on June 21, 2002. The regulation provides a stronger legal foundation, in line with Supreme Court rulings, for existing and future agency guidances. "The regulation should increase public awareness of the safety and soundness standards OFHEO employs in its

supervision of the Enterprises,” said OFHEO. “As with other federal financial regulators, the rule also provides a central location for such guidances.” (*OFHEO press release*, 8/22/02; *BNA Daily Report for Executives*, 8/23/02) The rule was published August 30 in the *Federal Register* and becomes effective September 30, 2002. (*Federal Register*, 8/30/02, pages 55691-55699)

- According to *BNA*, the regulation provides the regulatory framework to enforce minimum standards set forth in OFHEO’s policy guidances designed to identify key safety and soundness concerns regarding operation and management of Fannie and Freddie and to ensure that the conduct and practices of the companies “reasonably avoid the emergence of problems that might entail serious risks.” The minimum standards also reflect the need for internal policies and procedures in particular areas that, if not appropriately addressed, “may warrant supervisory action by OFHEO in order to reduce risks of loss and corresponding capital impairment.” OFHEO said, however, that the minimum standards are intended to stop short of dictating how Fannie and Freddie must be managed. (*BNA Daily Report for Executives*, 8/23/02)
- OFHEO said it hoped the regulation would give some of its rules greater protection if it ever faced a legal challenge and would give guidelines it has already issued higher standings in a court. OFHEO noted that the format of the regulations was designed to follow those used by the Office of the Comptroller of the Currency for national banks. OFHEO said it received comments from Fannie, Freddie, and the Mortgage Bankers Association of America, generally supporting the rule. (*BNA Daily Report for Executives*, 8/23/02)

OFHEO says Fannie & Freddie are adequately capitalized for this quarter under minimum capital requirements

OFHEO does not yet report whether Fannie & Freddie are adequately capitalized under risk-based capital requirements

- OFHEO Director Armando Falcon, Jr., announced that both Fannie and Freddie were adequately capitalized as of June 30, 2002. The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 requires OFHEO to determine the capital level and classification of Fannie and Freddie not less than quarterly. OFHEO determines whether Fannie and Freddie are adequately capitalized, undercapitalized, significantly undercapitalized or critically undercapitalized.
- OFHEO determined that Fannie’s minimum capital requirement was \$25.227 billion and its critical capital level was \$12.867 billion at June 30, 2002. Thus, Fannie’s core capital of \$26.382 billion on that date exceeded the minimum capital requirement by \$1.155 billion and exceeded the critical capital level by \$13.515 billion.* Freddie’s minimum capital requirement was \$19.520 billion and its critical capital level was \$9.950 billion at June 30, 2002. Thus, Freddie’s core capital of \$21.445 billion on that date exceeded the minimum capital requirement by \$1.925 billion and exceeded the critical capital level by \$13.515 billion.* (*OFHEO press release*, 9/12/02)

*Although OFHEO's risk-based capital rule is final, the '92 Act provides a one-year period between its effective date (September 13, 2001) and the time OFHEO may classify a GSE based on its risk-based capital requirement. Therefore, during this interim period, OFHEO will continue to classify the GSEs based on their minimum and critical capital requirements. (*OFHEO press release*, 9/12/02)

White House assistant who handled GSE issues is stepping down

- K. Philippa “Pippa” Malmgren, a special assistant to the President for economic policy, resigned from her position September 6. Malmgren plans to launch the Canonbury Group, a consulting firm that will

specialize in advising fund managers on international politics and policies, raise funds for alternative investments, and eventually manage assets. At the White House, Malmgren worked among other things, on government-sponsored enterprise policy. (*American Baker*, Michele Heller, 9/6/02)

Fannie Mae

Fannie tells Merrill Lynch conference it has plenty of room to grow

- Speaking September 5 before a Merrill Lynch Banking and Financial Services Investor Conference, Fannie's CEO Franklin Raines dismissed claims that a "housing bubble" is forming. He argued that people are not speculating in homes to make a quick buck and that people are buying homes because they need a place to live, and a home is a good, safe, long-term investment. Raines claimed that a housing bubble has never occurred nationwide and that a bubble "is particularly rare in Fannie Mae's realm of the market where homes cost an average of about \$160,000." He argued that housing prices will continue to increase for the rest of the decade and beyond, boding well for Fannie's growth.
- Raines dismissed concerns raised about Fannie's growth potential. He noted that Fannie's growth is not tied to the month-to-month flow of home buying and refinancing, but rather Fannie's growth is determined chiefly by "mortgage debt outstanding," which is the total stock of outstanding mortgage debt that needs to be managed. According to Raines, mortgage debt outstanding "has been – and will remain – one of the strongest growth markets in the economy." The market has already been growing at the upper end of Fannie's 8-10% projection for mortgage growth this decade, Raines said. He noted, "Altogether, as our market grows by 8-10 percent annually, it would more than double in size in this decade, going from \$5.2 trillion in 2000 to \$11-14 trillion by 2010. So you see, if Fannie Mae merely grew at the pace of our market, we could grow by 8-10 percent per year for the rest of the decade – a rate that is faster than GDP growth, and thus faster than most of the S&P 500. But we have grown faster than our market for many years. And that's because our growth is based on another business fundamental, and that's whether a company is competitive."
- Raines dismissed claims that Fannie dominates the entire mortgage market and that they do not have any real competition. He claimed that Fannie guarantees the credit quality of about 24% of the loans in their market, while commercial banks and Freddie each have a 17% marketshare. Next are thrifts and others and Ginnie Mae with 9%. In terms of owning mortgages and managing the risk on them – Raines claimed that commercial banks hold about 27%; thrifts 14%; Fannie 12%, followed by foreign investors 9%, Freddie 8%, life insurance companies 7% and pension funds 5%. Another 18% is split in smaller shares among the FHLBanks, credit unions, finance companies, state and local credit agencies and others. Raines believes that based on these numbers, Fannie has plenty of room to grow. "So you see, Fannie Mae has a great deal of competition," he said. "And with only 24% of the credit risk management market, and only 12% of the mortgage assets on our books, we have plenty of room to grow within our growing market."
- Raines dismissed claims that Fannie has grown too large and too fast and contended that the company has not grown any faster than the largest commercial banks. He acknowledged that the company benefited from the government's sponsorship of its mission, its mono-line focus on managing mortgages, its specialization in the long-term, fixed rate mortgage, and its risk management.
- Raines noted that if housing prices dropped suddenly 5% nationwide, which has never happened, Fannie's earnings would be cut by less than 10%. Such a decline "would be an apocalyptic event" for the housing market, Raines said. Yet it "would have cost less than 10 percent of our total net income per year." House prices would have to fall by 22% nationwide before Fannie loses even \$1, he said. He noted that Fannie is

only one of three companies in the S&P 500 that have produced double-digit growth in operating earnings per share for 15 years. “And so far this year, strong business volumes, a rising net interest margin and continued low credit losses all bode well to extend our record for a 16th year.” (*Fannie’s Chairman and CEO Franklin Raines speech before the 2002 Merrill Lynch Banking and Financial Services Investor Conference, 9/5/02; Bloomberg News, Al Yoon, 9/5/02*)

- In related news, Countrywide Credit Industries’ Chairman and CEO Angelo Mozilo told participants at the Merrill Lynch conference that “it is important to the country [that Fannie Mae and Freddie Mac] remain strong.” Mozilo said Countrywide is a big supporter of the GSEs and that, without them, his company could not exist. (*National Mortgage News Daily Web site, 9/5/02*)

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 “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) 9/10/02).

HUD Secretary Mel Martinez, Senator Wayne Allard (R-CO), Congresswoman Diana DeGette (D-DO), Congressman Tom Tancredo (R-CO), Congressman Mark Udall (D-CO) and Denver, CO Mayor Wellington Webb

- Fannie joined the above named officials to announce a new five-year \$35 billion investment plan for Colorado. (*Fannie press release, 8/29/02*)

Senator Richard Lugar (R-IN), Senator Evan Bayh (D-IN), Congresswoman Julia Carson (D-IN)

- Fannie joined with Congresswoman Carson to announce an eight-year \$33 billion investment plan for the state of Indiana. Statements by Senators Lugar and Bayh were included in Fannie’s press release. (*Fannie press release, 8/28/02*)

Senator Conrad Burns (R-MT)

- Fannie joined Senator Burns in announcing the availability of a Fannie’s HomeChoice mortgage program for low and moderate-income borrowers with disabilities. (*Fannie press release, 8/30/02*)

Senator Harry Reid (D-NV)

- Fannie announced Nevada’s first conventional loan on tribal land. A statement of support by Senator Reid was included in Fannie’s press release. (*Fannie press release, 9/12/02*)

Congressman Mark Udall (D-CO) and County Commissioner James Newberry

- Fannie joined the above named officials to announce the opening of a new affordable housing development. (*Fannie press release, 8/23/02*)

Congresswoman Anna Eshoo (D-CA), East Palo Alto, CA Mayor Duane Bay and Menlo Park Mayor Stephen Schmidt

- Fannie joined the above named officials and representative from Chase Manhattan Mortgage Corp. to announce a new \$5 million anti-predatory lending initiative. (*Fannie press release, 8/28/02*)

Congressman Thomas Udall (D-NM), New Mexico House Speaker Ben Lujan, and State Representative Lucky Varela

- Fannie joined the above named officials to announce the availability of Community Solutions, a \$5 million mortgage pilot created in cooperation with the New Mexico Nurses Association and local lenders. (*Fannie press release, 9/3/02*)

Congressman Doug Bereuter (R-NE)

- Congressman Bereuter gave the keynote address at Fannie's Nebraska Advisory Council meeting. (*Fannie press release, 8/28/02*)

Congressman Jim Matheson (D-UT)

- Fannie joined Congressman Matheson to announce a new Smart Commute initiative to encourage homeownership near public transportation. (*Fannie press release, 8/26/02*)

Congressman Doc Hastings (R-WA)

- Fannie joined Congressman Hastings in announcing the availability of a Fannie's HomeChoice mortgage program for low and moderate-income borrowers with disabilities. (*Fannie press release, 8/29/02*)

Congressman Silvestre Reyes (D-TX)

- Fannie joined Congressman Reyes in announcing a new mortgage underwriting pilot for low-income families. (*Fannie press release, 8/29/02*)

Congressman Baron Hill (D-IN)

- Fannie joined Congressman Hill to convene a housing roundtable with Southern Indiana employers to discuss employer-assisted housing benefit plans. (*Fannie press release, 8/29/02*)

Congressman Joseph Hoeffel (D-PA)

- Fannie joined Congressman Hoeffel to announce a new \$10 million Smart Commute initiative to encourage homeownership near public transportation. (*Fannie press release, 9/3/02*)

Congressman Michael Capuano (D-MA)

- Fannie joined Congressman Capuano to recognize the first employers to participate in an employer assisted housing initiative. (*Fannie press release, 9/3/02*)

Congressman Ronnie Shows (D-MS)

- Fannie joined Congressman Shows and the Metro Jackson, MS Habitat for Humanity to welcome a new homeowner into one of 100 homes being built nationally by all women volunteer crews over an 18-month period through the end of 2002. Local funding was provided by 44 corporate and individual sponsors, including Fannie. (*Fannie press release, 9/3/02*)

Freddie Mac

Freddie announces new sales vice president

- Freddie announced that Connie Ferran has been named vice president, Western States for Freddie's Community Lending division. Ferran joined Freddie in July 1991, and has held several positions within the organization. In her most recent position, she was senior director of credit for Community Lending. She also has served as product development director in the Marketing Department, director of mortgage credit policy and director of institutional risk policy. Prior to joining Freddie, Ferran spent five years with Crossland Savings in Glendale, CA where she managed mortgage warehouse lines of credit relationships. (*Freddie press release, 9/5/02*)

Federal Home Loan Banks

FHFB adopts new ethics rules governing the agency's directors, officers and employees to the FHLBank System

- The FHFB September 12 unanimously approved new standards of conduct governing the relationship of the agency's directors, officers and employees to the FHLBank System. FHFB Chairman John Korsmo said the need for new standards grew out of the changing regulatory relationship that developed after passage of the Gramm-Leach-Bliley Act in 1999. The legislation removed FHFB authority over numerous aspects of FHLBank operations. "The Finance Board is no longer the senior partner in the operation of the Federal Home Loan Banks," Korsmo said. "The Board, representing the public interest, is now the arms-length regulator for the safety and soundness of the System, and these standards reflect that fundamental change."
- The new standards prohibit FHFB directors, officers, and employees from attending any official business meetings of a board of directors, committee, or advisory council meeting of an entity regulated by the FHFB. The language does not, however, prohibit attendance before or after any such official meeting. Limited exceptions are also made for FHFB supervisory staff. The standards of conduct further clarify that individual FHFB directors may not speak or act on behalf of the FHFB, which exercises its authority jointly. The standards also reaffirm government rules on gift taking and reimbursement for travel, food or entertainment. The document also clarifies that the new standards apply to the Secretary of Housing and Urban Development or his designee only in their performance of FHFB-related duties, not in their HUD capacities. Action on the standards, originally scheduled for the August Board meeting, was postponed in order to add that clarifying language. HUD Secretary Mel Martinez has designated John Weicher, the assistant secretary for housing, to serve on the FHFB. (*FHFB press release, 9/12/02*)
- Korsmo proposed the standards of conduct following a commissioned study of FHFB practices by Greg Walden, a noted ethics attorney with the Patton-Boggs law firm in Washington, D.C. Walden reviewed the rules that governed other financial regulatory agencies, as well as the practices followed by their directors. (*FHFB press release, 9/12/02*) The report by Walden showed that the FHFB, which has long been criticized as being too close to the industry it regulates, has turned a blind eye to some common practices that are prohibited or would at least be questioned at other financial regulators. The new standards of conduct end a long-standing practice among FHFB officers and directors of participating in meetings hosted by the FHLBanks they regulate. (*Dow Jones Newswire, Dawn Kopecki, 8/7/02, 9/12/02*)

FHFB holds hearing to discuss a perceived FHLBank System cost of funds problem to determine whether the FHLBank System is paying too much for its borrowing in the debt market

FHFB Chairman John Korsmo notes that every dollar the FHFB borrows has “a very real and valuable but unwritten market presumption that the American taxpayers would step up to pay bondholders”

John McEvoy, the Chairman of the FHLBanks’ Office of Finance, says the FHLBank System’s borrowing costs “appear to compare very favorably to the debt costs” of Fannie & Freddie

- The FHFB held a public hearing at its September 12 board meeting on the cost of funds issue. The cost of funds issue centers on whether the FHLBank System is paying too much money for its borrowing in the debt markets and whether the System’s borrowing operations could be conducted more efficiently and cheaply. The system last year issued more than \$5 trillion in debt securities, mostly with very short-term maturities. According to some people within and outside the FHLBank System, savings could be achieved if the FHLBank System’s borrowing operations were better coordinated. In response, the FHFB circulated a controversial draft regulation, under which the Office of Finance’s board, currently comprised of three persons, would be expanded to include the presidents of all 12 FHLBanks and a new public interest chairman (making at least \$700,000 in compensation). The expansion was suggested by the FHLBanks to reduce the costs of raising money in the debt markets. However, the proposal generated controversy and was temporarily shelved. (*Dow Jones Newswire*, John Connor, 5/30/02, 7/29/02, 9/10/02, 9/12/02)
- The Office of Finance has a three member Board (two FHLBank Presidents and a public interest member) appointed by the FHFB to oversee the Office of Finance. The Office of Finance is operated on behalf of the 12 FHLBanks. Its primary function is to issue and service all debt securities for the FHLBanks. The Office of Finance also provides the FHLBanks with credit and general capital market data and manages their relationship with the credit rating agencies. In addition, the Office of Finance administers two other funding programs, the Resolution Funding Corporation (REFCORP) and the Financing Corporation (FICO). The members of the Office of Finance Board are: James Roy, president and CEO of the FHLBank of President (recently reappointed), Patrick J. Conway, president of the FHLBank of Des Moines, and John McEvoy, the public interest member who serves as chairman (will soon be retiring). (*FHFB press release*, 9/12/02)

Remarks at September 12 hearing

- In remarks at the September 12 hearing, FHFB Chairman John Korsmo said the FHFB must be more vigilant in overseeing the FHLBanks’ borrowing programs and that the hearing was appropriate “to promote public accountability by the Federal Home Loan Banks, their owners and managers, for the enormously valuable public endowment of borrowing privileges.” The members of the Board of the Office of Finance will testify about their “plans and strategies for guaranteeing wise use of the GSE status in capital markets.” He concluded, “I have heard it said that no ordinary business would publicly reveal its strategy for acquiring lowest-cost raw materials.” He noted, however, **“the raw materials for the Bank system is money borrowed from the public. Every dollar is borrowed through a special access to agency debt markets granted by Congress. Every dollar is borrowed with a very real and valuable but unwritten market presumption that the American taxpayers would step up to pay bondholders.”** (*Written statement by FHFB Chairman John Korsmo*, 9/12/02)
- Joe McKenzie, deputy chief economist of the FHFB, noted that the FHLBanks issued \$177 billion in bonds during the first half of 2002 in 4,475 separate bond transactions, and are expected to exceed these totals in the second half of 2002. “At June 30, 2002, the Federal Home Loan Banks had \$507 billion of bonds and \$134 billion of discount notes outstanding,” he said. McKenzie said the FHLBanks limit their interest rate risk by “micro-funding” their assets, which reduces hedging costs but potentially adds higher debt costs

because of the relative illiquidity of the debt issued. To assess the full funding cost, he said, the hedging costs and savings associated with a debt issuance must be factored. He noted that in order to meet members' demands, the FHLBanks need predominantly short-term funding. McKenzie said the FHLBanks "have a very small cost advantage relative to Fannie Mae and Freddie Mac when comparing auctioned discount notes;" since the beginning of 1999, "the yield on two-year global bonds is comparable with that of Fannie Mae/Freddie Mac securities, fluctuating between several basis points above and several below them;" and the FHLBanks in May 2002 issued a 10-year global bond "that priced approximately one basis point higher than a comparable Fannie Mae bond." (*Dow Jones Newswire*, John Connor, 9/12/02; *Written statement by FHFBS Deputy Chief Economist Joe McKenzie*, 9/12/02)

- Patrick Conway, president of the FHLBank of Des Moines and a member of the board of directors of the Office of Finance, and head of a FHLB debt cost task force, told the FHFBS that "the all-in cost of FHLBank System funding is cost effective when compared to comparable debt issued by other participants in the government securities market." Conway stated, "Overall, our cost of funds is competitive. There are selected opportunities for incremental improvement, and we have a work plan to address those opportunities." The task force has implemented improvements in the FHLBanks' debt issuance practices. An example includes the Office of Finance Board's formalizing a process in which the Office of Finance management is authorized to implement a debt issuance practice when a super majority of eight FHLBanks agree with the practice (previously required all 12 FHLBanks and management to agree). As a result of the task force's recommendations, the FHLBanks also reduced the number of TAP Auctions from twice a day to once a day and provided dealers with a longer notice period when issuing certain callable bonds. (*Written statement by President of the FHLBank of Des Moines Patrick Conway*, 9/12/02)
- James Roy, president of the FHLBank of Pittsburgh and also a member of the Office of Finance board, said the Office of Finance has "continuously pursued and achieved diverse and cost-effective funding solutions for the Banks along with virtually error-free servicing." Recent improvements to the Office of Finance include a reduction in the number of staff from 65 to 24 and the termination of senior managers and the hiring of John Darr as the new Managing Director. "The upshot of these changes was an exclusive focus on debt issuance and servicing," he noted. The Office of Finance relocated from downtown DC to a less expensive facility in Reston, VA, introduced pay for performance compensation systems, and launched comprehensive customer service surveys of the FHLBanks, and most significantly, invested heavily in Information Technology to streamline processing and simplify debt issuance. "In all, the past ten years have been a period of impressive progress for the Office of Finance...and we expect more of the same in the years to come." He concluded, "To be sure, there is always room for improvement." (*Written statement by President of the FHLBank of Pittsburgh James Roy*, 9/12/02)
- **John McEvoy, the Chairman of the FHLBanks' Office of Finance, said the FHLBank System's borrowing costs "appear to compare very favorably to the debt costs of the other housing GSEs," Fannie and Freddie.** He said this is particularly impressive when one considers that Fannie and Freddie are organized along the lines of standard, hierarchical corporations, whereas the Office of Finance services 12 regional FHLBanks and must reconcile their competing needs. **McEvoy said the headline coming out of the September 12 hearing should be: "Home Loan Banks pledge that their debt issuance practices, already competitive with those of the other housing GSEs, will get even better."** He noted, "The lowest sound cost of financing must be the goal of the GSEs." (*Dow Jones Newswire*, John Connor, 9/12/02; *Written statement by Chairman of the FHLBanks' Office of Finance John McEvoy*, 9/12/02)
- McEvoy noted that although the Office of Finance is directed by the FHFBS to secure funding at the lowest sound costs, "most banks always considered that mandate to include an unstated exception which allowed any of them market access at any time, in any amount, and even at any price." He noted that a few of the FHLBanks had raised funds through high-cost means, such as frequent auctions of callable bonds or longer-

maturity instruments. These kinds of funds compare least favorably to the average cost of funds raised by the other GSEs. “Ultimately, those higher costs are also likely to spill over even onto the majority of Banks, which are willing to aggregate and plan their debt issuance to capitalize on the best practical market timing...If a bank is following practices which raise its costs, other Banks’ costs, or all Banks’ costs, it should change its practice, not penalize its sister Banks and the public, which must bear the cost of those practices.” (*BNA Daily Report for Executives*, Richard Cowden, 9/13/02; *Written statement by Chairman of the FHLBanks’ Office of Finance John McEvoy*, 9/12/02)

- McEvoy noted that the number of Banks engaging in these practices is relatively small and that the Office of Finance has developed responses to reduce even that number. One is a “Best Practices Standard” to help guide bank access to the debt markets and another is an ongoing program to upgrade the Office of Finance’s internal research, analysis, and product development capability. McEvoy urged directors of the FHFb to enforce a strict “no exceptions” policy to assure that the FHBanks must raise funds in the most cost effective fashion. He stated, “I urge you to make clear in a normal communication to both the [Office of Finance] and the banks that there are no acceptable exceptions to the mandate in the existing [Office of Finance] charter which requires that it raise funds in the most cost effective fashion.” He added, “You might reasonably ask why it is necessary to do anything at all. Isn’t the mission mandate clear enough? Yes, it seems to be. But the ‘any time, any amount’ exception grew up in spite of that clarity and is still lurking out there...” (*BNA Daily Report for Executives*, Richard Cowden, 9/13/02; *Written statement by Chairman of the FHLBanks’ Office of Finance John McEvoy*, 9/12/02)
- McEvoy cautioned, however, that the FHFb should avoid micro-managing system borrowing operations. He said that “sound organizational management doctrine, effective separation of operational and regulatory roles, and the resulting maximum insulation of the federal government from liability for OF (Office of Finance) and Bank operations all argue compellingly against the Finance Board micro-managing OF operations and decisions.” (*Dow Jones Newswire*, John Connor, 9/12/02) McEvoy noted that he was retiring soon as an Office of Finance Board member. (*Written statement by Chairman of the FHLBanks’ Office of Finance John McEvoy*, 9/12/02)

FHFb Director Franz Leichter challenges FHFb Chairman John Korsmo on the FHFb’s recent re-organization

FHFb recently eliminated 21 positions and plans to hire 20 additional examiners

- FHFb director Franz Leichter challenged FHFb Chairman John Korsmo at a September 12 FHFb meeting for eliminating an agency office and terminating several employees without informing the Board. While the changes were seen as positive, the timing and short notice took many by surprise. (*Dow Jones Newswire*, Dawn Kopecki, 9/12/02)
- FHFb Chairman John Korsmo August 7 announced the reorganization of the FHFb. Under the new structure, the Office of Policy, Research and Analysis would be merged into the Office of Supervision, under the Supervision’s current director, Stephen M. Cross. The Office of Managing Director and the Office of Communications were eliminated. (*FHFb press release*, 8/7/02) Eight positions in the Office of Communications were eliminated and those resources were shifted to hire additional examiners. (*Dow Jones Newswire*, Dawn Kopecki, 9/12/02)
- “We had a major restructuring which was not done before the board of directors,” Leichter said, requesting that Korsmo provide some advance notice of major staff changes and personnel hires. Korsmo responded, “To the extent that this is an effort to undercut my authority, I will not (support that),” he said. “The

delegation was made to the chairman of this organization to appoint, promote, remove, raise compensation” for all personnel over nine years ago. (*Dow Jones Newswire*, Dawn Kopecki, 9/12/02)

- In related news, the FHFB has begun the process of placing many of its bank examiners in offices around the country. The FHFB’s Office of Supervision intends to hire 13 examiners - three of them supervisory examiners - by the end of 2003. Breaking with past practice, many of the new examiners will be located outside of the agency’s Washington headquarters, based in cities with FHLBanks. FHFB Chairman Korsmo noted that the agency recently underwent a major reorganization with the primary goal of putting more resources into supervision of the individual FHLBanks. He said his goal was to at least double the current staff of 11 examiners. The new examiners will also work in supervisory teams, each of which will concentrate on three or four FHLBanks, allowing them to develop a deeper understanding of those financial institutions’ operations. Korsmo added that placing examiners in regional offices will also make recruitment easier and reduce travel costs and other overhead. The FHFB is also hiring for the following positions: Senior Mortgage Analyst; Associate Director, Supervision Policy Division; and Associate Director, Supervision and Examination Division. (*FHFB press release*, 8/28/02) [See August 23, 2002 *GSE Report* for more information about the FHFB’s re-organization.]

FHLBank of Atlanta provides subsidized financing for new Krispy Kreme franchise

- The FHLBank of Atlanta announced that it is committing \$600,000 in subsidized financing to help underwrite the cost of Krispy Kreme’s newest store in Greensboro, NC, the first to be owned by a non-profit, community development corporation. The FHLBank of Atlanta helped develop the financing plan with Greensboro-based Project Homestead, which will benefit from a reduced interest rate on a conventional loan provided by FHLBank of Atlanta member Branch Banking & Trust. Project Homestead received the subsidized loan through the FHLBank of Atlanta’s Economic Development Growth Enhancement (EDGE) program. (*PR Newswire*, 9/10/02)

FHLBank of Atlanta launches pilot program offering matching funds for participation in the New Market Tax Credit Program

- The FHLBank of Atlanta has launched a pilot program to facilitate its members’ participation in the Treasury Department’s New Markets Tax Credit Program (NMTTC), reported Laura Thompson with the *American Banker*. Under the FHLBank of Atlanta’s program, companies that invest in businesses designated as “community development entities” qualify for a tax credit equal to 39% of their investment, paid out over seven years. The FHLBank of Atlanta will double that credit for its members by matching investments of up to \$100,000 per member. The funds will be repaid to the FHLBank of Atlanta after seven and before 10 years. For 2002, \$1 million is available to FHLBank of Atlanta members for this initiative. So far no bank has made an investment to qualify for the program. A few of the other 11 FHLBanks have had meetings and circulated materials about the program, but the FHLBank of Atlanta is the only FHLBank with a matching program. The FHLBank of Atlanta will wait to see how successful the program is before deciding whether to continue the program next year. (*American Banker*, Laura Thompson, 9/9/02; *FHLBank of Atlanta Web site*, www.fhlbatl.com)

FHFB adopts reduced FY 2002 budget that increases spending on safety and soundness

- The FHFB September 12 unanimously adopted a \$27 million Fiscal Year 2003 budget that reduces spending by 8% while significantly increasing expenditures for the agency’s supervision of the FHLBank System. The FY2003 budget is \$27,065,253, a decline of \$2.4 million from the FY2002 budget of \$29,509,767. At the same time, the FY2003 budget, which goes into effect on Oct. 1, includes a \$2.8 million increase related

to the expansion of the Office of Supervision, allowing the addition of: (1) 11 new bank examiners; (2) 4 analysts; (3) 1 senior risk advisor; and (4) 2 associate directors. (*FHFB press release, 9/12/02*)

FHFB adopts final rule making changes to its Affordable Housing Program (AHP) to aid home-buying opportunities

- The FHFB September 12 unanimously approved a final rule making changes to the Affordable Housing Program. FHFB regulations had authorized the FHLBanks each year to allocate the greater of \$3 million or 25% of their AHP contribution for homeownership set-aside programs. The rule adopted September 12 allows each FHLBank to set aside an additional amount of up to the greater of \$1.5 million or 10% of their annual AHP amount, specifically for first-time homebuyers. This increased funding authority will enable the FHLBanks to provide up to an additional \$24 million this year. The final rule also increases the maximum subsidy limit per household to \$15,000 for homeownership set-aside programs in general.
- FHFB Chairman John Korsmo said the additional set-aside dollars will complement national housing initiatives to expand first-time homeownership, especially among minority and immigrant households, those in rural areas and on American Indian reservations.
- AHP provides direct subsidies or loans at subsidized rates to FHLBank System's member institutions to finance the purchase, construction, or rehabilitation of affordable housing units. The FHLBank System contributes the greater of 10% of net earnings or \$100 million per year to the program. The FHLBanks' total AHP contribution for 2002 is \$240 million. (*FHFB press release, 9/12/02*)

FHFB names Arnold Intrater as General Counsel

- The FHFB announced that Arnold Intrater has been named the agency's general counsel. Intrater came to the FHFB as counsel to the managing director in August 2001 and has been serving as acting general counsel since September. Intrater previously served as deputy general counsel and general counsel at the FHFB from 1989-1992, addressing the major legal and management decisions that resulted from Congress' creation of the FHFB in 1989. His prior government positions also include service as the deputy general counsel and acting general counsel in the Peace Corps. From 1985-89 he was general counsel at the Office of Administration in the Executive Office of the President. As general counsel, Intrater will head one of the FHFB's three offices, overseeing a staff of 11. (*FHFB press release, 8/22/02*)

Farm Credit System/Farmer Mac

Critics claim Farmer Mac has strayed far from its mission of providing credit to farmers and ranchers

- Ben Jackson with the *American Banker* profiled Farmer Mac amid criticisms that the company has strayed from its mission. Jackson noted that Farmer Mac has been subject to criticisms over its finances by the *New York Times* and that the General Accounting Office is currently examining among other things, whether Farmer Mac has strayed from its mission. The Senate Agricultural Committee asked the GAO to investigate Farmer Mac's "fulfillment of its Congressionally established mission" and other issues raised in the *New York Times* article, including governance, investment practices, and compensation policy, particularly the granting of stock options to officers and directors.
- Some agricultural bankers noted Farmer Mac's Washington, DC headquarters as evidence that it is out of touch with farmers and ranchers and complained that the GSE is only interested in purchasing large loans. Joan Dean, the chairman of Glenwood State Bank in Iowa, said Farmer Mac would rather purchase a \$1

million loan than the average Glenwood loan of \$120,000 because the amount of paperwork is the same either way. Dean and other critics claim that Farmer Mac's management is more concerned with profits and share price than in meeting farmers' needs.

- Farmer Mac's President and CEO Henry Edelman defended the criticisms. "We manage for the benefit of farmers and ranchers and the lenders who serve them," Edelman said. "We address the solid, middle-of-the-road credits." Edelman blamed the company's stock price drop on short sellers, which he claimed are criticizing Farmer Mac to depress the stock price and earn profits. (*American Banker*, Ben Jackson, 9/10/02)

As Farmer Mac's stock dropped in the second quarter amid criticisms of its finances, large investment firms bought additional shares

- Farmer Mac's shares dropped 40% to \$26.70 by the end of the second quarter amid criticism of its finances, yet the stock was attracting interest from some of the biggest investment firms, reported Tyler Lifton with *Dow Jones Newswire*. According to Securities and Exchange Commission filings, Fidelity Investments bought 1.47 million shares, lifting its position to 1.63 million shares, or 16.14% of the total; Federated Investors raised its position by 553,000 shares to 904,000; Morgan Stanley Dean Witter took an additional 366,000 shares; Goldman Sachs & Co. bought 423,505 shares; J.P. Morgan Chase purchased 430,695 shares; and Blue Ridge Capital LLC and U.S. Bancorporation, bought 330,000 shares and 305,000 shares, respectively. Farmer Mac has been subject to criticisms over its finances in the *New York Times* and by Gotham Partners Management Co. and is subject to an investigation of its finances by the Government Accounting Office (GAO).
- Many of the assertions that sparked the selling weren't accurate, Farmer Mac chief executive officer Henry Edelman said in an interview with *Dow Jones Newswires*. He argued that the company isn't nearly as exposed to interest rate risk as critics claim and that, contrary to the views of some people, Farmer Mac is fulfilling its mandate. He said Farmer Mac's interest rate risk - reflected in any mismatch between the maturity component of its assets and liabilities - is less volatile than that of other GSEs. Farmer Mac disclosed for the first time ever quarterly data on its duration gap. At the end of the second quarter, Farmer Mac's duration gap was negative 2.9 months, meaning the duration of its assets on average was 2.9 months less than that of its debt liabilities. In comparison, Fannie's duration gap measured negative four months, before ballooning out to negative nine months in July.
- Farmer Mac's mortgage prepayment exposure also tends to be lower on average than that of the housing GSEs, according to Edelman. While Farmer Mac keeps "substantially all" mortgages it buys on its balance sheet, rather than packaging them into agricultural mortgage-backed securities - a tactic that increases the company's interest rate risk - that doesn't mean Farmer Mac is failing its Congressionally-mandated mission of creating a secondary market for agricultural loans as its critics claim, Edelman said. That's because simply buying and holding the loans is sufficient to increase the lending capacity of agricultural lenders, which is what Farmer Mac was created to do, according to Edelman. Farmer Mac's mission is to create a secondary market for "agricultural mortgages, not agricultural mortgage-backed securities," he said. Farmer Mac retains the vast majority of its loans on its books because it is more profitable to do so, he said. (*Wall Street Journal*, Tyler Lifton, 9/5/02)

Postal Service

President Bush signs FY 2002 supplemental appropriations bill containing \$87 million for the Postal Service

Bill also contains language reforming Alaska's subsidized "bypass mail"

Airline carriers sue the federal government over the Alaska bypass mail language

- President Bush signed into law the \$28.9 billion FY 2002 supplemental appropriations bill (HR 4775) August 2 which includes \$87 million to assist the Postal Service in protecting employees and postal customers from exposure to biohazardous material and to sanitize and screen the mail. (*BNA Daily Report for Executives*, 8/5/02) [The money for the Postal Service does not appear to be part of the emergency \$5.1 billion in funding that President Bush has rejected.]
- As noted in previous *GSE Reports*, the Postal Service already received \$175 million from President Bush last year to immediately improve Postal Service safety shortly after the September 11 terrorist attacks and anthrax scare. The Postal Service was also provided \$500 million for mail sanitization as part of a \$318 billion defense department appropriations bill signed by President Bush in January. (*DM News*, Melissa Campanelli, 2/6/02) In November 8, 2001 testimony before the Senate Appropriations Treasury and General Government Subcommittee, Postmaster General John Potter told lawmakers that the Postal Service needed an immediate \$2 billion to cover lost revenues from the September 11 terrorist attacks and \$3 billion in costs for equipment to sanitize the mail. (*BNA Daily Report for Executives*, Derrick Cain, 11/9/01)

Alaska "bypass" mail reform

- The supplemental appropriations bill also contained language reforming Alaska's "bypass mail" service which would limit the number of air carriers that can handle federally subsidized mail in Alaska. (*Fairbanks Daily News-Miner*, 7/19/02) Two airline carriers, Alaska Central Express Inc. and Evergreen International Inc., are suing the federal government over the new bypass mail reform language contained in HR 4775, arguing that the rules are unconstitutional and unfairly limit competition for federally subsidized mail. (*Associated Press*, 8/27/02; 9/1/02)
- Alaska Central Express filed its suit in US District Court in Anchorage August 2, the day President Bush signed HR 4775 into law. Alaska Central claimed the government, the Postal Service, and four larger airlines have conspired to drive the company out of business, costing about 100 jobs. The company noted that 70% of its revenues come from bypass mail. Evergreen filed its suit August 19. (*Associated Press*, 8/27/02; 9/1/02)

Background on Alaska bypass mail reform language

- Under "bypass mail," the Postal Service has been obligated since the 1980s to transport shipments of 1,000 pounds or more to rural Alaska - at parcel post rates. The parcel rates are well under what commercial air companies would charge to deliver goods to the state's remote areas. (*Denver Post*, Bill McAllister, 5/31/02) Such mail, usually groceries and other bulky goods, bypasses post offices and goes directly to rural Alaska on eligible air carriers chosen on a rotating basis. (*Fairbanks Daily News-Miner*, Sam Bishop, 7/19/02)
- Under the law, signed by the President and pushed by Senator Ted Stevens (R-AK) and Congressman Don Young (R-AK), the kind of air carriers eligible to carry bypass mail would be restricted. (*Fairbanks Daily News-Miner*, Sam Bishop, 7/19/02) The Postal Service acknowledged it had been losing as much as \$100 million a year on mail service in Alaska, much of it because of bypass mail. Senator Stevens and

Congressman Young hoped that by consolidating air traffic on the most heavily traveled routes, they could save as much as \$30 million a year. But in order to carry out that consolidation, the bill would limit contracts for those main routes to the four airlines that currently service them. (*National Journal's Congress Daily*, 6/3/02)

- Senator Stevens and Congressman Young believe too many air companies are trying to get into the business, which has become a lucrative way for the state's bush pilots to supplement their incomes. (*Denver Post*, Bill McAllister, 5/31/02) Senator Stevens and Congressman Young want the program to prop up passenger service to the bush, but some carriers are just hauling mail. The language Senator Stevens and Congressman Young included in the appropriations bill would make any new carriers on the "mainline" routes (between Alaska's larger cities and bush hubs) provide a minimum level of passenger service. Existing mainline carriers – Alaska Airlines, Air Cargo Express, Lynden Air Cargo and Northern Air Cargo – would be exempt from the passenger requirement. Smaller carriers on the routes that radiate from the bush hubs would receive most of the bypass mail if they carry most of the passengers. The smaller carriers would also have to upgrade to twin-engine aircraft on some routes. (*Fairbanks Daily News-Miner*, Sam Bishop, 7/19/02)

**White House is expected to appoint a Presidential postal reform commission in November, reports
*Kiplinger***

- President Bush is expected to appoint a bi-partisan Presidential postal reform commission in November to recommend an overhaul of postal operations, reported Jim Ostroff with *Kiplinger Business Forecasts*. Ostroff expects that the commission will make its recommendations by next summer and Congress will approve a reform plan based on the recommendations in 2004. He noted, "It's too early to fill in the details, but a central element of the plan will be allowing the Postal Service more flexibility to cut back its workforce and shut down unneeded facilities." (*Kiplinger Business Forecasts*, Jim Ostroff, 8/30/02)

Senate Government Affairs Subcommittee plans September 27 Postal Service oversight hearing

- The Senate Committee on Government Affairs' Subcommittee on International Security and Proliferation and Federal Service has scheduled a postal oversight hearing for September 27. Likely topics are an update on the Postal Service's Transformation Plan, postal finances and efforts to address last year's anthrax crisis and planning to prevent future attacks. Postmaster General John Potter and Government Accounting Office (GAO) Comptroller General David Walker are expected to testify. (*DM News*, Melissa Campanelli, 9/10/02)

Postal Service overspends on anthrax crisis – Inspector General finds that millions paid for irradiation machines were never used

Government Accounting Office (GAO) finds that air filters that the Postal Service is considering to protect against another biological attack need more testing and cost benefit analysis before implementation

- The Postal Service's Inspector General found that private contractors hired to decontaminate postal facilities last fall billed the government for at least \$50 million in unexplained cost overruns and \$40 million for mail-irradiation machines that have yet to be used, reported national correspondent Dave Altimari. In addition, one company received \$600,000 for work it never did, while another \$1 million went into preparing decontamination facilities that were never used. The findings come as postal officials are asking Congress for nearly \$700 million in emergency funding to help cover costs incurred during the anthrax crisis.

- The Inspector General spent five months examining 11 contracts, totaling \$104 million, awarded last fall during the height of the anthrax crisis. The reports concluded that the postal service cut corners unnecessarily, saying, “contracts and delivery orders were awarded using deviated purchasing procedures” that exposed the Postal Service to increased financial risk.”
- Among its findings, the Inspector General found that the cost of three contracts increased by nearly \$54 million over the original bids, with no documentation to explain why; postal officials spent \$181,000 on trailers to help move mail from the Brentwood facility in Washington, DC to Lima, OH to be irradiated, that sat idle; and the Postal Service purchased eight new irradiation machines for \$40 million to prepare decontamination facilities that were never used. (*Orlando Sentinel*, National Correspondent, Dave Altimari, 9/1/02; *Los Angeles Times*, 9/1/02; *Hartford Courant*, Dave Altimari, 9/1/02)

GAO study

- A study by the GAO, released September 9, found that air filters that the Postal Service is considering to use to protect against another biological attack need more testing and cost benefit analysis before implementation. The GAO study was requested by Congressmen Henry Waxman (D-CA) and Danny Davis (D-IL). Congressman Waxman is the ranking Democrat on the Government Reform Committee; Congressman Davis is the ranking Democrat on the subcommittee on civil service of the Government Reform Committee. (*DM News*, Melissa Campanelli, 9/10/02; *GAO Study*, “*Diffuse Security Threats: USPS Air Filtration Systems Need More Testing and Cost Benefit Analysis before Implementation*,” GAO-02-838, August 2002)
- In response to the anthrax crisis of October 2001, the Postal Service is considering using high efficiency air filtering systems (HEPA systems) as a prototype at two mail facilities and planned for implementation throughout the country to remove biological contamination from the air. The GAO found the following:
 - The USPS HEPA air filtration system design has not yet been proven to contain anthrax spores or reduce the levels of dust in a mail processing environment
 - HEPA system’s design and installation require additional energy and modifications to the mail processing equipment in order to work properly
 - USPS has not tested to determine whether the HEPA systems will not interfere with the air sampling and detection system
 - USPS has identified initial cost estimates, but has not yet completed investment analyses to identify the costs, benefits, and risks associated with alternative deployment scenarios for HEPA filtration systems. “As a result, USPS has no assurance that investing in HEPA air filtration systems will provide adequate risk reduction to its employees.”
 - “While USPS estimates that the total cost of its HEPA filtration initiative could be over \$300 million by the end of fiscal year 2002, without a complete investment analysis, the agency will not know whether these costs outweigh the benefits of the technology. Moreover, we believe that USPS’s \$300 million estimate is understated because it does not include other costs associated with maintenance.”
- GAO recommended the Postmaster General take steps to:
 - Perform additional tests to assess the system’s ability to capture biohazardous materials, and its compatibility with other proposed technologies before making a decision on whether to deploy the system nationwide; and
 - Evaluate the costs, benefits, and risks associated with implementing air filtration on mail processing equipment and other alternative solutions before a large-scale rollout is initiated. (*GAO Study*, “*Diffuse Security Threats: USPS Air Filtration Systems Need More Testing and Cost Benefit Analysis before Implementation*,” GAO-02-838, August 2002)

Two additions to the US Postal Service Board of Directors suggests the Administration wants to subject the Postal Service's business to closer scrutiny

- Postal experts believe that the background of two recent additions to the US Postal Service Board of Directors – Albert Casey and James Miller III - suggests the Bush Administration wants to subject the Postal Service's business to closer scrutiny, reported Dan Davidson with *FederalTimes.com*. “Both men are top-drawer, high quality candidates – and in that sense, out-of-character choices for the White House,” said Neil Denton, executive director of the Alliance for Nonprofit Mailers. “Their selection demonstrates that the growing importance of the Postal Service and its fiscal and management problems to the White House. (*FederalTimes.com*, Dan Davidson, 8/19/02)
- Nominating Casey and Miller to the Board of Directors could tilt it toward being more conservative as it decides whether to approve postal investment and management decisions, said those familiar with the two men. The nomination of Miller may send the “message that the problems and activities over there [Postal Service] will be watched more closely by this administration. It is hard to think of another appointee to the board of governors who the average person familiar with the Postal Service would know. So he does stand out and it's probably not accidental,” said James Gattuson, research fellow at the Heritage Foundation. Rick Merritt, executive director of PostalWatch Inc., said the addition of two members to the board with strong business backgrounds is a welcome development. (*FederalTimes.com*, Dan Davidson, 8/19/02)
- Miller is a former Reagan-era budget director and Federal Trade Commission head. Miller was head of the Office of Management and Budget under former President Reagan, from 1985-1988. From late 1981 to 1985, he chaired the FTC. He is now affiliated with Citizens for a Sound Economy. (*Associated Press*, 7/26/02) Casey was the President and CEO of the Resolution Trust Corporation. From 1968 to 1988, he was the Ann Cox Distinguished Professor of Business Policy at Cox School of Business after serving as the Postmaster General of the US in 1986. Casey was the chief executive of AMR Corp., from 1974 to 1985, and remained on the board of directors until 1991. He joined AMR Corp. after eight years as the President of the Times Mirror Company. (*White House press release*, 3/1/02)

Postal Service expects to finish the FY 2002 with a \$1.2 billion loss (less than expected)

Postal Service plans to earn a profit of \$600 million for FY 2003

- Thanks to aggressive organizational changes of cost-cutting, including a major cut in staff, the Postal Service is expected to finish FY 2002 in better financial condition than anticipated. In a report September 6 before the monthly meeting of the Postal Service Board of Governors, Postmaster General John Potter said the Postal Service is expected to finish FY 2002 later this month with a net loss of \$1.2 billion, well below earlier projections that ranged as high as \$4.5 billion. Richard Strasser, the Postal Service's chief financial officer said September 6 that the Postal Service expects to finish FY 2002 with \$66.5 billion in revenues and \$67.7 billion in expenses, for a loss of \$1.2 billion. Final numbers are expected at the end of September.
- Potter said measures taken to minimize the loss included reducing the number of career employees by 23,000 this year through attrition, and that 77 million work hours will be cut compared to last year. In addition, realignment of field management structures, aggressive balancing of work hours against appropriate workloads, and postponing a number of program expenditures have combined to reduce costs by more than \$2.5 billion this fiscal year. Currently, the Postal Service has about 753,000 workers, down from an all-time high of 797,795 in 1999.

- In addition to the improvements this year, continued cost-cutting and the rate increase that took effect this summer are expected to push the Postal Service into the black in FY 2003 with a profit of \$600 million, said Potter. Strasser noted that in FY 2003, the expectation is for income of \$70.4 billion and spending of \$69.8 billion, leaving the Postal Service with \$600 million in the black. However, Strasser warned that the \$600 million net income “is less than a one percent margin...If the economic recovery stalls, significant negative impact to postal finances could result, especially if there is no recovery in advertising mail volume.” (*Postal Service press releases, 9/6/02; Associated Press, Randolph Schmid, 9/6/02; DM News, Melissa Campanelli, 9/9/02*)
- The Governors also approved the FY 2002 Borrowing Resolution presented by Strasser. The FY 2002 plan projected a borrowing need of \$1.6 billion. Through stringent cost controls and reduced capital spending, the borrowing requirement for FY 2002 was reduced to \$700 million, raising the outstanding debt to \$12 billion. The Postal Service also obtained Board approval for the Automated Package Processing System to replace the mechanized Small Parcel and Bundle Sorting machines at 70 postal facilities nationwide. The Board approved funding to replace the Postal Service’s outdated General Ledger Accounting System with a Commercial Off-the-Shelf application and approved funding to complete a project approved last year that provides space in Arlington, VA for the Office of the Inspector General. The Board also welcomed Postmaster General Albert V. Casey to the Board of Governors, who was appointed to the Board by President Bush through a recess appointment August 6. Following Senate confirmation, Casey will serve the remainder of a nine-year term that will expire December 8, 2009. (*Postal Service press release, 9/6/02*)
- The Governors also approved two experimental filings with the Postal Rate Commission. The first is a new classification for Periodicals. The other supports a negotiated service agreement (NSA) between the Postal Service and Capital One Services, Inc., its fourth largest customer and the largest single producer of First-Class Mail. Details of the filings will be made public once the cases are filed, which is tentatively scheduled for mid-September. (*Postal Service press release, 9/6/02*)

Postal Service expects to propose another postal rate increase

- In January, the Postal Service is expected to set the wheels in motion for a 3 cent increase in the price of a first-class stamp and increases for business mail ranging from 10% to 20%. In its forthcoming proposal, the Postal Service plans to raise the price of a first-class stamp to 40 cents by early 2004 but phase in the business mail increases over two years. When fully implemented, the proposal will cost businesses up to 20% more to send commercial bulk mail; rates for periodicals and parcels will increase 15%, and overnight mail will increase more than 20%. The January announcement that higher postal rates are in the works will come just six months after the Postal Service raised prices an average of 9%. (*Kiplinger Business Forecasts, Jim Ostroff, 8/30/02*)
- Some observers predict that the holiday season will be slow, which could mean the Postal Service will announce as early as this year that another postage rate increase is necessary. Mail volume has declined in several major categories, including standard advertising and first class mail which comprises invoice and bill payments, said Robert McLean, executive director of the Mailers Council. “You can deduce from that that people aren’t paying bills because they aren’t buying anything,” he said. “My members say it will be a very slow mailing season and say they don’t expect a turnaround until sometime in 2004. I would say that the Postal Service will be filing [for a rate increase] at the end of this year at the latest.” (*FederalTimes.com, Dan Davidson, 9/2/02*)

Institute for Research on the Economics of Taxation (IRET) says the Postal Service's Transformation Plan raises many public policy questions

“Basic tax and economic theory tells us that it is wrong to favor one type of business or economic activity with a low tax rate while subjecting others to a high tax rate, because it creates economic distortions that reduce national income and output...It has been seen in practice how...Fannie Mae and Freddie Mac have come to dominate their market segments, nearly freezing out private competition, with only the advantage of an implicit government guarantee of their debt.”

Better cost management, rather than expansion, is the best solution for the Postal Service

- IRET released a paper on postal reform entitled, *“The Postal Service’s ‘Transformation Plan’: One Good Idea for Reducing Losses and Two Bad Ones.”* IRET noted that the Postal Service’s transformation plan recommended that the Postal Service be transformed into a Commercial Government Enterprise and be allowed to expand its product lines and operations to reduce its projected deficits. The Postal Service would be allowed to set its own postal rates and expand into new product lines in competition with private business -- while retaining its privileged position as a government agency.
- IRET believes the Postal Service’s Transformation Plan “raises many public policy questions.” **IRET noted: “Basic tax and economic theory tells us that it is wrong to favor one type of business or economic activity with a low tax rate while subjecting others to a high tax rate, because it creates economic distortions that reduce national income and output. The same holds for subsidies for the production or consumption of certain products. It has been seen in practice how ‘government sponsored’ entities such as Fannie Mae and Freddie Mac have come to dominate their market segments, nearly freezing out private competition, with only the advantage of an implicit government guarantee of their debt. These entities have become so large that they are generating concerns about the possible misallocation of capital in favor of the housing sector, and the effect they would have on the financial markets or on taxpayers should they get into financial difficulty. The Postal Service would have a double advantage. How much of the economy would the Postal Service take over if it were given free reign with both tax exempt status and federally guaranteed debt?”**
- Economists suggest that short of privatizing the service, better-cost management, rather than expansion, is the best route to alleviate its financial woes. Some of those management changes would require congressional approval.
- The paper noted the following:
 - Postal service revenues have increased every year, but costs have grown faster, turning a \$1.6 billion profit in 1996 into a \$1.7 billion loss in 2001.
 - Postal service employees’ wages were 28% higher than comparable private-sector employees in the mid-1990s, 34% higher after adjusting for skills and working conditions, and with fringe benefits, 42% higher than comparable nongovernment workers.
 - Labor costs account for three-fourths of the USPS’ total operating costs; thus allowing the agency to control wage rates that are now set by federal regulations could put the service in the black.
- The volume of mail and revenues from traditional postal services may be significantly reduced by electronic technology in the future. But that does not mean the USPS has to expand to reach profitability. In fact,

some of its new ventures have worsened its situation. One recently discontinued postal product, PPosteCS, cost the service \$7 million, but generated only \$8,000 in new revenue. IRET noted, “[I]f the [Postal Service] expansion strategy succeeds...it will displace more efficient private-sector firms...If the strategy fails, it will be adding new losses to the old ones.” (*IRET Congressional Advisory*, Advisory No. 129, May, 2002, Michael Schuyler, Senior Economist and Stephen J. Entin, President and Executive Director; *National Center for Policy Analysis-Daily Policy Digest*, 8/28/02)

Other GSEs

Transportation group wants to create “Trannie Mae” – a GSE for transportation infrastructure

- The American Association of State Highway and Transportation Officials (AASHTO) – the lobbying group representing state departments of transportation - wants to create a Transportation Finance Corporation (TFC), a centralized, federally chartered entity that would issue taxable tax-credit bonds to fund transportation infrastructure projects. The entity, patterned after Fannie and Freddie, would be designed to increase federal investment in transportation infrastructure by establishing an active market for tax-credit bonds. The name of the entity is expected to be “Trannie Mae” or “Trans Mac.”
- AAHSTO’s proposal calls for Congress to charter the TFC as a new, private, nonprofit organization that would be authorized to sell about \$60 million in tax-credit bonds over six years. The bond proceeds would be given as grants to states primarily to help finance highway and transit projects, and the Treasury would provide a tax credit to investors in lieu of interest payments. AASHTO is shopping the proposal to Congress, investment bankers, and rating agencies. Depending on the level of interest in the proposal, the association will vote later this fall on whether to adopt the proposal as part of its lobbying campaign to reauthorize the 1998 Transportation Equity Act for the 21st Century, which expires September 30, 2003. (*The Bond Buyer*, Humberto Sanchez, 9/3/02)

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