

The **GSE** REPORT TM

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Major Events

St. Louis Federal Reserve Bank President William Poole warns that the GSEs are a potential source of future instability in the financial markets

Poole warns about the following: (1) the GSEs' large debt load; (2) that few in the market and in government understand the GSEs' vulnerability; and (3) there is ambiguity about the GSEs' federal support

Poole recommends the government dispel the notion that the GSEs are backed by the government and impose higher capital requirements on the GSEs

Poole suggests removing the GSEs' line of credit to the Treasury

Poole wonders why the GSEs' capital standards are so far below that required of federally regulated banks

Addressing the GSEs now would not disrupt the housing market but the housing market will be "absolutely clobbered" if the GSEs are later thrown into a crisis

- **St. Louis Federal Reserve Bank President William Poole warned that the GSEs are a potential source of future instability in the financial markets.** Poole made his comments in an August 4 speech before The Council of State Governments' Southern Legislative Conference annual meeting. Poole noted that his comments reflected his personal views and do not necessarily reflect official positions of the Federal Reserve System.

Poole warns about the following: (1) the GSEs' large debt load; (2) that few in the market and in government understand the GSEs' vulnerability; and (3) there is ambiguity about the GSEs' federal support

- **Poole noted that the GSEs meet all three of his criteria for the "potential of creating financial instability."** Poole explained, "First, the GSEs are certainly large. In the United States today, **GSE securities and government-related mortgage pool securities outstanding, excluding deposits, exceed the total outstanding securities issued by all—I repeat, all—other private financial sector firms taken together.** Fannie Mae and Freddie Mac alone, as of last December 31, had securities outstanding of \$1.3 trillion and had guaranteed another \$1.8 trillion of mortgage backed securities (MBS). Looked at another way, **the total of GSE direct and guaranteed debt is 40 percent larger than the federal government's debt.** That debt, which we loosely call the 'national debt,' has, of course, been a matter of considerable discussion in recent years in the debates about federal deficits and surpluses. Second, although financial experts understand the vulnerability, my judgment is that **too few in the markets and in government understand the issues. Consequently, if there is ever a problem, it will take many by surprise.** Third, **there is tremendous ambiguity about the status of the GSEs.** The market prices GSE debt as if there is a federal guarantee, or a high probability of a guarantee, standing behind the debt. Yet, there is no explicit guarantee in the law."
- Poole warned, **"No one should underestimate the potential importance of the ambiguity over the financial status of the GSEs.** It is not sufficient for any single GSE to argue that its own financial condition is sound. If one GSE comes under a cloud, others may also. That has been our experience again and again. It is the process economists call 'contagion' whereby uninvolved or innocent firms are affected because the market has difficulty distinguishing solid firms from those at risk...In the case of the GSEs, the massive scale of their liabilities could create a massive problem in the credit markets. If the market value of GSE

debt were to fall sharply, because of ambiguity about the financial soundness of GSEs and about the willingness of the federal government to backstop the debt, what would happen? I do not know, and neither does anyone else.”

Poole recommends the government dispel the notion that the GSEs are backed by the government and impose higher capital requirements on the GSEs

- Poole recommended that the government act to dispel the notion the GSEs are backed by the government and impose higher capital requirements on the GSEs. “First, various aspects of federal sponsorship that the market reads as providing an implied guarantee of GSE debt should be withdrawn...The Secretary of the Treasury has the authority to buy GSE obligations; in the case of Fannie and Freddie, the authority is up to a maximum of \$2.25 billion for each firm. The GSEs could easily replace this potential source of emergency financial support with credit lines at commercial banks, following the widespread practice among issuers of commercial paper. The amount available at the discretion of the Secretary of the Treasury is too small in any event to deal with a crisis in the GSE debt market. **Eliminating the Treasury authority to lend to the GSEs would provide a signal that the government is serious when it says that there is no government guarantee of GSE debt.** Second, over a transitional period of several years the GSEs should add to the amount of capital they hold.”
- “Capital is important for the GSEs because their short-term obligations are large. Fannie Mae and Freddie Mac have debt obligations due within one year of about 45 percent of their debt liabilities. Any problem in the capital markets affecting these firms could become very large, very quickly. **Capital on the books of Fannie and Freddie is well below the levels required of regulated depository institutions...**[Fannie and Freddie’s] core capital requirement is 2.5 percent of on-balance sheet assets and 0.45 percent of outstanding mortgage backed securities and other off-balance sheet obligations...In the private sector, government securities dealers carry capital in the neighborhood of 5 percent, and other financial firms considerably more. For example, FDIC insured commercial banks hold equity capital and subordinated debt of a bit under 11 percent of total assets.”
- Poole concluded, “The issue with Fannie and Freddie is not one of disclosure. Their annual reports disclose quite well the high degree of complexity of their operations, and the small amount of capital they carry over that required by law. **My questions are these: given the complexity of their operations, is the capital standard in the law adequate? Why is the standard so far below that required of federally regulated banks? What will happen to the housing market if Fannie and Freddie become unstable?**” (*Federal Reserve Bank of St. Louis President William Poole speech before The Council of State Governments’ State Legislative Conference annual meeting, 8/4/02; Dow Jones Newswire, 8/5/02; Reuters, 8/4/02*)

Addressing the GSEs now would not disrupt the housing market but the housing market will be “absolutely clobbered” if the GSEs are later thrown into a crisis

- **Poole advised that the GSE issue be addressed now, rather than waiting for a crisis.** “There are different views on what, if anything, should be done about the GSEs. In the meantime, the prevailing view seems to be that GSE debt meltdown could not occur, or could not occur soon. **I do not see any immediate risk of a GSE debt problem, but am not willing to assume that in different conditions in the future one could not occur. A judgment that there is no potential vulnerability seems to me to be unwarranted in light of financial history of the United States and other countries. One thing I know for sure is that if the problem becomes immediate and real, then dealing with it will be very difficult because the urgency will be so great.**” (*Federal Reserve Bank of St. Louis President William Poole speech before The Council of State Governments’ State Legislative Conference annual meeting, 8/4/02*)
- **Speaking to reporters after the speech, Poole stated, “The time to act is while things are calm.” He said that addressing the issue of inadequate capital “in a sensible, orderly fashion” now shouldn’t**

disrupt the ability of the GSEs to meet the demands of the housing industry. But if the GSEs should be thrown into a crisis by a shortage of capital relative to debt, “the market for housing is going to be absolutely clobbered.” (*Dow Jones Newswire*, 8/5/02)

Capital Markets Subcommittee holds July 23 hearing to hear OFHEO’s views on its risk based capital rule for Fannie & Freddie and on the recent voluntary agreement by Fannie & Freddie to register their common stock with the SEC (while maintaining their exemption from registering their debt and mortgage-backed securities (MBS) with the SEC)

[Fannie & Freddie are the only two Fortune 500 publicly traded companies not subject to all SEC requirements]

Data shows that Fannie would have failed an early version of OFHEO’s risk-based capital rule before changes were made

Capital Markets Subcommittee Chairman Richard Baker (R-LA) was concerned that the risk-based capital rule was changed so that Fannie & Freddie would receive more favorable results; questioned political involvement

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OFHEO is open to subjecting Fannie & Freddie to MBS registration requirements but says disclosure goals may be met without registration

OFHEO hopes to propose a rule implementing Fannie and Freddie’s voluntary financial disclosure agreement with the SEC by October 1, 2002

The joint study by OFHEO, Treasury, and the SEC on the MBS disclosure/registration issue is expected to be completed by year-end and will examine allegations that Fannie & Freddie “cherry-pick” the best MBS for their portfolios

Congressmen Baker and Chris Shays (R-CT) request a copy of the written voluntary financial disclosure agreement

Congressman Shays believes that Fannie & Freddie’s voluntary financial disclosure agreement to register their common stock with the SEC does not address all his concerns

- The House Financial Services Committee’s Capital Markets Subcommittee held a hearing on July 23rd to hear testimony from OFHEO on the regulation of the GSEs, in general, and specifically on OFHEO’s risk based capital rule for Fannie and Freddie and on the recent voluntary agreement by Fannie and Freddie to register their common stock with the SEC (while maintaining their exemption from registering their debt and mortgage-backed securities (MBS) with the SEC). Capital Markets Subcommittee Chairman Richard Baker (R-LA) chaired the hearing. OFHEO Director Armando Falcon was the only witness.
- Congressman Baker was concerned about OFHEO’s risk-based capital rule. He was concerned that OFHEO’s amendments to the rule lowered the capital requirements for Fannie and Freddie boosting their results. Congressman Baker wondered how Fannie and Freddie would fare under a more volatile time period, particularly the quarter after September 11, and requested a comparison of Fannie and Freddie’s

results under the pre-amended OFHEO rule and the post-amended OFHEO rule. He requested in a letter to OFHEO Director Armando Falcon earlier this year that OFHEO run the stress test under four scenarios – (1) run the pre-amended version of OFHEO’s stress test (September 13, 2001 version) using fourth quarter 2001 numbers; (2) and first quarter 2002 numbers; (3) run the post-amended version (March 15, 2002 version) using fourth quarter 2001 numbers; and (4) first quarter 2002 numbers. OFHEO provided the results of the stress test to Congressman Baker a day before the July 23 hearing.

Highlights of the hearing:

1. Fannie would have failed an early version of OFHEO’s risk-based capital rule

If Fannie and Freddie were subjected to OFHEO’s pre-amended risk-based capital rule during the fourth quarter 2001 – Fannie would not have had sufficient capital, while Freddie would have passed

OFHEO’s data results showed that Freddie would have passed the stress test under all four scenarios, though its excess capital levels were less under the pre-amended rule. Fannie would have fallen short of its risk-based capital requirements by almost \$640 million, under the pre-amended version of the risk-based capital rule using fourth quarter 2001 numbers, in a low interest rate scenario. **The difference between Fannie’s results from the pre-amended version and the post-amended versions resulted in almost a \$3 billion swing.**

Congressman Baker displayed the following chart at the hearing:

Comparison of Fannie Mae Capital Requirements Pre- and Post Final Rule Amendment			
	Required Risk Based Capital	Total Statutory Capital	Over (under) Capitalized Statutory
Post- Amendment Down	\$23,666,332,602.81	\$25,973,000,000.00	\$2,306,667,397.19
Pre- Amendment Down	\$26,612,857,166.30	\$25,973,000,000.00	(\$639,857,166.30)
Difference	(\$2,946,524,563.49)		

2. Congressman Baker was concerned that the risk-based capital rule was changed so that Fannie & Freddie would receive more favorable results; questioned political involvement

Congressman Baker was concerned about the wide variations between the results of the pre-amended and post-amended versions of the rule and questioned whether the rule was changed so that Fannie and Freddie would receive more favorable results.

The changes cast doubt on the whole rule-making process, Congressman Baker said. “After eight and a half years, we had a test. We gave the test, one GSE passed, one GSE failed. 90 days later we had another test, amazingly enough, both GSEs passed. Imagine what our public school system would look like if we gave everybody in the class a test, then 30 days later we came back and gave them exactly the same test with prior announcement.” The differences in the rule raises questions whether “change were made because of

some political involvement,” Congressman Baker said. (*Federal News Service*, transcript of 7/23/02 hearing)

“Were the changes [to the risk-based capital rule] the result of the failure of either of the GSEs to pass the test or was it an underlying failure in the adequacy of the test? Did either GSE request a specific modification?” Congressman Baker asked. “There were modifications made to the [stress] test that caused the results to be different.” (*Dow Jones Newswire*, Dawn Kopecki, 7/23/02)

Congressman Baker noted that “the importance of the stress test cannot be emphasized enough, because essentially what is at stake is giving both investors and taxpayers the clearest possible financial picture of two government-backed companies with a combined debt of over \$1 trillion implicitly linked to taxpayer pockets.” (*Congressman Baker’s opening statement*, 7/23/02)

Falcon claimed that changes to the risk-based capital rule were minor and were made without the influence of the GSEs. The amended rule modified provisions related to counter-party haircuts, the treatment of multifamily loans, funding costs, and a series of technical changes. Falcon noted that bugs in the system were still being addressed by OFHEO on an ongoing basis. Falcon denied that OFHEO had taken suggested changes by Fannie and Freddie prior to the promulgation of the final rule that resulted in any modifications to the final promulgated rule.

Falcon claimed that he did not know at the time the risk-based capital rule was modified whether the changes would have increased or decreased Fannie and Freddie’s capital requirements. He also noted that OFHEO did not have access to the fourth quarter 2001 numbers for Fannie and Freddie at that time. “If you’re suggesting that we made changes to the risk-based capital rule to try to affect an outcome for the enterprises for the fourth quarter. I think that’s just incorrect,” Falcon said. “There’s no way we could try to game the stress test to try to make them pass” (*Dow Jones Newswire*, Dawn Kopecki, 7/23/02)

3. OFHEO argued that the results of the fourth quarter 2001 data should be kept confidential; Congressman Baker disagreed and released the information

OFHEO asked Congressman Baker to treat the data results as confidential. Falcon claimed that releasing the fourth quarter 2001 results could be considered misleading since Fannie and Freddie were not yet managing their activities to ensure they were meeting the requirements of the rule in its final form and the information could disrupt the market. “Congress wanted us to set up a new capital standard, not a trap. That is why it would be inappropriate to release results before the rule, as amended, was in place,” stated Falcon. (*Federal News Service*, transcript of 7/23/02 hearing)

Congressman Baker noted that OFHEO released information in 1999 showing that under a previous version of OFHEO’s risk-based capital rule, Fannie would have been undercapitalized and this information was not treated confidentially. Falcon denied providing the confidential information to anyone else, including the GSEs. However, when confronted by Congressman Baker that other Members had the information, Falcon noted that OFHEO had shared the information with Ranking Member Paul Kanjorski (D-PA). After studying the issue and legal consultation, Congressman Baker did not believe there was a basis for keeping the material confidential and did not believe that the release of the information would cause disruptions in the market and therefore released the information at the hearing.

4. Congressman Baker felt that the answers to his questions were unacceptable

Congressman Baker concluded the hearing by noting that he felt that he had no more information or understanding of Fannie and Freddie’s “financial picture” today than he did five years ago. “I’m not

comforted either by the written or oral explanation” by OFHEO “of how we are where we are. Something has to be done about this,” Congressman Baker said. “I don't know where we go from here,” he said. “I'm not at all happy about the consequences or the explanation as to how we got where we are. There's a \$3 billion swing, even in GSE terms is a significant swing,” Congressman Baker said of the amended risk-based capital rule. “We've got the August recess to figure out some solutions” (*Dow Jones Newswire*, Dawn Kopecki, 7/23/02)

In reports after the hearing, OFHEO spokesperson Stefanie Mullin claimed Congressman Baker's call to enact stricter rules governing Fannie and Freddie are meaningless. “He has no support,” said Mullin. “Did you see anyone else up there?,” asked Mullin, referring to the July 23 hearing. “You could clearly see he [Congressman Baker] has no support,” said Mullin. One expert who monitors the financial viability of the GSEs was incredulous when Falcon publicly admitted he tweaked the rule for a more favorable result. “They're sending CEOs to prison for the same thing,” he said. (*Housing Affairs Letter*, 8/2/02)

5. OFHEO is open to subjecting Fannie & Freddie to MBS registration requirements but says disclosure goals may be met without registration

Falcon testified, “OFHEO's goal is disclosure, not registration. After all, disclosure is the rationale underlying registration. Accordingly, OFHEO will not pursue a registration regime at this time. If our disclosure goals can be met without registration, and I'm confident that it can be, then registration is unnecessary. However, until the review is completed OFHEO...should not rule out registration in some form as a possibility.” (*Federal News Service*, transcript of 7/23/02 hearing)

During questioning by Congressman Shays, Falcon said he was not leaning one way or the other on whether Fannie and Freddie should continue to receive an exemption from registering their MBS and debt with the SEC.

Later during that same questioning by Congressman Shays, Falcon seemed to contradict his earlier remarks. “What we're trying to do with this [joint MBS] study is ensure that there's a level playing field and adequate information at companies that issue mortgage-backed securities,” Falcon stated. “If we can accomplish that – and I'm very confident that we can establish adequate information as well as a level playing field through the cooperation and joint study by myself, the SEC and the US Treasury – then registration is unnecessary.” He added, “I'm confident that we can get there with the right disclosure rules.” (*Dow Jones Newswire*, Dawn Kopecki, 7/23/02)

6. OFHEO hopes to propose a rule implementing Fannie and Freddie's voluntary financial disclosure agreement with the SEC by October 1, 2002

OFHEO plans to promulgate a rule to facilitate the implementation of the voluntary agreement. When pressed by Congressman Shays, Falcon expected that OFHEO would be able to issue a proposed rule by October 1, 2002, with a public comment period.

7. The joint study by OFHEO, Treasury, and the SEC on the MBS disclosure/registration issue is expected to be completed by year-end and will examine allegations that Fannie & Freddie “cherry-pick” the best MBS for their portfolios

The joint study was originally scheduled to be completed early in the next session of Congress, however, during a July 16 Capital Markets Subcommittee hearing, Treasury Undersecretary Peter Fisher was asked to complete the study by year-end. OFHEO's Falcon said he has conferred with the SEC and Treasury and

they have agreed “to make every effort to complete the review by year-end.” Falcon also suggested that a mid-term report could be made to Congress on the progress of the study.

In response to a question by Congressman Shays, Falcon noted that allegations that Fannie and Freddie are “cherry picking” the best MBS for their portfolio and leaving the rest for investors, would be examined in the joint report.

8. Congressmen Baker and Shays request a copy of the written voluntary financial disclosure agreement

Congressmen Baker and Shays requested that OFHEO provide all written documentation on Fannie and Freddie’s recent voluntary agreement to disclose information to the SEC. The Congressmen requested this same information from the Treasury Department at the July 16th Capital Markets hearing. Neither the Treasury Department nor OFHEO seemed to know if a written agreement existed.

9. Congressman Shays believes that Fannie & Freddie’s voluntary financial disclosure agreement to register their common stock with the SEC does not address all his concerns

Congressman Shays called Fannie and Freddie’s voluntary SEC disclosure agreement a “turning point in the debate.” However, he still has concerns with how the agreement will be enforced and OFHEO’s role in the rule-making. Second, he would like to know the policy reasons behind continuing the exclusion of Fannie and Freddie’s MBS and debt securities from the full registration requirements of the securities laws. And, he would like to know how the administration reached this agreement with Fannie and Freddie, since he knows of no precedent in which publicly traded companies dictate to government regulators what laws they will comply with.

“It’s true that Wells Fargo would have to disclose when they put together a pool so it’s not some kind of strange activity,” Congressman Shays asked Falcon. “Isn’t registration and disclosure somewhat parallel?” (*Bloomberg News*, Al Yoon, 7/23/02) Falcon responded affirmatively and noted, “any issuer of debt, just by virtue of what the market will demand, will put out some level of disclosure that accompanies that debt.” He believed that registration and disclosure were somewhat parallel. (*Federal News Service*, transcript of 7/23/02 hearing) Congressman Shays noted that MBS issuers in the jumbo market are subject to SEC requirements, and wondered what made the GSEs’ MBS different from the MBS from other private issuers, like Wells Fargo. Falcon said he could not explain the difference and noted that Congress was the one that made the initial determination to exempt the GSEs from SEC requirements.

Congressman Shays wondered whether Fannie was attempting to perpetuate its implicit government guarantee and questioned whether Fannie was “trying to have it both ways by assuring the administration and Congress that it will submit to the government regulation and assuring Wall Street that it will remain exempt from government regulation.” Congressman Shays noted that CFO Tim Howard recently stated, “We sought and attained concurrence from the SEC that voluntary registration under the 1934 Act would not change the fact that, among other things, securities issued or guaranteed by Fannie Mae are exempt securities under the Securities Act of 1933 and may be sold without registration under that Act.” Falcon believed that Fannie was attempting to clarify that they would be subject to the 1934 Act but not the 1933 Act. (*Federal News Service*, transcript of 7/23/02 hearing)

10. Financial Services Chairman Mike Oxley (R-OH) encourages OFHEO to work with the Committee

Chairman Oxley encouraged OFHEO to work with the House Financial Services Committee to enforce the risk-based capital rule for Fannie and Freddie. He said he would like to know what actions OFHEO will

take with the SEC to implement the agreement in which Fannie and Freddie agreed to voluntarily register their common stock with the SEC.

Congressmen Ken Bentsen (D-TX) and Harold Ford, Jr. (D-TN) questioned the relevancy of Fannie and Freddie's results under the pre-amended version of OFHEO's stress test rule since the rule was not yet finalized and the GSEs were not managing their operations in order to meet the confines of the rule.

(Source: Oral and written testimony from July 16 Capital Markets Subcommittee Hearing on the GSEs, unless otherwise indicated.)

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 is not 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. However, a trial run of OFHEO's public test of the risk-based model using fourth quarter 2001 results was delayed as a result of the proposed revisions. Originally, OFHEO testified that it would run the model using fourth quarter 2001 numbers, however, in light of the changes, OFHEO decided to use first quarter 2002 numbers instead. OFHEO announced June 27, 2002 that both Fannie and Freddie passed the first test run of OFHEO's risk-based capital stress test using first quarter 2002 numbers. Fannie exceeded its risk-based requirement by \$6.062 billion, while Freddie exceeded its requirement by \$15.680 billion. OFHEO will not use the risk-based capital standard to classify Fannie and Freddie for regulatory purposes until the end of the third quarter of 2002 (results of which will be released in December). Until then, Fannie and Freddie will be subject only to minimum capital requirements.

Background on Fannie & Freddie's voluntary SEC disclosure:

- On July 12, 2002, a voluntary financial disclosure agreement was reached among Fannie, Freddie, the SEC, OFHEO, and Treasury, in which Fannie and Freddie agreed to voluntarily register their common stock with the SEC, while retaining their exemption from registering their debt and MBS with the SEC. Therefore, Fannie and Freddie will not register their debt or MBS with the SEC as do other publicly traded companies. Under the agreement, Fannie and Freddie would be subject to the Securities Exchange Act of 1934 ['34 Act] which requires a publicly traded company to provide periodic disclosure requirements about the financial condition and management of their company but would not subject Fannie and Freddie to the Securities Act of 1933 ['33 Act] which requires a publicly traded company to submit a registration statement and prospectus when bringing new issues to market [such as debt and MBS]. Instead of subjecting Fannie and Freddie to registering their debt and MBS with the SEC at this time, the Treasury, SEC, and OFHEO will conduct a joint study to promote a more level-playing field with respect to initial offering disclosures between GSEs and non-GSE MBS issuers. [See July 19, 2002 *GSE Report* for more information about Fannie and Freddie's voluntary financial disclosure agreement with the SEC, OFHEO, and Treasury.]
- A bill introduced by Congressman Chris Shays (R-CT) and Edward Markey (D-MA) would among other things, subject Fannie and Freddie to mandatory registration of their securities, common stock, debt and

MBS with the SEC, as well as subject Fannie and Freddie to all SEC laws and requirements governing all other publicly traded companies. The bill repeals Fannie and Freddie's exemption from both the '33 and '34 Acts.

Washingtonian Magazine features a Fannie expose

“Fannie Mae projects a happy image, but as its debt grows bigger and its executives get richer, should taxpayers start to worry?”

- Ross Guberman wrote a detailed article about Fannie in the August 2002 issue of *Washingtonian* magazine. The article outlined the various concerns that GSE critics have raised over the years, such as Fannie and Freddie's SEC exemption, their growing debt, their government subsidy, high executive salaries, their lag behind private lenders in serving African-American and other underserved communities, and their extravagant spending on advertising and lobbying. Guberman interviewed many of those critics, including Congressman Christopher Shays (R- CT) who introduced legislation that would force the GSEs to register their securities with the SEC. Congressman Shays told Guberman that when he first thought about introducing the GSE legislation, he casually mentioned the idea to a few staff members of the House Financial Services Committee. The very next day, Fannie Mae lobbyist Duane Duncan called the Congressman and suggested a meeting with Fannie Mae CEO Frank Raines. Another lobbyist told Congressman Shays, “You're making a lot of people unhappy with this.” The unusual interest from Fannie led Shays to believe that he was “on to something.” **Congressman Shays added, “the more I look, the more convinced I am that they're not eager to disclose what they do. They're wonderful organizations, but they're trying to protect a privilege that could ultimately be destructive to them.”** Guberman added that Congressman Shays had broken an unspoken rule in Washington: “Don't mess with Fannie Mae.”
- Guberman noted that Fannie and Freddie have over a trillion and a half dollars in assets – more than the GDP of every country except the US, Germany and Japan. Their debt is expected to surpass the United States' in the near future. **Congressman Richard Baker (R- LA) told Guberman “the taxpayers are living under an enormous rock suspended by a single rope. Once it breaks, there's no recovery.”** The GSEs have also been criticized by the *Wall Street Journal* in recent months. One editorial likened Fannie and Freddie to Enron, particularly their high debt and their “terrible” financial disclosures. The *Economist* magazine also noted that the GSEs are “arguably the most worrying concentrations of risk in the global financial system.”
- Guberman noted that Fannie's government subsidies have angered many GSE observers, as well as the company's continued denial that a subsidy exists. **Former Clinton Administration Treasury official Rick Carnell noted that Fannie had tried to insert language into a House bill that would suggest the government backed its debt, even while Fannie denied the fact to the public. Carnell added that “Someone should pounce on Fannie's double talk...Fannie tells Congress, ‘Don't worry, Uncle Sam is not on the hook.’ Then it turns around and tells Wall Street, ‘Don't worry, Uncle Sam really is on the hook.’” Carnell further noted, “Someone should ask Fannie, ‘If the taxpayers don't subsidize you, why do you so object to giving up the special benefits you receive.’”**
- Another of Fannie's “perks” is their exemption from state and local income taxes. According to Guberman, Fannie's exemption costs the District of Columbia hundreds of millions a year. **Former DC Councilmember Bill Lightfoot told Guberman that he felt it was an “outrage” that the GSEs were exempt from paying state and local income taxes.** He sponsored a resolution to repeal this exemption in 1994 and was barraged with complaints from Fannie lobbyists and charities. The company even threatened to leave Washington if the measure passed. **Lightfoot added, “We have so many people in the District**

going without, while Fannie Mae sits rich, fat and happy with its huge salaries and profits. We could fix a lot of dilapidated schools and buy a lot of fire trucks if they paid their fair share.”

- Fannie’s competitors accuse Fannie of mission creep. Examples include Fannie’s insistence that lenders use Fannie’s automated underwriting system, Desktop Underwriter, to approve borrowers even though competitors have spent millions developing their own systems. Competitors also criticized Fannie’s partnership with retailer Home Depot to offer installment loans on home improvement items such as hot tubs. However, what worries lenders the most is Fannie’s advertising. The company spends millions each year on print and radio ads and begs the question, **“Why does a company that serves mortgage bankers need to promote itself with the public?”** A Fannie spokesperson told Guberman it was to help people associate Fannie with homeownership, and to “educate” the public about the company’s good works. **Those “good works” are often under the umbrella of the Fannie Mae Foundation, a Fannie funded organization that donated \$34.8 million in grants last year while spending more than that - \$44 million - on television “outreach” advertising.** Guberman added that **“housing advocates say Fannie’s Foundation should be doubling the size of its grants rather than spending millions to provide people with information available elsewhere.”** However, lenders find another explanation behind the Foundation’s advertising: **to brand Fannie’s name to the public to prepare for the day when Fannie lends directly to the consumer.**
- Fannie spends almost \$6 million annually on lobbying services, including a sizable in-house staff as well as retainers with many of Washington’s most prominent law firms and lobbying shops. The company also employs many former Congressional staffers and Administration employees in order to have sway with members of Congress. **Another form of persuasion comes in the fundraisers and public-relations events that Fannie has with members of Congress and local politicians to celebrate the number of mortgages Fannie has bought in their Districts – “like General Motors encouraging a senator to brag about how many constituents had bought its cars.”** Also disconcerting to critics is Fannie’s **“partnership offices”** throughout the US. The official line is that the local offices allow experimentation with innovative mortgage products, but a Fannie executive once admitted that the offices were a cheap way to expand Fannie’s political base.
- Fannie has also used their clout to get Hill staffers that they deem unruly fired. Controversy also surrounds both Fannie and its foundation. **The Fannie Mae Foundation has been accused of revoking grants to organizations such as the National Reinvestment Coalition after President John Taylor criticized Fannie’s record on lending to minorities. A study in the *St. Petersburg Times* found that the foundation’s grants often coincide with groups affiliated with Fannie’s powerful executives or in districts of powerful politicians. “Fannie Mae is a bit like the tobacco industry,” Charles Lewis says, “They use the foundation to try to put a happy face on what they do. The whole thing is part of a perpetual boondoggle so they maximize public risk and private gain.”**
- The article concluded with Guberman noting that Fannie will try to fight off any attempt by the Bush Administration to reform their business practices by appealing to Capitol Hill and the public. And while a few members of Congress are on the record for criticizing the GSEs, most are still in their corner. **As Fannie Mae CEO Raines told Guberman, “the ratio of action to criticism is very low. If something were really wrong, wouldn’t someone in the government do something?”** (*Washingtonian*, Ross Guberman, August 2002)

Fannie ties the granting of stock options to aggressive short-term growth incentives, raising concerns among critics that Fannie is taking unnecessary risks to increase its short-term growth, reports the *Wall Street Journal*

“I don't think it's appropriate at all” to offer short-term stock option incentives, says James Bianco, president of Bianco Research

- “For the past several years, critics have charged that Fannie Mae is taking unnecessary risk to boost its short-term growth. While the merits of those complaints are up for debate, one thing is for certain: The company certainly has some incentives to do so,” reported Patrick Barta with the *Wall Street Journal*. Fannie’s new company filings indicate that Fannie’s executive compensation provides executives with hundreds of thousands of options that ties the granting of some options for all permanent employees to aggressive growth goals that called for Fannie to double its earnings between the end of 1998 and 2003.
- Barta noted, “In the wake of accounting-related debacles at Enron Corp., WorldCom Inc. and elsewhere, stock-option awards have come under intense scrutiny amid concerns that they encourage senior managers to take greater risks to boost earnings packages.”
- Fannie’s incentives are also drawing attention now because they are part of new disclosures on insider transactions of stock that Fannie and Freddie voluntarily agreed to disclose in response to critics who said the companies were withholding information from investors. The GSEs, which are exempt from some federal securities laws, weren’t required to file such information.
- Fannie’s officials claim its plan shouldn’t be considered an incentive to increase short-term growth, because its goals call for earnings to double over a five-year, or relatively long, period. Fannie also noted that overall, it relies far less on options for compensation than other companies.
- Fannie’s shares have performed relatively well since January 1999, given the overall dismal stock-market conditions. Under terms of the plan, Fannie’s executives will be able to exercise millions of dollars of stock options in early 2004 if Fannie’s earnings reach \$6.46 a share, which appears to be within reach. If Fannie does reach its target, Fannie’s Chairman Frank Raines would be able to purchase 213,548 shares at a price of \$62.50 each in early 2004. Currently, with Fannie’s shares trading at around \$73 that makes his stake worth about \$2.2 million, which would be on top of and in addition to other options that are granted annually. If Fannie fails to achieve its goal, Raines and other employees would still be eligible for the options, but they wouldn’t be able to exercise all of them for four more years, and the company’s board would have the option of reducing compensation to offset the options.
- The stock incentives don’t prove Fannie Mae is taking unnecessary steps to boost earnings. **Still, given Fannie’s ties to the federal government, “I don’t think it's appropriate at all” to offer short-term stock option incentives, says James Bianco, president of Bianco Research, a Chicago bond-market research organization. “In the case of Fannie’s management, it raises the question of whether they're managing for \$6.46 a share, or managing the company for the long term?”** (*Wall Street Journal*, Patrick Barta, 7/17/02)

Fannie & Freddie urge brokers to bypass lenders and mortgage insurance companies by using the GSEs' automated underwriting systems

[Editorial Note: This action appears to conflict with the Mortgage Bankers Association's (MBA) policy statement on the GSEs – "The GSEs should not develop, distribute or use technology in a way that bypasses their seller/servicers by going direct to the customers or vendors of those partners, including, but not limited to consumers, owners/developers of housing, mortgage brokers, and other real estate professionals." (MBA GSE Policy Statement, 8/10/99)]

- At a recent National Association of Mortgage Brokers annual convention, both Fannie and Freddie were urging brokers to skip wholesale lenders and mortgage insurance companies by using the GSEs' automated underwriting systems. Both GSEs have been working to develop broker-facing portals that make it easy for originators to close loans that will eventually be sold to the GSEs. Still, some brokers that attended sessions offered by the GSEs during the convention seemed ill at ease with limiting their options by working with a portal controlled by either Fannie or Freddie. One broker asked Jan Hix, a former broker who now works as Fannie's Senior Manager of e-business technology why he should change his longstanding tradition of sending his loan file into his MI [mortgage insurance]-operated contract underwriter and moving on to the next file. Hix asked the broker why he would wait for hours to get a response from the mortgage insurance company when Fannie's automated underwriting system could return the answer within minutes. (*Origination News*, August 2002)

Fannie & Freddie developing mortgage products with insurance add-ons

Fannie is also developing a product with a home warranty add-on in which homeowners must choose from Fannie's "preferred" list of contractors to do repairs

[Editorial Note: How are insurance coverage and repair work within Fannie & Freddie's mission of providing liquidity to the secondary mortgage market?]

- Fannie and Freddie are developing mortgage products with insurance add-ons, reported columnist Kenneth Harney. Fannie is developing a product, called "Home Stay," which would provide up to half a year's worth of mortgage payments when borrowers suffer a loss of income because of disability, death of a spouse or unemployment. Under the concept Fannie is developing, your home loan would pay for itself for as much as half a year while a borrower is unemployed and low on cash. Fannie executives emphasized that key details-such as the cost to borrowers and the type of insurance add-on-are still being developed. Fannie expects to introduce this product later this year or early next year. Freddie is also examining unemployment add-ons and other insurance concepts.
- Fannie is developing another product, called "Home Manager," which would add a home warranty onto a home mortgage. The warranty coverage would extend at least to all major mechanical systems, and would be available through a "preferred provider" program, allowing a borrower the choice of contractors. If a borrower's roof needed replacement or their heating and air conditioning system died, a borrower would be able to pick from a list of local service companies participating in Fannie's program to make the repairs. Pricing, timing and other details are still being worked out, said Fannie's executives, but the product is likely to be introduced within the year. (*Newsday*, Kenneth Harney, 7/19/02)

Senate Appropriations Committee approves legislation providing \$30 million in FY 2003 to OFHEO

- The Senate Appropriations Committee July 25 reported legislation providing \$30 million in FY 2003 funding for OFHEO. The \$30 million is \$3 million more than funds enacted for FY 2002 and is the same amount requested by President Bush in his budget in February. The \$30 million was part of a VA-HUD appropriations bill (S. 2797). (*BNA Daily Report for Executives*, Karen Werner, 7/26/02) The increase in funding would be paid by Fannie and Freddie through semi-annual assessments, and not by taxpayers. Fannie and Freddie provide the funds for their own regulation, but determining the level of funding has been subject to the congressional appropriations process.

Remove OFHEO from the appropriations process

- President Bush's FY 2003 budget, released on February 4, recommended that OFHEO be removed from the appropriations process. OFHEO Director Armando Falcon has repeatedly called for OFHEO to be removed from the appropriations process and given authority to control its own budget. Other federal financial regulators, such as the OCC and OTS, are not subject to the appropriations process, and thus, simply collect their fees directly from the banks and thrifts they supervise. The Administration's FY 2003 budget stated, "In order to treat OFHEO similarly to other financial regulators, including the regulator of the Federal Home Loan Bank System, the Budget proposes legislation that would provide direct funding of OFHEO's activities with mandatory assessments on Fannie Mae and Freddie Mac." (*Budget of the United States Government, Fiscal Year 2003 - Appendix*, p. 518) [This recommendation was not included in the VA-HUD appropriations bill.]

Fannie Mae and Freddie Mac

Retired economist and noted financial author Charles Kindelberger warns that Fannie & Freddie may be fueling a potential housing bubble

Lyndon LaRouche publication warns Fannie & Freddie have caused a housing bubble

FHLBank of Chicago President & CEO Alex Pollock says the FHLBanks' Mortgage Partnership Finance (MPF) program is an alternative to holding so much risk in Fannie & Freddie

- Charles P. Kindelberger, a retired 91 year-old economist, and author of the 1978 economics classic: "*Manias, Panics, and Crashes: A History of Financial Crises*," is not surprised by the market turmoil unfolding during the past two years. He warned readers in the forward of the third edition of his book, released in 1996, of what looked "suspiciously like a bubble in technology stocks." Richard Sylla, who teaches a course on financial history at New York University's Stern School of Business has his students spend two weeks examining the book. "It is one of the most important books for people on Wall Street to read," he said.
- Kindelberger said he would like to write a fifth edition of the book with details from the latest corporate scandals, or a book about a housing-price bubble he sees developing, but he doesn't feel up to it. The trick with spotting real-estate bubbles, he said, is that they don't always spread. In 1925, for example, real estate prices in Florida soared and crashed, but didn't spread to the rest of the country. Yet, he noted that something is distinctly different about the nation's housing market today, compared to 1925. Fannie and Freddie own or guarantee nearly \$3 trillion in mortgages, helping to keep the mortgage market liquid with cash. This is boon to homeowners, but Kindelberger said he fears that Fannie and Freddie's deep nationwide presence in the market is fueling a speculative fire. "If I was 30 years younger," Kindelberger

said, "I'd write a small book on Fannie Mae and Freddie Mac." (*Wall Street Journal*, Jon E. Hilsenrath, 7/25/02)

Lyndon LaRouche publication

- Richard Freeman with *Executive Intelligence Review*, a Lyndon LaRouche publication, wrote an extensive article claiming Fannie and Freddie have caused "the greatest housing-real estate bubble in human history." He noted that Fannie and Freddie "are the linchpin of the housing bubble; without them, it could not exist." The housing bubble has been developing for two decades and it has been undergoing accelerated growth since 1995. Between 1995 and 2001, Fannie and Freddie (and a few similar, smaller agencies) acquired almost three-quarters of the \$2.25 trillion in new mortgage loans that all banks had made.
- Freeman further noted, "**Fannie Mae and Freddie Mac have raked in huge profits from the housing bubble. But they have also concentrated in themselves, an enormous exposure to mortgage debt...and have issued some obligations which are very risky. Thus, it is ironic that the housing market depends on Fannie Mae and Freddie Mac, which are in such rotten condition that they could puncture the very housing bubble which they are called upon to support.**"
- Freeman warned that "a wave of mortgage defaults is inevitable." He noted that Fannie's "risky obligations amplify the crisis, and threaten the bankruptcy of Fannie Mae, and the housing market bubble which depends on Fannie, Freddie, et. al." Fannie's risky obligations include the following: (1) Fannie's bonds make up over \$700 billion of its outstanding debt total of \$764 billion; (2) Fannie's guarantee on \$859 billion of mortgage-backed securities; and (3) Fannie's derivative obligations of \$533 billion in hedges. Fannie's three risky obligations total over \$2 trillion, while Freddie's total of these three risky obligations is \$2.91 trillion.
- Freeman warned that signs exist of an increase in mortgage problems. "In the first quarter of 2002, more than 4.65% of mortgage loans nationwide were delinquent (30 days past due), the highest level in ten years, and the rate of mortgage defaults is rising. Fannie Mae has taken extraordinary measures to roll over troubled homeowners' mortgages, in order not to have the level of defaults show up. But the housing bubble cannot be sustained." (*EIR*, Richard Freeman, 6/21/02)

FHLBank of Chicago President & CEO Alex Pollock says the FHLBanks' Mortgage Partnership Finance (MPF) program is an alternative to holding so much risk in Fannie & Freddie

- In a July 23 *Wall Street Journal* letter-to-the-editor, FHLBank of Chicago President Alex Pollock touted the FHLBanks' MPF program as an alternative to Fannie and Freddie. He noted that the *Wall Street Journal's* July 8 editorial, "*A Housing Bubble?*" points out the risk to taxpayers arising from the enormous, and rapidly growing, concentration of the nation's mortgage credit risk in Fannie and Freddie. The two GSEs currently hold or guarantee \$2.9 trillion of mortgages and are, according to the latest figures, on track to purchase 71% of all residential mortgages originated in the U.S. this year.
- Pollock stated, "It is easy to agree that this is a problem, but there is an alternative. GSEs do not have to concentrate credit risk in order to deliver the benefits of low-cost funding. Believing that mortgage credit risk is best managed by local bankers who know their customers, the Federal Home Loan Banks...have created the Mortgage Partnership Finance Program. With MPF, lenders sell mortgages to the Home Loan Banks, but retain the principal credit risk of the mortgages they originate. As a result, lenders and their homebuying customers receive a more efficient financing while the credit risk of MPF loans is dispersed among hundreds of participating financial institutions, rather than being concentrated in the GSEs." (*Wall Street Journal letter-to-the-editor*, FHLBank President and CEO Alex Pollock, 7/23/02)

- Created by the FHLBank of Chicago five years ago, the MPF Program provides FHLBank members an alternative to holding fixed rate, conventional conforming and government residential mortgage loans in portfolio or selling loans servicing released as a means of offering competitive loan origination rates. Under the MPF Program, the local lender manages the credit risk and customer relationship, while the FHLBank manages the funding, interest rate, and prepayment risks. “This structure allows lenders to keep their valuable customer relationships without paying costly guarantee fees charged by secondary market agencies to manage the credit risks of the loans they buy...Instead of paying guarantee fees, participating MPF lenders have collectively received over \$20 million in fees from the FHLBs since the program began for managing the credit risk of their own customers,” said the FHLBank of Chicago. (*FHLBank of Chicago’s MPF press release, 7/3/02*)

Fannie & Freddie to expense their executive stock options

Financial consultant Bert Ely calls the announcement “political pandering”

Fannie’s CFO is \$1.25 million richer after exercising an option to sell 20,000 shares of Fannie’s stock; Freddie’s Chairman sells 9,238 shares

- Fannie and Freddie announced July 23 that they will begin treating executive stock options as an expense against earnings. Fannie said it will recommend to its board that it begin expensing all stock-based compensation with its next grant cycle while Freddie said it expensed stock options in its second-quarter earnings statement, which it released July 23.
- Fannie and Freddie said the changes would not greatly affect their bottom lines. Fannie said that if the company had recorded all stock-option grants as an expense in the income statement based on their fair value, the additional expense would have reduced earnings per share by 10 cents in 2001, by 14 cents in 2000, and by 7 cents in 1999, or by about 2% to 3% in each of the past three years. Fannie also said that its overhang -- a measure used to calculate the potential dilution associated with a company’s stock-option plans -- was 3.9% at December 31, well below the industry average. Freddie said its overhang was 2.7% for the same period. Freddie said the additional expense would have lowered earnings per share in 1999 by 2 cents, in 2000 by 3 cents and in 2001 by 4 cents, or by less than 1 percent in each of the past three years. In the second quarter, Freddie said expenses associated with employee options were less than \$4 million, representing less than once cent per diluted common share. (*Wall Street Journal, 7/24/02; Washington Post, Kathleen Day, 7/24/02*)
- Financial consultant Bert Ely called the announcement “political pandering” on the part of the GSEs. “My sense is that this is not that big of a deal for them. They are not a Cisco or a Microsoft in terms of how they handed that stuff [stock options] out,” Ely said. (*BNA Daily Report for Executives, Richard Cowden, 7/25/02*)
- Fannie’s Chief Financial Officer Timothy Howard exercised an option to sell 20,000 shares of Fannie’s stock at \$80.51 per share on May 16, which was estimated to make him \$1.25 million richer. Freddie’s Chairman Leland Brendsel exercised an option to sell 9,238 shares, in which he was estimated to make \$478,528.40 from the sale. (*National Mortgage News, 7/29/02*)

Fannie & Freddie enjoy record second quarter earnings

Fannie & Freddie's retained mortgage portfolio slows

Fannie

- Fannie reported operating net income for the second quarter of 2002 of \$1.573 billion, a 19.7% increase compared with the second quarter of 2001. Operating earnings per diluted common share (operating EPS) of \$1.55 rose 22% above the same period in 2001. For the first six months of 2002, Fannie's operating net income was \$3.091 billion, compared with \$2.553 billion for the same period in 2001. Operating EPS for the first six months of 2002 was \$3.03, or 22.7% above the first six months of 2001.
- Operating net income and operating EPS exclude the variability in earnings that results from including unrealized gains and losses from the change in the market value of purchased options under Financial Accounting Standard No. 133 (FAS 133). Net income for the second quarter of 2002 including FAS 133 items was \$1.464 billion, an increase of 4.4 percent over the second quarter of 2001. EPS including FAS 133 items was \$1.44, 5.9 percent above the same period last year. Net income and EPS for the six months ended June 30, 2002, including FAS 133 items, were \$2.672 billion and \$2.61, respectively. Highlights of Fannie's financial performance in the second quarter of 2002 compared with the second quarter of 2001 include: (1) Growth in taxable-equivalent revenues of 21.4 percent; (2) Growth in adjusted net interest income of 22.4 percent; (3) An average net interest margin of 116 basis points compared with 109 basis points; (4) Growth in guaranty fee income of 18.6 percent; (5) Credit-related losses of \$17.3 million compared with \$16.2 million, and (6) Losses of \$224.7 million from the call and repurchase of debt compared with \$142.5 million.
- Fannie's business volume -- mortgages purchased for portfolio plus mortgage-backed security (MBS) issues acquired by other investors -- totaled \$159.8 billion in the second quarter of 2002, compared with \$165.7 billion in the second quarter of 2001 and \$197.8 billion in the first quarter of 2002. Business volume for the first six months of 2002 was \$357.6 billion, a 31.8 percent increase from \$271.3 billion for the first six months of 2001. Business volume in the second quarter of 2002 consisted of \$56.9 billion in portfolio purchases and \$102.9 billion in MBS issues acquired by investors other than Fannie's portfolio, compared with \$65.3 billion and \$100.4 billion, respectively, in the second quarter of 2001. (*Fannie press release, 7/15/02*)
- **“The most noteworthy development [of Fannie's earnings announcement], was the disappointing rate of growth in the retained portfolio in the quarter, and indeed for the past five quarters,” said Jonathan E. Gray, a senior research analyst and principal at Sanford C. Bernstein & Co. “The GSEs have the greatest opportunity for rapid volume growth – and at elevated spreads – during refi booms, when the preponderance of originations are fixed-rate...However, despite the surge in new mortgage spreads to an average of 112 basis points in 2001, there was no acceleration in retained growth, which remained at 16%.”** (*Origination News, Kyriaki Venetis, 6/02*)

Freddie

- Freddie announced operating earnings for second quarter 2002 were \$968 million, compared to \$769 million for the same period a year ago and \$893 million for first quarter 2002. Diluted operating earnings per common share were \$1.30 for second quarter 2002, compared to \$1.03 for second quarter 2001 and \$1.19 for first quarter 2002, a 26% increase.
- Freddie's operating earnings and diluted operating earnings per common share exclude certain accounting effects related to SFAS 133. As reported under generally accepted accounting principles ("GAAP"), net

income for second quarter 2002 was \$1.110 billion, an increase of 21 percent from second quarter 2001 net income of \$914 million. Diluted earnings per common share for second quarter 2002 were \$1.50, an increase of 21 percent from second quarter 2001 diluted earnings per common share of \$1.24. First quarter 2002 net income and diluted earnings per common share were \$1.413 billion and \$1.94, respectively.

- Highlights for second quarter 2002 include: (1) **Freddie's retained portfolio contracted by \$7 billion to \$519 billion during the second quarter, representing annualized growth of negative 5 percent;** (2) Freddie's fully taxable equivalent (FTE) operating net interest yield was 88 basis points in the second quarter, down 1 basis point from first quarter 2002; (3) Freddie's portfolio market value sensitivity remained a low 2.74 percent in the second quarter, unchanged from first quarter 2002; (4) Freddie's second quarter credit losses represented 0.8 basis points of its average mortgage portfolio, unchanged from first quarter 2002; (5) Freddie has concluded that its continuing strong credit innovations and experience have contributed to a loan loss reserve which has been \$250 million in excess of that required by GAAP, and as a result will reduce its reserves by this amount; (6) Freddie's administrative expenses were \$204 million in second quarter 2002, down \$24 million from first quarter 2002; (7) Freddie's administrative expenses now include the effect of expensing stock options. This expense was less than \$4 million in the second quarter, representing less than \$0.01 per diluted common share. (*Freddie press release, 7/23/02*)
- **Freddie is likely to show "negative" retained portfolio growth in the short-term, said Vaughn Clarke, Freddie's Executive Vice President and Chief Financial Officer in a quarterly earnings conference call. "We are currently seeing fewer attractive mortgage investment opportunities," he said. He added that "for the year as a whole however, we remain confident that our investment capabilities will allow us to grow our retained portfolio at a mid-teen rate."** (*Origination News, 6/02*)
- **Fannie and Freddie have been buying fewer mortgage loans and bonds for investments this year because they have become expensive relative to their own borrowing cost.** (*Reuters, 7/15/02*)

Fannie Mae

Fannie's purchasing of subprime mortgages increases

The number of loans Fannie purchases through its automated underwriting system triples to 60%

Fannie estimates its earnings have increased 90% over the last four years

- In a June 5 speech at a Sanford Bernstein conference, Fannie's Chairman Frank Raines noted that since the beginning of 1999, the share of its mortgage acquisitions coming through its automated underwriting system – Desktop Underwriter – has tripled from 22% to over 60%. Raines also noted that Fannie has increased its customized mortgage products, which include Fannie's Alt-A product and Expanded Approval product for subprime borrowers. In 1999, only 6% of Fannie's single-family business came from customized products. Today, 24% - a quarter of their business – comes from customized products. Raines noted that from 1994 to 1998, Fannie's taxable equivalent revenues grew at an average rate of 10%; 1999 - revenues grew by 11%; 2000 – revenues grew 12%; 2001 – revenues grew 30%; and in the first quarter of 2002, Fannie's revenues grew 25%. "Bottom line, if we reach the market consensus for the end of the year, our earnings will have increased by 90% in just four years." He added, "At a time when disappointment in the market is common and exuberance is much more rationale, how many other companies have delivered 90 percent growth in operating earnings in four years?" (*Fannie CEO Franklin Raines speech before the Sanford C. Bernstein Strategic Decisions conference, 6/5/02*)

Fannie finances \$8.7 billion in multifamily rental housing in first half of 2002

- Fannie announced that it participated in financing \$8.7 billion in multifamily rental housing in the first half of 2002. Fannie also announced that it has committed to invest \$736 million in low-income housing tax credit (LIHTC) properties to date, bringing Fannie's total LIHTC investment commitments to over \$6 billion. (*Fannie press release, 7/22/02*)

Fannie Mae Foundation appoints Special Advisor to the President of the US, Stephen Goldsmith, to its Board of Directors

- The Fannie Mae Foundation announced that it has appointed Stephen Goldsmith to serve on its Board of Directors. Goldsmith, former two-term Mayor of Indianapolis, served as Chief Domestic Policy Advisor for the George W. Bush Presidential campaign. Goldsmith currently serves as Special Advisor to the President for faith-based and not-for-profit initiatives, Chairman of the Corporation for National and Community and Community Service as well as Senior Vice President for e-Government and Strategic Development for ACS State and Local Solutions. (*PR Newswire, 7/25/02*)

Fannie appoints William Daley and Nathan Gatten as VPs for Government and Industry Relations

- Fannie announced the appointment of William Daley and Nathan Gatten as Vice Presidents for Government and Industry Relations. Daley joined Fannie in 1999 as manager for new business development in housing and community development. Since March 2000, he served as Fannie's Midwestern Regional Office's Director of Regional Public Affairs. Prior to joining Fannie, he served as Director of Public Liaison in the Office of the United States Trade Representative, deputy director for political affairs for the 1996 Clinton/Gore campaign, and liaison for the White House Office of Intergovernmental Affairs. Gatten also joined Fannie in 1999, as Director of Congressional Relations. Previously he was a professional staff member on the Senate Banking Committee with the responsibility for the Subcommittee on Financial Institutions, chaired by Senator Robert Bennett (R-UT). (*Fannie press release, 7/22/02*)

Freddie Mac

***Wall Street Journal* notes Freddie's political fundraising may be influencing the House Financial Services Committee**

Freddie contributes \$625,000 to the Democratic Senatorial Campaign Committee's (DSCC) 2002 Building Fund; Fannie contributes \$250,000

- *Wall Street Journal's* John McKinnon reported, "House Financial Services Committee Chairman Michael Oxley has been a busy man this year. With corporate-accounting scandals consuming lawmakers' attention, the Ohio Republican's committee has held eight hearings since January." But Congressman Oxley "also has found time to be the draw at seven fund-raisers with the chief lobbyist for one of the biggest companies his committee oversees: mortgage-market giant Freddie Mac." Including "similar events last year," Congressman Oxley has held a total of 17 fund-raisers with Freddie's lobbyist, Mitchell Delk, 14 of which were for members of the House Financial Service's Committee that oversees Freddie.
- Critics of Fannie and Freddie claim the fundraising and the GSEs' soft-money contributions and other giving has helped them avoid action by the House Financial Services Committee this year on legislation to

overhaul them. The critics also argue that “[Congressman] Oxley’s numerous fund-raisers with Delk belie his recent self-proclaimed zeal for the cause of tightening accounting rules.” A spokeswoman for Congressman Oxley “denies the fund-raisers helped slow action on overhauling the two government-sponsored enterprises,” noting that a Financial Services subcommittee has held two hearings on Fannie and Freddie just in the past month. The article noted, however, that “neither hearing so far has provided much momentum for overhaul efforts.”

- “It’s not unusual for a committee chairman to have maybe one fund-raiser in a two-year cycle with one powerful lobbyist or industry interest,” said Charles Lewis, executive director of the Center for Public Integrity, a political watchdog group. “But to have multiple events -- that starts to look like you’re the congressman from Freddie Mac.”
- “With both of these companies [Fannie and Freddie], there's growing concern about the amount of money they contribute to the political process,” said banking consultant Bert Ely. Ely said he was unfamiliar with Mr. Delk’s fund-raisers, but he said the company’s fundraising is “obviously intended to help maintain their favorable treatment.”
- The fundraisers are in addition to Freddie’s large soft-money political contributions. The article noted that as of early July, Freddie was the largest donor of soft money among publicly traded companies for the 2002 election cycle. Since last year, the company has donated \$2.1 million in soft money, the unlimited donations allowed under current law but largely banned after the November election under legislation passed by Congress this year. With its giving to date, Freddie appears to be on a pace to exceed its contributions for the 2000 campaign, when it gave about \$2.4 million. (*Wall Street Journal*, John McKinnon, 7/30/02)

Freddie contributes DSCC Building Fund

- In related news, Freddie contributed \$625,000 in soft money to the DSCC’s 2002 Building Fund, a special account used for rent and the upkeep or purchase of new buildings. The DSCC is currently in the process of purchasing a building for its new headquarters. Another large contributor was Fannie, which made \$250,000 in contributions. (*Roll Call*, Amy Keller, 8/1/02)

Freddie names Mike May Senior Vice President and Chief Operating Officer, Single Family Operations

- Freddie named Mike May Senior Vice President and Chief Operating Officer, Single Family Operations. May replaces Margaret Colon, who, in lieu of her planned retirement, will continue in a part-time capacity to lead Single Family’s efforts to develop a more robust mortgage asset management strategy. May will be responsible for all single family mortgage purchase and servicing operations, as well as the operational infrastructure and technology for Freddie’s single family business. May will continue as executive in charge of the corporation’s overhaul of internal legacy systems. In August 1998, May was named senior vice president of Customer Services and Control overseeing Single Family’s Control, Customer Support, Institutional Credit Risk, Quality Control, Transaction Processing and Year 2000 departments. Previously, May was vice president of Loan Prospector[®], managing the overall development, marketing and operations of Freddie’s automated loan evaluation service. He also served as vice president of Business Management, charged with the development and operation of Loan Prospector products and services, as well as vice president of Structured Finance, managing Freddie’s structured mortgage securities program, new product development, new issuance and ongoing servicing of all structured mortgage securities products. May also served as vice president of Freddie’s Securities Sales & Trading Group (SS&TG), where he oversaw activities including sales, trading, operations, control and research. He was an original member of SS&TG and was the group's first controller. May came to Freddie in 1983 from the Student Loan Marketing Corporation where he served as an internal auditor. (*Freddie press release*, 7/29/02)

Freddie selects US Bank as Master Servicer for Section 8 homeownership initiative

- Freddie announced that it has selected U.S. Bank (Minneapolis, MN) to be the master servicer for its Section 8 homeownership mortgage initiative. Under the initiative, homeowners are eligible to use funds from the federal Section 8 program for mortgage payments. According to Freddie, the benefit of U.S. Bank managing the master servicing is to help expand the Section 8 program because the greatest barrier to more lenders participating is the inability to service loans. However, this does not limit lenders to originate and sell service released to U.S. Bank. Lenders will still have the option to originate and service their own Section 8 mortgages. U.S. Bank's participation in Freddie's Section 8 homeownership mortgage initiative is intended to provide lenders who do not have the capability to service Section 8 mortgages with an outlet. *(Freddie press release, 7/29/02)*

Freddie, the National Council of La Raza, Wells Fargo Home Mortgage, Bank of America, and US Bank Home Mortgage launch program to increase Hispanic homeownership

- Freddie, the National Council of La Raza (NCLR), Wells Fargo Home Mortgage, Bank of America and U.S. Bank Home Mortgage launched today *En Su Casa* — a \$200 million program combining innovative technology, homeownership counseling and flexible mortgages to enable more Hispanic families to own homes. *En Su Casa* is a homebuyer assistance initiative that combines Freddie's CounselorMax—a new web-based technology for nonprofit counseling agencies—with flexible mortgage products geared to increase homeownership opportunities for Hispanic borrowers. *En Su Casa* addresses some of the key homeownership challenges facing Hispanic families including the lack of information about buying a home, language and cultural barriers, lack of credit history and impaired credit history.
- Debuting at 20 NCLR affiliates in Arizona, California, Texas, Colorado, Oklahoma, Kansas, Pennsylvania and Illinois, the initiative will soon expand to include five affiliates in Florida, New York and Los Angeles. Freddie has funded the initiative to span over three years. The funding supports technology development, basic start-up, and implementation in more than 20 Hispanic communities across the country.
- According to Freddie, the *En Su Casa* initiative will help demystify the homebuying process for more Hispanic families by making available new technology tools for community-based counseling agencies and offering flexible mortgage products. CounselorMax will enable community-based counseling agencies to streamline the education and counseling process, increasing the number of consumers who can be efficiently put on the path to homeownership. Using CounselorMax, the counselors can also analyze client qualifications and match their clients with the most affordable loan products and services. Lenders are then able to expedite the mortgage application and underwriting process. Bank of America, Wells Fargo, and U.S. Bank will provide affordable mortgage financing with flexible credit underwriting for qualified borrowers, that includes accepting non-traditional credit references. As a result, homebuyers may obtain mortgages that require as little as a \$500 down payment from their own funds. Freddie has committed to purchase \$200 million in eligible mortgages under the initiative from Bank of America, Wells Fargo and U.S. Bank, ensuring a continuous supply of mortgage funds for additional homebuyers. *(Freddie press release, 7/23/02)*

Federal Home Loan Banks

FHFB to hold a board meeting in September to discuss a perceived FHLBank System cost of funds problem

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

- FHFB Chairman John Korsmo said the FHFB is planning to hold a board meeting in September on the cost of funds issue to “air it out,” according to a July 26 interview with *Dow Jones Newswire*. He said there is significant debate within the FHLBank System as to whether there is a problem, and if so, how to measure and improve it. Korsmo said it would be appropriate to hear from the FHLBank presidents on the issue. (*Dow Jones Newswire*, John Connor, 7/29/02)
- The cost of funds issue centers on whether the FHLBank System is paying too much money for its borrowing in the debt markets. 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 had 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)

Farm Credit System/Farmer Mac

Capital Market Risk Advisors study finds that it is impossible to determine Farmer Mac’s interest-rate risk based on its limited disclosures and that the company’s reliance on short-term funding creates significant liquidity risks

- Capital Market Risk Advisors, Inc. was asked to comment on the interest-rate disclosures in Farmer Mac’s 10-K and 10-Q SEC filings, and to comment on the statements made by Farmer Mac’s management during a May 31, 2002 conference call regarding Farmer Mac’s match funding generally and, more specifically, the comments regarding disclosure of the impact of Farmer Mac’s own Market Value of Equity (“MVE”) test in describing Farmer Mac’s portfolio risks.
- Their conclusions were the following:
 - “Given Farmer Mac’s limited disclosures about its assets, liabilities, and derivative portfolio, it is impossible to determine the full extent of Farmer Mac’s exposure to interest-rate risk;
 - The company’s MVE test is an inadequate measure of interest-rate risk;
 - The data from Farmer Mac’s MVE test shows that Farmer Mac has a negatively convex portfolio – in every portfolio shift, up or down, the portfolio experiences a loss;
 - Farmer Mac’s reliance on short-term funding creates significant liquidity risks. Management’s statement indicate that the company does not hedge this risk.”
- The Capital Market Risk Advisors report was conducted for the investment firm Gotham Partners. Capital Market Risk is led by former Citibank Derivatives Group head Leslie Rahl. (*National Mortgage News Daily Web site*, 7/26/02) The full report is available on Gotham Partners Web site (www.gothampartners.com).

Farmer Mac accuses *The New York Times* of driving its stock price down

- Farmer Mac is accusing Alison Leigh Cowan, a reporter with *The New York Times*, of driving its stock price down. Farmer Mac claims that *The Times*' coverage of the company has been unfairly influenced by short-sellers. "We don't expect that everybody has the same view of Farmer Mac," said Farmer Mac's Chief Executive Henry Edelman to the *New York Observer's Off the Record*. "But when we see a symbiotic relationship between people who have a particular point of view and a journalist, that gives us concern." On April 29, Farmer Mac asked the SEC to investigate Cowan and her conversations with short-sellers. On April 30, *The Times* released a statement that said: "We are confident of the completeness, fairness and accuracy of our reporting."
- *The Times* has strongly defended its coverage of Farmer Mac. Farmer Mac claimed that since Cowan began writing about the company in April, Farmer Mac's stock price has fallen by half. The company's accounting and business practices have come under fire from the GAO, the Farm Credit Administration and the US Senate. Currently, almost half of Farmer Mac's 8.5 million shares available on the New York Stock Exchange have been sold short by investors who expect the stock to fall even further. (*New York Observer*, Sridhar Pappu and Ian Blecher, 7/29/02)

Farmer Mac Achieves Record Earnings

- Farmer Mac announced that it achieved record earnings for its second quarter, ended June 30, 2002. Diluted operating earnings per share grew to \$0.48, a 50 percent increase over second quarter 2001 diluted operating earnings per share of \$0.32. Operating income for the second quarter 2002 reached \$5.8 million and \$11.1 million for the year-to-date, compared to \$3.7 million and \$6.9 million for the same periods in 2001. Operating income, revenues and earnings per share are measures that exclude the effects of Statement of Financial Accounting Standards No. 133 ("FAS 133") and the net after-tax extraordinary gain of \$0.6 million recognized on the repurchase of a portion of the Company's debt in second quarter 2002. Net income for second quarter 2002, including the effects of FAS 133 and the extraordinary gain, was \$6.3 million or \$0.52 per diluted share.
- Farmer Mac President and Chief Executive Officer Henry D. Edelman stated, "Since the middle of the second quarter we have been subject to the efforts of admitted short sellers to depress the price of Farmer Mac's securities for their own gain. The activities of these short sellers have caused a substantial loss in stockholder value over a relatively compressed period of time – something that cannot be explained by any business development. Responding to the attention that has been focused on Farmer Mac, the Senate Agriculture Committee has sought the General Accounting Office's assistance 'to ensure that Farmer Mac's mission continues to be met in a financially sound manner.' We welcome that investigation for the objective review it should afford us. Farmer Mac, unlike many companies, is subject to examination of its operations, as well as related internal controls, by a federal regulator that examines the Company with full access to all related information. Furthermore, we now have in place a risk-based capital ("RBC") standard that measures our capital adequacy, providing assurance that we stay within the risk parameters that the Congress expected of us. The Board and management are fully committed to building the value of Farmer Mac for our stockholders and the country's agricultural sector." (*Farmer Mac press release*, 7/18/02)

Postal Service

House and Senate pass FY 2002 supplemental appropriations bill containing \$87 million for the Postal Service

Bill also contains language to reform Alaska's subsidized "bypass mail"

Congressman Duke Cunningham (R-CA) criticizes the language

- The House and Senate passed the conference report on a \$28.9 billion emergency supplemental appropriations bill (HR 4775), 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. The House passed the conference report on July 23 with a vote of 387 to 32. The Senate voted July 24 92-7 in favor of the bill. (*Thomas Web site*)
- 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 contains language reforming Alaska's "bypass mail" service. (*Fairbanks Daily News-Miner*, 7/19/02) 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)
- Senator Ted Stevens (R-AK) and Congressman Don Young (R-AK) teamed up to ensure that the supplemental appropriations bill contained bypass reform language. (*Fairbanks Daily News-Miner*, Sam Bishop, 7/19/02) Both Members introduced language restricting the kind of air carriers eligible to carry bypass mail. Senator Stevens' language was included in the Senate version of the FY 2002 supplemental appropriations bill; Congressman Young's language was included in the House version. (*Associated Press*, 6/8/02; *National Journal's Congress Daily*, 6/3/02) The House and Senate versions were merged in conference.
- 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 hope that by consolidating air traffic on the most heavily traveled routes, they can save as much as \$30 million a year. But in order to carry out that consolidation, their bills 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)

Congressman Cunningham criticizes the bypass reform language

- Congressman Cunningham criticized the language saying that it would unfairly route Alaska’s bypass mail to just a few companies, driving up costs. He called the provisions “an abuse of power by one senator [Senator Stevens] in the other body.” Congressman Cunningham noted that no hearings were held on the issue before the language was added to the supplemental bill. “We should not take up legislation like this on such an important bill,” he said. Senator Stevens’ spokeswoman Melanie Alvord said the bill didn’t have a hearing but it was passed by the Senate Governmental Affairs Committee in late May. (*Fairbanks Daily News-Miner*, Sam Bishop, 7/24/02)
- Bill Patch, a San Diego businessman who, along with a few others, owns 51 percent of Alaska Central Express, brought the bypass language to Congressman Cunningham’s attention. Alaska Central bypasses mail on the mainline routes between Alaska’s major cities and the larger bush hubs. It uses small planes but is reimbursed at the rate paid to the other mainline carriers who use large planes--Alaska Airlines, Northern Air Cargo, Air Cargo Express and Lynden Air Transport. The bypass language would require Alaska Central to provide a certain amount of passenger service if it wants to continue being eligible for the bypass business, which means taking on Alaska Airlines, the only bypass mail carrier that currently carries passengers on the mainline routes, Patch said. “Nobody is going to do that because nobody could afford to,” he said. (*Fairbanks Daily News-Miner*, Sam Bishop, 7/24/02)
- There is a chance Alaska Central could stay in the mainline bypass business without flying passengers following passage of the bill, but that depends upon the resolution of a dispute with the Postal Service, Patch said. The Postal Service last year announced that the company isn’t eligible for bypass mail because it flies small planes, Patch said. After the Postal Service decision, Alaska Central filed for bankruptcy and convinced a judge to issue a stay that allows the company to still receive bypass mail. If Alaska Central wins the dispute over its past eligibility, it could receive grandfather rights to fly bypass mail in the future without providing passenger service, because under the bypass reform language, any company that was eligible to fly bypass mail prior to Jan. 1, 2001, could continue to do so without the passenger requirement. Patch said establishing an arbitrary date that creates an additional hurdle for his company is unfair and unconstitutional. “Frankly, we’re going to challenge this bill in court shortly,” he said. “We will be there with the best lawyers in the country on due process and constitutional law.” (*Fairbanks Daily News-Miner*, Sam Bishop, 7/24/02)

House passes FY 2003 postal appropriations bill, which contains \$60 million for the Postal Service

House Appropriations Committee criticizes the Postal Service for failing to get its expenses under control

Mailers say Congress shares part of the blame

- The House of Representatives approved July 24 an \$18.5 billion Treasury, Postal and Government Appropriations bill (HR 5120), which contains \$60 million in fiscal year 2003 funding for the Postal Service. Included in the funding is \$29 million as part of the Revenue Foregone Reform Act of 1993, which

granted the Postal Service 42 annual payments of \$29 million to compensate for insufficient appropriations in previous years. The House rejected the Postal Service's request to have the remaining \$900 million due as part of the act paid at once. (*DM News*, 7/26/02)

- The House Appropriations Committee criticized the Postal Service for failing to get its expenses under control, but mailers claimed that Congress is part of the problem. The House Appropriations Committee's criticism was part of its report on proposed postal service FY 2003 appropriations. The committee said it remains concerned by the financial status of the Postal Service, with deficits projected of \$1.5 billion for FY 2002. The committee "continues to believe that deficits of this magnitude are unacceptable," the report said. The committee said "that USPS financial difficulties cannot be attributed solely to recent events, nor can the problem be resolved solely by increasing postal rates or by federal appropriations. Instead, the committee believes that USPS organization and practices must undergo fundamental changes to adapt to the current business climate." The committee "supports ongoing efforts by the Committee on Government Reform and encourages USPS to work with Congress in the passage of legislation that will return USPS to financial sustainability." The committee also criticized the Postal Service's bonus program and instructed postal officials to re-examine that program and report its decision to the panel by Dec. 31. (*DM News*, Melissa Campanelli, 7/19/02)
- The Postal Service "is being asked to take on extraordinary expenses that are part of a public service obligation, like the security of the mail, carrying post offices that are not profitable and delivering mail to far-reaching areas," said Neal Denton, executive director of the Alliance of Nonprofit Mailers. "But Congress does not seem interested in helping the postal service meet these obligations and at the same time can't seem to bring itself to pass legislative reform that would help the service pay for these expenses themselves." (*DM News*, Melissa Campanelli, 7/19/02)
- The Senate Appropriations Committee approved in early July the FY 2003 Treasury, Postal and General Government Appropriations bill, which also includes \$60 million for the Postal Service. (*DM News*, 7/26/02)

Senator Susan Collins (R-ME) introduces a bill calling for a Presidential postal reform commission

Mailers Council supports the bill

***DM News* editorial says, "The sooner the better" that the President appoint a commission**

- Senator Collins introduced a bill (S 2754) July 18 to establish a Presidential Commission on the US Postal Service. The Commission would be composed of 11 members appointed by the President, of whom one would be designated by the President as Chairperson; at least one would not be a Federal officer or employee; and at least one should be a union representative. The Commission's study is required to include the following: (1) the mission and role of the Postal Service, including the scope of competition with the private sector, the extent of the Postal Service's monopoly on letter mail; (2) the best structure to ensure the Postal Service's financial viability; (3) infrastructure, including post offices and mail processing centers; (4) regulatory and governance structure of the Postal Service; (5) the transparency and accountability of Postal Service operations; (6) the security of the Postal Service's employees and customers; (7) increasing the efficiency of the Postal Service, including cost-cutting measures, productivity, and technology implementation; and (8) other issues that the Commission determines is relevant to ensuring the long term viability and increased efficiency of the Postal Service. The bill was referred to the Senate Governmental Affairs Committee. (*S. 2754*)

- The Mailers Council urged the Senate to pass S. 2754. In May the Mailers Council called for a presidential commission, in response to rapidly rising postage rates and deficits. In a May 13 letter to President George W. Bush, the Mailers Council urged him to create a new postal reform commission with members that include business, business education and organized labor leaders without any direct interest in the mailing industry. (*Business Wire*, 7/30/02)
- A July 22 *DM News* editorial says rumors are circulating that a postal reform commission could be announced soon. “The sooner the better,” said the editorial. “The undertaking has been far too political for Congress to be able to get anything passed [on postal reform.]” The editorial added, “The USPS isn’t helping the situation. For one, it needs to get back to what it’s supposed to do – deliver the mail – and quit wasting time and money in areas it has no business being in...like sponsoring the US Pro Cycling Team in the Tour de France and other races...what does this have to do with delivering the mail?” Mail volume continues “to plummet,” added the editorial. “The only thing that will fix this mess is a complete overhaul. Rumors are circulating that President Bush will name a commission before Labor Day. Let’s hope his appointees will be braver in their recommendations than our lawmakers have been.” (*DM News Editorial*, Tad Clarke, Editor in Chief, 7/22/02)

Postal Service ends its controversial executive bonus program

Citizens Against Government Waste (CAGW) warns against replicating the same program with a different name

- Postmaster General John Potter said he is ending a controversial Postal Service executive bonus program and asked management groups to recommend a new compensation system. Potter announced the end of the bonuses in staff meetings July 19. The EVA program – for “economic value added” – was part of a pay-for-performance system covering more than 80,000 postmasters, supervisors, and management employees. The bonus program was criticized for awarding more than \$164.1 million in bonuses last year, despite reporting a \$1.7 billion deficit for fiscal year 2001. (*DM News*, Melissa Campanelli, 7/26/02; *Washington Post*, Stephen Barr, 7/22/02)
- A House Appropriations Committee report in June said the bonus program “does not provide the necessary incentives to improve postal performance.” The committee instructed postal officials to examine the program and report its decision to the panel by December 31. A Postal Service spokesman said Potter would present a new compensation program by that date. (*DM News*, Melissa Campanelli, 7/26/02)
- Some critics of the bonus plan, which included the Postal Service’s inspector general, hourly Postal Service employees and lawmakers, complained that the plan was inappropriate for a monopoly organization and permitted generous payouts, even when the Postal Service was losing money. The Postal Service continues to believe that the plan is valid and is being eliminated because Congress and the public misunderstood it. Critics believe that the real challenge will be in coming up with an alternative plan. The replacement program will be developed over the next year and take effect in October 2003, said Postal Service spokesman Jerry Kreinkamp. Any new plan would be based on individual instead of group accomplishments, would continue to be performance based, and would not include the controversial EVA concept, Kreinkamp said. (*Federal Times.com*, Dan Davidson, 7/29/02)
- Former Postal Service executive and adjunct fellow at the Lexington Institute, Charles Guy, said the Postal Service may find it difficult to devise a suitable plan since it does not appear to recognize any problems with the current system. “As long as [Postmaster General John] Potter thinks it’s all a perception issue, and the Board of Governors agrees, they will look for things that will not work,” said Guy. He said developing a management bonus program is much more difficult for a quasi-governmental agency than for a private-

sector company. “The Postal Service by statute is required to break even, so there is not much room to generate a fund of any size to distribute to management. The problem is that they look at themselves as analogous to a private-sector firm engaged in competition but they are not. They are little different from other government agencies. Those agencies usually have modest award programs that are based on merit and the judgment of management,” Guy said. Bernie Ungar, a General Accounting Office analyst who covers the Postal Service, agreed that the challenge for the agency will be coming up with an alternative. The fundamental problem with the Postal Service bonus plan was that it was not based on profit sharing, as are the plans of most companies, because the agency is forbidden by law from making a profit, Ungar said. (*Federal Times.com*, Dan Davidson, 7/29/02)

PostalWatch claims that the Postal Service is using “accounting trickery” to pay executive bonuses

- PostalWatch Executive Director Rick Merritt noted that a recent article by the *Washington Post* left the impression that the Postal Service is cutting back on its “pay-for-performance” executive bonuses. Merritt claimed, “Nothing could be further from the truth.” The Postmaster General indicated that he would terminate the EVA program and pay out a lump \$300 million supposedly earned in EVA reserve accounts to managers and executives. Merritt noted that according to the original formula used to calculate these awards, the EVA reserve accounts should be in the red by nearly \$1 billion. “The \$300 million about to be distributed comes from an Enron/WorldCom-style cooking of the books.” He explained, “In 1998 it became apparent that EVA reserve accounts would go into the red, as the formula was designed to do when postal fortunes decline. According to a December 2001 Inspector General report, postal managers disregarded the advice of consultants and modified the formula by adding an ‘aggressive’ inflation indexing adjustment. In essence, they used an accounting adjustment to create ‘economic value added’ where none existed solely for the purpose of paying themselves bonuses.” Merritt concluded, “The only difference between Enron, WorldCom and the U.S. Postal Service is that Enron and WorldCom won’t be using accounting trickery to mislead their stakeholders in the future.” (*Washington Post Letter-to-the-Editor*, Rick Merritt, PostalWatch, 7/31/02)

CAGW warns against replicating the same bonus program under a different name

- CAGW reacted “skeptically” to the news that the Postal Service was ending its executive bonus program. “Despite legendarily poor management, the Postal Service has long provided its supervisors and managers with a generous performance pay system, giving \$164 million in bonuses to Post Office higher-ups last year, while simultaneously posting a deficit of \$1.7 billion,” CAGW Vice President Leslie K. Paige said. “These same executives just hiked the stamp price three cents in what will be a futile attempt to bail themselves out of the financial death spiral they are in.”
- “The key to really reforming the postal service is not to replace one dysfunctional structure with another, but to usher in excellent performance in a market-competition model,” Paige continued. “That means if productivity is not improving, costs are increasing, demand is declining, and waste is ubiquitous, you fire executives, not give them bonuses. If someone doesn’t start holding the USPS management’s feet to that kind of fire, the agency will continue in its current abysmal financial state. One way or another, eventually consumers must be freed of this bureaucratic monopoly.”
- “Few non-bankrupt companies have as poor a record of cutting costs, enhancing productivity, and trimming unnecessary workers as the Post Office. Its unsustainable business model invests in labor-saving equipment without saving any money on labor, which still eats up close to 80 percent of its budget,” Paige said. “It spends federal money on image advertising and promoting its notoriously feeble Priority Mail -- yet instead of cutting costs and getting leaner, USPS increases rates. Consumers shouldn’t be overly impressed with Mr. Potter’s elimination of executive bonuses. There are many more demanding problems still to be addressed at the Postal Service.” (*CAGW press release*, 7/24/02)

President Bush nominates James Miller, President Reagan's former Budget Chief, to Postal Service Board

- President Bush is nominating James Miller, a former Reagan-era budget director and Federal Trade Commission head, to the board of governors of the US Postal Service. The nine-year term on the body would expire near the end of 2010. The Senate must confirm Miller to the post. 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)

ABC News commentary raises concerns about the Postal Service's sponsorship of the Tour de France while the Postal Service is facing financial problems

***International Herald Tribune* says the Postal Service should take the money it is using to sponsor the Tour de France and instead spend it on improving the mail service**

Postal workers criticize the sponsorship

Postal Service and the cycling team defend the sponsorship

- An *ABC News* commentary by John Stossel wondered why the Postal Service is sponsoring Lance Armstrong's team at the Tour de France. Stossel stated, "It's a monopoly. No one is allowed to directly compete with them...Why does a government-enforced monopoly spend millions of dollars on advertising? Why should the Postal Service be spending any money promoting itself...the Postal Service just rolled out another rate increase. Why do we have to give a government monopoly more money to do things like sponsor sorts watched mostly by people who don't even live in America?...Give me a break!" (*ABC News Commentary by John Stossel*, 7/19/02)
- "How come the US Postal Service...sponsors a pro cycle racing team?" asks Lee Dembart with the *International Herald Tribune*. "This is an outfit that lost \$1.6 billion, that has accumulated debts of \$13 billion, that will receive more than \$76 million from the US Treasury in 2002 and that expects still greater losses this year despite having just raised the price of a first-class stamp from 34 to 37 cents. And they have the money to sponsor a pro cycle team?" wrote Dembart. "If the Postal Service has a spare \$45 million to spend on marketing, it could do itself and its customers a bigger favor by spending it on improving mail service and maybe doing something about the scandalous additional charges paid by people overseas who receive packages mailed from the United States. If it wants to be involved with bicycles, it should give them to letter carriers to use on their appointed rounds." (*International Herald Tribune*, Lee Dembart, 7/26/02)

Postal workers criticize the sponsorship

- Patrick O'Donnell, a 15-year veteran of the Postal Service who overcame anthrax poisoning thinks Lance Armstrong should forgo his Postal Service paycheck to make his bigger. "It's just absurd that Lance [Armstrong] gets \$25 million from the same organization from which I have trouble getting a hundred bucks for drugs," said O'Donnell. More recently, among postal employees, "the cycling team has become quite a controversy" said Leroy Richmond, a mail sorter who also contracted anthrax. In July, Diane Todd, from the Postal Service communications department, sent managers and some postal union leaders an e-mail touting the four-year, \$25 million cycling team sponsorship, and encouraged employees to send them e-mails. "Sheer propaganda," is what Bill Lewis, a mail sorter and President of the Trenton, NJ Metro Area Local chapter of the AFL-CIO called the e-mail. "I felt sick to my stomach reading that figure," said Lewis. The same week the e-mail was sent, Lewis was talking to postal management about its plans to trim

\$200,000 from the budget for bathrooms in the new Hamilton facility that will replace the still contaminated plant. “Nothing against Lance, but it’s lunacy that the Postal Service is out there marketing themselves as if they were a legitimate business when they don’t even have to pay parking tickets,” said Congresswoman Ann Northrup (R-KY). Her district is home to 20,000 employees of United Parcel Service Inc. who she says “don’t get pay raises and bonuses in years they lose money because they don’t have taxpayers propping them up.” (*Wall Street Journal*, Maureen Tkacik, 7/29/02)

Postal Service and cycling team defend the sponsorship

- In an interview with *ABC News’ 20/20*, Deputy Postmaster John Nolan was blasted for the Postal Service’s sponsorship of the Tour de France. Nolan stated, “We generate business as a result of our advertising through Lance [Armstrong] and the post office bicycle team. It is psychic for our employees...it’s an uplifting thing...it feels good for our employees. It’s a sense of pride.” (*ABC News*, 20/20, 7/19/02) In a letter to the *Indianapolis Star*, Kenneth Braun, an Indiana District Manager with the Postal Service in Indianapolis, defended the Postal Service’s sponsorship of the Tour de France. Braun wrote, “The money it [Postal Service] spends on the sponsorship is not a ‘frivolous activity,’ but a strategic investment in advertising that has netted millions of dollars in new revenue, positive public perception and new product awareness. To imply that the Postal Service is a government monopoly that lacks competition is naïve.” He added, “Efforts such as advertising and sponsorships have generated revenue for us, just as they do for private sector businesses with which we compete in today’s marketplace.” (*Indianapolis Star, Letter-to-the-Editor* by Kenneth Braun, 7/22/02)
- In an interview with *Cyclingnews.com*, Mark Gorski, the Postal Service’s cycling team’s manager said the team had reached its goal of generating “four times the [Postal Service’s] sponsorship fee in tangible new business every year since 1997.” Gorski said the Postal Service had commissioned an agency to quantify the media value of Lance Armstrong’s 1999 Tour de France victory and found it was more than \$50 million. In an Internet poll recently, American Online asked viewers how they felt about the Postal Service’s sponsorship of a cycling team. Of 32,327 responses, 72.5% favored the alliance with Armstrong, compared with 27.5% who thought “the money should be used to help keep the cost of mail down.” (*Knight Rider/Tribune News Service*, Tony Pugh, 7/27/02)

Postal Service awards over \$100 million advertising contract to Interpublic Group

- Three agencies of The Interpublic Group of Companies won the Postal Service advertising contract that begins in September. Campbell-Ewald will be the lead creative agency while DraftWorldwide will handle direct marketing, and Initiative Media North will handle media planning and buying. Staff from all three agencies working on the account will work from Campbell-Ewald’s Detroit, MI headquarters. The contract is for two years, with options for three more years. (*DM News*, Melissa Campanelli, 7/26/02) The Postal Service account is estimated to increase Campbell-Ewald’s billings by an estimated \$136 million a year, or 7 percent. The new account could also mean about 75 additional jobs at the firm. (*Detroit News*, Becky Yerak, 7/26/02)
- The agency was selected after a three-month review that began with 21 agencies. “The major goal of the solicitation process was to consolidate responsibility in a single agency instead of spreading work over four agencies as we had been doing. That will provide continuity across all aspects of our account, and, at the same time, result in substantially reducing costs,” said Larry Speakes, Manager of Postal Advertising. The three multicultural agencies – Bravo Group; The Chisolm-Mingo Group Inc.; and A Partnership Inc. – will continue with the Postal Service. (*Postal Service press release*, 7/25/02) About \$10 million of the advertising budget is dedicated to these areas. (*DM News*, Melissa Campanelli, 7/26/02)

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