

The **GSE** REPORT™

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Major Events

Treasury Department warns the SEC that investors “may not fully understand the risks” associated with GSE securities and may not understand that GSE securities are not government-guaranteed

Treasury raises concerns about the marketing of Fannie & Freddie’s \$1,000 investment notes (debt) to consumers

America’s Community Bankers is pleased that the Treasury Department referred this issue to the SEC

Treasury warns about the marketing mutual funds containing GSE securities

Treasury notes that many mutual funds market themselves as being comprised primarily of securities that are backed by the full faith and credit of the US government, when they have a large proportion of GSE securities (that are not government-guaranteed)

- **In a June 4 letter to the SEC, Treasury Assistant Secretary for Financial Institutions Sheila Bair said that Treasury is “concerned that retail investors – either those that directly purchase GSE securities or those that hold GSE securities indirectly through a mutual fund – may not fully understand the risks associated with such investments.” Investors may not understand that securities of Fannie, Freddie, and other GSEs are not government-guaranteed.** “In particular, retail investors may not have a clear understanding that the GSEs’ relationship to the Federal government does not involve any Federal guarantee of the GSEs’ obligations,” warned Bair. (*Treasury Assistant Secretary Bair’s letter to SEC, 6/4/02; Reuters, Mark Felsenthal, 6/5/02*)
- **Bair said the Treasury Department had no comment on the merits of these investments but they “feel strongly that the marketing of these investments – which typically target small, less sophisticated investors – make clear the difference between a security issued by the government – which is fully backed by the full faith and credit of the US government – and a security issued by a government sponsored enterprise, which enjoys no such guarantee.”** (*Treasury Assistant Secretary Bair’s letter to SEC, 6/4/02*)

Treasury raises concerns about the marketing of Fannie & Freddie’s \$1,000 investment notes (debt) to consumers

- Bair raised concerns about the marketing of Fannie and Freddie’s \$1,000 investment notes (debt) to consumers. Bair noted that these retail investment securities are not sold directly by Fannie and Freddie, but through securities broker-dealers. She noted, “Some broker-dealer marketing efforts rely heavily on the GSEs’ relationship to the government as a selling tool. While the GSEs are required to and do clearly disclose that the Federal government does not guarantee their securities, little or no mention of the lack of a Federal guarantee is typically included in broker-dealers’ marketing efforts.” (*Treasury Assistant Secretary Bair’s letter to SEC, 6/4/02; Reuters, Mark Felsenthal, 6/5/02*) Fannie’s investment note program (launched in May 2001) is called “Investment Notes” and Freddie’s program (launched in April 2001) is called “FreddieNOTES. Freddie raised \$9.5 billion through sales of its FreddieNOTES since last April, while Fannie sold \$5.3 billion of its investment notes since last May. (*Dow Jones Newswire, Dawn Kopecki, 5/9/02*)
- Bair noted that sales literature circulated by some brokerage firms seem to “skimp on the warning label” that the GSEs are not government guaranteed. Bair cited as an example a sales piece by

Edward D. Jones, a regional brokerage firm that was offering Freddie's bonds in denominations sized for retail investors. The brochure noted that the issuer was "created by Congress" but never stated that its debts are not guaranteed by the government. Freddie's spokeswoman Sharon McHale said the company had already asked Edward D. Jones to discontinue the brochure. (*New York Times*, Alison Leigh Cowan, 6/6/02)

Treasury letter prompted by ACB letter raising concerns about Fannie & Freddie's \$1,000 investment notes

- *Dow Jones Newswires'* Dawn Kopecki reported that Treasury's letter was prompted by a March 8 letter by America's Community Bankers (ACB) which asked the Treasury Department to prohibit Fannie and Freddie from targeting their core customers, complaining that Fannie and Freddie's investment notes were being marketed as a safe alternative to bank certificates of deposit, which are backed by the FDIC. **The ACB told the Treasury Department that Fannie and Freddie's small denomination debt instruments "are inconsistent with the purposes for which these government-sponsored secondary market enterprises (GSEs) were created." The ACB said these investment notes appear to "be intended to establish the Freddie Mac and Fannie Mae brand names as retail brand names that would facilitate their entry into other retail markets, including that of deposit-like instruments and home mortgage loan originations."** (*Dow Jones Newswire*, Dawn Kopecki, 5/9/02, 6/5/02; *ACB's Diane Casey letter to Treasury Secretary Paul O'Neill*, 3/8/02)
- Banks are concerned that that these investment note programs could harm banks' ability to attract depositors and "threaten the deposit base of insured depository institutions across the country." Small banks simply don't have the resources to develop comparable products, the group said, and they can't really compete against Fannie and Freddie. Bankers are also concerned about Fannie and Freddie's aggressive marketing tactics under their investment note programs. Both GSEs shifted their marketing strategies to target retail investors about a year ago and critics said that retail focus misuses their government subsidy and oversteps their congressional charter by providing a product already offered by the private marketplace. The ACB charged that "dealers are marketing these instruments to relatively unsophisticated consumers, and possibly representing the securities as fully 'guaranteed' by the US government." (*Dow Jones Newswire*, Dawn Kopecki, 5/9/02, 6/5/02; *ACB's Diane Casey letter to Treasury Secretary Paul O'Neill*, 3/8/02)

ACB is pleased that the Treasury Department referred this issue to the SEC

- **"We're very pleased that the Treasury, first of all, took this request seriously and that they choose to refer this to the SEC. It lends credence to our argument that these investments need to be looked at,"** said Diane Casey, president and chief executive officer of ACB. (*Dow Jones Newswire*, Dawn Kopecki, 6/5/02) Casey said the Treasury Department has a comprehensive policy for addressing issues raised by Fannie and Freddie, and she believes "this is just one small aspect of that entire policy on how they want to see things changed or administered at the GSEs." **Casey is hoping that Treasury's letter will prod HUD (Fannie and Freddie's mission regulator) to take a position.** (*National Mortgage News*, Brian Collins, 6/10/02)
- **"We don't believe the sale of investment notes at retail level of \$1,000 are appropriate for the GSEs,"** said Casey. **"It points to the need for a strong and effective GSE regulator."** (*National Mortgage News Daily Web site*, 6/6/02)

Treasury warns about the marketing of mutual funds containing GSE securities

- **Bair also expressed concern that many mutual funds market themselves as being comprised primarily of securities that are backed by the full faith and credit of the US government, when they have a large proportion of GSE securities.** (*Reuters*, Mark Felsenthal, 6/5/02) Bair noted that “the current convention for naming mutual funds associated with US government securities and the disclosures associated with these funds may create confusion for retail investors regarding the relationship between the Federal government and the securities that make up the fund...many mutual funds that are named within the ‘US Government’ category actually have few if any securities that are backed by the full faith and credit of the US government.” (*Treasury Assistant Secretary Bair’s letter to SEC*)
- For example, Bair cited a fund managed by TD Waterhouse called the “US Government Money Market Portfolio,” which has about 90% of its investments in GSE securities. Of the fund’s \$1.18 billion in assets on October 31, 2001 at least 93% came from GSEs including Fannie, the Farm Credit System, and the FHLBank System. (*Dow Jones Newswire*, Dawn Kopecki, 6/5/02; *New York Times*, Alison Leigh Cowan, 6/6/02)

Fannie & Freddie’s comments

- Fannie and Freddie officials said they ensure their own materials reflect that the investments are not guaranteed or insured by the government. “While we believe that a vast majority of Freddie Mac broker-dealers have behaved appropriately in their marketing, if the SEC were to find that there was some room for improvement, we would be completely supportive of that,” said Freddie’s spokeswoman Sharon McHale. (*Dow Jones Newswire*, Dawn Kopecki, 6/5/02) McHale said she was pleased Treasury appears to be acknowledging that there is nothing wrong with their investment notes. “We’re pleased that Treasury validated our position that issuing these securities is entirely appropriate for us and also that the department recognized that we have been clear in disclosing that Freddie notes are not guaranteed by the government.” (*Reuters*, Mark Felsenthal, 6/5/02)
- Fannie and Freddie officials said they have no authority over how mutual funds are named or marketed. “It’s really not possible nor appropriate for us to conduct oversight of mutual funds,” said Fannie’s spokeswoman Janis Smith. (*Reuters*, Mark Felsenthal, 6/5/02)

SEC’s comments

- An SEC spokesman declined to say what action, if any, it might take. (*American Banker*, Michele Heller, 6/6/02)

OFHEO issues final corporate governance rule for Fannie & Freddie

Fannie & Freddie originally criticized OFHEO's proposed corporate governance rule and urged OFHEO to withdraw the proposal

Office of Management and Budget (OMB) requested that OFHEO issue stricter requirements than those presented in OFHEO's corporate governance rule

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

American Enterprise Institute (AEI) praises OMB for requesting that OFHEO issue stricter requirements than those presented in OFHEO's corporate governance rule

AEI requests that OFHEO consider a rulemaking to require that Presidentially appointed members of Fannie & Freddie's boards be directed to consider the interests of the government and taxpayers – rather than the shareholders

- OFHEO Director Armando Falcon, Jr. announced a final rule June 3 on corporate governance standards for the executives and boards of directors of Fannie and Freddie. “This rule represents a solid foundation for corporate governance that OFHEO will continue to build upon,” said Director Falcon. (*OFHEO press release*, 6/3/02) The rule was published in the June 4 *Federal Register*, and is scheduled to take effect August 5, 2002. (*Federal Register*, 6/4/02, pages 38361-38371)
- OFHEO received eleven comment letters on the proposed rule: (1) Fannie; (2) Freddie; (3) the Board Members of Fannie; (4) the Presidential appointees of Fannie's board; (5) a former Board Member of Fannie; (6) a lawyer with Gibson, Dunn & Crutcher, who is Chairman of the ABA's Committee on Corporate Governance on behalf of Fannie; (7) a Widener University professor, on behalf of Freddie; (8) a Georgetown University Law Center professor, on behalf of Freddie; (9) the National Association of Corporate Directors; (10) FM Watch; and (11) the Consumer Mortgage Coalition. (*Federal Register*, 6/4/02, page 38362) [Summaries of the Corporate Governance comment letters are available in the January 4, 2002 *GSE Report* (www.gsereport.com).]

Rule reflects current practices

- According to OFHEO, the corporate governance rule “to a large extent” reflects “the current practices” of Fannie and Freddie. (*Federal Register*, 6/4/02, page 38362) For example, the rule requires Fannie and Freddie to maintain audit and compensation committees for their boards, as well as conflict-of-interest standards for board members – which they already have. The rules do prohibit “excessive” compensation for board members and executives, however OFHEO does not define “excessive.” (*Wall Street Journal*, Patrick Barta, 6/4/02)

Analysts said OFHEO's rule will not result in broad changes in the way Fannie & Freddie currently operate

- Analysts said the rule would not result in broad changes in the way Fannie and Freddie operate. “They [OFHEO] are clarifying corporate governance rules,” said Paul Miller, an analyst at Friedman Billings Ramsey & Co. “It's basic maintenance.” Miller believes OFHEO is trying to address calls to strengthen the regulation of Fannie and Freddie without angering supporters of Fannie and Freddie in

Congress. “It’s a weak regulator and they are trying to beef it up,” he said. (*Bloomberg News*, Rob Gravely and Albert Yoon, 6/3/02)

- OFHEO’s final rule requires Fannie and Freddie to:
 - “Elect to follow the corporate governance practices and procedures of either the jurisdiction in which the Enterprise is located, Delaware law or the Model Business Corporation Act;”
 - “Establish and maintain audit and compensation committees of their boards of directors;”
 - “Ensure compensation of board members, executive officers and employees is not excessive, unreasonable or otherwise inconsistent with legal standards;”
 - “Implement minimum quorum and voting requirements for board actions;”
 - “Establish and maintain written conflict of interest standards;”
 - “Comply with specific minimum standards for the conduct and responsibilities of the Enterprises’ boards of directors.” (*OFHEO press release*, 6/3/02)
- The final regulation also states the broad authority of OFHEO to prohibit indemnification of an Enterprise’s board members and executives, including the indemnification of activities involving intentional misconduct or recklessness. (*OFHEO press release*, 6/3/02)
- The corporate governance regulation was proposed September 12, 2001 by OFHEO and cleared by the Office of Management and Budget (OMB) May 29, 2002. (*OFHEO press release*, 6/3/02)

OMB requested that OFHEO issue stricter requirements than those presented in OFHEO’s corporate governance rule

- OMB asked OFHEO to develop stricter requirements than those presented in OFHEO’s corporate governance rule. (*Reuters*, 6/3/02) As noted in the May 31, 2002 *GSE Report*, OMB sent a letter to OFHEO urging the agency to consider a new rulemaking to strengthen the corporate governance of Fannie and Freddie and require the two GSEs to make certain public disclosures. (*OMB press release*, 5/29/02) John Graham, Administrator of OMB’s Office of Information and Regulatory Affairs, wrote a May 29 letter to OFHEO Director Falcon requesting that OFHEO consider “further rulemaking that would include additional requirements to strengthen corporate governance” of Fannie and Freddie. OMB suggested OFHEO work closely with the SEC on this issue. (*OMB letter to OFHEO Director Armando Falcon*, 5/29/02)
- The OMB noted that unlike other publicly traded companies, Fannie and Freddie are not required to make periodic reports about their financial condition and special reports when material changes occur that affect their financial situation. In addition, Fannie and Freddie are not required to publish related disclosure materials required of other publicly traded companies. Fannie and Freddie currently disclose voluntarily information that is similar to that required of publicly-traded companies by the SEC. “Even though they are not subject to direct SEC oversight, as publicly traded companies, Fannie Mae and Freddie Mac should be subject to no lesser standard than applies to other companies,” said Graham. “While the Enterprises now voluntarily comply with many of these disclosures, they are not required to do so. Such voluntary compliance might be abandoned at a time when it is most needed,” said Graham. (*OMB press release*, 5/29/02)
- In April 2002, OFHEO announced a review of Fannie and Freddie’s public disclosures to determine whether their current disclosures meet SEC criteria, and plans to consult with analysts about additional disclosures that would enhance market transparency. Graham’s letter also indicated OMB considered OFHEO’s April announcement to be inadequate. OMB noted that OFHEO’s public

announcement did not commit to a rulemaking on disclosures. OMB requested that OFHEO consider a rulemaking to require Fannie and Freddie to disclose publicly the information that is required of publicly traded companies by the SEC, including any additional disclosures SEC requires in the future. "While the Enterprises now voluntarily comply with many of these disclosures, they are not required to do so. Such voluntary compliance might be abandoned at a time when it is most needed." OMB suggested that OFHEO also "consider disclosures to enhance market transparency related to the unique issues involved in the operation of government-sponsored enterprises." OFHEO should study the disclosures favored by the Multidisciplinary Working Group on Enhanced Disclosures." (*OMB letter to OFHEO Director Armando Falcon*, 5/29/02; *BNA Daily Report for Executives*, Richard Cowden, 5/31/02)

OFHEO's rule does not reflect OMB's recommendations

- **Contrary to OMB's May 29 letter to OFHEO, the corporate governance rule does not require the GSEs to establish independent audits. OMB also requested that OFHEO issue a regulation requiring the GSEs to disclose publicly the information that is required of publicly traded companies by the SEC. The OFHEO rule does not address harmonizing disclosure requirements with SEC requirements.** (*BNA Daily Report for Executives*, Eileen Williams, 6/5/02)

Fannie & Freddie's comments

- Fannie was initially critical of OFHEO's decision to place corporate governance standards in a regulation. However, OFHEO agreed to make some changes to its original proposal, according to Fannie's spokeswoman Janice Daue. (*National Mortgage News Daily Web site*, 6/4/02) Daue said that OFHEO incorporated some, but not all, of its suggestions in the final rule. (*Dow Jones Newswire*, Dawn Kopecki, 6/3/02) Fannie said June 3 that while it "generally" supports the final version of OFHEO's rule, it still has some concerns with the rule. Freddie said it is still reviewing the rule. (*Wall Street Journal*, Patrick Barta, 6/4/02) "We believe that our practices substantially comply with these regulations," said Freddie's spokesman Douglas Robinson. (*Dow Jones Newswire*, Dawn Kopecki, 6/4/02)
- Fannie and Freddie originally criticized OFHEO's proposed corporate governance rule and urged OFHEO to withdraw the proposal. Fannie and Freddie said the proposed rule was unnecessary and would duplicate the corporate governance standards they currently use. "Fannie Mae has many serious concerns about the proposed regulation and urges OFHEO to withdraw it entirely," Fannie said in its comment letter. "It would be unclear in many instances whether the new federal standards would supplement or supplant the applicable state law standards," Freddie said. "As a result there would be considerable confusion as to what rules directors must comply with." (*Dow Jones Newswire*, Jennifer Corbett Dooren, 12/14/01)

Congressman Shays' comments

- **"While we're thrilled the administration recognizes the shortcomings in Fannie Mae and Freddie Mac's disclosure practices, we continue to believe that OFHEO...is the wrong agency to be tasked with protecting investors," stated Len Wolfson, Congressman Chris Shays' (R-CT) legislative director.** (*National Mortgage News*, 6/3/02) Congressmen Shays and Edward Markey (D-MA) introduced a bill (HR 4071) on March 20 that would repeal Fannie and Freddie's exemption from SEC requirements.

AEI praises OMB

- In a May 30 letter to John Graham, Administrator of OMB's Office of Information and Regulatory Affairs, AEI Resident Fellow Peter J. Wallison praised the OMB for requesting that OFHEO consider

a rulemaking to require Fannie and Freddie to disclose what other public companies are required to report to the SEC. “There is a good reason for this: it is only with respect to the GSEs that the taxpayers bear any significant risk in the event of their financial default.” (*AEI’s Peter Wallison letter to OMB, 5/30/02*)

- **Wallison suggested OFHEO consider a rulemaking to require that the five directors appointed by the President to Fannie & Freddie’s boards be directed to consider the interests of the government and taxpayers – rather than the shareholders.** “Currently, they seem to regard their responsibility as solely to the shareholders of the GSEs, with no responsibility for seeing that the GSEs carry out their mandate to assist the mortgage market. As a result, as the Congressional Budget Office has found, the GSEs pass through to the mortgage market only a portion of the annual implicit subsidy they receive.” In his letter to the OMB, Wallison attached his May 3 letter to OFHEO Director Armando Falcon requesting that OFHEO consider a rulemaking on this issue. Wallison noted that he has not received a response from OFHEO. (*AEI’s Peter Wallison letter to OMB, 5/30/02*)
- In his letter to OFHEO, Wallison noted that Jim Murray, a former general counsel of Fannie, stated that there was an opinion of William Rehnquist, then writing as an Assistant Attorney General in charge of the Office of Legal Counsel, to the effect that the directors of Fannie were required to attend to the interests of the shareholders. Wallison believes that Mr. Murray’s recollection of the opinion “was incorrect.” Wallison believes “the opinion is strong authority for the opposite view—that Congress intended the presidentially-appointed directors to assure that Fannie attends to its housing mission, even if that is to the possible detriment of the shareholders’ interests.”
- Wallison attached a copy of the Rehnquist opinion, dated July 10, 1970, and addressed to The Honorable Richard C. Van Dusen, Under Secretary, Department of Housing and Urban Development. Wallison believes the opinion “actually deals with the rather narrow issue of whether the directors of Fannie Mae are Executive Branch employees and thus subject to the conflict of interest rules of Title 18. Mr. Rehnquist concluded that they were not.” (*AEI’s Peter Wallison letter to OFHEO, 5/3/02*)

HUD Secretary Mel Martinez notes that Fannie & Freddie may not be living up to their congressionally mandated goal of outperforming the broader market in serving low-income and minority borrowers

- HUD Secretary Mel Martinez urged Fannie and Freddie on June 8 to work harder to help low-income people and minorities buy homes, reported Mark Felsenthal with *Reuters*. In a speech before the National Association of Home Builders, Secretary Martinez said Fannie and Freddie may not have lived up to their congressionally mandated goal of outperforming the broader market in financing home loans for low-income and minority homebuyers. As part of their congressional charters, Fannie and Freddie are expected to lead the market.
- “The government-sponsored enterprises, created to increase the liquidity of mortgage markets, are supposed to lead the market in reaching underserved populations. While these entities have increased their commitments, too often they are seen as lagging behind lenders,” Secretary Martinez said in remarks prepared for delivery.
- Fannie’s spokesman Robert McC Carson agreed that more needed to be done but said his firm was already a prominent provider of mortgage financing to U.S. minority homebuyers. Freddie could not be reached for comment.

- A recent HUD study concluded the two GSEs were not financing as high a percentage of single-family homes for low-income borrowers or in high-density minority areas as the broader market. (*Reuters*, Mark Felsenthal, 6/8/02)

Chairman of the House Capital Markets Subcommittee Congressman Richard Baker (R-LA) asks the Treasury Department to provide testimony on the housing GSEs by mid-July

Congressman Baker would like Treasury to comment on the Shays-Markey bill repealing Fannie & Freddie's SEC exemption and on Ginnie Mae Choice bills

Treasury Undersecretary Peter Fisher says he is "not much concerned" with the GSEs' risk management and is still "pondering the net impact" of Fannie & Freddie's borrowing in the market

- Congressman Baker asked Treasury Undersecretary for Domestic Finance Peter Fisher to provide testimony by mid-July on the housing GSEs, reported Dawn Kopecki with *Dow Jones Newswire*.
- "I am particularly interested in your views on strengthening regulatory oversight and promoting transparency," Congressman Baker said in a May letter to Fisher. Congressman Baker said he expected to begin hearings on GSE housing issues within 60 days of his May 15 letter.
- "While the GSEs are currently well-managed and operate in a safe and sound manner, I believe that the potential risk the GSEs pose to the financial system and taxpayers are important matters of public policy that require your timely review," Congressman Baker said.
- Congressman Baker asked Fisher for Treasury's views on the Shays-Markey bill (HR 4071) that would repeal Fannie and Freddie's SEC exemption and Treasury's position on Ginnie Mae Choice bills that would allow Ginnie Mae to securitize privately insured mortgage loans. (*Dow Jones Newswire*, Dawn Kopecki, 6/6/02)
- In related news, Treasury Undersecretary Peter Fisher said on June 7 that he is "not much concerned" with the GSEs' risk management. Fisher was answering questions after his prepared remarks to a Bond Buyer conference in New York. "There are issues about market structure," but he said there are no red flags on GSE risk management. He said he "wished" that some other firms had as comprehensive risk management practices as the GSEs. (*Dow Jones Newswire*, Steven Vames, 6/7/02) Announcing that the US Treasury would not resume sales of 30-year bonds it suspended eight months ago, Fisher said he is still "pondering the net impact" of Fannie and Freddie's borrowing in the market. (*Bloomberg News*, Michael McKee and Brendan Murray, 6/7/02)

American Enterprise Institute (AEI) holds June 12 conference on Fannie & Freddie's disclosure requirements – a focus of the conference is the Shays-Markey bill

Congressman Chris Shays (R-CT) was the keynote speaker

Congressmen Shays and Edward Markey (D-MA) introduced a bill that would repeal Fannie and Freddie's exemption from SEC requirements (HR 4071)

Several speakers argue that Fannie & Freddie should disclose more information and be held to the same standards as other publicly traded companies

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

- AEI held a June 12 conference, entitled “*Are Fannie and Freddie Adequately Disclosing What Investors Need?*” According to an announcement by AEI: “Since the collapse of Enron, there has been an increasing focus on the adequacy of disclosure by public companies. Because they are exempt from registration with or reporting to the Securities and Exchange Commission, Fannie Mae and Freddie Mac are able to determine for themselves what and how they disclose information to investors. Fannie and Freddie contend that they meet or exceed all applicable SEC requirements, but legislation (the Shays-Markey bill) has been introduced that would eliminate their SEC exemption. This conference will explore whether Fannie and Freddie are adequately informing investors and others who may be relying on their public disclosure.” (*AEI Conference Announcement*) A focus of the conference was the Shays-Markey bill, which removes Fannie and Freddie's exemption from SEC requirements.

Highlights of the conference*:

- Congressman Shays spoke about the Shays-Markey bill to remove the GSEs' SEC exemption. He appeared very committed to the bill and saw no reason to back off his legislation. The fact that there was opposition to the bill has only increased his interest. Furthermore, he argued that the SEC, not OFHEO, should regulate the GSEs' financial disclosures.
- Congressman Shays noted that Capital Markets Subcommittee Chairman Richard Baker (R-LA) has agreed to do a hearing on the GSEs, with the Shays-Markey bill as part of the hearing. He believes that Congressman Baker sees this issue as a bargaining tool with Fannie and Freddie. He noted that Financial Services Committee Chairman Michael Oxley (R-OH) was not eager to take on this issue because he is busy with other issues.
- Bert Ely, Ely & Company, believes Fannie and Freddie should disclose more than what the SEC requires for other companies because Fannie and Freddie have two other obligations: (1) they must meet their affordable housing mission; and (2) they must not abuse GSE privileges at the expense of competitors. He believes the Shays-Markey bill will pass in some form or fashion. Ray Soifer, Soifer Consulting noted that “banks and thrifts also must satisfy disclosure requirements, imposed by their banking supervisors, that go beyond those established by the SEC.”

* Source: Written and oral comments from the June 12 conference, unless otherwise noted.

- Larry D. Wall, Federal Reserve Bank of Atlanta noted that comparing the GSEs' voluntary disclosures with banks' mandatory disclosures highlights several ways in which banks could improve their disclosure, but also highlights some weaknesses in the GSEs' voluntary initiatives. W. Scott Frame, Federal Reserve Bank of Atlanta, noted that some of Fannie and Freddie's subordinated debt has turned up in government bond funds, which may be of interest to the SEC.
- Dwight Jaffee, University of California at Berkeley, says Fannie and Freddie require special attention because (1) their potential exposure to interest rate risk is very large; and (2) their GSE status creates special concerns. Believes that increasing competition in the secondary market (Ginnie Mae and the FHLBanks) would cause more of the GSEs' government subsidies to pass through to mortgage borrowers, and might mitigate some of the concerns about Fannie and Freddie's large interest rate risk. He claimed OFHEO's stress test for Fannie and Freddie is a good start but needs to go further. Suggested mandatory interest rate risk standards for Fannie and Freddie.
- Steven Thomas, Financial Security Assurance, believes that the argument that requiring Fannie and Freddie to register their MBS with the SEC will disrupt the housing finance market is without merit. Fannie and Freddie's disclosures are much less complete than disclosures by non-agency MBS. The GSEs do not disclose the sort of loan-level information routinely disclosed by issuers of non-agency MBS, and are thus able to cherry pick and determine which of their pools have better prepayment characteristics. To the extent that Fannie and Freddie would be required to disclose the same loan-level information as non-agency MBS issuers, the efficiency of the market would improve. Further, this information arbitrage by the GSEs is becoming even more pronounced as the GSEs expand their market share (such as their expansion into the subprime market). Subjecting the GSEs and their MBS to SEC disclosure rules is likely to increase the efficiency of the MBS market. Subjecting the GSEs to SEC rules will not hurt the trading of agency MBSs and would not harm the TBA ("To be Announced") market.
- AEI provided examples of prospectuses used by other sellers of MBS (J.P. Morgan Chase), which includes a great deal more information than what Fannie and Freddie provide. The Chase prospectus is considerably longer and more detailed. AEI also provided a summary of the informational differences between the two, which is available on AEI's Web site (www.aei.org/past_event/conf020612.htm)

Detailed summary of comments at the conference*:

Introduction, Peter Wallison, AEI

- Protests by the GSEs that the companies are in sound financial condition should not necessarily be taken at face value. This is especially true in the case of Fannie and Freddie, which enjoy the wide support of analysts, and have audited financial statements, but are taking risks of which investors may not be aware.
- **Financial difficulties at Fannie or Freddie could cause losses for taxpayers, investors, and cause disruptions in the housing finance market. There are good policy reasons for exposing the financial condition of Fannie and Freddie to the broadest and most intensive kind of public scrutiny.**

* Source: Written and oral comments from the June 12 conference, unless otherwise noted.

- However, Congress has done the opposite and has exempted Fannie and Freddie from SEC requirements imposed on all other publicly held companies. Although Fannie and Freddie contend that they comply with all SEC requirements, “this voluntary compliance has limits.”

Keynote address, Congressman Christopher Shays (R-CT)

- **In response to the question of whether Fannie and Freddie are adequately disclosing what investors need, “the answer is a big, fat no.”**
- **“Fannie Mae and Freddie Mac disclose the information they want, when they want to, and in the format they want it in. They set their own disclosure practices, and then they act as their own enforcement arm. In the meantime, investors are asked simply to trust they are being told everything they need to know.” “[Congressman] Ed Markey and I want them to disclose what they don’t want to disclose precisely when they don’t want to disclose it.”** (*Reuters*, Mark Felsenthal, 6/12/02)
- Believes Fannie and Freddie do exceptional work and provide a vital role to the secondary market but they should not be able to operate above the law. “These are fine companies,” but they should have to compete in the marketplace. They are the only two Fortune 500 publicly traded companies that are not subject to SEC requirements.
- Fannie and Freddie argue that their disclosures are “equal to or better than another other companies,” but after “editorial criticism,” he continued, “they’ll announce a ‘new and improved’ disclosure practice, like in March when Fannie Mae agreed to post on its Web site the insider stock trades of top managers and board members.” (*Dow Jones Newswire*, John Connor, 6/12/02)
- In 1992, the SEC, Treasury and the Federal Reserve recommended removing the GSEs’ SEC exemption. The Shays-Markey bill simply implements this recommendation.
- There is no public policy interest or public interest reason to continue this SEC exemption. We have two separate rules in America – one for Fannie and Freddie and one for other companies.
- Both the *Wall Street Journal* and the Congressional Budget Office noted that voluntary disclosures by the GSEs could disappear when they are most needed.
- **Believes that the SEC, not OFHEO, should regulate the GSEs’ financial disclosures.** Fannie and Freddie claim they are too big and would overwhelm the resources of the SEC if they were subject to SEC oversight. He can think of no other more compelling reason to have the GSEs subject to the SEC, if this is their argument. “OFHEO was created in 1992 as a safety and soundness regulator. The SEC was created in 1934 to enforce the nation’s securities laws. Which would you rather have ensuring Fannie and Freddie provide investors with accurate and timely information?” (*Reuters*, Mark Felsenthal, 6/12/02) He noted that OFHEO took nine years to create its risk-based capital rules for Fannie and Freddie and said of any OFHEO disclosure initiative: “Let’s see, if they start now, they should have a final rule in place by 2011.” (*Dow Jones Newswire*, John Connor, 6/12/02)
- **He noted that Congressman Baker has agreed to do a hearing on the GSEs, with the Shays-Markey bill as part of the hearing. He believes that Congressman Baker sees this issue as a bargaining tool with Fannie and Freddie. He noted that Financial Services Committee Chairman Michael Oxley (R-OH) was not eager to take on this issue because he is busy with other issues. “He’s [Oxley] not sure its time has come.”** Cong. Shays noted that he needed to prove

that the time has come on this issue. **He sees no reason to “back off” on the legislation, although “we have a long way to go.” The fact that there is so much opposition to this bill only feeds his interest.**

- He noted that a compromise is possible on the fees that Fannie and Freddie would have to pay to register their securities. One suggestion might be saying that a company would have to pay no more than 5% of SEC’s fees. Otherwise, Fannie and Freddie might be paying 50% of the agency’s fees, he said. (*BNA Daily Report for Executives*, Marcia Kass, 6/13/02) In press comments, Fannie’s spokesman Robert McCarson said that wouldn’t satisfy Fannie’s objections to the bill, which concern the effect registration would have on trading in the mortgage debt market. (*Bloomberg*, Al Yoon, 6/12/02)

Panel 1: Comparing Fannie and Freddie to Banks

Speaker, Bert Ely, Ely & Co.

- **Believes Fannie and Freddie should disclose more than what the SEC requires for other companies because Fannie and Freddie have two other obligations: (1) they must meet their affordable housing mission; and (2) they must not abuse GSE privileges at the expense of competitors.**
- Compared the banks and thrifts’ financial disclosures, which are filed with the SEC, with Fannie and Freddie’s disclosures. Found that while Fannie and Freddie have less than half the capital of banks and thrifts, they have more interest rate risk and they hedge that risk only in part.
- Fannie and Freddie’s business model is fundamentally different than banks and thrifts. Fannie and Freddie, much like the pre-1980 S&L model – borrow short to lend long.
- Fannie and Freddie have a capital advantage over banks and thrifts. Fannie and Freddie have a big edge in holding long-term, fixed-rate mortgages due to their capital advantage (which is three to four times the leverage over banks and thrifts) and their lower funding cost due to their ability to issue “agency debt.” Banks and thrifts’ principal mortgage assets are ARMs and mortgage servicing rights. **Fannie and Freddie “skate much closer” to their regulatory capital minimums than do banks and thrifts.**
- A key disclosure difference is that thrifts provide an interest rate “gap analysis,” while Fannie and Freddie do not.
- Fannie and Freddie rely more extensively on derivatives to hedge risk exposure, which dictates that more disclosure is needed.
- Fannie and Freddie provide snapshot data rather than range data, which opens the door for “window dressing” by Fannie and Freddie.
- **Believes that the Shays-Markey bill will be enacted in some form or fashion.**
- If the Shays-Markey bill is enacted, presumably the SEC would ensure that there is greater uniformity in Fannie and Freddie’s disclosures (there are differences in their disclosures currently), but in the meantime, OFHEO could mandate greater comparability between the two companies.

- **Suggested more detailed disclosures by the GSEs to determine whether Fannie and Freddie are expanding beyond their mission and trampling on their private-sector competitors. Recommended a more detailed breakdown of their revenues, such as the fees they charges for use of their automated underwriting systems. Also, suggested Fannie and Freddie’s competitors should be called upon to specify the competition-oriented disclosures the two GSEs should make.**

**Speaker, Larry D. Wall, Federal Reserve Bank of Atlanta & W. Scott Frame,
Federal Reserve Bank of Atlanta**

- Views expressed were personal views and not that of the FRB of Atlanta. Discussed their study, *“Fannie Mae’s and Freddie Mac’s Voluntary Initiatives: Lessons from Banking,”* 2002)
- Reviewed the voluntary risk management disclosure steps that Fannie and Freddie have taken to reassure critics about their financial condition without actually subjecting themselves to any required disclosures. Compared the voluntary steps with similar – though mandatory – disclosures by banks.
- In October 2000 Fannie and Freddie announced six voluntary risk management initiatives. One initiative would enhance market discipline by having the GSEs issue subordinated debt. A second would increase liquidity by having the GSEs maintain a liquid securities portfolio. The other four initiatives would increase transparency by having the GSEs disclose their credit losses under certain scenarios, disclose their interest rate losses under certain scenarios, obtain a credit rating for the government’s exposure to loss, and disclose whether the GSEs comply with certain capital adequacy standards.
- Frame and Wall’s study compared the GSEs’ risk management initiatives with current banking standards. The analysis suggested that the GSEs’ initiatives are beneficial but could be made more effective. The authors pointed out that the contribution of the subordinated debt initiative to enhanced disclosure depends largely on whether investors believe the implicit guarantee extends to subordinated debtholders. The need for the liquidity initiative has not been established, the authors concluded, and can be criticized as allowing the GSEs to earn a credit spread. The most important of the disclosure initiatives, the one for interest rate risk, provides some new information but could be more informative if it summarized a wider set of interest rate scenarios.
- **“Fannie Mae and Freddie Mac, like commercial banks, have enhanced their disclosures, however, room for improvement remains for both the banks and the two GSEs.”** They found that Fannie and Freddie disclose more than banks do in the areas of credit and interest rate risk. But **“Fannie Mae’s risk exposure could also be improved by a focus on market values rather than accounting values, as is currently done by Freddie Mac,”** they said. They also said that the benchmark Fannie and Freddie use to measure interest rate risk is **“not as comprehensive as would be desirable.”** (*Dow Jones Newswire*, John Connor, 6/12/02) **They noted that the GSEs’ voluntary initiatives provide additional useful information to the financial markets. The comparison with banks highlights several ways in which banks could improve their disclosure. However, the comparison also highlights some weaknesses in the GSEs’ voluntary initiatives.**
- **Frame noted that some of Fannie and Freddie’s subordinated debt has turned up in government bond funds, which may be of interest to the SEC.**

Discussant, Ed Golding, Freddie Mac

- To the question, “Are Fannie and Freddie adequately disclosing what investors need?,” he responded, “Yes.”
- Their voluntary disclosures are enough and argued that additional disclosures would add unnecessary costs.
- The voluntary risk management disclosure standards Fannie and Freddie announced in October 2000 are unmatched by any other financial institution and they were announced during a time when the issue of financial disclosures was not making front-page news.
- Freddie has made improvements to its disclosures since Frame and Wall’s paper was released.
- Believes Freddie’s disclosures are high quality and in proper detail (enough information but not too much information to overwhelm the market). The quality of disclosures is more important than the quantity.
- Does not believe Ely’s suggestions for more regulation than what is currently required by the SEC or for competitors’ participation in developing the GSEs’ disclosures will have any support.
- The GSEs concentrate on single-family residential mortgages and is not comparable with other entities.
- He has seen nothing in today’s reports to suggest that Freddie needs to improve its disclosures.
- Although Freddie’s disclosures are voluntary, if the GSEs were to suddenly not disclose certain information, the market would view this as a tremendous signal that there are problems.

Discussant, Ray Soifer, Sofier Consulting, LLC

- Soifer’s comments focused on what information equity investors and analysts need to know in order to evaluate companies, because the stock market is an influential market disciplinarian over companies. “As with the vast majority of publicly-traded companies, the most influential market disciplinarian over Fannie and Freddie is the price of their common stock.”
- He noted that Ely suggests that as GSEs, Fannie and Freddie should face broader issues of accountability than do purely private-sector institutions, which may impose additional requirements for public disclosure. He commented that “banks and thrifts also must satisfy disclosure requirements, imposed by their banking supervisors, that go beyond those established by the SEC.”
- “Since credit risk is less significant to Fannie’s and Freddie’s earnings than to most other financial institutions,” in building their earnings models analysts focus primarily on revenue trends and interest rate risk. They also focus on expense management, operating efficiency, Fannie and Freddie’s business strategies, risk management (especially that of interest rate risk), and given the unique status of Fannie and Freddie – an assessment of political risk and management’s response. Analysts use these factors in creating their earnings estimates, determining their opinions about the prices at which Fannie and Freddie’s shares should trade, and determining buy/hold/sell recommendations.
- He compared the common shares of Fannie and Freddie with those of several other large US financial companies, which are substantial participants in housing finance. “Broadly speaking, the market is

valuing Fannie's and Freddie's shares comparably with these private-sector entities – more or less, as if these GSEs were high-quality thrifts.”

- “The stock market values the financial services industry, in general, at a substantial discount to the broad market averages such as the S&P 500. To a considerable extent, this discount is a consequence of the industry's lack of transparency...The quality of its risk management is the most critical factor determining its performance, and to the outside analyst, its portfolio is virtually a black box. The analyst is almost totally dependent upon the company's disclosure. That is why the subject of today's conference is so important.”
- He noted that Fannie and Freddie's price-to-book value ratios are higher compared with the private sector. “Some of this probably results from their low cost of capital,” but he thinks that it “mostly reflects the fact that equity investors value shares mainly in relation to predicted earnings rather than net asset value.” He added, “As you know, Fannie's and Freddie's equity ratios are somewhat lower than private-sector banks and thrifts. This is not, by itself, a meaningful indicator of capital strength – indeed, together with Farmer Mac, Fannie and Freddie are currently unique among the world's major financial institutions in their capital adequacy being regulated on the basis of stress-tested risk scenarios – but is included here as a way of explaining why their price-to-book ratios come out as high as they do.”
- Noted that The Working Group on Financial Disclosure, commissioned by the Fed, OCC and SEC and chaired by Walter Shipley, the retired chairman of Chase Manhattan, issued a report in 2001 in which it made a number of specific recommendations about the reporting of market and credit risk, which Frame and Wall discussed. More generally, however, the Working Group recommended that risk disclosure should be consistent with an organization's approach to risk management and because well-run firms may have very different, but equally valid, approaches to risk management and monitoring, meaningful comparisons across firms will be difficult to achieve and, indeed, are not as important as presenting the best currently available view of each firm's risk profile. Federal Reserve Board Governor Bies made many similar points.
- As is noted in both papers (Ely, Frame & Wall), there are substantial differences between the interest-rate risk disclosures of Fannie and Freddie, and between their respective disclosures and those of private-sector banks and thrifts. “I would suggest, though, that as Fannie and Freddie continue to improve their risk disclosure, we view these differences in the light of the Working Group's recommendations. To the extent that they reflect real differences in the way these institutions manage risk, the information they contain is highly relevant and useful.”
- Soifer used J.P. Morgan Chase as an example of a firm that “provides a more helpful disclosure of its market risk management, including interest rate risk,” than Fannie and Freddie's disclosures. Another good example of market risk disclosure is that of Deutsche Bank in its Annual Report on Form 20-F.
- The papers submitted at the AEI conference have touched on credit risk and market risk. “While most observers would agree with Fannie's and Freddie's management that, for them, market risk is the more significant of the two, just how much more significant is it, in quantitative bottom-line terms? The sum of individual market and credit risks does not add up to the risk of the portfolio as a whole, since diversification and correlation effects must be taken into account. The tool for doing that kind of analysis is economic capital, which I am given to understand that both Fannie and Freddie use internally, at least to some extent, but is not yet reflected in their external reporting. Although the

banking industry's reporting of economic capital, and the associated return, is still at an early stage of development, once again a review of Deutsche Bank's Form 20-F will produce some good ideas."

Panel 2: Disclosure for Derivatives and Mortgage Back Securities

Speaker, Dwight M. Jaffee, University of California at Berkeley

- **Fannie and Freddie require special attention because (1) their potential exposure to interest rate risk is very large; and (2) their GSE status creates special concerns.**
- **Believes that increasing competition, for example through the entry of Ginnie Mae or the FHLBanks into Fannie and Freddie's mortgage markets, would cause more of the GSEs' government subsidies to pass through to mortgage borrowers, and might mitigate some of the concerns about Fannie and Freddie's large interest rate risk.**
- Fannie and Freddie are increasingly making their money by purchasing their own mortgage-backed securities for their retained portfolios. At 12/31/92, Fannie and Freddie retained 2% of all Fannie and Freddie MBS. At 12/31/01, Fannie and Freddie retained 33% of all Fannie and Freddie MBS. This activity increases the GSEs' interest rate risk.
- **MBS prices depend on knowing their prepayment speeds, which depend on individual loan features, such as state location, borrower income, loan-to-value ratios, mortgage interest rates, etc. In competitive markets, much of the MBS information is disclosed. Fannie and Freddie however know more than they disclose about their MBS. He suggested then that Fannie and Freddie be required to provide MBS disclosures equivalent to those of competitive markets.**
- Fannie and Freddie could perfectly eliminate their large interest rate risk by doing the following: (1) the date and amount of each scheduled mortgage cash inflow must match with a corresponding liability cash outflow; (2) each optional mortgage cash inflow (i.e. prepayment) must match with an optional debt cash outflow (call option). Fannie and Freddie could readily achieve a perfect hedge by issuing a suitable array of long-term and callable bonds. However, Fannie and Freddie do not perfectly hedge because it is costly, and would reduce Fannie and Freddie's profits.
- Instead, Fannie and Freddie hedge their interest rate risk by (1) combining short-term debt with derivatives (rate swaps) to create synthetic long-term debt (instead of actual long term debt); (2) use interest rate option derivatives (swaptions) to hedge prepayment risk (instead of callable bonds); and (3) use dynamic hedging (in lieu of perfect gap hedging). **These techniques save costs, but raise risks. Fannie and Freddie are borrowing short and lending long, which is not a problem but it places a heavy burden on the GSEs' use of derivatives to hedge their risks. He contends that Fannie and Freddie could not carry out these hedging techniques as profitably if they weren't a GSE – these techniques provide no benefit to mortgage borrowers and the risks are borne by taxpayers.**
- He attempted to measure the risk Fannie and Freddie are retaining, and to estimate the effect on their market value of interest rate moves of varying sizes. He determined that this was not possible without more disclosure by the GSEs, and proposed a number of disclosures Fannie and Freddie should make in order to adequately inform the market about their sensitivity to interest rate changes.

- He suggested specific recommendations that Fannie and Freddie should make to their interest rate disclosures. He also suggested OFHEO do the following: (1) standardize disclosures to facilitate a comparison between Fannie and Freddie; (2) make random checks to stop window dressing; (3) validate valuation models on continuing basis; and (4) make an explicit strategy for responding to new problems (not ad hoc).
- Fannie and Freddie use dynamic hedging to protect against interest rate risk that is otherwise created by large interest rate shocks. The downside of Fannie and Freddie's use of dynamic interest rate hedging is that a firm can lose most or all of the market value of its equity either because interest rates move by a very large amount over a very short span of time, or because interest rates change steadily and by large amounts over longer periods of time.
- **OFHEO's stress test for Fannie and Freddie is a good start but needs to go further.** The OFHEO stress test subjects Fannie and Freddie to a 600 basis point rate shock for a 10-year period. However, he suggested that OFHEO use rate shock tests of about 1,000 basis points, in line with interest rate changes that were seen from 1976-1981 and 1981-1986. OFHEO should require random testing in terms of the size of rate changes to avoid window dressing by Fannie and Freddie. OFHEO should carry out and report continuing tests to validate its valuation model and should prepare operational plans for how it will respond were Fannie and Freddie to fail the stress test at some future date.
- **Fannie and Freddie, not the US taxpayers, should bear the risks/costs created by Fannie and Freddie's use of imperfect rate risk hedging because: (1) imperfect hedging provides no benefit to the mortgage market; (2) the expected profits or imperfect hedging flow to Fannie and Freddie's shareholders; (3) a very large and rapid change in interest rate levels could leave Fannie and Freddie with a serious liquidity crisis and systemic risk for the financial system, which would cause intervention by the federal government – creating significant costs for taxpayers. For these reasons, mandatory interest rate risk standards for Fannie and Freddie must be set.**

Speaker, Steven D. Thomas, Financial Security Assurance Inc.

- **Addressed the GSEs' argument that requiring the Fannie and Freddie to register their MBS with the SEC will disrupt the housing finance market. He finds this argument without merit. He supports repealing the GSEs' exemption from SEC requirements.**
- **Fannie and Freddie's disclosures are much less complete than disclosures by issuers of non-agency MBS. The GSEs do not disclose the sort of loan-level information routinely disclosed by non-agency MBS issuers.**
- Discussed the question of whether Fannie and Freddie use the superior individual loan information they have – and have not disclosed – to adversely select against the market in which they repurchase MBS.
- **In the private label MBS market, an issuer is obligated to disclose material information so that both the issuer and the investor share knowledge of the facts needed to price the purchase transaction fairly. By contrast, in the agency MBS market - Fannie and Freddie as issuers - possess significant material information denied to the general investor under the inadequate standards of disclosures that currently exist for the GSEs. Since Fannie and Freddie possess significant prepayment information and do not disclose this information, it allows the GSEs to select the pools that have better prepayment characteristics without paying the price that the**

market would normally charge if more detail were publicly available. To the extent that Fannie and Freddie would be required to disclose the same loan-level information as non-agency MBS issuers, the aggregate efficiency of the market would improve. Making the GSEs subject to SEC requirements would not disrupt the markets.

- **This information arbitrage by the GSEs is becoming even more pronounced as the GSEs expand into new lines of business. This is especially true as the GSEs (1) increase their participation in the subprime market; (2) conforming loan limit rises; and (3) computer model based loan underwriting allows for wider variances in loan characteristics. A report by Bear Stearns points out that the expansion of GSE market share exacerbates the impact of what it calls the agency “information deficit.”**
- **Subjecting the GSEs and their MBS to SEC disclosure rules is likely to increase the efficiency of the MBS market. Subjecting the GSEs to SEC rules will not hurt the trading of agency MBSs and would not harm the TBA (“To be Announced”) market.**

Discussant, Susan E. Woodward, Sand Hill Econometrics

- Dismissed concerns that Fannie and Freddie are cherry picking the most profitable portfolios. She said Fannie and Freddie’s MBS portfolios would have much wider spreads if that was the case. (*Dow Jones Newswire*, John Connor, 6/12/02) [Woodward has been a consultant to Freddie.]
- She believes that if the US wants to have a 30-year fixed-rate mortgage, the government needs to subsidize it, either through depositories or through Fannie and Freddie – so why not just subsidize through Fannie and Freddie. She believes that the government is going to incur risk with this subsidization, so why not have it in two companies (Fannie and Freddie), rather than a number of companies (depositories).
- She also believes that the guarantee fees charged by Fannie and Freddie are highly competitive.

Fannie and Freddie’s Comments (from the audience and in the press)

- Being required to register securities with the SEC would mean less, not more, information would be made public, because certain voluntary disclosures would no longer be required, said Fannie’s spokesman Robert McCarson. (*Reuters*, Mark Felsenthal, 6/12/02)
- During the question and answer period, a representative from Freddie claimed that Freddie does not cherry pick the most profitable portfolios. He called this sort of “cherry picking” illegal and subject to insider trading laws (which the GSEs’ are subject). He denied that Freddie was using information in an unfair or illegal manner and noted that Freddie had “Chinese firewalls” in place to prevent this behavior.
- Peter Wallison with AEI noted that Fannie and Freddie should be required to disclose all their information, so there would be no question about Chinese firewalls because everyone would have access to the same information.
- A representative from Freddie also argued that should Fannie and Freddie be required to register their securities with the SEC, the SEC would have to provide special rules that apply only to Fannie and Freddie due to their special circumstances.

***Wall Street Journal* editorial applauds Bush Administration for recommending Fannie & Freddie disclose more information**

Editorial praises the Shays-Markey bill removing the GSEs' SEC exemption, and suggests Fannie & Freddie's disclosures should go beyond SEC requirements - since taxpayers are at risk

- A *Wall Street Journal* editorial praised the recent letter sent by the Office of Management and Budget (OMB) to OFHEO regarding the GSEs' corporate governance disclosures. According to the editorial, "the actual text doesn't sound like much. OMB's chief of regulation, John D. Graham, suggests that OFHEO consider rules to strengthen the corporate governance practices of the two companies. But when the companies are Fannie Mae and Freddie Mac, two of the most politically well-connected and fiercely defensive companies on the planet, you may see why Mr. Graham deserved combat pay and maybe a silver star for meritorious service."
- The editorial noted that Fannie and Freddie have been "under post-Enron scrutiny" because they "run with giant leverage and provide only murky disclosure of the huge derivative positions necessary to hedge their obligations." And, worse, they enjoy an implicit government guarantee. OMB is concerned that the GSEs are not "subject to SEC standards of transparency." The editorial noted that the SEC requires all public companies with more than \$10 million in assets to file various public reports designed to provide investors with current information. However, Fannie and Freddie are not required to provide this information to the SEC or any other agency, making it "difficult for investors to understand just how much risk is attached to Fan and Fred's leverage, their derivative positions and their securities."
- The editorial added that investors got an idea of what the unknown could bring recently when Fannie decided to recall \$1.7 billion of its mortgage-backed securities, causing investors to lose around \$130 million. "The market went berserk and Fan rescinded its call." If Fannie had been forced to register with the SEC, investors would have received a prospectus with a list of possible risks, "including the provisions under which the MBSs were callable." Fannie defended itself by claiming that the MBSs were sold in the late 1980s and early 1990s and that recall terms were available to investors who "called to request terms of securities sold before 1994." The editorial's response to Fannie's defense was, "Whatever."
- OMB's letter did not suggest specific solutions to the GSE transparency issue, but urged OFHEO to hold the GSEs to the same standards of disclosure that the SEC asks of all other public companies. The GSEs claim this is not necessary since they already disclose a lot of their own data voluntarily. **"But OMB's Mr. Graham made the decisive point that voluntary disclosure is the kind that tends to disappear in times of trouble, just when investors need it most."** And the editorial noted, **"we're thrilled that the Bush Administration seems willing to take on Fan and Fred (an act of bravery second only to taking on Saddam Hussein.) And...the letter was in form of a 'prompt,' meaning that the Administration views the matter as a high priority."**
- However, the editorial added that OFHEO has not been the strongest regulator. The agency took 9 years to release its risk-based capital standards for the GSEs. Plus OFHEO is only responsible for the GSEs' safety and soundness, and lacks the enforcement power of the SEC. **The editorial believes that a "tougher remedy" for Fannie and Freddie's disclosure problems is Congressmen Shays and Markey's bill that would remove Fannie and Freddie's SEC exemption. In addition, some observers are pushing for more regulation, arguing that since taxpayers are the most**

vulnerable, Fannie and Freddie’s disclosures should go beyond SEC requirements. The editorial concludes that this idea “sounds good to us.” (*The Wall Street Journal*, editorial, 6/6/02)

***National Review* reports that Fannie & Freddie “may be headed for a defeat this year” as the Shays-Markey SEC bill repealing Fannie & Freddie’s SEC exemption gains steam**

Fannie’s Chairman claims Congress will not pass the Shays-Markey SEC bill because it would disrupt the housing market

Congressmen Shays and Markey note that opponents to their bill claim, “The Sky is Falling”

National Review

- *National Review*’s Ramesh Ponnuru reported that while Fannie and Freddie “run one of the most formidable lobbying operations in Washington...they may be headed for a defeat this year.” Fannie and Freddie’s critics have so far had limited success in getting Congress to impose stricter restrictions on the GSEs’ expansion plans “but now Fannie and Freddie’s opponents may be on the verge, for the first time, of removing one of their privileges.” Ponnuru noted that Congressmen Shays and Markey have introduced a bill that would remove Fannie and Freddie’s exemption from SEC requirements and recently the Bush administration urged more disclosures from Fannie and Freddie. Peter Wallison, a resident fellow at the American Enterprise Institute, noted that if the Shays-Markey bill passes, “it will reveal that they [Fannie and Freddie] are not invincible on Capitol Hill, and that is the thing that most worries them.” (*National Reviews*, Ramesh Ponnuru, 6/4/02)

Fannie’s Chairman claims Congress will not pass the Shays-Markey SEC bill repealing Fannie & Freddie’s exemption from SEC requirements because it would disrupt the housing market

- Fannie’s Chairman Franklin Raines said it is unlikely Congress will pass the Shays-Markey bill repealing Fannie and Freddie’s exemption from SEC requirements, reported Al Yoon with *Bloomberg*. “There is no one who will get more votes if they stand up and say, ‘I hurt the housing system today. Please vote for me,’” Raines told investors at a Sanford C. Bernstein & Co. conference in New York.
- According to *Bloomberg*, Fannie and Freddie claim that if they were forced to register their securities, it would be more expensive for them to raise capital. Those costs, estimated to be about \$150 million, they claim would be passed to homeowners in the form of higher mortgage rates. Raines claimed the bill would disrupt the mortgage market without improving transparency of the companies. He claimed that Fannie already meets or exceeds SEC disclosure standards. “It would be a total disruption and that’s why there is very limited support” for the proposal, Raines claimed. “I don’t expect this proposal to go very far.” He further claimed that the SEC would not be able to handle the volume of filings from the GSEs. Last year, Fannie sold about 1,500 debt issues and 40,000 mortgage-backed securities, compared with the 110 securities registered by the most-active seller, he said. (*Bloomberg News*, Al Yoon, 6/5/02)

The Congressmen note that opponents to their bill claim, “The Sky is Falling”

- Congressmen Shays and Markey introduced a bill (HR 4071) on March 20 that would repeal Fannie and Freddie’s exemption from SEC requirements. **In a May 22 “Dear Colleague” letter, entitled “The Sky is Falling,” the Congressmen urged their fellow colleagues to “reject the arguments” of those who suggest that Fannie and Freddie “should not have to live by the same rules as the rest of the business community.”**

- The Congressmen noted that since they introduced their bill, some of their colleagues “have gone to a Code Red Alert.” The Congressmen stated, “If you believe some of the statements made by those who support perpetuating these special-interest exemptions, merely requiring a routine filing with the SEC (the same filings done by all other publicly-traded companies, including Fannie and Freddie’s competitors) will lead to an economic calamity the likes of which we haven’t seen since the Great Depression, widespread homelessness, and – if all else fails – our personal favorite: unspecified ‘unintended consequences.’”
- “These are bold claims,” wrote the Congressmen, “especially when you consider what the bill *actually* does. For instance, if HR 4071 is enacted, the heads of Fannie Mae and Freddie Mac will be required to do a few simple things, such as notifying investors if they decide to dump their entire portfolios of company stock...We think Fannie Mae and Freddie Mac’s investors would like to know if the companies’ top executives determine their stock is headed south. Don’t you?”
- The Congressmen concluded, “The fact is, Congress and the American public have long recognized that properly-functioning capital markets require the disclosure of timely and accurate information to investors. This policy was echoed by the Federal Reserve, Treasury Department, and SEC, which in 1992 jointly recommended that Congress repeal Fannie and Freddie’s exemption from securities laws.” (*“Dear Colleague” letter by Congressmen Shays and Markey, 5/22/02*)

All GSEs

Some observers believe that recent comments by Senior Bush Administration officials (OMB, Treasury, & HUD) show that the Administration is working its way to a policy on the GSEs

“Whether taken collectively or individually, the signal is that the administration is paying close attention to the GSEs...” said Steve O’Conner of the Mortgage Bankers Association of America (MBA)

- Mark Felsenthal with *Reuters* wrote an analysis on recent Bush Administration officials’ comments about the GSEs. Three senior officials (OMB official John Graham, Treasury Undersecretary Sheila Bair and HUD Secretary Mel Martinez) have all recently raised concerns about the GSEs. [See earlier stories in this *GSE Report*.]
- While the officials have raised concerns about the GSEs, they have stopped short of questioning the GSEs’ congressionally granted benefits worth millions of dollars to the companies. “They’re incremental steps. They’re small steps. They seem to be steps consistent with the status quo framework,” said one mortgage finance industry official. “They are still nibbling things around the edges,” said a Democrat congressional aide. “I’m still very dubious of us doing legislation (concerning the GSEs),” the aide said.
- Observers said the Bush administration comments show that the administration is working its way toward a policy on the GSEs. “Whether taken collectively or individually, the signal is that the administration is paying close attention to the GSEs, which is appropriate given the crucial role they play in the nation’s housing system,” said Steve O’Conner with the MBA.

- An aide to Congressman Baker said the recent Bush Administration comments provide momentum for their upcoming GSE hearings. “The test will be in testimony by Treasury,” said Baker spokesman Michael DiResto. [See earlier story in this *GSE Report* for more information about Congressman Baker’s upcoming GSE hearing.] (*Reuters*, Mark Felsenthal, 6/10/02)

Fannie Mae and Freddie Mac

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

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

- OFHEO Director Armando Falcon, Jr., announced that both Fannie and Freddie were adequately capitalized as of March 31, 2002. The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 requires the OFHEO Director to determine the capital level and classification of the Enterprises not less than quarterly. OFHEO determines whether the Enterprises are adequately capitalized, undercapitalized, significantly undercapitalized or critically undercapitalized.
- OFHEO determined that Fannie’s minimum capital requirement was \$24.57 billion and critical capital level was \$12.529 billion at March 31, 2002. Thus, Fannie’s core capital of \$25.5 billion on that date exceeded the minimum capital requirement by \$928 million.* Freddie’s minimum capital requirement was \$19.39 billion and critical capital level was \$9.8 billion at March 31, 2002. Thus, Freddie’s core capital of \$20.5 billion on that date exceeded the minimum capital requirement by \$1.17 billion.* (*Reuters*, 5/17/02; *American Banker*, Tommy Fernandez, 5/20/02)

*Although OFHEO’s risk-based capital rule is final, the ‘92 Act provides a one-year period between its effective date (September 13, 2001) and the time OFHEO may classify a GSE based on its risk-based capital requirement. Therefore, during this period, OFHEO will continue to classify the GSEs based on their minimum capital requirement. (*OFHEO press release*, 12/14/01)

Fannie Mae

Fannie Mae Foundation contributes \$2 million to Brookings Institution

- The Fannie Mae Foundation provided a \$2 million grant over five years to the Brookings Institution’s Center on Urban and Metropolitan Policy. The grant kicks off another five-year policy research and analysis partnership between the two organizations. The Fannie Mae Foundation launched the Center in 1996 with a five-year \$1 million grant. The Fannie Mae Foundation and the Center plan to conduct research and produce policy briefs and white papers on a variety of housing and community development issues. All joint publications will be made available on the KnowledgePlex Web site. (*PR Newswire*, 5/30/02)

Freddie Mac

Some lenders remain concerned about Freddie's technology alliance with LendingTree

- Some lenders are concerned about LendingTree's technology alliance with Freddie's automated underwriting (AU) system, Loan Prospector, reported Scott Kersnar with *Mortgage Technology*. LendingTree is described by Kersnar as one of the few really significant Web sites for retail mortgage lending. The alliance, in which LendingTree provides a direct link to Freddie's AU system, is making it easier to qualify leads at the point of sale, but the alliance has some lenders complaining, **"When GSEs compete, we lose."**
- **Kersnar noted that the America's Community Bankers (ACB) is concerned about the LendingTree-Freddie partnership.** ACB has questions about GSE manipulations at the point-of-sale: **"We have an ongoing concern about GSE activity in the primary market, whether it be about Loan Prospector and LendingTree or GSE sale of debt instruments directly to consumers,"** said ACB's Robert Schermund. **"We remain vigilant in our effort to keep Fannie and Freddie efficient in the secondary market – and out of the primary market."** Many in the mortgage industry complain that the GSEs have used their control of the market to stifle development of other AU systems, viewing Fannie and Freddie's AU systems as little more than funnels to increase the GSEs' market-share. In Schermund's words, **"to access and process consumer credit needs through limited (GSE-controlled) channels."** (*Mortgage Technology*, April/May 2002)

Freddie announces that its automated underwriting (AU) system – Loan Prospector – has evaluated 20 million loans

Freddie says it will leverage its AU system to automate the origination process

- Freddie's Loan Prospector[®] automated underwriting service reached a milestone of evaluating its 20 millionth loan on June 7, announced Freddie. It took six years, from January 1995 to January 2001, for Loan Prospector volumes to reach 10 million loans, and only another 17 months for that volume to double to 20 million loans.
- Freddie claimed more than 14,000 lenders and mortgage brokers use the system. Roughly two-thirds of all newly originated mortgages that Freddie purchases are evaluated through Loan Prospector. "Our next step as an industry is to simplify the rest of the mortgage origination process," said Tricia McClung, Freddie Mac vice president of Loan Prospector. "New web-based tools need to be developed to streamline additional mortgage processes lenders and brokers use to originate home loans. That means leveraging automated underwriting to create a fully online origination process." (*Freddie press release*, 6/10/02)

Freddie gave over \$1 million to Jesse Jackson's Rainbow/PUSH Coalition, shortly after Jackson criticized the GSE for discriminatory practices

- Kenneth Timmerman of *Insight on the News* wrote an article that outlined the amount of money Freddie donated to Jesse Jackson's Rainbow/PUSH Coalition following Jackson's threatened boycott of the organization in 1998. According to Timmerman, Freddie donated \$1.05 million to "develop an infrastructure to support credit- and investment-outreach programs." Timmerman added, **"the large**

grant from Freddie Mac came on the heels of a highly publicized personal attack by Jackson on the company for alleged discriminatory lending practices and race discrimination against employees. Once the payments came in, however, Jackson's allegations went away. Critics wonder why."

- Timmerman noted that in 1998, Jackson held a press conference calling for an end to Freddie's discriminatory products and practices, and asked shareholders to divest themselves from the company. **Jackson claimed Freddie "trailed other lenders in terms of minority borrowers and lending practices" and "has failed to fulfill its government guidelines in granting loans to deserving households below conventional market rates."** However, "Jackson mysteriously allowed his sharply worded allegations to fade away like smoke, while behind closed doors he now appears to have been negotiating with Freddie Mac executives." Freddie officials denied that the company paid off Jackson. Spokesperson Sharon McHale told Timmerman that after Jackson's 1998 press conference, the company "began a dialogue" with Jackson, eventually leading to the \$1.05 million grant.
- Jackson's 1998 allegations were not without merit. Washington consultant Anne Canfield told Timmerman "numerous GAO and HUD studies have shown that regulated lenders – banks and thrifts who are subject to the requirements to the Community Reinvestment Act – have a far better track record of lending to minorities than do Fannie Mae and Freddie Mac." [Editorial Note: See earlier story in this *GSE Report* for HUD Secretary Martinez's comments that Fannie & Freddie may not be living up to their congressionally mandated goal of outperforming the broader market in serving low-income and minority borrowers.]
- Timmerman noted that not long after Jackson's attacks on Freddie, the GSE announced plans to purchase up to \$1 billion of loans to minority and low-income families through Bank of America and Rainbow/PUSH. At the press conference announcing the deal, Freddie's chairman Leland Brendsel also announced Freddie's \$1.05 million grant to Rainbow/PUSH, which was supposed to help Jackson's "1000 Churches Connected" program. The program was designed to create a network of regional managers who would train pastors in Jackson's "1000 Churches" to hold financial literacy classes for church members.
- However, there have been some concerns about the success of the program. Many church officials said that instead of working with Rainbow/PUSH, Freddie hired consultants to train pastors. And Rainbow/PUSH is charging churches a \$1000 membership fee, allegedly to defray costs of computers and materials. However, Timmerman noted that Compaq separately donated the computers. Even more telling, none of the people who have completed the courses have applied to take advantage of Freddie's loans. Timmerman noted, **"the question is whether the Rainbow/PUSH Coalition has been able to deliver, or whether the Freddie Mac board...merely intended to buy Jackson's support."**
- Timmerman also discussed the Jackson/Freddie Mac connection on the May 7th broadcast of Fox News' *The O'Reilly Factor*, hosted by Bill O'Reilly. During the show O'Reilly asked Timmerman about Jackson's 180-degree turn with Freddie. Timmerman responded, **"Jackson was encouraging at a press conference... Freddie Mac shareholders to divest from the company. He said...sell all of your shares. This is a horrible company. Racial discrimination, discriminatory loan policies. And not long after he did that, he turned around. He began what the Freddie Mac people called in interviews with me a 'negotiation' with Jesse Jackson. And they turned around and gave \$1 million to basically go away."**

- O'Reilly also asked Timmerman if there was any truth to Jackson's allegations. Timmerman said that he did not think it was a conscious policy on Freddie's part, but **"I've talked to people who look at the banking industry and the whole mortgage industry. And there is...a discrepancy between home mortgages for white and home mortgages for blacks. And there's a gap there. And things need to be done about it."** (*Insight on the News*, Kenneth Timmerman, 5/27/02; *The O'Reilly Factor*; 5/7/02)

Federal Home Loan Banks

A controversial FHFB proposal to expand the System's Office of Finance to include all 12 FHLBanks and to hire a new Office of Finance Chairman (making at least \$700,000 in compensation) is stalled

FHFB Directors Franz Leichter and Allan Mendelowitz ask FHFB Chairman Korsmo to withdraw "this ill-proposed regulation"

Directors of Atlanta FHLBank approve a resolution raising serious concerns about the proposal

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

- A controversial proposal to expand the board of directors of the FHLBank System's Office of Finance has stalled, reported John Connor with *Dow Jones Newswire*. "If the ball is still in play, it's in the court of the presidents (of the 12 Federal Home Loan Banks) and the board," FHFB Chairman John Korsmo said May 30 during a telephone interview in which he said he's willing to take responsibility for "running with the ball a little more aggressively than others intended." (*Dow Jones Newswire*, John Connor, 5/30/02)
- Korsmo made his comments after two members of the five-member FHFB asked him to withdraw the draft regulation to expand the board of directors of the FHLBank System's Office of Finance. **FHFB Directors Franz Leichter and Allan Mendelowitz said in a joint statement that "we firmly believe that the draft regulation put forward by the Chairman of the Federal Housing Finance Board to radically change the structure and mission of the Office of Finance of the Federal Home Loan Bank system is ill-considered and would adversely affect the Federal Home Loan Bank System." They called upon Korsmo to withdraw "this ill-proposed regulation."** (*Dow Jones Newswire*, John Connor, 5/30/02)
- Under the draft regulation, 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. Korsmo described this approach in a May 13 speech. The expansion, Korsmo said, was suggested by the FHLBanks to reduce the costs of raising money in the debt markets. Korsmo said the new chairman should be "someone with experience and authority enough to tell a dozen, well-compensated Bank presidents to sit down, be quiet, and get something done." (*Dow Jones Newswire*, John Connor, 5/30/02)
- Finance Board Directors Leichter and Mendelowitz, in their joint statement, said the draft regulation provides for a part-time Office of Finance board chairman making a starting salary of between \$700,000 and \$800,000 per year. "This figure is 30 times more than the current chairman of the board is paid, and would be more than the President of the United States, the Chairman of the Federal

Reserve, and the Secretary of the Treasury are paid all together,” they said. “This compensation is exorbitant, totally unjustified and a gross waste of the public funds.” They also noted that the draft regulation would empower the new chairman to hire his own staff without limitation, and said this would duplicate existing Office of Finance staff and “would create a two-headed system of leadership that could impair orderly debt issuance.” (*Dow Jones Newswire*, John Connor, 5/30/02)

- The board of directors of the Atlanta FHLBank approved a resolution that raised serious concerns about the proposal. “We urge you to reconsider this current proposal over a longer timeframe, in a manner that provides for the appropriate input from members, directors, and outside experts that can help shape the correct solution,” said the resolution. (*National Mortgage News*, Brian Collins, 6/3/02)

Regulatory relief bill, which contains a provision that would allow privately insured credit unions to join the FHLBank System, passes the House Financial Services Committee

American Bankers Association opposes the bill

- The House Financial Services Committee June 6 passed a regulatory relief bill, which among other things, would allow privately insured credit unions to join the FHLBank System if they meet certain eligibility requirements. The Financial Services Regulatory Relief Act of 2002, introduced by Congresswoman Shelley Moore Capito (R-WV) would make privately insured credit unions eligible to join the FHLBank System if state regulators of a privately insured credit union certify that the credit union meets eligibility standards for federal deposit insurance. (*House Financial Services Committee press release*, 6/6/02; *American Banker*, Michele Heller, 6/6/02, 6/7/02; *BNA Daily Report for Executives*, Karen L. Werner, 6/7/02)
- During the June 6 mark-up of the bill, Congressman John LaFalce (D-NY) introduced an amendment that would have struck out the language allowing privately insured credit unions to be eligible for membership in the FHLBank System. Congressman LaFalce believes the credit union provision would encourage credit unions to escape federal regulation. “If credit unions are to retain the privileges they enjoy, it’s imperative that they operate consistent with their special mission,” said Congressman LaFalce. “These provisions could change the direction of the credit union movement to its ultimate disadvantage.” The amendment was defeated by a vote of 17-29. (*House Financial Services Comm. Web site*, <http://financialservices.house.gov/legis.asp?formmode=item&number=143>; *Bloomberg News*, Bob Gravely, 6/6/02; *BNA Daily Report for Executives*, Karen Werner, 6/7/02)
- Currently, privately insured credit unions are excluded from FHLBank membership. According to Laura Thompson with the *American Banker*, the National Credit Union Administration insures nearly 97% of the country’s 10,079 credit unions. Private insurers cover most of the other 240, primarily American Share Insurance in Dublin, OH. Less than 10% of federally insured credit unions have actually joined a FHLBank. (*American Banker*, Laura Thompson, 5/8/02)
- The American Bankers Association is opposing the bill because they claim it would give tax-exempt, not-for-profit credit unions an unfair advantage over banks. (*Bloomberg News*, Bob Gravely, 6/6/02)

FHFB approves the FHLBanks of Chicago, Cincinnati, Dallas and San Francisco capital plans

FHFB expects to approve all 12 FHLBank capital plans by August; FHFB has approved 8 FHLBank capital plans so far

- The FHFB June 12 approved the capital structure plans of the FHLBanks of Chicago, Cincinnati, Dallas and San Francisco, bringing to eight the number of capital plans that the FHFB has approved. (*FHFB press release, 6/12/02*)
- The capital plans of the Cincinnati, Dallas and San Francisco FHLBanks passed by unanimous 5-0 votes. The FHFB approved the Chicago FHLBank's plan by a 4-1 vote. FHFB Director Franz Leichter, citing concerns about the plan's emphasis on voluntary capital, cast the lone negative vote. (*FHFB press release, 6/12/02*)
- The FHFB determined that the four capital plans meet all statutory and regulatory requirements regarding capital structure and did not compromise the submitting FHLBank's safety and soundness or that of the FHLBank System. All of the FHLBanks whose capital plans have been approved must still obtain Finance Board approval of their internal market risk model and risk assessment procedures and controls prior to implementing their plans. (*FHFB press release, 6/12/02*)
- The FHFB also held a June 5 field hearing in Cleveland to hear testimony on the FHLBanks of Chicago and Cincinnati's capital plans. FHFB Chairman John Korsmo said he was holding a FHFB hearing outside of Washington, D.C., to reaffirm the importance of the capital plan process, including the proposals from the Chicago and Cincinnati FHLBanks. In addition, he said, he wanted to make it more convenient for the FHLBanks' directors to outline their reasoning behind their respective approaches. (*FHFB press release, 5/28/02*)
- The FHFB Board will consider for approval in July the remaining four capital plans, those of the FHLBanks of Des Moines, Indianapolis, New York and Topeka. (*FHFB press release, 6/12/02*)
- The Gramm-Leach-Bliley Act, signed into law on November 12, 1999, amended the provisions of the FHLBank Act that relate to the capital structure of the FHLBanks. The law mandated the replacement of the existing subscription capital structure with a modern capital structure, with risk-based and leverage capital requirements that are similar to those of depository institutions. (*FHFB press release, 6/12/02*)
- The FHFB has also approved capital plans for the FHLBanks of Seattle, Atlanta, Boston and Pittsburgh. It expects to approve all 12 FHLBanks by August. (*FHFB press release, 5/28/02*)

FHLBank of San Francisco purchases its first loans through the Mortgage Partnership Finance (MPF) program

MPF program is a competitor to Fannie & Freddie in the secondary mortgage market

- The FHLBank of San Francisco has entered into a \$50 million commitment to purchase home mortgage loans through the MPF® Program from Gateway Bank, FSB. To date, the FHLBank of San Francisco has purchased loans from Gateway Bank with a median loan size of \$225,000. This marks the first time that the FHLBank of San Francisco has invested in individual mortgage loans.

- “We are pleased to have partnered with Gateway Bank to purchase our first mortgage loans through the MPF Program,” said Jennifer Burlison, Vice President, Mortgage Purchases, at the FHLBank of San Francisco. “The MPF Program adds much-needed competition to the secondary mortgage market. This is a win-win situation for community bankers and homebuyers.”
- Created by the FHLBank of Chicago five years ago, the MPF Program provides members of the FHLBank of San Francisco 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 Bank manages the funding, interest rate, and prepayment risks.
- “The MPF Program is an attractive alternative to selling fixed rate mortgages in the secondary market because we can maintain what we value most—our customer relationships,” said Poppi Metaxas, President and Chief Executive Officer of Gateway Bank, which is based in San Leandro, Calif. “This program allows us to free up funding for additional lending opportunities.”
- Offered by 9 of the 12 Federal Home Loan Banks, the MPF Program has more than \$27 billion in loans outstanding as of March 31, 2002. (*FHLBank of San Francisco press release, 6/10/02*)

<p>FHFB approves proposal to increase funds for homeownership set-asides in its Affordable Housing Program (AHP)</p>

- The FHFB June 12 approved a proposed rule that would increase funds for homeownership set-asides in the Affordable Housing Program (AHP). The proposal would enable a FHLBank to allocate annually the greater of \$4.5 million or 35 percent of its annual AHP contribution for its set-aside program. Currently, the FHLBanks are authorized by the FHFB’s regulations to allocate each year the greater of \$3 million or 25 percent of their AHP contribution for homeownership set-aside programs. The proposed rule would allow each FHLBank to set aside an additional amount of up to the greater of \$1.5 million or 10 percent of its annual AHP amount, specifically for first-time homebuyers. This increased funding authority would enable the FHLBanks to provide up to an additional \$24 million this year. With grants to families ranging from \$5,000 to \$10,000, the FHFB claims the initiative could provide assistance to 2,400 to 4,800 additional households. The proposed rule will have a 60-day public comment period upon publication in the *Federal Register*. (*FHFB press release, 6/12/02*)

Farm Credit System/Farmer Mac

“Ratings” for unrated Farmer Mac debt are confusing

Bloomberg stops giving faulty credit ratings information on Farmer Mac

Farmer Mac is the largest issuer of unrated debt in the US and the only GSE without a credit rating

- In an unusual move, Moody’s Investors Service issued a press release to clarify that it does not rate Farmer Mac’s debt and never has, reported Alison Leigh Cowan with the *New York Times*. Moody’s also said that Farmer Mac was the largest issuer of unrated debt in the United States, with \$3.2 billion outstanding, \$2.3 billion coming due within a year.
- “Nonetheless, confusion persists,” reported Cowan. In SEC filings, Fidelity Investments, which holds Farmer Mac notes in five of its mutual funds, claimed Farmer Mac’s paper had the highest rating (“AAA”) even though Farmer Mac has never been rated by a major agency. Fidelity admitted that the rating was only the assessment of its own researchers, and it said it would provide fuller disclosure in future reports.
- Part of the confusion stems from Farmer Mac’s status as a GSE, for which the company enjoys various benefits in exchange for carrying out its mission, such as the ability to borrow almost as cheaply as the government does because of a perception of government backing.
- Farmer Mac has never submitted to an outside rating. Fannie and Freddie are rated AAA by Moody’s, in part because of their GSE status. In a recent conference call with investors, Henry D. Edelman, Farmer Mac’s chief executive, said that it saw no need for an outside rating.
- Jennifer Engle, a Fidelity spokeswoman, said the fund company has assigned an AAA designation to Farmer Mac’s notes based on the research staff’s conclusion that the notes were “of equivalent quality.” “We conduct our own research,” Engle said, adding that “the critical component of our rating” is that Farmer Mac is a GSE.
- In 1990, Treasury officials proposed that GSEs be required to seek a credit rating to be eligible for government financing. Their plan was never adopted. (*New York Times*, Alison Leigh Cowan, 6/9/02)

Bloomberg stops giving faulty credit ratings information on Farmer Mac

- On June 7, Bloomberg market terminals showed Farmer Mac’s discount notes as having top ratings from Standard & Poor’s and Fitch Ratings. They have neither, reported *New York Times’* Alison Leigh Cowan. Chris Taylor, a spokeswoman for Bloomberg, said the company would look into the problem. (*New York Times*, Alison Leigh Cowan, 6/9/02)
- Bloomberg’s spokeswoman Chris Taylor said Bloomberg was likely given the faulty credit ratings information on Farmer Mac directly from the ratings agencies, reported Tyler Lifton with *Dow Jones Newswire*. “We had Fitch and S&P ratings on the Farmer discount notes that we believe we had gotten verbally on the phone from those ratings agencies,” Taylor wrote in an e-mail sent to *Dow Jones Newswires*. Because Farmer Mac is a GSE, “we had every reason to believe that they would be AAA,” she wrote.

- When asked if Fitch had told Bloomberg that it rated Farmer Mac’s short-term debt F1, a spokesman for the ratings agency said, “I don't have that information but we’ve never maintained a rating on them.” He said that Fitch spoke recently with Bloomberg representatives about several credit ratings, and “at that time, we reconfirmed with them that we do not maintain a rating on that entity.” A spokesman for S&P said, “If they say they have a rating from Farmer Mac, then it's not coming from us. We've never rated that entity or its debt issues.” He added, “We'll follow up with Bloomberg to iron out any confusion.”
- In March, Bloomberg took off the AAA ratings it showed as being assigned by Moody's Investors Service to Farmer Mac's medium-term notes. Taylor said that back in 1995, a Wall Street dealer told Bloomberg that Farmer Mac's medium term notes carried a AAA from Moody's, and that Moody's itself confirmed that statement to Bloomberg. A spokeswoman for Moody's told *Dow Jones Newswires*, "We don't have a rating on Farmer Mac and we never have, therefore I don't know why anyone would have a reason to confirm via telephone that we did."
- A spokeswoman for Farmer Mac provided a statement to *Dow Jones Newswire* June 12 saying, “Farmer Mac has never been contacted by Bloomberg to verify debt ratings. When it realized that in the past some of its (medium-term notes) had been shown mistakenly as rated, it called Bloomberg to correct, noting that all its securities were unrated,” the spokeswoman wrote. “Beyond that, it was a decision for Bloomberg," the statement read. “As to its short-term debt, Farmer Mac was unaware of any rating information on Bloomberg regarding its Discount Notes,” according to the spokeswoman.
- Lifton noted that Farmer Mac is not only the only GSE without a credit rating, but the largest unrated debt issuer in the US. (*Dow Jones Newswire*, Tyler Lifton, 6/12/02)

Cost of credit protection for Farmer Mac’s debt increases following media reports scrutinizing the company’s financial health and business practices

Analysts say any problems at Farmer Mac could have implications for other GSEs, such as Fannie & Freddie

- The cost of buying a credit default swap for debt issued by Farmer Mac has increased in recent weeks following media reports scrutinizing the company’s financial health and business practices, reported Tyler Lifton with *Dow Jones Newswire*. The cost of buying a credit default swap for debt issued by the company, known as Farmer Mac, “has increased dramatically, no question about that,” said Alec Crawford, mortgage and agency strategist at Deutsche Bank. (*Dow Jones Newswire*, Tyler Lifton, 6/4/02)
- The price to purchase a credit default swap, which acts like insurance, on a Farmer Mac bond has gone to somewhere around 2.4 percentage point from 0.4 percentage point, though it doesn’t appear that any of those derivatives have traded at current levels, dealers said. The credit default swaps market is considered a leading indicator for financial trouble, having signaled problems with Enron and WorldCom Inc. weeks before credit ratings agencies did. While few investors are predicting comparable problems for Farmer Mac, some fear a drop in investor confidence could shut the company out of the short-term debt funding markets, where it sells discount notes. (*Dow Jones Newswire*, Tyler Lifton, 6/5/02)
- Crawford said that many banks have ceased offering credit default swaps for Farmer Mac bonds amid the volatility. As a result, liquidity in that market has dried up, further increasing prices. He and

another source also said that equity investors betting on a downturn in Farmer Mac's share price may be trying to drive up the price of Farmer Mac's default swaps in order to make the company's financial health look increasingly uncertain. (*Dow Jones Newswire*, Tyler Lifton, 6/4/02)

Analysts say any problems at Farmer Mac could have implications for other GSEs, such as Fannie & Freddie

- **“While the fate of Farmer Mac itself is important, the small chance of a negative event at Farmer Mac needs to be weighed against potentially major implications for the other GSEs as well,”** said Deutsche Bank strategist Alec Crawford in a research report. In other words, Crawford told *Dow Jones Newswires*, there is a possibility that financial difficulties at Farmer Mac might negatively affect investor perception of other GSEs, which are much larger, even though they operate in much different businesses. While it would be cheap to bail out Farmer Mac relative to the other GSEs, “if there were problems at Farmer Mac, it might be an opportunity for the Federal Government to ‘prove’ that there is nothing behind the Farmer Mac implied guarantee but hot air and tight spreads,” said a report by Crawford. (*Dow Jones Newswire*, Tyler Lifton, 6/4/02, 6/5/02)
- **Farmer Mac is emerging as a potential litmus test for Fannie and Freddie. If the US were not to bail out Farmer Mac, it may go some way toward defining the extent of the so-called government “implicit guarantee” that the GSEs are believe to hold. “Everyone’s asking about them and their credit and their links to the government,”** said Mukul Chadda, agency strategist for Lehman Brothers. (*Dow Jones Newswire*, Tyler Lifton, 6/5/02)

Farmer Mac’s Chief Executive tells Wall Street not to worry about concerns about Farmer Mac’s short-term commercial paper because Farmer Mac is a “GSE”

“No GSE has ever been denied access to the market,” he said

- Farmer Mac’s management held a conference call on May 31 to reassure Wall Street that it could meet its earnings targets and that the \$4.4 billion in guarantees it had issued on farm loans did not pose any hidden problems, reported Alison Leigh Cowan with the *New York Times*. **Farmer Mac’s Chief Executive Henry D. Edelman told investors that concerns about the short-term commercial paper market were misplaced since the company is a GSE. “No GSE has ever been denied access to the market,” he said.** One caller suggested that Farmer Mac was “doing what the S&Ls did, borrowing short term and lending long term and as long as there’s no run on the banks you’re fine...” Edelman said Farmer Mac was “not engaged in the sort of mismatch you referred to.” (*New York Times*, Alison Leigh Cowan, 6/3/02)

Farmer Mac hires Weil Gotshal & Manges as criticisms increase

- Farmer Mac hired Weil Gotshal & Manges LLP as critics claim the GSE is mismanaging its debt and doesn’t disclose enough to investors. Weil Gotshal will join Fried Frank Harris Shriver & Jacobson in representing Farmer Mac. (*Bloomberg News*, Al Yoon, 6/7/02)

Short positions in Farmer Mac's stock increase 200%

- Short positions in Farmer Mac's stock increased 200% and the company's stock traded near a 52-week low, reported Paul Muolo with *National Mortgage News*. Muolo attributed the low stock price and increased short positions on a "scathing" financial report by Gotham Partners Management and an "unflattering" article in the *New York Times*. (*National Mortgage News*, Paul Muolo, 6/3/02) [See May 31, 2002 *GSE Report* for more information on the Gotham report and the *New York Times* Farmer Mac article.]

American Stock Exchange to start trading Farmer Mac options

- The American Stock Exchange announced that it will launch trading June 11 on Farmer Mac Class A options. Farmer Mac Class A options will open with strike prices of 25-30-35 and position limits of 22,500 contracts, according to Amex. The options will trade on a January expiration cycle with initial expirations in July, August, October, and January. The specialist is Bear Wagner Specialist, LLC. (*American Stock Exchange News Release*, 6/10/02)

Postal Service

Republican leaders are stalling an agreement on Postal Service reform legislation

- House Republican leaders are declining to give Government Reform Committee Chairman Dan Burton (R-IN) the "green light" for a legislative deal with Congressman Henry Waxman (D-CA), on a proposal to allow the Postal Service to tailor rates for high-volume business customers, reported Alan Ota with the *CQ Daily Monitor*. House aides from both political parties noted that the deal has been stalled by a cool reception from Republican leaders and by opposition from United Parcel Service of America and the Teamsters Union. "We have 100 percent agreement on policy," a Republican aide said of the Burton-Waxman deal. "Now we need to get a commitment from leadership."
- The aides said Democrats were insistent that Republican leaders promise to schedule a floor vote in advance of a planned June 20 mark-up. "We generally don't give commitments for floor time for bills we have not even seen yet," said a Republican aide.
- The compromise draft would create a new Postal Regulatory Commission, similar to the FCC. A summary of the compromise, by Congressmen Burton, Waxman, John McHugh (R-NY) and Danny Davis (D-IL), said the legislation would give the Postal Service more flexibility to make quick rate-setting decisions. The new regulatory commission would be authorized to issue subpoenas, conduct annual audits, and investigate complaints. The bill would also make the Postal Service subject to antitrust and fair-trade laws, equal customs procedures and federal income taxes. (*CQ Daily Monitor*, Alan K. Ota, 6/11/02)

Postal Service Board of Governors announces support for postal reform legislation

- The Board of Governors of the Postal Service June 4 announced its support of a bipartisan legislative proposal for postal reform legislation sponsored by members of the House of Representatives' Committee on Government Reform. Board Chairman Robert F. Rider said, "We commend Chairman

Dan Burton and Representatives Henry Waxman, John McHugh and Danny Davis for their effort to fashion a legislative proposal that goes a long way to address the needs of the Postal Service.”

- In a March 2001 letter to the President and the Postal Service’s legislative leadership, the Governors stated that significant statutory reform would be necessary to continue to provide consistent and satisfactory levels of universal service to the American people. Postmaster General John E. Potter said, “I am encouraged by the Committee's action in supporting the efforts of the Postal Service to continue meeting the communication needs of the American people.”
- “The need for change is even more apparent today,” emphasized the Board in a prepared statement. “The legislative proposal put together by the leaders of our House oversight committee gives this organization pricing flexibility it desperately needs. Although the bill as proposed does not address all of the legislative needs as set forth in our March 2001 letter, this Board supports the bill and looks forward to working with all interested parties through the course of the legislative process.” (*USPS press release, 6/4/02*)

Postal Service’s VP for Public Affairs and Communications believes the Postal Service’s transformation plan to turn the Postal Service into a commercial government enterprise is “the best solution”

- Azeezaly S. Jaffer, VP for Public Affairs and Communications at the Postal Service, responded to James Gattuso’s May 13 commentary in the *Washington Times*. [See May 31, 2002 *GSE Report* for a summary of Gattuso’s commentary.] Jaffer agreed with Gattuso that change was necessary but disagreed on “what form that change will ultimately take.” The current business model for the Postal Service, created in 1970, “was good for its time” but “doesn’t work anymore.”
- “Transforming the Postal Service into a commercial government enterprise offers the best solution for our nation. Privatization and wide-open competition may sound attractive, but they may not meet our nation’s expectations for equal access, equal levels of service and equal prices for this basic public service.” (Azeezaly S. Jaffer letter-to-the-editor, *Washington Times, 6/1/02*)

FY02 supplemental appropriations bill contains \$87 million for the Postal Service

- The Senate-passed version of the FY02 supplemental appropriations bill contains \$8.7 billion for homeland security, including \$87 million to assist the Postal Service in combating anthrax, biological and chemical weapons delivered through the mail system. The Senate passed its version of the appropriations bill on June 6. (*Senator Olympia Snowe press release, 6/7/02*) The House-passed version of the FY02 supplemental appropriations bill also contains \$87 million for the Postal Service.
- 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*)

Congress is considering legislation to reform Alaska's subsidized "bypass mail"

Postal Service strongly supports the legislation

- Congress is considering legislation on reforming Alaska's "bypass mail" service, reported Bill McAllister with the *Denver Post*. 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)
- Senator Ted Stevens (R-AK) and Congressman Don Young (R-AK) both introduced legislation that would restrict the kind of air carriers eligible to carry bypass mail. (*Denver Post*, Bill McAllister, 5/31/02) The Senate Governmental Affairs Committee approved Senator Stevens' bill on May 22. (*National Journal's Congress Daily*, 6/3/02) The Senate June 6 added bypass mail language to the FY02 supplemental appropriations bill. Senator Stevens offered the amendment, which was adopted by unanimous consent. (*Associated Press*, 6/8/02) The House-passed version of the supplemental bill included Young's language on bypass mail. (*National Journal's Congress Daily*, 6/3/02) The House and Senate versions must be merged in conference committee. "I don't expect any problems from the House or anybody on this bill," Stevens told the *Fairbanks Daily News-Miner*. (*Associated Press*, 6/8/02)
- The Postal Service acknowledged it had been losing as much as \$100 million a year on mail service in Alaska, much of it because of bypass mail. Senator Stevens and Congressman Young 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. Senator Stevens acknowledged at a Senate hearing May 13 that the idea of blocking new air carriers from delivering bypass mail is highly controversial in Alaska. Even so, he won the strong endorsement of Postmaster General John Potter to support the bill. "I'm very familiar with that legislation, and the Postal Service supports the passage of that legislation," Potter said at a hearing on the agency's request for new legislation that would give it greater power to set stamp prices. "We think it's vital to two things: one, providing a high level of service," Potter said, "as well as providing economic relief in the sense it will lower our cost to provide that service." (*Denver Post*, Bill McAllister, 5/31/02)

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