

The **GSE** REPORT™

www.gsereport.com

Contents of GSE Report™

Major Events

- HUD study finds that Fannie & Freddie lagged the primary market in serving low-income and minority borrowers in 2000 ([p. 4](#))
- *New York Times* says Farmer Mac is taking on more risk in an effort to maintain its growth at a time when critics claim it has outlived its usefulness ([p. 5](#))
 - Article says Farmer Mac's financial health is "somewhat dicey" and that it operates with the "barest of financial cushions beyond standards set by regulators"
 - Article criticizes Farmer Mac's directors for awarding themselves lucrative stock options
 - Farmer Mac calls the article a "smear article" and claims it contained "numerous inaccuracies"
 - Farmer Mac asks the SEC to review possible price manipulation and illegal trading activities by short sellers and the author of the *New York Times* article
 - Farmer Mac's regulator – the Farm Credit Administration (FCA) – declines to comment on the article
 - *Washington Post* article notes that the financial health of Farmer Mac, Fannie Mae, and Freddie Mac can be debated endlessly. But, "if Alan Greenspan is worried that Fannie Mae and Freddie Mac might need to be bailed out by the Treasury, the rest of us ought to start thinking about it as well. And while we're worrying about them, we might as well worry about Farmer Mac."
- Group of prominent scholars – the Shadow Financial Regulatory Committee - supports the "Shays-Markey" bill (HR 4071) ([p. 8](#))
 - The bill, introduced by Congressmen Chris Shays (R-CT) and Edward Markey (D-MA), would repeal Fannie & Freddie's exemption from Securities and Exchange Commission (SEC) requirements
 - Fannie & Freddie are the only two Fortune 500 companies not subject to SEC disclosure and registration rules
 - The Shadow Committee notes that Fannie & Freddie's objection that requiring SEC registration and reporting is a tax on housing "is worth considering only if Congress believes that requiring pharmaceutical companies to register their securities is a tax on drugs"
- Mortgage Bankers Association of America (MBA) opposes the Shays-Markey bill ([p. 10](#))
 - MBA says it has concerns with bill's "unresolved issues" and supports increased disclosures by the GSEs
 - Among the MBA's objections to the bill is that it would scare off investors — in China
 - Several sources say that many lenders do not support the MBA's position, reports the *American Banker*
 - "The idea that investors in the United States should be deprived of adequate disclosure in order to promote the sale of GSE bonds and securities to foreign investors is reprehensible and self-serving," says FM Watch Executive Director Mike House
- Treasury Undersecretary for Domestic Finance Peter Fisher says that he does not believe the FHFB has the legal authority to allow institutions to belong to more than one FHLBank (multi-district FHLBank membership) ([p. 12](#))
 - FHFB Chairman John Korsmo hopes for a vote by FHFB board members on multi-district memberships before the end of the year
 - FHFB – the Federal Housing Finance Board – regulates the FHLBank System
- American Land Title Association (ALTA) asks OFHEO to prohibit Fannie & Freddie from using alternative title insurance ([p. 13](#))
 - OFHEO – the Office of Federal Housing Enterprise Oversight – is Fannie & Freddie's safety and soundness regulator
- Banks are concerned about Fannie & Freddie's \$1,000 investment notes (debt) sales to consumers because it could harm banks' ability to attract depositors ([p. 14](#))
 - America's Community Bankers asks Treasury to prohibit Fannie & Freddie from targeting their core customers

All GSEs

- GSE debt news ([p. 15](#))
 - (1) Federal Reserve is still considering purchasing Ginnie Mae mortgage-backed securities for its administration of monetary policy
 - (2) Foreign investors are increasing their agency debt holdings more than their Treasury holdings
 - (3) Fannie's Chairman claims that some nations are investing more of their money in GSE debt than they are putting into their own countries
 - (4) Freddie sells its first Singapore-denominated debt
 - (5) FHLBank System may issue more long-term debt if its mortgage purchase programs continue to grow
 - (6) Fannie & Freddie's short-term debt decreases
 - (7) Sales chief at a small investment banking firm criticizes Freddie's euro benchmark debt program

Fannie Mae and Freddie Mac

- *Christian Science Monitor* calls for GSE reform ([p. 17](#))
 - "In this post-Enron world of more openness and strict accounting, these two enterprises need to change. Their possible collapse due to a scandal or a downward spiral in property markets would be too costly for taxpayers to bear."
- *Business Week* article notes that conservatives and liberals have seized on the Enron scandal to charge that, like Enron, Fannie & Freddie "keep investors in the dark and don't disclose enough information about their operations, including risky trading in derivatives" ([p. 18](#))

Fannie Mae

- Fannie's derivatives credit exposure increased in the first quarter ([p. 18](#))
- Fannie further expands its political reach by including Federal and State officeholders in its press conferences and press releases and increasingly using its Partnership Offices in press events ([p. 19](#))
 - Fannie has 51 Partnership Offices open across the country
 - Fannie "wins the gratitude of politicians by staging local events with them, often to 'announce' its plans to buy local mortgages... It's almost as if Ford or Microsoft could allow politicians to gain some credit with voters for every Escort or Windows package sold in their district." - *Wall Street Journal*, Nicholas Kulish & Jacob M. Schlesinger, 7/25/01

Freddie Mac

- *Forbes* article calls Freddie's new "Range Notes" lucrative but "scary" ([p. 20](#))
- David Stevens to head Freddie's single-family lending ([p. 21](#))

Federal Home Loan Banks

- Regulatory relief bill (HR 3951), which contains a provision that would allow privately insured credit unions to join the FHLBank System, passes the House Financial Services Financial Institutions Subcommittee ([p. 21](#))
 - House Financial Services Committee Chairman Michael Oxley (R-OH) says the FHLBank provision is a "common sense provision" and "of particular importance" to him
 - American Bankers Association (ABA), America's Community Bankers (ACB) and the Independent Community Bankers (ICBA) oppose this provision
 - FHLBanks are neutral on the issue
- Federal Housing Finance Board (FHFB) approves the FHLBanks of Boston and Pittsburgh's capital plans at its May 8 meeting ([p. 22](#))
 - FHFB expects to approve all 12 FHLBank capital plans by the summer; FHFB has approved 4 of the 12 FHLBank capital plans so far
- FHFB Chairman John Korsmo tells FHLBank Directors he plans to reaffirm "the bright red line of separation" between the FHFB and the FHLBank System ([p. 23](#))
- FHFB is considering expanding the System's Office of Finance to include all 12 FHLBanks ([p. 23](#))
- FHFB names new Deputy Director of the Office of Supervision ([p. 24](#))

Farm Credit System

- Farmer Mac issues \$35 million in preferred stock ([p. 24](#))
- Farm Credit Administration (FCA)'s final rule allowing a Farm Credit System institution to terminate its Farm Credit System charter and become a financial institution is effective May 13 ([p. 25](#))

Ginnie Mae

- National Association of Realtors discuss “Ginnie Mae Choice” at their midyear legislative meeting ([p. 25](#))
 - “Ginnie Mae Choice” supporters believe that the program could capture up to 20% of the high loan-to-value market now controlled by Fannie & Freddie
 - “Ginnie Mae Choice” supporters say the proposal will lower costs to consumers, increase revenue to the federal government, and create competition for Fannie & Freddie

Postal Service

- Senate Subcommittee holds May 13 hearing on the Postal Service’s transformation plan ([p. 26](#))
 - GAO Comptroller David Walker believes the transformation plan was a “good first step” but “does not adequately address certain key issues
 - Walker suggests Congress create a commission (similar to a base closing commission) to help make the unpopular choices necessary to solve the Postal Service’s structural problems
- Postal Service Inspector General testifies that Postal Service’s workers’ compensation has contributed to the financial troubles at the Postal Service ([p. 28](#))
- Postal Service halves its 2002 projected deficit; Postal Service will cut 20,000 jobs ([p. 28](#))
- Mailers Council calls on White House to create postal reform commission to study Postal Service ([p. 29](#))
 - Direct Marketing Association, which is a member of the Mailers Council, calls commission premature
- Representatives from 16 companies meet with Congressman Tom Allen (D-ME) to discuss Postal Service reform to avoid huge rate increases ([p. 30](#))
- Postal Service to hold May 28 Ratemaking Summit ([p. 30](#))
- White House is considering Acting Governor Jane Swift (R-MA) for a part-time position on the board that oversees the Postal Service ([p. 30](#))
- Postal Service hopes to save \$200 million over the next five years by overhauling its Intranet ([p. 30](#))
 - Postal Service’s network is the third largest in the world

Major Events

HUD study finds that Fannie & Freddie lagged the primary market in serving low-income and minority borrowers in 2000

- An April 2002 HUD study by Harold Bunce compares the borrower and neighborhood characteristics of single-family mortgages purchased by Fannie and Freddie between 1992 and 2000 with the characteristics of loans originated in the primary market during the same time period. The study, *the GSEs' Funding of Affordable Loans: A 2000 Update*, finds that Fannie and Freddie continued to lag the primary market in serving low-income and minority borrowers in 2000.
- The study found the following:
 - (1) **While both GSEs improved their affordable lending during the 1990s, they continued in the year 2000 to underperform the primary conventional conforming market in funding mortgages for lower-income borrowers and for properties located in low-income and high-minority census tracts (i.e., underserved areas).**
 - Between 1993 and 2000, 8.9% of Freddie's mortgage purchases were for very low-income borrowers, compared with 9.8% of Fannie's purchases, 12.9% of loans originated by depositories, and 13% of loans originated in the conventional conforming market (without estimated B&C subprime loans)
 - Considering the underserved areas category for the 1996-2000 period, 20.7% of Freddie's purchases financed properties in underserved neighborhoods, compared with 22.6% of Fannie's purchases, 24.4% of loans originated by depositories, and 25.2% of loans originated in the conventional conforming market.
 - GSEs underperform primary market in funding affordable loans - In 2000, both Fannie and Freddie fell significantly below the market in funding affordable loans. In 2000, special affordable loans accounted for 13% of Fannie's purchases, 14.3% of Freddie's purchases, and 16.8% of loans originated in the market.
 - GSEs underperform primary market in funding very low-income borrowers - In 2000, 24.9% of Fannie's mortgage purchases were for very low-income borrowers, compared with 27.1% for Freddie, and 29.7% originated by depositories. (Table 1 in HUD's report.)
 - GSEs underperform primary market in funding African-American loans – In 2000, 4.1% of Fannie's purchases were for African-Americans, compared with 4.3% for Freddie, and 5.4% originated by depositories. (Table 1 in HUD's report.)
 - GSEs also underperformed primary market in funding minority loans, loans in low-income tracts, high-minority tracts, high African-American tracts and underserved areas in the year 2000. (See Table 1 in HUD's report.)
 - (2) The GSEs' performance improved markedly between 1999 and 2000, allowing them to partially close their performance gap to the primary market.
 - (3) During most of the 1990s, Fannie's purchases were more targeted to low-income borrowers and underserved areas than Freddie's purchases; however, the relative performance of the two GSEs has been rather similar during the past two years.
 - (4) **While the GSEs account for a significant share of the total market for home purchase loans, their market share for each of the affordable lending categories is much less than their share**

of the overall market, and they contribute only a small share of funding in important market segments (such as the market serving first-time minority homebuyers)

- The GSEs' purchases were estimated to be 46-48% of all home loans originated in metropolitan areas during 2000 but only 24-29% of loans originated for African-American and Hispanic borrowers and approximately 35-37% of loans originated for low-income borrowers and for properties in underserved areas.
 - Using survey data on home purchases from 1997 to 1999, the study estimates that the GSEs' share of the market for first-time African-American and Hispanic homebuyers was only 10-11%, or less than one-third of their share (36%) of all home purchases during that period.
- (5) The GSEs' small market share in the first-time homebuyer market could be due to the preponderance of high (over 20%) downpayment loans in their mortgage purchases, although further study is needed.
- During 2000, approximately 55% of Fannie's special affordable, low-mod, and underserved areas loans had downpayments of at least 20%, a percentage only slightly smaller than the corresponding percentage (59%) for all Fannie's home loan purchases. Similar patterns of high downpayments on the goals-qualifying loans were evident in Freddie's 2000 purchases, as well as in prior years for both GSEs.

(HUD Housing Finance Working Paper Series, HF-013 – *the GSEs' Funding of Affordable Loans: A 2000 Update*, Harold Bunce, April 2002)

***New York Times* says Farmer Mac is taking on more risk in an effort to maintain its growth at a time when critics claim it has outlived its usefulness**

Article says Farmer Mac's financial health is "somewhat dicey" and that it operates with the "barest of financial cushions beyond standards set by regulators"

Article criticizes Farmer Mac's directors for awarding themselves lucrative stock options

Farmer Mac calls the article a "smear article" and claims it contained "numerous inaccuracies"

Farmer Mac asks the SEC to review possible price manipulation and illegal trading activities by short sellers and the author of the *New York Times* article

Farmer Mac's regulator – the Farm Credit Administration (FCA) – declines to comment on the article

***Washington Post* article notes that the financial health of Farmer Mac, Fannie Mae, and Freddie Mac can be debated endlessly. But, "if Alan Greenspan is worried that Fannie Mae and Freddie Mac might need to be bailed out by the Treasury, the rest of us ought to start thinking about it as well. And while we're worrying about them, we might as well worry about Farmer Mac."**

- Alison Leigh Cowan wrote an extensive April 28 article for the *New York Times* on Farmer Mac, entitled "*Big- City Paydays at 'Farmer Mac' – Pots of Gold for its Executives, but its Lending Risks Go Unnoticed.*" (*New York Times*, Alison Leigh Cowan, 4/28/02) Farmer Mac, a GSE, is a government-created, shareholder-owned company that provides money for loans to farmers in much

the same way that Fannie and Freddie raise money for home mortgages. Like Fannie and Freddie, a growing number of critics complain that these GSEs are being run for the benefit of shareholders, often to the detriment of their public mission and their private competitors. (*Washington Post*, Jerry Knight, 5/6/02) Like Fannie and Freddie, Farmer Mac enjoys many of the same GSE benefits, such as exemption from state and local taxes and an implied government guarantee, allowing Farmer Mac to borrow at close to Treasury rates.

- **A *Washington Post* article by Jerry Knight noted that the financial health of Farmer Mac, Fannie Mae, and Freddie Mac could be debated endlessly. But, “if Alan Greenspan is worried that Fannie Mae and Freddie Mac might need to be bailed out by the Treasury, the rest of us ought to start thinking about it as well. And while we’re worrying about them, we might as well worry about Farmer Mac.”** (*Washington Post*, Jerry Knight, 5/6/02) [As noted in the May 3, 2002 *GSE Report*, Federal Reserve Chairman Alan Greenspan said government support for mortgage agencies, such as Fannie and Freddie, might be leading investors to underestimate the risk of dealing in their securities. Chairman Greenspan also previously criticized the GSEs’ implicit government support as a subsidy to housing that distorts the economy’s allocation of resources. (*Wall Street Journal*, Greg Ip, 4/23/02)]

Article says Farmer Mac’s financial health is “somewhat dicey” and that it operates with the “barest of financial cushions beyond standards set by regulators”

- “Farmer Mac’s health is somewhat dicey, and it operates with the barest of financial cushions beyond standards set by regulators,” reported Cowan. “When I hear stories like this, I wonder how many more of these there are,” said Charles Lewis, executive director of the Center for Public Integrity in Washington. “This is why you have such skepticism about government, that you can create something like this and allow it to run rampant, something with \$4 billion in obligations and \$15 million in reserves.” (*New York Times*, Alison Leigh Cowan, 4/28/02)

Article criticizes Farmer Mac’s directors for awarding themselves lucrative stock options

- Fourteen years ago, Congress created Farmer Mac to help farmers obtain easier credit. Today, the company, while still depending on government guarantees, “has turned into one sweet honey pot -- though not for the intended beneficiaries.” Cowan noted, **“What Congress publicly set up to help the country’s farmers has quietly been used by its officers and directors to help themselves.”** Farmer Mac’s Chief Executive Henry D. Edelman, last year took home salary and stock options conservatively estimated at \$1.8 million. Edelman also controls \$27.6 million worth of Farmer Mac stock, even after selling \$2.8 million worth since last summer. (*New York Times*, Alison Leigh Cowan, 4/28/02)
- The article criticized Farmer Mac’s Directors for awarding themselves lucrative stock options saying the “the 15 board members, all politically connected and including five presidential appointees, sit atop average holdings valued at \$816,249. Nine have made millions more selling shares.” Cowan noted that without spending any money buying stock, insiders now own 13 percent of Farmer Mac -- all from stock option and restricted stock grants.” An additional 2.63 million shares are available for grant, so insiders could end up with 35 percent without further authorization. (*New York Times*, Alison Leigh Cowan, 4/28/02) Charles Lewis, executive director of the Center for Public Integrity, said most people would be angry if they understood that directors at a government-connected enterprise are getting rich for their service. (*The Plain Dealer*, Tom Diemer and Stephen Koff, 5/6/02)
- Board members control about 28 percent of the nonvoting publicly traded stock and 31 percent of the voting shares. Zions First National Bank owns all those voting shares and 15 percent of the public

stock. Zions Vice President W. David Hemingway is on Farmer Mac's board. Zions is both Farmer Mac's biggest shareholder and one of its biggest customers, selling more than \$90 million in farm loans to Farmer Mac last year. (*Washington Post*, Jerry Knight, 5/6/02)

Article notes that Farmer Mac has a heavy reliance on short-term debt to finance long-term obligations

- To increase returns, Farmer Mac also finances many of its long-term obligations with cheaper short-term funds – “never a stable situation.” Cowan noted that nearly 70 percent of Farmer Mac's debt financing comes from approximately \$2.3 billion worth of commercial paper that rolls over every eight days, on average. To minimize risk, the maturity and yield of assets and liabilities should generally match. But most of Farmer Mac's assets are illiquid multiyear mortgages. Farmer Mac has no bank lines to draw down if the commercial paper market were to grow skittish. And by Farmer Mac's own acknowledgment, its prized government guarantee would be of no use in a squeeze. (*New York Times*, Alison Leigh Cowan, 4/28/02)
- Cowan also noted that each year Farmer Mac has assumed more risky investments. A footnote in the 2001 financial statements shows \$166 million of preferred stock lodged in assets. Cowan noted that even a 5 percent drop in the value of those holdings could dent the scant \$15 million equity cushion the company has before it would have to invade its minimum capital mandated by regulation. (*New York Times*, Alison Leigh Cowan, 4/28/02)

Article raises questions on whether Farmer Mac has created a thriving secondary market for agricultural loans

- Cowan noted, “This borrow-big ‘Field of Dreams’ strategy has often prompted Farmer Mac to stray from its mission. In 1998, when two-thirds of its assets had drifted into preferred stocks, bonds and other nonfarm investments, mostly securities, the General Accounting Office criticized Farmer Mac in a report to Congress. Since then, Farmer Mac has lowered the figure to 45 percent, though it is still far higher than both Fannie's and Freddie's.” (*New York Times*, Alison Leigh Cowan, 4/28/02)
- “If Farmer Mac had created a thriving secondary market for agricultural loans, none of this might matter. But that dream is still elusive,” reported Cowan. (*New York Times*, Alison Leigh Cowan, 4/28/02)
- Farmer Mac's First Chairman John R. Dahl said Farmer Mac's reason for being just might be fading. “One of the reasons for Farmer Mac was double-digit interest rates,” he said. “But interest rates came down.” Besides, he added, “there are getting to be fewer and fewer people in agriculture.” (*New York Times*, Alison Leigh Cowan, 4/28/02)

Farmer Mac calls the article a “smear article” and claims it contained “numerous inaccuracies”

- Farmer Mac issued a rebuttal on April 29 to the *New York Times* article, claiming that the article was a “smear article” and contained “numerous inaccuracies.” The press release listed 19 inaccuracies in the article. (*Farmer Mac press release*, 4/29/02)

Farmer Mac asks the SEC to review possible price manipulation and illegal trading activities by short sellers and the author of the New York Times article

- Alleging that the *New York Times* article was prompted by short-sellers, Farmer Mac said it intended to refer the matter to the SEC for possible price manipulation and illegal trading activities by short sellers and Cowan. An SEC spokesman declined to comment. (*Dow Jones Newswire*, Tim Paradis, 4/29/02; *Wall Street Journal*, Patrick Barta, 4/30/02)

- Farmer Mac claimed that Cowan was “taken in by short sellers” by investors hoping to make a profit on falling share prices in the company. After the company’s better than expected 2002 first quarter earnings performance, investors betting on the company’s stock to fall faced millions of dollars in losses, Farmer Mac said. Farmer Mac believes those investors contacted Cowan to suggest she write an expose about Farmer Mac based upon their misconceptions about the company. Farmer Mac claimed Cowan “breached her professional duty in failing to ‘know’ her sources before writing an article, particularly a financial article that could benefit those sources.” The GSE noted that investments pegged to a decline in Farmer Mac’s shares increased in days prior to the release of the article. (*Reuters*, 4/29/02; *Farmer Mac press release*, 4/29/02)

New York Times stands by its article but does correct a minor error

- A *New York Times* spokeswoman said on April 30: “We are confident in the completeness, fairness and accuracy of our reporting. On one minor point, we have discovered an error and we plan to print a correction...The article said Henry Edelman’s prior firm, Paine Webber, was hired at \$66,000 a month. On closer reading of our notes, we find that the monthly rate was \$50,000, not \$66,000.” (*Dow Jones Newswire*, 4/30/02) The correction was printed in the May 1 issue of the *New York Times*. (*New York Times*, 5/1/02)

Trading in Farmer Mac shares was delayed a few hours until Farmer Mac could respond to the article

- Farmer Mac shares did not begin trading until nearly noon EDT on April 29, pending the release of a response from Farmer Mac on the article. Farmer Mac’s rebuttal was released prior to when trading began, however, its shares still promptly fell \$4.49, or 10.2% at \$39.50. (*Reuters*, 4/29/02; *Wall Street Journal*, Patrick Barta, 4/29/02)

FCA declines to comment on the article

- An FCA spokesman declined to comment on the article. (*Reuters*, 4/29/02)

Group of prominent scholars – the Shadow Financial Regulatory Committee - supports the “Shays-Markey” bill (HR 4071)

The bill, introduced by Congressmen Chris Shays (R-CT) and Edward Markey (D-MA), would repeal Fannie & Freddie’s exemption from Securities and Exchange Commission (SEC) requirements

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

The Shadow Committee notes that Fannie & Freddie’s objection that requiring SEC registration and reporting is a tax on housing “is worth considering only if Congress believes that requiring pharmaceutical companies to register their securities is a tax on drugs”

- Congressmen Shays and Markey introduced a bill (HR 4071) on March 20 that would repeal Fannie and Freddie’s exemption from SEC requirements.
- The Shadow Financial Regulatory Committee declared its support May 6 for the “Shays-Markey” bill. (*Statement of the Shadow Financial Regulatory Committee*, 5/6/02) The Shadow Committee, an independent committee sponsored by the American Enterprise Institute (AEI), is comprised of the

following prominent scholars: George Kaufman, CoChair, Loyola University, Chicago; Robert Litan, CoChair, Brookings Institution; George Benston, Emory University; Marshall Blume, University of Pennsylvania; Charles Calomiris, Columbia University; Franklin Edwards, Columbia University; Scott Harrington, University of South Carolina; Richard Herring, University of Pennsylvania; Paul Horvitz, University of Houston; Hal Scott, Harvard Law School; Kenneth Scott, Stanford University; and Peter Wallison, AEI. (*Shadow Financial Regulatory Committee Web site (www.aei.org/shdw, 5/8/02)*)

Shadow Regulatory Committee statement

- **The Shadow Committee issued a statement saying the “Shays-Markey” bill “is in the public interest, deserves support in Congress, and should be promptly adopted.” Fannie and Freddie have objected to the elimination of their SEC exemption contending that it would be costly to them to register and file with the SEC, and arguing that such a requirement would in effect be “a tax on housing.” However, the Shadow Committee noted that the “objection that requiring registration and reporting is a tax on housing is worth considering only if Congress believes that requiring pharmaceutical companies to register their securities is a tax on drugs.”**
- Fannie and Freddie continue to take the position that as a GSE, the US government does not back their securities. “If true, there would be no basis whatever for exempting their securities from the full disclosure that SEC registration would produce. As long as Fannie and Freddie retain this exemption, it fuels the perception that they have special protection from the government. If not true, the Committee still believes that, for a variety of reasons, full disclosure of investor risks is warranted even if the GSEs are government-backed.”
- “For one thing, Fannie and Freddie are active participants in purchasing MBSs issued with respect to pools of securities they have previously assembled, securitized, guaranteed and sold to investors. Current estimates are that they hold 34 percent of all MBSs they have previously sold. **Some market participants believe that the GSEs’ disclosures concerning the constituents of the underlying mortgage pools are not sufficiently detailed to permit investors to differentiate among the pools in order to price the interest rate risk associated with these securities. In that event, when Fannie and Freddie repurchase these securities they would be able to use their superior information about these pools to purchase those MBSs that have the best prices in relation to the true interest rate risk they represent. The disclosures required by SEC registration will provide more information to investors in these securities, allowing them to better understand the risk and value of the MBSs they buy and sell.”**
- “Even the GSEs’ debt securities could cause losses to investors who do not receive adequate disclosure. Recently, Fannie Mae was compelled to cancel a proposed repurchase of callable debt because investors—many of them small banks and thrifts—claimed that they were unaware at the time of acquisition that these securities could be called by Fannie Mae at any time. The early repurchase of the debt securities would have caused substantial losses among these institutions. Formal SEC disclosure might have avoided any misunderstanding.”
- “Finally, the Committee sees other reasons for requiring the GSEs to register with the SEC. Although Fannie Mae has recently agreed voluntarily to disclose insider trading by its directors and officers and has begun to publish its proxy statement on its website, these voluntary steps could be rescinded if the current pressure for disclosure eases. These minimal steps were taken only after the media called attention to the failure to disclose insider trading and after their proxy statement was posted on the website of the American Enterprise Institute last year. In addition, the financial statements of Fannie

and Freddie are not fully comparable with one another. Since they are supposed to be competitors, investors should be able to compare their financial results as an indicator of the quality of their managements. SEC registration and disclosure would likely result in more comparable financial statements.” (*Statement of the Shadow Financial Regulatory Committee, 5/6/02*)

Mortgage Bankers Association of America (MBA) opposes the Shays-Markey bill

MBA says it has concerns with bill’s “unresolved issues” and supports increased disclosures by the GSEs

Among the MBA’s objections to the bill is that it would scare off investors — in China

Several sources say that many lenders do not support the MBA’s position, reports the *American Banker*

“The idea that investors in the United States should be deprived of adequate disclosure in order to promote the sale of GSE bonds and securities to foreign investors is reprehensible and self-serving,” says FM Watch Executive Director Mike House

- The MBA announced May 9 that its Board of Directors, consisting of residential, multifamily, and commercial members, voted to oppose HR 4071. The MBA said that “While the MBA supports increased disclosure by the GSEs on their debt, equity and mortgage-backed securities to at least meet the standards applied by the SEC to private companies that issue securities, MBA does not endorse the specifics of the Shays-Markey legislation because it raises unresolved issues, such as:
 - the potential impact on the affordability of homeownership and rental housing;
 - the efficiency of the housing finance market, and
 - the potential of unnecessary additional liability of mortgage lenders.”
- “While MBA does not support HR 4071, we believe that strong, independent regulation of the GSEs is essential to ensure their continued financial safety and soundness,” said James M. Murphy, MBA Chairman. “As the customer base of the GSEs, MBA members are committed to work with the SEC, OFHEO, HUD and Congress to ensure strong regulatory oversight and eliminate disclosure inadequacies.” Murphy added, “We commend Congressman Markey and Shays for their concern about investors in GSE securities and for raising the need for the GSEs to provide full and complete disclosure; however, many MBA members raised serious concerns about the unknown consequences for the housing finance system that could result from HR 4071.” (*MBA press release, 5/9/02*)

Among the MBA’s objections to the bill is that it would scare off investors — in China

- Among the MBA’s objections to the bill is that it would scare off investors — in China, reported Tommy Fernandez with the *American Banker*. Several sources said MBA officials raised their concerns over Chinese investors with Congressman Shay’s Chief of Staff before releasing their statement.
- **The MBA had other objections to the bill, but the concerns about Chinese investors “raised the most eyebrows in the mortgage industry,” and observers said they were surprised the MBA would raise concerns about foreign-investors to oppose efforts to improve disclosure for domestic investors. “The idea that investors in the United States should be deprived of adequate**

disclosure in order to promote the sale of GSE bonds and securities to foreign investors is reprehensible and self-serving,” said FM Watch Executive Director Mike House.

- In an interview on May 14, MBA officials said there was no specific reason they singled out China. “We could have picked any country to make our point. We just chose the Chinese as an example,” said Stephen O’Connor, the MBA’s senior director of residential finance. Global capital markets are becoming a more important money source to the U.S. mortgage industry, O’Connor said. He noted that foreign governments and their central banks are among the major investors for Fannie and Freddie securities. O’Connor claimed that global investors are sensitive to any perceived changes in the status of the securities they purchase and that removing Fannie and Freddie’s federal exemptions could result in weaker demand for the GSEs’ paper. “The removal of the SEC status for these securities could lead to less investors and ultimately less capital for housing,” O’Connor said. “We did not conclude that registration would have the effect of raising the cost for housing capital, but we gathered enough facts to determine that it might.”
- Financial consultant Bert Ely noted that concerns that the bill could result in a perception that the government is pulling back from Fannie and Freddie shows there is an ambiguity about federal ties to the companies. “This is where fiction catches up with the reality,” he said. “Either they are or they aren’t backed by the government. Everyone is trying to dance around this and be Enron-like and oblique.” He said the important thing for the GSEs “is to be honest about what they are and what the status of their financial condition is, and that is ultimately how the financial markets work best.”
- Fannie and Freddie’s spokespeople said they were confused by the MBA’s foreign-investor argument. (*American Banker*, Tommy Fernandez, 5/15/02)

Several sources say that many lenders do not support the MBA’s position

- Several sources said that the MBA’s decision was preceded by a lively debate among its members – and that many lenders do not support the MBA’s position, reported Tommy Fernandez with the *American Banker*. Fernandez noted that a confidential MBA document shows that the association is split on the issue. Larger residential lenders reportedly supported HR 4071, while small and midsize lenders and commercial banks were opposed. Several sources said that the commercial leadership of the MBA voted in the past to oppose the bill, while the MBA’s residential board voted to support the bill, though with smaller lenders dissenting. Though MBA Chairman Murphy said that an “overwhelming majority” supported the MBA’s May 9 decision, officials acknowledged that the MBA held a previous conference call on the issue on May 7 in which members could not reach agreement. (*American Banker*, Tommy Fernandez, 5/13/02)

Congressman Shays’ comments

- **The MBA’s opposition to the bill is an obstacle but should not stand in the way of a hearing on the bill on its merits, said a Shays’ staff member. “Certainly the opposition from the MBA doesn’t make our job any easier, but it may make our job more important,” the staffer said. “It strikes our office as somewhat disingenuous to support full disclosure but to oppose legislation that requires full disclosure of all companies,” the staffer added.** (*Reuters*, Mark Felsenthal, 5/9/02)
- **In an interview with *CNNfn’s Market Call* on May 13, Congressman Shays stated, “In this era of Enron, it’s amazing to me that there are two major corporations, two Fortune 500 companies that don’t have to register and disclose with the SEC. It’s just, for me, it’s mind boggling that we wouldn’t want to know what these very important companies do. And so – but it’s a long**

fight...Fannie Mae and Freddie Mac don't want to give up this unique status they have, but I think ultimately they're going to have to.” (*CNNfn Market Call Transcript, 5/13/02*)

Treasury Undersecretary for Domestic Finance Peter Fisher says that he does not believe the FHFBS has the legal authority to allow institutions to belong to more than one FHLBank (multi-district FHLBank membership)

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

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

- As noted in the May 3, 2002 *GSE Report*, Assistant Secretary of Treasury for Financial Institutions Sheila Bair sent an April 9 letter to the FHFBS on permitting a single institution to belong to more than one FHLBank (multi-district membership). “A clear reading of the relevant language of the Federal Home Loan Bank Act strongly suggests that the Finance Board does not have the legal authority to grant multi-district membership,” she wrote. “We believe that multi-district membership must be considered in the larger context of evaluating the [FHLBanks’] charters, which is a process Congress should undertake.” (*American Banker*, Rob Blackwell, 4/25/02) Assistant Secretary Bair said the language and legislative history “raise considerable doubt as to whether the Finance Board has the authority to approve multi-district membership.” Bair told the FHFBS that “whether or not multi-district membership is an appropriate policy choice toward FHLBank modernization is a question for Congress to answer.” (*Dow Jones Newswire*, John Connor, 4/30/02)
- News that Assistant Secretary Bair was stepping down from her position in mid-June to accept a teaching position in Amherst, MA, triggered supporters of multi-district FHLBank membership to claim that Bair’s departure from the Treasury Department made Bair’s letter to the FHFBS moot because her successor could have different views. (*American Banker*, Rob Blackwell, 4/25/02)
- **However, Treasury Undersecretary for Domestic Finance Peter Fisher echoed Bair’s comments in a speech on May 13 before the Independent Community Bankers of America (ICBA). “Like the ICBA, we believe that a plain reading of the relevant language of the Federal Home Loan Bank Act strongly suggests that the Finance Board does not have legal authority to grant multi-district membership,” Fisher said. “Nor do we think that the relevant legislative history supports such an interpretation of the statute. We also question whether relevant multidistrict membership serves the interest of the System’s community banks and thrifts,” he added.** (*Dow Jones Newswire*, Deborah Lagomarsino, 5/13/02; *Remarks of Treasury Under Secretary Peter Fisher to the ICBA*, 5/13/02)
- Although the FHFBS has never approved a bank for multi-district FHLBank membership, more than 100 bank holding companies have financial institutions in more than one of the 12 FHLBank System districts, and nearly 200 members of the FHLBank System have branches extending beyond district lines, according to Scott Smith, acting director of the FHFBS’s Office of Policy Research and Analysis. (*BNA Daily Report for Executives*, Richard Cowden, 3/7/02) FHFBS Chairman John Korsmo said his intention is that FHFBS board members vote before the end of this year on the question of multi-district memberships within the FHLBank System. (*Dow Jones Newswire*, John Connor, 3/12/02) He told members of the ACB that his reading of the statute that created the FHLBank System does not give the FHFBS clear authority to allow a single thrift or bank to become a member of two or more

FHLBanks. He does not, however, have a closed mind and said the FHFBB may hold public hearings on multi-district memberships. (*National Mortgage News*, 3/18/02)

American Land Title Association (ALTA) asks OFHEO to prohibit Fannie & Freddie from using alternative title insurance

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

- ALTA requested that OFHEO prohibit Fannie and Freddie from using alternative title insurance products, reported *National Mortgage News*. OFHEO’s Deputy Director Jimmy Barton said OFHEO is reviewing the issue and plans to issue an opinion. (*National Mortgage News Web site*, 5/8/02) In 2001, ALTA filed a lawsuit against Radian Guaranty and its subsidiaries in Orange County, CA to prevent Radian from offering the product, called Radian Lien Protection. ALTA argued that the Radian product is title insurance and that the mortgage insurance company isn’t licensed to issue such insurance. (*ALTA press releases*, 11/20/01, 12/13/01)
- On April 19, 2002, the U.S. District Court for the Central District of California granted the motion by ALTA that its lawsuit against Radian Guaranty and its subsidiaries be remanded to California state court. ALTA originally brought the action in state court in California seeking to enjoin Radian from issuing its Radian Lien Protection (RLP) product in California and for damages and other relief. It is the contention of ALTA that the RLP product is title insurance and violates California law, which requires anyone issuing title insurance to be expressly and uniquely licensed as a title insurer. More than 30 other states have similar restrictions. Radian is not so licensed. (*ALTA press release*, 4/23/02)
- ALTA has also lobbied the issue in the offices of state regulators, with some success. Regulators in Florida, Texas, New Mexico and Connecticut advised Radian that Lien Protection is title insurance. In addition, North Carolina issued a general bulletin to all its licensees that “mortgage impairment” – a title-industry term for alternative products – is title insurance. (*American Banker*, Robert Julavits, 5/9/02)
- Radian argues that Lien Protection is a form of mortgage pool insurance and therefore does not need to be regulated as title insurance. (*American Banker*, Robert Julavits, 5/9/02)
- In related news, Senator Phil Gramm (R-TX) reportedly supports title insurance alternatives, such as Lien Protection and John Taylor, the Chief Executive of the National Community Reinvestment Coalition, says his group is examining the product for potential support. (*American Banker*, Robert Julavits, 5/9/02)

Banks are concerned about Fannie & Freddie's \$1,000 investment notes (debt) sales to consumers because it could harm banks' ability to attract depositors

America's Community Bankers asks Treasury to prohibit Fannie & Freddie from targeting their core customers

- Dawn Kopecki with *Dow Jones Newswire* reported that banks are concerned about Fannie and Freddie's \$1,000 investment notes (debt) sales to consumers because it could harm banks' ability to attract depositors. Fannie's program (launched in May 2001) is called "Investment Notes" and Freddie's program (launched in April 2001) is called "FreddieNOTES."
- **"Banks are very concerned because obviously these small depositors are a major base for the banks. And because Fannie and Freddie are selling these in \$1,000 increments, they are going after those clients,"** said Washington-based bank consultant Anne Canfield. **"Fannie and Freddie are government-sponsored enterprises; there's a lot of misunderstanding around that. People believe the government is behind [the notes] when it's not."**
- Kopecki noted that ads for the notes appear "harmless," with bankers arguing they look too harmless and a little too much like bank certificates of deposit. **America's Community Bankers asked the Treasury Department to prohibit Fannie and Freddie from targeting their core customers. 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 the aggressive marketing tactics Fannie and Freddie are using under the 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.**
- Bankers claim the notes aren't suitable for the little old ladies targeted by the Edward Jones ads in the weekly community newspaper in southeast Kansas promoting Freddie's notes. They probably don't understand that the GSE guarantee isn't technically the same as the one provided by the federal government, bankers said. And they certainly don't know how to price callable risk. "Do you know how to price a call option?" asked Bob Davis, a lobbyist for ACB. "The right to call the debt back if interest rates move in a way that's favorable to Fannie Mae and Freddie Mac has value in a way that the investor doesn't understand. ... The consumer doesn't know what he is giving up."
- The programs are doing well. 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)

All GSEs

GSE debt news:

- (1) Federal Reserve is still considering purchasing Ginnie Mae mortgage-backed securities for its administration of monetary policy**
- (2) Foreign investors are increasing their agency debt holdings more than their Treasury holdings**
- (3) Fannie's Chairman claims that some nations are investing more of their money in GSE debt than they are putting into their own countries**
- (4) Freddie sells its first Singapore-denominated debt**
- (5) FHLBank System may issue more long-term debt if its mortgage purchase programs continue to grow**
- (6) Fannie & Freddie's short-term debt decreases**
- (7) Sales chief at a small banking firm criticizes Freddie's euro benchmark debt program**

Background on GSE debt and the supply of Treasuries

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

Federal Reserve is still considering purchasing Ginnie Mae mortgage-backed securities for its administration of monetary policy

- According to minutes from the Federal Reserve Board's Federal Open Market Committee meeting on March 19, attendees renewed calls for the staff to study the feasibility of outright purchases for the System Open Market Account (SOMA) of mortgage-backed securities issued by Ginnie Mae, and the addition of foreign sovereign debt to the list of collateral eligible for US dollar repurchase agreements by the System.
- The minutes read, “All the members preferred continued reliance to the extent feasible on direct Treasury debt for outright System transactions, and they were persuaded that budget developments over the last year meant that constraints on Treasury debt supplies would not become as pressing an issue as soon as they had previously thought. Still, given the inherent uncertainty of budget forecasts, the likely significant needs for large SOMA operations in coming years and the lead times needed to implement new procedures, the Committee decided that the study of alternative market instruments should go forward once it was possible to do so without impeding the contingency planning effort. With regard to the two proposed alternatives for broadening the System's options for open market operations, the members instructed the staff to give a higher priority to further examination of outright purchases of GNMA-MBS. Although these securities have a number of shortcomings as an outright investment vehicle from the System's perspective, the market for GNMA-MBS was well developed and the securities were guaranteed by the full faith and credit of the U.S. government.” (*Minutes from FOMC meeting, 3/19/02*)

- Michael Derby with *Dow Jones Newswire* reported that the Fed chose purchasing Ginnie Mae MBS “the higher priority” because those securities are “risk-free,” and “because buying them would sidestep the political minefield that would come with a decision to renew the Fed’s long-halted capability to buy paper of government-sponsored enterprises like Fannie Mae and Freddie Mac.” (*Dow Jones Newswire*, Michael S. Derby, 5/9/02)

Foreign investors are increasing their agency debt holdings more than their Treasury holdings

- Fed data shows that foreign investors are increasing their agency debt holdings more than their Treasury holdings. The Fed said it held \$142 billion of agency debt in custody for foreign accounts in the week ended April 10, up from about \$133 billion at the end of last year. Treasury holdings in that period increased to \$608 billion from around \$600 billion. Last year, Treasurys holdings in those accounts gained \$10 billion while agency holdings increased nearly \$31 billion. (*Reuters*, Lynn Adler, 4/15/02)
- Foreign investors have been investing billions in agency securities because these securities have an implicit government guarantee. In the fourth quarter, foreigners bought 32% of the “agency securities” issued by Fannie, Freddie, and other similar GSEs. Non-US investors bought \$162 billion in agency securities in 2001, more than triple the 1997 number. (*Business Week Online*, 4/15/02)

Fannie’s Chairman claims that some nations are investing more of their money in GSE debt than they are putting into their own countries

- Last year, Fannie and Freddie sold billions in securities to foreign investors. Freddie sold more than \$125 billion in securities into the international markets in 2001, and Fannie sold perhaps twice that amount to foreign investors. Fannie’s Chairman Franklin Raines claimed that some nations are now investing more of their money in the US housing market than they are putting into their own countries. Neither Fannie nor Freddie will say exactly where the foreign money comes from because of confidentiality agreements, but the majority of it comes from Europe, Japan, and elsewhere in Asia. (*Chicago Tribune*, Lew Sichelman, 3/24/02)

Freddie sells its first Singapore-denominated debt

- Freddie sold for the first time Singapore-denominated bonds. It hired Deutsche Bank to help sell the bonds, worth S\$300million (\$167 million), its first sale to Singapore investors. The bonds will mature in five years. The proceeds from the issue will be swapped into US dollars. The only other Asian currency bonds issued by Freddie are two smaller issues denominated in yen and Hong Kong dollars. Louise Herrle, Freddie’s Vice President and Treasurer said, “Issuing in the Singapore dollar market helps raise the profile of Freddie Mac in the market there. It allows us to broaden our investor base for all our products,” she said in a telephone interview. (*Dow Jones Newswire*, Alan Yonan Jr., 5/13/02; *Channel News Asia*, 5/13/02; *Bloomberg News*, Michele Batchelor, 5/13/02, 5/16/02)

FHLBank System may issue more long-term debt if its mortgage purchase programs continue to grow

- If its mortgage purchase programs (Mortgage Partnership Finance (MPF) and Mortgage Partnership Program (MPP)) continue to grow at a healthy rate, the FHLBank System will likely sell more long-term bonds to fund that operation, said a spokesman for the FHLBank System on April 29. The FHLBank System said it is also planning to sell a 10-year bond, the first 10-year bond the System has sold since 1998. Regarding what has prompted the need for the new maturity, the spokesman said, “The mortgage (investment) programs have grown because they are a compelling alternative” to other options in the secondary mortgage market. “We think they will continue to grow and if they do,

prudence requires that (the FHLBank System) moves further out on the (yield) curve,” he said. Which means, for instance, that the System could issue seven- or 10-year bonds to market in the future, he said. The System typically sells debt securities of two-, three-, or five-year maturities. (*Dow Jones Newswire*, Tyler Lifton, 4/29/02) David Lindsay, fixed income portfolio manager at Columbia Management Group in Boston, plans to buy some of the new FHLBank notes because “for our accounts that use 10-year type agencies, having a name other than Fannie Mae or Freddie Mac is a nice thing to be able to do” to diversify. The FHLBank System “may do more issuance, there, but certainly they will never do as much as Fannie and Freddie do” in the 10-year sector, Lindsay said. “So probably there is a small give-up in liquidity in order to get the diversification, but to us that seems worth it.” (*Reuters*, Lynn Adler, 5/14/02)

Fannie & Freddie’s short-term debt decreases

- Fannie and Freddie’s short-term debt issuance has decreased somewhat this year, after considerable growth last year. At the end of April, Fannie’s short-term debt outstanding totaled \$284.8 billion, a \$3.7 billion net reduction from the end of 2001, a year during which Fannie’s short-term totals grew by \$65.2 billion, or 29%. In 2001, Freddie’s short-term debt increased by 66% to end the year at \$223 billion. As of May 3, Freddie’s short-term debt outstanding decreased to \$192 billion. The reduction in short-term funding results partially from the slower growth in Freddie’s mortgage investment portfolio, explained Freddie’s spokeswoman, adding that the portfolio is currently experiencing negative growth for the first time ever. Because Freddie is growing its portfolio more slowly, it has less need for debt funding, said the spokeswoman. Fannie’s spokeswoman said the GSE is selling less short-term debt this year because its purchases of mortgages in the secondary market are down and because it isn’t calling debt as quickly as it did last year, when it used short-term debt to fund those calls. (*Dow Jones Newswire*, Tyler Lifton, 5/9/02)

Sales chief at a small investment banking firm criticizes Freddie’s euro benchmark debt program

- Bankers say that Freddie, which has a successful euro benchmark program, sometimes allocates its own bonds – to the chagrin of banks that miss out. One disgruntled sales chief at a smaller firm said, “Freddie is basically a 200 pound gorilla. It can do what it wants.” (*eFinancial News*, Piers Townsend, 5/14/02)

Fannie Mae and Freddie Mac

***Christian Science Monitor* calls for GSE reform**

“In this post-Enron world of more openness and strict accounting, these two enterprises need to change. Their possible collapse due to a scandal or a downward spiral in property markets would be too costly for taxpayers to bear.”

- A recent editorial in the *Christian Science Monitor* called for reform of the GSEs. According to the *Monitor*, **“In this post-Enron world of more openness and strict accounting, these two enterprises need to change. Their possible collapse due to a scandal or a downward spiral in property markets would be too costly for taxpayers to bear.”** While the GSEs – Fannie in particular— have made steps to be more transparent, the *Monitor* said this is “not enough.”
- The *Monitor* noted that the recent bill introduced by Congressmen Shays (R-CT) and Markey (D-MA) calls for the GSEs to register their securities with the SEC. This law would force the GSEs to abide by the same laws of disclosure like other private corporations. The *Monitor* further noted that the

GSEs benefit from their GSE-status by borrowing at lower rates. They are considered to be “too big to fail,” and even Federal Reserve Chairman Alan Greenspan recently stated that Fannie and Freddie’s investors could be underestimating their risk.

- The *Monitor* concluded by noting, **“Both companies...carry systemic risk—their financial health obviously affects others...their debt could reach \$8 trillion by 2010. If Fannie or Freddie ever need a federal bailout, what happened at Enron could look more like a small tremor.”** However, the two GSEs have considerable political clout. The GSEs gave over \$4 million in 2000 to both parties, and the *Monitor* asks, **“Could all that money not possibly affect related legislation? Forcing greater financial transparency and de-politicizing Fannie and Freddie would do wonders for the long-term stability of both entities – and for the taxpaying public.”** (*The Christian Science Monitor*, Editorial, 4/29/02)

***Business Week* article notes that conservatives and liberals have seized on the Enron scandal to charge that, like Enron, Fannie & Freddie “keep investors in the dark and don’t disclose enough information about their operations, including risky trading in derivatives”**

- Rich Miller with *Business Week* reported that Fannie and Freddie’s supporters celebrated two years ago when the GSEs “disarmed critics on Capitol Hill and inside the Clinton White House by agreeing to a series of largely cosmetic changes in the way they do business. But no one is partying now.”
- According to Miller, **“Enron’s implosion has put Fannie and Freddie in the political crosshairs once more. And this time the threat may be more serious. A clutch of critics--from conservative ideologues against big government to liberal advocates of more affordable housing--have seized on the scandal to charge that, like Enron, the two companies keep investors in the dark and don’t disclose enough information about their operations, including risky trading in derivatives.”**
- Miller noted that behind the charges is the **“concern that future financial missteps by Fannie and Freddie could send tremors through the financial markets and the economy, leaving the government on the hook for a multibillion-dollar bailout.”** He further wrote, “Thanks to implicit federal subsidies, the two have grown so large through their issuance of mortgage-backed securities that they account for nearly half of the home-finance market.”
- The **“Shays-Markey” bill, in Miller’s opinion, “has gained unexpected momentum.”** Miller concluded, “Up to now, Fannie and Freddie have remained in control of events. **But as other business giants...have learned, the Enron scandal might be the force that alters that path of even the most powerful corporations.”** (*Business Week*, Rich Miller, 5/13/02)

Fannie Mae

Fannie’s derivatives credit exposure increased in the first quarter

- Fannie’s derivatives credit exposure increased in the first quarter but still remains relatively low, according to a first quarter financial report released by Fannie. Tyler Lifton with *Dow Jones Newswire* reported that accounting for collateral held, Fannie’s derivatives portfolio exposed the company to \$200 million in potential credit losses, as measured by the amount it would cost the company to replace those contracts should all of its counterparties default. At December 31, 2001,

Fannie's credit exposure, when collateral was accounted for, totaled \$110 million. At the end of March, double-A rated counterparties accounted for \$156 million of Fannie's credit exposure, while single-A rated counterparties held \$44 million of the agency's exposure. That compares to a \$566 billion notional balance, or face value, for Fannie's entire derivatives portfolio. A Fannie spokesman said that the GSE took on more derivative exposure during the first quarter to double-A rated counterparties because double-A rated counterparties aren't required to post as much upfront collateral as are lower rated counterparties. Fannie's credit exposure remains higher until the full amount of collateral is collected, the spokesman said. Freddie's derivatives' counterparty credit risk at the end of last year totaled \$69 million versus a \$1.05 trillion notional balance on its derivatives portfolio. Freddie has not yet released its comparable first quarter data figures. (*Dow Jones Newswire*, Tyler Lifton, 5/14/02)

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

Fannie has 51 Partnership Offices open across the country

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

Fannie has 51 partnership offices

- According to Fannie's Web site, the company has 51 partnership offices open across the country (http://www.fanniemae.com/contact/partnership_offices.html) 5/15/02).

Senator Jon Corzine (D-NJ) and New Brunswick Mayor James Cahill

- Fannie joined the above named officials to announce a \$9 million bond issuance that will provide mortgage financing for the conversion of the old Middlesex County Office building into 70 market-rate rental apartments; 14 units will be reserved as affordable rental housing. (*Fannie press release*, 4/22/02)

Senator Tim Johnson (D-SD)

- Fannie joined with Senator Johnson to announce the availability of Security 100, a low down-payment mortgage product from Security Mortgage Corporation and a new \$3 billion statewide affordable housing plan for South Dakota. (*Fannie press release*, 5/6/02)

Congressman Hal Rogers (R-KY)

- Fannie announced mortgage relief for flood victims in Kentucky. A statement of support by Congressman Rogers was included in Fannie's press release. (*Fannie press release*, 5/13/02)

Congressman Steny Hoyer (D-MD)

- Fannie announced mortgage relief for tornado victims in Maryland. A statement of support by Congressman Hoyer was included in Fannie's press release. (*Fannie press release*, 4/30/02)

Congressman Mike Pence (R-IN)

- Fannie joined Congressman Pence in convening a housing roundtable with East Central Indiana employers to discuss Fannie's Employer Assisted Housing program. (*Fannie press release*, 4/26/02)

Congressman Bill Jenkins (R-TN)

- Fannie joined with Congressman Jenkins to announce the grand opening of Doe Ridge Apartments in Johnson City, TN. (*Fannie press release, 4/22/02*)

Congressman J.C. Watts, Jr. (R-OK)

- Fannie joined with Congressman Watts in convening a housing roundtable. (*Fannie press release, 4/17/02*)

Other local officials with whom Fannie held press opportunities:

- (1) Reno, NV Mayor Jeff Griffin (*Fannie press release, 5/10/02*)
- (2) Philadelphia, PA Mayor John Street (*Fannie press release, 5/6/02*)
- (3) Norwalk, CT Mayor Alex Knopp (*Fannie press release, 5/3/02*)
- (4) Farmington, UT Mayor (*Fannie press release, 5/9/02*)
- (5) Montgomery, AL Mayor Bobby Knight (*Fannie press release, 4/22/02*)
- (6) Missoula County, MO Commissioner Jean Curtiss (*Fannie press release, 4/22/02*)
- (7) Fargo, ND Mayor Bruce Furness (*Fannie press release, 4/18/02*)
- (8) Miami-Dade County, FL Commissioner Dennis Moss (*Fannie press release, 4/19/02*)
- (9) Kansas City, MO Council members Troy Nash and Mary Williams-Neal (*Fannie press release, 4/26/02*)
- (10) Evansville, IN Mayor Russell Lloyd, Jr. (*Fannie press release, 4/17/02*)

Freddie Mac

***Forbes* article calls Freddie's new "Range Notes" lucrative but "scary"**

- **Marilyn Cohen with *Forbes Magazine* called Freddie's "Range Notes," which pay three to four points over the yield on investment grade bonds, "lucrative but scary." She claimed the notes challenge investors "to a game of interest rate chicken" and she has "put up a yellow light for these investments."** Cohen is President of Envision Capital Management, a Los Angeles fixed income money manager.
- Freddie has outstanding some \$5 billion of medium-term structured notes. Cohen defined "structured" as meaning that an investor does not have a simple coupon. For example: the Freddie Mac structured note maturing February 28, 2012, issued in January. The nominal coupon is 10.125% a year, about four points better than what you would expect on a ten-year Freddie. But you earn that 10.125% only on days when a money market interest rate (specifically, the three-month London Interbank Offered Rate, for dollar loans) stays below 7%. On days when Libor tops 7%, your investor coupon drops to 0%. Freddie Mac can call the note at any time after the first three months."
- For investors considering this product, Cohen offers five caveats.
 - (1) "First, don't for a moment think that this is a bond with a 10% yield and compare it to other yields available in the bond market. What you've got is a 6% bond coupled with a side bet in which you collect 4% for writing an insurance policy for Freddie Mac..."
 - (2) "Second, that call feature is bad news...It's like a poker game in which Freddie has the option of folding after the cards are dealt, losing only the ante, but if you get dealt a bad hand, you have to put more money into the pot."

- (3) “Third, know that if you want to play interest rate chicken, there are better ways to do it...you could buy a conventional Treasury bond and then, using a small part of your funds, take a modest flier in the options market...”
- (4) “Fourth, liquidity can be low...This means your chances of getting out before maturity at a good price are slim.”
- (5) “Fifth, think about who is selling you this note. Freddie Mac is not in the business of handing out excess returns to small investors...” (*Forbes Magazine*, Marilyn Cohen, 4/29/02)

David Stevens to head Freddie’s single-family lending

- Freddie Mac announced that David H. Stevens, senior vice president and general manager of the Community Lending division, has assumed responsibility for leading the National Lending division. Stevens will continue to manage efforts in Freddie’s Community Lending area. Each lending division will continue to operate independently under separate business models. Stevens will provide an integration point to ensure the needs of both National and Community lenders are met. He is responsible for directing all aspects of customer management including creating innovative customer execution strategies, overseeing affordable housing initiatives and serving as the company’s principal customer contact. Stevens joined Freddie in 1999. He reports to Paul T. Peterson, Freddie’s Executive Vice President of Single Family. Prior to joining Freddie, Stevens spent 16 years at World Savings where he held several senior executive positions. He holds a Bachelor of Arts degree from the University of Colorado, Boulder. (*Freddie press release*, 5/9/02)

Federal Home Loan Banks

Regulatory relief bill (HR 3951), which contains a provision that would allow privately insured credit unions to join the FHLBank System, passes the House Financial Services Financial Institutions Subcommittee

House Financial Services Committee Chairman Michael Oxley (R-OH) says the FHLBank provision is a “common sense provision” and “of particular importance” to him

American Bankers Association (ABA), America’s Community Bankers (ACB) and the Independent Community Bankers (ICBA) oppose this provision

FHLBanks are neutral on the issue

- The House Financial Services Subcommittee on Financial Institutions passed HR 3591 on May 8 by voice vote. The bill now heads to the full Financial Services Committee. Among other items, the bill contains a provision allowing privately insured credit unions to join the FHLBank System. (*House Financial Services Committee press release*, 5/8/02) Currently, such 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. If that statistic is any indication, then the 12 FHLBanks could expect to pick up an average of two members should privately insured credit unions be permitted to join. (*American Banker*, Laura Thompson, 5/8/02)
- Chairman Oxley noted in a prepared statement on the bill that “of particular importance” to him was the provision allowing privately insured credit unions to join the FHLBank System. Chairman Oxley

stated: “As the state credit union supervisors testified at our last hearing, this provision would present no safety and soundness risk and would give these institutions access to a stable and cost efficient source of liquidity; thereby, helping these institutions to better serve their members. It is fully consistent with current federal law, for example, most credit unions and even insurance companies can already become Home Loan Bank members. It is a common sense provision and I am pleased it is a part of this important legislation.” (*Prepared, Not Delivered, Opening Statement of Chairman Oxley, 5/8/02*)

- As noted in the May 3, 2002 *GSE Report*, the ABA, ACB, and the ICBA oppose this provision.
- Laura Thompson with the *American Banker*, noted that the FHLBanks are neutral on the issue. John von Seggern, the president and chief executive officer of the Council of Federal Home Loan Banks — the trade group representing 10 of the 12 banks — said that his members are in no position to tell Congress what to do and that any position they take could be misconstrued. “If we are going to lobby for additional members, that’s not a smart thing for us to do,” he said. Melissa Dallas, a spokeswoman for the FHLBank of Cincinnati agreed that most privately insured credit unions would meet criteria for membership. “I think that under the collateral underwriting guidelines we feel pretty confident that privately insured credit unions could use the FHLB to meet their needs,” she said. (*American Banker*, Laura Thompson, 5/8/02)

Federal Housing Finance Board (FHFB) approves the FHLBanks of Boston and Pittsburgh’s capital plans at its May 8 meeting

FHFB expects to approve all 12 FHLBank capital plans by the summer; FHFB has approved 4 of the 12 FHLBank capital plans so far

- The FHFB approved the FHLBanks of Boston and Pittsburgh’s capital plans at its May 8 meeting. The FHLBank of Pittsburgh’s plan does not include a stock purchase requirement on participating members, while the FHLBank of Boston’s capital plan requires a stock purchase requirement. FHFB Chairman John Korsmo issued an April 23 staff memo on the capital plans directing staff not to reject capital plans that initially set charges for mortgage purchase plan activities at “0%,” if the overall plans are otherwise sound and comply with board regulations. (*Dow Jones Newswire*, Jennifer Corbett Dooren, 5/8/02) Chicago FHLBank President Alex Pollock had warned the FHFB that a stock purchase requirement would cripple the FHLBank’s Mortgage Partnership Finance (MPF) program, and participating FHLBank members would go back to selling their loans to Fannie and Freddie. (*National Mortgage News Daily Web site*, 4/26/02)
- There was sharp disagreement among the FHFB Board Members on the capital plans, reported Richard Cowden with *BNA*. FHFB Board Members Franz Leichter and Allan Mendelowitz voted against the FHLBank of Boston capital plan on the basis of last minute changes made in the Boston’s capital plans in response to FHFB Chairman Korsmo’s April 23 staff memo. The original plan by the FHLBank of Boston required a stock purchase requirement, ranging between 3 and 6% for Acquired Member Assets [AMA] under the MPF program. In a May 1 letter to Leichter, Michael Jessee, President and Chief Executive Officer of the Boston FHLBank, said its plan upon implementation would require members to hold 4.5% capital stock against AMA activities. However, he added, “We believe that is appropriate as a starting point, but as MPF and other AMA programs evolve, we need the flexibility to capitalize these programs in the most efficient manner possible...” Leichter and Mendelowitz objected to this change of course. The Boston plan, however, was adopted on a 3-2 vote with FHFB Board Members J. Timothy O’Neill and John Weicher and FHFB Chairman Korsmo

voting in favor of the plan. The FHFBS voted unanimously for the Pittsburgh's FHLBank capital plan, which included a capital charge for AMA activity ranging as low as 1%. However, Leichter and Mendelowitz voted in favor of it because the bank included in its plan a bank board resolution pledging to adhere to a capital sufficiency test, which they viewed as an extra safety and soundness safeguard. (*BNA Daily Report for Executives*, Richard Cowden, 5/9/02)

FHFBS is evaluating the capital plans for the 12 FHLBanks

- The Gramm-Leach-Bliley Act (GLB), signed into law on November 12, 1999, amended the provisions of the FHLBank Act that relate to the capital structure of the FHLBanks. The law mandated the replacement of the existing subscription capital structure with a modern capital structure, with risk-based and leverage capital requirements that are similar to those of depository institutions. (*FHFBS press release*, 3/13/02) As required by GLB, all of the FHLBanks submitted proposed capital structure plans to the FHFBS by October 29, 2001. Each FHLBank must obtain FHFBS approval of its internal risk model and risk assessment procedures and controls prior to implementing its capital plan. (*FHFBS press release*, 2/13/02)
- The FHFBS has approved capital plans for the FHLBanks of Seattle, Atlanta, Boston and Pittsburgh. It expects to approve all 12 FHLBanks by the end of the summer. (*Dow Jones Newswire*, John Connor, 5/7/02)

FHFBS Chairman John Korsmo tells FHLBank Directors he plans to reaffirm “the bright red line of separation” between the FHFBS and the FHLBank System

- FHFBS Chairman John Korsmo told new FHLBank directors at a May 13 orientation that he plans to reaffirm “the bright red line of separation” between the FHFBS and the FHLBank System it regulates. “It’s very difficult sometimes not to say ‘we’ when referring to the Federal Home Loan Banks, but the fact is, the Finance Board is not part of the system. It is its regulator,” Korsmo said in prepared remarks. “My goal is to reaffirm what I call the ‘bright red line’ of separation between the Finance Board and the System, a separation demanded by Gramm-Leach-Bliley. I will still say hello to you on the street, but when it comes to the Federal Home Loan Banks, I will not substitute my business judgment for that of the directors and executives of the banks.” (*Dow Jones Newswire*, Dawn Kopecki, 5/13/02; *Remarks by FHFBS John Korsmo at the 2002 FHLBank Directors’ Orientation*, 5/13/02)

FHFBS is considering expanding the System’s Office of Finance to include all 12 FHLBanks

- FHFBS Chairman John Korsmo, speaking May 13 to the Independent Community Bankers Association said that the FHFBS is considering expanding the System’s Office of Finance to include all 12 FHLBanks. The office, which issues the consolidated debt obligations by which the system raises its funds, currently consists of just two bank presidents and a public interest director who serves as chairman. The expansion, Korsmo said, was suggested by the banks to help cut down on the costs of raising money in the debt markets. “It makes sense to me that all banks should be represented on that board, along with the public interest chairman,” Korsmo said. “I have also suggested to the presidents that it is critical that the effort succeed - a government-sponsored enterprise is obliged to the taxpayers to be efficient at raising funds at favorable rates.” Korsmo noted that he is also seeking a new individual to serve as the public interest director to head this expanded board of directors of the System’s Office of Finance. “The current chairman is John McEvoy, who has done an excellent job that I greatly appreciate,” Korsmo said. “However, his term has expired.” Korsmo added, “I am searching for a special individual to serve as the board’s new chairman – 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*, Dawn Kopecki, 5/13/02; *Dow Jones Newswire*, John Connor, 5/14/02; *Remarks by FHFBC Chairman Korsmo to the ICBA*, 5/13/02)

FHFBC names new Deputy Director of the Office of Supervision

- The FHFBC announced that Christie A. Sciacca will join the FHFBC as Deputy Director of the Office of Supervision on June 3. Sciacca is currently an Associate Director in the Division of Supervision at the Federal Deposit Insurance Corporation (FDIC). He started his career at the FDIC as an examiner in 1973. His most recent tenure at FDIC began in September 1996, and he has served in a number of leadership positions in supervision. Sciacca will work with the newly appointed Director of the Office of Supervision, Stephen M. Cross, who starts at the FHFBC on Monday, May 20.
- Sciacca previously served as Director of the FDIC’s Bank Technology Group, which was formed in May 2000 to establish the FDIC as a leader in developing policy in response to advances in bank technology. He also headed the Chairman’s International Initiative, a major outreach effort aimed at advancing international communication and coordination on deposit insurance issues. Sciacca has also served in the FDIC’s Division of Supervision as Associate Director of Policy, charged with shaping the agency’s supervisory and examination policies and practices, and as Assistant Director and head of the International Branch of the Division of Supervision. From 1986 to 1996, Sciacca was a founding partner and managing director with The Secura Group, a Virginia-based financial consulting firm. Prior to that, he spent 13 years at the FDIC, holding such positions as Assistant to the Chairman and Examination Specialist. As Deputy Director of the Office of Supervision, Sciacca will head the Finance Board’s team of bank examiners. (*FHFBC press release*, 5/15/02)

Farm Credit System

Farmer Mac issues \$35 million in preferred stock

- Farmer Mac announced that it has issued \$35 million (700 thousand shares) of fixed rate perpetual preferred stock that is cumulative as to dividends—the Corporation’s first-ever preferred stock issuance. The preferred stock, designated Series A, was offered to investors at \$50 per share with a fixed dividend rate of 6.40%. Dividends will be paid quarterly starting on June 30, 2002, and Farmer Mac will have the option to redeem all or part of the shares at \$50 per share plus accrued dividends at any time on or after June 30, 2012. The offering is structured to be eligible for the “Dividends-Received Deduction” under current federal tax law. Proceeds from the issue will be used for general corporate purposes. Bear, Stearns & Co. Inc. acted as the sole underwriter for the issue. The issuance, which has been under way for several months, increases Farmer Mac’s regulatory core capital from \$134.0 million as of March 31, 2002, to over \$169.0 million, and more than \$56.0 million in excess of its minimum capital requirement. (*Farmer Mac press release*, 5/6/02)

Farm Credit Administration (FCA)'s final rule allowing a Farm Credit System institution to terminate its Farm Credit System charter and become a financial institution is effective May 13

- As noted in the April 19, 2002 *GSE Report*, the FCA Board approved a final rule at its March 21 Board meeting allowing a System institution to terminate its FCS charter and become a bank, a savings and loan association, or other financial institution under Federal or state chartering authority. (*BNA Daily Report for Executives*, 4/8/02) The final rule was published in the April 8 *Federal Register* and will become effective 30 days after publication in the *Federal Register* during which either one or both houses of Congress are in session. (*Federal Register*, pages 17907-17917, 4/8/02) The FCA announced that the effective date of the rule is May 13, 2002. (*Federal Register*, pages 31938-31939, 5/13/02)
- The final rule amends existing regulations, in effect since 1991, so they apply to all System banks and associations, according to the FCA. The current rule excludes large banks and associations whose investment in its affiliated bank is greater than 25% of the bank's loans. FCS institutions were given authority to terminate System status by the Agricultural Credit Act of 1987. The rule provides clear procedures for termination of FCS status and ensures that all stockholders are treated fairly and equitably and that disclosure materials are easy to read and understand. The rule also ensures that non-terminating System institutions can continue to serve the credit needs of farmers, ranchers, and cooperatives. (*BNA Daily Report for Executives*, 4/8/02)

Ginnie Mae

National Association of Realtors discuss "Ginnie Mae Choice" at their midyear legislative meeting

"Ginnie Mae Choice" supporters believe that the program could capture up to 20% of the high loan-to-value market now controlled by Fannie & Freddie

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

- The National Association of Realtors discussed proposed Ginnie Mae Choice legislation at its 2002 midyear legislative meeting in May. (*US Newswire*, 5/15/02) There are currently two versions of "Ginnie Mae Choice" bills. The bills were introduced by Senator Wayne Allard (R-CO) and Congresswoman Marge Roukema (R-NJ) on November 1, 2001. Both would allow Ginnie Mae to securitize privately insured mortgage loans for the first time and allow Ginnie Mae to compete with Fannie and Freddie in the secondary mortgage market. (*Reuters*, Mark Felsenthal, 12/3/01)
- NAR's Ginnie Mae Choice panel featured Ann Schnare, Chairwoman for the Center for Housing Policy and representing the Mortgage Insurance Companies of America and Susan Wachter, professor of Real Estate and Finance at the Wharton School, University of Pennsylvania. Schnare stressed that this program would increase competition in the secondary mortgage market, qualify more borrowers for low-cost convention loans, result in a stronger Federal Housing Administration (FHA) loan program and increase net revenue to HUD. Wachter believes that the program would undermine the FHA program, increase the government's exposure to risk, negatively impact the federal budget, and fail to address disparities in homeownership rates. (*US Newswire*, 5/15/02)

- *National Mortgage News* reported that Schnare stated during the NAR's meeting that the Ginnie Mae Choice program could capture up to 20% of the high loan-to-value market now controlled by Fannie and Freddie. (*National Mortgage News Daily Web site*, 5/14/02)
- **Industry and political observers said Ginnie Mae Choice could pose a major competitive threat to Fannie and Freddie. Several analysts have said that a larger role for Ginnie Mae would stimulate competition through lower guarantee rates and better execution for mortgage banks. That would in turn check the growth of Fannie and Freddie, observers said.** (*American Banker*, Tommy Fernandez, 2/11/02)

Postal Service

Senate Subcommittee holds May 13 hearing on the Postal Service's transformation plan

GAO Comptroller David Walker believes the transformation plan was a "good first step" but "does not adequately address certain key issues"

Walker suggests Congress create a commission (similar to a base closing commission) to help make the unpopular choices necessary to solve the Postal Service's structural problems

- The International Security, Proliferation and Federal Services Subcommittee of the Senate Governmental Affairs Committee held a hearing on the Postal Service's transformation plan on May 13. Postmaster General John Potter and GAO Comptroller General David Walker testified.

Background on Transformation Plan:

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

Postmaster General John Potter

- Potter noted that the Postal Service's current operating charter is no longer adequate. The transformation plan that the Postal Service submitted to Congress recently is "about our need to change," said Potter. "It is a blueprint for modernizing every aspect of the way we do business." In the near term, however, the Postal Service will be conducting activities to modernize the system now. One such change is that the Postal Service has lifted the moratorium on closing post offices. Potter warned, however, that "this does not mean that there will be wholesale post office closings. But it does mean that we will restart the process to close those offices that have been 'suspended' or effectively closed, in some cases for more than a decade." Potter noted that these postal service closings are consistent with the transformation plan. Other near-term changes include (1) consolidating the postal service's existing processing network; (2) more aggressive purchasing strategies that leverage the USPS' size and buying ability; (3) improving union dispute resolution processes; and (4) modernizing the rate process under the existing regulatory framework.
- Potter noted that the Postal Service recommends that transforming the current Postal Service into a Commercial Government Enterprise would "put the Postal Service on a more businesslike footing, while keeping it dedicated to its mission of universal service." Potter stated that this "commercialized Postal Service" would provide the management tools that are available to private-sector businesses as we work to improve service to our customers, manage costs more efficiently and leverage our assets to generate new revenue opportunities." (*Statement of John Potter before the International Affairs, Proliferation, and Federal Services Subcommittee of Senate Governmental Affairs Committee, 5/13/02*)

GAO Comptroller General David Walker

- Walker stated that the need for a comprehensive transformation of the Postal Service "is more urgent than ever." The Postal Service is "a business model that does not work in the 21st century," he said. "The service's financial difficulties are not just a cyclical phenomena that will fade as the economy recovers." Walker stated, "We believe the service's worsening financial condition intensifies the need for Congress to act on meaningful reform and transformation legislation." Walker believes that the Postal Service's transformation plan was a "good first step." While the plan "provides a wealth of information about the Service's challenges, identifies numerous actions the Service plans to take under its existing authority, and outlines steps that would require congressional action," the plan "does not adequately address certain key issues or include an action plan with key milestones." (*Statement of David Walker before the International Affairs, Proliferation, and Federal Services Subcommittee of Senate Governmental Affairs Committee, 5/13/02; Bloomberg News, Bill Murray, 5/13/02; Reuters, Christopher Doering, 5/13/02*)
- Walker noted that Postal Service's plan "did not adequately address some key transformation issues that will need to be addressed for any transformation effort to be successful. These issues include the definition of universal postal service; strategies to address certain human capital matters such as postal pay comparability, performance management issues, management bonus arrangements, and workforce deployment and utilization; the Service's governance structure, transparency, and accountability mechanisms; and what mechanisms would be best suited for making progress on unresolved transformation issues." (*Statement of David Walker before the International Affairs, Proliferation, and Federal Services Subcommittee of Senate Governmental Affairs Committee, 5/13/02*)
- Walker suggested that Congress create a commission (similar to a base closing commission) to help make the unpopular choices necessary to solve the Postal Service's structural problems. "Real transformation will require tough choices, shared sacrifices and that it is unrealistic to expect that

given the complexity and controversy associated with these issues, that there will be consensus,” said Walker. No lawmaker will like the idea of voters complaining about the closure of their post offices, so putting together a commission is probably the only way to get it done. “In the end, nobody likes to close anything, and change is difficult,” said Walker. (*Bloomberg News*, Bill Murray, 5/13/02; *Associated Press*, 5/13/02)

- Potter did not sound enthusiastic about Walker’s plan for a commission, saying the Postal Service would prefer legislation that would allow it to close less-used post offices on its own. Currently, the Postal Service cannot close post offices without Congress’ approval, Potter said. (*Associated Press*, 5/13/02)

Statements by Senators

- Senator Daniel Akaka (D-HI), who chaired the hearing, found “details that were not clearly defined” in the transformation plan and requested that Potter return with a step-by-step proposal for reducing the Postal Service’s debt. (*Washington Post*, Stephen Barr, 5/14/02) “The Postal Service’s financial house has to be in order before it will be granted more flexibility,” he stated. (*Reuters*, Christopher Doering, 5/13/02) Senator Akaka noted that his subcommittee would hold several more hearings in the near future on postal reform. (*BNA Daily Report for Executives*, Derrick Cain, 5/14/02)
- Senator Mark Dayton (D-MN) questioned what a postal reinvention might accomplish, given the Postal Service’s mandate to provide mail service to all Americans. “I don’t see how you can do any better by getting into some sort of transformation.” (*Washington Post*, Stephen Barr, 5/14/02)
- Senator Ted Stevens (D-AK) cautioned against moving ahead on an immediate transformation effort and suggested the Postal Service wait until at least 2015 to reinvent itself. In the meantime, Congress could consider annual appropriations to ease the Postal Service’s debt load. (*Washington Post*, Stephen Barr, 5/14/02)

Postal Service Inspector General testifies that Postal Service’s workers’ compensation has contributed to the financial troubles at the Postal Service

- Karla Corcoran, Inspector General of the Postal Service told a House Government Reform Subcommittee that since 1998, annual Postal Service workers’ compensation costs have increased by 29% from \$567 million to \$731 million, contributing to financial troubles at the Postal Service. (*Testimony of Karla Corcoran before the House Committee on Government Reform’s Subcommittee on Government Efficiency, Financial Management and Intergovernmental Relations*, 5/9/02)

Postal Service halves its 2002 projected deficit; Postal Service will cut 20,000 jobs

- Postmaster General John E. Potter announced that the Postal Service faces a projected net loss of approximately \$1.5 billion in fiscal year 2002, with mail volume for the year expected to drop some six billion pieces below last year’s total. Despite the magnitude of this decline, Potter said cost-containment actions taken by the Postal Service have reduced this estimated net loss well below earlier projections that ranged as high as \$4.5 billion. Measures taken to minimize the loss include reducing the number of career employees by 20,000 this year through attrition, and that 60 million work hours will be cut compared to last year. A number of program expenditures also have been postponed, resulting in more than \$2 billion in reduced expenses. (*Postal Service press release*, 5/7/02)

Mailers Council calls on White House to create postal reform commission to study Postal Service

Direct Marketing Association, which is a member of the Mailers Council, calls commission premature

Mailers Council calls on White House to create postal reform commission to study Postal Service

- The Mailers Council, the nation's largest coalition of mailers and mailing associations, called on the White House to create a Presidential Commission on Postal Reform to evaluate the Postal Service. In a letter to President Bush, Mailers Council Executive Director Bob McLean noted that the USPS has found it increasingly difficult to provide universal service at an affordable price. The USPS reported a loss of \$1.7 billion in 2001 and projects a deficit of \$1.5 billion this fiscal year. Annual retirement plan costs will escalate to \$14 billion by 2010. The difficulties of the USPS are so severe the General Accounting Office put the agency on its High-Risk List, primarily because GAO believes billions of dollars in taxpayer money are at risk.
- Mailers "are gravely concerned about the financial stability of the USPS," McLean said in the letter. "This agency delivers essential services to millions of American citizens. It is part of a \$9 billion industry that provides jobs for nine million workers. Those essential services and the mailing industry, however, are threatened by a growing list of financial problems that deserve the administration's immediate attention."
- Congress will consider legislation to aid the Postal Service this month, McLean said, "and we will be pleased if such a bill addresses some of our concerns. However, many issues may be left unresolved that must be addressed now. A presidential commission would study the Postal Service and recommend changes to cope with the current challenges to its core mission." McLean noted that because of the importance of the Postal Service to the nation's economy, the Mailers Council believes this commission "must be named as quickly as possible and directed to submit a written report to the President outlining its recommendations within nine months of the commission's creation." (*Mailers Council press release, 5/13/02*)

Direct Marketing Association calls commission premature

- The DMA said that though a commission might prove desirable at some point, it also could delay needed postal reform legislation, reported Melissa Campanelli with *DMNews*. "I am very concerned that both the evolving bipartisan legislative effort and Postmaster General [John E.] Potter's strong public efforts to improve the efficiency of the service could be seriously undermined," DMA president/CEO H. Robert Wientzen said. "While we can certainly understand the frustration that appears to have moved many Mailers Council members to support a presidential commission, deferring to a commission now would result in a serious setback for the entire mailing industry. A commission would only be useful now in conjunction with effective legislation aimed at meaningful reform. A long, drawn-out effort would prove very costly to the postal service, the business mailing community and a sizable chunk of the nation's economy, putting many of those 9 million private sector jobs in jeopardy. We need to move ahead now to correct the problems by making the changes we can and assign the intractable issues to a study commission later. To defer to a commission now would let Congress off the hook." (*DM News, Melissa Campanelli, 5/14/02*)

Representatives from 16 companies meet with Congressman Tom Allen (D-ME) to discuss Postal Service reform to avoid huge rate increases

- Representatives from 16 companies met with Congressman Allen on May 7 to talk about the need for reform of the Postal Service to avoid huge rate increases, reported the *Portland Press Herald*. Denise Wilson, a Democratic staff member of the House Government Reform Committee, said there appears to be bipartisan support for reforming the Postal Service. She noted that the Committee is working on a bill that would give the Postal Service more flexibility to make business decisions and speed up the rate-making process. Allen said even though the reform bill will likely be controversial, it appears that the Committee will get a chance to vote on it this year. (*Portland Press Herald*, Edward D. Murphy, 5/8/02)

Postal Service to hold May 28 Ratemaking Summit

- Postmaster General John Potter announced that a historic Ratemaking Summit would be held May 28 in Potomac, MD. Jointly sponsored by the Postal Service and the independent Postal Rate Commission, the summit will focus on how the process and approach for establishing and changing postal rates in major “omnibus” cases can be improved. A topic of discussion at the Summit will also include the Postal Service’s transformation plan, which was released April 5. (*Postal Service press release*, 5/7/02)

White House is considering Acting Governor Jane Swift (R-MA) for a part-time position on the board that oversees the Postal Service

- *Boston Globe’s* Glen Johnson reported that the White House is considering Acting Governor Swift for a part-time position that would pay her up to \$42,000 annually to serve on the board that oversees the Postal Service, according to two Republican Party operatives. “I can’t comment on any job offers, but she would certainly be flattered to serve in that position or to be thought of as somebody who could be of use to the federal government in that position,” said Swift spokesman James Borghesani. Two positions on the board, including one held by a former governor, are slated to come open less than a month before Swift’s terms ends on January 2, 2003. (*Boston Globe*, Glen Johnson, 5/10/02)

Postal Service hopes to save \$200 million over the next five years by overhauling its Intranet

Postal Service’s network is the third largest in the world

- *CNET News’* Margaret Kane reported that the Postal Service hopes to save \$200 million over the next five years by overhauling its Intranet, according to postal officials. The Postal Service plans to centralize computer systems for 130,000 people at some 28,000 facilities nationwide. Among other things, the project calls for (1) eliminating redundant and older software packages; (2) replacing 85 district help desks with one central desk; (3) dropping the number of servers from 13,000 to 1,500; and (4) consolidating the number of support locations from 11,000 to 540. (*CNET News*, Margaret Kane, 5/10/02) With 130,000 users in 28,000 locations, the Postal Service’s network is the third largest in the world, surpassed in size only by Wal-Mart Stores Inc. and the Defense Department, postal officials said. (*Federal Computer Week*, William Matthews, 5/10/02)

May 17, 2002

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