

The **GSE** REPORT TM

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- Congressman Ken Bentsen (D-TX) introduces a bill (HR 5696) to remove OFHEO from the appropriations process [\(p. 11\)](#)
 - Congressmen Richard Baker (R-LA), Congressman Paul Kanjorksi (D-PA), and Congresswoman Carolyn Maloney (D-NY) are co-sponsors of the bill
 - OFHEO is the only federal financial regulator subject to the appropriations process
 - Bush Administration and OFHEO support removing OFHEO from the appropriations process
- Class action suit filed against Freddie’s automated underwriting (AU) system shortly after a class action discrimination lawsuit was filed against Fannie over its AU system [\(p. 13\)](#)
 - HUD expects to release its fair-lending review of Fannie & Freddie’s AU systems by year-end
 - HUD has been investigating Fannie & Freddie’s AU system for fair lending violations since 1999
 - HUD will also consider Fannie & Freddie’s affordable housing goals in 2003
- Freddie’s Chairman Leland Brendsel expresses interest in entering the jumbo market (loans above the conforming loan limit) and mortgage insurance market [\(p. 15\)](#)
 - Fannie & Freddie are prohibited from entering these markets
 - The conforming loan limit [the limit on the loan amount Fannie & Freddie can purchase] may increase to \$325,000 in 2003
- LendingTree terminates its \$2.5 million loan from Freddie [\(p. 17\)](#)
 - HUD and OFHEO have been reviewing Freddie’s loan for over a year (no reports have been issued to date)
 - America’s Community Bankers raised concerns that the loan violated Freddie’s charter and accused Freddie of acting like a commercial bank
 - FM Watch also claimed Freddie’s investment violated its charter
- FHFB Chairman John Korsmo says the FHLBanks may go beyond Fannie & Freddie’s recent voluntary financial disclosure agreement and serve as a “role model” for GSE financial disclosures [\(p. 18\)](#)
 - FHLBank officials appear to support adopting SEC-like disclosure standards for FHLBank debt securities and mortgage-backed securities (MBS) unlike Fannie & Freddie, which oppose such disclosures
 - Treasury Department called on all GSEs to comply with the same SEC disclosure requirements recently agreed to by Fannie & Freddie
 - Analyst James Bianco of Bianco Research calls Fannie & Freddie’s voluntary disclosures “kabuki theater”
- Senate Banking Committee Chairman Paul Sarbanes (D-MD) asks for more information from FHFB Chairman John Korsmo about his participation in a political fundraiser for which Presidents of the FHLBanks were asked to contribute [\(p. 19\)](#)
 - Federal investigators search the FHFB’s offices as part of an examination requested by Senator Sarbanes
 - Korsmo admits acquiring information about the political contributions of FHLBank executives

- *Tax Notes* publication publishes extensive tax analysis of Fannie’s use of its non-profit foundation to run self-promotional ads ([p. 22](#))
 - “Competitors see this issue of the foundation as yet another taxpayer subsidy to Fannie Mae in addition to its implicit government guarantee and its valuable exemption from state and local income taxes.”
 - “If Exxon, for example, asked for a ruling that a private foundation be allowed to promote its products, it would probably be turned down; but Fannie Mae’s foundation promotes Fannie Mae’s governmentally sanctioned mission.”
 - “Fannie Mae’s transfer of its advertising campaign to a private foundation may be yet another example of the migration of taxable functions to tax-exempt organizations”
- American Enterprise Institute (AEI) holds October 25 conference on Fannie & Freddie to discuss the degree to which Fannie & Freddie lower mortgage interest rates ([p. 24](#))
 - Panelists note that Fannie & Freddie do not lower mortgage interest rates enough to increase homeownership
 - For all the federal subsidies given to Fannie & Freddie, their impact for most homebuyers is negligible
 - Joseph McKenzie of the Federal Housing Finance Board, noted that Freddie, and to a lesser extent Fannie, have media ad campaigns that tout the effect of the GSEs on mortgage rates and use data comparing the mortgage interest rate differential between conforming and jumbo loans as evidence of their effect on lowering mortgage costs. McKenzie noted that Freddie’s calculation of this differential is incorrect

Fannie Mae and Freddie Mac

- Critics of Fannie & Freddie “have some allies within the Federal Reserve System,” reports John Connor with *Dow Jones Newswire* ([p. 30](#))
- Fannie & Freddie report third quarter earnings ([p. 31](#))
 - Critics raise concerns about the disparity between Fannie & Freddie’s net income under generally accepted accounting principles (GAAP) – Freddie’s net income soared in the third quarter, while Fannie’s fell
 - Fannie & Freddie reclassify mortgage assets in accounting change
 - Fannie’s net income drops from derivatives exposure
 - Fannie’s shareholder equity drops substantially, while Freddie’s increases
- Fannie & Freddie take different approaches to multi-family financing ([p. 33](#))
- GSE debt news ([p. 34](#))
 - (1) Fannie expects to increase its debt sales by 29% next year to \$290 billion; Fannie & Freddie drop issuance of 30-year bonds from their debt offering calendars
 - (2) Banks continue to increase their investments in GSE debt
 - (3) Bond Market Association (BMA) forms Callable Agency Securities Task Force – notes that issuance of callable debt has become increasingly important to the GSEs
 - (4) Foreign investors have purchased 33% of Fannie’s debt since 1998

Fannie Mae

- Fannie’s Chairman Franklin Raines concedes that Fannie is a legitimate subject of debate ([p. 35](#))
- Fannie’s new mortgage loan pilot program allows borrowers to skip mortgage payments ([p. 35](#))
 - Freddie does not have a “skip a payment” product yet
 - GE Capital has new job-loss mortgage protection product that saves more consumers money than Fannie’s product – GE’s product would save consumers approximately \$10,000 over the life of the loan compared to Fannie’s product
- Fannie sells \$300 million in preferred stock, its first sale since April 2001 ([p. 36](#))
- 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. 37](#))
 - 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

- Freddie introduces a new web-based system that integrates all secondary marketing functions onto a single platform including pricing and funding ([p. 38](#))
- New York Mayor vetoes New York City Council’s recently passed predatory lending bill ([p. 39](#))
 - Freddie noted that it might pull out of the high-cost home loan market in New York if the bill became law
- Freddie, Congressman Harold Ford, Jr. (D-TN), and the Consumer Federation of America launch nationwide credit education program for college students ([p. 39](#))
- Freddie names new Vice President Business and Market Management ([p. 40](#))

Federal Home Loan Banks

- Total Mortgage Partnership Finance (MPF) program loans outstanding up 64% for the third quarter, conventional loans grow 154% [\(p. 40\)](#)
 - The FHLBank System's MPF program is a competitor to Fannie & Freddie in the secondary mortgage market
- FHLBank of Cincinnati announce retirement of its President and CEO Charles Thiemann [\(p. 41\)](#)
 - David Hehman, executive vice president, named successor
- FHLBank of Atlanta starting its own Mortgage Purchase Program (MPP) [\(p. 41\)](#)

Farm Credit System/Farmer Mac

- Farmer Mac's third quarter earnings rose 2% [\(p. 42\)](#)
- Farm Credit Administration (FCA) issues proposed rule amending its capital regulations [\(p. 42\)](#)

Ginnie Mae

- Senate approves bill containing a provision repealing the 50% increase in the Ginnie Mae guarantee fee [\(p. 42\)](#)
 - Mortgage Bankers Association supports the repeal provision

Postal Service

- Postal Service's top lobbyist resigns after being accused of manipulating the Postal Service's federal budget to benefit the Democratic candidate for US Senate in Arkansas [\(p. 43\)](#)
 - Senate Minority Leader Trent Lott (R-MS) and Senate Governmental Affairs Committee Ranking Member Fred Thompson (R-TN) request more information about the budget moves
 - Postal Service denies the budget moves were politically motivated
 - Citizens Against Government Waste is outraged and asks for a public audit of the Postal Services' books
- Congressmen Phil Crane (R-IL) and Dana Rohrabacher (R-CA) reintroduce a postal privatization bill [\(p. 44\)](#)
- Consumer Action and the Office of the Consumer Advocate asks Postal Rate Commission (PRC) to regulate the Postal Service's expansion into commercial activities [\(p. 44\)](#)
 - Groups contend that the law requires that all services and products offered to the public must be subject to public hearings before the PRC
- Government Accounting Office (GAO) recommends Postal Service improve the management of its investments in information technology [\(p. 45\)](#)
- Senator Joseph Lieberman (D-CT) says the Postal Service needs help from Congress [\(p. 46\)](#)
- Group of nine Western Congressmen are upset with the Postal Service's announcement to stop contracting with private regional airlines to carry mail, using trucks instead [\(p. 46\)](#)
- Postal Service plans to announce in February an overhaul of its operations [\(p. 46\)](#)
- *Lake Worth Herald* editor says the Postal Service's response to its FOIA requests on the Postal Service's financial expenditures during the Tour de France are "woefully inadequate" [\(p. 47\)](#)
 - Several groups have criticized the Postal Service's \$25 million sponsorship of the Tour de France, given the Postal Service's financial problems
- Postal Service plans to eliminate over 1,000 accounting positions [\(p. 47\)](#)
- United Parcel Service decides not to comment on the Postal Rate Commission's (PRC) request for a Negotiated Service Agreement (NSA) with Capital One [\(p. 48\)](#)
 - Newspaper Association of America believes the NSA is "illegal"
 - Postal Rate Commissioner Ruth Goldway would not say whether the NSA would be approved
 - This is the first time the Postal Service has asked the PRC to endorse an agreement

Sallie Mae

- Sallie Mae sells its first non-federally backed student loan asset-backed security [\(p. 49\)](#)

Tennessee Valley Authority (TVA)

- Senate Minority Leader Trent Lott (R-MS) introduces a bill that will put TVA "on a short leash" [\(p. 49\)](#)

Major Events

Office of Management and Budget (OMB) to conduct a “formal review” of OFHEO’s proposed amendments to its risk-based capital rule for Fannie & Freddie

Capital Markets Subcommittee Chairman Richard Baker (R-LA) had asked OMB to delay and comment on OFHEO’s proposed amendments

FM Watch asks OFHEO to withdraw the amendments for further consideration

OFHEO delays action on four of the proposed 12 amendments, including the controversial FAS 133 amendments

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

- The OMB will conduct a “formal review” of OFHEO’s proposed amendments to its risk-based capital rule for Fannie and Freddie, that among other things, updates the treatment of accounting rules for derivatives transactions (Financial Accounting Standard 133 (FAS 133)). In an October 17 letter to Congressman Baker, OMB Director Mitchell Daniels wrote, “Because of the significant interest in this rulemaking, OMB has informed OFHEO that the final rule will be subject to formal review under Executive Order 12866.” Daniels noted that OMB’s review will “take into consideration the economic impact of this regulation.” (*OMB letter to Congressman Baker, 10/17/02; Bloomberg News, Al Yoon, 10/24/02*)
- Some industry observers viewed OMB’s letter “as a partial rebuke to OFHEO,” which had originally issued its proposal in September claiming that the proposal was “only technical in nature,” reported Rob Blackwell with the *American Banker*. An OFHEO spokeswoman would not answer specific questions about the letter but said, “We have a good working relationship with OMB.” (*American Banker, Rob Blackwell, 10/25/02*)

Congressman Baker had requested OMB delay the rule and review OFHEO’s proposed changes

- As noted in the September 27, 2002 *GSE Report*, Congressman Baker September 23 asked the OMB to delay and review OFHEO’s proposed amendments to its risk-based capital rule for Fannie and Freddie. OFHEO argued that its proposed rule made only technical and correcting changes to its risk-based capital rule. However, Congressman Baker asked the OMB to extend the comment period for the changes, arguing that they are substantive and deserve more debate and to review the FAS 133 change “because it may have significant impact on the enterprises.” Congressman Baker noted, “OFHEO, in proposing this change, shows that, if applied in the first quarter 2002, Freddie Mac’s risk-based capital requirement would have increased 29 percent.” (*Reuters, 9/23/02; Congressman Baker letter to OMB Director Mitchell Daniels, 9/23/02*)
- OFHEO first issued the proposed amendments to its risk-based capital rule on September 12, with only a 10-day comment period, which closed on September 23. (*Dow Jones Newswire, Dawn Kopecki, 9/23/02*) OFHEO then announced September 24 that it was providing an additional 30 days to comment on its proposed amendments to its risk-based capital rule for Fannie and Freddie. The new comment period ended October 29, 2002. OFHEO General Counsel Alfred Pollard said, “After receiving requests for additional time to review the proposed amendment to the Rule, OFHEO determined that an additional comment period would provide requestors ample time to consider the proposal.” (*OFHEO press release, 9/24/02*) OFHEO received four comment letters on the proposed amendments as of September 24: (1) Congressman Baker’s September 12 letter to OFHEO; (2) FM Watch; (3) Fannie Mae; and (4) Freddie Mac. (*OFHEO Web site*)

OFHEO received an additional comment letter from FM Watch on October 28 asking OFHEO to withdraw the amendments. (*OFHEO Web site*)

- In a September 12 letter to OFHEO Director Armando Falcon, Congressman Baker said he believes OFHEO is proposing a “substantive change” to the risk-based capital rule and he requested more information from OFHEO and a longer public comment period to respond to OFHEO’s proposed change in treatment of FAS 133 in the rule. Congressman Baker noted that because OFHEO’s proposed FAS 133 change impacts the risk-based capital requirement “in any particular quarter,” it should be considered a “substantive change.” He noted that OFHEO’s figures “show that the proposed FAS 133 change, if applied in the first quarter 2002, would have increased Freddie Mac’s risk-based capital requirement by \$1.652 billion and Fannie Mae’s requirement by \$121 million, if the adjustments had been made at that time. A 29% increase in Freddie Mac’s risk-based capital requirement is a significant impact.” Congressman Baker added, “[I]n order to better assess the impact of FAS 133,” Congressman Baker requested that OFHEO provide him – no later than September 20 - “the risk-based capital calculations for the enterprises based on September 30, 2002, financial data, calculated with and without the proposed FAS 133 change.” (*Congressman Baker’s letter to OFHEO Director Armando Falcon, 9/12/02*)
- In response to Congressman Baker’s September 12 letter, Falcon said OFHEO’s proposed FAS 133 change is “necessary and appropriate.” In a September 20 letter to Congressman Baker, Falcon said OFHEO planned to use the FAS 133 standard in its risk-based capital rule in time for the first capital classification utilizing the risk-based capital rule. Falcon said the change would not have impacted Fannie or Freddie’s capital classification at the end of first quarter 2002 had the rule been in force and the change in effect. “While FAS 133’s mark to market requirement will obviously impact total capital and the risk-based capital requirement, it will not consistently raise or consistently lower capital requirements” for Fannie or Freddie over time. The impact on either GSE in any quarter will depend on the GSEs’ portfolios and market conditions, he noted. “I agree the change is substantive, but it should not be viewed as either a benefit or detriment to the enterprises,” said Falcon in his letter. “It is simply an improvement to the accuracy of the stress test.” Falcon further noted that in response to Congressman Baker’s question on the relationship between the proposed FAS 133 change and the statutory management add-on, OFHEO’s proposed FAS 133 adjustments to capital requirements is made after the 30% add-on for management and operations risk. Falcon said OFHEO was on track to use third quarter 2002 data to make the first capital classifications based on both the leverage and risk-based capital requirements. OFHEO will publish these classifications by year-end 2002 and will comply with Congressman Baker’s request to advise him as to how both Fannie and Freddie fare under the risk-based capital rule with and without the proposed FAS 133 change. (*OFHEO Director Armando Falcon letter to Congressman Richard Baker, 9/20/02*) [See September 13 and September 27, 2002 *GSE Reports* for more information.]

FM Watch asks OFHEO to withdraw the amendments

- OFHEO received an additional comment letter from FM Watch on October 28. **“FM Watch continues to believe that OFHEO’s RBC [risk-based capital] rule is so seriously flawed that it should be withdrawn and re-evaluated,” said FM Watch Executive Director Mike House.** “In our letter to OFHEO, we reiterate our concerns that the GSEs be governed by rules as stringent as those applied to banks. In fact, we point out that Fannie Mae’s recent shift of \$135 billion from the ‘held-to-maturity’ portfolio to the ‘available for sale’ portfolio – increasing that portfolio by 500% -- suggests that Fannie has undertaken a massive bookkeeping exercise to ensure nominal compliance with the rule while not actually addressing the very real risk question out there. Again, allowing such an exercise to proceed confirms our concerns that the rule is flawed.”

- FM Watch’s letter highlighted the following points –
 - “OFHEO should withdraw this proposal until a definitive quantitative assessment of its impact can be made under numerous economic circumstances.
 - The proposal violates key provisions in the Administrative Procedures Act, based on the fact that OFHEO could still implement it immediately, without the delay mandated by the APA or the still more advisable one adopted by bank regulators when they change RBC requirements.
 - Due to the information standards guidelines required as of October 1, the proposed rule may now also violate the requirements of OMB’s Final Guidelines that require that regulators meet various standards regarding the information on which they base their actions. This proposal is in violation of OFHEO’s own guidelines regarding ‘objectivity, utility and integrity.’
 - The proposal also continues to violate Executive Order 93-12866, based on the fact that the rule would have significant economic consequences.” (*FM Watch press release, 10/30/02; FM Watch letter to OFHEO, 10/28/02*)

OFHEO delays action on four of the proposed 12 amendments, including the controversial FAS 133 amendments

- OFHEO issued a final rule November 1 implementing eight of the proposed amendments to the risk-based capital rule. Of the twelve amendments OFHEO proposed September 12, OFHEO adopted as final immediately, eight proposed amendments. In order to make these eight adjustments applicable to the first fully enforceable risk-based capital calculation for Fannie and Freddie, OFHEO determined that the amendments shall be effective immediately and shall apply to any data submissions from Fannie and Freddie received after the effective date. OFHEO noted that a waiver of the normal 30-day delay in the effective date is in the public interest because the eight changes rectify errors in the code and in the language of the rule that could mislead the public if unamended. In some cases, the changes reflect changes that have already been implemented in the computer software used to implement the stress test and are necessary for the stress test to be operational. Moreover, both Fannie and Freddie have participated in data and software validation processes with OFHEO for the past year and have been aware of the pendency of these technical changes, which OFHEO said would have no material impact on capital requirements, for many months. OFHEO did, however, decide to review and delay action until after the extended comment period closed on October 29 on four of OFHEO’s original 12 proposed amendments: (1) amendment that corrected a table that utilized original loan-to-value ratios rather than amortized original loan-to-value ratios (amendment number eight in the list of OFHEO’s original 12 amendments); and (2) proposed technical amendment regarding the definition of “unamortized balance” (amendment number seven); and two amendments relating to the implementation of FAS 133 in the risk-based capital rule (amendments numbered 11 and 12). (*Federal Register, pages 66533-66540, 11/1/02*)

Background on OFHEO’s risk-based capital rule:

- OFHEO’s risk-based capital rule establishes the level of capital Fannie and Freddie must maintain to survive a 10-year “stress test.” The rule was originally due December 1, 1994. After taking eight and a half years, OFHEO finally issued the rule on September 13, 2001. However the rule did not become enforceable until one year later (September 13, 2002). Then just three months after OFHEO published the rule that took more than eight years to produce, OFHEO announced proposed changes to the rule on December 18, 2001 with a brief public comment period. OFHEO announced the final amendment to its risk-based capital rule on March 15, 2002, which remained essentially the same as the original December 18, 2001 proposed changes.
- As a result of pressure from certain industry groups and the GSEs, OFHEO reduced substantially the requirements imposed by the initial risk-based capital rule. The amended March 15, 2002 version, among other things modified provisions related to counter-party haircuts, the treatment of multifamily loans,

funding costs, and a series of technical and clarifying changes. The amendment did not change the date that the risk-based capital rule became enforceable. During a July 23, 2002 Capital Markets Subcommittee hearing, Capital Markets Subcommittee Chairman Richard Baker (R-LA) raised concerns that the risk-based capital rule was changed so that Fannie and Freddie would receive more favorable results and he questioned political involvement in the changing of the rule. Data was released at the hearing which showed that Fannie would have failed an early version of OFHEO's risk-based capital rule before changes were made

- Although the regulation is considered enforceable September 13, 2002, there will be no immediate impact and OFHEO will publish the first enforceable data by the end of the year, using third quarter 2002 data. (*Dow Jones Newswire*, John Connor, 9/13/02) Until then, Fannie and Freddie will be subject only to minimum capital requirements.

Congressman Baker raises concerns with OFHEO about Fannie's duration gap, Fannie's reclassification of \$135 billion of mortgage assets, and Fannie's substantial drop (48%) in shareholder equity in the third quarter

Fannie's reclassification of mortgage assets and dwindling shareholder equity "call into question Fannie's interest-rate risk management" reports *StreetView*

Congressman Baker asks OFHEO whether Fannie's reclassification of mortgage assets during the third quarter may have narrowed Fannie's duration gap and assisted the company in meeting OFHEO's risk-based rule for Fannie & Freddie

OFHEO is studying Congressman Baker's request for information and notes that Fannie's reclassification of assets does not adversely impact Fannie's safety and soundness

- Congressman Baker sent an October 23 letter to OFHEO Director Armando Falcon raising concerns about Fannie's negative duration gap and Fannie's third quarter earnings statement, including a reclassification of \$135 billion of mortgage assets during the third quarter, and Fannie's substantial drop in shareholder equity. Congressman Baker questioned OFHEO whether its comment period extension on its proposed amendments to its risk-based capital rule for Fannie and Freddie from September 23 to October 29 (see earlier story) forced Fannie to make \$135 billion in its assets available for sale on its financial statements instead of accounting for them as held to maturity. Congressman Baker asked OFHEO to investigate the impact of the reclassification. Fannie's shareholder equity in the third quarter declined 28% over the prior six months to around \$15 billion, but without the \$135 billion transfer, Fannie's shareholder equity would have shrunk 48% to just \$10 billion. (*TheStreet.com*, Rebecca Byrne, 10/24/02; *Bloomberg News*, Al Yoon, 10/24/02; *Congressman Baker letter to OFHEO Director Armando Falcon*, 10/23/02)
- Fannie's reclassification of \$135 billion in mortgage assets was first reported in *StreetView*, a professional investor newsletter published by *TheStreet.com*. **The publication noted that Fannie has been "unwilling to pay for adequate hedging of its interest-rate risk, and this has contributed to both its large negative duration gap and, more importantly, the drastic decline in shareholder equity."** The publication noted that in the past six months, Fannie's shareholder equity declined 28% over the prior six months to around \$15 billion, but without the \$135 billion reclassification, Fannie's shareholder equity would have dropped 48% to just \$10 billion. As a percentage of assets, Fannie's shareholder equity fell to 1.8% on September 30, from 2.6% on March 31, and if the reclassification was reversed, the September 30 result falls to 1.3%. "These numbers call into question Fannie's interest-rate risk management. Furthermore, the decline in shareholder equity may force Fannie to make unprecedented changes in its business model to stop the hemorrhaging and to begin to right itself." In contrast, because of its superior interest-rate hedging, Freddie

reported its shareholder equity at \$22.5 billion at the end of the third quarter. Freddie's shareholder equity has gone up 41% in the last six months. **"Fannie Mae has paid for its inadequate interest-rate risk management with a balance sheet moving toward technical insolvency."** (*TheStreet View*, Mark Haefele, 10/17/02) [For more detailed information on Fannie and Freddie's third quarter earnings, see later story in this *GSE Report*.]

Congressman Baker asks OFHEO whether Fannie's reclassification of mortgage assets helped it to narrow its duration gap and meet its risk-based capital rule?

- Congressman Baker wrote the following: "Fannie Mae's third quarter 2002 earnings statement showed that the enterprise shifted \$135 billion of portfolio and investment securities from the 'held-to-maturity' to the 'available-for-sale' category, shortly before the quarter's end. How would the sale of \$135 billion of portfolio and investment securities impact Fannie Mae's duration gap? Was Fannie Mae's decision related to the fact that OFHEO will use September 30, 2002 financial data to make the first capital classifications based on both the leverage and risk-based capital standards and will enforce compliance? If Fannie Mae sells \$135 billion of assets over the next year, current monthly sales will multiply substantially. Furthermore, Freddie Mac maintains over \$200 billion in its 'available-for-sale' portfolio. Has OFHEO considered the potential impact on market liquidity and mortgage interest rates of such holdings?" (*Congressman Baker letter to OFHEO Director Armando Falcon*, 10/23/02)
- Fannie spokeswoman Janice Daue argued that Fannie's reclassification of mortgage assets "doesn't change the balance of the portfolio, and doesn't have anything to do with the implementation of the risk-based capital standard." She claimed that these transfers are common among companies and was made "so we have more flexibility in our portfolio." (*Bloomberg News*, Al Yoon, 10/24/02) A Fannie spokeswoman said OFHEO's new capital rule for Fannie and Freddie, implemented in September, provided the GSE with a one-time opportunity to reclassify the assets from the hold-to-maturity category into the available-for-sale group. This is more advantageous from an accounting perspective because it allows the GSE to value the assets at current market rates rather than at the purchase price. (*TheStreet.com*, Rebecca Byrne, 10/24/02)

Background on Fannie & Freddie's reclassification of mortgage assets

- Freddie first used the accounting tool, made possible for all financial services companies when the Financial Accounting Standards Board adopted FAS 133 new derivatives reporting rules in January 2001. Freddie reclassified less than \$100 billion in mortgage assets during the first quarter of that year. Fannie and Freddie currently have roughly \$275 billion and \$175 billion respectively in available-for-sale assets on their books. The accounting rules for available-for-sale assets are more advantageous than for securities held-to-maturity, accountants said, valuing the assets at current market rates and broadening their use for hedging purposes. "A lot of companies, including us, did this when FAS 133 went into affect. It's simply a risk management move," said Freddie's spokeswoman Sharon McHale. "It enables you to reconfigure cash flows should we need to." It also frees the securities from sales restrictions and penalties imposed on assets categorized as held until they mature. Finance companies can only reclassify securities when there has been regulatory change that significantly impacts a company's capital requirements. OFHEO implemented new capital rules for Fannie and Freddie in September that gave the two another opportunity to take advantage of the rule. "You always have more flexibility when something is available for sale," Fannie's Vice President for Financial Accounting Jonathan Boyles said, adding that the reclassification gives the company more leeway in using mortgage assets to hedge against derivatives losses or gains for accounting purposes. "That would give us the choice of linking a derivative against a debt instrument or a mortgage instrument. We have no near-term intention of doing any of this...but it gives us the flexibility to do that." While Fannie and Freddie claim the accounting change did not affect their bottom lines, some are questioning its impact on shareholder equity. (*Dow Jones Newswire*, Dawn Kopecki, 10/24/02)

Should OFHEO be concerned about Fannie's substantial drop in shareholder equity in the third quarter?

- Congressman Baker wrote the following: "OFHEO excludes the effect on equity from marketing-to-market derivatives under FAS 133 in determining capital adequacy for the enterprises. Fannie Mae's shareholder equity declined substantially in the third quarter 2002, to around \$15 billion. If Fannie Mae had not made the \$135 billion transfer, shareholder equity would have fallen to around \$10 billion. Does this reduced level of shareholder equity and even greater leverage concern OFHEO?" (*Congressman Baker letter to OFHEO Director Armando Falcon, 10/23/02*)

Background on Fannie's drop in shareholder equity

- Patrick Barta with the *Wall Street Journal* noted that shareholder equity is defined as the total value of a company once its liabilities are subtracted from its assets. Fannie's shareholder equity has dropped from \$20.75 billion in the first quarter to \$17.73 billion at the end of the second quarter, and at \$14.96 billion at the end of the third quarter. Fannie reported a 28% drop in shareholder equity over the past six months. Fannie's shareholder equity, however, would have been worse in the third quarter if Fannie had not reclassified \$135 billion in mortgages assets as "available for sale," meaning the assets could be sold rather than held in portfolio as usual. Under generally accepted accounting principles (GAAP), such a move requires companies to record the assets available for sale at their current market value. In this case, the move resulted in a gain of roughly \$4 billion that counted toward Fannie's shareholder equity, even though the company may never sell the securities or realize the gain. Without the reclassification, Fannie's shareholder equity would have been roughly \$11 billion (\$10.9 billion) -- only a little more than half its level six months ago, and a 48% drop over the last six months. While Freddie reclassified \$75 billion of its mortgage portfolio in the third quarter, Freddie's shareholder equity has risen this year to \$22.41 billion in the third quarter from \$15.37 billion nine months earlier. (*Wall Street Journal, Patrick Barta, 10/25/02; Dow Jones Newswire, Dawn Kopecki, 10/24/02*) In contrast to Fannie, Freddie's shareholder equity has gone up 41% in the last six months. Freddie said its accounting move had no effect on operating earnings or net income. (*TheStreet.com, Rebecca Byrne, 10/24/02*)

Congressman Baker raises additional concerns about Fannie's duration gap

- Congressman Baker raised a number of issues with OFHEO about Fannie's duration gap. Congressman Baker noted the following:
 - "On September 16, 2002, Fannie Mae announced a negative 14-month duration gap in August... When did you become aware of Fannie Mae's negative 14-month duration gap and how did this come to your attention? How do you ensure that you are fully informed on a timely basis if an enterprise is facing a substantial mismatch or other serious interest rate risk problem?"
 - "Fannie Mae has reported its duration gap on a monthly basis since March 2001 and last month Freddie Mac began reporting its duration gap. Do Fannie Mae and Freddie Mac calculate duration gap the same way? Do the duration gap disclosures of the enterprises provide a valid comparison? Would OFHEO consider requiring the enterprises to disclose truly comparable duration gap figures? Fannie Mae also discloses its net interest income at risk and Freddie Mac its portfolio market value sensitivity. Should the enterprises disclose those or other measures of interest rate risk in a comparable fashion?"
 - "In September, Fannie Mae narrowed its duration gap from negative 14 months to negative 10 months. Given OFHEO's heightened oversight, did Fannie Mae discuss with you its rebalancing strategy, including any internal risk management changes or market actions? Do any of the adjustments that Fannie Mae made to reduce its negative gap raise further supervisory concerns? For example, if Fannie Mae purchased long-term mortgages and funded those purchases with shorter

term debt, could this create problems if interest rates rise?” (*Congressman Baker letter to OFHEO Director Armando Falcon, 10/23/02*)

OFHEO’s response

- OFHEO spokeswoman Stefanie Mullin said October 25 that OFHEO is reviewing Congressman Baker’s letter and plans to respond shortly. The accounting issues Congressman Baker has raised, however, “do not adversely impact the safety and soundness of the enterprises,” she said. (*BNA Daily Report for Executives, Richard Cowden, 10/28/02*)

Background on Fannie’s duration gap

- As noted in the October 11 *GSE Report*, Fannie announced October 1 that its duration gap narrowed from negative 14 months in August to negative 10 months in September. (*Fannie press release, 10/1/02*) Fannie’s duration gap was negative nine months in July. (*Reuters, 10/1/02*) At negative 14 months, Fannie’s duration gap was the largest mismatch ever disclosed publicly, though it has been larger on an intra-month basis, a Fannie spokesman said. (*Reuters, Aleksandrs Rozens and Richard Leong, 9/16/02; Reuters, Aleksandrs Rozens, 9/16/02*) Fannie would not disclose its most negative duration gap measurement. (*National Mortgage News Daily Web site, 10/1/02*) Fannie’s current duration gap means that Fannie’s mortgage assets will be repaid and replaced at a lower interest rate 10 months sooner on average, than its debt. Though smaller at negative 10 months, the duration gap is still outside Fannie’s targeted duration gap range of plus or minus six months for a third month. (*Bloomberg News, Al Yoon, 10/1/02*)
- Fannie defended its 14-month duration gap in August and said the mismatch was not unusual during periods of heavy refinancing. In contrast to Fannie’s negative 14-month duration gap in August, Freddie announced that its duration gap was zero. OFHEO called Fannie’s negative 14 month duration gap a “substantial mismatch” and said it would increase its oversight to help Fannie balance its duration gap, including conducting weekly examinations of Fannie’s effectiveness in narrowing its duration gap. Capital Markets Subcommittee Chairman Richard Baker (R-LA) criticized OFHEO for not acting sooner and asked OFHEO for its weekly status reports on Fannie. Congressman Baker noted in his October 23 letter to OFHEO that OFHEO has been providing status reports in oral reports, due to the confidential nature of such information. A *Wall Street Journal* editorial and a group of prominent scholars – the Shadow Financial Regulatory Committee – said taxpayers should be concerned about Fannie’s duration gap and recommended prohibiting Fannie and Freddie from purchasing their own mortgage-backed securities for their retained portfolios. Citizens Against Government Waste (CAGW) stated that Fannie’s duration gap should lead to calls for increased financial disclosures by Fannie & Freddie. [For more information on Fannie’s negative 14 month duration gap and the reaction by the market, see the September 27, 2002 *GSE Report*, www.gsereport.com]

Explanation of a duration gap

- The gap represents a mismatch in cash flows between Fannie’s assets (mortgage bonds and loans it owns) and liabilities (debt it issues to buy these assets). The duration gap measures the difference, in months, between the durations of the assets and the liabilities in Fannie’s portfolio. “In simplest terms,” a duration gap is a “mismatch between borrowing and lending.” Fannie purchases mortgages from lenders in the secondary mortgage market and in order to purchase the mortgages, it sells bonds (issues debt) to investors. Fannie makes money by collecting more interest on the mortgages it holds than it pays out on the bonds (debt) it sells. For example, Fannie does not want to buy a 30-year mortgage using money that it borrows by issuing 10-year bonds. “If it did that, when the bonds come due, there wouldn’t be enough money to pay them off. The mismatch between the life of the mortgage and the life of the bond” is called a duration gap. (*Washington Post, Jerry Knight, 9/23/02; Philadelphia Inquirer, Andrew Cassel, 9/25/02*)
- As part of the GSEs’ October 2000 voluntary risk-management agreement, Fannie and Freddie announced that they would provide monthly interest-rate disclosures. Fannie announced that it would disclose the two primary measures of interest rate risk it uses in managing its mortgage portfolio business: portfolio net

interest income at risk and the effective asset/liability duration gap. Fannie first published its monthly interest rate risk disclosure in March 2001; Freddie in April 2001.

Congressman Ken Bentsen (D-TX) introduces a bill (HR 5696) to remove OFHEO from the appropriations process

Congressmen Richard Baker (R-LA), Congressman Paul Kanjorksi (D-PA), and Congresswoman Carolyn Maloney (D-NY) are co-sponsors of the bill

OFHEO is the only federal financial regulator subject to the appropriations process

Bush Administration and OFHEO support removing OFHEO from the appropriations process

- **Congressman Bentsen introduced a bill (HR 5696) removing OFHEO from the appropriations process, a move that could give OFEHO more funding and greater political independence, reported Reuters. Some lawmakers have charged that OFHEO is overmatched by Fannie and Freddie.** (*Reuters*, 10/21/02) Fannie and Freddie have doubled in size since the creation of OFHEO in 1992, raising concerns among lawmakers about OFHEO's ability to effectively regulate Fannie and Freddie. (*Bloomberg News*, Al Yoon, 10/21/02) Congressman Bentsen announced the legislation at a press conference with the bill's co-sponsors: Congressmen Baker, Congressman Kanjorksi and Congresswoman Maloney. (*Congressman Bentsen press release*, 10/21/02)
- **Congressman Bentsen noted that his legislation would remove OFHEO's budget from the "cumbersome and unnecessary appropriations process," putting it on the same level of other regulators such as the Federal Reserve Board. "In a time when the size of the portfolios of the GSEs has doubled since the creation of OFHEO, I believe we must act to ensure that OFHEO has the flexibility and stability that they need to effectively regulate...A more effective regulator will help to ensure that taxpayers are not at risk."** (*Congressman Bentsen press release*, 10/21/02) An OFHEO statement said that at the end of 1992, Fannie and Freddie held 19% of their book of business in portfolio, while guaranteeing 81% of it as mortgage-backed securities. By March of 2002, Fannie and Freddie together held about 43% of their assets in portfolio. (*BNA Daily Report for Executives*, Richard Cowden, 10/22/02)
- "This action is long overdue. OFHEO is the only federal financial regulator who must wait for its budget each year, and we act to ensure guaranteed, stable funding for this critically important regulator," said Congressman Bentsen. (*Congressman Bentsen press release*, 10/21/02)
- OFHEO is funded currently, not by taxpayer money, but by semiannual assessments on Fannie and Freddie. However, unlike other federal financial safety and soundness regulators, OFHEO's funding is subject to Congressional approval. Other federal financial safety and soundness regulators are not subject to the Congressional appropriations process, and thus, simply collect their fees directly from the banks and thrifts they supervise, without Congressional approval. **Congressman Bentsen noted his legislation would put OFHEO on the same level as other financial safety and soundness regulators** such as the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Housing Finance Board, the Federal Reserve Board, the Federal Deposit Insurance Corporation and the National Credit Union Administration. "I support this parity provision because I believe that all financial regulators should be treated in the same manner and that this special review of OFHEO's budget is cumbersome and unnecessary," said Congressman Bentsen. (*Congressman Bentsen press release*, 10/21/02)

- Congressman Bentsen noted his legislation would not add costs to taxpayers because OFHEO will continue to be funded by semiannual assessments on Fannie and Freddie. (*Congressman Bentsen press release*, 10/21/02)
- Congress approves OFHEO's overall budget as part of the Housing and Urban Development/Department of Veterans Affairs appropriations bill. As noted in the October 11, 2002 *GSE Report*, the House Appropriations Committee October 10 approved a HUD-VA appropriations bill that provides \$30 million in FY 2003 funding for OFHEO. The \$30 million is \$3 million more than funds enacted for FY 2002 and is the same amount requested by President Bush in his budget released in February. The increase in funding would be paid by Fannie and Freddie through semi-annual assessments, and not by taxpayers. As noted in the August 2, 2002 *GSE Report*, the Senate Appropriations Committee July 25 approved a HUD-VA appropriations bill (S. 2797), which also includes \$30 million in FY 2003 funding for OFHEO. (*BNA Daily Report for Executives*, Karen Werner, 7/26/02)
- The bill to remove OFHEO from the appropriations process may be attached to the HUD-VA appropriations bill, which is expected to be voted on by lawmakers during a post-election session that will begin November 12. (*American Banker*, Michele Heller, 10/22/02)

Administration supports removing OFHEO from the appropriations process

- **President Bush's FY 2003 budget, released on February 4, recommended that OFHEO be removed from the appropriations process.** The Administration's FY 2003 budget stated, "In order to treat OFHEO similarly to other financial regulators, including the regulator of the Federal Home Loan Bank System, the Budget proposes legislation that would provide direct funding of OFHEO's activities with mandatory assessments on Fannie Mae and Freddie Mac." (*Budget of the United States Government, Fiscal Year 2003 - Appendix*, p. 518)

OFHEO supports Congressman Bentsen's legislation

- OFHEO Director Armando Falcon issued the following statement: "I appreciate and fully support the efforts of these members to strengthen OFHEO's regulatory authority. This is an essential element of safety and soundness regulation and I urge its immediate passage." (*OFHEO press release*, 10/21/02) OFHEO spokeswoman Stefanie Mullin said removing OFHEO from the appropriations process has been an objective of OFHEO for some time. "It has been the director's priority since he's gotten here [in 1999]," Mullin said. (*BNA Daily Report for Executives*, Richard Cowden, 10/22/02)
- OFHEO said it would continue to be subject to Congressional oversight. OFHEO would still be required to submit its financial plans, forecasts, and reports of operations to the Secretary of HUD and the OMB and OFHEO would continue to report the results and conclusions of its examinations to Congress annually. (*OFHEO comments on removing OFHEO from the appropriations process*, *OFHEO Web site*)

Class action suit filed against Freddie's automated underwriting (AU) system shortly after a class action discrimination lawsuit was filed against Fannie over its AU system

HUD expects to release its fair-lending review of Fannie & Freddie's AU systems by year-end

HUD has been investigating Fannie & Freddie's AU system for fair lending violations since 1999

HUD will also consider Fannie & Freddie's affordable housing goals in 2003

Class action suit filed against Freddie

- A class action suit was filed in the US District Court in Philadelphia alleging that Freddie's AU system – Loan Prospector – violates the federal Fair Credit Reporting Act (FCRA) by failing to inform certain borrowers that their interest rate quotes are higher than standard because of problems detected in their credit files. The suit contended that the “class” of borrowers negatively impacted by Freddie's alleged violations numbers in the “hundreds of thousands” or millions.
- Freddie's AU system pulls credit file information from the three giant national credit repositories--Equifax, Experian and Trans Union--as well as electronic property valuation information. If the AU system rates an applicant as higher risk than optimal, Freddie may propose purchasing the loan at a higher interest rate or require a larger downpayment, or deeper mortgage insurance coverage. That practice, charges the suit by Philadelphia homeowner Donald Weidman, triggers disclosure responsibilities under FCRA, but Freddie does not comply. Under the FCRA, lenders, landlords and others who use credit file information to evaluate and price consumer applications, must inform the applicant whenever an “adverse action” occurs. Consumers charged higher rates--or rejected--must be told the names and addresses of all credit information sources used in reaching the adverse conclusion. Applicants can then review the credit information for errors and refile the application. Weidman's suit charges that Freddie provides no disclosure or notice to mortgage applicants who are quoted higher rates or inferior terms because of Freddie's AU credit file evaluations.
- Weidman charged that he applied last year for a home mortgage at several lending institutions, each of which used Freddie's AU system to turn him down or charge him higher than standard rates and terms. The suit alleged that Freddie never provided Weidman with the fair credit disclosures guaranteed him under federal law. Weidman's “class” of similarly affected applicants--borrowers who would receive monetary damages if the suit is successful--includes all mortgage applicants who were quoted a higher rate or rejected through Freddie's AU system during the past two years.
- Edmund Mierzwinski of Washington DC-based Public Interest Research Group claimed the suit against Freddie is just a hint of suits to come. “There is a broad exposure in the home mortgage lending industry” to legal challenges over non-compliance with FCRA, he said. “It is fundamental under the law that you are supposed to give loan applicants the right to see the credit report information whenever they are asked to pay more for credit or are rejected. But with automated underwriting, that doesn't happen’ in most cases, said Mierzwinski. He added that the underlying data in the credit files are often inaccurate or incomplete. Richard LeFebvre of AAA Credit of Flagstaff, AZ, said Fannie and Freddie's AU systems amount to “automated undermining of consumers’ rights” and use credit bureau information “that is often erroneous or out of date.” (*Realty Times*, Kenneth Harney, 10/28/02; *Washington Post*, Kenneth Harney, 10/25/02)
- James Francis, Weidman's attorney at the Philadelphia law firm of Francis & Mailman, said that at no time has Freddie “ever notified plaintiff of the decisions, recommendations and findings that it has made concerning plaintiff's mortgage applications that it communicated through its various lender partners, and therefore Freddie Mac has violated one of the basis tenets of the Fair Credit Reporting Act.” Legal experts

said FCRA requires lenders to provide “adverse action” notices if they use credit file information to reject an applicant or charge a higher interest rate. However, Freddie is not a lender, but its AU system evaluates applications submitted by lenders and returns a summary report, which lenders use to assess whether they would make the loan. Francis said that because of the “colossus” status of Freddie and its “manifold roles as a user of credit information, the company has deliberately made itself non-accountable to consumers and intentionally fails to comply with any of the requirements imposed on it by FCRA.” (*Inside Mortgage Finance*, 11/1/02)

- **The lawsuit stated that Freddie’s “flagrant disregard for the law apparently results from an arrogant position that, as a government-sponsored enterprise, it is somehow exempt from the grave responsibilities imposed by the FCRA...As such, mortgage applicants are harmed in that they are denied certain rights guaranteed by the FCRA...”** (*National Mortgage News*, 11/4/02)

Discrimination lawsuit filed against Fannie’s AU system

- The class action lawsuit against Freddie’s AU system comes shortly after a class action lawsuit was filed against Fannie. As noted in the September 27 and October 11, 2002 *GSE Reports*, African-American Safiyyah Rahman sued Fannie for discriminatory lending practices based on its AU system, Desktop Underwriter (DU). The lawsuit, filed September 13 in the U.S. District Court for the District of Columbia, charges Fannie with violating the Fair Housing Act, the Equal Credit Opportunity Act and the Fair Credit Reporting Act. Rahman claimed she was denied a mortgage loan or offered mortgage loans at higher interest rates, based upon a credit score produced by racial disparities in Fannie’s AU System. The lawsuit asked the court to prohibit Fannie from using “or relying upon racially discriminatory credit scoring systems in mortgage loan underwriting” and for an unspecified amount of economic and punitive damages as well as attorneys fees. (*Dow Jones Newswire*, Dawn Kopecki, 9/25/02) Fannie’s AU system, said the lawsuit, has a “disparate impact” on minority applicants and treats them less favorably than white applicants. (*Washington Post*, Kenneth Harney, 9/26/02)
- The lawsuit was amended September 27 to bring the action on behalf of a nationwide class. That class contains all minority borrowers who were allegedly rejected for a home loan or were charged a higher rate for their loan as a result of Fannie’s AU system. “The class is believed to comprise many thousands of mortgage applicants in the United States,” Rahman’s lawyers said in her amended filing. (*Reuters*, Mark Felsenthal, 10/1/02) Milberg, Weiss, Bershad, Hynes & Lerach - the nation’s largest class action law firm - is one of four firms representing Rahman. (*Dow Jones Newswire*, Dawn Kopecki, 9/25/02)

HUD expects to release its fair-lending review of Fannie & Freddie’s AU systems by year-end

- **HUD Secretary Mel Martinez told *Reuters* on October 22 that he will soon release the results of the fair lending study of Fannie and Freddie’s AU systems. “I think you’ll have it in the near future. It was a study that was done and it should have been released,” Secretary Martinez told *Reuters*. Secretary Martinez said it is likely the results of the study would be made public before the end of the calendar year.** (*Reuters*, Mark Felsenthal, 10/22/02)
- HUD has been investigating Fannie and Freddie’s AU systems since 1999. In February 1999, HUD sent letters to Fannie and Freddie requesting information to ensure that the GSEs’ systems comply with fair-lending standards. The GSEs did not release the requested information until January 31, 2000 after assurances from HUD that it would keep Fannie and Freddie’s proprietary information private. In March 1999, HUD commissioned an independent study by the Urban Institute, which found that Fannie and Freddie’s underwriting guidelines may inadvertently have a disparate impact on minority borrowers. The report also noted that Fannie and Freddie “do not appear to have gone as far as some primary lenders to serve low-income and moderate-income borrowers and to minimize disproportionate effects on minorities.” The report found that “Primary lenders are making more aggressive efforts” to serve the lower income and

minority homebuyers “by offering loan products with underwriting guidelines that are more flexible than the GSEs’ guidelines.” Further, the report noted that “depository lenders are serving low- and moderate-income borrowers better than the GSEs and so the percentage of loans purchased by the GSEs that are originated to low- and moderate-income borrowers is less than the percentage of loans originated in the primary market.” The report also advised that “there is some evidence that the GSEs’ purchase of loans made to black and Hispanic homebuyers have actually declined (in share and absolute number) over the last two years.” (HUD/Urban Institute Study, “A Study of the GSEs’ Single Family Underwriting Guidelines,” April 1999)

- A 2001 Mercer Management Consulting study found that Fannie and Freddie’s AU systems resulted in a smaller percentage of loans for minorities than AU systems created by other companies. [See March 30, 2001 *GSE Report* for more information, www.gsereport.com] Finally, Former Treasury Under Secretary Gary Gensler testified on March 22, 2001 that the GSEs’ AU systems are increasingly becoming the means by which originators decide to lend, which may result in less diversity in credit decisions and less price competition.

HUD will also consider Fannie & Freddie’s affordable housing goals next year

- HUD must decide in 2003 whether to keep or increase HUD’s affordable housing goals for Fannie and Freddie. “I’m not at liberty to suggest today what the outcome would be because that would be prejudging the process, but I know its coming, I’m focused on it and it’s going to be an important decision,” Secretary Martinez said. (*Reuters*, Mark Felsenthal, 10/22/02) As noted in the October 11, 2002 *GSE Report*, a not yet released HUD-commissioned study by Richard Williams, University of Notre Dame, noted that Fannie and Freddie receive significant benefits from their GSE status and in return are mandated to “lead the mortgage market” in making credit to low- and moderate-income families. The study found, however, that Fannie and Freddie are not “leading the market” when it comes to serving underserved borrowers.

Freddie’s Chairman Leland Brendsel expresses interest in entering the jumbo market (loans above the conforming loan limit) and mortgage insurance market

Fannie & Freddie are prohibited from entering these markets

The conforming loan limit [the limit on the loan amount Fannie & Freddie can purchase] may increase to \$325,000 in 2003

- In a recent interview with *National Mortgage News*, Freddie’s Chairman Leland Brendsel expressed interest in entering the jumbo market as well as the mortgage insurance market. He noted that mortgage insurance is an area that Freddie is constantly looking at, but would not reveal any concrete plans for entering the market. He added that Freddie has no current plans to push for legislation that would allow it to enter the jumbo market. (*National Mortgage News*, Paul Muolo, 10/21/02) [Fannie and Freddie are prohibited from entering the jumbo market. Jumbo loans are those loans that exceed the current 2002 single-family conforming loan limit of \$300,700.]

Conforming loan limit to increase in 2003

- Beginning in January 2003, Fannie and Freddie may be able to purchase loans as high as \$325,000, an increase from the current limit of \$300,700. (*Reuters*, Aleksandrs Rozens, 10/18/02) The Federal Housing Finance Board (FHFB) calculates the loan limit every year to reflect the increase in average home prices each October from the year before. This method of calculating the annual change in the loan limit is set forth in the Federal Housing Enterprises Safety and Soundness Act of 1992. By law Fannie and Freddie set their own mortgage limits, but the rate of increase cannot be larger than the annual percentage increase in house prices. (*Dow Jones Newswire*, Jennifer Corbett Dooren, 11/28/01) FHFB spokesman Carter Wood

said any change to the limit will be officially announced shortly before the Thanksgiving holiday in the week ending November 29. (*Reuters*, Aleksandrs Rozens, 10/18/02)

- Loans that qualify to be purchased by Fannie and Freddie are referred to as “conforming” in the mortgage business, while those above the limit are referred to as “jumbos.” Fannie and Freddie cannot purchase mortgage loans above the conforming loan limit. Conforming loans generally carry interest rates that are one-quarter to one-half percentage points lower than jumbo loans. (*Dow Jones Newswire*, Jennifer Corbett Dooren, 11/28/01; *Wall Street Journal*, Patrick Barta, 11/29/01)

It is likely Fannie & Freddie will purchase loans even greater than the new increased conforming loan limits

- As reported in previous *GSE Reports*, in a speech before the Merrill Lynch Investor Conference, Fannie’s Chairman Franklin Raines stated that Fannie and Freddie are expanding into jumbo loans (those over the conforming limit, which by law cannot be bought by Fannie and Freddie). Here’s how Fannie is using a “back door” into jumbos: Raines noted that “clever” lenders are breaking jumbo loans into two components and are structuring the jumbo debt amount into a first lien that is below the \$240,000 GSE cap [1999 conforming loan cap], with the remainder of the loan amount secured by a second mortgage. (*National Mortgage News*, 10/4/99)

Freddie unsuccessfully tried to enter the mortgage insurance industry in 1998

- In 1998, Freddie successfully included a “technical” provision in the HUD-VA Appropriations Conference Report (H.R. 4194) at the very last minute that would have expanded Freddie’s charter to allow the agency to enter the mortgage insurance business. Fannie and Freddie are required under their charters to protect themselves against default risk when the down payment is less than 20% of the loan amount. Freddie’s expansion proposal would have let Freddie do so by self-insuring, cutting the mortgage insurers out. Although the Freddie language passed the HUD-VA Appropriations bill, which was signed into law on October 21st, language was included in a catch-all Omnibus budget bill (H.R. 4328) that turned around and immediately repealed Freddie’s language that passed in the HUD-VA Appropriations bill. [See October 23, 1998 *GSE Report* for more information about Freddie’s efforts to expand into mortgage insurance, www.gsereport.com]
- The expansion effort by Freddie was so egregious that the bank trade groups for the first time came out in opposition to the GSEs. A joint bank trade letter was sent to Capitol Hill in opposition to Freddie’s charter expansion. The letter was signed by the American Bankers Association, the America’s Community Bankers, the Bankers Roundtable, Consumer Bankers Association, the Independent Bankers Association of America, and the Mortgage Bankers Association. The letter stated that “We must object to the expansion of the charter of any government sponsored enterprise (GSE), without the benefit of hearings, or any other examination of the issues surrounding such an expansion, and the potential increased risk to the GSE that such a move entails.” The letter further stated that the amendment “allows Freddie Mac to compete directly with the private market for mortgage insurance products. The market is already being well served by private mortgage lenders and insurers who have developed products greatly expanding homeownership possibilities for all Americans.” (*Joint trade group letter to House Speaker Newt Gingrich*, 10/8/98)

Treasury Department raised concerns in 1998 about Freddie’s attempted expansion into mortgage insurance

- The Treasury Department in 1998 opposed Freddie’s provision, saying it “may have significant consequences for Freddie Mac and the private mortgage insurance.” Then Assistant Secretary of the Treasury for Financial Institutions Richard Carnell wrote a letter to then Majority Leader Trent Lott (R-MS) noting that as a GSE, Freddie receives certain benefits from the federal government, which give Freddie “a substantial competitive advantage over fully private firms.” Carnell added that the provision may “increase the concentration of credit risk in Freddie; “reduce the market discipline provided by private mortgage insurers’ assessment of mortgage credit risk”; and “raise questions about the long-term viability of private

mortgage insurers in the market served by Freddie Mac.” Carnell noted, “Congress should consider whether the private market adequately and effectively offers mortgage credit enhancements and whether the expected benefits of the provision offset any increased risks and costs.” Carnell further noted that the provision could cost the federal government in terms of lost revenue. (*Assistant Treasury Secretary Richard Carnell letter to Senate Majority Leader Trent Lott, 10/6/98*)

LendingTree terminates its \$2.5 million loan from Freddie

HUD and OFHEO have been reviewing Freddie’s loan for over a year (no reports have been issued to date)

America’s Community Bankers raised concerns that the loan violated Freddie’s charter and accused Freddie of acting like a commercial bank

FM Watch also claimed Freddie’s investment violated its charter

- In LendingTree’s third quarter 2002 earnings statement, Keith Hall, Senior Vice President and CFO of LendingTree, announced that during the third quarter LendingTree “terminated” its \$2.5 million line of credit with Freddie. Hall said the company “believed there was little likelihood of utilizing the line based on our revised favorable outlook.” Hall added, “Based on our current cash position and expectations for continued positive operating results, we remain confident that we will have more than adequate cash to fund our operating needs for the foreseeable future.” (*LendingTree press release, 10/22/02*)
- Freddie’s 2001 loan to LendingTree, an online broker of mortgages and consumer loans, has been under fire for some time. LendingTree announced last year that Freddie provided it a \$2.5 million line of credit as part of a \$45 million financing package assembled to help fund the company. Fannie and Freddie’s safety and soundness regulator, OFHEO, noted in March 2001 that it initiated a review of Freddie’s loan to LendingTree. HUD Secretary Mel Martinez also noted in June 2001 that HUD had initiated a formal review of Freddie’s loan to LendingTree to determine whether the loan was within Freddie’s mission and whether the loan required prior approval from HUD as a new program. HUD is Fannie and Freddie’s mission regulator. To date, neither OFHEO or HUD, has issued a final report. [See March 30, April 13, and July 6, 2001 *GSE Reports* for more information about Freddie’s loan to LendingTree, www.gsereport.com]

ACB had asked HUD to review Freddie’s loan to LendingTree

- As noted in the April 13, 2001 *GSE Report*, the ACB sent an April 3 letter to HUD requesting that the agency review Freddie’s \$2.5 million loan to LendingTree. The letter, signed by ACB’s Chairman David Bochnowski, accused Freddie of exceeding its charter by providing the line of credit. “It appears that Freddie Mac has assumed the role of a commercial bank,” he wrote. “Through its financial link to a primary market participant, Freddie Mac has moved even closer to participation in the primary market, which we believe is clearly a violation of its charter authority and stated corporate mission and intent.” ACB said it had requested a similar review in June 2000 of Freddie’s investment in another online mortgage origination service – HomeAdvisor.com – but ACB has not received a response. “Therefore, we are again requesting a review of the mission appropriateness of these types of investments and activities for a government sponsored enterprise.” (*American Banker*, Rob Garver, 4/9/01; *National Mortgage News Daily*, 4/6/01)

FM Watch had also claimed Freddie’s investment violated its charter

- “The Freddie Mac loan to LendingTree is the first time a GSE has directly engaged in commercial banking, and one of the clearest examples of ‘mission creep’ that we have seen to date,” said FM Watch Executive Director Mike House. FM Watch believed the loan to LendingTree violated Freddie’s charter and that by

extending a line of credit to LendingTree, Freddie was acting like a commercial bank. FM Watch claimed this was the first time a GSE has performed a corporate finance service. “If there is a clearer example of non-charter activities than this, I haven’t seen it,” said House.

- FM Watch said Freddie’s investment was also controversial because LendingTree helped consumers obtain auto and other consumer loans, not just mortgages. According to *Mortgage Banking*, “LendingTree perceives itself as a cyberspace financial bazaar, where potential borrowers may shop for a variety of loans – mortgage, auto, small business, personal, credit cards.” LendingTree also claimed it is a marketplace – not a lender. (*American Banker*, Michele Heller, 3/21/01; *National Mortgage News Daily*, 3/21/01; *Wall Street Journal*, 3/22/01; *Mortgage Banking*, Louise Schiavone, 12/00)

FHFB Chairman John Korsmo says the FHLBanks may go beyond Fannie & Freddie’s recent voluntary financial disclosure agreement and serve as a “role model” for GSE financial disclosures

FHLBank officials appear to support adopting SEC-like disclosure standards for FHLBank debt securities and mortgage-backed securities (MBS) unlike Fannie & Freddie, which oppose such disclosures

Treasury Department called on all GSEs to comply with the same SEC disclosure requirements recently agreed to by Fannie & Freddie

Analyst James Bianco of Bianco Research calls Fannie & Freddie’s voluntary disclosures “kabuki theater”

Background:

- As noted in previous *GSE Reports*, on July 12, a voluntary financial disclosure agreement was reached among Fannie, Freddie, the SEC, OFHEO, and Treasury, in which Fannie and Freddie agreed to voluntarily register their common stock with the SEC (in compliance with the Securities Exchange Act of 1934), while retaining their exemption from registering their debt and mortgage-backed securities (MBS) with the SEC (1933 Securities Act). Therefore, Fannie and Freddie will not register their debt or MBS with the SEC as do other publicly traded companies. The Treasury, SEC, and OFHEO are currently conducting a joint study that is expected to be completed by year-end to promote a more level-playing field with respect to initial offering disclosures between GSEs and non-GSE MBS issuers. In July 16 testimony before the House Capital Markets Subcommittee, Treasury Under Secretary of Domestic Finance Peter Fisher called on all GSEs to comply with the same SEC financial disclosure rules recently agreed to by Fannie and Freddie. In a follow-up to his testimony, Fisher sent letters in August to Sallie Mae and the 12 FHLBanks, urging them to comply with the same financial disclosure rules agreed to by Fannie and Freddie.

FHFB Chairman says FHLBanks may go beyond Fannie & Freddie

- According to John Connor with *Dow Jones Newswire*, FHFB Chairman John Korsmo said FHLBank System officials are considering whether the FHLBank System should become “a role model” for GSE financial disclosures. “The goal is to make the system a model,” Korsmo said in an interview following a FHLBank System-wide task force meeting of FHLBank and FHFB officials. (*Dow Jones Newswire*, John Connor, 10/22/02) The task force was meeting to discuss two pieces of increased financial disclosures for the FHLBanks: (1) addressing debt and MBS in the context of the 1933 Securities Act; and (2) addressing the registration of common stock within the context of the Securities Exchange Act of 1934, as advocated by Treasury Under Secretary Fisher. (*Dow Jones Newswire*, John Connor, 10/2/02)
- **Korsmo said he saw no major obstacles to the FHLBank System going beyond Fannie and Freddie’s financial disclosures and instituting disclosure standards for the FHLBank System’s debt and any**

MBS it may issue. The initiative would track SEC rules in the 1933 Securities Act and would be implemented by the FHFBS. **“The other housing GSEs haven’t taken it that far,” said Korsmo.** (*Dow Jones Newswire*, John Connor, 10/22/02) Korsmo said some FHLBank officials believe the marketplace could look favorably on such a move and reward the FHLBank System with lower borrowing costs, particularly with respect to any MBS issued in the future. Korsmo, however, stressed that the FHLBanks would retain their 1933 Securities Act exemptions under such an approach. The FHLBank System currently doesn’t issue MBS but officials are considering the possibility. (*Dow Jones Newswire*, John Connor, 10/2/02)

- In terms of addressing the registration of common stock within the context of the Securities Exchange Act of 1934, as advocated by Treasury Under Secretary Fisher, Korsmo said this was “a bit more problematic” since the FHLBank System does not issue stock to the public and is organized as a cooperative. However, Korsmo indicated that the FHLBanks’ disclosure task force does not think the issue can be avoided and that the task force has made “real progress” on the issue. He said he will likely meet with the SEC and Under Secretary Peter Fisher on the issue. (*Dow Jones Newswire*, John Connor, 10/22/02)

Analyst James Bianco of Bianco Research calls Fannie & Freddie’s voluntary disclosures “kabuki theater”

- **James Bianco of Bianco Research referred to Fannie and Freddie’s enhanced voluntary financial disclosures as nothing more than “kabuki theater.” Bianco said he’s not impressed by Fannie and Freddie’s announcement of new voluntary disclosures. “They [Fannie and Freddie] say they’re on the vanguard of disclosure...They’re not.”** Bianco said Fannie and Freddie’s reports are filled with confusing cross-references. “What’s the difference between net mortgages and retained mortgages? It’s tough for investors to follow,” he added. “They can dump 2,000 pages of information on your lap and tailor it any way they want.” FHLBank of Chicago President Alex Pollock does not believe that Fannie and Freddie’s voluntary financial disclosures to the SEC is likely to change things. “The general view, which seems right to me, is it won’t affect it very much. They won’t be reporting anything very different from now under this voluntary agreement,” said Pollack. He noted that Fannie and Freddie “currently hold or guarantee \$2.9 trillion of mortgages and are...on track to purchase 71 percent of all residential mortgages originated in the US this year.” In his opinion, competition is as important as regulatory reform and that it takes a GSE (like the FHLBank System) to compete with Fannie and Freddie. (*Mortgage Banking*, Louise Schiavone, 9/1/02)

Senate Banking Committee Chairman Paul Sarbanes (D-MD) asks for more information from FHFBS Chairman John Korsmo about his participation in a political fundraiser for which Presidents of the FHLBanks were asked to contribute

Federal investigators search the FHFBS’s offices as part of an examination requested by Senator Sarbanes

Korsmo admits acquiring information about the political contributions of FHLBank executives

- FHFBS Chairman John Korsmo has come under criticism for being a special guest at an October 1 fundraiser for Rick Clayburgh, a friend of Korsmo, who is running as a Republican for Congress from North Dakota. Korsmo’s attendance was criticized because the presidents of several FHLBanks were invited to the fundraiser, just weeks after the FHFBS adopted new ethics rules that declared the FHFBS as the “arms-length regulator for the safety and soundness” of the FHLBanks. (*American Banker*, Rob Garver, 10/1/02) Korsmo said he had checked prior to the fundraiser with his general counsel, Arnold Intrater, and Greg Walden, a Washington attorney who helped the FHFBS develop its ethics rules. (*Associated Press*, Dale Wetzel, 10/2/02) [See September 13, 2002 *GSE Report* for more information about the new ethics rules and the October 11, 2002 *GSE Report* for more information about Korsmo’s controversial attendance at the fundraiser, www.gsereport.com]

- House and Senate lawmakers requested a federal investigation into Korsmo's participation in the fundraiser. At an October 3 Senate Banking Committee hearing on the nomination of Diane Furchtgott-Roth to fill a seat on the FHFB, Senate Banking Committee Chairman Paul Sarbanes (D-MD) and Ranking Member Phil Gramm (R-TX) criticized Korsmo for his participation at the fundraiser and indicated that they intended to bring him before the Senate Banking Committee. Senators Sarbanes and Gramm also sent letters to the Government Accounting Office, the FHFB's Inspector General and Korsmo requesting a federal investigation. The Senate Banking Committee approved all the nominees who appeared at the October 3 hearing, except for Furchtgott-Roth. Congressman Henry Waxman (D-CA) also sent a letter to the House Government Reform Committee Chairman Dan Burton (R-IN) raising concerns about Korsmo's participation in the fundraiser.
- Korsmo and Furchtgott-Roth have corresponded several times with lawmakers on the issue. In an October 9 letter to Korsmo, Senator Sarbanes cited language in the FHFB's new ethics rules, which said that members of the FHFB "must always carry out our regulatory responsibilities in a manner that is fair, objective, and impartial and clearly so." Senator Sarbanes asked Korsmo to respond to a series of questions, including: (1) "Do you agree that it is inappropriate, even if not illegal, for a financial regulator to allow his name to be used by a political campaign in an effort by that campaign to solicit funds from the regulated entities?"; (2) Did you or any member of the FHFB staff make suggestions as to whom from the Home Loan Bank System, or its members, the Clayburgh for Congress committee should solicit?; (3) Did you or FHFB staff provide any contact information for Home Loan Bank executives or its members to the Clayburgh campaign or any of its representatives?"; and (4) "Did you or any member of the FHFB staff solicit anyone's participation in the fundraiser, either as a sponsor or attendee?" (*BNA Daily Report for Executives*, 10/15/02) Senator Sarbanes wrote, "In my view, your conduct in the matter of the Clayburgh for Congress fundraiser raises serious questions as to whether you have lived up to the [ethics] standard you set for yourself." (*Dow Jones Newswire*, Dawn Kopecki, 10/10/02)
- Korsmo admitted his attendance at the fundraiser was a mistake in an October 11 letter to Senator Sarbanes. "In retrospect, I acknowledge forthrightly I should have erred on the side of caution." He noted that he did not plan the fundraiser and did not realize FHLBank executives were invited. In retrospect, he said he should have asked the organizers of the fundraiser not to invite FHLBank executives. "That was an oversight and a mistake on my part that I pledge not to repeat," he said. "Despite my oversight, however, there has been no credible suggestion that any of the organizers of the event misrepresented my participation in any way." (*Dow Jones Newswire*, Dawn Kopecki, 10/11/02) "I have known Rick Clayburgh and his family for more than 20 years," Korsmo said in his letter. "I believe it is safe to say that my longstanding friendship with Mr. Clayburgh and members of his family is the reason I was asked to participate in a Washington campaign event on his behalf." (*Associated Press*, Dale Wetzel, 10/11/02) Korsmo wrote, "I have not personally solicited and never will personally solicit any Federal Home Loan Bank executive for contributions to any candidate...I have not directed or tolerated and never will direct or tolerate any prohibited political activity by any Finance Board employee. And no member of the Finance Board staff played any part in soliciting contributions for the October 1 Clayburgh event." He noted that nothing in the FHFB's new ethics rules referenced procedures for FHFB members in regard to campaign finance rules. (*BNA Daily Report for Executives*, 10/15/02)
- Speaking to reporters, Korsmo attributed his participation in the event to "naiveté." He stated, "In retrospect, given who the hosts were [Chairman of the House Financial Services Committee Michael Oxley (R-OH), Congressman Bob Ney (R-OH) and Congressman Michael Ferguson (R-NJ)]. ...I probably should have realized that any invitation list might have included people from the Federal Home Loan Bank System." "It was a mistake on my part not to have assured myself that anybody whose activities may fall under the purview of the Federal Housing Finance Board would be there. I thought I had done everything

necessary. I certainly checked what the law was. I perhaps should have recognized that I would be judged by an unwritten standard that went beyond that.” (*BNA Daily Report for Executives*, 10/15/02)

- In response to Korsmo’s October 11 letter, Senator Sarbanes sent an October 18 letter to Korsmo asking for more information, claiming that Korsmo did not fully answer his questions about the fundraiser. Specifically, Senator Sarbanes wanted to know if Korsmo or his staff had any advance knowledge of the list of fundraiser invitees and whether they took any action to ensure that FHLBank executives were not included. The letter also asked if Korsmo or his staff have been involved in other fundraisers or have sought information about political contributions made by FHLBank executives. Senator Sarbanes further criticized Korsmo for his comments to the press that he is being held to an “unwritten standard” that is “higher than the legal standard.” (*American Banker*, Rob Garver, 10/22/02)

Federal investigators search the FHFB’s offices

- A team of federal investigators searched the FHFB’s offices October 28 in an inspection looking into possible fundraising improprieties, reported Rob Garver with the *American Banker*. The investigators seized computers from Korsmo and from all the employees attached to the office of the chairman and some from the office of the general counsel. The investigators, led by representatives of the FHFB’s inspector general, were collecting information as part of a probe requested in October by Senator Sarbanes. The Senator requested reports by the inspector general and the GAO. A FHFB spokesman described the search as routine. “This is what happens when a senator asks for an inspector general’s report,” and downloading e-mails and other data is “standard operating procedure” in such an investigation... We had our computers back in a couple of hours.” (*American Banker*, Rob Garver, 10/31/02) “They merely took the computers away for several hours, downloaded the information and returned them,” said FHFB spokesman Carter Wood, whose own computer was taken. “It’s standard operating procedure and was no surprise to us.” (*Dow Jones Newswire*, Dawn Kopecki, 10/31/02) Wood noted that Judith Hoffman, the director of its Office of Management, warned FHFB staff to expect investigators to request access to their computer files after Senator Sarbanes called for the investigation. During an October 21 meeting, staff from the Inspector General’s office formally told Hoffman and Don Demitros, the FHFB’s Chief Information Officer, that they would want access to staff computers, Wood said. “No one had specific knowledge of when the computers would be checked, or in which fashion they would be checked,” Wood said. “However, it is a routine step we fully anticipated.” (*American Banker*, Rob Garver, 11/1/02) FHFB Inspector General Edward Kelley could not be reached for comment. (*American Banker*, Rob Garver, 10/31/02)

Korsmo admits acquiring information about the political contributions of the executives of the FHLBanks

- In an October 30 letter to Senator Sarbanes, Korsmo admitted acquiring information about the political contributions of FHLBank executives, reported Rob Garver with the *American Banker*. However, he insisted that the information never affected the “actions and decisions I am bound to make in the public interest.” He wrote, “Regulatory issues confronting the Federal Housing Finance Board are not inherently ‘partisan’ and, from my perspective, only rarely have a partisan aspect.” Korsmo noted that “of course,” he had “acquired information regarding the political contributions of Home Loan Bank executives, officers, or employees.” He noted, however, that gathering such information is routine in preparing for meetings with executives. “For many years, in anticipation of meeting or working with individuals or organizations, I have sought information regarding such individuals or organizations available from public sources,” including “public information regarding political contributions readily available on the Internet,” Korsmo wrote. (*American Banker*, Rob Garver, 11/4/02) The letter was in response to Senator Sarbanes’ October 18 letter requesting more information from the FHFB, including whether Korsmo or his staff have been involved in other fundraisers or have sought information about political contributions made by FHLBank executives

***Tax Notes* publication publishes extensive tax analysis of Fannie’s use of its non-profit foundation to run self-promotional ads**

“Competitors see this issue of the foundation as yet another taxpayer subsidy to Fannie Mae in addition to its implicit government guarantee and its valuable exemption from state and local income taxes.”

“If Exxon, for example, asked for a ruling that a private foundation be allowed to promote its products, it would probably be turned down; but Fannie Mae’s foundation promotes Fannie Mae’s governmentally sanctioned mission.”

“Fannie Mae’s transfer of its advertising campaign to a private foundation may be yet another example of the migration of taxable functions to tax-exempt organizations”

- Lee Sheppard with *Tax Notes* wrote an extensive analysis of Fannie’s use of its non-profit foundation – the Fannie Mae Foundation – to run self-promotional ads. **Sheppard noted that Fannie “gets what it wants in Washington” in part, because “if you question the level of government subsidy for home ownership, you’re definitely a communist.”** He added, **“Although research has shown that Fannie Mae’s huge secondary mortgage market purchasing lowers mortgage interest rates by only about one quarter of a percentage point,”** Fannie **“is devastatingly effective at parrying its critics...Fannie Mae also gets what it wants in the tax administrative realm as well.”** The article referenced a recent *Wall Street Journal* article which discussed Fannie’s transfer of its public relations advertising campaign and its in-house housing research programs to the Fannie Mae Foundation, a section 501(c)(3) organization, along with \$350 million worth of its own shares. [See August 23, 2002 *GSE Report* for more information about the August 15 *Wall Street Journal* article on the Fannie Mae Foundation.]
- Fannie’s critics question the propriety of Fannie’s arrangement. **Sheppard argued that this issue matters because:** “Fannie Mae’s congressional charter calls for it to act as an intermediary between individual borrowers and the unforgiving credit markets so that residential mortgages may be more available and carry lower interest rates. Despite its federal regulation and the implicit government guarantee that attaches to its mortgage-backed securities, Fannie Mae is a publicly traded, private-sector company that pays federal income tax like any other financial intermediary. It is the world’s largest nonbank financial intermediary. It competes with other private sector mortgage purchasers. **So if an affiliated exempt organization takes over a function previously performed by Fannie Mae, it could be questionable under the tax law in addition to being anticompetitive.**”
- Fannie funded and established the Fannie Mae Foundation in 1979 and historically made Fannie Mae-funded grants of roughly \$14 million annually to tax-exempt affordable housing groups. In 1993, Fannie began an advertising campaign designed to make mortgage applications less intimidating to lower-income borrowers. Fannie deducted the roughly \$30 million annual cost of the advertising campaign on its own corporate return. However, in late 1995, Fannie moved the advertising campaign to the foundation and gave it \$350 million of its own shares to pay for the ads and other activities. Sheppard noted that “about this time, Fannie Mae’s valuable exemption from District of Columbia income taxes was being questioned, so the transfer to the foundation may have served public relations purposes as well.” He noted that the Fannie Mae Foundation makes annual donations of \$3 million to DC charities, “an amount that is roughly one-hundredth of Fannie Mae’s theoretical DC income tax liability, which has been estimated to be hundreds of millions of dollars.”
- The Fannie Mae Foundation is the largest corporate foundation in America in terms of assets. The foundation spends \$48 million (44%) of its roughly \$100 million total expenses and disbursements on advertising, while spending \$36.5 million (33%) on grants, according to its 2000 Form 990. “Legally, there

is never a question when a foundation gives money to a section 501(c)(3) organization – that’s what foundations are supposed to do. But a chunk of the Fannie Mae Foundation’s giving has little to do with housing...Nonetheless, the foundation’s giving to social causes is impressive.”

- Critics complain that the foundation’s high level of spending on advertising is disturbing because the advertising seems to benefit Fannie Mae primarily. “Competitors see this issue of the foundation as yet another taxpayer subsidy to Fannie Mae in addition to its implicit government guarantee and its valuable exemption from state and local income taxes.”
- The Fannie Mae Foundation has eight letter ruling blessings from the IRS on its transfer of its advertising campaign and other activities to the foundation. “An examination of the rulings shows that the foundation asked the IRS one question at a time, rather than asking for a single ruling on the end result. The rulings themselves indicate that the IRS was well aware of the cumulative effect of what it was permitting.” Sheppard noted that this piecemeal approach was unusual. “It is unusual for any exempt organization to ask the IRS for a letter ruling on anything. Most exempt organizations ask for their determination letter and then never ask for another ruling. These rulings are interesting in contrast to the major push the IRS has made on the private benefit doctrine in recent years. Fannie Mae is unique in that it has a governmental charter and a governmental mission. If Exxon, for example, asked for a ruling that a private foundation be allowed to promote its products, it would probably be turned down; but Fannie Mae’s foundation promotes Fannie Mae’s governmentally sanctioned mission.”
- The IRS ruled that Fannie’s transfer of its advertising campaign to the foundation would tangentially benefit Fannie Mae from the advertising, which the ruling referred to as “education outreach.” Sheppard noted, “The IRS concluded that this education outreach would contribute to the accomplishment of the foundation’s education goals, and would only incidentally benefit the private purposes of the corporate sponsor. Because Fannie Mae does not originate loans and would not be given preferential treatment regarding loans generated in the program, the IRS ruled that the arrangement would not jeopardize the foundation’s exempt status under section 501(c)(3), or constitute self-dealing under section 4941. ‘There is no requirement that originators of mortgages resulting from this program must sell their mortgages to Fannie Mae,’ the IRS noted.” For this ruling on Fannie, the IRS contrasted *American Campaign Academy v. Commissioner*, 92 T.C. 1053 (1989)
- “In the Fannie Mae Foundation’s case, there are clear public relations benefits to Fannie Mae from what the foundation does, but the law not only does not object to these benefits, but...considers them incidental. Of course, all public relations advertising eventually accrues to the bottom line of the advertiser indirectly, by creating goodwill,” Sheppard noted. **“The foundation’s advertising accrues to the benefit of Fannie Mae,” said Rick Cohen, president of the National Center for Responsive Philanthropy (NCPR). He questioned the robustness of the firewall between Fannie Mae and the foundation. “Paying for corporate advertising is a pretty direct way of furthering the corporations strategic agenda,” noted Cohen. That is, in his view, the Fannie Mae Foundation’s payment for advertising is a significant breach in the firewall.**
- Sheppard concluded, “Fannie Mae’s transfer of its advertising campaign to a private foundation may be yet another example of the migration of taxable functions to tax-exempt organizations.” (*Tax Notes*, Lee A. Sheppard, 9/2/02)

American Enterprise Institute (AEI) holds October 25 conference on Fannie & Freddie to discuss the degree to which Fannie & Freddie lower mortgage interest rates

Panelists note that Fannie & Freddie do not lower mortgage interest rates enough to increase homeownership

For all the federal subsidies given to Fannie & Freddie, their impact for most homebuyers is negligible

Joseph McKenzie of the Federal Housing Finance Board, noted that Freddie, and to a lesser extent Fannie, have media ad campaigns that tout the effect of the GSEs on mortgage rates and use data comparing the mortgage interest rate differential between conforming and jumbo loans as evidence of their effect on lowering mortgage costs. McKenzie noted that Freddie's calculation of this differential is incorrect

Overview of AEI conference

- AEI held a conference, entitled "*Do Lower Mortgage Rates Increase Homeownership?*," on October 25 to discuss among other things, the degree to which Fannie & Freddie lower mortgage interest rates. **AEI panelists noted that Fannie and Freddie do not lower mortgage rates enough to increase homeownership. "They're [Fannie and Freddie] not doing anything," AEI Resident Fellow Peter Wallison stated at the conference. "If they were privatized, [interest] rates would still be the same as they are now, because Fannie Mae and Freddie Mac don't really affect the rates." Joseph McKenzie, the Deputy Chief Economist of the Federal Housing Finance Board, said that Fannie and Freddie do lower interest rates, but normally only by a quarter of a percentage point. "The question then becomes, do these agencies affect homeownership with plus or minus 25 basis points only?" he said. If the GSEs had never been created, consumers would still have a large pool of loans to choose from, and competition would rule the market, he stated. (American Banker, Sarah Lockyer, Medill News Service, 10/30/02)**
- **According to a panel of prominent economists at the AEI conference, for all the federal subsidies given to Fannie and Freddie, their impact for most homebuyers is negligible. "You're more likely to help people if you lower down payments than if you lower interest rates," said Ron Feldman, an assistant vice president at the Federal Reserve Bank of Minneapolis. Feldman moderated the AEI conference. (Dow Jones Newswire, Dawn Kopecki, 10/25/02) The Minneapolis Federal Reserve Bank released a study by Feldman in August in its 2001 Annual Report finding that Fannie and Freddie's effect on mortgage rates is only negligible and has a minimal impact on helping renters buy a home. The study suggested that cash payments to potential homeowners would have a larger effect on homeownership than Fannie and Freddie. Copies of the study were distributed at the AEI conference. [See August 23, 2002 *GSE Report* for more information, www.gsereport.com]**
- Freddie's chief economist Frank Nothaft claimed: (1) lower mortgage interest rates increase homeownership; (2) Fannie and Freddie lower mortgage interest rates; (3) Fannie and Freddie's activities create a higher homeownership rate; and (4) alternative policy prescriptions to Fannie and Freddie to address mortgage affordability and homeownership are less cost efficient, more costly and politically unrealistic. (American Banker, Sarah Lockyer, Medill News Service, 10/30/02; *AEI Conference*, 10/25/02)
- **Research presented at the AEI conference provided evidence that lower mortgage interest rates may not be enough to increase homeownership. Howard Savage, the chief of the Census Bureau's housing economics statistics division, pointed to a 1995 report that showed total homeownership did not change significantly even after interest rates declined by 3 percentage points. "Interest rates won't affect people with cash and income problems," Savage said. "The rates could go as low as possible and**

couldn't change those problems with loans.” (*American Banker*, Sarah Lockyer, Medill News Service, 10/30/02) **Savage noted that downpayment subsidies would do more to improve the affordability of a modestly priced home than lower downpayment requirements or a significant reduction in interest rates.** (*AEI Conference*, 10/25/02)

- **Joseph McKenzie of the Federal Housing Finance Board, noted that Freddie, and to a lesser extent Fannie, have media ad campaigns that tout the effect of the GSEs on mortgage rates and use data comparing the mortgage interest rate differential between conforming and jumbo loans as evidence of their effect on lowering mortgage costs.** The FHFB compiles the monthly mortgage interest rate survey which is the typical data set that people use to compare the difference in mortgage rates in the conforming market (which Fannie and Freddie can purchase) versus the jumbo market which is above the conforming market (Fannie and Freddie cannot purchase). **McKenzie noted that Freddie's calculation of this differential is incorrect. Freddie assumes a 50 basis point interest rate reduction and applies it to 360 mortgage payments, and sums up these numbers without any discounting, which is not the way it should be done.** (*AEI Conference*, 10/25/02)

Introduction: PETER J. WALLISON, AEI

- **Fannie and Freddie justify their continued role as GSEs, by claiming that they increase homeownership by lowering interest rates. However, Fannie and Freddie were not established for the purpose of lowering interest rates. “Their charters say nothing about interest rates. They were established to bring liquidity to the residential mortgage markets.” Wallison noted that they are no longer needed to create liquidity.** “Because of innovations and developments in the capital markets since they were established, Fannie and Freddie are no longer necessary to create liquidity in the residential mortgage markets. As shown by the success of the so-called jumbo market, the unsubsidized secondary market is fully capable of doing what Fannie and Freddie are doing in creating liquidity for conventional/conforming mortgages.” Assuming that Fannie and Freddie were established to reduce interest rates, if Fannie and Freddie's 25-30 basis point reduction in interest rates is not found to have any substantial effect on homeownership – “then whatever basis there may be for their continued existence as government-backed entities has been eliminated. They have no basis for claiming that they advance the housing policies of the United States. They are then simply what those cynical economists have always said they were: a mechanism – and an inefficient one at that – for transferring a subsidy from all taxpayers to homeowners.” (*AEI Conference*, 10/25/02)

Panel 1: Mortgage Rates and Homeownership – Researchers discussed their analysis of how changes in mortgage rates affect homeownership

HOWARD SAVAGE, U.S. Census Bureau

- Howard Savage pointed to a 1995 Census Bureau report – “*Who Could Afford to Buy a House in 1995?*” - that showed total homeownership did not change significantly even after interest rates declined by 3 percentage points. “Interest rates won't affect people with cash and income problems,” Savage said. “The rates could go as low as possible and couldn't change those problems with loans.” (*American Banker*, Sarah Lockyer, Medill News Service, 10/30/02) **The study noted 69.9% of renters had cash and income problems (lack of cash for downpayment and closing costs, excessive debt and insufficient income) which means that interest rates can go as low as possible (getting close to that now) without making a difference to this group on whether they could afford a modestly priced home because these people not only have income problems but they have insufficient cash**
- **The study also found that downpayment subsidies would do more to improve the affordability of a modestly priced home than lower downpayment requirements or a significant reduction in interest rates. Lowering interest rates has almost no effect on the affordability of a modestly priced house for the total population of renters, including Black and Hispanic renters. In 1995, only 10.2 percent of**

renters could afford to buy a modestly priced home. Reducing interest rates by 1 percentage point would only increase the number of homeowners by 3/10 of 1 percent to 10.5 percent. If interest rates go down as low as 3 percentage points, such reduction would only increase the number by .9 percent to 11.1 percent. This is not a significant change in terms of the number of renters that can afford things and this is the impact of simply lowering mortgage interest rates. **Lowering interest rates has absolutely no effect on the number of Black renters that would be able to afford a home. In terms of Hispanics, there is a negligible effect of lowering interest rates on ability to afford a home.** [See chart below for more information.]

- Requiring lower downpayments only has only a small effect on the ability of renters to afford a home. Requiring even no downpayment would affect only 2 ½ percent of renters. **Providing downpayment subsidies is the only program that would make a difference.** A subsidy of at least \$2,500 for the downpayment would be required to significantly reduce the percentage of Black renters who would have qualified for a mortgage. A \$2,500 subsidy would have increased the number of Black renters that qualified for a mortgage by 2 percentage points, a \$5,000 subsidy by 13 percentage points, and \$7,500 subsidy by 19 percentage points. A \$10,000 subsidy would not significantly further increase (over a \$7,500 subsidy) the number of Black renters who could qualify for a mortgage. For Hispanic renters, a subsidy of at least \$5,000 would be required to significantly raise the percentage that would qualify for a mortgage. A \$5,000 subsidy would have increased the number of Hispanic renters who would have qualified for a mortgage on a modestly priced home by 7 percentage points, a \$7,500 subsidy by 12 percentage points, and a \$10,000 subsidy by 16 percentage points. Savage is working on updating the data from 1997-1999 but doesn't expect the results to change. (*"Who Could Afford to Buy a House in 1995?"* Howard Savage, 8/99; *AEI Conference*, 10/25/02)

Effects of Possible Policy Changes on the Affordability of a Modestly Priced House for Total, Black, and Hispanic Origin Renters: 1995			
Percentage who could afford to buy			
	Total	Black	Hispanic Origin(1)
Current mortgage requirements (2)	10.2	3.4	2.6
Modified Mortgage Requirements			
2.5 percent down payment	11.3	4.4	2.9
No down payment	12.7	5.7	3.2
Modified Interest Rate			
Interest rate 1 percentage point lower	10.5	3.4	2.6
Interest rate 2 percentage points lower	10.8	3.4	2.7
Interest rate 3 percentage points lower	11.1	3.4	2.7
Modified cash assistance			
\$1,000 down payment subsidy	11.0	4.2	2.9
\$2,500 down payment subsidy	12.6	5.2	3.3
\$5,000 down payment subsidy	21.2	16.1	9.9
\$7,5000 down payment subsidy	27.7	22.6	14.7

\$10,000 down payment subsidy	31.9	25.5	18.6
(1) Hispanics may be of any race (2) Current mortgage requirements in 1995 were 5% down, a 8.67 interest rate for conventional mortgages, and no subsidy Note: Assumes conventional, fixed-rate 30-year financing, with a 5% down payment Source: US Census Bureau, Survey of Income and Program Participation (<i>"Who Could Afford to Buy a House in 1995?"</i> Howard Savage, 8/99)			

SUSAN WACHTER, Wharton School, University of Pennsylvania

- Wachter presented findings from a paper she produced jointly with Roberto Quercia, University of North Carolina at Chapel Hill and George McCarthy, The Ford Foundation. The research was supported by grants from Freddie Mac and the Zell/Lurie Wharton Real Estate Center. Their study assessed the impact of affordable lending efforts on homeownership rates and assessed the potential impact of GSEs' affordable lending efforts. Wachter claimed the GSEs lower interest rates and for a given interest rate, they lower downpayments. The GSEs do this not only by their 25-35 basis point differential between GSEs versus jumbo loans but also through innovation and economies of scale that allow lower downpayments. The study found evidence that affordable lending initiatives, including those of the GSEs, may be having an impact on increasing homeownership. The study simulated four GSE affordable lending products (all Freddie products) in its assessment. The paper examined the impact of using flexible underwriting guidelines, primarily changes in the downpayment and house burden requirements on the affordability and homeownership propensities of targeted populations and geographic areas. The impact of changing these underwriting guidelines were then compared with those resulting from lower borrowing costs (lower interest rates). The study found that affordable lending efforts increase homeownership opportunities for underserved populations, but that impacts may not be felt equally by all groups. Under most affordable products, the impacts on all households, recent movers and central city households are smaller than for other households. Their study found that Freddie's Alt '97 (low downpayment mortgage product) had the largest impact on the homeownership propensities of all underserved groups and increased the relative probability of homeownership for young households by 27.1%, for black households by 21%, and for center city households by 15%. Changes in underwriting guidelines were found to have greater impact than changes in the cost of borrowing for all groups. (*"The Impacts of Affordable Lending Efforts on Homeownership Rates,"* Roberto Quercia, George McCarthy, Susan Wachter, 10/25/02; *AEI Conference*, 10/25/02)

ANTHONY YEZER, George Washington University

- **Yezer noted that lowering interest rates does not change the relative price of owning versus renting a home.** He questioned whether homeownership is a mortgage problem. Recent buyers tend to have little equity yet 30% of owners have no mortgage at all. The median owner (under 50 years of age) has only housing equity and government-insured assets in their portfolio. The average owner is poorly diversified. He believes that the country propagandizes people to mortgage up to their "eyeballs" and spend the next 30 years "burning their mortgage" as a major goal. "This makes no sense at all. Our use of mortgage credit is abysmal." Older mortgage owners have too little mortgage debt, while younger owners have too much mortgage debt. There is a housing equity trap that catches many because banks only lend when you don't need money (if you go to the A market when you lose a job, you can't tap your housing equity when you really need it because you don't qualify), so the subprime lenders are filling the gap between those caught in the equity trap. The government is part of the problem because (1) it encourages over-investment in housing equity; (2) FHA research is needed; and (3) banking legislation prevents researchers from using credit scores in their research. The following are changes that the government could make: (1) stop promoting homeownership for marginal credit risks; (2) encourage households to diversify; (3) promote the reverse annuity mortgage; (4) use FHA as an experiment in mortgage lending and recognize FHA is a primary program for first-time homebuyers; and (4) promote research into creditworthiness. The following are changes that the private sector could make: (1) design mortgage instruments for owners who now have no mortgages; (2) allow borrowers to miss payments, access home equity automatically; (3) stop pushing

the 30-year self-amortizing dinosaur (which was invented in the 1930s); and (4) optimal mortgages should consider the local housing market conditions (e.g., some areas where houses will appreciate in value, while others will depreciate) – which is a challenge to the GSEs. The problem of a national institution is we are stuck with a one size fits all mortgage policy. It is hard for them to offer different things to different people. (*AEI Conference, 10/25/02*)

Would more competition increase innovation?

- When asked during the question and answer period whether introducing more GSEs would increase competition and innovative products, Yezer noted that the GSEs have excellent economists and would be able to create these more tailored products he discussed but he's not sure why this hasn't been done. He believes more competitive markets in general, do tend to result in more innovation. It's a fair point but beyond the scope of his remarks. Wachter noted that franchise value is key to innovation, so it's not always true that adding more companies increases innovation and she believes the research actually goes against that theory. She argued that the GSEs have provided lots of innovation. (*AEI Conference, 10/25/02*)

Panel 2: Effects of Fannie Mae and Freddie Mac on Mortgage Rates

JOSEPH MCKENZIE, Federal Housing Finance Board

- The FHFB compiles the monthly mortgage interest rate survey which is the typical data set used to compare the difference in mortgage rates in the conforming market (which Fannie and Freddie can purchase) versus the jumbo market which is above the conforming market (Fannie and Freddie cannot purchase). **Freddie, and to a less extent Fannie, have media ad campaigns that tout the effect of the GSEs on mortgage rates and use data comparing the mortgage interest rate differential between conforming and jumbo loans as evidence of their effect. However, Freddie assumes a 50 basis point interest rate reduction and applies it to 360 mortgage payments, and sums up these numbers without any discounting, which is not the way it should be done.** First, it should be done on a present value basis. Freddie charges interest on its loans, it does not have a zero discount rate internally and presumably households don't have a zero discount rate. These savings should be discounted to the present. The second part of Freddie's calculation uses 360 mortgage payments. The actual maturity of a mortgage is closer to 360 days, not 360 months. Freddie's calculation also uses a 50 basis point differential between conforming and jumbo loans.
- There is inherent sponginess in what this differential is. However, the differential should not begin at 50 basis points because there is a body of literature and research – as spongy as it may be – that generally puts this differential at about 20-25 basis points. To look at the differential in mortgage rates between conforming and jumbo, one should start with a 25 basis point differential. There is a sponginess in the differential because the real estimate is unmeasurable and unobservable. There are some factors that are pluses and minuses that would affect the differential. On the plus side, the MERS data does not characterize loans as conforming and non-conforming – it only characterizes loans as jumbo and non-jumbo. So there are some loans that are below the conforming loan limit that are non-conforming for property or borrower characteristics but we don't know what there are. So when we estimate a 22 basis point differential between jumbo and non-jumbo, we must say some of these non-jumbo are non-conforming, with the result that the real conforming non-jumbo number is really lower, so then the estimated spread is a little higher. There are some partial effects that go on the minus side. If you never had Fannie or Freddie, you would have a very large pool of loans. When you have Fannie and Freddie, you divide the pool of loans. With some loans you create superior liquidity but for other loans you create inferior liquidity and indeed create less liquidity than you had before. You penalize some loans and reward other loans with the addition of Fannie and Freddie. If you had no Fannie or Freddie, jumbo loans could be combined with non-jumbo loans and the prepayment speeds would even out. Now when you have a relatively narrow slice of the market (jumbo), there is some uncertainty regarding prepayment speeds so there is probably some penalty that jumbo mortgages pay because of increased uncertainty of prepayment speeds. Without Fannie and Freddie, geographic diversification of a loan pool is not a particular issue because everything is lumped together. Because high

priced loans and high priced properties are geographically concentrated you create a lack of geographic diversity by separating the markets between jumbo and non-jumbo. The jumbo pool is less geographically diverse than the non-jumbo pool. This affects the sponginess of the differential assessment.

- McKenzie added that there may be a little mispricing of risk. To obtain a AAA rating on a pool of jumbo loans in a MBS, there is usually some sort of pool insurance required. On the other hand, to pool mortgages into a Fannie and Freddie security, usually no pool insurance is required. It's not a big item but still it's a mispricing of risk. The originator and ultimately, the jumbo borrower have to pay for this pool insurance. On the conforming loans, no one is actually paying for it, but the US taxpayers are acting as the re-insurance function. For all of these reasons, how much the GSEs affect homeownership is a difficult question. (*AEI Conference, 10/25/02*)

FRANK NOTHAFT, Freddie Mac

- Nothaft argued: (1) lower mortgage interest rates increase homeownership; (2) Fannie and Freddie lower mortgage interest rates; (3) Fannie and Freddie's activities create a higher homeownership rate; and (4) alternative policy prescriptions to Fannie and Freddie to address mortgage affordability and homeownership are less cost efficient, more costly and politically unrealistic. Assistant vice president at the Federal Reserve Bank of Minneapolis Ron Feldman's research showed that lower mortgage interest rates do indeed increase homeownership. Wachter's research found that by increasing the mortgage interest rates by 50 basis points, the aggregate homeownership rate in the US would be 1.1% lower than otherwise, with much larger effects on lower-income and minority and central city families. Savage showed that a decline in mortgage interest rates, increases the proportion of renters who could now qualify for a mortgage. The empirical research is consistent that lowering interest rates increase homeownership. Certainly there are downpayment restraints that are also significant and substantial factors.
- Fannie and Freddie lower mortgage interest rates as shown by the empirical research. He agreed with Wallison that Freddie's charters says nothing about lowering mortgage interest rates but the GSEs were chartered to provide stability and liquidity to the secondary market to the capital markets and respond appropriately to the capital market. For the past 15 years, Fannie and Freddie have been in the capital markets during times of stress to assure a steady flow of mortgage capital to meet the needs of American families. Conforming loans rates have remained low and stable through these stress periods. You don't see the same pattern in the jumbo and commercial market during these periods. Part of the reality is that Fannie and Freddie by fulfilling their charters by providing liquidity and stability to the secondary market and responding appropriately to the capital markets created lower mortgage interest rates. The homeownership rate is higher because of Fannie and Freddie's activities not just because Fannie and Freddie lower mortgage interest rates but because of the GSEs' innovations and new products that have been introduced into the marketplace. Freddie estimated that the number of homeowners today is probably 1 million to 2 million higher than it otherwise would have been.
- The current way the US has organized the housing finance system is optimal and efficient. It is the cheapest and lowest cost as possible to delivering mortgage finance to borrowers. The US has the most efficient housing financial delivery system in the world in terms of delivering mortgage credit to consumers. Alternative policy prescriptions to address homeownership and affordability typically take the form of taking tax money providing subsidies to people or providing a tax credit. He doesn't think Congress has much of an appetite for these types of proposals to increase tax receipts and tax revenues to create another subsidy program for homeownership. These proposals are typically expensive and are not politically feasible. He believes the US has a system that works very well, very efficiently, and is the envy of people around the world. (*AEI Conference, 10/25/02*)

Fannie Mae and Freddie Mac

Critics of Fannie & Freddie “have some allies within the Federal Reserve System,” reports John Connor with *Dow Jones Newswire*

- “As time goes by, it becomes increasingly clear that the good government types and business competitors who have been fretting over Fannie Mae and Freddie Mac have some allies within the Federal Reserve System,” reported John Connor with *Dow Jones Newswire*. Connor noted that concerns have been raised by Federal Reserve Board Chairman Alan Greenspan, St. Louis Fed President William Poole, Federal Reserve Board Governor Susan Bies, and Kansas City Federal Reserve Board President Thomas Hoenig. “What, if anything, does all this jawing mean and what does it portend? Darned if we know, except perhaps that Fed officials may be among the few people who can say less than glowing things about Fannie without having their phones ring off the hook and then reel in their remarks.” (*Dow Jones Newswire*, John Connor, 10/16/02)

Several Federal Reserve Banks raise GSE issues in 2002

- Federal Reserve Board Governor Susan Bies noted that Fannie and Freddie disclose less information about their securities than the private sector. She said she hopes Fannie and Freddie agree to financial disclosures under the 1933 Securities Act to improve transparency. She noted that Congress should focus on Fannie and Freddie’s growing size and leverage and challenged OFHEO to keep its risk-based capital standards for Fannie and Freddie current with the type of activity going on at Fannie and Freddie. Bies’ comments were made October 1 during a question-and-answer session after delivering a speech at the Carnegie Endowment for International Peace. (See October 11, 2002 *GSE Report* for more information.) The Kansas City Federal Reserve Bank President told Deborah Lagomarsino of *Dow Jones Newswire* in an October interview that “there are some issues” with respect to Fannie and Freddie and raised concerns about Fannie and Freddie’s leverage, transparency, and capital. (See October 11, 2002 *GSE Report* for more information.)
- The Minneapolis Federal Reserve Bank released a study in August in its 2001 Annual Report finding that Fannie and Freddie’s effect on mortgage rates is only negligible and has a minimal impact on helping renters buy a home. The study suggested that cash payments to potential homeowners would have a larger effect on homeownership than Fannie and Freddie. (See August 23, 2002 *GSE Report* for more information.) The Minneapolis study came just days after the St. Louis Federal Reserve Bank President William Poole warned that the GSEs are a potential source of future instability in the financial markets. (See August 2, 2002 *GSE Report* for more information.) In July, in an appearance before the Senate Banking Committee, Federal Reserve Board Chairman Alan Greenspan said the issue of financial disclosures among GSEs needs to be examined further. (See July 19, 2002 *GSE Report* for more information.) In April, Federal Reserve Board Chairman Alan Greenspan noted that government support for Fannie and Freddie might be leading investors to underestimate the risk of dealing in their securities. That same month, Federal Reserve Bank of San Francisco President Robert Parry noted that the economic role of Fannie and Freddie should be closely monitored. (See May 3, 2002 *GSE Report* for more information.) In the first quarter of 2002, the Federal Reserve Bank of Atlanta released two studies on the GSEs – one examining the federal subsidies that the GSEs receive, noting that there are costs associated with GSE subsidies and the second study comparing Fannie and Freddie’s voluntary risk management initiatives to current banking standards. (See April 19, 2002 *GSE Report* for more information.)

Fannie & Freddie report third quarter earnings

Critics raise concerns about the disparity between Fannie & Freddie's net income under generally accepted accounting principles (GAAP) – Freddie's net income soared in the third quarter, while Fannie's fell

Fannie & Freddie reclassify mortgage assets in accounting change

Fannie's net income drops from derivatives exposure

Fannie's shareholder equity drops substantially, while Freddie's increases

Disparity between Fannie & Freddie's net income under GAAP raises concerns

- Fannie and Freddie's net income figures in the third quarter, under GAAP, diverged sharply between Fannie and Freddie, reported Tommy Fernandez with the *American Banker*. Under GAAP, Freddie's net income soared 34% from a year earlier, to \$1.38 billion, while Fannie's fell 19% to \$994.3 million. Those figures differ markedly from the operating earnings of Fannie and Freddie in the third quarter - \$987 million at Freddie, up 21%; and \$1.63 billion at Fannie, up 18.4%. **Fernandez noted, "Each company downplays its GAAP results, and investors seem happy to focus on operating earnings. However, it is ironic that their earnings would be so hard to understand so soon after this summer's big push to make the government-sponsored-enterprises more comparable to Securities and Exchange Commission-regulated public companies."** (*American Banker*, Tommy Fernandez, 10/29/02)
- **Critics wonder if the confusing results are obscuring risks or problems, but no one wants to admit that they don't understand the GSEs' GAAP results. "The disparity has never been this big before," an equity analyst said. "Very few analysts feel they understand this...It is probably going to get a lot more attention than Fannie and Freddie really want to give it."** Fernandez noted, "If both GSEs use derivatives to hedge their risks, why do their GAAP results diverge so sharply?" Executives at Fannie and Freddie said they tie their hedges to different sides of the balance sheet: Freddie to its assets and Fannie to its liabilities, which triggers vastly different elements of FAS 133. (*American Banker*, Tommy Fernandez, 10/29/02)
- *Inside Mortgage Finance's* new publication, *Inside the GSEs*, notes that **Fannie reported the biggest difference on a GAAP and non-GAAP basis, a fact that appears to reflect its more aggressive interest risk hedging strategy.** Fannie's decline in net income on a GAAP basis was largely the result of a hefty \$965.2 million jump in unrealized losses in the time value of purchased options, which were adversely impacted by a drop in interest rates. **Freddie's results were much less volatile than Fannie's on a GAAP and non-GAAP basis, and the reason appears to be Freddie's more conservative tolerances for interest rate risk.** (*Inside the GSEs*, 10/23/02)

Fannie & Freddie reclassify mortgage assets in accounting change

- Fannie reclassified \$135 billion in mortgage assets last month, while Freddie reclassified \$75 billion of its mortgage portfolio. The GSEs reclassified a combined \$210 billion in mortgage assets from a hold-to-maturity status to available-for-sale during the third quarter. The move has raised eyebrows in the markets and questions from Congressman Richard Baker, who asked OFHEO to examine the impact of the reclassification on Fannie and Freddie's risk-based capital requirements and shareholder equity. (*Dow Jones Newswire*, Dawn Kopecki, 10/24/02) [See earlier story in this *GSE Report* for more information.]
- Fannie reported roughly \$15 billion in total shareholder equity in the third quarter, a 28% drop over the last six months. Without the reclassification of \$135 billion in assets last month, however, Fannie would have

reported roughly \$10.9 billion in shareholder equity, a 48% drop over the last six months. (*Dow Jones Newswire*, Dawn Kopecki, 10/24/02) Congressman Baker asked OFHEO whether “this reduced level of shareholder equity and even greater leverage concern OFHEO?” (*Congressman Baker letter to OFHEO Director Armando Falcon*, 10/23/02)

Fannie’s earnings

- Fannie reported October 15 a 19% drop in third-quarter net income as derivatives it uses to protect itself from interest rate swings lost value. Excluding the unrealized losses from the derivatives, earnings rose 18.4%. (*Reuters*, Mark Felsenthal, 10/15/02) The \$1.38 billion pretax markdown, brought on by the biggest quarterly drop in Treasury note yields since 1996, helped reduce net income 19%. (*Bloomberg News*, Al Yoon, 10/15/02) FAS 133 requires companies to record changes in the market value of all derivatives even if they are not sold. In the third quarter, the value of the purchased options experienced a net unrealized loss of \$1.38 billion. However, Fannie generally holds onto these purchased options to maturity, which means quarterly changes in the value of these derivatives was not actually realized. If this loss is excluded, Fannie’s operating earnings increased 18%. (*Dow Jones Newswire*, Janet Morrissey, 10/15/02)
- Fannie reported operating net income for the third quarter of \$1.631 billion, an 18.4% increase compared with the third quarter of 2001. Operating earnings per diluted common share (operating EPS) of \$1.62 rose 21.8% above the same period in 2001. For the first nine months of 2002, Fannie’s operating net income was \$4.722 billion, compared with \$3.929 billion for the same period in 2001. Operating EPS for the first nine months of 2002 was \$4.65, or 22.4% above the first nine months of 2001. (*Fannie press release*, 10/15/02)
- Operating net income and operating EPS exclude the variability in earnings that results from including unrealized gains and losses from the change in the market value of purchased options under FAS 133. Net income on a GAAP basis for the third quarter of 2002 including FAS 133 items was \$994.3 million, a decrease of 19.1% compared with the third quarter of 2001. GAAP EPS was \$0.98, 17.6% below the same period last year. The decline in GAAP net income and EPS in the third quarter was due to a \$965.2 million increase in unrealized losses in the time value of purchased options. GAAP net income and EPS for the nine months ended September 30, 2002 were \$3.667 billion and \$3.59, and \$3.925 billion and \$3.80 for the nine months ended September 30, 2001. (*Fannie press release*, 10/15/02)
- Highlights of Fannie’s financial performance in the third quarter of 2002 compared with the third quarter of 2001 include: (1) record commitments to purchase mortgages of \$128.0 billion for the quarter; (2) continued rapid growth in the combined book of business of 15.8% versus the third quarter of last year, and an annualized 13.8% versus the second quarter of 2002; (3) growth in the guaranty fee income of 20.5% compared with the third quarter of 2001; (4) an average net interest margin of 116 basis points, level with the second quarter of 2002 and 6 basis points above the third quarter of 2001; (5) an increase in fee and other income of \$43 million versus the third quarter of 2001; and (6) a further decline in credit-related losses to \$13.9 million from \$17.2 million in the second quarter and \$18.7 million in the third quarter of 2001. (*Fannie press release*, 10/15/02)
- Fannie’s business volume -- mortgages purchased for portfolio plus mortgage-backed security (MBS) issues acquired by other investors -- totaled \$186.8 billion in the third quarter of 2002, compared with \$158.8 billion in the third quarter of 2001 and \$159.8 billion in the second quarter of 2002. Business volume for the first nine months of 2002 was \$544.4 billion, a 26.6% percent increase from \$430.1 billion for the first nine months of 2001. Business volume in the third quarter of 2002 consisted of \$74.2 billion in portfolio purchases and \$112.6 billion in MBS issues acquired by investors other than Fannie’s portfolio, compared with \$64.2 billion and \$94.6 billion, respectively, in the third quarter of 2001. (*Fannie press release*, 10/15/02)

Freddie's earnings

- Freddie announced operating earnings for third quarter 2002 were \$987 million, compared to \$813 million for the same period a year ago and \$968 million for second quarter 2002. Diluted operating earnings per common share were \$1.34 for third quarter 2002, compared to \$1.08 for third quarter 2001 and \$1.30 for second quarter 2002. Freddie also announced that its duration gap averaged approximately negative 1 month in the third quarter, unchanged from second quarter 2002. (*Freddie press release, 10/23/02*) In contrast, Fannie announced October 1 that its duration gap narrowed from negative 14 months in August to negative 10 months in September. (*Fannie press release, 10/1/02*)
- Freddie's operating earnings and diluted operating earnings per common share exclude certain accounting effects related to FAS 133. As reported under GAAP, net income for third quarter 2002 was \$1.378 billion, an increase of 34% from third quarter 2001 net income of \$1.032 billion. Diluted earnings per common share for third quarter 2002 were \$1.90, an increase of 36% from third quarter 2001 diluted earnings per common share of \$1.40. Second quarter 2002 net income and diluted earnings per common share were \$1.110 billion and \$1.504, respectively. (*Freddie press release, 10/23/02*)
- Highlights for third quarter 2002 include: (1) Freddie's total mortgage portfolio grew by \$17 billion during the third quarter, representing annualized growth of 5%; (2) Freddie's retained portfolio grew by \$12 billion during the third quarter, representing an annualized growth of 9%; (3) Freddie's fully taxable equivalent (FTE) operating net interest yield was 86 basis points in the third quarter, down 2 basis points from second quarter 2002; (3) Freddie's portfolio market value sensitivity averaged 2.84% in the third quarter and only 4.5% in September; (4) Freddie's third quarter credit losses represented 0.8 basis points of its average mortgage portfolio, unchanged from second quarter 2002. (*Freddie press release, 10/23/02*)

Fannie & Freddie take different approaches to multi-family financing

- Fannie and Freddie take sharply different approaches to multi-family financing, reported Tommy Fernandez with the *American Banker*. In terms of volume, Fannie surpasses Freddie. In the first half of the year, Fannie purchased \$5.9 billion of multi-family mortgages (Fannie's 2001 volume was \$16.5 billion), while Freddie purchased \$3.1 billion (2001 volume was \$12.3 billion). Under Fannie's program, 26 lenders are designated as Delegated Underwriters and Servicers and authorized to originate multi-family loans for sale to Fannie without Fannie's prior approval. In return, the lenders share credit risk with Fannie. In contrast, under Freddie's program, Freddie makes all the underwriting decisions and assumes all the credit risk, limiting the role of mortgage bankers to finding deals and servicing loans. Fernandez noted that more obscure, entrepreneurial multi-family firms often deal with Fannie, while large financial services firms generally deal with Freddie. He believes the "difference stems from Fannie's willingness, and Freddie's reluctance, to delegate credit decisions to their respective correspondents." (*American Banker, Tommy Fernandez, 10/2/02*)
- Fannie also securitizes its multi-family loans, while Freddie portfolios virtually all of its loans, noted Howard Levine, President and CEO of ARCS Commercial Mortgage Co. The result is that Freddie can afford to be more "deal oriented" and can individually provide favorable pricing and terms for transactions. "The advantage to Freddie Mac, therefore, is that it is flexible with pricing. The market determines the price for Fannie Mae, whereas if Freddie Mac likes a deal, it can pay whatever it wants," said Levine. Freddie also prefers low leverage loans, said Levine. "They can get very, very aggressive if the transaction is not maximum LTV." Levine said "pet" Freddie deals also include large transactions over \$10 million, as well as longer terms of 18 years or more. (*Multi-Housing News, Keat Foong, September 2002*)

- In related news, Freddie expects its overall multifamily production volume for 2002 will be lower by about 15%, compared to the record \$12.3 billion in 2001. (*Multi-Housing News*, Keat Foong, September 2002)

GSE debt news:

- (1) Fannie expects to increase its debt sales by 29% next year to \$290 billion; Fannie & Freddie drop issuance of 30-year bonds from their debt offering calendars**
- (2) Banks continue to increase their investments in GSE debt**
- (3) Bond Market Association (BMA) forms Callable Agency Securities Task Force – notes that issuance of callable debt has become increasingly important to the GSEs**
- (4) Foreign investors have purchased 33% of Fannie’s debt since 1998**

Background on GSE debt and the supply of Treasurys

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

Fannie expects to increase its debt sales by 29% next year to \$290 billion; Fannie & Freddie drop their issuance of 30-year bonds from their debt offering calendars

- Fannie said it expects to increase debt sales by 29% in 2003 and drop its less frequently issued 30-year bond. Fannie said it plans to sell a total of \$290 billion in long-term debt, up from its 2002 estimate of \$225 billion. Although Fannie plans to drop issuance of 30-year bonds, it will issue maturities greater than 10 years through reverse inquiry based on investor demand and its portfolio needs. Under reverse inquiries, investors contact Fannie with requests for debt of a specific maturity, and Fannie aims to issue debt tailored to those needs, rather than sell through a prescheduled offering. Fannie sold only \$750 million via three 30-year bond reopenings. Freddie announced in September that would also eliminate 30-year bonds from its 2003 debt-offering calendar and would instead sell 30-year bonds according to market conditions. (*Reuters*, Lynn Adler, 10/28/02) Of the \$290 billion in long-term debt that Fannie plans to issue, the sales will include as much as \$30 billion of callable benchmark notes, said Fannie’s spokesman Jason Lobo. Fannie has sold \$172.5 billion in debt due in two or more years through September 30, 2002, including \$15.8 billion in callable benchmark debt. Fannie plans to keep the minimum size of its benchmark sales at \$4 billion in 2003. Freddie announced last month that it will reduce the minimum size of its equivalent issues for 2003 to \$3 billion from \$4 billion on expectations of lower funding needs. (*Bloomberg News*, Al Yoon, 10/28/02)

Banks continue to increase their investments in GSE debt

- According to *Inside Mortgage Finance’s* new publication, *Inside the GSEs*, the nation’s commercial banks added more than \$4 billion to their GSE holdings in the second quarter of 2002, bringing the industry’s total GSE holdings to \$202.01 billion as of June 30. (*Inside the GSEs*, 10/23/02)

Bond Market Association (BMA) forms Callable Agency Securities Task Force – notes that issuance of callable debt has become increasingly important to the GSEs

- The BMA has formed a Callable Agency Securities Task Force to examine existing trading conventions and examine whether steps should be taken to create greater liquidity and price transparency in the callable

market, reported John Connor with *Dow Jones Newswire*. The BMA noted in the September 2002 edition of its newsletter that the issuance of callable debt has become increasingly important to GSEs such as Fannie, Freddie, and the FHLBanks. “In recent years, a surge in this issuance has contributed significantly to the overall growth of GSE debt issuance. But while investor demand for callable debt has grown, the depth and liquidity of secondary market trading has not kept pace.” The BMA’s newsletter contains a roundtable discussion of callable agency debt issues, with participants from the leading dealers and Fannie, Freddie, and the FHLBanks. (*Dow Jones Newswire*, John Connor, 10/17/02; *BMA Newsletter*, September 2002, <http://www.bondmarkets.com/newletters/2002/902govroundtable.shtml>)

Foreign investors have purchased 33% of Fannie’s debt since 1998

- Since 1998, foreign investors have purchased 33% of Fannie’s benchmark notes and bonds, a Fannie official said. Asian investors make up 14% of the purchases, the official added. (*Reuters*, Mark Felsenthal, 10/21/02)

Fannie Mae

Fannie’s Chairman Franklin Raines concedes that Fannie is a legitimate subject of debate

- In an interview with the *Financial Times*, Raines conceded that Fannie is a legitimate subject of debate. He noted that there is a sizeable chunk of public subsidy involved in the US housing finance system, including tax deductibility of mortgage interest. “I think you can have a legitimate policy debate about that,” he stated. But if Congress and the American people want the system of housing finance that they currently have, Fannie and its peers are the best means to provide it. “Fannie Mae is a less expensive, less risky way to support housing than any of the alternatives,” he argued. “The US housing market is the best-functioning housing market in the world; it is most consumer-friendly. In this country, most people want long-term, fixed-rate mortgages. If Fannie Mae didn’t exist that wouldn’t be the case. When people say ‘oh, let’s change Fannie Mae,’ the conundrum they have is that no one has come up with a system that delivers more to the consumer.” (*The Financial Times*, Vincent Boland, 10/29/02)

Fannie’s new mortgage loan pilot program allows borrowers to skip mortgage payments

Freddie does not have a “skip a payment” product yet

GE Capital has new job-loss mortgage protection product that saves more consumers money than Fannie’s product – GE’s product would save consumers approximately \$10,000 over the life of the loan compared to Fannie’s product

- Fannie began a pilot program with six lenders, which allows homebuyers to skip monthly mortgage payments periodically without hurting their credit standing, reported syndicated columnist Kenneth Harney. (*Realty Times*, Kenneth Harney, 10/14/02; *Washington Post*, Kenneth Harney, 10/12/02) *Dow Jones Newswire’s* Julie Haviv reported that the program began two months ago and ten lenders are currently part of the program. (*Dow Jones Newswire*, Julie Haviv, 10/31/02) Under the program, which Fannie refers to as “Payment Power,” borrowers can skip up to two monthly mortgage payments per year, or as many as 10 payments over the full 30-year term of the loan. There is no late fee or other charge when a borrower exercises their right to skip. The missed payments (including principle, interest, taxes and other escrowed items) are rolled into the remaining principal balance of the mortgage and are amortized over the remaining term of the mortgage. To qualify for the program, a borrower must have a strong credit history at application, and must make on-time payments in all months except those where they opt to skip a payment. The new program –which may be marketed under different names – carries interest rates and other terms identical to regular conventional mortgages. However, the contractual right to skip payments will be spelled

out in the loan documents and an upfront participation fee will be charged (approximately \$600 on a \$100,000 mortgage). The upfront fee can be paid by the borrower or split with someone else, such as a builder, a Realtor, or private seller. The program is available on 1-2 unit homes and on condominiums.

- Toledo, OH's Northern Ohio Investment Co. is already marketing the product under the name "Rainy Day" mortgage. Countrywide Home Loans plans to roll out its version of the "Payment Power" mortgage in December. Other participating lenders, according to Fannie, will be rolling out their products in the coming weeks. (*Realty Times*, Kenneth Harney, 10/14/02; *Washington Post*, Kenneth Harney, 10/12/02) Paul Pavlishin, Fannie's director of single-family business product development and product manager for Payment Power says the pilot is scheduled to last nine to 12 months, during which time Fannie will gauge consumer interest, and then decide whether to continue the program. Freddie doesn't have a "skip a payment" type product and says it has no plans for such a product in the pipeline. (*Dow Jones Newswire*, Julie Haviv, 10/31/02)

GE Capital has new job-loss mortgage protection product that may be more consumer friendly than the Fannie product

- GE Capital introduced a new "Job Loss Payment" product that will pay up to \$5,000 a month in principal, interest, taxes, and other escrows for borrowers who become unemployed "through no fault of their own." GE's product will be restricted to homeowners who already own their houses and who have solid payment records. (*Washington Post*, Kenneth Harney, 10/19/02; *Realty Times*, Kenneth Harney, 10/21/02) Unlike traditional credit insurance, which is offered during the origination process, this product will be offered by mail after a loan is closed. Borrowers will be required to request the product in writing. (*American Banker*, 10/23/02)
- The GE program takes a different approach than Fannie's program. It is marketed solely to people who already own their own homes and make monthly payments on time. Unlike Fannie, which charges an upfront fee at the time of application of approximately \$600 at the time of application, GE's program provides current homeowners the option to purchase and cancel protection at any time.
- Under GE's program, for an add-on of \$25 to \$45 to the regular payment on a \$100,000 mortgage, GE will either pay 50% or 100% of the monthly mortgage bill for up to six months in the event of involuntary unemployment. For slightly higher premiums, the insurance will cover up to nine monthly payments. The coverage will be offered through dozens of mortgage banking and other firms. Consumers can cancel the insurance at any time. The actual insurance policies will be underwritten by GE Casualty, a GE subsidiary. GE's program is restricted to homeowners who work at least 30 hours a week, are not self-employed or seasonally employed. There is also a mandatory 180-day "vesting period" before a claim can be filed. But if the borrower becomes unemployed during that time, all premiums will be refunded. (*Washington Post*, Kenneth Harney, 10/19/02; *Realty Times*, Kenneth Harney, 10/21/02)
- **GE Capital's new job-loss mortgage protection product saves consumers more money than Fannie's product. GE's product would save consumers approximately \$10,000 in interest charges over the life of the loan compared to Fannie's product (based on a \$100,000 loan). For a comparison of the GE Capital and Fannie products, please see Appendix at the end of this *GSE Report*. ([Appendix](#))**

Fannie sells \$300 million in preferred stock, its first sale since April 2001

- Fannie announced October 21 an offering of \$300 million, or 6 million shares at \$50 stated value, of fixed-rate non-cumulative preferred stock, designated Series I. Proceeds from the issue will be used for general corporate purposes, including the replacement of Fannie Mae preferred stock issues redeemed earlier this year. (*Fannie press release*, 10/21/02) Fannie is selling the preferred stock to take advantage of low

interest rates. Proceeds from the sale will be used to replace higher cost preferred shares that were redeemed in June and January, said Janis Smith, a Fannie spokeswoman. The redeemed issues paid coupons of 6.45% and 6.5%. The preferred stock issue is the company's first since April 2001. (*Bloomberg News*, Al Yoon, 10/21/02)

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) 10/22/02).

Senator Jon Corzine (D-NJ), Brick, NJ Mayor Joe Scarpelli

- Fannie joined the above named officials to announce the availability of Fannie's MyCommunityMortgage loans in the Brick area. (*Fannie press release*, 10/14/02)

Senator John Ensign (R-NV)

- Fannie joined Senator Ensign in announcing a new five-year \$12 billion affordable housing plan for Nevada. (*Fannie press release*, 10/29/02)

Congressman Chris John (D-LA) and Louisiana Governor Mike Foster

- Fannie announced mortgage relief for hurricane victims. Comments of support by the above named officials were included in Fannie's press release. (*Fannie press release*, 10/4/02)

Congressman John LaFalce (D-NY) and Buffalo, NY Mayor Anthony Masiello

- Fannie joined the above named officials to announce an employer-assisted housing program for D'Youville College employees. (*Fannie press release*, 10/7/02)

Congressman Jimmy Duncan (R-TN) and Knoxville, TN Mayor Victor Ashe

- Fannie joined the above named officials to celebrate the success of an affordable 50-unit housing development. (*Fannie press release*, 10/22/02)

Congresswoman Diane Watson (D-CA)

- Fannie joined Congresswoman Watson to announce Fannie's H.O.M.E. program to help Californians with disabilities become homeowners. (*Fannie press release*, 10/29/02)

Congressman Barney Frank (D-MA)

- Fannie joined Congressman Frank in announcing the availability of Fannie's HomeChoice Mortgage product. (*Fannie press release*, 10/7/02)

Congresswoman Anne Northup (R-KY)

- Fannie joined Congresswoman Northup in announcing an historic elementary school that was converted to an assisted living facility for low-income seniors. (*Fannie press release*, 10/7/02)

Other local officials with whom Fannie held press opportunities:

- (1) North Dakota Governor John Hoeven (*Fannie press release, 9/30/02*)
- (2) Mayor of Bladensburg, MD and Chairman of the Redevelopment Authority of Prince George's County, MD David Harrington (*Fannie press release, 9/30/02*)
- (3) Phoenix, AZ Vice Mayor Claude Mattox (*Fannie press release, 10/1/02*)
- (4) Roseville, CA Mayor Pro Tem Rocky Rockholm (*Fannie press release, 10/4/02*)
- (5) Jeffersonville, IN Mayor Thomas Galligan (*Fannie press release, 10/8/02*)
- (6) Peoria, IL Mayor David Ransburg (*Fannie press release, 10/8/02*)
- (7) Perth Amboy, NJ Mayor Joe Vas (*Fannie press release, 10/16/02*)

Freddie Mac

Freddie introduces a new web-based system that integrates all secondary marketing functions onto a single platform including pricing and funding

- Freddie introduced October 22 a new web-based secondary market system that integrates all secondary marketing functions onto a single platform, expanding the ability of lenders to price, commit and fund mortgages with Freddie via the Internet. The system provides a process that incorporates the following functions: (1) pricing; (2) commitment; (3) loan allocation; (4) purchase editing; (5) note certification; and (6) funding. The announcement is the first phase of Freddie's system redesign. Over time this new system will become the standard way to do business with Freddie. "In today's environment we require lenders to use multiple systems to sell and deliver loans to Freddie Mac," said Senior Vice President and Single-Family Chief Operating Officer Michael May. "As an industry leader, we are now on a path of delivering a single, integrated system that supports all secondary marketing activities, products, and execution paths," May said.
- Initially, this system supports cash executions through mandatory, servicing-retained commitments. Currently the technology is available for lenders when selling fixed-rate and balloon/reset mortgages servicing retained for cash, with mandatory delivery. Going forward, Freddie expects to expand the product options beyond fixed rate mortgages and balloon/resets to include ARMs and other types of mortgages, and all execution paths.
- Approximately 200 lenders are using the new system today. "Doing business with Freddie Mac has gotten a lot easier with the advent of this new system," said Paul Snyderman, vice president secondary marketing of Metropolitan Bank & Trust, Huntington Hills, Ohio, one of the first lenders to use the system. "Having a system that manages the entire secondary process front-to-back in a real-time environment has significantly increased our operational efficiency and enhanced our ability to respond quickly to market movements," he said. In addition, the new system expands the options available to lenders selling loans to Freddie. "Lenders now have more flexibility in the contracting process and more choices for funding dates, which means that they can choose time frames that support their specific and changing capital and cash management needs," explained May. "Lenders can fund loans when ready or establish specific contract settlement dates," added May. (*Freddie press release, 10/22/02; Description of Freddie's new system on Freddie's Web site, 10/23/02*)

New York Mayor vetoes New York City Council's recently passed predatory lending bill

Freddie noted that it might pull out of the high-cost home loan market in New York if the bill became law

- New York City Mayor Michael Bloomberg vetoed the New York City Council's predatory lending bill on October 23. A New York City Council spokeswoman said October 24 that Democratic Speaker Gifford Miller plans a vote on overriding the veto either November 20 or December 4. The Council needs 34 votes for an override. The measure passed by a vote of 44 to 5 in September. (*American Banker*, Erick Bergquist, 10/25/02)
- As noted in the October 11, 2002 *GSE Report*, Freddie had noted that it might pull out of the high-cost home loan market in New York if the bill became law. The bill, signed October 3, by New York Governor George Pataki, would subject secondary market investors to penalties for originators' actions. The law is scheduled to take effect April 2003. (*American Banker*, 10/7/02) The law is similar to Georgia's predatory lending law, which went into effect October 1, in that it includes an "assignee liability" clause that would hold secondary market investors responsible for originators' violations. (Freddie said it would no longer purchase high-cost home loans in Georgia because its new state predatory lending law may expose it to lawsuits.) Freddie indicated that it may not be able to buy certain loans in New York if the bill became law. "The assignee liability clause is a concern," Freddie spokeswoman Sharon McHale said. However, "we are going to wait and see what happens" before any decisions about New York are made. The state legislature may come back into session later this year, and if it does, lenders plan on trying get the bill revised. (*American Banker*, Erick Bergquist, 10/3/02)
- Freddie said it would no longer purchase high-cost home loans in Georgia because its new state predatory lending law may expose it to lawsuits, a Freddie spokesman said October 2. The Georgia state predatory lending law, which went into effect October 1, makes the holder of a mortgage (secondary market investors) liable for legal challenges. "It's just not possible to evaluate whether a loan meets all the conditions of a law like that. It represents enormous legal liability that we're not equipped to address right now," said Freddie's spokeswoman Sharon McHale. (*Reuters*, 10/2/02) Fannie has not "made any determination about what we are planning to do in response to the law," said Fannie's spokesman Albert King. One lender, however, said Fannie has told lenders originating loans in Georgia that they will be charged higher guarantee fees, or charges levied to ensure principal and interest payments to bondholders. (*American Banker*, Erick Bergquist, 10/1/02) [See October 11, 2002 GSE Report for more information about the GA and NY state predatory lending bills, www.gsereport.com]
- Fannie had earlier sought to be exempted from the Georgia bill but later issued a statement saying it would no longer lobby on state anti-predatory lending laws. (*Reuters*, 10/2/02) Congresswoman Jan Schakowsky (D-IL) objected to Fannie's efforts to exempt itself from predatory lending laws and sent a letter to Fannie's Chairman Franklin Raines on April 25. Fannie released a statement shortly thereafter saying it would no longer "take an active role" in shaping state predatory lending legislation. [See April 19, 2002 and May 3, 2002 *GSE Reports* for more information on Fannie's attempts to exempt itself from state predatory lending legislation, www.gsereport.com]

Freddie, Congressman Harold Ford, Jr. (D-TN), and the Consumer Federation of America launch nationwide credit education program for college students

- Congressman Ford joined Freddie and the Consumer Federation of America October 21 to launch *Know Your Score*, a brochure to educate college students about why credit scores matter. The educational brochure is being handed out to students on college campuses, as well as being distributed electronically via e-mail to more than half-million college students nationwide. *Know Your Score* explains how a credit score is

determined, and offers examples of credit management behaviors that affect a credit score, facts about credit card debt, and the benefits of having a higher credit score. The *Know Your Score* brochure demonstrates how to build a strong credit record and a good credit score. Necessary steps include: 1) Establishing a credit record, 2) Paying bills consistently and on time, 3) Remembering that paying your bill a little late is bad — and a lot late is worse, 4) “Maxing out” credit lines is never a good idea, 5) Paying-off card balances instead of moving debt to other cards, and 6) Checking credit reports regularly to make sure they’re error-free. (*Freddie press release, 10/21/02*)

Freddie names new Vice President Business and Market Management

- Freddie announced that it named Iliana Ghanem Vice President, Business and Market Management within the corporation’s Single-Family Lending division. In this role, Ghanem will lead the strategy and business development functions for both the National and Community Lending segments and report directly to Senior Vice President, Single Family Lending, Dave Stevens. Prior to being named to this position, Ghanem was director of a Community Lending segment team responsible for developing business opportunities and delivering enhanced capabilities to community lenders. Ghanem, a 17-year veteran of the mortgage industry, joined Freddie in 1991 and has held a variety of increasingly responsible sales and management positions. Before joining Freddie, she was most recently a vice president at Loan America in Rockville, MD, where she was responsible for initiating and developing an East Coast wholesale business channel. (*Freddie press release, 10/29/02*)

Federal Home Loan Banks

Total Mortgage Partnership Finance (MPF) program loans outstanding up 64% for the third quarter, conventional loans grow 154%

FHLBank System’s MPF program is a competitor to Fannie & Freddie in the secondary mortgage market

- The FHLBanks’ MPF program grew to \$34.5 billion at the end of the third quarter, up 64% from one year earlier. The portfolio of MPF conventional loans showed robust growth, increasing 154% year-over-year. And, for the first time, over \$1 billion of MPF mortgages were funded on a single day, with 82 different lenders involved in funding the loans that day. MPF volume for the entire third quarter amounted to \$6.1 billion, 37% more than funded during the same quarter last year. Since beginning in 1997, over \$48.6 billion loans have been funded through the program, helping almost 400,000 families and individuals purchase a new home or lower the cost of their existing homes. (*FHLBank of Chicago’s MPF press release, 10/16/02*)
- **The FHLBank of Chicago noted that mortgage lenders continue to find the program a better alternative to selling fixed-rate mortgages to Fannie and Freddie. “We like the MPF Program from the competitive standpoint that we now have an alternative,” said J. Edward Norris III, President of Plantation Federal Bank in Pawley’s Island, S.C.** (*FHLBank of Chicago’s MPF press release, 10/16/02*)
- Created by the FHLBank of Chicago five years ago, the MPF Program provides FHLBank members an alternative to holding fixed rate, conventional conforming and government residential mortgage loans in portfolio or selling loans servicing released as a means of offering competitive loan origination rates. Under the MPF Program, the local lender manages the credit risk and customer relationship, while the FHLBank manages the funding, interest rate, and prepayment risks. “This structure allows lenders to keep their valuable customer relationships without paying costly guarantee fees charged by secondary market agencies to manage the credit risks of the loans they buy...Instead of paying guarantee fees, participating MPF

lenders have collectively received over \$20 million in fees from the FHLBs since the program began for managing the credit risk of their own customers,” said the FHLBank of Chicago. (*FHLBank of Chicago’s MPF press release, 7/3/02*)

- Thirty-five new FHLB members were approved to participate in the program during the third quarter, bringing the total participating financial institutions to 383 members, up 51% from the same quarter in 2001. In addition, over 100 members are in the process of joining the program. (*FHLBank of Chicago’s MPF press release, 10/16/02*)
- The competition provided by the MPF Program has attracted the attention of mortgage market observers, noted the FHLBank of Chicago. In a September 4, 2002 report from Wall Street investment firm Fox-Pitt, Kelton, Inc. entitled, “GSE Competition – An Update”, mortgage analysts Chris Buonafede and Hemant Hirani describe the MPF Program as having a “noticeable impact” on the secondary mortgage market. They note that it has “continued to grow in the first half of 2002, building on the momentum that began in earnest in 2001.” (*FHLBank of Chicago’s MPF press release, 10/16/02*)
- Importantly, the program has “gained market share of conventional originations and conventional mortgage debt outstanding” The median size of a MPF loan is \$115,250. Credit quality of MPF loans continues to be excellent, with only 0.10% of conventional loans more than 90 days delinquent or in foreclosure, far below the 2nd quarter 2002 national average of 0.98% as reported by the Mortgage Bankers Association of America. (*FHLBank of Chicago’s MPF press release, 10/16/02*)

FHLBank of Cincinnati announce retirement of its President and CEO Charles Thiemann

David Hehman, executive vice president, named successor

- The board of directors of the FHLBank of Cincinnati announced the retirement of president and chief executive officer Charles L. Thiemann and named as his successor David H. Hehman, executive vice president, both effective March 1, 2003. Thiemann, the longest serving president of the 12 FHLBs, joined the FHLBank of Cincinnati in 1964 as the institution’s economist. He was named president and chief executive officer in 1976. Besides his duties as CEO of the FHLBank Cincinnati, Thiemann has chaired the Conference of FHLBank Presidents, FHLBank System committees on research, housing and community development, finance, public policy and outreach, the FHLBank System Capital Task Force, the Office of Finance and the Financing Corporation. He was an early advocate of the Affordable Housing Program, established in 1989 as part of FIRREA legislation.
- Hehman has been with the FHLBank of Cincinnati since 1977, when he began his tenure as investment manager. He was named chief financial officer in 1983, executive vice president in 1990, and was given expanded responsibility for all financial and operational functions of the FHLBank Cincinnati in 1997. A former assistant professor of finance and economics, Hehman holds a doctorate in economics and serves on the Cincinnati Enquirer’s Board of Economists. He is a member of the board of directors of Brighton Properties, Inc., a non-profit affordable housing and services provider in northern Kentucky. (*FHLBank of Cincinnati, 10/18/02*)

FHLBank of Atlanta starting its own Mortgage Purchase Program (MPP)

- The FHLBank of Atlanta, an active user of the FHLBank of Chicago’s MPF program, is applying for approval to offer its own MPP program (an alternative to the MPF program). Currently, three other FHLBs – the FHLBank of Cincinnati, Indianapolis, and Seattle offer MPP to its members. (*National*

Mortgage News, Paul Muolo, 10/21/02) The FHLBanks' mortgage-purchase programs - the MPF and MPP programs - offer FHLBank System members an alternative to selling their loans to Fannie and Freddie.

Farm Credit System/Farmer Mac

Farmer Mac's third quarter earnings rose 2%

- Farmer Mac said its third-quarter earnings rose 2%. The GSE noted that a seasonal slowdown in agricultural lending and "adverse media coverage" cut new business. Farmer Mac's net income rose to \$5.03 million, or 42 cents a share, from \$4.93 million, or 41 cents, a year earlier. Interest expense declined to \$35.8 million from \$37.3 million, helping it to weather a decline in loan purchases and guarantees to \$236 million from \$358 million. Farmer Mac's shares are down 32% this year. Operating earnings per share, which excludes changes in market value of derivatives holdings, rose 17% to a record \$5.9 million, or 49 cents. Net interest income rose 27% to \$9.98 million in the third quarter, from \$7.87 million a year earlier. Guarantee fees increased to \$4.9 million, from \$4.2 million. Delinquent loans increased to \$91.3 million, representing 2% of Farmer Mac's purchased or guaranteed loan portfolio in the third quarter. Delinquencies in the third quarter of 2001 were \$71.7 million, or 2.2%. (*Bloomberg News*, Al Yoon, 10/22/02)

Farm Credit Administration (FCA) issues proposed rule amending its capital regulations

- The FCA issued a proposed rule amending its capital adequacy regulations to add a definition of total liabilities for the net collateral ratio calculation; limit the amount of term preferred stock that may count as total surplus; clarify the circumstances in which disclosure requirements may be waived for an issuance of equities by a Farm Credit System institution; and make several nonsubstantive technical changes. Comments are due November 21, 2002. (*Federal Register*, pages 64833-64835, 10/22/02)

Ginnie Mae

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

Mortgage Bankers Association supports the repeal provision

- The Senate passed by voice vote late October 17 a bill (S. 2239 – FHA Downpayment Simplification Act) that would reauthorize a law simplifying the Federal Housing Administration downpayments. The bill also would repeal a scheduled increase in the guarantee fee charged by Ginnie Mae for guarantee of mortgage-backed securities from 6 to 9 basis points. The increase would have gone into effect in FY 2004 (October 1, 2003). (*CQ Daily Monitor*, 10/18/02)
- The Senate Banking Committee approved S. 2239 on September 12. The Housing Affordability for America Act (HR 3995), which includes the Ginnie Mae provision, introduced by Congresswoman Marge Roukema (R-NJ) was reported out of the House Financial Services Committee in July, but has yet to be scheduled for a floor vote. (*MBA press release*, 9/12/02)
- The MBA supports the Senate bill as a significant step towards increasing homeownership and improving the supply of affordable rental housing. (*MBA press release*, 10/18/02) The MBA supports the provision

repealing the Ginnie Mae guarantee fee increase. (*MBA press release, 6/18/02*) The increase in the Ginnie Mae guarantee fee - included in the 1998 Higher Education Act - raises the annual fee that Ginnie Mae charges on mortgage loans from 6 basis points to 9 basis points, for loans made after October 1, 2004. The revenue from that increase would be used to increase the level of Federal receipts produced by Ginnie Mae. The MBA estimated this increase would cost \$30 million or more a year and would penalize families that are in need of government programs to buy a home. In addition, the MBA noted there is no financial basis for a guarantee fee increase because Ginnie Mae is currently operating at a profit. (*MBA press release, 3/18/02*)

Postal Service

Postal Service's top lobbyist resigns after being accused of manipulating the Postal Service's federal budget to benefit the Democratic candidate for US Senate in Arkansas

Senate Minority Leader Trent Lott (R-MS) and Senate Governmental Affairs Committee Ranking Member Fred Thompson (R-TN) request more information about the budget moves

Postal Service denies the budget moves were politically motivated

Citizens Against Government Waste is outraged and asks for a public audit of the Postal Services' books

- The Postal Service's top congressional lobbyist, Deborah Willhite, resigned October 21 amid allegations that she manipulated the federal mail budget to hurt the re-election chances of Senator Tim Hutchinson (R-AR) and benefit his opponent, Democrat Mark Pryor. Sources alleged that Willhite, a native of Arkansas, pushed for budget cuts for Arkansas post offices and have Senator Hutchinson blamed. Willhite reportedly pushed to have money for a seasonal postal facility in Blytheville, AR transferred to Georgia post offices, allowing supporters there to credit Democratic Senator Max Cleland (D-GA), who is also in a close re-election. Willhite, a contributor to the Democratic Party and a former official at the Democratic National Committee, has donated \$1000 to Pryor and \$500 to Cleland.
- Postal Service spokesman Gerald McKiernan said Willhite, senior vice president of government relations and public policy at the Postal Service, offered her resignation October 21, but that it was not made public until October 25. That is one day after Senator Lott called Postmaster General John Potter asking if the job cuts in Arkansas were politically motivated. Senator Lott requested a cost-benefit analysis of how moving resources out of Arkansas would help the Postal Service, said Senator Lott spokesman Ron Bonjean. Senator Lott also told Potter that "anyone who may be involved in playing politics in the Postal Service should not be in the Postal Service." Senate Governmental Affairs Committee Ranking Member Fred Thompson (R-TN) also asked for more information about the budget moves. Senator Thompson told Potter that he realizes that the Postal Service is engaged in a series of cost-cutting measures. "Before a decision that would have such a significant economic impact on the residents of Blytheville is carried out, however, I would like the opportunity to review the financial information on which the Postal Service relied to make this determination," Thompson said.
- *US News & World Reports* reported that Senator Trent Lott also demanded the resignation of Willhite. Willhite stated, "it's all a plot" to discredit her and that she planned to resign anyway. "It's a good story," she said, "but it's not the case."
- Congressman Marion Barry (D-AR) recently announced that the Postal Service has decided to close the Blytheville facility, eliminating 566 jobs, however Senator Hutchinson issued a statement saying that no

final decision has been made. A spokesman for the Postal Service said October 28 that Senator Hutchinson was correct and that no final decision had been made about the Blytheville Center.

- “Once you connect the dots in this matter, the picture becomes hauntingly clear that it smacks of politics,” said Senator Hutchinson’s campaign spokesman Anthony Hulen on October 28. “She [Willhite] had assured Senator Hutchinson for months that they were going to try and resolve this matter.” “All of a sudden she planned to resign – that just paints a picture that is political. The bottom line is we received word from all directions that she has been put under review, that this has not been resolved, and Senator Hutchinson is still fighting to keep these jobs in Blytheville, AR.”
- Postal Service spokesman Gerald McKiernan said the move to cut jobs at the Blytheville, AR facility is not a politically motivated decision to hurt Senator Hutchinson’s re-election campaign. “There is not a shred of truth to it,” he said. McKiernan said the Postal Service decided in August of last year to partner with FedEx, and that the work will instead be done out of the company’s Memphis, TN hub. “The Memphis FedEx hub is only 80 miles away from the Arkansas facility, and we just didn’t feel it was necessary any longer and decided not to activate this facility this year,” McKiernan said. (*US News & World Report*, Paul Bedard, 11/4/02; *Associated Press*, 10/29/02, *Washington Times*, Audrey Hudson, 10/30/02; *Arkansas Democrat-Gazette*, Kevin Freking, 11/1/02)

CAGW is outraged

- The Council for Citizens Against Government Waste (CCAGW) “reacted with outrage” to reports of Willhite’s resignation amidst allegations that she manipulated the books to punish Senator Hutchinson. “There has long been much to criticize at the USPS, from financial losses and taxpayer subsidies to regular price increases amidst poor service and low productivity,” CCAGW Vice President Leslie Paige said. “But this is a new level of corruption and mismanagement. Taxpayers and their representatives in Congress should be up in arms.” Paige continued, “Since this spring, CCAGW has been calling for a complete and public audit of USPS books to root out the millions of dollars of waste, fraud, and abuse we know exists... We have reiterated that call today with letters to the Chairman and Ranking Members of both the House Committee on Government Reform and Senate Governmental Affairs. This latest scandal confirms that not only do postal officials lose, misspend and abuse the postal budget with impunity, they may also be using their scarce resources to manipulate elections, which is clearly prohibited by the 1970 Postal Reorganization Act. It’s time for independent third party to get to the bottom of where all our money is going.” (*CCAGW press release*, 11/1/02)

Congressmen Phil Crane (R-IL) and Dana Rohrabacher (R-CA) reintroduce a postal privatization bill

- Congressmen Crane and Rohrabacher reintroduced a postal privatization bill (HR 5702). The bill was referred to the House Committee on Government Reform on October 28. (*Post.com Web site*, 10/31/02)

Consumer Action and the Office of the Consumer Advocate asks Postal Rate Commission (PRC) to regulate the Postal Service’s expansion into commercial activities

Groups contend that the law requires that all services and products offered to the public must be subject to public hearings before the PRC

- Consumer Action and the Office of the Consumer Advocate asked the PRC to regulate Postal Service expansion into unauthorized commercial ventures. The filing is available at the following Web site address: http://www.consumer-action.org/English/PressReleases/2002_10_15_petition.pdf. They also asked that the Postal Service be required to turn over development and revenue figures for such products and services, so that a judgment can be made as to whether they contribute to higher rates for monopoly mail and other

regulated postal services. The Postal Service contends that it does not need the approval of the PRC to offer non-postal products and services. The Office of the Consumer Advocate is a federal office, which is part of the PRC and is charged with assuring that postal rate increases are fair for consumers.

- Ken McEldowney, executive director of Consumer Action, said, “The Postal Service has moved aggressively, unsuccessfully and perhaps blindly into competition with businesses in offering non-letter delivery and communications services. We’re concerned that mail customers are paying for Postal Service failures through higher postal rates. To fulfill its role in regulating postal rates, the PRC should make the Postal Service provide concrete figures on the costs and returns of non-letter products.”
- “The Office of the Consumer Advocate is pleased to be working alongside Consumer Action to bring a joint request to the Commission for immediate review of largely loss-producing services that have never been examined in a public proceeding,” said Shelley Dreifuss, director, Office of the Consumer Advocate, Postal Rate Commission. “The Postal Service’s decision to sell these services to the public without first obtaining recommendations from the Postal Rate Commission is based on an incorrect interpretation of the Postal Reorganization Act,” contended Dreifuss. “Furthermore, the Postal Service’s inadequate accounting and reporting practices for unreviewed services necessitate the establishment of rules that will require the Postal Service to submit detailed cost and revenue information to the Commission. Detailed financial information is the only way to ensure that the purchasers of postal services—particularly first class services—will not have to pay for the costs of, and losses from, services that have never been authorized by the Commission.”
- The groups noted that the Postal Service has developed and marketed competitive non-letter products such as electronic bill payment, electronic document exchange, merchandise and prepaid phone cards. But instead of bringing innovations to the marketplace, the Postal Service has established an “alarming track record of losing money on new ventures.”
- Consumer Action and the Office of the Consumer Advocate contend that the laws governing the Postal Service require that all services and products offered to the public must be subject to public hearings before the PRC. The organizations insist that at the hearings the public must be presented with solid costs and revenue estimates for all new offerings.
- The Postal Service takes the position that it does not need the approval of the PRC to offer new “non-postal” products and services. In filing their request with the PRC, Consumer Action and the Office of the Consumer Advocate denounced that view, arguing that Congress has seen fit to give the Postal Service many advantages over private-sector business with its monopoly status—for instance it pays no property taxes on land, buildings or equipment it owns and, if it ever becomes profitable, it would not be required to pay income taxes. With these advantages comes a need for accountability. (*Consumer Action press release, 10/15/02*)

Government Accounting Office (GAO) recommends Postal Service improve the management of its investments in information technology

- The GAO issued a report recommending that the Postal Service improve the management of its investment in information technology. The Senate Governmental Affairs Committee and its Subcommittee on International Security, Proliferation, and Federal Services asked the GAO to evaluate how well the Postal Service manages its information technology investments. The GAO recommended the Postmaster General take several actions, including: (1) using a portfolio approach to information technology investment management, including establishing explicit cost, benefit, schedule, and risk criteria; and (2) evaluating the performance of investments as a whole in order to capture and institutionalize “lessons learned” to improve the investment process. The GAO recommended the Postal Service take steps to improve management of

its investments in information technology and said a “comprehensive guidance” would allow the Postal Service to better coordinate the process of managing information technology investments. “Although the Postal Service evaluates proposed IT [information technology] projects before investing in them, it does not fully manage these investments from a portfolio perspective by assessing projects on the basis of indicators that clearly link performance to initial selection criteria,” the GAO report said. “Such a portfolio approach would enable the Postal Service to consider proposed projects along with those that have already been funded and to select the mix of investments that best meets its mission needs,” the report said. (*GAO Report: “United States Postal Service: Opportunities to Strengthen IT Investment Management Capabilities,”* October 2002, GAO-03-03; *Dow Jones Newswire*, Jeff Bater, 10/16/02)

Senator Joseph Lieberman (D-CT) says the Postal Service needs help from Congress

- Senator Lieberman told attendees at a DMA Annual Conference that the US government, specifically Congress, has a responsibility to pass new legislation giving the Postal Service the flexibility and modernization it needs to compete in the 21st century. “USPS is a great institution with a proud history that has been pivotal to American life and the growth of the American economy,” he said. “But it needs help. I think, to some extent, our persistence and yours has begun to draw a response, but there’s much more to do.” Senator Lieberman called the Postal Service’s Transformation Plan and movement on the negotiated service agreements signs “that we’re moving toward a new reform consensus.” He noted that Senator Tom Carper (D-DE) has taken a special interest in postal reform. “As we go on, Senator Carper will play an increasingly important – and I am confident – a constructive role in the reform and modernization of the Postal Service that is necessary.” (*DMA Interactive*, 10/24/02)

Group of nine Western Congressmen are upset with the Postal Service’s announcement to stop contracting with private regional airlines to carry mail, using trucks instead

- The *Montana Forum* noted that “a group of nine Western Congressman are hopping mad about the Postal Service’s announcement last month to stop contracting with private regional airlines to carry our mail and shift the transport of rural mail to trucks. The Representatives, who include Montana’s Denny Rehberg, says the Postal Service can’t possibly deliver the mail as fast in trucks as it does now in planes. That’s darn believable. The Postal Service says it can. And when it can’t, it will go back to spot use of airplanes. That bears watching. The small, regional air carriers are unhappy too...they stand to lose about \$25 million a year” (*Montana Forum Editorial*, 10/26/02)

Postal Service plans to announce in February an overhaul of its operations

- The Postal Service is planning to announce in February a “sweeping redesign of its operations.” The plan is expected to call for consolidating or eliminating many transportation routes for efficiency. The new postal operations blueprint is the result of a study started in April as part of Postmaster General John Potter’s transformation plan to modernize how the Postal Service does business. The Postal Service plans to consolidate some mail processing plants, redefine the functions of others, standardize mail preparation, reduce costs for itself and mails and trim its staff, said Paul Vogel, Postal Service Vice President of Network Operations Management. The Postal Service is likely, however, to face difficulty implementing its blueprint, Gene Del Polito, President of the Association for Postal Commerce said. Improving operations could require the Postal Service to close down mail-processing operations at some plants and transferring them to others, which would take money the Postal Service does not have. Also, the Postal Service will need to notify Congress why some plants must be closed and jobs must be cut. Finally, the Postal Service may find its consolidation plans challenged by employee groups. (*FederalTimes.com*, Dan Davidson, 10/28/02)

***Lake Worth Herald* editor says the Postal Service's response to its FOIA requests on the Postal Service's financial expenditures during the Tour de France are "woefully inadequate"**

Several groups have criticized the Postal Service's \$25 million sponsorship of the Tour de France, given the Postal Service's financial problems

- As noted in previous *GSE Reports*, several groups have criticized the Postal Service's \$25 million sponsorship of the Tour de France, given the Postal Service's financial problems. On August 9 and September 6, Patrick Parrish, the editor of the *Lake Worth Herald* filed a "Media Expedited Request" with the Postal Service's Freedom of Information/Privacy Acts Officer "for all pertinent materials related to the travel, lodging, meals, entertainment expenses of the US Postal executives, employees, their spouses and any consultants, agencies or operatives of the US Postal Service in relation to the Tour de France 1997-2002." Parrish also forwarded copies of his FOIA request to the following Florida lawmakers: Senators Bob Graham and Bill Nelson and Congressmen Clay Shaw and Mark Foley. (*Lake Worth Herald*, editorial, 9/12/02)
- Parrish received a response dated October 4 from Robert Faruq, Sr., Manager of the Postal Service's record office that Parrish referred to as "woefully inadequate" in an October 14 letter to Faruq. "I must note that not even a forensic accountant could correlate the materials you sent to actual expenses of the USPS's support at the Tour de France," Parrish wrote. "I am sure you will agree the public has a right to know." Parrish noted that materials "that could directly identify postal employees and customers have been deleted" and again requested that the Postal Service forward the exact expense reports issued by all of the personnel, agents, consultants, and officials of the Postal Service who attended the Tour de France from 1997-2002. He said he reserved the right to appeal to the general counsel of the Postal Service or file a lawsuit if the requested information was not forthcoming. "It is unfathomable that the US Postal Service would allow expense reports to be filed as casually as those you have submitted to us under our Freedom of Information request," Parrish said. "Common sense dictates that an agency of the Federal Government would be more judicious with its funds, since the USPS is forever requesting millions of dollars just to stay in business," Parrish said. (*Lake Worth Herald*, Leonard Saffir, 10/17/02)

Postal Service plans to eliminate over 1,000 accounting positions

- The Postal Service plans to eliminate 1,060 accounting technician positions beginning in early November as part of a consolidation move. Within the next year, accounting centers in 85 postal districts across the US will be obsolete, said the Postal Service's Chief Financial Officer and Executive Vice President Richard Strasser. Instead, three accounting centers will assume all Postal Service accounting work and collectively will add about 350 employees to take on extra work, Strasser said. The Postal Service expects to save approximately \$25 million with the consolidation. (*FederalTimes.com*, Bridgette Blair, 10/21/02; *FederalTimes.com*, Tanya Ballard, 10/28/02)

United Parcel Service decides not to comment on the Postal Rate Commission's (PRC) request for a Negotiated Service Agreement (NSA) with Capital One

Newspaper Association of America believes the NSA is "illegal"

Postal Rate Commissioner Ruth Goldway would not say whether the NSA would be approved

This is the first time the Postal Service has asked the PRC to endorse an agreement

- As noted in the September 27, 2002 *GSE Report*, the Postal Service has filed a case with the PRC seeking a three-year experimental mail classification based on a NSA between the Postal Service and Capital One Services, Inc. The NSA includes discounts for Capital One First-Class Mail volume above an annual threshold of 1.225 billion pieces; and electronic return of undeliverable mail data by the Postal Service to Capital One. (*Postal Service press release*, 9/19/02) If approved, it would be first NSA between the Postal Service and one of its customers. If the PRC and the Board of Governors approve the NSA, the Postal Service would like to implement it by February 1, 2003 (*DM News*, 10/4/02)
- The Postal Service expects the NSA with Capital One to save at least \$8 million a year if it is approved by the PRC. The NSA would allow would allow the Postal Service to destroy (instead of return) mail that Capital One posts that cannot be delivered because of faulty or illegible addresses. Instead, Capital One would receive an electronic notice that a particular piece of mail could not be delivered. The Postal Service expects the \$8 million a year savings will be realized by not having to return mail that is undeliverable. The Postal Service also expects the agreement will generate more revenue from higher mail volume. Capital One expects to save \$6 million in discounts, according to filings with the PRC. The NSA will be a three-year experiment, after which both parties could renew the deal. The ultimate goal is to encourage Capital One to send more mail and thereby increase Postal Service revenues, said Steve Kearney, Postal Service vice president of pricing and classification. (*Federal Times*, Dan Davidson, 10/7/02)
- United Parcel Service decided not to oppose the NSA agreement. In a comment letter to the PRC, UPS said it "does not object to the granting of that experimental authority." UPS was widely expected to oppose the NSA request. A UPS spokesman said the company decided not to oppose the agreement because the request was narrowly drawn to include only delivery of first-class mail. In its comment letter, UPS said it may oppose future requests for volume-based discounts, saying it "does remain concerned about Negotiated Service Agreements in general, and their impact on the competitive marketplace in particular." (*Wall Street Journal*, Rick Brooks, 10/17/02) "Historically UPS has been opposed to granting this type of flexibility to the Postal Service," said David Bolger, a UPS spokesman. "We are not opposing this because we feel it's narrowly focused on first-class mail; this experiment is worth taking." (*Bloomberg News*, Amy Strahan Butler, 10/17/02)
- The Newspaper Association of America (NAA) told the PRC that it believes the NSA is "illegal." The NAA's comment letter stated, "Never before has the Postal Service, a taxpayer-built public service so dramatically departed from its statutory obligation of providing postal services to customers on a nondiscriminatory basis." The letter continued, "NAA has consistently and historically opposed the Postal Service entering into a negotiated deal on a selective and discriminatory basis to a single customer. Whether this proceeding is designated 'experimental' or not is essentially an irrelevant question – the proposal is both illegal and unwise and should be rejected regardless of the procedural posture." (*Newspaper Association of America's comment letter to the PRC*, 10/17/02)
- In an interview with *DM News*, Postal Rate Commissioner Ruth Goldway cited the Postal Service's request for a NSA with Capital One and stated, "All of [the commissioners] are open to new opportunities for rates

and classifications. We are open to ways to change the system within the law. Is this the concept for NSA that I had in mind? No. But I'm open to considering it," she said, though she would not say whether she thought the NSA would be approved. Goldway said NSAs "are not the salvation for the postal service. They are only one small part." Goldway further noted that the Postal Service is too focused on volume growth and instead needs innovation. She noted that the Postal Service should pay more attention to standards and quality issues. (*DMNews*, Melissa Campanelli, 10/29/02)

- Publishers and other high-volume Postal Service customers will watch the PRC's proceedings on the NSA because it will set the ground rules for future NSAs. The PRC can decide to accept, reject or modify the proposal. "No one has any idea how the PRC will respond," said Gene DePolito, president of the Association for Postal Commerce. "They could make it so ugly that no one will have anything to do with NSAs from here on." Stephen Kearney, Postal Service VP for Pricing and Classification, said that there is no reason to expect that the Postal Service will wait on the outcome of this first NSA before it introduces another one." (*Circulation Management*, 11/02)

Sallie Mae

Sallie Mae sells its first non-federally backed student loan asset-backed security

- Sallie Mae completed the sale of its first securitization of non-federally guaranteed student loans. The \$727 million offering of Private Credit Student Loans was lead managed by Merrill Lynch with Credit Suisse First Boston and Deutsche Bank Securities as co-managers. The notes are not federally guaranteed or reinsured as are the loans placed under Sallie's FFELP program, which have been the collateral for the past Sallie Mae asset-backed sales. The loans in the new offering are reported to have high Fair Isaac Co. (FICO) scores and are mostly those financing higher education such as medical school. The sale comprised two AAA classes and one each with A and BB ratings. (*Dow Jones Newswire*, David Feldheim, 10/11/02)

Tennessee Valley Authority (TVA)

Senate Minority Leader Trent Lott (R-MS) introduces a bill that will put TVA "on a short leash"

- Senate Republican Leader Trent Lott (R-MS) wants to put the TVA "on a short leash," reported John Connor with *Dow Jones Newswire*. Senator Lott introduced a bill requiring the TVA to provide Congress and the Administration with a 10-year business plan with respect to its development and financing needs, as well as an analysis of its financing and risk management strategies. While the TVA is preparing this analysis, Senator Lott's bill would require the TVA "to cease and desist from incurring new obligations or entering into any arrangements for the development or financing of new or replacement plant, equipment, or capacity." Senator Lott stated, "Likewise, during this period the TVA would be required to gain the concurrence of the Director of the Office of Management and Budget and the appropriate Senate and House Committee leaders before undertaking any additional financing or refinancing activities." (*Dow Jones Newswire*, John Connor, 10/7/02)

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Appendix

Job Loss Insurance & FNMA's Payment Power

Job Loss Insurance

- ✓ Fully Licensed, State Approved Insurance Product
- ✓ Rates Are Regulated – No Add-Ons Allowed
- ✓ Offers 4 Payment Choices at Borrowers' Option ...
 - ✓ Full Monthly Payment (PITI) For 6 Months
 - ✓ Full Monthly Payment (PITI) For 9 Months
 - ✓ ½ Monthly Payment (PITI) For 6 Months
 - ✓ ½ Monthly Payment (PITI) For 9 Months
- ✓ If Utilized, No Payment Increases or Negative Amortization
- ✓ Available On New Or Existing Homes
- ✓ Insurance Policy Is Cancelable
- ✓ Minimal Changes To Lenders Servicing Operations Required
- ✓ Reduces Servicer Costs Associated With Delinquency Servicing

FNMA Payment Power

- ✓ Not Licensed, Not Regulated, Not Insurance
- ✓ Projected Loss Ratios Would Not Meet NAIC 60% Standard
- ✓ Allows For 2 Payment Skips Per Year, 10 Over Life Of Loan
- ✓ If Utilized, Results in Negative Amortization & Monthly Payment Increases
- ✓ Available At Origination Only
- ✓ Lender Servicer Requirements Are Complex, Costly

Feature Comparison

Job Loss Insurance		
	Advantages	Disadvantages
Product Summary	Fully licensed and state approved insurance product	
Product Coverage	Covers entire monthly payment of borrowers option - coverage can last 6 or 9 months to cover all or half of mortgage payment	Triggering event is loss of employment
If Product Utilized	Retain original payment schedule and recorded as an actual payment - no NegAm	
	Job Loss insurance pays for all escrow items	
Credit Loss Protection	Prevents credit loss due to inability to make payment	
Co-Borrower Protection	All co-borrowers on note can obtain insurance	No co-borrower coverage offered on a single policy
Costs		Cost based on size of monthly payment - 4.5% of payment, with max benefit of \$6000
	if MI is required the rates are based on standard prices	
	Interest is tax deductible	
Product Availability	Available on new or existing loans	
		Requires 6 mo. vesting prior to payout
	Cancelable	
Product Eligibility	No credit underwriting required to be eligible for the insurance. If regular payments are made insurance is in effect.	
		Seasonal, Part-time, Contractors, Self-employed not eligible
Regulated Rates	Rates are regulated - no add-ons allowed	
Servicing Issues	Broadly offered through largest Servicers	Only marketed with selected Servicers
	- Minimal changes to servicing process required - Projected savings of approx. 25% within the delinquency / foreclosure operations	
Loan Salability	Does not affect loan salability in any way	
Servicing Salability		May affect servicing salability

FNMA Payment Power		
	Advantages	Disadvantages
Mortgage option within the mortgage instrument	Can be rescinded	
Borrower has option to skip up to 18 payments over life of the loan without providing a reason	Limited to 2 skips within a 12-mo. period (within guidelines, other lockout periods apply)	
No payment is made	Skipped P&I is added to UPB and recast into remaining life of the loan resulting in NegAm	
The servicer pays all escrow items and deducts T&I payment from the aggregate monthly remittance to Freddie Mac		
Prevents credit loss due to inability to make payment		
In case of co-borrowers, either may invoke a payment skip option		
Borrower may have option to select increased interest rate or pay a per-transaction fee	- Selection is at lenders' discretion - Selection of option made at origination	
Per transaction fee is based on UPB - \$100 (UPB = \$0 to \$20,000) - \$175 (UPB = \$20,000 to \$25,000) - \$225 (UPB = \$25,000 to Conf. Loan limits)	Borrower may not have money at time to pay the transaction fee	
Increased interest rate of 1/8 pct pt increases monthly payment - \$14.16 (based on \$150,000 loan amount)	- Originator and Servicer may add additional fees to offset the cost of servicing these loans	
		if MI is required the rates are based on Non Fixed Payment rates - 10 bps higher
Interest is tax deductible	Interest deductibility is reduced/delayed	
		Available only at origination
		Requires 3 mo. vesting prior to skip option is eligible
		Not cancelable
		Must meet credit eligibility requirements at underwriting - Must be DU "Approve/Eligible" - Currently only 30-yr fixed rates - 95% LTV/CLTV max
No eligibility requirements due to employment type		
		Lender can add additional rates/fees for servicing
		Only available with approved Servicers
		Very difficult and costly to administer for Servicers - Must identify loan properly - Must track skipped payments - Must recast loan payments after each skip - Must cover T&I during skipped payment - Must adjust 1098 reporting for adjusted interest
		Sale options limited to cash transactions
		May affect servicing salability

**Payment Power Payment Options ...
Based On A \$100k Loan**

Payment Power Details					
\$100,000 Loan					
30 yr fixed - 6.00% Loan			Pay As You Go		
P & I		\$599.55			
T & I		\$300.00			
Initial Payment		\$899.55			
		New	Payment	Overall	Per Skip
		Payment	Increase	Increase	Payment Fee
Year 1	Skip 1	\$904.97	\$5.42	\$5.42	\$100
	Skip 2	\$910.42	\$5.45	\$10.87	\$100
Year 2	Skip 3	\$915.95	\$5.53	\$16.40	\$100
	Skip 4	\$921.52	\$5.57	\$21.97	\$100
Year 3	Skip 5	\$927.20	\$5.68	\$27.65	\$100
	Skip 6	\$932.91	\$5.71	\$33.36	\$100
Year 4	Skip 7	\$938.74	\$5.83	\$39.19	\$100
	Skip 8	\$944.62	\$5.88	\$45.07	\$100
Year 5	Skip 9	\$950.61	\$5.99	\$51.06	\$100
	Skip 10	\$956.65	\$6.04	\$57.10	\$100
Additional Interest Charges =		\$9,785.05			\$1,000
Interest with skips		\$125,623.23			
Interest without skips		\$115,838.19			

Payment Power Details					
\$100,000 Loan					
30 yr fixed - 6.25% Loan			Increased Up-front Rate		
P & I		\$615.72			
T & I		\$300.00			
Initial Payment		\$915.72			
		New	Payment	Overall	
		Payment	Increase	Increase	
Year 1	Skip 1	\$921.38	\$5.66	\$5.66	
	Skip 2	\$927.08	\$5.70	\$11.36	
Year 2	Skip 3	\$932.86	\$5.78	\$17.14	
	Skip 4	\$938.68	\$5.82	\$22.96	
Year 3	Skip 5	\$944.61	\$5.93	\$28.89	
	Skip 6	\$950.59	\$5.98	\$34.87	
Year 4	Skip 7	\$956.67	\$6.08	\$40.95	
	Skip 8	\$962.81	\$6.14	\$47.09	
Year 5	Skip 9	\$969.07	\$6.26	\$53.35	
	Skip 10	\$975.37	\$6.30	\$59.65	
Additional Interest Charges =		\$10,465.36			
Interest with skips		\$132,123.55			
Interest without skips		\$121,658.19			

- ✓ **Additional Interest Charges Total Approximately \$10K Over Life of Loan**
- ✓ **Under Pay as You Go Option - Payments Increase \$57 Per Month**
- ✓ **Under Increased Up-Front Rate Option – Payments Increase \$20/Month**