

The **GSE** REPORT TM

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[**Editorial Note:** Fannie Mae's duration gap has been at the forefront of every discussion about the mortgage market since Fannie Mae announced a 14-month duration gap in its *August 2002 Monthly Summary*.

The duration gap is only a symptom of the real problem. The real problem is that Fannie Mae is not hedging for the convexity of their interest rate risk. When combined with capital requirements that are two to three times lower than other regulated financial institutions and a gigantic portfolio, a situation is created that is potentially unsafe and unsound.

In the down rate scenario, Fannie Mae can try to manage their problem through growth. This “growth strategy,” however, simply masks Fannie Mae’s underlying mismatch. If at some point Fannie Mae is not able to grow out of their problem, such as in a rising interest rate environment, Fannie Mae’s financial condition could be threatened.

This situation also creates a problem for policymakers because this will result in a GSE that controls an even greater portion of the mortgage market. Even at Fannie Mae’s current size, their mismatch may inhibit the Federal Reserve Board from raising or lowering interest rates, as they would otherwise do. This dynamic cannot be maintained over the long-term.]

Fannie announces a negative 14 month duration gap

- Fannie reported that its duration gap widened to negative 14 months in August, a dramatic increase from July’s negative nine months. (*Dow Jones Newswire*, Dawn Kopecki, 9/16/02) 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 and Freddie’s portfolios. “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.
- Fannie’s duration gap has widened for four consecutive months, as a result of expected interest income disappearing from Fannie’s book because of the record volume of home refinancings. (*Reuters*, Aleksandrs Rozens and Richard Leong, 9/16/02) The gap means that Fannie’s mortgage assets will be repaid and replaced at a lower interest rate 14 months sooner, on average, than its debt. A smaller gap is important to the GSE, because it makes most of its money on the difference between the return on its mortgage assets and the costs of its liabilities. (*Bloomberg News*, Al Yoon, 9/16/02) A negative number reflects falling interest rates, a positive number reflects rising interest rates.
- The August duration gap is at widest not seen since October 2001 when it was at negative 10 months, when the US Treasury said it would eliminate the sale of 30-year bonds, and interest rates fell after the September 11 terrorist attacks. At negative 14 months, Fannie’s latest duration gap is the largest mismatch ever disclosed publicly, though it has been larger on an intra-month basis, a Fannie spokesman said. Fannie’s Vice President of Investor Relations Mary Lou Christy said that the duration gap has been wider on an intra-month basis, but this is the widest it has been at the end of the month. “We have had another 14-month negative duration before we released the monthly numbers (on a regular basis) two years ago,” she said. “Every time we have been in a heavy refinance cycle, many MBS [mortgage-backed securities] will refinance and the duration of your assets will shorten. It has happened before.” Christy noted, “At the end of 1997 and early 1998 we had five (consecutive) quarters of negative duration.” (*Reuters*, Aleksandrs Rozens and Richard Leong, 9/16/02; *Reuters*, Aleksandrs Rozens, 9/16/02) Fannie officials said the

negative 14 month number is not an all-time high for the company. (*National Mortgage News Daily Web site*, 9/18/02)

How serious is the issue?

- The “prospect that the next great financial accident might involve Fannie Mae, with or without Freddie Mac, has been increasingly obvious since the Federal Reserve’s rate-cut cycle began in January 2001,” reported Howard Simons with *The Street.com*. “Fannie Mae...has one of the largest and most sophisticated interest rate derivative books, but after the experiences of Enron, Bankers Trust, Long Term Capital Management, etc. I’m less impressed by all this razzle-dazzle than the company would like me to be. The more complex any derivative position is, the more likely its operator is engaged in smug self-delusion.” He suggested that Fannie may be “too big to hedge.” Simons noted, “Fannie Mae is not bigger than the entire base of mortgages that can be refinanced. If the yield curve flattens by virtue of note yields falling...Fannie’s duration gap will continue to grow. At some point a danger arises that the company won’t be able to exit its massive positions, and that may necessitate a public bailout...What mortgages will save in monthly payments they’ll lose in increased taxes and the risk of future inflation.” (*TheStreet.com*, Howard Simons, 9/24/02)
- Jim Bianco, President of Bianco Research, is concerned that Fannie may present a “healthier duration gap” for September, and engage in a form of month-end “window dressing” for OFHEO. Thus, Fannie is willing to risk a “cure” that might worsen its illness. The real problem for financial markets and the economy is that if and when interest rates start to rise, which would decrease refinancings and cause Fannie’s duration gap to shrink to more normal levels, Fannie would have to “get rid of all that stuff they’ve bought,” he said, forecasting the “sheer volume” of such selling could cause a sharper rise in Treasury rates than the one that occurred last November-December. (*The Street.com*, Aaron Task, 9/23/02)
- The duration gap disclosure doesn’t mean that Fannie is in trouble. “But it does mean Fannie Mae’s huge \$747 billion loan portfolio has greater exposure to a sudden shift in interest rates.” (*Wall Street Journal*, Patrick Barta, 9/16/02) Fannie and Freddie control more than 40% of the US mortgage market through loans they own or guarantee. Fannie’s portfolio surpassed \$730 billion in August, while Freddie’s was more than \$520 billion. For the sake of comparison, Fannie and Freddie’s mortgage holdings are roughly five times the entire size of all residential mortgage debt in Canada, which amounted to \$447 billion in 2001. (*National Post*, Ian Karleff, 9/20/02)
- “Need something to worry about...Fannie Mae’s duration gap is widening...How serious an issue? Well, aside from being the biggest player in the American housing market, Fannie Mae also enjoys special status as a government-chartered entity. If it were to become insolvent, pressure would be huge for some kind of government bailout. And in a time when federal finances are already being stretched...bailing out the nation’s largest housing lender could present Congress with some ugly choices, to say the least. This isn’t a prediction of doom; under a half-dozen scenarios, the problem could go away and never become a crisis. But it’s something to worry about for sure.” (*Philadelphia Inquirer*, Andrew Cassel, 9/25/02)

Fannie defends its negative 14 month duration gap

- Fannie’s Chairman and CEO Franklin Raines said Wall Street is “over obsessed” with Fannie’s duration gap. “A number that we watch quite carefully and use as a guide for us has now become one of those kinds of numbers Wall Street is fixated on,” he said in an interview with *Bloomberg Television*. “But we’re quite comfortable with our ability to manage the duration gap.” He further noted that investors would not have been alarmed by Fannie’s recent announcement of a negative 14 month duration gap if they had been monitoring the gap for 10 or 15 years. “The nice thing about a negative duration gap is that it’s caused by lots of refinances,” he said. “When mortgages refinance, those mortgages turn around and come back into

the market. In fact, Fannie Mae tends to grow faster during refinance periods. So, the cure is part of the cause.” (*Bloomberg News*, Anna Dubrovsky, 9/23/02)

- Fannie’s Chief Financial Officer Tim Howard said the company’s mismatch is not unusual during a period of “heavy refinancing” and will probably be corrected as the company replenishes its assets. (*Bloomberg News*, Al Yoon, 9/16/02) In a conference call with fixed-income investors, Howard said the company won’t accelerate its strategy to reduce interest-rate risk despite the focus on its duration gap. Fannie’s goal is to narrow the duration gap “in a reasonable amount of time” and in such a way “that has as low an impact on our long term costs as we can possibly have.” (*Bloomberg News*, Al Yoon, 9/26/02)
- The negative 14 month duration gap compares to Fannie’s preferred target range of plus or minus six months. Fannie noted, however, that its plus or minus six month duration gap “is a management guideline, not an absolute risk limit,” according to Fannie’s Howard. He noted, “Over the past dozen years, the duration gap has been outside our target range about one-third of the time.” He added that “it is not unusual, in a period of heavy refinancing, for a duration gap to turn sharply negative” and that Fannie’s duration gap was outside the target range during each of the last major refinancing waves in 1993, 1998, and 2001. He noted that Fannie’s asset durations have tracked the Lehman Mortgage Index duration drop of 17 months in August from 42 months in March. Howard claimed that the widened duration gap would not affect Fannie’s earnings and it will remain in compliance with OFHEO’s risk-based capital standard. (*Statement by Fannie’s CFO Timothy Howard on August financial data*)

Widening duration gap could put Fannie’s net interest income at risk

- The widening duration gap can also place net interest income at risk if it is not eventually narrowed or closed. Fannie also announced that its net interest income at risk over the next four years rose from 5.1% in July (when the duration gap was negative nine months) to 6.7% in August. (*Dow Jones Newswire*, Dawn Kopecki, 9/16/02) Fannie said a higher share of its interest rate income would be vulnerable if there were sudden shifts in the outright levels of interest rates or in the difference between short- and long-term interest rates. “They give us reasons to pause because more interest rate income is at risk,” said Jennifer Scutti, analyst at CIBC World Markets. (*Reuters*, Aleksandrs Rozens and Richard Leong, 9/16/02)

Activity in the Treasury market was affected by the news – Traders expected Fannie to increase its purchases of Treasuries to rebalance their duration gap – Fannie, however, can use several alternatives to Treasuries to rebalance its duration gap

- Soon after Fannie’s announcement that its duration gap fell to negative 14 months in August, buying activity in the Treasury market boosted in anticipation that Fannie would need to purchase fixed-income products to lengthen the duration of its assets, traders said. (*Dow Jones Newswire*, Tyler Lifton, 9/16/02) Bond traders cited Fannie’s announcement as a factor behind increased demand for US Treasuries. They said Fannie would need to purchase billions in longer-dated Treasuries to offset its heavy portfolio runoffs. (*Reuters*, Aleksandrs Rozens and Richard Leong, 9/16/02) “The news that one of the biggest players in the market has such a large mismatch, means that the path of least resistance is for longer dated maturities to trade higher,” said Michael Cheah, portfolio manager at SunAmerica Asset Management. The news pressured the 10- and 30-year Treasury yields to new lows for the year around 3.85% and 4.73% earlier in the session and the move “has a lot to do with Fannie Mae...It shows there is a potential buyer of duration in the market” and that buyer is big enough to push prices higher, said Jim Caron, market strategist with Merrill Lynch. (*Dow Jones Newswire*, Michael MacKenzie, 9/16/02) With Fannie’s assets and liabilities mismatched, “people figure at some point they’re going to have to cover that and buying will beget more buying” in Treasuries, said Robert Calhoun, chief investment officer of Tattersall Advisory Group, a unit of Wachovia Corp. (*Bloomberg News*, Gerald Ryerson-Cruz, Elizabeth Stanton, Al Yoon, 9/16/02)

- Bond traders had been speculating that Fannie would purchase 10-year Treasuries to balance its duration gap, said Paul Miller, an analyst at Friedman, Billings, Ramsey Group. The speculation was unfounded, he said. (*Bloomberg News*, Al Yoon, 9/24/02) Treasury yields could rise further, however, if market players unwind purchases made in anticipation of heavy buying by Fannie. “A lot of people were going into the market thinking Fannie Mae would be buying duration in the Treasury and swap markets and were hoping to front-run them, but they’ve realized that the rally doesn’t have that many legs so they’re kind of getting out,” said Mukul Chadda, agency strategist at Lehman Brothers. (*Reuters*, Lynn Adler, 9/26/02)
- Fannie can use a wide variety of options besides Treasuries to bring its portfolio back in line, such as issuing more shorter-term debt and reconfiguring its balance of derivatives. (*Wall Street Journal*, Patrick Barta, 9/16/02) Another alternative would be to enter into swap contracts to receive fixed coupon payments, and pay a floating rate. (*Bloomberg News*, Al Yoon, 9/16/02) Fannie could also call debt it has issued and could buy mortgage bonds, said Jeff Ho, mortgage bond analyst at UBS Warburg. If Fannie bought mortgage bonds, it would likely do so in the most liquid part of the market, which would be 30-year Fannie Mae 6 percent mortgage bonds, Ho said. (*Reuters*, Dan Wilchins, 9/13/02)
- Fannie’s CFO Timothy Howard stated, “Our strategy is to rebalance over time rather than immediately, and to use a combination of mortgage purchases, debt issuances, and derivatives to minimize the cost and market impact of this rebalancing...Periods of heavy refinancing are associated with somewhat higher levels of risk, but historically they also present opportunities’ to offset the duration gap, including buying cheaper mortgages. The meaning of the duration gap has been misinterpreted, he said. “In the current environment we have the ability to move the gap down fairly quickly,” he said. “I won’t give the exact numbers but the reported progress will be dependent in part on what interest rates do. Interest rates have come down since August and that’s the equivalent of running or pedaling into a backwind,” he said. “We will be back within a manageable number of months,” he said. “We will get back but will do so in a way that minimizes the long-term costs to the company.” Howard made his comments at the Banc of America Securities 32nd Annual Investment Conference. (*Bloomberg News*, Al Yoon, 9/24/02)
- In a September 18 letter to investors, Fannie’s Treasurer Linda Knight said it can adjust its portfolio by replacing the loans refinanced with new mortgages to lengthen its asset duration. “In addition, in the coming months, our rebalancing strategy will include funding these longer-term liabilities (which we can now do at lower cost, given that interest rates are so low). This action – which again, is routine – will help bring our duration gap, which we reported was minus 14 months, back within our preferred six months. There are other tools we will use as well.” (*Reuters*, 9/18/02; *Fannie’s Treasurer Linda Knight letter to investors as re-printed by Bloomberg News*, 9/18/02)
- On September 24, Fannie bought back \$846 million of its benchmark note debt, which will help a bit to correct its duration gap, though market professionals said it is only a drop in the bucket compared to what needs to be done if interest rates don’t rise. A debt buyback is a step in the right direction, but “I still haven’t seen a really good breakdown that tells me” what overall strategy Fannie is employing, said Mitchell Stapley, Chief Fixed-Income Officer for Fifth Third Investment Advisors. (*Dow Jones Newswire*, Michael Mackenzie, 9/25/02)

Freddie’s duration gap is zero

- For the first time, Freddie reported its duration gap measure, two days after Fannie announced its negative 14 month duration gap. Freddie announced that its duration gap held at approximately zero at the end of August, virtually unchanged from July and that over the past year, Freddie’s monthly average duration gap has ranged from plus or minus one month. Freddie also announced that its portfolio market value sensitivity (PMVS), which measures interest-rate risk, was 2.11% for August 2002, virtually unchanged from July 2002’s PMVS of 2.08%. Freddie said PMVS measures both the duration gap and the risk associated with

managing the prepayment option embedded in Freddie's mortgage assets. Freddie stated that its disclosure "demonstrates that Freddie Mac's interest-rate risk remains low" and that company "strives to maintain a close relationship between its assets and liabilities and to hedge a significant portion of the option risk inherent in its mortgage assets." (*Freddie press release, 9/18/02*)

- Fannie said its duration gap is not comparable to Freddie's because the companies use different models to generate the figures. (*Bloomberg News, Al Yoon, 9/18/02*) "Our number and the Freddie Mac number are not comparable," stated Fannie's CFO Howard. "Our duration gap is the simple difference between our asset durations and our liability durations. The duration number Freddie Mac cited was an estimate derived from their own internal measure of market value sensitivity, whose components are not known." (*Statement by Fannie's CFO Timothy Howard on August financial data*)
- Freddie claimed, however, that the company's measurement of its duration gap is indeed similar to Fannie's. Freddie's spokeswoman Sharon McHale said that even if Freddie used the same methodology as Fannie uses to compute duration gap, it would still come up with virtually the same, "approximately zero" number for Freddie. (*National Mortgage News, Ted Cornwell, 9/23/02*)

Freddie appears to be a more conservative approach to hedging its interest-rate risk than Fannie

- Speaking at the Banc of America Securities' annual investment conference, Freddie's CEO Leland Brendsel noted, "Freddie Mac's aim is to maintain a very close match in our funding between our assets and liabilities, and in doing this forgo much of the interest-rate spread." The interest margin between Freddie's funding and mortgages is about 300 basis points without hedging costs, he said. With hedging costs, the net interest margin is 88 basis points, he said. Freddie "protects about three-quarters of the option risk in our portfolio. That's important because it says our portfolio stays well matched if rates move and there's less of a need to rebalance the portfolio." He added, "Even with all this volatility over the past year, the PMVS, or portfolio market value sensitivity, has stayed low and the duration gap was tight," or within a range of plus or minus one month. (*Bloomberg News, Al Yoon, 9/26/02*) Freddie acknowledged that their active interest rate risk management, though prudent, is also pricey. "Yes, it's expensive to hedge the way we do," said Freddie's spokeswoman Sharon McHale. "We have no plans to deviate from it because it maximizes our shareholder value in the long run." She declined to detail how much Freddie spent in 2002 on hedging interest rate risks. (*Reuters, Richard Leong, 9/18/02*)
- Fannie's Senior Vice President of Portfolio Strategy, Peter Niculescu says it is in the best interest of shareholders to fund or hedge only around half of Fannie's pre-payment risk, thereby keeping costs down. (*Financial Times, Vincent Boland and Jenny Wiggins, 9/27/02*)
- Freddie's duration gap hasn't widened because it typically responds to changes in interest rates faster than Fannie through the purchase of derivatives that protect its investors, analysts said. The strategy, though, can be more expensive to execute, and Freddie may not profit as much when interest rates turn. Freddie has a "very active hedging strategy," said Shrikant Ramamurthy, a strategist at Greenwich Capital Markets Inc. "They have a more conservative philosophy." (*Bloomberg News, Al Yoon, 9/18/02*)
- Jennifer Scutti, analyst at CIBC World Markets, said that Freddie constantly rebalances its portfolio to match its mortgage assets and liabilities, while Fannie attempts to lower its interest rate risk through various hedging techniques. (*Reuters, Aleksandrs Rozens and Richard Leong, 9/16/02*)
- Analysts agree that Freddie takes a more conservative albeit expensive approach in managing its interest rate risks by using a higher level of option-embedded debt instruments, which Sandler O'Neill managing director Mike McMahon says is at 75% versus 57% for Fannie. Freddie says it rebalances its debt portfolio

more frequently than Fannie by using a higher percentage of callable debt, at the expense of its interest margins, which are 20 to 25 basis points lower than those at Fannie. (*National Post*, Ian Karleff, 9/20/02)

- Citing the difference between Fannie's reported duration gap and Freddie's, a trader at a US bank noted, "Either Fannie is taking on more risk than Freddie or Freddie is better at hedging their portfolio." (*Reuters*, 9/18/02) Paul Miller of Friedman, Billings, Ramsey Group noted, "At Fannie, the theory is that they can manage themselves through this volatility. Freddie doesn't want to take any risk...Freddie hedges much more tightly." (*Washington Post*, Jerry Knight, 9/23/02)

"Fannie Mae Plays Wild Child to Freddie Mac's Good Kid"

- In an article entitled, "*Fannie Mae Plays Wild Child to Freddie Mac's Good Kid*," Aaron Task with *The Street.com*, suggested that Fannie's operating style is more aggressive than Freddie's. "To some the distinctions are merely a matter of management philosophy. To others, they're evidence that the top executives of Fannie Mae are pursuing growth without enough regard for risk." Jim Bianco, President of Bianco Research, who has no position in either Fannie or Freddie, suggests the motive may be the compensation structure and self-interest of Fannie's executives. "The only major difference [between Fannie and Freddie] is the vesting schedule," he said. "Fannie Mae has tied top management compensation to hitting earnings goals at the end of next year," while Freddie's proxy statement disclosed no similar arrangements of options grants tied to specific goals.
- Task noted that at the end of August, Fannie's mortgage portfolio has grown to \$747 billion, up 5.9% since December, despite falling rates and record refinancings. Since the GSE began providing monthly updates in December 1997, Fannie has never reported a monthly decline in its mortgage portfolio. In comparison, Freddie's mortgage portfolio also has risen since last year, although at \$525.8 billion at the end of August its size has shrunk slightly since March. Through August, Fannie had grown the amount of mortgages it's pledged to purchase this year by 93.4%, compared to Freddie's 45%.
- Task compared Fannie and Freddie to the "Ant and the Grasshopper." He noted that Freddie is "more apt to hedge its portfolio" than Fannie. Although Freddie's portfolio is smaller than Fannie, the notional value of its derivatives contracts was larger at the end of June, \$704 billion compared to Fannie's \$600 billion. Although some feel there are inherent risks in derivatives, Freddie's Senior Director of Finance Rob Weiss noted that Freddie uses derivatives only to manage its risks, "not to generate income or speculate." He added that Freddie only uses "vanilla derivatives," such as swaps, puts or calls on Treasury features with highly rated counterparties, and its positions are marked to market daily. And of the \$704 billion notional value at the end of June, Freddie's net exposure was just \$350 million, Weiss said.
- "There has always been a perception that Freddie Mac runs a much more hedged book [than Fannie], and the numbers bear that out," said Scott Simon, mortgage specialist at bond-fund Pimco. "Philosophically, Freddie Mac's management has said, 'We're doing such a high-quality [carry] trade, why not spend some of the amazing income hedging the risks?' I think Fannie Mae, said, 'The trade makes so much money, we can afford to underwrite the risk.'"
- Task concluded, "Fannie Mae attributed its duration-gap woes to a '100 years flood'-type event, namely a historic decline in mortgage rates that sparked a record level of refinancing activity. However, Freddie Mac had to operate in the same environment, and hasn't experienced similar shocks. The distinctive ways the firms manage risks shows why that proved to be the case. What's prompting Fannie Mae to pursue this path and whether it remains a prudent one in the current environment are other issues investors ought to consider." (*The Street.com*, Aaron Task, 9/27/02)

OFHEO says it will increase its oversight of Fannie's portfolio and its duration gap

- In a September 16 letter to House Capital Markets Subcommittee Chairman Richard Baker (R-LA) and Ranking Member Paul Kanjorski (D-PA), OFHEO said that while Fannie remains “safe and sound,” OFHEO has increased its oversight of Fannie’s mortgage portfolio and its duration gap, requiring weekly reports on its exposure to interest-rate risks through this latest refinancing boom. “We consider negative 14 months to be a substantial mismatch, but we find that [Fannie’s] management is moving appropriately and aggressively to address the current level of risk.” Falcon added, however, “My attention will remain heightened over the next several months until the risk measure for portfolio sensitivity is returned to management’s preferred operating range of plus or minus six months.” Falcon noted that OFHEO had taken several steps, such as meeting with Fannie’s senior officials to discuss their plans for returning the duration to the preferred operating range. Falcon has also instructed OFHEO’s Office of Examination and Oversight to provide him with weekly status reports on the changes in Fannie’s portfolio sensitivity and the effectiveness of its rebalancing efforts. He warned that “in the event there are adverse development with management’s effectiveness in reducing the level of interest rate sensitivity, OFHEO may take additional action.” (*Dow Jones Newswire*, Dawn Kopecki, 9/17/02; *OFHEO Director Armando Falcon letter to Congressman Richard Baker and Congressman Paul Kanjorski*, 9/16/02) Freddie was not included in the letter because its business strategies and ways to handle risk are different from Fannie’s, said OFHEO Spokeswoman Stefanie Mullin, citing OFHEO’s chief examiner Scott Calhoun. (*Bloomberg News*, Al Yoon, 9/17/02)
- OFHEO does not plan to make public its new weekly assessments of Fannie’s duration gap, according to an OFHEO spokeswoman September 18. OFHEO’s weekly reports will be oral presentations by OFHEO’s chief examiner to the director, said the spokeswoman. There may be supporting internal documents for each report, but OFHEO does not envision releasing the results of the review, the spokeswoman added. “So far we have no plans to release this information to the public,” she said. She added that OFHEO expects to provide information to Congressional Members on request. (*Reuters*, Mark Felsenthal, 9/18/02)

Fannie claims OFHEO’s weekly oversight of its duration gap is no different than current oversight - Fannie claims it suggested providing the weekly reports, not OFHEO

- **In response to OFHEO’s letter to Congressman Baker that OFHEO’s examiners would be providing weekly reports on efforts to close the duration gap, Fannie’s CFO Timothy Howard said, “The weekly reports were suggested by us, and not a requirement made by our regulator,” he said. “The letter that went out that was intended to signal the regulator was on top” of the issue, he said. “This was misinterpreted by the press that our regulator was going to force a pacing on us. It’s not true.”** Howard made his comments at the Banc of America Securities 32nd Annual Investment Conference. (*Bloomberg News*, Al Yoon, 9/24/02)
- Fannie disputed that OFHEO was doing anything differently in its weekly oversight of Fannie, than it has in the past, since OFHEO examiners are in Fannie’s office daily. “The reality is that this is a job the regulator does every day,” said Fannie’s spokeswoman Janice Daue. “It’s very appropriate for a regulator to inform a Congressman” about what it is doing, she said. (*Bloomberg News*, Al Yoon, 9/17/02)
- *CNBC* Anchor Consuelo Mack asked Fannie’s Chairman and CEO Franklin Raines to respond to the assertion that federal regulators are increasing their regulation of Fannie’s portfolios and seemed more concerned about the duration gap issue than Fannie. Raines responded, “Well, I don’t think they are more concerned than we are. We in fact have federal regulators here every day....what they [regulators] have said was that they will do on a weekly basis, they will be looking at some data that they otherwise had looked at less frequently.” (*CNBC/Dow Jones Business Video, Interview with Franklin Raines*, Carl Quintanilla, Consuelo Mack, 9/23/02)

Congressman Baker criticizes OFHEO's concerns about Fannie as "overdue" - asks OFHEO for its weekly status reports on Fannie

- Congressman Baker September 18 criticized OFHEO for not addressing Fannie's growing risk sooner. "OFHEO's recognition of Fannie Mae's problem is overdue and your delaying allowed unacceptable levels of risk to continue for far too long," In a letter to OFHEO Director Armando Falcon, Congressman Baker noted that he had alerted OFHEO to his concerns about Fannie's interest rate risk in a December 17, 2001 letter when Fannie's duration gap was a negative 10 months. OFHEO responded in a January 29, 2002 letter: "Fannie Mae's approach to managing interest rate risk is to take prudent actions to rebalance the risk of the portfolio when it moves out of the target range... Depending on the size of the duration gap, Fannie Mae may not necessarily take those rebalancing actions immediately or in large size. Management will instead take actions progressively over a period of time that may last as long as several months." Congressman Baker noted, "'Several months' have elapsed and Fannie Mae's negative duration gap has significantly widened, not narrowed, much less has been brought back into an appropriate range. It appears that your statement - 'Management will instead take actions progressively over a period of time that may last as long as several months.' - was a misplaced confidence." He noted that Fannie's negative duration gap has been a problem for almost a year. (*OFHEO Director Armando Falcon letter to Congressman Richard Baker, 9/18/02 as re-printed by Bloomberg News*)
- Fannie's spokeswoman Janice Daue said Fannie's duration gap had fallen back this year within the company's preferred range of plus or minus six months. "[Congressman Baker's letter] is just a fundamental misstatement of the facts," she said. Daue said Fannie's duration gap had been within the company's preferred range for most of 2002, with the exception of July and August. (*Dow Jones Newswire, Dawn Kopecki, 9/18/02*)
- In a letter to OFHEO Director Armando Falcon, Congressman Baker September 20 asked OFHEO to provide him with its weekly written reports on the status of Fannie's portfolios. The letter followed Congressman Baker's September 18 letter to OFHEO and subsequent September 19 letter from OFHEO to Congressman Baker. "I realize this may necessitate additional work by OFHEO's examiners," Congressman Baker said. "But I make this request in the context of an extraordinary convergence of housing market indicators, some at historic levels, which give me cause for concern and which may call for ongoing monitoring by my subcommittee." (*Dow Jones Newswire, John Connor, 9/21/02; Reuters, Mark Felsenthal, 9/20/02*) He noted the following housing market indicators: mortgage financing applications have reached their highest levels ever; 30-year fixed-rate mortgages are at record lows; housing starts declined again; and second-quarter foreclosure rates are at their highest level in 30 years. "It is against this background that I consider, in your words, the 'substantial mismatch' of Fannie Mae's duration gap and your supervisory responsibility," wrote Congressman Baker. "While no one could have predicted these market conditions, taken together they are potentially troubling, and I doubt OFHEO's risk-based capital test is adequate to the task of providing a complete and accurate risk profile of the enterprises." Congressman Baker noted that his "concern with Fannie Mae is not based on a continual decline in the enterprise's duration gap since October 2001." Rather, he said, "I am concerned about the sharp return to a negative duration gap, which has gone from bad to worse in July and August 2002." (*Dow Jones Newswire, John Connor, 9/21/02, 9/23/02*)

OFHEO says Congressman Baker's concerns were based on "incorrect information"

- In response to Congressman Baker's September 18 letter, OFHEO Director Armando Falcon said that he believes Congressman Baker's concerns "are based on incorrect information." In a September 19 letter to Congressman Baker, Falcon noted that Congressman Baker's letter stated that Fannie's negative duration gap "has been a problem for almost a year." Falcon responded, "In fact, until the current disclosures, Fannie Mae has not operated outside the company's target range since October 2001. The October gap was returned to the target range the following month and Fannie has remained within the target range through

June of this year.” Falcon added, “As of July and August, Fannie Mae has moved outside the target range...I would reiterate that Fannie Mae remains safe and sound, and our examiners are continuing to monitor the implementation of their strategy to move back within the target range.” (*OFHEO Director Armando Falcon letter to Congressman Richard Baker, 9/19/02 as re-printed by Bloomberg News*)

OFHEO says Congressman Baker’s request for weekly reports “is under advisement”

- Congressman Baker’s request that OFHEO provide him with weekly reports on Fannie’s status “is under advisement,” said an OFHEO spokeswoman. How long Congressman Baker’s request will be “under advisement” was not clear. (*Dow Jones Newswire, John Connor, 9/26/02*)

Merrill Lynch downgrades Fannie after news of Fannie’s duration gap widening

- Fannie’s stock rating was lowered by Merrill Lynch & Co. for a second time this year. The downgrade came two days after Fannie said its duration gap widened to negative 14 months. Merrill analyst Michael Hughes cut his rating on Fannie’s shares to “neutral” from “buy” and recommended investors opt for shares of Freddie. “We do not believe that Freddie Mac has a comparable duration issue due to a more aggressive hedging strategy,” Hughes said. (*Bloomberg News, Al Yoon, 9/18/02*) Hughes said he felt Fannie should have a “higher risk premium” on its shares in light of recent news about its duration gap. Hughes believes Fannie is a “savvy mortgage player” and will work to reduce the gap, however, he felt he needed to downgrade the stock in light of the potentially higher interest rate risk. He believes Fannie will manage its duration gap issue without any impact on earnings. He said Fannie still faces a challenge in reducing the gap, given the “headwind of continued declines in mortgage and long-term interest rates.” He believes net interest margins could decline as Fannie replaces its higher-yielding assets with lower-yielding, newly originated and longer-duration assets. (*Dow Jones Newswire, Janet Morrisey, 9/18/02*) “The use of liability-shortening tools tends to be expensive if used over a sustained period of time,” said Hughes. “And the use of asset lengthening tools tends to further drive down mortgage rates, which can perpetuate both mortgage refinance activity and the company’s duration problem.” (*Reuters, 9/18/02*) Hughes does not hold shares in Fannie, but his firm has had an investment banking relationship with Fannie. (*Dow Jones Newswire, Janet Morrisey, 9/18/02*)

Fannie’s disclosure rattles some investors

- Fannie’s disclosure “somewhat rattled” investors, according to the *Wall Street Journal*. The disclosure creates “a general level of concern when you see a huge financial institution reporting what seems to be a mis-hedging of their assets and liabilities,” said Robert Young, a mortgage analyst at Solomon Smith Barney. “It looks like a pretty sizable gap.” (*Wall Street Journal, Patrick Barta, 9/16/02*)
- Many market players are focused on Fannie’s need to purchase duration – either through swaps, Treasuries, or mortgages – to correct its mismatch. Some analysts estimated that Fannie would have to purchase as much as \$110 billion in the equivalent of 10-year exposure to get its duration gap back within its preferred range of plus or minus six months. “You’ve got to worry about Fannie,” said a trader at a US bank. “The view is that Fannie has to go long a lot of duration.” (*Reuters, 9/18/02*)
- “The Fannie Mae duration gap is a real concern, because of their leverage,” said James Camp, portfolio manager at Eigel Asset Management in St. Petersburg, FL, which manages \$1.5 billion in assets. “Freddie Mac’s being balanced would bode better for them in terms of their risk management.” (*Reuters, Richard Leong, 9/18/02*)
- Jay Zelko, who has shares of Fannie and Freddie in his \$700 million Evergreen Strategic Growth Fund, said Freddie “has totally immunized its portfolio.” He told *Bloomberg Radio* that he would not purchase additional shares of Fannie until it corrects its gap to “more appropriate levels.” (*Bloomberg News, 9/18/02*)

- “They [Fannie and Freddie] make a lot of money in rising or declining markets as long as there is no sharp swings in interest rates,” said Sandler O’Neill managing director Mike McMahon. **“They are money machines and a duopoly, with huge barriers to entry called government.”** It’s a “big risk factor” for both Fannie and Freddie that lending rates will fall further, said McMahon. “Freddie and Fannie will have to call more debt and refinance at lower rates to maintain duration. It’s kind of like a rat in a wheel having to run faster to keep up,” he said. (*National Post*, Ian Karleff, 9/20/02)
- Some market professionals expressed surprise that Fannie ended August as mismatched as it did, because it indicated that Fannie hedged itself less than they had expected. (*Dow Jones Newswire*, Tyler Lifton, 9/16/02)

Other investors are less concerned

- The duration gap could lead to more worries if interest rates stay low for an extremely long period of time. But for now, said Kevin Jackson, a mortgage-bond strategist at RBC Dain Rauscher in Chicago, “I don’t think [Fannie Mae is] in any trouble.” (*Wall Street Journal*, Patrick Barta, 9/16/02) Jackson noted, “If Fannie Mae’s gap consistently stays at negative 14 months for several months straight, that will be when there is a cause for concern, but right now it is not a problem.” (*Dow Jones Newswire*, Julie Haviv, 9/18/02) Analysts at US Bancorp Piper Jaffray said, “While the widening does increase the overall risk profile of Fannie Mae, we point out that the duration gap fluctuates significantly in volatile interest rate environments.” (*Dow Jones Newswire*, Tyler Lifton, 9/16/02)
- Some analysts see relief that Fannie announced that its mortgage purchases and commitments in August increased, which suggests that its duration gap could shrink in coming months. “It would take them a couple of months. As long as they bring the gap to minus eight or nine months, I’m not going to be too worried,” said Jennifer Scutti, analyst at CIBC World Markets. (*Reuters*, Aleksandrs Rozens and Richard Leong, 9/16/02) With the rise in commitments to buy loans “the [duration] gap begins to self correct,” said Paul Miller, an analyst at Friedman, Billings, Ramsey Group Inc. That said, “if we are looking at minus 14 next quarter, I will begin to have concerns.” (*Bloomberg News*, Al Yoon, 9/16/02) Fannie announced that its retained commitments for the mortgage portfolio increased to \$41.3 billion in August, an \$11.5 billion increase from July. Mortgage portfolio purchases increased to \$21.3 billion, up 31% from July. The mortgage portfolio grew at a compound annual rate of 5.6% in August. Outstanding portfolio commitments surged to \$59.4 billion at month-end, up from \$38.2 billion in July and Fannie’s total business volume rose to \$59.2 billion. (*Fannie monthly summary*, August 2002)
- Relative to other risks in the equity markets, this is nothing to worry about, said Dave Dreman, Chief Investment Officer at Dreman Value Management. Interest rates are more likely to go up now, which would shorten the duration gap. More than 5% of Dreman Value Management’s \$7 billion in equity holdings is in Fannie’s stock. A duration gap would have to persist for years to have a significant impact, said Howard Shapiro, equity research analyst at Goldman Sachs. (*Reuters*, Dan Wilchins, 9/13/02)
- “I do not see this as a credit risk,” said Mary Shafer, portfolio manager at Principal Capital Income Investors in Des Moines, IA, which manages \$40 billion in bonds. A small rise in interest rates could quickly rebalance the company’s cash flows, he said. (*Reuters*, Mark Felsenthal, 9/18/02)
- Lehman Brothers analyst Bruce Harting says the duration gap is a “misleading measurement of interest rate risk.” He added, “Large (refinancing) waves always cause the fall of the duration gap...It turns negative during refi waves because the duration of loans shortens in expectation of prepaying. Once the refi wave is completed, the asset durations extend significantly.” A large duration gap does not necessarily mean slower earnings growth. Harting also noted that rising interest rates could narrow Fannie’s duration gap. Lehman

Brothers has an investment banking relationship with Fannie, according to *Dow Jones Newswire*. (*Dow Jones Newswire*, Janet Morrissey, 9/18/02)

- UBS Warburg analyst Gary Gordon reiterated his strong buy on Fannie, noting that the company is trading at its cheapest valuation in over a decade. Gordon stated, “The duration gap is one element. It is definitely a negative element, and there are costs in trying to reduce that duration gap, but they have two positives: great interest margins and loan volume growth... You can’t ignore the positives.” Gordon or a member of his team holds long-term positions in Fannie and his firm has had an investment banking relationship with Fannie, according to *Dow Jones Newswire*. (*Dow Jones Newswire*, Janet Morrissey, 9/18/02; *American Banker*, Tommy Fernandez, 9/23/02)
- Sanford C. Bernstein & Co. analyst Jonathan Gray noted that while Fannie’s duration gap has widened, the overall risk is low. “The largest negative duration gap poses a risk only in a falling rate environment, (and) the likelihood of rates falling significantly appears low.” He noted that Fannie could close the gap by adding new mortgages to its retained portfolio, which will lengthen the duration of its assets, and it can repurchase long-term debt and issue cheaper short-term debt. “The large negative duration gap is a minor side effect of a very positive development for the GSEs – a record level of refinancing activity. Historically, refi booms have provided “significant opportunity” for Fannie to grow its retained portfolio at an above-average pace and elevated spreads. Gray holds shares in Fannie, however, his firm does not have an investment-banking relationship with the company. (*Dow Jones Newswire*, Janet Morrissey, 9/18/02)
- Prudential analyst Charles Gabriel said in a September 18 report that Fannie’s mismatch “should not be viewed as a serious opening for reinvigorated housing GSE political/regulatory risk.” He further noted that OFHEO Director Falcon’s letter to Congressman Baker is not unusual and “perhaps is also opportunistically signaling that the agency is on the job and being effective.” (*Dow Jones Newswire*, Dawn Kopecki, 9/18/02)

***Wall Street Journal* editorial says taxpayers should be concerned about Fannie’s duration gap because they “are implicitly on the hook” if Fannie fails**

Editorial recommends prohibiting Fannie & Freddie from buying mortgage-backed securities for their portfolios

Purchasing their mortgage-backed securities creates “enormous and unnecessary risk, just so Fan and Fred can fatten their earnings”

- A September 23 *Wall Street Journal* editorial noted that the *Journal* has “caught heck from the sages of Wall Street for suggesting over the past year that Fannie Mae was exposed to too much interest-rate risk. Well, all of a sudden a lot of investors seem to agree with us.” Investors have been selling Fannie’s stock after the company announced that its duration gap widened to negative 14 months, disclosing what Fannie once called its “‘superior’ risk management is coming undone.”
- The editorial asked, “What happened?” Falling interest rates have encouraged a record number of home refinancings and therefore of mortgage prepayments, causing Fannie’s assets to pay off faster than expected. “Beyond this obvious fact, however, things get murky.” The *Journal* speculated that maybe: (1) Fannie was caught without enough callable debt to keep pace with prepayments; (2) Fannie’s use of derivatives was “inadequate, leaving the company under-hedged;” (3) Fannie’s forecasting models “are deeply flawed;” or (4) Fannie was “intentionally skimping on its overall hedging.” The *Journal* noted that callable bonds are more expensive to issue than noncallable bonds and, in times of volatile interest rates, it is more expensive

to run a derivative position that is “perfectly” hedged. Fannie “has promised double-digit increases in earnings growth, so it has strong incentive to keep hedging costs down and risks up.”

- “[O]nly Fannie knows for sure what happened. Despite increasingly skeptical markets post-Enron, Fan’s disclosure about its hedging remains scanty. Trust us, the company says. Even now Fannie and her boosters on Wall Street are pooh-pooing this latest evidence that something is wrong with its risk management and are discounting potential dangers.”
- “Well, investors are free to trust Fannie all they want. But taxpayers -- who are implicitly on the hook if this ‘government-sponsored enterprise’ fails – shouldn’t have to backstop high-risk, roll the dice for higher earnings, practices. So we’d like to suggest a solution: Fannie (and...Freddie Mac) should be forbidden to buy mortgage-backed securities.”
- The *Journal* claimed that the “heart of the matter” is that in order for Fannie and Freddie to purchase these mortgage-backed securities, Fannie and Freddie must issue debt. The *Journal* noted:
 - Currently Fannie and Freddie each hold more than 30% of their own mortgage-backed securities outstanding;
 - Fannie and Freddie hold nearly 7% of each other's securities, requiring them to issue more than a trillion dollars of debt;
 - Fannie and Freddie must hedge against the interest-rate risk on their total trillion-plus dollars of mortgage securities
- **Fannie and Freddie’s purchasing of their mortgage-backed securities “does not aid” Fannie and Freddie’s original Congressional mission to create a liquid secondary mortgage market.** “That market is now big enough and deep enough to prosper without them. Nor does buying securities lower interest rates since the companies must borrow to finance their buying.” **Fannie and Freddie purchase mortgage-backed securities to increase their earnings.** Fannie and Freddie can borrow cheaply because of their implicit backing by the government, profiting from the spread between their lower cost of borrowing and the higher interest rates on the mortgage-backed securities. “The profits from their mortgage portfolios dwarf the profits they earn on their supposedly core business, which are the fees they get from guaranteeing principal and interest on the mortgages they securitize.”
- “[T]axpayers are taking on enormous and unnecessary risk, just so Fan and Fred can fatten their earnings. This is called privatizing profit but socializing risk. Congress and the Bush Administration should take a close look at Fannie Mae and Freddie Mac’s huge portfolios of mortgage-backed securities to see if they still serve any useful public purpose.” (*Wall Street Journal* editorial, 9/23/02)

Group of prominent scholars – the Shadow Financial Regulatory Committee – says Fannie’s duration gap of negative 14 months should concern taxpayers

Recommends prohibiting the GSEs’ purchase of mortgage-backed securities

- The Shadow Financial Regulatory Committee held a luncheon and press briefing on September 23. The Shadow Committee, an independent committee sponsored by the American Enterprise Institute (AEI), is comprised of the following prominent scholars: George Kaufman, CoChair, Loyola University, Chicago; Robert Litan, CoChair, Brookings Institution; George Benston, Emory University; Marshall Blume, University of Pennsylvania; Charles Calomiris, AEI and Columbia University; Franklin Edwards, Columbia University; Scott Harrington, University of South Carolina; Richard Herring, University of Pennsylvania;

Paul Horvitz, University of Houston; Hal Scott, Harvard Law School; Kenneth Scott, Stanford University; and Peter Wallison, AEI. (*AEI Invitation for September 23 briefing*, www.aei.org/inv020923.htm)

- The Shadow Committee released a statement at the luncheon noting that Fannie’s duration gap of negative 14 months “appears to imply a significant increase in the risk of loss to Fannie Mae, and thus is a matter of concern to taxpayers in light of the implied guarantee from taxpayers” enjoyed by Fannie and other GSEs. The Shadow Committee noted that given Fannie’s “highly leveraged position,” a duration gap of negative 14 months “implies that a one-percentage point decline in interest rates could result in about a 40% decline in its capital.” The Shadow Committee warned that “Such a decline in capital could result in Fannie Mae falling substantially below its minimum required capital, which is already low relative to that of any private financial institution.” (*Statement of the Shadow Financial Regulatory Committee on Fannie’s Duration Gap, Statement 181, 9/23/02*)
- The Shadow Committee noted, “It is possible that more complicated measures of interest rate risk exposure would imply a lesser exposure to loss.” However, the Shadow Committee –“like investors and taxpayers--is unable accurately to measure the true interest rate risk exposure of the GSEs because they do not disclose detailed information on their derivatives hedging practices.” (*Statement of the Shadow Financial Regulatory Committee on Fannie’s Duration Gap, Statement 181, 9/23/02*)
- The Shadow Committee noted, “Fannie Mae’s bet that interest rates will rise places taxpayers at risk” and reinforces the Shadow Committee’s view that these GSEs should be “fully privatized, which would entail the elimination of implicit government guarantees, the reform of corporate governance, and the enhancement of public disclosure.” In the meantime, the Shadow Committee recommended an alternative measure, such as “including proposals to prohibit GSE purchases of mortgage backed securities, which are a primary means for undertaking interest rate risk--may be advisable as a means of limiting taxpayers’ exposure to risk.” Charles Calomiris, a member of the Shadow Group from Columbia University, stated that the Shadow Group believes “it might be a good idea...to prohibit the purchase of mortgage-backed securities, which we don’t regard as a necessary, bona fide function of the GSEs.” He added, “We think it’s a primary way for them to undertake interest rate risk.” Calomiris further noted that Fannie’s duration gap of negative 14 months was a “significant threat to taxpayers.” (*Statement of the Shadow Financial Regulatory Committee on Fannie’s Duration Gap, Statement 181, 9/23/02; BNA Daily Report for Executives, Richard Cowden, 9/24/02; Comments by Charles Calomiris at Shadow Financial Regulatory Committee luncheon, 9/23/02*)

Discrimination lawsuit filed against Fannie over its automated underwriting system, Desktop Underwriter

Nation’s largest class action firm is representing the plaintiff

Similar lawsuits may be offered, as well as attempts to certify class action lawsuits

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

- African-American Safiyyah Rahman sued Fannie for discriminatory lending practices based on its automated underwriting (AU) system, Desktop Underwriter. The lawsuit, filed Sept. 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 loans at higher interest rates, based upon a credit score produced by racial disparities in Fannie’s AU System. The lawsuit asks the court to prohibit Fannie from using or “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, says the lawsuit, has a "disparate impact" on minority applicants and treats them less favorably than white applicants. (*Washington Post*, Kenneth Harney, 9/26/02)

- Fannie requires lenders to use its AU system to screen loans it may want to buy by assigning applicants a classification based upon their credit score. If Fannie determines that an applicant's risk rating is a "caution," it will not purchase the loan, the lawsuit stated. "This rejection results in adverse action to the consumer through outright rejection of the application for the loan or through the offer of a loan at a high interest rate," the lawsuit stated. "As so many loans are sold to Fannie Mae, lenders have a strong incentive to adopt Fannie Mae's underwriting guidelines," the lawsuit alleged. "Fannie Mae's underwriting guidelines thus determine the mortgage credit available to a borrower." (*Dow Jones Newswire*, Dawn Kopecki, 9/25/02)
- Approximately 58% of the 5.2 million loans that Fannie purchased last year were underwritten using its AU system. Lenders can still sell Fannie their loans underwritten on other AU systems if they "represent and warranty" to Fannie that the mortgages adhere to Fannie's credit standards. (*Dow Jones Newswire*, Dawn Kopecki, 9/25/02)
- Rahmaan is a single mother of eight children. While the lawsuit was filed by an individual - Milberg, Weiss, Bershad, Hynes & Lerach - the nation's largest class action law firm, is one of four attorneys representing Rahmaan. (*Dow Jones Newswire*, Dawn Kopecki, 9/25/02)

Similar lawsuits may be offered, as well as attempts to certify class action lawsuits

- "A credit report reform advocate said similar lawsuits are in the offing, as are attempts to certify class action lawsuits," reported *Reuters*. "This is only case one," said Richard Le Febvre, president of AAA American Credit Bureau, a consumer credit reporting agency. Rahmaan was a client of Le Febvre's. (*Reuters*, Mark Felsenthal, 9/25/02)

Fannie's comments

- Fannie's spokeswoman Janice Daue stated that the company was "confident" that its AU system complies with fair lending laws and "does not consider factors such as race or gender in assessing default rates and was developed without reference to such factors." (*Washington Post*, Kenneth Harney, 9/26/02) A Fannie spokeswoman said Fannie's AU system does not approve or deny mortgage applications, claiming that lenders make those decisions, and stressing that Fannie is not a credit reporting agency. However, the lawsuit said Fannie's AU system has such control over the mortgage market that it essentially "determines the credit available to a borrower." (*National Mortgage News*, 9/30/02)

Lawsuit cites Freddie's 1999 study

- The lawsuit cited a 1999 study by Freddie as indicating that the "raw credit data upon which the entire scoring system is based is undeniably skewed by race." The Freddie study found that African Americans are twice as likely as whites to have bad credit. The Freddie study examined 12,000 credit files and found 27% of white borrowers had "bad" credit records, while 34% of Hispanics and 48% of African-American borrowers had "bad" credit records. (*Washington Post*, Kenneth Harney, 9/26/02) While Freddie has a similar automated credit scoring system, the company is not named as a defendant in the lawsuit. (*Dow Jones Newswire*, Dawn Kopecki, 9/25/02) Freddie had no immediate comment on the lawsuit, but Freddie's spokeswoman Sharon McHale said the 1999 study underlined "the disparities that exist in credit histories" among racial groups and "showed the need for better credit education in minority communities." (*Washington Post*, Kenneth Harney, 9/26/02) [See the October 1, 1999 and October 29, 1999 *GSE Reports* for more information on Freddie's controversial 1999 study (www.gsereport.com)]

HUD has been conducting a fair lending investigation of Fannie & Freddie's automated underwriting system since 1999

- HUD has been investigating Fannie and Freddie's automated underwriting 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)
- Neither *Dow Jones Newswire* or *Reuters* were able to obtain comments from HUD on the status of their investigation. (*Dow Jones Newswire*, Dawn Kopecki, 9/25/02; *Reuters*, Mark Felsenthal, 9/25/02). However, former HUD official Allen Fishbein said that without speaking about the merits of the lawsuit, a lack of knowledge about AU systems could lead borrowers who have been frequently denied to question its fairness. Given how broadly it is used to determine whether an applicant qualifies for a loan, the government would be well served to review the system, he said. "It would be very much in the interests of both of those companies [Fannie and Freddie] to have HUD release its review and release it if in fact the two companies feel the two systems are bias-free," he said. (*Reuters*, Mark Felsenthal, 9/25/02)

2001 Mercer study finds that Fannie & Freddie's AU systems result in a smaller percentage of loans for minorities than systems by other companies

- A 2001 Mercer Management Consulting study found that Fannie and Freddie's AU systems resulted in a smaller percentage of loans for minorities and low-income borrowers than similar systems developed by private-sector companies. The study also found that private-sector companies' AU systems, when compared with Fannie and Freddie's AU systems, approved 10% more borrowers for loans than Fannie and Freddie's AU systems. The study concluded that if lenders had more choices among the AU systems, a greater number of prospective homebuyers would receive loan approvals. (For more information on the Mercer study, please see the March 30, 2001 *GSE Report*, www.gsereport.com)]

Former Treasury Under Secretary Gary Gensler notes that the GSEs' AU systems may result in less diversity

- "To the extent that the GSEs now finance a significant portion of their sector of the mortgage market, the willingness of a GSE to purchase a mortgage has become a far more significant factor in deciding whether to originate that mortgage. The GSEs' automated underwriting systems are increasingly becoming the means by which originators decide to lend. This technology will make the process more efficient. In the long run, however, this trend may result in less diversity in credit decisions and less price competition." – Former Treasury Under Secretary Gary Gensler (*Testimony of Treasury Under Secretary Gary Gensler before House Capital Markets Subcommittee*, 3/22/01)

OFHEO extends its comment period on proposed amendments to its risk-based capital rule for Fannie & Freddie

Capital Markets Subcommittee Chairman Richard Baker (R-LA) asked OMB to delay and comment on OFHEO's proposed amendments to its risk-based capital rule for Fannie & Freddie

OFHEO argued that it is only making technical and correcting changes to its risk-based capital rule, however, Congressman Baker believes that the changes are substantive and deserve more debate

Fannie, Freddie, and FM Watch all comment about OFHEO's brief comment period

- OFHEO announced September 24 that it is providing an additional 30 days to comment on its proposed amendments to its risk-based capital rule for Fannie and Freddie. OFHEO published, what it referred to as “technical and correctional amendments” in the September 12 *Federal Register*. The previous comment period closed on September 23, 2002. The new comment period ends 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's notice of the comment period extension was also published in the September 30 *Federal Register*. (*Federal Register, page 61300, 9/30/02*) OFHEO received four comment letters 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*)

Congressman Baker requests OMB delay the rule and review OFHEO's proposed changes

- Congressman Baker September 23 asked the Office of Management and Budget (OMB) to delay and review 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)). OFHEO argued that its proposed rule makes only technical and correcting changes to its risk-based capital rule, however, Congressman Baker asked OMB Director Mitchell Daniels to extend the comment period for the changes, arguing that they are substantive and deserve more debate. Congressman Baker also asked Daniels 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*)
- As noted in the September 13, 2002 *GSE Report*, OFHEO 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. Congressman Baker wrote to the OMB, “At this late date, only days before the third quarter 2002 ends, the need for urgency to substantially modify the rule is not clear to me.” (*Dow Jones Newswire, Dawn Kopecki, 9/23/02*)
- 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's letter to OFHEO Director Armando Falcon, 9/12/02*)

- “[I]n order to better assess the impact of FAS 133,” Congressman Baker requested that OFHEO provide him – no later than September 20 - “the risk-based capital calculations for the enterprises based on September 30, 2002, financial data, calculated with and without the proposed FAS 133 change.” Copies of the letter were also sent to the Ranking Minority Member on the Capital Markets Subcommittee Paul Kanjorski (D-PA) and Treasury Under Secretary Peter Fisher. (*Congressman Baker’s letter to OFHEO Director Armando Falcon, 9/12/02*)
- 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 plans 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*)

FM Watch asks OMB to review OFHEO’s proposed changes

- FM Watch sent a September 23 letter to OMB requesting OMB review OFHEO’s proposed changes to its risk-based capital rule for Fannie and Freddie. FM Watch believes that the proposed amendment – relating to the calculation of the RBC requirements to account for the affects of FAS 133 – is “extremely significant” and that “OFHEO’s failure to recognize this points to a major problem in the RBC [risk-based capital] framework established for the GSEs.”
- “Events in the capital markets during the past few days have shown everyone that Fannie and Freddie have concentrated on their books massive amounts of risk,” said Mike House, FM Watch Executive Director. “The decision of these GSEs to hold more than 38% of their own mortgage-backed securities has made them outsized players in the debt markets. When news accounts assert that the markets are moving based on two factors – the decisions that Fannie Mae makes and whether or not we go to war with Iraq – it is clear that these GSEs are outsized players in the debt markets.”
- FM Watch noted, “Because of their immense size, the GSEs are literally moving markets as investors seek to anticipate their moves into and out of the US Treasury market and other financial markets. The time has come for Congress and the Administration to reassess the proper role of these two entities, the risk they hold on their books and their impact on the capital markets. Much more than GSE shareholder profits are at stake.” (*FM Watch press release, 9/24/02*)

OFHEO says not aware of any review by OMB

- OFHEO knows of no plans for OMB’s review of the rule changes, an OFHEO spokeswoman said. (*Reuters, 9/24/02*)

Summary of other letters that OFHEO received on the proposed changes:

FM Watch letter to OFHEO

- FM Watch's Executive Director Mike House disagreed with OFHEO's assertion that the proposed FAS 133 change is "technical," and "strongly believes not only that the proposed amendment relating to the calculation of the RBC requirements to account for the effects of FAS 133 is extremely substantive, but also that OFHEO's failure to recognize this points to a major problem in the RBC framework established for Fannie Mae and Freddie Mac."
- The letter continued, "These GSEs collectively have \$2.83 trillion in outstanding obligations, clearly presenting a major systemic risk. That OFHEO should view as 'technical' a rule that would change one GSE's required RBC by 29% argues that it has failed yet to understand that the RBC rule must be a major defense that protects taxpayers and the financial system from GSE risk."
- FM Watch also urged OFHEO to defer acting on the proposal "because rapid action on it may violate Executive Order 93-12866," which "requires agencies to submit 'significant' rulemakings" to the OMB and Congress "in advance of taking final action on them." FM Watch noted that the rule's impact "clearly is significant and OMB review is therefore mandatory." (*FM Watch Executive Director Mike House letter to OFHEO, 9/23/02*)

Fannie Mae letter to OFHEO

- Fannie's Senior Vice President and General Counsel Ann Kappler said Fannie "supports" OFHEO's proposed amendments to the risk-based capital requirement. The changes "reflect the commendable fact that OFHEO is committed to an ongoing technical review of the regulatory engineering of the RBC rule. Given the great complexity of the RBC construct, such an approach is central to the RBC requirement's proper functioning over time."
- Fannie noted, however, that OFHEO's short comment period may not be appropriate. "Fannie Mae thinks it is vital...that OFHEO consider the important statutory requirements applicable to rulemaking proceedings under the Administrative Procedures Act as it continues to refine the rule. Specifically, under 5 U.S.C. §553(d) publication of a final rule in the *Federal Register* must occur not less than thirty days before the rule becomes effective, except for good cause found and published with the rule. While the proposal, if adopted, would become effective immediately upon publication in the *Federal Register*, the preamble to the proposal offers no explanation whatsoever as to why the agency seeks to avoid the normal thirty-day delay in the effective date of the proposed revisions. In our view, this requirement is particularly important in situations where an agency has elected to offer interested parties an abnormally short comment period – only ten days, in this case." (*Fannie's Senior Vice President and General Counsel Ann Kappler letter to OFEHO, 9/23/02*)

Freddie Mac letter to OFHEO

- Freddie agreed with the "substance of the proposed amendments" and that "the proposed amendments relating to FAS 133 will better integrate that accounting standard into the calculation of the risk-based capital requirement," said Freddie's Executive Vice President, General Counsel and Secretary Maud Mater. Freddie supports the FAS 133 amendment although it will increase Freddie's capital requirement by a significant amount. A footnote in the paper noted, "Given that OFHEO estimates that the FAS 133-related portion of the proposed amendments would have resulted in an increase in Freddie Mac's capital requirement of more than \$1.6 billion for a recent period, we question the conclusion that the proposed amendments 'are not economically significant for purposes of Executive Order 12866.'" Mater noted that

Freddie “has substantial concerns about the possibility of an immediate effective date for amendments that could increase Freddie Mac’s capital requirements by more than \$1 billion for the first capital classification to take risk-based capital requirements into account. However, we would support OFHEO’s making all of the other amendments effective immediately when issued.”

- Freddie also has “reservations about the proposed use of guidelines to update certain specifications outside of the text of the [risk-based capital] Rule, particularly because the Rule would not specify the methodology that the guidelines would apply.” Freddie recommended that “In order to comply with the statutory completeness obligation, OFHEO must establish stress test specifications in the Rule rather than through guidelines.” Freddie recommended that if OFHEO wants to amend the Rule quickly, “precluding it from taking the step we believe are necessary with respect to this rulemaking,” OFHEO should “incorporate the necessary specifications and/or methodologies in the text of the Rule in a subsequent rulemaking.”
(Freddie’s Executive Vice President, General Counsel and Secretary Maud Mater letter to OFHEO, 9/23/02)

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 Barney Frank (D-MA) says he would consider proposals to remove Fannie & Freddie's line of credit to the Treasury and their special tax exemptions, but then appears to back off statements, after calls from Fannie & Freddie

Citizens Against Government Waste (CAGW) chides Congressman Frank on his GSE flip-flop

- Congressman Frank said September 23 that he would “listen to” proposals to remove Fannie and Freddie’s line of credit to the Treasury and their special tax exemptions. “I think the major advantage Fannie and Freddie have is the misperception about their paper,” he said. “There is no guarantee.” He noted that Fannie and Freddie are well run and help lower the cost of homeownership. However, he said that Fannie and Freddie’s \$2.5 billion line of credit to the Treasury is unnecessary and gives investors the false impression that the federal government would bail out the GSEs, should they ever fail. “I would take a look at it,” said Congressman Frank, when asked if he supported removing the line of credit. “I don’t think [the line of credit] makes a lot of difference.” He noted, “The likelihood of them going under are zero.” Congressman Frank made his comments to reporters after a September 23 speech before the National Association of Federal Credit Unions’ 2002 congressional caucus. Congressman Frank is the next Ranking Democrat on the Financial Services Committee after Congressman John LaFalce (D-NY), who announced plans to retire from public office at the end of the year. There is also a chance Congressman Frank could chair the House Financial Services Committee, if the Democrats take control of the House after November’s elections. (*Dow Jones Newswire*, Dawn Kopecki, 9/23/02)
- Congressman Frank issued a clarification later that day on September 23 that downplayed his earlier remarks. A spokesman for Congressman Frank said the statement was issued after Congressman Frank’s office received several complaints from Fannie and Freddie. “During an impromptu conversation with journalists after my speech to credit unions on Monday morning, I apparently spoke imprecisely and gave an inaccurate impression of my views regarding federal policy governing Fannie Mae and Freddie Mac,” Congressman Frank said in a statement. “With regard to the specifics of the federal policy, because I do not think there is a general problem here, and because in particular I do not think that there is any federal guarantee implicit or explicit that purchasers of Fannie Mae and Freddie Mac securities would be bailed out in the extremely unlikely case that there was any problem. I have not focused on these issues.” Congressman Frank said he will “listen to what various people have to say on the subject, but I start from a position in favor of the existing arrangements with regard to both Fannie Mae and Freddie Mac.” (*Dow Jones Newswire*, Dawn Kopecki, 9/23/02)
- Congressman Frank told the *American Banker* that examining the GSEs’ policy, “is not on my list of things that need to be addressed. At this point, I am very supportive of the status quo” on Fannie and Freddie’s charters and on their regulation. He reiterated his comments that there is no “implicit or explicit” federal guarantee of Fannie and Freddie’s debt. “There is no federal guarantee...It wouldn’t prevent (Fannie and Freddie’s) paper from being devalued.” (*American Banker*, Michele Heller, 9/24/02)
- Congressman Frank told *Reuters* on September 24 that he supports Fannie and Freddie. “I do not regard Fannie Mae and Freddie Mac as problems. I regard them as great assets, and they have been very helpful. Among other things I would look at is how would we continue to make sure they do socially useful things, but they are not on my priority list to look at,” he stated. Congressman Frank said he was not accustomed to having his comments watched so closely and would take greater care in making statements about the GSEs in the future. “I’m not used to being a potential Chairman,” he said. “The point that I meant to get across was that I do not see any need for any significant change with regard to Fannie Mae and Freddie Mac and that I believe they play a very useful role in helping to reduce mortgage costs,” he said. He stressed his support for the existing arrangement with Fannie and Freddie’s \$2.5 billion line of credit to the Treasury and

other GSE benefits. “The status quo is fine now, but if people want to talk about it, well talk about it.”
(*Reuters*, 9/24/02)

- Though his statements were softened, policy analysts felt that Congressman Frank’s statements were significant to the markets. “The fact that Barney Frank is willing to look at these issues increases the likelihood that Fannie-Freddie reform could receive more attention next year,” said Andrew Parmentier, a policy analyst for Friedman, Billings, Ramsey. “It is a huge thing because Wall Street looks at the line of credit and the implicit backing of the US government as two primary reasons to own the stocks.” (*Dow Jones Newswire*, Dawn Kopecki, 9/23/02)

CAGW chides Congressman Frank on his GSE flip-flop

- In a press release entitled, “*CAGW Chides Barney Frank for GSE Flip Flop*,” CAGW noted that “Barney was frank when he questioned Fannie & Freddie’s \$4.5 billion Treasury credits; Hours later, he meekly clarifies he has no objections to the subsidy. ‘Et tu, Barney,’” asked CAGW Vice President Leslie Paige.
- “Barney Frank is nationally famous for his sharp tongue and penchant for blurting out uncomfortable truths,” Paige said. “That the GSEs could get a leader of Frank’s stature to appear to reverse himself illustrates their tremendous influence over Congress.”
- “Did Barney get the thumb screws treatment or what?” Paige continued. “Fannie and Freddie, hugely profitable as they have been, wield resources and influence in the capital that would make most private corporations drool. The moment a politician wavers from their political playbook, their lobbyists swarm like locusts. Frank’s office on Monday probably looked like Normandy on D-Day.”
- “Nevertheless, despite his hasty retreat this week, Rep. Frank took an important step by saying aloud what so many think: that it is questionable whether Fannie and Freddie, hugely profitable as they are, should continue to be implicitly backed by Uncle Sam while able to duck full transparency requirements,” Paige concluded. “If only Frank had had the chutzpah to stick to his guns.” (*CAGW press release*, 9/25/02)

Treasury Under Secretary Peter Fisher says Treasury’s main GSE focus will be on improving their disclosures

FHFB is still examining Treasury’s call for other GSEs to voluntarily agree to the same financial disclosures under the SEC, as recently agreed to by Fannie & Freddie

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

- The Treasury Department’s main GSE focus will be improving their corporate disclosure, according to Treasury Under Secretary Peter Fisher. “Given the role that all the GSEs ... have in our capital markets, we think this is really a pretty important step to get everybody inside the ‘34 act [Securities Exchange Act of 1934],” Fisher told the Exchequer Club. (*National Mortgage News Daily Web site*, 9/19/02)
- 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 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 John Korsmo said the FHFB is still considering the Treasury Department's call for other GSEs to follow Fannie and Freddie's lead in voluntarily registering under the '34 Act. Korsmo noted that the FHFB's system-wide task force created to study the issue met on September 24. In a September 13 interview, Korsmo noted that FHLBank officials involved in the process appear to be focused on ways to move forward on the issue and want to ensure that whatever the Treasury and the SEC recommend would be appropriate for the FHLBanks' cooperative system. In terms of timing, Korsmo said it "better be sooner rather than later," noting the increased emphasis on disclosures caused by this year's corporate scandals. (*Dow Jones Newswire*, John Connor, 9/13/02)

Fannie & Freddie and others in the financial services industry successfully convince Senator Richard Durbin (D-IL) to remove sections from his proposed bankruptcy bill that would threaten the securitization market and the economy

Treasury Department, Federal Reserve, SEC, and CFTC also oppose sections of the bill, claiming it will "undermine the operation of the US financial markets"

- A variety of financial services firms, including Fannie and Freddie, the Bond Market Association, and the Consumer Mortgage Coalition objected to provisions in a bankruptcy bill by Senator Durbin that they claimed would threaten securitized loans. Michael Williams, vice president for legislative affairs at the Bond Market Association (BMA), said Senator Durbin agreed to propose a substitute bill without the securitization provisions. The bill - the Employee Abuse Prevent Act of 2002 (S. 2798) - is separate from a bankruptcy overhaul bill that's pending final House and Senate approval. (*Dow Jones Newswire*, John Connor, 9/10/02, 9/13/02, 9/19/02) Senator Durbin indicated that he has not ruled out considering these provisions in the future. (*BMA Legislative Issues*, 9/20/02) Congressman William Delahunt (D-MA) introduced an identical bill (HR 5221) on July 26.
- The President's Working Group on Financial Markets (Department of Treasury, Board of Governors of the Federal Reserve System, US Securities and Exchange Commission, and the Commodity Futures Trading Commission) sent a joint letter September 19 to Senator Durbin opposing portions of the bill. The letter stated, "The legislation is intended to help protect employees and retirees when their company becomes insolvent by giving a bankruptcy trustee greater power to recharacterize transactions and claim assets from the creditors of the bankrupt company. We are deeply concerned, however, that it will undermine the operation of the US financial markets. As a result, borrowers and investors, including the very employees and retirees that this legislation is intended to protect, would face higher costs of credit and lower investment returns." The group added that the bill "threatens the certainty of financial market participants that securities or funds that are either pledged as collateral or delivered in settlement will not be reclaimed at a later date. Certainty that funds and securities transfers are final and irrevocable is essential to the smooth operation of the financial markets." The group noted, "In addition the proposed legislation risks creating substantial uncertainty regarding the enforceability of a wide range of secured transactions and financial instruments that play a crucial role in the US capital markets or otherwise facilitate risk management. As a result, financial markets would be less efficient - borrowers would face higher costs of credit and investors would receive lower returns as intermediaries were forced to charge larger fees to compensate for the greater risk and uncertainty." The group asked that Senator Durbin eliminate the provisions in the bill that "threaten the operation of the US financial markets." A similar letter was also sent to Congressman Delahunt. (*President's Working Group letter to Senator Durbin*, 9/19/02)

- A joint September 12 housing industry letter sent to Senator Durbin noted that the securitization provisions of his bill posed a “significant risk of destabilizing the secondary mortgage and mortgage-backed securities markets and causing an immediate and substantially adverse effect on the economy.” The financial services firms were concerned that two sections of the bill “would create substantial uncertainty as to the treatment of conventional mortgage loan securitizations in bankruptcy.” The group said the two sections “would significantly curtail or altogether eliminate the ability to use securitization as a proven technique for reducing mortgage lenders’ financing costs, increasing liquidity in the secondary market and enhancing reasonably-priced credit availability to homebuyers.” The groups further warned that because the proposals would apply to existing securitization transactions, the sections in question “also are likely to impair the value of existing mortgage-backed securities, many of which we note are held by pension plans, mutual funds, or in individual 401(k) accounts. “It would be a terrible irony if, in an attempt to protect American workers from the consequences of the illegal and unethical business practices of some of their employees, the Act had the unintended effect of limiting their opportunity to own a home, which has proven to be one of the best ways for the working people of America to create wealth for themselves.” (*Dow Jones Newswire*, John Connor, 9/13/02) Cendant Mortgage Corporation, Countrywide Home Loans, Consumer Mortgage Coalition, Fannie Mae, Freddie Mac, Mortgage Bankers Association of America, National Apartment Association, National Association of Homebuilders, National Association of Realtors, National Multihousing Council, The Real Estate Roundtable, and Washington Mutual signed the joint letter. (*Joint financial services industry letter to Senator Durbin*, 9/12/02)
- BMA’s lobbyist Williams said the provisions affecting securitized loans and repurchase agreements could disrupt the market. “It affects all types of securitized and repurchase agreements that have taken place.” For future transactions, the bill “throws open all case law” and would make it “impossible to get true sales opinions because the bankruptcy trustee could unwind it,” he said. Without a true sales opinion, ratings agencies are unable to assign a credit rating to a securitized loan package, he said. According to an August 20 letter to Senator Durbin, BMA said the provisions in question “would undermine well-established principles of bankruptcy law as well as securitization and repo practice and jeopardize the availability of useful and legitimate financial instruments to individual companies. This lack of availability and reduced legal certainty will undoubtedly lead to increased consumer costs.” Besides the BMA, others opposing these provisions include the Securities Industry Association, the Financial Services Roundtable, the Mortgage Bankers Association of America, and the Options Clearing Corporation. (*Dow Jones Newswire*, Rob Wells, 9/10/02; *BMA letter to Senator Durbin*, 8/20/02)
- The American Bankers Association noted in a September 10 memo to Members of the Senate Judiciary Committee that it had deep concerns about the bill and believed the bill “would cause grave economic harm to both workers and retirees.” The ABA further noted that if the Committee plans to act on the bill that “at a minimum, extensive hearings be held.” (*ABA memo to Senate Judiciary Committee*, 9/10/02)
- A September 16 letter by the American Securitization Forum to Senator Durbin noted that the provisions in question “would have severe and unintended consequences on the securitization markets and the domestic economy.” The provisions in question, if enacted, “would throw into doubt the structural integrity of several trillion dollars of existing mortgage-backed securities (MBS) and asset-backed securities (ABS) transactions in which both sale characterization and priority of security interests are fundamental. And, if enacted...would dramatically limit the ability of US companies...to securitize their assets in the future...if these provisions are passed, US companies will have an important source of funding and liquidity wrenched away and many smaller companies will be forced into bankruptcy, the value of pension fund investments in MBS and ABS will be severely impaired, and the cost of borrowing to consumers will rise immediately. These provisions, if enacted, will ultimately hurt, not help, employees and retirees.” (*American Securitization Forum letter to Senator Durbin*, 9/16/02)

- The Global Documentation Steering Committee also noted in a September 13 letter to Senator Durbin that the provisions in question “would have a very negative impact on the financial markets.” (*Global Documentation Steering letter to Senator Durbin, 9/13/02*)

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

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

OMB Director Mitchell Daniels says having TVA follow corporate disclosure requirements would be “useful” in making the TVA run more like a business

Draft OMB letter caused confusion at the hearing by saying TVA’s bonds were backed by the government (which the government has always denied)

TVA plans to discuss its financial disclosures with the SEC

- The Senate Banking Committee scheduled a September 17 hearing to discuss TVA’s financial disclosures. The Senate Banking Committee noted that the TVA is owned by the U.S. Government and has no public shareholders. TVA’s annual revenues are approximately \$7 billion. The Committee noted that the TVA uses debt financing and has approximately \$25 billion of debt outstanding held by approximately 200,000 individuals and institutions. TVA is not required by federal law to make certain disclosures or to comply with the Securities Act of 1933 and the Securities Exchange Act of 1934. TVA voluntarily publishes press releases, annual and quarterly reports and offering circulars for the benefit of investors, including financial statements certified by PriceWaterhouseCoopers. (*Senate Banking Committee press release, 9/13/02*)

Senator Jim Bunning (R-KY) wants the SEC to regulate TVA’s bond

- Senator Jim Bunning (R-KY) requested the hearing because he was concerned that TVA investors were not properly protected by the current system. **“In light of all the recent problems we’ve seen in financing of private-sector companies, it only seems fitting that someone is watching out for the TVA investors,” Senator Bunning said. “Right now they do not have all the consumer protections that other bondholders enjoy. We do not need an Enron in the middle of the Tennessee valley.”** (*BNA Daily Report for Executives, Richard Hill, 9/18/02*) At a June 18 Senate Banking Committee mark-up of S. 2673 (the Public Company Accounting Reform and Investor Protection Act of 2002), Senator Bunning sought to file an amendment to subject the TVA to the Securities Exchange Act of 1934. However, in return for dropping the amendment, Senate Bunning was given a hearing on the issue. (*BNA Daily Report for Executives, 9/16/02; Senate Banking Committee press release, 9/13/02*) Senator Bunning said at the September 17 hearing that his goal is to make TVA more transparent for investors. **“If it’s good enough for the public sector, I think we need to closely look at imposing the same sort of accounting rules on quasi-government groups like TVA,” he said. “I’d like to see more disclosure, I’d like to see more accountability. For all we know everything might be going just fine at TVA, but we don’t know right now.”** (*BNA Daily Report for Executives, Richard Hill, 9/18/02*) “Nobody really oversees TVA,” said Senator Bunning. (*Dow Jones Newswire, Judith Burns, 9/17/02*)
- Senator Bunning said more regulatory control over the TVA was needed, because the TVA is failing to reduce its roughly \$25 billion debt quickly. “The debt is astronomical,” Senator Bunning said. “It is affecting the rates that they’re charging the customers. I have a lot of people in Kentucky who are paying more.” Senator Bunning said he was concerned about a dispute between the TVA and the Bush administration over the TVA’s debt management that centers on long-term lease payments the TVA is

making on combustion turbine units. TVA said those payments are expenses, not debt. The Office of Management and Budget said it wants the \$300 million to be counted as debt. TVA has a \$30 billion debt cap. Senator Bunning also hopes SEC disclosure might force the TVA to provide a long-term business plan and provide bond-rating agencies and its bondholders with more information. (*Associated Press*, Nancy Zuckerbrod, 9/18/02; *Chattanooga Times/Chattanooga Free Press*, Andy Sher, 9/19/02)

Senator Mike Enzi (R-WY)

- “Investors in TVA are left without this government watchdog protecting their investments,” Senator Enzi said at the hearing. (*Associated Press*, Nancy Zuckerbrod, 9/18/02)

Draft OMB letter caused confusion at the hearing by saying TVA’s bonds were backed by the government

- OMB Director Mitchell Daniels sent the Senate Banking Committee a letter on September 17 that caused confusion during the hearing. The letter stated that the government backs TVA’s debt securities. TVA critics have always said such backing is implied, while the government has previously maintained that it does not back TVA bonds. OMB spokeswoman Amy Call said the letter was a draft. “It was not a final representation of OMB’s position,” she said. A subsequent OMB letter to the Senate Banking Committee did not state whether the administration believed the government backed TVA’s debt. (*Associated Press*, Nancy Zuckerbrod, 9/18/02)
- President Bush has argued that the TVA should be run more like a business and OMB Director Daniels said in his letter to the Senate Banking Committee that having the TVA follow corporate disclosure requirements would be “a useful step in that direction.” (*Dow Jones Newswire*, Judith Burns, 9/17/02)

TVA plans to discuss its financial disclosures with the SEC

- TVA spokesman John Moulton said September 18 that the TVA is working to set up a meeting with the SEC. “We need to sit down with the SEC and let the SEC understand all the impact of whether we enhance our reporting requirements to the SEC or whatever. Until we do that, we’re not ready to say why we shouldn’t or would (comply).” (*Chattanooga Times/Chattanooga Free Press*, Andy Sher, 9/19/02)
- The following people testified at the September 17 hearing:
 - Ms. Skila Harris, Director, Tennessee Valley Authority;
 - Mr. Alan L. Beller, Director, Division of Corporate Finance, Securities and Exchange Commission;
 - Mr. Craven Crowell, Chairman, CGW Group, and former Chairman, Tennessee Valley Authority;
 - Professor Alan G. Pulsipher, Executive Director and Marathon Oil Company Professor of Energy Policy in the Center for Energy Studies, Louisiana State University; and
 - Mr. Daniel T. Gates, Managing Director, Moody's Investor Service (*Senate Banking Committee Web site*)

Skila Harris, Director, TVA

- Harris defended the TVA’s SEC exemption, claiming that the President, Congress, the Treasury Department, the Federal Energy Regulatory Commission, and the Office of Management and Budget adequately regulate the TVA. Harris said TVA regularly provides those officials with financial and operational information and that PricewaterhouseCoopers (PWC) audits the TVA’s financial statements. (*BNA Daily Report for Executives*, Richard Hill, 9/18/02) Harris also noted that before the TVA can issue bonds with maturities of one year or more, the Secretary of the Treasury must approve the time of issuance and maximum interest rate of the bonds. (*Written testimony of Harris*, 9/17/02) “Make no mistake,” Harris

said, “as a government agency, TVA is subject to considerable oversight.” (*Gannett News Service*, Larry Bivens, 9/17/02)

- Harris stopped short of following the lead of Fannie and Freddie, which volunteered to make financial disclosures under the Securities Exchange Act of 1934, which requires a publicly traded company to provide periodic disclosure requirements about the financial condition and management of the company. [Fannie and Freddie retained their exemption from the Securities Act of 1933, which requires a company to submit registration and disclosure information about their debt and mortgage-backed securities.] Unlike the TVA, Fannie and Freddie are publicly traded companies, but like the TVA, they are exempt from federal securities laws and SEC oversight. Harris would not commit to voluntarily registering with the SEC, nor would she rule it out. “I don’t think we fully understand what that all entails,” she said. (*Dow Jones Newswire*, Judith Burns, 9/17/02; *Associated Press*, Nancy Zuckerbrod, 9/18/02)
- Even though it is not subject to US securities laws, Harris said it will improve its financial disclosures and will work with the SEC to improve its reports to bondholders. For example, the TVA is developing a code of financial ethics to bring it in line with corporate certifications required under the new Sarbanes-Oxley Act and starting next year, TVA will no longer enter into contracts with PWC for non-audit services. Harris noted that TVA’s board of directors and chief financial officer will also personally certify TVA’s financial statements to the government. (*BNA Daily Report for Executives*, Richard Hill, 9/18/02; *Dow Jones Newswire*, Judith Burns, 9/17/02)

Alan L. Beller, Director, Division of Corporate Finance, SEC

- Beller said TVA’s disclosures “would be enhanced” if they were subject to SEC requirements, however, he supported continuing TVA’s exemption from SEC requirements and hoped the TVA would submit to the SEC reporting, disclosure, and registration rules voluntarily. “We are looking to an alternate solution to [losing the] exemption,” said Beller, “whether that solution is voluntary disclosure or voluntary registration.” Beller said he based his recommendation to retain the exemption on the fact that the TVA is not a profit-making corporation with private shareholders; thus, he said, “a different statutory regime may be appropriate.” Although the TVA’s financial results comply with generally accepted accounting principles, Beller believes there is room for improvement in other areas. He said a review of recent financial statements on TVA’s Web site shows that its management discussion and analysis sections are short on trend information; its market risk disclosure information is more abbreviated than the SEC requires; its business report is less comprehensive than that of an SEC-reporting company; and its disclosure of material contracts nonexistent. TVA bondholders, he said, “are entitled to the same type of information as that provided by other issuers of public debt.” Beller added, “We further believe that the commission’s detailed disclosure rules and filing requirements and the staff review and comment process provide the best framework for disclosing information to which investors are entitled.” (*BNA Daily Report for Executives*, Richard Hill, 9/18/02; *Dow Jones Newswire*, Judith Burns, 9/17/02)

Craven Crowell, Chairman, CGW Group, and former Chairman, TVA

- Crowell said that making TVA subject to SEC requirements would increase the bureaucracy at the TVA and hamper its ability to manage its debt. “TVA needs the ability to move quickly and take full advantage of refinancing opportunities without being encumbered by another layer of process.” (*Gannett News Service*, Larry Bivens, 9/17/02) “I just think it doesn’t make any sense to put a layer of bureaucracy on TVA that’s not there now that affects the flexibility,” Crowell said. “It’s going to cost money.” He believes that SEC regulation could harm TVA’s ability to move quickly in the marketplace, costing ratepayers millions of dollars in areas such as bond refinancing deals. He believes TVA does a “good job” of disclosing information to investors. He believes TVA’s board shouldn’t “give in on this issue and they should fight this issue. This is a red herring, in my opinion.” (*Chattanooga Times/Chattanooga Free Press*, Andy Sher,

9/19/02) He believes that the TVA “already exceeds the reporting requirements that would be expected of any other corporation both public and private.” (*Written testimony by Crowell, 9/17/02*)

Professor Alan G. Pulsipher, Executive Director and Marathon Oil Company Professor of Energy Policy in the Center for Energy Studies, Louisiana State University

- Pulsipher, a former TVA economist, said that the TVA should have to comply with SEC disclosure requirements but that the TVA needs to address a more serious problem. “TVA, its customers and its investors have a more serious problem of corporate governance and control,” he said, “that is the result of an obsolete and inherently contradictory organizational structure that is long overdue for a fundamental redesign.” (*Gannett News Service, Larry Bivens, 9/17/02*)

Daniel T. Gates, Managing Director, Moody's Investor Service

- Gates testified, “While we prefer that all financial reporting be subject to the disclosure standards set forth in the 1933 and 1934 Acts, we believe that the TVA has operated in good faith in providing accurate and reliable financial information to facilitate our rating analysis of the Authority’s power bonds.” Gates noted that **“as a general rating approach to Government-Sponsored Enterprises such as TVA, Moody’s uses an integrated analysis of both the fundamental creditworthiness of the enterprise as a business, and the enterprise’s relationship with the US government.”** Gates stated that while they support improvements in the quality of information that market participants receive, this does not reflect any concerns over the financial information that the TVA provides. Gates concluded, “Moody’s generally supports efforts to enhance financial disclosure, because they improve the overall reliability of financial information in the marketplace, and thus contribute to more efficient capital markets.” (*Written testimony by Gates, 9/17/02*)

All GSEs

America’s Community Bankers and GW University to hold October 4 symposium on GSEs
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- America’s Community Bankers and The School of Business and Public Management of the George Washington University are holding a joint forum on GSE policy on October 4. Formal presentations and comments will be provided by the following people:
 - Dave Crowe (National Association of Home Builders)
 - Catherine England (Marymount University)
 - Dwight Jaffee (University of California at Berkeley)
 - James Miller (George Mason University and The CapAnalysis Group)
 - Peter Wallison (American Enterprise Institute)
 - Richard Williams (University of Notre Dame)
 - Lawrence White (New York University)

Fannie Mae and Freddie Mac

Fannie & Freddie continue to make large soft money contributions

Fannie decides not to revive its PAC

- According to figures compiled by *Inside Mortgage Finance's* new publication, *Inside the GSEs*, Freddie is the number one corporate soft money contributor to political parties this year. For the 2001-2002 election cycle, Freddie donated \$2.53 million in soft money contributions, beating out number 2 Phillip Morris with \$2.28 million and Microsoft at three with \$1.67 million. Fannie came in fifth place among corporate soft money contributors with \$1.28 million. (*Inside the GSEs*, 8/28/02)
- According to figures compiled by the Center for Responsive Politics, so far in this current election cycle (2001-2002), Freddie has donated \$2.25 million, while Fannie has donated \$1.37 million in soft money political donations. In the last election cycle, Freddie donated \$2.46 million and Fannie \$1.59 million. (*National Mortgage News*, Paul Muolo, 9/9/02)
- Fannie has explored the option of reviving its dormant political action committee (PAC) that was put on hold in the 1980s, but ultimately rejected the idea. The PAC would provide a way for Fannie to contribute to candidates and political causes when legislation goes into effect in November that will curb large soft money donations. A Fannie spokeswoman confirmed that the company considered reviving its PAC, but said the idea is “not an option as of today.” (*National Mortgage News Daily Web site*, 9/13/02; *National Mortgage News*, Paul Muolo, 9/16/02)

Fannie Mae

Fannie is tightening its standards on cash-out refinancing loans

Move could slow the mortgage-refinancing boom

- Fannie told lenders that it is tightening its standards on cash-out refinancing loans, citing internal data that the loans have higher default rates, the *Wall Street Journal* reported. The *Journal* noted that Fannie's move “could take some wind out of the mortgage-refinancing boom, and thus the economy.” The changes, effective February 1, 2003, affect only those loans both with Fannie or securitized. However, changes made by Fannie “tend to filter throughout the marketplace, since lenders sell so many of their loans to the company. And Freddie...said it, too, is examining cash-out refinance loans.”
- With the changes not effective until 2003, Fannie's Chief Economist David Berson estimated that cash taken from refinancings will likely be at least as big as last year's \$110 billion. Fannie estimated that consumers are spending more than 50% of the cash they take out when they refinance mortgages. The refinancings could give consumers an additional \$50 billion or so to spend thanks to lower monthly mortgage payments, the *Journal* said.
- Fannie said it will begin charging lenders more for cash-out refinance mortgages whose loan amounts are between 70% and 85% of the value of the home. That fee would almost certainly be passed along to consumers through higher mortgage rates or higher closing costs and in some cases the fee would total as much as one-half a percentage point of the value of the loan. For example, on a \$100,000 loan, a borrower could pay as much as \$500 more than before. Fannie said it will also tighten standards for borrowers, in some cases, who consolidate first and second liens under one loan.

- As a result, “there is going to be a group of people that will get snagged in the inability to refinance,” said Robert Walters, a senior vice president at Quicken Loans, an online mortgage lender. (*Wall Street Journal*, Patrick Barta and John McKinnon, 9/25/02)

Fund manager recommends selling Fannie stock because the leverage on its balance sheet is so high

- In a *National Post* article, “*Buy and Sell Roundtable*,” a panel of five leading Toronto-based portfolio managers whose mandates include US stocks, discussed their stock picks and pans. Davis-Rea Ltd. Vice President Andrew Martyn recommended Fannie’s stock as a “sell.” He noted that the multiple on Fannie’s stock “looks pretty cheap but the leverage on the balance sheet is huge.” He added, “It is a great derivatives manager, but if management ever stops being a great derivatives manager, it will blow away the company’s equity. The long-bond and Fannie Mae tend to move in sync. I think US long bonds are high and could go down. There are risks.” (*National Post*, Sonita Horvitch, 9/13/02)

Fannie is expanding its location-efficient mortgage (LEM) program

Location-efficient mortgages (LEMs) are more costly and risky than proponents claim, says CATO Institute researcher Allen Blackman

- To discourage sprawl, policymakers are using location-efficient mortgages (LEMs), which allow families willing to live in densely populated, transit-rich communities to obtain larger mortgages with smaller down payments than traditional underwriting guidelines allow. According to proponents, LEMs reduce sprawl by making homes in “location-efficient” communities more affordable to low- and middle-income borrowers who would ordinarily live in less expensive fringe areas. (*National Center for Policy Analysis Digest*, 8/8/02; Allen Blackman, “*Testing the Rhetoric*,” *Regulation*, Vol. 25, No. 1, Spring 2002, Cato Institute, <http://www.cato.org/pubs/regulation/regv25n1/v25n1-4.pdf>)
- One of Fannie’s pilot programs, called Smart Commute, is currently being used in Minneapolis, Pittsburgh, Salt Lake City, and Philadelphia. Fannie hopes to expand the program soon to Washington, DC, Atlanta, Baltimore, Louisville, and State College, PA. The program allows borrowers to obtain higher mortgages if they buy near train stations and bus stops and agree to limits on how many cars they own. Buyers who purchase a home within a quarter-mile of a bus line or a half-mile of a train station can qualify for a mortgage up to 8% larger than they could get under a traditional loan. The borrowers must agree to limit the number of cars they own to no more than one per adult driver. (*Realty Times*, M. Anthony Carr, 5/17/02; *Associated Press*, David Caruso, 9/7/02; *Atlanta Journal and Constitution*, Janet Frankston, 9/16/02) When asked in an interview if anyone would check to see if a borrower stops taking the train to work or purchases another car after they obtain their loan, Michelle Desiderio with Fannie stated, “There’s nothing that you can do to police a potential home buyer as to whether or not they’re going to buy a car the day after they get the loan.” But she noted that loan applicants get a stern lecture about how they can afford a bigger loan only because they saved money using mass transit. (*Marketplace*, *Minnesota Public Radio*, David Brown and Beatrice Black, 9/25/02)
- A predecessor program to Smart Commute was Fannie’s Location Efficient Mortgage, launched in the late 1990s in Chicago, Los Angeles, San Francisco, and Seattle, based on the same concept. One of the basic differences between the two programs is that the LEM used a formula called the Location Efficient Value, calculated by a computerized mapping tool. Various houses presented various income credits depending on their proximity to mass transit. With Smart Commute, the credited income is either \$200 for single borrowers or \$250 for two borrowers who work. (*Realty Times*, M. Anthony Carr, 5/17/02)

Location-efficient mortgages (LEMs) are more costly and risky than proponents claim, says CATO Institute researcher Allen Blackman

- LEMs, however, may have more costs and risks than proponents claim. Cato researcher Allen Blackman found no demonstrable relationship between location efficiency and the probability of default. Thus making low-down-payment loans available to borrowers in location efficient areas is tantamount to making such loans available to a random sample of borrowers, which in turn, means that the loans have a higher default risk.
- Location efficiency does not reduce borrowers' default risk, claimed Blackman:
 - While homeowners in location-efficient areas may actually enjoy transportation cost savings, those savings are simply not large enough to affect their propensities to default.
 - Estimates of transportation cost savings generated by the LEM computer model --often hundreds of dollars per month -- are overstated.
 - Real estate markets efficiently capitalize any financial benefits from location efficiency into housing prices -- such as the premium on houses close to a subway stop.
 - Thus, homeowners in location-efficient areas end up spending their transportation cost savings on higher mortgage payments, leaving their disposable income (and their ability to repay debt) unchanged.
- According to Blackman, the party that currently bears the cost of mortgage default on LEMs is Fannie, which has agreed to purchase \$100 million worth of LEMs from primary lenders during a two-year pilot phase. Private mortgage insurance purchased by LEM borrowers typically covers a fraction of default costs. (*National Center for Policy Analysis Digest*, 8/8/02; Allen Blackman, "Testing the Rhetoric," *Regulation*, Vol. 25, No. 1, Spring 2002, Cato Institute, <http://www.cato.org/pubs/regulation/regv25n1/v25n1-4.pdf>)

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

Fannie has 51 Partnership Offices open across the country

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

Fannie has 51 partnership offices

- According to Fannie's Web site, the company has 51 partnership offices open across the country (http://www.fanniemae.com/contact/partnership_offices.html) 9/26/02).
- *Inside Mortgage Finance's* new publication, *Inside the GSEs*, noted that Fannie "showed exactly how useful its Partnership Offices can be in winning friends on Capitol Hill by hosting 25 separate news events in the month of August involving no fewer than 30 different US senators or representatives." (*Inside the GSEs*, 9/11/02)

Senator Edward Kennedy (D-MA)

- Fannie joined Senator Kennedy and the Greater Boston Chamber of Commerce to launch a program to promote employer-assisted housing to 300 chambers of commerce throughout the country. (*Fannie press release, 9/23/02*)

Senator Charles Schumer (D-NY)

- Fannie joined with Senator Schumer to celebrate the opening of Gibb Mansion, which will provide 71 units of low-income and supportive housing for individuals living with AIDS and HIV. The Pratt Area Community Council developed the program. (*Fannie press release, 9/23/02*)

Congressman John Larson (D-CT), Hartford, CT Mayor Eddie Perez, State Representative Ken Green, and other Hartford city officials

- Fannie joined the above named officials to announce the availability of Fannie's HomeStyle Remodeler program. (*Fannie press release, 9/21/02*)

Congressman Terry Everett (R-AL)

- Fannie announced that it has made a \$250,000 Community Development Financial Institution (CDFI) certificate of deposit investment in First Tuskegee Bank. A statement of support by Congressman Everett was included in Fannie's press release. (*Fannie press release, 9/16/02*)

Other local officials with whom Fannie held press opportunities:

- (1) Florida State Senator Kendrick Meek and Commissioner Dorrin Role (*Fannie press release, 9/20/02*)
- (2) Laredo, TX Mayor Betty Flores (*Fannie press release, 9/20/02*)
- (3) Harford, MD County Executive Jim Harkins (*Fannie press release, 9/20/02*)
- (4) Las Cruces, NM Mayor Ruben Smith (*Fannie press release, 9/20/02*)
- (5) Hialeah, FL Mayor Raul Martinez (*Fannie press release, 9/19/02*)
- (6) Utah Lt. Governor Olene Walker (*Fannie press release, 9/16/02*)

Freddie Mac

Freddie sells its on-line mortgage process and closing technology to Montreal-based BCE Emergis, while Freddie keeps the right to market the tools to lenders in the US

Freddie is wrapping the technology into its automated underwriting system, Loan Prospector

- Freddie and BCE Emergis announced September 19 that Montreal, Quebec based-BCE Emergis has agreed to acquire on-line mortgage processing and closing technology tools from Freddie, while Freddie has agreed to distribute the tools to its lenders in the United States' mortgage market. These tools will enable mortgage lenders and brokers to obtain third-party services needed to process, close and fund mortgage loans via the Internet, as well as provide the capability to create, execute and store mortgage documents in a secure electronic environment. (*Freddie press release, 9/19/02*) A Freddie spokesperson said the GSE will receive a sales commission for its distribution work, but would not disclose the details. (*National Mortgage News, 9/23/02*)
- BCE Emergis will acquire the tools in their current stage of development from Freddie for an initial payment estimated at and not exceeding US\$6.0 million, deferred payments totaling \$12.0 million plus interest, and other consideration dependent on future usage. Freddie will market the tools to lenders in the US mortgage market, making them broadly available on its automated underwriting system (Loan Prospector) and integrating them with its automated underwriting process. BCE Emergis will manage their

development, implementation and operation. BCE Emergis will also use the platform to complement its other solutions in the e-lending area. The tools for ordering third-party services needed to process a loan are already available on a limited basis on Freddie's Loan Prospector website and will be broadly available by the end of the year. The tools related to electronic closing and document storage should be available in 2003. (*Freddie press release, 9/19/02*)

Freddie and Dovenmuehle Mortgage form a business arrangement that will provide subservicing for small and mid-sized community lenders

- Freddie and Dovenmuehle Mortgage Inc. announced September 23 a new business relationship designed to provide additional servicing alternatives to targeted small and mid-sized community lenders. Lenders that sell their mortgages to Freddie under this new arrangement and retain the servicing rights will have the option of choosing Dovenmuehle to subservice the loans within a private-label framework, which allows the lenders to retain their customer relationships and on-going business cross-selling opportunities.
- The arrangement is the latest initiative from Freddie for lenders that choose not to make the significant capital investment necessary to service residential mortgages. "Servicing has increasingly become an economies of scale business," said David Stevens, senior vice president for Single Family Lending at Freddie. "And lenders that want to remain competitive originators and offer a full suite of banking products are seeking multiple business solutions. Our arrangement with Dovenmuehle is an important tool lenders can use to strengthen their business operations and financial positions."
- Under the arrangement, lenders that want to employ a sub-servicer for mortgages sold to Freddie will be able to take advantage of competitively priced private-label servicing provided by Dovenmuehle. Dovenmuehle is an organization exclusively dedicated to sub-servicing but also provides other technology options for its customers. For example, through the use of proprietary Dovenmuehle technology, lenders can select to accept and process payments at branch locations and obtain automated daily updates from Dovenmuehle to their own general ledger or other internal systems, as necessary.
- "We are pleased by the selection of Dovenmuehle by Freddie Mac to provide residential mortgage subservicing to financial institutions throughout the United States," said Bill Mynatt, President and Chief Executive Officer of Dovenmuehle Mortgage, Inc. "Given our size, technology and commitment to outstanding customer service, Dovenmuehle is well-positioned to continue providing meaningful servicing solutions to financial institutions."
- More details about the arrangement will be available in the coming weeks. (*Freddie press release, 9/23/02*)

Federal Home Loan Banks

FHFB hires an attorney to examine whether the FHFB has legal authority to grant multi-district FHLBank memberships

- The FHFB has hired Oliver Ireland with Morrison and Foerster to review whether the FHFB has the legal authority to grant multi-district FHLBank memberships. FHFB Chairman John Korsmo hopes that within a month, the FHFB will have Ireland's input and will be able to discuss the issue at the FHFB's December board meeting. (*National Mortgage News, 9/23/02*)

- As noted in the June 28, 2002 *GSE Report*, the FFHB was having a difficult time finding a law firm that would be taken seriously by policymakers and that didn't represent Fannie or Freddie, or other housing finance interests. (*Dow Jones Newswire*, Dawn Kopecki, 6/21/02)
- As noted in the May 3 and May 17, 2002 *GSE Reports*, Treasury Undersecretary for Domestic Finance Peter Fisher and then Treasury Assistant Secretary for Financial Institutions Sheila Bair stated that they do not believe the FHFB has the legal authority to allow institutions to belong to more than one FHLBank.
- Although the FHFB has never approved a bank for multi-district FHLBank membership, more than 100 bank holding companies have financial institutions in more than one of the 12 FHLBank System districts, and nearly 200 members of the FHLBank System have branches extending beyond district lines, according to Scott Smith, acting director of the FHFB's Office of Policy Research and Analysis. (*BNA Daily Report for Executives*, Richard Cowden, 3/7/02)

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

- As noted in the September 13, 2002 *GSE Report*, the FHFB September 12 unanimously approved a final rule making changes to its Affordable Housing Program. The final rule, effective October 21, 2002, was subsequently published in the September 19 *Federal Register*. (*Federal Register*, pages 58978-58982, 9/19/02)
- FHFB regulations had authorized the FHLBanks each year to allocate the greater of \$3 million or 25% of their AHP contribution for homeownership set-aside programs. The rule adopted September 12 allows each FHLBank to set aside an additional amount of up to the greater of \$1.5 million or 10% of their annual AHP amount, specifically for first-time homebuyers. This increased funding authority will enable the FHLBanks to provide up to an additional \$24 million this year. The final rule also increases the maximum subsidy limit per household to \$15,000 for homeownership set-aside programs in general. (*FHFB press release*, 9/12/02)

Farm Credit System/Farmer Mac

Gotham Partners releases third report raising concerns about Farmer Mac

Gotham notes that Farmer Mac is trying to steer the debate away from its finances by attacking critics of the company

- Gotham Partners Management Co., LLC, a New York-based investment manager, released a third report critical of Farmer Mac. The new report specifically compares Farmer Mac's public statements with excerpts from a GAO Report and Farmer Mac's recent 10-Q filing with the SEC. [Details of Gotham's first and second reports are available in the May 31, 2002 and July 19, 2002 *GSE Reports*, www.gsereport.com]
- William Ackman from Gotham Partners stated, "We believe that Farmer Mac has attempted to steer the debate away from the facts by attacking the company's critics. While short sellers are an attractive target particularly in a bear market, this debate should be about factual issues concerning Farmer Mac. It is obvious to us why Farmer Mac has encouraged its investors to focus their attentions elsewhere."

- In “*Buying the Farm Part Three*,” Gotham concluded:
 - “Farmer Mac indicated in the Second Quarter 10-Q that its Business Prospects Have Been Dampened.”
 - “Farmer Mac’s Access to the Capital Markets Has Been Impaired.”
 - “Farmer Mac’s Contingency Arrangements Have Increased Risk To Discount and Medium-Term Note Buyers.”
 - “Farmer Mac Continues to Be Unwilling to Obtain a Credit Rating Despite Its Reduced Access to the Medium-Term Note (MTN) Market.”
 - “Expensing Options Will Reduce Farmer Mac's Earnings Substantially.”
 - “In the Short Term, Farmer Mac Can Report Earnings Gains Simply By Allowing Its Reserves As a Percentage of Guarantees to Decline.”
 - “Farmer Mac’s Delinquencies Reflect Serious Credit Quality Problems.”
 - “Farmer Mac ‘Finds’ \$4.8 Million of Bankrupt Loans After the Filing of the Second Quarter Press Release.”
 - “The Farm Bill Will Not Meaningfully Mitigate the Company’s Credit Risk.”
 - “Farmer Mac Disclosed In The 10-Q That U.S. Farm Income Is Expected to Decline by 13.4% in 2002 Even Including the Benefit of the Recently Passed Farm Bill.”
 - “Collateral Values Will Not Protect Farmer Mac from Losses on Its Delinquent Loans.”
 - “Farmer Mac Speculates on Interest Rate Movements.”
 - “The GAO’s Previous Reports on Farmer Mac Provide a Wealth of Information About the Company.”

- “Buying the Farm Part III,” in addition to Parts I and II, are available on Gotham's website at <http://www.gothampartners.com>. (PR Newswire, 9/19/02)

Postal Service

Ninth Circuit rules that the Postal Service can be sued under federal antitrust laws as long as the activity in question was not taken at the command of Congress

- The Ninth Circuit ruled that the Postal Service can be sued under the federal antitrust laws as long as the activity complained of was not taken at the command of Congress (recognizing that Congress has conferred a legal monopoly on the Postal Service over mail delivery in and from the US). The case is FLAMINGO INDUSTRIES (USA) LTD. v. UNITED STATES POSTAL SERVICE, No. 01-15963 (August 23, 2002). (PostCom Web site, www.postcom.org, 9/27/02)

Government Accounting Office (GAO) asks Postal Service to reassess its accounting procedures

- The GAO sent a letter to Postal Service officials, board members, and the agency’s inspector general September 13 suggesting that the Postal Service reassess its accounting procedures and enhance its disclosures regarding its pension and post-retirement health obligations. The GAO suggested the Postal Service use accrual accounting instead of its current pay-as-you-go method for its pension and post-retirement health obligations. (DMNews, Melissa Campanelli, 9/19/02)

Senator Ted Stevens (R-AK) is confident that recently passed language reforming Alaska's subsidized "bypass mail" will withstand legal challenges from two airline carriers

- As noted in the September 13, 2002 *GSE Report*, President Bush signed into law the \$28.9 billion FY 2002 supplemental appropriations bill (HR 4775) August 2, which contained language reforming Alaska's "bypass mail" service. The bill would limit the number of air carriers that can handle federally subsidized mail in Alaska. (*Fairbanks Daily News-Miner*, 7/19/02) Two airline carriers, Alaska Central Express Inc. and Evergreen International Inc., have sued the federal government over the new bypass mail reform language contained in HR 4775, arguing that the rules are unconstitutional and unfairly limit competition for federally subsidized mail. (*Associated Press*, 8/27/02; 9/1/02)
- Senator Stevens said the new mail-hauling rules should withstand legal challenges from the airlines. "I don't have any fear that they're not constitutional," he told the *Alaska Journal of Commerce*. Senator Stevens and Congressman Don Young (R-AK) crafted the law to close loopholes in Alaska's costly rural mail distribution system. "We've done the best we can," Senator Stevens said. "We gave this very careful consideration, and we think it is fair." (*Associated Press*, 9/23/02)
- Evergreen International and Alaska Central Express officials claimed the new law favors existing carriers and effectively limits competition for bypass mail. Senator Stevens said the new rules are in place to keep the program from extinction. He noted that the Postal Service could award rural mail contracts to a single carrier if it were not for bypass mail. "We have to reduce the loss," he said of bypass mail costs, which account for about 10 percent of the Postal Service's red ink nationwide. (*Associated Press*, 9/23/02)

Background on Alaska bypass mail reform language

- Under "bypass mail," the Postal Service has been obligated since the 1980s to transport shipments of 1,000 pounds or more to rural Alaska - at parcel post rates. The parcel rates are well under what commercial air companies would charge to deliver goods to the state's remote areas. (*Denver Post*, Bill McAllister, 5/31/02) Such mail, usually groceries and other bulky goods, bypasses post offices and goes directly to rural Alaska on eligible air carriers chosen on a rotating basis. (*Fairbanks Daily News-Miner*, Sam Bishop, 7/19/02)
- Under the law, signed by the President, the kind of air carriers eligible to carry bypass mail would be restricted. (*Fairbanks Daily News-Miner*, Sam Bishop, 7/19/02) The Postal Service acknowledged it had been losing as much as \$100 million a year on mail service in Alaska, much of it because of bypass mail. Senator Stevens and Congressman Young hoped that by consolidating air traffic on the most heavily traveled routes, they could save as much as \$30 million a year. But in order to carry out that consolidation, the bill would limit contracts for those main routes to the four airlines that currently service them. (*National Journal's Congress Daily*, 6/3/02)
- Senator Stevens and Congressman Young believe too many air companies are trying to get into the business, which has become a lucrative way for the state's bush pilots to supplement their incomes. (*Denver Post*, Bill McAllister, 5/31/02) Senator Stevens and Congressman Young want the program to prop up passenger service to the bush, but some carriers are just hauling mail. The language Senator Stevens and Congressman Young included in the appropriations bill would make any new carriers on the "mainline" routes (between Alaska's larger cities and bush hubs) provide a minimum level of passenger service. Existing mainline carriers - Alaska Airlines, Air Cargo Express, Lynden Air Cargo and Northern Air Cargo - would be exempt from the passenger requirement. Smaller carriers on the routes that radiate from the bush hubs would receive most of the bypass mail if they carry most of the passengers. The smaller carriers

would also have to upgrade to twin-engine aircraft on some routes. (*Fairbanks Daily News-Miner*, Sam Bishop, 7/19/02)

Postal Service abandons its plans to use electron-beam devices to zap harmful bacteria

Postal Service spent \$40 million last fall purchasing the machines

- “A year after the anthrax-by-mail crisis, the US Postal Service has abandoned its plans of installing expensive electron-beam devices in mail sorting facilities to zap harmful bacteria. The agency says it has since shifted its goal toward finding hand-held devices that would allow postal carriers to detect harmful materials.” The Postal Service spent \$40 million last fall purchasing its first eight electron beam machines, but Robert Cannon, a Postal Service spokesman in Boston said all eight have yet to be installed because of problems with the equipment. He said the machines can erase computer discs, make foods taste bitter and discolor envelopes. (*Boston Herald*, Kay Lazar, 9/24/02)
- As noted in the September 13, 2002 *GSE Report*, the Postal Service’s Inspector General found that the Postal Service overspent on the anthrax crisis, and noted among other things that the Postal Service purchased eight new irradiation machines for \$40 million to prepare decontamination facilities that were never used. The Inspector General also found that private contractors hired to decontaminate postal facilities last fall billed the government for at least \$50 million in unexplained cost overruns and \$40 million for mail-irradiation machines that have yet to be used. In addition, one company received \$600,000 for work it never did, while another \$1 million went into preparing decontamination facilities that were never used. The Inspector General also found that the cost of three contracts increased by nearly \$54 million over the original bids, with no documentation to explain why and that postal officials spent \$181,000 on trailers to help move mail from the Brentwood facility in Washington, DC to Lima, OH to be irradiated, that sat idle. (*Orlando Sentinel*, National Correspondent, Dave Altimari, 9/1/02; *Los Angeles Times*, 9/1/02; *Hartford Courant*, Dave Altimari, 9/1/02)
- The September 13, 2002 *GSE Report* also noted that a September 9 General Accounting Office (GAO) study found that air filters that the Postal Service was considering to protect against another biological attack needed more testing and cost benefit analysis before implementation.

Industry leaders form the Mailing Industry CEO Council to lobby on the need for postal reform and industry standards

Group plans to announce its support for a presidential commission on postal reform

- Senior executives from leading U.S. companies have joined together to form the Mailing Industry CEO Council, a non-profit organization that will focus on unifying the mailing industry and promoting the critical role that mail plays in business and commerce. According to Council President and Pitney Bowes Chairman and CEO Michael J. Critelli, “Action is critical to raise awareness of the serious challenges facing our postal system and the need for reform. The Mailing Industry CEO Council will work to establish public policies and industry standards that will foster industry growth...The mission of the CEO Council is to unify the industry, promote the value of mail, and to collectively lobby for public policies that will enable this industry to continue to thrive.” According to Council Secretary and Treasurer and ADVO, Inc. Chairman and CEO Gary M. Mulloy, “The CEO Council will work to ensure our public policymakers understand the need for transformation of the postal system.” The Council was established on June 26, 2002. (*PR Newswire*, 9/18/02)

- Critelli and other members of the Mailing Industry CEO Council said September 23 that they hope to raise the profile of what they estimate is a \$900 billion industry. The members will personally lobby lawmakers on the importance of the mailing industry to business, and the importance of the US Postal Service to the mailing industry. There is currently no single trade association or group speaking for the mailing industry. And the Postal Service, as a government agency, is prevented by law from lobbying. The CEO Council will be able to raise the voice of the mailing industry, said John Nolan, the Deputy Postmaster General. Nolan sits on the Mailing Industry Task Force. “When it comes to legislation the squeaky wheel sometimes gets the grease, and so it makes a lot of sense. It’s just that we can’t advise them on what to do,” Nolan said. The member CEO’s plan to lobby on the case for reform and the creation of industry standards. As one of its first moves, the group plans to announce its support for a presidential commission on postal reform, said Critelli. (*Associated Press*, Robert O’Neill, 9/23/02)
- The Mailing Industry CEO Council Board of Directors currently includes Mr. Critelli, Mr. Mulloy and twelve others:
 - * William L. Davis, Chairman, President and CEO, R.R. Donnelley & Sons Company
 - * C. Hamilton Davison Jr., President and CEO, Paramount Cards Inc.
 - * David F. Dyer, CEO, President and Director, Lands' End, Inc.
 - * Richard M. Hochhauser, President and CEO, Harte-Hanks, Inc.
 - * Judy F. Marks, President, Distribution Technologies, Lockheed Martin Corporation
 - * Charles D. Morgan, Chairman and Company Leader, Acxiom Corporation
 - * Nigel W. Morris, President, COO and Director, Capital One Financial Corporation
 - * Thomas O. Ryder, Chairman and CEO, The Reader's Digest Association, Inc.
 - * David Sable, President and CEO, Wunderman New York
 - * Charles W. Schellhorn, President and CEO, DST Output
 - * Michael P. Sherman, President, Fingerhut Companies, Inc.
 - * Dr. Jerome Swartz, Chairman and Chief Scientist, Symbol Technologies, Inc. (*PR Newswire*, 9/18/02)

Postal Service files Postal Rate Commission request for a Negotiated Service Agreement (NSA) with Capital One

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

Postal Service also files a request that would offer small-circulation periodicals an opportunity for discounts

- The Postal Service has filed a case with the Postal Rate Commission (PRC) seeking a three-year experimental mail classification based on a Negotiated Service Agreement (NSA) between the Postal Service and Capital One Services, Inc. The NSA between the Postal Service and Capital One 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)
- When the Postal Service asked the PRC to endorse the three-year experimental NSA with Capital One, “it stepped into new territory,” reported Paul Alberta with *Direct Newslines*. The Capital One filing is the first time the Postal Service has requested an endorsement from the PRC on such an agreement. The article noted that the PRC’s approval would pave the way for other high-volume, first-class and Standard Mail mailers to negotiate similar agreements with the Postal Service. Capital One is the Postal Service’s fourth-largest customer and the largest single producer of first-class mail. (*Direct Newslines*, Paul Alberta, 9/21/02)

- Three years ago, United Parcel Service and the Coalition Against Unfair USPS Competition, challenged the Postal Service's authority to offer the service, a joint venture with Canada Post and France's La Poste, without seeking the PRC's endorsement and the approval of its governing board. The PRC, which is expected to order a dismissal of the challenge, suspended proceedings in the case last year when postal officials sought the PRC's support for the rate increase that went into effect in January. Two weeks after the PRC called for a status report on the service, the Postal Service said the challenge was moot because it ended the service this past May 31. (*Direct Newsline*, Paul Alberta, 9/21/02)
- The Postal Service filed a proposal with the PRC on September 26 that would offer small-circulation periodicals an opportunity to receive work-sharing discounts with larger, mass-customization periodical mailers. The case was filed as an experimental case, which means that it could be handled in quicker fashion than other cases. (*DM News*, Melissa Campanelli, 9/27/02)

Postmaster General says the Postal Service won't raise rates "until well into 2004"

President of the Association for Postal Commerce says just because the Postal Service projects a \$600 million profit for FY 2003 doesn't mean its problems are fixed

- Postmaster General John Potter told participants at the Fall 2002 National Postal Forum on September 23 that there will be no general rate increase "until well into 2004." The Postal Service is expected to finish FY 2002 with a loss of less than \$1 billion, which is down from a loss estimate of \$1.2 billion announced just three weeks before. The Postal Service reduced its workforce by 23,000 career employees in the past year to make up for a drop in mail volume of 6 billion pieces. The Postal Service also expects to make a profit next year, expecting to earn about \$600 million in FY 2003. It would be the first profit since 1999. The Postal Service's FY 2002 ended September 6, but final accounting is continuing. Earlier in the year, the Postal Service expected to lose \$1.35 billion. (*Associated Press*, 9/23/02; *Bloomberg News*, Bill Murray, 9/23/02)
- In related news, Robert Michelson, manager of International Marketing at the Postal Service, said international rates would not increase in 2003, although they are scheduled to increase in 2004. (*DM News*, Melissa Campanelli, 9/23/02)
- While the Postal Service is expected to earn \$600 million in FY 2003, the Postal Service's Chief Financial Officer Richard Strasser told *DM News* that there is little margin for error if the economy stumbles. "While \$600 million is a whale of a lot of money to you and I, it is less than 1 percent of our revenue stream," said Strasser. "If the economic recovery stalls, significant negative impact to postal finances could result, especially if there is no recovery in advertising mail volume. We'll have to see as 2003 unfolds." (*DM News*, Melissa Campanelli, 9/16/02)
- While Congress and President Bush have provided about \$750 million to assist the Postal Service in recovering from the anthrax and terrorist attacks, that money has been kept in a separate account for those purposes and is not included in the overall accounting for postal operations. (*Associated Press*, 9/23/02)
- Potter also noted at the National Postal Forum that starting in January, Priority mail, Express mail, and other postal products will be available in select Hallmark Gold Crown stores across the country. (*DM News*, Melissa Campanelli, 9/24/02)
- Potter noted that in 2003, the Postal Service will focus on the following four objectives:
 - Continue its commitment to improve service performance;

- Explore with the Postal Rate Commission alternatives to the rate-making process within the current legislation, including negotiated service agreements and phased rates;
- Use the transformation strategy to grow the Postal Service's business by enhancing existing products and services and expanding access and convenience to postal services;
- Manage its finances and reduce costs. FY 2003 will be the second year in their five-year commitment to take \$5 billion out of their costs by 2006. (*Remarks by Postmaster General John Potter at the National Postal Forum, 9/23/02*)

A \$600 million profit doesn't mean the Postal Service's problems are solved

- Gene A. Del Polito, President of the Association for Postal Commerce, said that although the Postal Service may go through 2003 without a postal rate increase, mailers should prepare for an increase in January 2004. "I'm telling people it will be an average rate increase of 15 percent," he told members of the Direct Marketing Idea Exchange on September 18. He added that rates may increase as much as 20 percent for catalogers. He noted that just because the Postal Service is projecting a \$600 million profit for FY 2003, the Postal Service's problems are not fixed. The Postal Service's mail volume dropped 2.7 percent in 2002, while for FY 2003, the Postal Service is projecting an increase of 1.9%. "I can't figure out where the volume increase is coming from," he said. Another concern is the Postal Service's retirement benefits, which the GAO estimated cost the Postal Service \$8 billion last year, growing to \$16 billion in 2010. He recommended three options for reforming the Postal Service: (1) Keep the Postal Service the way it is and pay for rate increases; (2) Keep the system the way it is and subsidize it with tax dollars; and (3) privatize the system. (*DM News, Melissa Campanelli, 9/19/02*)

Lockheed Martin wins \$300 million contract from the Postal Service for package-sorting machines

- Lockheed Martin won a \$300 million contract from the Postal Service to build and install 74 package-sorting machines, beginning in 2004. The Postal Board of Governors must approve additional quantities beyond this initial buy. If all additional quantities are exercised through 2006, more than 120 systems could be delivered. (*PR Newswire, 0/24/02; Bloomberg News, James Gunsalus, 9/24/02*)

***Lake Worth Herald* sends second FOIA request letter to the Postal Service to find out how many postal managers, spouses, and consultants went overseas during the Tour de France**

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. A September 12 *Lake Worth Herald* editorial noted that on August 9, 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." In a second letter to the USPS, dated, September 6, Parrish said, "To date, I have heard nothing." He noted, "The aforementioned expenses are a matter of public record and should be readily available. What is the delay in answering?" he asked the USPS. 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*)

Director of Distribution and Postal Affairs at Time Inc. says the Postal Service is entering a “death spiral”

Recommends a Presidential Postal Reform Commission

- Jim O’Brien, Director of Distribution and Postal Affairs at Time Inc., says the Postal Service is entering a “death spiral” of declining revenues, rising expenses and rapidly escalating rates. O’Brien made his comments September 26 at the New England Mail Order Association Fall 2002 Conference. The possibility of a Presidential Postal Reform Commission was characterized as providing hope for the future since it would give Congress the political cover to act. “I’ve met with White House staffers six times in the past year, and they are looking for names for the presidential commission,” he said. “A commission of independent businesspeople can get together, and the politicians can say, ‘It’s not me.’” (*DM News*, Glenn Kalinoski, 9/27/02)

Sallie Mae

Competitor sues Sallie Mae alleging that it has abused its position to increase profits at the expense of student borrowers

- College Loan Corp. (CLC) sued the Student Loan Marketing Association (Sallie Mae), Sallie Mae’s parent company, and several of its affiliates on September 16 in federal court in Alexandria, VA, alleging that Sallie Mae and its affiliates illegally abused their positions to increase earnings and profits at the expense of student borrowers by:
 - Systemically denying borrowers their right to consolidate student loans with the lender of their choice. CLC alleges that Sallie Mae intentionally misapplied the “single holder rule” and is denying borrowers their right to consolidate loans with other lenders, and in numerous cases, preventing those borrowers from obtaining a lower interest rate. The “single holder rule” requires borrowers to consolidate multiple loans with their current holder, unless they have loans with more than one holder. The suit alleges that Sallie Mae obstructed and diverted the loans of borrowers who wished to consolidate with CLC by misapplying that rule. Sallie Mae claims that all of its affiliates constitute the same holder and that it is still the holder of the loan it has sold to securitization trusts. CLC noted that Sallie Mae took the opposite position in recent litigation against the Department of Education, in which it avoided paying a statutory offset fee to the Federal Government by claiming it was no longer the “holder” of securitized loans once they have been transferred.
 - Improperly diverting loan applications to Sallie Mae affiliates without the consent of borrowers.
 - Offering illegal inducements to colleges and universities in return for loan referrals. CLC alleges that Sallie Mae has offered illegal inducements to colleges and universities in return for agreements to steer students needing student loans to lenders that sell their loans to Sallie Mae and away from competitors like CLC.
 - Illegally attempting to induce the three major national credit bureaus to block CLC’s access to borrower information so that CLC would not be able to inform borrowers of their consolidation rights. CLC alleges Sallie Mae violated the federal Sherman Antitrust Act and Virginia Antitrust Act. Sallie Mae is required by law to report borrower information to at least one national credit bureau. (*US Newswire*, 9/16/02)

- “Sallie Mae has violated the trust placed in them by thousands of students and their families,” said Mark Brenner, general counsel for CLC. “It is reprehensible that they are putting their pursuit of additional profits ahead of the rights of young Americans.” (*US Newswire*, 9/16/02)
- CLC is seeking a declaration that Sallie Mae’s misapplication of the “single holder rule” violates the Higher Education Act, and an order enjoining Sallie Mae from obstructing students attempting to consolidate their loans in the future. The complaint also seeks at least \$50 million in damages for losses due to Sallie Mae’s illegal conduct. CLC is also seeking treble statutory and punitive damages. (*US Newswire*, 9/16/02)
- Sallie Mae said it is “confident” that its “policies and procedures are...consistent with the rules followed by the hundreds of companies who compete in the student loan marketplace.” (*Washington Post*, Albert Crenshaw, 9/16/02)
- Sallie Mae was founded in 1972 as a GSE. In 1996, Congress passed a bill requiring Sallie Mae to fully privatize by September 30, 2008. The board of directors of Sallie Mae, however, voted for early privatization, and the GSE will be fully privatized by 2006. Sallie Mae’s student-loan business is now segregated into a subsidiary that still enjoys benefits from its GSE status over other competitors, such as: an exemption from state and local income taxes; holders of its debt don’t pay state taxes on the interest they receive; its cost of capital is lower, in part because of its government links; can obtain cash from the Federal Financing Bank at rates that its competitors can’t; and its debt securities are rated “AAA,” from Moody’s and S&P, in part because of its GSE status. The units outside the student-loan business do not have an implicit or explicit government guarantee, but Sallie Mae’s earnings and its stock price remain almost entirely dependent on the performance of the student-loan business. (*MSN.com*, Daniel Gross, 8/27/02)

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