

The **GSE** REPORT™

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Major Events

Federal Reserve Board Chairman Alan Greenspan urges Congress to study “economic distortions” created by Fannie & Freddie’s implied government guarantee

Stresses the importance of Congressional oversight over the GSEs

Widespread belief that the government backs the GSEs undermines market discipline

Regulators should consider whether GSEs have appropriate capital, including evaluating the GSEs’ funding and market liquidity risks

Financial institutions’ large holdings of GSE debt are best monitored by bank regulators, rather than imposing regulatory or legal limits

Fed has made “extraordinary statements of concern about the adequacy of the GSEs’ regulatory oversight,” says Cong. Baker

By noting the “importance” of Congressional oversight, Greenspan adds credibility to Cong. Baker’s efforts to strengthen regulation over the GSEs

FM Watch thanks Greenspan for “agreeing with its long-standing request for more GSE capital”

Greenspan urges Congress to study “economic distortions” created by Fannie & Freddie’s implied government guarantee

- In an April 21 letter to Capital Markets Subcommittee Chairman Richard Baker (R-LA), Greenspan wrote that he is “concerned about the economic distortions created by the implied subsidies generated” by Fannie, Freddie, and the FHLBanks. Greenspan stressed the importance for Congress to study the role of the GSEs in the economy and their “important consequences for the structure and efficiency of financial markets.” (*Congressman Baker press release, 4/24/03*)
- The GSEs are “able to borrow funds at a lower cost than comparably situated private-sector borrowers, a benefit that clearly results from government sponsorship. The lower borrowing costs of these institutions, of course, reflect the widespread belief that the government is unlikely to let a GSE fail.” (*Greenspan letter to Congressman Baker, 4/21/03*)

Widespread belief that the government backs the GSEs undermines market discipline

- “The existence, or even the perception, of government financial support,” Greenspan said, “undermines the effectiveness of market discipline.” Because government backing of the GSEs undermines the effectiveness of market discipline to constrain their leverage, regulators must rely on assessing whether the GSEs hold appropriate amounts of capital relative to their risks and the costs they might impose on others, including taxpayers to ensure that the GSEs do not pose a systemic threat, Greenspan said. However, according to Greenspan, it is not

enough to evaluate capital adequacy solely with regard to credit and interest rate risk, but “funding liquidity and market liquidity risks also need to be considered, given the significant roles” the GSEs play in the market. (*Greenspan letter to Congressman Baker, 4/21/03; Congressman Baker press release, 4/24/03*)

Financial institutions’ large holdings of GSE debt are best monitored by bank regulators, rather than imposing regulatory or legal limits - stresses the importance of Congressional oversight of GSEs

- Greenspan’s comments came in response to a letter sent by Congressman Baker in February, seeking comment about potential risks posed by the concentration of financial institutions’ holdings of GSE debt. “As noted in past testimony, I believe that asset concentrations are best monitored and evaluated by bank supervisors rather than limited by regulatory or legal ceilings,” Greenspan said. Despite his “reservations about the usefulness of legislated asset concentration ratios,” Greenspan stressed the “importance of Congressional oversight and study of the role” of the GSEs in our economy. Greenspan included a table in the letter outlining the extent of the holdings of GSE obligations by commercial banks. According to the table, 2947 commercial banks hold more than 100% of their capital in agency debt and 1947 commercial banks hold more than 100% of their capital in agency mortgage-backed securities. (*Greenspan letter to Congressman Baker, 4/21/03; Congressman Baker press release, 4/24/03*)

Fed has made “extraordinary statements of concern about the adequacy of the GSEs’ regulatory oversight

- In response, Congressman Baker noted the similarity to St. Louis Federal Reserve Bank President William Poole's remarks in March about the need for the GSEs to add to the amount of capital they hold and his concerns that liquidity problems in the capital markets affecting Fannie and Freddie could “become very large, very quickly.” (*Congressman Baker press release, 4/24/03*)
- “The Federal Reserve, even though it doesn't regulate the GSEs, has made some extraordinary statements of concern about the adequacy of the GSEs' regulatory oversight, capital, and liquidity,” Congressman Baker said. “I share those concerns. Since the GSEs provide liquidity to other financial institutions, liquidity problems of their own would have tremendous ramifications for the economy, for the markets, and for taxpayers. Chairman Greenspan has strongly urged Congress to study this situation, and his direction will certainly help form the substantive basis for upcoming subcommittee hearings.” (*Congressman Baker press release, 4/24/03*)
- A copy of Greenspan’s letter to Congressman Baker can be found online at: <http://www.baker.house.gov/News/FEDLETTER.pdf> A copy of Congressman Baker’s original letter to Federal Reserve Board Chairman Alan Greenspan can be found online at: www.baker.house.gov/News/greenspan_letter.htm

By noting the “importance” of Congressional oversight, Greenspan adds credibility to Cong. Baker’s efforts to strengthen regulation over the GSEs

- By noting the “importance” of continued Congressional oversight of the GSEs, Greenspan “made it infinitely harder for opponents to marginalize Rep. Baker’s efforts to toughen supervision [of the GSEs].” Industry insiders agree that Greenspan’s letter raises the political risk facing Fannie and Freddie. AEI Resident Fellow Peter Wallison noted that Greenspan is “attempting to enhance Baker’s position” against Fannie, Freddie, and the FHLBanks. “That is why he responded, for the third time, directly and personally to a letter from Baker asking for his views on GSEs. The letter asks for enhanced congressional oversight. He is directly suggesting that it is important for Baker to hold these hearings.” (*American Banker*, Rob Garver, 4/28/03)
- However, a political consultant with ties to the GSEs noted that Greenspan and Fannie’s Chairman Franklin Raines “have a very close relationship” and that Greenspan “has to respond” to Congressman Baker’s questions. The consultant did not believe that the recent Greenspan letter added momentum to Congressman Baker’s efforts to overhaul Fannie and Freddie’s regulatory structure. “He’s [Cong. Baker] not going to get any traction, but he just continues to be bullheaded,” said the consultant. (*Market News International*, 4/24/03)

Fannie & Freddie’s comments

- “Chairman Greenspan’s letter is consistent with the comments he has made about the GSEs over the years,” Fannie said in a statement. “Much of his letter sets forth sound and sensible practices for the regulation of all financial institutions.” (*Bloomberg News*, Al Yoon, 4/24/03) Freddie’s spokeswoman Sharon McHale said Freddie shared Greenspan’s concerns about market and liquidity risks and noted the firm has taken several steps to mitigate those risks, such as having enough cash on hand to operate for three months without access to the capital markets. Fannie has enough cash to withstand a three-month disruption, said Fannie’s spokesman Chuck Greener, adding that Fannie is subject to rigorous examination from OFHEO and a stringent risk-based capital rule. (*Dow Jones Newswire*, Jennifer Corbett Dooren, 4/24/03) Greener further stated, “We agree with him [Greenspan] that asset concentrations are best monitored by bank supervisors rather than limited by regulatory or legal ceilings.” (*National Mortgage News*, Brian Collins, 5/5/03)

FM Watch thanks Greenspan

- FM Watch said “it couldn’t be more pleased with Chairman Greenspan’s letter and Congressman Baker’s commitment to more Congressional oversight of the GSEs’ systemic risk.” FM Watch said it was particularly interested in Greenspan’s belief that “in the case of the housing-related GSEs – to ensure that these institutions do not pose a systemic threat regulators cannot rely wholly on market discipline and must assess whether these institutions hold appropriate amounts of capital relative to the risks they assume and the costs they might impose on others, including taxpayers.” (*FM Watch press release*, 4/25/03)

Treasury Assistant Secretary Wayne Abernathy says OFHEO should examine whether Fannie competes directly with lenders in the primary market, which could violate its charter

Abernathy continues to push to have all 12 FHLBanks register with the SEC

FHLBanks are discussing a three-year trial disclosure program

- Treasury Assistant Secretary for Financial Institutions Wayne Abernathy said OFHEO should examine whether Fannie is competing directly with lenders in the primary market, which could violate its congressional charter. In remarks to reporters April 23 following a speech before the Women in Housing and Finance group, Abernathy said that in Fannie's first-ever 10-K financial disclosure, filed recently with the SEC, Fannie acknowledged competing with mortgage originators. "It raises questions. That's something their regulator ought to look into," said Abernathy. He noted that investors would not have had that information if Fannie and Freddie had not agreed with the Treasury, SEC, and OFHEO last July to file their common stock with the SEC. (*Reuters*, Mark Felsenthal, 4/23/03; *Dow Jones Newswire*, Dawn Kopecki, 4/23/03)
- Abernathy noted that statements Fannie made in its 10-K surprised him. "How many of you knew that Freddie and Fannie said they are competing with mortgage originators? That's what they said in their disclosures," he said. Abernathy said the Bush administration is "very pleased" with Fannie and Freddie's roles in supporting the housing market but he said the administration would keep an eye on whether the two GSEs strayed beyond their missions. Abernathy said statements in Fannie's 10-K could be understood to mean that Fannie competes directly in the primary mortgage market. "Well, they [Fannie] claim that they don't. You have to go and talk to them, what do they really mean by it. But some people have looked at it [the filing] and they've said: 'Hey, they've been very explicit about being in the origination field, and they're supposed to be in the secondary market,'" he stated. Abernathy noted that Fannie's statement on competition in its 10-K disclosure by itself, would not constitute a charter violation, but it calls for examination. "It's not a violation if you say that you're in those markets, it's a violation to be in those markets," he said. (*Reuters*, Mark Felsenthal, 4/23/03)
- Treasury later downplayed Abernathy's comments, saying Abernathy had not intended to recommend a regulatory inquiry. A Treasury aide said Abernathy intended only to draw attention to the usefulness of Fannie and Freddie's new financial disclosures, not highlight a potential concern. "Fannie Mae has acknowledged it can compete with loan originators. There are loan originators who purchase mortgages, and they also may purchase mortgages in the secondary market, just like Fannie Mae or Freddie Mac. There's nothing wrong with that," the Treasury spokesperson said. The aide declined to say what questions Abernathy thought had been raised by Fannie's 10-K remarks. (*Reuters*, Mark Felsenthal, 4/23/03)

Abernathy continues to push to have all 12 FHLBanks register with the SEC

- Abernathy continued to call on the FHLBanks to register with the SEC, as Fannie and

Freddie agreed to do. The FHLBanks have argued that registration would be costly and cumbersome. "I heard the same thing from Freddie and Fannie before they decided to file their disclosures with the SEC," Abernathy said. "How many of you knew that Fannie had golden parachutes for its executives? They hadn't provided that before. But they provide that information now." Abernathy added, "There is information that they didn't provide before even though they said they were providing it because there is now a legal standard." He noted, "As a group, the Federal Home Loan Banks put somewhere in the neighborhood of, on net, \$600 billion of new securities in the marketplace every year. And yet, they're not subject to the same kind of SEC disclosures that other providers of debt and bonds are. I think that should change. I think it ought to be through the SEC." (*Dow Jones Newswire*, Dawn Kopecki, 4/23/03)

FHLBanks are discussing a three-year trial disclosure program

- As a compromise, the FHLBanks are coalescing around the idea of a three-year trial financial disclosure program to see how registration with the SEC may work. The FHFBB would administer the program during the three-year trial period. FHLBank of Boston Chairman William Morrissey outlined the compromise at a speech before the FHLBank of Boston's annual meeting, and other FHLBanks are meeting to discuss the program. However, FHFBB Chairman John Korsmo and the Treasury appear to be unreceptive to the compromise and are encouraging the FHLBanks to register with the SEC. (*National Mortgage News Daily Web site*, 4/23/03, 4/24/03; *National Mortgage News*, Brian Collins, 4/28/03)
- Morrissey recommended that federal regulators create a temporary financial disclosure program for the FHLBanks because regulators cannot impose the same disclosure requirements on the FHLBanks as they have on Fannie and Freddie. Last July, Fannie and Freddie reached an agreement to voluntarily register their common stock with the SEC. Since then, Treasury, the SEC, and the FHFBB have been urging the FHLBanks to do the same. Speaking at the FHLBank of Boston's annual meeting, Morrissey stated, "The SEC is not the model for Federal Home Loan Bank disclosure for two simple reasons...The banks are not public companies, nor can a member of the public invest in the banks. Fannie and Freddie, by contrast, are public companies." Morrissey recommended that the FHFBB, not the SEC, run the program, despite recommendations from the SEC and the FHFBB that the SEC is best suited to regulate the FHLBanks' disclosures. (*Dow Jones Newswire*, Dawn Kopecki, 4/21/03)

Background on GSEs' financial disclosures

- Due to their GSE status, Fannie, Freddie and the FHLBanks are exempt from registering their securities with the SEC. Last July, the SEC, OFHEO, and Treasury reached an agreement with Fannie and Freddie, in which Fannie and Freddie agreed to voluntarily register their common stock and file quarterly and annual reports with the SEC (in compliance with the Securities Exchange Act of 1934), while remaining exempt from registering their debt and MBS with the SEC under the 1933 Securities Act. Fannie March 31, 2003 filed for the first time its Form 10 registration statement and initial Form 10-K annual report to the SEC, providing its audited financial statements for 2002. Freddie has yet to file registration statements with the SEC. It plans to do so in June when it is finished restating earnings from

previous years.

- In July 16, 2002 testimony before the House Capital Markets Subcommittee, Treasury Undersecretary Peter Fisher called on all GSEs to comply with the same financial disclosure rules agreed to by Fannie and Freddie. In a follow-up to his testimony, Undersecretary Fisher sent letters in August of last year to the 12 FHLBanks and Sallie Mae, urging them to comply with the same voluntary financial disclosure rules agreed to by Fannie and Freddie. Until recently, all 12 FHLBanks had been opposed to registering their stock with the SEC. However, in March, breaking ranks from the other 11 FHLBanks, the board of directors of the FHLBank of Cincinnati voted unanimously to begin registering its stock with the SEC. FHFB Chairman John Korsmo is in favor of having the FHLBanks register their common stock with the SEC. The SEC called for greater financial disclosures by the FHLBanks and said that registration of FHLBanks' securities with the SEC would not impede the markets. HUD is undecided on whether the FHLBanks should register their stock with the SEC.
- Fannie and Freddie and all 12 FHLBanks and FHFB Chairman John Korsmo are unanimous, however, in their opposition to registering their debt with the SEC. As part of Fannie and Freddie's voluntary agreement, the Treasury, OFHEO, and SEC issued a joint report February 2003 that recommended Fannie and Freddie provide more disclosures on their MBS. The joint report found that Fannie and Freddie disclose less information than private-label issuers and that additional disclosures would not disrupt the market as Fannie and Freddie had argued previously. As a result of the report, Fannie and Freddie pledged to voluntarily provide more information on their MBS.

<p>Congressman Pat Toomey (R-PA) and 16 other members of the House Financial Services Committee oppose Treasury's proposal to require the FHLBanks to register their stock with the SEC</p>

- Congressman Toomey and 16 other members of the House Financial Services Committee oppose the Treasury Department's proposal to require the FHLBanks to register their stock with the SEC and endorsed a compromise plan put forward by the FHLBanks, the *American Banker* reported. The letter, addressed to Treasury Secretary John Snow, Federal Housing Finance Board Chairman John Korsmo, and National Economic Council Director Stephen Friedman, warned that forcing the banks to register their stock with the SEC could have unintended consequences. (*American Banker*, Rob Garver, 5/2/03) Maintaining oversight of the FHLBanks by the Federal Housing Finance Board would avoid "potential dangers, such as market disruptions, increasing the cost of funds, or precipitating structural changes to the FHLBanks," the lawmakers wrote. (*Bloomberg News*, Al Yoon, 5/2/03) House Financial Service Committee Vice Chair Sue Kelly (R-NY) also signed the letter, circulated by Congressman Toomey. (*American Banker*, Rob Garver, 5/2/03)

Latest Basel draft seems to disfavor GSEs

- The third consultative paper issued by the Basel Committee April 29 -- like an earlier draft of the proposed international capital rules -- appears to eliminate the more favorable regulatory risk weighting currently afforded to GSEs for their debt, equity and mortgage-backed securities, according to Federal Financial Analytics Inc. The proposal, like the earlier draft, “would almost surely lead U.S. and international bank regulators to treat all of the housing GSEs as if they were corporate entities,” according to FFA’s “GSE Activity Report.” (*National Mortgage News Daily Web site*, 4/30/03) Comments on the third consultative paper are due by July 31, 2003. The Basel Committee on Banking Supervision’s goal is to finalize the New Accord by the fourth quarter of this year with implementation to take effect by year-end 2006. A copy of the complete Basel paper is available at: <http://www.bis.org/bcbs/bcbsep3.htm>

Fannie & Freddie’s motions to dismiss class-action lawsuits against their automated underwriting systems have failed

Judge, however, dismisses allegations that Fannie violates the FCRA and ECOA

- Fannie and Freddie are both facing separate class-action lawsuits against their AU systems, alleging different violations of the law. However, both Fannie and Freddie’s motions to dismiss the suits have failed. (*Origination News*, 4/25/03)
- The US District Court for the Eastern District of Pennsylvania on March 19 denied Freddie’s motion to dismiss a lawsuit (Donald Weidman v. Freddie Mac) that alleges that Freddie failed to provide the “adverse action” notices required by the federal Fair Credit Report Act (FCRA). (*Realty Times*, Kenneth Harney, 3/24/03) The federal judge noted that both parties are in stark disagreement with respect to Freddie’s role in the origination process and its use of credit reporting information. The plaintiff’s attorney, Jim Francis, said the judge’s decision allows discovery to start, which will probably take approximately six months. His firm, Francis and Mailman P.C. specializes in FCRA cases. (*Origination News*, 4/25/03)
- In Safiyah v. Fannie Mae, US District Court Judge Richard Roberts has allowed the plaintiff’s attorneys to pursue allegations that Fannie’s AU system (Desktop Underwriter) discriminates against minority applications. Fannie asked for a dismissal, but the judge ruled that the plaintiff does not have to prove, at this stage in the process, whether she qualified for the loans at the interest rate she requested. But the judge dismissed allegations that Fannie violates the FCRA and Equal Credit Opportunity Act (ECOA) by failing to provide notification of a loan rejection, saying ECOA and FCRA only apply to lenders. The plaintiff’s attorney, Barry Weprin (partner at Milberg, Weiss in New York), said he might ask the judge to reconsider the dismissal of the FCRA violation based on the Weidman decision. (*Origination News*, 4/25/03)

Fannie Mae and Freddie Mac

Wells Fargo Home Mortgage discusses its alliance agreement with Freddie

- In an interview with the *American Banker*, Peter J. Wissinger, the president and chief executive officer of Wells Fargo Home Mortgage (the top mortgage originator and servicer last year), set out an ambitious goal for the company to expand its originations market share to 20 percent over the next five year. According to the newspaper, in a February interview, Wissinger also intimated for the first time that Wells Fargo Home Mortgage may have outgrown Freddie, which has purchased the bulk of Wells' loans in recent years. The *American Banker* article by Erick Bergquist noted that much of the company's expansion over the past several years has been the result of its ground-breaking alliance agreement it reached with Freddie in the late 1990s, which lowered the company's guarantee fees in return for agreeing to sell the bulk of its loans to Freddie. The alliance agreement was the first of many such agreements by which Fannie and Freddie acquired the bulk of the country's originations from its top producers. As Wells has become stronger, Wissinger has clearly begun to seek more out of Freddie, reported Bergquist. "When we created the alliance, we were a much smaller company and were happy with our relationship with Freddie...At the time, the deal with Freddie allowed us to eliminate or streamline from 250 to 300 credit or program parameters."
- Currently Wells generates more than 30 percent of Freddie's volume and 13 percent of the overall originations market, and "in terms of delinquencies and defaults, we are of the highest quality," Wissinger said. "Who wouldn't want our loans? Why wouldn't Fannie clamor for that?" Bergquist noted that it would not be surprising for the FHLBank System to expand its relationship with Wells. On April 28, a spokeswoman for Wells downplayed Wissinger's earlier comments, insisting that Wells has not had any formal agreement to send Freddie the majority or all of its loans for "several years." Asked whether Wells had reduced the share of its loans sent to Freddie, she said that Wells has "confidential" relationships with "several investors." (*American Banker*, Erick Bergquist, 4/30/03)

Fannie & Freddie cap some mortgage bond production for seventh month

- Fannie and Freddie this month capped creation of certain mortgage bonds for the 7th consecutive month, a sign of the turmoil in the bond market caused by historically low mortgage rates. The limits imposed by Fannie and Freddie come simultaneously with a massive home refinancing wave prompted by record low rates. The magnitude of the refi wave has swamped lenders with applications and slowed the entire loan process, creating a shortage of some mortgage bonds.
- Fannie and Freddie limited the production of these complex securities because lenders are not able to process the underlying loans quickly enough. The simplest of these bonds, known as pass-throughs, are backed by home loans and are used to create complex bonds known as

collateralized mortgage obligations (CMOs) and Remics (real estate mortgage investment conduits). Fannie capped limited creation of CMOs backed by 15-year, 5% pass-throughs for May delivery at \$9 billion and limited creation of CMOs backed by 30-year, 5 ½ percent pass-throughs to be delivered in May. Freddie said it limited the creation of CMOs backed by 30-year, 5 ½ percent securities and 5% securities and 15-year, 4 1/2% and 5% pass-throughs for May delivery. (*Reuters*, Aleksandrs Rozen, 4/22/03)

Former Comptroller of the Currency & adviser to Fannie responds to concerns raised by the Fed that Fannie & Freddie are less capitalized than commercial banks and escape capital market discipline

- Former Comptroller of the Currency Eugene Ludwig wrote an opinion piece for the *Financial Times* responding to concerns that have been raised by Fed officials, including Federal Reserve Board Chairman Alan Greenspan, that Fannie and Freddie are less capitalized than commercial banks and “misconceptions” that Fannie and Freddie (being fully guaranteed by the federal government) create a moral hazard, escaping capital market discipline. Ludwig noting that Fannie and Freddie are “exceptionally well run and controlled” and have “been a strong support for the housing market” and “shown great ability in managing appropriate capital and liquidity positions.”
- Fannie and Freddie’s large size should not cause anxiety about systemic risk because large institutions can diversify their risk to a much greater extent than smaller ones, can manage liquidity with greater agility, and can hire the most talented staff to build state-of-the-art risk management systems. “Although they do indeed have the potential to do economic damage when they get into trouble, they do not inherently pose greater risk. Indeed, they may even be less risky,” argued Ludwig.
- Ludwig added, “The fact that Fannie and Freddie hold less capital than commercial banks does not necessarily mean they do not hold enough.” Ludwig argued that home mortgages are very low-risk and “Virtually ever serious supervisor worldwide...has given mortgages a lower risk-weighting than any other form of private debt.” Finally, he argued that Fannie and Freddie are heavily regulated and closely supervised and “have nothing like the level or type of ‘non-quantifiable’ risk characteristics of recent corporate debacles.” Ludwig is a managing partner at Promontory Financial Group and an adviser to Fannie. (*Financial Times*, column by Eugene Ludwig, 4/28/03)

Fannie Mae

Fannie's Chairman tells Wall Street the company examines the issue of relinquishing its federal charter all the time

- During a private question-and-answer session between the company and its investors and analysts recently, Fannie's Chairman Franklin Raines was asked about Fannie relinquishing its federal charter and giving up its GSE status. Raines replied that the company looks at the issue all of the time, but currently thinks it is economically beneficial to retain its ties to the government. (*National Mortgage News*, Paul Muolo and Brian Collins, 4/7/03)
- In response to a similar question at a UBS Warburg Global Financial Services Conference in New York on April 30, Raines said Fannie's GSE charter is "a balancing of pluses and minuses" and that if the minuses begin to outweigh the pluses, he would have "a fiduciary duty" to the company's shareholders to do something about that. (*National Mortgage News Daily Web site*, 5/1/03; *National Mortgage News*, Brad Finkelstein, 5/5/03)

Fannie's Chairman responds to GSE critics

- During a question and answer session at a UBS Warburg Global Financial Services Conference in New York on April 30, Fannie's Chairman Franklin Raines said that Fannie's critics had hired lobbyists "to stir the pot," but that these efforts are "not making any progress." He noted that FM Watch has lost many backers and that they "haven't done much for their clients," while Fannie has "worked closely with their clients and helped them make a lot of money and serve the American homeowner." (*American Banker*, Robert Julavits, 5/1/03)

Less than 100 of Fannie's "Location Efficient Mortgages" have been originated

Misunderstood LEM "may be a lemon"

- Since Fannie's LEM was rolled out in March 2000, less than 100 such mortgages have been written in the four cities involved – Chicago, Seattle, San Francisco and Los Angeles, reported *Origination News* in an article entitled, "Misunderstood LEM may be a Lemon." Various partners are retooling the product to accelerate the demand. The LEM product consists of mortgages on residences located near public transportation that obtain higher eligibility limits, a low downpayment of 3 percent regardless of income, all to help the environment by driving less.
- However, the nonprofits that brought the concept to Fannie conducted market research last summer that found that they need to expand the number of banks offering the product and to

rethink their marketing message. According to David Goldstein, Director of the Energy Program for the Natural Resources Defense Council (one of the nonprofits involved in formulating the concept), rising home prices are a factor. In San Francisco, Fannie's eligibility cap at \$325,000 has not kept pace with exploding house prices, part of the reason why only six people have signed up. This is less of a problem in Chicago and Seattle, where 25 and 31 LEMs have been signed up respectively. There have been 11 in Los Angeles. Another problem for the LEM has been Fannie's shift in the past few years toward automated underwriting systems that do not consider location efficiency. Darlene Dugo, director of Fannie's Chicago Partnership Office, noted the value of location efficiency, calculated using an algorithm available at locationefficiency.com, can be added to an applicant's income prior to using the automated underwriting system. The extra step, however, has "put off" new lenders and partners that want to offer the product. Since Fannie's partnership office in Seattle added location efficiency to its automated model six months ago, applications definitely spiked, said Dianne Wasson, Vice President and Manager of Affinity Lending for HomeStreet Bank. (*Origination News*, 2/03)

Fannie purchased \$60 billion in subprime loans in 2002 – 50% increase over 2001

- Fannie purchased \$60 billion in subprime loans last year under its expanded access program, which also includes Fannie's Timely Payment Rewards mortgages. "That represents more than a 50 percent increase over 2001," Fannie's Counsel Carol Evans told a National Community Reinvestment Coalition conference. (*National Mortgage News Daily Web site*, 3/17/03)

Fannie's efforts to purchase more small multifamily loans is a hit with Dime

- Fannie's efforts to purchase more small multifamily loans is popular with Dime Community Bancshares Inc., a \$3 billion-asset New York City bank. Dime sold \$21 million of apartment mortgages to Fannie in the first quarter, on top of the \$73 million it sold Fannie in December. Gains on those sales accounted for most of the \$656,000 of profit from asset sales that Dime garnered in the first quarter. Dime committed in December to sell Fannie \$200 million of loans over 18 months, but now expects to reach that goal by the end of the year, after which it expects to sign on for another commitment. The multifamily loans Dime sells to Fannie average about \$1.2 million. (*American Banker*, John Hackett, 4/23/03)

Freddie Mac

Freddie reports shrinking market share to Fannie for first quarter 2003

Freddie's total mortgage portfolio declines

Freddie's retained portfolio grows modestly

Freddie's delinquencies remain low

Freddie is not releasing its first quarter earnings results until its restatement of its financial results for last three years is completed

Freddie reports shrinking market share to Fannie for first quarter 2003

- Freddie reported that its market share relative to Fannie was 32 percent in the first quarter of 2003, down from 42 percent in the first quarter 2002 and 41 percent in the fourth quarter 2002. Freddie attributed the decline to the implementation of higher fees and weak PC [participation certificate] security price performance early in the first quarter. Over the balance of the year, Freddie expects its market share to return to more typical levels. Market share for March 2003 was 37 percent, up from 29 percent in February 2003. (*Freddie press release, 4/24/03*) Over the years, Freddie's average share of the loan purchase market has been about 40 – 41 percent. (*American Banker, John Hackett, 4/25/03*)
- Freddie's spokeswoman Sharon McHale attributed the decline in market share to three factors: (1) Freddie's mortgage-backed securities were trading at a substantial discount to Fannie's; (2) Freddie introduced new pricing criteria for A-minus loans this year, which require the lenders that sell loans to Freddie to supply additional information, which some lenders found it a problem" and created technical problems in getting a loan through the lender's system and onto Freddie's system; and (3) many of its largest customers delivered an unusual amount of loans in December, meaning there were fewer to pass on in January. The company insists that the falloff had nothing to do with the new guarantee fee floor it announced in November 2001. (*American Banker, John Hackett, 4/25/03*)
- Increasingly analysts and even executives at Fannie have said that the market share trend may reflect differences between the lenders that the GSEs have chosen as alliance partners. In a recent conference call to investors, Fannie's CFO Timothy Howard speculated that the alliances may account for Freddie's diminished market share, stating, "The share changes that you are seeing are driven by something else going on at our alliance lenders vs. Freddie's alliance partners." (*National Mortgage News, Ted Cornwell, 4/28/03*)

Freddie's total mortgage portfolio declines

- Freddie's total mortgage portfolio (retained portfolio plus PCs held by other investors) declined at a 1 percent annualized rate in first quarter 2003, from \$1.311 trillion at December 31, 2002 to \$1.307 trillion at March 31, 2003. Freddie said the decline reflects new business

purchase volume of \$173 billion in first quarter 2003, up from \$151 billion for first quarter 2002 and down from \$239 billion for fourth quarter 2002. Total mortgage portfolio growth was also affected by liquidations of \$177 billion in first quarter 2003, up from \$86 billion in first quarter 2002 and down from \$189 billion in fourth quarter 2002. Freddie's Total PC portfolio declined by \$9 billion (or at a 3 percent annualized rate) during first quarter 2003 to \$1.073 trillion, from \$1.082 trillion at fourth quarter 2002. Freddie attributed the decline from lower than typical market share, which the company expects to return to more typical levels over the course of the year. (*Freddie press release, 4/24/03*)

Freddie's retained portfolio grows modestly

- Freddie's retained portfolio grew by \$1 billion during first quarter 2003 to \$569 billion from \$568 billion in fourth quarter 2002, representing annualized growth of 1 percent. Freddie attributed this modest growth to a decline in the returns available on mortgage investments and high mortgage prepayments. Freddie continues to anticipate retained mortgage portfolio growth of 8 to 12 percent in 2003. (*Freddie press release, 4/24/03*)

Freddie repurchases more debt

- Freddie repurchased \$6.5 billion of long-term debt during first quarter 2003, compared to debt repurchases of \$3.3 billion in first quarter 2002 and \$7.3 billion in fourth quarter 2002. (*Freddie press release, 4/24/03*)

Freddie's delinquencies remain low

- Freddie's non credit-enhanced single-family delinquency rate was 0.30 percent and its multifamily delinquency rate was 0.01 percent at the end of February 2003. (*Freddie press release, 4/24/03*)

Freddie's duration gap declines

- Freddie primary indicator of interest-rate risk (PMVS) averaged 2.59 percent in first quarter 2003, compared to 2.74 percent in first quarter 2002 and 3.28 percent in fourth quarter 2002. Freddie's duration gap averaged approximately negative 1 month in first quarter 2003, compared to zero months in first quarter 2002 and fourth quarter 2002. (*Freddie press release, 4/24/03*)

Freddie delays its first quarter earnings

- Freddie has delayed releasing its first quarter earnings until its restatement of its financial results for the last three years is completed. Freddie expects the effect of the restatements will materially increase its reported earnings for prior periods. The restatement process is expected to be completed by the end of the second quarter 2003, with results released shortly afterward. Freddie will publish other information about the corporation's first quarter 2003 business performance in late April. The information will include business volume (retained portfolio volume, total PC volume, liquidations, net growth and market share) as well as credit and interest-rate risk management results (delinquency rate, real estate owned (REO) activity, portfolio market value sensitivity (PMVS) and duration gap). (*Freddie press release, 3/25/03, 4/24/03*)

- Freddie’s restatement of earnings was prompted after its new auditor PricewaterhouseCoopers LLP raised objections to the way Freddie had been recording income for certain types of hedging instruments under the advice of now defunct Arthur Anderson. [See February 3, 2003 *GSE Report* for more information on Freddie’s restatement of earnings, www.gsereport.com]

Federal Home Loan Banks

National Mortgage News editorial agrees with FHLBank of San Francisco President that consolidation among the FHLBanks is likely to occur, but not desired

- As noted in the April 7, 2003 *GSE Report*, the FHLBank of San Francisco said that there “are numerous forces at work that may drive the System to consolidation into a single, massive, and very powerful government-sponsored enterprise,” reported John Connor with *Dow Jones Newswire*. In a message to its members in its 2002 annual report, the FHLBank of San Francisco said the new system would be “engaged in a business and serving a function very different from the business and function it has historically performed, and more like those performed by the other housing GSEs [Fannie and Freddie].” Unlike Fannie and Freddie, the FHLBank System is structured as a cooperative with 12 FHLBanks. “By eliminating local control of the FHLBanks and undermining the regional nature of the System, it seems likely that such consolidation would reduce the System’s responsiveness to the needs and priorities of local businesses and communities,” the report stated. “While there may not be visible political support for consolidation at this time, it may become more attractive as other changes take place.” “Forces” that could drive the System to consolidation include: the FHLBanks’ mortgage purchase programs, securitization authority for the FHLBanks, SEC registration, and multi-district FHLBank membership. (*Dow Jones Newswire*, John Connor, 4/2/03; “*Message to our Members*,” D. Tad Lowrey, Vice Chairman of the Board, Mary Lee Widener, Chairman of the Board; Dean Schultz, President and CEO, *FHLBank of San Francisco, 2002 Annual Report*)
- An April 28 *National Mortgage News* editorial noted, “We agree with Dean Schulz, president of the San Francisco district bank, who in a recent letter told his members the changeover is inevitable, even though he himself did not want it to happen. Our view is that while the combination is probably necessary to achieve the weight needed for survival, we would hate to see the industry become more monolithic than it already is, considering the big GSEs’ steady growth in market share.” (*National Mortgage News*, 4/28/03)

Farm Credit Administration/Farmer Mac

Farmer Mac's loan activity declines in first quarter

Farmer Mac's first quarter profits rise on derivatives gains

- Farmer Mac's loan activity declined 46 percent in the first quarter 2003 from the fourth quarter 2002, with long-term standby purchase commitments (LTSPs) accounting for most of the change. Purchases, guarantees, and commitments for first quarter 2003 totaled \$268 million, with LTSPCs comprising \$167 million of the total. Fourth quarter 2002 numbers totaled \$497 million with a LTSPC portion of \$396 million. Farmer Mac's loan portfolio exceeds \$5.5 billion, according to the company's first quarter statement. (*MortgageDaily.com*, 4/29/03)
- Farmer Mac announced April 23 that its first quarter profit tripled, led by gains in the value of financial contracts used to protect its portfolio from interest rate swings and increased revenue. Farmer Mac's net income for the first quarter of 2003 rose to \$8.4 million, or \$0.70 per diluted share, compared to \$2.8 million and \$0.23 per diluted share for fourth quarter 2002 and \$7.2 million and \$0.59 per diluted share for first quarter 2002. Farmer Mac benefited from a \$3.76 million gain in the value of derivatives. (*Bloomberg News*, Vivien Lou Chen, 4/23/03; *Farmer Mac press release*, 4/23/03)
- Profit excluding changes in the value of derivatives increased to \$5.9 million, or \$0.49 a share for the first quarter, compared to \$5.9 million for fourth quarter 2002 and from \$5.3 million, or \$0.44, a year earlier. Net interest income, which does not include guarantee fees for loans purchased prior to April 1, 2001, was \$9.5 million for first quarter 2002, compared to \$8.7 million for fourth quarter 2002 and \$7.5 million for first quarter 2002. Guarantee and commitment fees were \$5.1 million for first quarter 2003, compared to \$5.1 million for fourth quarter 2002 and \$4.6 million for first quarter 2002. Delinquent loans decreased to \$76.2 million, representing 1.58 percent of Farmer Mac's purchased or guaranteed loan portfolio in the first quarter of 2003, compared to \$79.2 million or 2.11 percent in the first quarter of 2002. (*Bloomberg News*, Vivien Lou Chen, 4/23/03; *Farmer Mac press release*, 4/23/03)
- Farmer Mac's Class C share rose to \$1.09 to \$25.14 in New York Stock Exchange composite trading. Farmer Mac's shares have declined 51 percent in the last 12 months after reports by hedge fund Gotham Partners LP alleged the GSE was a high risk because it didn't raise reserves as loan delinquencies rose, and relied on short-term debt to finance long-term investments. Farmer Mac has called the research "flawed and unfounded." According to the *New York Times*, New York State Attorney General Elliot Spitzer is probing Gotham for its research. (*Bloomberg News*, Vivien Lou Chen, 4/23/03)

Postal Service

President Bush signs bill reducing the Postal Service's payment to the Civil Service Retirement System (CSRS) fund

- President Bush signed legislation (S. 380, now Public Law 108-18) April 23 that changes the way the Postal Service pays into the CSRS fund. Without this change, the Postal Service risked overpaying its CSRS obligation by \$78 billion, costs that would have to come from postage and fees paid by its customers. The change will not affect retirement benefits for current or former Postal Service employees. It also will not affect employee contributions to CSRS. (*Postal Service press release*, 4/23/03)
- The legislation requires the Postal Service to use some of the savings to pay down its \$11.1 billion debt with the Treasury. By law, the agency is prohibited from borrowing more than \$15 billion. Other savings would be used to continue funding retiree health benefits. The legislation was prompted by reports by the Office of Personnel Management and GAO, which found that the Postal Service had overpaid the CSRS fund. The Postal Service, however, could not reduce its payments to the CSRS fund without legislation. By changing the way the Postal Service's retirement benefits are calculated, the legislation could help keep postal rates flat until FY 2006. Projected savings include \$2.9 billion this fiscal year and \$2.6 billion in FY 2004. The Postal Service cannot use the savings to pay executive bonuses. (*Associated Press*, Jim Abrams, 4/9/03; *BNA Daily Report for Executives*, Derrick Cain, 4/24/03) After FY 2005, any savings would be held in escrow until Congress approves a Postal Service plan for spending the money. (*Washington Post*, Christopher Lee, 4/9/03)

Postal Service response

- "We are grateful to President Bush for his action on behalf of the Postal Service," said Postmaster General Jack Potter, who commended the entire mailing community, including the postal unions and management associations, for their efforts in support of this legislation. "The new law is an important tool to help maintain the financial stability of the Postal Service. But we also will continue to manage the organization more efficiently than ever as we implement the strategies of the Transformation Plan," added Potter. (*Postal Service press release*, 4/23/03)

Senators Byron Dorgan (D-ND) and Ron Wyden (D-OR) want Postal Service's Inspector General (IG) fired

Postal Service Board of Governors says it will wait for report before acting on Senators' request to fire the IG

Citizens Against Government Waste (CAGW) also calls for IG's removal

Senator Chuck Grassley (R-IA) and the President's Council on Integrity and Efficiency have also been probing the allegations against the IG

Senators Dorgan and Wyden want Postal Service IG fired

- Senators Dorgan and Wyden called on the Postal Service's Board of Governors to fire Inspector General Karla Corcoran, saying she has frivolously spent her office's funds rather than weeding out waste in the Postal system. In a May 1 letter to S. David Fineman, Chairman of the Postal Service's Board of Governors, the Senators said Corcoran's "team-building" events are a misuse of time and money. The Senators said that Corcoran's office spent about \$2 for every \$1 in wasteful spending it uncovered. For example, in 1001, the Postal IG spent \$117 million, to identify \$56 million in wasteful spending. "IG Corcoran seems to have been too busy wasting her own agency's resources to have been much of a watchdog for the Postal Service." (*Wall Street Journal*, Sarah Lueck, 5/1/03; *Senator Dorgan and Wyden letter to Fineman*, 5/1/03)
- The Senators said IG Karla Corcoran wasted millions of dollars on a series of "bizarre" staff retreats at which members of her 725-person staff were required to dress as the Village People, wear animal costumes, build gingerbread houses, cat costumes, do a striptease, and participate in mock trials. "This is outrageous behavior," Senator Dorgan said. "When people buy postage stamps, they expect that money to be used to move the mail not to be wasted on exercises that have employees dressed in animal costumes." Senator Wyden stated, "I can't see how these huge expenses of ratepayer money and Postal Service time seemed even marginally acceptable to the Inspector General." (*Senator Dorgan press release*, 5/2/03)

Postal Service Board of Governors says it will wait for report before acting on Senators' request to fire the IG

- The Postal Service's Board of Governors told Senators Wyden and Dorgan that it would not consider removing Corcoran until it received a government report on the issue in late May. In a letter to the Senators, Fineman said the board was already aware of the allegations after receiving a "lengthy, anonymous letter" in October. Fineman said the letter was forwarded to the President's Council on Integrity and Efficiency, which then directed the IG at HUD to conduct an investigation. That investigation began in December and Fineman said he expects it to be complete prior to the board's June 2 meeting in Washington. "We will carefully consider the findings and any recommendations at that time, and take action which is appropriate... We can appreciate and share your concerns. We feel, however, that it is best to

await the receipt of the report from the HUD IG.” (*BNA Daily Report for Executives*, Derrick Cain, 5/5/03)

IG’s response

- Corcoran released a statement saying she was “stunned by the actions of Senators Dorgan and Wyden.” She said their letter was “riddled with misleading facts and unfair accusations.” She said she had no plans to resign and that her agency has identified more than \$2.2 billion in savings over the past six years and that in 2001, her office spent \$82 million and identified more than \$275 million in waste, contrary to the \$56 million cited by the Senators. While the “team-building programs” are “not typical” among other federal OIGs, “they are practices among many Fortune 500 companies...and by the US Postal Service.” (*Prepared Statement by Karla Corcoran*, 5/1/03)

CAGW calls for Postal IG’s removal

- CAGW May 1 called on the Postal Service’s Board of Governors to remove Corcoran from her position “due to extensive, ongoing mismanagement.” CAGW noted that allegations of abuses in her office have sparked an investigation by Sen. Charles Grassley (R-IA), Chairman of the Senate Finance Committee as well as the President's Council on Integrity and Efficiency, the IG community's self-policing body.
- “CAGW has been watching with growing alarm frequent reports of mismanagement within the USPS OIG, headed by Ms. Karla Corcoran,” CAGW Vice President Leslie Paige wrote in a letter to Board of Governors Chairman S. David Fineman. “Reports of rampant waste, cronyism, questionable management and personnel practices, and substandard performance when it comes to uncovering waste, fraud and abuse have prompted us to contact you to respectfully request that the USPS Board of Governors ask for Ms. Corcoran’s resignation as soon as possible.”
- CAGW noted that current and former auditors and investigators have made numerous allegations involving a team-building program invented by Corcoran, in which employees are often rewarded with cash bonus checks. In one instance, several employees received bonuses of \$1,000 each for writing letters to get a senior IG executive relieved of his military reserve duty in Afghanistan. In addition, every year since her hiring date in 1997, the IG has convened an annual week-long meeting that requires all 750 employees to fly to Washington, D.C. where they sing songs, play games, build sand castles, dress in costumes, and mimic animals. CAGW estimates these annual events have already cost taxpayers more than \$1 million each, not counting lost employee work time.
- CAGW alleges that there have been “rampant abuses of relocation benefits within the OIG.” CAGW also noted that Corcoran has retained the services of a private law firm even though the OIG has a number of staff attorneys and has buried the payments under the category of legal advice on government accounting standards. “These kinds of accounting shenanigans in an IG's office are inappropriate, if not downright suspicious,” Paige said. In its letter, CAGW cited the fact that “Other federal OIGs with smaller budgets and fewer investigators and auditors issue more work product and produce more savings to the taxpayers than USPS’

OIG.”

- “Enough is enough. Tens of millions of dollars have been wasted by this IG. She has lost her credibility and her effectiveness. Chairman Grassley has been a great champion of having a strong IG program and his staff is working hard to get to the bottom of these allegations. But it is up to the USPS Board of Governors to ask this IG to resign and appoint new leadership,” Paige concluded. “It would be a slap in the face of postal ratepayers, the USPS and Congress, to permit Ms. Corcoran to remain in her position. CAGW hopes that the Board of Governors will take immediate action on this issue at its upcoming meetings next week.” (*CAGW press release, 5/1/03*)

Senator Grassley and the President’s Council on Integrity and Efficiency probing the allegations

- As first reported by *The Washington Times* in December, Corcoran has been under investigation by Senator Chuck Grassley (R-IA) and the President’s Council on Integrity and Efficiency since last October. Senator Grassley would not yet join his colleagues’ call for Corcoran’s resignation. “Senator Grassley feels that it’s important to thoroughly investigate someone and let any pending investigations be completed before taking the step of calling for someone’s resignation,” said Senator Grassley’s spokeswoman Jill Gerber. “Of course, other senators have the right to do what they see as the correct course of action.” Senator Grassley demanded answers in January to lengthy questions about the management style of Corcoran, and in return, the IG’s office dropped off 600 pages of documents that Senator Grassley’s office found largely nonresponsive. (*The Washington Times, James Lakely, 5/3/03*)

GAO Report criticizes the Postal Service for delaying anthrax test results to employees

Postal Service says it was not their job to disseminate the information

- Postal Service officials violated Occupational Safety and Health Administration rules and undermined the credibility of management when they delayed the report of anthrax test results to employees at a contaminated mail facility in Wallingford, CT, according to an April 2003 *GAO Report*. (*Washington Post, Christopher Lee, 4/22/03*)
- In 2001, letters containing anthrax spores were mailed to news media personnel and two members of Congress, resulting in 23 illnesses and five deaths. The Wallingford facility was first tested in November 2001 and no contamination was found. The Wallingford facility was then retested later in the year, after a local woman died of anthrax, possibly after exposure to contaminated mail that had been processed through the facility. Facility workers received antibiotics on November 21, 2001 – the day the elderly woman died. In early December, tests turned up dangerous levels of anthrax in a sample from a mail-sorting machine. The facility remained open and workers were only told that “trace” amounts had been found and were advised to continue taking antibiotics. No workers became ill. Despite several union requests, Postal Service officials did not release the detailed contamination report until September 2002, nine months after they first learned of the results. (*Washington Post, Christopher Lee, 4/22/03; Associated Press, Lolita Baldor, 4/22/03*)

- The Postal Service’s decision not to release the detailed test results after the Greater Connecticut Area Local American Postal Workers Union requested all the facility’s test results in January and February 2002, said GAO, did not satisfy (OSHA’s) disclosure requirements for disclosing results that are requested. GAO said the failure was “understandable” given the circumstances at the time, the advice it received from public health officials, an ongoing criminal investigation, and uncertainty about the sampling methods used. Postal officials were not cited for nondisclosure, but OSHA noted that a “failure to effectively communicate issues which can have an effect on a worker’s health and safety, can lead to fear and mistrust.” (*Associated Press*, Lolita Baldor, 4/22/03; *BNA Daily Report for Executives*, 4/23/03)
- GAO recommended that the Postal Service work with OSHA, GSA, and the National Response Team – a group chaired by the Administrator of the EPA and comprising 16 federal agencies - to revise their existing guidelines or regulations to require that they promptly inform workers of available test results. Among its recommendations, the GAO said agencies should revise their guidelines to: (1) reflect OSHA’s regulations for disclosing test results requested by workers when available to workers, and others; (2) require prompt communication of test results, including quantified results when available to workers and others; (3) specify the terminology that should be used to communicate quantitative test results to employees and others, and any limitations associated with the test results; (4) define what is meant by the validation of test results and explain the steps that must be taken to validate sampling or testing methods that are undertaken by the agency itself or by another organization; and (5) specify the agencies that should be involved in deciding what information to communicate to workers, and others, as appropriate. (*BNA Daily Report for Executives*, 4/23/03)
- Senator Joseph Lieberman (D-CT), who requested the GAO investigation, said, “It is difficult for me to fathom why postal workers were kept in the dark about this level of anthrax contamination...Postal and health officials, through their own missteps, put Wallingford employees at serious and unnecessary risk. We can only thank God that no postal employee died as a result.” (*Associated Press*, Lolita Baldor, 4/22/03)

Responses to GAO Report

- In response to the GAO Report, Postal Service Executive Vice President Patrick Donahoe agreed that test results should be released “as quickly as possible” and he said the agency is revising its guidelines for responding to anthrax incidents. (*Associated Press*, Lolita Baldor, 4/22/03)
- Union officials, however, said the report was “very generous” to the Postal Service and noted, “we are unaware of any circumstances under which it is understandable to ignore statutory worker protection standards.” (*Associated Press*, Lolita Baldor, 4/22/03)
- The Postal Service noted that it was not the agency’s job to disseminate the information and that it was the responsibility of health agencies to release medical information. “On that

score, we deliver mail,” said Gerry McKiernan, a Postal Service spokesman. “We’re not medical experts. We took the advice the medical experts gave us at the time.” But one of those experts, Dr. James Hadler, Connecticut’s chief epidemiologist said the State Department of Public Health and the Centers for Disease Control had told postal managers that the information should be released. “They told us, ‘We want to be the ones to tell the media and our employees,’” Dr. Hadler said. Senator Lieberman faulted both the health department and the Postal Service for not revealing the extent of contamination to workers. (*New York Times*, 4/24/03)

- The GAO Report, “*US Postal Service: Better Guidance is Needed to Improve Communication Should Anthrax Contamination Occur in the Future*,” (GAO-03-316, April 2003) can be found online at: www.gao.gov/cgi-bin/getrpt?GAO-03-316

House Postal Task Force requests new GAO study on Postal Service’s financial outlook and status of the Postal Service’s Transformation Plan

- In an April 28 letter to Comptroller General David Walker, Congressman John M. McHugh (R-NY), Chairman of the House Special Panel on Postal Reform and Oversight and Ranking Member Congressman Danny K. Davis (D-IL) stated, “In testimony before the House Committee on Government Reform in April 2001, you highlighted concerns about the Postal Service’s financial outlook and announced that the GAO had added the Service’s transformation efforts and long-term outlook to its High-Risk List.” The Congressmen asked the GAO to “monitor and periodically report on the Postal Service’s financial outlook and the status of the Service’s actions to implement its Transformation Plan.” More specifically, the Congressmen would like the GAO to evaluate the following areas: Financial Condition and Outlook, Infrastructure, Contracting; Workforce; Mail Safety and Security. (*Congressmen McHugh and Davis letter to General Walker*, 4/28/03)

Postal Service responds to watchdog groups’ request for the FTC to investigate the Postal Service’s “misleading” ad campaign

- The Council for Citizens Against Government Waste (CCAGW) and the National Taxpayers Union April 18 called on the Federal Trade Commission (FTC) to investigate whether the Postal Service’s promotions of its Priority Mail delivery service violate the nation’s “truth in advertising” laws. CCAGW and NTU wrote letters to Mary Engle, the FTC’s Associate Director in the Division of Advertising Practices, requesting the investigation. (*CCAGW press release*, 4/18/03; *NTU press release*, 4/18/03) Another watchdog organization, PostalWatch, released an April 18 study accusing the Postal Service of running ads that misrepresent priority mail as a 2-day delivery service. [See April 21, 2003 *GSE Report* for more information, www.gsereport.com]
- The Postal Service rebuts the charges. “The [PostalWatch] study is using data deceptively,” Postal Service spokeswoman Monica Hand said. For example, she said, PostalWatch used

Origin Destination Information System data, which is “an internal tool used to show mail volume flows from post office to post office. It does not measure delivery, and it is not used to measure service because it is not precise.” Hand added, “We use an independent third party to measure end-to-end delivery of Priority Mail... We look at the information, which is usually trended quarterly, and the recent reports show that two-day delivery service is within the industry standard, which is between 90 and 97 percent.” Also Hand said, comparing Priority Mail ODIS data with First-Class Mail ODIS data could be misleading because “on average, Priority Mail pieces travel longer distances than First-Class mail pieces. And for any class of mail, the higher percentage of local pieces, the lower the average delivery time.”

She concluded, “Bottom line, we think that Priority Mail is a reliable two-to-three-day delivery service,” she said. “You can compare it to other two-day services.” (*DM News*, Melissa Campanelli, 4/25/03)

Presidential Postal Reform Commission holds April 29 field hearing in Chicago

- The Presidential Postal Reform Commission held its fifth public meeting on April 29 in Chicago. The focus of the meeting was issues related to the Postal Service’s workforce, including the collective bargaining process and binding arbitration. On July 31, the Commission will deliver a report to the President, articulating a vision for the Postal Service’s future and recommending the legislative and administrative steps necessary to enact reforms needed to ensure the viability of postal services. (*Federal Register*, page 18328, 4/15/03; *USPS Newslink*, 4/25/03) The testimony submitted by various parties is posted on the Commission’s Web site: <http://www.treas.gov/offices/domestic-finance/usps/meetings/4-29-03/witnesses.html>

Highlights of Testimony

- The National Association of Letter Carriers President William Young urged the Commission to “tread lightly” in making changes to the collective bargaining structure governing postal employees, and rejected suggestions that such employees be placed under the Railway Labor Act. Young said collective bargaining has worked well under the Postal Reorganization Act of 1970 with “an extraordinary record of labor peace” and no significant work disruptions. (*NALC press release*, 4/29/03)
- National Association of Postmasters of the United States President Wally Olihovik testified that “whether or not a specific post office earns a profit does not – and should not – determine its existence. For many Americans, a post office is the sole nexus between a community and the federal government. Community identity and postal accountability are contingent on the presence of post offices. Interaction with front-line postal managers assures postal customers, large and small, that their mailing needs will be addressed promptly.” (*PostCom Web site*, 4/30/03)
- American Postal Workers Union President William Burrus called collective bargaining “the worst form of industrial governance for the Postal Service, except for all the others.” Testifying before the Commission, Burrus said, “There are two fundamental rights that make

the present system of collective bargaining strong and effective” – the right to bargain over wages and working conditions, and the right to a prompt and effective resolution of disputes that result from collective bargaining.” (*APWU press release, 4/29/03*)

Lexington Institute says Postal Service is playing a “dangerous game” by under-pricing offerings in competitive markets, while over-pricing its monopoly services

- The Postal Service “is playing a dangerous game: under-pricing product offerings in commercially competitive markets while over-pricing its monopoly service,” says Dan Soifer, Executive Vice President of the Lexington Institute in an issue brief. The cross-subsidy harms:
 - “Captive regular mail users, forced to pay more than fair value for monopoly services,” and;
 - “Commercial markets (overnight mail and package delivery, e.g.) that depend on true competition to match consumer need and supplier opportunity; and the Postal Service, itself, which focuses more on covering costs than controlling them, neglecting important statutory duties in the process.”
- A copy of the report is available online: <http://www.lexingtoninstitute.org/postal/030421.pdf> (“*The Postal Service’s Dangerous Game*,” Dan Soifer, Lexington Institute, 4/21/03)

Postal Service’s plan to provide discounts for large mailers could produce more junk mail, says *Wall Street Journal*

- The Postal Service’s proposal to provide special discounts for credit card firm Capital One Financial Corp., the nation’s heaviest user of first-class mail, in hopes of generating new revenue, is the first time the Postal Service has offered reduced rates specially created for just one customer. The Postal Service hopes eventually to strike discount deals with possibly thousands of mailers, potentially leading to more junk mail for consumers, reported the *Wall Street Journal*. The Newspaper Association of America maintains offering special discounts to companies like Capital One is unfair to anyone stuck paying 37 cents a stamp. Capital One’s competitors aren’t happy either. FleetBoston Financial Corp. has asked the Postal Rate Commission to delay the start of discounts for Capital One until other companies “had the chance to negotiate similar arrangements.” In response, the Postal Service is spelling out rules for other big mailers to follow. Critics suggest the Postal Service is letting itself be backed into a corner by large customers that still might abandon it someday in favor of electronic communication. Questions have also been raised about the Postal Service’s math. Shelley Dreifuss, head of the consumer-advocate office at the Postal Rate Commission, worries the Postal Service might actually lose money on discounts, partly because the Capital One proposal includes price cuts on millions of pieces the post office initially expected to get even if it doesn’t offer discounts. “I would like to see [discounts] used as a method of last

resort,” she said. (*Wall Street Journal*, Rick Brooks, 4/3/03) The Postal Service’s Board of Governors is expected to discuss its opinion and recommended decision on its experimental negotiated service agreement with Capital One at its May 5 meeting. (*Federal Register*, 4/24/03, page 20188)

Postal Service announces new mail contract with airlines

- The Postal Service awarded contracts April 25 that will allow it to begin shipping mail on the airlines that offer the best service for the lowest price starting June 28. The contracts are expected to increase efficiency and improve service to customers. Currently all 54 certified airlines in the US share in carrying the mail, with volume divided evenly among carriers operating the same route. The Postal Service paid the airlines about \$370 million last year to carry the mail. Under the new system, airlines entered bids to carry the mail over various routes, and mail will be sent aboard planes of those that offer the best price. If service slips on a route, however, the mail will be switched to the carrier with the next best price, said Paul Vogel, Postal Service Vice President for Network Operations Management. Vogel said the Postal Service worked with the Air Transport Association and with airline officials in setting up the new system.
- Because the new deals vary from airline to airline, and the Postal Service can shift mail depending on the service, the final cost won’t be known until the end of the fiscal year. To measure performance, the new contracts include a provision that the airlines must scan the mail four times – when the Postal Service provides the mail to the carrier, when the carrier loads the mail onto a flight, during transfers to connecting flights, and upon delivery to the Postal Service following the flight’s arrival. Vogel announced 18 contracts on April 25 but he said about 34 airlines will be involved in carrying mail as subsidiaries or partners of other airlines. (*Associated Press*, Randolph Schmid, 4/25/03; *USPS NewsLink*, 4/29/03)

President Bush appoints James Miller III to Board of Governors of Postal Service

- President Bush bypassed Congress on April 22 and installed 11 people whose nominations had languished for as long as 16 months. By signing the appointments during the congressional recess, President Bush bypassed the Senate confirmation process. Such appointments are valid until the next Congress takes office, in this case in January 2005. Among the appointments are James C. Miller III to be governor of the Board of Governors of the Postal Service. President Bush nominated Miller on July 26, 2002, and again on January 9, 2003. (*Associated Press*, 4/22/03) Insiders said Miller has been a longstanding critic of the Postal Service and has repeatedly called for its privatization. (*DM News*, 4/24/03)
- Miller is Chairman of CapAnalysis (an affiliate of Howrey Simon Arnold & White). He also serves as a Distinguished Fellow with the Center for Study of Public Choice at George Mason University and as a Senior Fellow of the Hoover Institution at Stanford University. He serves on a number of Boards of Directors including the Boards of Washington Mutual

Investors Fund, Atlantic Coast Airlines, The Tax Exempt Fund of Maryland and Virginia, J.P. Morgan Value Opportunities Fund, and the Recipro Corporation. Previously, he served as Director of the Office of Management and Budget (1985-88), Vice Chairman of the Administrative Conference of the United States (1987-88), Chairman of the U.S. Federal Trade Commission (1981-85), and Administrator of the Office of Information and Regulatory Affairs (1981). He holds a B.B.A. in Economics from the University of Georgia and a Ph.D. in Economics from the University of Virginia. (*Senate Governmental Affairs Committee press release, 4/1/03*)

- Miller succeeds Einar Dyhrkopp, whose term expired in December. The board consists of nine presidential appointees plus the postmaster general and deputy postmaster general. (*DM News, 4/24/03*)

Postal Commentator Cary Baer cautions the President's Commission on Postal Reform about standardization

- Cary Baer, a direct marketing consultant and past Chairman of the Association for Postal Commerce (Postcom), wrote a commentary in *DM News* cautioning the President's Commission on Postal Reform about standardization. Baer noted that the Commission "seems to have locked onto...standardization." Baer cautioned, however, "Who could be against rational standardization? Well, many are, depending on how you define 'rational.' What seems logical as today's standard may become very restrictive as new techniques in direct mail marketing are developed." Baer added, "Standards are fine, but USPS engineers alone cannot set standards. Current and future technological capabilities must be considered. But also important are industry costs and capabilities. The mailing community must be at least an equal partner in setting standards." (*DM News, Commentary by Cary Baer, 4/29/03*)

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