

# The **GSE** REPORT™

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## **Major Events**

Two year old, recently publicized Fed report says Fed reluctant to invest in Fannie/Freddie MBS issues

- The Federal Reserve thinks mortgage-backed securities (MBS) issued by Fannie Mae and Freddie Mac are considered to be “of high credit quality” but still, the central bank does not want to invest much of its money there. A recently released, two-year old study by the Fed shows Federal Reserve chairman Alan Greenspan and his staff are concerned that if the Fed starts loading up on GSE debt and MBS, it would have the impact of “inappropriately” fostering Fannie and Freddie’s ability to expand their operations. “This expansion could further affect credit allocation and increase systemic risk,” according to the Fed’s report, noting that on September 30, 2000, the GSEs along with Ginnie Mae, had outstanding debt of \$1.575 trillion (compared to the federal government’s outstanding debt today of \$6 trillion, which is increasing).
- The Fed’s report for the first time highlights why the Fed would be reluctant to buy the debt of the government-sponsored enterprises in its “Alternative Instruments for Open Market and Discount Window Operations”:

some market participants appear to believe that the U.S. government would not allow the GSEs to fail; that is, they perceive a strong implicit guarantee. The triple-A ratings assigned by Moody’s Investors Service and Standard and Poor’s reflect the perception of this implicit guarantee. The effective subsidy to the operations of the GSEs that results from the perception of an implicit government guarantee likely affects credit allocation among sectors of the economy. In addition, the implicit subsidy no doubt has supported the GSE’s large scale of operations, which, in turn, may be seen as posing a significant systemic risk. The System’s outright purchase of GSE obligations (or even its continued use of these obligations in repurchase agreements) could enhance the liquidity of GSE obligations and thereby inappropriately foster the ability of the GSEs to expand their operations; this expansion could further affect credit allocation and increase systemic risk.

- In the event Treasuries end up in short supply, the report doesn’t rule out the use of Fannie or Freddie securities which like Treasuries are widely and easily traded and regularly issued in numerous maturities, but suggests they be “limited” and only within a diverse portfolio. Freddie Mac spokesperson David Palombi noted the report was produced for an “economic climate that no longer exists” and that it did not represent official Fed policy. A spokeswoman for Fannie Mae declined to comment. Palombi said Freddie Mac operates with “rock solid financial safety” and is subject to “rigorous governmental oversight and substantial capital requirements.”
- The study was released before the Christmas holiday, but was authored two years ago when

the Fed was concerned there might not be enough Treasury instruments around for it to purchase. With a soft economy and the federal government running deficits which will require the issuance of more Treasuries to finance, the point is moot. It is not clear why the report was issued two years after internal circulation within the Fed. (*National Mortgage News Daily*, Paul Muolo, 12/28/02 and the *Wall Street Journal*, Greg Ip, 12/23/02)

OFHEO's first risk-based standards report suggests  
Fannie Mae more prone to risk than Freddie Mac

- Freddie Mac is better situated to withstand severe economic shock than its larger cousin, Fannie Mae, according to a new capital standard recently put into effect by the companies' federal regulator, the Office of Federal Housing Enterprise Oversight, although both companies meet minimum risk-based capital requirements as of September 30th.
- Freddie Mac's capital exceeded its minimum requirement by a much larger margin than Fannie Mae. Freddie Mac had total capital of \$23.1 billion, some \$18.2 billion more than required by the standard. Fannie Mae had \$27.3 billion or \$5.8 billion more than required by the standard of \$21.44 billion. The results support the common notion that Freddie is currently a more conservative manager of risk than Fannie Mae.
- The standard was mandated by Congress in 1992 under the Federal Housing Enterprises Financial Safety and Soundness Act of that year, to periodically test whether the two GSEs can survive a sudden shift in interest rates and a severe housing market recession over a 10-year period (or if home prices were to drop the most they've ever fallen anywhere in the country for any 10-year period in the past 20 years). The risk-based standard, which took years to develop, utilizes data about interest rates, housing market conditions and the companies' hedging strategies, among other indicators, to determine how much capital each company should hold to meet its obligations in any emergency.
- Fannie rattled the bond market last September when it announced its duration gap had swung outside preferred parameters while Freddie's duration gap remained well within those parameters. Goldman Sachs analyst Howard Shapiro noted, "It's possible to conclude that Fannie Mae may manage its interest-rate risk somewhat more stringently in the future" after receiving criticism for its strategies." Bert Ely, a financial services consultant in Alexandria, Virginia, criticized the risk-based test for taking only a "snapshot" on the last day of each quarter, instead of measuring stress throughout the quarter, but noted that Freddie is more conservative in how it hedges risk. Congressman Richard Baker (R-LA) criticized the integrity of the test after OFHEO made changes to a preliminary version that allowed Fannie Mae to turn a capital deficit into a surplus. OFHEO and Fannie rebutted that the company wasn't expected to follow the guidelines of a preliminary test.
- OFHEO also released results of a second, "minimum capital" standard set by Congress in 1992 as another, less complex, measurement method. Under this standard, to which Fannie and Freddie must conform, Fannie and Freddie must hold a certain percentage of capital

related to the size of their assets and their off-balance sheet obligations. As of September 30<sup>th</sup>, Freddie exceeded its minimum capital requirement by \$2.1 billion, Fannie Mae by \$729 million. Fannie Mae's senior vice president, Arne Christenson said, "the results announced today demonstrate that even in the demanding environment of late September, both [companies] managed their risks so effectively that they could pass a stress test" considered by many to be stringent, adding, "It is unclear whether any bank or thrift in America today could meet such a test."

- Critics, including industry rivals, members of Congress and conservative political commentators have said that the companies, with multibillion-dollar lines of credit to the Treasury, use the advantage of their government charters to increase the size of their borrowings to levels posing risks to the financial system and taxpayers if they fail. The companies have the ability to require Treasury to buy up to \$2.25 billion of their debt, which investors have said suggests the government would take measures to prop them up in difficult financial times. They also charge that OFHEO has been a weak regulator.
- Fannie Mae shares declined 46 cents to \$64.74 on New York Stock exchange composite trading on December 30<sup>th</sup>, while Freddie Mac rose 11 cents to \$58.93, and are down 9.9% in 2002. (*Wall Street Journal*, Patrick Barta, 12/31/02, *The Washington Post*, Al Yoon, 12/31/02, *Reuters*, 12/31/02, *BNA*, Karen Werner, 12/31/02, *The American Banker*, Michele Heller, 12/31/02), *Bloomberg News*, Al Yoon, 12/31/02 and *Dow Jones Newswire*, Dawn Kopecki, 12/30/02)

Rep. Baker writes OFHEO questioning test results on Fannie/Freddie risk measurement
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- Congressman Richard Baker (R-LA), chair of the House Banking Committee's Financial Services Subcommittee, with oversight over Fannie and Freddie, wrote to Armando Falcon, the Director of the Office of Federal Housing Enterprise Oversight, urging the OFHEO to require the two GSEs to disclose their comparable interest rate risk. Baker said, "These disclosures would be informative not only for the public and investors, but also for the enterprises themselves. I urge OFHEO to implement such a uniform standard in the near future and to ensure disclosures are made in an accurate, consistent, and timely manner." The Louisiana Congressman, noting that OFHEO announced that Fannie and Freddie were adequately capitalized as of September 30, '02, but that "...OFHEO's results showed sizeable differences between Fannie Mae and Freddie Mac, in the amount by which each enterprise's total capital exceeded it." Both companies were considered buffered to survive a housing price collapse or sharp interest rate swing, but Freddie Mac's cushion was more ample than Fannie's. Baker questioned OFHEO's reliance on Fannie and Freddie to determine how they calculate and report duration gap and other measures of interest rate risk exposure, which OFHEO uses to test quarterly the capital strength of the GSEs. (*American Banker*, Michele Heller, 1/9/03 and *Reuters*, 1/8/03)

## Federal Housing Finance Board Shared Funding Program Continues to Generate Controversy

- The Federal Housing Finance Board's recent approval of a Chicago Federal Home Loan Bank's secondary market program continues to generate controversy among some FHLBank members and some members of Congress. America's Community Bankers is demanding that the Finance Board and the Chicago FHLBank provide more information about the Shared Funding Program (SFP) approved in early December, which will allow the Chicago FHLBank to buy and sell member-issued mortgage-backed securities. ACB in a December 20 letter says, "To date, very little information has been provided about how the SFP will be structured, how it will operate, or how it may impact either in a positive or negative manner the individual FHLBanks or the System's risk profile." Trade groups such as the Financial Services Roundtable, Consumer Bankers Association and the Consumer Mortgage Coalition have praised Finance Board chairman John Korsmo for approving the Shared Funding Program, and ACB notes the SFP may increase competition in the secondary market and lower mortgage financing costs, while arguing that "its risks should be appropriately disclosed to the FHLBanks and their members."
- Congressman Ed Royce (R-CA) expressed concerns that the SFP may eventually lead to the FHLBanks issuing mortgage-backed securities (MBS): "I have concerns with the impact this ruling could have on moving the FHLBank system closer to issuing mortgage-backed securities, a practice which I currently believe falls outside of the FHLBank charter."
- The Finance Board heard from outgoing Senate Banking Committee Chairman Paul Sarbanes (D-MD), (who will become the ranking member on the Committee in January when Congress reconvenes) who pointed out that Congress gave the other GSEs, Fannie Mae and Freddie Mac, specific authority to issue MBS, but not the FHLBanks, saying "It is clear that Congress did not intend the FHLBanks to engage in securitization of mortgages." In response, Carter Wood, agency spokesman for the Finance Board, said that the Board was not working on a proposal to allow the FHLBanks to issue MBS, saying there is no such proposal anywhere, but acknowledging that the new program has "muddied the waters" but it does not allow the Chicago bank to issue MBS.
- At a December 20<sup>th</sup> Finance Board meeting, Alan Mendelowitz called the staff's approval of Chicago's SFP application "inappropriate" because it lacked the board's review. Chairman Korsmo noted that the shared funding program application was consistent with the Finance Board's regulation for staff approval, but he agreed to consider amendments to the agency's rules that would allow for board review of future applications. (*National Mortgage News*, 12/30/02)
- On December 20, 2002, the Federal Housing Finance Board adopted a resolution eliciting information from the 12 Federal Home Loan Banks regarding the changing financial services industry and its effect on terms of membership in the banks, with the Board voting 4-1 to approve the resolution, and Director Franz Leichter voting no.

## Fannie's Vice Chair Gorelick to step down in July

- Jamie Gorelick, Fannie Mae's Vice Chairman, is leaving the agency in July it was announced on January 10<sup>th</sup>, to devote substantial time to the bipartisan national commission investigating the September 11, 2001 terrorist attacks and to pursue other interests. She will be succeeded by Timothy Howard, the chief financial officer who will be nominated to be elected to the Board of Directors at the annual meeting in May. Fannie chair Franklin Raines praised his vice chair, "Jamie Gorelick's leadership is a big reason why Fannie Mae is a great company that achieves its mission of bringing the American dream to all Americans," adding that her "...unwavering focus on our corporate responsibility has made Fannie Mae the market leader in serving minority and lower-income families, a model corporate citizen, and one of America's best places to work."
- Gorelick joined Fannie in May 1997 as Vice Chairman, a post in which she shared responsibility for the overall management of the firm, directed efforts to reach underserved markets and oversaw external relationships, legal and regulatory affairs. Gorelick decided, however, that "...fulfilling my duty to this [9/11] Commission is not compatible with the full-time commitment required of a Vice Chair of Fannie Mae." Gorelick has an extensive government service record, at the Justice Department, and as a former General Counsel at the Department of Defense, both under President Clinton, and as Assistant to the Secretary and Counselor to the Deputy Energy Secretary under President Jimmy Carter. She also serves on numerous corporate and nonprofit boards, including United Technologies Corporation; Schlumberger, Ltd., The John D. and Catherine T. MacArthur Foundation; Harvard College Board of Overseers; America's Promise and the National Park Foundation, as well as serving on the CIA's National Security Advisory Panel. Howard, Gorelick's successor, joined Fannie in 1982 and became Chief Financial Officer in 1990. He will be responsible for Fannie's mortgage portfolio business, corporate risk management, and corporate financial management. (*Fannie Mae press release, 1/10/03*)

## GATORS Technology powering new Freddie Mac Loan Prospector

- Pittsburgh-based General American Corporation (GAC), one of the country's leading technology providers to the real estate settlement services industry, announced the culmination of a 2-year collaboration with Freddie Mac, resulting in an innovative exchange and technology upgrade with a new vendor service offering in Freddie's Loan Prospector software. The upgrade offers mortgage processing and closing tools that utilize the internet to provide cheaper, more efficient access to third-party services needed to process, close and fund mortgage loans, with GAC's GATORS web-enabled software as a foundation.
- General American CEO Rich Snedden commented, "We are honored that Freddie Mac partnered with us to build this remarkable technology. It's exciting to be a contributor in perfecting this revolutionary vendor management system that will now allow lenders and settlement service providers alike to move orders, data and products more efficiently and at greatly reduced costs to consumers when compared to the process in place today." Snedden explains that the lending solutions offered in the new Loan Prospector technology will enable

mortgage lenders of all sizes to provide borrowers with a new level of benefits, including streamlined closing processes, reduced service times for title, appraisal and other settlement services; and real time status reports. It will also enable automated vendor selection based on past performance criteria—including service times, quality and costs. Originally selected by Freddie as an integral component, GATORS technology, according to Snedden, has the “scalability to handle millions of transactions annually,” rendering it a “great foundation” for the project.

- BCE Emergis, an e-commerce services company based in Quebec, Canada, acquired the on-line technology tools from Freddie and will manage their development, implementation and operation (see the December 20, 2002 *GSE Report* for additional information.) Gunnar Bergstrom, president of the e-lending solutions unit of BCE Emergis and a former Freddie Mac Vice President of Mortgage Technology Services, said, “Freddie selected GAC after careful consideration of all the technology platforms available in the market because they provided a great deal of flexibility to work with what the GSE identified as a wide variety of lenders’ needs. GATORS maintains the intelligence and technological wherewithal to manage both high-volume and high-service requirements at an affordable cost to both vendors and lenders.” The new exchange solutions will be accessible to the more than 10,000 mortgage lenders and brokers using Loan Prospector’s automated underwriting service. Development teams worked from Freddie and GAC worked closely for two years to customize GATORS and create the technology enhancements. GAC is continually perfecting its GATORS technology which provides the systemic infrastructure for the company’s real estate vendor management and service fulfillment business. GATORS technology seamlessly provides order management and production modules to build title insurance, closing and appraisal services to its three national processing centers. GAC services more than 4,000 customers, manages a network in excess of 10,000 independent vendors, and is recognized as a technology leader in the \$25 billion real estate settlement services market. (*Bloomberg.com / PR Newswire, 1/6/03*)

Freddie’s Loan Prospector a wake up call to vendor-management platforms
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- When Freddie announced the official commercial launch of LoanProspector.com, some vendor-management platforms realized it was time to enhance and refine the value of their platforms. The potential value of one-stop shopping is real and it would be a mistake to underestimate the long-term significance of the LoanProspector.com denouement. Fannie and Freddie are betting they can leverage their investor power to position themselves in the Internet world more effectively than can the major vendors. What remains to be seen is whether other vendor-management networks can provide transactional services that the GSEs do not.
- As Fannie and Freddie say goodbye to their value-added networks and tie them to the Internet versions of their LP and DU automated underwriting systems, the race will be on to keep the GSEs from taking one-stop shopping to a level where there are only two shops in the mortgage creation mall. Freddie’s Tricia McClung said, “The main driver for us is that Freddie Mac wants to be a buyer of electronic mortgages as the world of e-mortgages

unfolds...The vendor-services piece is a major stepping stone in that direction.”

- In October 2002, a million loans were processed through Loan Prospector, more than half of those via Loan Prospector on the Internet. As lenders and brokers are offered the ability to access vendor services using the same data they use to get an LLP decision, complete with the ability to check loan status in real time, the need to transact with vendors any other way will be reduced. Freddie’s new improved user interface better mimics the loan application, and the system provides two-way interfaces to the majority of Freddie’s existing vendor community. All existing LPI customers are being converted to LoanProspector.com and vendors that want to keep those customers will want to follow suit, barring any unlikely regulatory barriers. (*Mortgage Technology*, Scott Kersnar, January and February 2003)

## ***Fannie Mae and Freddie Mac***

New joint study urges HUD, FTC to evaluate credit scoring, including AU

- HUD and the Federal Trade Commission were urged to evaluate credit-scoring systems regularly, including AU systems. Home buyers could pay higher mortgage premiums because of inaccurate credit scores, according to a joint study by the Consumer Federation of America and the National Credit Reporting Association, “Credit Score Accuracy and Implications for Consumers” which reported that common discrepancies included omissions of revolving accounts in good standing and mortgage payments which were never late. The study also recommends creditors provide consumers with a free copy of their report showing the basis of an adverse decision and credits should quickly learn to reconsider a decision if inaccuracies are found. (*Housing Affairs Letter*, 12/20/02)

Fannie & Freddie donated \$4.2 million in soft money before the ban

Fannie Mae and Freddie Mac donated at least \$4.2 million in soft money during the last election cycle according to the Center for Responsive Politics. Freddie Mac gave more than twice as much as Fannie Mae, \$2.8 million versus \$1.33 million. Nationally, Freddie ranked seventh among all soft-money donors and Fannie Mae ranked 27<sup>th</sup>. American International Group, a member of FM Watch, donated \$1.57 million, ranking 22<sup>nd</sup>. Freddie Mac increased its soft money contributions by about 20% in the 2001-2002 cycle, while Fannie’s soft money donations increased by 12%, according to the Center’s data. Freddie chairman and chief executive Leland Brendsel donated \$30,000 to politicians and political causes in 2001-2002, and his counterpart at Fannie, Franklin Raines, donated \$9,000. New campaign finance laws that took effect in November limit soft-money donations by corporations. (*National Mortgage News Daily*, 1/3/03)

### Congress acts quickly to renew lapsed flood insurance

- With the National Flood Insurance Program having lapsed in its authorization, expiring on December 31, 2002, the 108<sup>th</sup> Congress' top priority was renewing the Federal Emergency Management Agency's authority to issue flood insurance policies. Without flood insurance, lenders are prohibited legally from originating mortgages in the more than 19,000 communities that are located at least partially in a flood plain. FEMA states that 90% of all natural disasters are flood-related and some 8 million households are at risk from flooding at any given moment. Fannie Mae and Freddie Mac announced they would continue to buy loans on properties in flood zones through the middle of January, and the Federal Housing Administration has said it will continue to insure loans on houses in susceptible areas, so there has been no disruption from the expired authorization. (*Chicago Tribune*, Lew Sichelman, 1/5/03)
- The House and Senate acted quickly to resolve the lapse, passing legislation in both houses by January 9<sup>th</sup>, renewing for one year the flood insurance program which had expired December 31<sup>st</sup>. The measure passed the Senate by voice vote, retroactively providing coverage until December 31, 2003. Legislators from both parties would like to overhaul the program later this year, which was originally established by a 1968 housing law. (*CQ Daily Monitor*, 1/10/03)

### Loan purchases by Fannie/Freddie show little impact on revitalization in Cleveland

- According to a research paper funded by the Department of Housing and Urban Development, loan purchases by Fannie Mae and Freddie Mac had very little effect on the revitalization of underserved neighborhoods in Cleveland during the 1990s. The market share of the two GSEs in Cleveland fluctuated around 10% from 1993 to 1999 and the study found it was mainly private lenders, some motivated by the Community Reinvestment Act requirements, who supported the boom in housing sales and prices. The HUD study has yet to be published, however, Frank Nothaft, Fannie's chief economist, said there are market reasons to explain why the GSEs' market share in underserved neighborhoods is low, including the fact that Fannie and Freddie purchase only a small percentage of subprime and FHA loans. Professor George Galster of Wayne State University remarked at a meeting of the American Economic Association in Washington in early January, "It is the non-GSE sector that is doing all the heavy lifting, not the GSEs." (*National Mortgage News*, 1/6/03)

### Formula change means Fannie/Freddie to get slightly higher loan limits in 2004

- In a December 27 Federal Register notice, the Federal Housing Finance Board announced that effective January 1, 2003, it would stop using geographical data as a weighting factor in its Monthly Interest Rate Survey, and instead, data would be weighted by lender type and size. Analysts suggest the methodology change shows the predominance of "national" mortgage lenders and the declining significance of regional factors in the mortgage market. The FHFB will now survey the largest lenders in each of three lender-type classes, with

existing savings and loans and mutual savings banks categories merged into a solitary category. The FHFB survey is used to calculate annual changes in loan limits used by Fannie and Freddie as well as the Federal Home Loan Banks in their purchases of individual loans. The methodological shift is anticipated to increase this year's average home price by roughly \$1700, meaning a 2004 GSE loan limit should be increased by the same amount. (*Federal Register*, 12/27/02)

#### New FHA loan limits kick in for new year

- The Department of Housing and Urban Development officially increased the limits on single-family mortgages insured by the Federal Housing Administration as of January 1<sup>st</sup>, when the new “floor” or basic mortgage limit, is \$154,896 while the maximum or “ceiling” in high-cost areas is \$280,749. The new FHA loan limits are based on the increase in the ceiling on conventional home loans that can be purchased or securitized by Freddie Mac, which rose 7.3% effective January 1<sup>st</sup>. The floor, which covers most of the nation's 3000 counties, is set at 48% of the Freddie Mac limit. The ceiling, applying to about 3 dozen high-cost markets, is 87% of the conforming loan limit or 95% of the median house price for the area, whichever is less. (*National Mortgage News Daily*, 1/3/03)

#### U.S. agencies outpace Treasuries

- Expectations that rising U.S. federal deficits will create a heavy Treasury debt burden spurred U.S. agency debt to outperform Treasuries securities on January 6<sup>th</sup>. Ten-year Fannie Mae notes due September 2012 yielded 49 basis points more than Treasuries late Monday, about 1.5 basis points less than late Friday. At last year's widest levels, these notes were quoted at a spread of around 77 basis points. Deutsche Bank expects “agencies to outperform Treasuries again in 2003 as we believe that swap spreads will continue to contract from current levels and a deteriorating fiscal picture should lead to increased Treasury issuance.” (*Reuters*, Lynn Adler, 1/6/03)

#### Delinquencies on Fannie/Freddie conventional loans fall in 3<sup>rd</sup> quarter

- The Mortgage Bankers Association reported that mortgage delinquency dropped in the 3<sup>rd</sup> quarter despite a frail economy, and the number of mortgages in foreclosure was unchanged. Delinquencies on conventional loans- those held or guaranteed by Fannie Mae and Freddie Mac- dropped 6 basis points from the previous quarter, to 3.14%. Delinquencies on FHA-insured mortgages dropped 19 basis points, as did VA loan delinquencies, to 7.81%. (*American Banker*, Tommy Fernandez, 1/8/03)

#### Mortgage bond prepayments rise in December suggesting longer refinancing wave

- So-called prepayments on mortgage bonds sold by Fannie and Freddie increased from November as the average 30-year mortgage rate ended the month at 5.93%, the lowest level in more than three decades. The constant prepayment rate on Fannie's 30-year 6.5% issues,

the biggest portion of outstanding mortgages, rose to 56.4% in December, according to the GSE. At that speed, 56.4% of the \$329 billion outstanding would be prepaid within a year. The rate of prepayment in Freddie Mac 30-year 6.5% issues was 57.2% in December, compared with 56.2% in November. The company's 7% mortgages were prepaid at a 61.5% rate, up from November's 61.4%. Demand for mortgages has reduced the premium on mortgage bonds. The current Fannie Mae 30-year mortgage bond yields 5.16%, 1.17 percentage points more than the 10-year Treasury note. The spread is the smallest since May. (*Bloomberg.com*, Al Yoon, 1/8/03)

#### Mortgage rates plummet to lowest level in nearly 4 decades

- Freddie Mac announced in its weekly nationwide survey of mortgage rates that rates fell to their lowest level in almost 4 decades, with the average rate on a 30-year fixed-rate mortgage declining to 5.85 percent in the week ending on January 3rd from 5.93% the previous week. The 30-year fixed rate mortgage of 5.93% was the lowest since the mortgage giant began tracking 30-year mortgage rates in 1971, surpassing the previous low record reported by Freddie Mac of 5.94% in mid-November. The 15-year fixed rate also hit a new low, falling to 5.24% from 5.32% the week of January 2<sup>nd</sup>, the lowest level since Freddie Mac began tracking 15 year rates in 1991. The average rate on 1-year adjustable rate mortgages rose to 4.06% from 4.01%. (Freddie began tracking ARMs rates in 1984)
- Calling it an "amazing year" for housing, Freddie Mac's chief economist Frank Nothaft said, "Just when we were sure mortgage rates couldn't possibly drop any lower, we were surprised yet again," attributing the decline to the "...possibility of military actions abroad, heightened terrorism alerts and an unexpected drop in consumer confidence." Nothaft predicted that 30-year rates would continue to hover around 6 percent for "at least another few months." (*The Washington Post*, 1/3/03 and *CBS MarketWatch.com*, Kristen Gerencher, 1/2/03. *Associated Press*, Jeannine Aversa, 12/27/02 and AP, Martin Crutsinger, 1/2/03)
- Freddie Mac also reported that last year's volume of refinancing meant that roughly \$80 billion was injected back into the U.S. economy, somewhat lower than 2001's \$84 billion. (*Reuters*, 1/2/03)

#### November new-home sales hit record; median price decline

- November's annual rate of single-family home sales was up from a revised pace of 1.011 million homes in October and beat a previous record of 1.053 million set in September. Economists had expected the rate to fall to 1 million. Part of the reason for the decline in the median price from \$167,300 in November from October's \$178,900, the biggest decline since July, is because sales rose in the Midwest, according to Fannie Mae's chief economist, David Berson. Sales surged in the Midwest 41.2% last month, but sales slumped in the more expensive Northeast. Next year, new home sales may total 938,000 which would be the second best year on record, according to forecasts by builders groups. The November sales increase shows the relentless strength of the housing market, according to John Shin, an economist at Lehman Brothers Inc., the third biggest underwriter of debt this year, including

issues from Fannie Mae. (*Bloomberg News*, 12/27/02)

Freddie's annual forecast sees rise in mortgage rates by year's end with 40% drop in refi's

- In Freddie's annual forecast, chief economist Frank Nothaft predicted mortgage rates should rise toward the end of the year as the economic recovery gained footing and with a possible return of confidence in other investments, but should average no more than 8.1% in 2003. He said mortgage writing is expected to drop by 20% in 2003 as the refinancing stampede slows, with home purchase mortgage originations expected to be at or above the 2002 level, but refinancing likely to fall about 40% this year. (*Reuters*, Mark Felsenthal, 1/7/03)

Another \$2 trillion year for mortgage industry predicted

- Fannie Mae's chief economist, David Berson, predicts \$2.03 trillion in production in 2003, compared to last year's \$2.5 trillion and \$2.06 trillion in 2001. Despite the expected decline in the refinancing market, Berson is optimistic that the purchase money market (loans used to buy new or existing homes) will stay red hot in 2003. The only negative forecast for the industry is that production could decline significantly in 2004, with Fannie Mae predicting \$1.45 trillion in residential production for 2004, a 28% decline from 2003 and a 42% plunge from 2002. Refinances are expected to fall to 27% of production in 2004 and 23% in 2005. Fannie also says rates should not go much higher than 6.5% in the new year.
- Berson also predicted that mortgage debt could rise by 8% this year compared to 11% in 2002 and 10% in 2001. In response to a press briefing question about "worst case" scenario of war with Iraq, he said oil could rise to \$70 or \$80 per barrel, cautioning, "It's a good thing mortgage lenders don't make loans backed by SUVs..." (*National Mortgage News Daily*, 1/5/03)
- A new study commissioned by the GSE-funded Homeownership Alliance and prepared by Mark Zandi, chief economist for the Economy.com., cautions that if mortgage rates hit 7%, the refi market will "evaporate." The study also says that if rates rise to 6.5% about 1/3 of borrowers will be eligible to refinance. Refis accounted for 63% of all loans funded through the first 9 months of 2002 and Zandi predicted \$170 billion worth of equity would be extracted during 2002. Zandi sees concern over the potential for heightened credit-risk posed by the increased mortgage debt loans of cash-out borrowers, yet sees refis as strong even with increasing rates in '03 thanks to growing popularity of ARMs. The Homeownership Alliance is managed by a former top aide to Senator John McCain (R-AZ) and is bankrolled by not only Fannie and Freddie but by other housing-mortgage related groups. (*Origination News*, Paul Muolo, January '03 and *Chicago Tribune*, Mark Felsenthal, 12/28/02)

### *Forbes* exposes “rate games,” references Fannie/Freddie

- In an article by Bernard Condon, *Forbes* magazine claims that banks have found a risky way to do business in giving a shot to their earnings by loading up on mortgage securities with juicy yields. These mortgage-backed securities bought by banks most often have been issued by Fannie Mae or Freddie Mac, which like Treasurys, have virtually no credit risk. However, unlike Treasurys, if interest rates climb, they get hammered; but if rates fall, they don't rise in value by a corresponding amount because the mortgages on which they are based can be paid off by the borrower at any time. The buyer of a mortgage security from Fannie Mae gets compensated for the built-in option by pocketing a rich yield—about 1.5 percentage points more than the yield on ten-year Treasurys. In economic terms, it's a fair trade, but the accounting is peculiar. The holder of the mortgage paper counts the whole yield as “income,” without allowing for the value of the option he is giving away.
- If rates turn around and go the other way, the modest profits on holding mortgage securities could turn into big losses. Thus Fannie drew much criticism last quarter for taking advantage of a regulatory change to write up \$135 billion of its mortgage securities. The move boosted shareholder equity 36% but the gain could vanish if rates rise. James Bianco of Bianco Research in Chicago says bankers are still making the mistake of thinking of mortgage-backed securities as “high-yield Treasury securities because they have no credit risk, but that over the past 20 years, “interest rate risk has buried more people than credit risk.” (*Forbes*, 12/23/02)

### Fourth quarter S&P expected earnings per share for Fannie, Freddie

- The Standard & Poor's 500 index expected earnings per share report for the 4<sup>th</sup> quarter of 2002 lists Fannie Mae (FNM) and Freddie Mac (FRE), with Fannie on 1/15 at 1.63 and Freddie on 1/22 at 1.28. Earnings estimates are provided by Thomson First Call. (*Bloomberg News*, 1/9/03)

## **Fannie Mae**

### More news on Michele Davis' appointment to Fannie Mae

- FM Watch chief Mike House has been known to say that when someone leaves government service to go work for Fannie Mae or Freddie Mac, they're going to Valhalla. (to those not familiar with Norse mythology, Valhalla or Walhalla was the martial paradise for Odin's slain heroes, to which the Valkyries brought their dead warriors). The newest Valhallaite is Michele Davis, assistant secretary for public affairs at Treasury and formerly with retired member Dick Arney, who served as House majority leader. (For additional information, please see the December 20, 2002 *GSE Report*). Ms. Davis was named vice president of regulatory policy at the GSE. *The Washington Times* also reported upon Davis' new post, describing the former Arney staffer as “silver tongued” and claiming Davis did not skip out because she knew that Treasury Secretary Paul O'Neill was going to be canned, but rather, held Fannie Mae off while she helped O'Neill with his heavy lifting. The article

acknowledged her hire was a smart move for Fannie: “A Republican with strong ties to the administration, Davis might help the organization’s effort to shake off demands from some fiscal conservatives to privatize.” (*National Mortgage News Daily*, 12/28/02 and *The Washington Times*, Robert Stacy McCain, 1/3/03)

*Fortune* names Fannie as one of 100 best companies at which to work

- Fortune magazine describes these companies as trying hard to do right by their staff, even in hard times. Employees ending up feeling like it’s more than just a place to work. Fannie Mae ranked 45<sup>th</sup> on the list of 100 best firms, followed by Procter & Gamble and Starbucks. The list is compiled using a survey of a random sample of employees from 269 candidate companies, with more than 1000 firms considered. Companies are asked to describe their HR policies and workplace culture and greater weight (2/3 of the total) of scoring relies on employee responses and the remainder on *Fortune*’s evaluation of the company’s benefits and practices. Fannie improved its standing from last year, when it ranked 79. It has 4,770 employees, 42% minority and 51% female, with 8% job growth (345 new employees in one year). Fannie’s training hours per year was 4; its entry-level salary is \$28,600; its professional salary is \$55,000 per year, and its 2001 revenues were \$50,803,000. Employees receive a “healthy day off” and a day of “home purchase leave.” A 100% forgivable home loan- worth up to \$33,000 in some markets- is part of the deal. (*Fortune*, 1/20/03 issue)

*Forbes*’ article sees subprime lending as a curse, cites Fannie

- Subprime lending is a curse afflicting an array of industries beyond credit cards, including wireless, autos and housing. The bull market of the ‘90s removed the word “risk” from lenders’ vocabularies since they had already saturated creditworthy borrowers with loans. In doing so, they descended to “subprime hell.” Next in the parade of subprime disasters is Fannie Mae, the Achilles’ heel of the strong housing market, i.e. the low-income and other high-risk borrowers that Fannie and other government-sponsored lenders are attracting with down payments of 3% or lower.
- The second recessionary dip, led by consumer retrenchment, seems to be unfolding. Mounting layoffs will eliminate those subprime house buyers with few other assets, then the whole housing sector will be jeopardized as their exit ripples through the move-up market. Homeowners in bankruptcy have swelled in numbers from 450,000 five years ago to 750,000, and 1.2% of mortgages are in foreclosure. Bankruptcy filings and mortgage delinquencies are moving up.
- Fannie is not risk-free; its required core capital is only 2.4% of on-balance-sheet assets. With its new PaymentPower program, borrowers can skip two payments every 12 months. But they’ll show up on the bad-loan list someday. Avoid stocks of subprime lenders. When nonpayments become a deluge, the subs will be underwater. (*Forbes*, Gary Shilling, 12/23/02)

#### Fannie urges its advertising firm to retrieve money paid to 19 congressional staffers

- Fannie's Austin, Texas-based GSD&M market research firm retained Maryland-based research firm OMR to test-market radio and print advertising promoting Fannie's image. In turn, OMR hired Congressional staffers last November to participate in the research, paying them \$200 for an hour's work. OMR sent the staffers letters raising the question of compliance with House and Senate ethics rules barring honorariums and asked them to return the money to OMR to be donated to charity. (*Housing Affairs Letter*, December 20, '02)

#### Fannie Mae to announce 2002 4<sup>th</sup> quarter earnings

- Tim Howard, chief financial officer for Fannie Mae, will hold a conference call on January 15<sup>th</sup> at 4:00 pm EST to report fourth quarter 2002 earnings results. The conference call will be webcast at [fanniemae.com](http://fanniemae.com) and remains available for 30 days after the call. (*Fannie Mae press release*, 1/7/03)

#### Fannie makes it onto Zacks Brokerage Firm buy list

- Fannie Mae, along with Capital One Financial Corporation, Viacom and Prudential Financial, Inc., made it onto the coveted Zacks.com Brokerage Firm Buy List portfolio, which includes just those stocks that currently appear on the core recommended lists of at least three of the top 15 brokerage firms. These stocks are considered to be among the best large cap stocks to own for the long term according to Wall Street experts. Fannie's prospects are bright because of continued low mortgage rates with many looking to buy housing in the coming months and the overall health of the mortgage business buoyed by the strong housing market.
- Fannie has continued to beat Wall Street's Earnings Per Share or EPS estimates in the three of the past four quarters. Recently Fannie Mae went through a new risk-based capital test designed to test whether the mortgage finance companies have enough capital to weather a protracted downturn in the U.S. economy and passed with flying colors and renewed confidence from analysts. Three of the top 15 brokerage houses have this company labeled as a core holding with as much as 50% upside. A synopsis of why these stocks are on the Brokerage Firm Buy list says about Fannie: "This might be a good time to get in before the eventual market recovery drives prices through the roof." (*Business Wire*, December 31, '02)

#### Morgan Stanley analyst touts Fannie stock

- Barron's describes Fannie as "once a must-own stock" but says it has become an object of passionate debate and deep perplexity, with attention centered on the health and stability of its enormous pool of home mortgages. Scaring Wall Street last fall with its wide duration gap, alarms sounded from several directions about Fannie's purportedly dangerous derivatives exposure. Analyst Ken Posner of Morgan Stanley regards this as an example of investors penalizing Fannie for its unusual level of openness about its balance sheet

condition, shared by its counterpart Freddie Mac but unheard-of among typical financial institutions.

- Posner's point, achieved through detailed calculations of how Fannie's mortgage portfolio behaves, is that investors are over-estimating the hit the company will take on its retained mortgage book. He also emphasizes Fannie's long experience in managing these risks. "If he's right, the stock is a steal at current prices." Since Posner made his case on January 4<sup>th</sup> (Friday), the stock edged 2% higher on the day to 67.83, up 2.63 on the week. The market, for now, remains unpersuaded. (*Barron's Online*, Michael Santoli, 1/6/03)

*National Law Journal* profiles Fannie's general counsel

- Ann Kappler, senior vice president and general counsel of Fannie Mae, was featured in the *National Law Journal* article, "Guarding Mortgage Turf." Kappler, a magna cum laude Dartmouth graduate and editor-in-chief of the law review at New York University School of Law, has been nearly four years as Fannie's top lawyer, supervising 105 lawyers and tracking major legal issues through membership on all key senior management committees. Kappler waves off criticism that Fannie Mae's SEC registration is simply an effort to ride out the post-Enron corporate accountability storm, noting that the stock registration is nearly irreversible and that Raines and CFO J. Timothy Howard are putting their signatures and careers on the line by personally certifying Fannie Mae's financial statements. She said Fannie strives to "stay ahead of the curve on transparency and disclosure."
- Kappler expressed "absolute confidence" in Fannie's automated underwriting system in face of the lawsuits alleging that Fannie's AU discriminates against minority loan applicants. Fannie's foes are cited as a coalition of banks, mortgage insurers, appraisers and other mortgage-industry groups who formed FM Watch, a lobbying and public relations campaign against the purportedly unfair, anticompetitive government benefits Fannie and Freddie derive. Kappler scoffs at FM Watch's claim to be a consumer watchdog, and states that the group is a guise for competitors hoping to displace Fannie and Freddie in the secondary mortgage market without assuming their commitment to affordable mortgages. Kappler dismisses as "baseless and belied by the facts" FM charges stemming from a March 2001 *Wall Street Journal* report that Fannie Mae had threatened CEOs with a loss of underwriting business if they remained active in FM Watch. (*National Law Journal*, William C. Smith, 12/12/02)

Fannie buys back \$1.009 billion of its debt

- Fannie announced it bought back \$1.009 billion from five outstanding debt issues maturing between 2010 and 2030, and said it would buy back as much as \$1.5 billion from seven targeted issues. Fannie has bought back a total of \$7.876 billion in seven repurchase operations in 2002. Fannie bought back the following reference debt:

-7.250% of January 15, 2010 for \$109 million  
-7.125% of June 15, 2010, for \$25 million

- 6.125% of March 15, 2012, for \$675 million
- 7.125% of January 15, 2030, for \$100 million
- 7.250% of May 15, 2030, for \$100 million

- Fannie did not buy back the 6.375% as of June 15, 2009 or the 6.625% of September 15, 2009, which were eligible for this operation. (*Reuters*, December 20, '02 and *Dow Jones Newswire*, 12/20/02)

#### Seniors attracted to reverse loans by low interest rates, including Fannie's Home Keeper

- A record number of senior citizens are signing up for reverse mortgages. Seniors hurt by the low interest generated by savings and rising health care costs are opting for reverse mortgages, a loan enabling a homeowner to convert home equity into monthly income, with no mortgage payments due during the life of the loan, which is repaid when the borrower moves out of the house. A record 13,049 reverse mortgages were made in the federal government's fiscal year 2002, up 63% over the last highest mark in 1999 of 7,982 reverse mortgages. The Fannie Mae Home Keeper loan is geared toward single seniors in their 80s who own an expensive property. About 95% of those who get mortgages opt for the Home Equity Conversion Mortgage loan which is federally insured because it works out to their advantage. Loan limits for reverse mortgages have been increased for calendar year 2003, with limits varying by geographic areas. The highest loan limits will increase to \$280,749 from \$261,609 in 2002. Reverse mortgages are an adjustable-rate loan, but the amount of money a senior gets each month does not change, instead the changing interest rate affects the outstanding balance of the loan. As long as the senior can pay the taxes and insurance on the property, the senior can live in the property as long as desired, even if the loan money is exhausted. (*Chicago Tribune*, 1/5/03)

#### Fannie invests in Broadway Financial

- Broadway Financial Corporation, the holding company of Broadway Federal Bank, announced that on December 30, 2002, Fannie Mae invested \$1 million into the company in return for non-voting Preferred Stock of Broadway Financial Corporation. The Preferred Stock will bear a non-cumulative dividend of 5% per annum. Broadway Federal Bank is a community-oriented savings bank, primarily originating residential mortgage loans and conducting funds acquisition in the geographic area known as Mid-City and South Los Angeles. At September 30, 2002, the bank met the capital requirements necessary to be deemed "well capitalized" for regulatory capital purposes. President and CEO Paul Hudson stated his appreciation with Fannie Mae's support of the bank's housing programs: "It also is a tangible statement that Fannie Mae supports the Bank's mission to profitably serve the financial needs of underserved communities." (*Business Wire*, 12/31/02)

### Fannie hosts international housing finance forum in Miami

- Fannie Mae will host its Series II symposium from January 27-29, “Securitization for Housing Finance,” to provide members of the housing finance communities from around the world with an understanding of the best practices developed in the U.S. housing finance system. The forum is a series of educational symposia focused on key housing finance subjects. Series II is being held at the Fontainebleu Hilton Resort in Miami, Florida, and will concentrate on the core concepts of mortgage securitization, including in-depth analysis of mortgage securities instruments; comprehensive review of structuring options and credit enhancement mechanisms; examination of the securitization transaction; and tools and techniques for valuation and pricing and hedging of mortgage securities. The event will offer simultaneous interpretation into Spanish because of the large presence of Latin American participants. In addition to symposia, Fannie Mae’s International Housing Finance Services Group (IHFS) provides advisory services across the housing finance spectrum to foreign governments and financial institutions, aiding countries in the process of expanding homeownership opportunities. (*Fannie Mae news release, 1/6/03*)

### Fannie kicks in \$25K for DC Mayor Anthony Williams’ inaugural

- Fannie Mae was among the largest donors to District of Columbia Mayor Williams’ inaugural festivities on January 3<sup>rd</sup>, along with Pepco Holdings Inc., Comcast Corp., and Chevy Chase Bank, with \$25,000 in contributions apiece. The D.C. Mayor was sworn in for his second term of office with inaugural events toned down to reflect the District’s economic realities and \$200,000 budgeted for three inaugural events, half of the mayor’s first inauguration costs. Procedures for raising private funds were modified in response to audits by the D.C. Inspector General that had been critical of the mayor’s previous fundraising activities and accordingly, all donations are recorded with the D.C. Office of Partnerships and Grants Development every quarter and posted on the office’s web site. (*Washington Post, Sylvia Moreno, 12/31/02*)

### Fannie chair on hand for Black Caucus swearing-in ceremony

- Franklin Raines was an invited participant to the Congressional Black Caucus’ ceremony to swear in its new leadership team on January 7<sup>th</sup> at the Hyatt Regency on Capitol Hill. Other notable guests included incoming House Democratic Majority Leader Nancy Pelosi, Caucus chairman Elijah Cummings (D-MD); Rep. Sheila Jackson-Lee (D-TX), 1<sup>st</sup> vice chairman, Rep. Corrine Brown (D-FL), 2<sup>nd</sup> vice chairman, and Patrick Swygert of Howard University. (*Federal News Service, Inc., 1/7/03*)

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](http://www.fanniemae.com/contact/partnership_offices.html)) 10/22/02)

#### Minneapolis Mayor Rybak joins Fannie, city officials to mark completion of RiverStation

- The Minneapolis Mayor joined with city officials, local housing partners, business and community leaders and Fannie Mae to announce completion of the final phase of RiverStation, a new affordable housing development comprised of 348 condominiums and townhouses located on the site of the former Burlington Northern rail yards north of the city’s downtown. Mayor Rybak said, “We are excited to see a development like this that allows moderate-income residents an opportunity to purchase homes on the river.” The \$65 million development, located on the riverfront, includes 18 different “DownTownHome” floor plans in an urban mix of flat-style and two-level townhomes with brick and stone exteriors, and priced from \$95,500 to \$270,000. The homes have private entrances and patios, underground parking and historic lighting and landscaping, and the complex is already 98% sold. The development was financed in part through an initial \$2.575 million equity investment to the developer, HunterGregory, from Fannie’s American Communities Fund, part of the \$2 trillion American Dream Commitment to increase home ownership rates and serve 18 million targeted families nationwide by the decade’s end. (*Fannie Mae press release*, 1/9/03)

## **Freddie Mac**

### Freddie tightens refinancing

- Beginning April 1, the Freddie Mac will raise fees charged to lenders on some cash-out refinance loans in which borrowers extract equity from a home while refinancing. The GSE will begin charging fees for some “special purpose” cash-out refinance loans previously excluded from fees, and reduce the amount of equity some borrowers can take out when they refinance but don’t use the firm’s AU system. (*Housing Affairs Letter*, 12/20/02)
- Of Freddie-Mac-owned loans refinanced during the 3<sup>rd</sup> quarter of 2002, approximately 45%

resulted in a new mortgage with a balance at least 5% higher than the original mortgage. In the 2<sup>nd</sup> quarter of the year, 66% of refinanced loans had higher loan amounts and in the 3<sup>rd</sup> quarter of 2001, 60% did. Frank Nothaft, chief economist for Freddie, said that while it appears that a larger percentage of borrowers in prior periods took cash out when they refinanced, it is not necessarily so. "As mortgage rates rise to slightly higher levels, we will see fewer refinances, but more of those refinances will be cash out, since most homeowners will no longer be able to get a lower mortgage rate by refinancing. Therefore the incentive to refinance becomes that of taking some of the equity out of housing to meet other needs." He explained further that, "The average loan-to-value ratios on refinance loans remains close to 70%, showing that the average family maintains a significant quantity of home equity after refinancing." Approximately 20% of refis during the 3<sup>rd</sup> quarter had a lower loan amount. The Freddie Mac study looks at loans on properties where the company has funded two successive loans on, but does not track the use of funds made available from refis. (*Origination News*, Vol. 12, No. 3, December, 2002)

#### Guam bankers ask Freddie to defer 3 months' mortgage payments

- The Guam Bankers Association is asking Freddie Mac to allow island homeowners to defer three months' worth of mortgage payments and add the deferred payments to the end of the loan. Guam homeowners have seen their funds depleted after super typhoon Pongsona devastated the island in early December and following an earlier typhoon in July. Jackie Marati, president of the bankers association, said Freddie's policy would permit a 3-month payment deferral program but the corporation requires that those deferred payments be added on to the succeeding twelve months, which would offer little relief to Guam homeowners hurt by the typhoons. Marati noted that a Freddie sanctioned payment deferral program will not hurt a borrower's credit record. The association hopes to hear back from Freddie shortly. Island homeowners whose mortgages were directly financed under a U.S. Department of Agriculture, Rural Development agency program can avail themselves of a blanket moratorium on scheduled payments not to exceed 180 days. Some 1500 to 1600 home loans on the island are financed directly under this program. (*Pacific Daily News*, Gaynor Dumatol Delano, 12/27/02)

#### Freddie, Lancaster City and County, PA housing authorities team on housing initiative

- Freddie announced on January 7, along with the Housing Authorities of Lancaster City and County, Waypoint Bank, Bank of Lancaster County, Tabor Community Services, Inc., Lancaster Housing Opportunity Partnership, a new 3-year initiative to enable low-income renters to become homeowners by turning their Section 8 federal housing vouchers into monthly payments on affordable home mortgages. Qualified families will be able to use federal Section 8 housing choice vouchers to begin building personal wealth in the form of home equity. Section 8 vouchers typically help lower-income families afford local rental housing. HUD adopted new rules in 2001 to encourage homeownership by allowing some voucher holders to use their federal rent subsidy to cover mortgage payments instead. Freddie Mac has committed to purchase mortgages made to qualified Section 8 voucher holders to help ensure a constant flow of mortgage credit that will help additional families

become homeowners. Mike Saib, Freddie's vice president of expanding markets, said, "By purchasing the mortgages Waypoint Bank and the Bank of Lancaster County will make to voucher holders under this exciting new initiative, Freddie Mac will enable many more hard working families to achieve the dream of homeownership and to stake their claim on America's future." Qualified borrowers under the program can finance a home with as little as 2% of the purchase price coming from their own personal resources. To qualify, the borrower must participate in the Housing Authorities Self-Sufficiency Program, have been employed for at least one year and earn at least \$10,300 per year, with an employment exception for the elderly or borrowers with disabilities. (*Bloomberg.com* or PRNewswire-First Call, 1/7/03)

## **Federal Home Loan Banks**

### Korsmo Affirms Finance Board's Authority to Address Multidistrict Memberships

- Chairman Korsmo's opening statement on the resolution contained these highlights:
  - "There is still a debate over the Finance Board's statutory authority to address the question of multidistrict memberships for institutions operating under a unitary thrift charter. Some people read one specific section of the law to say that the Board has no authority to deal with that issue. In fact, that's the way I read it myself. But in the opinion we received from Morrison and Foerster, the argument is made that the Finance Board not only has the authority, but indeed the affirmative obligation to address districts membership questions if by doing so the safety and soundness of the Federal Home Bank System is enhanced or if by failing to do so the safety and soundness of the Federal home Loan Bank System is jeopardized. When Congress created the System 70 years ago, it anticipated Home Loan Banks operating where their members' capital was located, and that meant right in their home districts. Now, many member banks to business literally across the nation, and that means their capital is not concentrated in any one region. This very important development requires a fresh look at single versus multidistrict memberships, and especially at the impact that limiting memberships might have on safety and soundness. Today's resolution is a preliminary step to encourage the Banks to think anew about these issues in a new context. Staff will complete research already under way into modernized membership options. The next step will be for the Finance Board to consider a proposed regulation for submission to the Banks, Bank members, affordable housing advocates, banking trade groups, and the public for comment. No later than the June 2003 meeting, I hope to present to the Board for approval again, if warranted, a final regulation to modernize membership terms." (*FHFB press release, 12/20/02*)

## ***Farm Credit System/Farmer Mac***

Analyst's study exposes obsolescence, problems with farm credit system, urges privatization

- In a new study by Bert Ely, sponsored by the American Bankers Association (ABA), Ely provides examples of what's wrong with the farm credit system, contending that the system and its constituent institutions have outlived their original mission, ignore what remains of their original purpose, and use government-subsidized lending to aid those who can afford private-sector lending. One example is a number of farm credit system institutions who participated in \$30 million worth of a \$499 million loan to an individual who wanted to buy 460,000 acres of timberland in Alabama, Tennessee, and Mississippi. The borrower was WorldCom CEO Bernie Ebbers; another example is a 50-acre wooded estate, with a fieldstone mansion, with little evidence of any farming activity, purchased with an \$840,000 first mortgage from a Farm Credit System lender. (*ABA Banking Journal*, 1/03)
- Ely, a specialist in deposit insurance and banking, was one of the first persons to predict publicly a taxpayer bailout of the FSLIC. He earned an MBA from Harvard Business School, and his Bachelor's degree in Economics from Case Western Reserve University. Currently, Ely writes the monthly Farm Credit Watch, distributed by the ABA and formerly was the chief financial officer of a public company, a consultant with Touche, Ross and Company, and before that, an auditor with Ernst and Ernst. In his latest report, he states that the farm credit system, created in 1916, and expanded in 1933, is trying to meet needs that no longer exist. Like any government bureaucracy facing obsolescence, the FCS has tried to reinvent itself, but has done so in a manner Congress never intended or foresaw.
- Ely sees the misguided reinvention of the FCS in three key ways:
  1. system-wide consolidation, with the FCS shrinking from more than 800 local lending organizations in 1984 to roughly 104% at present, with the shrinkage leading to perhaps as few as 20 organizations by 2010. He says, "The FCS has abandoned its mission as it consolidates into larger associations headquartered scores or hundreds of miles from the farmers and ranchers they serve." An accompanying restructuring has reduced system-wide income tax burden to such low levels that the system paid none at all in 2001.
  2. warped lending, with a growing portion of the FCS lending going to non agricultural or only quasi-agricultural purposes, loans to rural businesses or to the wealthy for the sake of "lifestyle lending" such as financing for estates and hunting preserves.
  3. faltering lending to "YBSs," that is, the FCS is not lending to young, beginning and small farmers despite its legal obligation to them.
    - Ely claims "empire building has led to mission abandonment and a focus on larger borrowers, at the expense of serving YBS farmers," despite the fact that

the latter mission was imposed by Congress in 1980. A GAO study in 2002 found a bit less than half of the system's lenders don't have a program in place for serving YBS farmers and ranchers. Ely's solution is to mandate making the estimated \$1 billion annually-subsidized FCS private, to erase its subsidized advantages over private-sector lenders like the banks. (The Farm Credit System: Reinvented and Mission Challenged, Bert Ely, 11/02)

#### Farm Credit System not helping the right people

- Congress bailed out the farm system in 1987, yet today, as the country's farmers and ranchers are aging, there is not a ready supply of young people to move into their place. The scarcity of young farmers and ranchers may be due to the fact that they find it difficult to get start-up financing. Congress imposed a commitment on the system in 1980 to serve young, beginning and small farmers. Each association in the system is required to "prepare a program for furnishing sound and constructive credit and related services to young, beginning, and small farmers and ranchers." The FCS is rapidly abandoning its mission to serve the credit-deprived to focus on lending to larger farming operations as well as for nonfarm purposes. Many of its associations are pursuing two types of lending that violate the spirit, if not the letter of the law, one category encompassing "farm-related" businesses and another, rural "lifestyle" lending. Many young and beginning farmers are also small farmers, hence they are being double and triple-counted in the FCS reporting system. It's doubtful the enterprise's genuine YBS lending increased dramatically from the end of '98 to the end of '01, since total lending to small farmers rose just 4.6% over that 3-year period. That increase accounted for just 5.2% of the increase in FCS loans and loan commitments to farmers and ranchers over that period. In other words, large farmers, those with yearly sales topping \$250,000, accounted for 98.4% of FCS loan growth from '98 to '01.
- The number of FCS associations could drop to 50 or fewer by the end of 2005 and to 20 or fewer by 2010 (there are slightly more than 100 today). Assets range from \$1 billion to approaching \$10 billion, and the typical FCS association will no longer be a local institution run by farmer-directors, but rather professional managers headquartered some distance from the markets they serve. Salaries of FCS presidents have grown along with the growth of FCS institutions, and for the first time in 2001, an FCS bank president made \$1 million, with salaries rising above the inflation rate.
- The system has evolved not to serve agriculture and farmers and ranchers, but wealthier and better-off rural residents with little connection to agriculture. Congress should engage, and the government should break up some of the mega-associations, turn down mergers and return the system to its roots. (*American Banker*, John Blanchfield, 12/27/02)

## Postal Service

### Philadelphia lawyer elected chairman of Postal Service's Board of Governors

- S. David Fineman, the managing partner at Fineman & Bach, P.C., a 30-lawyer firm in Philadelphia, was elected chairman of the Postal Service's Board of Governors, succeeding Robert F. Rider. Fineman became Vice Chairman in January 2001 and was re-elected in January 2002. He serves as chair of the Strategic Planning Committee. President Clinton appointed him a Governor to the USPS Board of Governors in May 1995 for a term expiring December 2003. Previously, Fineman served as special counsel to the Commonwealth of Pennsylvania's Secretary of Banking and the state's Insurance Commissioner. He was a member of the Industry Policy Advisory Committee, a CEO-level committee advising the U.S. Commerce Secretary and U.S. Trade Representative on international trade issues. Fineman earned his law degree from George Washington University and formerly lectured on business law at Temple University. (*USPS Press Release*, 1/9/03)

### Complaints spur Senate probe of IG

- Several former Postal Service auditors and investigators in a letter to Senator Chuck Grassley (R, IA), the new chair of the Senate Finance Committee, accused Inspector General Karla Corcoran of wasting agency dollars, employee intimidation, and operational inefficiency. (For more information see Dec. 20<sup>th</sup> *GSE Report*). Senator Grassley has a staff member investigating the charges. Grassley's spokeswoman said the Senator is not releasing the letter because of the large number of signatories and people mentioned in the text, in an effort to protect their privacy. But the spokeswoman said the sources of the letter are considering its release. Grassley's inquiry so far is internal and he has not contacted the GAO on the matter. Corcoran's office said she has not received any correspondence from the Senator's office on the accusations and defended her agency's policies: "We operate in a glass house, and there are no curtains. We therefore understand the need for full disclosure," adding, "When we have the facts at hand, we plan to respond openly and truthfully." (*The Federal Paper*, 1/6/03)

### USPS announces record \$1 billion profit in 1<sup>st</sup> quarter of its fiscal year

- The Postal Service announced that it recorded a \$1 billion profit in the first quarter of its fiscal year, topping expectations by \$200 million. Christmas mail volume over the busy 3-month period produced income to help balance slower periods. The agency's chief financial officer, Richard Strasser, Jr., said the post office had revenue of \$16.1 billion during the period covering September 7 to November 29<sup>th</sup>, \$300 million less than had been anticipated, but cost cutting and staff reductions lowered expenses by \$500 million. The post office had a net loss of \$1.35 billion last fiscal year but expects to end this year in the black due to cost cutting and the rate increase that went into effect last summer. Strasser projected the second quarter will be similar to the first, with revenue and volume lagging behind projections due to a slower economy, but that cost controls are expected to produce a net income at or above a

planned \$360 million for the quarter. (*Associated Press*, 1/7/03)

#### Postal Commission gets underway; panel meets with Postmaster General Potter

- On January 8<sup>th</sup>, the newly created 9-member presidential commission met with Postmaster General John Potter, who summed up the task at hand: “The key question is, how can we provide universal service to all Americans and still make it affordable in the face of potentially declining mail volume? That is the central public policy issue facing this commission.” Potter told the commission members that it had recently considered privatization and concluded no business would covet delivering just a few pieces of mail each day to each household and that parts of the USPS were commercially desirable but “there are some segments that no one in their right mind would want.” Privatization, he said, “. . . is inconsistent with the mandate of universal service.” UnderSecretary Peter Fisher told the panel that everything is on the table, including privatization, noting that government around the world have privatized large portions of their delivery mechanisms, but quickly added that the commission members must consider the agency’s public service role.
- The panel has until July 31 to devise its set of recommendations, unlike the Kappel Commission, which made a series of recommendations in 1968 laying the groundwork for the modern-day Postal Service, which had a year to complete its findings. In a given year, 1.7 million new addresses are added to the Postal Service’s delivery system, equalling 3400 new routes, creating the need to hire 4,800 new carriers and build 8 new delivery facilities to the tune of \$50 million each, according to the agency’s chief financial officer, Richard Strasser. Meanwhile, mail volume is declining, having dropped 5 billion pieces between 2000 and 2002, and the biggest concern is the drop in single-letter, first class mail from 54.3 billion pieces in 1998 to 49.3 billion in 2002. First class mail covers 66% of the agency’s fixed costs. The panel must also examine the postal service’s labor situation, which is roughly 80% of expenses; its large retirement and health care obligations as well as overall efficiency and the rate-setting process, which generally takes up to 18 months. (*National Journal’s Congress DailyAM*, 1/9/03 and *Reuters*, 1/8/03)
- The House passed legislation on January 8<sup>th</sup> to authorize the continuance of the national flood insurance program which provides \$26 billion in flood insurance coverage to U.S. homeowners. The House unanimously adopted the one-year extension and the Senate is expected to follow suit shortly. The reauthorization accidentally was neglected when Congress adjourned last November. (*National Journal’s CongressDailyAM*, 1/9/03)

#### Postal commission needs to set realistic goals

- A former director of the office of economics at the U.S. Postal Service, now an adjunct fellow with the Lexington Institute, Charles Guy, sees the newly appointed presidential commission on the postal service as enjoying a powerful opportunity to steer the service through its most critical period, and focus quickly beyond the rhetoric of prominent stakeholders, including the USPS itself. The true source of the USPS’ fiscal woes predates the tragic events of 9/11, of anthrax, slowing mail and a sluggish economy, and is the fact

that the postal service never accepted bottom-line financial achievement as its ultimate measure of success. The issue is clouded by the “break-even requirement of the Postal Reorganization Act and the ease with which postage rates may be increased to allow financial solvency. However, declining mail volume following the frequent postage increases of the last six years may suggest this easy solution is no longer available.”

- Guy regards two essential management actions as intensifying the postal service’s financial distress:
  1. its failure to budget consistently for and achieve productivity increases made possible by its large capital investments, and
  2. a pricing strategy designed to spur mail volume growth, and hence revenue, by offering more postage discounts for large mailers. Postal management is unable to capture consistently the requisite cost savings, so this strategy has failed.
  
- Guy sees no simple solutions to the service’s financial problems but urges the commission to focus on the achievement of a few limited objectives:
  - Limit the business activities of the Postal Service to its core mission of providing mail service for traditional letters, periodicals and packages. USPS attempts to compete with private carriers of time-sensitive mail has been a major distraction of valuable management time and effort away from controlling total system costs.
  - Improve management incentives to achieve productivity increase needed to restrain the rise of postage rates for all mailers. Flaws of the postal service’s recently discarded economic-value-added reward system must be avoided. Financial rewards for management must be consistent with the performance of the overall system, including both in productivity and net income achievements. Management cannot be allowed to make changes to the performance measurement system solely to enhance their own awards, as was done with the economic-value-added rewards system.
  - Establish consistent and clear financial reporting, similar to quarterly reports provided by private sector companies to the SEC. The GAO has proposed this needed reform, and improvements and transparency are essential to a financially viable postal service.
  - Expand the power of the Postal Rate Commission to include subpoena power and enhance the oversight capacity of the Postal Service Board of Governors. The regulatory authorities of the Postal Service must never be denied timely and accurate information pertinent to the performance of the postal service. (*FederalTimes.com*, Charles Guy, 1/6/03)

Post office begins rate increase process

- The Postal Service is starting to seek a rate increase even as it waits for Congressional action that would make that step not necessary. The internal process for a rate increase is underway, postal vice president Azeezaly Jaffer confirmed, but the amount of the increase won't be determined until that analysis is completed. Last fall, a financial review revealed that the Postal Service had paid too much into a worker retirement program for those who joined the agency before 1983. Correcting that error would permit the post office to cut payments into the system by \$2.9 billion in 2003 and \$2.6 billion in 2004. Postmaster General Potter said that money could allow a delay in the rate increase until 2006. Reducing the payments, however, requires Congressional action and that has not yet happened. (*Associated Press*, 1/9/03)

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