

The **GSE** REPORT™

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Major Events

Federal Reserve Board Chairman Alan Greenspan says changing GSE oversight won't harm mortgage interest rates

Says GSEs should be handled like private corporations, with regard to the SEC

Comments about bank holding of GSE debt - Congressman Baker asks Fed to study the issue

Congressman Shays says Greenspan's comments "put holes" in Fannie & Freddie's arguments against registering their debt securities

CAGW applauds Greenspan

- Chairman Greenspan gave the following remarks when asked at a February 11 Senate Banking Committee hearing on the US economy to comment on whether additional regulation of GSEs such as Fannie and Freddie is necessary because investors act as if their debt is backed by the federal government:
 - "The major issue here is to what extent is the subsidy, which is implicit in the GSE debentures even though they are not legally an obligation of the United States government – they are not backed by the full faith and credit of the United States, it's the market that presumes that they will be bailed out – enables them to sell mortgages at a number of basis points below what the market would otherwise be. As a consequence of that, some of that does go into lower mortgage rates, but as best we can judge it's a very small number. So, I'm not at all convinced that many of the proposals really make all that much difference to the secondary mortgage market or to the level of mortgage rates to the American people." (*Bloomberg*, Michael McKee, 2/11/03)
 - "The SEC is already involved in the question of making judgments as to whether certain types of securities ought to be regulated or not regulated. These are private corporations and should be handled the way private corporations are handled, with regard to the SEC." (*Bloomberg*, Michael McKee, 2/11/03)
- Greenspan was responding to questions by Senator John Sununu (R-NH). Although Greenspan wouldn't comment on specific legislative or regulatory proposals, GSE critics took his comments as an endorsement of the Shays-Markey bill, which would remove Fannie and Freddie's SEC exemption. "To us [Greenspan's testimony] calls for the basic question as to why they are treated differently to begin with," said FM Watch Executive Director Mike House. (*Dow Jones Newswire*, Dawn Kopecki, 2/11/03)

Congressman Shays says Greenspan's comments "put holes" in GSEs' arguments against registering their debt securities

- **Congressman Chris Shays (R-CT) said Greenspan's comments "put holes" in the GSEs' arguments that registering their debt securities would raise mortgage interest rates. "To have all this be voluntary on the part of the GSEs is absurd," he told *MortgageWire*. Congressman Shays said he plans to re-introduce the bill he co-sponsored last year with Congressman Edward Markey (D-MA) that would remove Fannie and Freddie's exemption from SEC requirements and would subject Fannie and Freddie to the same disclosure requirements as all other publicly traded companies. (*National Mortgage News Daily*, 2/13/03)**

Greenspan's comments on bank holding of GSE debt

- Greenspan stated February 12 at a House Financial Services Committee hearing on monetary policy that there is no immediate need to limit the amount of GSE debt held by commercial banks. Institutional investors face restrictions on how much they can concentrate their portfolios in any one security. While national banks cannot hold more than 10% of their capital in the corporate bonds of any one issuer or lend unsecured more than 15% of their capital to any one borrower, there are no limits on the holdings of GSE debt. When asked by Capital Markets Subcommittee Chairman Richard Baker (R-LA) whether Congress should examine limiting such investments, Greenspan stated, "We are obviously aware of the issue that you're raising...anytime there is a concentration of anything, it gets our attention...the history of bank defaults and in fact defaults of other institutions has been too heavily peppered with institutions with concentrations of something...And the trouble is that you could never in advance list all of the things that people could get too much of in their balance sheets. So it's far better to leave it in general to the underlying process that we currently have, but it may be there are discussions within our staff which I am not aware of – and I would just like to quickly double check." (*Reuters*, 2/12/03; *House Financial Services Committee Q&A with Greenspan*, *CNNfn: Market Coverage*, *Federal Document Clearing House*, 2/12/03)
- Congressman Baker added, "Well, my question really went to the validity of a significant study on the matter because it appears that the number of institutions and the amount held per institution continues to go up because of the number of attractive alternatives for bank investment are fairly limited." Greenspan responded, "Oh, no, no. I think that is correct. But I was curious to know whether or not we, in fact, had done something internally which I had not seen yet." Greenspan promised to respond to further questions from Congressman Baker on the issue. (*Reuters*, 2/12/03(*Reuters*; *House Financial Services Committee Q&A with Greenspan*, *CNNfn: Market Coverage*, *Federal Document Clearing House*, 2/12/03)
- Also responding to question from Congressman Shays, Greenspan agreed that Fannie and Freddie should be treated the same as other private companies in general. (*Reuters*, 2/12/03)

Congressman Baker asks Fed to study bank holding of GSE debt

- Following up on Greenspan's testimony, Congressman Baker sent a letter February 13 asking Greenspan whether regulators should limit the amount of GSE debt banks can hold. "Banks,

savings associations and credit unions are not limited in their holdings of GSE debt, unlike corporate bonds, of the most highly rated issuer. While recognizing that attractive investment opportunities are limited, I am most concerned about the fact that many financial institutions have large concentrations of GSE debt investments relative to capital,” said Congressman Baker’s letter. (*Dow Jones Newswire*, Dawn Kopecki, 2/14/03; *Reuters*, 2/14/03; *American Banker*, Rob Garver, 2/18/03) The Congressman noted that a Fed report last year shows 36% of commercial banks held GSE debt in excess of 50% of their total capital. (*National Mortgage News*, 2/24/03)

- Congressman Baker was concerned that if interest rates rise too quickly, it would hurt the GSEs, and in turn, the entire banking system. Congressman Baker asked Greenspan to examine “the extent to which GSE debt is currently held by federally insured depository institutions and the growth of such holdings over the last five years.” He also asked Greenspan to examine the impact to the broader economy if one of the GSEs should fail, and whether there should be limits on the amount of GSE debt held by a commercial bank, thrift, or credit union. Congressman Baker also sent the letter to the Treasury Department, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and the National Credit Union Administration. A Fed spokesman said the Fed had received the letter and was preparing a response. (*Dow Jones Newswire*, Dawn Kopecki, 2/14/03; *Reuters*, 2/14/03; *American Banker*, Rob Garver, 2/18/03)
- **Congressman Baker’s request for the Fed to study the issue is “fact-finding” but he is “also trying to put some pieces together toward legislation,” said Congressman Baker’s spokesman Michael DiResto. If the Fed advises against limits, that item would not make it into the ‘legislative shopping cart,’ DiResto said. Other areas under consideration for inclusion in legislation include removing OFHEO from the appropriations process and increasing OFHEO’s “prompt corrective action powers,” two items that Congressman Baker has supported in the past, DiResto said.** (*Market News International*, Claudia Hirsch, 2/20/03)

CAGW applauds Greenspan

- Citizens Against Government Waste (CAGW) February 11 applauded Greenspan for his remarks regarding Fannie and Freddie. “Despite being publicly traded corporations, Fannie and Freddie are currently exempt from many federal securities laws, including those requiring open books,” CAGW Vice President Leslie Paige said. **“In an age of Enron and Arthur Andersen, these two companies, which are linked to the federal government and benefit from the perception of taxpayer backing, should have to abide by the same rules as their competitors.”** CAGW noted that although Greenspan wouldn’t comment on specific legislative or regulatory proposals, some observers took his comments as an endorsement of the Shays-Markey bill to improve GSE accountability.
- CAGW noted that Fannie and Freddie agreed in July to give up some of their federal perks and begin registering their common stock and filing financial disclosures with the SEC early this year. They additionally agreed this month to enhance their mortgage-backed securities disclosures as recommended in a report released last week by the SEC, Treasury Department

and OFHEO. However, Greenspan said the companies' effect on mortgage rates is negligible enough that any change or increase in their oversight wouldn't significantly impact mortgage rates or the secondary markets. The companies had vehemently fought increased SEC oversight saying it was a "tax on home ownership."

- **“Investors owe Chairman Greenspan and Sen. Sununu a debt of gratitude for advancing the cause of full financial disclosure,” Paige added. “The status quo is not good enough: If they won’t do it on their own, Congress must force Fannie and Freddie to be more transparent and accountable.”** (*PR Newswire*, 2/11/03)

SEC Chairman William Donaldson says GSEs should be “role models” for disclosures

- In a written response to a question submitted by Senator Chuck Hagel (R-NE) in connection with his nomination proceedings, SEC Chairman William Donaldson said the GSEs should be “role models” for disclosures. Senator Hagel asked if the FHLBanks need to be regulated by the both the Federal Housing Finance Board and the SEC. Donaldson said the FHLBanks, like other GSEs, publicly offer debt securities that aren’t backed by the full faith and credit of the US. “I support what I believe is the Commission’s view and the view of the Administration that government-sponsored enterprises should be role models for disclosure,” he said. “As such, I believe that they should comply with the ‘gold standard’ of disclosure – the disclosure requirements of federal securities laws,” he said. “Until further study, I’m not prepared to determine the exact manner in which that compliance should be achieved.”
- In a written response to a question submitted by Senator Jim Bunning (R-KY), Donaldson said the Tennessee Valley Authority (TVA) has expressed an interest in increased disclosures. “While TVA is an agency and authority of the United States, its debt is not backed by the full faith and credit of the United States,” he said. “It is my understanding that the commission staff has had preliminary discussions with TVA regarding potential means of meeting Commission disclosure standards, such as voluntary compliance or registration under the Exchange Act, and that TVA has expressed an interest in enhanced disclosure...I expect to work with the staff in this area and to support efforts that achieve improved disclosure.” Donaldson’s responses to these questions and others were made public February 11. (*Dow Jones Newswire*, John Connor, 2/11/03)

Treasury, OFHEO and SEC issue joint report recommending Fannie & Freddie provide more disclosures on their MBS

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Cong. Shays and Markey to re-introduce legislation to repeal Fannie & Freddie's exemption from SEC requirements - report underscores need for more information about Fannie & Freddie's finances

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FHLBanks reach tentative agreement on disclosing more financial information – Treasury not likely to accept

Treasury-OFHEO-SEC report

- The Treasury Department, OFHEO, and the SEC February 3 issued a joint report on disclosure practices in the mortgage-backed securities (MBS) market, which recommended that Fannie and Freddie provide additional pool-level disclosures on the MBS they sell to investors. **“The Task Force finds that, given the current state of the MBS market, enhanced disclosures by MBS issuers – particularly the GSEs that issue securities in these markets – would be both justified and feasible...”** The additional disclosures recommended include: loan purpose (i.e., whether a purchase or refinance); original loan-to-value (LTV) ratios; standardized credit scores of borrowers; servicer information; occupancy status (owner-occupied or investor); and property type (e.g., detached, condo). The report noted that these additional disclosures would benefit the MBS market, and found that the “benefits of enhanced transparency would ultimately outweigh any costs.” Additional

disclosures “could assist investors in their decision-making, improve efficiency, pricing and market confidence, and, insofar as it improves market quality and transparency, enhance safety and soundness.” In addition to the six disclosure recommendations, the report noted a number of other possible desirable disclosure enhancements that should be given consideration including: debt-to-income ratio, points paid, and level of documentation (e.g., high, medium, low). **A table included in Appendix B of the report compared the content of MBS disclosures provided by Fannie and Freddie to private-label issuers, finding Fannie and Freddie provide fewer disclosures than private-label issuers.** The report found no evidence to substantiate allegations that Fannie and Freddie were “cherry picking” the best loans by using non-public information for their respective portfolios.

- **The report noted that Fannie and Freddie had argued that additional disclosures could adversely affect the liquidity and efficiency in the TBA (to-be-announced) market.** Fannie and Freddie had raised this argument in the context of a bill (HR 4071) introduced in March of last year by Congressman Chris Shays (R-CT) and Edward Markey (D-MA) that would have removed Fannie and Freddie’s exemption from SEC requirements and would have subjected Fannie and Freddie to the same disclosure requirements as all other private-label issuers. **The report disagreed with Fannie and Freddie’s arguments and found “more persuasive the arguments of other investors and market participants who counter that any adverse effects from additional disclosure would be short-term, and ultimately would be outweighed by the benefits of greater information flowing into, and therefore more informed analysis of, the MBS market.”** Further, the Treasury, OFHEO, and the SEC will continue to monitor the MBS markets in general and “if future developments warrant,” they may consider additional steps to enhance Fannie and Freddie’s MBS disclosures. (*Treasury-OFHEO-SEC Staff Report: Enhancing Disclosure in the Mortgage-Backed Securities Markets*, 1/03) [A copy of the report can be found on the following Web sites: <http://www.ustreas.gov/press/releases/docs/disclosure.pdf>, <http://www.ofheo.gov/docs/press/mbsstudypr2303.pdf>, <http://www.sec.gov/news/studies/mortgagebacked.htm>]

Background:

- The report was the result of a voluntary financial disclosure agreement that was reached among Fannie, Freddie, the SEC, OFHEO, and Treasury last July, 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, (1933 Securities Act). Treasury, OFHEO, and SEC agreed at the time to conduct a joint report on MBS disclosure practices to promote a more level-playing field with respect to initial offering disclosures between GSEs and non-GSE MBS issuers. In July 16 testimony before the House Capital Markets Subcommittee 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, Fisher sent letters in August of last year to Sallie Mae and the 12 FHLBanks, urging them to comply with the same financial disclosure rules agreed to by Fannie and Freddie.

Fannie & Freddie pledge to voluntarily provide more disclosures on their MBS

- On the day the joint report was issued, Fannie and Freddie pledged to voluntarily increase their MBS disclosures and begin providing the six additional disclosures recommended by the joint report. Fannie announced that it will begin providing all six recommended disclosures monthly beginning in April, while Freddie will start in June. Fannie's information will show up in a mortgage bond deal's prospectus and Fannie will publish loan pool data from older deals on its Web site. Freddie will also publish its data on its Web site. (*Fannie press release, 2/3/03; Freddie press release, 2/3/03, 2/13/03; Reuters, Aleksandrs Rozens, 2/20/03*)

Cong. Shays and Markey to re-introduce GSE SEC legislation

- **Cong. Markey said the report “underscores the need to repeal the exemption from disclosure requirements of the federal securities laws that Fannie Mae and Freddie Mac currently receive, so that investors and the markets can obtain better and more detailed information about these securities...Representative Shays and I will soon be reintroducing the bill that we drafted in the last Congress to repeal these disclosure exemptions, and I’m hopeful that this new report will help us convince our colleagues of the benefits of adopting legislation.”** (*BNA Daily Report for Executives, Richard Cowden, 2/4/03*)

Cong. Shays says MBS report confirms that Fannie & Freddie’s MBS disclosures are “inadequate”

- **Congressman Shays issued the following statement: “The report confirms that Fannie and Freddie’s MBS disclosures are insufficient and makes a number of positive recommendations, but none of them will have the force of law because these two companies are exempt from the Securities Act of 1933.”**
- **“I continue to believe we shouldn't have a ‘separate but equal’ disclosure regime for Fannie and Freddie. There's only one way to create a truly level playing field between all MBS issuers and that is to repeal Fannie and Freddie's exemption from the securities laws and have them compete in the marketplace like everyone else.”** (*Cong. Shays press release, 2/3/03*)

Cong. Baker calls the report a “good step”

- **The report “reflects what we found in our hearing last year - that Fannie Mae and Freddie Mac disclose some information about their MBS but unlike others in the market, share little or no MBS-pool loan-level information. It makes sense that companies with ties to taxpayers’ pockets should disclose more, not less, than what purely private companies disclose, or at the very least be required to disclose the same amount,”** said Cong. Baker.

“These recommendations are a good step toward increasing investor protection and improving investor pricing, without diminishing Fannie and Freddie's fulfillment of their housing mission.”

“While I commend Fannie and Freddie for accepting these recommendations, I count on OFHEO, the SEC, and Treasury to help Congress ensure that investors receive these and other disclosures in a comparable fashion from both companies, and to demonstrate the same leadership on the equally important issue of strengthening GSE regulatory oversight as they have on improving GSE disclosures.” (*Cong. Baker press release as reported by Bloomberg News, 2/3/03*)

MBA applauds Fannie & Freddie’s move to provide more disclosures

- “The actions of Fannie Mae and Freddie Mac will improve prices in the MBS market, which will translate into more affordable credit rates for borrowers.” – John Courson, Mortgage Bankers Association of America (MBA)’s Chairman (*MBA press release, 2/4/03*)

Economists say Fannie & Freddie’s new disclosures don’t go far enough

- **The Shadow Financial Regulatory Committee, a group of publicly recognized independent experts on the financial services industry, released a statement regarding the registration of mortgage-backed securities of Fannie and Freddie at a February 24 press luncheon. The group noted that Fannie and Freddie’s voluntary disclosures for their MBS is “not as extensive as the information required of non-GSE private issuers of MBS.” While the Committee views this as “an important step forward,” it believes that “it does not go far enough” and that Congress should reconsider the Shays-Markey bill. “In opposing this bill [Shays-Markey], Fannie and Freddie argued that requiring them to register their MBS with the SEC – and to make the disclosures that registration would require – would disrupt the markets and raise interest rates. The task force report [Treasury, OFHEO, SEC joint report] rejects these arguments, and the GSEs now seem to have abandoned them. Therefore, the Committee believes that Congress should now proceed to reconsider the Shays-Markey bill.”** (*Shadow Financial Regulatory Committee statement No. 189, 2/24/03; Dow Jones Newswire, Dawn Kopecki, 2/24/03*)
- The Shadow Committee, an independent committee sponsored by AEI is comprised of the following prominent scholars: George Kaufman, CoChair, Loyola University, Chicago; Robert Litan, CoChair, Brookings Institution; George Benston, Emory University; Marshall Blume, University of Pennsylvania; Charles Calomiris, AEI and Columbia University; Franklin Edwards, Columbia University; Scott Harrington, University of South Carolina; Richard Herring, University of Pennsylvania; Paul Horvitz, University of Houston; Hal Scott, Harvard Law School; Kenneth Scott, Stanford University; and Peter Wallison, AEI.

AEI’s Resident Fellow Peter Wallison says Congress should reconsider the Shays-Markey bill

- **“The report casts substantial doubt on the arguments that Fannie and Freddie advanced against requiring them to register their MBS with the SEC,”** said Wallison. **Fannie and Freddie argued that it would disrupt the market, “but clearly the authors of the report were not impressed by this argument, and thus it should no longer dissuade Congress from proceeding with a new version” of the [Shays-Markey] bill...Registration of MBS would be the best way to assure that investors have the information they need to evaluate and price these securities properly.”** (*American*

Banker, Rob Garver, 2/4/03)

FM Watch praises report but will continue to push for legislation

- **“We agree with the Task Force’s conclusion that additional disclosures by the GSEs are both justified and feasible. It should be duly noted that the Task Force did not agree with the GSEs’ argument that additional disclosures would harm the TBA market. In fact, the Task Force actually supported investors by stating that additional disclosures would result in greater benefit to the MBS market. In addition, it is important to note that the report states that private issuers of MBS are generally doing a better job of disclosure than the GSEs. Ultimately, a truly level playing field can only come through the repeal of Fannie and Freddie’s securities law exemptions.”** – Mike House, Executive Director, FM Watch (*FM Watch press release, 2/3/03*)
- “Overall, what [the report] said was that [Fannie and Freddie] should disclose more,” House said. The report, as well as Fannie and Freddie’s new pledges to increase disclosures should be seen in the context of ongoing progress towards securing more disclosures, he said. “In a way this is a pretty big victory... We’re still going to be advocating for more transparency [from Fannie and Freddie], but you have to look at how far we’ve gotten, given where we started.” House said the report did not address all of FM Watch’s concerns but marked the beginning of a new phase focused on forcing the GSEs to increase their disclosures. “We would like to see [the administration] lay out their strategy for enforcement... That gets you back to Shays-Markey. We are going to have to have legislation.” (*BNA Daily Report for Executives, Richard Cowden, 2/4/03*)

GSEs’ disclosures not up to the level of information provided by private sector

- Andrew Davidson, President of Andrew Davidson & Co., Inc. said he welcomes any additional information provided by Fannie and Freddie, however, providing the information on a “pool-level” basis is not necessarily the best form of disclosure. The ideal form would be to get the loan-level information every month, which is currently available in the jumbo market. “I’m glad that this staff report came out and that the GSEs are responding to the request to provide more data,” said Davidson. “However, even more data would be welcome. This is still not bringing the agency MBS market up to the level of detail available to the non-agency market, and I would consider getting to that level a minimum goal. I hope that Fannie and Freddie would look to become proactive in trying to provide that type of information to the investor community.” (*Asset Securitization Report, Karen Sibayan & Sally Runyan, 2/10/03*)
- Some market players would like Fannie and Freddie to disclose even more financial information. “We believe that the additional data elements, which have been long included in non-agency (bond) prospectuses will improve the ability of investors to evaluate likely prepayments,” said Michael Youngblood, Director of Research at GMAC RFC Securities of Bethesda, MD. However, he said, “the additional data elements still fall short of information non-agency issuers routinely provide, including default and loss performance of loans, which can contribute significantly to changes in cash flows.” Having that level of data, Youngblood said, would be helpful because defaults and delinquencies in mortgage bonds show up as

prepayments. Therefore, it is difficult for investors to measure the impact of interest rates on a bond pool because they do not know which loans are prepaid because of refinancings and which are prepaid because of credit risk – defaults and delinquencies. (*Reuters*, Aleksandrs Rozens, 2/20/03)

FHLBanks reach tentative agreement on disclosing more financial information

- In two days of meetings in February, the presidents of the 12 FHLBanks reached a tentative agreement under which their institutions would comply with the Securities Exchange Act of 1934. The FHLBanks would offer to operate under an exclusion in the law that lets some commercial banks and thrifts issue stock without registering and filing their disclosures with the SEC. The majority of commercial banks that issue equity securities do so through holding companies, which are fully subject to SEC regulation. However a provision of the 1934 law allows banks that issue stock directly to abide by all the requirements of the law without coming under direct SEC supervision. Such institutions file SEC-like disclosures with their primary federal regulators instead, which are responsible for enforcement. The FHLBanks and FHFB Chairman John Korsmo have disagreed on how to address Treasury Undersecretary Peter Fisher’s request last year that all GSEs comply with the same financial disclosure rules agreed to by Fannie and Freddie. A Treasury Spokeswoman February 13 offered little hope that the administration will find the proposal acceptable. “Treasury advocates that all GSEs comply with the ’34 Act administered by the SEC,” she said. “This means disclosing to the SEC. Disclosing to the Federal Housing Finance Board is not the same thing.” (*American Banker*, Rob Garver, 2/14/03)

OFHEO issues proposed rule to implement the voluntary financial disclosure agreement that was reached among Fannie, Freddie, the SEC, OFHEO, and Treasury last July

- OFHEO issued a proposed rule on securities and financial disclosures for Fannie and Freddie, which expresses the authority of OFHEO regarding disclosure of financial information and provides support for the voluntary registration of common stock by Fannie and Freddie under the Securities Exchange Act of 1934. (*OFHEO press release*, 1/21/03) Comments on the proposed rule are due by March 24, 2003. OFHEO said it issued the proposed rule in part to facilitate the process of Fannie and Freddie’s voluntary registration under the Exchange Act. (*Federal Register*, pages 3194-3196, 1/23/03) The proposal outlines the disclosures that Fannie and Freddie will need to make to the SEC and asserts OFHEO’s authority over the GSEs’ financial disclosures but directs them to file the documents with the SEC. (*American Banker*, 2/13/03)

President Bush's FY 2004 budget warns that the large size of some GSEs is a "potential problem"

Proposes more funding for OFHEO and removing OFHEO from the appropriations process

Discusses limiting the size of Fannie & Freddie's retained mortgage portfolios

Reports that Fannie & Freddie lag the primary market in affordable housing

Encourages HUD to strengthen Fannie & Freddie's affordable housing goals

Questions whether FHLBanks are meeting their mission

Calls on TVA to halve its debt

More funding for OFHEO

- President Bush's FY 2004 budget, released on February 3, recommended a \$2 million increase in funding to OFHEO to \$32 million. The increase in funding would be paid by Fannie and Freddie through semi-annual assessments, and not by taxpayers. Fannie and Freddie provide the funds for their own regulation, but determining the level of funding has been subject to the congressional appropriations process. (*Budget of the United States Government, Fiscal Year 2004*)

Remove OFHEO from the appropriations process

- The Administration's FY 2004 budget recommended that OFHEO be removed from the appropriations process. The budget stated, "**In order to treat OFHEO similarly to other financial regulators, including the regulator of the Federal Home Loan Bank System, the Budget proposes legislation that would provide direct funding of OFHEO's activities with mandatory assessments on Fannie Mae and Freddie Mac.**" (*Budget of the United States Government, Fiscal Year 2004 - Appendix, p. 519*) The recommendation was also included in the Administration's FY 2003 budget, but was never acted upon.
- OFHEO Director Armando Falcon has repeatedly called for OFHEO to be removed from the appropriations process and given authority to control its own budget. OFHEO's recent systemic risk report on Fannie and Freddie also recommended that OFHEO be removed from the appropriations process. Other federal financial regulators, such as the OCC and OTS, are not subject to the appropriations process, and thus, simply collect their fees directly from the banks and thrifts they supervise.

GSEs, such as Fannie & Freddie, have a close relationship to the government

- The Administration continued with a lengthy discussion of the GSEs in the "Analytical Perspectives" section of its FY 2004 budget. The Administration explained, "neither the on-budget nor the off-budget totals include transactions of government-sponsored enterprises, such as Federal National Mortgage Association (Fannie Mae). Federal laws established these enterprises for public policy purposes, but they are privately owned and operated

corporations. **Because of their close relationship to the Government, the budget discusses them and reports their financial data in the Appendix to the budget and in some detailed tables.**” (*Analytical Perspectives, Budget of the United States Government, Fiscal Year 2004*, page 463) [Editorial Note: The Administration made similar statements in the FY 2002 and 2003 budgets. See April 13, 2001 and February 8, 2002 *GSE Reports* (www.gsereport.com) for more details.]

- The Administration noted that in 2002, the face value of GSE lending totaled \$3.6 trillion, noting that Fannie and Freddie had almost \$3 trillion in combined lending.

Face Value of Government-Sponsored Enterprise Lending (1)

(in billions of dollars)

GSE	Outstanding			
	1999*	2000**	2001	2002
Fannie Mae	1,141	1,231	1,460	1,689
Freddie Mac	838	913	1,101	1,254
Federal Home Loan Banks (2)	357	435	477	524
Farm Credit System	66	67	75	83
Total	2,402	2,646	3,113	3,550

(1) Net of purchases of federally guaranteed loans

(2) The lending by the FHLBanks measures their advances to member thrift and other financial institutions. In addition, their investment in private financial instruments at the end of 2002 was \$215 billion, including federally guaranteed securities, GSE securities, and money market instruments. (*Analytical Perspectives, Budget of the United States Government, Fiscal Year 2004*, page 215)

* Source: FY 2002 Budget

** Source: FY 2003 Budget

Large size of some GSEs could pose a potential problem

- The FY 2004 budget noted that uncertainties about the Federal Government’s liability have increased in some areas and that **“the large size of some GSEs” is a “potential problem.”** The budget noted, **“Financial trouble of a large GSE could cause strong repercussions in financial markets, affecting federally insured entities and economic activity.”** (*Analytical Perspectives, Budget of the United States Government, Fiscal Year 2004*, page 192) [Editorial Note: The Administration made a similar statement in the FY 2002 and 2003 budgets.]

GSEs not backed by the federal government but enjoy special privileges that create the impression that they are supported by the government

- “In return for serving social purposes, GSEs enjoy many privileges, which differ across GSEs. In general, GSEs can borrow from Treasury in amounts ranging up to \$4 billion at Treasury’s discretion, GSEs’ corporate earnings are exempt from state and local income taxation, GSE securities are exempt from SEC registration, and banks and thrifts are allowed

to hold GSE securities in unlimited amounts and use them to collateralize public deposits. These privileges leave many people the impression that their securities are risk-free. GSEs, however, are not part of the Federal government, and their securities are not federally guaranteed. By law, the GSEs' securities carry a disclaimer of any US obligation." (*Analytical Perspectives, Budget of the United States Government, Fiscal Year 2004*, page 189) [Editorial Note: The Administration made similar statements in the FY 2003 budget.]

Fannie & Freddie discussion in FY 2004 budget:

Fannie & Freddie receive special benefits, which give the perception that they are government supported – special benefits give the GSEs a funding advantage over private firms

- “Because they receive substantial advantages from the Federal Government, such as conditional access to up to \$2.25 billion of US Treasury borrowing and exemption from State and local income taxes, some perceive the Enterprises as having Government support – despite the fact that the Government explicitly does not guarantee their securities. As a result, they are able to fund their operations at lower cost than would other private firms with similar financial characteristics.” (*Analytical Perspectives, Budget of the United States Government, Fiscal Year 2004*, page 198)

Fannie & Freddie enjoy benefits from their GSE status, yet do not pass along all their benefits to consumers

- The budget cited the Congressional Budget Office's May 2001 report, which estimated that in 2000, Fannie and Freddie's annual GSE subsidy was \$10.6 billion. Of this amount, CBO estimated that borrowers received \$6.7 billion of the subsidy, while Fannie and Freddie retained about \$3.9 billion, or 37% of their subsidy for their shareholders. The budget added, “Subsequently, through September 2002, the Enterprises have increased their combined debt-funded retained portfolios by 29 percent and their off-balance sheet MBS by 34 percent.” (*Analytical Perspectives, Budget of the United States Government, Fiscal Year 2004*, page 198-199)

Limiting the size of Fannie & Freddie's retained mortgage portfolios discussed

- “The bulk of the Enterprises' profits reflect the rewards they earn for taking and managing risks. These risks mainly fall into two categories: Credit Risk and Interest rate risk.” In terms of interest rate risk, the risk arises from the mortgages and other assets that Fannie and Freddie hold in their portfolios. As of September 30, 2002, Fannie and Freddie held a combined \$797 billion of their own previously issued MBS, accounting for 62 percent of their combined mortgage asset portfolio. “Although holding substantially more securities rather than individual loans could facilitate the sale of portfolio assets should the Enterprises choose to liquidate these assets, some have proposed limiting the size of the Enterprises' retained portfolios for both MBS and individual loans. These proposals are based partly on a desire to minimize the Enterprises' exposure to possible losses that could result from substantial interest rate risk.” (*Analytical Perspectives, Budget of the United States Government, Fiscal Year 2004*, page 198)

Numerous studies say Fannie & Freddie lag the primary market in affordable housing

- “Numerous studies by HUD and other researchers have shown that Fannie Mae and Freddie Mac generally have trailed the rest of the private mortgage market in funding mortgage loans for low-income and minority families. For example, during the 1997-1999 period, HUD estimates that while the home loans acquired by these Enterprises represented 36 percent of all new home buyer purchases, they represented only 15 percent of homes purchased by first-time minority families.” (*Analytical Perspectives, Budget of the United States Government, Fiscal Year 2004*, page 199)

Encourages HUD to strengthen Fannie & Freddie’s affordable housing goals

- “HUD is also looking at new ways to encourage improved performance from the Enterprises. HUD’s current rule established the Enterprises’ housing goals for 2001-2003. In accordance with its rulemaking responsibilities, HUD is re-examining these housing goals to determine appropriate performance levels for the years 2004-2006. At the same time, HUD is looking at ways to create new housing goals incentives that will have the effect of increasing minority homeownership, thereby further ensuring that the benefits each Enterprise derives from its Congressional charter are used to increase minority homeownership opportunities.” (*Analytical Perspectives, Budget of the United States Government, Fiscal Year 2004*, page 199)
- Shortly after the budget was released, Fannie announced that for the ninth year it exceeded HUD’s affordable housing goals in 2002. Fannie announced that more than 51.6 percent of the company’s business served low- and moderate-income families; 32.7 percent served underserved areas and 21.3 percent served special affordable housing. (*Fannie press release, 2/6/03*)

Federal Home Loan Banks discussion in FY 2004 budget:

Moderate growth, yet net income falls

- The FHLBs experienced moderate growth in the past year, while their profitability declined slightly. Outstanding advances reached \$490.7 billion in September 2002, a 5.1 percent increase over the \$466.8 billion outstanding a year earlier. As of September 30, 2002, about 69 percent of advances had a remaining maturity of greater than one year- up from 64 percent one year earlier. Mortgage loans outstanding were \$47.1 billion, up from \$22.6 billion one year earlier. Mortgage loans accounted for approximately 6.2 percent of total FHLBs’ assets. The FHLBs reported net income of \$1.9 billion for the year ending September 30, 2002, down from \$2.1 billion in the previous 12 months. (*Analytical Perspectives, Budget of the United States Government, Fiscal Year 2004*, page 199)

FHLBank System issued \$4.6 trillion in debt in 2002

- “In 2002, the FHLBS issued \$4.6 trillion in debt securities, most of which represented the rollover of overnight or short-term debt. While the majority of the debt issued by the System

is overnight or short-term, 79 percent of debt outstanding had an original maturity of one year or longer. Total debt outstanding was about \$688 billion at the end of 2002.” (*Analytical Perspectives, Budget of the United States Government, Fiscal Year 2004*, pages 199)

FHLBanks’ purchase programs offer members an alternative way of doing business but also increase risk

- “FHLB advances, like secured loans from other creditors, could indirectly increase the Federal Government’s exposure to credit risk. As in the case with other financial intermediaries, FHLBs are potentially exposed to interest rate risk, which should be carefully managed. The System’s new investment activities, including mortgage purchase programs [such as the MPF program which offers lenders an alternative to selling their loans to Fannie and Freddie in the secondary mortgage market] involve more risk while offering new alternative ways of doing mortgage business.” (*Analytical Perspectives, Budget of the United States Government, Fiscal Year 2004*, pages 200)

Encourages all GSEs to voluntarily register their stock with the SEC

- The Administration last year “encouraged” all GSEs, including the FHLBs, to voluntarily register their equity securities with the SEC. The budget noted, “Unlike Fannie Mae and Freddie Mac, which have committed to participating in the disclosure process, the FHLBs have not yet decided to register their stock with the SEC.” (*Analytical Perspectives, Budget of the United States Government, Fiscal Year 2004*, pages 200)

Questions whether FHLBanks are meeting their mission

- “The FHLBs evolving member composition and investment activities raise questions about the degree to which the System continues to promote the public policy objective of providing liquidity to home mortgage lenders. As a result of opening membership to commercial banks and credit unions, for example, many member institutions now have very limited involvement in mortgage lending.”
- “In addition, like other GSEs, the FHLBs issue debt securities at close to US Treasury rates and invest the proceeds in higher-yielding securities. Through September 2002, the FHLBs’ investments other than advances rose to \$215 billion, compared with \$194 billion a year earlier. As a percentage of total assets, these investments may enable the FHLBs to provide benefits to member institutions, they do not necessarily result in lower costs to home buyers.” The budget cited a Congressional Budget Office study that found that of the \$3 billion annual subsidy the FHLBs receive, only \$0.3 billion was passed on the mortgage borrowers in the form of lower interest rates. (*Analytical Perspectives, Budget of the United States Government, Fiscal Year 2004*, pages 200)

Farm Credit System discussion in FY 2004 budget:

- The Administration noted that the financial condition of the Farm Credit System’s banks and associations during 2002 continued a 14-year trend of improving financial health and performance. (*Analytical Perspectives, Budget of the United States Government, Fiscal Year 2004*, page 205)

TVA discussion in FY 2004 budget:

- The Administration called on the Tennessee Valley Authority (TVA) to reduce its \$25.3 billion debt in half. TVA, which has a statutory debt limit of \$30 billion, also has \$865 million in lease/leaseback arrangements that aren't covered by the debt limit but carry as much risk as traditional debt and are recorded as liabilities on TVA's balance sheets. The FY 2004 budget called on TVA to reduce its debt to a "healthy debt level range" of \$13 to \$15 billion and to put in place reforms that will make TVA more competitive. In addition, the Administration proposed legislation to ensure that lease/leasebacks and other arrangements that are the equivalent of traditional debt financing are included under TVA's debt cap. At the current rate, the FY 2004 budget said it would take 25 years to get TVA's debt into the "healthy" debt range. In addition, it said that if the TVA carries out planned capital construction actions, it may actually increase rather than decrease its debt. "The administration is committed to identifying a TVA debt reduction target within the 'healthy' range, and having a plan by September 30, 2003, to reach the number in a reasonable period of time," the budget added. The budget said the TVA at present "is carrying excessive debt relative to its assets and is planning major investments before it has a strategic plan in place." (*Dow Jones Newswire*, John Connor, 2/3/03)
- TVA Chief Financial Officer David Smith said that if forced to implement the Administration's plan, TVA would be forced to increase its rates by as much as 18%. Just a week earlier, TVA announced plans for a proposed 8.1% rate hike on residential and commercial customers, its first rate hike since 1998. Senate Majority Leader Bill Frist (R-TN) said there was room for improvement at the TVA. "While there is concern about how to handle TVA's debt level, I believe TVA does need to continue to reduce debt each year in order to lower its cost and be more competitive in the future." Congressman John Duncan, Jr. (R-TN) said he is satisfied that TVA's current management is making progress in reducing its debt. He and Congressman Zach Wamp (R-TN) sent a letter last December to OMB Director Mitch Daniels in protest, when they heard about the Administration's plans for an extreme debt reduction schedule. Congressman Bart Gordon (D-TN) also criticized the Administration's proposal, "It smells to me like this could potentially be a backdoor of justifying some sort of privatization or selling the lakes... You wonder whether there's another motive here. You can't help it." (*Dow Jones Newswire*, 2/4/03; *Dow Jones Newswire*, Jennifer Morrow, 2/5/03)
- Columbus Light and Water Department Director Fred Hayslett said he would join utility officials across the region in opposing the Administration's proposed debt reduction plan for the TVA. Hayslett said an increase in rates would scare off business and slow the pace of development in the region. "It's detrimental to economic development," he said. Legislation is also pending in Congress to implement the debt reduction. The bill, which has the backing of Senator Trent Lott (R-MS), would require the TVA to create a 10-year plan to reduce its debt. Senator Lott introduced similar legislation last fall, but the bill died in Congress. If the debt isn't reduced, the bill would strip TVA of its ability to borrow money. (*Dow Jones Newswire*, 2/10/03)

Senate Banking Committee Chairman Richard Shelby says GSEs “should stand on their own”

- In a broad-based interview with *BNA* on February 13, Senator Shelby stated that the GSEs “have done a lot of good things and really helped homeownership,” appearing to support a strong regulatory approach as opposed to legislative reform. “But ultimately, I think the GSEs ought to stand on their own.” He said he had no “vendetta” against the GSEs and that they are being regulated more than ever before. “I think they ought to be run right, run solid, and on good financial footings,” he said. “They’re stronger than they were and they do some good, and I think you have to accept that as a positive thing.” (*BNA*, Adam Wasch, 2/14/03)

OFHEO releases systemic risk study of Fannie & Freddie

Odds of Fannie & Freddie failing and causing a financial crisis are “remote,” however, the GSEs have grown so large that if their financial health were to falter, it could disrupt the housing and financial system

Consequences of Fannie & Freddie’s failure is greater than in the past

OFHEO plans four regulatory actions and offers two legislative recommendations to increase its supervision of Fannie & Freddie’s systemic risk

Fannie & Freddie dismiss report

Fannie releases its own systemic risk study

Executive Summary:

- OFHEO released February 4, a 115 page report, “*Systemic Risk: Fannie Mae, Freddie Mac and the Role of OFHEO.*” OFHEO Director Armando Falcon released the report during a speech before the Bond Market Association. “Fannie Mae and Freddie Mac are in strong financial condition today, and the possibility of either Enterprise failing or contributing to a financial crisis is remote. OFHEO employs examinations, a stringent risk-based capital stress test, and other tools to reduce the possibility of systemic risk,” said Falcon. “However, in the unlikely situation that an Enterprise experienced severe financial difficulties, there could be disruptions to the housing market and financial system given their size and central role in the housing and financial markets.”
- The report suggested that it would be useful to look at the hypothetical possibility of systemic risk under two different situations. In the first case, Fannie and Freddie are strong and other parts of the financial system are destabilized. In the second, either Fannie or Freddie is itself experiencing difficulties. If Fannie and Freddie are financially strong during a stressful economic period they are a source of stability and their activities can protect mortgage lending and the housing sector. However, Fannie and Freddie have grown so large and have

such a central role in the housing and financial markets that if they experienced financial difficulties, it could disrupt the housing and financial markets. OFHEO believes, however, that any systemic disruptions would be minimal as OFHEO could take prompt corrective action and other market participants could fill the short-term market void.

- “The potential disruption from a systemic event involving Fannie Mae and Freddie Mac is much greater than it was a decade or two ago,” noted Falcon. Over the past ten years, the dollar volume of outstanding mortgages that Fannie and Freddie own or guarantee has tripled to more than \$3 trillion. As a share of all residential mortgage debts, that is about 45 percent, up from 32 percent a decade ago. In their principal business area - prime, conforming, conventional, fixed-rate, and single-family loans - their share is about 75 percent, up from perhaps 50 percent. “The consequences of an Enterprise's failure would be greater than in the past. The interdependencies between the Enterprises and the other participants in securities and derivatives markets are among the highest of all privately owned financial institutions.”
- OFHEO plans to undertake four regulatory actions and offered two legislative recommendations to increase its supervision of Fannie and Freddie’s systemic risk. OFHEO’s plans to undertake the following regulatory actions: (1) enhance OFHEO’s supervisory tools; (2) conduct additional research; (3) increase GSE transparency; and (4) clarify OFHEO’s conservatorship process. OFHEO recommended two legislative proposals: permanently funding OFHEO by removing OFHEO from the appropriations process and providing OFHEO with receivership authority. (OFHEO report: “*Systemic Risk: Fannie Mae, Freddie Mac and the Role of OFHEO*,” February 2003; *Statement of OFHEO Director Armando Falcon, Jr. before the Bond Market Association’s Eighth Annual Legal and Compliance Conference, 2/4/03*; *OFHEO press release, 2/4/03*) [The report may be found at the following Web site address: www.ofheo.gov/docs/reports/sysrisk.pdf]

Detailed summary

- The report has six chapters. Chapter 1 reviews the literature on systemic risk. Among other factors that contribute to systemic risk are high levels of interdependence among financial institutions, high leverage of the institutions, bubbles in asset prices, weak market discipline, and lax safety and soundness regulation. The chapter also reviews the ways that a shock can be transmitted from a failing institution to the larger financial system. The chapter concludes by suggesting that the various financial regulators, including OFHEO and the bank regulators, each have some information about the institutions they regulate, but that they should increase their collection of information relating to interdependencies among institutions and should consider sharing that information.
- Chapter 2 discusses the environment in which the GSEs operate, with special attention to interdependencies among the GSEs and other financial institutions. It discusses the laws and regulations that apply to Fannie Mae and Freddie Mac and presents data on the operations of the two GSEs. The report noted that the top ten originators of conventional loans sold nearly half of their originations to one of the two GSEs. Also, the largest lenders have arrangements to sell a large proportion – for several, over 50% -- of their loans to either Fannie or Freddie. The chapter also discusses the increase in borrowers’ average loan-to-value (LTV) ratios,

which are lower than in the mid-1990s, but higher than they were a decade ago. GSE purchases of multifamily mortgages have increased from 11 percent of multifamily mortgages in 1990 to about 60 percent in 2001. That year the GSEs purchased over \$28 billion of multifamily mortgages. Altogether, the combined book of business of the two GSEs exceeded 43 percent of outstanding residential mortgage debt at the end of 2001.

- The chapter contains many other statistics, on the growth of GSE debt and MBSs and on derivatives. In mid-2001 the combined notional amount of the Enterprises' interest rate derivatives comprised more than 7.5 percent of OTC single-currency, dollar-denominated interest rate derivatives of all end-users. As a share of the notional amounts of end-user financial institutions—a relevant universe of comparable entities—the combined contracts of Fannie Mae and Freddie Mac constituted 10.5 percent of the market. The report does note that, “Fannie Mae and Freddie Mac are subject to an erosion of their liquidity in derivatives markets.” At year-end 2001, five counterparties accounted for almost 60 percent of the total notional amount of Fannie's OTC derivatives, and 58 percent of Freddie's.
- The report provided information about bank holdings of GSE obligations, estimating that more than 30 percent of commercial banks with assets above \$1 billion hold debt of Fannie or Freddie exceeding 10 percent of their equity. OFHEO's analysis indicates that banks whose holdings of Enterprise debt represent a substantial share of equity appear generally to be institutions with less than \$1 billion assets.
- The chapter concludes that, “The Enterprises are so large that the direct interdependencies between them and other participants in securities and derivatives markets may exceed those of any other privately owned financial institutions. The magnitude of those interdependencies implies that, if either Enterprise became insolvent or illiquid, investors in its debt and, potentially, its derivatives counterparties could incur losses. Fannie Mae and Freddie Mac are themselves vulnerable to conditions in the market for OTC interest rate derivatives.”
- Chapter 3 looks at economic effects of Fannie and Freddie's activities. It examines the extent that the GSEs lower mortgage rates and suggests that some of the spread between conforming and jumbo mortgages may be due to factors other than the GSEs' purchase of conforming mortgages, such as differences in the credit and prepayment risks of the loans and fixed costs (such as settlement fees as a percent of the mortgage amount). The chapter also raises the prospect that the two GSEs operate pro-cyclically, i.e., that they could contribute to bubbles in housing prices. Also, while the GSEs do contribute to homeownership, there are arguments that those effects may be modest. The GSEs' dominant position in housing, however, means that any shock that caused a sudden large disruption or cessation of GSE mortgage purchases could cause mortgage rates to rise and housing starts to decline.
- Chapter 4 looks at ways to assess systemic risk. Current econometric models and data and other quantitative techniques are inadequate for trying to measure the possibilities of systemic risk actually materializing. An imperfect but more useful approach is scenario analysis to analyze potential effects on systemic risk of particular institutions or markets. The chapter

begins by stating that the two GSEs are highly profitable and financially strong. However, every firm, even one that is consistently highly profitable, has some probability of failure.

- The chapter presents three scenarios. The first scenario is benign. In a period of reduced liquidity the GSEs help to mitigate systemic risk. The second scenario posits that one enterprise develops serious solvency problems but remains liquid. There are few adverse economic effects of this scenario and no systemic event occurs. OFHEO plays a significant role in addressing the solvency problems of the significantly undercapitalized enterprise. In the third scenario one enterprise suffers large losses and a systemic event results. The scenario could unfold in different ways, depending on (1) how government and the markets respond to the sell-off in the markets for the failed enterprise's obligations and (2) the financial health of the other enterprise. As this scenario plays out, the importance of the linkages described in the earlier chapters becomes clear. Investors, including commercial banks, and derivative counterparties take losses as the shock is transmitted from the failed GSE. In the short run, the Federal Reserve would bear a heavy burden of deciding on an appropriate response. It would be concerned about the risk that the GSE's condition would deteriorate further, the precedent that would be created by a bailout, and potential complications for monetary policy in an already difficult financial environment. The implicit nature of the government guarantee creates uncertainty how the government will respond, and the accumulation of uncertainty over time is a major factor in systemic risk. The chapter points out that the third scenario would not have been possible a decade or two ago when the GSEs posed a much less systemic threat to the US economy. Since 1992 the outstanding debt of Fannie Mae has grown fivefold and the outstanding debt of Freddie Mac has grown twenty fold.
- Chapter 5 notes how OFHEO's actions reduce the risk of GSE failure. Chapter 6 concludes with a discussion of OFHEO's regulatory actions and recommendations for legislation. The regulatory actions are as follows:
 - A. Continue the Planned Enhancements to OFHEO's Supervisory Tools
 - B. Conduct Additional Research
 - C. Enhance Enterprise Transparency (i.e., disclosures) to Improve Market Discipline
 - D. Clarify OFHEO's Conservatorship Authority Through Regulation

There are two legislative recommendations:

- A. Permanently Fund OFHEO (i.e., without need for appropriations) to Insure That It Has Adequate Resources and Budget
- B. Grant Receivership Authority to OFHEO

(OFHEO report: "*Systemic Risk: Fannie Mae, Freddie Mac and the Role of OFHEO*," February 2003)

Fannie & Freddie dismiss report

- "This simply in our mind, is not a serious piece of policy research," said Freddie's

spokeswoman Sharon McHale. “It’s based on this completely speculative doomsday scenario where we essentially wake up and are insolvent.” Fannie’s spokesman Chuck Greener stated: “The Falcon paper is a review of research on systemic risk and discussion of hypothetical scenarios. The director himself acknowledged these scenarios are hypothetical and quite remote.” (*Dow Jones Newswire*, Dawn Kopecki, 2/4/03)

Fannie releases its own systemic risk study

- On the day of the release of the OFHEO study, Fannie released its own study stating that, “Its regulatory regime requires it to operate in a very low-risk manner...Fannie Mae’s regulatory regime is designed to ensure the company’s reliability in the midst of a severe economic crisis. Its risk-based capital stress test requires the company to be able to survive a prolonged period of extreme general distress in the housing markets accompanied by substantial movement in interest rates.” (*Systemic Risk: A Fannie Mae Perspective*, by Noel Fahey, Fannie Mae Papers, Volume 2, Issue 2, February 4, 2003) Fannie Mae also released a paper that it commissioned, *Systemic Risk: A Regulator’s Perspective*, by Eugene Ludwig, Fannie Mae Papers, Volume 2, Issue 1, February 3, 2003, sounding the same theme. (“Notably, over the last decade, financial regulators, including the OCC, Federal Reserve, Office of Thrift Supervision (OTS), FDIC, and the Office of Federal Housing Enterprise Oversight (OFHEO) have dramatically improved safety and soundness supervision of regulated financial institutions.”)

White House intends to nominate new OFHEO Director

Changing the leadership is not enough says Cong. Baker

Fannie, Freddie, & FM Watch release comments

- President George W. Bush announced February 4 his intention to nominate Mark C. Brickell of New York, to be Director of OFHEO for a term of five years. He is currently the Director and CEO of Blackbird Holdings (electronic trading system for derivatives contracts). Prior to this, he served as the Managing Director at J.P. Morgan & Company, where he worked for 25 years. He is a graduate of the University of Chicago and earned an MBA from Harvard Business School. (*White House press release*, 2/4/03) Brickell’s nomination is subject to Senate confirmation. A timetable for Brickell’s appointment has yet to be disclosed. OFHEO spokeswoman Stefanie Mullin said she did not know how long confirmation would take, but that “it could take months.” (*BNA Daily Report for Executives*, Richard Cowden, 2/6/03; *Securities Industry News*, John Sandman, 2/17/03)
- The current OFHEO Director Armando Falcon, Jr., a Democrat appointed by President Bill Clinton, was asked by the White House to leave his post at OFHEO more than a year before his five-year term was up to enable President Bush to appoint his own director. Falcon, who became director of OFHEO in 1999, submitted a resignation letter February 4 and said he would remain the director until the Senate confirms a successor. (*American Banker*, Rob Garver, 2/6/03; *Wall Street Journal*, Patrick Barta and Jeanne Cummings, 2/5/03; *Reuters*,

Mark Felsenthal, 2/4/03)

- Sources said Falcon was asked by the Administration for his resignation the morning of February 4, just hours before he released OFHEO's systemic risk report on Fannie and Freddie which examined scenarios under which Fannie and Freddie could experience severe financial difficulties that could cause disruptions in the housing and financial markets. Sources said Administration officials and officials of Fannie and Freddie were displeased with parts of the report, while GSE critics said the report did not go far enough. (*Washington Post*, Daniela Deane, 2/6/03) [See earlier story in this *GSE Report* for more information on the systemic risk study.]

Cong. Baker's comments

- A spokesman for Congressman Baker said the Congressman would like to see OFHEO be granted more powers as a regulator and that Falcon's departure did not in itself necessarily mean OFHEO would become a stronger regulator. "Mr. Falcon performed an admirable job under the circumstances," the spokesman said, adding, "A change of personnel at the top of OFHEO doesn't have a great deal of significance because we're still dealing with a flawed agency." (*BNA Daily Report for Executives*, Richard Cowden, 2/6/03) Cong. Baker hopes that Brickell will strengthen the oversight of Fannie and Freddie. (*Washington Post*, Daniela Deane, 2/6/03)

Fannie's comments

- Fannie's spokesman Chuck Greener stated that Falcon "has assembled a superb examinations staff and has put in place a comprehensive regulatory structure... We have appreciated Director Falcon's dedication and hard work. Fannie Mae looks forward to working with Mark Brickell upon his confirmation as the new director of OFHEO." (*American Banker*, Rob Garver, 2/6/03)

Freddie's comments:

- Freddie's spokeswoman Sharon McHale stated, "We enjoyed a constructive working arrangement with Director Falcon. The risk-based capital rule is a major achievement that he should be proud of and we look forward to working with him as the nomination process proceeds... We welcome the White House announcement of the President's intention to nominate Mr. Brickell." (*American Banker*, Rob Garver, 2/6/03)

FM Watch's comments

- FM Watch Executive Director Mike House stated, "FM Watch congratulates the White House on the nomination of Mark Brickell as the new Director of OFHEO. We expect that Director Brickell will invigorate what can best be described as a 'sleepy' regulator. The new OFHEO needs to thoroughly examine and hold the GSEs accountable for their potential risk to taxpayers. Further, we hope that Mr. Brickell will take an active interest in assuring that the GSEs meet safety and soundness standards that are comparable to those applied to private sector participants in the nation's housing finance market." (*FM Watch press release*, 2/5/03)

Fannie bids on Consecos servicing rights

Fannie has a \$7 billion investment in Consecos manufactured-housing securities

Cong. Baker questions the impact on Fannies risk

Financial Services Roundtable and FM Watch oppose Fannies entry into servicing

Fannie says it doesnt intend to service the loans

MBA is okay with Fannies bid on Consecos servicing rights, if Fannie doesnt enter the servicing arena

- Fannie placed a \$70 million bid February 19 for the servicing rights to \$23 billion in manufactured-housing mortgages in the bankruptcy of Consecos Finance Corp. Fannie, which doesnt expect to service the loans, filed a “floor bid” in the US Bankruptcy Court for the servicing platform. “We did this to resolve an impasse in the court over the disposition of the manufactured housing servicing platform in bankruptcy,” said Fannies spokeswoman Janice Daue. “The move was consistent with our objective to have that manufacturing servicing operation be purchased by an entity that has or will make a long-term commitment to this important segment of the housing finance industry.” (*Dow Jones Newswire*, Dawn Kopecki and Erik Ahlberg, 2/20/03)
- Fannies bid was based on an oral agreement between Consecos and other creditors in the bankruptcy. Fannie will need to submit a formal offer to make its bid official. (*Dow Jones Newswire*, Dawn Kopecki and Erik Ahlberg, 2/20/03) Fannie and Consecos have strong ties. Fannie owns or guarantees \$10 billion of mortgage-related securities backed by mobile homes. Consecos services about 70 percent of these securities, Fannie said. (*Bloomberg News*, Robert Bruggess, 2/20/03; *Associated Press*, Mark Jewell, 2/21/03)

Congressman Baker’s response

- “There’s uncertainty about exactly what type of risk Fannie is really taking on here?” said Michael DiResto, spokesman for Cong. Richard Baker. “Is there an amount of intertangling with Consecos that we’re unaware of and that would impact the risk to Fannie Mae?” (*Dow Jones Newswire*, Dawn Kopecki, 2/22/03) Officials at Fannie noted that Fannie hasn’t suffered any losses thus far. “This has had no material impact on Fannie Mae,” said Fannie spokeswoman Janice Daue, adding that the Consecos bonds Fannie owns all still have investment-grade ratings or are insured by others with similar ratings. “We have a multilayer cushion of credit that stands between Fannie Mae and the (manufactured housing) bonds.” (*Dow Jones Newswire*, Dawn Kopecki, 2/22/03)

Financial Services Roundtable response

- “Servicing loan portfolios is a separate for-profit business that is and should be conducted in the competitive marketplace and not by” government-sponsored companies like Fannie Mae,

said Steve Bartlett, president of the Financial Services Roundtable. “If a GSE were to attempt to do that, it would significantly expand their activities beyond their mission and raise the stakes on Capitol Hill.” (*Wall Street Journal*, Patrick Barta and Dawn Kopecki, 2/24/03; *Dow Jones Newswire*, Dawn Kopecki, 2/22/03)

MBA’s response

- “We’ve had conversations with some of the Fannie Mae officials, and we have been assured that they have no intention to service the loans. Apparently they are protecting their interests in a difficult bankruptcy situation,” said MBA spokeswoman Laura Armstrong. “If they are not entering the servicing arena, we are okay with this at this moment. But we reserve the right to come back to this if they don’t stay true to their word.” (*Dow Jones Newswire*, Dawn Kopecki, 2/22/03)

FM Watch’s response

- FM Watch said it “plans to take appropriate action” to stop Fannie from entering the mortgage servicing business. “Fannie Mae’s decision to enter the mortgage servicing business through this maneuver is the perfect indication of just how far Fannie has strayed from its original mission of providing liquidity to the secondary mortgage market for conventional mortgage loans,” said FM Watch Executive Director Michael House. “While servicing mortgages may be allowed by its charter, Fannie Mae’s claim that this move is designed to protect mobile home owners doesn’t make sense. The fact is Fannie made an investment in \$10 billion of Conseco loans and only has \$800 million in loss allowance. Fannie Mae has no business expanding into this new area without first getting approval from HUD.” House continued, “Once again, Fannie Mae is putting the interest of its stockholders ahead of the interests of taxpayers and homeowners. HUD and Congress should stop Fannie from entering into the servicing business. And FM Watch plans to take appropriate action to make sure that this incursion is stopped and calls on other industry organizations to do likewise.” (*FM Watch press release*, 2/20/03) House said he is concerned that once Fannie dips its toes into the servicing arena, it will inevitably attempt to dominate that industry. Even subcontracting the servicing to someone else would be a problem, he said, because “if they’re the ones picking who does the servicing, they can always underbid anybody on servicing.” (*American Banker*, Erick Bergquist, 2/24/03)

Fannie says it doesn’t intend to service the loans

- Fannie’s spokeswoman Janice Daue said Fannie’s charter would allow it to service those mortgages if needed. (*Dow Jones Newswire*, Dawn Kopecki and Erik Ahlberg, 2/20/03) However, Fannie officials said the company does not intend to service the loans, and would likely hand off the work to someone else if it won the bidding. The officials said the company was merely protecting its \$7 billion investment in Conseco securities, whose value could be adversely affected by the bankruptcy, and help ensure the long-term stability of the manufactured-housing market. They said the bid would only be triggered if no other company wanted to take over the servicing and was designed to set a “floor” price for the servicing’s markets value. (*Wall Street Journal*, Patrick Barta and Dawn Kopecki, 2/24/03)

Fannie Mae and Freddie Mac

GSEs urged to privatize in *Wall Street Journal* editorial

Three government reports detail how Fannie & Freddie have increased their risk

Fannie & Freddie don't want to privatize because if they were completely private, they would have to nearly double their capital and earn less profits

- A *Wall Street Journal* editorial outlined three recent government reports on the GSEs detailing how Fannie and Freddie have increased their risk. The editorial urged the GSEs to privatize. Fannie and Freddie were the subject of a joint report by the Treasury, SEC and OFHEO on the GSEs' MBS disclosures. Fannie and Freddie agreed to disclose their common stock information to the SEC last summer after a "torrent of criticism." However, the GSEs still disclosed much less than other private financial institutions and they still resisted disclosing information about the trillions of dollars in mortgage-backed securities (MBS) they issue. The joint report recommended that the GSEs provide much more information on their MBS to investors. "Fan and Fred – again after months of fierce resistance – then agreed. But the task force also left the regulatory door open to requiring additional disclosures."
- The Office of Management and Budget also recently commented on the GSEs in the FY 2004 President's Budget. OMB looked at the risks the GSEs assume when repurchasing their own MBS and found that the GSEs hold \$797 billion of their MBS, for a combined total of 62% of their portfolios. The OMB speculated that a limit on the GSEs' portfolios might minimize the risk. However, "it horrifies Fan and Fred because their mortgage-backed securities are key to making profits."
- Finally, OFHEO released a report on Fannie and Freddie's systemic risk. Although this report was somewhat favorable, the editorial noted that OFHEO's description of the financial system and the central role taken by the Fannie and Freddie was "not reassuring." GSE debt is widely held – by US banks, pension funds, foreign investors and by individual investors. The editorial warned that "trouble at Fan and Fred could provoke a financial contagion that would spread rather quickly...Perhaps the scariest part of OFHEO's report, however, is its assumption that, in the case of a crisis caused by Fan and Fred, the government would have to act to prevent contagious illiquidity from causing an economic meltdown. The only question for OFHEO seemed to be when the Federal Reserve would have to act, not whether it would."
- The editorial goes on to note that the implied government bailout is precisely what stops Fannie and Freddie from privatizing. "Specifically, this implicit government guarantee insures a high credit rating no matter how reckless their leverage or other practices might be." Fannie and Freddie have AAA bond ratings, despite the fact that they are leveraged around 29-to-1 or 30-to-1, much higher than the 12.5-to-1 ratio required by regulators for private

banks. The editorial added, **“if Fan and Fred were completely private financial institutions – with no government guarantee, implicit or explicit – they would have to almost double their capital to more than \$99 billion from \$52 billion now. And even that increase would only bring them to the minimal capital that banks use to maintain for mortgages, but perhaps still short of earning a AAA rating.” If they were forced to increase their capital, their return on equity would fall from 25 percent to 12 or 13 percent (comparable to banks’ earnings), transforming Fannie and Freddie “into less profitable companies.”**

- The editorial concluded, **“The broader point is that here are two companies at the center of America’s financial system running with high leverage, big derivative positions and inadequate disclosure, and exposing the economy to systemic risk. The success of their mission to provide lower mortgage-interest rates is doubtful. Yet because of their implicit government backing, Fan and Fred can issue low-cost debt and earn big fat returns. This combination of public risk and private profits has been noted by their regulators. We wonder if Congress will take note, too.”** (Editorial, *Wall Street Journal*, 2/19/03)

FM Watch asks OMB to review OFHEO’s risk-based capital rule for Fannie & Freddie

- FM Watch wrote Office of Management and Budget (OMB) Director Mitchell E. Daniels, Jr. February 10 urging that OMB initiate a comprehensive review of OFHEO’s risk-based capital rule. The letter stated that an OMB review is imperative because OFHEO is not only making substantive changes to the rule but is also violating the Administrative Procedures Act (APA) by making these changes without allowing public scrutiny and comment. FM Watch argued that OFHEO has made so many changes to the rule – through unpublicized major rewrites – that OFHEO itself is now describing it as an “interim” rule.
- “After 10 years in the making, what was just months ago a ‘final’ rule is so flawed that OFHEO not only has to keep changing it – it has also had to rename it,” said Mike House, FM Watch Executive Director. “The rule as it now stands is essentially dysfunctional and the rule-making process has become a farce. We’re asking OMB to put an end to all of this embarrassment and send this rule back to the drawing board.”

The letter asks for a comprehensive OMB review of the rule based on the following:

- “the results of OFHEO's first enforceable run of the RBC rule, which permits the GSEs to operate at astonishing leverage ratios well in excess of those at which federal law requires bank regulators to shutter an insured depository;”
- “the fact that these capital ratios are so low because OFHEO allows the GSEs to count net-positive derivative positions as if they were actual shareholder equity and permits the cross-subsidization of interest rate risk and credit risk derivative positions. Bank rules – including the revised ones being developed by international regulators in Basel – all

require substantial amounts of shareholder equity to ensure appropriate risk management incentives;”

- “the volatility and risks associated with derivatives have been demonstrated anew through recent GSE announcements. As noted, Freddie Mac has been unable to issue audited financial reports for 2002, and its past years are also in doubt. Throughout the second half of 2002, Fannie Mae announced that its interest-rate risk went in and out of its own risk boundaries, even as its GAAP-dictated shareholder equity plummeted; and”
- “OFHEO compounded derivatives-related risks by making undisclosed changes to the treatment of swaptions and futures in the first enforceable run of the RBC rule. It decided to call these long-used derivatives ‘new activities’ and then changed the final rule, which it now describes as an ‘interim’ one for purposes of assessing capital for any activity OFHEO decides to call ‘new.’ This change exacerbates the taxpayer risk related to the RBC rule, and violates the statutory requirement that the RBC standard be transparent, that is, clearly and easily replicable by others. Undisclosed revisions made each time the standards are run to accommodate changing GSE needs is highly inappropriate, as well as questionable under both OFHEO’s governing law and the Administrative Procedures Act.” (*FM Watch press release, 2/11/03*)

A complete copy of the FM Watch letter to OMB is available at www.fmwatch.org

Background on OFHEO’s risk-based capital rule:

- OFHEO’s risk-based capital rule establishes the level of capital Fannie and Freddie must maintain to survive a 10-year “stress test.” The rule was originally due December 1, 1994. After taking eight and a half years, OFHEO finally issued the rule on September 13, 2001. However the rule did not become enforceable until one year later (September 13, 2002). Then just three months after OFHEO published the rule that took more than eight years to produce, OFHEO announced proposed changes to the rule on December 18, 2001 with a brief public comment period. OFHEO announced the final amendment to its risk-based capital rule on March 15, 2002, which remained essentially the same as the original December 18, 2001 proposed changes.
- As a result of pressure from certain industry groups and the GSEs, OFHEO reduced substantially the requirements imposed by the initial risk-based capital rule. The amended March 15, 2002 version, among other things modified provisions related to counter-party haircuts, the treatment of multifamily loans, funding costs, and a series of technical and clarifying changes. The amendment did not change the date that the risk-based capital rule became enforceable. During a July 23, 2002 Capital Markets Subcommittee hearing, Capital Markets Subcommittee Chairman Richard Baker (R-LA) raised concerns that the risk-based capital rule was changed so that Fannie and Freddie would receive more favorable results and he questioned political involvement in the changing of the rule. Data was released at the hearing which showed that Fannie would have failed an early version of OFHEO’s risk-based capital rule before changes were made

- On September 12, 2002, OFHEO issued twelve proposed “technical and corrective” amendments to its risk-based capital rule, with only a 10-day comment period. Critics suggested the amendments were, in fact, substantive. After commenters requested additional time to comment, OFHEO announced an additional 30 days to comment. OFHEO issued a final rule November 1 implementing eight of the proposed twelve amendments. Of the twelve amendments, OFHEO adopted as final immediately, eight proposed amendments. OFHEO did, however, decide to review and delay action until after the extended comment period closed on October 29 on four of OFHEO’s original 12 proposed amendments: (1) amendment that corrected a table that utilized original loan-to-value ratios rather than amortized original loan-to-value ratios (amendment number eight in the list of OFHEO’s original 12 amendments); and (2) proposed technical amendment regarding the definition of “unamortized balance” (amendment number seven); and two amendments relating to the implementation of FAS 133 in the risk-based capital rule (amendments numbered 11 and 12). (*Federal Register*, pages 66533-66540, 11/1/02)
- On October 17, the OMB said it would conduct a “formal review” of OFHEO’s proposed amendments to its risk-based capital rule for Fannie and Freddie, that among other things, updates the treatment of accounting rules for derivatives transactions (FAS 133). In an October 17 letter to Congressman Baker, OMB Director Mitchell Daniels wrote, “Because of the significant interest in this rulemaking, OMB has informed OFHEO that the final rule will be subject to formal review under Executive Order 12866.” Daniels noted that OMB’s review will “take into consideration the economic impact of this regulation.” (*OMB letter to Congressman Baker*, 10/17/02; *Bloomberg News*, Al Yoon, 10/24/02)
- On December 30, OFHEO released the first run of its risk-based capital rule after it became enforceable during the third quarter of 2002. On February 13, OFHEO adopted, effective March 17, 2003, three of the remaining four “technical” amendments: the amendment that corrected a table that utilized original loan-to-value ratios rather than amortized original loan-to-value ratios (amendment number eight in the list of OFHEO’s original 12 amendments) and two amendments relating to the implementation of FAS 133 in the risk-based capital rule (amendments numbered 11 and 12). OFHEO determined that it was appropriate to delay adopting the amendment regarding the definition of “unamortized balance” (amendment number seven), because the same term appears in numerous other places throughout the rule. (*OFHEO press release*, 1/24/03; *Federal Register*, pages 7309-7313, 2/13/03)

<p>FM Watch urges HUD to protect nation’s housing markets from GSEs’ current systemic risks</p>

- FM Watch sent a letter to HUD Secretary Mel Martinez urging HUD to take some much-needed steps to protect the nation’s housing markets from volatility in light of the financial uncertainty revealed by Freddie’s January 22nd announcement that it may have to restate its earnings for 2002 (and possibly 2001 and 2000) and Fannie’s sudden jump in interest-rate risk last year.
- The letter stated, “The GSEs – like all other major financial companies on which the overall

economic system depends – are fundamentally based on trust. If the markets lose confidence in their ability to provide regular, predictable reporting, the resultant dramatic swings in debt and equity pricing can have profound and adverse impact on the GSEs, forcing them to make the implicit guarantee a real one by drawing down on their line of credit at Treasury and, perhaps, even increasing their demands on the federal purse.”

In order to help control excessive GSE risk, FM Watch urged HUD to take these steps:

- “Move promptly to impose needed discipline on new GSE activities. HUD must issue guidance implementing Congress’ mandate that the department pre-approve new programs at Fannie Mae or Freddie Mac. OFHEO’s flawed risk-based capital rule provides no protection against the risks involved in such programs, and they can also adversely affect the competitiveness on which a thriving residential mortgage market depends. As the GSEs increase their risks, they should not simultaneously be allowed to use their government-provided benefits to enter new lines of business and possibly drive out competition, potentially leaving consumers no competitive service providers; and”
- “Undertake an independent review of the OFHEO risk-based capital rule, as well as other OFHEO regulatory actions. We understand that OFHEO is an independent agency, but it falls under HUD, which is therefore responsible for ensuring that OFHEO meet its responsibilities and does not act counter to HUD’s obligation to protect the nation’s residential housing market. In addition to adopting a completely different approach to risk-based capital than all other financial regulators, OFHEO has recently compounded market perception of an implicit guarantee for Fannie Mae and Freddie Mac, thus increasing taxpayer risk.” (*FM Watch press release, 2/20/03*)

More community banks selling loans to Fannie & Freddie

Community banks cite competition from Fannie & Freddie as a challenge

- A growing number of community banks sold residential mortgages into the secondary mortgage market, reflecting the low interest-rate environment and increased loan production in 2002, according to America's Community Bankers 10th annual Real Estate Lending Survey. Most bankers expect sales to increase, or at least remain the same, in 2003.
- The survey found that 72 percent of the community banks responding to the survey sold mortgages into the secondary market in 2002, compared to 55 percent in 2001 and 49 percent in 2000. (*ACB press release, 2/5/03*) Thirty percent sold to Freddie, compared with 23 percent in 2001, while 22 percent sold to Fannie, up from 19 percent in 2001. Fewer banks, however, sold loans to the FHLBank System’s Mortgage Partnership Finance and Mortgage Purchase programs. Only 9 percent reported sales through these programs, down from nineteen percent. The group attributed this decrease to an increase in the number of respondents and because there were fewer participating thrifts, which are more likely to sell

loans to these programs. Loan sales to private conduits and wholesalers also increased. Thirty-one percent sold to this channel, compared to 26 percent in 2001. (*American Banker*, Tommy Fernandez, 2/10/03)

- In terms of dollar volume, community banks selling into the secondary market sold 45 percent of their originations in 2002, compared to 41 percent in 2001 and 17 percent in 2000. (The percentages exclude two very large survey respondents whose data would have tended to distort the results. If all respondents are included, the "average" community bank sold 39 percent of originations). (*ACB press release*, 2/5/03)
- According to the survey, the use of automated underwriting has grown significantly over the last several years, with 52 percent of respondents using automated systems in 2002, up from 41 percent in 2001 and 38 percent in 2000. The survey also found that 63 percent of respondents used an automated home mortgage loan origination system, an increase of 1 percentage point over last year's survey and 2 percentage points over 2000. Some 53 percent said they link the underwriting and origination software. (*ACB press release*, 2/5/03)
- Looking ahead, 30 percent of respondents said they expect to sell more of their loan production to the secondary market in 2003, while 43 percent expect no change. Some 63 percent said demand for home equity lines of credit would rise in 2003. Forty-one percent predicted an increase in commercial real estate lending, compared to 11 percent expecting a decline. (*ACB press release*, 2/5/03)
- Responding to a question posed for the first time asking bankers about their biggest challenge in mortgage lending, the top three were: competition from Fannie and Freddie, mortgage bankers, large lenders and unregulated lenders; mortgage pricing and profitability; and staffing to meet demand. (*ACB press release*, 2/5/03)
- The survey was compiled from responses by 320 community banks, broadly reflecting community banking and including 139 commercial banks. The questionnaire was mailed in the fourth quarter of 2002, requesting information as of Sept. 30. The margin of error was 5.5 percent. The survey included all ownership types, charters, asset sizes and regions of the country. According to ACB, the survey is available at \$125 for ACB members, \$195 for nonmembers by calling (888) 872-0568. (*ACB press release*, 2/5/03)

New fees from Fannie & Freddie are making cash-out refinancings more costly for consumers

- New rules from Fannie and are making it more costly for many homeowners to tap their equity when they refinance, reported the *Wall Street Journal*. The changes mean consumers may pay an interest rate that is one-eighth of a percentage point higher – or upfront fees of roughly \$500 to \$1,500, depending on the size of the loan. Fannie and Freddie claim the new fees are needed because cash-out refinancings are riskier than other mortgages. The new rules, which apply, to cash-out refinancings that involve loans of more than 70 percent of a home's value could stymie some borrowers, lenders say. "It won't make as much economic

sense,” explained Dan Arrigoini, President of US Bank Home Mortgage, a unit of US Bancorp. (*Wall Street Journal*, Ruth Simon, 2/18/03)

Fannie & Freddie accounted for more than 40% of all multifamily loans last year

- Commercial mortgage originations during the final quarter of 2002 increased to a pace 18 percent above the same period a year earlier and were up 5.2 percent for the year as a whole, according to the quarterly survey of mortgage bankers conducted by the Mortgage Bankers Association of America (MBA). The 44 MBA members reporting in the survey reported that multifamily lending surged to its highest level of the year during the fourth quarter - \$14 billion. Fannie originations at reporting institutions during the fourth quarter were up 5 percent from a year earlier; Freddie’s total was little changed. Together, Fannie and Freddie accounted for 40 percent of total multifamily originations – about the same as the third quarter. Multifamily lending overall in 2002 was up slightly more than 3 percent among the mortgage bankers surveyed despite lower rates of funding by Fannie and Freddie. Fannie and Freddie still absorbed, however, almost 40 percent of the overall product in 2002 at reporting institutions; in 2001, the comparable figure was 47 percent. That shift was driven by declines in their lending totals of 21 percent at Fannie and 11 percent at Freddie. In contrast, FHA multifamily lending was reported to be up 23 percent for the year. (*MBA press release*, 2/3/03)
- In related news, Fannie announced that it closed 2002 with a record \$22 billion in multifamily investments. Fannie said one of its largest areas of growth was in small loan production. In 2002, Fannie financed \$4.1 billion in small loans, which included \$2.25 billion in structured transactions. (*Fannie press release*, 1/22/03)
- Freddie announced that it closed 2002 with a record number of \$14.3 billion in multifamily investments. Freddie recorded the following results in different components of its multifamily business: \$6.9 billion through flow programs; \$3.5 billion in negotiated transactions; \$883 million of investment in low-income housing tax credits; \$1.4 billion in mortgages featuring fixed-to-float option and nearly \$4 billion in mortgages featuring early rate-lock deliveries; over \$400 million in ARM flow financings and more than \$380 million in revolving credit facility commitments indexed to Freddie’s Reference Bills; more than \$230 million in seniors housing mortgages; and over \$2 billion in targeted affordable housing products. (*Freddie press release*, 1/31/03)

Fannie & Freddie cap some mortgage bond production for the fifth month

- Fannie and Freddie this month capped creation of certain mortgage bonds for the 5th consecutive month, a sign of the turmoil 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). The agencies told *Reuters* they had enacted the limits. Fannie capped limited creation of CMOs backed by 15-year, 5% pass-throughs for March delivery and had not yet imposed a limit on CMOs backed by 30-year pass-throughs. Freddie said it limited the creation of CMOs backed by 30-year, 5 ½ percent securities and 15-year, 5% pass-throughs for March delivery. (*Reuters*, Aleksandrs Rozen, 2/6/03)

Fannie Mae

Fannie expands its partnership with AFL-CIO

- Fannie announced plans February 3 to expand its partnership with the AFL-CIO and Countrywide Financial Corp. to provide \$1.2 billion in mortgage financing to union members over the next three years. Countrywide has originated more than 2,000 mortgages to mostly low-income union members through the AFL-CIO's Housing Investment Trust since the program's inception in late 2000, according to Countrywide. Over the next three year, Fannie will fund approximately 10,000 new home loans through the program and then package them as securities for the AFL-CIO's Housing Investment Trust, a pension fund with more than \$3 billion in assets. (*Dow Jones Newswire*, Dawn Kopecki, 2/3/03)

Freddie Mac

Freddie commits \$2 million to NeighborWorks initiatives to expand minority homeownership

- Freddie has committed \$2 million to help the national NeighborWorks® network of nonprofit housing and community-revitalization organizations for initiatives to expand minority homeownership. Announced February 20 at Neighborhood Reinvestment Corporation's Training Institute in Atlanta, the partnership marks the expansion of a 10-year alliance. Freddie's expanded five-year commitment also includes sponsorship of national symposia to address critical housing and community revitalization issues.
- NRC plans to use Freddie's new five-year grant to build additional NeighborWorks HomeOwnership Centers, while expanding the activities of more than 50 existing HomeOwnership Centers serving communities nationwide. The funding will also help expand the scope of the HUD Housing Choice Voucher program, which enables qualified

renters to apply the equivalent of their Section 8 rental subsidies to mortgage payments. Additionally, Freddie will be a leading national sponsor of major symposia on housing and community development issues. The symposia will be conducted as part of Neighborhood Reinvestment Corporation's Training Institute, which is held four times annually in locations around the country. (*Freddie press release, 2/20/03*)

Federal Home Loan Banks

Five of the 12 FHLBanks support multi-district FHLBank membership

FHFB expects to issue formal rule-making in June

- Only five of the twelve FHLBanks told the FHFB that they support FHLBank multi-district membership, according to letters submitted to the FHFB. The Seattle, Chicago, and Pittsburgh FHLBanks support multi-district membership, while the FHLBanks of Dallas and New York are pushing for a limited form of multi-district membership. The Atlanta, Des Moines, Topeka and San Francisco FHLBanks are opposed to multi-district membership, while the Boston and Indianapolis FHLBanks appear to be neutral on the issue. (*National Mortgage News, 2/24/03*) The Cincinnati FHLBank has also not adopted a formal position at this time. The FHLBanks recently submitted their responses to a resolution the FHFB adopted on December 20, 2002, asking them to identify "specific concerns, if any, arising from the ongoing changes in the financial services industry comprising the Federal Home Loan Bank System membership and suggesting appropriate supervisory or regulatory responses from the Federal Housing Finance Board." The FHLBank responses are located on the following Web site: <http://www.fhfb.gov/PressRoom/responses2003.htm>. In December 2000, the FHFB received the first of four petitions from FHLBanks seeking to retain as members institutions that had merged into members of other FHLBank districts. The FHLBanks located in Dallas, New York, Atlanta and Chicago filed the petitions. In January 2002, FHFB Chairman John Korsmo asked the respective FHLBanks to withdraw the petitions so the FHFB could undertake a more thorough review of the issues involved in multi-district membership. Korsmo said he plans to begin a formal rule-making in June if the FHFB's analysis of membership issues determines that action is warranted. (*FHFB press release, 2/13/03; FHLBank responses to FHFB on multi-district membership*)
- As noted in the May 3 and May 17, 2002 *GSE Reports*, Treasury Undersecretary for Domestic Finance Peter Fisher and then Treasury Assistant Secretary for Financial Institutions Sheila Bair stated that they do not believe the FHFB has the legal authority to allow institutions to belong to more than one FHLBank.

FHFB rejects plan to limit the Chairman's authority

- In a 3-2 vote along party lines, the FHFB rejected a plan to limit the FHFB Chairman's authority. Democratic board members, Franz S. Leichter and Allan I. Mendelowitz, offered an amendment during a January 29 FHFB meeting that would have reversed a 1933 rule that gave the Chairman nearly unlimited authority in personnel and policy matters. The FHFB's Republican members, John Weicher and Timothy O'Neill, backed FHFB Chairman John Korsmo in opposing the proposal. O'Neill offered a non-binding resolution that states that the Chairman's post doesn't have the power to "exercise unilaterally the rulemaking and adjudicatory functions of the Federal Housing Finance Board." The FHFB put off final votes on that resolution until the next FHFB meeting. (*Dow Jones Newswire*, Dawn Kopecki, 1/29/03)

FHLBanks respond to Gregory Baer's letter to *American Banker*

- As reported in the February 3, 2003 *GSE Report*, former Treasury official and current consultant for Fannie Mae, Gregory Baer, wrote a letter to the editor of the *American Banker* criticizing the FHLBank Shared Funding Program. In response, the chairman of the Council of FHLBanks and Chairman of the FHLBank of Seattle Mike Radway wrote a letter to the editor of *American Banker*. According to Radway, Baer's motivation for the letter was not his concern for the FHLBank System, but out of his client Fannie's concern over competition from the new program. Radway refuted Baer's assertion that the FHLBanks are under-regulated, by noting that the Gramm Leach Bliley Act of 1999 included "extensive" modernization of the system. Radway also agreed that the FHLBanks may not have attracted the Congressional attention that Fannie and Freddie have over the past few years, but attributed that to the actions of the GSEs, and not a lack of Congressional attention to the FHLBanks. Radway also noted that the FHLBanks are subject to comprehensive oversight from their regulator, the Federal Housing Finance Board. In addition, Radway takes offense at Baer's assertion that the FHLBanks pay no taxes and have no affordable housing goals. Indeed, they are not subject to federal income tax, but pay 20% of their income to offset the cost of the Resolution Funding Corp. bonds sold to the FDIC. The FHLBanks also provide 10% of their income to affordable housing programs.
- According to Radway, the main concern of Fannie and Freddie is not safety, but competition. However, that concern is misplaced. "We do not want to be like Fannie Mae and Freddie Mac, but we do offer financial institutions and their customers important alternatives to the other housing GSEs. Our mortgage purchase programs, MPP and MPF, involve a credit enhancement of our members' mortgages and are fundamentally very different from the other housing GSEs' offerings. We partner with our members, who are also our only stockholders, we do not compete with them." (Mike Radway, Letter to the Editor, *American Banker*, 1/31/03)

Fitch comments on insurance companies' use of FHLBank advances

- Fitch Investors Service Inc. said insurance companies that use FHLBank convertible advances could face ratings risks. In a February 4 press release, Fitch said insurance companies that planned little or no borrowing improved financial flexibility and liquidity, while insurers that borrow excessively or use proceeds in a risky manner will likely develop negative ratings. (*Dow Jones Newswire*, 2/4/03)

Council of FHLBanks hires former Senate Banking Committee staffer as a consultant

- The Council of Federal Home Loan Banks, the trade association lobbying group for 10 of the 12 FHLBanks, has hired Philip E. Bechtel as a consultant on legislative and regulatory matters. He is a former chief counsel of the Senate Banking Committee. (*American Banker*, Rob Blackwell, Michele Heller and Todd Davenport, 2/18/03)

FHFB unanimously approves 28 public interest directors

Last year, two FHFB members claimed the process for selecting board members was too political

- The FHFB January 29 unanimously approved the appointment of 28 public interest directors to serve a three-year term on the boards of directors of the 12 FHLBanks. A total of 82 public interest directors serve on the boards of the 12 FHLBanks. For the year 2003, the FHLBanks of Boston, Atlanta, Des Moines, and Seattle each have three openings, while the FHLBanks of New York, Pittsburgh, Cincinnati, Indianapolis, Chicago, Dallas, Topeka and San Francisco each have two openings. Public interest directors formerly served four-year terms, but the Gramm-Leach-Bliley Act of 1999 mandated that all directors serve three-year terms and required that directors' terms be staggered into three approximately equal classes. The process of phasing in the change in term lengths was completed with the most recently appointed class of public interest directors. As a result, all 28 of the appointments beginning Jan. 1, 2003 will be for the full three-year terms.
- Each FHLBank board of directors has a chairman and a vice chairman, elected by the board members. The Gramm-Leach-Bliley Act set the maximum annual salary of directors at \$15,000; vice chairs at \$20,000; and chairs at \$25,000. The legislation requires the FHFB to adjust these limits annually, based on the annual percentage increase of the Consumer Price Index. The salary limits for 2003 are \$16,152 for directors, \$21,537 for vice chairmen and \$26,921 for chairmen. Two public interest directors at each FHLBank are designated as Community Interest Directors because of a history of involvement in their communities. As required by FHFB regulation, each board of directors must convene a minimum of six in-person board meetings annually. (*FHFB press release*, 1/29/03)
- The *American Banker* noted that the same vote on selecting board members last year

prompted a revolt by the two Democrats (Franz S. Leichter and Allan I. Mendelowitz) on the five-member FHFB, who criticized the selection of the directors and complained that they had been shut out of the nominating process. (*American Banker*, Rob Blackwell and Rob Garver, 2/303) See April 5, 2002 *GSE Report* for more information, www.gsereport.com)

FHFB publishes prices for FHLBank services

- The FHFB published the prices charged by the FHLBanks, effective February 11, for processing and settlement of items (negotiable order of withdrawal or NOW), demand deposit accounting (DDA), and other services offered to members and other eligible institutions. (*Federal Register*, pages 6921-6923, 2/11/03)

FHFB expands regulatory information on its Web site

- A new section of the FHFB's Internet website expands the amount of information on the agency's regulatory activities. The "Freedom of Information Act (FOIA) Reading Room" is located at the following Web address: http://www.fhfb.gov/fact_asp/fact_main.asp.
- The searchable archives include access to the following decision documents from the FHFB: Approval Letters, Chairman's Orders, Federal Register Notices, General Counsel Opinions, Managing Director's Orders, No Action Letters, Resolutions, Regulatory Interpretations, and Waivers. The archive currently includes documents from 1995 to present. Documents dating back to the agency's creation in 1989 are expected to be added by mid-year. (*FHFB press release*, 2/14/03)

Farm Credit System/Farmer Mac

SEC and New York Attorney General Eliot Spitzer examine short-sellers' potential manipulation of Farmer Mac's stock prices

- The enforcement staff of the SEC and New York Attorney General Eliot Spitzer have been examining complaints that hedge funds could be working together to manipulate stock prices to bolster their trading positions. Farmer Mac complained to the SEC after becoming the object of short sales from several funds, including Gotham Partners Management Corp., Aquamarine Fund and Tilson Capital Partners, according to Farmer Mac's Chief Executive Henry Edelman. (*Wall Street Journal*, Randall Smith, Henry Sender and David Armstrong, 1/22/03) Gotham Partners told its investors in January that Spitzer had launched a formal investigation into allegations raised against the company. (*Dow Jones Newswire*, Robert Grant, 2/6/03)

Postal Service

Bills introduced in House and Senate to address the Postal Service's overpayment to the Civil Service Retirement (CSRS) fund

Postal Service thanks legislators for introducing legislation - Postmaster General confident that legislation will get passed

GAO Report says Postal Service overpaid the CSRS fund even more than previously thought

CAGW has mixed reaction to GAO Report

CBO Report says an OPM proposal to reduce the Postal Service's overpayment would increase the overall budget deficit by \$10 billion to \$15 billion over five years

- Members of the House and Senate introduced legislation February 12 that would let the Postal Service lower its payments to the CSRS fund. Congressmen John McHugh (R-NY), Henry Waxman (D-CA), Tom Davis (R-VA), and Danny Davis (D-IL) introduced the House bill (HR 735). Senators Susan Collins (R-ME), Tom Carper (D-DE), and Sam Brownback (R-KS) introduced similar legislation in the Senate (S. 380). Late last year, the Office of Personnel Management (OPM) discovered that the Postal Service had overpaid the CSRS fund that pays its retirees by over \$70 billion. The Postal Service said that it could use that money to avert a new rate increase until possibly 2006. The OPM proposed legislation models the Postal Service's payment to CSRS after its payments to the current Federal Employee Retirement System (FERS). This would result in a reduction in the Postal Service's annual obligation to CSRS by \$2.9 billion, allowing the Postal Service to delay its postal rate increase beyond 2004 to at least 2006. (*Congressman John McHugh press release, 2/12/03*)
- The McHugh/Waxman/Davis bill differs from the original OPM language in that the Postal Service would be required to apply the funds saved to pay down its debt to the Treasury. After 2005, the bill requires the Postal Service and OPM to calculate the difference between the cost to fund CSRS under the bill and the cost under the old law. These funds would be held in escrow until Congress acts on a Postal Service proposal outlining what should be done with the funds. (The Senate bill is silent on the escrow issue.) Additional mandates, in the form of a sense of Congress, would direct that some portion of saved funds be used: (1) to hold postage rates unchanged until at least 2006; (2) to fund retiree health benefits; and (3) to not pay for executive bonuses. (*Congressman John McHugh press release, 2/12/03; GovExec.com, Matthew Weinstock, 2/12/03*)
- No timetable has been set for action on either bill, and no decisions have been made on hearings, but Robert Taub, Congressman McHugh's Chief of Staff, said Congressmen McHugh and Davis "plan expeditious action on this. They realize they have to move quickly. This is definitely something they are not hanging back on." (*DM News, Melissa Campanelli,*

2/18/03)

Postal Service response

- Postal Service Senior VP of Government Relations Ralph Moden thanked Congressional Members for introducing the CSRS legislation. (*USPS press release*, 2/14/03) Speaking before the quarterly Mailers Technical Advisory Committee meeting, Postmaster General John Potter said postal officials are hopeful they will get CSRS legislation passed that will help halt rate increases until 2006. “If we can get that legislation [through Congress], we are committed to hold rates until 2006. We are working hard on the legislation,” Potter said. However, in the interim, “we are acting like we don’t have it. We are managing the bottom line as hard as we can.” (*DM News*, Melissa Campanelli, 2/6/03) Although he has not yet seen the legislation, Postal Service Chief Financial Officer said he was pleased that Congress was moving on the issue. (*GovExec.com*, Matthew Weinstock, 2/12/03)

GAO Report

- A General Accounting Office report released January 31 found that the Postal Service overpaid the CSRS fund more than it had originally calculated. The GAO examined the OPM’s analysis, which found that the Postal Service had overpaid the CSRS fund that pays its retirees by over \$70 billion. The GAO concluded that OPM’s analysis underestimated the overfunding, in part because the OPM included costs for military service of Postal Service employees. However, under current law, the Treasury Department covers the military portion, not the Postal Service. The GAO estimated the Postal Service’s projected overpayment would total \$103.1 billion versus the \$71 billion the OPM initially projected. The GAO said Congress should determine whether some of the projected surplus should be used to pay the Postal Service’s \$11.1 billion debt and address its \$40 to \$50 billion in unfunded health obligations for retirees. (*GAO Report: “Review of OPM Analysis of USPS Costs,”* GAO-03-448R, 1/31/03; *GovExec.com*, Matthew Weinstock, 1/31/03; *Washington Post*, Christopher Lee, 2/1/03)

Postal Service responds to GAO Report

- Postal Service Chief Financial Officer Richard Strasser said he welcomed the GAO’s findings that the Postal Service overpaid into the CSRS fund, but was disappointed that Congress should decide what to do with the savings. “I was a little disappointed that GAO indicated that Congress needed to determine what to do with these funds,” said Richard Strasser, the Postal Service’s Chief Financial Officer. “We’ve already gone on record indicating that we would use them to pay down debt...I’d like to think that Congress would, as they have in the past, delegate financial matters to the Postal [Service] Board [of Governors] and postal management.” (*Washington Post*, Christopher Lee, 2/1/03; *Associated Press*, Randolph Schmid, 1/31/03)

CAGW has mixed reaction to the GAO Report

- CAGW Vice-President Leslie Paige noted that the GAO found that, depending upon how the overfunding number is calculated, the savings could be between \$70 billion and \$103 billion. (The difference is related to which agency is obligated to pay benefits for postal retirees who also served in the military. Under current law, the U.S. Treasury is obligated for those

expenditures. A change in the law could shift those costs to the USPS).

- Paige stated, “Either way, the USPS will realize substantial savings when the correction is made and U.S. Postmaster General John Potter has announced that a correction in the funding mechanism would obviate the need for a postal rate hike until at least 2004. However, CAGW is most interested in GAO's assertion that the legislative 'fix' sought by OPM and the USPS is not a simple matter of changing a formula. There are important policy implications associated with this change to the USPS statutes. For example, the USPS has not addressed its unfunded liabilities in the aggregate. According to GAO, the USPS is also facing \$40 to \$50 billion in unfunded healthcare liabilities for its retirees and owes the U.S. Treasury \$11 billion. This does not include commitments to its worker's compensation fund.”
- “The Congressional Research Service has also implied that it might be prudent to defer changes to the postal statutes until the Presidential Commission on Postal Reform completes its work and presents a body of recommendations to Congress that address postal reform in a more comprehensive way. That process is on a fast track, with results expected by July 31, 2003.”
- “There is a danger that any piece of postal legislation, regardless of how simple and focused it appears to be at the start, will end up being festooned with extraneous amendments and elements that have nothing to do with the 'simple' recalculation of retirement benefits. In that event, all we'll have done is muddy the waters further, needlessly complicating the already complex task of the presidential commission, or, worse yet, rendered the whole commission exercise moot.”
- “It makes sense to us that, if Congress must go forward with corrective legislation, it should reject any other attempts to meddle with the postal statutes with non-germane issues, and that the legislation should specify that the savings accrued from a change in the funding formula be put to use paying down the USPS' \$11 billion debt to the U.S. Treasury and/or funding its other liabilities, such as healthcare. In so doing, Congress would be contributing to the long-term financial health of this agency and assisting the commission in its reform goals.”
(CAGW press release, 2/6/03)

CBO Report

- A January 27 Congressional Budget Office (CBO) report to Senator Jim Nussle (R-IA) analyzed the OPM's draft legislation reducing the Postal Service's payments to the CSRS. The CBO report stated, “Although reducing the Postal Service's payments to the retirement fund would improve the agency's internal fiscal position, it could increase deficits or reduce surpluses in the unified budget by as much as \$10 billion to \$15 billion over the 2003-2007 period and by as much as \$36 billion to \$41 billion over the 2003-2013 period. The impact would depend on whether the Postal Service responded to its improved fiscal position by delaying increases in postage rates, by increasing spending, by repaying debt owed to the Treasury, or by some combination thereof.”
- The CBO added, “A more complete accounting for retirement costs, however, involves more

than how pensions are funded. It takes into account all retirement costs, including health benefits. The Postal Service accounts for pension obligations as they are earned by its employees, but it does not do the same retiree health benefits...If the Postal Service accounted for and funded both retiree pensions and health benefits as they were earned by its employees, its operating costs would be higher, and some combination of increased postal rates or cost savings would be required. Those changes would reduce overall budget deficits or increase surpluses.” (CBO Acting Director Barry Anderson Letter to Senator Jim Nussle, 1/27/03)

Presidential Postal Reform Commission hears suggestions on reforming the Postal Service at February 20 public meeting

Commission receives 250 comment letters

Commission announces subcommittee members and upcoming field hearings

- Approximately 20 organizations gave suggestions on reforming the Postal Service at a February 20 public meeting of the nine-member Presidential Postal Reform Commission. (*DM News*, 2/21/03) This was the second public hearing by the Commission, with its report due to the President by July 31, 2003. President Bush formed the Commission in December. The following Web site contains copies of the February 20 witness testimony to the Presidential Postal Reform Commission: <http://www.treas.gov/offices/domestic-finance/usps/comments/index.html>
- Postal Service Chief Financial Officer Richard Strasser said the Postal Service needs more flexibility in setting its rates, possibly changing them at different times for businesses and the public. Businesses tend to prefer smaller, but regular rate increases, while the public prefers more convenient rates and less frequent increases, Strasser explained. He also recommended allowing the Postal Service to accumulate funds in years when it makes a profit to reduce the pressure for rate increases when economic downturns lower income. (*Associated Press*, Randolph Schmid, 2/20/03)
- UPS Chairman and CEO Mike Eskew expressed support for a healthy and viable Postal Service, focused on its core mission. However, “to the extent the Postal Service competes in the private sector, it must be on a level playing field with proper accounting, transparency, full disclosure and oversight,” he added. (*Business Wire*, 2/20/03)
- Direct Marketing Association President and CEO H. Robert Wientzen said that many of the DMA’s suggestions for reforming the Postal Service – involving labor issues, work sharing and pricing – require changes in the law. However, much can be done under existing law. He urged the Commission to endorse recommendations in the Postal Service’s 2002 Transformation Plan. (*DM News*, 2/21/03)
- The National Association of Letter Carriers President William Young testified that retaining

mail service to all Americans six days a week “must be the cornerstone of any postal reforms.” He endorsed the use of new technology and work sharing discounts to enhance the economic viability of the Postal Service. (*US Newswire*, 2/2/03)

Commission receives 250 comment letters

- The Commission received 250 written comment letters before the February 12 filing deadline. (*DM News*, Melissa Campanelli, 2/21/03)
- Postal Rate Commission Commissioner Ruth Goldway said the current law has never worked well and does not protect consumers and that eventually demonopolization and privatization are the answer and that transforming the Postal Service into a GSE may not be the answer. She noted that constructing a new regulatory policy will take some time, but some reforms can be enacted that will ease the transition to competition including, overhauling the Postal Service’s management bonus pay system. (*Goldway’s comments to the Presidential Postal Reform Commission*, 2/3/03)
- The Association of Postal Commerce said that reform is needed but should be implemented incrementally. The group called the system of postal products and prices “unworkable” and said the business model and monopoly statutes must be changed and the labor and management system reconsidered. (*DM News*, Melissa Campanelli, 2/13/03, 2/21/03)
- The Mailers Council offered six recommendations: (1) continue universal service; (2) improve productivity; (3) enhance mailer options; (4) enhance postal compensation; (5) improve financial transparency; and (6) invest in technology. (*DM News*, Melissa Campanelli, 2/13/03, 2/21/03)
- The Alliance of Nonprofit Mailers recommended reforms covering universal mail delivery, the postal monopoly, the rate-setting process, controlling costs, adjustments in service, competition with the private sector and Postal Service governance and oversight. (*DM News*, Melissa Campanelli, 2/13/03, 2/21/03)
- American Business media said the Postal Service’s efficiency and cuts to staff and labor policies should be addressed. It recommended keeping the current rate-setting system and defining the term universal service. (*DM News*, Melissa Campanelli, 2/21/03)
- PostalWatch recommended among other things, that the Postal Service be “de-commercialized and limited to providing mail service and should be banned from additional markets and exit from competitive markets in which it is currently engaged. (*PostalWatch’s comments to the Presidential Postal Reform Commission*)
- The Institute for Research on the Economics of Taxation (IRET) recommended that the Commission focus on better cost management and the Postal Service’s current business practices and the many political constraints that sharply raise the government agency’s expenses. (*IRET Congressional Advisory, Advisory No. 147*, 2/5/03)

- The Washington Legal Foundation (WLF) urged the Commission to determine whether the Postal Service has the statutory authority to engage in a variety of commercial activities offered to the public that fall outside the Postal Service’s mandate to deliver the mail. WLF further argued that even if the Postal Service can legally engage in some of these commercial activities without the Commission establishing the rates for these services, the Commission should, at a minimum, establish rules to require the Postal Service to provide a full accounting of the costs and revenues of these services, particularly since many of these activities are operating at a financial loss. WLF argued that the Postal Service is unfairly and illegally competing with the private sector. (*WLF press release, 2/5/03*)
- The following Web site contains copies of the comment letters submitted by various parties to the Presidential Postal Reform Commission: <http://www.treas.gov/offices/domestic-finance/usps/comments/index.html> PostCom has also created a special Web page which lists the testimony provided to date: <http://postcom.org/public/2003/pretest.htm>. (*PostCom Web site, 2/21/03*)

Commission announces subcommittee members and upcoming field hearings

- The Commission January 22 announced the members of four subcommittees established during the Commission’s January 8 public meeting. The subcommittees are comprised of members of the Commission. Commission Co-Chairs James Johnson and Harry Pearce are ex-officio members of each subcommittee. The Business Model Subcommittee members include Chairman Richard Levin, Don Cogman, Carolyn Gallagher, Norman Seabrook, and Robert Walker. The Private-Sector Partnership Subcommittee members include Chairman Joseph Wright, Don Cogman and Normal Seabrook. The Technology Challenges and Opportunities Subcommittee members include Chairman Robert Walker, Dionel Aviles and Joseph Wright. The Workforce Subcommittee members include Chairwoman Carolyn Gallagher, Dionel Aviles and Richard Levin. (*Treasury press release, 1/22/03*)
- The Commission announced the dates and locations of upcoming field hearings: March 18 in Austin, TX; April 4 in Los Angeles and April 29 in Chicago. (*DM News, Melissa Campanelli, 2/21/03*)

GAO continues to list Postal Service on its “high-risk” list
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- As part of GAO’s Performance and Accountability Series, the GAO issued a report on the Postal Service’s major management challenges and program risks. In the 2001 Performance and Accountability Report, the GAO identified financial, operational, and human capital challenges threatening the Postal Service’s ability to carry out its mission. Since then, the GAO found that these challenges have continued and its financial difficulties have increased, resulting in GAO’s placing the Postal Service’s transformation and long-term outlook on its high-risk list.
- The GAO believes that the Postal Service should:
 - “Work with Congress, the Presidential Commission, and stakeholders to implement

- the [Transformation] Plan and report on progress and financial impact of actions taken to support the Plan;
- “Develop strategies to realign its infrastructure and workforce, to support its business model;
 - “Continue efforts to cut costs, improve productivity, and address long-term financial issues such as its debt and retirement-related obligations; and
 - Improve transparency and timeliness of financial and performance information.”
- (GAO Report: “Major Management Challenges and Program Risks: US Postal Service,” GAO-03-118, 1/03)

Postal Service Inspector General responds to Senator Grassley’s ethical conduct investigation

Inspector General report finds \$236.6 million in potential Postal Service savings

- After being questioned in writing by Senator Grassley regarding her professional conduct, the Postal Service Inspector General Karla Corcoran has replied by sending 600 pages of documents for his review and investigation. Senator Grassley demanded answers in January to 24 lengthy and detailed questions about the management style of Corcoran. Senator Grassley’s aides said they were expecting direct answers to the questions, not hundreds of pages of documents. Senator Grassley has collected testimony and documents from more than 50 current and former employees of the Inspector General’s office that he said contained “troubling disclosures” about the way the office operates. The President’s Council on Integrity and Efficiency is also investigating the allegations. (*Washington Times*, James Lakely, 2/10/03) [See December 20, 2002 *GSE Report* for more information.]
- Independent audits and investigations of the Postal Service by the Office of Inspector General have identified more than \$236.6 million in potential savings and benefits in the last six month reporting period (April 1 to September 30, 2002), according to the September 2002 Semiannual Report to Congress just posted on its Website at uspsoig.gov (*PostalWatch.org Web site*, 1/22/03)

CATO Handbook for Congress calls for Postal Service privatization

- Director of Fiscal Policy Studies Chris Edwards suggested in the chapter on the federal budget in the CATO Handbook for Congress that among under things, that government spending can be curbed through the privatization of all government-operated businesses, such as the Postal Service. (*PostalWatch.org Web site*, 1/22/03)

Direct Marketing Association supports Postal Service’s plan for phased postal rate increases

- The DMA sent a February 4 letter to the Postal Service supporting a plan unveiled in January by postal officials for phased postal rate increases. The plan would implement new rates no

earlier than April 2004, with a second rate increase scheduled for spring 2005. If a traditional, non-phased rate case is filed, the postal service has said rates would increase in fall 2004. Though phased rates would be more frequent, many mailers like them because the increases would be smaller and more predictable, allowing mailers to better plan the increases into their budgets. Jerry Cerasale, DMA senior vice president of government affairs, expressed support for the plan in a letter to USPS associate general counsel Dan Foucheaux, with several conditions, including that all proposed rates would be based on two increases set at least one year apart and that the Board of Governors should state that any negative change in the postal service's financial condition will not lead to a reduction in the time between phased rate increases. (*DM News*, 2/5/03)

Reps. Manzullo and Velazquez ask Postal Service to halt its office supply deal with Boise Office Solutions

GAO Report finds deal has been costly and ineffective

Rep. Manzullo plans to hold a hearing on issue

- House Small Business Committee Chairman Manzullo and Ranking Democrat Congresswoman Velazquez asked the Postal Service to rescind its national office supply contract with Boise Office Solutions after the General Accounting Office found the Postal Service saved only \$1 million through the deal. The Postal Service had estimated that the deal, which began in April 2000 and was extended for two more years, would have saved the Postal Service \$28 million a year. (*Philadelphia Business Journal*, Kent Hoover, 2/3/03)
- The request came on the heels of GAO Report, requested by Congressman Manzullo, which shows the Postal Service's recent bundled contract with Boise has been ineffective and costly. Congressman Manzullo said he is planning a full Small Business Committee hearing to examine the office supply contract further. (Congressman Manzullo press release, 1/21/03)

The GAO Report concluded the following: "The Postal Service has not been successful in implementing its national-level contract to purchase most office supplies from Boise. Although the national contract was intended to be a mandatory source of office supplies, the Postal Service purchased less than 40 percent of its office supplies from Boise in 2001. GAO found that the Postal Service did not perform as planned under the contract because it did not take sufficient actions to ensure that the contract would be used. As a result, the Postal Service has not been able to realize its estimated annual savings of \$28 million. In fact, it was only able to provide documentation for \$1 million in savings for 2001. (GAO Report: "Contract Management: Postal Service's National Office Supply Contract Has Not Been Effectively Implemented," GAO-03-230, 1/03)

Mailers Council study shows postal productivity improved, but still lags private sector

- A Mailers Council study on Postal Service productivity shows that while the Postal Service has reversed its declining productivity trend in recent years, it has continued to fall behind private industry in improving productivity. The study updates results from a report published in 2000. The report shows that the Postal Service will never keep up with private sector productivity gains because of its current business model, size and financial burdens (which include pension liabilities, retiree health care, workers' compensation and debt). The study reveals that within its current structure the Postal Service could improve productivity by such actions shrinking the size of its work force and mail processing network, improving the use of technology, investing in a new capital improvements program and streamlining transportation management. (*Mailers Council press release, 2/12/03*)

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