

# The **GSE** REPORT™

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## **Major Events**

Freddie ousts CEO, Greg Parseghian, and General Counsel, Maud Mater, amid accounting errors

OFHEO directed the company to replace Parseghian and Mater

Parseghian and Mater criticized for their role in the company's accounting problems

Questions also raised about Parseghian's \$17 million profit from sales of Freddie Mac stock

OFHEO plans to review Parseghian and Mater's compensation packages

High-profile names mentioned as potential successors

Freddie may be pressured to change its business model and revamp its board

Fitch Ratings downgrades Freddie's subordinated debt and preferred stock ratings, citing Freddie's management shake-up

- Freddie's Board of Directors announced August 22 that it was directed by the Office of Federal Housing Enterprise Oversight (OFHEO) to replace the company's Chief Executive Officer and President, Greg Parseghian, and commence a search for his successor. OFHEO, Freddie Mac's safety-and-soundness regulator, directed the Board to take this action in a letter dated August 22, 2003. Parseghian will remain as CEO until a replacement is named. (*Freddie press release, 8/22/03*) Parseghian became CEO less than three months ago when Freddie's Board of Directors removed CEO Leland Brendsel and two other top executives, amid an accounting review of the company's earnings and alleged employee misconduct.
- The search for Parseghian's successor will begin promptly. No timetable has been set for its completion, although the company said the search would be conducted expeditiously. In addition, OFHEO has directed that the Board replace its Executive Vice President and General Counsel, Maud Mater. Deputy General Counsel Joan Donoghue will serve as Acting General Counsel until a permanent General Counsel is named. (*Freddie press release, 8/22/03*)

### Freddie's comments

- "We want to thank Greg Parseghian for his outstanding contributions to this Company, first as Chief Investment Officer and most recently as our CEO," said Board Chairman Shaun O'Malley. "But after discussions with our regulator and Greg, we believe it is now in the interest of the company to accede to OFHEO's directive." O'Malley noted that the company's restatement process "remains unaffected by this change, and is still on track to be completed during the third quarter." (*Freddie press release, 8/22/03*)

### Parseghian's comments

- Parseghian said, "Freddie Mac is a great company with a bright future. I am committed to ensuring a successful leadership transition. It has been a privilege to serve in a leadership

role at Freddie Mac for the past seven years, and I want to thank my fellow employees for their support and efforts.” (*Freddie press release*, 8/22/03)

#### Parseghian and Mater criticized for their role in the company’s accounting problems

- Sources said OFHEO Director Armando Falcon and his investigators concluded that Parseghian and Mater had to leave Freddie because of their role in the accounting and disclosure problems that are forcing the company to correct errors in its financial statements that may total as much as \$4.5 billion. (*Washington Post*, Kathleen Day, 8/23/03)
- Last month, an independent recent special accounting report prepared by the law firm, Baker Botts, for Freddie’s Board of Directors revealed that Parseghian played a more active role in the questionable accounting practices than previously known. The Board of Directors had previously stood by Parseghian, defending the Board’s decision to make him Freddie’s chief executive, even after the report was released in late July. [More information on the Baker Botts report available in this *GSE Report*.]
- Citing an unnamed source, the *Wall Street Journal* reported that there were two primary reasons why OFHEO pushed for Parseghian’s ouster. First, OFHEO was concerned about the recent Baker Botts report suggesting Parseghian played an active role in Freddie’s questionable accounting practices. Second, OFHEO’s continuing investigation into the company raised questions about the manner in which Parseghian ran Freddie’s loan portfolio in recent years, creating a “company within a company” whose values didn’t always mesh with Freddie’s broader housing mission. Among other things, it was a corporate culture in which employees felt they could break the rules without repercussions, the unnamed source said. Falcon believed it would be inappropriate for someone who had encouraged that kind of culture to run the company. Falcon was concerned about Mater’s role in Freddie’s failure to properly disclose the transactions it used to manipulate earnings, sources said. (*Wall Street Journal*, Patrick Barta, 8/25/03)

#### Questions raised about Parseghian’s \$17 million profit from sales of Freddie Mac stock

- Parseghian made a profit of more than \$17 million from selling all the company stock he could in early 2001, shortly after he helped implement strategies that the Baker Botts report concluded were designed to eliminate the effect of FAS 133 and keep earnings growth steady, the *Washington Post* reported. Parseghian sold more than 366,000 shares of Freddie’s stock in February 2001, which was the first time he was allowed to sell the company’s restricted stock and stock options after having been employed for five years. (*Washington Post*, Kathleen Day and David Hilzenrath, 8/16/03)
- Insider trading laws say executives are prohibited from selling stock in their companies when they possess material information that’s not available to the public. Legal experts differed on whether Parseghian’s February 2001 stock sales might violate insider-trading laws. (*Washington Post*, Kathleen Day and David Hilzenrath, 8/16/03)
- Parseghian issued a statement about the stock sales saying, “I have nothing to hide” and that he sold the stock because “I believed this to be a prudent strategy to diversify my financial position.” He noted that all of his stock sales were in accordance with Freddie’s trading policies and after consultation with Freddie’s Legal Division. “Each of my trades in Freddie

Mac stock has been in full compliance with the law and I am confident that any legal proceeding will reach the same conclusion,” he said. (*Washington Post*, Kathleen Day and David Hilzenrath, 8/16/03; *Written statement by Parseghian*, 8/15/03)

#### OFHEO plans to review Parseghian and Mater’s compensation packages

- OFHEO Director Armando Falcon said that Parseghian and Mater’s final compensation package will be subject to review by OFHEO and any further relationship of Parseghian with Freddie may only occur upon notice and approval by OFHEO. (*OFHEO Director Armando Falcon letter to Freddie’s Chairman Shaun F. O’Malley*, 8/22/03)

#### High-profile names mentioned as potential successors

- Among those being mentioned as possible successors to Parseghian are Treasury Undersecretary for Domestic Finance Peter Fisher, who announced he will leave his job in October and former Fannie Mae Chairman James Johnson. (*Associated Press*, Martin Crutsinger, 8/13/03) Sources also told *National Mortgage News’ Mortgage Wire* that former Bush Administration economic advisor Larry Lindsey, among others, was mentioned as a potential successor. (*National Mortgage News’ Daily website*, 8/22/03)

#### Freddie may be pressured to change its business model and revamp its board

- As Freddie searches for a new CEO, the company is likely to come under pressure to change its business model and revamp its board, reported the *Wall Street Journal*. The departure of Parseghian “is stimulating more debate about whether Freddie Mac should change the way it runs its business, reversing its recent shift toward becoming more like a Wall Street investment firm than a mortgage agency designed to help homeowners. At the same time, a growing number of critics are questioning the credibility of the board, which insisted that Mr. Parseghian was the best person to lead the company even though an independent report on the accounting problems suggests that some of the questionable practices executed by Mr. Parseghian’s group were disclosed to the board.” (*Wall Street Journal*, Patrick Barta and John McKinnon, 8/25/03)
- Freddie’s spokesman David Palombi said it would be inappropriate to speculate about any changes to the board, adding that the current board “has worked diligently throughout to resolve the accounting issues and foster public disclosure of its progress.” As to whether the company might change its strategy, he noted that the company’s problems have to do with weaknesses in accounting and disclosure, not its risk-management or other operations. The company has “no present intention to change [its] business model,” he said. (*Wall Street Journal*, Patrick Barta and John McKinnon, 8/25/03)
- Sources said OFHEO will issue its own report on Freddie’s accounting problems, probably in mid-September, but is unlikely to censure Freddie’s board for failing to more actively oversee the company. (*Washington Post*, Kathleen Day, 8/23/03) OFHEO’s move to force Freddie’s board to oust Parseghian and Mater was the result of the first-stage of OFHEO’s investigation. The second phase will address the compensation packages awarded to Freddie’s previously ousted executives. The third phase will include how well the board did its job and recommendations for the company, including such things as limiting how long a member can serve on the company’s board. (*American Banker*, Barbara Rehm, 8/25/03)

### Fitch Ratings downgrades Freddie's subordinated debt and preferred stock ratings

- Fitch Ratings downgraded August 23 the subordinated debt and preferred stock ratings for Freddie to "AA-" from "AA". The ratings remain on Rating Watch Negative. Fitch has also affirmed Freddie's long-term senior debt rating of 'AAA' and short-term rating of 'F1+', citing Freddie's GSE status, "exceptionally strong operating platform, and leading position within the domestic housing finance system." Approximately \$10 billion in preferred stock and subordinated debt are affected by today's action.
- Fitch downgraded the company's subordinated debt and preferred stock ratings, citing the August 22 announcement of another significant change within Freddie's senior management. "While there is depth in accounting and risk management within the organization, this announcement introduces additional risk related to the management transition now under way, in Fitch's opinion. The ongoing and now increased challenges that are created from the need to install a new CEO and certain division heads is sufficient in Fitch's opinion to make a distinction in its subordinated debt and preferred stock ratings from levels prior to these undertakings."
- "Going forward, Fitch is awaiting the completion of the restatement of Freddie Mac's financial results in order to finalize its analysis on the expected level of earnings volatility and appropriate capital levels in future periods....The resolution to the Rating Watch Negative will be heavily influenced by the selection of the CEO and certain division heads, clarity of the capital management, particularly post restatement and other factors." (*Business Wire*, 8/25/03)

### Background on Freddie's accounting issue:

- Freddie announced June 9 the removal of three of its top management team amid an accounting review of its earnings and alleged employee misconduct. Freddie's President and Chief Operating Officer David Glenn was fired for not fully cooperating with the accounting review and altering documents related to Freddie's restatement of its earnings for the past three years. Chairman and CEO Leland Brendsel retired "at Freddie's request" and Chief Financial Officer Vaughn Clarke resigned. The company's Executive Vice President – Chief Investment Officer, Gregory Parseghian, was briefly named Chief Executive Officer and President.
- OFHEO, the SEC, and NYSE have all launched formal investigations and federal prosecutors have launched a criminal investigation into the accounting practices and allegations of employee misconduct. OFHEO does not believe that Freddie's removal of its top management is sufficient and is still concerned about Freddie's management practices and control. Freddie is also the target of hearings and legislation on Capitol Hill and several class action shareholder lawsuits. The Federal Reserve, Treasury and HUD have indicated they are monitoring the situation. Freddie's troubles have renewed calls for GSE reform and strengthening the oversight of Fannie and Freddie.
- The management shake-up came after Freddie announced in January that it would delay the release of its 2002 financial statement and restate earnings for at least the previous two years (2000 and 2001), after its new auditor (Pricewaterhouse Coopers) recommended certain changes to its accounting policies, in particular the way it treats derivatives. Freddie's

previous auditor was Arthur Anderson. Freddie announced it would further delay the reporting of its restated earnings for the past three years until the end of the third quarter but still expects to report “materially” higher earnings.

Freddie releases independent report on its accounting errors

Former Freddie executives violated accounting and reporting rules to present steady earnings growth

“Steady Freddie” image ultimately led to accounting problems

Freddie’s financial disclosures were below the standards required of a SEC registered company

Report identifies Parseghian’s role in questionable transactions

- At the direction of its Board of Directors, Freddie released July 23 an independent report prepared by the law firm of Baker Botts LLP, special counsel to the outside directors of Freddie’s Board, in connection with its review of the facts and circumstances relating to accounting errors identified during the company’s restatement process. The full report may be found at Freddie’s web site, [www.freddiemac.com](http://www.freddiemac.com).
- The 107-page report finds that former top executives violated accounting and reporting rules and withheld information from the Board of Directors in an effort to present a pattern of steady earnings growth. “This is a painful day for Freddie Mac,” said Freddie’s Chairman of the Board Shaun O’Malley, referring to the report. “In the simplest terms: the findings reflect poorly on the past accounting, controls and disclosure practices used by Freddie Mac.” (*Remarks of Freddie’s Chairman of the Board Shaun O’Malley, 7/23/03*)
- “This is not a story of rampant criminal misconduct or abuse of authority for personal gain. Rather, it is a story of serious failures by prior senior management” of Freddie, said James Doty of Baker Botts. “The story presented in the report is one replete with accounting errors. Those errors often resulted from decisions by employees who lacked the expertise to appreciate the accounting issues at stake. The prior senior management maintained a public corporate image at the expense of good management practices and effective internal controls. The previous management also micromanaged the information flow to the Board, and ultimately to the public and markets. The result was a pattern of financial disclosure practices that fell below the standards required to a registered public company.” (*Remarks by James Doty, Baker Botts, 7/23/03*)
- For years, Freddie was known as “Steady Freddie,” a reference to a policy of conservative management articulated by Freddie’s former CEO Leland Brendsel, with the help of former President David Glenn. The staff was well aware of the mandate to maintain Steady Freddie’s reputation, and that ultimately led to the accounting problems, the Baker Botts report said. (*USA Today*, Christine Dugas, Del Jones and Elliot Blair Smith, 7/24/03) The report referred to “Steady Freddie,” as the “strategy of achieving stable earnings growth, minimizing volatility, and attempting to assure that the financial statements would better reflect management’s perception of the long-term profitability of the business.” (*Baker Botts*

*report on Freddie, 7/23/03)*

- The Board retained Baker Botts last December to conduct an investigation into allegations made in two anonymous letters. In general, Baker Botts found that the more serious allegations in the letters were unfounded. However, in the course of the probe, investigators uncovered accounting errors that led to the announcement on January 22 that Freddie's 2002, 2001, and 2000 earnings results would be restated. Baker Botts' investigation widened as a result. The fallout from the restatement process and investigation resulted in Freddie's June 9 announcement of the removal of three of its top management team amid an accounting review of its earnings and alleged employee misconduct. (*Baker Botts report on Freddie, 7/23/03*)
- The report's findings focused mainly on several transactions entered into in late 2000 and early 2001 in response to then-changing accounting rules, especially FAS 133, which addressed accounting for derivatives. Freddie entered into those transactions to defer recognition of certain income and to smooth its financial results. According to the report, Freddie's corporate accounting section was particularly weak during that period, and often relied too much on the expertise of Arthur Andersen. "Since 1998 (and possibly earlier), Freddie Mac's Corporate Accounting area has been relatively anemic for an institution of its size, complexity, and importance, both with respect to skill sets of certain key personnel and staff resources, and reliance on manual, as opposed to automated, processes," the report noted. Transactions in response to FAS 133 resulted in the unintentional misapplication of Generally Accepted Accounting Principles (GAAP). In some cases, the report said, Arthur Andersen backed the accounting treatment. (*BNA Daily Report for Executives, R. Christian Bruce, 7/24/03; Baker Botts report on Freddie, 7/23/03*)

#### Report identifies Parseghian's role in questionable transactions

- "As the Senior Vice President of Funding and Investments, Greg Parseghian was involved in several of the transactions we investigated," noted Doty with Baker Botts. "However, he did not have responsibility for the Company's accounting and disclosure. Like others, he was aware that the objective of some of the transactions was to defer earnings. We believed he relied in good faith on Corporate Accounting and/or Arthur Andersen to provide the necessary accounting advice and to ensure that transactions were accounted for in accordance with GAAP." (*Remarks by James Doty, Baker Botts, 7/23/03*)
- Despite the report's findings, the company continues to expect that the cumulative effect of the restatement will be to increase retained earnings as of December 31, 2002, by a range of \$1.5 billion to \$4.5 billion, and expects to report a material increase in the fair value of shareholders' equity for year-end 2002 over 2001. (*Summary of Baker Botts' report, 7/23/03*)

#### Parseghian had promised to address problems identified in special counsel report

- In prepared remarks to more than two dozen securities analysts at a closed-door August 6 luncheon at New York's Le Cirque restaurant, then CEO Greg Parseghian said he told Chief Financial Officer Martin Baumann to adopt "each and every" accounting change recommended in the Baker Botts report. He emphasized that the company would focus "on creating long-term value for shareholders, and not on short-term objectives, such as earnings targets." He added that he would "not compromise long-term value objectives for the sake of

reducing volatility in short-term earnings results.” He promised a “new era of open communication” and “more outward facing” in its business, saying that Freddie had been too “inwardly-focused” in the past. “You are going to hear it from us straight – whether we have a great year or a bad year – and we’re going to tell you why it happened.” (*Remarks by Freddie’s CEO and President Greg Parseghian to Securities Analysts*, 8/6/03; *Washington Post*, Kathleen Day and David Hilzenrath, 8/7/03)

- Parseghian added that the company plans to make three disclosures of its financial results: GAAP results, a non-GAAP supplemental measure, and fair value. GAAP, however, will be the primary measure of Freddie’s results. (*Remarks by Freddie’s CEO and President Greg Parseghian to Securities Analysts*, 8/6/03)
- A lawyer for Freddie said the closed door meeting with analysts did not violate securities rules about making material information public because Freddie is exempt. The lawyer noted, however, that Freddie behaves as if it were covered by the rules. A spokesman for Freddie said that company lawyers were at the luncheon to ensure that all material statements by Parseghian were made public. (*Washington Post*, Kathleen Day and David Hilzenrath, 8/7/03)
- *Dow Jones Newswire* reported that the company’s new “open culture,” espoused by Parseghian has limits. While the texts of Parseghian’s presentations to investors and analysts were made available to the public, the transcripts of the question-and-answer segments have not been released to the public. When asked about the lack of question-and-answer transcripts at these events, a Freddie spokesman stated, “He’s [Parseghian] meeting with investors and analysts...They are small meetings. The Q&A is not available because it’s not that kind of meeting. They’re closed meetings. He’s meeting with people we want to communicate with.” (*Dow Jones Newswire*, John Connor and Dawn Kopecki, 8/20/03)

Senators Hagel, Sununu and Dole introduce new GSE bill

Freddie officials expect a bill moving its regulator to Treasury but without changing capital requirements or mission to go through in October

- Senators Chuck Hagel (R-NE), John Sununu (R-NH) and Elizabeth Dole (R-NC) introduced July 31 a bill to improve oversight of Fannie and Freddie. The Federal Enterprise Regulatory Reform Act of 2003 (S. 1508) would move the current safety and soundness regulator, OFHEO, out of HUD and into the Treasury Department. The new independent regulator would be called the Office of Federal Enterprise Supervision (OFES).
- “This bill takes a critical first step toward ensuring that oversight of Fannie and Freddie is strengthened and investor confidence is restored. The success of these organizations has a direct effect on the stability of the American economy. The new regulator in the Treasury Department would be better equipped to oversee these large financial institutions,” Senator Hagel said.
- Among other things, the bill would:

- Give OFES oversight of Fannie and Freddie’s mission as well as safety and soundness;
- Give OFES authority to regulate the type and amount of assets Fannie and Freddie can hold;
- Give OFES enhanced enforcement powers like those of other financial regulators;
- Fund OFES through assessments instead of through Congressional appropriations;
- Require several governmental studies, including one on the risk implications of GSEs purchasing their own mortgage backed securities, one on the feasibility of merging OFES with the Federal Housing Finance Board (regulator of the FHLBank System), and one on the feasibility of consolidating OFES with the OTS. (*Senator Hagel press release, 7/31/03*)
- Require other governmental studies including a study on the extent obligations issued or guaranteed by Fannie and Freddie are held by federally funded depository institutions, the extent unlimited holdings by the institutions could lead to “systemic risk issues,” and the effects of placing “prudent limits” on holding of enterprise obligations by insured institutions. (*BNA Daily Report for Executives, 8/1/03*)

Freddie officials expect a bill moving its regulator to Treasury but without changing capital requirements or mission to go through in October

- Analysts attending the closed-door August 6 luncheon with Wall Street analysts said Freddie officials believe regulation of the GSEs will be transferred from OFHEO to Treasury. Freddie “expects (a) bill moving (its) regulator to Treasury but without changing capital requirements or mission, to go through in October, consistent with what we’ve heard from FNM (Fannie Mae),” Morgan Stanley Analyst Ken Posner, who attended the luncheon, said in a note to investors. (*Reuters News, 8/6/03*)

Fannie’s comments

- “We anticipate that there will be a number of bills introduced, and we look forward to working with the administration and all members of Congress in achieving a consensus,” said Fannie’s spokesman Chuck Greener. (*CQ Today, Siobhan Hughes, 7/31/03*)

Treasury Department to testify on regulatory structure of GSEs at House Financial Services Committee September 10

Treasury Secretary Snow says he hasn’t reached conclusion on Fannie & Freddie

- The House Financial Services Committee announced that Treasury Secretary John Snow’s testimony on the regulatory structure of the GSEs scheduled for September 4 has been changed to Wednesday, September 10 at 10 a.m. (*House Financial Services press releases, 8/4/03*)
- The administration said it is weighing a top-to-bottom revamp of how the government regulates the GSEs, reported *Bloomberg*. “The administration is currently assessing the stature, powers, oversight and resources of the current regulatory regime relative to other financial institutions’ regulators, and the unique requirements associated with regulating GSEs,” Treasury Spokesman Robert Nichols said in an August 12 statement. (*Bloomberg News, Bill Arthur, Simon Kennedy and James Tyson, 8/12/03*)

- Secretary Snow said he has yet to decide what recommendations he will make to Congress about how Fannie and Freddie should be regulated. In an interview with *CNBC*, Secretary Snow said he had reached no “conclusion” yet other than that “there should be better transparency, good disclosure and effective regulation, oversight.” (*Bloomberg News*, Simon Kennedy, 8/13/03)

Senator Robert Bennett (R-UT) to hold hearing on the regulation of FHLBanks September 9

- Senator Robert Bennett (R-UT), chair of the Senate Banking Committee’s Financial Institutions Subcommittee, plans to hold a hearing on September 9 that will focus on FHLBank supervision. FHLB Chairman John Korsmo is expected to testify, along with a Treasury official and industry representatives. (*American Banker*, Rob Garver, 8/14/03)
- The FHLBanks have been drawn into the calls for stricter oversight of Fannie and Freddie. While Congressman Richard Baker (R-LA) did not include the FHLBanks in his GSE bill, he believes that “enhanced oversight and supervision of the bank system is highly justifiable.” “We’ve got all kinds of plans, but the problem is I want to make sure that we don’t diffuse [our effort] to pass something that affects Fannie and Freddie by taking on the additional political weight of 12 bank presidents and what that means in Congress. However, if the FHLBanks do not get a new regulatory structure this year, the issue will be at the top of the list next year. Congressman Ed Royce (R-CA) introduced a GSE bill (HR 2803) on July 21 that would strengthen regulation of Fannie, Freddie and the FHLBanks, creating a new regulator for the three GSEs under the Treasury Department. In the early 1990s, the General Accounting Office proposed consolidating all of the housing GSE regulators. (*American Banker*, Rob Garver, 8/14/03)

Senator Jon Corzine (D-NJ) plans to introduce GSE bill in September

- In an interview with *Bloomberg News*, Senator Corzine said he plans to introduce a bill in September that would move OFHEO to Treasury and provide detailed guidelines for portfolio management at Fannie and Freddie. “We can make our bill a little more complete” than similar legislation already announced, he said. Treasury should periodically review the way Fannie and Freddie calculate the risk of their investments and should schedule regular audits to ensure the two GSEs don’t have excessive risk, he added. “Fannie and Freddie would actually benefit from the Treasury because the markets have more confidence in Treasury as a regulator” than they do in HUD, he said. (*Bloomberg News*, James Tyson and Andrew Dunn, 8/8/03)

#### Congress has introduced several GSE bills

- Congressman Richard Baker (R-LA) introduced a bill June 24 (HR 2575) to strengthen regulatory oversight of Fannie and Freddie. The bill would abolish OFHEO and shift safety and soundness regulation of Fannie and Freddie to the OTS, under Treasury. The OTS would be renamed the Office of Housing Finance Supervision (OHFS).

- Congressman Christopher Shays (R-CT) and Congressman Edward Markey (D-NY) introduced legislation (HR 2022) to remove the GSEs' SEC exemption and require Fannie and Freddie to register their debt and mortgage-backed securities with the SEC. The bill is entitled, "The Leave No Securities Behind Act."
- Congressman Ed Royce (R-CA) introduced a GSE bill (HR 2803) on July 21 that would strengthen regulation of Fannie, Freddie and the FHLBanks. The bill would create a new regulator for the three GSEs under the Treasury Department.
- Senators Chuck Hagel (R-NE), John Sununu (R-NH) and Elizabeth Dole (R-NC) introduced a GSE bill that would among other things, move OFHEO to Treasury. [More information available in this *GSE Report*.]
- Congressman Pete Stark (D-CA) introduced May 15 the "Secondary Mortgage Market Fair Competition Act" (HR 2117) that would amend Fannie and Freddie's tax-exempt status to allow states to tax these corporations' pre-tax earnings as they do private mortgage companies.

Senators Bennett, Enzi, Johnson and Schumer support moving GSE regulation to Treasury

- In an August 1 letter to Treasury Secretary John Snow, Senators Robert Bennett (R-UT), Mike Enzi (R-WY), Tim Johnson (D-SD), and Charles Schumer (D-NY) said they supported moving GSE regulation to the Treasury Department. "We are aware that the administration is examining the option of relocating the housing enterprises' financial regulatory authority to the Department of the Treasury. We endorse this option and want to express our desire to work – in a bipartisan manner – with you and your colleagues in the administration." The Senators said they would like to ensure that the GSEs "have a strong, independently financed financial regulator" that will enhance the "enterprises' mission." (*Joint letter by Senators Bennett, Enzi, Johnson and Schumer to Treasury Secretary Snow, 8/1/03*)

Treasury, HUD, and FHFB call on FHLBanks to voluntarily register with the SEC

ACB "disappointed" with the joint letter

Majority of FHFB members support SEC registration

- The Treasury Department, HUD and the FHFB sent a joint letter July 24 calling on all 12 FHLBanks to voluntarily register with the SEC under the Securities Exchange Act of 1934. The letter was sent to the chairmen and vice-chairmen of the boards of directors of the FHLBanks, as well as to the presidents of each of the institutions. (*Treasury, HUD, FHFB joint letter, 7/24/03*)
- An administration source said the letter is intended to send a simple message: This is an administration priority – not just the views of FHFB Chairman John Korsmo or former Treasury Under Secretary Peter Fisher. Noting that SEC Chairman William Donaldson did

not sign the letter, FHLBank of New York President Alfred DelliBovi, who has tried to persuade Bush Administration officials that SEC registration for the FHLBanks does not make sense, is holding out hope that the SEC will agree that the FHLBanks do not belong under its purview. “The question that remains unanswered is what the SEC is going to ultimately conclude. They may conclude that we don’t fit there.” The *American Banker* noted that the issue appears to be a “standoff.” While the Administration could try to make SEC registration mandatory, FHLBank officials doubt the FHFB has the authority to force the issue, and would likely sue the agency if it tried. (*American Banker*, Barbara A. Rehm, 7/28/03)

- The Treasury Department and FHFB Chairman John Korsmo have been pushing the 12 FHLBanks to comply with the same voluntary financial disclosure rules agreed to by Fannie and Freddie in July 2002 in which Fannie and Freddie agreed to voluntarily register their common stock and file quarterly annual reports with the SEC (in compliance with the Securities Exchange Act of 1934), while remaining exempt from registering their debt and MBS with the SEC under the 1933 Securities Act. [Fannie voluntarily filed for the first time its Form 10 registration statement and initial Form 10-K annual report with the SEC in March 2003, providing its audited financial statements for 2002. Freddie has not yet filed registration statements with the SEC. It had planned to do so in June of this year when it finished restating earnings from previous years, but now says the earnings restatements may be delayed until later in the third quarter and it will not be able to register with the SEC until mid-2004.]
- The joint Treasury/HUD/FHFB letter said the FHLBanks registering with the SEC would “provide better information to financial markets” and “enable FHLBanks to become role models for corporate transparency rather than exceptions to our nation’s standards for disclosure and investor protection.” The agencies noted that compliance with the Securities Exchange Act of 1934 “will not have an undue effect on the operations, structure, or services and products offered by the Banks.” The joint letter added, “Events of recent months serve to remind all who own, or regulate government-sponsored enterprises of the importance of providing periodic financial and governance reports on terms familiar to investors. We now ask that you accept Exchange compliance and SEC jurisdiction as part of the responsibility flowing from your public endowment and ready access to agency debt markets.” (*Treasury, HUD, FHFB joint letter*, 7/24/03)

#### ACB “disappointed” with the joint letter

- “We’re disappointed in the letter,” said Robert Davis, executive vice president and managing director of government relations at America’s Community Bankers. The ACB, ABA and ICBA sent a joint letter to the SEC in which they said SEC registration by the FHLBanks “would be unnecessarily burdensome for our member institutions and their shareholders” and would provide little if any benefit to holders of the system’s debt. The banking trade groups supported a disclosure system run by the FHLBanks’ regulator – the Federal Housing Finance Board – not the SEC. In a June 24 letter to the banking trade groups, SEC Corporate Finance Director Alan Beller, noting the FHLBank System is one of the world’s largest debt issuers, said holders of FHLBank debt “are entitled to the same information that is provided to investors in other public debt securities.” (*Dow Jones Newswire*, John Connor, 7/2/03, 7/25/03)

### Majority of FHFB members support SEC registration

- A majority of the five-member FHFB support the FHLBanks' voluntarily registering with the SEC, reported *Dow Jones Newswire*. This suggests that the votes are there if the FHFB decides to adopt a rule to force the FHLBanks to register "voluntarily" with the SEC. (*Dow Jones Newswire*, John Connor, 8/6/03)

Senate Banking Committee to vote on the nomination of OFHEO Director nominee Mark Brickell in September

- The Senate Banking Committee will not hold a vote on the nomination for Mark Brickell as the new director of OFHEO until September at the earliest, a Senate Banking Committee spokesman said. Senate Banking Committee Chairman Richard Shelby (R-AL) had said he wanted the committee to vote on Brickell's nomination before the Senate's August recess. However, the vote was delayed in part because Democrats sent a long list of follow-up questions to Brickell after his July 22 confirmation hearing. (*Dow Jones International News*, Rob Wells, 7/31/03)

Fannie's risk of loss is larger than publicly disclosed, reports *New York Times*

- Fannie faces much bigger losses from interest rate swings than it has publicly disclosed, according to computer models used by the company to estimate the value of its assets and debts, reported Alex Berenson with the *New York Times*. At the end of last year, the models showed that Fannie's portfolio would have lost \$7.5 billion in value if interest rates rose immediately by 1.5 percentage points, internal company documents provided to the *New York Times* indicated. At that time, the market value of all the assets on Fannie's books, minus all the company's debts, was about \$15 billion. So it would have lost roughly half its market value from such a sharp increase in interest rates, according to the computer models. An unidentified former Fannie employee provided the models to the *New York Times*. Fannie officials acknowledged that the company estimates the value of its portfolio weekly, though it discloses such information to investors only once a year. The models provided to the *New York Times*, are several months old, the Fannie executives said, and present an incomplete and misleading view of Fannie's financings. (*New York Times*, Alex Berenson, 8/7/03)

Two states and a labor union pension fund sue Freddie

- Two states and a labor union pension fund are suing Freddie to recover lost funds, accusing the company of misleading investors. (*Reuters*, Lynn Adler, 8/8/03) The West Virginia Investment Management Board's investment committee voted August 6 to pursue a class-action lawsuit against Freddie. (*Associated Press*, Gavin McCormick, 8/6/03) The West Virginia Investment Management Board and a Teamster fund sued Freddie in New York federal court on August 8. Both plaintiffs combined their suits and are seeking class action status. The labor union's fund is the Central States Teamster Fund. Ohio Attorney General Jim Petro said on August 8 that he would file a lawsuit against Freddie to recover funds lost by the state teachers' retirement system and public employees' retirement system. A

spokesman for Petro said the two Ohio pension funds covering teachers and general state employees lost an estimated \$25 million between 2001 and July 2003. The West Virginia Investment Management Board, which is the investment manager for the state of West Virginia, claimed it lost about \$1.8 million in its Freddie's investment. The Central States Teamster Fund claimed it lost about \$8.2 million. A spokeswoman for Freddie said they had not yet seen the lawsuits and were unable to comment. (*Reuters*, Lynn Adler, 8/8/03) The West Virginia and Teamsters suits were filed in federal court in New York; the Ohio suit was filed in Ohio federal court. The newest lawsuits join a group of at least 17 others that have been filed since June, when Freddie ousted its top three executives in connection with a series of questionable accounting decisions. (*Wall Street Journal*, Patrick Barta, 8/11/03)

- A *Cincinnati Enquirer* editorial noted, "If Freddie Mac was manipulating its public image at the expense of Ohio employees' and teachers' pension funds, it should be made to part with some of its \$600 billion in assets." (*Cincinnati Enquirer editorial*, 8/12/03)
- The litigation is a boon to bondholders favoring stronger regulation of Fannie and Freddie, said James Cusser, who manages \$1.7 billion, including Freddie Mac debt, at Waddell & Reed Inc. in Shawnee Mission, KS. "The good news is: The more scandal and flak that Freddie and Fannie get, the more Uncle Sam will bring them under his wing," Cusser said. "They will become more and more like financial utilities as opposed to the go-go stocks they used to be – and that's good news for bondholders. We love it." (*Bloomberg News*, Andrew Dunn and James Tyson, 8/8/03)

Fannie admits investment in synthetic fuel tax credit under review by IRS

Congressman Richard Baker (R-LA) questions Fannie's investment

Equity research firm issues first "sell" recommendation on Fannie's stock in at least seven years, citing the synthetic fuel tax credits

CAGW asks "How does this investment help low-income Americans buy a home?"

- The *Wall Street Journal/Dow Jones Newswire* reported that Fannie acknowledged that it used a tax credit being scrutinized by the Internal Revenue Service. The company said it made a "small" investment several years ago in three synthetic fuel limited partnerships to take advantage of a corporate tax credit. The IRS launched a formal investigation in June to determine whether synthetic fuel tax credits have been abused, questioning the scientific validity of the procedures and tests used in making synthetic fuels. A Fannie official said the investment and its benefits are minimal, although the official would not divulge details of the financial arrangement. The little-known investments are disclosed--along with Fannie's low-income housing tax credits--as "tax-advantaged investments" under "other income" in its financial reports. (*Wall Street Journal/Dow Jones Newswire*, Dawn Kopecki, 8/13/03)
- The investments came to light after Santa Monica equity research firm, MDB-Analytiq last month initiated coverage of the company with a rare "sell" rating, citing concerns about the lack of disclosure about the credits and their potential impact on earnings if revoked. MDB estimates that Fannie's synfuels' interests have produced anywhere from \$500 million to \$1.2

billion in actual earnings since Fannie's initial investment in 1998--numbers the company disputes. (*Wall Street Journal/Dow Jones Newswire*, Dawn Kopecki, 8/13/03)

- MDB's sell recommendation was the first issued on Fannie in at least seven years. Currently none of the 28 research firms tracking Fannie has issued such a recommendation, said Peter Conley, MDB Managing Director and Director of Equity Research. Other concerns about Fannie raised by MDB include negative trends in areas such as pre-tax margin, use of leverage and the ratio of loan reserves to loans. In addition, there is a "divergence" between Fannie's future earnings guidance and economic factors suggesting a slowing in the growth rate of new and refinanced residential mortgages because of projected increases in mortgage rates. Further, Fannie has less money in reserve to cover defaults than it did in the past, although it has been buying mortgages with greater default risk, noted Conley. (*Pensions and Investments*, 8/4/03)

#### Fannie's comments

- Fannie officials said the company's synfuel tax credits are minimal, boosting 2002 earnings of \$4.53 per share by just over a penny and increasing EPS cumulatively since 1998 by about 5 cents. "These investments are nonmaterial contributors to Fannie Mae's performance," said a Fannie spokesperson. "The information contained in their [MDB] report was materially false, it was not based on information provided by Fannie Mae." (*Wall Street Journal/Dow Jones Newswire*, Dawn Kopecki, 8/13/03)

#### Congressman Richard Baker (R-LA) questions Fannie's investment

- "This disclosure raises the very troubling question of just how investing in alternative fuel helps Fannie accomplish its government-chartered mission of creating homeownership opportunities for low-income families," Congressman Baker told *Dow Jones Newswire* in a statement. "I can't think of a better example of why serious reform is needed to closely monitor Fannie and Freddie's mission compliance," said Congressman Baker. (*Dow Jones Newswire*, Dawn Kopecki, 8/13/03)
- Fannie officials said its charter gives the company "general investment powers" to carry out its mission. "These investments are well within our charter authority," Fannie's spokesman Chuck Greener said in a statement. (*Dow Jones Newswire*, Dawn Kopecki, 8/13/03)
- A spokesman for Freddie said the company has never invested in the synthetic fuel industry. (*Dow Jones Newswire*, Dawn Kopecki, 8/13/03)

#### CAGW says Fannie's tax breaks should help fuel GSE reform – "How does this investment help low-income Americans buy a home?"

- The Council for Citizens Against Government Waste (CCAGW) – the lobbying arm of CAGW - reiterated its call for swift enactment of substantive GSE reforms in the wake of revelations by the *Wall Street Journal* that Fannie had admitted to having a financial interest in a synthetic fuels company in order to reduce its taxable income.
- "This story raises serious questions about the manner in which Fannie Mae is leveraging its charter and the valuable privileges Congress granted it. These revelations merit a full investigation by Congress and Fannie Mae's regulators," said CCAGW Director of Special

Projects Leslie K. Paige. "The GSEs were charged with a public mission in exchange for tax exemptions, disclosure exemptions, anti-trust exemptions and a raft of other benefits that are today worth more than \$10.6 billion annually. It is absolutely outrageous that Fannie Mae, a GSE that is already endowed with tens of billions in implicit subsidies, has used that financial windfall to invest in a synthetic fuel company in order to get even more lucrative tax breaks. It is even more egregious since the IRS has concerns about abuses of this synthetic fuel tax break. How does this investment help low-income Americans buy a home? What it does is allow a huge company that has become rich on taxpayer-backed subsidies to get even richer. Where are Fannie's regulators, OFHEO and the Department of Housing and Urban Development? This new information indicates the need for an immediate change in the oversight structure on the activities of all the nation's GSEs."

- Momentum is building in Congress to strengthen oversight of all the GSEs. "While CCAGW applauds members of both the House and the Senate for stepping up to address this important issue, SEC registration and disclosure must be a part of any worthwhile reform package," added Paige. "These recent revelations are only the tip of a very large iceberg. The reality is that nobody really knows what these entities are doing, the risks they are taking, or how they are accounting for their assets. These recent stories, coupled with the fact that the taxpayers would be called upon to bail them out in a financial crisis, ought to be lighting a fire under Congress. It is inexcusable that the GSEs continue to be exempt from SEC disclosure. Fannie Mae and Freddie Mac have been operating in the shadows long enough. The veil of secrecy must be lifted." (*PR Newswire*, 8/14/03)

## ***Fannie & Freddie***

Largest mutual fund company, Fidelity Investments, cuts its stakes in Fannie & Freddie
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- Fidelity Investments, the largest US mutual fund company, cut its stakes in Fannie and Freddie's stock in the second quarter, according to an SEC filing on August 14. Fidelity reduced its holdings of Freddie's stock by 48 percent in the second quarter and dropped about 17 percent of its Fannie stock. As of March 31, Fidelity was the largest holder in Fannie and Freddie with about 55 million shares of Freddie's stock and 97 million shares of Fannie. As of June 30, Fidelity held 28 million shares of Freddie and 80 million shares of Fannie. Even with the lower stakes, Fannie was one of the 10 largest stocks in Fidelity's flagship \$62 billion Magellan fund, as well as in a number of other portfolios. (*Reuters*, Mark Wilkinson, 8/14/03; *Bloomberg News*, Aaron Pressman, 8/14/03)
- While a Fidelity spokeswoman said the company does not comment on its holdings and would not discuss any specifics, Fidelity's actions are closely watched by those in the industry and could cause others to follow suit. (*Mutual Fund Market News*, Chris Frankie, 8/25/03)

European Central Bank recommends central banks reduce their holdings of Fannie & Freddie?

Fannie claims it is an unsubstantiated rumor

Are Asian central banks trimming their exposure to agency debt?

Will Chinese officials threaten to reduce their purchasing of Treasuries and agency debt to cool yuan criticism?

Foreign central banks lower their holdings of agency debt

- *Bloomberg* reported that the European Central Bank is selling all the Fannie and Freddie bonds it holds and has recommended that its national central banks do the same, citing an unnamed person who has seen the recommendation. The Frankfurt-based Bank gave its opinion at the last meeting of the 18-member governing council on July 10, said the unnamed person. The European Central Bank based its advice on credit risk, the source said. European central banks buy less than 10 percent of new agency debt sales, whereas Asian central banks often buy 25 percent to 35 percent of debt being sold, said Boris Loshak, a strategist who follows Fannie and Freddie for Barclays Capital. The European Central Bank probably owns about \$2 billion to \$3 billion of agency debt and has sold about 25 percent of that, analysts who follow European banks said. (*Bloomberg News*, Emma Vandore, Christian Baumgaertel, Rainer Buergin, Christine Harper, Al Yoon, 7/29/03)
- The European Central Bank sold US agency debt from the European Central Bank's foreign exchange reserves through one of the European Central Bank's national central banks, a source at the national central bank told *Reuters* on July 30. Asked whether he had seen orders to sell from the European Central Bank, the source told *Reuters*: "Yes, I think it is fair to say that." He declined to comment on how large the selling was or why the European Central Bank had sold. The European Central Bank sales were conducted recently, according to market participants, with a large volume on July 18 totaling in the "hundreds of millions of dollars," a mortgage trader said at the time. The European Central Bank declined to comment. Fannie's Chairman Franklin Raines said July 30 that he was unaware of any policy change by the European Central Bank with regard to member holdings of agency debt, however, he would not be surprised if a conservative investor like the European Central Bank would consider reducing its holdings of agency debt in light of Freddie's accounting scandal. (*Reuters*, Douwe Miedema and Lynn Adler, 7/30/03)
- Speculation about the European Central Bank's actions have plagued the agency markets in recent weeks, touched off by a vague decision by the European Central Bank on July 2 that it was tightening risk standards in its market operations program for its 15 member banks in the first quarter of next year. However, European Central Bank officials told *Dow Jones Newswire* that US agency securities have never been eligible to use for that purpose and the July 2 decision only applied to European agency securities. European Central Bank officials declined to comment about the claims in the *Bloomberg* story. (*Dow Jones Newswire*, Dawn Kopecki, 7/28/03) Germany's Bundesbank and Spain's central bank both said they had no plans to sell US agency debt last month. Both are members of the European Central Bank.

(*Bloomberg News*, Beth Thomas, Chris Cooper, Al Yoon, 8/14/03)

- Linda Knight, senior vice president and treasurer at Fannie, called reports of a European central bank selloff “unsubstantiated” and said she had “no knowledge” of a policy change that would affect Fannie’s debt securities. (*Wall Street Journal*, 7/29/03) Knight said the European Central Bank may have become more cautious in the wake of the accounting scandal at Freddie, but that Fannie did not think the central bank is turning against US agency debt. “The ECB is a very careful, considerate central bank that’s managing foreign-currency reserves,” she said. “I think it’s possible that, given everything that’s been going on at Freddie Mac, they may have taken a more cautious approach for the time being. But we wouldn’t really view that as a change in policy, really – just a careful review of circumstances that they’re observing at the marketplace.” (*Dow Jones Newswire*, Netty Ismail, 8/15/03) A spokesman at Freddie said “it would be inappropriate to speculate on rumors concerning European Central Bank policy.” (*Wall Street Journal*, 7/29/03)

#### Are Asian central banks trimming their exposure to agency debt?

- Asia’s central banks are gradually trimming their exposure to US agency debt, analysts said July 30. “We have seen agency selling from Asian customers, but not in any great size so far,” said one trader of agency debt in Japan. Central banks are the dominant Asian holders of US agency securities, and the talk of Asian selling raised worries that they could be exiting the sector. Around 70-80% of all official Asian reserves, which now top \$1.2 trillion, are invested in dollar-denominated assets. (*Reuters*, 7/30/03)
- Asian investors don’t appear to be selling Fannie’s debt, said Fannie’s Senior Vice President and Treasurer Linda Knight. Asian central banks hold more than 20 percent of Fannie and Freddie’s debt, reported *Dow Jones Newswire*. (*Dow Jones Newswire*, Netty Ismail, 8/11/03) In Asia, “we haven’t noticed any selling, but people are becoming more cautious in terms of how they allocate new money,” Knight said in an interview in Tokyo, where she is meeting with investors. For investors, “there continues to be some questions, mainly related to Freddie,” Knight said. She said she hoped that investors would become more confident when Freddie releases its audited earnings. Hisanori Takayama, a fund manager in Tokyo who helps manage the equivalent of about \$25 billion at Taiyo Life Insurance Co., Japan’s eighth-largest life insurer, said he was looking to sell some of the Fannie and Freddie bonds he owns because of the “negative news” on the companies. Knight declined to say whether she and other Fannie officials were meeting with the Bank of Japan in Tokyo or with other Asian central banks. A Bank of Japan official declined to comment on whether the central bank owns agency bonds. (*Bloomberg News*, Beth Thomas, Chris Cooper, Al Yoon, 8/14/03)
- Knight and Arne Christenson, a senior vice president of regulatory policy at Fannie, and Michael Kenney, a senior manager at Fannie, are visiting countries including China, Taiwan, and Singapore. Knight said “the purpose of the trip is to meet with a wide range of important investors.” Fannie is seeking to reassure investors “by answering their questions face-to-face. We want to make sure people have the information they need.” (*Bloomberg News*, Beth Thomas, 8/14/03)
- Last year, Asian investors held 21.7 percent or \$13.617 billion of Fannie’s debt, while European investors held 10 percent at \$6.275 billion. International participation for 2002 was 31.7 percent. (*Dow Jones Newswire*, Julie Haviv, 7/29/03)

Will Chinese officials threaten to reduce their purchasing of Treasurys and agency debt to cool yuan criticism?

- Chinese officials plan to tell Treasury Secretary John Snow that they might reconsider the country's hefty buying of Treasurys and US agency debt if Washington doesn't cool its calls for China to revalue the yuan, according to *Reuters*, citing a recent report by Medley Global Advisors. The Medley report quoted Chinese officials saying they will reiterate that they have not sold any Treasurys or agencies and have in fact, continued to buy those securities, sources said. But unless the US calms its criticism, Chinese officials plan to tell Secretary Snow during an expected visit this year that they may reconsider their purchase of Treasurys and Fannie and Freddie's debt, sources said. Total Treasurys and agencies owned by foreign central banks stand at \$935 billion, and most of those belong to Asian central banks. (*Reuters*, Eric Burroughs and Gertrude Chavez, 8/8/03)

Foreign central banks lower their holdings of agency debt

- Agency debt held in custody for foreign central banks has declined over the past seven weeks, to \$183.25 billion, from a record \$189.8 billion, according to the Federal Reserve. Foreign central banks sold \$585 million of agency debt in the week that ended July 23, the Fed said. (*Bloomberg News*, Emma Vandore, Christian Baumgaertel, Rainer Buergin, Christine Harper, Al Yoon, 7/29/03)
- The decline in the amounts held by the Fed was probably due to bonds maturing and investors not investing new money, as opposed to selling of securities, said Linda Knight, senior vice president and treasurer at Fannie. (*Bloomberg News*, Beth Thomas, Chris Cooper, Al Yoon, 8/14/03) Knight acknowledged Fannie has seen "a somewhat lessened demand" for its paper from foreign investors, but she added, "I think that has to do with a lot of the concerns we've been talking about in the marketplace." (*Dow Jones Newswire*, Netty Ismail, 8/11/03)

OFHEO solicits comments by August 27 on its draft strategic plan
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- OFHEO is soliciting comments on its revised Strategic Plan. In accordance with the requirements of the Government Performance and Results Act of 1993 that agencies update their Strategic Plans every three years, OFHEO has developed its FY 2003-2008 Strategic Plan and soliciting the views and suggestions of those entities potentially affected by or interested in the plan. Comments are due August 27, 2003. OFHEO's draft FY 2003-2008 Strategic Plan may be viewed on OFHEO's web site at: [www.ofheo.gov/OFHEOReports.asp](http://www.ofheo.gov/OFHEOReports.asp) (*OFHEO press release*, 8/11/03)
- OFHEO's main goals for 2003-2008 include:
  - Ensuring Fannie and Freddie comply with safety and soundness standards, are adequately capitalized, and comply with other legal requirements;
  - Enhancing the public understanding of the nation's housing finance system;
  - Contributing to Federal efforts to promote efficient and effective financial markets and homeownership.

- OFHEO’s draft report noted that in 2002, Fannie and Freddie assisted in the funding of \$1.375 trillion of mortgages and at year-end 2002, the outstanding amount of mortgage-backed securities guaranteed by Fannie and Freddie has increased to \$2.6 trillion. Since 1992, mortgage investments at Fannie and Freddie have grown by more than 620 percent to \$1.4 trillion. In the debt markets, especially the long-term debt markets, Fannie and Freddie are two of the largest private issuers in the world. At year-end 2002, Fannie and Freddie had \$1.5 trillion in debt outstanding. Fannie and Freddie are also two of the largest end-users of derivatives. At year-end 2002, the combined notional amount of derivatives contracts used by Fannie and Freddie exceeded \$1.5 trillion.
- OFHEO also noted that Fannie and Freddie’s GSE status “continues to give them advantages over other firms in the housing finance market.” Fannie and Freddie have promised double-digit earnings growth, however, “Various regulatory changes, such as HUD’s new affordable housing goals for Fannie Mae and Freddie Mac, the implementation of risk-based capital requirements for the Enterprises and the Federal Home Loan Banks, and the new mortgage purchase programs initiated by these banks in recent years, may affect each Enterprises’ volume of business, financing strategies and risk. Continued growth of the Enterprises requires increased attention to the associated systemic implications.”
- In terms of regulating Fannie and Freddie’s capital, OFHEO said it plans to evaluate and update Fannie and Freddie’s minimum and risk-based capital standards to ensure that Fannie and Freddie’s capital requirements are consistent with Fannie and Freddie’s evolving risk profiles. OFHEO will continually evaluate the risks associated with new programs and activities of Fannie and Freddie, conduct additional analysis and tests to address risks that may not be reflected in OFHEO’s stress test, and apply capital measurement tools to capture alternative perspectives of risk.
- OFHEO said it will continue to ensure that its safety and soundness standards are communicated in a timely fashion to Fannie and Freddie and will strengthen and enhance its enforcement mechanisms available to remedy potential violations. “The dynamics of the financial markets and the breadth and depth of the Enterprises’ participation warrant an increased emphasis on these mechanisms,” said OFHEO. The agency will also review the overall compensation and termination benefits for Fannie and Freddie’s executives to see that they meet statutory requirements for comparability with payments made by similar organizations. Should another regulator or judicial body determine a violation of law under a statute that is not within OFHEO’s direct enforcement authority, OFHEO may take such supervisory action as determined necessary within its authorities relating to safety and soundness and the chartering acts.
- OFHEO will work with Fannie and Freddie to improve and enhance the public disclosures of their activities, including measures of their risk exposure. OFHEO plans to keep other federal financial regulators (FDIC, FRB, NCUA, OCC, OTS, FHFB, FCA, and OSMO) informed about OFHEO’s regulatory activities and solicit their views about issues related to Fannie and Freddie. OFHEO said it will also ensure there is sufficient disclosure of information regarding Fannie and Freddie’s operations to allow market participants to trade their obligations efficiently and effectively in the financial markets.

- OFHEO cited its lack of financial independence as an external factor that could prevent OFHEO from reaching its strategic goals. Unlike all other federal financial regulators, OFHEO’s funding is subject to the annual appropriations process. OFHEO also noted that “Significant increases in unemployment, significant decreases in house prices, prolonged changes in interest rates could significantly affect the financial condition of the Enterprises. During exceptionally adverse economic periods, the Enterprises may be unable to meet regulatory standards.” (*OFHEO FY 2003-2008 Strategic Plan*, 8/11/03-Draft)

House Appropriations Committee rejects \$4.5 million in additional funding requested by OFHEO for accounting examinations of Fannie & Freddie

Approves budget increase for OFHEO

- The House Appropriations Committee July 21 approved legislation providing \$32.4 million in FY 2004 for OFHEO. The funds are \$2.6 million more than FY 2003 and are in line with President Bush’s proposed FY 2004 budget, which recommended more funding for OFHEO. In separate action, the Committee did not take up a supplemental funding request from OFHEO for \$4.5 million to undertake its accounting examinations of Fannie and Freddie. There was no official White House request for the additional funding, the Committee spokesman said, and the agency has asked for additional funding in letters in past years. The OFHEO funds are part of the \$37 billion VA-HUD Appropriations bill. (*BNA Daily Report for Executives*, Jeff Day, 7/23/03) Since OFHEO is funded through assessments on Fannie and Freddie, the request will not have a budgetary impact. 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.
- The Committee also did not take up President Bush’s budget request recommending that OFHEO be removed from the appropriations process. “The committee does not recommend proposed language as an administrative provision under this title to take funding for OFHEO off-budget,” the committee report on the VA-HUD appropriations bill said. (*National Mortgage News Daily web site*, 7/22/03)
- President Bush’s FY 2004 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. 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.

Cong. Richard Baker (R-LA) calls on Congressional Members to support GSE reform

- Congressman Baker called for bipartisan unity in supporting GSE regulatory reform. “We are aware that the administration is examining the option of relocating Fannie and Freddie’s regulatory authority to the Department of Treasury,” Congressman Baker said in a prepared statement. “With the Hagel and Baker bills as a starting point for discussion, now is the time when we need to work in a bipartisan manner with the administration to help achieve a timely transfer of regulatory authority to Treasury and a strengthening of supervision that balances the essential status and mission of Fannie and Freddie with the strength and authority a new regulator will require, taxpayers deserve, and the housing markets demand.” (*Market News International*, Claudia Hirsch, 8/1/03) “Homeownership is not a partisan issue and neither is taxpayer protection,” said Congressman Baker. “I’m calling upon members of Congress in both chambers and on both sides of the aisle to come together quickly and work cooperatively for that resolution,” Congressman Baker said. (*Dow Jones Newswire*, Dawn Kopecki, 8/1/03)

*Washington Times* editorial calls for moving OFHEO to Treasury

- A *Washington Times* editorial noted: “Freddie Mac’s sheer size, coupled with its implicit guarantee from the government, will likely allow it to weather its accounting imbroglio. But due to the Office of Federal Housing Enterprise Oversight’s [OFHEO] delayed detection of Freddie’s exotic accounting practices, the lawmakers calling for transferring regulation of the company to the Treasury Department are on target. Such a shift would restore investor confidence in government oversight of Freddie Mac, thereby benefiting both the company and millions of homeowners.”
- “OFHEO has been fairly accused of being slow to bolster its oversight of Freddie Mac... The mortgage market that Freddie and Fannie dominate is critical to America’s economic stability. For this very reason, Congress should ensure that any governmental review of their financial health is rigorous and trusted.” (*The Washington Times*, Editorial, 7/28/03)

HUD Inspector General releases audit report on administrative operations of OFHEO

- The HUD Inspector General released July 29 an audit of certain administrative operations of OFHEO. The IG’s audit objectives were to review the appropriateness of travel expenditures at OFHEO during the last four years, to determine whether OFHEO’s compensation levels are comparable to other Federal financial regulators, and to evaluate whether space utilization is reasonable.
- The IG found that OFHEO did not ensure that it used its funds at optimum efficiency, as the agency paid for lodging costs above the maximum per diem rate and also leased office space in excess of the government recommendations and averages. OFHEO sometimes did not detect its employees’ travel card misuse or travel voucher errors. The IG concluded that OFHEO’s compensation levels are comparable to other regulatory organizations and

recommended that the Director of OFEHO improve its policies and procedures in order to ensure that its funds are used efficiently and ensure procedural changes that have been initiated for the review of travel related expenditures are fully implemented and effective.

- The complete IG audit report may be found at the following web site:  
<http://www.hud.gov/oig/ig370002.pdf> (Audit Report, HUD Office of Inspector General, Administrative Operations, OFEHO, Audit Report No. 2003-KC-0002, 7/29/03)

Federal agency long-term debt increases during first half of 2003
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- Federal agencies increased long-term new issue volume to \$683.6 billion during the first half of the year, according to a report by the Bond Market Association (BMA), up 50.7 percent from the \$453.7 billion issued in the same period last year. The increase in issuance activity during the first half of the year was attributable to a continued high level of conforming residential home mortgage originations and sales, supported by the low-interest-rate environment during the first half of the year. The FHLBank System led the surge in long-term debt issuance during the first half of 2003, with \$353 billion in new sales, up 108.3 percent from the \$169.7 billion issued during the first half of 2002. The Farm Credit System also experienced significant growth in long-term debt issuance; new sales volume rose 79.6 percent, to \$32.5 billion in the first half of 2003. In contrast, long-term debt issuance from Freddie and the TVA decreased during the same period. (*Research Quarterly, Bond Market Association, 8/2003*)
- The BMA noted, “In early June, Freddie Mac announced it would replace members of its executive team over an investigation of an earnings restatement. As a result, some regulators and lawmakers called for a change in the regulatory scheme of the housing-related government sponsored enterprises. The issue could influence the federal agency sector in future quarters.” (*Research Quarterly, Bond Market Association, 8/2003*)

Long-term federal agency debt issuance:

\$ billions	2002	2002: Q2	2003: Q2	YTD-to-YTD %Change	YTD-to-YTD \$Change
FHLB	435.4	169.7	353.5	108.3%	183.8
Freddie Mac	295.5	141.3	129.5	-8.4%	(11.8)
Fannie Mae	238.5	112.0	155.1	38.5%	43.1
Sallie Mae	20.5	11.3	12.0	6.1%	0.7
Farm Credit System	50.1	18.1	32.5	79.6%	14.4
Tennessee Valley Authority	1.5	1.3	1.0	-23.1%	(0.3)
Totals	1041.5	453.7	683.6	50.7%	229.9

Source: *Research Quarterly, Bond Market Association, August 2003*

Short-term federal agency debt outstanding:

\$ billions	6/30/02	3/31/03	6/30/03	% Change *	\$Change *
FHLB	134.3	143.0	156.4	9.4%	(13.4)
Freddie Mac	180.3	174.0	218.5	25.6%	44.5
Fannie Mae	274.8	318.0	340.4	7.0%	22.4
Sallie Mae	29.2	23.8	24.6	3.4%	0.8
Farm Credit System	31.1	16.1	15.3	-5.0%	(0.8)
Tennessee Valley Authority	2.2	3.3	2.5	-24.2%	(0.8)
Totals	651.9	678.2	757.7	11.7%	79.5
* Percentage and amount change between 6/30/03 and 3/31/03					
Source: <i>Research Quarterly, Bond Market Association, August 2003</i>					

- Conforming agency MBS issuance increased to \$1.08 trillion in the first half of 2003, up 68.7 percent from the \$637.6 billion issued during the same period last year. Fannie’s issuance increased to \$645.6 billion in the first two quarters of the year, more than double the \$311.0 billion issued in the same period one year ago. New issue volume of Freddie’s MBS totaled \$325.1 billion in the first half of 2003, up 35.2 percent from the \$240.4 billion issued during the first half of 2002. Ginnie Mae’s guaranteed mortgage securities issuance volume increased 21.8 percent in the first half of the year, totaling \$105.0 billion. (*Research Quarterly, Bond Market Association, August 2003*)
- Issuance of agency collateralized mortgage obligations (CMO) increased to \$360.3 billion in the first half of 2003, up 49.5 percent from the \$158.8 billion issued last year. However, on a quarterly basis, CMO issuance decreased 21.2 percent when compared to the first quarter of 2003, and all three agencies experienced a decline in their quarterly CMO issuance volume. (*Research Quarterly, Bond Market Association, August 2003*)

Fannie & Freddie show interest in E*Trade’s portable mortgage
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- E\*Trade Group, Inc. June 9 announced that its subsidiary, E\*Trade Mortgage, has launched its “Mortgage on the Move” program, enabling consumers to lock in today’s low portable mortgage rates on a home loan and then transfer the rate to the next home they purchase, potentially saving thousands of dollars in interest. “Mortgage on the Move” is available for a limited time to borrowers across the US. With “Mortgage on the Move,” borrowers secure a new purchase money mortgage loan at competitive interest rates. The program enables borrowers to transfer the terms of the loan to a new future residence, rather than paying off the existing loan and applying for a new loan at a potentially higher market interest rate. (*E\*TRADE Group press release, 6/9/03*) Portable mortgages are common in other countries, including Australia and Ireland. (*Washington Times, Chris Baker, 6/10/03*)
- E\*Trade Mortgage says that positive consumer response to its new product has sparked interest in the secondary mortgage market. The company said it has been approached by

Fannie and Freddie, and by the Bond Market Association. The company plans to set up meetings with the companies to discuss the possibility of creating a secondary market for the portable loans. (*Wall Street Journal*, Queena Sook Kim, 6/18/03)

- Fannie piloted a portable mortgage program several years ago, but it never gained momentum. “There are no active discussions about a portable mortgage product within the company right now,” said Alfred King, a spokesman for Fannie. (*Investment News*, Frederick Gabriel, Jr., 6/16/03)
- “Portable mortgages are a concept that we have been looking at,” said Freddie’s spokesman Doug Robinson. “At the moment, we do not purchase portable loans from lenders who originate them, but we certainly are always interested in new ideas that make homeownership more accessible and affordable.” (*San Jose Mercury News*, Daniel Vasquez, 6/10/03)

OFHEO releases working paper on the loss distribution of subprime and prime mortgages

- Anthony Pennington-Cross, a senior economist at OFHEO, authored a working paper to address loss distributions between subprime and prime mortgage loans. The full version is available on OFHEO’s website at: <http://www.ofheo.gov/media/pdf/03-1subprime.pdf>
- OFHEO said the conclusions of its working papers are those of the author and do not imply concurrence by other OFHEO staff. (*Mortgage Servicing News*, August 2003)

## **Fannie Mae**

Fannie’s interest rate risk exposure grows significantly

Wild interest rates could cause problems for Fannie & Freddie, says a new study

### Fannie’s interest rate risk exposure grows significantly

- Fannie said its risk exposure to rising interest rates grew significantly in July. Fannie said August 13 that the gap between the maturity of loans it owns and that of debt it has issued has jumped to positive six months at the end of July. That is the biggest positive “duration gap” Fannie has had in more than three years. (*Washington Post*, Albert Crenshaw, 8/14/03)
- “The bigger the gap, the bigger the risk that if rates go up further,” Fannie’s profit will be affected, said Igor Krutov, an analyst at Vontobel USA Inc. in New York. (*Bloomberg News*, Al Yoon, 8/13/03)
- The "duration gap" is considered a key measurement of the company's financial risk. A positive gap means that, on average, the debt Fannie used to buy mortgages it owns would mature -- and have to be refinanced, possibly at higher rates -- sooner than the mortgages it owns. A negative gap means that the mortgages would mature sooner. A positive gap "signals greater exposure to [risk from] rising interest rates" because the duration of the

company's assets exceeds the duration of its liabilities. (*Washington Post*, Albert Crenshaw, 8/14/03)

- The six-month duration gap is still within parameters set by Fannie as acceptable interest rate risk, but the extra hedging Fannie will have to undertake to guard against a rapid rise in interest rates is likely to depress its profitability, the company said. Fannie, which began reporting its duration gap monthly this year instead of quarterly, has had a negative duration gap -- its mortgage portfolio maturing sooner than its debts -- since the second quarter of 2002. But the swift change in market conditions in July caused a seven-month swing in the gap, to positive six months in July from negative one month in June. (*Washington Post*, Albert Crenshaw, 8/14/03)
- Fannie's duration gap remained within the company's preferred range, despite historic levels of interest-rate volatility, said Fannie's Senior Vice President for Investor Relations Jayne Shontell. Fannie targets a range of negative six months to positive six months for the duration gap. Fannie noted that July included the largest change in mortgage rates over the course of one month since 1987. (*Dow Jones Newswire*, Madeleine Lim, 8/13/03)
- Freddie's duration gap number for July will be announced within the next week to 10 days. Its gap has held steady, with a zero gap registered for both May and July. (*Dow Jones Newswire*, Julie Haviv, 8/13/03)

#### Wild interest rates could cause problems for Fannie & Freddie, says a new study

- Fannie and Freddie in managing their financial risk have chosen to maximize profit at the expense of the safety and security of their mortgage portfolios in the event of wild interest rate swings, according to a study by Dwight Jaffee, a professor of banking, finance and real estate at the University of California, Berkeley. (*Inman News Features*, Jessica Swesey, 6/17/03)
- Fannie and Freddie's strategies for balancing interest rate risk could put them in a position that would require government intervention and leave taxpayers to foot the bill if interest rates undergo a large or rapid change. Fannie and Freddie use "imperfect" risk balancing strategies that protect their capital against frequently occurring interest rate changes, but not against low probability interest rate scenarios, the study noted. Imperfect hedging strategies represent a trade-off in which the company accepts low-probability interest rate risk in exchange for substantial savings in transaction costs. "Fannie Mae and Freddie Mac will perform best when interest rates are stable, and their performance will deteriorate the more that interest rates change, in either direction," Jaffee wrote. (*Inman News Features*, Jessica Swesey, 6/17/03)
- Derivatives often provide the most cost-effective means for Fannie and Freddie to manage their interest rate risk, according to the study. Each company would've sacrificed about \$1 billion in annual income if it had completely hedged its interest rate risk. The imperfect hedging strategies enabled the companies' profits to soar, but raised concern over the significant residual interest rate risk that resulted. "While imperfect dynamic hedging is highly cost effective, it imposes significant potential costs on U.S. taxpayers in terms of a potential future Fannie Mae and Freddie Mac bailout," Jaffee wrote. It is perfectly legal for Fannie Mae and Freddie Mac to engage in imperfect hedging strategies because Congress

hasn't set standards for the amount of interest rate risk the two companies can accumulate, the study noted. Jaffee suggested that OFHEO expand its risk-based capital stress test for Fannie and Freddie to cover a wider range of possible interest rate shocks and at random dates. (*Inman News Features*, Jessica Swesey, 6/17/03)

- A complete copy of Jaffee's paper, "*The Interest Rate Risk of Fannie Mae and Freddie Mac*," February 2003 is available at: <http://faculty.haas.berkeley.edu/jaffee/FinalJFSR.pdf>

Fannie's Chairman Franklin Raines defends his company, claiming Freddie's accounting issues have raised mortgage rates

Raines calls on Congress and the Bush administration to quickly resolve any uncertainties about the regulation of Fannie & Freddie

- Fannie's Chairman and CEO Franklin Raines said July 30 that Freddie's recent accounting problems have been "devastating to the reputation (s)" of both companies and have raised mortgage rates for consumers. "It has caused material harm to consumers because we've seen uncertainty injected into the capital markets and that uncertainty takes the form of higher interest costs," Raines said. "Interest rates on mortgages, I believe, wouldn't be quite as high as they are today if we didn't have this event," he said, speaking at a press conference at Fannie's headquarters. He added that other factors in the broader economy also contributed to the recent rise in interest rates. (*Dow Jones Newswire*, Dawn Kopecki, 7/30/03)
- Raines believes that Fannie's securities have been unjustly punished from Freddie's accounting problems. "I think we've suffered unfairly. We did not do these things. We should not be subject to the same penalty that they are being subjected to," he said. "Although the impact on us has not been as strong on us as it has been on Freddie Mac, I think it has been far stronger than has been warranted by the facts." (*Dow Jones Newswire*, Dawn Kopecki, 7/30/03)
- Raines noted that while Fannie didn't agree with the new derivatives rule (FAS 133), they never tried to manage around it when the rule was implemented. He also said Fannie had strong internal controls that were lacking at Freddie. For example, all of Fannie's accounting systems are fully automated and policies and decisions are centralized in that department. (*Dow Jones Newswire*, Dawn Kopecki and Jennifer Corbett Dooren, 7/30/03)

Raines calls on Congress and the Bush administration to quickly resolve any uncertainties about the regulation of Fannie & Freddie

- Raines called on Congress and the Bush administration to quickly resolve any uncertainties about the regulation of Fannie and Freddie. (*Reuters*, Mark Felsenthal, 7/30/03) Raines said the company wants a regulator that Congress can have faith in, and that Fannie is working with the Treasury Department regarding regulatory proposals. "We will wait to see what" Treasury Secretary John Snow "has to say September 4 on this topic," he said. [Secretary Snow's testimony was recently moved from September 4 to September 10. See earlier story in this *GSE Report*.] "We don't think going around and making a lot of symbolic changes is useful unless you want to test how well the cloth can stay together after you've pulled out a

number of threads.” Raines said he hope Snow’s leadership “will lead to a speedy resolution of this issue.” (*Bloomberg News*, Robert Burgess, 7/30/03)

#### Response to Raines’ comments

- Freddie’s spokeswoman Sharon McHale said the reason the company’s audit is taking so long is because the process itself is intensive, not because its accounting systems aren’t automated, as Raines suggested. She also dismissed the idea that the company’s accounting problems were to blame for the recent rise in interest rates. “I think there were a lot of things going on in the market that caused interest rates to rise, one was the Fed’s action. There were also some stronger-than-anticipated economic indicators that were released,” she said. “I think the Fed action was the primary driver, certainly not Freddie Mac.” (*Dow Jones Newswire*, Dawn Kopecki, 7/30/03)
- Wall Street traders also disagreed with Raines’ assessment, saying that while it is impossible to be sure Freddie’s problems have had no impact on the cost of raising money in recent weeks, other money-market factors have been far more important. For example, longer-term interest rates have shot upward, since the end of June, when the Federal Reserve cuts its target for overnight interest rates by a quarter-percentage point when many investors had expected a half-point reduction. Recently, as many investors shifted their portfolios in response to these changes, one effect has been to widen the interest rate spread between the securities of Freddie and Fannie and comparable Treasury securities, the traders said. (*Washington Post*, David Hilzenrath, 7/31/03)

Goldman Sachs re-initiates coverage of Fannie’s stock, with lower rating
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- Goldman Sachs revived its coverage of Fannie’s stock with a lower rating of “in-line,” saying growth will slow at the company. Goldman in February fired six analysts and dropped coverage of several companies, including Fannie, to reduce costs. Former analyst Howard Shapiro rated Fannie “outperform” as late as February 6, after upgrading the company from “in-line” on January 15. (*Bloomberg News*, Al Yoon, 8/12/03)
- Falling net interest margins and reduced growth in Fannie’s \$812 billion portfolio of mortgages “may limit upside near-term,” according to a research report by Goldman Sachs analysts Robert Hottensen and Jason Nichols. (*Bloomberg News*, Al Yoon, 8/12/03)
- While Fannie is a “consistent earnings machine,” the Goldman Sachs analysts believe the “sweet spot” is “passing.” Hottensen said he expects Fannie to have per-share earnings of \$7.15 this year, which would be a 13% improvement, and \$7.85 in 2004, which would be up 10%. Hottensen wrote that Fannie shares are worth \$80 according to his “economic profit model” but that they “might remain well below ‘economic value’ as the market transitions and rotates to cyclical beneficiaries of a more robust economic recovery.” On other hand, Hottensen touted Fannie’s market-share gains over Freddie and low price-earnings ratio as positives, and wrote that he does not expect “drastic” regulatory changes. (*American Banker*, Jody Shenn, 8/13/03)

## **Freddie Mac**

Freddie for first time offers its commercial mortgage-backed securities (CMBS) for sale

- Freddie recently sold \$650 million of CMBS, the first time Freddie, which owns nearly \$30 billion of CMBS, has offered such bonds for sale. The bid list was made up of 17 tranches from eight deals that were issued between 1997 and 2001. “Dealers invited to bid were apparently tripping over themselves to snap up the bonds at high prices in an effort to curry favor with Freddie, which is perhaps the biggest buy-side player in the CMBS market. Most of the bonds traded at spreads that were at least 5 bp [basis points] tighter than market levels.” (*Commercial Mortgage Alert*, 7/25/03)

Freddie’s lobbyist had 50 fundraisers for congressional members in past 2 ½ years

- Freddie’s chief lobbyist, Mitch Delk, hosted at least 50 fundraisers for congressional Republicans in the past 2 ½ years, more than half of which benefited lawmakers serving on House and Senate committees that oversee Freddie. While such fundraisers are not illegal, they raise questions about the influence of campaign money on the legislative process. Public Citizen, an advocacy group formed by Ralph Nader, documented the fundraising efforts by Delk from postings listing fundraising events on a web site run by Republican fundraising firm. (*Associated Press*, *Pete Yost*, with contributions by *Marcy Gordon*, 7/18/03)
- The *Washington Post* did a follow-up article, noting that Delk had a “discount arrangement” with the expensive downtown restaurant, Galileo, in which he hosted numerous fundraisers for congressional members. The restaurant reportedly charged him just \$500 - \$25 a plate for a three-course dinner, wine, drink, tax and tip for up to 20 dinners. Delk reported his payment for each dinner as an “in-kind” donation to the congressional member he hosted. (*Washington Post*, *Kathleen Day*, 8/4/03)

Freddie loses market share to Fannie

- Freddie has been losing market share to Fannie, reported *Dow Jones Newswire*. After increasing by approximately 6 percent in May to 37.5 percent, Freddie once again gave up ground in June with its market share of business volume declining to 34.5 percent. That’s a far cry from its historic average of 40-45 percent, according to Fox-Pitt, Kelton, Inc. (*Dow Jones Newswire*, *Julie Haviv*, 7/24/03)

Conflict of interest questions surround Freddie's former auditor serving on the board of one of Freddie's favorite charities

- Former Freddie Mac auditor, Arthur Andersen LLP partner, Robert G. Arnall, was a member of the board of trustees of one of Freddie's favorite charities, raising conflict of interest concerns, reported the *Wall Street Journal*. Arnall was the top outside auditor for Freddie's financial statements audits for seven years. In 1999, Arnall became vice chairman of the board of the Phillips Program for Children and Families and in 2001 he became chairman of the group's board. Freddie and the Freddie Mac Foundation contributed \$74,425 to the Phillips Programs in the fiscal year ended August 2001 and \$95,081 in fiscal year 2002, or about 30 percent of the program's total private contribution, according to the charity.
- Freddie and Andersen say the auditor's charity work didn't tarnish the audits in any way. But some auditing specialists caution that an auditor who puts himself or herself in this type of situation creates an appearance of conflicting interests and impaired objectivity. There are no rules that expressly would have prohibited Arnall from serving in his two roles simultaneously. Still, some provisions in the American Institute for Certified Public Accountants' Code of Conduct suggest that auditors should avoid similar predicaments. (*Wall Street Journal*, Jonathan Weil, 7/21/03)

Freddie's new CEO and President named Chairman of the Freddie Mac Foundation

- The Freddie Mac Foundation Board of Directors named Gregory Parseghian, CEO and President of Freddie, to serve as Chairman of the Freddie Mac Foundation. Parseghian served on the Freddie Mac Foundation Board of Directors for the past two years. (*PR Newswire*, 7/25/03) Freddie's former CEO Leland Brendsel, who founded the Foundation, announced his resignation June 13 from the Foundation, saying he feared "unwanted attention" to the organization from his continued role as chairman that would interfere with its work. (*PR Newswire*, 6/13/03; *Washington Post*, Jacqueline Salmon, 7/26/03)

## **FHLBanks**

FHFB Chairman to ask Board to withdraw its controversial proposed revisions to its mortgage purchase programs

FHLBanks' mortgage purchase program is becoming a stronger competitor to Fannie & Freddie, reports *Business Week*

- FHFB Chairman John Korsmo said he will ask the Federal Housing Finance Board (FHFB) to vote to withdraw a proposal to revise that regulations that govern the FHLBanks' Acquired Member Asset (AMA) programs at its September 10 meeting, allowing for consideration of a new proposed rule at a later time. Chairman Korsmo said he hopes the revised language will

“better express the objective of placing greater responsibility on FHLBanks to prudently manage AMA programs,” he said. (*FHFB press release*, 8/20/03) The FHLBanks’ AMA programs include the Mortgage Partnership Finance (MPF) program and Mortgage Purchase Program (MPP).

- The FHFB issued the proposed revisions to its regulations on July 1, 2003 with a September 2 deadline for comments. Differing sides clashed on whether the proposed revisions were considered “mission creep.” AMA critics claim the program would divert the FHLBank System from its original mission, but some bank executives said it would improve competition in the secondary mortgage market by revamping outdated restrictions. (*American Banker*, Rob Garver, 7/9/03)
- The proposed revisions would have eliminated the current requirement that acquired member assets must be originated or issued through a member, housing associate, or affiliate thereof. Chairman Korsmo said the proposed revisions do not break new policy ground or allow significant expansion of FHLBank authority for AMA programs. (*FHFB press release*, 8/20/03; *Dow Jones Newswire*, John Connor, 8/20/03)
- The FHFB said it would reissue the plan in the future after making some changes and improving the marketing of the plan. “It appears...that the intention of this proposed regulation is largely misunderstood,” said Chairman Korsmo in a letter to the Council of FHLBanks, which requested a 90-day extension of the comment period. (*American Banker*, Todd Davenport, 8/21/03)
- “Our members looked at it, and a lot of them came to the conclusion that despite the way it was presented – as kind of a minor adjustment – they were really worried that it would increase the risk to the system over all and undermine the cooperative nature of the system,” said Steve Verdier, a vice president and legislative counsel at America’s Community Bankers. (*American Banker*, Todd Davenport, 8/21/03)

FHLBanks’ mortgage purchase program is becoming a stronger competitor to Fannie & Freddie, reports *Business Week*

- The FHLBank System’s Mortgage Partnership Finance Program (MPF), developed by the FHLBank of Chicago, is “honing in” on Fannie and Freddie’s territory and is “thriving,” reported *Business Week*. “We are growing...three or four times faster than Fannie Mae or Freddie Mac,” said Alex Pollock of the FHLBank of Chicago, the brainchild of the MPF program. Pollock has been forced to play “political hardball,” particularly in response to efforts by Fannie to curtail the program. He has beat back repeated attempts in Washington, particularly by Fannie, to curtail or quash the MPF program. “Clearly, as Pollock’s program gets bigger, this fight will get nastier.” (*Business Week*, Joseph Weber, Ann Therese Palmer, Amy Borrus, 8/4/03)

FHFB delays multi-district FHLBank membership issue
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- FHFB Spokesman Carter Wood noted that the FHFB’s multi-district membership proposal (allowing a bank to belong to more than one FHLBank) has been “put on hold again,” and

that more time is needed to work on the proposal, reported *National Mortgage News*. (*National Mortgage News daily web site, 7/28/03*)

- As noted in the July 7, 2003 *GSE Report*, Senator Christopher “Kit” Bond (R-MO) and Senator Barbara Mikulski (D-MD) asked the FHFB to seek legal opinions from the Department of Justice’s Office of Legal Counsel before proceeding any further on multi-district FHLBank membership or possible securitization of mortgages. In a recent letter to FHFB Chairman John Korsmo, the lawmakers said they understood the FHFB “may consider a proposal to allow for the securitization of mortgages, even though the legal basis for such a program is in question.” On the multi-district FHLBank membership, the lawmakers said they understand that the FHFB as early as next month might consider a rule to eliminate single-family district membership in favor of multi-district membership. They said such a change “would fundamentally alter – with no Congressional direction – the membership structure of the Federal Home Loan Bank System.” The lawmakers also noted the “very questionable legal ground” for multi-district membership and questioned “whether the FHFB has the statutory authority to authorize multi-district membership.” (*Dow Jones Newswire, John Connor, 6/20/03*)

Citigroup appointed custodian for \$300 billion in assets serviced by FHLBanks

- Citigroup Global Transaction Services announced July 29 it has been appointed custodian for \$300 billion in assets serviced by 7 out of 12 banks of the FHLBank System, collectively representing one of the largest appointments in the history of the transaction services industry. Citigroup said it had been appointed custodian for the FHLBanks of Chicago, Des Moines, Indianapolis, New York, Pittsburgh, San Francisco and Topeka. Prior to the appointment, Citigroup already served as custodian for an additional \$130 billion of assets serviced by the FHLBanks of Atlanta and Boston. (*Citigroup press release, 7/29/03*)
- Citigroup (the fourth largest keeper of records about stocks and bonds) beat State Street Corp., the world’s largest custodian, in getting the business. Citigroup’s spokesman Kevin Heine declined to say how much revenue the contract would bring Citigroup. (*Bloomberg News, George Stein, 7/29/03*)

*American Banker* runs series on strife within the FHLBank System

- The FHLBanks and their regulator (the FHFB) are frequently at odds due to the unusual tension between the System’s public mission of providing liquidity for home loans and the private-sector pressure to pay a competitive return to shareholders, reported Rob Garver in a series in the *American Banker*. (*American Banker, Rob Garver, 7/31/03, 8/1/03*)

## S&P downgrades FHLBank of New York to Negative

### Downgrading may strengthen calls for FHLBanks to register with the SEC

- Standard & Poor's Ratings Services revised its outlook on the FHLBank of New York (FHLB-NY) to negative from stable, according to an August 8 press release from Standard & Poor's as reported by *Dow Jones Newswire*. At the same time, the 'AAA/A-1+' counterparty credit ratings were affirmed. The outlook revision reflects the incremental credit risk the FHLBank of New York has taken over time, primarily in its investment portfolio or manufactured housing asset-backed securities. "The FHLB-NY has added investments to its portfolio that, although they had minimal credit risk at the time of the investment, have proven to contain larger portions of credit risk than the Bank and Standard & Poor's had expected," said credit analyst Jonathan Ukeiley. During the falling interest rate environment of the past several years, the FHLB-NY's profitability has drifted lower, lessening the capacity the Bank would have to absorb credit losses. The negative outlook reflects the greater credit risk profile the FHLB-NY has assumed. If credit losses are incurred and depress profitability or reduce the capital base, the bank's credit ratings could be lowered. If, however, FHLB-NY manages to work through any potential losses, realized or otherwise, and reduces the risk profile of the investment portfolio, the outlook could be brought back to stable. (*Dow Jones Newswire*, 8/8/03)
- The revision to negative from stable is the first of its kind for a FHLBank since S&P began rating them six years ago, said Jonathan Ukeiley, an analyst at S&P. Financial consultant, Bert Ely, said that to absorb losses on these manufactured housing investments, the FHLBank of New York might have to cut the dividend it pays its member banks, dip into its retained earnings, or both. "They don't have a lot of cushion to absorb losses," he said. S&P's Ukeiley said that reducing the dividend "is one of the many possibilities" facing the FHLBank of New York if credit problems worsen. However, "as with most marketable securities, the market value could come back" eventually. Paul Heroux, the chief credit officer at the FHLBank of New York said it was too early to say whether the FHLBank would cut its dividend. "We haven't determined there is a loss," he said. "Until we know that, we won't have any ideas as to what the impact would be." (*American Banker*, Erick Bergquist, 8/11/03)
- The FHLBanks' Office of Finance said it believes S&P's action "is primarily related to recent downgrades by S&P of its ratings on certain asset-backed securities owned as investments by the FHLBank of New York that are backed by manufactured housing loans." The Office of Finance noted that all of this type of securities owned by the FHLBank of New York were rated AAA by S&P at the time of their purchase and are still rated investment grade by S&P (and are designed as held-to-maturity by the FHLBank), and most of them are still rated AAA by S&P. As of June 30, 2003, the FHLBank of New York had total assets of \$98.2 billion, of which approximately \$1.64 billion, or 1.7%, were asset-backed securities supported by manufactured housing loans. Of this \$1.64 billion amount, approximately \$923 million are still rated AAA, approximately \$272 million are rated AA, approximately \$180 million are rated A-, and approximately \$265 million are rated BBB-. As of June 30, 2002, the other eleven FHLBanks own less than \$50 million of asset-backed securities supported by

manufactured housing loans in the aggregate, all of which are still rated AAA by S&P. “We do not believe that the situation cited by S&P will have a material adverse effect on the financial condition or results of operations of the Federal Home Loan Banks,” said John Darr, Managing Director of the FHLBanks’ Office of Finance. (*FHLBanks’ Office of Finance press release, 8/8/03*)

#### Downgrading may strengthen calls for FHLBanks to register with the SEC

- The S&P announcement “immediately gave some ammunition to the [SEC] disclosure proposal’s supporters,” reported Rob Garver with the *American Banker*. In a customer note, *Federal Financial Analytics*, a Washington consulting firm, said the FHLBank of New York has been the most vocal in opposing SEC disclosure, and if the FHLBanks filed an SEC 10-Q report, this “would have forced a disclosure of which part of the [FHLBank of New York’s] book went to what, and the rapid slide in credit quality on the trailer ABS would then have been apparent.” Former Treasury Assistant Secretary for Financial Institutions Gregory Baer, who represents companies critical of the FHLBank System, said the S&P announcement “is likely to strengthen calls for SEC registration” of the FHLBanks’ capital stock. (*American Banker*, Rob Garver, 8/14/03)

FHFB approves capital plan amendments for FHLBanks of Boston and San Francisco
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- The FHFB August 6 approved amendments to the capital structure plans for the FHLBanks of Boston and San Francisco. The changes mirror provisions found in other FHLBank capital plans previously approved by the FHFB. The amendments also contained clarifying language.
- The Boston Bank’s capital structure plan, originally approved on May 8, 2002, was amended to:
  - Reduce the required notice, or “opt out,” period for member financial institutions choosing to withdraw before the plan’s effective date;
  - Change the approach to the repurchase of excess stock at conversion and provide flexibility for members; and
  - Allow the Bank to hold general stock offerings.
- The capital structure plan for the FHLBank of San Francisco, approved June 12, 2002, was amended to:
  - Reduce the required notice, or “opt out,” period for member financial institutions choosing to withdraw before the plan’s effective date;
  - Reduce the mortgage asset component of the initial activity-based stock purchase requirement;
  - Establish an initial cap of \$25 million per member on the membership stock purchase requirement; and
  - Give the Bank’s board of directors discretion to change the cap within a range of \$10 million to \$50 million.
- The Gramm-Leach-Bliley Act of 1999 included provisions to strengthen the safety and soundness of the FHLBanks by replacing their existing subscription capital structure with a permanent capital structure that includes risk-based and leverage capital requirements. The

FHFB has approved new capital plans for all 12 FHLBanks, and five Banks have already implemented them.

- The FHFB also approved a restated organization certificate requested by the FHLBank of New York. The certificate reflects the Bank's new capital structure. (*FHFB press release, 8/6/03*)

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

Farm Credit Administration (FCA) extends comment period on its controversial eligibility and scope of financing regulations

FCA holds June 26 hearing on issue

ICBA urges FCA to drop the FCS "non-farm lending agenda"

- The FCA has extended the comment period an additional 90 days for the advance notice of public rulemaking on eligibility, scope of financing, and moderately priced rural housing. The new deadline for comments is October 29, 2003. (*FCA press release, 7/25/03*)
- Specifically, the FCA is considering whether to revise its regulations governing eligibility and scope of financing for farmers, ranchers, and aquatic producers or harvesters who borrow from Farm Credit System institutions. Also, it is considering whether it should modify its regulatory definition of "moderately priced" rural housing. (*FCA press release, 7/25/03*)
- The crux of the issue, according to the *American Banker*, is whether the FCA should continue to make a distinction between full-time and part-time farmers. Current regulations allow the lenders to lend to part-time farmers - defined as those who have a primary business other than farming - "on an increasingly conservative basis as the emphasis moves away from" full-time farming. (*American Banker*, John Reosti, 7/3/03)

### FCA holds June 26 hearing on issue

- The FCA heard testimony June 26 from farmers, agricultural lenders, and others on the eligibility and scope of financing regulations and whether the agency's definition of "moderately priced" rural housing should be revised. (*FCA press release, 6/26/03*)
- In May 2003, FCA published an advance notice of proposed rulemaking seeking suggestions on whether, and how, to change the eligibility criteria for a bona fide farmer. A current regulation defines an eligible farmer, rancher, or aquatic producer as a person who either owns agricultural land or is engaged in the production of agricultural products. The notice also asked for public comment on what limits, if any, FCA should place on lending by FCS institutions for farmers' other credit needs; and whether to retain the current regulatory distinction between part-time and full-time farmers. (*FCA press release, 6/26/03*)
- The recommendations at the FCA meeting ranged from no modifications of current

regulations to suggestions that would require changes to the regulations. (*FCA press release, 6/26/03*)

- Farm Credit lenders have said proposals to tie individual loan amounts to the borrower's farm income, or to ban them from nonfarm lending, are unworkable. They argued at the FCA hearing that most farmers are now entrepreneurs with many nonfarm interests that are so intertwined with their farming operations that separating them is neither realistic nor possible. All 12 of the Farm Credit lenders who spoke at the hearing said the agency should lift all restrictions on their lending authority. Preventing them from financing part-timers - a position the banking industry advocates - would cost them many of their best customers, the lenders said. (*American Banker, John Reosti, 7/3/03*)
- Bankers at the hearing countered that the Farm Credit System was chartered to lend only to farmers and that they have no business making other loans. All their loans should be tied to a borrower's farm income, the bankers said. (*American Banker, John Reosti, 7/3/03*)
- Those testifying included Jim MacDonald, Economic Research Service, U.S. Department of Agriculture, Washington, D.C.; Dale Pohlmann, President, Ravenna Bank, for the Nebraska Bankers Association; Daryl Oldvader, CEO, Farm Credit Services of Missouri, Jefferson City, Mo.; Donnie Winters, President and CEO, FCS of Mid-America, Louisville, Ky.; James Schiller, CEO, GreenStone Farm Credit Services; Barry Cooper, CEO, Farm Credit of Southern Colorado; Kenneth Graff, CEO, Farm Credit West, Visalia, California; Michael Firestine, Lebanon Valley Farmers Bank (Pa.), for the American Bankers Association; Gary Smith, Chairman, Northwest Farm Credit Services; and Dwight Hossle, President, Dacotah Bank, for the South Dakota Bankers Association. (*FCA press release, 6/26/03*)
- Also testifying were Mark Wheeler, a young and beginning farmer and a Director of Farm Credit of Southwest Florida; Ed Schenk, Chairman, Farm Credit Council; Gayle Kaalberg, Farmers and Merchants Bank, for the Iowa Bankers Association; John Dean, Chairman, Glenwood State Bank (Iowa); Bert Ely, President, Ely & Company; Curtis Griffith, Chairman, City Bank, for the Independent Bankers Association of Texas; James Caspary, President, First National Bank of Clifton (Ill.) for the Independent Community Bankers of America; Ken Auer, CEO, Farm Credit Council; Tim Ohlde, President, Elk State Bank of Clyde, for the Kansas Bankers Association; J. Robert Frazee, President, MidAtlantic Farm Credit; Bernard Dietz, Baltimore, Md.; Brian Demmer, farmer, for AgStar Financial Services; Gary Matteson, farmer, Enfield, Conn. and Vice Chair, First Pioneer Farm Credit, for Cobank. (*FCA press release, 6/26/03*)
- The complete testimony from the June 26 hearing is available on the FCA's website at: <http://www.fca.gov/publicmeeting06-26-03.htm>

#### ICBA urges FCA to drop the FCS "non-farm lending agenda"

- The Independent Community Bankers of America (ICBA) asked the FCA to drop its proposal being pushed by Farm Credit System (FCS) institutions to allow loans for non-farm purposes to "part-time" farmers on an unrestricted basis. "Apparently the System has amnesia when it comes to remembering why they were created- to serve, as the law clearly says, 'bona fide farmers and ranchers,'" stated Jim Caspary, Chairman of ICBA's Agriculture-Rural America Committee and President of First National Bank in Clifton, Illinois. "We're not discussing a

Farm Credit System here that is on the ropes. To the contrary, the System comes to you asking for quite a dramatic expansion at a time when they are as healthy as they've ever been and are growing rapidly, with many institutions experiencing double digit growth," Caspary told the FCA board.

- System representatives have petitioned FCA to drop the current regulatory distinction between full-time and part-time farmers and to allow loans for any lending purpose even though the System was created by Congress as a Government Sponsored Enterprise with a unique and limited federal charter aimed at serving bona fide farmers and ranchers.
- "If the FCS shifts its focus to serving everybody, then it weakens its legally mandated emphasis on serving farmers," explained John Dean, Chairman & CEO of Glenwood State Bank in Glenwood, Iowa. Caspary and Dean pointed out to FCA board members that: the System's loan volume increased by 50 percent since 1996, while the number of farmers has declined; the FCS customer base has increased three percent in each of the past two years; and the System's share of farm debt is increasing rapidly. The ICBA witnesses also noted USDA surveys show, for example, "only 4 percent of operators of rural residential/lifestyle farms reported farming as their occupation." ICBA also explained that current FCA housing regulations are already too open-ended and need to be tightened to prevent FCS from focusing on the most expensive rural residences. (*ICBA press release, 6/26/03*)

FCA approves OFI lending proposal
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- The FCA Board July 10 approved a proposed rule designed to increase the flow of credit to farmers, ranchers, and aquatic producers and harvesters, by promoting greater cooperation between Farm Credit System and non-System lenders. The proposed rule would amend FCA regulations governing the funding and discount relationship between other financing institutions (OFIs) and System banks. Regulations on the Farmers' notes program, as well as certain capital regulations, also would be revised.
- By law, Farm Credit banks are authorized to fund and discount short- and intermediate-term loans to certain OFIs, including commercial banks, savings institutions, credit unions, trust companies, agricultural credit corporations, and other agricultural and aquatic lenders. The proposed rule removes regulatory barriers that hinder the flexibility of the OFI program. The amendments would allow any Farm Credit System bank to fund OFIs, and require the banks to disclose to OFIs how they price loans to their Farm Credit associations.
- The FCA published an advance notice of proposed rulemaking in the *Federal Register* on April 20, 2000 seeking public comment, and held a public meeting in August 2001 in Des Moines, Iowa.
- The proposed rule also makes changes to the Farmers' notes program, which currently authorizes certain FCS associations to invest in notes, contracts, and other obligations that farmers and ranchers give to certain lenders. The proposed regulations would enhance the program to include more non-System lenders, and allow Farmers' notes to aquatic producers and harvesters and farm-related service businesses to be eligible investments for FCS associations. It also would allow all FCA direct lender associations to invest in short- and

long-term loans made by other lenders to eligible farmers and ranchers.

- In addition, the rule would differentiate the capital risk-weighting of Farm Credit System banks' loans to OFIs and investments in Farmers' notes, depending on the structure and risk-mitigating characteristics of the entities involved.
- After the 30-day period for congressional review required by law, the proposed regulation will be published in the *Federal Register* with a 60-day public comment period. (*FCA press release, 7/10/03*)

Senate confirms two Bush nominees as Farmer Mac directors
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- The Senate confirmed President Bush's nominations Glen Klippenstein and Julia Bartling to serve on the board of directors of Farmer Mac, according to a regulatory filing with the SEC on June 26. (*Dow Jones Newswire, Dan Lowrey, 6/26/03*)

US Court of Appeals rules favorably on FCA loan participations final rule
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- The United States Court of Appeals for the District of Columbia Circuit July 29 upheld the FCA's final rule on loan participations for Farm Credit System institutions.
- While the rule remains in effect, the Court ordered the case sent back to FCA to respond to a comment letter submitted by the plaintiffs. In addition, the Court upheld FCA's interpretation of the 1992 amendments to the Farm Credit Act of 1971 (Act).
- The lawsuit, *Louisiana Federal Land Bank Association, FLCA, et al., v. FCA*, was filed originally by the Farm Credit Bank of Texas and its affiliated Federal and Credit Associations in Alabama, Mississippi, and Louisiana on June 30, 2000. The complaint concerned a final rule, published April 25, 2000, (see 65 FR 24101) that repealed existing FCA regulations requiring a System lending institution to obtain consent from other System institutions when participating with non-System lenders in loans originated outside its chartered territory. In the July 29 decision, the Court:
  - Agreed with FCA that the rule was a logical outgrowth of FCA's proposed rule amending 12 CFR 614.4070;
  - Held that the 1992 amendments to the Act only prevent FCA, without the Farm Credit Bank of Texas' consent, "from issuing or changing a charter so as to allow competition in the former Jackson territory; but it just as clearly does not prohibit the FCA from doing anything else—such as changing a regulation—that would have a similar effect;"
  - Disagreed with the plaintiffs' argument that the 1992 amendments ratified its exclusive charter; and
  - Held that the so-called "exclusive charter" provision did not provide Texas with any "independent grant of authority," but rather referred to the consent provisions in the 1992

amendments. (*FCA press release, 7/30/03*)

## **Postal Service**

President's Postal Commission releases its final report
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- The President's Commission on the United States Postal Service July 31 released its final report to President George W. Bush and Treasury Secretary John Snow. The report, capping eight months of public meetings on key issues, outlines the Commission's recommendations for legislative and administrative steps to "ensure the long-term viability of postal services in the United States." The nine-member bipartisan Commission was established by President Bush on December 11, 2002, with the task of articulating a vision for the future of the Postal Service to ensure efficient, cost-effective operations while minimizing the financial exposure to taxpayers. The Commission's report contains recommendations for legislative and administrative reforms in the Postal Service's business model, use of technology, partnerships with the private sector, and the work force. (*Department of the Treasury press release, 7/31/03*)
- The Commission rejected proposals to privatize the agency, instead saying it should remain a self-sustaining part of the government, concentrating on its main mission of providing universal mail service. (*Associated Press, 8/1/03*)
- The Commission noted, "Without significant modernization, the Postal Service will have three choices: dramatically roll back service, seek a rate increase of unprecedented scale, or fall even further into debt, potentially requiring a significant bailout." (*Page V, Commission report*)
- The Commission's major recommendations include making it easier for the post office to close unnecessary offices, simplifying the process for changing rates, cutting staff while making better use of automation and offering new services such as personalized stamps. (*Associated Press, 8/1/03*)
- Among the Commission's recommendations
  - Ease the restrictions on closing unnecessary post offices, but retain any office needed to assure service, even if it loses money;
  - Simplify and speed up the system for changing postal rates, currently nearly a year long;
  - Take advantage of the expected retirement of 47 percent of the postal work force by 2010 to reduce staff without layoffs, while increasing efficiency with more automation;
  - Establish a new, corporate-style board of directors to oversee the Postal Service;
  - Establish an independent panel to recommend closings and consolidations of mail sorting and distribution facilities;
  - Add new services, such as personalized stamps featuring photos of customers'

- children, dogs or business;
  - Speed up collective bargaining and add pension and post-retirement health coverage to the items to be negotiated;
  - Create a pay-for-performance, or bonus system for management and union workers;
  - For security reasons, set up a system to track mail and obtain sender identification for every piece of mail. (*Associated Press*, Randolph Schmid, 7/31/03)
- According to the Commission, more than \$3 of every \$4 in Postal Service revenue goes to cover the costs of current and retired postal employees. Of the \$92 billion in debt weighing on the post office, more than \$48 billion represents unfunded obligations for retiree health benefits. “The size of the workforce determines the costs of the workforce,” the Commission said. “Getting the right size workforce is the critical issue when it comes to controlling the costs of the workforce and upholding the Postal Service’s ability to compensate its employees in a manner competitive with the private sector.” The report recommended that collective-bargaining rules must be changed to put employee benefits on the table. The Commission would create a regulatory body to set pay policy and limits on total compensation of new employees and create a pay-for-performance system covering all employees. (*Washington Post*, Stephen Barr, 8/3/03)
- The Commission strongly recommended that the Postal Service voluntarily comply with applicable SEC financial reporting requirements for public companies. “While the Postal Service does, in many respects, conduct financial reporting over and above what is required today of federal agencies, it remains behind the level of disclosure offered by its corporate peers,” the report said. “The commission strongly recommends that the Postal Service be required to close the cap by voluntarily complying with applicable provisions of the major SEC reporting requirements,” specifically citing quarterly 10-Q, annual 10-K, and “significant event” SK-8 reports. (*Dow Jones Newswire*, John Connor, 8/1/03)
- The Commission’s 208-page report – “*Embracing the Future: Making the Tough Choices to Preserve Universal Mail Service*” - can be found on the Commission’s web site at: <http://www.treas.gov/offices/domestic-finance/usps/pdf/report.pdf>

Senate Governmental Affairs Committee may hold September 3 hearing on Commission’s report

Congressman McHugh also expects to hold a September hearing

- The Senate Governmental Affairs Committee may hold a September 3 hearing to discuss the Commission’s recommendations. (*DM News*, Scott Hovanyetz, 8/19/03)
- House Government Reform Committee’s Special Panel on Postal Reform and Oversight Chairman John McHugh (R-NY) said he intends to invite the Commission to a hearing before he releases his latest version of a postal reform bill. Congressman McHugh has introduced several reform bills during the past 10 years. (*BNA Daily Report for Executives*, Derrick Cain, 8/4/03)
- “I plan to invite the Commissioners to formally testify before a Special Panel hearing in

September. Understandably, there are some initial concerns raised by the Commission's recommendations to cut the workforce and begin a round of facility closures, and I plan to closely examine those issues during the hearing," said Congressman McHugh. "However, those recommendations notwithstanding, I believe most of the Commission's report –which among other points calls for a new postal regulatory board and a modern ratemaking process regulation – are reflective of the legislative efforts we've been leading through Congress over the past decade," said the Congressman. (*Congressman McHugh press release, 7/31/03*)

#### Senator Carper praises work of President's Postal Commission

- Senator Tom Carper (D-DE) praised the final Commission report, saying its overall recommendations on how to modernize the Postal Service were reflective of his efforts to give the agency more freedom to operate like a private business. He was particularly pleased that the Commission rejected privatization. Senator Carper noted that the Commission's recommendations were similar to his postal reform bill (S. 1285). However, he expressed concern over recommendations that he said could lead to lower pay for postal workers and more labor disputes. Senator Carper objected to how the Commission suggests revising worker pay standards, liming union collective bargaining over wages to 180 days and making pension and retiree health benefits subject to negotiation too, rather than part of existing federal plans. Senator Carper noted that the Commission's recommendations, specifically those relating to re-examining how postal workers' salaries compare to similar jobs in the private sector, are unnecessary and that the Postal Service should use the boom in employee retirements expected in the coming years to adjust its workforce through attrition and early retirement offers. Senator Carper also said setting hard and fast time limits for contract mediations, as recommended by the Commission, could push more disputes into arbitration. Senator Carper does agree with the Commission's controversial recommendation to close underused post offices and sell such real estate to maximize profits. (*Senator Carper press release, 8/1/03; The News Journal (Wilmington, DE), 8/2/03*)

#### Postal Service Board of Governors applauds Commission for its report

- The Governors of the Postal Service applauded the Commission for its work on the report. Chairman S. David Fineman praised the Commission for "their commitment in taking on a complex and difficult task" of learning about the Postal Service. "In a short, concentrated period of time," said Fineman, "the Commission listened to all the stakeholders' positions on the Postal Service's future, then made some difficult choices in finalizing the report." (*Postal Service press release, 8/4/03*)

#### Postal Rate Commissioner Ruth Goldway says Commission's report is a "good start"

- In a *New York Times* commentary, Commissioner Goldway stated that while people have criticized the Postal Service's \$40 million sponsorship of Lance Armstrong over the last six years when it has been losing money, the "debate should not be about the money. The amount spent on Lance Armstrong is a tiny fraction of the agency's \$66 billion annual

budget. Nor should it be about the need to advertise. The Postal Service must – it faces stiff competition from Federal Express and the United Parcel Service, among others. The problem is that the Postal Service has little oversight. Because it is an independent federal agency with commercial responsibilities, it does not have to report to the Securities and Exchange Commission, comply with Federal Trade Commission’s truth-in-advertising rules or face shareholder scrutiny. Last week a commission appointed by President Bush announced recommendations that include a call for greater financial transparency. This is a good start.” (*New York Times commentary, PRC Commission Ruth Goldway, 7/22/03*)

National League of Postmasters gives President’s Postal Commission “high marks”

- The President’s Postal Commission’s first set of recommendations released June 16 “seem to indicate that the Commission has done its work,” said Steve LeNoir, President of the National League of Postmasters. “We applaud their efficiency and dedication.”
- “While we originally had some concerns that the Commission might undercut universal service and six day delivery, its preliminary actions seem to have generally removed those concerns,” LeNoir added. “It also recommended that the Postal Service retain sole access to customer mailboxes.” Bob Brinkmann, the League’s Legislative Counsel, continued, “That doesn’t mean that the League is going to agree with all the Commission’s recommendations in the end, and indeed, we might vigorously oppose some. We have particular concerns about suggestions to close small post offices that provide invaluable public services at very low cost.” (*National League of Postmasters’ news, 7/16/03*)

Mailers Council applauds Commission and strongly supports postal reform legislation

- The Mailers Council, the nation’s largest coalition of mailers and mailing associations, applauded President Bush and the President’s Postal Commission for its work on postal reform. The Mailers Council called on Congress to hold hearings on the report and to debate postal reform legislation. “Lacking significant postal reform the Postal Service can survive only with substantially higher postage, a government bailout, or both.” The Mailers Council urged “Congress to respond to the Commission’s report as quickly as possible to assure the continued existence of the United States Postal Service.” (*Mailers Council press release, 8/13/03*)

Mailing Industry CEO Council praises Commission’s report

- The Mailing Industry CEO Council praised the Commission’s report and “sees a bright future for the Postal Service and mail growth” if the Postal Service is “allowed to operate like a business and increase reliance on the private sector.” (*PR Newswire, 7/31/03*)

Newspaper Association of America applauds Commission's report as "first step"

- NAA President and CEO John Strum applauded the Commission's report, calling it the "first step in restoring public confidence in the Postal System." He added, "While we may not agree with all the recommendations, we stand ready to work closely with Congress and the USPS to improve the country's postal system." (*Business Wire*, 7/31/03)

Magazine Publishers praises Commission's report

- Magazine Publishers of America President and CEO Nina Link called the Commission's report "a truly outstanding piece of work," which includes many of the major recommendations that have been strongly advocated by the MPA. (*Business Wire*, 7/31/03)

American Postal Workers Union says Commission's report is "seriously flawed"

- APWU President William Burrus called the Commission's report "seriously flawed." He believes the Commission's recommendations would give the Postal Service authority to close post offices at will, give too much authority to a Postal Regulatory Board and contain anti-worker proposals, he said. "The recommendations are intended to serve only the needs of the big advertising mailers, at the expense of the American people," Burrus said in a statement. He promised a vigorous campaign to ensure that the recommendations do not become law. (*APWU press release*, 7/31/03; *DM News*, Scott Hovanyetz, 8/1/03)

National Association of Letter Carriers says letter carriers are at risk by recommendations of the Commission's report

- The Commission's recommendations on workforce issues "would render Letter Carriers and other postal employees second-class citizens," said NALC President William H. Young. The Commission's worst recommendations:
  - "Give a new Postal Regulatory Board power to determine total compensation for all postal employees based on comparability with private sector workers and then impose it as a cap for new employees."
  - "Make pension and post-retirement health care plans subject to collective bargaining, thereby allowing flexibility to sever postal retirees from existing federal pension and retiree health care plans."
  - Urge the Postal Service to carefully study a pay-for-performance compensation program for both management and bargaining unit employees."
- "It is inconceivable to envision a postal reform bill that would allow postal employees to receive differing levels of pay for the same work or a measure that would revoke the promise made to retired letter carriers that they will receive comprehensive retirement and health benefits," said Young. "We are confident the Senators and Representatives in Congress will

understand the adverse impact of these proposals and will refuse to put their stamp of approval on them.” (*NALC Bulletin*, 7/24/03)

National Association of Postal Supervisors praises some of the report’s recommendations but raises concerns about others

- “Many of the Commission’s recommendations are good and deserve Congressional respect,” including closing low-volume post offices, providing more flexibility to the Postal Service in setting rates, and to expand pay-for-performance systems, said Vincent Palladino, President of the National Association of Postal Supervisors. However, there are several Commission proposals that “should be left on the doorstep”:
  - “The proposal to establish a Postal Regulatory Board with expansive power over postal operations, including even pay comparability of postal workers, is seriously flawed.
  - The proposal to create a base closure-like commission to recommend the closure of mail processing and distribution facilities, without also recommending the closure of small post offices, is half-baked. Indeed, if the mandate of the Postal Service is to operate like a business, the Postmaster General alone should have the authority to decide how the Service network of plants and post offices should be aligned and which facilities should be closed or consolidated.” (*National Association of Postal Supervisors statement*, 7/31/03)

Heritage Foundation says Commission’s report is a step in the right direction but wishes the Commission had gone further

- A commentary by James Gattuso, research fellow for regulatory policy at the Heritage Foundation, noted that the Commission’s report included “much-needed improvements” and more regulatory oversight. However, “more oversight alone is not enough.” Gattuso wrote, “The Postal Service’s very status as a protected government monopoly should be reconsidered. Among other things, this means privatization, a step already taken by several other nations. The commission, however, quickly dismissed this important reform. It cited the disruption privatization could cause, but more likely the concern was political, not economic, fallout. A second, perhaps even more important step would be to repeal USPS’ statutory monopoly on letter mail...Allowing such competition would be good for USPS as well as for consumers.”
- The Commission’s suggested reforms “would be a step in the right direction and could perhaps open the door to more substantial change...It’s now up to Congress (and USPS itself) to implement change. That won’t be easy — change will be fiercely resisted, not least by the powerful postal unions. And Congress in the past has shown little appetite for postal reform — considering it both too dull and too controversial. But this time — with the Internet breathing down the postman’s back — the issue may be harder to ignore.” (*Washington Times commentary*, James Gattuso, Heritage Foundation, 8/18/03)

Lexington Institute calls Commission's report "measured steps down a perilous path"

- The Commission's recommendations "opt to follow the steep and perilous path of seeking to return the Service to healthy viability while continuing to preserve it as a government monopoly. You can give an ostrich bigger wings, but can you make it fly?" questioned a Lexington Institute report by Don Soifer.
- "Nonetheless, several significant reforms are recommended by the Commission that have real potential to protect postal consumers and taxpayers from further, and more expensive, postal service meltdown." Soifer particularly highlighted the following reforms in the report: (1) efforts to reconsider labor expenditures; (2) preventing postal management from overcharging for monopoly-protected products and services, and then leveraging the postal monopoly by cross-subsidizing products that compete with private sector providers; and (3) putting in motion a process similar to the military Base Realignment and Closure Commission to consider closing low-activity post offices.
- Soifer noted, "Each of these reforms, and many others...could have gone much further. But that won't matter if even these modest, but nonetheless sensible, reforms fail to make the leap from written recommendation to reform reality. That burden now falls to Congress, the Bush Administration, and the current Postal Board of Governors." (*Lexington Institute, Issue Brief, Dan Soifer, Executive Vice President, 8/1/03*)

*Washington Post* editorial says Commission's recommendations are "headed in the right direction"

- "While many fundamental problems within the overall structure [of the Postal Service] remain to be resolved -- and the report discusses possibilities for doing so -- these aforementioned practical and consumer-oriented steps are headed in the right direction."

*Atlanta Journal-Constitution* says Postal Service overhaul "overdue"

- An August 8 editorial stated: "The Postal Service needs the freedom to find and make cuts where needed, and a reformed board of governors with greater power to raise rates and trim employees. It needs the power to do creative things such as move services out of big fixed facilities and into kiosks in malls, stores or banks. It needs technology to process faster and better. In a word, it needs to be more businesslike. President Bush, who designated the commission that put this fresh report in his hands, should make those reforms a priority." (*Atlanta Journal and Constitution* editorial, 8/8/03)

Privacy groups decry Commission's recommendation to track mail

- Privacy groups are criticizing the Commission's recommendations to use tracking codes to verify who sends and receives mail through the Postal Service, reported the *Washington Post*

and *Computerworld*. “Intelligent mail” would include bar codes so senders could track the progress of their packages. “You have to question the Big Brother aspect of the government being able to document who is writing who,” said Rick Merritt, executive director of PostalWatch. (*National Journal’s Technology Daily*, 8/8/03)

Senator Harry Reid (D-NV) proposes bill limiting rural post office closures

- Senator Reid introduced legislation that would curb the Postal Service’s ability to close post offices in small rural communities. Where the Postal Service has closed a rural post office, Senator Reid’s legislation would direct the Postal Service to provide a plan for the rehabilitation and economic development of closed offices in consultation with the affected community. It also authorizes \$10 million in grants to local communities to assist in the rehabilitation. The bill would require the Postal Service to prove that closing post offices in areas with populations of less than 20,000 would have a positive effect on the economy and quality of life in the area. (*DM News*, Scott Hovanyetz, 8/14/03; *Senator Reid press release*, 8/1/03)

Postal Service Inspector General Karla Corcoran retires amid controversy

Postal Service Board of Governors selects new Inspector General

Senator Charles Grassley (R-IA) calls the retirement “a step in the right direction”

CAGW is relieved by Corcoran’s retirement

- The Postal Service Board of Governors has selected David Williams to be the second Inspector General of the US Postal Service. The current Inspector General, Karla Corcoran, “has expressed her intention to retire immediately and will do so with the thanks of the Governors for her service,” said the Postal Service. (*USPS press release*, 8/19/03)
- The selection of Williams culminates an extensive, five-month recruitment effort by the Governors, who were assisted by the executive search firm, Heidrick & Struggles. Williams has served as the Inspector General at four different federal agencies: Internal Revenue Service, Department of Treasury, Social Security Administration and Nuclear Regulatory Commission. (*USPS press release*, 8/19/03)
- A recent investigation by the President’s Council on Integrity and Efficiency (PCIE) found that Corcoran “followed a pattern and practice of unprofessional conduct in the management of the USPS OIG, used questionable judgment in areas within her discretion, extravagantly expended USPS funds, and engaged in personnel practices which were either questionable or not in accord with USPS policy,” wrote Grant Ashley, chairman of the council’s integrity committee. The committee recommended that “the most severe administrative sanctions available be taken against Ms. Corcoran,” Ashley wrote in a July 28 report cover letter to Clay Johnson III, council chairman and deputy director for management at the Office of Management and Budget. (*Washington Post*, Christopher Lee, 8/20/03)

- Among its findings, the PCIE report found that Corcoran:
  - Spent more than \$1 million for each of the last three all-employee annual retreats;
  - Cost her agency \$100,000 in cancellation fees to move the December 2002 annual meeting location from Alexandria, VA to Washington, DC;
  - Spent \$41,796 on mechanical shades for two conference rooms;
  - Humiliated employees by yelling at them in public;
  - Forced retirements of several employees, including one who refused to hide team-building expenses. (*Associated Press*, Larry Margasak, 8/19/03)
- Senator Charles Grassley (R-IA) said the report's findings were "simply stunning" and called the "resignation a step in the right direction." He said the report shows "a pattern and practice of unprofessional conduct in her management," along with extravagant spending and questionable personnel practices. In May, Senators Byron Dorgan (D-ND) and Ron Wyden (D-OR) called for Corcoran's resignation after learning of the staff retreats. (*Washington Times*, James Lakely, 8/21/03; *Associated Press*, Larry Margasak, 8/19/03)

#### CAGW is relieved by Corcoran's retirement

- Citizens Against Government Waste (CAGW) applauded the Postal Service Board of Governors for retiring Corcoran as Inspector General of the United States Postal Service. For four months, CAGW has called for her termination.
- Citing the PCIE report, CAGW President Tom Schatz said, "The Office of Inspector General was created for the express purpose of rooting out waste and fraud in the U.S. Postal Service. It adds insult to injury to see the inspector general engaging in the kinds of activities it is supposed to prevent. The departure of Karla W. Corcoran should give taxpayers and postal ratepayers a sigh of relief."
- Schatz concluded. "Taxpayers and postal ratepayers deserve to have a watchdog with unassailable credentials. CAGW is proud to have played a role in Corcoran's removal, and will keep a watchful eye on all changes at the inspector general's office." (*CAGW press release*, 8/20/03)

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