

The **GSE** REPORT™

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More fallout from Freddie's accounting issues

Freddie releases special counsel report on its accounting

Background:

- 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 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 special counsel report on its accounting

- At the direction of its Board of Directors, Freddie released July 23 the 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 certain of the principal accounting errors identified during the company's previously announced restatement process. The full report may be found at Freddie's web site, www.freddiemac.com. [A more complete summary of the Board Counsel's report will be in the next *GSE Report*.]

In response to GSE issues, Congress has introduced several 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 new 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. [More information available in this *GSE Report*.]
- Senator Chuck Hagel (R-NE) said he plans to introduce a new GSE bill with Senators John Sununu (R-NH) and Elizabeth Dole (R-NC) 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.

Capitol Hill holds hearings - Lawmakers introduce bills

Treasury Secretary John Snow to testify on regulatory structure of GSEs at House Financial Services Committee in September

- The House Financial Services Committee announced that Treasury Secretary John Snow's testimony on the regulatory structure of the GSEs has been scheduled for September 4. The hearing was originally scheduled for July 25 but was postponed due to a scheduling conflict, the Committee said. (House Financial Services press releases, 7/11, 7/15/03; *Dow Jones Newswire*, Dawn Kopecki, 7/15/03)

Senate Banking Committee holds July 17 hearing on Freddie's accounting issue

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Senate Banking Committee may hold more hearings on GSEs

CAGW and FM Policy Focus commend Senate Banking Committee for its hearing

- The Senate Banking Committee heard testimony July 17 from OFHEO Director Armando Falcon on Freddie's accounting issues. The Senators "grilled" OFHEO, questioning how it could miss widespread accounting problems at Freddie and whether it was "up to the task" of regulating Fannie and Freddie. (*Dow Jones Newswire*, Dawn Kopecki, 7/17/03)

Members criticize OFHEO and support moving GSE regulation to Treasury

- Several of the Senators indicated support for legislative proposals that would abolish OFHEO and move regulation of Fannie and Freddie to the Treasury Department. “These days, the kind of financial instruments that these (government sponsored enterprises) engage in are way beyond the understanding of your borders,” said Senator Chuck Schumer (D-NY) to Falcon. “Treasury seems to know these things.” (*Dow Jones Newswire*, Dawn Kopecki, 7/17/03) Perhaps there should be an “Office of GSEs” at Treasury, Senator Schumer said. (*Bloomberg*, Bill Arthur, 7/17/03) “I have some real doubts about OFHEO’s ability to monitor safety and soundness,” Senator Schumer said. He noted, “None of us are very happy on either side of the aisle with what has happened with oversight.” (*Reuters*, Mark Felsenthal, 7/17/03)
- Asked if he supports moving OFHEO to Treasury, Senate Banking Committee Richard Shelby (R-AL) said, “We’ll consider everything after we hold our hearings – some of them will be in September. I think we should not rule out anything. We need a strong regulator. We need a regulator that is on top of things, knows what is going on, and has the ability to be involved diligently.” (*American Banker*, Rob Garver, 7/18/03)
- Falcon told the Senators that moving OFHEO from one agency to another wouldn’t “accomplish much.” (*CBS Market Watch*, Matt Andrejczak, 7/17/03)

New GSE bill to be introduced

- Senator Hagel announced that he and Senators Sununu and Dole will introduce legislation moving OFHEO to Treasury. Senator Hagel said that Treasury “has the experience and expertise needed to supervise” Fannie and Freddie and called the move “a natural fit.” (*American Banker*, Rob Garver, 7/18/03)

OFHEO’s investigation into Freddie’s accounting to be completed by end of September

- Falcon said OFHEO would like to complete its report on its investigation into Freddie’s accounting issue by the end of September. He noted that it was essential that OFHEO receive additional funding to meet that goal. OFHEO recently requested \$4.5 million in additional funding.

Members question why OFHEO gave a glowing review of Freddie’s management and internal controls in its annual report

- In OFHEO’s annual report to Congress, released June 4, OFHEO signed off on Freddie’s management and internal controls. However, just five days later, Freddie announced the removal of three top management executives and told OFHEO that there were serious lapses in those areas. (*Dow Jones Newswire*, Dawn Kopecki, 7/17/03)
- Falcon told the Senators there was a “misperception based on my original report to Congress that we weren’t aware of the accounting problems or weren’t working on it.” (*Dow Jones Newswire*, Dawn Kopecki, 7/17/03) Falcon conceded to lawmakers that future reports to Congress might benefit from a greater level of detail. “Perhaps we should have a lower threshold of what gets included in these reports,” he said. (*Market News International*, Claudia Hirsch, 7/17/03) Falcon noted that safety and soundness regulators like OFHEO do not attempt to set regulatory accounting principles for financial reporting and they do not

review accounting policies for conformance with GAAP. Instead, independent auditors are charged with certifying that a company's statements conform with GAAP, he said. By contrast, Falcon said, OFHEO reviews Freddie's transactions to ensure they are consistent with sound risk management. (*BNA Daily Report for Executives*, Karen Werner, 7/18/03)

OFHEO said it detected accounting problems at Freddie as early as 2001

- OFHEO said that Freddie's accounting problems have been brewing for several years and it questioned Freddie's competence in that area when it tried to implement complicated derivatives rules (FAS 133) in 2001. OFHEO flagged problems with Freddie's 2000 and 2001 consolidated financial statements, which were also noted by Freddie's auditor, Arthur Anderson in an internal letter to senior managers. Falcon said he realized that he needed a team of accountants on OFHEO's examination staff to oversee the implementation of FAS 133. Falcon said that Freddie entered into several transactions to minimize the impact of FAS 133 in the fourth quarter of 2000 and the first quarter of 2001, which were later questioned by Freddie's new auditor, Pricewaterhouse Coopers. (*Dow Jones Newswire*, Dawn Kopecki, 7/17/03)

OFHEO clashes with Freddie's internal auditor

- Falcon criticized the law firm Freddie has retained to conduct its internal audit (Baker Botts) for its "lack of candor" about Freddie's management team. At a May 27 meeting, Falcon said Baker Botts expressed no concerns about "inappropriate or improper behavior" in response to direct questions. (*Dow Jones Newswire*, Dawn Kopecki, 7/17/03) OFHEO later learned that on April 29 Pricewaterhouse Coopers had told Freddie's board that it was not willing to "accept the representations" of the Freddie's top managers, according to Falcon.
- OFHEO wasn't informed until June 5 that Freddie had an "urgent communication" to discuss with OFHEO, Falcon said. Freddie's board told OFHEO the next day that it decided to remove Freddie's top management. OFHEO officials met with members of Freddie's board on June 7 to review much of what OFHEO already knew about the restatement process. "However, new issues relating to Mr. Glenn and the termination and replacement of senior management were also presented; particularly the lack of confidence in Mr. Glenn expressed a month earlier by PwC (Pricewaterhouse Coopers)," Falcon said. "I considered the information regarding Mr. Glenn to be a clear signal of a breakdown in the integrity of Freddie Mac's control environment at the highest levels." OFHEO opened a formal investigation that day into the company's accounting practices and employee misconduct. "Following this meeting, as occurred after the meeting on May 27, additional matters came to light and, again, reflected a lack of candor that concerned me deeply," Falcon said. (*Dow Jones Newswire*, Dawn Kopecki, 7/17/03)
- Falcon stated, "There was a breakdown in integrity at a couple of levels – a breakdown in integrity in top management and a breakdown in integrity in the outside counsel," Falcon testified. (*Reuters*, Mark Felsenthal, 7/17/03)
- Baker Botts disputed Falcon's assertions. "My recollection... is that no questions were asked about the honesty and integrity of Freddie Mac's Chief Operating Officer David Glenn," James Doty with Baker Botts said in a letter delivered July 17 to the Senate Banking Committee. (*CBS Market Watch*, Matt Andrejczak, 7/17/03) "At no time has any

representative of OFHEO expressed any concern to us...with respect to our candor and cooperation,” wrote Doty. (*Reuters*, Mark Felsenthal, 7/17/03)

- “I stand by what I said in my testimony,” Falcon told the lawmakers. (*CBS Market Watch*, Matt Andrejczak, 7/17/03) After the hearing, Falcon said, “Maybe this is all a misunderstanding...but at that time it certainly appeared to us that they weren’t being fully forthcoming.” (*American Banker*, Rob Garver, 7/18/03)
- But Senator Jim Bunning (R-KY) asked Falcon why he didn’t begin its investigation much earlier: in January when Freddie disclosed that it would have to restate its earnings for the past three years. (*Associated Press*, 7/17/03)

OFHEO’s risk-based capital model may be flawed

- Calling the magnitude of Freddie’s accounting discrepancy “mind-boggling,” Senator Jon Corzine (D-NJ) explicitly endorsed moving OFHEO to Treasury. (*American Banker*, Rob Garver, 7/18/03) Freddie expects that its restatement of earnings will increase earnings by between \$1.5 billion and \$4.5 billion for the period 2000-2002. “What is the explanation of such a wide range?” Senator Corzine asked. “It’s mind-boggling to me that there is such a gap,” he said, adding that OFHEO’s risk-based capital model should have thrown out “red flags.” He added, “Without being able to explain three billion (dollars), it makes me wonder about the risk model.” Falcon said he doesn’t expect the accounting irregularities to affect Freddie’s capitalization but added that if necessary, the regulator could re-run its risk-based capital stress test for any quarter. (*Market News International*, Claudia Hirsch, 7/17/03) Falcon expected, however, that a re-run of its risk-based capital stress test would not be necessary since the test runs on raw data that is not dependent on the accounting issues with Freddie.
- Falcon testified that the net cumulative effect of the new accounting treatments for Freddie was an increase in income in prior years, thus increasing the amount of capital on a cumulative basis. Senator Sarbanes noted that had Freddie’s accounting errors resulted in a reduction in prior income, rather than an increase in income, Freddie might have been undercapitalized, which may have been “unbeknownst to the regulator.”

Senator Shelby is “troubled” by OFHEO’s actions

- “You’re the regulator, but you’ve been in the dark,” he told Falcon. “That’s troubling.” (*Dow Jones Newswire*, Dawn Kopecki, 7/17/03) “OFHEO was in the dark, perhaps out of their depth and obviously didn’t know what was going on at Freddie Mac, perhaps at Fannie Mae,” Senator Shelby told reporters after the hearing. “I don’t think that they were doing their job – not to the standards we need.” (*BNA Daily Report for Executives*, Karen Werner, 7/18/03)
- Senator Shelby added that Freddie’s restatement could have been worse if profits had been overstated instead of understated. “You [OFHEO] wouldn’t have known as a regulator had it been a huge loss instead of an appreciation in value,” Senator Shelby said. Falcon responded, “If there was going to be a loss as a result of this restatement, I think we would have known.” (*Bloomberg*, Bill Arthur, 7/17/03) Falcon said the earnings in question are real earnings and not manufactured earnings. OFHEO was fully aware of the transactions and the agency had

to examine them to make sure they were effective hedging activities. If they were not, Falcon said, OFHEO would have picked that up in its examination and would have been aware of the economics of the transactions. It was a matter of accounting and whether to recognize the income from the transactions over time, or recognize it all at once, Falcon said. OFHEO has not routinely been taking a qualitative look at whether a particular accounting policy used by auditors is consistent with GAAP, he said. (*BNA Daily Report for Executives*, Karen Werner, 7/18/03)

Members reluctant to provide OFHEO with more funds for its accounting examinations

- The lawmakers also expressed reluctance to provide the \$4.5 million of additional funding OFHEO requested to its \$30 million budget this year, in order to undertake its accounting examinations of Fannie and Freddie. (*American Banker*, Rob Garver, 7/18/03)

OFHEO says Freddie's accounting lapses are "serious" but not a "crisis"

- Regarding Freddie's accounting lapses, Falcon said, "Is this a serious matter? Yes. Is there a crisis? No. While challenges remain, Freddie Mac remains safe and sound." (*Bloomberg*, Bill Arthur, 7/17/03)

Senate Banking Committee may hold more hearings on GSEs

- Senator Shelby promised to hold additional hearing on OFHEO this fall. "We know that we haven't gotten to the bottom of this, but we will." (*American Banker*, Rob Garver, 7/18/03) Senator Shelby indicated that his panel may hold additional hearings that include testimony from Fannie, Freddie, and the Treasury. "We haven't worked out our full schedule yet," he said. (*Market News International*, 7/10/03)

Statements by Senators:

Senate Banking Committee Chairman Richard Shelby (R-AL)

- Congress should examine the scope and sufficiency of OFHEO's regulatory authority over the GSEs. The public must have confidence that OFHEO has the necessary authority and the resources to effectively regulate the enterprises. He expects that the Senate Banking Committee will hold hearings to review the findings and the conclusions of the various investigations into Freddie's restatement.

Senator Tim Johnson (D-SD)

- Need to take a measured approach and not politicize the accounting review. He is committed to ensuring that OFHEO has the resources and tools for its accounting review. Congress needs full information before taking any drastic steps that could roil the markets. Any "knee-jerk" reaction by OFHEO or Congress could have unintended consequences for the economy and the housing market.

Senator Michael Enzi (R-WY)

- Need to take a step back so that Congress can thoroughly understand the facts before taking any action if action is necessary. Congress needs to also conduct an in-depth discussion as to whether there was sufficient regulatory oversight over Freddie's accounting. He is not convinced there was sufficient oversight. OFHEO placed too much emphasis on Freddie's outside auditor – Arthur Anderson. He is also troubled by OFHEO's most recent request for

an additional \$4.5 million in funding for its accounting review of Fannie and Freddie. He does not believe OFHEO has provided compelling evidence for the additional funding.

Senator Chuck Schumer (R-NY)

- This is a timely and important hearing. There are three courses of action that could be taken: (1) Fannie and Freddie could be completely privatized – he opposes this and believes that the current blend between public and private is the right way to go; (2) leave things as they are regulatorily – he has some real doubts about OFHEO’s ability to regulate safety and soundness and does not believe OFHEO has a good track record; or (3) take safety and soundness and maybe even the whole responsibility of Fannie and Freddie and move it to Treasury (this needs exploration but on the surface makes some sense). Treasury seems to be the best group to regulate Fannie and Freddie, given the complexity of the new products the GSEs are introducing.

Senator Jim Bunning (R-KY)

- This is a timely and important hearing. He is concerned about Freddie’s accounting issue and finds it disconcerting that three days before Freddie’s accounting issue was announced, OFHEO released a glowing report about the GSE. He noted that Freddie’s internal auditor – Baker Botts – disputes Freddie’s testimony. He also finds this disturbing. OFHEO’s request for \$4.5 million in additional funding for its accounting review of Fannie and Freddie gives more ammunition to those who favor moving the regulation of Fannie and Freddie to Treasury. He expects the upcoming Senate confirmation hearing for OFHEO director – nominee Mark Brickell will be tough given the current situation.

Senator Paul Sarbanes (D-MD)

- This is a timely and important hearing. Congress needs to ensure that OFHEO has the appropriate tools and funding it needs to regulate, particularly given the size and complexity of the GSEs and their central role in economy and housing system. Some progress has been made at OFHEO over the past three years since Armando Falcon took over as director (e.g., the completion of the GSEs’ risk-based capital requirements). He has questions about the effectiveness of the Federal Housing Finance Board, the regulator of the FHLBank System and would like the Committee to examine the issue in the future. He said it appears that the FHFB is seeking to “reconfigure the membership and expand the powers” of the FHLBank System without regard to its statutory authority and significantly increased risk its proposed action would bring to the FHLBank System.

Senator John Sununu (R-NH)

- He has two issues he hopes to have addressed at this hearing or at future hearings: (1) the need and capabilities of OFHEO to regulate Fannie and Freddie’s safety and soundness and to address Freddie’s accounting issue; (2) role of OFHEO and the relationship OFHEO has to other regulators (FHFB, OTS, OCC, etc.) Congress should examine the strengths and weaknesses of all the financial regulators and ensure that regulators are not conducting unnecessary duplication.

Senator Elizabeth Dole (R-NC)

- In a written statement, Senator Dole said Congress must ensure there is proper oversight of Fannie and Freddie.

Senator Chuck Hagel (R-NE)

- This is an important and timely hearing. He has been concerned about the GSEs for a number of years. He questions whether the GSEs are getting into troubled waters and whether they are expanding outside their missions. Congress should look at how exemption from SEC regulation, state regulation and income taxes might create an unfair advantage for GSEs as they compete with private-sector companies. “If we are to continue to provide GSEs with the framework to operate under an implied government backing, I believe that they should be held to a higher standard than private organizations and subject to more scrutiny than the private sector.” Congress should take a broad look at all the GSEs. He and Senators Sununu and Dole will introduce legislation next week moving OFHEO to Treasury. The legislation will be patterned after the House legislation. Treasury has the experience and expertise needed to supervise Fannie and Freddie – “it’s a natural fit.”

Senator Jon Corzine (D-NJ)

- In a written statement, Senator Corzine called for Treasury oversight of Fannie and Freddie. He suggested that the safety and soundness regulation of Fannie and Freddie should be moved from OFHEO to the Treasury Department, as a new, separate division. Under Senator Corzine’s proposal, the underlying housing mission of the GSEs – including their housing goals and fair housing oversight – would remain at HUD.

Senator Debbie Stabenow (D-MI)

- During the question and answer period, Senator Stabenow said that Fannie and Freddie are important to the liquidity and success of the housing market and that Congress move forward with due diligence and deliberation on its examination of the GSEs.

CAGW commends Senate Banking Committee for its hearing - says more transparency is needed before disaster strikes

- The Council for Citizens Against Government Waste (CCAGW) – the lobbying arm of Citizens Against Government Waste - commended the Senate Banking Committee for working to address Freddie’s recent accounting problems and calling for increased scrutiny. “Over the last two years, this country has seen the collapse of reputedly well-run companies like Enron and WorldCom. Freddie Mac and Fannie Mae are much larger and their activities are more systematically integrated into our economy,” CCAGW Director of Special Projects Leslie Paige said. “During a time of \$455 billion deficits and economic hardship, this carelessness is inexcusable.”
- “GSEs are exempt from Securities and Exchange Commission registration and disclosure rules and, therefore, do not require the same transparency that is crucial to maintaining confidence in our capital markets,” Paige continued. “Enron and WorldCom could end up looking like a cakewalk if there is more trouble ahead.” OFHEO, which failed to identify Freddie’s “most recent financial misadventure before it was disclosed,” is currently investigating the corporation’s accounting practices. Director of OFHEO Armando Falcon, Jr. claims that the organization lacks the resources to be effective, and has requested \$4.5 million in additional funding for its accounting examination into Freddie and Fannie. “Congress should not reward failure by giving OFHEO more money,” Paige concluded. “Rather, senators and representatives should move OFHEO from the Department of Housing and Urban Development to the Department of the Treasury, as proposed in H.R. 2575.”
(*CAGW press release, 7/18/03*)

FM Policy Focus Chairman J.C. Watts' comments

- “The corporate scandals of the past two years have made Americans justifiably nervous about the financial state of our most important industries. The recent reports of accounting irregularities at Freddie Mac are another reminder of why more transparency and accountability are critical, particularly for government-sponsored enterprises.”
- “The GSEs’ current regulatory structure is divided between two agencies -- the Office of Federal Housing Enterprise Oversight (OFHEO) and HUD. As we have long contended, this bifurcated structure has been ineffective. We commend Senator Shelby for holding a hearing to examine the problems with GSE oversight, and for his long-standing interest in this issue.”
- FM Policy Focus recommends that oversight of Fannie and Freddie “should fall under one single regulator housed in the Treasury Department, with the full panoply of regulatory and enforcement powers, including the authority to:
 - Examine GSE activities that impact their safety and soundness status, including prior review of all new programs;
 - Take steps to bring the capital requirements of both GSEs to levels equivalent to those of other large, regulated financial institutions; and
 - Require the GSEs to make effective disclosure – including full, mandatory SEC registration-- to ensure that investors and risk counterparties have all the information they need to make informed judgments that, in turn, supplement supervisory assessments.” (*FM Policy Focus statement, 7/17/03*)

Senate Governmental Affairs Subcommittee holds July 21 hearing on costs and benefits of GSEs

Senator Fitzgerald says GSEs should be regulated by Treasury

Senator Fitzgerald says GSEs should have adequate regulation, adequate capital, and be required to file with the SEC

Witnesses range from complete privatization of the GSE to status quo

- The Subcommittee on Financial Management, the Budget, and International Security of the Senate Governmental Affairs Committee held a hearing July 25 on the oversight of the GSEs and the risks and benefits of GSEs to consumers. The following individuals testified:
 - Alex Pollock, President and CEO, FHLBank of Chicago
 - Peter Wallison, Senior Fellow, American Enterprise Institute (AEI)
 - Bert Ely, Ely & Co.
 - Bart Harvey, Chairman and CEO, the Enterprise Foundation
 - James C. Miller III, Senior Fellow, Hoover Institution
 - Dr. Susan Wachter, Wharton School of Business, University of Pennsylvania
 - W. Michael House, Executive Director, FM Policy Focus

- Subcommittee Chairman Peter Fitzgerald (R-IL), who chaired the hearing, was also the only Senator that attended the hearing. While the GSEs have supplied an important public policy mission – to help provide homeownership to low- and moderate-income homebuyers, Congress “cannot ignore continuing news reports regarding both the size and complexity and the financial status” of the housing GSEs, in particular Fannie and Freddie. Senator Fitzgerald believes that Fannie and Freddie are probably sufficiently hedged to withstand an economic downturn but like other financial institutions, are not strong enough to withstand a severe downturn like the 1930s.

Senator Fitzgerald says Treasury should regulate GSEs

- Fannie and Freddie should be regulated by the Treasury Department, Senator Fitzgerald told reporters. “Most in Congress would want to follow the lead of Treasury,” said Senator Fitzgerald. He said he personally thinks Treasury should regulate the GSEs instead of OFHEO. “OFHEO is wrapped in a department that would not be optimal to be regulating two of the largest financial institutions in the world.” He believes that shifting regulation of the GSEs to the Treasury is likely since Treasury appears to support the move. “I think there’s increasing support for that, and I think the fact that it appears that Treasury is for moving the regulation to the Treasury, that most Senators will listen to the Treasury Department,” he told reporters. He said he doubted whether Congress would take other action on Fannie and Freddie, such as breaking them into smaller companies, prohibiting them from buying back their own securities or limiting the amount of their debt that banks can hold. “Any congressional action would probably be limited to establishing a new regulator,” he said. “Fannie and Freddie seem to have a lot of support in Washington,” he said. (*Bloomberg*, Bill Arthur, 7/21/03; *Reuters*, Mark Felsenthal, 7/21/03)

Senator Fitzgerald said GSEs should have adequate regulation, adequate capital, and required to file with the SEC

- In an interview with *CNBC*, Senator Fitzgerald said he came away with three conclusions from his hearing: “Number one, if we are to continue supporting Fannie Mae and Freddie Mac with government charters, we ought to make sure we have effective regulation...Number two, we ought to make sure they have adequate capital...And number three...they ought to have to file with the SEC.” (*CNBC News Transcript, Business Center*, 7/21/03)

Alex Pollock, FHLBank of Chicago

- Congress can ensure all of the GSE benefits and charter advantages are passed on to consumers by encouraging greater competition in the GSE sector. No amount of re-regulation can substitute for the effects of competition. He sees three possible outcomes to the current public policy debate about the GSEs: (1) continued expansion and dominating role of Fannie and Freddie in the secondary mortgage market; (2) complete privatization of the GSEs by removing all their ties to the federal government (probability is close to zero); and (3) creating a more competitive and economically efficient GSE sector. As a practical matter, the only way to improve the secondary mortgage market to benefit community lenders and homebuyers is through greater competition. Realistically, competition in the mortgage funding business can only come from the third housing GSE, the FHLBanks, because to compete with a GSE, you must have the advantages of a GSE.

Peter Wallison, American Enterprise Institute

- Fannie and Freddie create enormous risks for the government, taxpayers, and for the economy, yet provide no benefit to homebuyers. Fannie and Freddie are no longer needed for their original purpose – to provide liquidity for the housing finance system – “they should be thanked and sent home.” Fannie and Freddie now claim their mission is to reduce the cost of mortgages to enable people to buy homes who might otherwise not be able to do so. However, the US housing finance system gets very little benefit from the continued existence of Fannie and Freddie. The reduction in interest rates that Fannie and Freddie point to as a result of their activities, which is small in any case, and is swamped by macro changes in interest rates as a result of economic conditions. Further, it is not clear that the lower interest rates benefit homebuyers, but perhaps benefit home sellers instead. This small reduction in interest rates does not put people in homes or improve homeownership rates because most renters lack the downpayment necessary to buy a home. Finally, Fannie and Freddie do less for minority housing than ordinary commercial banks, and Fannie and Freddie seem to discriminate against minority homebuyers rather than assist them.
- In terms of costs, at the end of 2002, Fannie and Freddie had aggregate outstanding debt of \$1.5 trillion, and aggregate outstanding guarantee obligations of \$1.8 trillion – almost \$3.5 trillion in liabilities. Even a small part of this obligation would “make the S&L bailout look like a dime-store operation.” Because Fannie and Freddie are integral to the health of the housing market, the failure of either of them could have a systemic effect on the economy. “And since there are only two of these companies...the continued health of our economy depends on decisions by only two corporate managements. If one of them makes a grave mistake, the entire economy could suffer.”
- Wallison ultimately recommended privatizing Fannie and Freddie and breaking them up into five or six smaller entities. However, a more modest and temporary proposal is having Congress prohibit Fannie and Freddie from buying back or accumulating any substantial portfolio of mortgage or mortgage-backed securities to reduce their risk to taxpayers and to the economy generally. Fannie and Freddie’s activities should be limited to forming pools of mortgages and selling MBS that they guarantee. The risks on this activity – which is simply credit risk – are far less than the interest rate risk they have been taking, and it would have no effect on mortgage interest rates.

Bert Ely, Ely & Company

- Fannie and Freddie have been growing rapidly, posing an increased systemic risk. Fannie and Freddie have inadequate financial disclosures and a lack of comparability in the disclosures of the two companies. OFHEO’s risk-based capital test for Fannie and Freddie is outdated and too rigid. A complete privatization of the GSEs is the only true solution to the GSE problem. The benefits of privatization include: (1) elimination of GSE risk to taxpayers; (2) a much more efficient housing finance system; (3) a level competitive playing field among housing finance firms; (4) a more flexible and adaptive housing finance industry; and (5) targeted delivery of the housing finance system to just those homebuyers on the cusp of homeownership. Other proposals are “tweaks to the GSE problem” – they have merit but are insufficient to address the GSE problem. Such “tweaks” include (1) full SEC registration by Fannie and Freddie; (2) restructuring GSE regulation; (3) increasing OFHEO’s budget and powers; (4) eliminating state income tax exemptions; (5) repealing Fannie and Freddie’s Treasury line of credit; (6) increasing capital requirements for Fannie and Freddie;

and (7) ending mission creep.

Mike House, FM Policy Focus

- For Fannie and Freddie to be in full compliance with their charters and fulfill their congressionally mandated mission, they need effective government oversight with sound capital, effective supervision, and market discipline from enhanced disclosures. “Fannie Mae and Freddie Mac are 0-for-3.” FM Policy Focus recommended Congress enact legislation this year that includes the following components:
 - Strengthen GSE regulation by moving this responsibility from HUD to Treasury
 - Make the new regulator a member of the Federal Financial Institutions Examination Council (FFIEC);
 - Provide the new regulator with powers comparable to those available to bank regulators, including the approval of new products and activities;
 - Require that GSEs hold bank-like capital;
 - Fund the new regulator through assessments on the GSEs, comparable to those supervisory fees which fund bank regulators;
 - Tighten the national affordable housing standard that now applies to the GSEs by making that standard apply within individual metropolitan statistical areas;
 - Repeal Fannie and Freddie’s exemptions from the Securities Act of 1933 and the Securities Exchange Act of 1934;
 - Repeal the GSEs’ exemption from the privacy provision which, under Gramm-Leach-Bliley, apply to all other financial institutions;
 - In the context of maintaining a liquid secondary market and adequate capital, cap the amount of their own and each other’s MBS which the GSEs may hold in their own portfolios;
 - Limit the GSEs’ non-mission portfolio assets and investments;
 - Cap the amount of debt the GSEs may issue without seeking Treasury approval; and
 - Establish a clear limit on the GSEs’ business activities to a strictly secondary market role that prohibits encroachment into primary market activity.

James C. Miller III, Senior Fellow, Hoover Institution

- All GSEs can stand improvement but these are well-run institutions that have done an outstanding job for the housing market. He has participated in two major studies that address the benefits and costs of the housing GSEs. In a paper co-authored with Dr. James Pearce, Miller found that Fannie and Freddie save American consumers between \$8.4 billion and \$23.5 billion per year in the form of lower mortgage costs. The study also found that the funding advantages these GSEs derive from their relationship to the federal government amounts to between \$2.3 billion and \$7 billion per year. He noted that even the lowest estimate for consumer benefits exceeds the highest estimate of funding advantage. In another study, produced by CapAnalysis (where he is Chairman), addressing the stringency of OFHEO’s risk-based capital stress test for Fannie and Freddie. CapAnalysis applied the OFHEO stress test to the thrift industry, resulting in a failure by the thrift industry.

Bart Harvey, Chairman and CEO, the Enterprise Foundation

- Fannie and Freddie have been indispensable to the Enterprise’s efforts to expand housing opportunity for low-income homebuyers and renters. In many cases, the GSEs alone were willing and able to help the Enterprise Foundation meet the needs of the people and places it serves. Without the GSEs, much of their work simply would not have been possible. Fannie

and Freddie are subject to strong affordable housing requirements. Fannie and Freddie have been leaders in the creation of innovative lending programs to finance affordable housing.

Dr. Susan Wachter, Wharton School of Business, University of Pennsylvania

- The US has one of the best housing finance systems in the world. The federal chartering of Fannie and Freddie has advanced the efficiency of this system. Fannie and Freddie have contributed to the expansion of homeownership, providing affordable residential mortgages for low- and moderate-income households who otherwise would not have the opportunity to become homeowners. GSEs have accomplished this through their special affordable lending programs and through lower downpayment and mortgage rates that would not have prevailed but for the presence of the GSEs. The gains in homeownership are also attributable to the GSEs' technical innovations, such as automated underwriting. By accessing the global capital markets, the GSEs stabilize the US housing market, which in turn, has stabilized the US economy.

Senate Banking Committee holds GSE confirmation hearing on July 22

Committee considers the nomination of OFHEO Director nominee Mark Brickell and FHFB Director nominee Alicia Castaneda

Senate Democrats question whether OFHEO nominee Brickell will be tough enough

Brickell "is a potential step in precisely the wrong direction," says *Washington Post* editorial

Brickell says it's important to keep Fannie & Freddie's capital rules updated

Brickell will ensure Fannie & Freddie are GAAP compliant

FHFB nominee Castaneda receives light treatment at hearing

Brickell worth at least \$5 million

- The Senate Banking Committee held a July 22 confirmation hearing for Mark Brickell to be the new director of OFHEO. Brickell, chief executive officer of the electronic derivatives exchange Blackbird Holdings and former JP Morgan vice president, was nominated by President Bush in February. Administration officials in February asked for the resignation of the current Clinton appointee OFHEO Director Armando Falcon, who had more than a year remaining in his term.
- Senate Democrats, led by Senator Paul Sarbanes (D-MD), questioned whether Brickell would be tough enough, particularly whether Brickell's free-market background would make him a bad fit for the job. Senator Sarbanes said he wasn't sure Brickell was "the right person for this position." Senator Jack Reed (D-RI) said, "I'm not sure someone who as consistently opposed regulations, transparency, and oversight for the derivatives markets should be director of an agency that regulates the GSEs." (*American Banker*, Rob Blackwell, 7/23/03)

- Senator Shelby did not indicate a time when the Committee would formally vote on Brickell's nomination and instead urged him to answer another set of written questions from Committee Members. (*Dow Jones Newswire*, Rob Wells, 7/22/03)

Washington Post editorial

- Senator Sarbanes said, "Serious questions" have been raised as to whether Brickell "is the right person for this position at this time." Senator Sarbanes quoted from a *Washington Post* editorial questioning Brickell's nomination. The editorial read: "[Brickell] strikes us as a potential step in precisely the wrong direction...Brickell...has a long track record of opposing government regulation of financial services and leaving most of the work to market forces. In particular, Brickell led lobbying efforts to prevent regulation of derivatives, the arcane financial instruments that are critical to the risk management operations of Fannie Mae and Freddie Mac. Questionable accounting for derivatives is at the heart of the recent troubles at Freddie Mac. Mr. Brickell also weighed in on the side of Fannie Mae and Freddie Mac when they argued that they should be able to set up their own tests, rather than one devised by OFHEO on whether they had adequate capital on hand, a change that OFHEO said would diminish its regulatory independence and vigor." (*Senator Sarbanes' opening statement*, 7/22/03; *Washington Post editorial*, 7/22/03)

Brickell says it's important to keep Fannie & Freddie's capital rules updated

- Senator Sarbanes questioned Brickell about a letter he co-signed when he was an executive manager of J.P. Morgan in March 2000 recommending that OFHEO allow Fannie and Freddie to use their own internal models to evaluate their capital adequacy. Brickell stated, "We encouraged OFHEO to take a flexible approach, like the approach the banking regulators take, rather than an inflexible one. I think it is worth saying that a rigid regime for capital is not necessarily a tough regime." Brickell noted that it was important to keep "an open mind" about capital standards for Fannie and Freddie. (*American Banker*, Rob Blackwell, 7/23/03)
- Brickell noted, "The approach we talked about in that letter we believe is more demanding, not only of the financial institution but more demanding of the regulator because the regulator would have to satisfy himself that the models being used by the financial institution achieve the purpose of the regulation and don't lead to leakage of capital through regulatory arbitrage...I think it was something worth considering. And OFHEO hasn't adopted it and, indeed, OFHEO is constrained in some ways by the statute which hardwires into law many of the parameters of the capital rule. One thing that the committee may wish to consider as it talks about ways to strengthen OFHEO is to give OFHEO the ability to tailor its capital rules as closely as possible to the risks being taken by Fannie Mae and Freddie Mac." (*FDCH Political Transcripts*, 7/22/03)
- He added, "It's important for OFHEO to be able to continuously upgrade the capital rules it uses in its oversight of Fannie Mae and Freddie Mac." OFHEO should not "fall behind the quality of regulation used by other regulators." (*Dow Jones Newswire*, Rob Wells, 7/22/03)

Brickell will ensure Fannie & Freddie are GAAP compliant

- When questioned about his earlier opposition to FAS 133, on when income from derivatives must be realized for accounting purposes, Brickell said FAS 133 generated vigorous

discussions among CEOs of companies that would be affected by its application and he worked for institutions that participated in the process. When asked by Senator Sarbanes whether he opposed FAS 133, Brickell said he had recommended changes that could have improved the rules, as many people did at the time. Now, Brickell said, FAS 133 is not an option, but it is part of GAAP that Fannie and Freddie must comply with. Brickell said he would ensure Fannie and Freddie apply the standard and all GAAP. He stressed that, if confirmed, he would not have a choice about supporting FAS 133, since it is the law of the land. (*BNA Daily Report for Executives*, Alexei Alexis, 7/23/03)

FHFB nominee Castaneda receives light treatment at hearing

- FHFB Director nominee Alicia Castaneda, a senior vice president at Bank of America, received lighter treatment at the hearing. She was questioned about predatory lending and housing for minorities. (*American Banker*, Rob Blackwell, 7/23/03) Senator Shelby said he planned to “expeditiously move” her nomination. Senator Sarbanes said he planned to support her nomination. (*Dow Jones Newswire*, Jennifer Corbett Dooren, 7/22/03) As noted in the April 7, 2003 *GSE Report*, the previous nominee to the FHFB, Diana Furchtgott-Roth, was “tripped up” over a fundraising investigation of FHFB Chairman Korsmo.

Brickell worth at least \$5 million

- Brickell’s financial statement shows he has stocks, mutual funds and other assets worth between \$5 million and \$16 million, according to a summary of Brickell’s financial holdings released by the Office of Government Ethics. (*Dow Jones Newswire*, Rob Wells, 7/11/03)

House Energy and Commerce Subcommittee holds July 22 hearing on FASB derivatives accounting standards related to Freddie’s accounting issues

Subcommittee plans to hold hearing on Freddie’s re-audit

Opening Statements:

- The Subcommittee on Commerce, Trade and Consumer Protection of the House Committee on Commerce held a July 22 hearing on Financial Accounting Standard Board’s (FASB) derivatives accounting standards. Subcommittee Chairman Cliff Stearns (R-FL) noted that the event that triggered the hearing was Freddie’s announcement of restated earnings. However, while Freddie is testifying at the hearing, Congressman Stearns understands that Freddie’s CFO Marty Baumann will not be able to remark on specifics of the company’s earnings restatement, since it is ongoing. The main focus of the hearing was FASB’s standards on derivatives (known as FAS 133). It is important to find out if the FASB standard is providing timely and accurate information on derivatives to investors. A hearing solely about Freddie will take place as soon as the reaudit is concluded.
- The total amount of outstanding derivatives in the US markets is over \$127 trillion, while the GSEs have over \$5 trillion outstanding. The basic rule of FAS 133 is that all derivatives should be simply stated – however there are many additional pages of rules for hedging. This is where the concern lies – do Freddie and other companies such as Fannie, use the hedge rules to mask flaws in their accounting, potentially leading to a great financial failure? Stearns concluded by noting that FASB needs to clarify the rules of FAS 133, particularly regarding hedging. If FASB does not act, Congress will.

- Ranking Member Jan Schakowsky (D-IL) said that derivatives are a valuable part of the financial system if the rules regulating them are clear. It appears that FAS 133 is not clear with regards to hedging. Congresswoman Schakowsky agrees with Congressman Stearns that the subcommittee needs to hold a hearing on Freddie's earnings restatement once that information is public. Freddie is an important company, playing a vital role in the economy.

Panel:

Leslie Seidman, Member, Financial Accounting Standards Board

Marty Baumann, Executive Vice President, Chief Financial Officer, Freddie Mac

Peter Wallison, Resident Fellow, American Enterprise Institute

Dr. Thomas J. Linsmeier, Russell E. Palmer Endowed Professor & Chairperson, Department of Accounting & Information Systems, Eli Broad College of Business, Michigan State University

- Seidman noted that the use of derivatives rose exponentially in the 1980s, prompting Congress and the GAO to encourage FASB to develop standards for derivatives. The result was FAS 133, issued in 1998, which calls on organizations to report all derivatives at their full value. Changes to the value should be reported in the period of the change. However, special circumstances are allowed for hedge accounting. Since hedging defers money on derivatives, FASB has a strident criterion that varies based on the nature of the derivative. That is why FAS 133 includes over 100 pages of rules on accounting. FASB also understands that derivative accounting is changing and is undergoing a massive review of the processes so that FASB can more effectively regulate derivatives. FASB is also open to guidance from Congress.
- Baumann, the new CFO of Freddie, stated that the reaudit should be concluded by the end of the 3rd quarter. Since the restatement is currently underway, and due to federal investigation, Baumann cannot comment on specifics of Freddie's restatement. The report by Baker Botts, a law firm doing an independent review of the events, should be released shortly. Baumann said he wants to make two things clear – first, Freddie is “unquestionably” safe and sound, passing OFHEO's risk-based capital rule by a wide margin. Secondly, Freddie will fulfill its commitment to register with the SEC. Regarding FAS 133, Baumann noted that GAAP accounting is the cornerstone of Freddie's business. The company supports FASB and also supports fair value measures since they are beneficial to investors. Baumann also pledged that Freddie will issue fair balance accounting sheets each quarter. Baumann concluded by noting that he has concerns with a principle-based accounting framework, because it would require vigorous oversight.
- Wallison noted that his testimony would not be on FASB, but rather the ethics of accounting in general. Wallison is concerned about Freddie's accounting troubles and the potential problems that come from a scandal of this magnitude. The markets are relying on a “thin reed” of information – regulation and accurate accounting. OFHEO is not up to the task of regulating the GSEs and was not aware of Freddie's accounting problems until the company informed its regulator. The housing market is unique – it is completely dominated by two companies. If Fannie and Freddie were to fail, there could be a systemic effect on the entire economy. That is why Congress should think about privatizing the GSEs. At a minimum, Congress should prohibit them from buying back their MBS and accumulating portfolios of

mortgages.

- Linsmeier reported that politics played a major role in the shaping of FAS 133 and looks to play a major role in any changes made to the FASB's standards. FAS 133 has become too complicated, and led to Freddie's restatement. However, a move to principle-based accounting would not have changed things – Freddie still would have violated FASB's standards. Linsmeier said the solution is to force the GSEs to report in the same manner that other public companies do. Core capital tests should include derivatives.

Questions/Comments:

- Cong. Stearns asked about GAAP accounting – is it inefficient? Both Wallison and Linsmeier noted that more information should be available, particularly in regards to cash flow. Congressman Stearns then asked Baumann if Freddie was going to continue to use hedge accounting in order to be more transparent to investors. Baumann replied that Freddie does not want to mislead investors. Stearns then asked if he could commit to not using hedges. Baumann answered that Freddie will follow the rules. Stearns then asked Seidman if hedges impede on issuing fair market disclosures. Seidman noted that it depends on the type of hedge, but that could be the case.
- Cong. Schakowsky asked Seidman about FASB's status in reviewing fair value disclosures. Seidman replied that FASB is in the process of looking at the whole picture. Schakowsky then asked Linsmeier about the political process he described in his testimony – would it have an impact on fair value? Linsmeier noted that it would – look at what has happened in Europe.
- Cong. Bass asked Baumann about the mediation process at Freddie – how will they be sure that all their problems are solved? Baumann told Bass that Freddie has presented its remediation plan to OFHEO for their review. The company's new plan starts at the Board level in making sure transactions are transparent.
- Cong. Markey opened his statements by singing a unique rendition of “Mac the Knife” that substituted the GSEs and their creative derivative accounting for the shady title character of the song. After his song was over, Markey asked Baumann about the company's June 25th press release that quoted an outside counsel as stating that Freddie's accounting process did not meet the standards of the SEC. Yet for years, Freddie has always claimed to surpass SEC standards. Baumann replied that he could not get into specifics due to the ongoing investigation and reaudit. Markey then asked about hedging – did Freddie try to get around FAS 133 by using hedges? Baumann again replied that he could not get into specifics, but that the independent counsel had those findings – that is not necessarily what he would have concurred. Baumann then reiterated that Freddie is committed to the SEC process.
- Cong. Strickland asked Wallison about his thoughts on GSE privatization – how would there be any affordable housing funding if the GSEs were privatized? Wallison answered that the GSEs' \$10 billion government subsidy is not economically efficient. The private market and tax breaks would serve homeowners needs much more effectively.
- Cong. Stupak asked about FASB's thoughts on hedging. Does it support the process?

Seidman said that hedging is complex – there are many types. FASB is undergoing a major review of FAS 133 and is open to any direction from Congress.

- Cong. Stearns asked Baumann about fair market value – if Freddie disclosed that, would we need hedging rules? Baumann said no – that would be the simplest. Linsmeier said that fair market value may work for some sectors of the economy but not all. Cong. Stearns then issued a warning to FASB, directed at Seidman, that FASB should really act on revising their rules on derivatives and hedging. Otherwise, Congress will get involved.

House Capital Markets Subcommittee cancels GSE hearing, citing uncooperativeness of Fannie & Freddie

Congressman Baker hints that he may be forced to subpoena the two companies to testify

“...it’s clear they know they are in big trouble and are stalling for time,” says the *Wall Street Journal*

Congressman Baker says support growing for regulatory reform of the GSEs

- Capital Markets Subcommittee Chairman Richard Baker (R-LA) cancelled a subcommittee hearing scheduled on July 17 on the regulatory reform of Fannie and Freddie, citing lack of cooperation from the companies themselves as the reason. The purpose of the hearing was to discuss Congressman Baker’s bill (HR 2575) to strengthen oversight of Fannie and Freddie. Congressman Baker hoped to solicit input and feedback from the two GSEs on his bill. “This is a serious issue for Congress to take up, and I did not want it to be said that we weren’t taking into consideration the perspective of the companies themselves,” Congressman Baker said. “We keep seeing in the news that both companies say they invite stronger oversight. I hoped that they would appear voluntarily before Congress and present us with a more detailed expression of that view. Their lack of cooperation is unfortunate and raises questions about their seriousness.” Congressman Baker hinted that he may be forced to subpoena the two companies. “They cannot put off the subcommittee’s questions indefinitely, however, and we will revisit this discussion at a later date, when I have no choice but to consider extending a different form of invitation to receive their testimony.” (*Congressman Baker press release, 7/16/03; BNA Daily Report for Executives, 7/17/03*)

Fannie & Freddie’s response

- A source familiar with the matter said Fannie informed Congressman Baker’s office they would not appear at the July 17 hearing. Freddie then reiterated its willingness to testify but noted that “it didn’t make a lot of sense to come alone,” said the source. (*Market News International, Claudia Hirsch, 7/16/03*) “[W]e were ready to testify and we never told anyone that we wouldn’t testify,” Brad German, a Freddie spokesman told *BNA*. “We’re willing to work with Congressman Baker on his bill, we have had such conversations with him in the past, and we anticipate we’ll continue to have them in the future,” German added. (*BNA Daily Report for Executives, Joe Tinkelman, 7/18/03*) Fannie’s SVP of Communications Chuck Greener said the company “respectfully declined the invitation to testify” because the company “has no specific knowledge of, or insights into, Freddie Mac’s issues.” He added, “To the extent the hearing is about regulatory change, it would be

premature or presumptuous for us to testify on this matter prior to the Administration. As always, we are prepared to testify before Mr. Baker's committee, or any other committee, at the appropriate time, which we have done on a number of occasions in recent years and have expressly told Representative Baker that." (*Bloomberg News*, 7/16/03)

- Congressman Baker's spokesman said that in Congress Baker's view, "both companies resisted. They may have resisted in different ways. [Cong. Baker] was looking for a detailed expression of [the GSE's] ideas on strengthening regulation and the proposed bill itself. Freddie may have been willing to appear. But based on what was learned on a staff level, [Freddie was] not going to give the kind of detailed expression that the congressman was seeking," DiResto said. DiResto said Congressman Baker is interested in seeing if the GSEs have "ideas on how to make their oversight more effective. He also didn't want it to be said that they were not consulted." (*BNA Daily Report for Executives*, Joe Tinkelman, 7/18/03)

Wall Street Journal editorial

- "The House had to cancel a hearing scheduled for today because the witnesses, Fannie Mae and Freddie Mac, wouldn't cooperate. Pretty rude for two companies that were created by Congress. The purpose of the hearing... was to discuss proposed legislation to strengthen regulatory oversight of the two mortgage-financing giants. Fannie and Freddie have long stated they favor strong oversight, but when it came time to offer specifics they clammed up... Whatever the excuse, it's clear they know they're in big trouble and are stalling for time."
- "Either the feds should rein them in or cut them loose. We've long argued for the latter. In the meantime, they are answerable to Congress... Perhaps Fannie and Freddie will remember their manners when asked to R.S.V.P. to a subpoena." (*Wall Street Journal editorial*, 7/17/03)

Congressman Baker says support growing for regulatory reform of the GSEs

- Congressman Baker's spokesman Michael DiResto said, "We're encouraged that we seem to be witnessing support growing for regulatory reform" of the GSEs. "We take a lot of encouragement from the fact that Senator [Chuck] Hagel is planning to introduce legislation that has a great deal of similarity to [Congressman Baker's] bill." (*BNA Daily Report for Executives*, Joe Tinkelman, 7/18/03)
- DiResto said Congressman Baker supports the Shays-Markey bill (HR 2022) and that Congressman Baker has told Congressman Christopher Shays (R-CT) that he and Congressman Edward Markey (D-MA) are welcome to present their legislation during the mark-up of his bill in the form of an amendment. (*BNA Daily Report for Executives*, Joe Tinkelman, 7/18/03)

Congressman Ed Royce (R-CA) introduces new GSE bill to strengthen regulation of Fannie, Freddie & FHLBanks

- Congressman Royce introduced legislation July 21 to strengthen regulation of Fannie, Freddie and the FHLBanks. The bill, HR 2803 (the Housing Finance Regulatory

Restructuring Act of 2003), would create a new regulator for the three GSEs under the Treasury Department. (*Thomas Congressional Web site*, 7/21/03) The bill would combine Fannie and Freddie's current safety and soundness regulator (OFHEO) and the FHLBanks' regulator (FHFB) as a new agency (named Office of Housing Finance Oversight) under the Treasury Department. (*Bloomberg News*, Al Yoon, 7/22/03)

- The bill differs from Congressman Baker's GSE bill (HR 2575), which abolishes OFHEO and shifts safety and soundness regulation of Fannie and Freddie to an expanded Office of Thrift Supervision (OTS), under Treasury. Under Congressman Baker's bill, the OTS would be renamed the Office of Housing Finance Supervision (OHFS). Congressman Baker's bill also does not address the FHLBanks. Congressman Baker said that he will consider Congressman Royce's bill when the subcommittee debates GSE regulation. "It's a positive development and a further sign of support on the committee that oversight of Freddie and Fannie needs reform," said Congressman Baker's spokesman. "When Congressman Baker introduced his own bill, he said he was open to discussion to strengthen the bill and make the new regulator more effective." (*American Banker*, Michele Heller, 7/9/03)
- Congressman Royce's bill would still require HUD to set Fannie and Freddie's affordable housing goals, however, HUD would no longer regulate the GSEs' charter activities. That power would go to the new agency under Treasury. (*Dow Jones Newswire*, Dawn Kopecki, 7/22/03)

House rejects amendment that would have capped the amount of Fannie & Freddie's debt held by "government" funds

Treasury warned in 2002 about the marketing of mutual funds containing GSE securities

Treasury noted that many mutual funds market themselves as being comprised primarily of securities that are backed by the full faith and credit of the US government, when they have a large proportion of GSE securities (that are not government-guaranteed)

Wall Street Journal reports that many "federal" and "government" funds contain a large part of their assets in Fannie & Freddie's debt

- The House Financial Services Committee approved legislation July 23 to increase disclosures on mutual funds. The bill, HR 2420 – the Mutual Funds Integrity and Fee Transparency Act – was approved by voice vote. (*House Financial Services Committee press release*, 7/23/03)
- The Committee rejected by voice vote an amendment offered by Congressman Christopher Shays (R-CT) that would require mutual funds that advertise themselves as investing in "federal" or "government" securities to hold at least 80% of their assets in securities issued or backed by the US or other governments. The bill would have forced many to change their name or reduce their holdings of debt issued by Fannie and Freddie, which are not guaranteed by the federal government. Congressman Shays said the measure was aimed at preventing funds that invest largely in Fannie and Freddie's debt from suggesting that the fund is backed by the government. Opponents argued that there had been no evidence of problems at mutual funds that invest in Fannie and Freddie debt. Committee Members said they feared

unintended consequences and saw no need for the restriction. (*Dow Jones Newswire*, Judith Burns, 7/23/03; *Bloomberg News*, Bill Arthur, 7/23/03)

Treasury warned in 2002 about the marketing of mutual funds containing GSE securities

- In a June 4, 2002 letter to the SEC, then Treasury Assistant Secretary for Financial Institutions Sheila Bair said that Treasury is “concerned that retail investors – either those that directly purchase GSE securities or those that hold GSE securities indirectly through a mutual fund – may not fully understand the risks associated with such investments.” Investors may not understand that securities of Fannie, Freddie, and other GSEs are not government-guaranteed. “In particular, retail investors may not have a clear understanding that the GSEs’ relationship to the Federal government does not involve any Federal guarantee of the GSEs’ obligations,” warned Bair. (*Treasury Assistant Secretary Bair’s letter to SEC*, 6/4/02; *Reuters*, Mark Felsenthal, 6/5/02)
- Bair expressed concern that many mutual funds market themselves as being comprised primarily of securities that are backed by the full faith and credit of the US government, when they have a large proportion of GSE securities. (*Reuters*, Mark Felsenthal, 6/5/02) Bair noted that “the current convention for naming mutual funds associated with US government securities and the disclosures associated with these funds may create confusion for retail investors regarding the relationship between the Federal government and the securities that make up the fund...many mutual funds that are named within the ‘US Government’ category actually have few if any securities that are backed by the full faith and credit of the US government.” (*Treasury Assistant Secretary Bair’s letter to SEC*)
- For example, Bair cited a fund managed by TD Waterhouse called the “US Government Money Market Portfolio,” which has about 90% of its investments in GSE securities. Of the fund’s \$1.18 billion in assets on October 31, 2001 at least 93% came from GSEs including Fannie, the Farm Credit System, and the FHLBank System. (*Dow Jones Newswire*, Dawn Kopecki, 6/5/02; *New York Times*, Alison Leigh Cowan, 6/6/02)

Wall Street Journal reports that many “federal” and “government” funds contain a large part of their assets in Fannie & Freddie’s debt

- The *Wall Street Journal* reported that Fannie and Freddie’s debt often constitutes the vast majority of bond mutual-fund portfolios that are frequently referred to as “government” or “federal” mutual funds, despite the fact that Fannie and Freddie aren’t directly part of the government and are not government guaranteed. According to researcher Morningstar Inc., 182 bond funds with about \$180 billion in assets had more than one-third of their assets in Fannie or Freddie-related debt, even though their fund names didn’t mention mortgages, or Fannie or Freddie themselves. More than 80 had at least half of the assets in Fannie and Freddie’s debt, while 74 of those were carrying names that included the words “government” or “federal.” (*Wall Street Journal*, Aaron Lucchetti, 7/11/03)

Cong. Barney Frank (D-MA) does not believe Congress will pass a bill on the GSEs

- Speaking after a speech to the Women in Housing and Finance, House Financial Services Committee Ranking Democrat Barney Frank (D-MA) said he does not believe there will be a

bill anytime soon on the regulation of Fannie and Freddie. He added that he does not believe the GSEs should be regulated by the Office of Thrift Supervision (as proposed by Congressman Baker's bill). Congressman Baker said OTS regulation would create a "wholesale-retail" conflict. Congressman Frank said that there is "no need for any great charter change" for Fannie and Freddie. "With regard to Freddie Mac, as far as I can see, we have an accounting problem, a derivatives problem," Cong. Frank said. "At this point, I have a question about whether accounting, as it is practiced at the upper reaches of the corporate world, is more like astrology or alchemy...I don't think the problem with Freddie Mac is special to the charter of the GSEs." He added that Fannie, however, "is too rich to be jerking around the people who buy manufactured housing." (*BNA Daily Report for Executives*, Marcia Kass, 7/22/03; *American Banker*, Rob Blackwell, 7/22/03)

Despite Freddie's billion dollar accounting scandal, Fannie & Freddie likely to keep their GSE government benefits

- Despite a billion-dollar accounting scandal at Freddie, Fannie and Freddie are likely to maintain their government benefits as lawmakers fear a "heavy-handed" response to the accounting issue would upset the housing market, reported John McKinnon with the *Wall Street Journal*. Congressman Baker, under pressure from Fannie and Freddie allies and top Bush administration people, agreed to introduce a limited GSE reform bill that would strengthen government oversight of Fannie and Freddie, but do little else. Senator Shelby says he is unsure whether legislation is even needed. "Still, unless Freddie Mac's accounting scandal mushrooms enough to alter the political landscape, the companies' success at beating back the opposition just when they seemed most vulnerable would provide fresh evidence of their renowned lobbying ability and the impact of their outsize political opposition."
- McKinnon believes it unlikely Congress will go much further than Congressman Baker's bill. "Heading toward an election year, President Bush and the Republicans...are desperate to keep the housing market humming. Legislation that cuts the companies' government ties could undermine the market, at least temporarily, by making it more expensive for them to borrow – costs that inevitably would be passed on to consumers via higher interest rates." Fannie and Freddie have been lobbying that point hard to Members of Congress. (*Wall Street Journal*, John McKinnon, 7/7/03)

Administration continues to investigate

Chairman Greenspan comments about regulation of the GSEs and their subsidies

GSE regulator should consider the FHLBanks as well

Cong. Baker commends Chairman Greenspan's comments

- Speaking before a Senate Banking Committee hearing on the Federal Reserve's Semiannual Report to Congress, Senate Banking Committee Chairman Richard Shelby (R-AL) questioned Chairman Greenspan about the GSEs. The following was the exchange between

the two officials:

- Senator Shelby: "...tomorrow this Committee will hold a hearing focused on the oversight of government-sponsored enterprises, with an eye toward the accounting issues that have recently surfaced at Freddie Mac. Some people have criticized OFHEO, the regulator, noting that it lacks many of the powers that the bank regulatory agencies possess. Without getting...into who the GSE regulator should be or where the regulator should be situated, what additional authorities, if any, in your judgment, should the GSE regulator have?"
- Chairman Greenspan: "It's difficult to say, because I think the broader issue, as I have indicated in public testimony previously, is the question of the subsidy which the financial markets grant to the GSEs on the presumption that they will be bailed out, in the event of difficulty, by the federal government. Their debentures, as they point out quite correctly, are not guaranteed by the full faith and credit of the United States, and there is no statute under which there is effectively a government guarantee or subsidy issue - "
- Senator Shelby: "It's a strong perception, isn't it?"
- Chairman Greenspan: "There is a strong perception. And I do think that in considering the issue of where the focal point of supervision and regulation is, is it be in the context of understanding how that particular subsidy impacts on the financial structure of those institutions and the various markets that they were involved in. As I've said previously, these are very well run companies – leaving aside the most recent problems with regard to accounting – and it's not an issue of them having, for example, techniques in derivative employment that are not the very finest in risk management. They do very well in that regard. The problem has got to do with a much broader question. And I think what you need is a regulatory supervisor which has the capability of viewing the GSEs in total, not only Fannie and Freddie, but I would include the Federal Home Loan Banks in this as well, in a manner which – to construct a regulator which has the reach to fully grasp the various very major questions which are involved in these now very important institutions in our financial system."
- Senator Shelby: "They would need the reach and the depth, though, wouldn't they, to get into real regulation."
- Chairman Greenspan: "It's going to be an interesting transition, I believe." (*Senate Banking Committee hearing on Fed's Monetary Report, Federal News Service transcript, 7/16/03*)

Cong. Baker commends Chairman Greenspan's comments

- Congress Baker commended Chairman Greenspan's comments, stating, "When Chairman Greenspan tells Congress the current regulator lacks the capabilities to do the job fully and describes what it would mean to construct a new regulator that does, it certainly gives us a lot to think about, and I commend him for sending the message." (*Congressman Baker press release, 7/16/03*)

Treasury and Fannie working on a narrow deal?

- Citing unnamed Washington sources, Claudia Hirsch with *Market News International* reported, “Rumblings are growing louder of a potential deal between...Fannie Mae and Treasury, now in the early stages of discussion, that would relocate the company’s regulator to Treasury.” Sources said discussions between the Administration and Fannie may yield consensus as soon as early September. According to two sources, two items are not at issue: establishing financial safety and soundness regulatory authority over Fannie and Freddie within an agency at Treasury, and removing the GSE regulator from the appropriations process. “Movement of OFHEO to Treasury is basically a done deal,” said a GSE-friendly portfolio manager with ties to Washington. Sources are unclear, however, if OFHEO’s basic structure and staff would remain intact within the new agency. While HUD is widely expected to retain regulatory authority over Fannie and Freddie’s affordable housing goals, new program authority – or some part of it – could shift to Treasury, sources said. Fannie and Freddie may oppose that move if it means their growth could be hampered in any way, as HUD has rarely inserted itself in either company’s new program approval. Fannie and Freddie are also opposed to a new regulator having the power to place either company in receivership. (*Market News International*, Claudia Hirsch, 7/8/03, 7/24/03)
- Observers are convinced that Fannie and Freddie would support limited regulatory reform, in part to increase investor confidence in their companies. Hirsch speculated that Fannie and Freddie’s vast lobbying efforts could slow down Congressman Baker’s GSE bill. “By contrast, a collaborative deal, blessed by both the GSEs and the White House, could conceivably avert the regular legislative process and might find itself attached to an unrelated must-pass bill by year end before economy-sensitive reelection campaigns heat up.” A portfolio manager with close Washington ties added, “If Fannie goes along with this and goes through this dramatic move, it wants assurances...that no one can go after them for anything else for the foreseeable future.” (*Market News International*, Claudia Hirsch, 7/8/03)
- According to Arne Christenson, Fannie’s Senior Vice President of Regulatory Policy, talks with the Bush Administration and Congress are “at a stage of trying to get a good sense of what the facts are.” He said policymakers are “unanimous” in their support of Fannie and Freddie’s mission and that no one has mentioned changing their GSE status or charter. He suggested that Treasury’s policy stance is not yet formed and declined to speculate on the timing of any possible deal. (*Market News International*, Claudia Hirsch, 7/15/03)
- According to *Dow Jones Newswire*, Fannie’s lobbyists have approached Treasury with their own regulatory proposal, according to officials and aides familiar with the matter. Fannie’s executives apparently sought another “voluntary” solution that doesn’t require legislation, but were reportedly told that a voluntary initiative wouldn’t work and legislation would be necessary. (*Dow Jones Newswire*, Dawn Kopecki, 7/11/03)

Treasury Secretary John Snow says Fannie & Freddie need disclosure and effective regulation

Snow stops short of recommending Fannie & Freddie register their MBS

Snow discusses GSEs with new Treasury Undersecretary for Finance

- Testifying at a July 9 Financial Services Committee hearing on FCRA, Secretary Snow was asked by Congressman Christopher Shays (R-CT) to clarify Treasury's position on whether Fannie and Freddie should register with the SEC. The following is the exchange between the two officials:
 - Congressman Shays: "...I...want to just voice a concern about a lack of clarity on the Department of Treasury as it relates to GSEs. And I want to understand what your position is at it relates to why we would allow Freddie Mac and Fannie Mae to not have the same kind of disclosures as any other Fortune 500 company. And I'd like to know when this lack of clarity will be clearer."
 - Secretary Snow: "Congressman, that's an issue we're reviewing right now, and in the context of the recent disclosures that have made the news at Freddie Mac. We've always articulated the need for disclosure, and have been in the forefront of pushing for the disclosure under the '34 act. And I'm pleased that Fannie Mae has now done that and is submitting the '34 act information. And once you go into '34 you don't come back out."
 - Congressman Shays: "But what confuses me is you have Alan Greenspan making it very clear he sees no reason why they also shouldn't be under the '33 act. And I'm just wondering why there would be any argument that they shouldn't be under."
 - Secretary Snow: "Well, there doesn't seem to be any current difficulties with their issuances. But clearly there needs to be transparency, disclosure and good transparency, and effective regulation." (*FDCH Political Transcripts, House Financial Services Committee hearing, 7/9/03*)
- Testifying at the same hearing, Congressman Ed Royce (R-CA) asked Secretary Snow to comment on GSE regulatory reform in general. The following was the exchange between the two officials:
 - Congressman Royce: "...I would like to know, in your view, what are the attributes of an effective world-class regulator in respect to GSE oversight?"
 - Secretary Snow: "...I think the attributes would be the ability to understand the risks in the enterprise, the ability to understand the business, a command of the facts of a business, a command of the facts with respect to the risks that the capital structure of a business poses, the ability to get at the information you would need to have to know that. So transparency, disclosure, and as with all regulators, the ability to hold the attention of the regulatee, to bring sanctions for conduct that poses risk to the system,

to the financial system. So ability to lay in credit standards, risk standards, capital standards, and then sanctions to see that the standards are observed.” (*FDCH Political Transcripts, House Financial Services Committee hearing, 7/9/03*)

Snow discusses GSEs with new Treasury Undersecretary for Finance

- Secretary Snow said he and the new nominee for Treasury Undersecretary for Finance Kenneth Leet discussed among other issues, Fannie and Freddie. “I wanted to get him into our thinking on those issues and get his reaction,” Snow said, without disclosing what Lee had said. Leet, nominated by the President, must still be confirmed by the Senate. (*Reuters, 7/16/03*)

SEC widens its investigation into Freddie’s accounting issue

- According to *Dow Jones Newswire’s* Dawn Kopecki, the SEC has broadened its investigation of Freddie to include reserve accounts, people familiar with the matter said. Regulators are examining whether Freddie used its reserve accounts to steer profits in an effort to smooth earnings. Currently, the SEC's investigation has focused on Freddie's accounting for hedge instruments, including derivatives. Specifically, regulators have been looking into when Freddie has booked income for certain derivatives transactions.
- In July 2002, Freddie said it was in discussions with the SEC about its reserve accounting. Shortly thereafter, the company reduced its reserves for loan losses by \$246 million. And in last year's fourth quarter, it donated \$225 million to charities, including \$200 million to its own foundation. Now some lawmakers are re-examining the timing of those gifts, which reduced fourth-quarter earnings by 21 cents a share. In previous years, Freddie's contributions had been considerably less, averaging \$11 million annually. Freddie had disclosed in its fourth-quarter earnings report that the \$225 million in donations offset the effects of a \$246 million "adjustment" to reduce its loan-loss reserves during the previous quarter. That move had the effect of increasing earnings for the year by 23 cents a share. The company said it was necessary to reduce the reserve account because it was overfunded by about \$250 million and did not meet GAAP requirements. Securities attorneys said the company could have created more problems for itself if the donations were meant to offset the reduction in the reserve account -- and if the company didn't properly disclose the link.
- "What I, as a regulator, would want to know is if there were any reasons as to why it was done at this time that were not disclosed," said Frank Razzano, a former federal prosecutor and SEC trial attorney. Mr. Razzano said Freddie has an obligation to report why it made those changes in the same quarter, not just the fact that changes were made.
- The executives "knew what they were doing [with the reserves] was not in conformance with GAAP, but they didn't believe it was material," Freddie’s spokesman David Palombi said last week. "From a size standpoint, it wasn't material." (*Dow Jones Newswire, Dawn Kopecki, 7/7/03, 7/8/03*)

Freddie says it will not be able to register with the SEC until at least mid-2004

Freddie's CEO says the company is committed to fulfilling its July 2002 pledge to register with the SEC

Freddie expects adjustments to its earnings prior to 1998 but does not plan to disclose those adjustments

- Freddie said it will not be able to comply with a promise it made last July to voluntarily register its common stock with the SEC until mid-2004 at the earliest, reported *Dow Jones Newswire*. Further, Freddie's earnings restatement from 2000 through 2002 will impact financial results in prior years. As a result, Freddie's 2002 annual report will include some revisions to Freddie's financial data through 1998, said Freddie's spokeswoman Sharon McHale. Freddie is also recalculating data going back even farther in the 1990s as Freddie corrects its accounting for transactions that were executed earlier in the decade. However, McHale noted that Freddie is not required and is not planning to disclose adjustments prior to 1998. (*Dow Jones Newswire*, Dawn Kopecki, 7/11/03)
- Freddie's Chief Executive and President Gregory Parseghian said Freddie remains "enthusiastically and irrevocably committed" to fulfilling its July 2002 pledge to register with the SEC. In a recent letter to Treasury Secretary John Snow, Parseghian said he was writing to "reaffirm and underscore Freddie Mac's commitment" to completing the voluntary SEC registration process. "While the restatement and re-audit of prior year financial statements have temporarily delayed completion of this (voluntary registration) process, please be assured that hundreds of professionals are working day and night to get our financial statements right, with the ultimate objective of SEC periodic reporting," Parseghian told Snow. (*Dow Jones Newswire*, John Connor, 7/22/03)

OFHEO begins to investigate Fannie

OFHEO asks for an additional \$4.5 million in funding for accounting examinations of Fannie & Freddie

- In a letter to lawmakers, OFHEO said it plans to conduct a special accounting review of Fannie. "While I do not have specific concerns about Fannie Mae's accounting practices, such a review would be most prudent under the circumstances," OFHEO Director Armando Falcon wrote lawmakers. Falcon told senior members of the Senate Banking and Appropriations Committees that he will evaluate whether Fannie is conforming with generally accepted accounting principles (GAAP). (*Reuters*, Mark Felsenthal, 7/14/03; *Washington Post*, David S. Hilzenrath and Kathleen Day, 7/15/03)
- Falcon said in a July 14 interview that, in light of the problems at Freddie, members of Congress have asked him whether anything is wrong with Fannie's accounting. Falcon said he saw no reason to believe Fannie has broken any accounting rules, but is unable to answer

any questions without a special review. Falcon noted that staff members of the House and Senate appropriations committees have expressed support for the examination. OFHEO has not determined the scope of its review of Fannie's accounting. It may focus on policies rather than the way Fannie accounted for individual transactions, he said. (*Washington Post*, David S. Hilzenrath and Kathleen Day, 7/15/03)

- OFHEO also asked Congress for an additional \$4.5 million of supplemental funding to its \$30 million budget this year to undertake its accounting examinations of Fannie and Freddie. Since OFHEO is funded through assessments on Fannie and Freddie, the request will not have a budgetary impact. "The requested resources are necessary to obtain contract services for investigative support and forensic accounting experts," Falcon wrote to lawmakers. "OFHEO's goal of concluding the investigation of Freddie Mac expeditiously is dependent on receiving these funds as soon as possible." (*OFHEO Director Armando Falcon letter to lawmakers*, 7/14/03 (as reported by *Market News International*, 7/14/03))

Fannie & Freddie's response

- Fannie officials said the company welcomes OFHEO's investigation and supports whatever funding level Congress decides is appropriate for supervision. "We are fully GAAP compliant," said Fannie's spokesman Chuck Greener. (*Reuters*, Mark Felsenthal, 7/14/03)
- Freddie's spokeswoman Sharon McHale said it is appropriate for Congress to determine OFHEO's budget, but refrained from further comment. (*Dow Jones Newswire*, Dawn Kopecki, 7/14/03)

OFHEO to examine role of Freddie's new CEO in accounting scandal

- The *Wall Street Journal* reported that OFHEO is examining whether Freddie's new chief executive – Gregory Parseghian – was involved in the company's recent accounting problems. OFHEO is "reviewing everyone's role in the issues under investigation," including current employees, a person familiar with the investigation said. Freddie's spokesman David Palombi said an internal investigator assured Freddie's board that there was no reason to suspect Parseghian had any involvement in the company's accounting problems. Parseghian "was not responsible for the accounting policy determinations that are the subject of the restatement, financial reporting and disclosures, or the company's earnings objectives," Palombi said. (*Wall Street Journal*, Patrick Barta, John McKinnon and Gregory Zuckerman, 7/11/03)
- The board's internal investigation, meanwhile, is expected to show that some company officials designed and conducted large numbers of sophisticated financial transactions in order to shift hundreds of millions of dollars in earnings into future years, according to unnamed people familiar with the internal inquiry. The results of the board's internal investigation appear to increase the chances for regulatory action against the company as well as its former executives, by highlighting the lengths to which the company went to smooth its earnings from 2000 through 2002, according to legal specialists. Beginning in the late 1990s, the SEC has waged a concerted enforcement campaign against deliberate earnings management. (*Wall Street Journal*, Patrick Barta, John McKinnon and Gregory Zuckerman,

7/11/03)

- According to the *Wall Street Journal*, in one set of trades, Freddie engaged in a series of swap-type transactions in 2001 that had minimal economic purpose but had "a huge impact on earnings," according to one person familiar with the situation. Unlike many of Freddie's other earnings-management transactions, this one was done without the prior knowledge of its accountant at that time, Arthur Andersen LLP, according to a person familiar with the investigation. When Andersen auditors found out about the transaction, they told the company never to engage in it again, according to the person. Auditors described it as "barely GAAP." (*Wall Street Journal*, Patrick Barta, John McKinnon and Gregory Zuckerman, 7/11/03)
- Investigators have found that the first transaction that involved questionable accounting involved a synthetic Treasury forward contract. As the year 2000 progressed, the company found it needed to do more of that transaction to get earnings off its books. Approval for that transaction went to the office of the vice chairman, then David Glenn. Andersen's Chicago office also approved that transaction, according to the internal investigation. (*Wall Street Journal*, Patrick Barta, John McKinnon and Gregory Zuckerman, 7/11/03)

OFHEO says Fannie & Freddie are adequately capitalized for first quarter 2003

After Freddie restates its earnings, OFHEO will determine whether to recalculate the risk-based and minimum capital requirement for prior quarters

OFHEO's "core-capital" standard may be "off," reports *Wall Street Journal*

- OFHEO determined that as of March 31, 2003, Fannie's risk-based capital requirement was \$16.555 billion. Fannie's total capital of \$30.309 billion on that date exceeded the risk-based capital requirement by \$13.753 billion. Fannie's minimum capital requirement was \$28.226 billion. Fannie's core capital of \$29.517 billion exceeded the minimum capital requirement by \$1.291 billion.
- As of March 31, 2003, Freddie's risk-based capital requirement was \$5.198 billion. Freddie's total capital of \$26.512 billion on that date exceeded the requirement by \$21.314 billion. Freddie's minimum capital requirement was \$21.773 billion. Freddie's core capital of \$26.107 billion exceeded the minimum capital requirement by \$4.334 billion. (*OFHEO press release*, 6/30/03)
- OFHEO said when Freddie's financial restatement is concluded, the GSE will resubmit appropriate financial data and the OFHEO director will determine whether to recalculate risk-based and minimum capital requirements for prior quarters, and whether to reclassify Freddie. (*OFHEO press release*, 6/30/03)

OFHEO's "core-capital" standard may be "off," reports *Wall Street Journal*

- OFHEO's "core-capital" standard, which is the primary measure OFHEO uses to test whether Fannie and Freddie have adequate capital on hand every quarter, excludes billions of dollars

of certain accumulated losses that have built up over the years. “Indeed, it would be possible for a financial institution with liabilities exceeding assets to pass OFHEO’s core-capital, by OFHEO’s tally,” reports Jonathan Weil with the *Wall Street Journal’s* *Heard on the Street*. “To the extent you want to know their current economic condition, the core-capital number overstates their true capital,” says Tom Linsmeier, a Michigan State University accounting professor in East Lansing. Fannie and Freddie say they are well capitalized and that OFHEO’s core-capital standard is sound, as does OFHEO. (*Wall Street Journal*, Jonathan Weil, 7/22/03)

Department of Justice asks OFHEO to join the inter-agency Corporate Fraud Task Force

- US Deputy Attorney General Larry Thompson said July 22 that the Department of Justice has asked OFHEO to join the Corporate Fraud Task Force. Thompson said OFHEO “will work with our prosecutors and investigators and the other regulatory agencies.” (*Dow Jones Newswire*, Alex Keto, 7/22/03) President Bush appointed the inter-agency task force last July to direct corporate fraud investigations following accounting scandals at Enron and WorldCom. The task force is comprised of officials from the Justice Department, the SEC, the Federal Energy Regulatory Commission, the Commodity Futures Trading Commission, and the Labor Department. (*Bloomberg*, Amy Strahan Butler and Judy Mathewson, 7/22/03)

Other Fannie & Freddie news

Fannie may have lost billions in last two years, reports *New York Times*

- Some institutional investors and analysts say that Fannie had billions of dollars in losses the last two years that are hidden by complex accounting, the *New York Times* reported. While the losses are deferred, they will hurt Fannie in the future, cutting into its capital base and making it more vulnerable to a future drop in housing prices or sharp changes in interest rates. James Bianco, president of Bianco Research, said that Fannie didn’t seem to have enough equity capital to protect itself from a market slump and that buyers of its debt did not seem to care because they believed that the government would protect them. “The government should be very concerned that they have this out-of-control liability that’s just leveraging itself up to sky-high,” he told the *Times*. “It’s a bad situation.” Fannie said recently that it would change its business strategy to take less risk, although some outside analysts say that it is still taking too much risk and that it needs to disclose more information about the risks in its giant mortgage portfolio. Fannie strongly disputes these contentions and says it provides investors with all the data they need. (*New York Times*, Alex Berenson, 7/23/03)

Financial Services Roundtable supports moving OFHEO to Treasury

GSE regulator should have authority over safety and soundness and new programs

- In a letter to Treasury Secretary John Snow, Financial Services Roundtable President and Chief Executive Steve Bartlett said, “We believe that the Treasury Department is the most appropriate cabinet agency in which to place OFHEO.” “The operations of the enterprises have reached a level where their role and financial stability is of importance not only to financial markets but also to our economy as a whole.” The Financial Services Roundtable said the GSE regulator should have an “abundance of staff” to ensure the GSEs’ safety and soundness as well as approving new products and services. [OFHEO currently regulates Fannie and Freddie’s safety and soundness, while HUD regulates the GSEs’ new programs.] Fannie and Freddie should also be required to disclose financial details and register their securities with the SEC, as other publicly traded companies do. Funding for the new GSE regulator should be removed from the Congressional appropriations process to protect against “political pressures” on its budget. (*Bloomberg*, Brendan Murray, 7/22/03)

More class action shareholder lawsuits filed against Freddie

- In addition, to federal prosecutors launching a criminal investigation of Freddie, the firm is also the target of several class action shareholder lawsuits. The following law firms have filed class action shareholder lawsuits against Freddie, on behalf of purchasers of Freddie’s securities (* new lawsuits since last *GSE Report*):
 - Abbey Gardy, LLP
 - Alfred G. Yates, Jr., PC
 - Bernard M. Gross, PC
 - Bernstein Liebhard & Lifshitz, LLP *
 - Brian Felgoise, PC
 - Cauley Geller Bowman & Rudman, LLP
 - Charles J. Piven, PA
 - Chitwood & Harley, LLP
 - Cohen, Milstein, Hausfeld & Toll, PLLC
 - Emerson Poynter LLP
 - Faruqi & Faruqi, LLP
 - Glancy & Binkow LLP
 - Law Offices of Marc S. Henzel
 - Milberg Weiss Bershad Hynes & Lerach LLP
 - Much Shelist Freed Denenberg Ament & Rubenstein, PC
 - Schiffrin & Barroway, LLP
 - Shepherd, Finkelman, Miller & Shah, LLC
 - Spector, Roseman & Kodroff, PC
 - Weinstein Kitchenoff Scarlato Karon & Goldman Ltd.
 - Weiss & Yourman
 - Wechsler Harwood LLP *

- Wolf Haldenstein Adler Freeman and Herz LLP
(*PRIMEZONE*, 6/9/03, 6/11/03, 6/17/03, 6/19/03, 6/20/03, 7/10/03; *Market Wire*, 7/10/03; *PR Newswire*, 6/11/03, 6/12/03, 6/17/03, 6/19/03; *Business Wire*, 6/11/03, 6/20/03, 7/9/03)

At least nine employees have been removed as a result of Freddie's accounting scandal

- At least nine employees at Freddie have been removed by the company as a result of Freddie's accounting scandal, a source at the company confirmed to *National Mortgage News*. Those fired include: Chairman and Chief Executive Leland Brendsel, president David Glenn, chief financial officer Vaughn Clarke and Gregory Reynolds, a former comptroller who last year moved to the business side of the company. The source declined to provide the publication with the names of the other five employees. (*National Mortgage News' Daily web site*, 7/25/03)

Freddie retains more lawyers, lobbyists and public relations firms

Freddie retains former aide to Congressman Baker, Pat Cave

- Freddie, its audit committee and several former Freddie executives have retained some of Washington's most experienced securities and trial lawyers to work on Freddie's recent accounting issues. Freddie recently hired the public relations firm Prism Public Affairs, headed by three former Powell Tate executives. Freddie's audit committee hired James Doty, a former SEC general counsel, to conduct an internal investigation of Freddie's accounting issues. Doty was reportedly hired last December to investigate allegations from an anonymous whistleblower that claimed improprieties related to Freddie's Y2K rollover. While Doty did not find substantial merit to the charges, company officials said, he is heading up a team of about a half dozen lawyers from the DC office of Baker Botts to investigate Freddie's accounting issues. (*Dow Jones Newswire*, Dawn Kopecki, 7/10/03)
- Freddie has hired several lawyers at the DC office of Cleary, Gottlieb, Steen, & Hamilton, including David Becker, a former SEC general counsel, on its recent accounting issues. Freddie's lawyers at Cleary, Gottlieb are coordinating the company's response to the regulators and to shareholder class action lawsuits while defending the company's severance arrangements with its recently ousted top management. In addition, Freddie's VP, General Counsel, and Secretary Maud Mater, is leading a team of nearly 100 in-house lawyers, dozens of which are devoted almost full-time to the accounting restatement. (*Legal Times*, Jonathan Groner, 6/16/03; *Dow Jones Newswire*, Dawn Kopecki, 7/10/03) Freddie also brought in lawyers from Covington & Burling. According to an unnamed source, the company may also turn to Williams & Connolly, one of Washington, DC's top litigation firms. Financial services partners Stuart Stock and John Dugan are coordinating the company's response to OFHEO. (*Legal Times*, Jonathan Groner, 6/16/03)
- Ousted Freddie executive David Glenn hired Thomas Vartanian of the DC office of Fried, Frank, Harris, Shriver & Jacobson to represent him; departing CEO Leland Brendsel has hired Proskauer Rose to negotiate his severance deal. (*Legal Times*, Jonathan Groner,

6/16/03) Just last month, Brendsel hired high-profile, white-collar criminal defense attorney John Dowd at Akin, Gump, Strauss, Hauer & Feld. However, Dowd recently left the case, citing an “internal matter” at the firm. *Dow Jones Newswire* reported that Dowd left the case because his firm also represents FM Policy Focus – one of Fannie and Freddie’s most ardent critics. Freddie would not say whether any of its current officers, including new chief executive Gregory Parseghian (who is now under investigation by OFHEO) has hired their own counsels outside the company. (*Dow Jones Newswire*, Dawn Kopecki, 7/10/03)

Freddie retains more lobbyists

- Freddie hired Pat Cave, a former official at the Treasury Department and legislative aide to Congressman Baker. Cave currently works for conservative lobbying shop the Federalist Group. In March, Freddie hired Terry Haines, the House Financial Services Committee’s former chief counsel under Chairman Michael Oxley (R-OH) and former Bush Treasury Department Deputy Assistant Secretary Amy Smith who now works at Bartlett & Bendall. Freddie also retained a former top aide to Senate Banking Committee Chairman Richard Shelby (R-AL), Lendell Porterfield, at Van Scoyoc Associates Inc. (*Dow Jones Newswire*, Dawn Kopecki, 7/21/03)
- Freddie also recently retained the Alpine Group, where lobbyist Rod Shaw is handling the account; Ryan, Phillips, Utrecht & MacKinnon, where Jeff MacKinnon is handling the account; and Winstead Sechrest & Minick, where Fred McClure is working on the issue. Freddie also retained Paul Equale, a former insurance lobbyist who is now a solo practitioner and Laurie Sullivan of Sullivan & Baldick. (*The National Journal*, Peter Stone, 7/19/03) Other lobbyists retained by Freddie include Susan Hirschmann, a former chief of staff to then-House Majority Whip Tom DeLay (R-TX) now with Willians and Jensen and Mitch Bainwol, who served as staff director for Senate Majority Leader Bill Frist (R-TN). Freddie also brought on outside lobbyists David DiStefano, Jeffrey Walter, Paul Equale and Laurie Sullivan. (*Roll Call*, Brody Mullins and Michael Grass, 7/16/03)

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

- The value of debt issued by Fannie and Freddie recently fell to its lowest level in two months July 21 amid market rumors that European central banks had been encouraged to reduce their holdings. Unconfirmed reports that the European Central Bank (ECB) had recommended that central banks reduce their holdings of agency debt sparked selling. Central banks had been doubling their holdings of agency securities over the past three years. In mid-July \$184 billion of agency securities were held in custody accounts for central banks at the US Federal Reserve, up from \$88 billion three years ago. (*Financial Times*, Adrienne Roberts and Jenny Wiggins, 7/22/03)
- *Market News International* reported that it was “reliably informed” that the ECB told eurozone national central banks to reduce the allocation of US agency debt in their portfolios due in particular to concerns over Freddie’s accounting. The first sell instructions to national central banks took place around the middle of last week, followed by several more sell orders in following days. For now, however, the sell orders have been concluded, and the ECB’s market policy towards the agencies is likely to be put on hold at least until the autumn, as the ECB awaits US developments over the regulatory fate of Fannie and Freddie. The ECB has

not issued a “life sentence” on the agencies and may begin buying again once ongoing regulatory and transparency issues have been resolved. (*Market News International*, 7/25/03)

GSE short-term and long-term debt increases during first quarter

GSE short-term and long-term debt increases

- Federal agencies increased long-term new issue volume to a record \$1.04 trillion in 2002, according to a report by the BMA, up 13% percent from the \$921.5 billion in 2001. The spike in issuance activity in 2002 was attributable to increased activity in the home mortgage market. Long-term issuance by all federal agencies increased, with the exception of Fannie and the Tennessee Valley Authority. (*Research Quarterly*, *Bond Market Association*, 2/2003)

Long-term federal agency debt issuance:

\$ billions	2000	2001	2002	YTD-to-YTD %Change	YTD-to-YTD \$Change
FHLB ¹	190.8	383.0	435.4	13.7%	52.4
Freddie Mac	95.2	235.2	295.5	25.6%	60.3
Fannie Mae	110.2	249.4	238.5	-4.4%	(10.9)
Sallie Mae	16.5	19.5	20.5	5.1%	1.0
Farm Credit System	13.1	31.0	50.1	61.6%	19.1
Tennessee Valley Authority	2.3	3.4	1.5	-55.9%	(1.9)
Totals	428.1	921.5	1,041.5	13.0%	120.0

¹ Percentage and amount change between 12/31/02 and 9/30/02
Source: *Research Quarterly*, *Bond Market Association*, February 2003

- Short-term federal agency debt outstanding increased to \$668.5 billion as of the end of December, up 5.8% from the \$631.9 billion outstanding at the end of September. However, the volume of debt outstanding decreased 6.9% when compared to the \$718.3 billion outstanding at the end of December 2001. Fannie accounted for most of the increase in short-term outstanding, totaling \$303.8 billion at the end of December, up 18.1% from the \$257.2 billion outstanding at the end of September. (*Research Quarterly*, *Bond Market Association*, February 2003)

Short-term federal agency debt outstanding:

\$ billions	12/31/01	9/30/02	12/31/02	% Change *	\$Change *
FHLB	139.8	140.1	147.0	4.9%	6.9
Freddie Mac	222.8	172.8	164.1	-5.0%	(8.7)
Fannie Mae	288.5	257.2	303.8	18.1%	46.6
Sallie Mae	31.1	28.7	25.6	-10.8%	(3.1)
Farm Credit System	33.6	29.6	24.8	-16.2%	(4.8)

Tennessee Valley Authority	2.5	3.5	3.2	-8.6%	(0.3)
Totals	718.3	631.9	668.5	5.8%	36.6
* Percentage and amount change between 12/31/02 and 9/30/02					
Source: <i>Research Quarterly, Bond Market Association</i> , February 2003					

- Issuance of agency MBS increased to \$1.46 trillion in 2002, up 33.7% from the \$1.09 trillion issued in 2001. Issuance was particularly strong in the fourth quarter of 2002, totaling \$509.6 billion, up 62.6% from the \$313.5 billion issued in the third quarter of 2002, and up 54% from the \$331.0 issued in the fourth quarter of 2001. Fannie’s new issuance totaled \$739.6 billion in 2002, up 40% from the \$528.4 billion issued in 2001. Freddie’s new issuance increased 40.4% in 2002, up from the \$389.6 billion issued in 2001. Issuance of Ginnie Mae MBS remained relatively flat, totaling \$174.0 billion in 2002, compared to the \$174.6 billion issued in 2001. (*Research Quarterly, Bond Market Association*, February 2003)
- Issuance of agency collateralized mortgage obligations (CMO) increased to \$540.9 billion in 2002, up 49.3% from the \$362.3 billion issued in 2001. On a quarterly basis, CMO issuance totaled \$171.6 billion in the fourth quarter, up 33.7% from the \$128.3 billion issued in the third quarter, and relatively flat from the \$169.3 billion issued in the fourth quarter of 2001. Freddie’s CMO new issue activity totaled \$331.7 billion, up 72.3% from the \$192.5 billion issued last year. Fannie’s issuance increased to \$143.9 billion in 2002, up 16.5% from the \$123.5 billion issued in 2001. Ginnie Mae’s issuance increased to \$65.3 billion in 2002, up from the \$46.3 billion issued in 2001. However, Ginnie Mae’s CMO issuance levels decreased to \$14.7 billion in the fourth quarter of 2002, down 12% from the third quarter of 2002, and down 39.3% from the fourth quarter of 2001. (*Research Quarterly, Bond Market Association*, February 2003)

Fannie’s profits fall 25 percent, as derivatives used to hedge interest rate fell

Fannie’s earnings miss analysts’ estimates by a penny

Fannie plans to reduce the volatility of its duration gap

- Fannie reported a big drop in second-quarter earnings due to changes in the value of derivatives contracts, even though its business expanded significantly. Fannie reported that its profits fell 25 percent in the second quarter. Under generally accepted accounting practices (GAAP), Fannie reported net income of \$1.10 billion, or \$1.09 a share, compared with \$1.46 billion, or \$1.44 a share, in the second quarter last year. Declining interest rates triggered a paper loss of \$1.9 billion on Fannie’s portfolio of derivatives. “The increase in unrealized losses was due to the declining interest rate environment and an increase in the balance of purchased options used to hedge interest rate risk,” Fannie said in a statement. Under non-GAAP measures, Fannie said its “core business earnings,” which exclude these paper losses, grew substantially. Not including the accounting impact of the paper loss on its derivatives, which Fannie uses to hedge interest rate risk, Fannie reported “core business earnings” of \$1.86 billion in the second quarter, up 18.2 percent over \$1.57 billion a year earlier. “Core business diluted earnings” were \$1.86, up 20 percent ahead of last year’s

second quarter, but a penny shy of Wall Street analysts' estimates. Analysts had expected Fannie to post earnings of \$1.87 a share, according to Thomson Financial. (*Washington Post*, Albert Crenshaw and David Hilzenrath, 7/16/03; *Associated Press*, 7/15/03; *Fannie press release*, 7/15/03)

- Fannie said its “core business earnings” better reflect the economic reality of its performance than GAAP net income measurements because the losses booked on its derivatives are not realized. The “mark to market” accounting rule, since it was established in January 2001, has caused wide swings in the reported net income of Fannie and Freddie. (*Washington Post*, Albert Crenshaw and David Hilzenrath, 7/16/03)
- The non-GAAP “core business earnings” measure “has drawn criticism from some investors who believe it obscures volatility inherent in the company’s business, creating an impression that Fannie Mae is taking on less risk than it actually is.” Freddie recently announced that it plans later this year to begin releasing new fair value balance sheet investor disclosures on a quarterly basis rather than an annual basis. While Fannie provides a fair value balance sheet only once a year. (*Wall Street Journal*, Patrick Barta, 7/16/03)
- Fannie also reported net interest income of \$3.5 billion, up 38.2 percent for the second quarter and a 26.5 percent increase in core net interest income of \$2.8 billion. The company reported a 49.3 percent increase in guarantee fee income for the second quarter, while credit-related expenses decreased from \$24.2 million to \$22.6 million and losses of \$739.8 million from the call and repurchase of debt compared with \$224.7 million last year. (*Fannie press release*, 7/15/03)
- Fannie’s business volume – mortgages purchased for portfolio plus mortgage-backed securities issues acquired by other investors – totaled a record \$410.5 billion in the second quarter of 2003, compared with \$159.8 billion in the second quarter of 2002 and \$335.9 billion in the first quarter of 2003. (*Wall Street Journal*, 7/15/03) The size of the company’s portfolio – which now totals \$812.5 billion – declined at a 1.7 percent annual rate. The company’s stockholder equity also declined slightly. (*Wall Street Journal*, Patrick Barta, 7/16/03)
- Fannie said it plans to do more to manage its duration gap – a key measure of its interest-rate risk exposure. The duration gap measures the differences between the portfolio’s assets and liabilities. Previously, Fannie “has taken a more laissez-faire approach to its duration gap, which has zigzagged frequently, than Freddie, whose mantra has been to keep its gap at or near zero.” However, this does not necessarily mean Fannie will use derivatives more often than it does now. Rather, “we are going to have more options in our debt than we traditionally had, and we are going to rebalance” the investment portfolio more with callable debt,” said Fannie’s spokesman Chuck Greener. Fannie’s duration gap was criticized last August when the company reported that falling interest rates had caused Fannie’s duration gap to widen to minus 14 months. (*American Banker*, Erick Bergquist, 7/16/03)
- Now Fannie said its goal is to keep the gap within the company’s goal of plus or minus six months almost all the time. Prior to this year, Fannie had allowed the portfolio duration gap to exceed the plus-or-minus six month band about one-third of the time. A gap of minus six

months means the company's assets would be paid off six months sooner than its liabilities. The company said the change could reduce the volatility of its core earnings, but could also lower the net profit margins on the mortgages it owns over the longer term. The duration gap narrowed to an average of minus-one month in June from minus-five months in May. For the first six months of the year, the company's duration gap averaged a negative three months. (*Wall Street Journal*, Patrick Barta, 7/16/03; *Fannie press release*, 7/15/03)

- Fannie sold 66 percent of all mortgage-backed securities issued between itself and Freddie this year through May, up from 58 percent in all of 2002, according to *Bloomberg* data. (*Bloomberg News*, Al Yoon and Terence Flanagan, 7/15/03)
- Fannie's board also voted to raise the company's quarterly dividend to 45 cents a share from 39 cents a share, its second increase this year. Fannie has been increasing its dividend at the beginning of each year and the recent increase will be its first mid-year increase since 1993. Fannie's Chief Financial Officer Timothy Howard said the company wanted to increase its payout as a reduction in the US tax rate on stock dividends has increased demand for dividend-paying stocks. (*Bloomberg News*, Terence Flanagan, 7/14/03)

Fannie issues paper attacking CBO study, which found that Fannie & Freddie received \$10.6 billion of annual subsidies from the federal government

- Fannie published a paper by David Gross, Vice President of Lexecon, which took issue with CBO's 2001 study. The 2001 CBO study found that Fannie and Freddie received \$10.6 billion in subsidies from the federal government the previous year, passing about \$6.7 billion to homebuyers and retaining the rest for employees and shareholders.
- Gross criticized CBO's argument that the spread between debt issued by Fannie and Freddie and debt issued by similarly rated banks and financial companies represents an implicit subsidy for the firms and that the GSE borrowing rate is lower because of the market perception that the GSEs have an implicit federal guarantee. "While it is possible that an implicit government guarantee would lower the risk associated with a bond, the spread between any two bonds depends on many additional factors," the paper said. "For the spread to accurately capture the value of the government guarantee, everything about the two bonds (and the companies that issue them) must be the same except for the guarantee." The paper said CBO failed to account for such key factors as the levels of liquidity of GSE debt versus the debt of companies in the comparison group and differences in risk. (*Dow Jones Newswire*, John Connor, 7/8/03)
- Assuming the CBO is correct, CBO's methods could be used to measure the expected cost of government guarantees to the banking system. "Applying the CBO methodology we find an annual expected cost (subsidy) of between \$14.8 billion and \$24.7 billion, substantially larger than the alternative estimates of the expected cost of deposit insurance," the paper said. (*Dow Jones Newswire*, John Connor, 7/8/03; *Fannie Mae Paper*, "The Government's Role in Promoting Financial Sector Stability," David B. Gross, Lexecon Inc., Volume II, Issue 3, July 2003)

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

Fannie has 57 partnership offices

- According to Fannie’s Web site, the company has 57 partnership offices open across the country (<http://www.fanniema.com/partnerhsipoffices/index.jhtml>) 4/14/03).

Fannie held press opportunities with the following officials:

- (1) Senator Pete Domenici (R-NM), Senator Jeff Bingaman (D-NM), Congresswoman Heather Wilson (R-NM) and Albuquerque, NM Mayor Martin Chavez (*Fannie press release, 5/28/03*)
- (2) Congressman Jim Nussle (R-IA) and Dubuque, IA Mayor Terry Duggan (*Fannie press release, 5/28/03*)
- (3) Congressman Steve Pearce (R-NM), State Senator Ben Altamirano, and Socorro City Councilor Gary Jaramillo (*Fannie press release, 6/6/03*)
- (4) Congresswoman Marsha Blackburn (R-TN) (*Fannie press release, 5/28/03*)
- (5) Congressman Chip Pickering (*Fannie press release, 5/29/03*)
- (6) Congressman Michael Burgess (R-TX) (*Fannie press release, 6/23/03*)
- (7) Congressman Jim Kolbe (R-AZ) (*Fannie press release, 6/25/03*)
- (8) Congressman Paul Ryan (R-WI) (*Fannie press release, 6/30/03*)
- (9) Congressman Silvestre Reyes (D-TX) (*Fannie press release, 7/2/03*)
- (10) St. Petersburg, FL Mayor Rick Baker (*Fannie press release, 5/29/03*)
- (11) Los Angeles County Supervisor Yvonne Brathwaite Burke (*Fannie press release, 6/2/03*)
- (12) Salt Lake City Mayor Rocky Anderson and Councilwoman Nancy Saxton (*Fannie press release, 6/24/03*)
- (13) DC Mayor Anthony Williams, and Councilmember Jim Graham (*Fannie press release, 6/10/03*)
- (14) Riverside, CA Mayor Ronald Loveridge (*Fannie press release, 6/10/03*)
- (15) Fargo, ND Mayor Bruce Furness (*Fannie press release, 6/12/03*)
- (16) DC Mayor Anthony Williams (*Fannie press release, 6/18/03*)
- (17) Texas State Representative Richard Raymond (*Fannie press release, 6/18/03*)
- (18) Patterson, NJ Mayor Jose “Joey” Torres (*Fannie press release, 6/25/03*)
- (19) Montgomery County, MD County Executive Douglas Duncan (*Fannie press release, 7/2/03*)
- (20) Sandy, UT Mayor Tom Dolan (*Fannie press release, 7/8/03*)
- (21) Jackson, MS Mayor Harvey Johnson (*Fannie press release, 7/11/03*)

FHLBanks

SEC sees benefits to having the FHLBanks register with the SEC

SEC says it can accommodate the concerns of the FHLBanks

ABA, ACB, and ICBA oppose the FHLBanks' registration with the SEC

Former Treasury aide says FHLBanks' opposition to SEC registration is "untenable"

- In a June 24 letter to 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." He added, "we believe our detailed disclosure rules and filing requirements, and our staff review and comment process, provide the best framework for disclosing that information." The letter was sent to the America's Community Bankers, American Bankers Association, and the Independent Community Bankers Association of America in response to a joint letter from the groups to him in which they opposed SEC registration by the FHLBanks, saying it "would be unnecessarily burdensome for our member institutions and their stockholders" and would provide little if any benefit to holders of the FHLBank System's debt. The banking trade groups supported a disclosure system run by the FHLBanks' regulator – the Federal Housing Finance Board – not the SEC. (*Dow Jones Newswire*, John Connor, 7/2/03)
- Beller also noted that the SEC can accommodate both the FHLBanks' concerns and "be in the interests of the investors of the Banks' debt." Beller wrote "although the Banks currently provide financial statement audited in accordance with US Generally Accepted Accounting Principles, we believe that investors would benefit if our experienced staff reviewed those statements in the same manner as it reviews the statements of other issuers of public debt securities." Beller said the SEC would work with the FHLBanks as they develop their first annual filings. "In addition, we are very experienced in dealing with issuers who must continually access the market without unnecessary delay," he wrote. (*Dow Jones Newswire*, John Connor, 7/2/03)
- 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 last July 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 it will not be able to register with the SEC until at least mid-2004.]

Former Treasury aide says FHLBanks' opposition to SEC registration is "untenable"

- Former Assistant Treasury Secretary Sheila Bair said the FHLBanks, by resisting voluntary registration with the SEC, are creating the perception that the FHLBank System is resisting transparency, reported John Connor with *Dow Jones Newswire*. Bair said that this is "an untenable position in this post-Enron environment." Such "a lack of transparency only exacerbates concerns that as the FHLBanks take on new business ventures, the risks will not be apparent to the taxpaying public that could end up footing the bill." Bair is now a professor of financial regulatory policy at the Isenberg School of Management, University of Massachusetts-Amherst. Bair's comments came in a new paper, funded by Fannie, entitled, "*Is the Federal Home Loan Bank System Forsaking Its Roots?*" (*Dow Jones Newswire*, John Connor, 7/9/03)

Federal Reserve Bank of Cleveland commentary says FHLBanks' mortgage purchase programs increase competition in the secondary mortgage market, lowering the cost of homeownership

Commentary cautions that the growth in the programs has capital implications for the FHLBanks

Commentary says mortgage purchase programs help FHLBanks meet their mission

Differing sides clash on whether FHLB's proposed revisions to its mortgage purchase programs are "mission creep"

Mortgage purchase programs include the MPF and MPP programs, which are competitors to Fannie & Freddie in the secondary mortgage market

MPF continues strong growth for second quarter

Federal Reserve Bank of Cleveland says FHLBanks' mortgage purchase programs increase competition in the secondary mortgage market, lowering the cost of homeownership

- In a recent commentary, the Federal Reserve Bank of Cleveland noted that the FHLBanks' mortgage purchase programs increase competition in the secondary mortgage market. The commentary, by Fed staffers David Maloney and James Thomson, stated, "...to the extent that the FHLB mortgage-asset programs displace or reallocate loan sales that would have normally been purchased by Fannie Mae or Freddie Mac, the Mortgage-Partnership Finance Program (MPF), Mortgage Purchase Program (MPP), and the Shared Funding Program increase the competitiveness of the secondary mortgage market – further lowering the cost of housing finance to homeowners." The commentary noted that the views expressed in the piece are those of the authors and not necessarily of the Federal Reserve Bank of Cleveland. (*Federal Reserve Bank of Cleveland Commentary, "The Evolving Role of the Federal Home Loan Banks in Mortgage Markets,"* Daniel K. Maloney and James Thomson, June 2003)

Commentary cautions that the growth in the programs has capital implications for the FHLBanks

- The commentary noted that the FHLBanks' assets have grown considerably since the mortgage purchase programs began. Over the past 12 months, total mortgage assets have more than doubled, rising from \$27.6 billion on December 30, 2001 to \$60.1 billion at the end of 2002. Mortgage assets increased from 3.62 percent to 7.93 percent of total assets, accounting for 49 percent of total FHLB asset growth over the same period. However, the

commentary noted, “Continued strong mortgage growth has implications for the capital adequacy of the FHLBs. Asset growth exceeded FHLB capital growth in eight of the last 10 years, including 2002, and as a consequence, the FHLB’s capital-to-asset ratio declined from 6.92 percent in 1991 to 4.76 percent as of December 31, 2002. Moreover, the shift in asset composition from low-risk advances to mortgages and mortgage-backed securities has implications for capital adequacy because the FHLBs are subject to risk-based capital requirements.” The commentary added, “Even with the loss-sharing agreements in place, FHLB mortgage holdings are riskier than advances and hence, under risk-based capital requirements, incur a higher capital charge (require more capital to be held against them) than advances. In other words, asset growth driven primarily by the mortgage-asset programs requires higher growth in FHLB capital than balance-sheet growth driven by advances.” (*Federal Reserve Bank of Cleveland Commentary, “The Evolving Role of the Federal Home Loan Banks in Mortgage Markets,”* Daniel K. Maloney and James Thomson, June 2003)

Commentary says mortgage purchase programs help FHLBanks meet their mission

- The commentary noted, “Increased holdings of mortgage-backed securities and direct holdings of mortgages through the two new FHLBs mortgage-asset programs represent new methods for fulfilling the FHLBs’ original housing-related mission... In addition, part of the FHLB System’s mission is to promote access to housing for all Americans. The FHLB mortgage-asset programs indirectly support this goal by providing member institutions liquidity to accommodate further residential mortgage loan originations.” (*Federal Reserve Bank of Cleveland Commentary, “The Evolving Role of the Federal Home Loan Banks in Mortgage Markets,”* Daniel K. Maloney and James Thomson, June 2003)
- A copy of the commentary can be found at:
<http://www.clevelandfed.org/Research/Com2003/0603.pdf>

Differing sides clash on whether FHFB’s proposed revisions to its mortgage purchase programs are “mission creep”

- Differing sides are “starting to clash” on a new FHFB proposed rule that revises the regulation of its mortgage purchase programs [Acquired Member Assets (AMA) programs], focusing the agency’s supervisory role on risk management while giving the FHLBanks more flexibility in developing and operating their AMA programs. The FHLBanks’ AMA programs include the Mortgage Partnership Finance program (MPF) and Mortgage Purchase Program (MPP). The comment period for the proposed rule ends September 2, 2003. (*American Banker*, Rob Garver, 7/9/03; *FHFB press release*, 6/18/03; *Federal Register*, pages 39027-39038, 7/1/03)
- The 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. Some FHLBank executives welcomed the FHFB’s new proposal. “Generally speaking, we are favorably impressed,” said Kelli Bono, the FHLBank of Seattle’s chief financial officer. Critics believe that the proposal is an attempt to gradually shift the FHLBanks from their original mission of providing mortgage liquidity to a more profit-driven model that increases risk. “The proposal abandons the legal and policy basis of the system as a member-owned cooperative providing liquidity to members,” said Gregory Baer, a former Treasury assistant secretary for financial institutions, who now is a partner at Wilmer, Cutler & Pickering, representing companies critical of the

system. [Wilmer, Cutler & Pickering represents Fannie.] (*American Banker*, Rob Garver, 7/9/03)

- Former Assistant Treasury Secretary Sheila Bair, now a professor of financial regulatory policy at the Isenberg School of Management, University of Massachusetts-Amherst, said the effort was “deeply alarming.” Bair’s comments came in a new paper, funded by Fannie Mae, entitled, “*Is the Federal Home Loan Bank System Forsaking Its Roots?*” Bair wrote, “The system is taking risks for which it is not prepared, and inviting scrutiny and controversy by forging ahead with activities that far exceed its congressional charter and with which it has no historic experience or expertise.” (*Dow Jones Newswire*, John Connor, 7/9/03; *American Banker*, Rob Garver, 7/9/03)
- In response to critics, Jonathan West, general counsel for the FHLBank of Indianapolis, stated, “We are not trying to expand our charter...As our MPF programs evolve it is appropriate and normal to seek some additional regulatory flexibility. We very much commend the Finance Board for making this proposal, so that we will have a reliable competitive alternative for our members both large and small...It is not mission creep and I think the member-users of the system are smart enough to know that those comments are just trying to distort things and to put us at a competitive disadvantage.” (*American Banker*, Rob Garver, 7/2/03)

MPF continues strong growth for second quarter

- The FHLBanks announced the second quarter 2003 financial results for the MPF program. Highlights include:
 - Total outstanding MPF assets rose 125% over the past year to \$68.8 billion, as of June 30, 2003, despite record prepayment rates.
 - The number of FHLB members approved for MPF increased to 530, up 53% from one year earlier.
 - MPF volume during the second quarter was \$22.1 billion, more than four times the amount funded during the same quarter last year. Single-day fundings of more than \$2 billion occurred twice during the quarter.
 - A second MPF Shared Funding™ transaction was completed in June, creating \$524 million of Shared Funding mortgage-backed certificates.
 - MPF loans continue to display excellent credit quality. Only 0.10% of conventional loans were more than 90 days delinquent, less than one-tenth the national average for conventional, fixed-rate mortgages of 1.02%.
- Consistent with the program’s design to provide lenders a competitive alternative to the traditional secondary market agencies, over 90% of the MPF loans funded during the second quarter were conventional loans while the balance were FHA/VA loans.
- Since beginning in 1997, the MPF program has been used by FHLB members to fund an aggregate of almost \$100 billion of mortgages, helping more than 730,000 families purchase a new home or lower the cost of their existing home. MPF loans have been funded in all 50 states, Washington, D.C and Puerto Rico. The median size of a MPF loan is \$123,649 and more than half of all loans have been made to borrowers with incomes below 115% of area median income. (*MPF press release*, 7/15/03)

House Judiciary Committee approves regulatory relief bill (HR 1375), which contains provision allowing privately insured credit unions to become FHLBank members

- The House Judiciary Committee approved by voice vote July 9 a regulatory relief bill (HR 1375) that would among other things, allow state-chartered, privately-insured credit unions to become FHLBank members if they meet certain eligibility requirements. The House Financial Services Committee approved the bill in May.
- A regulatory relief bill (HR 3951), containing a provision that would allow privately insured credit unions to join the FHLBank System, was considered during the last session of Congress. The bill was approved by the House Financial Services Committee but never made it to the House or Senate floors. [See July 19, 2002 *GSE Report* for more information, www.gsereport.com]

Ginnie Mae

Ginnie Mae to provide more loan-level data on its multi-family mortgages

- Ginnie Mae announced that it will make certain loan-level data available to the public on Ginnie Mae multi-family mortgages that back Ginnie Mae-guaranteed securities. Ginnie Mae will now make delinquency information available to the public “in order to achieve a fair and open market in Ginnie Mae-guaranteed multi-family securities.” Ginnie Mae said the change “should lead to greater investor confidence and more accurate pricing on these securities,” which “could decrease the cost of borrowing to finance apartment buildings, and thus decrease the rents of low- and moderate-income families that live in those buildings.” The effective date for the change was July 14, 2003. (*Federal Register*, page 41656, 7/14/03)

Postal Service

Senator Tom Carper (D-DE) introduces postal reform bill

Senator Carper hopes his bill will guide the President's Commission on the Postal Service as it completes its work

Cong. John McHugh (R-NY) says this may be the year for postal reform

- Senator Carper introduced June 18 a postal reform bill (S. 1285) that would give the Postal Service greater authority to make business decisions. The bill also calls for the retooling of the Postal Rate Commission (PRC) into the Postal Regulatory Commission with greater oversight responsibilities. The legislation, the Postal Accountability and Enhancement Act of 2003, is based on a bill introduced last year in the House by Congressman John McHugh (R-N.Y.) that enjoyed the support of most of the mailing community and nearly all organizations representing Postal Service employees. The Postal Service's Board of Governors also endorsed it. The bill does not yet have co-sponsors. (*Senator Carper press release, 6/18/03*) Senator Carper's spokesman Bill Ghent said there are no hearings or markups expected for the bill prior to the August recess. (*BNA Daily Report for Executives, Derrick Cain, 6/19/03*)
- "My bill does not attempt to reform the Postal Service by rolling back universal service or taking pay, benefits or collective-bargaining rights away from employees," said Senator Carper. "The bill gives the Postal Service the flexibility it needs to compete in the 21st century." (*Senator Carper press release, 6/18/03*)
- Senator Carper hopes his legislation will guide the President's Commission on the Postal Service before it releases its report at the end of the month. "I commend President Bush for his leadership in putting the Commission together," said Senator Carper. "I urge those on the Commission to take careful consideration of the work Congress has done on postal reform over the past decade, including the bill I am introducing today. I hope they can look to the Postal Accountability and Enhancement Act as a touchstone as they complete their work." (*Senator Carper press release, 6/18/03*)
- The Carper legislation would seek to strengthen the Postal Service's standing and long-term viability by:
 - Preserving universal service and employee collective-bargaining rights.
 - Renaming the Postal Rate Commission the Postal Regulatory Commission, strengthen qualifications for Commission members and give the Commission the authority to create a new system of rates and service standards for most of the Postal Service's products. The Commission could also subpoena Postal Service employees and records and punish or fine the Postal Service for violating any rate or service regulation it issues.
 - Creating a modern rate system by requiring the Postal Regulatory Commission in two

years to create a new system for pricing and classifying the Postal Service's Market Dominant products, such as First Class Mail and others that are part of the postal monopoly. The new system should give the agency more pricing flexibility, allowing them to use rates to encourage safer, sender-identified and easily traceable mail and to encourage people to mail during non-peak periods. The Postal Regulatory Commission could also institute emergency price increases during certain times, such as a national fuel crisis, that threaten the agency's ability to fulfill its universal service mandate. In addition, the bill requires mailers, the Postal Service and the Commission to agree to a schedule of rate increases over a period of time to make them more predictable and less frequent. Most importantly, the bill authorizes the Postal Service to negotiate with mailers service agreements aimed at increasing volume and better tailoring services to mailer needs.

- Establishing modern service standards by authorizing the Commission to create within two years a set of service standards for its Market Dominant products. The bill also requires the Postal Service to realign its operations in order to meet those new service standards. This could include closing or consolidating some facilities no longer needed to meet the new standards.
- Ensuring that the Postal Service competes fairly with companies like the United Parcel Service and FedEx by preventing the agency from using revenue from its monopoly products, such as First Class Mail, to underwrite expenses for its competitive products, like Priority Mail. The Postal Service is also prohibited from issuing regulations that would give the agency an unfair advantage over private sector companies, and the agency would have to pay an assumed federal income tax on products that private firms also offer. (*Senator Carper press release, 6/18/03*)

Comments on the legislation

- “I applaud Senator Carper for his efforts on postal reform,” said Bill Young, President of the National Association of Letter Carriers. “Ensuring that the Postal Service has the flexibility to thrive in the 21st century is of vital importance to my members and the public we serve. Senator Carper’s bill is an important step in that it aims to improve service nationwide and preserves the protections and benefits letter carriers depend on. We look forward to working with Senator Carper to get comprehensive postal reform legislation passed into law.” (*Senator Carper press release, 6/18/03*)
- “The issue of postal reform is critical to the country, magazine readers and the entire mailing industry,” said Ann Moore, chairman and CEO of Time, Inc. “Senator Carper’s bill provides the Postal Service with much-needed flexibility that allows it to operate in a more business-like manner, which is important to any reform bill. We appreciate his leadership, and we look forward to continuing to work with him and [Governmental Affairs Chairwoman] Susan Collins.” (*Senator Carper press release, 6/18/03*)
- “We’re supportive of this bill and the [Senate Governmental Affairs] Committee’s interest in it,” said Neal Denton, executive director of the Alliance of Nonprofit Mailers. (*Direct Newslines, Larry Riggs, 6/18/03*)
- The Direct Marketing Association expressed its support for Senator Carper’s bill. “We

appreciate Senator Carper's interest in a strong, financially viable Postal Service," Jerry Cerasale, DMA's senior vice president, government affairs. (*Direct Newswire*, 6/19/03)

Cong. McHugh says this may be the year for postal reform

- In an interview with Stephen Losey at *Federal Times*, Cong. McHugh said this may be the year for postal reform. The Congressman has offered legislation to transform the Postal Service in every Congress since 1996 and, though none has become law, he is not discouraged. Cong. McHugh noted that Congress has been able to sweep postal reform under the carpet as long as there is no pressing emergency, however, he is optimistic that this year is different because the President's Commission may force legislators to focus on the issue. In terms of reform, Cong. McHugh would like the Postal Service to have enough flexibility to survive and adapt, but it should not be allowed to take advantage of its monopoly on first-class mail to create an unfair marketplace for private mailers. He recommends a strong regulator to oversee the Postal Service, along the lines of the Federal Trade Commission and the Federal Communications Commission. (*Federal Times.com*, Stephen Losey, 6/30/03)

Postal Service's IG finds more than \$81.5 million in potential savings for Postal Service

OIG audit blasts the Postal Service's sponsorship of the Tour de France

Lake-Worth Herald and CAGW say postal officials continue to waste millions on sports sponsorships

- The Postal Service's Office of the Inspector General identified \$81.5 million in potential savings and benefits for the Postal Service in the last six month reporting period (October 1, 2002 to March 31, 2003), according to the OIG's March 2003 Semiannual Report to Congress, released June 19. "A breakdown of the \$81.5 million includes \$37.6 million in potential savings, \$20.8 million in unrecoverable costs, \$14.7 million in questioned costs, \$6.9 million in cost avoidances, and \$1.5 million in fines, penalties and restitution," explained Inspector General Karla W. Corcoran. The full report is available at: http://www.uspsoig.gov/sarc/SARC_MAR_FY03.pdf (*USPS OIG press release*, 6/19/03)
- In this reporting period alone, the OIG issued 210 audit reports, 65 management advisories and other products; and closed 191 investigations. The following are examples of the OIG's findings during the six-month time period:
 - An audit identified that improved handling of Address Change Service mail could potentially save the Postal Service \$14 million.
 - An investigation resulted in a \$1.4 million cost avoidance in a lawsuit against the Postal Service involving an individual who allegedly tripped and fell over a steel mat at a postal facility. The investigators discovered the claimant ignored prior warnings from the Postal Service.
 - A review determined that more effective monitoring of death benefit claims by the Postal Service's Injury Compensation Control Office would have avoided an estimated \$1.3 million in questionable benefits being paid to survivors. (*USPS OIG*

press release, 6/19/03)

- In its previous report, released January 22, the OIG found more than \$236.6 million in potential savings and benefits during the reporting period from April 1, 2002 to September 30, 2002. (*BNA Daily Report for Executives*, Derrick Cain, 6/20/03)

OIG blasts the Postal Service's sponsorship of the Tour de France

- The OIG “produced a scathing indictment” of the Postal Service’s \$48 million in sponsorship costs between 1996 and 2002, reported the *Lake Worth Herald* in its “Whistleblower Series.” The review was contained in a confidential 18 pages of “restricted” documents obtained exclusively by *The Lake Worth Herald and Observer* newspapers. The OIG audit, conducted from August 2001 through February 2003 disclosed that the Postal Service “has not effectively managed its sponsorships.” The OIG asked the Postal Service management, “Why should the Postal Service support sponsorships given that it lost over \$1.6 billion in 2001 and \$676 million in 2002, despite reducing costs and raising the price of First-Class stamps?” The OIG recommended that the Postal Service not enter into any new sponsorship agreements or extensions on current agreements.” (*Lake Worth Herald Whistleblower Series*, Leonard Saffir, 7/3/03)
- A copy of the OIG’s report that was released to the public on the Postal Service’s sponsorships is available at: http://www.uspsoid.gov/FOIA_files/OE-AR-03-003.pdf
- *The Lake Worth Herald* asked, “Shouldn’t the post office be directing its efforts into more efficient mail delivery, more cost savings within the organization, better ways to deal with for-profit competitors and leave the heavy duty sponsorships to private businesses which can properly track the effectiveness of said campaigns?” (*Lake Worth Herald Whistleblower Series*, Leonard Saffir, 7/3/03)
- “Specifically, the Postal Service was unable to track or verify revenue associated with sponsorships, lacked goals and objectives for some sponsorships, and did not manage tickets and invitations appropriately. As a result, the Postal Service could not determine return on investments, measure the effectiveness of its sponsorships, and take advantage of networking opportunities to generate revenue,” said the OIG report. “The Postal Service needs to consider sponsorships in light of its monopoly status, financial condition, investment returns, and core mission,” the audit said. The audit reported that the Postal Service lacked goals and objectives for 10 of the 11 sponsorships it reviewed. (*Lake Worth Herald Whistleblower Series*, Leonard Saffir, 7/3/03)
- The Postal Service spent a total of \$48 million on sponsorships between 1996 and 2002. The Postal Service spent \$40,246,107 on cycling alone between 1996 and 2002 – broken down into \$26,188,631 in contract costs, \$12,446,297 in advertising costs and \$1,611,179 in related expenses (which include postal management, travel, hotel and entertainment expenses in France during the Tour de France). Since 1996, the Postal Service had one national (Lance Armstrong pro-cycling team) and over 200 local sponsorships. In 1998, the Postal Service eliminated all but five sponsorships. With costs for this year’s Tour de France, which got underway recently, the total costs for sponsorships since 1996 are well over \$50 million. The OIG asked, “Why would the Postal Service sponsor the Pro-Cycling team whose major event

is the Tour de France when the primary job of the Postal Service is to deliver mail domestically?” (*Lake Worth Herald Whistleblower Series*, Leonard Saffir, 7/3/03, 7/10/03)

- In addition to the \$40 million-plus on cycling-related expenses, the Postal Service spent:
 - \$3,656,000 on tickets to the New York Yankees’ games (1999-2002)
 - \$1,936,000 for New York Giants tickets (1998-2002)
 - \$338,000 for Notre Dame football tickets (2001-2002)
 - \$632,000 for Chicago Bears football tickets (1998-2002)
 - \$79,000 for Ryder Cup tickets (2001)
 - \$630,000 for Tampa Bay Devil Rays tickets (1998-2000) (*Lake Worth Herald Whistleblower Series*, Leonard Saffir, 7/10/03)
- Postal officials said they had already begun making improvements before receiving the new OIG report and they challenged some findings of the recent report. (*Associated Press*, Randolph Schmid, 7/7/03)

Tour de France contract is the fifth largest contract awarded by the Postal Service

- A firm that specializes in postal contracts (Wickwire Gavin) compiled a list of the top 100 contracts awarded by the Postal Service in 2001. The data was compiled from the Postal Service’s SNAPS/IMPROMPTU tracking system. The list contains only new contracts awarded in USPS Fiscal Year 2001 (September 9, 2000-September 8, 2001) by the USPS Headquarters Purchasing group for supplies, services, and equipment. Tailwind Sports (USPS Pro Cycling Team) received over \$38 million from the Postal Service FY 2001. (*Postal Watch web site*, 7/10/03; *PostalMag.com*, 7/9/03)

CAGW

- CAGW July 10 criticized the Postal Service for its “abysmal track record of botched marketing initiatives and mismanaged sports sponsorship expenditures.” CAGW noted that a February 25, 2003 uncensored, draft report by the OIG and obtained by CAGW, shows that USPS has “bungled its sports sponsorship programs.”
- “Lance Armstrong is a champion and hero to millions of Americans. Each year, he delivers a stirring performance at the Tour De France,” said CAGW Director of Special Projects Leslie K. Paige. “Unfortunately, Armstrong’s top sponsor, the USPS, is going downhill fast financially and managing to lose millions on its sports sponsorships. Despite a corporate loss of \$676 million in 2002, the most recent sponsorship contract with the cycling team reportedly cost the USPS more than \$40 million. This does not include the costs associated with sending postal executives and their spouses on junkets to the Tour De France as they have done in the past.”
- “Postal officials routinely pedal the line that sponsorship of the cycling team raises ‘brand awareness’ in Europe and results in \$19 million in revenue annually. Yet, they present no verifiable evidence of this and, according to the IG report, fail to quantify any impact to the bottom line with any of its sports sponsorships. International sales account for only 2.6 percent of the USPS’ total revenue and anecdotal evidence suggests that the USPS’ performance in the international arena is substandard. Congress, the Presidential Reform

Commission, and the USPS Board of Governors ought to put the brakes on these wasteful expenditures,” Paige said.

- “The USPS is a government-owned monopoly and does not need to spend money on ‘brand’ advertising. In its current fiscal crisis, it cannot rationalize sponsorships of any kind. Postal officials simply recycle the feel-good mantra that these sponsorships boost the agency’s image and make postal employees feel good. If postal officials want to retread their image, they should bow out of the sports sponsorships, redirect those revenues to improving mail delivery, reduce costly overhead, and furnish better customer service. Lance Armstrong will continue to deliver without USPS sponsorship,” Paige concluded. (*CAGW press release, 7/8/03*)

CAGW says Postal Service’s retail operations are grossly mismanaged

CAGW publicizes the results of USPS’ OIG audit on Postal Service retail operations

OIG report unavailable on the USPS’ OIG website

- CAGW publicized July 10 the results of a Postal Service’s OIG audit on operations at its approximately 1,400 postal retail operations. The report was obtained by CAGW despite being unavailable on the USPS’ OIG website. CAGW explained that a postal retail store operates much like a traditional post office except that it features an open display area so that customers can purchase merchandise and stamps without standing in full service lines.
- “This report demonstrates that the USPS has no business being in any competitive businesses,” said CAGW Special Projects Director Leslie Paige. “If the postal service can’t even adhere to basic accounting standards or determine the financial viability of its retail stores, it should not be permitted to compete freely in the private sector in other commercial activities.”
- The report, dated February 28, 2002, discloses that USPS improperly accounted for key financial data. For example, labor and revenue figures for both the new retail stores and traditional retail post offices were lumped together, making it impossible to determine retail store profitability. Construction cost estimates were also not reliable, the report said, because the USPS did not itemize the costs of building the facilities. Also, managers at postal retail outlets failed to implement management controls over store operations, putting the USPS at high risk for financial losses due to theft.
- Highlights of the report include:
 - Open merchandise counters designed to expedite customer service were not staffed at a majority of the visited sites;
 - Merchandise was not tracked or inventoried at any of the visited sites; and
 - Security systems designed to detect theft of stamps and other merchandise did not sense such items when they passed through sensors.

- USPS responded that the auditors should not have been trying to determine the stores' profitability because "the vast majority of post offices regardless of format (postal store or traditional) are not profitable, much like component parts of other USPS networks (e.g. individual plants or carrier routes)." Though the auditors agreed with postal management's assertion that most post offices are not profitable, they stated that it is still important to evaluate financial performance in order to make decisions.
- "At the June hearing before the President's Commission on Postal Reform, Postmaster General Potter reiterated his long-standing desire to have the USPS compete freely in the private sector and retain profits," stated Paige. "When asked to be specific about what goods USPS would offer, Mr. Potter said the agency should be able to offer anything that makes money, such as beverages, greeting cards, and financial services. This report clearly shows that the USPS has mismanaged its current retail outlets. Such financial incompetence should not be rewarded by giving the USPS more freedom to fail and lose millions more ratepayer dollars." (*CAGW press release, 7/10/03*)

President's Commission on Postal Service publishes consumer survey

Few surveyed see a need for a major Postal Service overhaul and a majority oppose privatization of the Postal Service

APWU Board authorizes special assessment of union members' dues to fund a campaign against the Commission's expected report

- The President's Commission on the Postal Service has posted the results of its consumer opinion survey by Peter D. Hart Research Associates, Inc. on its web site. <http://www.treas.gov/offices/domestic-finance/usps/docs/consumer-survey.pdf>. The Commission also posted the minutes of its public meetings on its website. <http://www.treas.gov/offices/domestic-finance/usps/meetings.html>
- According to *Alliance Breaking News*, "interesting findings" from the survey include:
 - Americans view the Postal Service favorably
 - Postal Service is doing enough to stay competitive with other delivery services
 - Few Americans see a need for a major Postal Service overhaul
 - Rates invoke some concern, but Postal Service personnel receive high marks
 - A majority opposed privatization of the Postal Service
 - The public supports rate increases to avoid cuts in USPS service (*Alliance Breaking News, 7/3/03*)
- Highlights of the survey include:

Question #3: "When you think about what it would take to make the US Postal Service work extremely well, would that require a total overhaul of the entire Postal Service, some major changes, some minor changes, or does the Postal Service work extremely well as it is now?"

	5/03	11/94
Total overhaul	6	12
Some major changes	16	27
Some minor changes	43	36
Works extremely well as it is now	30	21
Depends (VOL)	1	1
Not sure	4	3

Question: #9: “Would you favor or oppose a proposal to change the Postal Service into a private company, independent or government funding or management with the flexibility to change services and pricing to meet changing market opportunities? (If ‘Favor/Oppose,’ Ask:) And would you say that you (favor/oppose) this proposal strongly or not so strongly?”

Favor-strongly	13
Favor – not strongly	11
Oppose – not strongly	14
Oppose – strongly	53
Not sure	9

Question #11: “In the past the Postal Service has received taxpayer money to subsidize the mail service and cover any difference between the income from postage sales and the cost of the delivery service. More recently, the Postal Service has operated almost entirely on the income it generates in postage sales. Would you favor or oppose a proposal to again use taxpayer money to subsidize the postal service and cover any difference in the cost of the service and the income from postage sales? (If ‘Favor/Oppose,’ Ask:) And would you say that you (favor/oppose) this proposal strongly or not so strongly?”

Favor-strongly	18
Favor – not strongly	18
Oppose – not strongly	18
Oppose – strongly	36
Not sure	10

Question #13a: “I am going to read you some specific proposals that have been suggested for reforming the US Postal Service so it can more effectively and efficiently provide mail service for all Americans. For each one, please tell me whether that is something you would strongly favor, somewhat favor, somewhat oppose, or strongly oppose.”

“Authorize the Postal Service into expand non-postal businesses such as electronic bill-paying over the Internet”

Strongly Favor	Somewhat Favor	Somewhat Oppose	Strongly Oppose	Not Sure
23	23	15	31	8

(Source: Peter D. Hart Research Associates, Inc. study #7006, 5/03)

APWU Board

- Vowing to fight “whatever it takes” to defeat anti-worker “reforms” likely to be recommended by the Commission, the APWU National Executive Board at its July 8 meeting authorized a special assessment of union members’ dues to fund a media campaign. The assessment, which passed in a nearly unanimous vote by the Board, is an \$8 assessment per member, to be paid in \$2 increments over the course of four pay periods. APWU President William Burrus stated, “We have to be prepared to react to whatever happens. Whether this means loudly opposing commission recommendations or fighting against detrimental legislation, we must do everything in our power to defend consumers and workers.” Burrus said the money would be used to launch a public education campaign in key congressional districts. The effective date of the assessment will be determined by the APWU president based on the Commission’s final report. “If the media campaign proves to be unnecessary,” Burrus noted, “the special assessment will not take place.” (*APWU News Service*, Vol. 33. No. 13, 7/8/03)

Center for the Advancement of Capitalism files amicus brief in Postal Service antitrust case

Supreme Court to decide whether Postal Service can be sued under antitrust laws

- The Center for the Advancement of Capitalism filed an amicus brief with the US Supreme Court in the case of *US Postal Service v. Flamingo Industries, Ltd*, according to *Postal Watch*. (*Postal Watch web site*, 7/10/03) As reported in the June 9, 2003 *GSE Report*, the Supreme Court said May 27 that it will decide next year whether the Postal Service can be sued for antitrust violations. Flamingo, an Illinois-based maker of mail sacks, sued the Postal Service under five antitrust claims, alleging that the Postal Service is trying to create a monopoly in the mail sack business, driving US companies out of business by transferring work to foreign manufacturers. (*Wall Street Journal*, Robert Greenberger, 5/28/03; *Dow Jones Newswire*, Mark Anderson, 5/27/03)
- The Postal Service claims they are immune from all antitrust suits because they are not a “person” but a sovereign government agency, which means the Postal Service would be exempt from all antitrust and “competition” laws to which normal businesses are subject. This would give the Postal Service an additional advantage over private businesses such as UPS and FedEx. The Center for the Advancement of Capitalism’s amicus brief supports neither party in the case, but does ask the Supreme Court to affirm a lower court decision requiring the case to go to trial. (*Postal Watch web site*, 7/10/03)

Postal Service to market art, toys and furnishings

Postal Service spokesman’s wife works for Art Select, the company that will sell the Postal Service’s artwork

- The Postal Service “is about to push the envelope on marketing – big time,” reported Bruce Horowitz with *USA Today*. The Postal Service expects to add tens of millions of dollars in licensing revenue by marketing its brand. In the past six months, the Postal Service has

increased licensing revenue by 139 percent. The Postal Service has begun to open minibranches in about 350 Hallmark card shops with plans to add hundreds more. Negotiations are currently underway with major supermarkets, drugstores and convenience stores for hundreds of additional minibranches. (*USA Today*, Bruce Horovitz, 6/9/03; *DM News*, Melissa Campanelli, 6/20/03)

- The Postal Service also plans to begin selling artwork based on its stamps. The prints, from about 300 postage stamps, will be sold at www.postalartgallery.com. The art, which will be custom framed and matted, will sell for \$39 to \$5000. The web site will be run by Art Select Inc., www.artselect.com, which is a Postal Service licensee. This is the first time the Postal Service has sold this type of stamp imagery. The Postal Service also plans to market kids' toys. The familiar blue Postal Service collection box has been molded into a plastic bank. Finally, the Postal Service plans to market postal designer wear. A multi-license deal has been signed with Elaine Gold, who has done fashion design for Anne Klein and Jones New York. She plans to include postal imagery on everything from watches to rainwear and eventually to men's ties, handbags, jewelry and belts. Gold has no plans for postal furniture but she plans other home furnishings such as placemats, pillows, and beach towels. (*USA Today*, Bruce Horovitz, 6/9/03; *DM News*, Melissa Campanelli, 6/20/03)
- Postal Service's top spokesman Azeezaly S. Jaffer acknowledged to *Linns' Stamp* publication that his wife works for Art Select, which has a potentially lucrative three-year contract with the Postal Service to sell the framed reproductions of US Postal Service stamps. According to other Postal Service spokesman, there is no ethical conflict. Jaffer said he recused himself from negotiations with the company. (*Linns Stamps*, Bill McAllister, 7/14/03)
- The Postal Service risks harming its image by diluting the brand and shifting the image away from delivering mail, said Dave Dolak, a marketing consultant. "These are mostly acts of desperation by a marketer who thinks its branch is misunderstood," said brand consultant Pam Murtaugh. "The brand isn't the problem – the service is." (*USA Today*, Bruce Horovitz, 6/9/03)

AEI holds June 2 session on Postal reform as part of its Postal Reform Initiative

AEI releases a paper on postal reform

- AEI is sponsoring a Postal Reform Initiative – a series of conferences and publications to assess the mission and operations of the Postal Service, propose a vision of a modern postal industry, and suggest how the US could arrive at this destination. President George W. Bush recently established the Commission on the United States Postal Service, whose final report in August 2003 may lay the groundwork for the first major reform of the U.S. Postal Service in thirty years. Mirroring the administration's initiative, AEI is sponsoring its own Postal Reform Initiative. The Initiative, led by Rick Geddes, an AEI adjunct scholar, parallels the work of the Presidential Commission. The March 17 opening session of the Initiative discussed key objectives that the President's Postal Reform Commission should strive for and how those objectives can be realized. AEI held its second session on April 30 to focus on the mission of the Postal Service, how technology has affected this mission, and the meaning of universal service. AEI's third session on June 2 focused on the antitrust (or competition)

issues that may arise under postal reform. Rick Geddes, Cornell University, moderated the session.

- The speakers included:
 - Bill Kovacic, Federal Trade Commission;
 - David Sappington, University of Florida; and
 - J. Gregory Sidak, AEI
- The panelists urged the President’s Commission on Postal Service to examine competition policy issues and anti-competitive behavior incentives during its consideration of major postal reform.
- Kovacic said competition policy issues such as improper exclusion and cooperation among rivals need consideration. Under improper exclusion, Kovacic noted that while the Postal Rate Commission makes rapid price increase difficult to attain, a lack of a “price floor” on Postal Service products can serve to exclude competitors. In terms of “cooperation among rivals,” Kovacic noted that issue involves examining the need for traditional prohibitions on collusion as well as possible side effects of mandatory access and cooperation.
- Sappington said the key distinction between the Postal Service and competitors is that these “public enterprises” are “less focused on profit.” Sappington argued that a reduced focus on profit could lead to public enterprises’ being less aggressive toward competitors because of their more limited concern with profit. “The less-profit oriented is the public enterprise, the more willing it is to bear the costs required to limit the competitive threat of its rivals, and thereby increase its own scale and scope.”
- Sidak recommended a stronger role for the Postal Rate Commission in which the Commission would define the Postal Service’s “monopoly” through a series of public rule-makings and the Commission would also decide what products the Postal Service can offer consumers. “The PRC should have the power to make the Postal Service exit any market not at the core of the statutory monopoly,” Sidak said. (*BNA Daily Report for Executives*, Derrick Cain, 6/3/03)
- AEI also released a May 28 postal reform paper by Rick Geddes from Cornell University entitled “Opportunities for Anticompetitive Behavior in Postal Services.” The Postal Service receives a number of government-granted subsidies that provide an artificial competitive advantage over private firms. The Postal Service has the “incentive and the ability to inefficiently compete in activities where it faces competition.” In light of this fact, “enhanced scrutiny under antitrust laws is appropriate.” He added, “Furthermore, because a monopoly position in one market may enable the USPS to reduce competition in another market, it is probably wise to construe its statutory monopolies narrowly. Moreover, limits on its ability to expand beyond the market covered by its statutory monopoly are appropriate.” (*AEI Postal Reform Paper, “Opportunities for Anticompetitive Behavior in Postal Services,”* Rick Geddes, 5/28/03) A copy of the complete paper is available at: www.aei.org/include/pub_print.asp?pubID=17488

Washington Legal Foundation joins CAGW, NTU, and 60 Plus in calling for FTC to investigate the Postal Service's ad campaign

- In a letter to the Federal Trade Commission (FTC), the Washington Legal Foundation, urged the FTC to investigate whether the Postal Service's Priority Mail campaign complies with federal laws governing deceptive trade advertising. The Washington Legal Foundation "further objects to the deceptive advertising by the USPS because it unfairly competes with those services and products offered by companies in the private sector which clearly are subject to FTC jurisdiction for any false advertising." The Foundation noted, "The USPS is currently promoting its Priority Mail services in a broad and expensive deceptive advertising campaign that promises consistent two-day delivery... False and deceptive advertising is unlawful under federal law. Federal truth-in-advertising laws prohibit 'any person' from making any 'false advertisement' for the purpose of inducing or which is likely to induce consumers to purchase products or services. Moreover, 'unfair or deceptive acts or practices in or affecting commerce' are unlawful." (*Postal Watch web site*, 6/24/03; *Washington Legal Foundation letter to FTC*, 6/24/03)
- The Council for Citizens Against Government Waste (CCAGW) [the lobbying arm of Citizens Against Government Waste], the National Taxpayers Union, and the 60 Plus Association, also called on the FTC to investigate whether the Postal Service's promotions of its Priority Mail delivery service violate the nation's "truth in advertising" laws. (*CCAGW press release*, 4/18/03; *NTU press release*, 4/18/03; *The 60 Plus Association letter to FTC*, 5/8/03) Another watchdog organization, PostalWatch, released an April 18 study accusing the Postal Service of running ads that misrepresent priority mail as a 2-day delivery service.

IRET recommends an independent assessment of the Postal Service's property holdings to identify surplus real estate

Transforming surplus real estate into revenue would help the Postal Service financially and increase the tax bases for state and local governments

- The Institute for Research on the Economics of Taxation (IRET) recommended an independent assessment of the Postal Service's property holdings to identify surplus real estate. "Properties not needed for postal operations should be identified and transformed into revenue. That would simultaneously help the Postal Service financially and assist the economy by putting scarce resources to better uses. In addition, if the tax-exempt Postal Service owned less real estate, that would increase the tax bases of financially strained state and local governments." The Postal Service's real estate currently has a book value of \$15 billion.
- "Private-sector companies are energized by the profit motive to use their real estate and other assets as efficiently as possible. Part of the process is regularly asking if some real estate holdings are not needed and could earn higher returns.... The US Postal Service faces weaker market incentives and more political constraints. Although it insists that it does an excellent job at converting underutilized real property into revenue, it has furnished too little

information about the market values and utilization rates of its thousands of real properties to enable regulators, Congress, and the public to determine if it should be doing better. To answer that question, there should be a comprehensive, independent assessment of the Postal Service's real property holdings and an evaluation of which are excess and how much they are worth at current market values. That information is needed for proper oversight of the Postal Service and would increase openness and accountability at the government agency." (*IRET Congressional Advisory, Advisory No. 155, Michael Schuyler, 6/24/03*)

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Canfield & Associates, Inc.
801 Pennsylvania Ave., NW, Suite 625
Washington, DC 20004
Phone: (202) 661-2100
Fax: (202) 661-2101
www.canfieldassoc.com