

The **GSE** REPORT™

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Major Events

Freddie removes its management team

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Freddie's president, David Glenn, altered documents related to Freddie's restatement of its earnings for the past three years

Gregory J. Parseghian Named Chief Executive Officer and President

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[Details to follow in next *GSE Report*]

OFHEO releases its annual report to Congress on Fannie & Freddie

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OFHEO says it is "satisfied" that Freddie's Board of Directors and management are "taking the appropriate action" in its restatement of earnings for the past three years

OFHEO recommends removing the agency from the appropriations process and giving it receivership authority in the event Fannie or Freddie is not viable

- OFHEO June 4 released its 2003 annual report to Congress on its examination of Fannie and Freddie. A copy of the complete report can be found on OFHEO's web site at: www.ofheo.gov (*OFHEO press release, 6/4/03*)
- The following are highlights from the report:

OFHEO took its first regulatory action against Fannie last September

- OFHEO noted that it took its first-ever regulatory action against one of the GSEs last year, when a key measure of Fannie's interest rate risk [its duration gap] was substantially imbalanced. It is the only formal supervisory action OFHEO has ever taken against one of the companies and is just shy of a more serious enforcement action, reported *Dow Jones Newswire*. (*Dow Jones Newswire, Dawn Kopecki, 6/4/03*)

- “A Prompt Supervisory Response action (12 CFR 177) was taken in September, 2002, to address concern regarding Fannie Mae’s substantial duration gap imbalance. The concern involved the trend and size of the imbalance between the duration of Fannie Mae’s mortgage assets and its liabilities. Fannie Mae was required to submit for OFHEO’s review an action plan for correcting the imbalance within an acceptable time frame as well as the steps that would be taken to protect against future concerns. OFHEO maintained daily oversight of the implementation of the plan and the imbalance was rectified within an acceptable time frame. In addition, Fannie Mae demonstrated an ability to maintain an appropriate duration gap over the next six months. Accordingly, the Prompt Supervisory Response was lifted in April, 2003.” (*OFHEO annual report to Congress*, June 2003, page 3)
- OFHEO noted that in the second-half of 2002, Fannie’s duration gap widened “significantly, which if not corrected, would have posed a safety and soundness concern.” OFHEO added, however, that Fannie’s management “effectively executed a plan that rebalanced the portfolio’s sensitivity position. Examiners and Fannie Mae representatives were in close communication while the sensitivity position was outside the company’s targeted operating range. Examiners focused on management’s compliance with its prescribed policies, the quality of management’s action plans and the effectiveness of management’s actions.” (*OFHEO annual report to Congress*, June 2003, pages 33-34)
- Last September, Fannie reported that in August 2002 its duration gap widened to negative 14 months, the widest ever reported number and more than twice the size of Fannie’s targeted duration gap range of plus or minus six months. The gap represents a mismatch in cash flows between Fannie’s assets (mortgage bonds and loans it owns) and liabilities (debt it issues to buy these assets). The duration gap measures the difference, in months, between the durations of the assets and the liabilities in Fannie and Freddie’s portfolios. [For more information on Fannie’s duration gap, see September 27, 2002 *GSE Report*, www.gsereport.com]

OFHEO says it is “satisfied” that Freddie’s Board of Directors and management are “taking the appropriate action” in its restatement of earnings for the past three years

- In January, Freddie announced that it would delay the release of its 2002 financial statements and restate earnings for at least the previous two years “materially” higher after its new auditor (PriceWaterhouseCoopers) recommended certain changes to its accounting policies, in particular the way it treats derivatives. OFHEO’s annual report noted that Freddie’s “reaudit and delay in 2002’s statements is prudent and appropriate under the circumstances. In addition, management and its Board of Directors initiated efforts in 2002 to enhance the expertise and controls in the area of financial accounting and operational control.” OFHEO said its examiners evaluated Freddie’s management and the Board of Director’s actions and found these to be “enhancements.” OFHEO concluded, “We remain satisfied that the Board of Directors and executive management are taking the appropriate action.” (*OFHEO annual report to Congress*, June 2003, page 38)

OFHEO recommends removing the agency from the appropriations process and giving it receivership authority in the event Fannie or Freddie is not viable

- OFHEO included two legislative recommendations in its report to strengthen the financial safety and soundness of Fannie and Freddie: Remove OFHEO from the appropriations process and give OFHEO receivership authority in the event an Enterprise is not viable. OFHEO noted that currently its assessments of the Enterprises are subject to the annual Congressional appropriations process, while other regulators' assessments are exempt. OFHEO noted that permanently funding OFHEO would permit the agency to adapt more easily to changes in the ever expanding range of Fannie and Freddie's activities and to act quickly should serious problems develop or a financial crisis become more likely. OFHEO's funding would then be the same as that of the other federal safety and soundness regulators. The legislative language OFHEO is recommending is identical to that recommended by the Administration in its FY 2004 budget. OFHEO also recommends that it be given the ability to appoint a receiver to close and wind up the affairs of an Enterprise that is not viable. Other federal safety and soundness regulators already have this explicit authority. (*OFHEO press release, 6/4/03; OFHEO Director Armando Falcon letter to Senator Shelby and Congressman Oxley accompanying OFHEO annual report, 6/15/03; OFHEO annual report to Congress, June 2003, page 39; Management's Discussion and Analysis FY 2002, pages 3-4*)

Fannie & Freddie have doubled in size and their business strategies have changed since OFHEO began operations in 1993 – increasing Fannie & Freddie's risk profiles

- “Since OFHEO began operations in 1993, the Enterprises have more than doubled in size and fundamentally shifted their business mix from guarantors of mortgage-backed securities to asset managers. In response to more ambitious affordable housing goals and the shift in business strategy, the Enterprises have also expanded business products and structured programs to purchase high loan-to-value mortgages to support the drive to higher rates of homeownership, to promote the expansion of reverse mortgages for elderly homeowners, and to develop the means to reach less credit worthy borrowers.”
- “To fund their expanded portfolios, the Enterprises issued innovative debt instruments, including instruments denominated in foreign currencies and established a program of regular issuances that frequently viewed as an alternative to U.S. Treasury securities. The Enterprises have also increased their use of derivative instruments from a notional amount of \$72 billion at year-end 1993 to \$1.3 trillion on September 30, 2002, representing a more than seventeen-fold increase. Each of these initiatives represents a heightening of the sophistication and complexity embedded in the risk profiles of Fannie Mae and Freddie Mac.”
- “At the same time, dramatic advances in technology represent the foundation for the Enterprises new business initiatives. The Enterprises employ cutting edge risk management techniques, built on quantitative models, to manage the many alterations of their risk profiles. Automated underwriting and related technology innovations by Fannie Mae and Freddie Mac have revolutionized the mortgage finance process and have led to significant shifts in the structure of the mortgage finance industry. These technologies carry with them operational challenges that not only permit the Enterprises to leverage their resources but also heighten

their operational risks. These developments and trends have challenged the resources of OFHEO in its oversight role.” (*OFHEO annual report to Congress*, June 2003, *Management’s Discussion and Analysis FY 2002*, pages 1-2)

Fannie & Freddie had record amounts of business in 2002, while asset growth was moderate

- Fannie and Freddie surpassed the records for mortgage purchase volumes and securitizations they set in 2001, while assets grew at a more modest pace. Fannie and Freddie increased their mortgage portfolios at a much slower rate, in part because strong demand for mortgage assets by commercial banks limited the attractiveness to Fannie and Freddie of acquiring such assets. The combined assets of Fannie and Freddie increased by a healthy 13.5 percent in 2002 to \$1.6 trillion, almost double the level five years before at the end of 1997. Fannie and Freddie’s combined mortgage portfolios increased by 15 percent last year to \$1.4 trillion. (*OFHEO annual report to Congress*, June 2003, page 2)

Credit losses and credit risk remain low

- Credit losses and credit risk indicators remained low for Fannie and Freddie. Combined Enterprise credit-related losses increased \$18 million, or 12 percent to \$166 million, due to higher charge-offs. Despite that increase, the Enterprises’ credit loss rates remained relatively unchanged from the previous year. Combined Enterprise estimated exposure to sudden 5 percent decline in house prices rose last year from \$788 million to \$874 million, but remained less than 2 percent of combined core capital. (*OFHEO annual report to Congress*, June 2003, page 2)

Fannie & Freddie met risk-based and minimum capital requirements

- Fannie and Freddie were considered adequately capitalized by OFHEO under its minimum and risk-based capital requirements. More detailed information on the capital requirements was included in Chapter 3 of OFHEO’s annual report. (*OFHEO annual report to Congress*, June 2003, page 3)

Fannie’s CEO Franklin Raines explains why his company’s securities have outperformed Freddie’s recently

Raines notes that Freddie’s prepayment speeds in its portfolio are lower than those held by other investors, while Fannie’s prepayment speeds in its portfolio and those held by investors have similar prepayment speeds

Fannie & Freddie have been accused of “cherry picking” the best mortgages -- keeping for its own portfolio the mortgages least likely to refinance

- As noted in the May 27, 2003 *GSE Report*, Freddie has been losing market share to Fannie. One reason often cited is that Fannie’s securities backed by pools of mortgages have dropped below those of similar Fannie bonds, because Freddie’s mortgage-backed securities are pre-paying a lot faster than Fannie’s. This has led to Freddie taking immediate action last month to rein the pace of home mortgage re-financings and slow down pre-payments to address the

market share loss. [See May 27, 2003 *GSE Report* for more details, www.gsereport.com]

- Fannie’s Chairman and CEO Franklin Raines further explained why Fannie’s securities have outperformed Freddie’s, reported Jody Shenn with the *American Banker*. Mortgage-backed securities “that we hold in portfolio or that investors hold have pretty much the same prepayment speed,” Raines said during a question-and-answer session after addressing a Sanford C. Bernstein conference. “That is not the truth for” Freddie’s securities, he said. The prepayment speed of the Freddie securities held in portfolio “have been much lower than that held by other investors, and I’m sure that’s had a negative impact as well.” (*American Banker*, Jody Shenn, 6/6/03)
- Freddie’s spokesman Douglas Robinson acknowledged there appears to be a difference in prepayment speeds between their mortgage-backed bonds held in Freddie’s portfolio and those held by investors, as indicated by their divergent liquidation rates. In April, the annualized liquidation rate for Fannie’s mortgage portfolio was 59.4%, compared with 50.8% for the securities it guarantees, most of which are held by investors – while Freddie’s retained portfolio was 49.2%, compared to 86.8% for its securities it guarantees, most of which are held by investors. (*American Banker*, Jody Shenn, 6/6/03)
- The implication is that Freddie’s investors have ended up with the least desirable securities of all those that Freddie guarantees. As Shenn pointed out, an earlier joint study released in January by the Treasury, OFHEO, and SEC noted that concerns had been raised about Fannie and Freddie “cherry-picking” the best mortgages for their own portfolios “thanks to their privileged information.” The report, however, found the argument “unpersuasive” and that “no evidence was brought forward of any impropriety in creating their portfolio mix.” (*American Banker*, Jody Shenn, 6/6/03) [See February 24, 2003 *GSE Report* for more information on the joint Treasury, OFHEO, and SEC report, www.gsereport.com A complete copy of the joint report can be found at: <http://www.ustreas.gov/press/releases/docs/disclosure.pdf>]
- As noted in the May 27, 2003 *GSE Report*, Freddie was accused of “cherry-picking” the best loans for its portfolio. “Everything Freddie Mac says it’s doing to improve their bonds, it’s all smokescreens,” said Kevin Jackson, a mortgage bond strategist at RBC Dain Rauscher. The real problem, Jackson said, is that Freddie is keeping for its own portfolio the mortgages least likely to refinance, and selling the rest to investors. “Freddie Mac is cherry picking. They take all the best mortgages for themselves,” Jackson said. Freddie said that its portfolio managers do not cherry pick, and have no information that isn’t available to other investors. (*Reuters*, Dan Wilchins, 5/22/03)

Correction

- The May 27, 2003 *GSE Report*, cited a May 23 *American Banker* story in which David Andrukonis, Freddie’s Senior Vice President for Capital Deployment in Freddie’s single-family division, was cited as stating that one way the company plans to “incent” lenders to deliver loans that pay off more slowly, is to reduce guarantee fees by 2 to 3 basis points for lenders whose portfolios have prepaid slowly. (*American Banker*, Erick Bergquist and Marc

Hochstein, 5/23/03) The *American Banker* issued a correction May 28 that said Andrukonis' statement was incorrectly paraphrased. Andrukonis reportedly said that Freddie would probably reduce by 2 to 3 basis points the yield, not the guarantee fees, on mortgage-backed securities for lenders whose portfolios were prepaid slower or faster than average. (*American Banker, Correction, 5/28/03*)

HUD plans to issue proposed rule in August on Fannie & Freddie's affordable housing goals

Administration encouraged HUD to strengthen Fannie & Freddie's affordable housing goals, noting that Fannie & Freddie lag the primary market in affordable housing

- According to HUD's semiannual regulatory agenda, the agency plans in August to propose affordable housing goals for Fannie and Freddie for calendar year 2004 forward. HUD said it plans to "make any necessary revisions" to the its rules "to ensure that the GSEs meet the laws' requirements and carry out their public missions." The current affordable housing goals apply through 2003. The comment period for the proposed rules is expected to end October 2003. HUD noted that the dates are estimates and are not commitments to act on or by the date. (*Federal Register, page 30390, 30397, 5/27/03*)

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

- President Bush's FY 2004 budget, released on February 3, noted: "Numerous studies by HUD and other researchers have shown that Fannie Mae and Freddie Mac generally have trailed the rest of the private mortgage market in funding mortgage loans for low-income and minority families. For example, during the 1997-1999 period, HUD estimates that while the home loans acquired by these Enterprises represented 36 percent of all new home buyer purchases, they represented only 15 percent of homes purchased by first-time minority families." (*Analytical Perspectives, Budget of the United States Government, Fiscal Year 2004, page 199*)

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

- President Bush's FY 2004 budget further noted: "HUD is also looking at new ways to encourage improved performance from the Enterprises. HUD's current rule established the Enterprises' housing goals for 2001-2003. In accordance with its rulemaking responsibilities, HUD is re-examining these housing goals to determine appropriate performance levels for the years 2004-2006. At the same time, HUD is looking at ways to create new housing goals incentives that will have the effect of increasing minority homeownership, thereby further ensuring that the benefits each Enterprise derives from its Congressional charter are used to increase minority homeownership opportunities." (*Analytical Perspectives, Budget of the United States Government, Fiscal Year 2004, page 199*)

HUD plans to issue a rule prohibiting Fannie & Freddie from purchasing certain loans with high cost or predatory features

- According to HUD's semiannual regulatory agenda, the agency, under its long-term actions, said it will establish regulatory restrictions, consistent with Fannie and Freddie's voluntary restrictions, which will prohibit the GSEs from purchasing certain loans with high costs and/or predatory features. HUD noted that a June 2000 HUD/Treasury report entitled "Curbing Predatory Home Mortgage Lending" noted that by providing a source of funding, entities that purchase or securitize loans with high cost and/or predatory features are, knowingly or unknowingly, supporting the activities of predatory loan originators. The report recommended regulatory restrictions that would prohibit Fannie and Freddie from purchasing certain types of loans with high costs and/or predatory features altogether. HUD has identified the timing for action on the proposed rule as "undetermined," which means the rule is still under review by HUD for which a determination of the next action has not yet been made. (*Federal Register*, page 30390, 30400, 5/27/03) [See June 23, 2000 *GSE Report* for more information on the HUD/Treasury joint report, www.gsereport.com]

HUD plans to issue a notice providing that certain data from Fannie & Freddie be publicly available

- According to HUD's semiannual regulatory agenda, the agency plans to issue a notice in June providing that certain loan-level mortgage data submitted by Fannie and Freddie to HUD be reclassified from proprietary to non-proprietary and made available to the public. HUD noted that all dates in its semiannual regulatory agenda are estimates and are not commitments to act on or by the date (*Federal Register*, page 30390, 30401, 5/27/03)

OFHEO plans to amend its minimum capital rule for Fannie & Freddie and amend its corporate governance regulations

- According to OFHEO's semiannual regulatory agenda, the agency plans to issue a notice of public rulemaking to amend its minimum capital rule for Fannie and Freddie "to accommodate changes in Generally Accepted Accounting Principles, clarify reporting requirements, and make supervisory monitoring of capital more transparent." OFHEO said it also plans to issue a notice of public rulemaking to amend its corporate governance regulation to incorporate changes in Federal law and standards affecting governance of public corporations. OFHEO provided no timetables for action. (*Federal Register*, pages 31168-31169, 5/27/03)

CCAGW, NTU, and Project on Government Oversight support Shays-Markey bill, which removes Fannie & Freddie's SEC exemption

- The Council for Citizens Against Waste (CCAGW) [the lobbying arm of Citizens Against Government Waste], the National Taxpayers Union (NTU) and Project on Government Oversight sent a May 22 letter to Congressional Members urging them to support HR 2022, the "Leave No Securities Behind Act," introduced by Congressmen Chris Shays (R-CT) and Ed Markey (D-MA). The groups argued that the bill would "close a gaping hole in US financial disclosure laws."
- Although the GSEs agreed last July to voluntarily register their stock with the SEC, that agreement did not apply to Fannie and Freddie's mortgage-backed securities, or MBS portfolio. "HR 2022 would close that loophole and make that voluntary agreement law." Fannie and Freddie guarantee more than 40 percent of the US mortgage market and benefit from \$10.6 billion in annual subsidies. Two companies "of such size and sway over the entire economy should not be permitted to decide autonomously when and what to disclose."
- "Contrary to the claims of GSE executives," the bill "will not impair the efficiency of the nation's mortgage markets and will have no negative impact on consumers." A joint report in January, 2003 by the Treasury Department, the Office of Federal Housing Enterprise Oversight and the SEC found that enhanced disclosure in the MBS market "could better enable investors to analyze and predict prepayments and other risks, which may help them to make more informed investment decisions." And, Federal Reserve Chairman Alan Greenspan has noted several times that Fannie and Freddie should be treated like any other publicly traded company.
- "HR 2022 will protect both investors and taxpayers. At a time when the adequacy of corporate governance and the importance of full disclosure are high on the public's agenda, we believe that Fannie Mae and Freddie Mac should no longer be allowed to escape established transparency rules." (*CCAGW, NTU, and Project on Government Oversight Dear Colleague Letter on Shays-Markey bill, 5/22/03*)

Bond Market Association to discuss the increasing CMO shelf and administration fees charged by Fannie & Freddie

Agency-backed deals cost dealers more than four times private-label deals

- The Bond Market Association's mortgage-and asset-backed securities businesses group is trying to address agency collateralized mortgage obligation (CMO) fees by combining the benefits of the agencies' excellent credit quality with the lower fee structures of the private-label market. The BMA, in a prepared statement, told *Bond Week* that it "is exploring the creation of a collective mechanism to facilitate the private label issuance of agency REMIC [Real Estate Mortgage Investment Conduit] securities by participating dealer members of the

association.” The differential in fees between triple-A agency guaranteed CMOs and triple-A private-label counterparts is substantial, with agency-backed deals costing dealers more than four times private-label deals.

- The basis for the BMA discussions are twofold--the first is the complaint of several dealers that they have not been given the to-be-announced (TBA) pass-through allocations they requested for their CMO deals. The second topic is the increasing CMO shelf and administration fees charged by Fannie and Freddie. Based on documents provided by a top-ranked CMO, updated March 3, a \$1 billion Fannie 30-year 6% deal would cost a dealer a minimum of \$1.9 million--\$530,000 to open the first \$250 million and \$190,000 per each additional \$100 million. A 5.5% or 5.75% coupon would be \$215,000 per additional \$100 million. In comparison, a \$1 billion prime collateral “private-label” deal would incur approximately \$450,000 worth of regulatory, legal, ratings and accounting fees, according to the same dealer's whole loan group.
- This fee differential, says one sell-sider involved with the discussions, “is clearly the most contentious aspect of discussions, and arguably the most futile, since Fannie and Freddie have very little incentive to work with us on it: they make big bucks with no risk.” An MBS veteran involved in the talks dissents, however, taking a more conciliatory approach. “The GSEs make plenty of dough doing this, but they have a lot of expenses and pressures a lot of Street guys don't take into account.”
- Another pro says discussions are embryonic, with any solution a very long time away. All agree that it is best for the discussions to be under the umbrella of the BMA, since, as one high-profile MBS sell-sider, “Freddie and Fannie would be absolutely ruthless if we did this unilaterally.” (*Bond Week*, Roddy Boyd, 3/31/03)

Fannie responds to Senator Sarbanes’ request to investigate Fairbanks

Fannie asks Fairbanks to refund money to borrowers and fix servicer defects

Freddie expected to respond shortly

- Senate Banking Committee Ranking Democrat Paul Sarbanes (D-MD) announced that Fannie has told Fairbanks Capital Corp., which services subprime mortgages, to refund money to borrowers and fix defects in some servicing practices. Senator Sarbanes called the agreement “almost unprecedented” and a “dramatic step toward preventing the abuses that have been so harmful to borrowers.” (*Dow Jones Newswire*, Dawn Kopecki, 6/4/03; *American Banker*, Michele Heller, 6/4/03)
- Senator Sarbanes urged Fannie and Freddie in a late March letter to investigate allegations of predatory loan-servicing practices at Fairbanks. Senator Sarbanes noted that Fairbanks was allegedly requiring borrowers to buy unneeded insurance and charging excessive fees. “Fairbanks...is reported to have caused some significant problems for a number of

homeowners...including double charges, unnecessary insurance being forcibly added to mortgages at great costs to consumers, escrow problems, and even foreclosure,” Senator Sarbanes wrote. (*American Banker*, Michele Heller, 4/8/03, 6/4/03)

- In a letter to Sarbanes, Fannie’s Chairman Franklin Raines said Fannie found that Fairbanks had some practices that were out of compliance under its servicing contract. “Problems included inadequate internal controls, inadequate customer responsiveness and dispute resolution practices, and the improper assessment of certain fees and charges,” Raines said. Fairbanks agreed to implement remedial actions and will not service any new Fannie-owned loans until those are fully implemented, he said. (*Dow Jones Newswire*, Dawn Kopecki, 6/4/03; *American Banker*, Michele Heller, 6/4/03) Excluded from this agreement are certain closed loans. (*MortgageDaily.com*, Anne Lineberry, 6/4/03)
- Fannie also required Fairbanks to “fairly compensate any borrowers charged inappropriate or improper fees,” and Fannie will keep its staff at Fairbanks’ offices to “closely evaluate Fairbanks’ progress in meeting the terms of our agreement” and will preview all foreclosure referrals before they are processed, Raines wrote. (*American Banker*, Michele Heller, 6/4/03; *Dow Jones Newswire*, Dawn Kopecki, 6/4/03)
- Many of Fairbanks's senior management positions have been changed in the past month and the company is changing its servicing processes, spokeswoman Haidee Schwartz told the paper. Fairbanks has also agreed to restructure its financing. (*Dow Jones Newswire*, Dawn Kopecki, 6/4/03)
- A spokeswoman for Freddie said the company is planning to respond to Senator Sarbanes “shortly.” (*American Banker*, Michele Heller, 6/4/03)
- HUD and the FTC are currently investigating allegations that Fairbanks overcharged and harassed customers. (*American Banker*, Michele Heller, 4/8/03)

FM Policy Focus writes letter-to-editor urging HUD to take immediate action to block Fannie’s PaymentPower™ program and establish a pre-clearance process to protect consumers
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- As noted in the May 27, 2003 *GSE Report*, FM Policy Focus formally petitioned HUD May 20 to block Fannie’s new program - “PaymentPower™.” Claiming that the program is an “entry by Fannie Mae into direct consumer loan origination,” FM Policy Focus “urged HUD to act quickly on its petition” and to institute a pre-clearance process that will protect American consumers, stop the GSEs from further encroachments into the primary mortgage market and into the general business of providing retail financial services. (*FM Policy Focus press release*, 5/20/03) [See May 27, 2003 *GSE Report* for more information on PaymentPower™, www.gsereport.com.]
- A May 27 *American Banker* article by Rob Garver noted reported that FM Policy Focus’ decision to use PaymentPower™ as its first criticism of the GSEs since undergoing a new

makeover “may lead to as many headaches for the lobbying group as for the GSEs.” Garver noted that several of FM Policy Focus’ complaints against Fannie’s PaymentPower™ program conflict with at least some of the business practices of FM Policy Focus members and that there were potential inconsistencies with FM Policy Focus’ comments about the OCC, adding that the OCC has not issued a rule or legal interpretation that these “skip-payment” programs are illegal for national banks. Garver also noted that bank attorneys were “hard-pressed” to equate honoring the skip-payment option with the origination of a new loan and that sources charged FM Policy Focus as misrepresenting PaymentPower’s™ pricing strategy. (*American Banker*, Rob Garver, 5/27/03)

FM Policy Focus Letter-to-the-Editor

- FM Policy Focus Executive Director Mike House, wrote a June 6 letter-to-the-editor in the *American Banker*, stating that the May 27 article had “numerous errors of fact.” House argued that PaymentPower™ puts Fannie into the loan origination business by providing a new extension of credit (and a new loan) to cover mortgage principal, interest, real estate taxes, and property insurance each time a borrower uses the skipped-payment option. This new loan not only capitalizes payments due to Fannie as the holder of the loan, but also to third parties for additional obligations over the life of the loan (i.e., taxes and insurance). House argued, “If Fannie can do PaymentPower, then in the future it could provide any add-on service after loan origination.” Unlike home equity lines of credit or other loan products, in PaymentPower, after Fannie purchases the mortgage, the lender/servicer does not make the new loan to cover the skipped payment. Instead, Fannie effectively makes the new loans for skipped principal, interest, taxes, and insurance.
- House wrote, “Nothing about this product makes it like the ‘loss mitigation’ products” cited by HUD as a reason why the agency has not reviewed the product. Under PaymentPower, a borrower can skip a payment as soon as four months after mortgage origination and the loan must be current for a payment to be skipped – “ensuring there is no loss to be mitigated.” Further the loan may be used for a wide range of desires, including vacations and “investments.” House wrote, “Sounds to us like direct competition from Fannie Mae for a wide range of traditional financial products - credit cards, home equity loans, and even margin loans.”
- “Banks can, and do, make lots of loans with skipped-payment features, but they then must do so (as the OCC states in your story) in conjunction with prudent underwriting standards. The OCC does not, however, permit national banks to offer skip-a-payment plans pursuant to its broader decision to permit national banks to offer products otherwise considered credit insurance,” House argued. House further took issue with quotes by unnamed sources saying that the group misrepresented the pricing of the product.
- House concluded, “FM Policy Focus' main concern is this: HUD should pre-clear new GSE programs like this, as required under existing law, to ensure that Fannie Mae and Freddie Mac engage in only those activities that further their secondary market mission without posing undue risk to taxpayers and consumers. All insured depositories and financial holding companies must get regulatory clearance for new programs... The two housing GSEs exercise

far more market power than any bank or savings association, and their huge size also creates significant systemic risk. Congress intended that the GSEs use their manifest taxpayer-subsidized benefits to promote affordable housing through a liquid secondary market. Effective regulation that ensures appropriate prior review of new programs is vital to this goal.” (Mike House, Executive Director, FM Policy Focus, Letter to the Editor, *American Banker*, 6/6/03)

Fannie Mae and Freddie Mac

Why not shift OFHEO into the Treasury? suggests John Connor with *Dow Jones Newswire*

- John Connor with *Dow Jones Newswire* noted that in a recent letter to Congressman Richard Baker (R-LA), Treasury Under Secretary for Domestic Finance Peter Fisher said in part that “we think that Congress could usefully consider the powers and resources of both the Office of Federal Housing Enterprise Oversight and the Federal Housing Finance Board and/or whether structural changes might improve the effectiveness of our oversight and regulation of the government-sponsored enterprises and other financial institutions.” In response, Connor suggested putting OFHEO within the Treasury Department.
- “OFHEO, while staffed by fine and dedicated people, doesn’t appear to have a lot of friends. Those who are hostile toward Fannie Mae and Freddie Mac like to whack OFHEO as a way of getting at the two firms, and those who adore and/or are beholden to Fannie and Freddie, or petrified of them, aren’t clamoring for strong regulation of the sort that could discomfort the regulated entities,” wrote Connor.
- “Putting OFHEO within the Treasury Department arguably would give it a big league blocker and flack catcher and an institutional home in what many people consider one of the finest departments in the federal government. It’s hard to imagine that OFHEO would be subject to the Congressional appropriations process...if it was tucked with Treasury, or that it would have taken longer than the Manhattan Project to finalize the risk-based capital rule [for Fannie and Freddie].” (*Dow Jones Newswire*, John Connor, 6/2/03)

Mortgage Servicing News notes “expect a ‘charter move’” by Fannie or Freddie in “near future”

- Paul Muolo, Executive Editor of both *Mortgage Servicing News* and *National Mortgage News*, noted that “in time” either Fannie or Freddie “will make a charter move, probably within five years.” He added, “What exactly that move will involve, I don’t know. It may entail a complete relinquishment of the charter or some type of change that would allow one of the firms to enter new business lines or markets while keeping some portion of the charter...Rest assured, the day is coming.” (*Mortgage Servicing News*, Paul Muolo, 5/16/03)

US Banker article calls Fannie & Freddie “out of step”

- In an extensive cover story by John Engen in the *US Banker* called “Out of Step,” Engen noted that Fannie and Freddie receive numerous benefits from their GSE status that give Fannie and Freddie a “gargantuan advantage in the market” over their private-sector competitors. “For the better part of a decade, bankers have nervously eyed the steady expansion” of Fannie and Freddie, “arguably with good reason.” As GSEs, Fannie and Freddie receive numerous benefits including: (1) exemption from state and local taxes; (2) exemption from registering most securities with the SEC; (3) sharply lower capital requirement; (4) access to the Fed’s electronic funds transfer system; (5) \$2.5 billion line of credit from the Treasury Department; and (5) the market’s perception that their debt issuances are backed by the government. With Fannie and Freddie’s share of the conventional mortgage market reaction saturation levels, bankers say Fannie and Freddie must expand beyond their core mandate to keep shareholders happy. “If and when they do, the advantages of government sponsorship will make them formidable competitors.” This “mission creep” has “most bankers seeing red-and scrambling to get out from underfoot.” Engen concluded that “Despite the big bank protests, the GSEs’ advantages appear secure for now... Given the meaty challenges facing lawmakers, it seems even less likely to garner much attention.” (*US Banker*, John Engen, May 2003)

Fannie & Freddie purchase 37 percent of total multi-family investments for first quarter 2003

Critics accuse Fannie & Freddie of pumping too much money into the multi-family market, encouraging over-construction

- The Mortgage Bankers Association reported that mortgage bankers originated \$18.9 billion in new commercial/multi-family mortgages in the first quarter of 2003, according to the MBA’s quarterly survey of key commercial members. The \$18.9 billion volume was 38 percent higher than for the same period a year earlier. While the first-quarter lending pace fell noticeably from the \$29.4 billion reported for the fourth quarter of last year, a decrease is normally seen in the year after the customary surge in year-end activity.
- The first quarter increase was buoyed by marked increases in investments in commercial mortgages by CMBS conduits (up \$3.2 billion or 86 percent from a year earlier) and by commercial banks (up \$967 million or 50 percent). Other sectors registering increases included credit companies and pension funds. Life insurance company activity was little changed from a year earlier. Life insurance companies and commercial banks each purchased 15 percent of the loans originated in the survey. Participating mortgage bankers reported that investments by Fannie and Freddie were down markedly from a year earlier. Together, Fannie and Freddie accounted for purchases of 37 percent of total multi-family originations during the first quarter of 2003. A year ago, the comparable figure was just more than 50 percent. (*MBA press release, 5/20/03*)

Critics accuse Fannie & Freddie of pumping too much money into the multi-family market, encouraging over-construction

- Fannie spent \$20 billion on multi-family mortgage debt and equity in 2002, an equal amount in 2001 and expects to spend \$175 billion more by 2010. Freddie spent \$14.5 billion in 2002 and \$12.3 billion in 2001. Critics say Fannie and Freddie are pumping too much liquidity into the multi-family market, encouraging over-construction. But the *ABA Banking Journal* noted that over-construction usually means lower rents, thereby satisfying GSE federal mandates to expand the availability of low-cost housing. (*ABA Banking Journal*, James Peterson, contributing editor, 5/03)

OFHEO asks for comments on its Strategic Plan

- OFHEO is seeking comments as it updates its Strategic Plan. OFHEO is currently developing its 2003-2008 Strategic Plan and is soliciting the views and suggestions of those entities potentially affected by or interested in the plan. Comments are due June 18, 2003. OFHEO's current Strategic Plan, for 2000-2005 may be viewed on OFHEO's Web site at <http://www.ofheo.gov> in the "About OFHEO" section. (*Federal Register*, pages 33520-33521, 6/4/03)

GSE debt news:

- (1) Federal agency short-term debt and long-term debt increase in first quarter 2003
- (2) Fannie & Freddie are limiting sales of their debt in 2003
- (3) Foreign central banks increase their holdings of agency debt
- (4) FHLBanks' bonds trade at lower prices than comparable Fannie or Freddie bonds
- (5) Fannie permanently extends its long-term funding desk hours to benefit international investors

Federal agency short-term and long-term debt increase in first quarter 2003

- Federal agencies increased long-term new issue volume to \$344.6 billion in the first three months of the year, according to a report by the Bond Market Association (BMA), up 43.5 percent from the \$240.1 billion issued in the same period last year. The increase in issuance activity in the first quarter was attributable to increased activity in the home mortgage market. Long-term issuance by the FHLBanks, Fannie Mae, Sallie Mae and the Farm Credit System increased. Freddie and the TVA's long-term issuance declined. The FHLBanks led the way with \$176.9 billion in new-issue sales, up from the \$90.6 billion issued during the first quarter 2002. Issuance activity was also driven by growth in Fannie and Freddie's retained mortgage portfolios. Fannie's retained mortgage portfolio increased 12.5 percent, to \$823.3 billion as of March 2003, up from the \$731.9 billion at the end of the first quarter last year. Freddie's retained mortgage portfolio totaled \$568.2 billion as of March 2003, up 8 percent from the \$526.1 billion at the same time last year. (*Research Quarterly, Bond Market Association*, 5/2003)

Long-term federal agency debt issuance:

\$ billions	2002	2002: Q1	2003: Q1	YTD-to-YTD %Change	YTD-to-YTD \$Change
FHLB	435.4	90.6	176.9	95.3%	86.3
Freddie Mac	295.5	75.5	66.8	-11.5%	(8.7)
Fannie Mae	238.5	61.9	76.5	23.6%	14.6
Sallie Mae	20.5	4.7	5.2	10.6%	0.5
Farm Credit System	50.1	7.2	19.1	165.3%	11.9
Tennessee Valley Authority	1.5	0.2	0.1	-29.0%	(0.1)
Totals	1041.5	240.1	344.6	43.5%	104.5

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

- Short-term federal agency debt outstanding increased to \$678.2 billion as of March 2003, up 1.5 percent from the \$668.5 billion outstanding at the end of December. (*Research Quarterly, Bond Market Association, May 2003*)

Short-term federal agency debt outstanding:

\$ billions	3/31/02	12/31/02	3/31/03	% Change *	\$Change *
FHLB	128.3	147.0	143.0	-2.7%	(4.0)
Freddie Mac	212.5	164.1	174.0	6.0%	9.9
Fannie Mae	270.7	303.8	318.0	4.0%	14.2
Sallie Mae	30.7	25.6	23.8	-7.0%	(1.8)
Farm Credit System	34.8	24.8	16.1	-35.1%	(8.7)
Tennessee Valley Authority	1.8	3.2	3.3	3.1%	0.1
Totals	678.8	668.5	678.2	1.5%	9.7

* Percentage and amount change between 3/31/03 and 12/31/02

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

- Issuance of agency MBS increased to \$502.6 billion in the first quarter of 2003, up 39.5% from the \$360.2 billion issued in the first quarter of 2002. However, issuance decreased slightly from the \$509.6 billion during the fourth quarter of 2002. Fannie led the way with \$292.6 billion in MBS during the first quarter of 2003, up 66.4 percent from the \$176.0 billion issued the same time last year. Issuance of Freddie's MBS increased 15.1 percent from a year ago, to \$160.0 billion in the first quarter of 2003. Freddie's MBS issuance declined 18.8 percent, however, when compared to the fourth quarter of 2002. Ginnie Mae's MBS new issue activity totaled \$50.8 billion in the first quarter, up 12.4 percent from the

\$45.2 billion issued in the first quarter of 2002. (*Research Quarterly, Bond Market Association*, May 2003)

- Issuance of agency collateralized mortgage obligations (CMO) increased to \$179.9 billion in the first quarter of 2003, up 40.7 percent from the \$127.9 billion issued last year. An increase in prepayment rates contributed to the increase in agency CMO issuance in the first quarter. Freddie saw the largest issuance volume in the period totaling \$107.1 billion, up 38.7 percent from the \$77.2 billion issued in the first quarter of 2002. Fannie's CMO issuance increased to \$51.4 billion, up from the \$36.8 billion issued in the first quarter of 2002. Issuance of Ginnie Mae's CMO increased 54.0 percent, to \$21.4 billion in the first quarter, up from the \$13.9 billion issued one year ago. (*Research Quarterly, Bond Market Association*, May 2003)

Fannie & Freddie are limiting sales of their debt in 2003

- Fannie and Freddie are limiting sales of their agency debt to the minimum amounts they announced in 2002 for this year's borrowings. Record US home refinancings and costly mortgage assets are slowing down Fannie and Freddie's long-term borrowing needs. Fannie and Freddie are slowing the growth of their investment portfolios, buying fewer home loans and mortgage-backed securities, and as a result are limiting sales of their debt. "If we're not buying, we don't need to borrow" as much, said Phil Guth, Freddie's senior director of global debt funding. Fannie and Freddie will keep relying more heavily on callable debt, which better matches their assets when mortgages are rapidly prepaying. "Net supply in agencies has vaporized," said Merrill Lynch, which forecasted a 35 percent drop in total net agency issuance to \$150 billion this year, due mainly to slowing retained portfolio growth. Merrill estimated that net Fannie and Freddie supply in April dissipated to \$13 billion from \$93 billion in the same period last year. Gross agency issuance, in contrast, "has truly been breathtaking," increasing 40 percent through April from last year's record pace to \$433 billion, said Merrill fixed-income strategist Rajiv Setia. (*Reuters*, Lynn Adler, 5/23/03)

Foreign central banks increase their holdings of agency debt

- The Fed's custody of US agencies for foreign central banks rose about \$3 billion in the latest reporting week to a record \$187.45 billion on May 28. Foreigners bought about \$49 billion of agency debt in the first quarter of 2003, a 46 percent increase from \$33.6 billion in the same period last year. The Treasury had said previously that foreigners purchased \$192 billion of agency debt in 2002, compared with \$83 billion of Treasuries and \$182 billion of corporates. (*Reuters*, Lynn Adler, 5/30/03)

FHLBanks' bonds trade at lower prices than comparable Fannie or Freddie bonds

- There are key differences in the way the FHLBanks and Fannie and Freddie organize their debt issuance, and that's reflected in their bond prices, reported *Dow Jones Newswire*. Some of the FHLBanks' bonds currently trade at lower prices than comparable Fannie or Freddie bonds. One of the disadvantages of holding FHLBank securities is its unpredictable debt issuance. Unlike Fannie or Freddie, the FHLBanks have no financing calendar and offerings are often launched less than 24 hours before pricing. Currently the FHLBanks' three-year global debt trades about 2.5 basis points cheaper than Fannie's comparable three-year notes.

The article noted that there is also the issue of selecting underwriters. The FHLBank selects its underwriters based on who will give them the best deal. Earlier this year, FHLBank deals went through a series of weak secondary support by primary underwriters. However, the FHLBanks' long-end global issues are very popular among some investors. "FHLB's global debt offerings generally get a good market response and trade similarly to where comparable Fannie Mae and Freddie Mac debt trades," said Andy Brenner, head of global fixed income at Investec Ernst and Company in New York. And on the long end, the system's bonds have a certain scarcity value. (*Dow Jones Newswire*, Julie Haviv, 5/30/03)

Fannie permanently extends its long-term funding desk hours to benefit international investors

- Fannie announced June 3 that it is permanently extending its long-term funding desk hours to benefit international investors. The company noted that the funding desk hours, extended on a trial basis earlier this year to 5:00 a.m. EST, provided international investors the opportunity to execute new issue, long-term debt securities through dealer underwriters on a real-time basis more closely aligned with their own trading hours. Fannie believes that the extended hours will also help position Fannie's debt structures as an integral part of the daily international trading picture, providing international traders with a better understanding of how these products can address the portfolio needs of their clients. "We will continue to issue long-term debt securities with a primary focus on callable debt securities during these expanded hours," said Fannie Mae Senior Vice President and Treasurer Linda Knight. "The securities will be issued in response to reverse inquiry from investors communicated through dealers who underwrite debt securities for Fannie Mae. All Benchmark Securities® will continue to be priced during New York trading hours in accordance with the Benchmark Securities calendar." (*Fannie press release*, 6/3/03)

OFHEO celebrates its 10-year anniversary by updating its logo and web site
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- OFHEI Director Armando Falcon, Jr. marked the 10-year anniversary of OFHEO by unveiling an updated web site and logo. OFHEO's updated web site at www.ofheo.gov includes two new major features: A section where Fannie and Freddie's disclosures will be posted, and an interactive House Price Calculator, to estimate the value of a home by state, city or region. OFHEO issued a final rule June 2 updating its logo for its 10-year anniversary. OFHEO noted that over the past ten years, OFHEO "has met and continues to meet its mandate to ensure that the Enterprises are well-capitalized and operating in a safe and sound manner. Accordingly, on the occasion of OFHEO's successful completion of a range of regulatory duties and its 10 year anniversary, the Agency has determined to update its logo." OFHEO noted that the triangle representing the roof of the current logo has now been property centered. "In a sense, the roof of the logo, like OFHEO, has been strengthened and put in good working order. OFHEO looks forward to continued success." (*Dow Jones Newswire*, John Connor, 6/2/03; *Federal Register*, pages 32627-32629, 6/2/03; *OFHEO press release*, 6/3/03)

Fannie Mae

Fannie introduces new mortgage product for military personnel that will compete with VA loans

- Fannie announced the Home Front Mortgage, a new \$5 million mortgage pilot designed to help active duty military personnel stationed at Fort Campbell purchase homes in Tennessee or Kentucky. The Fort Campbell Federal Credit Union (FCFCU) is offering the product in conjunction with Affordable Housing Resources, a nonprofit housing organization. Fannie has committed to purchase \$5 million in eligible mortgages originated by FCFCU. The product features no downpayment requirement and would aid people who might otherwise have trouble borrowing money because they carry too much debt, said John Moorhead, CEO of the FCFCU. Moorhead said homebuyers typically have trouble obtaining conventional loans if more than 36 percent of their income goes toward paying off their debt. But military personnel can obtain these loans if up to 45 percent of their income goes toward paying off the mortgage debt and other debt, he said. Military personnel can currently obtain mortgage loans that don't require downpayments and are backed by the Department of Veterans Affairs, but applicants must pay fees associated with these loans. The fees increase the second time military personnel try to secure the loans, penalizing the many people in the military who move because of their service. (*Fannie press release, 5/28/03; Associated Press, 5/27/03*)

Fannie raises its origination forecast for 2003 to a 42% increase over 2002

- Fannie raised its forecast for mortgage originations in 2003 by 12 percent to \$3.7 trillion, as a decline in home loan rates should spark more refinancings and home sales. Fannie's prior estimate was a record \$3.3 trillion, 27 percent more than 2002 a record year. The new volume would outstrip 2002's mortgage origination record of \$2.6 billion by 42 percent, according to Fannie's chief economist David Berson. Fannie also forecast new records for mortgage refinancings and home sales. Refinancings should account for \$2.59 trillion of the year's loan creation, nearly matching last year's total production.
- "We project a rise in refinance originations of 61 percent to an astounding \$2.59 trillion. This by itself is almost as large as last year's total origination figure," Berson said. Longer term, however, when the economy's health returns and interest rates begin to rise, home loan creation will trail off as refinancings become less appealing. "We continue to project a sharp falloff in originations in 2004, as the refi boom comes to an end – down by 45 percent to a still strong \$2 trillion," Berson said. Even if refinancings decrease next year, that annual home loan volume would be the fourth highest ever, behind \$3.7 trillion this year, \$2.6 trillion last year, and \$2.03 trillion in 2001, according to Fannie. Total mortgage debt outstanding is expected to increase in 2003 by 10 percent to \$7.1 trillion, according to Berson. The company said it expects to grow faster than 8-10 percent growth in mortgage debt outstanding through the decade by increasing market share. (*Reuters, Lynn Adler, 6/2/03; Market News International, 6/2/03; Bloomberg News, Al Yoon, 6/2/03*)

Deputy campaign manager for Cong. Gephardt's (D-MO) presidential campaign to lobby for Fannie

- Steve Elmendorf, former chief of staff to Congressman Gephardt, has signed on with Fannie as a lobbyist. Elmendorf is currently the deputy campaign manager for Gephardt's presidential campaign. (*The Hotline*, 6/2/03; *The Hill*, 6/3/03)

Fannie to open new office space in Maryland

- Fannie will open a new office near Frederick, MD in 2005, providing 200 jobs, according to Fannie spokesman Alfred King. Fannie officials, however, have not determined how many of the jobs will be new and how many will be transferred from offices in Washington, Reston, VA, and Herndon, VA. "It will probably be some combination of both," he said. King said the building would be a "technology facility," but did not elaborate, citing security concerns. Fannie has signed a letter of intent to buy 39 acres for up to 750,000 square feet of employment space. (*Associated Press*, 5/16/03)
- As noted in the April 7, 2003 *GSE Report*, Fannie was searching for up to 210,000 square feet of office space in Montgomery or Frederick counties in Maryland to develop its own data center and office building. Reports were that Fannie wanted to build a 100,000-120,000 square foot \$130 million data center and a neighboring 90,000 square foot office space. Sources said Fannie planned to invest at least \$130 million in the data center, which needs to be up and running by the end of 2004. (*Washington Business Journal*, 3/14/03)

Freddie Mac

Freddie enhances its fixed-floating rate financing option for multi-family customers

- Freddie announced that it has financed \$2 billion in multi-family mortgages with its Fixed-to-Float option, introduced May 2002, and will now offer additional loan maturity terms to the product. Freddie is adding 6-, 8- and 9-year fixed-rate terms to the product, in addition to the 10-year term that has been available for this product, to enable customers to secure financing at multiple points along the yield curve. At the end of the term of a Fixed-to-Float mortgage, the borrower can extend the loan for one year. If the borrower extends, the rate converts to 250 basis points over the one-month Freddie reference bill, a benchmark that according to Freddie, historically has been 10 to 15 basis points lower than the London Interbank Offered Rate, the usual floating-rate index. (*Freddie press release*, 6/2/03; *American Banker*, Marc Hochstein, 6/4/03)

Federal Home Loan Banks

More than a dozen issuers of non-housing tax-exempt bonds backed by FHLBanks' standby letters of credit have approached the IRS to voluntarily enter into settlements

IRS has determined that these bond issues constitute an illegal federal guarantee

- The IRS gave issuers of non-housing tax-exempt bonds backed by FHLBanks' standby letters of credit until April to enter the voluntary compliance agreement program (VCAP), or face audits after determining that letters of credit constitute an illegal federal guarantee that does not qualify for tax-exempt status. Issuers that complied faced a fine determined by a formula in which a 29 percent tax is imposed on the interest earned, with 30 percent of that amount then owed to the IRS. (*Bond Buyer*, Susanna Duff, 6/3/03) "Closing agreement" is IRS parlance for a settlement that enables the agency to recoup some of the money from problematic municipal bond deals and allows the bonds involved to remain tax-free. (*Dow Jones Newswire*, John Connor, 5/30/03)
- Mark Scott, head of the IRS' tax-exempt bond enforcement program, told *Dow Jones Newswire*, that parties involved in a dozen or more of these FHLBank standby letter of credit bond deals have come to the IRS to benefit from the agency's VCAP program for municipal bonds. Scott declined to discuss specific transactions, but noted that at least one agreement has been completed and that a number of others are "close to done." (*Dow Jones Newswire*, John Connor, 5/30/03)
- As noted in previous GSE Reports, the Illinois Development Finance Authority was the first to settle with the IRS over state and local bonds supported by standby letters of credit from the FHLBanks. The 12 FHLBanks have been lobbying to make the enhancements legal, while the Association of Financial Guaranty Insurers (AFGI) has asked Congress and the Treasury Department to block the FHLBanks from changing the tax code in favor of the FHLBanks. [See April 7 and April 21, 2003 *GSE Reports* for more information, www.gsereport.com]

Farm Credit Administration/Farmer Mac

Farm Credit System lenders urge FCA to loosen restrictions on lending to part-time farmers

Stiff opposition expected from community bankers

FCA asks for comment on whether to revise its regulations

- Farm Credit System lenders are urging the Farm Credit Administration (FCA) to loosen restrictions on lending to part-time farmers, a move which community bankers are expected to oppose. Community bankers have complained for years that Farm Credit lenders are now competing with banks for higher-quality loans instead of fulfilling their mission of lending to small farmers. Farm Credit lenders, however, have argued that it is more difficult for them to meet that obligation, as a greater number of small farmers now depend on off-farm income to sustain their farms, but current rules allow them to make a loan to a part-time farmer only if the loan is used primarily for agriculture. (*American Banker*, Ben Jackson, 5/30/03)
- The FCA is holding a public hearing on the issue on June 26 and issued an advance notice of proposed rulemaking May 2. In an interview with the *American Banker*, Michael Reyna, FCA Chairman and CEO, said that its three-member board is not leaning one way or the other on the issue. “We have not committed to change the rule. We have committed to exploring the rule,” he said. (*American Banker*, Ben Jackson, 5/30/03)
- FCA issued an advance notice of proposed rulemaking May 2 to consider whether to revise its regulations governing the eligibility and scope of financing for farmers, ranchers, or harvesters who borrow from Farm Credit System institutions. The FCA is also considering whether to revise its regulatory definition of “moderately priced” rural housing. Comments are due by July 31, 2003. The FCA started the rulemaking in response to several petitions. FCA wants to know if the definition of a bona fide farmer, rancher, or aquatic producer should be changed and is investigating whether limits should be placed on lending for producers’ other credit needs, and how access to these needs should be regulated. The FCA is also considering how to regulate access to the other credit needs of eligible farmers who derive most of their income from off-farm sources and whether the FCA should retain the current regulatory distinction between full-time and part-time farmers. (*BNA Daily Report for Executives*, Marcia Kass, 5/2/03; *Federal Register*, pages 23425-23427, 5/2/03; *FCA press release*, 5/6/03)

FCA considers new rules for Farmer Mac’s non-mission investments, its policies and operations for young, beginning and smaller farmers and ranchers, its capital requirements, and disclosures to shareholders

FCA considers new rules for Farmer Mac’s non-mission investments

- According to FCA’s semiannual regulatory agenda, the FCA is planning to issue a notice of

public rulemaking October 2003 that would propose liquidity standards and regulatory limits for non-mission investments permitted by Farmer Mac. (*Federal Register*, page 31302, 5/27/03)

FCA may revise its policies and operations for young, beginning and smaller farmers and ranchers

- FCA said it plans to revise its loan policies and operations for young, beginning, and small farmers and ranchers. The FCA received comments last year on its advance notice of public rulemaking and held a public hearing on the issue in October of last year. The FCA plans to issue a notice of public rulemaking in June 2003, with a final rule by March 2004. (*Federal Register*, page 31301, 5/27/03)

FCA considers rulemaking on Farmer Mac's capital

- FCA plans to issue a notice of public rulemaking September 2004 to review the net collateral ratio requirement for Farm Credit banks and consider a capital leverage ratio for other Farm Credit System institutions. (*Federal Register*, page 31301, 5/27/03) FCA plans to issue a notice of public rulemaking June 2004 to revise the capital risk weightings of assets consistent with the other Federal bank regulatory agencies and other risk-weighting issues affecting System institutions. (*Federal Register*, page 31301, 5/27/03) FCA plans to issue a notice of public rulemaking April 2004 that would revise and clarify existing risk-based capital regulatory standards for Farmer Mac. (*Federal Register*, page 31302, 5/27/03)

FCA considers revising its disclosures for shareholders

- The FCA listed a “disclosure to shareholders” agenda item but said the timing of the notice of public rulemaking was “to be determined.” (*Dow Jones Newswire*, John Connor, 5/27/03; *Federal Register*, page 31304, 5/27/03)

Postal Service

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

- The Supreme Court said May 27 that it will decide next year whether the Postal Service can be sued for antitrust violations. The case is *US Postal Service v. Flamingo Industries, Ltd.*, 02-1290. (*Associated Press*, Gina Holland, 5/27/03) Flamingo Industries, 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. The US District Court for the Northern District of California dismissed the antitrust claims, saying that Congress didn't intend to impose antitrust liability on the quasi-governmental Postal Service. However, the US Court of Appeals for the Ninth Circuit, in San Francisco, ruled that for legal purposes the

Postal Service is a “person” subject to such antitrust suits. (*Wall Street Journal*, Robert Greenberger, 5/28/03; *Dow Jones Newswire*, Mark Anderson, 5/27/03)

- The Justice Department filed the appeal on behalf of the Postal Service. The appeal argued that the Postal Service has a “manifestly governmental character” and that allowing it to be sued under antitrust laws would allow expensive litigation that “could undermine the ability of the Postal Service to carry out its legislative mandate to provide universal mail service at reasonable rates.” Flamingo Industries argued in court briefs that Congress has allowed the Postal Service to be sued and that antitrust allegations are not exempt. (*Dow Jones Newswire*, Mark Anderson, 5/27/03) “Preventing the Postal Service from anticompetitive behavior would further, not hinder, Congress’ intent that the Postal Service compete on an equal footing with entities such as Federal Express and UPS,” Flamingo’s attorney Harold Kent said in a filing. (Associated Press, Gina Holland, 5/27/03)
- United Parcel Service Inc. said it “believes the [Postal Service] should be subjected to the same antitrust scrutiny as the private-sector entities with which it competes.” (*Wall Street Journal*, Robert Greenberger, 5/28/03)

Presidential Postal Reform Commission holds public meeting May 28-29 in Washington, DC

Commission to hold two more meetings before releasing its report July 31

- The Presidential Postal Reform Commission held two days of public meetings on May 28 and May 29 in Washington, DC. (*President’s Commission on the US Postal Service web site*, <http://www.treas.gov/offices/domestic-finance/usps/>) Topics included the agency’s financial outlook, pricing issues, employee benefits and postal reform. (*DM News*, Melissa Campanelli, 5/29/03)

May 28 hearing

- Winthrop Watson, Managing Director at JP Morgan Chase, said current trends suggest that large rate increases will be needed in the future to maintain the Postal Service’s break-even mandate and that if the Postal Service were a private company, it would need considerably more operating and financial flexibility to make it in today’s environment, according to The Association for Postal Commerce (postcom.org). (*DM News*, Melissa Campanelli, 5/29/03; *postcom.org web site*)
- Michael Bradley, an economist often used by the Postal Service for rate cases, said that the Postal Service goes to 94% of its 140 million addresses everyday and that the economics of this network structure is fairly unique, according to postcom. (*DM News*, Melissa Campanelli, 5/29/03; *postcom.org web site*) The Postal Service is able to attribute 58 percent of its annual costs, which leaves approximately \$30 billion non-attributable. Two-thirds of the non-attributable costs come from the Postal Service’s delivery and retail network. Bradley said the Postal Service has been trying to improve its attributable costs and have

conducted studies on the issue. When Commission co-chair Harry Pearce suggested to Bradley that the Postal Service's cost system is "murky at best," Bradley said he urges the commission not to mandate a set cost attribution rate. (*BNA Daily Report for Executives*, Derrick Cain, 5/29/03)

- James Holsen, VP of Industrial Engineering for UPS, said that his company can attribute 95 percent of its costs. While developing price attribution is difficult, it is not impossible, and is necessary in the private sector. Commission co-chair Harry Pearce asked Holsen about the size differential between UPS and the Postal Service in regards to determining costs – the Postal Service hits about 140 million addresses annually compared to about 7 million at UPS. Holsen said, "Size is not an issue for breaking down costs," and noted that UPS has been doing such attribution since it was a much smaller company. (*BNA Daily Report for Executives*, Derrick Cain, 5/29/03)
- Tom Rand, Aon Consulting, said postal workers receive benefits that are 25 percent more generous than those provided in the private sector, according to postcom. He also said that postal workers are protected from adverse effects of inflation, and that they can retire at full benefits at 55, something rare in the private sector. (*DM News*, Melissa Campanelli, 5/29/03; *postcom.org web site*)
- William Clay (former House post office and civil service committee chairman), Chairman, Consumer Alliance for Postal Services (CAPS), said the universal service includes all of the Postal Service's current services and he advocated no major changes to postal reform. (*BNA Daily Report for Executives*, Derrick Cain, 5/29/03) Clay opposes the closing of postal facilities without public involvement and opposes reductions in the frequency of mail delivery. He does not believe that technology is making mail service obsolete. Business mailers are given unwarranted discounts for their mail, and encouraged the Commission to determine to what extent bulk mailers are not paying their fair share. (*DM News*, Melissa Campanelli, 5/29/03; *postcom.org web site*)
- Jim Martin, President, 60 Plus Association, recommended that the Postal Rate Commission be strengthened and a "senior" added to the governing board. He believes that the Postal Service should get back to the core business of delivering the mail, and forget Priority and Express Mail. (*postcom.org web site*)
- Gary Mulloy, Chairman and CEO, Advo, said the Postal Service should be changed from an operational focus to a market-based focus and that negotiated service agreements should be expanded. Universal service is the Postal Service's "proud burden" as well as its competitive advantage. (*postcom.org web site*)
- James O'Brien, Dir., Distribution and Postal Affairs, Time Inc., said that current rates do not reflect the actual costs of service and that rates must be de-averaged and unbundled to reflect true costs. (*postcom.org web site*)

- Max Heath, National Newspaper Association, recommended continued work-sharing, particularly for local delivery. The group opposes negotiated service agreements based on volume. (*postcom.org web site*)
- Guy Wendler, American Business Media, argued that the Postal Service lacks the necessary flexibility to control costs. He recommended using the military's base closing model for postal facilities and argued that the Commission should be provided subpoena power. (*postcom.org web site*)
- Brad Nathan, President, Quebecor World Logistics, said outsourcing initiatives should be expanded and that the Postal Service be given more flexibility in transportation management. (*postcom.org web site*)
- The Commission posted the full written testimony of the witnesses at the May 28 hearing at: <http://www.treas.gov/offices/domesticfinance/usps/meetings/witness0528.html>

May 29 hearing

- David Walker, US Comptroller General of the GAO, said the ability of the Postal Service to remain financially viable is at risk because mail volume growth has stagnated and its business model is not well suited to operate efficiently in a competitive environment. The Postal Service has made improvements on its own, but its plan "doesn't go far enough." Walker suggested major changes in the role and mission of the Postal Service, given that the Internet and private companies are performing basic postal functions. He also suggested more flexibility and incentives to increase revenues, cut costs, and address the long-term health plans of the workers and retirees. He further suggested better labor-management relations. (*National Journal's Congress Daily*, Michael Posner, 5/29/03) Walker urged the Commission to consider SEC reporting requirements as a possible guide for improving the transparency of the Postal Service's financial and operating performance. (*Dow Jones Newswire*, John Connor, 5/29/03)
- Postmaster General John Potter, said if the Postal Service is to be run like a business, it needs the freedom to set its prices like a business. He believes that the complex 16-month process involved in setting rates hampers the agency. He suggested that the Postal Service's governing board be allowed to set prices for mail service, with an after-the-fact review by an outside agency. Potter also recommended setting aside the requirement that the Postal Service break even and allow it to retain earnings in good years to help cover losses in other years; include benefits, not just wages and work rules, in contract negotiations and streamline the collective bargaining process; and eliminate restrictions on closing post offices and relocating or consolidating mail facilities. If those steps do not work, he further suggested reducing the number of days mail is delivered; relaxing on-time delivery standards; considering other sources of income; asking nonprofit agencies to pay a larger share of the mail costs; and having taxpayers assume the burden of paying for universal service. (*Associated Press*, Randolph Schmid, 5/29/03)

- Vincent Palladino, President, National Association of Postal Supervisors, said the Postal Service needs the ability to consolidate and close postal facilities without congressional interference and that performance-based compensation should be extended to the entire postal workforce. (*postcom.org web site*)
- Jane Weizman, consultant to the Commission from Watson Wyatt Worldwide, said that a postal incentive compensation plan should be self funded from incremental financial results, and that incentives should be linked to customer satisfaction through measurement of attainment of product and service guarantees. (*postcom.org web site*)
- Robert Reisner, Executive Managing Director, Global Insight, testified on price cap regulation. He noted that incentive pricing can be made to work for a public enterprise and that this would provide a means by which the Postal Service would be motivated to “partner” with private sector entities. (*postcom.org web site*)
- The Commission posted the full written testimony of the witnesses at the May 29 hearing at: <http://www.treas.gov/offices/domestic-finance/usps/meetings/5-29-03/witnesses.html>

Two additional public meetings before July 31 report

- The Commission, which is required to submit a postal service reform report by July 31, will hold two more public meetings in Washington in July. The dates have not been chosen, according to Treasury Department spokeswoman Betsy Holahan. The Commission is finished hearing witness testimony, but stakeholders can file closing remarks. The final two meetings are expected to focus on the recommendations of the Commission’s subcommittees and the drafting of the report. (*BNA Daily Report for Executives*, Derrick Cain, 5/30/03)

Postal Service Board of Governors approves first negotiated service agreement (NSA) – the deal is the first time the Postal Service has offered reduced rates for just one customer

Agreement is between the Postal Service and Capital One

More agreements are expected to follow

- The Postal Service Board of Governors announced June 2 that it had approved the Postal Rate Commission’s (PRC) recommended decision to implement the three-year experimental NSA between the Postal Service and Capital One, the Postal Service’s fourth largest customer and the nation’s largest producer of First-Class Mail. The agreement includes discounts for Capital One if its First-Class mail volume exceeds 1.225 billion pieces annually. (*Postal Service press release*, 6/2/03; *PRC press release*, 5/15/03)
- The deal is the first time the Postal Service has offered reduced rates created for just one customer, but already postal officials have held talks with at least 10 other financial-services companies interested in their own arrangements. (*Wall Street Journal*, Rick Brooks, 5/20/03)

“We’ve heard from every credit card company we can think of,” said Mike Plunkett, the Postal Service’s Manager of Pricing Strategy. (*American Banker*, W.A. Lee, 5/21/03) [See May 27, 2003 *GSE Report* for more information on the NSA, www.gsereport.com]

Senator Tom Carper (D-DE) to introduce postal reform bill that would make closing facilities easier

- Senator Carper plans to introduce a postal reform bill similar to the Postal Accountability and Enhancement Act that died in a House committee last June, but with several key changes – including a provision to make it easier to close postal facilities. Like the previous bill, this bill would require a regulatory commission to establish a new rate-setting process for categories including First-Class, Periodical and Standard-Mail. However, the bill eliminates a price cap in which rates for Market Dominant products could not rise more than the Consumer Price Index. The previous bill also did not specifically authorize negotiated service agreements, while Senator Carper’s new bill does. (*DM News*, Melissa Campanelli, 6/2/03)

Postal Service revenue down as mail volume remains stagnant

- The Postal Service said its revenue for the last three months was nearly a half-billion dollars less than expected because mail volume remained flat. Revenue for the third quarter of the fiscal year was just over \$16 billion, \$483 million less than anticipated, postal Chief Financial Officer Richard Strasser told the Postal Service’s Board of Governors. Expenses were \$15.8 billion, \$370 million less than originally planned. Net income for the quarter was \$224 million, \$112 million less than projected. For the year-to-date (fiscal year started in September), the agency had a net income of \$1.879 billion, \$373 million over plan. For the second consecutive month, total mail volume declined. First-class mail dropped 2.4 percent, down 566 million pieces from last year. While Standard mail, increased by 3.2 percent, it was less than the 3.5 percent growth forecast. (*Associated Press*, Randolph Schmid, 6/2/03; *Postal Service press release*, 6/2/03)

June 9, 2003

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