

The **GSE** REPORT™

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Major Events

OFHEO fines Freddie \$125 million and places Freddie under Consent Order
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- Armando Falcon, Jr., Director of OFHEO, announced that Freddie Mac has agreed pay a civil money penalty of \$125 million and to implement corrective measures, as part of a Consent Order with OFHEO. The \$125 million penalty in the Consent Order is the largest civil money penalty by a safety and soundness regulator and the first fine imposed by OFHEO in its 10-year history.
- “A government sponsored enterprise like Freddie Mac lives on a public trust that should never be violated,” said OFHEO Director Falcon. “OFHEO will take strong action against an enterprise and responsible individuals if that trust is ever broken.” Under the terms of the Consent Order, Freddie Mac is undertaking remedial actions relating to governance, corporate culture, internal controls, accounting practices, disclosure and oversight.
- While conducting its investigation, OFHEO took numerous actions regarding present and former executives at Freddie. These included: the freezing of compensation packages, removal of the CEO and General Counsel, the levying of a civil money penalty on the former Vice Chairman, and beginning the process of terminating the former CEO and CFO for cause.
- Separately, OFHEO released its staff report on its investigation of matters relating to Freddie Mac’s restatement, which is not part of the Consent Order. (*OFHEO Press Release*, 12/10/03; *Freddie Mac Press Release*, 12/10/03)

Requirements of Consent Order

- OFHEO sets forth array of corporate governance requirements and corrective actions in Freddie Mac’s Consent Order regarding cooperation in pending investigations and litigation; board of directors and management functions; internal controls; internal audits, internal accounting, management of risk management transactions; public disclosures and regulatory reporting; oversight and reporting; and the GSE’s \$125 million civil penalty, due and payable on December 19, 2003.
- Under the Consent Agreement, Freddie Mac is required to separate the position of Chairman and Chief Executive Officer within a reasonable period of time and develop a management succession plan. “The Board shall determine what limits, if any, to establish on the terms of Board members.” The Board is directed to establish a chief risk officer with responsibility for Freddie’s oversight function and a chief compliance officer.
- According to Freddie Mac spokeswoman, Sharon McHale, OFHEO, Freddie and its incoming Chairman and CEO Richard Syron have agreed on a three-year time frame

by which a successor CEO will be appointed. As executive chairman, Syron would retain oversight of accounting and some other functions. (*OFHEO Stipulation and Consent to the Issuance of Consent Order*, 11/09/03; *Washington Post*, David S. Hilzenrath and Kathleen Day, 12/11/03; *Market News International*, Main Wire, 12/11/03)

OFHEO's scathing 185-page report on Freddie reveals deep problems

- Freddie Mac developed a corporate culture that placed a very high priority on strong and steady growth in profits, including, when necessary, using means that failed to meet its obligations to investors, regulators and the public. The company employed a variety of techniques ranging from improper reserve accounts to complex derivative transactions to push earnings into future periods and meet earnings expectations. The conduct of Freddie Mac was hidden and revealed only by a chain of events that began when it changed auditors in 2002. This report describes the circumstances leading to Freddie Mac's \$5 billion restatement and makes recommendations on corrective and preventative measures.
- **Corporate Culture and "Tone at the Top":** A corporate culture evolved that placed a very high priority on meeting the earnings estimates of Wall Street analysts but neglected key elements of the infrastructure of the company needed to support growth. Freddie Mac created and maintained reserve accounts that did not comply with GAAP and entered into transactions with little or no economic substance, all for the express purposes of obtaining accounting results that would support the goal of reporting steady earnings growth and meeting analyst expectations.
- Freddie Mac managed General and Administrative expenses to a rigid guideline. The preoccupation of management with adhering to the expense limits resulted in an insufficient allocation of resources—both dollars and staffing—to divisions responsible for accounting, financial reporting, and internal controls. The lack of attention by senior management and the Board of Directors to those functions resulted in transactions not being recorded in financial statements in accordance with GAAP.
- **Improper Management of Earnings:** Freddie Mac used several strategies to shift earnings into future reporting periods, reflecting the proclivity of management to increase operations risk in the quest for more stable earnings.
 - Management executed several interest rate swap transactions that moved \$400 million in operating earnings from 2001 to later years. Those transactions had virtually no other purpose than management of earnings — specifically, making operational results appear to be less volatile than they were.
 - Management created an essentially fictional transaction with a securities firm to move approximately \$30 billion of mortgage assets from a trading account to an available-for-sale account. Other than to reduce potential earnings volatility, the transaction had no other meaningful purpose.

- Freddie Mac adopted, and then quickly reversed, a dubious change in its methodology for valuing swaptions. That change had the effect of reducing the value of the derivatives portfolio of the Enterprise by \$730 million.
- On at least one occasion, a transaction was entered into at the instruction of management for the purpose of disguising the effective notional amount of the Freddie Mac derivatives portfolio and thereby allay the concerns of an investor.
- From 1998 to 2002, management purposefully kept loan loss reserves at an unusually high level by using aggressive assumptions, even though actual and foreseeable credit losses were rapidly declining. Both management and the Board of Directors were aware that the Securities and Exchange Commission had criticized that practice as an inappropriate form of earnings management.
- Freddie Mac used another non-GAAP reserve to dampen earnings fluctuations occasioned by unpredictable premium amortization caused by changing mortgage prepayment speeds. Management changed key assumptions in the calculation of the reserve when necessary to achieve a desired earnings result.
- Senior Freddie Mac management failed to disclose to the public information that would have revealed more fully the nature of transactions undertaken to manage earnings and the intent to do so. Such disclosure would have called into question the accounting treatment of the transactions adopted by Freddie Mac.
- **Incentives Created by Executive Compensation:** The compensation of senior executives of Freddie Mac, particularly compensation tied to earnings per share, contributed to the improper accounting and management practices of the company. The size of the bonus pool for senior executives was tied, in part, to meeting or exceeding annual specified earnings per share targets. Achieving earnings per share targets played a substantial role in the formula used to set the size of the corporate bonus pool. The informal process by which Mr. Brendsel (former CEO) and Mr. Glenn (former COO) revised the scorecard results, and therefore the amount of funds available for individual bonuses, reinforced in the minds of managers and other employees the importance of achieving earnings per share targets.
- **Weak Accounting, Auditing and Internal Controls:** Weaknesses in the staffing, skills, and resources in the Corporate Accounting Department of the company led to weak or nonexistent accounting policies, an over reliance on the external auditor, weak accounting controls, and an over reliance on manual systems. Given the size of the company and the role in the housing finance and capital markets, those weaknesses effectively increased the systemic risk posed by the company.

- For most of the period in question the Chief Financial Officer and the Controller of Freddie Mac promoted an attitude that the Enterprise should transact around GAAP because, they believed, financial statements prepared in accordance with GAAP would not reflect the true economics of the business of Freddie Mac.
- The Internal Audit Department of Freddie Mac did not accept responsibility for the reliability and integrity of the financial information of the Enterprise, did not follow-up effectively on identified deficiencies, and did not communicate effectively with management and the Board.
- Management and the Board failed to meet their responsibilities for adopting sound accounting policies and establishing and maintaining a strong internal control system to assure that financial statements were prepared in accordance with GAAP.
- **Inadequate Disclosure:** Freddie Mac knowingly circumvented prevailing public disclosure standards in order to obfuscate particular policies and specific capital market and accounting transactions. A disdain for appropriate disclosure standards, despite oft-stated management assertions to the contrary, misled investors and undermined market awareness of the true financial condition of the Enterprise.
- Freddie Mac executives, without objection from the non-executive members of the Board or its Audit Committee, accepted a convenient and mechanical but inadequate definition of materiality accepted by the external auditor in order to exempt from scrutiny and specific disclosure as “immaterial” accounting errors of up to five percent of profits, or \$100 million to \$285 million.
- Within Freddie Mac, no one took responsibility and was ultimately accountable for public disclosures.
- **Board of Directors:** For the most part, the same long-tenured shareholder-elected Directors oversaw the same CEO, COO, and General Counsel of Freddie Mac from 1990 to 2003. The oversight exercised by the Board might have been more vigorous if there had been a regular turnover of shareholder-elected Directors or if Directors had not expected to continue to serve on the Board until the mandatory retirement age. Conversely, the terms of the presidentially appointed Directors are far too short, averaging just over 14 months, for them to play a meaningful role on the Board. The position is an anachronism that should be repealed so shareholders can elect all Directors.
- The Board of Directors was apprised of control weaknesses, the efforts of management to shift income into future periods and other issues that led to the restatement, but did not recognize red flags, failed to make reasonable inquiries of management, or otherwise failed in its duty to follow up on matters brought to its attention.

- **Recommended Actions:** Freddie Mac should implement a comprehensive, company-wide initiative to establish a proper “tone at the top” and develop a corporate culture that rewards integrity and the acceptance of responsibility and individual accountability, and that penalizes failure to adhere to legal and regulatory requirements or professional standards of appropriate conduct.
- Freddie Mac should prudently plan for any future growth, including taking steps to attract and retain personnel with the skills necessary to manage the growing risks associated with future growth.
- Freddie Mac is under a statutory mandate to operate in a safe and sound manner, which includes having systems and management structures in place to ensure that operations risk receives the same attention as credit and interest rate risks. An inadequate provision of resources to compliance and internal controls is an unsafe and unsound practice.
- OFHEO should take steps to ensure that the following recommendations are implemented:
 1. Freddie Mac should separate the functions of the CEO and the Chairman of the Board.
 2. Freddie Mac should develop financial incentives for employees based on long-term goals, not short-term earnings.
 3. OFHEO should establish a regulatory system of mandatory disclosures for the GSEs or their securities exemptions should be repealed.
 4. OFHEO should consider requiring a periodic change of the external auditors at Freddie Mac, not just a change in engagement partner.
 5. OFHEO should require Freddie Mac to hold a capital surplus and should consider limiting the growth of the retained portfolio until Freddie Mac produces timely and certified financial statements.
 6. OFHEO should establish a “materiality” standard for the provision of sufficient information to the Board of Directors.
 7. Freddie Mac should impose strict term limits on the members of the Board of Directors.
 8. OFHEO should ensure that the Board becomes more actively involved in oversight of Freddie Mac.
 9. Freddie Mac should establish a formal compliance program

10. Freddie Mac should establish the position of chief risk officer
11. Freddie Mac should document the legitimate business purpose of every significant derivative transaction
12. Freddie Mac should establish and maintain superior accounting controls.
13. Freddie Mac should prevent undue reliance on the external auditor.
14. Freddie Mac should strengthen and clarify the role of the internal audit department
15. OFHEO should expand its capacity to detect and investigate misconduct.
16. OFHEO should conduct a special examination of the accounting practices of Fannie Mae (*Report of the Special Examination of Freddie Mac*, OFHEO, 12/03)

Reaction to OFHEO's report on Freddie

...from Congress

- Senate Banking Committee Chairman Richard Shelby said in a statement that the OFHEO report “clearly confirms that there were serious accounting, disclosure, and management issues that led to Freddie Mac’s earnings restatements.” He added, “It also serves to underscore the deficiencies of OFHEO as a regulator in that OFHEO never detected the breakdown in the accounting and audit function at Freddie Mac.” (*American Banker*, Rob Blackwell and Jody Shenn, 12/11/03)
- Representative Barney Frank (D-MA), the senior Democrat on the House Financial Services Committee, said, “The basic thing is for Freddie to stop being cute with the accounting.” He added, “It’s not clear that there’s a systemic problem there, it’s just a couple of people made some really stupid decisions.” (*Bloomberg News*, James Tyson, 12/10/03)
- “The revelations about Freddie’s management were expected and not really revelations, but what is new is the extent to which the board knew what was going on and did nothing,” said Representative Richard Baker (R-LA). “Their actions –or non-actions—are an embarrassment to the company and another black mark on the integrity of the capital markets.” (Dow Jones Newswires, Dawn Kopecki, 12/10/03)

...from Freddie Mac

- While saying he is in favor of a strong regulator for the GSE, Freddie Mac’s chief financial officer, Martin Baumann said he disagrees with OFHEO’s recommendation

to slow the company's portfolio growth in light of massive accounting irregularities. "We don't see any reason to change our business activities," said Baumann. He added that Freddie Mac hasn't agreed to the recommendations in the OFHEO report, in part, because the company hasn't yet released its updated financial statements. Baumann said Freddie Mac doesn't need to raise any more capital, despite OFHEO's recommendation. "If anything, we might have equity investors asking us to give them something back" in the form of dividends, he said. "We've been very prudent," he added.

- Baumann said he has hired more than 100 accounting staff, plus external accountants, consultants, and compliance experts to help disclosure practices. "We're all working very hard to close the books soon after the months end," he said. "We're going to be very transparent."
- As for Freddie's regulator, Baumann said he isn't concerned with who oversees the industry "as long as it's a strong regulator." (*Dow Jones International*, Karen Richardson, 12/12/03)

... from the critics

- Critics, such as Peter Wallison of the American Enterprise Institute, say the accounting mistakes reviewed by OFHEO raise doubts about whether Freddie Mac should be able to keep its government charter. Syron and other top Freddie Mac executives "have to be able to show that they have their arms around a very complicated, very complex financial animal and are aware of all its flaws," Wallison said. Otherwise, "critics are going to be saying we cannot afford an organization as dangerous as this to the whole economy to continue as a government-backed entity." (*Bloomberg News*, James Tyson, 12/10/03)
- J.C. Watts, Chairman of FM Policy Focus, issued a statement saying, "OFHEO's report shows that Freddie Mac's previous management and current board were placing the American taxpayer at great risk in order to focus on maximizing its profits. Since Freddie Mac's inappropriate conduct and improper management of earnings occurred under OFHEO's 'watch,' OFHEO is proven again to be an inadequate regulator. Many of the steps being mandated by OFHEO now—having a chief risk officer for example—have long been standard requirements for strongly regulated financial institutions."
- Watts added, "Congress must create—as soon as it returns—a strong, single new regulator for GSEs that will have the necessary tools to adequately protect the taxpayer, including full authority over capital, activities, and new programs. Finally, the report states that 'Freddie Mac remains exposed to substantial management and operations risk' and recommends that OFHEO require Freddie Mac to hold a capital cushion of up to 30% over its regulatory requirements. It also recommends imposing limits on the growth of Freddie Mac's retained portfolio until the remediation plan is implemented."

- Watts concludes, “Not only should these measures be implemented immediately for Freddie Mac, but in light of Fannie Mae’s recent accounting errors, OFHEO should impose comparable limits on its retained portfolio until its review of Fannie’s accounting practices has been completed.” (*FM Policy Focus press release*, 12/10/03)
- It’s “outrageous for a company of that size and dealing with such sophisticated financial instruments,” to not even have an updated accounting-policy manual, said Michael Gran of, professor of accounting at University of Texas in Austin. “Derivatives accounting is as complex as anything, and if there is ever an area where you need expertise, it’s in derivatives.” (*Bloomberg News*, Al Yoon, 12/11/03)

...from the Street

- Wall Street’s reaction to the accounting scandal at Freddie has been muted because the accounting maneuvers understated earnings rather than overstating them. In the eyes of institutional investors, the sins of Freddie’s former managers—many of whom have either been fired or forced out—do not compare to those committed by Enron and Worldcom, which manufactured earnings. (*TheStreet.com*, Mathew Goldstein, 12/10/03) [Reminder: Freddie’s restatement included \$1 billion in *overstated* earnings for 2001. (*Bloomberg News*, James Tyson, 12/10/03)]
- Paul Miller an analyst at Friedman, Billings, Ramsey & Co., Inc., said [Freddie’s] stock climbed because, with the report out and settlement reached, there is “less to worry about.” Mr. Miller said, “It is a box being checked. New CEO? That box is checked. The OFHEO report? That box is checked?” (*American Banker*, Rob Blackwell and Jody Shenn, 12/11/03)
- According to the *Financial Times*, “There’s plenty of bluster in the OFHEO’s report on Freddie Mac’s failings. But there is nothing to cause alarm for Freddie’s battle-scarred investors and a \$120m fine amounts to less than 20 cents per share. The cloud of uncertainty surrounding Freddie is slowly lifting.” The *Financial Times* points out that the small group of executives who caused the accounting problems has left, a new experienced CEO has been hired and the 2000-2002 financial restatements are complete.
- The wait for timely reporting will drag on next year, and time will tell if the new CEO will make strategic shifts at the firm. Freddie’s shares have underperformed Fannie Mae’s by a wide margin this year, although bond spreads have widened only a little, courtesy of the de facto government guarantee. As the uncertainty lifts, there is potential for the shares to recover, though the prospect of tighter regulation of Freddie and Fannie should curb enthusiasm. The OFHEO recommends that Freddie Mac hold a capital surplus and “consider” limiting growth until it is able to resume timely financial reporting. A more effective regulator in the future is likely to make greater conservatism mandatory. (*Financial Times*, 12/11/03)
- “Falcon has been on his way out for a year and this is kind of his parting shot,” said Craig Smith, an analyst at David L. Babson & Co, Boston, which owns 1.7 million

shares of Freddie. “He gets to claim a victory.” (*Bloomberg News*, James Tyson, 12/10/03)

Potential “fallout” from OFHEO’s investigation
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... for Freddie Mac

- While OFHEO is considering limiting Freddie Mac’s portfolio growth or imposing a 30% capital surcharge against it, the regulator doesn’t have a time frame or procedure for such a move worked out just yet. “What we are going to do is consider how much of a surplus should be maintained until all of these remediation efforts are implemented,” said Armando Falcon, Jr., Director of OFHEO. (*Dow Jones Newswire*, Dawn Kopecki, 12/10/03)
- If Freddie Mac adopts OFHEO’s recommendation that directors leave the board after ten years of service or upon reaching the age of 72 (whichever comes first), the policy would apply immediately to seven of Freddie’s thirteen directors--George Gould, Henry Kaufman, John McCoy, Ronald Poe, Donald Schuenke, Christina Seix, and William Turner. (Bert Ely, 12/10/03)
- OFHEO’s report could fuel the numerous shareholder class actions that have been filed since the full extent of the accounting irregularities became public in June. While Freddie’s stock has been relatively stable for the past several months, it still trades some \$5 below its pre-scandal price.
- Freddie Mac’s settlement with OFHEO doesn’t end investigations by the Securities and Exchange Commission and the Department of Justice. (*TheStreet.com*, Matthew Goldstein, 12/10/03)
- Freddie Mac may face more penalties, said Ron Geffner, a former SEC enforcement attorney now with Sadis & Goldberg, New York. “This is going to be the first of several actions against them, and now that they are paying a fine it may mean that they are not open to immunities.” (*Bloomberg News*, James Tyson, 12/10/03)

...for Wall Street firms

- OFHEO is continuing to investigate the Wall Street firms that were on the other side of deals Freddie Mac used to shift earnings in the future. “There is evidence to date that one or more of the counterparties undertook to manage earnings may not have acted properly,” said OFHEO in its report. “Given the substantial financial rewards for making the transactions happen and the desire of the counterparties to keep a large customer happy, and given the significant role they played in the transactions, their activities should be the subject of further investigation of OFHEO.”
- OFHEO, which is investigating J.P. Morgan Chase, Credit Swiss First Boston, Citigroup, Goldman Sachs, and about 20 other investment firms, said some firms could be barred from doing business with either Freddie Mac or Fannie Mae.

- OFHEO Director Armando Falcon, Jr. asked, “What was their role in these transactions? Did they actively participate?” Or did they simply fail to make sure the transactions served a legitimate business purpose, and were not done just to help manage earnings, he said. A key question, according to Falcon, is whether the profits the investment banks get from underwriting Freddie Mac securities “gives them an incentive to look the other way?” (*TheStreet.com*, Matthew Goldstein, 12/10/03; *New York Times*, Jonathan D. Glater, 12/10/03)

...for Fannie Mae

- OFHEO’s findings ratcheted up the pressure on Fannie Mae, which is now subject to its own OFHEO examination. At one point, the OFHEO report cites a meeting in which OFHEO says several Freddie Mac board members and former chief operating Officer David Glenn appeared to discuss knowledge of earnings management activities at Fannie Mae. Against the initials “SR,” standing for Stephen Ross, a Freddie outside director and professor at MIT, the note-taker wrote “FMNA banking this yrs gain.” This would appear to show that Ross was wondering whether Fannie Mae would also be shifting its 2001 gains into 2002. Freddie’s then-COO Glenn appears to reply “Yes—don’t know how much.” OFHEO concludes that “the same incentives and motivating forces [at Freddie Mac also] exist at Fannie Mae.”
- Several analysts said that they saw trouble for Fannie Mae in the OFHEO report on Freddie. They noted similarities between the two, including the corporate culture that sets ambitious earnings growth targets. “There is nothing in the report that says, Yes, Fannie is doing” the types of things Freddie was accused of, said Bert Ely, an analyst from Alexandria, VA. “But there are certainly some strong inferences.”
- “They face the same issues,” said Andrew Davidson, the president of Andrew Davidson & Co., New York. “Freddie had more derivatives, but they both have mortgages with prepayment risk, and an accounting setup that is detrimental to getting the job done correctly.” He continued, “Even if it did a better job applying relevant accounting rules, [Fannie still] engaged in activities that manage earnings, including moving assets out of held for maturity, and purchasing back high-cost debt.”
- Thomas H. Stanton, author of two books on government-sponsored entities, said the talent of Freddie management team was overestimated and that the same may be true of Fannie Mae. “We are at a stage now where we can’t take anything for granted,” he said. “These guys are huge and doubling in size every five years or so, and there is the real question that at a certain size these companies just outrun their internal controls. OFHEO had better go and take an in-depth look [at Fannie too].”
- Fannie Mae has said that it is cooperating with OFHEO’s examination and is delivering requested documents to the regulator. But an industry source said that Fannie may be much more aggressive than Freddie and it might question the OFHEO’s authority to collect some of the information it requested.

- Fannie could come under pressure to split the roles of its chairman and chief executive, as Freddie was ordered to do by OFHEO. Currently Franklin D. Raines holds both titles at Fannie. (*Wall Street Journal*, Patrick Barta and John D. McKinnon, 12/11/03; *Washington Post*, David S. Hilzenrath and Kathleen Gray, 12/11/03; *TheStreet.com*, Peter Eavis, 12/11/03; *American Banker*, Rob Blackwell, 12/12/03)

Freddie names its third CEO of the year

- Freddie Mac's board of directors has named Richard F. Syron as chairman and chief executive officer effective before the end of the year, succeeding Gregory J. Parseghian. Current Freddie Mac chairman Shaun F. O'Malley will become lead director of the company's board and George D. Gould will remain as chairman of the board's Governance Committee. Parseghian has agreed to stay on as a consultant for a few months after Syron takes over, a company spokesman said.
- Syron, age 60, has a reputation as a level-headed, no-nonsense executive, who most recently served as the executive chairman of Thermo Electron, a maker of analytical instruments used by pharmaceutical companies in the development of drugs. In 1999, he joined Thermo Electron, a struggling company with 24 separate entities and 11,000 employees. According to Andrew Sidoti, an analyst who follows the firm, Syron did a good job of re-organizing the company by completing seven tender offers, 45 divestitures, and two spin-offs to help the firm focus on its core business.
- Before taking the job with Thermo Electron, Syron served for five years as chairman and chief executive of the American Stock Exchange, and before that was the president of the Federal Reserve Bank of Boston from 1989 to 1994. Syron also has experience in the mortgage finance business, having served as president of the Federal Home Loan Bank of Boston in the 1980s. Syron graduated from Boston College and received a doctorate in economics at Tufts University.
- Freddie Mac did not disclose Syron's compensation package. Syron stated that he would make less than former CEO Brendsel, though he added that his compensation would be "in the same neighborhood." Brendsel made about \$3.3 million in salary and bonuses and received about \$4.7 million in restricted stock awards in 2001, the most recent year for which figures are available. (*Freddie Mac Press Release*, 12/07/03; *New York Times*, Jonathan D. Glater, 12/09/03; *Wall Street Journal*, Patrick Barta and John D. McKinnon, 12/08/03; *Washington Post*, Kathleen Day, 12/09/03)

Syron's focus at Freddie

- In a telephone interview with the *New York Times*, Syron stated, "One of the things I'm going to be looking at first is being sure I totally understand the accounting and control procedures and we're in the kind of shape that I'm pretty confident we are in right now." He continued, "Freddie Mac is not a turnaround situation," adding that he spent time reviewing the Baker Botts report and met with Freddie's accounting

firm, PricewaterhouseCoopers. “My impression from the report was that this is a company that strayed a bit,” he said. “It made mistakes, the mistakes that it made were accounting mistakes and I am not a sufficient diviner of the past to understand how much this was the accounting firm, how much it was other things. They were not economic mistakes.” One of Syron’s first priorities will be to recruit someone with experience in portfolio management to be the No. 2 executive in the company. (*New York Times*, Jonathan D. Glater, 12/09/03)

- In an interview with the *Washington Post*, Syron stated his first task will be to “revitalize the reputation” of Freddie Mac. He reiterated the company’s position that Freddie’s woes stem from accounting problems only and that the underlying business is robust. He said he intends for Freddie to follow the spirit, not just the letter, of new ethics laws recently mandated by Congress. “We should be the model in leading the way in good corporate governance,” he said. (*Washington Post*, Kathleen Day, 12/08/03)
- In an interview with the *Boston Globe*, Syron said “[Freddie Mac] has lost some of their earlier, long-earned credibility,” which is a “very fragile commodity that has to be rebuilt.” To rebuild credibility, he said he would draw on his experience as Thermo Electron’s CEO “by telling people what we’re going to do and doing it.” He added, “This complex organization needs to be fully transparent.” (*Boston Globe*, Kimberly Blanton, 12/08/03)

Mixed reaction to Syron appointment

- “While Mr. Syron is a ‘lower profile’ hire than some had hoped, his resume and skill set seem well matched for [Freddie Mac’s] needs,” said Citigroup analyst Matthew L. Vetto in a written report. “On balance, we view the appointment positively.”
- Some analysts, such as David Hochstim at Bear Stearns, said they were disappointed that Freddie Mac’s CEO, Gregory J. Parseghian, will be leaving the company. But, they welcomed Syron, citing his operational and political experience. (*Washington Post*, Kathleen Day, 12/09/03)
- Ken Posner, a Morgan Stanley analyst, noted in a report that there is “no evidence” that Syron has “hands on experience in mortgage investment or risk management.” Syron could overcome this, Posner noted, by hiring experienced people to run Freddie’s retained portfolio, following Parseghian’s departure. (*American Banker*, Rob Blackwell and Jody Shenn, 12/09/03)
- National Home Builder President Kent Conine provided a ringing endorsement for Syron, stating “Richard Syron is well qualified for the top job at Freddie Mac. He has the experience, credentials and confidence of his peers in the financial marketplace to handle the management, financial and public policy issues currently confronting Freddie Mac.”

- “Syron “is just what Freddie needs to not only deal with the mistakes they made and some of the cuteness that was going on but at the same time he is a guy who is motivated to carry out the housing mission,” said Representative Barney Frank (D-MA). (*Bloomberg News*, Al Yoon, 12/08/03)
- “I question whether [Syron] fully appreciates what he’s getting into—the organization rot and the depth of accounting problems,” said Washington banking consultant Bert Ely, a persistent Freddie Mac critic. Ely believes that Freddie Mac would have fared better by hiring a chief from the mortgage business. (*USA Today*, Thomas Fogarty, 12/08/03)
- “Syron is a depressing compromise by a self-interested board,” wrote Peter Eavis in a column on *TheStreet.com*. “It is another example that corporate America is failing to exploit great opportunities to usher in new leaders who can be relied upon to reform and clean up companies.” Syron’s name, Eavis notes, became “infamous” earlier this year when he, as director and head of the compensation committee, enthusiastically endorsed an obscene—and possibly illegal—pay package of \$21.2 million for David D’Alessandro, CEO for John Hancock Financial. There was much chatter on Wall Street, Eavis noted, that Syron was a “B-list” candidate, chosen because all A-listers had demanded a complete overhaul of Freddie’s board. Freddie’s board is considered compromised and ineffectual, given the past actions of management and in-actions of the board. Looking at Syron’s actions at John Hancock, he is likely to be the last guy to clean house at Freddie Mac. (*TheStreet.com*, Peter Eavis, 12/09/03)
- Washington and market insiders immediately began second-guessing Freddie’s choice of Syron, noting his \$2,000 contribution of Senator John Kerry’s presidential campaign and his recent criticism of the war in Iraq. “We are in a very tricky time here now,” said one GSE source, speaking on condition of anonymity. “There is an expectation that the pick would be a Republican or an agnostic—how did we end up with this?” This view was shared widely by political insiders, many of whom said they were astounded the Freddie board had chosen someone with such strong Democratic ties. During the past three elections, Syron has given \$14,000 exclusively to Democrats, including Senator Kerry, Senator Joe Lieberman (in 1999), Senator Jack Reid (D-RI) and Representative Patrick Kennedy (D-MA).
- Some industry sources said, given Syron’s comments against the Iraq war and open support of Democratic candidates, that Freddie’s board choice was “like asking for a fight” with the Bush administration, which has taken an increasingly tough line against the GSEs on the debate of their regulatory reform. An industry source said, “Business is very important, but if you are a GSE, you can’t be oblivious to politics. To be public on [the war], that doesn’t show good political sense.”
- Syron’s early reviews were decidedly mixed. During a speech to Freddie’s employees on the day of his appointment, Syron came across to GSE insiders as confident and unscripted, in contrast to previous company executives. He urged employees to bring any bad news to him quickly and said he was not seeking any radical changes at

Freddie. But, he also alarmed some in the crowd by making what he acknowledged as an “off-color” joke, intended to poke fun at his age. He said that he is so old that when he walked into a bar with his wife and her friend he didn’t understand the bartender’s question whether he had a “doubleheader” planned.

- Meanwhile, Freddie Mac stock traded erratically during the day of Syron’s announcement, dropping 0.36% in volatile trading to \$55.15, on a day the Dow Jones industrial average was up more than 1%. Yields on its agency debt were little changed versus Treasuries (*American Banker*, Rob Blackwell and Jody Shenn, 12/09/03; *Reuters News*, Lynn Adler and Philip Klein, 12/08/03)

OFHEO launches review of Fannie’s accounting

- In a letter to Fannie Mae dated November 21, OFHEO outlined an extensive first document request as a starting point for its investigation of the GSE. The letter contains 18 somewhat specific requests, including “copies of all communications (including e-mails) between January 1999 and October 2003 regarding deficiencies, shortcomings, weaknesses or failings in accounting practices or financial reporting at Fannie Mae or the failure to comply with accounting policies of Fannie Mae.” OFHEO is also requesting copies of “all documents relating to the decisions to classify assets as “available for sale” as opposed to “held to maturity” from January 1999 to date, along with documents from the GSE’s outside auditor, KPMG.
- An OFHEO spokeswoman said that this letter is just the beginning of regulator’s special examination of Fannie Mae. The exam process is expected to be so extensive and time consuming that OFHEO is conducting a search for an outside forensic auditor to handle the task.
- “This is pursuant to the OFHEO review announced in July,” said a Fannie spokeswoman. “We fully support the OFHEO’s review, and we will be working with them to provide all the necessary information. (*The American Banker*, Rob Blackwell, 11/25/03; *The Bulletin’s Frontrunner*, 11/25/03; *The Washington Post*, 11/25/03; *National Mortgage News*, 12/01/03)

Fannie Mae and Freddie Mac

Rumblings on GSE reform

- Treasury Secretary John Snow met with House Financial Services Chairman Michael Oxley on December 2nd to discuss the Administration’s plan to increase the oversight of Fannie Mae and Freddie Mac, among other issues. Treasury spokeswoman Anne Womack Kolton declined to elaborate on the talk, saying it was a private conversation.

- While Oxley’s spokeswoman wasn’t available for comment, some say that Oxley is said to be warming up to some of the administration’s ideas, one of which would give the new regulator broad prior approval powers over new activities at the companies. The administration is also entertaining discussions about removing the companies’ so-called line of credit with the U.S. Treasury.
- Fannie Mac CEO Franklin Raines recently said he’s opposed to removing the credit line, which allows the Treasury Secretary to purchase up to \$2.25 billion of companies’ debt in times of crisis. Raines said the markets place a tangible value on that credit line that could negatively impact his company’s ability to boost the U.S. mortgage markets if removed.
- The Federal Reserve is working on a study for release later this month that is expected to conclude that the companies’ special federal benefits are no longer necessary. (*American Banker*, Dawn Kopecki, 12/03/03)

Snow open to cutting GSE credit lines

- U.S. Treasury Secretary John Snow said he is open to discussing severing the government lines of credit that the GSEs enjoy, if Congress wants. “It is not part of our original proposal. We’ve laid out what we think is most important... but if Congress wants to put that on the table and talk about it, of course, we’ll respond.” Snow said in an interview with *Reuters*. Snow said that Fannie Mae and Freddie Mac do not pose an immediate risk to taxpayers, in spite of recent accounting problems that have shaken investor confidence and drawn calls for better oversight. “Not at the present, but our responsibility is to make sure they never do,” he said.
- Snow also said he looks forward to meeting the Richard Syron, the newly named CEO for Freddie Mac, whom he called a “very good choice.” Snow said he would press Syron to expand the company’s financial disclosures and would urge him to accept stronger regulation to reduce the volatility in the way investors value Freddie Mac. (*Reuters*, 12/08/03)

GSE Reform isn’t going away...

- In a speech to the Consumer Federation of America, HUD Assistant Secretary John Weicher told the audience that the Bush administration’s efforts to tighten controls on Fannie Mae and Freddie Mac won’t impede the housing industry or the ability of the largest U.S. home mortgage financiers to provide funding for American home buyers. “We are not intending to change their role in the housing market and we are not intending by any stretch of the imagination to weaken the housing market,” he said. “No President running for election wants to weaken a significant part of the economy just in time for the election.”

- After his speech, Weicher declined to say whether the Bush administration during the past month has narrowed differences with Fannie Mae and Freddie Mac. “We’re still working and we still believe in the same” regulatory framework proposed in September.
- Senator Paul Sarbanes (D-MD), senior Democrat on the Senate Banking Committee, said Congress next month will again consider strengthening regulation of Fannie Mae and Freddie Mac. “I don’t think the issue is going to go away,” said Sarbanes after a speech to the Consumer Federation of America. “It is a big issue.”
- Federal supervision of Fannie Mae and Freddie Mac is “getting worse,” said Wayne Abernathy, assistant Treasury secretary for financial institutions. “What will drive the solution is the fact that the problem isn’t going away,” said Abernathy in a speech before the Consumer Federation of America. “This is an issue that is being driven by the problem, and the problem isn’t getting any better—if anything, it’s getting worse.”
- “When you don’t have a proper supervisor, it leads to a lot of questions about the range” of the companies’ activities, said Abernathy. Inadequate oversight “leads to accounting questions, it leads to questions of their activities, it leads to questions of the conduct of their operations,” Abernathy said. In recent weeks, Treasury and the companies haven’t discussed the differences over regulation, he said. “We have not been engaged in any kind of negotiations with anybody.” (*Bloomberg News*, James Tyson, 12/04/03)

High priority placed on GSE regulatory reform in ‘04
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- Many observers predict that congressional efforts to reform the regulation of GSEs will be even more complicated because of presidential-election politics and other challenges. Even so, Senate Banking Committee Chairman Richard Shelby (R-AL), as well as the panel’s leading Democrat, Senator Paul Sarbanes (D-MD), said reform will remain a priority.
- “As soon as we get back up there and get going in January, we will continue our hearings on the GSEs because we are learning a lot,” said Shelby in a phone interview. “We are in the process of drafting legislation that would ensure a strong and credible regulator for the GSEs,” he said. “We are not there yet, and we are not ready to go into detail on this, but I think this is very important reform. It deserves thoughtful, careful consideration by the committee because there is just so much involved.”
- In the interim, Sarbanes said he wants Armando Falcon, Jr., the current head of OFHEO to remain until his agency completes its investigation of Freddie Mac’s earnings restatement scandal. He noted that the nomination of Mark Brickell to succeed Falcon as head of OFHEO “is complicated” by the fact that Congress is

considering reform of the regulatory structure for the GSEs. Falcon's term expires next fall.

- Neither lawmaker has dropped any hints about how he plans to overcome the myriad problems facing the reform effort. Those include an increasingly tough White House stance, accusations of duplicity on all sides, and continued resistance by the GSEs and housing advocates to some of the Bush administration's proposals.
- For starters, the policy makers will have to resolve where to "house" a new agency to regulate the GSEs. Treasury Secretary Snow, among others, has argued that if the new regulator is put inside his agency, it should not be insulated, like other financial regulators, from the oversight of rules and testimony by the department. But lawmakers do not appear willing to create a Treasury bureau that lacks substantial independence. Shelby said, "We want the regulator to be independent, whatever house it might be in or if it is in its own structure." But he cautioned that he was not endorsing any specific approach, including whether to create a new regulator outside of Treasury. "We are not there yet," he said, "We are looking at all options."
- A second issue is which regulator should have new product approval authority over the housing GSEs. The administration has said that this power should be with the new regulator. Shelby said his focus will remain on ensuring that any new supervisor has the appropriate tools to do the job. "The main thing I believe is that we have got to have a strong regulator," he said. "A regulator that knows that is going on, that has the resources to say yes or say no, and knows what it is doing. The housing industry is very important to this country."
- Shelby repeated that he believes "strongly" that "any legislation dealing with GSEs" should include Fannie, Freddie and the FHLBanks.
- Some observers said they think that presidential election year politics could slow or scrap any momentum on a GSE bill. "It will make it more difficult," said Shelia Blair, a former Treasury assistant secretary for financial institutions in the current administration. "I don't think it is an election issue, but there are some very important constituencies in both parties that have a big interest in housing, whether it's consumer advocates or home builders or the realtors," she said. "In an election year, that reinforces incentives to play to your constituencies as opposed to actually trying to get a bill passed. That is institutionally true on all sides."
- Most observers still said the bill could face other serious difficulties. Perhaps the largest obstacle is that several key players have proven intractable. The White House has taken an increasingly hard-line view, sources said, because it does not want to be seen weak on what it considers a corporate-governance issue. Its approach even ruffled feathers at the Treasury, whose role in the debate was diminished by the growing involvement of White House officials who insisted it stay open to all reform possibilities. Though many believe that Treasury would be willing to compromise to help pass a bill, sources said a bill is not the White House's primary objective.

Instead, they said, the White House is most concerned about appearing to have sought the toughest reforms, and would rather wait on the GSEs to compromise. A Treasury spokeswoman called that idea “ridiculous.” She said that the administration is unified in both its approach to and the underlying belief that there should be fundamental reform of the regulation of the housing GSEs and FHLBanks.” She added that the administration is not backing off of any of its demands. “Anything less than the elements outlined by Secretary Snow and [HUD Secretary] Martinez would not represent meaningful reform, a goal which this administration will not compromise,” she said.

- Any compromise between the administration and the GSEs appears unlikely for now. Fannie’s CEO Franklin Raines has opposed the administration’s call to give a new regulator the ability to raise minimum capital or receivership powers. Housing advocates remain resolutely against new product-approval authority at the Treasury. An outside agency could sidestep some of those concerns. While many believe that Treasury would be willing to compromise to pass a bill, sources said the White House does not favor the idea. Sources said the White House believes such a structure – made up possibly of a five-member board with representatives from the Treasury and HUD—would be little improvement over the current setup. “What is the momentum for going back to what we have with just a new seal?” said an industry source speaking on condition of anonymity. “I don’t see how the presence of one or two executive branch board members heightens the prestige or credibility of the agency.”
- Meanwhile, the discussion continues to unfold in a rapidly changing environment, where new revelations about accounting misdeeds at Freddie Mac add more fuel to the political fire, considerably improving the chances for a bill. (*American Banker*, Rob Blackwell, 12/08/03; *National Mortgage News Online*, 12/05/03)

A reminder from the marketplace

- Richard Lehmann, editor of *Income Securities Investor*, warns of a damaging scenario for companies with significant mortgage exposure. He reminds his readers about Freddie Mac, a GSE with derivative exposure that can’t be accurately estimated. This company, which will not report its 2003 results until June 2004, is in the midst of an accounting and corporate governance overhaul. Between Fannie Mae and Freddie Mac, there are trillions of dollars of derivatives exposures that the interest rate reversal earlier this year may have set off unpredictable financial chain reactions that could shake the very foundation of the economy a la Long Term Capital Management or the S&L crisis of the ‘80s. (*Comtex News Network*, Zacks.com Expert Watch, 12/09/03)
- In Prudential’s *Equity Research Potomac Perspective*, Charles A. Gabriel, Jr. wrote, “Analysts and investors conditioned to seeing housing GSEs Fannie Mae and Freddie Mac evade reformers are often likened to ‘boiling frogs’—failing to detect rising temperatures until the worst is upon them. As the White House plays its legislative hand amid a GSE regulatory restructuring drive, I pull one foot out of the cauldron,

acknowledging the prospects for and potential costs of failure.” (*Prudential Equity Group, Equity Research Potomac Perspective*, Charles A. Gabriel, Jr., 12/10/03)

Political/regulatory risk rising for GSEs

- Timothy Howard, Fannie Mae’s vice chairman and CFO, recently listed several “areas of focus” regarding the company cited by equity investors. “Political/regulatory risk” topped the risk category. Chances are excellent this area will move into even higher profile in the period ahead, as steps are taken to resolve the Freddie Mac mess and what appears to be a fresh resolve among key players to try to rein in Fannie and Freddie.
- In an election year, it is unlikely that Fannie and Freddie will be routed on Capital Hill. The two GSEs almost certainly can beat back any legislation they see as uncongenial, simply by continuing their largesse and their practice of hollering from the rooftops about the threat of misguided policies boosting homeownership costs.
- What is probable, however, is that the Bush Administration’s new practice of treating the firms as objects of concern will continue and grow in intensity and other potentially influential parties will pitch in and back the Administration. Hits from political risks, known in some circles as headline risk, can take a toll where the GSEs’ live, in the markets. (*Dow Jones Capital Markets Report*, John Connor, 12/08/03;
- After years of buying billions of dollars of securities issued by Fannie Mae and Freddie Mac, China has been stepping up its purchases of asset-backed securities (ABS). Analysts and traders in the \$1.7 trillion ABS market say demand has quickened in recent months, as the GSEs have been hit with a barrage of negative publicity. “The headline and event risks surrounding the GSEs like Fannie and Freddie have rekindled Chinese investors’ appetites for safe and liquid securities,” said Gyan Sinha, head of asset backed research for Bear Stearns, New York. (*Barron’s Online*, Jennifer Ablan, 12/01/03)
- According to Cumberland Advisors, the headline risks are impacting the federal agency paper in the marketplace. With Fannie and Freddie constantly in the news, restatements of earnings, even when positive, are now destabilizing and hurting the GSEs’ creditability. They’re seen as additive to the market volatility of federal agency paper. We have entered an era when all GSEs have a political sword over their heads. (*Barron’s Online*, Cumberland Advisors, 11/26/03)

Editorial pages speak out on GSE reform

- *Wall Street Journal* notes that after a promising start to bring serious oversight to Fannie Mae and Freddie Mac, the reform effort is dead for this year. What happened? Fannie and Freddie deployed their famously powerful lobbying machine

all over Capitol Hill. While they gave lots of lip service to welcoming a stronger regulator, their private lobbying was lethal.

- The breadth of the GSEs' lobbying is truly remarkable. Freddie's chief lobbyist, Mitch Delk, has held at least 50 fund-raisers for Congressional Republicans in recent years. Representative Michael Oxley (R-OH), the chair of the House Services Committee, was the featured guest at 19 of these events. Thirty of the 50 parties were for members of the House and Senate committees that oversee Freddie.
- Fannie and Freddie specialize in hiring inside the Beltway. Last year, Fannie hired Michele Davis, a former Treasury spokeswoman who had been communications director for Dick Army, the former GOP House majority leader. Freddie recently retained Terry Haines, former chief counsel to the House Financial Services Committee, and Dwight Fettig, the former legislative director for Senator Tim Johnson (D-SD). Most recently, Freddie hired Pat Cave a former deputy assistant secretary at Treasury and former legislative aid to Representative Richard Baker (R-LA), a vocal advocate for stricter oversight of the GSEs.
- There's also a handy pot of cash provided by the GSEs' charitable organizations. The Fannie Mae Foundation seems to favor groups active in the districts of friendly politicians. It also contributes to key political constituencies, such as the National Urban League and nonprofit arms of the Congressional Black and Hispanic Caucuses.
- There's a question in the financial marketplace if Fannie and Freddie let their political priorities influence their business decisions. Several years ago, the heads of three prominent financial firms complained to in *Journal* interviews that the GSEs threatened to retaliate against them for criticisms the firms made about the GSEs' business practices. And, there have been rumors about similar hardball tactics with the GSEs' clients in setting guarantee fees. Firms friendly to the GSEs are rumored to receive discounts on these fees, which negotiated secretly as part of the mortgage securitization process. The companies' spokespersons deny this.
- Notably in October when a bill to have Treasury regulate the GSEs was being discussed in Congress, key members of Congress received faxes critical of the bill from firms that do business with Fannie and Freddie. This year's faxes all followed advice outlined by a helpful e-mail from Coleen Maroon of Fannie's Chicago office. The email describes how the oversight proposal will "severely restrict our ability to work with our lenders" and unnecessarily increase capital standards. The email goes on to request that its customers fax or email Representative Oxley and "additionally fax a copy of any letter you send to my attention." While no overt threats for compliance with the request were made, such threats are arguably unnecessary.
- All of this is reminiscent of the political clout that the savings and loan industry once wielded in the 1980s. Its political favoritism was also justified by appeals to help housing and promote thrift. By the time that political class realized the danger it had created it was too late. This time, Congress has a chance to act before we have "déjà

vu all over again.” We only hope they take it. (*Wall Street Journal* editorial, 11/25/03)

- In an editorial, the *Sunday Advocate* (Baton Rouge, LA) addressed the urgent need for GSE regulatory reform, noting that Representative Richard Baker (R-LA) has been proven right about the need for vastly more aggressive federal monitoring of GSEs. While precious little of what Baker has proposed has made it into law, that must now change in light of Freddie Mac’s earnings restatements, which Baker calls “Enron country.” Only a weak agency in HUD with a \$39 million budget oversees these mortgage giants. Baker’s call for a stronger regulatory scheme cannot be reasonably rejected by Congress. (*Sunday Advocate* editorial, 11/23/03)
- And *The Clarion-Ledger* (Jackson, MS) notes that another scandal has undermined investor confidence in Wall Street and trust in the ability of government to ensure a level playing field. Freddie Mac now joins the ranks for such rogues as Enron, Worldcom, etc. The “rot” of corruption has now reached center and the loss of trust and confidence is devastating. The Bush administration is on watch front and center and during some of the worst financial scandals in American history, demanding action, whether the public notices or not. (*The Clarion-Ledger* editorial, 11/29/03)

Conferees approve OFHEO Budget

- As part of the \$820 billion omnibus appropriations bill, House and Senate conferees agreed to provide \$7.5 million in additional funding for special investigations of Fannie Mae and Freddie Mac’s accounting problems. In approving OFHEO’s budget, the appropriators imposed new spending restrictions on OFHEO, including a requirement that the agency clear its budget plan with HUD for the first time. This restriction appears to be a slap at the agency for holding housing conferences and promoting research relating to the housing markets and the two GSEs.
- OFHEO spokeswoman Corinne Russell said “We are pleased that Congress is supporting the full amount we need for our investigations and our enhanced staffing for examiners and lawyers.” She noted that the other requirements were “workable.”
- The conference dropped the Senate passed provision sponsored by Senator Christopher Bond (R-MO), providing OFHEO a special \$10 million reserve for emergency needs. (*National Mortgage News*, Brian Collins, 12/08/03)
- [The omnibus appropriations conference report was passed by the House. The Senate failed to take action on the conference report before adjourning in December but is expected to take it up when the Senate reconvenes in January 2004]

FDIC: Basel II could stretch US housing/GSE safety net
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- FDIC sparked a public dispute among regulators, when it released a study questioning the wisdom of proposed new international capital rules for banks. The FDIC said the Basel II proposals could sharply reduce bank capital requirements, hampering the ability of U.S. officials to prevent bank failures. The FDIC suggested the public interest would be better served by retaining some sort of minimum capital requirements. The FDIC study predicts that capital levels at U.S. banks affected by the Basel proposals would fall by at least 18% to 29% and in some cases by more than 40%.
- In addition, the FDIC said that the Basel II models appear to drastically shrink the capital required for mortgages to creditworthy borrowers. The lower requirements would fall to the same low levels required of Fannie Mae and Freddie Mac. “Is this an expansion of the federal safety net around housing? Does it in effect say that we think banks have a risk-free opportunity in making one- to four-family mortgages, especially prime mortgages?” said FDIC research director George French.
- The Basel II proposals are intended to give banks more flexibility without changing the basic levels of required capital. Supporters, including the Fed, have said that some banks might be required to hold more capital, while others hold less. Only the top 20 U.S. banks are expected to switch to the new standards. While the FDIC generally doesn’t have direct oversight of the big banks expected to switch to the new framework, the FDIC oversees the federal deposit insurance program, which covers banks’ deposits of \$100,000 or less. (*Wall Street Journal*, Rebecca Christie, 12/08/03; *Financial Times*, Gary Silverman, 12/09/03)

Fannie and Freddie raise loan limits

Rep. Brad Sherman (D-CA) proposes bill to raise ceiling on loans in high cost states

- Fannie Mae and Freddie Mac increased the size of home loans they are permitted to buy from lenders, making it easier for some homeowners to offset recent increases in home prices. Effective January 1st, the GSEs will begin purchasing loans of as much as \$333,700 in value, 3.4% higher than the current loan limit of \$322,700. In a sign that home appreciation is cooling, the 2004 increase is the smallest since 1996. In 2003, the loan limit increased 7.3%. The GSEs’ maximum loan amounts are 50% higher for first mortgages on properties in Hawaii, Alaska, Guam and the U.S. Virgin Islands. Multi-family loans increase as follows: two family loans to \$427,150; three family loans to \$516,300; and four-family loans to \$641,650.
- Fannie Mae estimated that the higher loan limit would allow as many as 95,000 homebuyers to save as much as \$21,000 over the life of a 30 year loan. Freddie Mac claims that the benefits could be even broader, reducing costs for as many as 150,000 families to save as much as \$38,700 over the life of the loan. According to lenders, loans financed through the GSEs cost about 0.375% less than loans financed through other means. (*Fannie Mae press release*, 11/25/03; *Fannie Mae Press Release*,

12/02/03; *Freddie Mac press release*, 11/25/03; *Wall Street Journal*, Patrick Barta, 11/26/03)

Rep. Brad Sherman (D-CA) proposes bill to raise ceiling on loans in high cost states

- Representative Brad Sherman (D-CA) has introduced legislation to increase conforming loan limit in states with significantly higher housing costs. Under this measure endorsed by 20 co-sponsors, the ceiling on loans that can be purchased by Fannie Mae and Freddie would be 50% higher in any state that has at least one metropolitan statistical area where the average price of houses exceeds the national average. Currently, Alaska and Hawaii qualify for a special 50% dispensation in recognition of their higher housing costs. Under this bill, eight states would be added to the list, including California, New York, New Jersey, Pennsylvania, Connecticut, Massachusetts, New Hampshire and Maine. (*PR Newswire*, 12/02/03)

Fannie and Freddie won't buy "high-cost" loans
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- On November 26th, Fannie Mae and Freddie Mac announced that they will stop buying high cost loans in New Jersey, a day before the state's strict lending law went into effect. New Jersey's "Home Ownership Security Act" (HOSA) was passed with the aim of curbing lending abuses like exorbitant fees and interest rates faced by "subprime" borrowers. Under this law, a loan is high-cost if its interest rate is five percentage points or more above the rate on "conforming" loans that fits the purchase criteria of Fannie Mae or Freddie Mac. The lender who makes the high cost loan and the investor who makes the high cost loan could face unlimited legal liabilities if the lender and holder of the mortgage were found to be violating the new law. Fannie Mae also noted that the treatment of home improvement loans, manufactured home loans, and refinanced loans that are classified "covered loans" under the New Jersey law creates "potential legal and business risks" that need to be monitored. "If necessary, we may announce restrictions on their delivery in the future," Fannie Mae stated.
- On November 21st, Fannie Mae announced that it will stop buying high-cost and similar home loans issued in Illinois and New Mexico once those states' anti-predatory lending laws go into effect on January 1st.
- Fannie Mae has also stopped purchasing risky, high cost loans made in New York, Georgia, Kentucky and Arkansas, which passed similar laws to deter anti-predatory lending. (*Fannie Mae press release*, 11/21/03; *Reuters*, 11/26/03; *Reuters*, 11/26/03; *The Bond Market Association*, Legal and Regulatory Issues, 12/08/03)

Federal agency debt surges

- According to the Bond Market Association, long-term debt issuance by federal agencies totaled \$1.01 trillion during the first three quarters of 2003, up 36.5% from \$740.0 billion issued for the same period last year. The strong mortgage market,

supported by historically low interest rates and high volumes of conforming residential home mortgage originations, contributed to the strong issuance levels.

- Issuances declined slightly in the third quarter, totaling \$338.9 billion, down from \$344.6 billion issued in the second quarter. Mortgage interest rates increased during the third quarter from their lows in June, but rates are still historically low and continue to attract homebuyers.
- The Federal Home Loan Bank System totaled \$483.9 billion in issuance, up 62.5% from \$297.8 billion issued during the first three quarters of 2002. Long-term issuance by Fannie Mae surged during the first nine months of the year, totaling \$272.4 billion, up 57.9% from the same period last year. The increase in Fannie Mae's issuance was, to a great extent, driven by the increase in its retained mortgage portfolio, which totaled \$919.4 billion as of September 30, up from \$797.7 billion at the end of 2002. Freddie Mac long-term issuance decreased by 12.9% to \$19.9 billion and Sallie Mae issuance decreased 3.6% to \$16.2 billion.
- Long-term issuance by the Farm Credit System increased 38.0% to \$43.2 billion for the first nine months of the year, while the Tennessee Valley Authority's long term issuance increased 64.3% to \$2.3 billion for the corresponding period. (*The Bond Market Association Research Quarterly*, November 2003)

Fannie Mae

Fannie Mae tells *Wall Street Journal* it “welcomes” regulation by Treasury

- In response to the *Wall Street Journal*'s editorial “White House Fannie Pack,” Chuck Greener, senior vice president of Fannie Mae’s communications, disputed three of the *WSJ*'s assertions. [For additional information, see the November 25, 2003 *GSE Report*]. Greener objected to the *Journal*'s claim that Fannie Mae worked to “stop a bill in Congress that would transfer its regulation to the Treasury Department. In fact, stated Greener, Fannie’s Chairman and CEO Frank Raines testified before the House and Senate that Fannie Mae in fact supports legislation that would provide for a strong, credible, well-funded regulator at Treasury.
- Greener also pointed out that The *Journal* quoted the chairman of the White House Council of Economic Advisors, Dr. N. Gregory Mankiw, saying that Fannie retains most of its “implied subsidy.” In fact the CBO estimates that Dr. Mankiw cited say that Fannie passes “most” of the benefit, 63%, to the consumers in the form of lower mortgage costs.
- Finally, Greener noted that any claim that Fannie retains an implied subsidy should acknowledge how any earnings are used. More than 24% of Fannie’s profits –over \$1.4 billion last year—go back to the U.S. Treasury in the form of federal income taxes. The rest increases capital in the form of retained earnings (53%) or is paid out in dividends to shareholders (23%), who expect a return on investment.
- As a private company with a public mission [and public subsidy], Fannie Mae succeeds when it achieves the public benefit of expanded home ownership through the effective use of private capital, concludes Greener. (*Wall Street Journal*, Letters to the Editor, Chuck Greener, 11/26/03)

Freddie Mac

“Fast Freddie” slow to offer details in its \$5 billion restatement

- On November 21, 2003, Freddie Mac released its restated (unaudited) financial statements for 2000, 2001 and 2002, which filled 150 pages of financial results. Freddie’s audited financial statements will not be provided until its 2002 annual report is released at the annual meeting in the first quarter of 2004.
- Analysts were disappointed to find that Freddie will not be releasing its 2003 results until the end of June 2004, when it plans to issue quarterly and full-year results simultaneously, because of the lack of proper accounting infrastructure. Freddie remained uncertain when it would be able to start reporting earnings on a timely basis. And, it will be 2005 before Freddie Mac gets its records in order so it can

register with the SEC. That will be *two years* behind Freddie's "big sister," Fannie Mae.

- Other analysts said it was difficult to identify how much of the volatility in Freddie's earnings was due to accounting mistakes and how much to natural volatility of its mortgage business, which is affected by changes in interest rates. Martin Baumann, Freddie's CFO, told analyst that it was hard to distinguish between the two kinds of volatility. The company's previous management team "massaged" the company's earnings to give the impression of a smooth and steady flow. The restatements showed that Freddie's earnings are far more volatile than it had previously reported.
- According to CFO Martin Baumann, Freddie Mac still lacks effective internal controls. Freddie is actively working on its internal control processes and documentation for its internal controls, so that the outside auditors would be in a position to give an opinion at the end of the audit for *fiscal year 2004*.
- "It's very bare bone numbers," said Bert Ely, financial consultant and long-time critic of Freddie Mac. "There's still a lot we don't know." (*Financial Times*, Jenny Wiggins, 11/23/03; *International Herald Tribune*, Kenneth N. Gilpin, 11/22/03; *Freddie Mac's conference call with analysts*, 11/21/03)

Reactions to Freddie's restatements

- "One of the nation's largest financial institutions [Freddie Mac], a backbone of the U.S. housing market, conceded that it had overstated earnings in 2001 by \$1 billion—while offering only a throwaway explanation for the massive reduction," wrote Peter Eavis on *TheStreet.com*. "Wall Street could care less... judging by the reaction of [Freddie's] stock and the mostly clueless questions posed by brokerage analysts on the conference call with Freddie's managers on Friday [November 21st]. But the federal entities probing Freddie, including the Justice Department, will certainly be interested to learn why Freddie overstated its earnings, and why it understated them." He added, "the Freddie restatement literature is rife with talk of correcting past 'errors.' Look, Baker Botts makes it clear that many of the transactions it examined, including some new ones detailed on Friday, were intentionally dreamed up by Freddie managers. These weren't mistakes, and insisting otherwise only shows that Enron and Worldcom debacles changed nothing in corporate America. The only other explanation is that Freddie lawyers, already preparing a defense against the government, advised the company to use neutral sounding—and disgustingly deceitful—term [errors]. It will be sweet indeed when people go to jail for the so-called errors."
- During 2001 and 2002, Freddie used derivatives and every other possible strategy to produce the earnings it wanted. Much of its accounting, we now know, was totally misbegotten; in some cases because Freddie's financial folks were too incompetent to understand the rules. Had Freddie's charade continued, the profits "stored up" would have been fed back into earnings and outsiders would never have been the wiser. There's a lesson to be learned for conniving managers: Don't let your outside

accounting firm [Arthur Anderson] fail. After Anderson tanked, Freddie hired PricewaterhouseCoopers, who balked at certifying the GSE's 2002 audit. Then, the house came tumbling down and its senior management was fired. Now, Freddie has handled its apparent inability to report correct profits by simply ducking the job. It has put out no earnings reports for 2003.

- “It is really incredible to me that we have a major public entity that cannot give us financial information,” said former investment banker Frank Partnoy, a professor at the University of San Diego School of Law. Partnoy said the situation indicates either that Freddie is “much more primitive” than other financial institutions—or that “the reports we get from banks, if they were truly scrubbed down the way Freddie’s have been, would expose similar errors.” (*Bureau of National Affairs*, Richard Cowden, 11/24/03; *TheStreet.com*, Peter Eavis, 11/21/03; *International Herald Tribune*, Kenneth N. Gilpin, 11/22/03; *Washington Post*, David S. Hilzenrath and Kathleen Day, 11/22/03; *Fortune Magazine*, Carol J. Loomis, 11/22/03)
- On *CNN Money Morning* with Kathleen Hays, David Kotok, chief investment officer at Cumberland Advisors, responded to the bad news at Freddie by saying, “Investors are going to have to face a reevaluation of the government agencies. Fannie, Freddie, the news continues to flow. It isn’t good. There are more and more questions about the integrity of the reporting and we’re starting to see some changes in the markets. We’re starting to see people come away from agencies, away from mortgage credits, and say, I don’t know what’s brewing there but I don’t like it and maybe there’s more credit risk. And then you see government panels trying to investigate. We’re going to get more of that in the next Congress. I think it’s a bad situation and it’s worsening because of the news.” (*Analyst Wire*, CNN Money Morning, Kathleen Hays, 11/21/03)
- On *Market Roundtable* on CNNfn, Allan Chernoff raises the issue of smoothing out of earnings, which Freddie Mac was clearly doing. He states, “Clearly they were not the only guys in the game. So, many companies were engaged in that. Do you think that there’s much more to come in terms of learning of companies that were sort of playing with the books here?”
- Neil Weinberg, senior editor of *Forbes* responds, “Well, I think it depends on how far we dig. But obviously this is something, like a lot of scandals that have come out, something that was standard operating procedure on Wall Street for a long time. And all of a sudden people lost money and the rules of the game changed and it’s, my goodness, now this isn’t allowed anymore. So I think that that’s where we are. Now I think if regulators continue to dig, they’ll certainly find a lot of smoothing going on, probably with companies from technology to blue chips.
- Floyd Norris, business writer for the *New York Times*, addressed this issue in his November 28th article “The World is Volatile, So Why Should Earnings Show Smooth Gains?” Norris notes that “to far too many executives in corporate America, the right to report steadily rising quarterly earnings is fundamental, ranking right up

there with life, liberty and the pursuit of happiness. If that belief is not changed, the current wave of corporate reform will ultimately fail.” Using Freddie Mac’s efforts to smooth earnings as an example, Norris notes that the GSE shifted more than \$420 million in profits through such maneuvers, which impacted pro forma operating earnings that Wall Street believes provides a more accurate view of “real earnings.”

- While Freddie Mac now says this maneuver was improper, it thinks that many others were legitimate because they at least had some business purpose in addition to shifting earnings from one period to another. The company assumes, you see, that smoothing earnings is a perfectly acceptable goal. It should not be. The reality is that life is volatile and accounting should reflect the truth. Much of Wall Street likes things the way they are and it won’t be easy to change their attitude.
- When Gregory J. Parseghian, then Freddie’s chief investment officer, was persuading Goldman, Sachs to do an offsetting trade, he explained profits were too high, that “we have the opposite issue that the rest of corporate America has right now.” The Goldman official responded, “It’s true. But the purist says it’s the same coin. It’s just a different side of the same coin.” And, so it was. Misleading investors is no less serious if the company is hiding profits rather than inventing them. (*New York Times*, Floyd Norris, 11/28/03)
- The staggering sum of fees [of over \$100 million for Freddie’s restatement to date]—perhaps more clearly than anything else in the [eleven] months-long scandal—illustrates for critics of the GSE just how egregious an error in judgment Freddie Mac made in calculating the perceived value of smoothing its earnings. (*Market News International Main Wire*, 11/24/03)

And Freddie’s incestuous relationship with the Street continues...

- While individual investors are understandably skittish about Freddie’s dismal disclosure record, Wall Street still loves Freddie. It is an incestuous relationship, inherently suspect because the big financial firms make millions of dollars a year doing various mortgage securities and bond business with Freddie. They were also parties to some of the deals that Freddie used to manipulate its earnings.
- During its conference call to analysts on November 21st, one analyst “fawned” over Gregory J. Parseghian, who is being forced out the job of CEO because of his participation in the manipulation of earnings. It’s a shame that Wall Street doesn’t have higher ethical standards. (*Washington Post*, Jerry Knight, 11/24/03)
- "The fact that virtually every line item in the income statement is different shows why this [audit] took so long [eleven months]," said Bruce Harting, an analyst at Lehman Brothers. "These changes make me feel a lot better about the future of the company." ...*Say what?* (*The International Herald Tribune*, Kenneth N. Gilpin, 11/22/03)

- Don Luskin with Trend Macrolytics, explained Freddie Mac’s accounting problems to viewers of Market Roundtable on CNN FN, by saying “We’re kind of into the world now where instead of uncovering just the giant frauds, we’re, in fact, discovering things that were just sort of complicated that nobody quite knew how to fit it into generally accepted accounting principals, because you know big operations like these mortgage managers are doing things that have essentially never been done before, that there are no good accounting rules. So mistakes are going to happen. They’re potentially honest mistakes, but they are potentially very large.” (*Analyst Wire*, Market Roundtable, Third Round, CNNFN, 11/21/03)
- Despite the pending investigations and unresolved questions about Freddie Mac’s accounting, two-thirds of Wall Street research analysts who follow the company rate its stock as either a buy or strong buy maintaining positive coverage of Freddie Mac’s stock. The firms who have recently issued recommendations include UBS Warburg LLC (buy2), PNBC Bank (buy), Credit Swiss First Boston (outperform), Friedman, Billings, Ramsey & Co. (outperform), Raymond James & Associates (market perform). (*TheStreet.com*, Matthew Goldstein, 11/21/03; *Bloomberg News*, Al Yoon, 11/25/03; *Comtex News Network*, 11/24/03, 12/04/03, and 12/08/03)
- In sharp contrast to the Wall Street “herd,” Wachovia Securities recently suspended their rating on Freddie Mac and withdrew earnings estimates until their belief that the company has provided sufficient information to form a reasonable basis for opinion. Joel Houck, analyst for Wachovia, wrote that he was “disappointed” by the lack of [Freddie’s financial] information on 2003 in its restatement and “frustrated” that it included only earnings calculated under GAAP, “given that analysts have historically analyzed and forecast operating earnings.” (*The American Banker*, Jody Shenn, 11/26/03, *Comtex News Network*, 11/25/03)
- Reflecting Wall Street’s view of the Freddie Mac, *Money Magazine* touted “Steady Freddie” as one of its most promising picks among scandal stocks. *Money* noted that Freddie has relatively easy access to capital, because of the perception that the government will bail it out of financial trouble and it enjoys a line of credit from the Treasury. While the Bush administration would like to tighten regulation of the GSE, few analysts are betting that any regulatory change will happen soon, thanks to Freddie’s powerful and well-funded lobbying operations. And, politicians are loath to go after any company that ensures stability in the housing market. Freddie has a strong cash position, a wide net profit margin of 37% and its 15% long-term growth rate is double that of the S&P 500. (*Money Magazine*, Donna Rosato, 11/27/03)

Uncertainties loom over Freddie

- Naming its new chairman and CEO and reaching a settlement with OFHEO still leaves much unresolved at Freddie. Last month, Freddie announced that it will not release 2003 financial statements until June 2004. According to a source, Freddie expects to hold its 2003 annual meeting by February or March and its 2004 annual

meeting in the fall. Freddie expects that its current board members will be re-nominated.

- Also, pending at Freddie are two ongoing investigations into wrongdoing and an IRS audit. The Justice Department is investigating the circumstances surrounding the disappearance of notes taken by a former senior executive and has provided testimony before a grand jury.
- The SEC also has an ongoing investigation to determine if Freddie's inaccurate financial statements amounted to fraud. Sources said that Freddie expects the SEC probe to be completed by February or March and that it will involve additional fines, possibly \$50 million.
- As a result of settled tax rulings in September for the GSE, Freddie Mac added \$155 million to its fourth quarter profit total from a reduction of tax reserves in its November 21st restatement. Freddie said that the reserve total could change if the IRS appeals the rulings, but if another related case is ruled in favor of the GSE, it also might recognize additional "material boosts in other quarters." All told, the IRS says that Freddie underpaid taxes by \$215 million as a result of improper treatment of intangibles between 1985 and 1990, while Freddie claims it overpaid \$92 million during that period. The tax consequences, if any, of Freddie Mac's restatements is another issue that has not been resolved. (*Washington Post*, Kathleen Day, 12/08/03; *The American Banker*, Jody Shenn, 12/01/03)

Wonder what he knows...

- To date, Freddie's board and new management team have fired at least 15 people in connection with the GSE's restatement. Recently, one of those fired, Byron Boston, former vice president of investments, told *National Mortgage News* that the real story isn't about who was fired, "but who's still there." Mr. Boston refused to elaborate. (*National Mortgage News*, Paul Muolo and Brian Collins, 12/01/03)

Freddie names Goeltz to board

- Freddie Mac announced that Richard Karl Goeltz, former vice chairman and chief financial officer for American Express, was elected to the GSE's board of directors. Goeltz, 61 years old, fills one of two vacant positions on Freddie Mac's board of directors, created by dismissal of Freddie's CEO and president in June. In 1999, Goeltz retired from American Express after three years as chief financial officer, where he was responsible for 5,000 people covering traditional finance, treasury, tax, international audit, support services and estates. Prior to joining American Express, Goeltz spent four years as group chief financial officer at National Westminster Bank and 22 years at Joseph Segram & Sons Inc.

- Goeltz serves as director for Warnaco Group, where he is chair of the audit committee and a member of the nominating and governance committee. He is also a director and member of the audit committee of The New Germany Fund, a NYSE-listed closed end fund. Goeltz is a member of the Board of Overseers of Columbia Business School and a member of the Court of Governors and the Council of the London School of Economics and Political Science and deputy chairman of its Finance and General Purposes Committee.
- Goeltz is a former member of both the Financial Standards Board Advisory Council and the United Kingdom's Accounting Standards Board. He also served on the New York Federal Reserve's International Capital Markets Advisory Committee and The 59 Wall Street Funds Board of Trustees. Goeltz received his M.B.A. from Columbia Business School and his B.A. in economics from Brown University. He also studied at the London School of Economics and New York University.
- "Wall Street wants fresh blood in that board room so this is a step in the right direction," said Paul Miller, analyst at Friedman Billings Ramsey Inc., Arlington, VA. "Plus, it also looks like he is an accounting expert." Freddie's chairman Shaun O'Malley said that he expected "several new directors over the next year and a half." (*Freddie Mac Press Release*, 12/04/03; *Bloomberg News*, Al Yoon, 12/04/03; *Wall Street Journal*, 12/05/03)

Freddie's portfolio growth down, market share up in October

- Freddie Mac said its investment portfolio grew at an annualized rate of 27% in October to \$655.5 billion, nearly half its rate of growth in September of 50.6%. As a result of its aggressive discounting of guarantee fees on mortgages, Freddie Mac increased its market share in mortgage-backed securities from 41% in September to 46% in October. Freddie Mac's mortgage portfolio grew 33.8% in October to \$1.387 trillion, according to the GSE's monthly business summary.
- Freddie Mac also said that its October duration gap, which measures any mismatch in cash flows between its assets and its debt liabilities, was zero months versus -1 month in September.
- Monthly portfolio and mortgage securities growth is one of the only ways investors and analysts can gauge Freddie Mac's progress, since the GSE has not released any quarterly earnings reports during 2003 and won't do so until June 2004.
- Chris Buonafede, an analyst with Fox-Pitt, Kelton Inc., said in a research report that the rebound in Freddie Mac's market share is a positive development, but he viewed it as "low quality" given the [negative] earnings impact. Moreover, Freddie Mac's increase in market share isn't enough to convince some investors to buy its mortgage-backed bonds. "There are still too many question marks going on with Freddie and the recapturing of market share is not enough to shift our view of their securities,"

said Michael Hoeh, senior portfolio manager at The Dreyfus Corporation. (*Reuters*, 11/25/03; *Bloomberg News*, Al Yoon, 11/25/03; *Wall Street Journal*, Julie Haviv, 11/25/03)

Freddie declares dividend

- Freddie's board of directors declared a quarterly dividend on the corporation's voting common stock of \$0.26 per share, matching its dividend for the previous two quarters. Fourth-quarter dividends will be payable on December 31, 2003 to shareholders of record as of December 15, 2003. The board will continue to evaluate dividends each quarter, said a company spokesman. The delay of earnings calculations will not necessarily preventing the board from increasing dividend payouts. (*Freddie Mac press release*, 12/05/03; *The American Banker*, Jody Shenn, 12/08/03)

Freddie's web auctions may hurt liquidity

- For the first time in two years, Freddie Mac will be selling its most liquid reference notes via an Internet auction the first week of December, rather than through the more traditional syndicate of dealers. While the move will save Freddie underwriting expenses on the sale, the GSE's decision could backfire because the auction process circumvents Wall Street's agency-underwriting heavyweights, which in return for the underwriting fees guarantee that secondary market trading in securities remain liquid. "The issue here is that the Internet is not a proven channel and Freddie Mac is still dependent on [Wall] Street's distribution channels," said RBC Dain Raucher's Krylov. "Should the Internet action prove very effective this may put more pressure on fees the Street [underwriters] can charge." (*Dow Jones Newswires*, Julie Haviv, 12/01/03).

Freddie Mac shuns loans requiring arbitration

- Freddie Mac became the first player in the secondary market to adopt a policy of no longer investing in subprime mortgages that contain mandatory arbitration clauses. This policy, effective August 1, 2004, is aligned with the GSE's existing prohibition on the use of mandatory arbitration for prime market mortgage instruments. "Freddie Mac believes that all homeowners should be able to voluntarily choose the mortgage dispute resolution option that they believe to be in their best interests," said Paul Peterson, Freddie's chief operating officer. "We remain committed to helping families build wealth through home ownership."
- Such "mandatory arbitration clauses" are often put into subprime mortgages, which are loans for borrowers with patchy credit. Consumer advocates have complained that these customers usually don't realize that they are signing away their right to sue. Instead, they must resolve disputes with lenders through arbitration. Lenders usually

select and pay for the arbitrator, which may make him or her less objective, said Eric Stein, spokesman for the Center for Responsible Lending. According to Tom Methvin, a lawyer at Beasley Allen, Montgomery, AL who represents victims of predatory lending, consumers rarely win in arbitration, and cannot appeal the decision. “It’s a kangaroo court,” he said.

- “I applaud Freddie Mac for this move,” said John Taylor, CEO of the National Community Reinvestment Coalition, a nonprofit consumer group in Washington. “It raises the bar for themselves and for Fannie Mae to eliminate unnecessary, mandatory-arbitration clauses from subprime loans. Mandatory arbitration supports abusive practices.” (*Freddie Mac Press Release*, 12/04/03; *Reuters*, 12/04/03; *The American Banker*, Erick Berquist, 12/05/03)

International GSEs

EU harmony bordering on impossible

- European Union member states are committed to integrating retail financial markets, including the mortgage market, but harmonization is bordering on the impossible.
- A new institution, the European Mortgage Finance Agency (EMFA), is being proposed by the European Mortgage Finance Agency Project, headed by Rob Thomas. EMFA’s role would be to create a unified mortgage backed securities market by establishing a standardized issuing platform for lenders and a guarantee to investors of the timely payment of interest and capital. With an implicit guarantee from the EU, EMFA would be AAA-rated, providing lenders with an incentive to participate in a European funding market. This is a more practicable approach than a mortgage directive to compel lenders to integrate.
- By creating a stable source of long-term funding, EMFA would give consumers across Europe the option of a long-term fixed rate mortgage loan without redemption penalties.
- Most UK loans are variable rate while fixed rate loans dominate in France and Germany. By allowing all EU consumers access to the same type of long-term fixed rate mortgages without redemption penalties, EMFA would start to unify the impact of monetary policy across the eurozone. (*Sunday Telegraph*, Rob Thomas, 11/22/03)

Brits “askance” at EMFA proposal

- British homebuyers who fix their mortgage rates have historically proved unwilling to do so for longer than five years at most. Many look askance at anything over two.

- Just as homebuyers were bracing themselves for another run of base-rate increases last week, proposals were announced to launch a European Mortgage Finance Agency (EMFA), which would provide funding for ultra-long-term fixed rate mortgages.
- According to Rob Thomas, general manager of the EMFA project, the agency would give British consumers a better deal by providing them with lower mortgage rates and better mortgage products. Thomas said that EMFA should operate like Fannie Mae with “quasi-government support.” EMFA is seeking a similar arrangement with EU governments. If it succeeds, it will be able to offer borrowers across Europe “the ultimate consumer friendly product”.
- Ray Boulger of Bradford & Bingley is skeptical. “I find it very hard to believe that they’ll ever get government backing,” he says. “The British Government has been phasing out tax breaks for mortgage borrowers. And I see no reason why European governments as a whole will be willing to ask all the taxpayers in Europe to subsidize the – say – 50 per cent who buy property.”
- Leeds & Holbeck Building Society took advantage of the publicity surrounding long-term fixes to announce the launch of a range of mortgages with rates fixed at 5.99% for 15, 20 and 25 years. Borrowers are offered penalty-free exit windows after five years, and every two years thereafter.
- The Cheshire Building Society, the only other lender with a 25-year mortgage, charges just 5.2%. It allows penalty-free early redemption after six years, and then every two years. (*Sunday Telegraph*, Liz Dolan, 11/23/03)

Housing collateral “non-functional” in EU

- In Italy, mortgage lenders typically take six years, and with success far from guaranteed, to access the housing collateral in the case of default. While on a much smaller scale of dysfunction than Italy, the process is also slower in France.
- The EU guarantee would in effect subsidize banks in countries with underdeveloped mortgage markets and encourage risky lending, exposing EU taxpayers to what could be very serious long-term risks. Moreover, the poor data on mortgage markets, including lack of data on default rates and accurate house price indices, in many European countries are great impediments to transparent pricing of risk. The situation is crying out for reform.
- Rob Thomas should direct his efforts elsewhere and persuade the European Commission and national governments to reform property law and legal and other institutions such as land registries, so that housing collateral can function effectively across the EU. (*Financial Times*, John Muellbauer, 11/29/03)

U.K favors “hybrid mortgages”

- A source close to a government-sponsored review will favor the introduction of ‘hybrid mortgages,’ US-style fixed-rate home loans without early repayment penalties.
- Fixed-rate mortgages in the U.K. typically carry heavy early-payment penalties leading most borrowers to opt for variable-rate loans that track short-term rates set by the Bank of England.
- The Treasury believes borrowers are too sensitive to changes in short-term interest rates and that this exacerbates the ups and downs of the economic cycle.
- The source also said David Miles, a professor of finance at Imperial College London who is conducting the review, is unlikely to favor proposals to emulate the U.S. secondary mortgage market, by creating a homegrown Fannie Mae.
- In recent weeks, the European Mortgage Finance Agency, with the backing of some of Europe’s biggest mortgage lenders, said it wanted to create a single wholesale market for home loans in which a U.S.-style government sponsored enterprise would buy loans from banks and repackage them in a standard format as mortgage-backed bonds.
- The Treasury also asked Kate Barker, a member of the Bank of England’s Monetary Policy Committee, to find out why housing supply in the U.K. has not met demand in recent years. “It will be hard to come up with hard policy conclusions,” at this stage, she said.
- Both studies were commissioned by the Treasury when it said in June that the U.K. wasn’t ready to adopt the euro. The Chancellor said at the time that the nature of the British housing market was an obstacle to membership. (*Dow Jones Newswires*, Gonzalo Vina, 12/02/03)

Federal Home Loan Banks

Elections to FHLBank boards

- The FHLBank-Dallas has announced the election of Charles G. Morgan, Jr., Anthony Sciortini, Chesley N. Brooks, Jr., and James E. DuBose as directors of the Bank. All four will serve three-year terms as industry directors, commencing January 1, 2004. Mr. Morgan is executive vice president of Pine Bluff National Bank, Pine Bluff, AR. He is new to the Board and succeeds John L. Robbins, Jr., as the industry director for Arkansas. Mr. Sciortini is president and CEO of State-Investors Bank, Metairie, LA. He was appointed to the Board in July 2003 to fill a vacant industry director position.

Mr. Brooks is chairman and CEO of OMNIBANK, N.A., Houston, TX. He was re-elected to the Board for a third term. Mr. DuBose is president of Colonial Savings, Fort Worth, TX. He was appointed to the Board to fill a newly created director position. (*PR Newswire*, 12/08/03)

- Lynn V. Schneider, president and chief executive officer of American Bank & Trust, Huron, SD, was recently elected to a three-year term on the board of directors for the FHLBank-Des Moines. (*Aberdeen American News*, 12/04/03)

Tennessee Valley Authority

Is TVA bankrupt?

- Dennis Logue, dean of the University of Oklahoma's Price School of Business, and Paul MacAvoy of Yale's School of Management argue that the TVA is headed for a financial meltdown because of rising costs and mounting competition, raising the specter of a federal bailout. Although the federally owned TVA enjoys a triple-A bond rating, Logue and MacAvoy argue that the GSE is solvent only by virtue of inflated assets on its books. With its debt dangerously high, the professors argue that the TVA could face a liquidity crisis in as little as five years.
- "By most measures, they are broke, warns Logue. No stranger to utility finance, he was a part of the Price Waterhouse team that prompted the July 1983 shutdown of the Washington Public Power Supply System's nuclear reactors before completion, challenging rosy scenarios for electricity demand. The incident, dubbed "Whoops," resulted in the biggest municipal bond default in history.
- The TVA, created 70 years ago by Congress for control and economic development in the Tennessee Valley, now sells power to 158 municipally owned distributors and 62 large industrial and federal users in a seven state-region. The GSE has three nuclear plants, 11 fossil-fuel plants, 29 hydroelectric plants, six combustion storage plants and one pumped storage plant. Like Fannie Mae and Freddie Mac, The TVA is a government-sponsored enterprise. Unlike Fannie and Freddie, its only equity holder is Uncle Sam.
- Logue and MacAvoy co-wrote a paper on the TVA, running calculations on its future cash flow, enterprise value, implied equity value and other measures of financial strength. In their view, TVA's liabilities already exceed their assets. GAAP accounting reflects a \$1.07 billion net worth for the TVA, only because of excessive values placed on old, unfinished nuclear power plants that may never operate, say the professors. TVA is "converging towards illiquidity at an early date," as more and more private rivals spring up, warns MacAvoy. TVA's \$150 million credit line with the Treasury may be of scant help. Both Logue and MacAvoy believe that TVA's debt holders should be preparing for the worst.

- Standard & Poor’s TVA analyst Scott Taylor disagrees, saying that the agency’s credit measures are in line with other investment-grade utilities and demand for power in their territory is growing between 300 and 600 megawatts a year. OMB claims the TVA is on the road to financial health, not ruin, making progress in debt reduction and business development. OMB stated that if the TVA ever faced a severe liquidity squeeze, it could raise rates or sell of some operations to private companies.
- Norman Angus, principal at CTN Associates, says the breakup value of the company’s generating plants and transmission lines likely would fall far short of currently assigned values. Others point out that an energy bill before the Senate may make it more difficult for the TVA to implement future rate increases to cover rising costs.
- The TVA, like WPPS, pulled the plug on construction of expensive nuclear power plants in the early 1980s when it became evident that demand for the electricity would not materialize. Instead of writing off the plants as losses, TVA carried them on their books as a \$6.1 billion asset, as though the plants would be completed one day. This accounting fiction is not illegal, because the TVA is a regulated entity and convention allows it to carry the non-asset assets on its books. TVA’s own annual report notes that such treatment would be disallowed for a non-regulated entity. In 2001, TVA wrote down \$2.1 billion of incomplete plants, leaving \$4.1 billion in questionable nuclear assets on its books. In a written response to *Barrons*, the TVA says it is carrying the plants on its books until it can decide how best to make them a productive asset.
- MacAvoy and Logue see competition arising from deregulation as providing a more serious strain. Until now, TVA had a monopoly in its territory. At some point, the professors believe that the TVA will be unable to compete on pricing because of its high debt, the steep cost of Clean Air Act compliance, and restriction on selling power outside its service area.
- TVA plans to reduce its debt by \$3 billion to \$5 billion in the next 10 to 12 years. OMB demanded this reduction because TVA was close to its \$30 billion debt limit set by Congress. TVA’s plan for debt reduction relies upon savings through cost cutting and changes in laws by Congress, which will allow it to sell power outside its territory.
- MacAvoy and Logue hold little hope, saying the TVA is “using heroic assumptions.” MacAvoy says that TVA is a house of cards. Bondholders might want to fold their hand before it begins to topple. (*Barrons*, Jim McTague, 11/24/03)

TVA raises residential rates and lowers commercial rates to “boost” local economy

- In hopes of strengthening the valley’s economy, TVA recently passed a 2% decrease in electric fees for its large manufacturing customers. Effective October 1st, the board

increased residential rates by 7.4% and decreased medium to large manufacturing customers' rates by 2%. This action will net \$365 million a day to pay down TVA debt and fund the clean air initiative. (www.bizjournals.com, K. Denise Jennings, 11/21/03)

Sallie Mae

Computer glitch over ten-year period raises student's monthly payments

- As many as one million student borrowers will be paying higher monthly payments as a result of a computer glitch at Sallie Mae. Because of the error, borrowers were undercharged for more than ten years and must now make up the amount they underpaid. The glitch will increase the monthly payment for affected borrowers by as much as \$100 a month, but on average by \$8 to \$9 a month. Sallie Mae said that no student will end up paying more money overall because of the error. (*Credit Union Journal*, 12/08/03)

Strong demand for Sallie Mae securities

- Backed by strong demand domestic and overseas buyers, Sallie Mae sold a \$2.3 billion securitization of government-guarantee student loans on December 3. To date this year, Sallie Mae has sold \$29 billion in securitizations, a record high and more than double its previous record. During 2002, Sallie Mae's entire securitization program amounted to \$14 billion and in 2001 its volume was only \$6 billion. (*Dow Jones Newswires*, 12/03/03)

Treasury is looking for "temporary" regulator

- Treasury recently ran ads seeking a candidate for the number two position at the Office of Sallie Mae Oversight, which pays as much as \$124,783 a year. Their ad did not mention that the job will be phased out in two years, when Sallie Mae is slated to become a fully private entity. (*American Banker*, Barbara A. Rehm, Todd Davenport, and Craig Linder, 12/08/03)

Money Magazine picks Sallie

- In their quest to identify 20 companies with all the promise of becoming the market's "Next Big Thing," *Money Magazine* selected Sallie Mae, noting "it should prosper as Generation Y goes to college." (*Money*, Stephen Gandel, Lisa Gibbs, Pablo Garlaza, 12/03)

Farm Credit System/Farmer Mac

Farm lenders see threat as GSE seeks to diversify

- CoBank, the nation's largest Farm Credit lender, wants the federal law changed so that it can lend to a new generation of co-operatives recently authorized by changes to Wyoming and Minnesota laws. Co-Bank, whose charter restricts lending to farmer-owned co-operatives, says it needs more lending power to remain competitive. But, bankers argue that the \$27 billion Denver-based company is trying to encroach on their turf and would use its status as GSE to undercut them on rates.
- "If they get what they are asking for, anything that has some farmer element could become an eligible CoBank borrower," said John H. Blanchfield, the director of the American Association's Center for Agricultural and Rural Banking.
- While CoBank has yet to find a sponsor to its proposal to change the definition of a farmer-owned co-op, the GSE is circulating a proposal among the House and Senate agriculture committees. Jack Cassidy, CoBank's senior vice president for corporate relations, said the recent changes to the two state laws compel his company to seek expanded definitions so it can meet its obligations under the Farm Credit Act to lend to farmers under the new state laws. (*American Banker*, Ben Jackson, 12/08/03)

Postal Service

Bush administration pushes for postal reform

- The Bush Administration has called on Congress to enact comprehensive postal reform to ensure that the U.S. Postal Service can continue to provide affordable and reliable service, while limiting the exposure of taxpayers and operating appropriately within the competitive marketplace. The administration outlined five basic goals for postal service reform:
 - **Implement best practices**, by ensuring the Postal Service's governing body is equipped to meet the responsibilities and objectives of an enterprise of its size and scope;
 - **Transparency**, by ensuring that important factual information on the Postal Service's product costs and performance is accurately measured and made available to the public in a timely manner;
 - **Flexibility**, by ensuring the Postal Service's governing body and management have the authority to reduce costs, set rates, and adjust key aspects of its business in order to meet its obligations to customers in a dynamic marketplace.

- **Accountability**, by ensuring that a Postal Service operation with greater flexibility has appropriate independent oversight to protect consumer welfare and universal mail service; and
- **Self financing**, by ensuring that a Postal Service operating with greater flexibility is financially self-sufficient, covering all of its obligations. (*White House Press Release, 12/08/03*)

House Committee on Government Reform makes postal reform top priority

- In response to the Administration’s call to action on postal reform, Representatives John McHugh , Tom Davis, Henry Waxman, and Danny Davis released the following joint statement:
- *“We want to thank the Administration for continuing to highlight the need for postal reform, since we believe this is a critical, daunting issue. Without a fundamental shift in the Postal Service, we face a series of unattractive options to keep the postal service operating. While the postal pension reform enacted earlier this year means postal rates will not rise until 2006 at the earliest, the Postal Service continues to be hampered by flagging revenue, high costs, and an untenable debt load. This crisis has been brewing for many years, and it’s time to act on comprehensive reform. Too many jobs, too many businesses, and too many families are depending on us. We’re committed to working in a bipartisan manner on postal reform when we reconvene in January, and we’ll do so with close attention to the guiding principals laid out today by the President.”* (*Press Release from Representative John M. McHugh, 12/08/03*)

Support for postal reform building

- Wally Olihovik, President of the 42,000-member National Association of Postmasters of the United States, praised the Bush administration for outlining its basic principals for postal reform. “Postmasters are pleased that the White House reaffirmed its support of a universal and affordable Postal Service.” He added, “The President articulated the need to better equip the Postal Service to remain viable.” NAPUS has actively communicated with key White House personnel and the Congressional leadership to guarantee that these important policy-makers consider the views of our nation’s postmasters as this legislative process moves forward. NAPUS will continue to work with the White House, the Congress and the Postal Service to enact legislation that would enhance the Postal Service for the American citizens and businesses that rely on its services and safeguard the universal service that postal customers expect and deserve. (www.napus.org, NAPUS Press Release)
- The Association of Postal Commerce (PostCom), an organization representing companies that value preserving a universal mail delivery system for business and commerce, praised President Bush for his support to enact comprehensive postal reform. PostCom’s president Gene Del Polito said a postal crisis has been building

for the past several years and has been largely ignored. “The President and this Administration understand all too well the importance of our postal system as a part of our nation’s infrastructure,” said Del Polito. “The Bush Administration also understands fully that the loss of our industry and our economy would suffer if the postal system is allowed to drift into fiscal collapse.” He added, “The time for discussion is over. It’s time to get a meaningful reform package enacted into law.” (*PostCom press release*, 12/10/03)

USPS books \$3.9 billion “surplus” for fiscal year 2003

- For its fiscal year ending September 30, the Postal Service ended the year with a \$3.9 billion surplus. Net income from operations was \$900 million, instead of the projected \$600 million, said USPS chief financial officer Richard Strasser. The USPS’ profit was 50% higher than forecasted because of lower expenses and more efficiency, as mail volume continued to decline. Most of the surplus--\$3.8 billion--was used to reduce the agency’s debt from \$11.1 billion to \$7.3 billion, he said.
- Strasser said that these results were achieved in part, though a reduction in staff and other cost cutting measures. The agency reduced its work force by 24,400 through attrition rather than layoffs. The Postal Service now employs 729,000 people. He noted that these results were achieved despite a decline in mail volume of about 600 million pieces and the addition of 1.8 million delivery addresses to its rolls, which increased the agency’s obligations. Overall, the USPS had revenue of \$68.5 billion for the year.
- As a result of the Postal Civil Service Retirement Reform Act of 2003, the Postal Service was permitted to stop overpaying into retirement accounts, which increased the USPS’s net income by \$3 billion. In recent years, the agency’s investments have had higher-than-expected returns, which has resulted in the Postal Service making large overpayments to those accounts.
- Strasser cautioned that the USPS continues to face long-term structural challenges. The Postal Service’s costs are forecast to rise 40% over the next 14 years and annual losses could reach \$8.5 billion by then unless the agency makes changes.
- “In the near term, postal finances look excellent,” Strasser said. “However continued declines in First-Class mail volume, continued growth in delivery addresses, the 30-year old postal rate setting process, and continuing marketplace changes threaten the ability to finance universal service as we define it today.” He added, “The [Postal Service’s] business model is still greatly at risk.” (*DM News*, Melissa Campanelli, 12/10/03; *Washington Post*, Brian Faler, 12/10/03; *Bloomberg News*, Nicholas Johnson, 12/09/03)

Accounting changes for Postal Service's CSR

- The Postal Service removed its supplemental liability to the Civil Service Retirement and Disability Fund from its 2003 third quarter balance sheet in a bookkeeping change that will not affect USPS income, said the agency. “This change has no impact on our income statement or our statement of cash flow and does not alter the postal service’s accounting policy for pension costs,” said USPS chief financial officer Richard J. Strasser, Jr. “This change acknowledges the fact that any supplemental liability is subject to recalculation by the Office of Personnel Management on an annual basis with up to 12 months allowed to complete the estimate.” The change, which eliminates both the \$5.8 billion asset and liability on the balance sheet, was prompted by the Postal Civil Service Retirement System Funding Act of 2003. (*DM News*, 12/04/03)

Disability settlement could cost USPS millions

- On December 3rd, an administrative law judge approved a settlement for 25,000 employees that the Postal Service placed on disability rehabilitation positions—which the plaintiffs called “dead-end” jobs—since 1992. The plaintiffs could receive up to \$25,000 each in back pay and emotional distress charges. The amount of damages depends on what year a promotion was denied and could vary from \$5,500 to \$25,000. The Postal Service will likely pay hundreds of millions of dollars in damages in settlement of this class-action suit. (*FederalTimes.com*, Stephen Losey, 12/08/03)

Case concerning right to sue USPS heard by the Supremes

- The Supreme Court has heard arguments in *United States Postal Service v. Flamingo Industries*, concerning the issue of whether the USPS can sue or be sued, including for alleged anti-trust violations. In arguments before the Court, the Bush administration argued that Congress in 1970 did not remove the Postal Service’s status as a federal agency immune from the anti-trust laws. Congress wants the Postal Service to act in a “business-like” way, while retaining its agency status, added Deputy U.S. Solicitor General Edwin Kneeder. The Flamingo case stems from a contract relationship the company had with the Postal Service, producing mailbags for the agency. In 1997, Flamingo lost the contract with the USPS and was forced to close the company. The company’s owner suspected that postal managers had changed specifications for mail sacks in a way that his company couldn’t comply so they could claim an emergency shortage and dump Flamingo’s contract in favor of a cheaper version made in Mexico. The owner’s daughter convinced him to file a lawsuit arguing that the Postal Service had violated anti-trust laws by colluding with Mexican manufacturers to suppress competition and create a monopoly of mail sack

production. The U.S. Supreme Court is expected to render a decision on the case in July. (*Daily Herald*, S.A. Mawhorr, 11/29/03; *Chicago Daily Law Bulletin*, Steve Lash, 12/02/03)

Cost cutting in Postal Service's future

- With ever increasing costs at the Postal Service and a decrease in revenue with people sending more email messages via the Internet, the USPS is evaluating smaller post offices across the country to identify peak operating hours. On an office-by-office basis, the Postal Service will identify costs that can be saved by closing offices when customers aren't around. (*Sullivan County Democrat*, Jeanne Sager, 12/02/03)
- Cost cutting measures are being identified throughout the USPS. More than 1,300 personnel specialists and clerks will retire or move on to other jobs when the Postal Service closes its 80 district personnel offices. The offices will be consolidated into one central office in Eagan, MN, that will manage personnel and benefits programs for postal workers, said spokeswoman Kristin Krathwohl. The Postal Service will start phasing out 1,250 nonunion personnel specialists and 90 clerk positions in summer 2005 and will finish by fall of that year. Approximately 40% of these employees will be eligible for retirement. (*FederalTimes.com*, Stephen Losey, 12/01/03)

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