

The **GSE** REPORT™

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Major Events

Freddie's "stunning" restatement

- On Friday, November 21, Freddie Mac announced the cumulative net effect of their restatement through December 31, 2002, was an increase in GAP net income of \$5.0 billion and an increase in regulatory core capital of \$5.2 billion.
- Broken down by year, the restatement found that actual earnings in 2000 were \$3.7 billion, actually \$1.1 billion higher than originally reported. In 2001, the company earned \$4.1 billion, *down* \$989 million from the initially reported figure. In 2002, the company earned \$10 billion, an increase of \$4.3 billion over the previously reported results.
- Freddie Mac announced that it overstated 2001 net income by \$989 million, primarily because of "unrealized losses on derivatives not in hedge accounting relationships."
- The greatest cumulative income impact resulted from the accounting corrections related to accounting for derivatives and security classifications, totaling \$5 billion pre-tax and \$1.7 billion pre-tax, respectively. Freddie Mac determined that a substantial amount of its accounting hedges did not qualify for hedge accounting treatment, due in part, to the fact that some were executed for purposes other than risk management, which resulted in mark-to-market gains and losses on the company's income statements.
- Corrections relating to security classifications also resulted in an increase of \$2.7 billion to cumulative Accumulated Other Comprehensive Income. Transactions involving securities previously classified as "held-to-maturity" that were accounted for as financings should have been accounted for as sales. As such, the entire "hold-to-maturity" portfolio had to be reclassified as "available for sale" and unrealized gains and losses were recorded in the Accumulated Other Comprehensive Income category on the balance sheet.
- The fair market value of Freddie Mac's net assets (net of tax effect) grew \$4.6 billion during 2002.
- Freddie Mac says it met all capital requirements set by its regulator for all quarters of its earnings statements.
- Freddie Mac plans to provide its 2002 annual report and hold its related annual stockholders' meeting in the first quarter 2004.
- The company's objective is to release quarterly and full-year 2003 results by June 30, 2004 and provide its 2003 annual report and hold its stockholders' meeting as soon as practicable thereafter. (*Freddie Mac Press Release*, 11/21/03; *thestreet.com*, TSC

staff, 11/21/03; *Dow Jones Newswire*, 11/21/03; *American Banker*, Rob Blackwell, 11/24/03)

Freddie 'fesses up, *sort of*...

- The restatement contained dozens of pages of financial data and discussion but has not been audited by Freddie's auditors, PricewaterhouseCoopers. An audited report will not be provided until Freddie's 2002 annual report is released at the annual meeting in the first quarter 2004. (*Financial Times*, Jenny Wiggins, 11/24/03)
- "It's very bare bones numbers... There's still a lot we don't know," said Bert Ely, financial consultant in Alexandria, VA. Ely observes --
 - Freddie did not release audited financial statements for the years 2000-2002. A full set of audited financial statements includes, in addition to the consolidated balance sheets, statements of income, and statements of stockholders' equity Freddie released, an auditor's opinion letter and a full set of footnotes. As an example, Freddie's last audited financial statements, for 2001, included 16 footnotes.
 - A complement in the annual report of a public company to its audited financial statements is Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A). That analysis covered 28 pages in Freddie's 2001 annual report and provided statistical detail about Freddie's activities. Freddie did not release an MD&A on Friday. Presumably at some time in the not-too-distant future it will release an MD&A for the 2000-2002 period which will, among other things, revise and correct the MD&A published in Freddie's 2000 and 2001 annual reports.
 - The financial statements Freddie published on Friday did not include revised balance sheets for the years ended December 31, 2000, and December 31, 1999. The full three years' financial restatement will not be complete until those two balance sheets have been published, with an auditor's attestation. The December 31, 1999, balance sheet should be particularly interesting because it will show a 40% reduction in stockholders' equity capital on that date, with equity capital dropping from a reported \$11.525 billion to \$6.895 billion, equal to 1.79% of its assets. This \$4.63 billion drop in equity capital can be calculated from the Consolidated Statements of Stockholders' Equity that Freddie released on Friday, as follows: Additional paid-in capital on December 31, 1999, increased by \$150 million (line 8 of the statement), retained earnings on that date increased by \$576 million (line 16), but accumulated other comprehensive income (AOCI) dropped by \$5.356 billion! (Line 23). This adjustment indicates that Freddie understated its unrealized losses on its investments, as of December 31, 1999, by \$5.356 billion, or approximately \$8.4 billion on a pre-tax basis [Appendix II, table at the bottom of page 3]. According to the brief discussion on page 3 of Appendix II, this adjustment is due to the reclassification of securities from held-to-maturity to available-for-sale. While it can be argued that 1999 data is ancient history, a

40% downward adjustment in net worth is hardly insignificant and merits further explanation. This indicates further the magnitude of accounting problems at Freddie Mac that extend back before the restatement period.

- While Freddie acknowledged that its future earnings will demonstrate more volatility than reported earnings in the past did, stating on page 4 of the November 21 news release that "the company anticipates that its net income for the periods following the restatement will continue to reflect greater volatility than previously reported from quarter to quarter," the November 21 news release did not address a key point Freddie noted in an Information Supplement dated June 25, 2003, when it stated (bottom of page 1 and top of page 2) that "the corporation continues to expect that adjustments affecting its income will relate substantially to changes in the timing of income recognition and, as a result, cumulative increases related to these adjustments will have offsetting effects in future periods." That is, pulling income into the 2000-2002 periods, which is one consequence of the restatement, will have a depressing effect on future earnings. Freddie's statements last Friday gave no quantification of the negative impact of the restatement on future earnings.
- Freddie disclosed the existence of two majority-owned REITs [Appendix II, page 6]. Freddie's restated balance sheet consequently shows \$2.309 billion of minority interest in consolidated subsidiaries (presumably the REITs) on December 31, 2002, down from \$2.619 billion on December 31, 2001. Appendix II does not provide any explanation as to who the minority stockholders are and whether or not they have profited unfairly, at the expense of Freddie's stockholders, through their participation in the ownership of these REITs. Additionally, Appendix II's discussion of the REITs [page 6] notes that Freddie owns 99.9% of the common stock of the two REITs. There is no discussion of who owns the other .1% of the common stock of the REITs and how they have fared with that investment. This ownership structure has similarities to the infamous Enron special-purpose entities that the since-indicted Andrew Fastow helped to create.
- The November 21 news release provided quarterly net income numbers for 2001 and 2002, but not for 2000.
- The November 21 news release discusses Freddie's "fair value balance sheets" (FVBS) as of December 31, 2002, and 2001 [pages 6 and 7] but does not present the FVBS as of those dates nor is there any discussion of Freddie's FVBS as of December 31, 2000. There is additional discussion of Freddie's FVBS, as of December 31, 2001, on page 14 of Appendix III, but again no presentation of a FVBS in a format comparable to the FVBS, as of December 31, 2001, presented in footnote 13 to Freddie's 2001 financial statements, as published in its 2001 annual report. It will be difficult to assess Freddie's FVBS until it is published in sufficient detail.
- The range of accounting errors reported by Freddie is breathtaking as to both number and magnitude. The scope of these errors raises several questions:
 - (1) How did Freddie's accounting get so bad and why did Freddie's directors fail to act years ago to improve Freddie's accounting?

- (2) Did OFHEO have any indication of the magnitude of Freddie's accounting problems and if not, why not?
- (3) What assurances are there that Freddie's near twin, Fannie Mae, has not experienced similar accounting problems?
- These errors also suggest that Freddie's finances are much more complicated, and therefore prone to error and miscalculation, with possible systemic consequences, than had been previously understood even by financial experts. This is extremely troubling given the size of Freddie, and of Fannie. (*Financial Times*, Jenny Wiggins, 11/24/03; analysis prepared by Mr. Bert Ely, Ely & Company, Inc., 11/24/03)

Analysts, regulators and Congress react ...

- Traders said the restatement removed some, but not all, uncertainties about Freddie Mac. “They need to show me the 2003 numbers are going to be in line with expectations and there aren’t going to be any mistakes, said Steve Mahoney, portfolio manager at Glenmede Trust Co. (*Reuters*, Mark Felsenthal, 11/21/03)
- “Analysts were disappointed to find that Freddie would not be releasing any 2003 results until the end of June and that it remained uncertain when it would be able to start reporting earnings on a time basis. They were, however, heartened to hear that Freddie intended to complete by the end of the year its search for a new chief executive to replace Greg Parseghian.” (*Financial Times*, Jenny Wiggins, 11/24/03)
- OFHEO, Freddie Mac’s federal regulator, said “the magnitude of the accounting improprieties and management misconduct” revealed from the company’s restatement underscores the need for remedial action. “The necessity of this restatement and the magnitude of the accounting improprieties and management misconduct reinforce the need for remediation and enforcement actions,” said Armando Falcon, director of OFHEO. “The circumstances that give rise to this restatement are the subject of our ongoing investigation and will be fully addressed in our forthcoming report,” Falcon said.
- “With Freddie’s billion-dollar overstatement and no previous warning that such a surprise would surface in reported earnings, we’ve now arrived in Enron territory, we should all be gravely concerned,” said Representative Richard Baker (R-LA). “Freddie’s admission fractures the company’s credibility, its error having come, at best, though doubtfully, as a result of incompetence and at worst, because of intentional market manipulations that raise the most troubling questions, not only about a few bad apples, but the company as a whole, all the way up to the board,” Baker added. “What other surprises await us?” he questioned. (*Dow Jones Newswire*, John Conner, 11/21/03; *Dow Jones News Wire*, Dawn Kopecki, 11/21/03; *Comtex Newswire*, 11/21/03)
- “Back in June, a Freddie Mac lobbyist, presumably one of thousands, claimed the company had a ‘great story to tell’ because ‘the restatements are going to be up and

not down,” said Representative Christopher Shays (R-CT). “Even by that nonsensical standard, today’s announcement must have come as terrible news, but I’m sure Freddie will find some way to spin it and assure us that everything is hunky dory.” He added, “What troubles me is that it appears likely that Freddie Mac has known all along that it would restate its earnings downward in 2001, but kept this important information hidden from investors, Congress, and regulators.”

- “In face of the latest reincarnation of the company’s restatement, it’s absolutely astonishing that Congress has yet to step in and rein in this financial behemoth. Freddie Mac is the fourth-largest financial firm in the country, said Shays. “It obviously can’t add or subtract, yet it has the chutzpah to dictate laws it will comply with, and it continues to tell Congress and the White House what type of regulation is acceptable to it.” (*Congressman Christopher Shays Press Release, 11/21/03*)

Baker Botts supplemental report unveils more shenanigans
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- The supplemental report for Freddie’s board of directors prepared by the law firm Baker Botts L.L.P. states that the picture that increasingly emerges from a review of relevant documents “involves the awareness of the Chief Executive Officer, Chief Operating Officer, and Financial Officer of the use of accounting to achieve desired financial results.” According to the report, the picture that emerges points to “the relegation of F&I (funding and investments) to implementation of this predetermined strategy, as distinct from strategic planning,” as well as “a practice of limited transparency to the Board of techniques for achieving results.”
- The Baker Botts report details how Wall Street firms, including Credit Suisse First Boston, Citigroup, and Goldman Sachs, were drawn into earnings massages using interest rate swaps and mortgage bonds. The report details trades that it describes as “outside the accounting pale.” It pinpoints mortgage bond trades that two Freddie units, Funding and Investment (F&I) unit and a securities sales and trading group (SS&TG) arranged with Saloman Brothers, the investment banking unit of Citigroup. “The Salomon trades contravened... a limitation on the trading relationship between SS&TG and F&I, according to the Baker Botts report. Freddie Mac’s two departments, Baker & Botts said, “violated corporate tax guidance that the transactions not be prearranged.”
- The Baker Botts report indicates that one of the three firms, Goldman Sachs, raised questions about whether the transactions it was doing with Freddie Mac was acceptable by accounting standards. In two separate conversations, Goldman employees asked questions to obtain a “degree of comfort” as to why Freddie was doing the transactions, so that Goldman could have a better understanding of the motivation of the trades. Questions were asked of Greg Parseghian, who became Freddie Mac’s CEO this summer. Although the statements made by Parseghian in conversations with Goldman “appear to have been inaccurate at the time it was made”

there is no basis for concluding that Parseghian attempted to mislead Goldman, according to the Baker Botts report.

- This report reviews, among other things, a series of trades between Credit Suisse First Boston and Freddie Mac executed on July 19, 2002. These trades involve one pair of transactions in which CSFB sold \$8 billion in mortgage backed securities to Freddie and simultaneously agreed to repurchase the same type and amount of securities at a specified future date, while protecting Freddie Mac against any prepayment risk during the intervening period. The report stated, “We found no evidence that Freddie Mac entered into the transactions for purpose of affecting its reported financial results. We also found no evidence that Freddie Mac aided and abetted a securities law violation by CSBF namely, ‘parking.’” However, the law firm also said that “our ability to make findings on the purpose and intent behind transactions was limited in light of F&I’s failure to make an in-depth inquiry of CSFB as to the reasons for the transactions. (*Dow Jones Business News*, John Connor, 11/21/03; *Reuters*, 11/21/03)

Overstatement of 2001 earnings boosted bonus compensation for Freddie’s execs

- It appears that Freddie’s overstated earnings in 2001 may have boosted that year’s compensation for its executives. According to the GSE’s proxy statement for 2001, bonuses “were based primarily upon corporate performance,” including earnings. It shows the board of directors awarded then chairman and CEO Leland Brendsel a cash bonus of \$2.1 million on top of his \$1.1 million salary. David W. Glenn, was vice chairman and president, received a \$1.3 million bonus on top of an \$850,000 salary. Gregory J. Parseghian, who was chief investment officer, received a \$750,000 bonus on top of a \$1 million salary. During 2001, Glenn exercised options for Freddie Mac stock worth \$6.8 million and Parseghian exercised \$11.6 million in stock options, the report stated.
- David R. Doty, an attorney who led an investigation of the accounting errors for Freddie Mac board, said that he did not examine the effect of the accounting misstatements on executive pay. (*Washington Post*, Kathleen Day and David S. Hilzenrath, 11/21/03)

U.S. Attorney goes to grand jury

- As part of its criminal investigation on Freddie Mac, the U.S. Attorney’s Office in Alexandria, VA has “taken testimony before the grand jury.” No details were provided regarding the testimony. In public disclosures on Friday, Freddie Mac said it is “cooperating in all respects with this investigation.”
- In June, the U.S. attorney announced it had opened a criminal investigation involving the company. Freddie Mac reiterated its previous disclosure that its current chairman,

Gregory Parseghian, a former board member, and PricewaterhouseCoopers, its current independent audit firm, have received subpoenas from the SEC for documents and testimony. (*Dow Jones Newswire*, John Connor, 11/21/03)

The IRS and Department of Labor investigating Freddie

- Freddie repeated its previous disclosure that it has received inquiries from the IRS in connection with its regular audits of the company's tax returns for prior years, some of which relate to matters connected with the company's restatement.
- The GSE also repeated its previous disclosure that the Department of Labor has advised the company that it has opened an investigation of Freddie's Thrift/401K Savings Plan. In a new disclosure, Freddie Mac said the Labor Department requested interviews with certain individuals who have responsibilities with respect to the Thrift/401K Savings Plan. (*Dow Jones Newswire*, John Connor, 11/21/03)

Management attempts to assuage investors, analysts concerns on conference call

- When performing before two distinct audiences on Friday with its earnings restatement, Freddie Mac could either bow to lawmakers, looking for contrition, or try to reassure investors looking for signs of stability in a shaky company. Perhaps assuming that it wasn't possible to satisfy congressional critics, Freddie Mac opted to put on a confident face for the market.
- Freddie Mac executives sought to put the company's accounting troubles behind it. "The board is working closely with management to implement a remediation program that will serve both our mission and our shareholders," said Freddie Mac Chairman Shaun O'Malley. "We will face these issues squarely with the objective to do the right thing."
- During the conference call to investors, Freddie's chairman Shaun F. O'Malley declared that the company had righted itself and was pointed in the direction of solid growth. "We've added expertise to make sure this never, ever happens again," said Martin Baumann, Freddie's EVP and chief financial officer in an interview.
- "Our people at Freddie Mac are making an extraordinary effort.... Business fundamentals as well as our safety and soundness remain strong," said chief operating officer Paul Peterson. "And you can be assured that an uninterrupted focus on risk management will remain the hallmark of this company."
- While acknowledging embarrassing events, Freddie executives said it was time to move on. "We fully recognize the bad position that Freddie Mac has been in, and frankly how unhappy we are that we find ourselves in this position, said chief operating officer Paul T. Peterson in an interview. "Having said that, I think everybody—the regulator, legislators, investors, seller-servicers—all want to know

that we have a clear vision and a clear aim at getting this behind us. That is where we really need to focus our attention.”

- When asked why Freddie didn't disclose the \$989 million overstatement in earnings in 2001, when it went public with estimates in its underreported earnings, Freddie Mac EVP and chief financial officer Martin Baumann said, “There were many accounting corrections that the company had to make.” Baumann said that company auditors at PricewaterhouseCoopers had just completed on Thursday the massive reckoning, which was announced the following day.
- Asked repeated about the delay in releasing 2003 financial results, Baumann said Freddie had spent so much time and energy cleaning up past accounting that it had not yet rebuilt its infrastructure for current and future results. “I don't think it is reasonable to be criticizing Freddie Mac not that we have spent all this effort trying to provide accurate, clear information going forward,” said Baumann. “It is not that hard to understand our timetable.”
- Freddie Mac has spent roughly \$100 million in its massive reaudit to date, said the GSE's executives. This money has been spent during 2003 to beef up its internal accounting staff as well as outside auditors and investigators used to correct accounting errors prior to 2002. (*Dow Jones Business News*, Dawn Kopecki, 11/21/03; *Dow Jones Newswires*, Dawn Kopecki, 11/21/03; *Comtex Newswire*, 11/21/03; *American Banker*, Rob Blackwell, 11/24/03)

Wall Street analysts say Freddie's derivatives moves were “unnecessary”

- When it came to accounting for derivatives, Freddie Mac's shenanigans were not just potentially illegal, they were unnecessary. Their derivatives deception was likely unnecessary because investors have been forgiving when companies clearly outline consistent earnings fluctuations from the derivatives rule, analysts and accounting professionals said. “That's the irony here,” said an analyst in the Midwest.
- Freddie Mac was concerned about the impact a relatively new derivatives accounting regulation on its earnings, what it tried to minimize by entering into a series of shady transactions. FAS 133 has hit companies like Freddie Mac and Fannie Mae “hard” because they use derivatives extensively to reduce the risk of investing in mortgages. That has led Fannie Mae to report earnings according to GAAP and earnings according to its own performance rules, which ignore certain changes in the value of derivatives. Investors largely pay attention to earnings performance according to Fannie Mae's own measures.
- “Freddie Mac probably could have done just what Fannie Mae does, and break out certain effects of FAS 133 separately, and investors would probably not have punished them,” said John Barnet, an analyst at the Center for Financial Research & Analysis. (*Reuters*, Dan Wilchins, 11/21/03)

Freddie says it will register with SEC “as soon as practicable”

- The GSE stated, “Freddie Mac had previously announced its intention to register Freddie Mac’s common stock with the SEC in order to become a reporting company under the 1934 Act. Freddie Mac reiterates its commitment to return to timely reporting and complete the voluntary registration process with the SEC as soon as practical.” The GSE agreed last year to register with the SEC under the voluntary registration provisions of the 1934 Securities and Exchange Act, but was unable to do so because of its restatement process. (*Dow Jones International News*, 11/21/03)
- “Freddie is still fudging, still stalling the release of financial information that investors can get from every other company in the Washington region. After promising the long-overdue-first-quarter report would be available by now, Freddie officials now say investors will have to wait until June to find the answer – 15 months instead of the usual six weeks after the end of the quarter. And it will be 2005 before Freddie gets its records in order so it can register with the Securities and Exchange Commission and start filing periodic financial reports – a basic investor protection provided by every public company in town except Freddie.” (*The Washington Post*, “Did You Hear,” 11/24/03)

Despite unknown or unconfirmed financials, Fitch affirms Freddie Mac at AAA / F1+

- In a press release, Fitch Ratings (NY) has reaffirmed Freddie Mac’s long-term senior debt rating of ‘AAA and its short-term rating of ‘F+1’ following Freddie Mac’s restatement of earnings for the periods 2000, 2001 and 2002. Freddie Mac’s ‘AA-‘ subordinated debt and preferred stock rating remain on rating Watch Negative. Approximately \$10 billion in preferred stock and subordinated debt are affected by today’s action.
- **Central to Fitch’s ratings assessment of Freddie Mac is its U.S. government charter and GSE status**, its leading position within the domestic housing finance system and Fitch’s comfort with its core interest rate risk and credit management capabilities. While Fitch believes that a shift in regulatory oversight from the OFHEO to another authority is likely, “we believe the U.S. Government’s commitment to the residential housing system will continue.”
- While disappointed with the necessity of a large, multi-year restatement and by the accounting expertise and control weaknesses outlined in the Baker Botts report, Fitch is encouraged by Freddie Mac’s commitment to making vast improvement in the depth and breadth of its staff’s accounting expertise; the hiring of a chief compliance officer, and the creation of the Enterprise Risk officer position.
- Fitch was encouraged that Freddie Mac’s overall risk profile did not change as a result of the restatement process.

- Resolution of the Rating Watch Negative for Freddie’s ‘AA’ subordinated debt and preferred stock will be influenced by (i) the outline of a detailed capital management plan; (ii) the selection of a CEO for Freddie Mac; and (iii) the release of the update to the Baker Botts report and result of the OFHEO’s investigation. Additional uncertainties that remain could have a material impact on the rating, including changes an incoming CEO may elect to implement, possible regulatory changes, and potentially substantial tax liability related to certain transactions booked in 2001. (*Dow Jones Newswire*, 11/21/03)

Law firm hired by Freddie Mac’s CEO says stock sales by Parseghian legal

- The well-publicized sales of certain Freddie Mac stock by the agency’s former CEO Gregory Parshegian “were not in violation of any applicable federal securities law,” according to a legal analysis provided to Freddie’s Board by the law firm of Gibson, Dunn & Crutcher, LLP. The law firm’s opinion was released in a new supplemental report by the law firm Baker Boots LLP. Baker Botts noted that stock sales by Freddie’s CEO received extensive publicity and that he engaged Gibson Dunn to review the propriety of the trades in light of information and findings in an earlier Baker Botts report. (*Dow Jones Newswire*, 11/21/03)

Fannie Mae and Freddie Mac

Upcoming Fed Paper finds Fannie and Freddie subsidy unneeded

- The Federal Reserve is preparing a staff study that finds the Fannie Mae’s and Freddie Mac’s federal benefits are largely unnecessary and that the companies don’t lower mortgage costs much for consumers. The study is expected to arrive at similar conclusions as other studies and recent statements by CBO, which told lawmakers last month that the GSEs no longer need the subsidies they get from the federal government to bolster the U.S. housing market. People knowledgeable about the new Federal Reserve study said it is expected to be released in early December.
- Federal Reserve Chairman Alan Greenspan made similar comments publicly, telling lawmakers in February that the GSEs’ effect on mortgage rates is negligible. Greenspan also criticized the GSEs’ implied federal backing, saying it distorted markets at the expense of other federal and private sector initiatives. (*Dow Jones Newswires*, Dawn Kopecki, 11/17/03)

Former Clinton Labor Secretary says administration is “absolutely right” about GSE regulation

- In comments on National Public Radio, former Clinton Labor Secretary Robert Reich said the happy story of Fannie Mae and Freddie Mac facilitating home ownership has a “darker side.” Like other big corporations, Reich says, the GSEs have shareholders who want high returns and executives who get multi-million dollar paychecks. Following two years of revelations of “cooked books and shady dealings” on Wall Street, everyone is a bit nervous about Fannie and Freddie.
- Unlike other corporations, if Fannie Mae or Freddie Mac ever went belly-up, American taxpayers would foot the bill. Since 1995 the GSEs have tripled their combined debt to more than \$2 trillion. At this rate, their debt will exceed the debt of the entire federal government. Since the financial markets assume that the federal government guarantees their debt, Fannie and Freddie can borrow money at a discount and use the cash pretty much as they want.
- It doesn’t take a Wall Street wizard to know that when the taxpayers bear the downside risks and executives and shareholders get the upside gains, there may be temptation to take undue risks with money. “Now, I’m not suggesting Fannie and Freddie are doing anything they shouldn’t be doing,” noted Reich. “I’m just saying there’s cause to worry.”
- The Bush administration wants to put Fannie and Freddie under the watchful eye of Treasury. Reich states, “They are absolutely right about this.” Fannie and Freddie have a lot of lobbying muscle in Congress, which they are using to fight-off stricter regulation. But, Reich notes, “they can’t have it both ways. They can’t have the advantages of being subsidized by the public without being accountable to the public.” (*National Public Radio Market Watch*, Robert Reich and David Brown, 11/18/03)

Former Clinton Treasury Assistant Secretary for Financial Institutions, Rick Carnell, backs reform

- In prepared remarks to be provided at a cancelled Senate Banking Committee hearing, Richard S. Carnell, former Assistant Secretary for Financial Institutions in Treasury from 1993 to 1999 and currently associate professor at Fordham University School of Law, Carnell identifies six fundamental questions Congress faces in restructuring a GSE regulator; offers suggested answers to those questions; describes the GSEs’ “double game” of denying that they have the full faith and credit government backing, while they work to reinforce the market perception of implicit government backing; refutes the GSEs’ attempts to liken FDIC-insured banks to GSE; and examines “systemic risk” of the GSEs.

- Carnell recommends that the new agency should regulate Fannie Mae, Freddie Mac and the FHLBank System. This agency should take over the functions currently performed by the OFHEO and Federal Housing Finance Board (“Finance Board”). Establishing one agency to regulate the three GSEs would help make the agency more independent of the firms it regulates; increase the agency’s prominence in way that would help it attract and retain capable staff; permit economies of scale and efficiencies; and facilitate greater consistency of GSE regulation.
- Ideally, Carnell states, the new agency should have responsibility both for the GSEs safety and soundness and for the GSEs' housing mission. Giving the new agency these responsibilities would have three advantages. First, it would promote accountability by both the regulator and the GSE. This approach also simplifies compliance by the GSEs. Finally, giving one agency responsibility for both safety and soundness and promoting the housing mission would promote better-informed decision-making.
- In structuring the agency, Carnell argues that the *paramount* goal should be to help assure the agency’s independence from the firms it regulates. The housing GSEs are powerful, aggressive and politically effective. They are adept at capturing and cowing regulators. A sound governance structure, combined with other reforms, can help the agency avoid such capture or intimidation. Two possible government structures offer the best prospects for maintaining such independence. The first option would be to make the agency an autonomous bureau of the Treasury Department. The Treasury has an institution commitment to safety and soundness, has the will and institutional credibility to stand up to the GSEs, and would not easily be pushed around. Carnell believes that Treasury would also diligently carry out its responsibilities for the GSEs’ housing mission,
- An alternative approach would involve placing the agency under a five-member board that would include the Treasury, HUD, and three appointed members nominated by the President and confirmed by the Senate. The President would designate, and Senate would confirm, one of the three appointed members as the chair the board and executive head of the agency. The Treasury, HUD and the appointed members would each bring their own perspectives and expertise to bear.
- Carnell recommends that the agency be independent from the appropriations process because the GSEs have used the appropriations process to pressure OFHEO. To reinforce the new regulator’s independence from the firms it regulates, Congress should end its reliance upon appropriations.
- Carnell believes that the new agency should have the authority to modify capital standards in light of experience and changing market conditions. The GSE enforcement and prompt corrective action rules should also be strengthened along the lines of their banking counterparts.

- Congress should also provide a receivership mechanism adequate for dealing with a GSE if their liabilities were to exceed their assets. Under existing law, no adequate legal mechanism exists for dealing with a GSE bankruptcy, since the GSEs are not subject to the Bankruptcy Code. In the event of a bankruptcy, an insolvent GSE would remain adrift until Congress enacted special legislation, triggering great risk of serious consequences in the financial markets. A receivership mechanism, providing an orderly means for dealing with a failed GSE's obligations, would help limit and contain the harm resulting from a GSE's failure.

- Carnell observes that the GSEs play an extraordinarily successful "double game" in dealing with their relationship with the federal government. As the GSEs deny that they have any formal, legally enforceable government backing, the GSEs work to enforce the market perception of *implicit* government backing. To curb the "double game," Carnell suggests that any GSE legislation correct faulty statutory disclaimers of federal liability for Fannie and Freddie; correct sloppy language in the Secondary Mortgage Market Enhancement Act of 1984, stating that for some purposes Fannie and Freddie securities "shall be considered to be obligations issued by the United States;" prohibit any GSE from representing that the U.S. Government directly or indirectly backs the GSE with the intent to induce anyone to rely on that representation to buy a security; and prohibit any government agency or official from characterizing the GSE securities as government securities.

- Carnell observes that Fannie and Freddie wrongly argue that the federal government gives FDIC-insured banks benefits comparable or greater than those benefits it gives the two GSEs, and that the GSEs' success simply reflects their greater efficiency. As wholesalers, Fannie and Freddie have lower overheads than banks, which predominately offer retail services. Additionally, the government's perceived implicit backing of Fannie and Freddie actually tends to provide a greater net subsidy than FDIC insurance for six structural reasons:
 - unlimited coverage of all GSE obligations versus the \$100,000 limit for FDIC insured deposits;
 - no receivership mechanism for GSEs, which reinforces the market perception that the government would assure full payment of the firm's creditors;
 - no cross-guarantees provided by the GSEs to protect taxpayers, while insured banks pay FDIC insurance premiums which, in effect, cross-guarantee FDIC's risk exposure;
 - company-specific statutes that avoid the discipline of having to comply with the same rules as thousands of other businesses;
 - protection from effective competition subsidizes GSE shareholders; and
 - not having to pay fees or to provide public benefits that would, if imposed, cost the GSEs' shareholders.

- Fannie and Freddie are often characterized as "too big to fail," meaning that the government would be forced to rescue them lest their failure unleash "systemic risk" that would harm the nation's financial system and economy. If investors expect the government to rescue troubled GSEs, investors will tend to let GSEs take greater risks

than they otherwise would have taken. This weakening of market discipline on the GSEs will, in turn, increase the risk that the GSEs will ultimately get into trouble. Thus, “too big to fail” and “systemic risk” are to a large extent *circular*: they have roots in prevailing expectations, and they easily become self-fulfilling prophecies. Insofar as investors expect the government to rescue troubled GSEs, market discipline on GSEs will weaken, which will tend to increase the risk that the GSEs ultimately will get into financial trouble. If the government acts in a timely way, it can correct “too big to fail” expectations in the marketplace. Congress did just that in the passage of the FDIC Improvement Act of 1991 by curtailing the practice of treating FDIC-insured banks as “too big to fail.” Proper and timely government action can thus reduce the potential for systemic risk. Effective safety and soundness regulation of GSEs can further reduce that risk. (*Improving the Regulation of Fannie Mae, Freddie Mac and the Federal Home Loan Banks*, Statement of Richard S. Carnell, 11/13/03; *Market News International*, Claudia Hirsch, 11/12/03)

New York Times editorial weighs-in to support Bush administration’s reform effort

Wall Street Journal editorial page continues in its calls for reform; prefers privatization

Dow Jones Capital Markets reminds readers of thrift crisis cost

New York Times editorial weighs-in to support Bush administration’s reform effort

- Our political system can be rather nimble in reacting to financial crises, but when it comes to preventing them, well, that’s another story. Issues that seem more urgent can get in the way of reforms that can stave off the next crisis, as can bureaucratic inertia and the fact that the status quo benefits powerful interests. Efforts in Washington to strengthen financial oversight of Fannie Mae and Freddie Mac are a case in point. Accounting irregularities at both companies in recent months, though not in themselves catastrophic, have served as a warning that it no longer makes any sense to have these institutions regulated by an obscure office within the Department of Housing and Urban Development.
- The Bush Administration is rightly pushing for the Treasury Department to regulate the two giants, along with a network of FHLBanks. Their current regulator is ill-equipped to keep tabs on Fannie’s and Freddie’s sophisticated hedging strategies and other financial moves they use to manage their huge investments.
- Lax regulatory oversight of these companies is made more worrisome by confusion over the extent to which Uncle Sam backs them up. An “implied guarantee” gives Fannie and Freddie a competitive edge in the marketplace, part of which is passed on to homebuyers. There is a danger, however, in having the marketplace complacently assume that normal risk assessments need not apply to these players.
- Even without signs of imminent calamity, it is hard to argue that these financial enterprises—essentially two huge hedge funds—should continue to evade the type of

rigorous oversight that banks face on issues like capital requirements and new lines of business. Yet, it looks as if Freddie and Fannie, along with the homebuilders' lobby, may succeed in blocking legislation to transfer regulatory oversight to Treasury.

- The GSEs helped to add liquidity to the housing market and put more working families in new homes. That mission need not be threatened by stronger oversight of their finances. Indeed, it will be protected. (*New York Times*, Editorial Desk, 11/21/03)

Wall Street Journal editorial page continues in its calls for reform; prefers privatization

- The *Wall Street Journal* noted that with an election year coming, most public officials prefer to “make nice” with just about everyone. So, give White House chief economist N. Gregory Mankiw full marks for daring to tell the truth about the systemic risks posed by Fannie Mae and Freddie Mac. Mankiw did the taxpayer a service by wading into the debate over how to monitor the GSEs that have become repositories of enormous financial risk. Fannie in particular has marshaled its political troops to stop a bill in Congress that would transfer its regulation to the Treasury Department from a feckless unit of HUD. Fannie prefers feckless.
- The GSEs have so far avoided calamity, though you might get an argument from the shareholders, who’ve had to cope this year with at least three accounting or earnings surprises. Mankiw says that the “implicit public guarantee” may create an incentive for the duo to take even more risk. In an epic understatement, Mankiw said, “The savings and loan crisis of the 1980s illustrates the adverse incentive effects that can arise as a result of government guarantees.”
- Fannie responded with its usual huffing and puffing, and by citing a new study by Mankiw’s predecessor, Glenn Hubbard, which “shows there is no systemic risk.” Hubbard study, however, was limited to the narrow area of “liquidity risk.”
- The GSEs throw around so much money that they have been able to make themselves immune from serious political accountability. Their “kept politicians” on Capitol Hill are bipartisan. Particularly notable, though, is the support Fannie and Freddie receive from liberals who normally detest corporate welfare. As Mankiw pointed out, most of the federal subsidies for the GSEs go to enrich the private investors and executives, not the poor homeowners.
- One weakness of democracy is that it tends to ignore problems before they erupt into crises. The risk portfolios of Fannie Mae and Freddie Mac are classic examples. We’d prefer to see both GSEs privatized. Short of that, the least U.S. taxpayers deserve is the assurance that companies that profit from taxpayers’ subsidies are subject to a complete financial “entrail reading” by the U.S. Treasury. (*Wall Street Journal*, Editorial Desk, 11/11/03)

Dow Jones Capital Markets reminds readers of thrift crisis cost

- The initial drive to regulate Fannie Mae and Freddie Mac dates back to the late 1980s and the days of the thrift crisis. Advocates of regulating the GSEs argued a dozen or so years ago that the federal government was as exposed to Fannie's and Freddie's large and growing liabilities by virtue of their implied federal backing, as the government was exposed by savings and loan associations going south by the "boatload." In 1992, Congress created OFHEO to oversee the safety and soundness of the two GSEs, and today a new discussion is underway over whether the OFHEO should be replaced with a stronger regulator.
- The thrift bailout illustrates the costs passed on to taxpayers when regulatory action is "delayed." In 1988, Richard Pratt, a former chief of the Federal Home Loan Bank Board, told Congress that \$50 billion would be needed to resolve the thrift crisis. As it turned out, Pratt's figure was a bit "low." A cost figure of \$200 billion is often tossed around and higher estimates aren't hard to find. In fact, the final tally isn't in.
- For proponents of GSE regulation, the idea at the outset was that an ounce of prevention would be worth a pound of cure. Now, Congress is embarked on a new quest to strengthen the regulation of Fannie, Freddie and perhaps the FHLBanks. A view can be heard within the Bush administration that real GSE reforms must be imposed next year, if people don't want to wait for another possible debacle. (*Dow Jones Capital Markets*, John Conner, 11/18/03)

Bush team committed to GSE regulatory reform, despite continued opposition
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- Suspicion grows that Fannie Mae and Freddie Mac face a formidable challenge as the regulatory reform debate unfolds with an awakened, and perhaps even aroused, Bush Administration. The administration has made it clear that it doesn't plan to tiptoe around the GSEs, and its thinking and tactics will become more apparent in the months ahead.
- In recent weeks, the Administration has stepped up the pressure, first with a shot across the bow of GSEs' lines of credit with the Treasury. Treasury then addressed the implied guarantee issue, saying that placing the GSEs' regulator in Treasury could increase the perception of federal backing unless the new regulator had real power. Next came the broadside from Gregory Mankiw, Chairman of the White House's Council of Economic Advisors, who said the GSEs create a "systemic risk to our financial system." CBO chimed in with the view that the "GSE status and benefits it conveys are no longer necessary for Fannie Mae, Freddie Mac, and the FHLBanks [to] perform." Rumor has it that the Federal Reserve will soon release a study, agreeing with CBO's position on the GSEs' status. Don't be surprised if there are more "shots" to come...
- Also, don't be surprised if the Administration comes up next year with a clear alternative to a GSE regulator "housed" in Treasury—perhaps a new approach with a

regulatory board whose members might include, among others, top people at the Treasury, HUD, and FDIC. (*Dow Jones Capital Markets Report*, John Connor, 11/17/03)

Treasury Secretary Snow stands firm

- Snow stated that “A strong regulator is necessary to continuously assess the capital adequacy, the lines of business, and the risk profile of these entities, because of the potential ramifications of their operations on the financial markets and housing markets.” Snow added that the proposed inclusion of the FHLBanks under the new regulator has drawn some interest...”
- Snow added that the administration wants to improve GSE oversight for the long run, but doesn’t see an imminent crisis. “It isn’t that we face a crisis tomorrow.. or that we’re even close to the edge of the cliff. The point is to make sure you never get there,” said Snow. (*Bloomberg News*, Brendan Murray, 11/12/03, *Dow Jones International News*, Rebecca Christie, 11/13/03)

US Treasury says “no compromise” on GSE reform legislation

- Treasury Assistant Secretary for Financial Institutions, Wayne Abernathy, stressed that the Bush administration is not interested in a negotiated deal with the GSEs. “Our main focus ... is to get the regulatory system right,” said Abernathy. “When it comes to key elements, and it comes to safety and soundness you have no room for compromise,” he added.
 - Abernathy indicated that the issue of where to house the regulator is a “secondary one.” “Treasury has no desire to regulate the GSEs, but if the department offers to house the regulator, Treasury must be able to provide important policy input on the GSEs,” said Abernathy.
- Abernathy indicated that a credible regulatory must have unquestioned authority over the GSEs, noting that Fannie and Freddie are two of the largest financial institutions in the world, and “two that have some of the largest political clout.”
- Abernathy indicated that one reason effective regulation is needed is because banks hold so many GSE obligations. In his view, financial markets will not be comfortable until government oversight is stiffened because “we really don’t know what is going on” at the GSEs; markets don’t respond well to surprise developments at the GSE giants.

Opposition to the Administration’s proposals persists...

- The GSEs continue to lobby against legislation that would ensure effective government oversight. They remain strongly opposed to giving any new regulator authority over new activities; minimum capital standards; and are against giving the new regulator receivership authority, power that would allow the regulator to take over GSE operations in the event of a failure.

- Fannie Mae and Freddie Mac are using their wealth to protect their status and to influence the congressional debate on a variety of issues, including the way the companies are regulated. During the first six months of 2003, Fannie spent \$3.8 million lobbying Congress, and Freddie spent \$5.9 million, according to reports the companies filed with Congress. Those figures do not include campaign contributions by company employees.
- As the House committee was preparing draft legislation in October that would change how the GSEs were regulated, Fannie Mae asked mortgage lenders that do business with it to write to a key member of Congress and provided “talking points” for guidance. “[Fannie and Freddie] have all these advantages, yet they have the chutzpah to dictate what laws they will comply with, and they continue to tell Congress and the White House what type of regulation is acceptable to them,” said Representative Christopher Shays (R-CT) in a letter to Representative Michael G. Oxley (R-OH). Shays continued, “They publicly praised the regulatory proposals made this fall by the Administration and the House Financial Services Committee, and then proceed to kill them behind closed doors.”
- Senate Banking Committee ranking minority member, Senator Paul Sarbanes (D-MD) criticized placement of GSE regulator in Treasury in a speech at a Women in Housing and Finance luncheon. Sarbanes reviewed several concerns, including –
 - Increasing the value of the GSEs’ implied guarantee if the regulator were to be moved to Treasury;
 - Treasury’s opposition to being given responsibility for the new regulator that is independent of Treasury’s oversight or control; and
 - The housing advocates’ concern that Treasury would not be sympathetic to the housing mission.

(Reuters, Mark Felsenthal, 11/14/03; Dow Jones Newswire, Dawn Kopecki, 11/07/03; Market News International, Chris Middleton, 11/07/03; Bloomberg News, James Tyson, 11/07/03; The Main Wire, 11/11/03; National Mortgage News Online, 11/10/03; Bureau of National Affairs, Richard Cowden, 11/17/03; (American Banker, Rob Blackwell, 11/20/03; (Washington Post, David S. Hilzenrath, 11/17/03))

Fannie and Freddie escape action in Congress, <i>for now</i>
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- Fannie Mae and Freddie Mac appear to have weathered their toughest political season in years. Chairman of the Senate Banking Committee, Senator Richard Shelby (R-AL) said that efforts to change how the government regulates the GSEs will not result in legislation this year. Scrutiny of the GSEs has triggered debate about whether the agencies should retain federally conferred advantages that help them boost profits and keep competitors at bay.
- Edward J. Kane, a Boston College finance professor compared Franklin D. Raines, the CEO of Fannie Mae who had led the company to years of double-digit growth, to

a baseball player suing a corked bat. The public thinks, “Here’s this marvelous home run hitter, and he’s good, he’s a very good hitter—he’s just getting a little extra distance from the cork. The cork in Kane’s analogy is the federally conferred advantages that Fannie and Freddie enjoy, including the GSEs’ lower interest rates on borrowings, built-in demand for the securities they issue, lower capital requirements, and exemption from state and local taxes. The GSEs claim they pass along their benefits to consumers in the form of lower interest rates. The CBO estimated, however, that the GSEs’ federal charters granted economic advantages worth \$10.6 billion in 2000, of which the companies retained \$3.9 billion.

- The GSE relationship has paid off handsomely for the companies’ shareholders and executives. Fannie Mae has given shareholders an average annual return, including dividends, of more than 16% over the past 10 years [1992-2002], while Freddie Mac’s annual return was more than 17% over the corresponding period. In contrast, the Standard & Poor’s 500 stock-index’s average annual return in the past decade was slightly more than 10%. Compensation for Fannie’s CEO Raines was more than \$18 million, including a bonus of \$3.3 million and options valued at \$6.7 million. Leland C. Brendsel, the longtime Freddie Mac CEO who was forced to retire in June, received compensation in 2001 of more than \$11.9 million, including a bonus of \$2.1 million and options valued at \$3.9 million.
- The key for Fannie Mae and Freddie Mac is their ability to borrow money cheaply. Together, Fannie and Freddie had outstanding debt of \$1.5 trillion at the end of last year. In comparison, the national debt held by the public was \$3.5 trillion. The GSEs use their low cost money to buy mortgages and mortgage-backed securities that provide a higher return. Since 1993, Fannie Mae has increased its portfolio of mortgage-related investments from \$190.2 billion to \$797.8, while Freddie Mac increased its portfolio from \$55.9 billion to \$583.4 billion. Each of the GSEs now holds about 33% of the outstanding mortgage-backed securities it has issued, making the companies, in a sense, their own best customer. The GSEs’ investments in mortgages, however, increase the companies’ vulnerability to swings in interest rates, potentially increasing the risk of a government bailout.
- Since the GSEs are allowed to hold less capital than other financial institutions to cushion against losses, Fannie and Freddie have achieved higher returns on equity. From 1990 to 2000, Fannie and Freddie achieved an average annual return on equity of 23.7%, compared with 13.7% for a large group of private-sector financial services companies, according to CBO. (*Washington Post*, David S. Hilzenrath, 11/17/03)

Congressman Richard Baker (R-LA) vows “aggressive” GSE reform in 2004

- Cong. Richard Baker (R-LA), chairman of the House Financial Services Subcommittee on Capital Markets, Insurance and GSEs, told *Market News International* that “aggressive” legislation to reform the GSEs’ regulation will proceed in 2004. “I fully expect when we return early next year there will be some

new approach for GSE governance developed,” said Baker. “The will is there. I am trying to find a way to get closure on this,” he said, adding that he will use the next two months’ Congressional recess to work with lawmakers, administration officials, and company representatives to craft reform legislation agreeable to all parties.

- Baker said, “What we will ultimately pass as a compromise will be what would have been characterized as a radical bill a year ago. It’ll be aggressive.” When asked if some middle ground on new product approval may be found by splitting authority between HUD and the new regulator, Baker said “It’s a possibility,” but added that centralized authority was more likely. “If I had to make a prediction, I would say that wherever this goes, all of it goes. Whether it’s safety and soundness issues, new product approval, you name the issue, I think it’s going to wind up under one roof.” He added, “The ability to control the growth and therefore the risk of these enterprises is probably best gauged by a single regulator.” (*Market News International*, Claudia Hirsch, 11/21/03)
- In a separate statement to the *Dow Jones Newswires*, Baker said the impasse over reform of the regulation of the GSEs “has to do with nothing other than Fannie and Freddie fighting tooth and nail to hold onto every last penny” of what he characterized as their annual federal subsidy of more than \$10 billion. (*Dow Jones Newswires*, John Connor, 11/21/03)

Drumbeat for privatization ensues...

Shadow FOMC addresses need for GSE reform

- In their semi-annual meeting, the Shadow Open Market Committee said that the fact the markets perceive that the GSEs issue privileged securities with an implicit government backing is a “problem.” The Committee said, “The second problem is that they no longer just facilitate the mortgage market, but rather have added onto their balance sheet increasing levels of interest rate and credit risk. This is a volatile mix.” Shifting responsibility for Fannie and Freddie oversight to the Treasury Department “does not resolve the issues, particularly if the Treasury is unable to raise these GSEs’ capital requirements.”
- The solution, the committee said, is to privatize Fannie Mae and Freddie Mac and regulate them like other financial institutions. Hess said, Freddy and Fannie “lived a charmed life.” Hess compared the GSEs to Ben Affleck and Jennifer Lopez, “they get into lots of trouble, most of which makes it into the news. Plus they repeat their mistakes again and again.” He continued, “To allow the continuing parade of lobbyists to carve out and maintain an advantage for Fannie Mae and Freddie Mac would be to squander an opportunity to better underpin our financial system.”
- The Shadow is a group of prominent, private-sector economists who analyze monetary policy, which includes co-chairs Charles Plosser of the University of Rochester and Anna Schwartz of the National Bureau of Economic Research, along

with Claremont College's Gregory Hess, Pacific Research's Lee Hoskins, Bank of America Securities' Mickey Levy, Carnegie-Mellon's Bennett McCallum, and Alan Stockman, also at the University of Rochester. (*The Main Wire*, Anne-Sophie Louis-Juste and Isabelle Fiedler, 11/12/03, *Dow Jones News Wire*, Dawn Kopecki, 11/10/03; *Wall Street Journal*, Dawn Kopecki, 11/10/03)

"Time to privatize Fannie Mae and Freddie Mac"

- As a follow-up to his comments in the Shadow Committee, Hess argued that the time has come to privatize Fannie and Freddie. Hess notes that, like millions of Americans, he refinanced his mortgage recently. With long-term rates down sharply, you saved a bundle by refinancing. The lesson learned is that when the environment changes, you change with it.
- Government programs aren't good at change and typically outlive their useful purpose. That is clearly the case with Fannie Mae and Freddie Mac, Hess argues. Both GSEs were necessary when they were created; then mortgage markets were less liquid and the U.S. banking system was regionalized and substantially less capitalized, financial markets were less developed, and the baby boom push for more housing was well under way. Today, the market's perception of an implicit federal backing for the GSEs and their lower capital requirements lowers the GSEs' operational costs, while exposing taxpayers to risk. Fannie and Freddie don't just buy mortgages and package them for investments anymore, which is why they were created. They repurchase large amounts of mortgage-backed securities they issue, providing a profit opportunity by taking on more interest rate risk. "Adding risk to your portfolio is one thing, but it's another if the U.S. government is perceived to be liable for it." Hess said.
- Hess adds, "Insisting that Fannie Mae and Freddie Mac perhaps hold a little bit more capital in five years and report a bit more about their activities aren't bad things in and of themselves. Yet the U.S. taxpayer remains financially exposed to the risks undertaken by these government-protected, for-profit institutions. Better to just leave them for profit, explicitly remove the implicit guarantee, treat them like any other financial institution, and fix the problem once and for all." (*San Diego Union-Tribune*, Gregory D. Hess, 11/07/03)

AEI's Peter Wallison comments on AEI privatization project

- Peter J. Wallison, fellow and co-director of American Enterprise Institute's program on financial market deregulation, spoke on the goals of AEI's project concerning the privatization of the housing GSEs. The AEI project assumes that the goal to privatize the housing GSEs is good policy and deserves to be carefully considered by Congress as an alternative to tighter regulation. Many independent observers in the housing market today and financial officials and former financial officials from both Democratic and Republican administrations share the view that the housing GSEs have simply grown too big, too risky and too politically powerful to be effectively regulated or allowed to continue on their current course.

- AEI intends to create a road map, including the necessary legislation, so that when some lawmaker decides to explore the idea there is already a worked out proposal available. The proposal should result in a fully competitive seamless market, with no participant having a financial advantage over any other and with no artificial or government created barriers to entry into any of the submarkets of the residential mortgage markets. The privatization plan should have the least possible impact on the housing market, so that congressional sponsors can assure their colleagues that the mortgage market will continue to function and consumers will not notice a difference in the prices or services that they receive today and those they receive in a privatized market. At the end of this project, AEI hopes to have a fully drafted legislative proposal, ready for introduction in Congress by one or more lawmakers who are interested in stimulating the debate about GSE privatization. (www.aei.org, “Privatization of the Housing GSEs,” Peter J. Wallison, 10/27/03)

Senate increases funding for OFHEO, but hampers regulator by limiting use of funds
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More funds voted for OFHEO

- During action on a HUD/VA appropriations bill, the Senate by voice vote unanimously approved an amendment sought by the Bush administration and proposed by Senate Kit Bond (R-KS) to increase funding for the Office of Federal Housing Enterprise Oversight (OFHEO) by \$7.5 million this fiscal year. This \$7.5 million add-on has been sought by the OFHEO and the Administration to be used on the agency’s Freddie Mac investigation and review of Fannie Mae accounting issues. Approximately \$3.0 million of this add-on is earmarked for the investigation of Fannie Mae’s accounting irregularities, \$1.5 million for the completion of the investigation of Freddie Mac’s accounting, and \$3.0 million for the hiring 18 examiners.
- Bond’s amendment included an extra \$10 million “contingency funding” that would be made available only upon a certification by the Secretary of Treasury that there is an emergency need for additional funds. As he proposed the amendment, Bond said, “There is, I believe, a compelling need to reform the regulatory structure governing Fannie Mae and Freddie Mac. At a minimum, the senior management of OFHEO must be replaced, and replaced now. Senior management, in my view, has repeatedly failed to meet the most basic requirements of OFHEO’s mission. For example, it took over 10 years for OFHEO to issue its risk-based capital standards, despite the fact that this is OFHEO’s primary mission and key to its regulatory oversight of the GSEs.” He continued, “This failing became more evident when OFHEO publicly praised Freddie Mac’s management just days before Freddie Mac’s management was removed for accounting irregularities.” Bond said that he applauds the work of key lawmakers in the House and Senate for making regulatory reform of OFHEO a priority, and added that “I look forward to working with them next year to help develop the right regulatory system.” (*Dow Jones Newswires*, John Connor, 11/13/03; *Dow Jones Newswire*, Dawn Kopecki, 11/13/03; *Bloomberg News*, John Tyson, 11/13/03)

Despite Bond's assertions, Senate bill requires that at least 60% of OFHEO's 2004 budget be used for "licensed audit personnel and audit support."

- The Senate-passed HUD-VA Appropriations bill includes language requiring at least 60% of OFHEO's 2004 budget of \$39.9 million to be used for "licensed audit personnel and audit support," an undefined term. (Senate-passed version of H.R. 2681, page 169, lines 21-23)
- The extra \$10 million funds recently approved by the Senate for OFHEO came with restrictions that might hamper its supervision of Fannie Mae and Freddie Mac. "OFHEO is concerned about limitations on its discretion about how best to utilize the funds, and we are working with Congress to address these concerns," stated Corinne Russell, spokeswoman for OFHEO. "The restriction serves no purpose and it could end up harming our ability to meet our regulatory responsibilities," said Russell. House and Senate appropriators are working on a final version of the VA-HUD (*National Mortgage News Online*, 11/21/03)

Senate postpones vote for new head of OFHEO until 2004
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- The Senate Banking Committee is putting off votes on the nomination of Mark Brickell to head the OFHEO until next year, after the regulator completes a report on Freddie Mac's accounting problems and management, said committee spokesman Andrew Gray. Officials said that report by the OFHEO is expected to be completed in December.
- Regardless of the OFHEO report, Brickell's nomination is clearly in trouble. Senator Paul S. Sarbanes (D-MD), among other Democrats, is expected to place a hold on Brickell's nomination. Sarbanes led the charge against him at a hearing last summer, questioning his free-market bent and his past lobbying for light regulation for over-the-counter derivatives on behalf of J.P. Morgan.
- Additionally, Brickell could have a conflict of interest. In a September 15 response to written questions to Democrats, Brickell said that he and his wife had no to plans to sell more than \$1 million of shares and options his wife holds at Citi. Brickell maintained in his answer to Senator Jack Reed (D-RI) that he would recuse himself from participating in matters related to Citigroup. Since Brickell's comments, OFHEO announced a counterparty investigation of Salomon Smith Barney, an investment-banking unit of Citigroup; it is not clear when the counterparty investigation would be completed. (*Dow Jones News International News*, Dawn Kopecki, 11/18/03; *American Banker* 5Rob Blackwell; *Dow Jones Newswire*, Rebecca Christie, 11/21/03)

Fannie Mae

Congress may force Fannie to disclose more accurate numbers

- Peter Eavis, Senior Columnist at *TheStreet.com*, reports that Congress could soon force the GSEs to disclose new numbers that could put them in a “bad light”—particularly Fannie Mae. While Fannie had recently liberalized some of its disclosure policies, Fannie has long refused to disclose certain numbers that are crucial to determining its safety and soundness. That stubborn stand has led many critics to suspect that the agency is hiding huge areas of weakness on its balance sheet.
- Fannie’s stonewalling may come to an end now that lawmakers are asking the company to provide the data in question. Senator Chuck Hagel (R-NE), who is sponsoring GSE regulatory reform legislation, has requested that Fannie identify the amount of unrecoverable derivatives losses that reside in its equity and to provide Congress an estimate of market value of its equity for each quarter over the past three years. In the past, Fannie has refused to provide this information to the press. If Fannie refuses to provide this information to Congress, their refusal could increase the level of nervousness on Capitol Hill and intensify the scrutiny of the GSEs.
- Fannie was asked the following questions: “With reference to the \$16.09 billion of ‘cash flow hedging results’ losses in your equity account, as reported in your quarterly statement, exactly what proportion of those losses are either realized, unrecoverable or not recoupable because you closed out derivatives at a loss, and paid out the loss amount in cash? Are these losses likely to reverse themselves as the hedges come to maturity?”
- With the information requested by Hagel, one could judge conclusively whether Fannie’s management risked wiping out its equity by failing to properly protect itself against interest rate movements. Purchasing protection against swings in interest rates can be expensive, but it pays when rates move violently as they have over recent years. Critics contend that Fannie spent too little to insure itself in an effort to keep costs down and post Wall Street-pleasing earnings growth.
- Eavis estimates that Fannie could have booked unrecoverable losses of over \$6 billion in last year’s third quarter as it was forced to close out loss-making derivatives called swaps. Fannie could have held onto them and risked even bigger losses if interest rates continued falling, which would have pushed its capital below \$10 billion—way too low for its asset base of \$840 billion. Instead, it looks like Fannie closed the swaps out, paying out billions of dollars in cash and booking large losses in equity in the process, which are bled into earnings over time. “Scandalously,” this accounting treatment lets Fannie avoid booking the full sum of the realized losses in its earnings in the period they occurred. Taking the swaps route allowed Fannie to defer the losses.

- Fannie has also been requested to provide historical quarterly figures for the “fair value” of Fannie’s equity. Fannie provides this at year-end and says it is considering a more regular disclosure. One reason Fannie may not want to disclose this more regularly is that in the past it has produced an equity number below its minimum capital requirement. The last thing Fannie would want is for regulators to start taking its fair value equity into account when assessing its regulatory capital. Perhaps new GSE legislation could require that Fannie more regularly provide a fair value balance sheet.
- What is the impact of these issues for investors? *If* regulatory requirements go up, Fannie may end up issuing billions of dollars of stock, which would dilute current shareholders—but would certainly strengthen the U.S. housing market, which is what Congress cares about. (*TheStreet.com*, Peter Eavis, 11/20/03)

Fannie’s third quarter 10Q heightens suspicions about its bookkeeping

More disclosure needed to quantify losses in Fannie’s equity account

- Fannie Mae did not disclose anything new about the \$1.1 billion balance sheet error it made in its third-quarter earnings announcement. Fannie did give out new numbers on the amounts of cash it spent on derivatives, which may give an indication of the size of the unrecoverable losses lurking in Fannie’s equity account.
- In the cash flow statement, Fannie disclosed for the first time that it spent a “whopping” \$6.6 billion of cash to settle and purchase derivatives used for hedging in the third quarter of 2002. This is a key number, since it is seen by some as a proxy for how much Fannie had to pay out to settle loss-making derivatives contracts during this quarter, when sharp increases in interest rates caused mortgage prepayments for which Fannie was not prepared. The prepayments pummeled Fannie’s balance sheet and forced the GSE to take drastic measures to protect equity, including closing underwater swaps at a loss. The \$6.6 billion cash outflow number may not represent the whole realized loss from the closed-out swaps, but Fannie doggedly refuses to release the number for realized hedging losses that reside outside of equity. Investors, and possibly even regulators, are forced to make their own guesses as to the size of these unrecoverable losses. In the third quarter of 2003, Fannie’s net hedging cash outflows were \$2.7 billion, which shows that the GSE could still be closing out derivatives at a loss.

Fannie reclassifies assets, possibly to boost shareholder equity

- Fannie Mae’s recently filed third-quarter 10Q with the SEC contains a number of disclosures that only reinforces suspicions about the company’s bookkeeping and its ability to manage interest rate risk. The filing shows Fannie has made some big –and perhaps dubious—changes in the way it classified billions of dollars of mortgages. One possible explanation for the odd-looking asset classifications is that they may have been designed to boost Fannie’s already weak shareholder’s equity.

- Fannie’s asset classification disclosure in the 10Q filing is intriguing. In the past, Fannie has traditionally booked only very small amounts of new mortgages as available for sale (AFS). Importantly, Fannie refers to itself repeatedly as a hold-to-maturity investor. Indeed, most of Fannie’s assets are in the held-to-maturity class of the balance sheets. Price movements of held-to-maturity assets do not affect equity.
- In the third quarter of this year, Fannie booked a huge amount of new mortgage purchases in the AFS category. The net addition to the AFS category was \$53 billion. The gross amount could have been higher – perhaps by as much as \$80 billion. To get to the gross number for the AFS category, more detailed disclosure on mortgage liquidations from prepayments is needed. Fannie does not disclose the prepayments for the AFS mortgages, making this calculation impossible.
- The jump in AFS assets means that Fannie Mae is exposing its diminishing equity to even more interest rate risk. Changes in the value of AFS assets get marked into equity, whereas changes in held-to-maturity assets, where Fannie typically books nearly all of its new mortgages, do not. If interest rates rise, any losses on AFS assets would eat into equity. Fannie Mae may have exposed its diminishing equity to even more interest rate risk in a maneuver to book gains on the AFS assets as equity. After the quarter ended, Fannie might have looked over the mortgages it bought that period, and realized that it could record an equity boosting unrealized gain on those mortgages that benefited from a fall in interest rates from late August to the end of September. Then, it might have gone back and reclassified the money making mortgages as AFS assets, boosting equity in the process. Fannie previously denied that it did this.
- For the first time, Fannie disclosed that during 2002’s bruising third the third quarter, it shifted \$21 billion of mortgages from AFS into the held-to-maturity segment in last year’s balance sheet. In that period, Fannie shifted \$124 billion of mortgages from held to maturity to AFS. A shift from held-to-maturity to AFS is allowed only under extraordinary circumstances, like a change in accounting rules. Fannie cited that particular exception, moved the assets, and booked the unrealized gains of \$4 billion in its equity in the process. Conveniently, the gains appeared just as interest rate movements were crushing Fannie’s equity.
- Why did Fannie shift \$21 billion of mortgages *to* held-to-maturity at the same time as it shifted \$124 billion *from* held-to-maturity? Perhaps Fannie wanted to “lock in” some of the unrealized gains it had made on assets in AFS. If mortgages gain in value in AFS, the risk remains that that the gain can be wiped away if interest rates move adversely in the future. By moving an asset into held-to-maturity, where market movements are no longer reflected in equity, the gain is effectively “protected.”
- And the shifts continue... In the third quarter of 2003, Fannie moved \$12 billion of AFS assets into held-to-maturity, but didn’t disclose the size of any “protected” gain from the move. (*TheStreet.com*, Peter Eavis, 11/15/03)

Third quarter results show Fannie had trouble hedging its portfolio

- Fannie Mae's third quarter report shows the company's struggle to hedge its \$913 billion mortgage portfolio and \$1.2 trillion in mortgage-backed securities against a prolonged period of record low interest rates and tremendous volatility in the fixed income market. The GSE lost \$2 billion in repurchasing \$185 billion of its own debt during the first nine months of 2003, compared to a loss of \$534 million in repurchasing \$127 billion of its debt in the corresponding period in 2002. During the nine month period, Fannie reported a 281% increase in expense to repurchase just 46% more debt. (*Dow Jones Newswire*, Dawn Kopekci, 11/17/03)

Fannie Mae reports five-fold increase in losses in 2003

- During the first nine months of 2003, Fannie Mae booked \$237 million of losses on mortgage investments, representing a five-fold increase from its \$47 million loss provision during the first nine months of 2002. Fannie Mae wrote down the value of its investments in securities backed by prefabricated and mobile homes by \$101 million this year, bringing the agency's total write down to \$152 million for the portfolio.
- Fannie's total \$152 million loss provision represents 1.7% of Fannie's \$8.8 billion investment in manufactured housing loans. In contrast, the FHLBank of New York said in September it had a \$183 million loss on a \$1 billion portfolio of similar securities. (*Wall Street Journal Online*, Patrick Barta, 11/17/03; *Bloomberg News*, Al Yoon, 11/14/03)
- Some investors believe the write-down is too small given the size of Fannie Mae's \$8.8 billion troubled mobile home portfolio. The mobile home loan sector is experiencing a deep depression and many of Fannie's bonds are backed by loans made by Conseco, which collapsed in 2002. Some estimate that a markdown totaling over \$1 billion is to be expected, if a comparison to a recent charge taken by another financial institution is any guide.
- During 2002, Conseco Finance, the industry's biggest retail lender, filed for bankruptcy and many tranches of its bonds, which Fannie Mae holds, have been severely downgraded. To help manage its losses, Fannie Mae established a \$150 million fund to provide financing for GreenTree Finance (successor to Conseco Finance) to fund mortgages on repossessed mobile homes. Establishing this fund also represents a shift in Fannie's operating strategy, which in the past had limited itself to buying mortgages and asset bonds rather than getting involved in providing funds to originate new mortgages.
- Moody's "expects this additional funding to help over time, but uncertainty remains as to its impact on the performance of these deals," according to Moody's. Moody's Investor Service also placed on review 87 classes from 13 Conseco Finance Corporation's manufacturing housing bond deals, as a result of high levels of cumulative losses and repossessions.

- Fannie’s language used in the 10Q regarding the mobile home loan bonds was a little more “hedged” than in previous filings. Fannie stressed the “in-house nature” of its valuations of the mobile home loans bonds. Specifically, Fannie wrote in the 10Q filing, “Our cash flow analyses involve various assumptions that require significant management judgment because of inherent uncertainties related to the actual future performance of these assets.” In other words, Fannie can later point back to this language and say, “Look, we always knew it wasn’t an exact science due to the ‘inherent uncertainties’ of the assets in question.” (*Dow Jones Newswires*, Christine Richard and David Feldheim, 11/14/03; *National Mortgage News*, 11/10/03; *Bloomberg News*, Al Yoon, 11/14/03; *Dow Jones Newswire*, Dawn Kopecki, 11/17/03; *TheStreet.com*, Peter Eavis, 11/15/03)

Fannie Mae walks tightrope on the mobile home front: Congress vs. “red ink”

- The October 28, 2003 edition of *The GSE Report* noted Fannie and Freddie came under Congressional pressure from House Financial Services Committee Ranking Democrat, Barney Frank (D-MA) for tightening their guidelines for manufactured housing loans. (*National Mortgage News*, 10/13/03)
- Fannie, which has a \$9 billion investment in the troubled manufactured housing (or mobile home) sector, announced it would continue to accept 30-year 95% loan-to-value mortgages as long as lenders that have demonstrated exceptional expertise in the tough manufactured housing sector secure those mortgages. This represents a loosening of guidelines issued this past summer, requiring that loan-to-value amounts not to exceed 90% on 30-year mortgages.
- Fannie Mae has worked out an agreement to buy loans from Washington Mutual and is actively seeking other qualified originators. Other Fannie Mae guidelines, which took effect on August 24, hold appraisers to stricter procedures and lower the amount of equity that can be taken out of a manufactured home in a refinance transaction. (*Dow Jones Newswires*, Christine Richard and David Feldheim, 11/14/03)

Fannie Mae’s guaranty fee income soars in 2003; raises mortgage interest rates
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- During the nine months ended September 30, 2003, Fannie Mae’s guaranty fee income soared to \$1.8 billion—a 39% increase over the same period last year. Fannie attributed the surge to a 26% rise in average outstanding MBS and a 10% increase in its average guaranty fee of 20.5 basis points from 18.6 basis points. (*Dow Jones Newswire*, Dawn Kopecki, 11/17/03)
- The November 11, 2003 edition of *The GSE Report* noted that the ... “overcharges hurt mortgage lenders, squeezing their profit margins, and perhaps home buyers, too, nudging up mortgage interest rates” ... (*The Wall Street Journal*, John D. McKinnon and Patrick Barta, 10/29/03)

Fannie Mae's portfolio shrinks in October, duration gap unchanged

- Fannie Mae said its investment portfolio shrank \$4.5 billion to \$912.7 billion at October 31, as commitments to buy homes fell for a third month. Fannie Mae committed to buy \$12.3 billion of mortgages in October, the least since March 2002 and down from \$28 billion in September, reflecting “a narrowing of mortgage to debt spreads during the month.”
- Robert P. Napoli, a senior research analyst at U.S. Bancorp Piper Jaffray, said tighter spreads between mortgage rates and Fannie's debt, as well as rival Freddie Mac's effort to win back market share, dampened the GSE's portfolio growth.
- “The difference between mortgage yields and where we could fund the debt to buy these mortgages did not meet our hurdle rate,” said Mary Lou Christy, vice president of investor relations. “If spreads are not as advantageous over the long term we chose not to buy. We are very opportunistic when we buy for the mortgage portfolio.”
- While the mortgage portfolio growth rate ebbed in October, Fannie Mae's outstanding MBS grew at a compound annual rate of 32.6%, compared with a drop of 14.6% in September.
- The agency said its business volume dropped to \$100 billion in October, down from \$145.6 billion in September. Year-to-date, Fannie Mae has increased its portfolio by 18.8%, but slower growth may be seen ahead. Christy stated that Fannie Mae's mortgage growth rate would be in the mid-teens this year.
- Fannie Mae's duration gap remained unchanged at +1 month in October, while the agency's one year portfolio net interest income at risk from a 50 basis point move in interest rates jumped 4.5% in October versus 2.7% in September. (*Bloomberg News*, Al Yoon, 11/13/03; *The Main Wire*, 11/13/03, *Reuters*, 11/13/03; *American Banker*, Jody Shenn, 11/17/03)

Fannie's CFO on damage control duty...

- In a conference call hosted by Merrill Lynch, Fannie's CFO, Timothy Howard, was assuring investors that the company is conservatively managed and that Congress won't hurt its operations. Howard noted, “It would seem that the value of our equity would track the exceptional growth of our core business earnings, but that has obviously not been the case. While our core business earnings have more than doubled over the last five years, our share price has actually come down a bit.” Howard says others blame it on the company's critics, “who are raising issues that worry investors.”

- “Being recognized as one of the lowest-risk financial institutions in the world is critical to our ability to retain the support of policy makers, to preserve our low cost access to debt and to maintain the liquidity of our mortgage-backed securities,” said Howard. In a response to Howard’s statement, Bethany McLean with *Fortune Magazine* noted, “Well, it’s obvious that being seen as low-risk does all of those things—but is it true that Fannie Mae is low risk?” (*Dow Jones Newswires*, Dawn Kopecki, 11/19/03; *CNNMoney.com.*, Bethany McLean, 11/19/03)

Fannie corporate insiders sell stock

Outlook for Fannie “unsettled,” as investors ditch Fannie’s shares

Fannie corporate insiders dump stock

- Fannie Mae insiders sold 78,000 shares through six transactions over the past six months, while buying just 1,000 shares. Timothy Howard, the chief financial officer and vice chairman, acquired 26,200 common shares for \$18.98 each on November 13 and sold them all that same day for more than \$69 for a profit of about \$1.3 million. Robert Levin, the agency’s executive vice president of housing, made a \$2.6 million profit when he exercised an option for 51,200 shares at \$18.98 each and sold them for more than \$69 each. Fannie Mae spokesman Jason Lobo said the executives’ options were about to expire and they sold the stock for portfolio diversification. (*Fannie Mae Press Release*, Franklin D. Raines, 10/20/03; *National Mortgage News*, Paul Muolo, 11/10/03; *Reuters*, 11/17/03)

Outlook for Fannie “unsettled,” as investors ditch Fannie’s shares

- Investors are ditching their shares of Fannie Mae as concerns about their accounting practices linger and as declining home purchases and the prospects of stronger regulatory oversight threatens to slow their growth.
- Since the announcement of its accounting irregularity, the stock price of Fannie Mae has fallen 7.7% by November 14, while the S&P Index had risen 0.3% during the same period. “Fannie’s stock has essentially become weak after they that accounting error,” said Matthew Park, equity analyst at AG Edwards & Sons.
- Fannie predicts that mortgage originations industry-wide are likely to be 50% lower next year. Delinquencies are also on the rise, with significant increases expected in the Midwest, Texas, and portions of the Southeast. As the economy has improved, Fannie Mae has been able to reduce its allowance for potential losses on these loans.
- Analysts also attribute the recent slide in Fannie’s shares to concerns over the company’s future growth prospects. “The question is, what is the earnings power of these companies [GSEs]?” said Jonathan Gray, analyst at Bernstein. Earnings from Fannie’s large mortgage portfolio are expected to fall as mortgage rates rise and new home purchases slow. Investors also worry that the regulators may require Fannie to scale back their portfolio.

- With some analysts believing that the concerns about regulatory change are overblown, the consensus rating on Fannie Mae is midway between a “strong buy” and a “buy.” According to the research firm First Call, there are nine “strong buy,” nine “buys” and four “holds” recommendations from research analysts for Fannie Mae.
- Fannie Mae’s earnings are expected to increase 13% this year, versus 24% forecast for the diversified financial industry. Fannie Mae projects a 9% increase in earnings for fiscal year 2004 and expects a five-year annualized growth rate of 13%, in line with its peers. (*Chicago Tribune*, Andrew Leckey, 11/11/03, *Financial Times*, Jenny Wiggins, 11/17/03)

Raines predicts \$11-\$14 trillion mortgage portfolio by 2010

- By the end of the decade, Fannie Mae CEO Franklin Raines predicts that Fannie’s portfolio will balloon to somewhere between \$11 - \$14 trillion. Raines predicts that the portfolio will grow 8% to 10% annually, more than doubling its current \$5.5 trillion size. (Speech made by Franklin Raines to the Mortgage Bankers Association, 11/20/03)

Raines courts Asian, retail investors

- Fannie Mae’s CEO Franklin D. Raines participated in Fannie Mae’s annual trip to meet Asian investors, meeting with potential investors in Malaysia, South Korea, Hong Kong and Japan. Fannie Mae’s spokeswoman Linda Knight said, “We have to consider where growth is and there is tremendous growth in the wealth of private individuals in Asia.” Fannie Mae’s focus on retail investors is a new strategy for the GSE. Raines added that Fannie Mae was unlikely to launch bonds aimed solely at retail investors in the near term due to high distribution costs. (*Business Times*, 11/11/03; *Financial Times*, Francesco Guerrera, 11/12/03)

Fannie Mae announces new officers

- On November 20, Fannie Mae announced the promotion of the following new vice presidents and officers of the company: Emmanuel Bailey, vice president for Human Resources; Joy Cianci, managing director for Lender Management and Operations in eBusiness; Amy Edwards, vice president for eBusiness Financial and Business Services; Ann Eilers, vice president for Audit; Thomas King, vice president and Deputy General Counsel for Strategic Business Initiatives; and, Charles Rumfola, vice president for Manufactured Housing.

Freddie Mac

Freddie Mac probe widens to Wall Street

- U.S regulators are investigating the roles Wall Street firms played in questionable deals that Freddie Mac concocted to massage earnings. Morgan Stanley and Salomon Smith Barney, now a Citigroup unit, were among the firms that executed the deals, an informed source said. The inquiry suggests that OFHEO is taking the role of the Wall Street firms more seriously than believed.
- Corinne Russell, spokeswoman for OFHEO stated, “We are in the process of reviewing the counterparties’ roles in transactions relevant to our investigation. We are considering several monetary penalties as part of that wider range of actions available to us.” The OFHEO will determine whether the investment banks’ actions “endangered the safety and soundness of Freddie Mac” and may take actions ranging from barring the bank(s) from doing future business with the company to referring the case to the SEC for further review. Regulators are at least a month from deciding whether to make such a determination.
- OFHEO is considering seeking a substantial civil penalty from Freddie Mac, stemming from its accounting misdeeds, according to people close to the investigation. A big monetary penalty for Freddie Mac could compound the company’s image problems.
- According to Thomson Financial, Freddie Mac has paid Morgan Stanley \$27.5 million in fees during 2003 and Citigroup \$25.6 million. Citigroup is Freddie Mac’s second-largest underwriter this year, with 81 issues amounting to \$21 billion. Morgan Stanley is the eighth largest underwriter of Freddie Mac debt with \$13 billion sold in 79 issues.
- Freddie Mac’s ties to Citigroup run deep. The head of Freddie Mac’s audit committee, Thomas W. Jones, is also head of private banking for Citigroup. Gregory Parseghian, who headed Freddie’s investment strategies, was an alumnus of Salomon. Parseghian stepped in as Freddie’s CEO this summer, but OFHEO insisted on his removal after investigations showed his prior involvement in many of the company’s most egregious accounting abuses.

OFHEO joins DOJ Corporate Fraud Task Force and hires “big guns”

- OFHEO is cooperating with a Department of Justice Corporate Fraud Task Force, which involves the SEC, Treasury Department, the FBI, as well as several other federal agencies. OFHEO was added to the task force in July. The SEC is conducting its own investigation of Freddie Mac’s accounting.

- OFHEO has turned to a litigation team from Crowell & Moring to help in its ongoing probe of accounting irregularities at Freddie Mac. Litigator Stuart Newberger is heading the team, which includes former U.S. Attorney Wilma Lewis, white-collar specialist Richard Beizer. (*Bureau of National Affairs*, Richard Cowden, 11/19/03; *Legal Times*, Jonathan Groner, 11/17/03)

Embattled Freddie Mac hires “spin doctor” ahead of earnings restatement

- Freddie Mac retained Rowan & Blewitt, a Virginia consulting firm that specializes in corporate crisis management, which has been quietly working behind the scene with the GSE for months. According to Rowan & Blewitt’s website, the firm has a “distinguished track record” of helping “major corporations and organizations deal with threats to corporate reputation, brand value, market value, and profitability.” Hank Boerner, managing director for Rowan & Blewitt, confirmed that the firm was working with Freddie. “I don’t think the organization is in crisis, but they are dealing with a number of issues, said Boerner. In advance of Freddie Mac’s earnings restatement, sources said Rowan & Blewitt has been trying to line up accounting experts and other professionals to talk to reporters covering the GSE.
- Freddie Mac issued a press release, stating that it is hiring experts on corporate governance and finance to help restore investor confidence after an accounting scandal. Freddie is hiring Charles Elson, a University of Delaware professor and corporate governance expert, to help its board strengthen supervision of the company’s management and governance. “
- Freddie Mac is also hiring David Martin, former Securities and Exchange Commission director of corporation finance, to help improve financial disclosure. (*Reuters*, 11/17/03; *Thestreet.com*, Matthew Goldstein, 11/17/03)

...And before its earnings restatement, Freddie fires head of shareholder relations

- In a sign of internal stress related to the coming earnings restatement, sources said that Freddie Mac fired Robert Weiss, director of shareholder relations. Several sources said his departure appears to be related to an internal dispute about how to present Freddie’s restatement of the past three years’ results. It is rumored that Weiss clashed with colleagues over how to present the overstatement and the amount of pretax earnings to be restated, which will be much higher than the change to after-tax profit. According to the story circulating among Freddie employees, investors and analysts, Weiss wanted to highlight those potentially embarrassing numbers, while others at Freddie wanted to bury them in a lengthy release. (*American Banker*, Erick Bergquist and Rob Blackwell, 11/21/03)

“Those Who Influence the Market Most” speak out on Freddie

- Among the individuals the *Wall Street Journal* identified as “those who influence the markets most” was Howard Schilit, Founder of the Center for Financial Research & Analysis. In an interview with the newspaper, Schilit said that his biggest disappointment in 2003 was that “Freddie Mac’s accounting problems should have been a bigger deal in the media. The mind-set has already become, ‘Accounting trouble was last year’s problem, so let’s party on.’”
- Also featured in this *Wall Street Journal* article was Thomas Jones, Chairman and CEO of Global Investment Management, Citigroup, who said that his biggest surprise in 2003 was the scandal at Freddie Mac, “a company that I thought was well run, with high integrity.” (*Wall Street Journal Online*, 11/10/03)

Freddie narrows list for new CEO

- At an informal news briefing, Robert B. Zoellick, the U.S. trade representative, said in response to a question that it was not unusual for people with his background to be approached for such a position [as CEO of Freddie Mac]. Zoellick, a protégé of James A. Baker, III, the former Treasury Secretary and Secretary of State, has held senior posts in both departments and also in the White House. A spokesman for Zoellick said, “Ambassador Zoellick is proud to be serving President Bush and carrying out the president’s trade agenda. He is focused on completing major trade agreements this year to be moved through Congress.”
- Other candidates for Freddie Mac’s CEO, include Eugene A. Ludwig, a former comptroller of the currency, and Richard C. Breeden, the former chairman of the SEC.
- Two new names have been added to the list of candidates for Freddie Mac’s CEO—John T. Dillion, former chairman of International Paper Co., and W. Roger Haughton, chairman of PMI Group. Freddie’s headhunting firm, Korn/Ferry is vetting candidates with crisis management skills and strong business fundamentals to help restore Freddie’s shatter image on Wall Street, sources said. The firm would not discuss the search.
- David R. Palombi, a spokesman for Freddie Mac said, “The search is proceeding on schedule. We have not gotten into commenting on literally any of the two dozen names that have been bandied about as potential successors.” The company will probably select a chief in the next few months, no later than February, Palombi added. (*New York Times*, Jonathan D. Glater, 11/15/03; *New York Times*, 11/17/03; *American Banker*, Erick Bergquist and Rob Blackwell, 11/21/03)

Freddie to bridge price gap versus Fannie

- Freddie Mac disclosed recently that to support Gold/Fannie Mae swaps, it will be selling FNMA passthroughs from its retained portfolio. The purpose of this move is to fund the purchase of Golds. Freddie will also be buying and selling other agency securities. Freddie also implied that it would implement a small, albeit significant adjustment in the operating procedure of its retained portfolio.
- In research written shortly after Freddie Mac's announcement, JPMorgan analysts surmised that reimbursing originators for the difference in execution between the Golds and FNMA would be very costly to the company. Guarantee fees are in the 12 to 16 basis points range while the execution difference is worth roughly six basis points. "We believe that this renewed commitment to gain market share will be partly successful," a JPMorgan analyst wrote.
- Freddie Mac representatives stated that this is only one part of a whole game plan, which includes lowering guarantee fees to provide better execution for lenders, as well as diversifying the mix of lenders and products that the company uses so that prepayment on its securities will be more in line with market averages.
- Reaction to Freddie Mac's move has been somewhat muted. Art Frank, head of mortgage research at Nomura Securities International, believes that it is going to be Freddie's purchases over time that will lead to an improvement in pricing. "I think Freddie's goal is to narrow the spread gap with Fannie. It's probably not realistic to think that they could totally close the gap," said Frank.
- Frank believes that there are three basic reasons why the Gold/FNMA price spreads favor the later. First, the Golds have slightly poorer liquidity than the FNMA's, making the FNMA's more attractive for large trades with short holding periods. FNMA's trade outright in the inter-dealer broker screens, while GOLDs and GNMA's tend to trade on swap to FNMA. This creates a small difference in liquidity, which is enough for most active trading accounts to prefer FNMA. The second reason for the price spreads is the prepayment differential between the Golds PCs and FNMA securities, especially in premium coupons. Golds have been prepaying faster compared to their FNMA counterparts. According to Frank, this differential has narrowed in the last couple of months. The third reason for the spread differential is the "negative headlines" about Freddie. While Fannie has received its share of bad publicity, Frank said that some view Fannie as the better bet, especially those outside the U.S.
- In a recent report by UBS, the more significant news in Freddie's announcement was the "subtle change in operating procedure." Despite the fact that both Fannie and Freddie portfolios have traditionally been opportunistic, Freddie was believed to be more so. Freddie's statement implies that the GSE will on occasion buy mortgages when it is not exactly economically advantageous, just to support the price spreads.

“They clearly view a price spread correction as crucial to the future success of their business,” wrote UBS. “And the thought is that Freddie is in the market on a more consistent basis, then the price spread will not get out of line.” The extent to which Freddie changes its operating procedure remains to be seen. “So while this may marginally reduce the variability of Freddie Mac’s portfolio growth, it is not likely to have a huge effect,” wrote analysts.

- According to UBS, the Gold/Fannie relationship may benefit from the improvement in less liquid trades. “It is a known fact that there are considerably fewer Golds available to trade compared to FNMAs, making Golds harder to short. Although the liquidity differential makes it harder for Gold/Fannie relationships to consistently trade at full parity, the market is improving for less liquid product,” said the analysts. “We have seen a tightening of Golds versus Fannies, as well as a tightening of Jumbo and Alta-A versus Agency paper in both the fixed and hybrid arenas,” wrote UBS. “Freddie’s actions may speed the narrowing of the Gold/Fannie differentials.” (*Asset Securitization*, Karen Sibayan, 11/10/03)

International GSEs

Seoul Government announces plan for Korean Fannie Mae

- While Franklin Raines, Chairman and CEO of Fannie Mae, was visiting Seoul, Korea, the Seoul government announced plans to establish a new agency, temporarily called “Korea Housing Finance Corp.” with functions similar to Fannie. The state-run corporation, which is expected to start-up in January, will provide funds to the secondary market by selling bonds and using the proceeds to buy mortgages, giving borrowers easy access to housing loans with maturities of more than 20 years.
- Raines dismissed concerns that Korea’s new long-term mortgage loan system would fuel a housing bubble. “We believe the mortgage system should encourage steady growth of home prices, not a super-high growth,” said Raines. “Housing bubbles tend to occur when either we have a constrained supply of houses or people believe their ability to buy houses may only happen now so every one rushes to buy houses now,” added Raines. (*The Korean Herald*, Kim Ji-ho, 11/13/03)

European mortgage lenders call for a homegrown Fannie Mae, but seek to avoid problems associated with U.S. GSEs

Financial Times editorial blasts EMFA proposal

EMFA General Manager, Rob Thomas strikes back....

European mortgage lenders call for a homegrown Fannie Mae, but seek to avoid problems incurred with the American GSEs (Fannie Mae and Freddie Mac)

- On November 17, a proposal was announced to form a major new European financial institution, the European Mortgage Finance Agency (EMFA), to revolutionize the way mortgages are funded in Europe. The EMFA seeks to create a single, liquid market for international investors.
- The proposals have the backing of five of Europe's leading mortgage lenders, including Spain's Credit Agricole SA, Ireland's Irish Life & Permanent PLC, Portugal's Banco Commercial Portugues SA, and Britain's Northern Rock PLC. For the project to take off, the European Commission needs to back the EMFA.
- The European Union ("EU") wants the completion of a single market in Europe and financial services is one area where it is keen to see progress. "The Commission is of course in favor of measures to break down current obstacles to mortgage credit," said Jonathan Todd, spokesman for the European Commission. "Mortgage credit is one of those areas we are very interested in," he said, but declined to comment specifically on the EMFA plan.
- EMFA would be sponsored by the EU, and the EU would be offered a 10% stake free by the banks supporting the EMFA. These lenders would take most of the rest of the agency's equity, though they plan to offer small stakes at big discounts to other European banks to help build support. Thomas adds, the *EMFA's setup would go one better than Fannie Mae and Freddie Mac because it's designed to share the benefits not just with the agency's owners, but with the homeowners and investors too.*
- European governments would need to provide at least an implicit guarantee to debt issued by EMFA, similar to the guarantee provided by the U.S. government to Fannie Mae and Freddie Mac, to allow it to borrow money more cheaply than participating banks. "There is no project without government involvement," Thomas said. Perhaps the greatest obstacle will be finding the political will from what will soon be 25 EU member states to support the pan-European issuer. Even if the guarantee is only implicit, it will imply a use of common resources, and that will mean extensive inter-government negotiations.
- Lenders may be slow to support the EMFA. "It's tough work and will be a hard project to go for one single institution providing one service across Europe, said Ted Packmohr, a credit analyst at Dresdner Kleinwort Wasserstein in Frankfurt. "It's much harder in Europe to set something up than in the U.S. because of the different

regimes in different countries. It's not just the legislative framework. Mortgages themselves vary from country to country." (*Dow Jones Newswires*, Tom Marshall and Gonzalo Vina, 11/16/03; *Press Release European Mortgage Finance Agency Project*, 11/17/03; *Bloomberg News*, Jonathan Rosenthal and Cecile Gutscher, 11/17/03)

Financial Times editorial blasts EMFA proposal

- The European Mortgage Finance Agency has proposed a step change in the integration of European's fragmented retail financial services industry. The proposal under consideration proposes that the EU should "sponsor" a secondary market. The problem is that the EMFA wants the EU to go much further by providing sufficient implicit or explicit guarantees so that the EMFA could borrow in international capital markets with an AAA credit rating. It proposes special tax status, preferential tax status, preferential status for EMFA debt, and access to a European Central Bank credit line.
- The EMFA suggests there would be substantial social benefits from such taxpayer subsidies. But, if subsidizing mortgage finance is so beneficial, one can sensibly question why EU governments do not simply issue debt themselves to finance property purchases. That would be cheaper than the EMFA proposal, and a liquid market in government debt already exists. The answer is that it would obviously be a misuse of taxpayers' money, which would ultimately damage the credit worthiness of government.
- The EU should encourage the private sector to establish a secondary mortgage market; it must eliminate regulatory barriers that stop its development; it could even consider official approval of certain products. That is where its involvement should cease. (*Financial Times*, London, England, Editorial desk, 11/18/03)

EMFA General Manager, Rob Thomas strikes back....

- According to Thomas, the *Times'* discussion of subsidies is misleading. The EMFA proposal sees the private sector financing EMFA with no cost to the taxpayer. EMFA could also protect taxpayers by reinsuring the credit risk that it took on. A positive spin-off of this approach would be the creation of a transparent market in mortgage credit risk, with risk borne by the private sector. (*Financial Times*, Rob Thomas, 11/20/03)

Federal Home Loan Banks

FHLBanks combined 3 rd quarter income plummets 42%

- The FHLBank system said its third quarter total net income fell 42.3% to \$285 million because of low interest rates and losses at three regional banks. According to Federal Housing Finance Board, the FHLBank's regulator, third quarter net income fell as a result of \$82 million drop in combined net interest income due to low interest

rates and a decrease in “other income” of \$169 million, in part due to losses sustained by three regional FHLBanks in Atlanta, Pittsburgh and New York.

- The FHLBank of New York lost money invested in securities pooling manufactured housing loans. The FHLBanks of Atlanta and Pittsburgh incurred losses related to heavy mortgage refinancing and unrealized losses from mortgage derivatives.
- On September 30, 2003, the FHLBank system reported total assets of \$809 billion and total capital of \$39 billion. The 12 regional FHLBanks saw a slowing in demand for their primary in of business, short-term advances to the system’s 8,104 thrifts, banks, credit unions and insurance companies. Advances increased by a modest 3.1% to \$505.9 billion during the third quarter compared to the same time frame in 2002.
- At the same time, demand soared for the controversial new program that allows FHLBanks to purchase mortgages and hold them in portfolio while putting the credit risk off to other investors. Mortgages held in portfolio more than doubled from \$47.1 billion at September 30, 2002 to \$108.1 billion at September 30, 2003. At the end of the third quarter, mortgage loans held in portfolio represented 13.4% of the system’s assets, compared to 6.2% reported last September. The FHLBanks of Chicago, Des Moines and Seattle hold the largest percentage of loans through the mortgage purchase programs at 42.8%, 12.6% and 10.4%, respectively.
- The FHLBank system increased its use of interest-rate derivatives to better manage risk, reporting a notional outstanding balance of interest-rate contracts at \$676 billion during the third quarter, compared to \$654.3 billion during the three months ended September 30, 2002.
- The FHLBanks also decreased their securities holdings of other GSEs, by \$5.5 billion from \$24.6 billion at September 30, 2002 to \$19.1 billion this September.
- Operating expenses for the system’s third quarter increased 12.4% compared to the same quarter the year earlier to \$109 million. The increase reflects “the FHLBanks’s higher staffing levels to manage the mortgage programs and the growth and complexity of their balance sheets as well as general pay and benefits increases, including an increase in pension costs,” according to the quarterly report. “The FHLBanks had approximately 123 more full-time equivalent employees during the third quarter of 2003 compared to 2002, and approximately 97 more full-time equivalent employees during the first nine months of 2003 compared to the first nine months of 2002.”
- At September 30, 2003, the 12 regional FHLBanks’ memberships included 5,977 commercial banks, 1,610 thrifts, 706 credit unions, and 79 insurance companies. The FHLBanks’ aggregate membership of 8,104 represented a 1.2% increase from the end of last year. (*Wall Street Journal*, Dawn Kopecki, 11/14/03; *Wall Street Journal*, John Connor, 11/14/03; *Dow Jones Newswire*, 11/14/03)

S&P cuts three FHLBanks' ratings

- Standard & Poor's lowered its credit rating outlook on the FHLBanks of Chicago, Indianapolis, and Seattle to "negative" from "stable," after a review found increased risk tied to changes in interest rate risk. S&P also confirmed its "negative" outlook on the FHLBanks of Pittsburgh and Atlanta, and "stable" outlooks for the remaining seven FHLBanks.
- The FHLBanks of Chicago, Indianapolis and Seattle are among the biggest participants of the Mortgage Partnership Finance Program, in which lenders sell mortgages to the FHLBanks and the lenders agree to manage the credit risk on the debt. "This change in business mix, with higher asset growth in fixed-rate residential mortgages versus advances from their members, is a critical change in the bank's profile," S&P said in its statement.
- While Standard & Poor's said this had resulted in an elevated interest rate risk exposure that "is not commensurate with the bank's current AAA long-term counterparty credit rating." ***S&P stated it had left the AAA rating unchanged "because of the banks' status as government sponsored entities."*** (*Bloomberg News*, Al Yoon, 11/17/03; *American Banker*, Rob Blackwell, 11/18/03)

FHLBanks boost lobbying budgets

- In their "K Street Files," *Roll Call* states "Since Congress began scrutinizing quasi-governmental entities earlier this year, much has been said about the well-oiled lobbying and public relations machine run by mortgage finance giants Fannie Mae and Freddie Mac. Meanwhile, another group of federally-chartered companies has ramped up its own lobbying operations to guard against excess federal regulations." In the last year, the nation's dozen Federal Home Loan Banks have boosted their budgets in Washington, hired new K Street firms and even sponsored out-of-town seminars for key Congressional aides." So far this year, the 12 FHLBanks have hired a half-dozen lobbying shops, including Piper Rudnick; Fierce, Isakowitz & Blalock; O'Connor & Hannan; Bergner Bockorny Castagnetti Hawkins & Bain; and the Federalist Group.
- According to *Roll Call*, "The FHLBanks have also increased their reliance on the law firm Fried Frank Harris Shriver & Jacobson. Newly released lobbying records show that all 12 FHLBanks pay the firm nearly \$1 million [annually]. At the beginning of 2002, only five of the banks had the firm on the payroll."
- The industry's trade association, the Council of Federal Home Loan Banks, has hired several new lobbyists, including Philip Bechtel, a former staffer on the Senate Banking committee. (*Roll Call*, Brody Mullins and Michael E. Grass, 11/10/03)

Federal Housing Finance Board and FHLBanks clash over cost of SEC registration

- An industry-commissioned study says that registering FHLBank stock with the SEC could have adverse effects on the market perception of the FHLB system as a GSE and increase the system's borrowing costs, perhaps as much as \$750 million over three months in a worst-case scenario. First Manhattan Consulting Group's study estimated the cost from an increase in FHLB spreads resulting from a worst-case perceived impairment of GSE status in the eyes of investors to be \$250 million for each month that a substantial number of investors come to view system debt as not issued by a GSE, and said three months might be needed for investors to adjust. In addition to funding costs, the study also said that there could be liquidity costs resulting from SEC registration, which would "most likely" reach \$300 million to \$500 million, if a negative disclosure by a bank were to slow down debt issuances system wide.
- The staff of the FHLBank's regulator, the Federal Housing Finance Board (FHFB), cited the alternative view that the increased transparency provided by SEC registration could lead to lower system funding costs, and termed the scenario of a higher funding cost due to SEC registration "extremely unlikely." The FHFB staff dispute the cost of losing the GSE status by saying, "given that Fannie Mae and Freddie Mac have already voluntarily agreed to SEC registration and that their debt spreads to Treasuries, if anything, have tightened, the SEC registration of FHLBank stock seems extremely unlikely to raise FHLBank system funding costs."
- According to FHFB staff, the problem with the First Manhattan study "lies with the initial assumption that SEC registration will increase the probability of a funding disruption of that magnitude for the FHLBank system." On the contrary, the staff said, "registration of FHLB stock with the SEC should enhance the markets' sense that the FHLB system is providing appropriate data to investors." A spokesman for the FHFB said, "We don't accept the premise [of the study]. The premise of the First Manhattan study is that SEC disclosure might increase the likelihood of market disruption. It is not the disclosure regime that would create a disruption, it is what is being disclosed."
- Industry officials say that the FHFB was wrong if it thought brushing off estimates of the costs of registering FHLBank stock would ease bankers' fears and criticized the FHFB for not conducting its own study of the issue. "We have people in Washington, DC, ramming this down our throat and they don't have all the answers," said Dale J. Torpey, president and CEO of Federation Bank, Washington, Iowa and chairman of the FHLBank-Des Moines. "This is not the way things are supposed to be done... It has the potential to be very injurious to community banks."
- America's Community Bankers filed a Freedom of Information Act request on March 11 asking the FHFB to release any analyses the board used in reaching its conclusion to push for registration. On October 28, the board replied with a note that said the

request was “now obsolete due to the passage of time.” The trade group refiled its request on November 14, arguing that the First Manhattan study and the FHFBS’s response was not obsolete. Diane Case-Landry, president of America’s Community Bankers, said, “It is time for the Finance Board to bring forth the documentation they have said they have had all along to provide a basis to convince the industry that these numbers are too high.”

- The FHFBS spokesman said that FHFBS Chairman John Korsmo “based his analysis on the materials provided by the banks.” The bank information, said Korsmo, “did not make a case for there being increased costs associated with disclosures. It did raise many important questions, and those are the questions that could and can be resolved through meetings with the SEC.” (*American Banker*, Rob Blackwell, 11/13/03; *American Banker*, John Connor, 11/13/03; *American Banker*, Rob Blackwell, 11/17/03)

FHFBS rule change needed by FHLBank-Indianapolis
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- Since it began buying mortgages from its members in June 2001, the FHLB-Indianapolis has amassed a \$7.3 billion portfolio. The Bank’s president, Martin L. Heger, says the Bank could do even better if the FHFBS would amend its rule barring FHLBanks from purchasing assets from any organization other than its member banks to provide for purchases from bank subsidiaries. In Michigan, more than 50 banks make mortgages through subsidiaries to take advantage of Michigan state laws, which taxes subsidiary income at a lower rate than mortgage income generated by banks directly. While these banks are free to sell their mortgages to Fannie Mae, Freddie Mac, or another secondary market player, many would prefer to sell to the FHLBank because they are shareholders and receive direct benefits, in the form of quarterly dividends, which increase the banks’ profitability.
- The Michigan Bankers Association, the Michigan Office of Financial and Insurance Services, Senator Debbie Stabenow (D-MI), and a number of Michigan banks have asked the FHFBS to amend the Acquired Member Assets regulation to allow the 12 FHLBanks to buy mortgages from a subsidiary when a banks owns 80% or more of its stock.
- Critics of this proposal, including two former assistant secretaries of Treasury, said the amended regulation would move the FHLBank system too far from its mission of lending to banks. Sheila Bair, who served as President Bush’s first assistant of the Treasury for financial institutions said that allowing the FHLBanks to purchase subsidiaries’ assets would “dilute the parameters Congress set for the system” and create safety and soundness issues. Gregory Baer, who held the same position in the Clinton administration, agreed with Bair’s assessment. “The statute say the FHLBanks can only lend to” or buy from members, “and only members,” he said. “Their subsidiaries aren’t members.” This year, Blair, now a professor of financial regulatory policy at the University of Massachusetts, Amherst’s Eugene M. Isenberg

School of Management, published a report critical of such plans. Fannie Mae funded the report.

- The FHFB has been considering changes to asset regulations for more than five months, but it has shied away from letting the FHLBanks buy loans made by any subsidiary. A spokesman for the agency said that it is continuing to study the rule but has set no timetable for proposing amendments. Its deliberations may have become more complicated following Standard & Poor's recent announcement that it has revised its outlook for three FHLBanks, including Indianapolis, because of concerns about their mortgage-purchasing activities. (*American Banker*, John Resoti, 11/19/03)

Provident CEO named to board of FHLBank-San Francisco

- Craig G. Blunden, President and CEO, Provident Savings Bank, F.S.B. and its holding company Provident Financial Holdings has been elected to the Board of Directors of the FHLBank-San Francisco for a three-year term. (*Business Wire*, 11/18/03)

Farm Credit System/Farmer Mac

Farmer Mac reports third quarter 10Q filing

- The Federal Agriculture Mortgage Corporation (Farmer Mac) filed its 10Q on November 14 with the SEC. Farmer Mac reported that four of its officers each have adopted a prearranged trading plan in accordance with SEC rule 10b5-1 and Farmer Mac's policy on securities trades by company personnel. The plans were entered into by the officers for personal financial planning purposes. (*Farmer Mac Press Release*, 11/14/03)

FCA trying to expand its mandate again...

- FCA's board voted to reopen the public comment period on a proposed rule designed to enhance the Farm Credit System's (System) service to young, beginning, and small (YBS) ranchers and producers or harvesters of aquatic products. The proposed rule, which will amend existing regulations, delineates the components that each System association must include when developing programs for YBS farmers and ranchers. The rule would allow System associations the flexibility to design programs unique to the needs of the borrowers in the areas they serve, and encourages the establishment

of advisory committees comprised of YBS farmers and ranchers. (*Farm Credit Administration Press Release*, 11/13/03)

Sallie Mae

House Budget Committee Chairman Nussle (R-IA) criticizes federal Direct Student Loan Program

Investigations of fraud and abuse of student loan programs underway

House Budget Committee Chairman criticizes federal Direct Student Loan Program

- As reported in the October 28, 2003 *GSE Report*, an article published in *U.S. News & World Report*, "BIG MONEY ON CAMPUS," argues that the Education Department's Federal Direct Student Loan Program should be expanded because it saves taxpayer dollars.
- House Budget Committee Chairman Nussle (R-IA) disagrees, arguing that savings have yet to appear. In a letter to the editor, Nussle wrote ... "in every year since its inception a decade ago, the FDSLPL has borrowed far more funds from the U.S. Treasury than it has repaid, contributing annually to the national debt. That this cash-flow pattern will reverse itself is largely an act of faith. It is only the result of revised budget rules enacted in 1990 that the FDSLPL can make any pretense at cost-savings. Thus, in a 1995 report, the nonpartisan Congressional Research Service stated, "Claims of savings from one form of loan over another (direct versus guaranteed) are purely artifacts of budget score keeping. More recently, the General Accounting Office determined that even under newer rules, any cost savings from FDSLPL is contingent upon projected interest rate scenarios that may or may not ever come to pass. The volatility of these projections is apparent in the most recently published annual re-estimates of loan program costs in which the cumulative projected cost of the outstanding FDSLPL portfolio rose by \$4.6 billion while guaranteed student lending costs dropped by \$3 billion. To assess the potential for future dramatic and costly re-estimates, the House Budget Committee recently asked the General Accounting Office to determine the ability of the Department of Education to accurately predict the cash flows and performance of the FDSLPL portfolio. Meanwhile, the jury remains out." (Letter to the Editor, *U.S. News & World Report*, Representative Jim Nussle, 11/17/03)

Investigations of fraud and abuse of student loan programs underway

- In response to what some see as the U.S. Department of Education's failure to prevent wasteful spending, fraud and abuse in the multi-billion dollar student loan program, the department's Inspector General's office is examining the loan practices of two colleges at which loans from Sallie Mae have increased significantly. The IG decided that the education department needed to provide better guidelines to lenders. The department has responded by saying it wanted to conduct more extensive analysis so as not to hastily harm lenders with the formation of new policy based upon isolated

occurrences of abuse. The National Association of Student Financial Aid Administrators is still deciding what route to take in response to recent allegations.

- Representative George Miller (D-CA) called for a Congressional hearing on this issue. “The Education Committee should hold hearings on the serious issues raised and the Department of Education, which has failed to properly oversee these programs, should immediately correct these abuses,” said Miller in a press release. Hearings will be held in the spring and Representative Tom Petri (R-WI) is planning to introduce legislation in early 2004 aimed at strengthening the direct loan program, where students take out a loan from the Treasury rather than a private company. (*University Wire*, Virginia Zignego, 11/18/03)

Students call on Congress to protect consolidation program

- The Coalition for Student Loan Fairness is calling on Congress to protect the popular Federal Consolidation Loan Program (FCLP) in the Higher Education Re-Authorization bill, urging members to strengthen the program by repealing the rule that limits consumers’ ability to shop for the best deal for a consolidation loan.
- The Coalition asked Congress to repeal the “single holder rule,” which prohibits student loan holders from shopping for better rates on consolidation loans by requiring borrower who have all of their loans held by a single lender to consolidate with that lender, even if they can get better terms elsewhere. The nation’s largest banks and Sallie Mae vehemently oppose the repeal of the single holder rule, which own over 70% of the outstanding student loans.
- The Coalition is also asking that (i) consolidation loans maintain their current fixed rate structure; (ii) student borrowers not be charged a fee to consolidate their loans; (iii) students be able to refinance consolidation loans to take advantage of lower interest rates; and (iv) Congress approach expansion of extended repayment terms on Stafford loans cautiously, since extension of these loans may be more costly the federal government than consolidating the loans. (*PR Newswire*, 11/10/03)

Postal Service

Congress seeks to block not-for-profit mail ruling

- Congress is squaring off with the Postal Service over plans to allow commercial non-profit mailings, saying they will devastate consumer confidence in the sector. In a letter to the postmaster general and board of governors, members of Congress vented

their objections to the non-profit cooperative ruling, which legitimizes commercial firms' attempts to run non-profit campaigns. The ruling is being criticized as diminishing consumer protection against "junk mail," at a time when legislation to bar unwanted phone calls and email is increasing. The last-ditch attempt to reverse the ruling, which went "live" on November 13, was made by a Senator Joe Lieberman (D-CT), Representative Henry A. Waxman (D-CA), Representative David R. Obey (D-WI), and Representative John W. Olver (D-MA). (*Washington Post*, Christopher Lee, 11/11/03)

Group pushes for "do-not-junk-mail" registry

Associations act to defend direct mail

- The Center for a New American Dream (CNAD) is calling on Congress for a "do-not-junk-mail" registry," similar to the popular do-not-call list that prevents unwanted telemarketing. To date, CNAD has helped 10,000 people petition lawmakers for this registry. The Postal Service says it delivers nearly 90 billion pieces of junk mail each year and the average postal carrier hauls 18 tons of it.
- There is debate about the "value" of junk mail. According to Lou Mastria with the Direct Marketing Association, "In fact, most people in the U.S. receive and appreciate things like catalogs." The DMA says people shouldn't assume the mail is junk. The group says its offers consumers choices and discounts they wouldn't necessarily get at a store. The DMA offers a program to opt out of direct mailing lists. "It's called our mail preference service and consumers can sign on for free simply by sending a postcard or a letter to DMA, Mastria said. (*NBC17 Consumer Watch*, 11/17/03)

Associations act to defend direct mail

- With the increasing number of news stories equating direct mail with cold calling and electronic spam, mailing associations are moving to promote direct mail in hopes of forestalling passage of any do-not-mail legislation. The Association for Postal Commerce began Project Fairness in October to promote direct mail. The Envelope Manufacturers Association is developing materials to promote the importance of mail and the economic value of mail for mailers and other interest groups. Also, the Mailing and Fulfillment Service Association is alerting its members to the threat of a do-not-mail legislation. The Direct Marketing Association said it is following legislative action on the state and national levels and alerts its members when it sees something. (*DM News*, Melissa Campanelli, 11/10/03)

Postal Rate Commission adopts periodic reporting regulations

- In the Federal Register, the Postal Rate Commission noted that it is "adopting a final rule that updates periodic reporting regulations. These regulations identify data and

information that the Postal Service is to file with the Commission on a regular, ongoing basis. The final rule differs from the proposed rule in several important aspects. The Commission has narrowed or eliminated some filing requirements and has incorporated some flexibility in meeting other requirements. The Postal Rate Commission believes that these changes should facilitate the public's ability to more readily grasp the quantitative basis and support for Postal Service proposals. (*PostCom.org*, 11/19/03)

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