

# The **GSE** REPORT <sup>TM</sup>

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## ***Major Events***

Chairman of Council of Economic Advisers addresses GSE reform

Bush Administration steps up pressure on Fannie and Freddie

Fannie responds to White House comments on “GSEs’ systemic risk”

### Chairman of Council of Economic Advisers addresses GSE reform

- Dr. N. Gregory Mankiw, Chairman of the Council of Economic Advisors, spoke to the Conference of State Bank Supervisors about the Bush administration’s proposals to reform the housing GSEs. In his speech, Dr. Mankiw reiterated the administration’s commitment to homeownership and the creation of affordable housing opportunities, supported by a *healthy* system of housing finance. Proper regulation plays a critical role in supporting a strong financial system. The administration has proposed reforms that will give housing finance a regulatory framework as strong as those in place for other financial sectors.
- By charter, housing GSEs enjoy a number of special privileges, including lines of credit at the U.S. Treasury and statutory exemption from SEC registration and disclosure requirements faced by private institutions.
- The various charter privileges of the housing GSEs give rise to an implicit subsidy for the GSEs. The privileges signal a special relationship between the GSEs and federal government and feed market perceptions that GSE debt has the backing of the U.S. government. This notion is inaccurate. The GSE charters *do not* require the federal government to bail out a troubled GSE. Given that perception, investors are willing to accept a lower yield on GSE debt than on the debt of other private companies. According to a CBO analysis of GSE debt securities compared with similar securities from similar sorts of companies in 2001, the average spread across all types of GSE debt securities was 41 basis points. In today’s financial market, such a funding advantage is enormous. This funding advantage is the implicit subsidy to the GSEs.
- The implicit government subsidy gives GSEs an advantage over private firms, allowing GSEs to dominate the market for certain types of mortgage securities. Today, GSEs account for two-thirds of all mortgages that receive a credit guarantee.
- Most observers believe that GSEs pass some of the subsidy along to homeowners in the form of lower mortgage interest rates. In a comparison of interest rates on conforming mortgages that GSEs can purchase with those on jumbo mortgages that they cannot purchase, CBO found that the interest rates on jumbo loans were 18 to 25 basis points above those of conforming loans. This “spread” may overstate the benefit conferred on holders of conforming mortgages, since some of the spread likely comes from the greater size and liquidity of the conforming mortgage market. All told, these estimates suggest that the reduction in conforming mortgage interest

rates stemming from GSEs falls well short of their funding advantage. CBO estimates that only about half of the total subsidy provided to GSEs gets passed on to homebuyers. The remainder of the subsidy gets passed on to the enterprises' executive compensation and shareholder profits.

- The critical issue for the policymaking and regulatory community is that the subsidy creates a source of systemic risk for our financial system. This risk arises because the subsidy has allowed the GSEs to become gigantic. From 1995 to 2002, debt issued by GSEs has more than tripled, totaling \$2.2 trillion at the end of 2002. In contrast, the privately held debt of the U.S. government is \$3.2 trillion. If recent trends continue, GSE debt will soon exceed the privately held debt of the federal government.
- GSEs have used the proceeds from issuing debt to amass enormous portfolios of mortgage-backed securities. At the end of 2002, Fannie and Freddie held more than one quarter of all outstanding mortgage-related securities. The GSEs now have major interests outside the business of securitizing mortgages and are in the asset management business, with their financial health depending heavily upon the performance of their mortgage-backed security portfolio.
- While the credit risk of their mortgage-backed security portfolio is relatively low, the GSEs are exposed to other risks, including interest rate risk and prepayment risk that leave the GSEs exposed to losses from both increases and decreases in interest rates. The GSEs engage in a variety of hedging activities to reduce their exposure to these types of risk, which if done successfully helps insulate the GSEs' portfolio from these risks.
- The available information suggests that the GSEs place a high priority on risk management and that their efforts to date have been largely successful. However, even small errors can damage an institution's health and the size and complexity of the GSEs' assets and operations mean that it is hard for even the companies to keep track of their own situations. What is worrisome is that investors might accept lack of transparency in financial information because they are assured by an implicit public guarantee.
- Risk management is particularly crucial in housing GSEs, given their relatively small amounts of capital available to cushion against unforeseen losses. According to the CBO, Fannie Mae and Freddie Mac's ratio of private equity to assets is 3.7%. CBO found this capital ratio was less than half of that for a group of other large firms engaged in providing financial services.
- The enormous size of the mortgage-backed securities market means that any GSE problems impact the financial system as a whole. This risk is a systemic issue because the GSE debt obligations are widely held by other financial institutions. A small mistake at in GSE risk management could have ripple effects through the financial system.

- While there is no way to fully eliminate the underlying risk, it is possible to reduce the risk by ensuring that the housing GSEs are overseen by an effective regulator. The current regulators do not have the tools or stature to deal effectively with the current size, complexity and importance of housing GSEs. The Administration believes that legislation to reform GSE regulation should empower the new regulator with sufficient strength and credibility to reduce systemic risk. The new GSE regulator should be given the following powers and authorities:
  - permanent funding mechanism by allowing it to assess the entities being regulated;
  - broad authority to set both risk-based and minimum capital standards;
  - authority to reject new GSE activities; and
  - receivership powers necessary to wind down the affairs of a troubled GSE.
  
- How will these reforms affect housing markets? While opponents of reform predict dire consequences on the housing market, it is difficult to evaluate their conclusions. The GSEs likely pass on some of their subsidy to homeowners in the form of lower interest rates on conforming mortgages, which approximates 18 to 25 basis points according to CBO. The magnitude of the subsidy is small, relative to normal fluctuations of interest rates which over the past three years have moved in a range of more than 250 basis points.
  
- Worries about the supply of mortgages are also unfounded. If the housing GSEs were to lose some of their implicit subsidies, private financial institutions would eagerly step in. Between 1995 and 2002, pools of privately securitized mortgages have more than tripled, reaching \$750 billion at the end of last year.
  
- Opponents of regulatory reform suggest that it would conflict with the goal of making homeownership possible for all Americans. While Fannie Mae and Freddie Mac are required to promote affordable housing for low and moderate-income families, studies by HUD and independent analysts have shown that GSEs have historically lagged the private market in funding these types of loans. With this in mind, the administration has proposed adding a home purchase goal to the law to ensure that Fannie and Freddie keep funding new homeowners.
  
- We must take actions to guarantee the long-term effectiveness of the regulatory structure, which will strengthen all elements of our financial system. The Administration seeks to create a “world class” regulator for GSEs to ensure the important role that the housing sector plays in fostering strong and sustainable economic growth. (*Speech by Dr. N. Gregory Mankiw, Chairman of Council of Economic Advisors, 11/06/03*)

## Bush Administration steps up pressure on Fannie and Freddie

- The White House stepped up the pressure for tighter oversight of Fannie Mae and Freddie Mac, warning that their “gigantic” size is creating risks for financial markets, while the benefits they confer on homeowners are relatively small. Dr. Gregory Mankiw, the Chairman of the Council of Economic Advisors, delivered these remarks before the state banking supervisors, appearing to signal a new phase in the administration’s efforts to improve the regulation of the housing GSEs. The White House strategy appears to be to reach past Congress and appeal directly to financial markets. Mankiw’s speech, the first significant remarks by a White House official on GSEs, was crafted with input from a working group headed by White House Chief of Staff Andrew Card. “This is an issue that lots of us in the White House are very interested in and very focused on and we think is very important...and we hope to get the legislation done,” said Mankiw.
- When asked by his audience how much of the GSEs’ implicit subsidy is “siphoned off” by the GSEs to boost political influence and finance lobbying efforts, Mankiw said “there is no question that the GSEs do a fair amount of lobbying and do a lot of campaign contributions and that gives them clout. “They’re private companies and as private companies that is their legal right,” said Mankiw. “But on the other hand, they’re also government sponsored entities...One could sort of question that activity.”
- During the 2002 federal elections, Fannie Mae and Freddie Mac contributed \$6.57 million to candidates, or about half the \$12.6 million given by the top 20 donors in the mortgage banking industry, according to the Center for Responsive Politics, a research group. Fannie Mae has hired 14 lobbying firms and Freddie Mac has hired 26 lobbying firms, and report total lobbying expenses of \$9.7 million for the first six months of 2003, according to FECInfo.com, a web site that monitors lobbying. (*Wall Street Journal*, John D. McKinnon, 11/07/03; Market News International, Chris Middleton, 11/06/03; *Bloomberg News*, Brendan Murray and Simon Kennedy, 11/7/03)

## Fannie responds to White House comments on “GSEs’ systemic risk”

- In response to Mankiw’s remarks, Fannie Mae and Freddie Mac officials maintained that they are in broad agreement with the administration on the need for a strong regulator. “That’s great,” said Freddie spokesman David Palombi. “We have been strong supporters of getting a strong financial regulator.” Fannie spokesman Chuck Greener said, “If the thrust of the comments made today was that the GSEs should be regulated by a strong financial regulator—we agree.”
- Greener disputed the Mankiw’s suggestion that the GSEs are a “hazard,” citing the newly released Fannie Mae Paper titled “Evaluating Liquidity Risk Management at Fannie Mae,” written by former Chairman of Council of Economic Advisors (CEA) R. Glenn Hubbard. In this paper, Hubbard states “my assessment of the firm’s liquidity risk management practices lead me to conclude that a ‘liquidity crisis’ for

Fannie Mae is an extremely remote possibility.” Hubbard said that arguments that a liquidity crisis at Fannie could impact the entire U.S. mortgage market “is not compelling.” In an interview, Hubbard declined to say whether he thinks the GSEs pose systemic risk in other respects, but said his study examined one aspect “pretty narrowly.”

- Fannie Mae describes the “Fannie Mae Papers” as “an occasional series on policy issues of interest to the housing community.” The papers are commissioned by Fannie Mae, but a company spokesman said the firm hasn’t given out any information on the fees paid for the papers. Other Fannie Mae Papers have been authored by former Clinton administration officials, including ex- CEA chairman, Joseph Stiglitz and former Comptroller of the Currency Eugene Ludwig (*Wall Street Journal*, John Connor, 11/06/03; *Wall Street Journal*, John D. McKinnon, 11/07/03; *Dow Jones International*, John Connor, 11/06/03)

Fannie Mae corrects third quarter earnings announcement

Third quarter restatement draws questions about Fannie’s accounting skills

OFHEO meets with House and Senate committees to review Fannie’s accounting error

#### Fannie Mae corrects third quarter earnings announcement

- At 12:40 p.m. on October 29, Fannie Mae announced that it would withdraw its October 16 third-quarter earnings release without saying why. The market briefly “unraveled” in an information void, with Fannie’s shares declining by more than 5%. Shares rebounded after the company announced at 2:20 p.m. that the restatement would affect only its balance sheet and not its income statement. Fannie Mae’s shares closed down 2.4% at the end of the day.
- In its second press release, Fannie Mae stated that its third-quarter earnings release contained math mistakes and the company is “withdrawing” the release and issuing a corrected one. “The errors were discovered in the course of the standard review in preparation of the company’s form 10Q for the third quarter and were primarily made in conjunction with the implementation of Financial Accounting Standard 149” the company said. A spokesman said that the accounting error came from “honest mistakes made in a spreadsheet used in the implementation of a new accounting standard.” Soon after that, the text of the 8K/A addendum was filed, showing increases to unrealized gains on securities, accumulated other comprehensive income, and total shareholder equity (of \$1.279 billion, \$1.136 billion and \$1.136 billion, respectively).
- In a statement, the OFHEO said that it is evaluating the circumstances surrounding this error, including Fannie’s reliance on manual accounting systems. “The error underscores the need for the special review OFHEO is about to begin of accounting

policies, practices and internal controls at Fannie Mae,” stated Armando Falcon, director of OFHEO.

- Fannie Mae’s announcement prompted harsh criticism from Representative Richard H. Baker, (R-LA). He said, “Here we go again. First Freddie, now Fannie and here’s Fannie, just like Freddie, after announcing a bigger than \$1 billion accounting error, asking us to believe that it’s no big deal.” In July, Baker asked GAO to review Fannie Mae’s accounting policies to see if they were in line with GAAP, in light of accounting problems found at Freddie Mac. “Before something calamitous occurs, Congress must demand professional oversight to give us the straight facts about these companies’ books,” said Baker. “In light of this new development, I expect to hear from GAO officials this week and will press them to complete their inquiry forthwith.”
- Senate Banking Committee Chairman Richard Shelby said he also was concerned and requested a briefing by the OFHEO. “It is always a concern when a public company’s accounting function breaks down and the public receives incorrect information,” Shelby said in a statement. “These disclosures about accounting problems at Fannie Mae are particularly troubling in light of the similar problems this year at Freddie Mac.”
- Banking Committee member Senator Wayne Allen (R-CO) said in an interview with *Bloomberg News*, “The Banking Committee, most members, are concerned that they weren’t being completely forthright on their record-keeping system, and so that raises questions of accountability. There are some tough questions that need to be raised by the Banking Committee. I am supporting the idea of having a different regulatory body that has more capacity in analyzing exotic transactions that Fannie Mae and Freddie Mac use.” The Treasury, he noted, has that expertise.
- “It’s embarrassing. I do think that they handled this very poorly,” said Mike McMahon, an analyst with Sandler O’Neill. McMahon said Fannie should have halted trading in its stock and then released all the information about its revised earnings, in order to avoid initial panic selling in the stock.
- Bert Ely, a longtime Fannie Mae and Freddie Mac observer, said that the scale of the revision suggested there was more to it than a computational error. “Is this an indication of serious accounting problems at Fannie Mae? I think this raises substantial accounting and procedural issues (for the company),” he said.
- Fannie Mae blamed *Business Wire*, a press release distributor, for improperly issuing a statement about its earnings, sparking a sell off that briefly erased more than \$4 billion of the company’s market value. Fannie said it did not authorize *Business Wire* on Wednesday (October 29) to release the (initial) statement in which the company said it was withdrawing its third quarter earnings results. That release contained no specifics and confused and concerned market analysts. Cathy Baron Tamraz, president of Business Wire, said a “misunderstanding” led to a snafu involving

Fannie Mae's revision of its third quarter earnings report. Tamraz said no employees have been disciplined and that Business Wire was still investigating what went wrong. (*Fannie Mae Press Release*, 10/30/03; *OFHEO Press Release*, 10/29/03; *The Main Wire*, 10/30/03; *New York Times*, Jonathan Glater, 10/30/03; *Dow Jones Newswires*, Dawn Kopecki, 10/30/03; *American Banker*, Jody Shenn, 11/04/03)

### Third quarter restatement draws questions about Fannie's accounting skills

- Fannie Mae's restatement of its third quarter earnings following a computation error raised eyebrows and new concerns on Wall Street about the company's accounting skills. While the restatement did not affect the company's income statement, the news was still unsettling for many analyst and investors who have watched Fannie's competitor, Freddie Mac, grapple with accounting irregularities, executive firings and restatements.
- Fannie Mae said that "honest mistakes" were to blame for errors in its third quarter earnings. These errors, discovered during a review of the company's financial statements, related to the implementation of a controversial and complicated accounting rule concerning the mark-to-market treatment of certain derivatives.
- The day after announcing their earning release contained errors totaling more than \$1 billion, Fannie Mae said it remains "proud of accounting processes and controls." Jayne Shontell, Fannie Mae's senior vice president for financial relations said, "Far from being a failure of our accounting system, this event demonstrates that our accounting processes and controls work as they should."
- In a June 30 interview with *Business Week*, Fannie Mae CEO Franklin Raines described the "fine job" that Fannie was doing in accounting for derivatives, relative to his competitor, Freddie Mac. Raines said, "...when it came to our accounting for derivatives, we spent millions of dollars on internal systems [and] we maintain strict control over what kind of derivatives can be used and our accounting for them. Everyone who has looked at it, from our internal auditors to our regulators, found that we are doing this in a state-of-the-art way. We are compulsive about managing risk."
- Analysts said that there was concern in the market about the scale of Fannie's revisions, which included a 60% understatement of unrealized gains on securities but did not affect its income. The revision also raised further concerns about the quality of the accounting systems used by Fannie, despite prior assurances from CEO Raines.
- In a letter to the editor in the *Washington Post*, a reader responds to Jane Shontell's claim that the restatement was "far from being a failure of our accounting system." The reader writes... "Really? Ms. Shontell must have been severely affected by the recent change in the Earth's magnetic field due to intensive sunspot activity. May I suggest the following statement instead: "Fannie Mae is embarrassed by and deeply regrets the substantial error reported in its last quarterly report. We want to assure our investors that corrective action has been take to preclude an error such as this occurring in the future." (*Financial Times*, Vincent Boland, 10/31/03; *Dow Jones*

*Newswire*, Janet Morrissey, 10/30/03; *Thestreet.com*, George Mannes, 10/31/03; *Washington Post*, David S. Hilzenrath, 10/31/03; *Washington Post Letters to the Editor*, Ernest W. Sheppard, Olney, VA, 11/06/03)

#### OFHEO meets with House and Senate committees to review Fannie's accounting error

- OFHEO met with the staff of the House Financial Services Committee and Senate Banking Committee to discuss Fannie Mae's \$1.1 billion accounting error. These talks coincided with efforts by Senator Jon Corzine (D-NJ) and other senators to agree to a bill strengthening oversight of Fannie Mae and Freddie Mac, said Andrew Gray, Senate committee spokesman. The Senate Banking Committee, after hearing Fannie Mae executives explain the accounting mistake, wants more information on the company's bookkeeping. "We are interested in finding out exactly what happened," said Gray, noting that the committee backs OFHEO's planned investigation of the company. (*Bloomberg News*, 10/30/03; *Bloomberg News*, 10/31/03)

#### AEI holds seminar on "Privatization of the Housing GSEs"

- Financial services consultant Bert Ely, president of Ely & Co., Alexandria, VA, and Washington, DC attorney Tom Stanton, a longtime industry observer, laid out proposed framework for removing Fannie Mae's and Freddie Mac's federal subsidies in a seminar, sponsored by American Enterprise Institute (AEI), a conservative think tank.
- Ending federal support of Fannie Mae and Freddie Mac would reduce mortgage costs and end taxpayer exposure to default by the two largest buyers of U.S. mortgages, according to the AEI studies. In one study, Bert Ely concluded that the removal of a government credit line and other benefits to Fannie and Freddie would reduce homeowner mortgage costs by as much as half a percentage point. "We'd see a net gain for borrowers," stated Ely, resulting from reductions in mortgage origination fees and other savings from greater competition and efficiency. There would be "lower rates across the board." Ely's conclusions support testimony from officials of the Congressional Budget Office before the Senate Banking Committee, who argued that Fannie and Freddie don't need the credit line and other government support in order to meet their government-mandated goal of making housing more affordable.
- Efforts in Congress to remove government support would face substantial resistance from Fannie Mae and Freddie Mac, noted Tom Stanton, who authored the second AEI study on GSE reform. Fannie and Freddie "are immensely powerful politically," Stanton said. "That political power makes it an open question when circumstances are right for removal of government sponsorship." (*Bloomberg News*, James Tyson, 10/27/03)
- While the prospects for totally privatizing Fannie and Freddie may be years away from being a serious proposal on Capital Hill, GSE privatization is getting more and

more notice in Washington. Peter Wallison, resident fellow at AEI responsible for organizing the privatization project, believes that the GSEs are one crisis away from realistic discussion of a wholly new policy response to them. (*Bloomberg News*, James Tyson, 10/27/03; *Dow Jones News*, Dawn Kopecki, 10/27/03)

- Sharon McHale, a Freddie Mac spokeswoman, responded, “The benefits we receive from our links to government are significantly exceeded by the benefits we supply consumers.” A Fannie Mae spokeswoman declined to comment. (*Financial Times*, Vincent Boland, 10/26/03).

#### Fannie and Freddie criticized on lender fees

- Already under scrutiny for their rapid growth and the risk they pose to the taxpayers, Fannie Mae and Freddie Mac face new criticism that they overcharge lenders for the services they provide. This purported overcharging squeezes the mortgage lenders’ profit margins and increases the cost of mortgages to consumers by as much as one-tenth a percentage point. While the impact might not be significant to an individual homebuyer, the total sums involved can be “huge” in a \$6.5 trillion mortgage market. A Treasury spokeswoman said the Bush administration is willing to consider ideas for a change on this issue, if members of Congress are interested.
- The alleged overcharges come in form of “guarantee fees” (G fees) collected by Fannie and Freddie from lenders in exchange for guaranteeing payment of their mortgages sold to the GSEs. The G fees, which represent a huge part of the GSEs’ revenues, appear to far exceed what the companies need to cover their current losses from default. In 2002, Fannie Mae collected \$1.8 billion of G fees, yet had credit related expenses of only \$178.7 million, according to Stuart Feldstein, president of SMR Research Corp., Hackettstown, NJ. “Both companies are wildly profitable on this,” stated Feldstein. According to a study performed by Keefe, Bruyette & Woods, Fannie’s guarantee business had an average return on equity of 38.7% between 1994 and 2002. (*Wall Street Journal*, John D. McKinnon and Patrick Barta, 10/29/03)

#### Cong. Shays (R-CT) calls for probe of Fannie and Freddie’s political influence

- Representative Christopher Shays (R-CT) said he plans to ask for a federal investigation into lobbying activities of Fannie Mae and Freddie Mac to examine “how they manipulate the system.” In an interview with *Dow Jones*, Shays stated, “How is it these corporations have been able to manipulate Congress and the White House for so many years, so they don’t have to abide by the same rules that every other company in the U.S. has to abide by. Someone needs to look into this.” He went on to comment, “I don’t know which organization is best to do it. Frankly, I’m not sure Congress has the appetite to do this because of the influence these institutions. It’s not an easy thing to take on Fannie and Freddie.” Shays also questioned Fannie Mae’s use of its charitable foundation to advertise for the company and sway members of Congress. “The ads are designed to influence votes, they’re not designed to sell products,” said Shays.

- Sharon McHale, Freddie Mac’s spokeswoman, responded that the company clearly discloses all of its lobbying activities and expenses, unlike some of its competitors that lobby through a group called FM Policy Focus. Officials at Fannie Mae did not return calls for comment. (*Wall Street Journal On Line*, Dawn Kopecki, 10/31/03)

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| HUD shelves Fannie, Freddie underwriter study |
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- An investigation of claims of racial disparities created by the loan-underwriting systems developed by Fannie Mae and Freddie Mac, ordered in 1999 by then-HUD Secretary Andrew Cuomo, has been indefinitely shelved. Current HUD Secretary Mel Martinez told Dow Jones Newswires “...we ran into all kinds of difficulties releasing it because of the confidential nature of (the data) and the methodology of the study. At the end of the day, I became disenchanted with what I thought was an outdated study that was going to reflect, frankly, outdated information.” He added that there was a general unfairness to the companies in the way the study was conducted. Fannie Mae and Freddie Mac are currently targets of two separate lawsuits that allege that the companies’ underwriting systems produce discriminatory results for minority borrowers.
- Representative Jan Schakowsky (D-IL) is taking HUD to task for refusing to release a report on the possible discriminatory impact of Fannie Mae and Freddie Mac’s automated underwriting systems. Schakowsky maintains that HUD provided Fannie and Freddie with copies of the report. In a letter to HUD Secretary Mel Martinez, Schakowsky said “I have deep concerns about your decision to allow companies you regulate to view the report before providing it to Congress and the public... Releasing the report would serve to inform Congress and the public as to whether these systems work in a non-discriminatory fashion.” (*Dow Jones International*, Dawn Kopecki, 10/24/03, *National Mortgage News Online*, 11/03/03)

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| MIs riled up by amendment proposed by Fannie Mae |
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- According to a draft of possible amendments on pending legislation to restructure oversight of Fannie Mae and Freddie Mac, the GSEs would be allowed to use “spread accounts” for credit enhancement purposes on mortgage loans where the loan-to-value is 80% or higher.” One mortgage insurance official familiar with the amendment said the spread accounts contemplated could serve as a type of mortgage insurance (MI).
- The draft amendment notes that FHLBs are not subject “to the statutory credit enhancement requirement applicable” to Fannie and Freddie. The draft suggests that FHLBs be brought under the same “regime” and leaves the door open to the notion that “all housing GSEs should be authorized to use this form of credit enhancement for business that would qualify under Fannie Mae-Freddie Mac housing goals.” One former MI official said that the amendment would not eliminate Fannie and Freddie’s

need to use MI, but “could severely damage the MI industry. (*Mortgage Servicing News*, November 2003)

Congress calls for investigation into Sallie Mae’s Federal Family Education Loan Program

- Key Democratic Members of Congress are demanding an investigation of the student loan industry in the wake of disclosures that private lenders have used questionable tactics to lure colleges and universities away from Education Department’s direct-loan program into the Federal Family Education Loan Program (FFELP) at great cost to taxpayers. Federal government budget analyses show that direct loans are cheaper than FFELs. Representative Chris Van Hollen (D-MD), member of the House Education Committee, told *US News*, “The federal student loan program should serve students, not lenders and lobbyists.”
- Van Hollen and Representative Dale Kildee (D-MI) have called for GAO to investigate a wide range of controversial practices by the lenders, including the use of the special subsidy designed to help nonprofit groups issue special bonds to finance student loans. Lenders have found ways to “earn” this subsidy, which guarantees them a 9.5% return on certain student loans. According to *US News*, this subsidy cost taxpayers \$432 million last year. Specifically, Van Hollen and Kildee want to know if the subsidy payments are improper and how the subsidy might be halted.
- In an effort to make the direct loan program more attractive to schools, Senator Edward Kennedy (D-MA) will propose a plan to reward schools participating in the direct-loan program with a percentage of the government’s savings for use as financial aid for students. The legislation would also eliminate the upfront fee the government charges borrowers in the direct loan program, matching a deal offered by many private lenders. Kennedy also wants to eliminate the special subsidy
- Members of the Education Council, a trade group for private lenders, called on lawmakers last week to defend the special subsidies, while Sallie Mae called on financial aid officers across the country to defend its program. The battle will be engaged next year, when Congress takes up the loan provisions of the Higher Education Act, the law governing student lending. (*US News & World Report*, Julian E. Barnes and Megan Barnett, 11/03/03)

***Fannie Mae and Freddie Mac***

CRS Report to Congress: Improving the Effectiveness of GSE Oversight

- On October 8, 2003, the Congressional Research Service issued an updated report for Congress entitled “Improving the Effectiveness of GSE Oversight: Legislative

Proposals” by Loretta Nott, Analyst in Economics Government and Finance Division and Mark Jickling, Specialist in Public Finance Government Finance Division.

- As noted in the report, Fannie Mae and Freddie Mac, the two largest GSEs, were created to establish a secondary mortgage market in order to improve the distribution of capital available for home mortgage financing. To help the GSEs in their mission, Congress gave them several statutory benefits, including lower funding costs, the ability to fund operations with less capital, and lower direct costs, not available to private companies. These statutory benefits have enabled the enterprises to grow rapidly and become the dominant players in the secondary mortgage market. In 1992, Congress established the Office of Federal Housing Enterprise Oversight (OFHEO), an independent agency in HUD to oversee the financial safety and soundness of the enterprises. OFHEO is authorized to set capital requirements, conduct annual risk based examinations, and generally enforce compliance with safety and soundness standards for the GSEs.
- Since the creation of OFHEO in 1992, mortgage investments at the GSEs have grown by more than 620% to \$1.4 trillion, making the GSEs the largest debt issuers in the world. At the end of 2002, the combined debt of the enterprises totaled \$1.5 trillion, representing approximately 50% of all publicly held federal and GSE debt. In addition to enterprise debt, investors now hold over \$1.7 trillion in mortgage-backed securities issued by Fannie Mae and Freddie Mac.
- With rapid growth of the GSEs, questions have been raised about the effectiveness of the current regulatory regime. The IMF recently stated that GSE “regulators need to look closely at whether agencies’ capital adequacy is sufficient, bearing in the mind the questions about internal controls that have emerged in Freddie Mac... it is unclear whether [the GSEs] have taken sufficient account of the risk that the market may not be deep enough to allow them to continuously hedge their growing portfolios in times of stress.” (IMF *Global Financial Stability Report: Market Development and Issues*, September 2003, pp. 16-22)
- While legislative proposals have been introduced in the past to address GSE regulatory reform, Congress did not take action on them. With the announcement of Freddie Mac’s restatement of income due to incorrect accounting for derivatives, the adequacy of GSE regulation has become a prominent legislative issue. To date, four bills have been introduced in the 108<sup>th</sup> Congress that aim to strengthen the current regulatory framework and improve the effectiveness of GSE supervision, including H.R. 2575 (Representative Baker), H.R. 2803 (Representative Royce), S. 1508 (Senators Hagel\Sununu\Dole), and S. 1656 (Senator Corzine). The House Financial Services Committee released a manager’s amendment in preparation for a mark-up originally scheduled for October 8, 2003. Objections were raised about the manager’s amendment by the Department of Treasury, claiming that the bill falls “short of real reform.” Subsequently, the mark-up was postponed until further notice and the status of the manager’s amendment is uncertain.

- On September 10, 2003, Treasury Secretary John Snow presented the Administration's recommendations before the House Financial Services Committee. In addition to reconstituting the GSE regulator into Treasury, Secretary Snow also outlined several recommendations intended to strengthen the new agency's regulatory, supervisory, and enforcement powers. These recommendations include:
  - funding the agency by assessments on its regulated entities that are not subject to the congressional appropriations process;
  - giving the agency prior approval authority over new activities;
  - providing the agency the authority to direct, if necessary, the liquidation of an enterprise's assets;
  - giving the agency discretionary powers to adjust risk-based capital standards; and
  - providing Treasury a stronger degree of involvement in the authority of the new agency, requiring the new agency to clear new regulations and congressional testimony through the department.

The Administration also encouraged Congress to consider eliminating the statutory requirement for the President to appoint five members of the enterprises' board of directors, resulting in all eighteen board members being elected by the shareholders for a one-year term.

- Currently no legislative proposal encompasses all of the Administration's recommendations. While the legislative proposals take somewhat different approaches to regulatory reform, all appear to:
  - abolish OFHEO and reconstitute the GSE regulator within the Department of Treasury;
  - increase the budget autonomy of the new regulator by exempting its assessments from the annual appropriations process; and
  - enhance the safety and soundness and enforcement tools available to the new regulator.
- With the growing dominance of GSEs in the U.S. mortgage markets and the possible risks they pose to the financial system, there has been growing consensus about the potential gains from reconstituting the safety and soundness regulator under the auspices of Treasury. Under Treasury, this new office can benefit from the department's financial expertise and prominence. Expertise can be shared with OTS and the Office of Controller of the Currency and the importance of the regulator's mission for safety and soundness oversight can be emphasized.
- It is a fundamental principle of financial regulation that the office be independent and at arm's length from the enterprise. In a 1997 report, GAO noted that a housing GSE regulator needs to have the "independence and prominence that would allow it to act independently of the influence of the housing GSEs, which are large and politically influential institutions. If a GSE had more political clout and prominence than its regulator, it would be that much more difficult for the regulator to implement

corrective action. Establishing the safety and soundness regulator in Treasury allows the agency to acquire immediately the government prominence needed to oversee the enterprises. Although there appears to be consensus about reconstituting the GSE regulator within Treasury, there is ongoing debate over how involved Treasury should be with regulatory responsibilities of the new office.

- Under the current regulatory structure, OFHEO's assessments are subject to annual congressional appropriations process. OFHEO has argued for many years that this process hinders its ability to conduct effective long-term planning and limits its flexibility to allocate resources. During periods when the government operates under a continuing resolution, OFHEO has been forced to cut back its activities. The agency claims that it is unable to respond quickly to important regulatory concerns, such as Freddie Mac's restatement of income, without stretching thin its ability to conduct its safety and soundness oversight responsibilities. OFHEO has recommended that the agency be permanently funded and exempt from the appropriations process, like other federal regulators, such as the Federal Reserve, OTS, OCC and FHLBB.
- All five legislative proposals authorize the director of the new entity to collect annual assessments, exempt from the congressional appropriations process. However, the wording of H.R.2575, H.R.2803, S.1508 and S.1656 retain the requirement that assessments be placed in a fund in the Treasury, which means that the offices established in these four bills *are not* removed from the appropriations process. The legislative language in the House Financial Services manager's amendment is similar to other federal bank regulators and would completely remove the new regulator from the appropriations process. The bills employ different language as to what costs the assessments are authorized to cover, potentially exposing the regulator to challenges by enterprises regarding the appropriateness of the assessments. With the exception of the House Financial Services manager's amendment, the bills do not address the regulator's funding requirements during a crisis. As the four bills are currently written, the safety and soundness regulator may find itself without sufficient funding in a time of crisis. The Housing Financial Services manager's amendment authorizes the GSE regulator to maintain a working capital fund in the "amount the Director deems necessary..."
- In the current regulatory environment, HUD has the oversight responsibilities for the housing mission of the enterprises, including approval authority for any new program and enforcement of compliance with affordable housing goals. A legislative compromise was made to split the oversight functions of mission approval from safety and soundness to resolve the potential conflicting interests that could arise from the two functions. In the Safety and Soundness Act, Congress included a temporary provision that authorized OFHEO to consult with HUD in regard to the safety and soundness of any proposed new programs. There is growing consensus that combining the mission and safety and soundness regulation would not necessarily create conflict. Financial regulators, such as the Federal Reserve, OTS, OCC, and FDIC have successfully fulfilled both roles.

- All of the bills would retain HUD Secretary's authority for affordable housing goals. H.R. 2803 and S. 1508 both transfer prior approval authority of new programs from HUD to the director of the new regulatory agency at Treasury. Under S 1656, new programs must be approved by the director, in consultation with the HUD Secretary. H.R. 2575 proposes to retain prior approval authority with the HUD Secretary, but expand the authority to all new "activities" rather than just new "programs" and would remove the current 45 day time limit that HUD must meet in order to avoid automatic approval of a new program. The House Financial Service manager's amendment retains approval authority with the HUD Secretary and the 45-day time limit, but expands the Secretary's authority to both new and ongoing programs. The HUD Secretary is also required to consult with the new safety and soundness regulator in regard to these programs.
- Congress has set in statute the minimum capital level requirements for the enterprises and the parameters of OFHEO's risk-based capital model. OFHEO does not have the authority to enforce capital requirements based on alternative parameter assumptions or an increase in perceived risk due to unsafe and unsound practices.
- H.R. 2575 and S. 1508 would give the director discretion to apply alternative interest rate scenarios to the risk-based capital model. S. 1508 also requires that the risk-based capital requirements be similar to those used by federal banking regulators. These bills also authorize the director to increase the required minimum and critical capital levels for the enterprise by regulation or order.
- H.R. 2803 proposes that safety and soundness standards be prescribed by the director, pursuant to Section 39 of the Federal Deposit Insurance Act. While it could possibly be interpreted as providing the ability to set capital standards, the bill offers no provision to amend the capital requirements currently set out in statute. Thus, the current law's specific language pertaining to capital may obviate the bill's broader construction and prevent any changes to current standards. S. 1656 mandates that the director review the adequacy of current risk-based capital standards and make recommendations to Congress for changes in statutory levels. The bill would authorize the director to modify the capital level if the current level were determined inadequate to ensure safety and soundness.
- The House Financial Services manager's amendment would delete the statutory capital levels in current law and authorize the director to establish risk-based capital requirements by regulation or order. The director would file an annual report with Congress, describing the risk-based capital standard, the underlying test and assumptions, and the minimum and critical capital levels.
- All of the bills, except H.R. 2803, would authorize the director to reduce the capital classification of an enterprise by one level, if the director determines in writing that the enterprise is engaging in conduct that could result in rapid depletion of core capital or the value of the underlying collateral for mortgages held or securitized by

the enterprises has decreased significantly. These bills authorize the director to issue cease-and-desist orders to address unsafe and unsound conditions or practices with respect to the enterprises and their affiliates. H.R. 2575 and the House Financial Services manager's amendment would also authorize the director to appoint a receiver to liquidate a critically undercapitalized enterprise.

- In the context of these bills, CRS suggests that two issues need to be clarified. First, it is not clear from the legislative language what constitutes a "rapid depletion of core capital." Second, the determination that an enterprise is in an unsafe and unsound condition depends upon potential depletion of capital and enforcement powers hinge on the enterprise being deemed "undercapitalized." There are circumstances in which an enterprise could be considered adequately capitalized, yet conducting unsafe and unsound practices. In this context, H.R. 2803 would call for the same broad enforcement authority as federal bank regulators that does not depend on the capitalization of the enterprises. (*Congressional Research Service: Improving the Effectiveness of GSE Oversight: Legislative Proposals*, Loretta Nott and Mark Jickling, 10/08/03)

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| Is mention of GSE's credit line "veiled threat"? |
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- A top Treasury officer said to a Reuter's reporter that if Congress was willing to examine the issue of the line of credit, Treasury was willing to hold that conversation. While no version of GSE legislation contains any mention of cutting the line of credit, Treasury is authorized to extend it in law, but it is not mandated by Congress. These statements briefly shook the stock prices and bond yields of Freddie Mac and Fannie Mae.
- Treasury later emphasized that the administration had not proposed eliminating the lines of credit, but was open to considering it and other options that might be proposed by lawmakers.
- "I am increasingly concerned about Treasury's hard-ball tactics to exploit the need for regulatory reform for political purposes (which) will jeopardize the ability of Congress to pass a bill this year," Senator Tim Johnson (D-SD) told *Market News International* on October 24<sup>th</sup>. "It is completely unacceptable to me that administration officials are raising veiled threats, in this case the line of credit, in response to strong resistance to their reform proposal on a new regulator. Housing is too important in this already weakened economy to risk playing politics." (*Market News International*, Denny Gulino, 10/24/03; *The New York Times*, Stephen Labaton, 10/24/03)
- In an interview with the *American Banker*, Angelo R. Mozilo, Countrywide Financial's chairman, said "I think it's ludicrous that you have a President who articulates the importance of homeownership among the American people, particularly focused on those families who have been excluded from the process at one time or another, and at the same time you have other segments of the

administration talking about removing the linchpin that makes that possible. This is one of the most bizarre things I've ever seen. It's irresponsible." (*American Banker*, Erick Bergquist, 10/27/03)

### Treasury's push to fix GSEs

#### Gloves come off in GSE squabble

#### Treasury's push to fix GSEs

- Fannie Mae's recent \$1 billion "computation error" will likely reinforce the Bush administration's hard line on reforming the housing GSEs. According to sources, the White House has stubbornly resisted compromise on GSE legislation because it worries about leaving the President vulnerable to partisan attacks if Freddie or Fannie have more troubles in the upcoming election year. The sources argue that Fannie and Freddie pose risk to the administration because of their special ties to government, including presidential appointees to their board of directors, and because they have trumpeted their close relationship with the White House.
- The administration wants to appear tough on reform and has been unwilling to rule any measure out, even such radical proposals as privatization. When asked if Treasury was willing to consider privatizing GSEs, a Treasury spokeswoman said, "Anything that a member of Congress is wants to bring to our attention, we are open to having that conversation." While academics have been pushing for privatization, several sources confirmed that the administration has no intention of supporting such a radical proposal. According to sources, Treasury has been instructed to respond to all questions in the same way – that it is open to any discussion.
- Until now, many Democrats have openly sided with the housing lobby, contending that the administration proposal would damage the housing sector. While some have pushed for tougher safety and soundness regulations, Democrats could be vulnerable if another problem at Fannie or Freddie is made public.
- One source said that the administration's strategy is a reaction to its bad experience with the passage of Sarbanes-Oxley Act in 2002. Many thought that the Republicans were outflanked by the Democrats during the debate, where the GOP was perceived as softer on corporate reform. The White House has no intention of repeating that mistake with GSEs and wants to be certain that it is on the cutting edge of the debate.
- The White House's strategic position with GSE reform has drawn criticism from many quarters. When Treasury Assistant Secretary for Financial Institutions Wayne Abernathy said he was open to severing Fannie and Freddie's \$2.25 billion lines of credit, Senators were outraged and industry officials were quick to condemn the comments as well. The National Association of Homebuilders has been harshly critical of the administration's position with GSE legislation.

- The underlying problems for all interested parties in the GSE reform debate is that Fannie, Freddie and even the Federal Home Loan banks are now viewed as suspect, because much of their accounting is a mystery. “The thing that last week’s event (Fannie’s \$1 billion computation error) teaches is that disconcerting surprises can come from any of these companies at any time,” said Bert Ely, an Alexandria consultant, who has called for GSE privatization. (*American Banker*, Rob Blackwell, 11/03/03)

### Gloves come off in GSE squabble

- The gloves are coming off in the evidently escalating squabble over re-regulation of Fannie Mae, Freddie Mac and perhaps the Federal Home Loan Banks. Initially, everyone was in agreement with shifting regulation of Fannie and Freddie to a new entity in Treasury. Then, there was a lack of agreement on the particulars, followed by an abrupt cancellation of a House mark-up of a bill to revamp regulation of the housing GSEs.
- The combatants appeared to be retreating to their respective corners, with Freddie keeping a very low profile due to its accounting woes, boardroom shakeup and multiple federal investigations. Then, Assistant Secretary Wayne Abernathy stepped into the ring and gonged the line of credit bell. Abernathy said that Treasury would be willing to discuss removing the housing GSE’s lines of credit if lawmakers wanted to go down that road – a shot across the GSEs’ bow.
- In response to Abernathy’s remarks, Fannie Mae’s chairman Frank Raines said, “I’ve said for many years that the line of credit has symbolic importance. And you start pulling threads out of the fabric, you don’t know which one will be the cause to make the fabric fall apart. There appears to be absolutely no support in Congress to do it. I don’t think anything will come of it, so I don’t think it was a helpful suggestion.”
- A week later, the Chairman of Council of Economic Advisors (CEA), Gregory Mankiw entered the fray with a detailed discussion of the significance of the GSEs’ implied guarantee and the systemic risk posed by the enterprises.
- Fannie Mae then releases a study by former CEA Chairman Glenn Hubbard, who preceded Mankiw in that post. Hubbard said in his assessment of Fannie’s liquidity risk practices “lead me to conclude that a ‘liquidity crisis’ for Fannie Mae is an extreme remote possibility.”
- The plug has been pulled on passing a GSE reform bill this year, but a common refrain is that everything will come together next year. The perception that a breakthrough is just around the corner is fed by statements such as one by Fannie Mae on November 6 that “there is bipartisan consensus to establish a world-class financial regulator for GSEs, which Fannie Mae supports.”

- Right now, however, it is hard to see how it all comes together in light of the deep divisions over all important details, unless enough dynamite “explodes” as a result of the Freddie Mac investigation and breaks the logjam. (*Dow Jones Newswire*, John Conner, 10/06/03)

Legislative reform of GSE unlikely in 2003

Others claim GSE bill not dead yet, only delayed

NY FHLBank Chief comments on the risk of delaying GSE reform

Senate Banking Committee to hold hearing on GSEs November 13

### Legislative reform of GSEs unlikely in 2003

- The Bush Administration and the GSEs are engaged in a game of “political chicken” over the reform of regulations governing Freddie Mac and Fannie Mae. With each side convinced that the other will blink first, the conflict makes passage a bill this year unlikely. While the White House assumes that the GSEs will be forced to accept its key demands to calm Wall Street’s concerns about inadequate supervision, Fannie and Freddie prefer no bill at all. (*American Banker*, Rob Blackwell, 10/27/03)
- Senate Banking Committee Chairman Richard Shelby (R-AL) cast doubt whether legislation to reform Fannie Mae and Freddie Mac will pass this year. “Comprehensive regulatory reform of this nature deserves careful consideration and this committee will work diligently to craft an appropriate reform package. Whether we can do so this fall is not clear, but I will certainly make this a continued priority as chairman,” stated Shelby in his opening statement at the October 23<sup>rd</sup> Senate Banking Committee meeting. Barney Frank (D-MA), ranking member of the House Financial Services Committee predicted that action on GSE legislation would have to wait until 2004 because Fair Credit Reporting Act legislation is absorbing the time remaining in the current congressional session.
- Fannie Mae Chief Executive Franklin Raines stated, “Time is running out very rapidly (for passage of GSE legislation). We had very good prospects early on with broad agreement on a narrow bill. But as others have come up with (divisive) ideas, I think that subverts the process to making it a struggle to possibly getting it done.” Raines criticized Treasury Assistant Secretary Wayne Abernathy for saying the administration would consider removing the GSEs line of credit with the federal government. While the GSEs have never accessed the lines of credit, Raines argued that it is symbolically important on Wall Street. Raines added that there was “absolutely” no support in Congress to remove the companies’ credit lines. (*Bureau of National Affairs*, R. Christian Bruce and Karen L. Werner, 10/27/03; *National Mortgage News*, 10/27/03; *Dow Jones Newswires*, Dawn Kopecki, 10/28/03; *American Banker*, Rob Blackwell, 10/27/03)

### Others claim, GSE bill not dead yet, only delayed

- With passage of GSE regulatory legislation “dead” for the year, Washington and Wall Street sources say that financial markets may well help determine if compromise legislation is passed in 2004. According to Peggy Peterson, deputy chief of staff for the House Financial Services Committee, there are no signs of active negotiations between Treasury, the GSEs and key congressional offices.
- Treasury has outlined policy principles that it has deemed as a floor for any negotiations, among them the assumption of authority over new lines of business Fannie and Freddie might enter into. Congressional Democrats and some Republicans, as well as the GSEs themselves, have staunchly opposed the proposed migration of the GSEs’ “mission” oversight from HUD to Treasury.
- “No one here has changed their position,” said Treasury spokeswoman Anne Womack Kolton. “We have laid the principles that we see as essential for fundamental reform, and we’re sticking to them. We believe that we are on the right side of this policy debate.”
- “It looks like there won’t be a GSE reform bill this year. Market reaction will have a lot to do with whether there’s a bill next year,” said John Butler, senior strategist for Lehman Equity Research in New York and former staffer on the House Services Committee.
- “Whether or not there’s going to be a bill next year depends on what the investment community says to Fannie and Freddie,” agreed Bert Ely, an Alexandria financial institutions consultant and critic of the housing GSEs. “Can the investors comfortably rest with continued political risk for the GSEs?” he asked.
- Jean Genirs, head of liquid markets at Deutsche Bank, New York, said “A couple of months ago everyone thought (legislation) was on the fast track. It’ll take longer, and the market is now resolved to that.” She noted the failure to move any bill at all would disappoint the market, and that the Street would value signed legislation that increases the companies’ “transparency and control measures.” The new regulator, if not Treasury, must have real credibility and name recognition to market participants, she added.
- Another debt agency trader said that the market is expecting oversight authority to go to Treasury, and any other outcome would be a market negative. With Treasury policing the GSEs’ safety and soundness, this trader said, their government tie would be much more explicit, a prospect that “cheers” the market.
- “Should substantive discussions resume, observers suggest that a more politically independent alternative to Treasury might materialize. “Democrats don’t trust Treasury with the housing mission, and they never will,” said one portfolio manager.

Democrats' support will be crucial to passing any reform measure out of the narrowly divided Senate. (*The Main Wire*, Claudia Hirsch, 11/03/03)

#### NY FHLBank Chief comments on the risk of delaying GSE reform

- Alfred A. DelliBovi, president of the Federal Home Loan Bank of New York, urged the GSEs to reach a deal to enhance their regulation before it is too late. "The GSEs would be very wise to get legislation moved as soon as possible, before these more radical concepts find their way into the mix," said DelliBovi. "We ought to get the legislation moved and settled so that these other ideas can stay in the brine of the think tank." (*American Banker*, Rob Blackwell, 10/29/03)
- While Fannie, Freddie and their housing industry allies have stalled passage of GSE Reform in 2003 placing the GSEs under strict Treasury Department oversight, the match is far from over. The GSEs face a potential public relations nightmare in coming months, as Freddie restates its past three years' earnings in November 2003 and deals with resulting tax consequences; the Congressional watchdog, the GAO, issues a critical report; and the results of a criminal probe of Freddie's accounting become public. The drumbeat of bad news about the GSEs could convince even the most GSE-friendly lawmakers that the time for reform has arrived. (*Business Week*, Mike McNamee with Paula Dwyer, 10/27/03)

#### Senate Banking Committee to hold third hearing on GSEs on November 13

- The Senate Banking Committee will hold a hearing on proposals to regulate the GSEs on November 13<sup>th</sup>. Witnesses have not yet been announced. (*Senate Banking Committee Press Release*, 11/6/03)

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| Senator Allard discusses need for GSE regulation |
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- In an interview with *Bloomberg News*, Banking Committee member Senator Wayne Allard (R-CO) said that GSEs "have a lot of influence on members in the Senate. Obviously, they'd like to go ahead with business as usual. But we have to be careful that we fully understand the issue because with the GSEs, stocks will fluctuate easily depending how the Banking Committee responds."
- "We don't want to create an unnecessary problem there if there isn't a problem. On the other hand, we're protecting the taxpayer and we don't want to have a GSE fail. Most people are assuming that they are secured by the government, which they are not. Then it becomes an issue of whether they are too big to fail. They are covering such a large part of the markets and they are such huge financial institutions that it will be very difficult for Congress to ignore the impact that they would have."
- "We just want to have accountability, so that we fully understand financial stability—so that when we have an economic downturn there won't be a bailout required by the federal government." (*Bloomberg News*, 11/30/03)

### Shelby plans “near term” vote on Brickell to head OFHEO

- According to Senate Banking Committee spokesman Andrew Gray, Chairman Richard Shelby is working to schedule a near term Committee vote on the confirmation of Mark Brickell as head the OFHEO. “Mr. Brickell is ready for action, ready for a vote,” noted Gray. At Brickell’s nomination hearing on July 22, some Democrats on the committee voiced strong opposition to Brickell’s nomination, noting his past advocacy of the derivatives industry. While Brickell’s chances to clear the committee may be good, several industry observers said that they expect a Democrat, most likely Senator Paul Sarbanes (D-MD), would block the full Senate’s consideration of the nomination.
- The delay of Brickell’s nomination will likely delay the nomination of Thomas Curry to the FDIC’s board and Alicia Castaneda to the Federal Housing Finance Board. The three nominations were tied together at the committee level and would probably be voted on at the same time. (*Market News International*, 10/30/03; *American Banker*, Michele Heller and Rob Blackwell, 10/31/03)

### Brian Roseboro picked to replace Peter Fischer as Treasury Undersecretary for Financial Institutions

- President George W. Bush plans to nominate Assistant Treasury Secretary Brian Roseboro as Undersecretary for domestic finance. Roseboro, the U.S. Treasury’s acting undersecretary for domestic finance, was chosen to fill the job permanently, as successor to Peter Fisher, when Kenneth Leet, managing director of Goldman Sachs, withdrew his name from consideration for health reasons. As Treasury’s undersecretary of domestic finance, Roseboro would oversee the department’s stance on Fannie Mae and Freddie Mac, at a time when Bush administration is suggesting that Treasury should become their regulator. Since July 2001, Roseboro has served as assistant secretary for financial markets. Prior to entering government, Roseboro was deputy director of market risk management for American International Group, New York. He has also worked as the chief dealer on foreign exchange desk of the New York Federal Reserve.

### Editorial pages speak out on need for GSE reform

- In an editorial appearing October 28<sup>th</sup>, the *Christian Science Monitor* argues that the time has come to rein in Fannie and Freddie. The U.S. cannot allow these GSEs, which account for 45% of home mortgages, to fail or falter. The administration’s efforts to tighten regulation of Fannie and Freddie, by shifting regulatory oversight of this pair to Treasury and providing Treasury with the tools to approve new products and determine capital levels, have been stymied by the GSEs’ legendary lobbying abilities. If Congress doesn’t take this step, it should sever Fannie and Freddie’s advantageous ties with the government, including the symbolic line of credit that gives the public the illusion that the government will bail out these agencies. Such a move would help put Fannie and Freddie on a level playing field with its competitors.

While privatization is the ultimate way to accomplish this goal, tougher regulation, enacted sooner rather than later, would be a welcome interim step. (*Christian Science Monitor*, “Reining in Fannie and Freddie,” 10/28/03)

- The *Wall Street Journal* opines that Fannie Mae’s news that it has had to revise its balance sheet by \$1.1 billion is just one more sign that the government sponsored mortgage giant and its brother, Freddie Mac, need to be examined from stem to stern. “Fannie Mae pooh-poohed the accounting error... to which we say, ‘get real.’” This is the third time in about a year that Fannie or Freddie has jolted the market with an accounting problem. The basic problem is that the duo’s operations are essentially a black box, with no one quite sure how they are juggling all of their enormous risk. It is too dangerous for a modern economy to have so much financial risk contained in two companies that have an implicit taxpayer guarantee – especially without adequate regulatory scrutiny. Congress now has one more reason to embrace Representative Richard Baker’s plan to bring the pair under Treasury supervision. So far Fannie and Freddie have blocked this with their usual political intimidation. But Members might start thinking about how they’ll explain themselves if they do nothing and the next Fannie or Freddie surprise is ugly. (*Wall Street Journal*, “Fannie’s Black Box,” 10/31/03)
- The *Washington Times* focused on Fannie Mae’s announcement that it made a \$1.1 billion error on its third-quarter balance sheet appears to validate calls for regulatory reform of the mortgage giant and Freddie Mac. In light of the accounting problems at Freddie Mac, Fannie Mae has been held up by opponents of regulatory reform as a larger, more financially responsible company. The transparency at Fannie, they argued, proved that Freddie’s understatement of earnings between 2000 and 2002 was an aberration. Fannie’s fall from grace seriously weakens this argument. The problems at Fannie Mae have put new impetus behind the legislative efforts. Congress should approve effective but restrained regulatory reform early next year, if the issue isn’t resolved before this year’s recess. (*Washington Times*, “Now Fannie fumbles, too,” 11/04/03)

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| Market questions GSEs on impact of hedging moves |
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- Fannie Mae and Freddie Mac face growing concerns in the marketplace because of the size of their growing portfolios. While these GSEs may have some of the best hedging expertise in the world, there are concerns about the effectiveness of their hedging strategies given the size of their portfolios.
- There is growing concern in the capital markets that the GSEs’ heavy reliance on Treasury securities to hedge mortgage portfolios could distort the market for those assets. If huge entities, like Fannie and Freddie, have to “flood” the market with either purchases or sales to rebalance their positions in response to an interest rate move, will the pricing of those assets be affected? Some believe that the GSEs may have inadvertently have put upward pressure on interest rates this summer because of their rebalancing needs.

- The size of the mortgage-backed securities market, representing 35% of fixed income debt versus 22% for Treasuries, helps illustrate this problem.
- Another concern about GSEs is “counterparty risk.” When the GSEs enter into option-based contracts or swap agreements, what will happen if a rate movement triggers a reciprocal transaction and the counterparty to the deal cannot deliver?
- Fannie Mae and Freddie Mac say that collateral arrangements with highly rated counterparties reduce the risk of counterparty failure on a transaction. Further, they dispute the notion that their hedging transactions could disrupt the market for Treasury securities. It should be noted, however, that Fannie Mae has started to rely on more option-based debt offerings as a larger part of its interest rate risk management program.
- In a recent webcast with investors, Fannie Mae’s chief financial officer, Timothy Howard, indicated that Fannie Mae intends to grow its retained portfolio further, picking up market share as other buyers of mortgage assets, primarily commercial banks, decided to sell them in favor of other assets. He claimed that there is no evidence that the GSEs have distorted Treasury prices because of their hedging moves. Fannie Mae has a diverse hedging strategy and deals with many business partners, making it easier for the agency to conduct its hedging strategy without affecting the market, he said. (*Mortgage Servicing News*, Ted Cornwell, November 2003)

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| National Association of Home Builders protests attacks on housing GSEs |
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- Homebuilders are turning into vociferous critics of the Bush Administration’s plan to increase oversight of Fannie Mae and Freddie Mac. The feud arises from the administration’s plan to move most oversight of the GSEs to the Treasury Department, where they would likely face tougher scrutiny. Homebuilders strenuously object to moving the approval of new products for GSEs from HUD to Treasury, fearing that Treasury would limit their ability to develop new products, such as interest only loans and no down-payment loans.
- According to the National Association of Home Builders (NAHB), the recent accounting and management issues at Freddie Mac have triggered an opportunistic onslaught against the housing GSEs that ignores the will of the people and the intent of policymakers, and threatens the economic recovery now underway. According to NAHB Chief Economist David Seiders, “the housing sector of the U.S. Economy has turned in a truly heroic performance, through both the recession of 2001 and the job recovery since then.” Without the housing sector performance, Seiders argues, the recession would have been longer and deeper and the recovery would have been weaker to date. “It is understandable,” Seiders said, “that the recent problems at Freddie Mac have raised questions about the quality of regulation dealing with the safety and soundness of GSEs. But anti-housing factions already have stretched

“regulatory reform” into areas of mission oversight and program approval. And now we are hearing even more alarming suggestions out of the Treasury Department that would weaken or destroy the GSE status of Fannie and Freddie. Cutting the GSE’s line of credit to the Treasury would raise the cost of home mortgage credit and undermine housing’s support to the economy and the job market. Indeed, just the suggestion caused immediate damage to GSE borrowing costs as well as GSE stock values.”

- After learning about Fannie Mae’s “computational errors” in its third-quarter statements, Jerry Howard, President of the NAHB, stated, “It will be a lot harder for those of us that care about housing policy to stay in focus. Now it is all about finance. The finances are under an even brighter spotlight.” He continued, “From the perspective of people who are engaged in this battle, we don’t need to give the anti-housing forces any ammunition, and this has done that. Even though from our perspective, it might be blank ammunition, it is still going to make a big sound for a while.”
- Howard contends that Treasury’s “institutional bias” against housing will effectively shut off the pipeline for new mortgage products that have increased home ownership to historic levels.
- Part of the homebuilder’s suspicions of Treasury is related to a seven-year standoff with the agency over the Mortgage Revenue Bond Program. Under this program, the states issue bonds to fund mortgages for first-time homebuyers. The bonds are tax-exempt and the states pass on the savings to homebuyers in the form of below market interest rates. To qualify for the program, the price of the home must fall below the average price of a given area. Despite lobbying efforts by the homebuilders association, Treasury hasn’t adjusted the average home price for nearly a decade. States can adjust the price through a costly and time-consuming process. More than 40 states have price limits that fall short of the current average price for a new home. “After watching how the Treasury has handled this housing program, which is only a small piece of the housing market, the administration wants to give them responsibility over Freddie and Fannie?” asks Howard. “I don’t think so.” A Treasury official stated says the agency began an effort to update the prices early this year and hopes to complete the exercise in early 2004.
- Critics say that the GSEs have created programs that divert funding from their coffers in ways that don’t always benefit first-time homebuyers. For example, homebuilders won HUD approval last summer to create a \$500 million Fannie-run secondary market for construction loans taken out by builders. Such programs “aren’t about putting people into homes, [they are] about profits for Fannie, Freddie and homebuilders,” said Mike House, executive director of FM Policy Focus, a Washington lobbying group funded by competitors of the GSEs. NAHB defends the program, saying that it falls within the companies’ mission to create a secondary market for housing finance, because, they claim, it lowers the builders’ overall cost of

financing. (*PR Newswire*, 10/24/03; *American Banker*, Rob Blackwell, 10/31/03; *Wall Street Journal*, Queena Sook Kim, 11/03/03)

## ***Fannie Mae***

Fannie Mae's accounting error fuels calls for reform

Peter Eavis of *Thestreet.com* says there are troubling questions on Fannie's books

OFHEO seeking accounting firm to review Fannie Mae's accounting policies

### Fannie Mae's accounting error fuels calls for reform

- According to campaigners for reform of GSEs, Fannie Mae's admission that it made errors on its balance sheet figures in the third quarter has strengthened the case for greater oversight and more internal controls. "This shows the need for true disclosure and reiterates the need for adequate oversight," said Mike House, executive director of FM Policy Focus, a group campaigning for reform of Fannie Mae and Freddie Mac. As a result of Fannie's admission, some analysts said support for the GSEs was weakening as a result of accounting problems at both agencies. There are fears that Fannie Mae may not have told the full story about the balance sheet mistakes and that the agency may face growing accounting problems, similar to the problems experienced by Freddie Mac.
- Fannie Mae struggled to explain the confusion that surrounded its release of revised figures. The company blamed *Business Wire* for the confusion over the release. Mr. House said that the company's attempt to deflect blame for the fall in its share price on to a disseminator of press releases compounded its problems. "It borders on the absurd to blame the confusion on a press release," he said. (*Financial Times*, Vincent Boland, 11/03/03)

### Peter Eavis of *Thestreet.com* says there are troubling questions on Fannie's books

- *Thestreet.com's* Peter Eavis reported that there's something about Fannie Mae's billion dollar accounting error that just doesn't add up. Last week, Fannie said that computational errors caused it to understate shareholder's equity by \$1.14 billion in its third quarter earnings release.
- While the market has more or less brushed aside Fannie's equity error, it is highly unlikely that the pro-reform forces will accept Fannie's explanation at face value. What sort of data would an outside observer need to assess Fannie's claim that the understated equity was simply an error? What questions need to be asked?

- The best place to start is examining what happened in the balance sheet for there to be an increase in equity in the amended earnings release. Equity increased after Fannie adjusted two equity numbers, one upward and one downward. The negative adjustment of \$143 million increased the loss in equity that resulted from the introduction in July of accounting rule FAS 149. Given the relative “smallness” of this adjustment, it is perhaps not a pressing issue.
- The real story may lie in the \$1.28 billion positive adjustment to a line in Fannie’s equity that tracks unrealized market gains on its balance sheet assets classified as “available for sale (AFS).” In the original third quarter earnings release, gains on these AFS assets were stated as \$2.14 billion. After the adjustment, that figure was increased to \$3.42 billion. At the end of June, only \$150 billion or 18% of Fannie’s net mortgage assets were labeled AFS and the other \$670 billion were classified as held-to-maturity (HTM). Critically, market moves on these HTM assets do not show up in equity.
- Fannie clearly linked both the negative and positive errors to the introduction of FAS 149. Why didn’t the positive adjustment also get included in the equity line that is specially designated for the new accounting rule?
- Before the admission of the error, the unrealized gains on Fannie’s equity were actually \$1.5 billion lower in the third quarter than in the second. With the later positive adjustment to these gains, they are down only \$227 million. Fannie’s balance sheet looks healthier and the company managed to avoid another drop in equity, a source of concern in the market.
- Why did Fannie decide to record the gains in the securities line and not in FAS 149 line? The company says that the \$1.28 billion gain reflects the change in the market value of securities after they came onto Fannie’s balance sheet. Fannie’s spokeswoman says that the spreadsheet error caused Fannie not to pick up the correct “FAS 149 price” of its securities. The FAS price refers to the cost basis of the mortgages or the price at which the bonds actually came on to Fannie’s balance sheet. If the quarter-end price was higher than the FAS 149 price, a gain would occur. If the spreadsheet failed to pick up the lower FAS 149 price, there would be no gains. Fannie says it later discovered that it hadn’t recorded the lower purchase prices and thus was able to book the gains, once it recorded them.
- If this is true, Fannie would have to have taken a stark and possibly dubious departure from past bookkeeping practices in order to book the full \$1.28 billion adjustment in the unrealized gains segment of equity. Only the market change in available for sale assets gets booked in the line for unrealized gains on AFS. Traditionally, Fannie has only been booking a small proportion of its new mortgage purchases as AFS, yet it appears to have booked the vast majority of it in that segment in the third quarter. By doing so, it was able to record the \$1.28 billion in the reissued earnings statement.

- When asked if the lion’s share of the third-quarter mortgage production was booked in AFS, Fannie spokeswoman Janis Smith responded in an email, “We are primarily a hold-to-maturity investor. The decision to classify assets as AFS is not an accounting decision. It is a business decision made by our portfolio group at the time the securities come on our books.”
- A simple calculation using interest rate moves shows that Fannie would need to have booked close to the total mortgage production in the quarter in AFS to create the \$1.28 billion gain during the third quarter. While the calculation is “rough,” it is hard to see any other way in which the \$1.28 billion gain could have materialized during the quarter.
- Why did the apparent shift toward AFS classification in the third quarter occur? The least “kind” explanation is that Fannie made the shift from HTM to AFS retroactively after the quarter had ended, once it saw that it could book some gains. Perhaps Fannie Mae took advantage of a small error in the FAS 149 accounting to reclassify some securities from HTM to AFS, using hindsight? When asked, Smith responds, “No, we didn’t, nor would GAAP permit us to.” If Fannie did shift assets to AFS in possibly an improper manner, why wait to change the classification in the restatement, when critics would carefully review its numbers? Why would Fannie take such a risk for a \$1.28 billion unrealized gain, when the company’s regulatory capital levels are not at such critical levels?
- At this point, the Fannie’s \$1.28 billion gain cannot be explained by anything other than a dramatic shift toward AFS classification. If Fannie is booking more of its mortgage production in AFS, future interest rate moves could wipe out those gains and make Fannie’s shareholders’ equity even weaker than it is. (*TheStreet.com*, Peter Eavis, 11/05/03)

OFHEO seeking accounting firm to review Fannie Mae’s accounting policies

- OFHEO posted a solicitation on its web site to hire an accounting firm to conduct a special examination of Fannie Mae. The accounting firm will identify weaknesses in accounting policies and controls, with an emphasis on critical accounting policies and practices, unusual transactions and sensitive accounting estimates. (*FedBizOpps*, 11/07/03)

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| Mobile home loan problems at Fannie? |
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- Investors in Fannie Mae are whispering about another potential source of trouble at Fannie Mae – the company’s deteriorating \$9 billion portfolio of manufactured homes. Concerns stem from Fannie Mae’s heavy concentration of manufactured housing exposure in securities from Conseco, Inc., which filed for bankruptcy-court protection last year in part because of problems with mobile-home loans, and recently emerged from bankruptcy. After downgrading Conseco’s credit rating in 2002, Moody’s Investors Service, Inc. put Conseco mobile home securities on review for

another possible downgrade in October, citing “continued performance deterioration” and “high levels of cumulative losses and repossessions.” Standard and Poor’s has also recently downgraded numerous Conseco securities. According to the Wall Street Journal, approximately 70% or \$6.3 billion of Fannie Mae’s mobile home portfolio is tied to Conseco loans.

- As a part of its bankruptcy reorganization, Conseco sold its lending unit, which manages and collects the loans backing the bonds held by Fannie Mae, to CFN Investments. A term in the sale increased the loan servicing fee from 0.50% of the loan amounts to 1.25% for the first 12 months and then 1.15%. With markedly reduced cash flows and rising bad loan debts, rating agencies like Moody’s and Standard & Poor’s have slashed ratings on many of these bonds. The FHLBank of New York sold \$1.03 billion of bonds backed with mobile home loans, booking a \$183 million or 18% loss.
- Some housing analysts say that the improving economy could reverse the tide of mobile home defaults and that the sector already has hit bottom or will soon. It is unlikely that Fannie Mae would suffer a loss big enough to seriously jeopardize its long-term financial health, because the \$9 billion mobile home portfolio is only 1% of its total portfolio of \$900 billion.
- Fannie Mae says its mobile home securities are “still performing” and that its credit enhancements, such as insurance, should help mitigate any losses. The company also holds senior positions on most securities, meaning it would only suffer losses after other investors do. “We’ve looked at it very hard, and we do not believe that any potential additional impairment that might be recorded [from manufactured housing loans] would be material to Fannie Mae’s operating results,” said Chuck Greener, Fannie Mae’s spokesman.
- In a little noticed item in its second quarter filing with the SEC, Fannie Mae said 25% of its mobile home securities were rated a triple-B, following recent downgrades, which suggested that the quality of the securities had deteriorated. In its 2002 annual report, Fannie Mae said the “vast majority” of its mobile home securities were rated double-A-minus or better. In the first quarter filing, such securities represented “a substantial majority” and in the second quarter, they were just “a majority.” Fannie Mae said that it had reviewed its mobile-home securities and “recorded impairment where appropriate,” but declined to give specific numbers because it says they weren’t material.
- If Fannie follows the lead of rating agencies, it will have to make material charges in its income statement—possibly exceeding \$1 billion—on the troubled manufactured housing bonds. A write-down of that size would be a much bigger blow to the creditability of Fannie’s management than its \$1 billion “computational error” reported on October 29, because the company has so far insisted that no large write down is needed on these bonds. (*Wall Street Journal*, Patrick Barta and Gregory Zuckerman, 11/03/03; *TheStreet.com*, Peter Eavis, 10/31/03)

### Fannie Mae paper likens derivatives to “smart bombs”

- In a new paper published by Fannie Mae, Christopher Culp, an adjunct professor of finance at the University of Chicago’s Graduate School of Business, said one of the leading myths about derivatives is that they have caused major financial losses because of their risks. Noting that Berkshire Hathaway Chairman Warren Buffet described derivatives as “financial weapons of mass destruction,” Culp said, “In reality, they might be better classified as smart bombs with which corporations can apply laser –like accuracy and precision to remove unwanted risk.” Culp said the vast majority of so-called derivatives-related disasters of the mid-1990’s were not caused by derivatives but rather by “poor risk targeting.” He noted, “Derivatives, like smart bombs, can also cause significant devastation to their users if they are not handled properly. For the most part, however, these risks of derivatives are not fundamentally different from the risks to which other financial activities expose firms.” (*Dow Jones International News*, John Conner, 10/27/03)

### CitiMortgage and Fannie Mae announce \$100 billion affordable housing alliance

- Said to be the largest affordable housing lending alliance in Fannie’s history, CitiMortgage and Fannie Mae announced a \$100 billion affordable housing alliance, which will reach up to one million low- and moderate-income households, including minorities and other underserved households, through the end of the decade. This partnership is part of CitiMortgage’s overall \$200 billion affordable housing commitment under its Opportunities Within Neighborhoods program. Citi and Fannie also announced the completion, two years early, of a \$12 billion, five-year commitment made in 2000. (*Business Wire*, 10/29/03; *National News Online*, 10/30/03)

### Fannie Named in “Great Places to Work” in *Washingtonian Magazine*

- According to the *Washingtonian Magazine*, it is hard to think of an employee benefit not offered by Fannie Mae. Employees enjoy “typical” benefits, such as a pension and 401(K) plan. And then there are the “extras,” including \$100 Metrochek each month for commuters; \$10,000 in adoption assistance; and a forgivable loan of up to (the lesser of) \$35,000 or 7% of the purchase price of a home, depending upon location. Employees have access to numerous services, including a travel agency, eldercare consultant, on-site emergency childcare and programs for employees’ children during school breaks. Employees are reimbursed for childcare costs necessitated by business travel or overtime. To encourage volunteerism, Fannie offers its employees ten hours a month of volunteer leave. Employees who participate in a 30-minute health assessment and follow-up are given a day off. Fannie Mae, whose senior management is 39% women and 25% minority, is one of the most diverse workforces visited by the magazine’s staff. (*Washingtonian*, “Great Places to Work,” November 2003)

## ***Freddie Mac***

### Probes of Freddie Mac make Wall Street nervous

- After paying out hundreds of millions of dollars in fines and suffering serious damage to their reputations, Wall Street firms are eager to forget the scandals of the past three years. Banks and brokerage firms may experience more pain if they are found to have abetted the accounting problems at Freddie Mac, which is currently under investigation by Justice Department, SEC, OFHEO, and the IRS.
- Three Wall Street firms, Morgan Stanley, Citigroup, and Blaylock & Partners, have so far been named in connection with some questionable accounting maneuvers that were highlighted in a report released in July by Baker Botts, Freddie's legal counsel commissioned by the board to examine Freddie's books. These firms may not have had any idea how Freddie was accounting for trades they did with the company and the transactions themselves may not turn out to be contrary to accounting rules.
- However, the Baker Botts' report described transactions that any properly run investment bank would have considered unusual. For example, the so-called CTUG transaction involved Freddie parking securities at an unnamed counterparty bank for just a couple of hours without actually selling them. In another transaction, the Baker Botts report quotes a trader at an unnamed bank telling a Freddie employee that he didn't "want to be taken off in handcuffs for doing something that is not kosher" after hearing the details of a transaction proposed by the GSE. This transaction was in relation to mammoth transactions called linked swaps with five different parties, which resulted in pushing unexpectedly high operating earnings into the future.
- While the Baker Botts report makes no apparent effort to determine the extent to which the investment banks might have helped Freddie construct some of the criticized transactions, it would be devastating if the banks had played a central role. To date, there is no evidence that the banks played a role. Federal probes found that J.P Morgan and Citigroup bankers knew the transactions that they arranged for Enron would have a misleading effect on Enron's books. Both banks paid out huge settlements as a result of the Enron investigation.
- Over time, the ongoing federal investigations into Freddie's accounting may dig up much more, inside and outside of Freddie. Wall Street cannot breath easy yet. (*TheStreet.com*, Peter Eavis, 10/30/03)

OFHEO issues subpoenas and key players “lawyering up”

Freddie management shakeup continues

Search for Freddie Mac CEO continues

Freddie reorganizes management structure and creates two new senior positions in finance division

OFHEO issues subpoenas and key players “lawyering up”

- Key players in the Freddie Mac accounting imbroglio continue to hire lawyers to help them deal with an array of government probes. Two lawyers close to the investigation said that Maud Mater, who was ousted two months ago as Freddie Mac’s executive vice president and general counsel at the suggestion of regulators, has tapped John Douglas as her attorney. Douglas, 53, chairs the financial services group of Atlanta’s Alston & Bird and served as general counsel of the FDIC in the late 1980s.
- On October 22<sup>nd</sup>, former Freddie Mac president David Glenn signed a consent order, neither confirming nor denying any wrongdoing, and agreed to cooperate with OFHEO investigators. Under this consent agreement, Glenn has agreed to pay a \$125,000 civil fine and forego \$13 million in severance pay. Glenn is represented by Thomas Vartanian, a partner in the D.C. office of Fried, Frank, Harris, Shriver & Jacobson.
- OFHEO issued subpoenas to Leland Brendsel, former Freddie Mac chairman and chief executive officer, and Vaughn Clark, former chief financial officer. An OFHEO spokeswoman said, “We are not satisfied with their cooperation to date.” According to a source close to the investigation, other former officers have been subpoenaed as well. (*National Mortgage News Online*, 10/27/03; *Australian Financial Review*, Sean Aylmer, 10/25/03)

Freddie management shakeup continues

- Freddie Mac forced out three vice presidents and a trader, completing its disciplinary actions against employees named in an internal company probe of accounting irregularities. Sources identified the ousted individuals as Robert Dean, senior vice president of market risk oversight; Byron Boston, vice president of investments, Mustafa Chowdhury, a vice president of asset liability management, and trader Smriti Popenoe. Dean and Chowdhury devised a “policy” to revalue Freddie Mac’s derivatives to create a \$731 million loss, a key component behind the company’s restatement. Popenoe participated in trading that circumvented an internal rule and moved securities from one area of Freddie Mac to another, reducing the company’s tax burden. Boston and one other vice president had knowledge of these trades. To date, ten employees have lost their jobs at Freddie Mac, as a result of the accounting

probe. (*Washington Post*, David S. Hilzenrath and Kathleen Day, 10/29/03;  
*Bloomberg News*, Al Yoon, 10/28/03)

### Search for Freddie Mac CEO continues

- Freddie Mac's search committee, led by Chairman Shaun O'Malley, is talking to prospective candidates on a list provided by search firm Korn/Ferry International, said spokeswoman Sharon McHale. The committee is "just getting through the first round of interviews," she said.
- With less than two months to go for self-imposed deadline for picking a chief executive officer, the Search Committee has narrowed down its list of candidates to a small group of candidates. Sources say this list includes Robert Zoellick, a former Treasury Department official; Richard Breeden, a former Securities and Exchange Commission chairman; and Eugene Ludwig, a former comptroller of the currency. Other names being discussed include T. Timothy Ryan, a managing director of J.P. Morgan Chase & Co.; and Paul T. Peterson, the executive vice president of Freddie Mac.
- Mr. Zoellick is considered a leading candidate, because of his ties to the Bush administration and his substantial GSE experience. Currently the U.S. Trade Representative, Zoellick held several posts at Treasury in the 1980's, including the counselor to then Secretary James Baker, the executive secretary, and the deputy assistant secretary for financial institutions. Later, he was under secretary of state for economic and agricultural affairs, and he was appointed the White House chief of staff in August 1992. In 1993, Zoellick was appointed executive vice president at Fannie Mae, where he ran its affordable housing business and helped manage its legal, regulatory and government relations activities. His inside experience with Freddie's main competitor could give Zoellick an edge. However, some sources said that Zoellick has key drawbacks, including a lack of management experience. One observer characterized Zoellick's past jobs as largely intellectual and not involving hands-on management. It is also unclear if Zoellick would want the position.
- Mr. Breeden has similar strengths and weaknesses. Breeden is currently chairman of Richard C. Breeden & Co., Greenwich, CT, a consulting firm that specializes in corporate restructuring. He has extensive government experience under Presidents Reagan, George H.W. Bush, and Bill Clinton. Breeden's tenure from 1989 to 1993 as the SEC's chairman could be a valuable asset for Freddie Mac. More recently, Breeden was appointed in July 2002 as the corporate monitor for MCI WorldCom after their bankruptcy. Like Zoellick, Breeden has limited management experience. Breeden and Zoellick share a reputation for a sometimes overbearing personality.
- Mr. Ludwig, head of the Promontory Financial Group and Promontory Interfinancial Network, appears to be popular with the banking industry and other insiders. Ludwig worked as comptroller from 1993 to 1998. After his OCC tenure, Ludwig worked for two years as vice chairman of Bankers Trust Corp, prior to the Deutsche Bank

acquisition. As head of Promontory companies, Ludwig has worked extensively as a consultant to several companies, including Fannie Mae. While Ludwig has management experience, he has one potential drawback – he is a Democrat.

- In the interim, Greg Parseghian, the Company's Chief Executive Officer and President, will remain as CEO until a replacement is named. When the new CEO is selected, Parseghian may remain in a consultative role for a reasonable transition period at the discretion of the Board and CEO. (*Freddie Mac Supplement*, 10/29/03; *Bloomberg News*, James Tyson, 10/28/03; *American Banker*, Rob Blackwell, 11/07/03)

#### Freddie reorganizes management structure and creates two new senior positions in finance division

- On September 29, 2003, Freddie Mac announced that it made important changes to its senior management and organization structure, including the creation of new senior executive positions in its Finance division. Jerry Weiss was appointed senior vice president and chief compliance officer, a new position in the Finance division reporting directly to the chief financial officer. Weiss joins the company from Merrill Lynch Investment Managers, where he was first vice president and Global Head of Compliance.
- Freddie also named Margaret Colon as senior vice president and chief administrative officer, also a new position responsible for the new Corporate Strategy and Administration division, reporting to the chief executive officer. Colon has more than 20 years experience with Freddie Mac, including her role as senior vice president and chief operating officer in the company's Single Family division. Colon was formerly senior vice president of Infrastructure Initiatives Program Management.
- In the Finance division, Dave Andrukonis, formerly senior vice president for Capital Deployment, was named to the newly created position of senior vice president, chief enterprise risk oversight officer. Andrukonis will oversee market risk, operating risk, and credit risk.
- John Woods was named senior vice president and principal accounting officer, a new position to lead the accounting policy and reporting functions.
- Freddie Mac also announced organizational changes to divisions that work with lenders and with investors in Freddie Mac's mortgage and debt securities. These changes include:
  - Mike May, formerly SVO and COO, single family operations, fills a new position SVP, mortgage sourcing, operations and funding. May will have direct responsibility for Freddie Mac's relationships with lenders, servicers and investors in the corporation's mortgage-backed securities.
  - Nazir Dossani, formerly SVP of Investments in Freddie Mac's funding and investments division, is now SVP of the investments and capital markets division.

- Jerome Lienhard, formerly SVP of debt funding within the funding and investments division, was named SVP of debt and equity financing. (*Freddie Mac Supplement*, 10/29/03)

Freddie Mac takes steps to support the weak market price of its mortgage securities

Market uncertain that Freddie can boost the value of its mortgage securities

#### Freddie Mac takes steps to support weak market price of its mortgage securities

- In a statement posted on Freddie’s website, the company said it was moving to support the price of its mortgage securities, which had weakened considerably over recent months relative to comparable Fannie Mae securities. To boost the value of its securities, Freddie Mac has begun cutting the fees it charges to lenders for its securitization services. While this strategy has boosted Freddie’s market share that is closer to historic levels, it has put downward pressure on the average portfolio guarantee fee.
- In a second step to boost the market price of its securities, Freddie Mac announced it would begin selling off some of its holdings of mortgage backed securities (MBS) issued by Fannie Mae, and use the proceeds to purchase its own MBS. On December 31, 2002, Freddie owned \$77 billion of Fannie Mae securities, out of its total investment portfolio of \$583 billion. By temporarily suspending its internal rate of return thresholds, Freddie could use the proceeds from the sale of Fannie securities to buy up more of its own MBS, in order to drive up its own MBS price and further reduce the gap between Freddie and Fannie MBS prices. The company warned that if its strategies don’t succeed in the long term, “this could have a material adverse effect on the profitability of Freddie Mac’s securitization business.”
- Before Freddie Mac’s accounting problems surfaced, the pricing of Freddie’s mortgage backed securities were coming under pressure as a result of the record setting refinance mortgage boom. The wave of refinanced mortgages undercut the performance of Freddie Mac’s securities versus Fannie Mae’s, because the mortgages in the Freddie Mac pools tended to be refinanced much more quickly. Faster prepayments of Freddie Mac securities have resulted in lower market values.
- Some investors suspect that Freddie Mac is “cherry picking” some of its best loans to hold in its own portfolio, leaving loans that are more likely to repay in the securities it sells to others. While Freddie strenuously denies that it inappropriately picks out the best loans, data supplied by the company in its recent month summaries of business activities confirm that loans owned by Freddie perform better.
- Freddie Mac has lost market share during 2003, as lenders shunned lower prices on its securities in favor of Fannie Mae’s mortgage backed debt. According to *Bloomberg News*, Freddie Mac has sold 36% of the \$1.6 trillion mortgage backed bonds issued by the companies during 2003, down from 42% in 2002. Freddie Mac

has already boosted its share of mortgage bond issues in October to 52%, compared with 41% in September and 36% year-to date,” said Moshe Orenbuch, an analyst at Credit Swiss First Boston. “The October figure, based upon preliminary data, is the highest for Freddie Mac since September 2000 and above its “historical” market share of 40% to 45%,” Orenbuch wrote in a research note. (*Freddie Mac Supplement*, 10/29/03; *Wall Street Journal* John D. McKinnon and Patrick Barta, 10/24/03; *Wall Street Journal*, John D. McKinnon, Patrick Barta and Aaron Lucchetti, 10/31/03; *Bloomberg News*, Al Yoon, 10/30/03)

#### Market uncertain that Freddie can boost the value of its mortgage securities

- After underperforming its rival Fannie Mae for about six months, Freddie Mac’s recent initiative to turn around its mortgage-backed securities has some investors cautiously optimistic, while others remain doubtful. Market participants note that actions will speak louder than words and Freddie has several issues yet to tackle.
- “One of Freddie Mac’s biggest problems is that the liquidity of its MBS is not as good as Fannie Mae’s,” said Art Frank, director of mortgage-backed security research at Nomura Securities International. “Fannie Mae’s MBS have more liquidity and trade at a narrower bid-to-offer spread, which makes them more appealing to accounts that actively trade like hedge funds. Freddie Mac is quite determined to get their securities to trade closer to fair value versus Fannie Mae’s, and I suspect they will have some success. By early 2004, the pricing gap between Freddie Mac and Fannie Mae should be narrower.”
- Probably the biggest problem Freddie Mac faces right now is its reliance on a small number of mortgage servicers, such as Wells Fargo and ABN Amro, while Fannie Mae represents a larger and more diverse market segment. Freddie Mac’s servicers also tend to be in a faster prepaying market segment. “The accounting problems and management shakeup at Freddie Mac has caused some investors, especially those abroad, to be more negative on the Freddie name” Frank said.
- Andrew Harding, director of taxable fixed income securities at National City Investment Management Company in Cleveland, said that Freddie’s move to sell Fannie securities and purchase its own won’t inspire him to change his current allocation in the sector. “They need to make their securities more attractive and by constricting supply, they raise the price on their securities and I think it will backfire on them. They are slowly becoming a nonentity and it could hurt the performance of their MBS.”
- “Freddie Mac’s plan “seems like a non-starter,” said Jon Denfeld, who helps manage \$5.8 billion in assets at Shay Asset Management in Chicago. “Freddie needs to address governance and oversight to maintain investor confidence.” (*Wall Street Journal*, Julie Haviv, 11/03/03; *Bloomberg News*, Al Yoon, 11/03/03)

Freddie estimates up to \$30 million taxes owed, following restatement

Freddie Mac loses U.S. Tax Court ruling on debts before 1985

Freddie estimates up to \$30 million taxes owed, following restatement

- Freddie Mac estimates it will owe up to \$30 million in back taxes as a result of its restatement of earnings from 2000 through 2002. In a letter sent to Representative Christopher Shays (R-CT), Freddie Mac board member George Gould said that the amount is a fraction of the additional \$4.5 billion in income Freddie expects to report and isn't expected to materially impact earnings. Shays was furious when he later found out from a news report that the IRS was reviewing the company's tax treatment of certain transactions related to the restatement that could result in a tax bill of up to \$750 million, which Gould did not mention at the hearing. Gould said he didn't disclose the potential \$750 million tax bill at the hearing because the probability that Freddie will have to pay that amount is very low. The IRS would first have to rule against Freddie and then penalize it for the full amount. (*Wall Street Journal*, Dawn Kopecki, 10/31/03)

Freddie Mac loses U.S. Tax Court ruling on debts before 1985

- Freddie Mac lost a dispute with the U.S. Internal Revenue Service over its deductions of bad debts incurred before 1985, when it was tax exempt. In this ruling, Tax Court Judge Robert P. Ruwe said that Freddie Mac can't claim a tax break on bad debts incurred before 1985. "Since the petitioner was tax-exempt during this period, it realized no tax consequence from its accrued interest," Ruwe wrote in his opinion.
- The IRS says the company owes \$246.5 million in taxes from 1985 to 1990 for improperly claiming a number of deductions, while Freddie says it overpaid its taxes during this period of \$160.3 million.
- Robert Willens, a managing director for Lehman Brothers, said Freddie Mac already has won some of the bigger issues in the case, including the right to claim about \$1.5 billion in deductions from some intangible property. It lost this ruling on bad debt deductions and a ruling dealing with the amortization of trademark expenses incurred while tax exempt. "They're losing the smaller ones, but they're winning the big issues," Willens said. Douglas Robinson, Freddie Mac's spokesman, reiterated that the tax disputes wouldn't have a material adverse effect on the company's finances if it were to lose. (*Bloomberg News*, 10/30/03)

## ***Federal Home Loan Banks***

### **Pittsburgh FHLBank reports \$6.8 million loss, but says will pay dividend to shareholders**

- The Pittsburgh FHLBank announced a third quarter loss of \$6.784 million, stemming from heavy mortgage refinancing and unrealized losses on derivatives. Changes in the value of derivatives cut third quarter earnings by \$21.9 million. The bank also attributed losses to faster-than-expected refinancing of mortgage assets, which return money to the bank sooner than it had planned, forcing it to reinvest at lower interest rates. Thirty year mortgages reached four-decade lows in June, spurring the biggest wave of refinancing in U.S. history. The bank said it believed that the effect of the refinancing wave was largely behind it.
- The Pittsburgh FHLBank's third quarter loss is in line with the \$6.5 million loss it had forecasted on October 8. Despite the loss, the bank said in early October that it would use earnings from previous periods to pay dividends to shareholders.
- Jay Roy, the Pittsburgh FHLBank's chief executive officer and president, said that the bank was changing the way that it manages risk, so that changes in the fair value of derivatives does not influence earnings.
- Losses reported by the FHLBanks in Atlanta, New York and Pittsburgh for the third quarter have given increased ammunition to critics of the FHLB system, calling for structural changes in the regulatory regime governing the system. (*Reuters*, 11/04/03)

### **New York FHLBank terminates incentive plan for 2003**

- In a report to members, Alfred DelliBovi, president of the FHLBank of New York, said that officers and certain employees of the Bank are losing their incentive compensation for 2003 as a result of the Bank's financial problems. The lost compensation, totaling about \$3.1 million, will affect DelliBovi and some 152 other employees. DelliBovi's foregone compensation is said to be approximately the same as the incentive compensation of \$334,640 that he received in 2002.
- Noting that that the Bank's regulator had directed the FHLBanks to establish formal retained earnings policies not later than March 31, 2004, DelliBovi said, "Given our need to build rebuild retained earnings and the loss of investment income from the nearly \$2 billion in MBS investments we sold in September, we expect that future dividends paid by the FHLBank will be at a lower level relative to prevailing market rates than dividends in the past." Previously, the Bank had announced the elimination of its third quarter dividend to "enable the Bank to finish the quarter with close to \$100 million in retained earnings, providing a substantial foundation for rebuilding retained earnings as quickly as possible."

- DelliBovi noted that some members have asked about the possibility of the Bank's stock being classified as an impaired asset because it has paid no dividend. He noted that the definitive guidance exists for the carrying value of the FHLBank's stock in the AICPA Guide for Banks and Savings Institutions. This guidance says "fair values for securities, excluding FHLBank stock, are based on quoted market prices" and "the carrying value of FHLBank stock approximates fair value based on the redemption provisions of the Federal Home Loan Bank." He went on to say, "We appreciate the concern underlying this inquiry, and we are working swiftly to meet this issue head on. We are communicating not only with our regulators, but also with the regulators of our members so they have a full understanding and are aware of the steps we are taking to protect the value of member capital and to resume a stable dividend. The retained earnings policy our board is working to adopt will produce a stable dividend." (*Wall Street Journal*, John Connor, 11/3/03)

Regulator turns up heat on need for FHLBanks to retain earnings

Chairman Shelby insists that FHLBanks also get new regulator

Regulator turns up heat on need for FHLBanks to retain earnings

- On November 4, Federal Housing Finance Board Chairman John Korsmo sent each of the twelve FHLBanks a letter, underscoring the regulators' desire for the banks to develop appropriate retained earnings policies. Along with his letter, Korsmo enclosed a transcript of a recent Finance Board meeting at which the members agreed on the importance of the FHLBanks building appropriate levels of retained earnings. The board members stressed that a supervisory bulletin directing each FHLBank to assess the adequacy of retained earnings in light of alternative future financial and economic scenarios reflected the view the board.
- The supervisory bulletin states "if a FHLBank does not have a formal retained earnings policy, the Finance Board expects that each FHLBank's board of directors will adopt a retained earnings policy before March 31, 2004. The retained earnings policy should specify the priority the FHLBank places on retained earnings relative to dividends." (*Dow Jones International News*, John Connor, 11/06/03)

Chairman Shelby insists that FHLBanks also get new regulator

- In an interview with *Market News International*, Senate Banking Committee Chairman Richard Shelby said that his staff is working hard to put the final touches on his legislation overhauling the regulation of GSEs. "We are getting a lot closer. The lawyers in my office are fine-tuning the language. We hope to have something pretty soon," said Shelby. He stated that committee hearings this fall bolstered his view that his legislation places the FHLBanks under the same purview of the new regulator as well as Fannie and Freddie. "There is no doubt that (the FHLBanks) need a stronger regulator, a new regulator," he said. Shelby said his panel "could" mark-up

GSE legislation this fall if the congressional session slips into late November or December. It is more likely, he added, that the GSE bill will be considered by the Banking Committee in early 2004. (*Market News International*, John Shaw, 11/06/03)

## ***Sallie Mae***

### Sallie and credit bureaus end dispute over disclosure

- Facing legislative pressure over its withholding of loan data from two of the three major credit bureaus, Sallie Mae has reversed course and will once again report to all three bureaus. Sallie announced that it has reached agreements with Experian Inc. and TransUnion LLC to furnish them with credit data.
- Senator Dick Durbin, (D-IL) introduced an amendment to a Fair Credit Reporting Act renewal bill that would mandate reporting of student loan data. He withdrew the amendment after Sallie Mae announced its reverse course and Senators Richard C. Shelby (R-AL) and Paul S. Sarbanes (D-MD) assured him that they would support an amendment to the Higher Education Act to require the lender to report to all three bureaus.
- Sallie Mae had stopped providing the two bureaus information last year, because it was concerned that competitors were using the data to poach customers. The lenders policy drew criticism, when stories about borrowers being hurt by the lack of data in their credit histories began to appear in the press. (*American Banker*, W.A. Lee, 11/06/03)

### Sallie Mae to acquire Academic Management Services

- Sallie Mae has reached an agreement with UICI to acquire Academic Management Services (AMS), one of the top 20 originators of federal student loans and a leading provider of tuition payment plans. The purchase will include AMS's loan origination, tuition payment plan and loan servicing businesses, as well as a \$1.4 billion student loan portfolio. UICI estimates the sale of AMS will generate net cash proceeds of \$25.3 million. The acquisition is expected to close in November, subject to regulatory approval and other closing conditions. (*PR Newswire*, 10/30/03)

## *Postal Service*

### Postal Service (reluctantly) forges new working relationship with UPS

- United Parcel Service is rolling out a new, bare-bones service called “UPS Basic,” in which UPS will deliver small mail packages weighing up to five pounds to post offices, and the post office would make the final delivery in rural areas. The key to the UPS move is a little-known postal discount program, called Parcel Select, designed to cut Postal Service costs by giving consolidators huge price breaks.
- This new service is designed to steal some of the post office’s biggest customers, particularly mail-order merchants that often avoided UPS because of its comparatively steep rates.
- In a recent internal email, reviewed by *The Wall Street Journal*, U.S. Postal Service officials suggested that they underestimated the threat of UPS. As long as any outside company meets the rules for using Parcel Select, the company is entitled to discounts. “This is a net loss of revenue and volume,” wrote Robert P. Fisher, a top postal executive in an email. The new UPS service “is resulting in large, immediate revenue losses,” Mr. Fisher said. “We’ll get rural and anything that they can’t make money on.”
- FedEx might announce a similar pilot program soon. (*Wall Street Journal*, Rick Brooks, 11/06/03; *DM News*, Melissa Campanelli, 10/29/03)

### Postal Service retracts notice to identify senders, citing privacy misunderstanding

#### USPS says new products will have privacy policies

- As noted in the 10/28/03 issue of *The GSE Report*, the Postal Service published on October 21<sup>st</sup> in the *Federal Register* a proposed rule that “seeks to enhance mail security” by requiring all discount mail be “sender identified.” On October 27<sup>th</sup>, the Postal Service announced it will withdraw this notice because the issuance has caused misunderstanding and concerns by privacy advocates. In a statement, Stephen M. Kearney, vice president pricing and classification for the Postal Service, said “Sender –Identified Mail: Enhanced Requirement for Discount Mailing, a notice intended to clarify business customer information, will be reissued.” (*United State Postal Service Press Release*, 10/27/03; *Washington Times*, Audrey Hudson, 10/30/03)

#### USPS says new products will have privacy policies

- Zoë Strickland, the Postal Service’s chief privacy officer said that as new postal products are developed, they will include privacy policies. “The postal service is a trusted business that seeks to develop modern products and services to meet customer

needs. Part of that equation includes best-in-class privacy policies,” Strickland said. (*DM News*, Melissa Campanelli, 11/04/03)

Rules proposed to allow refunds for unused, undated meter postage and apply codes to flat mail

- The Postal Service filed a proposal in the *Federal Registry*, announcing it will mechanically apply unique USPS identification codes to flat-sized mail pieces not bearing POSTNET barcodes. The new system, scheduled for deployment in 2004, will reduce costs associated with the current manual system of applying codes. (*DM News*, Melissa Campanelli, 10/29/03)
- The Postal Service has published in the *Federal Register* a proposed rule that would “allow refunds for unused, undated metered postage.” The proposed rule would “benefit any mailer who generates significant quantities of unused, undated metered postage and is able to meet refund criteria.” (*Federal Register*, 10/29/03)

Vantage Group, et al agree to pay US \$4.5 million to settle civil false claims act allegations

- Vantage Group, Inc., a Brookline, MA based company and two of its subsidiaries, Vantage Financial Services and Vantage Direct Marketing Services (Vantage) have agreed to pay the United States \$4.5 million to settle a civil action, alleging that through the 1990s, Vantage engaged in a scheme to defraud the U.S. Postal Service. According to the government’s complaint, Vantage, a for-profit company that conducts fund raising programs on behalf of nonprofit organizations, entered into “secret side letters” outside of their standard contract, providing Vantage a financial stake and share in the costs and benefits of the nonprofits’ mailings. Under these side agreements, Vantage and its senior officers caused tens of millions of pieces of mail to be sent at the reduced, non-profit rate, saving the company millions of dollars in postage. Approximately 22% or \$990,000 of the settlement will be paid to Lawrence Sakad, a former Vantage employee, who brought this misconduct to the government’s attention by filing suit under the False Claims Act. (*United States Post Office Press Release*, 10/28/03)

Postal Service approves cooperative mailing rules for nonprofits

- On November 13<sup>th</sup>, new postal regulations take effect that dismantle the cooperative mailing rules governing mailing rates paid by commercial fundraisers when they work on behalf of non-profit organizations. Under these regulations, commercial fundraisers will also be required to provide the nonprofits that hire them with donor lists, including their contact information and the precise amount of their contribution. ([www.backstage.com](http://www.backstage.com), Leonard Jacobs, 10/27/03)

- According to *Alliance Report*, the Postal Service's new rule dismantling the protections against cooperative arrangements in fundraising would make all of the Vantage deals "perfectly legal." (*Alliance Report*, 10/29/03)

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