

# The **GSE** REPORT™

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## Major Events

Administration criticism torpedoed markup of GSE reform bill

Treasury insists new activity approval reside within its purview and that it set regulatory policy, rather than the new “independent” regulator

- On the eve of the planned markup of the H.R. 2575 (the Secondary Mortgage Market Enterprises Regulatory Improvement Act) in the House Financial Services Committee, the Bush Administration stated that it did not support the House bill to revamp Fannie and Freddie. According to a senior Treasury official, the bill would be only “marginally better” than the status quo. Although the Treasury criticism fell short of a veto threat, the legislation, commented Assistant Treasury Secretary Wayne A. Abernathy, “. . . is not a credible bill. You really aren’t getting reform.” Abernathy said the Administration “doesn’t support sending the legislation to the House floor in its current form because it isn’t strong enough to achieve the goal of making the markets safer and more secure.”
- The Administration objected to two provisions in HR 2575, one making the new regulator of the companies an independent unit of Treasury (the new Office of Housing Finance Supervision (OHFS) in Treasury would replace the OFHEO at HUD), much like financial regulators housed at Treasury that oversee banks and thrifts; the other giving the Department of Housing and Urban Development oversight over the companies’ business activities. The HUD provision was pushed mostly by Democrats but was accepted by Chairman Oxley and subcommittee chair Rep. Baker as a compromise needed to move the bill. The independence provision was supported broadly from committee Democrats and Republicans.
- The bill drafted by Oxley would limit Treasury’s role in new product regulation. The Treasury Department would be focused on overseeing financial safety and soundness. Everything else would fall under the watch of HUD. The draft assigned a new office in HUD with the task of regulating the mission of Fannie and Freddie, termed the Office of Government-Sponsored Enterprise Mission Oversight, retaining a number of responsibilities HUD now possesses and designed to strengthen regulation of the twin GSEs. Secretary Snow had called for new-activity approval to be transferred to the new OHFS at Treasury. Under the draft, HUD has authority to review all new and ongoing activities of the GSEs, with advance notice required from Fannie and Freddie when they wish to engage in new activities. HUD would also monitor and enforce the GSEs’ compliance with housing goals, with civil and criminal penalties for enforcement actions. Through a transition process, the draft bill would transfer OFHEO employees to the new regulator at Treasury.
- Assistant Treasury Secretary Abernathy stressed that the proposed new regulator of Fannie and Freddie must be endowed with the right to block new activity,” so they “aren’t allowed to stray from what their important responsibility is.” Abernathy pointed out that “Every world-class regulator has . . . the ability to say no to new

activities” of the regulated entity and that without this power, the regulator would be “crippled.”

- Another problem with the draft, Abernathy said, was that moving regulatory functions under Treasury would reinforce the false impression that the government would make good any losses suffered by Fannie and Freddie. An alternate plan, Abernathy offered, might have the new regulator separate from both HUD and Treasury, not unlike the Federal Reserve and the Federal Trade Commission. Abernathy said the administration would be open to reviewing any proposals that would provide the new regulator more flexibility to adjust the GSEs’ minimum capital requirements and the ability to revoke Fannie and Freddie’s \$2.25 billion line of credit with Treasury.
- Abernathy said Treasury must have “some role over policy,” to include responsibility over supervision of regulatory development, a role in developing the regulator’s budget and priorities, and control over testimony delivered to Congress. He expounded that Treasury would not expect a central role in day-to-day operations of the regulator or a role in its supervisory and examination functions. The Assistant Treasury Secretary stated, “We know we’re only at the beginning of this process,” but added that the administration still holds “strongly” to the policy outline it recommended as a “floor” for negotiations. The draft bill does include the administration’s proposal to end the presidential-appointee process for the GSEs’ board of directors, which Secretary Snow said would ensure greater independence from political interference.
- Committee Democrats Barney Frank (D-MA) and Paul Kanjorski (R-PA) said they would oppose any attempt to make the regulator less independent from Treasury or to move business oversight out of HUD. Kanjorski said, “At some point it’s better we don’t mess with this than do a bad job.” Frank said he opposes giving Treasury the right of approval of business activities, fearing Treasury would sacrifice activities that are good for consumers in the interest of lowering the companies’ market risks. Congressman Paul Gillmor (R-OH) declared, “What the administration wanted is not something that the votes are there for. It’s kind of put the chairman and the committee in an almost impossible situation.”
- Banking consultant Bert Ely said the derailed markup was tantamount to the administration throwing down “the gauntlet to Fannie and Freddie. It is not just a shot against the bow, it is a missile across the bow. It is intended to get Fannie and Freddie to back off.” He added that “Fannie and Freddie need a [regulatory reform] bill this year... They’ve been told by Wall Street to get the issue off the table. Ely described Treasury’s last-minute opposition to the legislation as an example of “Treasury pushing back,” calling it “a big poker game, a game of bluff.” (Kathleen Day, *The Washington Post*, 10/8/03; Dawn Kopecki, *Dow Jones Newswires*, 10/7/03; David Weidner, *CBS MarketWatch*, 10/7/03; *Associated Press*, 10/8/03; Claudia Hirsch, *Market News International*, 10/7/03; Richard Cowden and Kip Betz, *The Bureau of National Affairs, Regulation & Law*, 10/7/03; Siobhan Hughes, *CQ Today*,

10/7/03; Karen L. Werner, *Bureau of National Affairs, Regulation & Law*, 10/06/03; and Claudia Hirsch, *Market News International*, 10/2/03)

Rep. Baker faults Fannie and Freddie for markup derailment

Markup fallout; odds running against enacting GSE reform this year

- In the wake of criticism from the Treasury Department which derailed the October 8th mark-up of the GSE regulatory reform bill, Subcommittee chair Congressman Baker (R-LA) faulted Fannie Mae and Freddie Mac:

I'm dismayed by the postponement, but let's be clear that the blame falls squarely on Fannie Mae and Freddie Mac. From the moment the administration presented the committee its proposal, Fannie and Freddie lobbyists have swarmed the Hill and flooded member offices with document after document designed to gut all meaningful reform out of legislative consideration. Apparently the lessons of Freddie's ongoing troubles haven't sunk in, and Fannie and Freddie have relapsed into their tired old methods of obstructionism. The only difference this time is their mendacity, giving public lip service to supporting the administration while working furiously behind the scenes to attack real reform. It's time we stop the charade and finally let Fannie and Freddie know that Congress created them, and Congress – not Fannie and Freddie, will decide what constitutes their sufficient regulatory oversight and their adequate fulfillment of their housing mission.

In 1992, we created OFHEO and had to live with that weak regulator for a long time. We can't get it wrong again. However, if next week the committee is unable to mark-up and pass a strong reform bill, I will recommend to the chairman that we hold off until the time is right to get it right. And in the meantime, we should devote ample time to numerous relevant inquiries of Fannie and Freddie business practices ongoing at OFHEO, the SEC, the GAO and the Justice Department. Also, with a combined \$1.5 trillion in taxpayer-backed debt and a combined \$11 billion yearly government-granted subsidy between the two companies, surely we should get straightforward answers to many questions.

- Baker then asks what compensation Fannie and Freddie executives really make, and how it compares with other corporations; why one of the most profitable companies in the world can't make a tax contribution to the District of Columbia with "one of the worst homelessness problems in the country," and why other Fortune 500 companies comply with SEC rules but these two companies, with taxpayers standing behind them, do not. (*Press Release from U.S. Rep. Richard H. Baker*, 10/7/03)

Markup fallout; odds running against enacting GSE reform this year

- Rep. Richard Baker's (R-LA) first draft GSE reform bill created a Treasury-based regulator for the housing GSEs. When Treasury Secretary Snow and HUD Secretary

Martinez presented the Administration's proposals in September before Congress, they demanded more, including authority for approving any new products offered by the GSEs to be placed in the hands of the new Treasury regulator. Fannie and Freddie regard a tough new Treasury regulator as threatening the companies' new products and stemming their growth.

- More recently, House Financial Services chairman Michael Oxley (R-OH) floated a bill closer to what Rep. Baker sought and what the politically powerful housing GSEs said they could accept, but which failed to include two central demands by the Bush Administration, yet still managed to anger Freddie and Fannie officials. Specifically, Treasury wants more control over the GSE regulator in its Department than it has over the Office of the Comptroller of the Currency or the Office of Thrift Supervision. Treasury wants prior approval of the agency's regulations, congressional testimony and budget. Treasury officials also want prior approval of new activities, but have been less vocal on this subject after industry groups, Fannie and Freddie said they oppose moving that authority from HUD.
- A GSE source said the Oxley bill's strengthened product approval at HUD is micromanagement: "This could have come out of the Kremlin...It is so overly prescriptive." Committee Democrats already opposed the Oxley bill and had warned they would try to amend it during the markup. Fannie, Freddie and others in the housing markets also privately complained to lawmakers that several provisions would interfere with the housing sector.
- In the midst of the House pre-markup turmoil, Senator Shelby broke with his House counterparts, announcing he would include regulation of the Federal Home Loan banks, along with Fannie and Freddie, in his bill.
- The Administration's criticism of the bill was the most serious blow for lawmakers' hopes that reform legislation could be completed this year. A senior administration official, however, left open the possibility of supporting alternatives. Chairman Oxley was forced to choose between bipartisan votes and the Administration in calling off the markup. His decision to cancel the markup is thus seen as strengthening the Bush Administration's chances of getting a bill containing provisions advocated by the Treasury Department. An eventual Committee markup, plus any news from pending GSE investigations, would strengthen the Administration's hand and create a tougher tone among House Financial Services Committee members on Fannie and Freddie. (Patrick Barta and John D. McKinnon, *The Wall Street Journal*, 10/8/03; Karen L. Werner and Richard Cowden, *Bureau of National Affairs, Regulation & Law*, 10/9/03; Rob Blackwell, *The American Banker*, 10/6/03; and Rob Blackwell and Jody Shenn, *The American Banker*, 10/8/03)

Fannie's Raines and Freddie Mac officials upbeat on prospects for finalizing legislation
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Fannie CEO Franklin Raines said he doesn't see any issues that can't be resolved on legislation aimed at toughening oversight of the housing GSEs. He praised

Representative Michael Oxley (R-OH), chairman of House Financial Services Committee, for making “enormous progress in creating a bipartisan bill that can gain tremendous support.” Raines said he didn’t see any issues that weren’t “bridgeable” that would stop the bill, if the focus was kept on it over the next few weeks. Officials at Freddie Mac too think chances of legislation this year remain better than 50-50. David Palombi, a spokesman for Freddie, said, “There’s a lot more common ground than divisions and we’re committed to moving it forward.” (Connell McShane, *Bloomberg News*, 10/9/03; and John D. McKinnon and Patrick Barta, *The Wall Street Journal*, 10/10/03)

Senate Banking Committee chair calls for GSE regulation under one roof

GSE hearing scheduled for October 16th

- Richard Shelby (R-AL), Chairman of the Senate Banking Committee, would give a new regulator for Fannie and Freddie the duty of overseeing the regional Federal Home Loan Banks as well, according to a spokesman. Senator Shelby believes the time is right to bring regulation of government-sponsored mortgage finance enterprises under one roof. His aide said, “A majority of the (home loan) banks would be open to changes under certain conditions. We now have the opportunity to address the FHLBank regulator within the context of this overall overhaul.” Senator Shelby’s spokesman said the Senator has been considering for some time including the Home Loan banks in his bill, citing the system’s \$710 billion of debt as well as recent troubles at two FHLBanks, New York and Pittsburgh. Senator Paul Sarbanes (D-MD), ranking Democrat on the Banking panel, supports the inclusion of the FHLBanks in the bill as well. (Mark Felsenthal, *Reuters*, 10/3/03 and Rob Blackwell, *American Banker*, 10/3/03)

#### GSE hearing scheduled for October 16th

- Senator Shelby, Chairman of the Senate Banking Committee, hopes to pass legislation this year to remake the federal regulator of Fannie Mae and Freddie Mac, planning a hearing for Thursday, October 16<sup>th</sup> at 10:00 a.m. Shelby has invited Treasury Secretary John Snow, Housing Secretary Mel Martinez, as well as senior representatives from Fannie Mae and Freddie Mac, to testify. Committee spokesman Andrew Gray said, “We’ve committed to a bipartisan, bicameral process...In order to complete anything this year, we need to move forward as quickly as we can.”
- Shelby, before the House Financial Services Committee scotched its scheduled markup of the GSE reform bill, had said about Treasury Secretary Snow and House Financial Services Chairman Michael Oxley, “I think we’re on the same page in the book.” Shelby volunteered that his basis for a bill is the one already introduced by Senators Elizabeth Dole (R-NC), John Sununu (R-NH) and Chuck Hagel (R-NE). Senator Shelby stated that he and Representative Oxley decided at a breakfast meeting with Secretary Snow in mid-September to try to finish legislation revamping OFHEO this year.

- Addressing Georgetown University’s McDonough School of Business, the Banking Committee chair stated, “I’m sure we will move a Senate bill... Will it be similar (to the House bill), yes. Will it be the same, probably not.” Shelby indicated a hearing would help flesh out the issue of adding the Federal Home Loan Bank System into the new regulatory regime. With lawmakers expected to be in session throughout November, it would be difficult, but not inconceivable, to complete legislation before adjournment. (Dawn Kopecki, *Dow Jones Newswires*, 10/8/03 and 9/26/03)

Adoption of Royce FHLBank amendment seen more likely with Senate bill adding FHLBs
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- Advocates for including the FHLBanks in a GSE regulatory restructuring bill were confident they had the votes to pass their amendment if the House Financial Services Committee had marked up the bill as scheduled October 8<sup>th</sup>. Congressman Ed Royce (R-CA), along with Representatives Jim Leach (R-IA), and Carolyn Maloney (D-NY) were ready to offer the FHLBank amendment until the abrupt cancellation of the markup the evening before.
- Royce’s amendment would eliminate the Federal Housing Finance Board currently charged with FHLB regulation, creating instead a separate division of the proposed Office of Housing Finance Supervision (OHFS) within Treasury. Royce proposed two divisions within OFHS, each with its own deputy director, with one overseeing Fannie and Freddie’s financial safety and soundness and the other supervising the FHLB’s mission adherence as well as financial safety. Royce’s draft would make the FHLB division within OHFS independent of Treasury, and funded through assessments on the 12 regional federal home loan banks, with the FHLB system issuing the banks’ debt.
- Mariel Donath, president and chief executive of the Community Bankers Association of New York State, said, “The momentum was there...I do think we would have won the vote.” Others were optimistic the committee would concur with a single regulator of the FHLBanks, Fannie Mae and Freddie Mac. Support for the Royce amendment picked up once Senate Banking Committee leaders announced they would include the FHLBanks in their bill, said Donath, and Treasury officials seem more open to including the FHLBanks as well. (*National Mortgage News*, 10/9/03 and Claudia Hirsch, *Market News International*, 10/7/03)

Fannie Mae maneuvers to restrict, create tax liability for FHLBs, threatens MI industry
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- Prior to the scheduled House Financial Services Committee markup of the GSE reform bill, Fannie Mae lobbyists circulated a proposal that would impose broad new restrictions and tax liability on the 12 FHLBanks if they were brought under the same regulatory regime at Treasury as planned for Fannie and Freddie. Copies of the 3-

page Fannie legislative amendments were provided by an industry source, but verified by two lawmakers who said the memo came from Fannie Mae. A Fannie spokesman would neither confirm nor deny the memo, titled, "Proposed Elements of Possible FHLBank Legislation, and subheaded, "Confidential and Subject to Attorney-Client Privilege."

- The proposals would hamper the Federal Home Loan Bank System's ability to operate in the secondary mortgage market by capping loan purchases, barring FHLBanks from purchasing or investing in mortgages that are above Fannie's and Freddie's loan limit (currently \$322,700), and subjecting the banks to federal income taxation. (The FHLBanks currently are exempt from state and local taxes on interest earned on FHLBank debt.)
- The Fannie document reads, "Fannie Mae and Freddie Mac should not be subject to federal income taxation while another set of housing" entities, the FHLBanks, are exempt. Fannie's memo recommends giving the FHLBanks a tax credit to offset certain annual payments made to the federal government. The proposal being pushed by Fannie lobbyists would also prohibit FHLBanks from purchasing mortgages through institutions that are not members of the system. If Treasury did become the regulator of all 3 GSEs, Fannie did not want the department to create "separate examination/supervision bureaucracies for Fannie Mae/Freddie Mac and the FHLBanks within the new regulator."
- The proposal seeks to increase disclosure requirements for the FHLBanks and their regulator as well as to give HUD, which sets annual affordable housing goals for Fannie and Freddie, the same kind of authority over the FHLBanks, which are currently regulated by the Federal Housing Finance Board.
- The Fannie proposal also seems to weaken Fannie and Freddie's credit enhancement requirements for loans with loan-to-value ratios above 80% that are viewed as more of a credit risk, allowing them to use spread accounts as credit enhancements. Mortgage insurance companies were at risk of losing a ton of business if Fannie's amendment became law. One former mortgage insurance official told *Mortgage Wire* that this "takes the MIs out," adding it would not eliminate Fannie's and Freddie's need to use MI, but would severely damage the MI industry. At least four of the nation's seven MI firms are publicly traded, but their stocks barely budged at the publicized reports of Fannie's 3-page memo on possible amendments.
- Treasury and Fannie Mae were said to be involved in a form of brinksmanship in regard to the legislation, with Fannie's "aim to exclude the FHLBanks from the regulator proposed for the housing GSEs at Treasury... Bert Ely, an Alexandria-VA based banking consultant, explained that Fannie's proposal on new provisions for the FHLBanks shows "they want [the bill] on their terms." (Dawn Kopecki, *Dow Jones Newswires*, 10/7/03, Richard Cowden and Kip Betz, *The Bureau of National Affairs, Regulation & Law*, 10/7/03; and *National Mortgage News*, 10/8/03 and 10/7/03)

Treasury official says implied government backing is “misperception”

- Treasury’s Assistant Secretary for financial institutions, Wayne Abernathy, said the Treasury Secretary must have tight and meaningful control over the new GSE regulator if a proposed new regulator is placed under the Department. To do otherwise, he noted, would reinforce what he already believes is a widespread “misperception” about the perceived government backing of the debt issued by such enterprises, which include housing giants Freddie and Fannie. “If Treasury sponsorship is also called for, let the Treasury do its job,” and use its expertise to manage the new regulator in a way that would be meaningful, Abernathy said in comments before the Institute for International Bankers in New York.
- Abernathy said, “I don’t know that we have a preference” for whether the regulator is inside or outside of Treasury, but he repeated, the Treasury Secretary must have meaningful control of its activities: “We can’t stand for a crippled regulator.” He warned that “there is a great hazard” that by putting the regulator in Treasury, without the Secretary’s having stringent control over the regulator, the misperception about government backing of agency debt would be reinforced. He added, “We should not be in the business of giving investors false confidence.” (Michael S. Derby, *Dow Jones Capital Markets Report*, 10/7/03 and *Reuters*, 10/7/03)
- Abernathy sees an increased chance that the Federal Home Loan Banks could come under supervision of any new regulator created for Fannie and Freddie. “The atmosphere for including the home loan banks is even more favorable since (Treasury) Secretary (John) Snow testified,” Abernathy remarked at a Bank Insurance and Security Association seminar in Washington. Snow said in congressional testimony in September that he supported stronger oversight for the dozen regional FHLBanks now overseen by the Federal Housing Finance Board. (*Reuters*, 10/8/03)

## ***Fannie Mae and Freddie Mac***

Former Fed Chair Volcker admonishes Fannie, Freddie for stock options for execs

- Paul Volcker, past chairman of the Federal Reserve, criticized the issuance of stock options to senior executives by Fannie Mae and Freddie Mac, saying “It’s inappropriate for GSEs to have stock options... Come to think of it, I think that may be ‘Example A1 of why it’s not good.’” Former U.S. Comptroller General Charles Bowsher, who also served as head of the General Accounting Office, agreed with Volcker: “It’s inappropriate.” Earlier in the day, both men had testified before the Senate Banking Committee on a range of corporate governance and accounting issues, including the issue of stock options. Volcker told the committee that there is a role for stock options – a role best suited to start-up companies hard-pressed to pay top executives in cash. He criticized the use of stock options in large, mature companies as executive compensation. Fannie Mae’s proxy statement to shareholders in April 2003 said that in 2002, Chairman and CEO Franklin Raines got a cash salary of \$992,500, a bonus of \$3.3 million and options to buy 311,731 Fannie Mae shares. Fannie valued those options at \$6.7 million based on an exercise price of \$69.43 each and certain assumptions about their performance over the 10-year life of the options. A Fannie spokeswoman said the company started expensing its stock options this year. (Kevin Drawbaugh, *Reuters*, 10/2/03)

Shadow Financial Regulatory Committee says GSE legislation misses opportunity for real reform

- The American Enterprise Institute’s independent Shadow Financial Regulatory Committee describes the bills before Congress, H.R. 2575 and S. 1508 as “useful first steps,” but argues that Congress “must go further to address the fundamental issues with respect to Fannie Mae and Freddie Mac.” The committee, composed of prominent academics principally from Ivy League schools, claims that the Treasury testimony, “while containing useful and constructive ideas, did not address the tough questions. Indeed, the danger is that Congress and the Administration may miss the opportunity for real reform.”

- The AEI adjunct group warns:

The central question raised by the quasi-public status of Fannie and Freddie is whether the taxpayers and the economy itself can be adequately protected, by regulation alone, against the risks these two government-sponsored enterprises (GSEs) create. Not only have Fannie and Freddie now issued over \$1.5 trillion in debt obligations – for which the US government is perceived by many to be the implicit backer – but the very fact that there are only two GSEs, and that they completely dominate the residential real estate finance, adds other dimensions of risk. A major mistake by the management of either company could seriously impair the housing finance process and, through the housing market, adversely

affect the economy as a whole. Moreover, if either should suffer substantial losses, the taxpayers could be called upon to make good on their debt obligations.

- The Committee notes that Fannie and Freddie are receiving much attention because of a “major error of judgement” by Freddie’s management, an error without systemic consequences, but the Committee points out, “there is no reason to assume that future errors will be so inconsequential.” Congress and the Administration are proposing marginally better regulation of Fannie and Freddie, but it is “not the right answer over the long run.” Fannie and Freddie’s political power, it augurs, “will make the new agency’s effective use of its statutory authority highly questionable.”
- Under the various bills and in Treasury’s proposal, the new regulator will have authority to increase the minimum capital of Fannie and Freddie, but it is doubtful it will be able to exercise that authority if the result might be higher mortgage interest rates. In the past, the GSEs avoided reform by arguing that a status change could cause rising mortgage rates. “The lesson of the S&L debacle of the 1980s is clear: regulators will not act on matters that have serious political consequences until a crisis is upon them.” Fannie and Freddie are aware of this, and for that reason, are not opposing a new regulator. The recent increase in Fannie’s share price indicates investors recognize the threat of any real restraints on the GSEs has receded.
- Eliminating or reducing the GSEs risks could be accomplished without more regulation. The Committee recommends prohibiting or limiting their purchase of mortgage-backed securities (MBS) which entail substantial interest rate risk. Bills now before Congress only call for a study of whether Fannie and Freddie should be permitted to accumulate larger portfolios of mortgages or MBS, and Treasury went less far than the Clinton Treasury, which called for elimination of the so-called line of credit. Also recommended is severing the GSEs’ “indicia of their government support” – including the president’s authority to appoint five directors of each company, their so-called Treasury line of credit, their exemption from portions of the securities laws and from state and local taxes. These privileges and immunities are the source of investors’ views that the government will not let Freddie or Fannie fail, and account for their lower borrowing costs than competitors and the absence of significant market discipline.
- The Committee regards the end of the president’s board appointment authority as insufficient in itself, but as at least a constructive step in the right direction – which ultimately should be privatization of these companies:

Nevertheless, until privatization can be achieved, the Committee believes that it would be preferable to lodge the regulation of Fannie and Freddie in the Treasury Department, that the new agency should be responsive to direction from the Secretary, and that it should be authorized and directed to regulate and supervise Fannie and Freddie as though they were insured banks. This would include raising their capital requirements to levels currently deemed adequate for insured banks, and limiting their activities outside the secondary mortgage market.

*(Statement of the Shadow Financial Regulatory Committee on Legislation on Fannie Mae and Freddie Mac, Statement No. 196, 9/22/03)*

FM Policy Focus commends House banking members for leadership on GSEs, but says effort doesn't go far enough

National Taxpayers Unions recommends GSE privatization to Chairman Oxley

Americans for Tax Reform warns Speaker against HUD legislative provisions

National Housing Conference urges Fannie/Freddie financial regulation under Treasury

- FM Policy Focus, an industry-supported watchdog organization monitoring the housing GSEs, tells Chairman Oxley it continues to support establishment of a strong single GSE regulator in the Treasury Department along the lines of the Administration's proposal.
- "We agree with the Administration," the letter states, "that all authority over programs, products and activities should be housed at Treasury Department. HUD's responsibility is properly directed toward oversight of GSE affordable housing responsibilities, and the experience of the last eleven years has demonstrated that the GSEs ignore HUD when offering new programs, products and activities. There is no evidence the GSEs will be any more willing to accede to HUD in the future. Indeed, their aggressive lobbying to water down the Discussion Draft even further is a clear indication that they remain convinced HUD should play virtually no role in overseeing the GSEs' insatiable growth."
- FM Policy Focus faults both the October 2 Discussion Draft and the Treasury proposal for omitting regulator flexibility over minimum capital, insisting that full authority for the new regulator to impose bank-like capital – both minimum and risk-based – is essential for meaningful regulator reform and to assure adequate capitalization of Fannie and Freddie.
- FM Policy Focus wrote House Financial Services Committee members on September 29<sup>th</sup>, commending their "leadership in creating a new regulator for the housing GSEs, especially Fannie Mae and Freddie Mac," saying their "willingness to tackle this difficult issue and your commitment to do so in a responsible manner is of great significance to America's taxpayers and the nation's economy."
- The FM Policy Focus letter expressed concern about non-charter activities of Fannie and Freddie, noting they were "extraneous to the GSEs' missions and, in our opinion, focus on maximizing GSE stockholder profits at the expense of both the private sector and homebuyers seeking affordable housing." Poor GSE regulation, the letter

warns, will jeopardize both the secondary markets and affordable housing, which the new regulator must prevent from occurring.

- Restructuring of the housing GSEs, FM Policy Focus lays out, should include the following elements:
  - Regulatory authority regarding activities, programs and products, comparable to those available to bank regulators such as the OCC, including prior approval of all products and activities;
  - No “grandfathering” of existing GSE programs because many are beyond their charters, with few pre-screened by HUD and no opportunity for public review or comment.
- The watchdog group says it agrees with Franklin Raines that standards for program approval should be included in the statute, however, Congress should go beyond his suggestion that charter compliance and innovation be the standards, as that would be a lesser standard than applies now, for it omits public interest: “It would be absurd to have a government-sponsored entity offering programs or engaging in activities without any assessment as to whether the activity or program served the interest of America’s taxpaying citizens.”
- FM Policy Focus stated its support for HUD’s request for expanded powers to promote affordable housing goals, but suggests three more standards be applied to GSE goals:
  - 1) GSEs should have affordable housing income standards comparable to standards that apply to lenders under community reinvestment programs,
  - 2) The GSEs should be required to achieve their goals in each MSA, rather than meeting a national standard, and;
  - 3) Income standards in rural areas should be similarly structured and the GSEs must demonstrate that they have achieved rural goals based on local, rather than national, performance.
- Fannie and Freddie, the letter states, “have a return on equity which is double that of the rest of the industry. They have credit losses near zero, an impossibility if they are really devoting the bulk of their considerable resources to loans made to low-and-moderate income homebuyers... We urge you to look beyond the rhetoric of the GSEs and force them to focus less on returning double-digit profits to their stockholders and more on directing those profits into affordable housing finance as required by their charters.”
- The Committee should require, FM Policy Focus stipulates, that no programs be approved without HUD certification.

- Finally, the letter supports Treasury’s recommendation that the new regulator be empowered to review the risk-based capital and the minimum capital standards, and to make changes to those standards as appropriate. Failure to provide such authority would especially disadvantage affordable housing initiatives where products often bear higher risk that must be reflected in GSE capital requirements. Regarding Treasury’s request for oversight of the new regulator’s Congressional testimony and regulations, FM Policy Focus asks to “consider the importance of maintaining a close relationship between the new regulator and Treasury to allow the regulator to fulfill its responsibilities to protect taxpayers and benefit homebuyers.” (*FM Policy Focus Letter from Mike House, Executive Director, to Congressmen Michael Oxley (R-OH), Barney Frank (D-MA), Richard Baker (R-LA), Paul Kanjorski (D-PA), Bob Ney (D-OH) and Maxine Waters (R-CA), 9/29/03; FM Policy Focus Letter to Committee on Financial Services, Chairman Oxley, 10/6/03*)

National Taxpayers Unions recommends GSE privatization to Chairman Oxley

- The NTU (National Taxpayers Union), in an October 7<sup>th</sup> letter to House Financial Services Committee chair, Michael Oxley (R-OH) reminded the Chairman that NTU and its 350,000 members have supported complete privatization of federal GSEs for more than a decade. NTU Founder and Chairman Emeritus James Davidson testified before House Ways and Means Committee on this topic in September 1989 in what was then billed as the “first oversight hearing on GSEs in recent memory.”
- In June 2000, Vice President for Communications Pete Sepp, the NTU letter said, testified before Congress warning that “market discipline cannot prevail if Congress allows the institutions it creates to privatize profits but socialize risks.” Earlier this year, the letter added, NTU warned House members that “trillions of dollars in potential taxpayer liabilities add up to one big reason for better monitoring of GSEs like Fannie Mae and Freddie Mac...[C]orporate scandals and bankruptcies ought to convince policymakers of the need for more fiscal stewardship now.” Given the recent Freddie problems with its own balance sheet, “Congress can and should confront comprehensive GSE reform with all deliberate speed.”
- NTU recommends more thorough reform than transferring oversight to a new office in Treasury, specifically:
  - privatize the GSEs entirely, along the lines of the Student Loan Marketing Association;
  - Levy a GSE ‘user fee’ that would reflect the subsidy margin that Freddie and Fannie enjoy over private lenders (not just the costs of federal oversight);
  - Auction off competing GSE housing finance franchises in a manner similar to the successful FCC spectrum auctions;
  - Replace the lender-of-last resort practices of the GSEs with a targeted housing tax credit, thereby preventing much of their housing market price distortions.

- Another approach that should have been incorporated into the current bill, NTU argues, is the language from H.R. 2022, the “Leave No Securities Behind Act,” which would have helped bring accountability to Fannie and Freddie by subjecting them to the same registration and reporting requirements under federal securities laws that burden other firms. NTU writes that it supports an amendment to provide the new Treasury regulator with authority to establish minimum capital standards for the GSEs and opposes striking bill language to weaken the new regulator’s power to establish financial management guidelines for Fannie and Freddie. The taxpayers advocacy group urges Members of the House and Senate to “resist calls from various special interests to halt even this modest and imperfect step toward reform,” and called for “much bolder steps” in the future. (*Letter from NTU President John Berthoud to Chairman Michael Oxley, 10/7/03*)

#### Americans for Tax Reform warns Speaker against HUD legislative provisions

- In an October 1<sup>st</sup> letter to House Speaker Dennis Hastert (R-IL), Americans for Tax Reform (ATR), urges opposition to legislative provisions being promulgated by HUD “which would have a disastrous effect on the mortgage finance system.” ATR describes HUD’s legislative changes as “the worst example of big government social engineering to come out of HUD,” and predicts it “would create yet another bureaucratic structure at HUD devoted to allocating the Nation’s mortgage credit based on political considerations rather than on the business judgment of private enterprises.”
- The ATR letter supports the new, independent regulator to be created at Treasury to oversee the housing GSEs, “so that the American taxpayer’s exposure to a fiscal problem is minimized,” but argues that proposed HUD changes do nothing to further goals of safety and soundness and could, in fact, create the conditions for future fiscal problems. HUD’s new regulations empower the HUD Secretary to create various housing “subgoals” that would be required to meet annually, and require them to direct mortgage purchases specifically to meet these goals. GSEs would be forced thereby to allocate credit based on decisions made by government bureaucrats rather than on mortgage market needs.
- The proposed HUD changes allow the Secretary to establish specific numerical goals based on political considerations, which could favor certain communities over others: “Helping underserved areas, expanding opportunity, and removing barriers to homeownership faced by certain groups is one thing. But allowing HUD the authority to potentially establish a strict quota system for allocating mortgage credit is quite another.” (Americans for Tax Reform; 10/1/03)

#### National Housing Conference urges Fannie/Freddie financial regulation under Treasury

- The National Housing Conference (NHC) appealed to House Financial Services Chairman Michael Oxley (R-OH), recommending that the financial regulation of Fannie Mae and Freddie Mac be assigned to the Treasury Department. The NHC

announced it is suggesting that a separate affordable housing “mission” regulator for Fannie and Freddie be created within HUD.

- According to a study conducted by NHC’s research affiliate, the Center for Housing Policy, there has been nearly a 70% rise in the number of working families who spend more than half their income on paying the rent or mortgage. NHC President Conrad Egan said, “Under the watchful eye of a knowledgeable mission regulator within HUD, Fannie Mae and Freddie Mac could stretch their capability to do even more to meet our nation’s affordable housing needs.” He emphasized that Congress should “act responsibly to ensure the safety and soundness of these important agencies by assigning their financial regulation to the Treasury Department.” (*U.S. Newswire*, 10/7/03)

Mortgage analysts say new Fannie/Freddie regulator will reduce political headline risk
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- Fannie and Freddie’s securities have been susceptible to headline risk, meaning when a story appears and the news cause agency spreads to widen whenever an influential policymaker makes an “off-color” comment about either company. Freddie’s headline risk susceptibility has been especially acute over the past several months as it struggles to regain its footing from an accounting scandal and Congress weighs changes to the way the housing GSEs are regulated. Fannie and Freddie stock prices have dropped 5.9% and 11% respectively since Freddie announced its management shake-up in early June.
- Chris Buonafede, an equity analyst with Fox-Pitt Kelton, Inc. believes that strengthening Fannie and Freddie’s regulator would “...take that issue off the table... In the near-term, I think it means less political risk or more certainty.” Fannie and Freddie’s market sensitivity has spooked some lawmakers and regulators into silence because of a hard lesson learned three years ago after remarks by then-Treasury Undersecretary Gary Gensler, which proved to be costly for Freddie. A Federal Reserve official said no one wants to “pull a Gensler.” Gensler endorsed legislation by Representative Richard Baker (R-LA) to strip some of the GSEs’ federal benefits, including their never-used \$2.25 billion line of credit with the Treasury. Bond investors dumped agency debt on the news, widening the yield differential between 10-year Treasury notes and 10-year agency notes to 1.11 percentage points, well above the average spread that year of about .72 percentage points.
- Rep. Barney Frank (D-MA) accidentally moved markets last year when he took over the top Democrat slot on House Financial Services and seemed to endorse some of Gensler’s ideas. Frank said Fannie and Freddie were so well-managed they didn’t need a Treasury line of credit, and that the credit line was too small to head off a potential disaster. The remark sparked widening spreads and the stock sank within two hours of Frank’s comments before he issued a clarification. Former Treasury Secretary Paul O’Neill and former SEC chair Harvey Pitt similarly clarified their comments about Fannie and Freddie which unintentionally roiled the markets.

Mindful of this history, the normally outspoken former chair of Senate Banking, Phil Gramm (R-TX) would only tell reporters he was “praying” on the issue.

- Debt traders are sensitive to Fannie and Freddie securities since they have become two of the nation’s largest issuers of debt. At more than \$2 trillion, the GSEs’ outstanding mortgage-backed securities (MBS) are equal to two-thirds of the U.S. public debt, according to the Congressional Budget Office in a May 2003 report. The Administration has been exceedingly careful in crafting its proposals to strengthen GSE oversight, postponing public comment until recently and steering clear of more market-sensitive ideas that were key to Gensler’s and Baker’s original plans in 2000, say lobbyists and Congressional staffers. Rep. Baker said the resulting bill would eliminate “the political risk to the enterprises of threatening changes to their charter.” Fannie executives, who have long fought Baker throughout the years, are now lobbying Congress to pass legislation that will likely bear his name as quickly as possible.” (Dawn Kopecki, *Dow Jones Newswires*, 10/6/03)

OFHEO says Fannie/ Freddie adequately capitalized
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- OFHEO said in a statement that Fannie and Freddie held enough capital as of June 30th to exceed both their risk-based and minimum capital requirements, as required by statute. The regulator measures the GSEs in two ways: 1) the minimum capital standard, is a straight percentage of assets; 2) the risk-based test, determining how much capital and risk-hedging the companies need to withstand a prolonged collapse of U.S. housing markets or extreme interest rate gyrations.
- Fannie exceeded its risk-based capital requirement of \$18.11 billion by \$13.36 billion and its minimal capital requirement of \$29.15 billion by \$1.5 billion, according to OFHEO.
- Freddie exceeded its risk-based capital requirement of \$14.72 billion by \$24.62 billion and its minimal capital requirement of \$22.69 billion by \$6.27 billion. OFHEO said Freddie Mac’s earnings restatement could impact its minimum capital and risk-based capital surpluses, saying it would decide whether to re-run capital adequacy tests for Freddie after the company issues its restated earnings. (*Reuters*, 9/30/03 and OFHEO Press Release, 9/30/03))

OFHEO promotes counsel Stephen Blumenthal to Acting deputy Director
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- Armando Falcon, Jr., Director of OFHEO, named Stephen A. Blumenthal as Acting Deputy Director of OFHEO. Blumenthal has been serving as Counsel to the Director and head of the Special Examination Unit currently investigating accounting and management practices at Freddie Mac. Blumenthal came to OFHEO from Schwab Washington Research Group where he served as an analyst in banking and financial services. Blumenthal’s other prior work experience includes serving as Counsel to the Energy and Commerce Committee (now the Commerce Committee) in the House

of Representatives, as Vice President and Director of Regulatory Relations for the Securities Industry Association, and as an attorney in the Office of the General Counsel of the National Association of Securities Dealers. He is a graduate of Johns Hopkins University and Rutgers Law School. (*OFHEO News Release*, 9/30/03)

#### Fannie, Freddie expected to hike loan limits

- Fannie and Freddie are expected to raise limits on home loans they help finance, a move that could lower mortgage costs for homebuyers. While any changes to the loan limits would not take effect until January, such increases are usually announced in November, lenders anticipating the hike are already offering larger loans to borrowers. Fannie and Freddie periodically raise the limit on loans they can buy and guarantee, enabling more borrowers access to lower loan rates that typically result in mortgages that the GSEs can purchase.
- Lenders told *Reuters* that members of the home loan industry have raised limits for conventional 30-year mortgage loans to as high as \$339,000 from \$322,700. Last year, the loan limit was raised 7.3% to \$322,700 from \$300,700. Frank Nothaft, Freddie's chief economist, who expects 2003 home sales to hit a pace of 6.76 million from last year's 6.54 million, said "The (expected) increase in the loan limit gives families the opportunity to refinance into a lower conforming rate. That is important to strengthen family finances...(and) important at this juncture where the economy is uncertain." (Aleksandrs Rozens, *Reuters*, 10/2/03)

## Fannie Mae

OFHEO searching for accounting firm to conduct special review of Fannie Mae

Fannie may have understated what it paid its chairman, CEO and top execs

- OFHEO's Procurement Office issued a Request for Proposals (RFP) seeking an accounting firm with demonstrated abilities to work with complex derivatives instruments, valuation and hedging activities, and securitizations transactions "to assist in conducting a special examination" of Fannie. The purpose of the review is "to identify weaknesses in accounting policies and internal controls with an emphasis on critical accounting policies and practices, unusual transactions and sensitive accounting estimates." The OFHEO bulletin states that specific attention should be given to:

Policies and transactions that relate to the timing of income recognition; policies and transactions that relate to derivative financial instruments and securitizations;

transactions that do not appear to have a valid business or risk management purpose; transactions that have been executed without appropriate authorization; process management uses to formulate sensitive accounting estimates; and estimates, judgments and uncertainties and how they are determined and subsequently monitored.

- Armando Falcon, Jr., OFHEO Director, announced the review in his July 17<sup>th</sup> testimony before the Senate Banking Committee: “The special review would independently evaluate the accounting policies at Fannie and examine whether their implementation is resulting in a high level of conformance to GAAP.”
- The OFHEO solicitation states that the agency does not know the actual level of effort that will be required, as Phase I, the initial review of accounting policies and internal controls would be followed by Phase II, the comprehensive study of questionable policies and transactions discovered in Phase I. (*OFHEO News Release*, 10/9/03; *FedBizOpps*, 10/8/03)

Fannie may have understated what it paid its chairman, CEO and top execs

- Key disclosures for 2000-2001 at Fannie Mae obscured the actual level of compensation received in those years by Raines and other top executives. Raines stands to receive millions of dollars worth of options early next year from a compensation arrangement that is based on a measure of earnings that is subjectively determined by Fannie and not prescribed by U.S. accounting rules.
- The complete pay amounts for 2000 and 2001 were eventually disclosed in a proxy statement filed with the Securities and Exchange Commission for 2002. Before 2002, Fannie chose not to file SEC-registered financial statements, despite having publicly traded stock. This exemption, due to Fannie’s GSE status, appears to have allowed the company to provide compensation disclosure that would have been considered incomplete under SEC guidelines.
- The 2002 SEC-registered disclosures suggest CEO Raines is making over \$6 million more than the pre-2002 compensation tables suggest. The new SEC-registered disclosure, however, does not show how much Raines stands to make under options linked to Fannie’s in-house earnings measure. Fannie spokeswoman Janis Smith refused to comment on the completeness of past compensation disclosures, claiming “Fannie’s disclosures are best-in-class” and characterizing the questions about Raines’ compensation as “a personal campaign against our chairman – and I am not going to facilitate that.” Former Fed Chairman Paul Volcker recently commented on the issue of executive compensation at GSEs, telling Reuters “It’s inappropriate for GSEs to have stock options.”
- Before its 2002 SEC-registered proxy filing, Fannie did not provide a full and accurate reading on what Raines and other top officials earned. The company’s tables left out important data. For example, in its 2001 proxy statement, Fannie said Raines made \$2.78 million in LTIP, or long-term incentive plan, payments in the year. That

sum is incomplete because it excludes the dollar value for the shares deferred under the plan. A footnote explains that Raines deferred 49,699 shares in the plan in 2001. But investors had no way of knowing how much those shares were worth because the date they were awarded is unknown. SEC-registered proxies must include any deferred compensation in the dollar totals listed in the compensation tables.

- Fannie chose a less complete form of disclosure than required under SEC guidelines, perhaps to give the impression Raines was earning less than he was. Fannie chose to start filing SEC-registered financial statements in the first quarter of this year, perhaps recognizing that its government-granted exemption did not look good in the post-Enron environment.
- Incomplete disclosure on LTIP payouts combined with the earnings-linked options plan suggests the culture at Fannie is unfairly tilted towards enrichment of senior executives. The earnings-linked options were not included in a table that estimated the value of options granted in 2000, and their estimated value has not been included in a Fannie statement since then, including the SEC-registered 2002 proxy. But they could be lucrative for Raines since he has the purchase right over 213,000 Fannie shares at a strike price of \$62.50. Because they are earnings-linked, the options are much harder for an outside investor to value using standard models. (Peter Eavis, *thestreet.com*)

Fannie Mae lobbying against key tenets of Administration proposal
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- Fannie lobbyists were making calls on House lawmakers, asking for signatures on a letter originating from Representative Carolyn Maloney's (D-NY) office, arguing against the provision which would give the company's new regulator authority to approve new products and activities. A copy of the letter reads, "The housing industry and housing advocates are united in their insistences that the GSE program approval remain at the Department of Housing and Urban Development (HUD)...Furthermore, we must ensure that this program approval standard not stifle innovation or slow the growth of affordable housing."
- In an internal memo circulated to Capitol Hill earlier in the week, Fannie said aspects of the Treasury proposal "would mean literally hundreds of prior approval notices required from Fannie Mae and Freddie Mac to Treasury every year – decreasing flexibility and innovation currently contemplated." Fannie's memo said that the Treasury proposal grants both HUD and Treasury general oversight responsibilities, saying that would be "unnecessary and confusing." Fannie Mae spokeswoman Janice Daue said the document is not a "final formal position by the company," but rather, "a discussion document," adding, "We clearly continue to support the Treasury's proposal to move our safety and soundness regulator over" to Treasury.
- The memo provides a candid look at Fannie's initial opinion of Treasury's proposed legislation: "In effect, the language changes the mission, status and charters of Fannie Mae and Freddie Mac and strips all authority from Congress in favor of the

two regulators established in HUD and Treasury.” The memo also criticizes the Treasury’s proposal on funding for the new agency as well as for beefed-up supervision of Fannie and Freddie’s housing goals within HUD: “The funding provision for the Treasury regulator does not contain any protection against regulatory excess spending and there is no direction to the regulator to focus operations on safety and soundness...In fact the language appears to encourage the regulator to collect more than it needs for its operations.” (Dawn Kopecki, *Dow Jones Newswires*, 10/2/03)

Raines reverses course, says HUD should keep new product approval

- Fannie chair and CEO Franklin Raines had said in testimony on Capitol Hill September 25<sup>th</sup> that it was up to Congress to decide whether to give the new GSE regulator product-approval authority. Raines had said he didn’t care which agency has authority over product approval, as long as the legislative language encourages innovation. In a statement e-mailed to *American Banker*, Chuck Greener, Fannie’s senior vice president of communications, reverses Raines’ position:

After discussions with others in the housing industry...and policymakers in Congress, it is clear that a consensus is forming that the powers to regulate Fannie Mae’s housing mission including program approval should remain at HUD in the interest of housing and housing finance. To help keep the legislative process moving forward, Fannie Mae too joins in this consensus, and believes all the powers to regulate our housing mission should remain at HUD.

- Greener said Fannie could not support any “change to Fannie Mae’s charter, mission or status.”
- Raines subsequently said HUD should have a “bias” towards approving all new products at Fannie Mae unless they are “contrary” to its charter, adding that Congress should pass legislation setting a “standard” by which HUD exercises its authority over new products and programs. In an interview with *Mortgage Wire*, Raines expressed his pleasure with the draft proposal being finalized at House Financial Services Committee, noting that HUD historically has been “fairly restrictive” on new programs, citing the agency’s recent approval of an acquisition, development and construction loan product. HUD, he said, applied “a bunch of restrictions” on the ADC program that he believes “are not needed.”
- Treasury has made product approval central to its plan and Treasury Assistant Secretary Wayne Abernathy reiterated that new-program authority was critical before a Housing Financial Services hearing on October 1<sup>st</sup>. Fannie is having second thoughts about other aspects of the Administration’s proposal, as evidenced by a three-page internal analysis of Treasury’s proposal sent to House Financial Services leaders that called elements of the plan duplicative, burdensome and unprecedented.

The document objects to the Treasury regulator's enhanced enforcement authority because it could restrict liquidity and violate due process.

- The Treasury proposal would allow its agency to limit the growth, investments, and activities of Fannie and Freddie if they did not meet regulatory goals. Further, the three-page analysis complains there is no protection against excess spending by the new Treasury regulator, which is funded by fees from Fannie and Freddie, adding that HUD provisions likewise are damaging by requiring that the agency disclose confidential company information and by granting it authority "that extends well beyond the boundaries of current fair-lending and fair-housing laws." (*National Mortgage News*, 10/4/03 and 10/2/03; Rob Blackwell, *American Banker*, 10/02/03)

#### Fannie origination costs rise sharply

- A survey of 101 lenders of all types, sizes, and locations found origination costs for correspondents soaring in the past year, rising 28%, from \$1601 per loan to \$2,144. Wholesalers, meanwhile, saw their origination costs rise \$14, from \$785 per loan to \$916, while online lenders reported a slight drop in costs, from \$1,846 to \$1,831. Fannie Mae cautioned that the annual study of origination costs should be viewed as a representative sample rather than as an industry average or statistical study, but added that the results provide useful insights into lending costs.
- The survey found, not surprisingly, that automated underwriting is now the norm. It also said that the closer automation is to the point of sale, the larger the cost savings and the bigger the bump in productivity. (*National Mortgage News*, 9/30/03)

#### Fannie 3<sup>rd</sup> quarter earnings to be announced October 16<sup>th</sup>

- Fannie Mae will report third quarter earnings on Thursday, October 16<sup>th</sup>. Tim Howard, chief financial officer, and Jayne Shontell, senior vice president of investor relations, will host a conference call at 4:00 p.m. EST. The conference call will be webcast and available for 30 days after the call. Tim Howard will discuss briefly the quarter's results and will be joined by other members of Fannie's senior management for questions and answers. (*Pressi.com*, 10/8/03)

#### Fannie Mae Foundation showers funds on favored Capitol Hill charities

#### Bush White House honors Franklin Raines for corporate leadership

- Almost a year after the soft money ban was enacted by Congress, Fannie CEO Franklin Raines pledged \$1 million to Representative Ciro Rodriguez (D-TX), chairman of the Congressional Hispanic Caucus and its charitable arm, the CHC Institute. The money is not for Rodriguez or any Hispanic Caucus members, instead

it helped the Hispanic Caucus launch a two-year campaign designed to put more Hispanics in homes. Two years ago, Fannie funded a similar housing venture with the Congressional Black Caucus with another \$1 million contribution. Critics see another value in the donations besides boosting minority homeownership: “By contributing millions of dollars to the favorite charitable causes of key political constituencies, the mortgage-financing giant has helped to cement its political backing on Capitol Hill as it works to head off new federal oversight of its business.”

- The Foundation has steered more than \$27 million to a “vocal team of nonprofit housing advocates that have loyally supported Fannie Mae in letters to lawmakers and testimony before Congress,” such as the National Council of La Raza, the National Urban League, the Maryland-based Enterprise Foundation, and the Consumer Federation of America. Two key minority groups have received particular attention; the Congressional Black Caucus has received \$573,600 since 1992, including a \$98,600 check last year to fund a homeownership program it sponsored with historically black colleges. Meanwhile, the foundation gave \$225,800 to the Congressional Hispanic Institute, including \$30,000 last year to sponsor its 25<sup>th</sup> annual gala.
- Fannie responds that the goal of the foundation is to promote affordable housing and the Foundation’s spokeswoman, Beverly Barnes, says “We don’t take into consideration anything that they are doing on Capitol Hill when we decide our grants.” The foundation has handed out more than \$30 million to nearly 700 organizations yearly, Barnes notes, so it is inevitable that some grants would end up in supporters’ hands. Fannie Mae Foundation, she elaborates, is a completely separate organization, with its own officers and independent from its parent. However, the foundation receives all of its funding from Fannie Mae and Raines doubles as chairman of the foundation, with ten other Fannie executive sitting on the foundation’s 19-member board.
- The foundation’s annual report shows that more than half of the \$81 million it spent last year went to fund an extensive advertising campaign, rather than housing grants. Foundation supporters say the \$49 million television, radio and newspaper ads play a key role in educating consumers about the home-buying process. Opponents say the campaign is carefully targeted to boost Fannie’s image on Capitol Hill.
- Though the foundation doles out hundreds of grants annually, not all affordable housing advocates accept the cash. Bruce Marks of the Neighborhood Association said Fannie’s money is intended to silence its critics in the housing community. Marks said, “I have never seen a foundation out there or even a corporation that is as aggressive as Fannie Mae in giving out hush money... They do what no other foundation that I have seen has done. They say, ‘The condition of us giving you money is that you don’t criticize us and you support Fannie Mae in everything that Fannie Mae wants.’” (Brody Mullins, *Roll Call*, 10/6/03)

### Bush White House honors Franklin Raines for corporate leadership

- The Bush Administration, perhaps deciding that Fannie Mae needed a “little bucking up,” honored Fannie for its corporate leadership, bestowing the award upon Chairman and CEO Franklin Raines at a White House ceremony September 30<sup>th</sup>. The award is named for former Commerce Secretary Ron Brown, killed in 1996 in a plane crash in Croatia. The nine judges included Alma Arrington Brown, widow of the former Clinton official, and a senior vice president of Chevy Chase Bank. Fannie was recognized for its program helping employees buy homes. (Craig Linder and Michele Heller, *The American Banker*, 10/6/03)

Fannie announces mortgage relief for Isabel victims in VA, NC, MD and DC
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- Fannie Mae announced mortgage relief provisions in place for borrowers facing hardship in the wake of widespread damage and flooding caused by Hurricane Isabel. Fannie Mae’s disaster relief provisions give lenders the discretion to help borrowers in several ways, including suspending mortgage payments for up to three months, reducing payments for up to 18 months, or in more special cases, creating longer loan payback plans. Payment relief is available for single-family mortgages, including condos, serviced by Fannie lenders in storm-affected areas. All changes will be made on a case-by-case basis.
- U.S. Senator George Allen (R-VA), formerly Governor of Virginia, said ‘It is inspiring to see the persevering spirit of Virginia’s families as they clean up and get back to living...Homeowners in disaster areas should not have to worry about making mortgage payments if their home has been damaged by a hurricane. By getting our boots on the ground, we have been able to get a direct, human response to promptly assist distressed families.’
- Senator Elizabeth Dole (R-NC) said “Many North Carolina families are struggling to recover from the effects of Hurricane Isabel...Homeowners in disaster areas should not have to worry about making mortgage payments if their home has been damaged by a hurricane.”
- In the nation’s capital, Delegate Eleanor Holmes Norton (D-DC), echoed the NC and VA Senators: “Residents in the District are still struggling to recover from the effects of Hurricane Isabel. Homeowners who suffered serious financial damage should not have the additional worry of mortgage payments if their home has been damaged by the hurricane,” and praised Fannie for its “magnanimous offer” to DC homeowners. U.S. Representative Albert Wynn (D-MD) commended Fannie as well for working with lenders to alleviate the financial burdens on families with homes damaged by Isabel: “This mortgage relief assistance offers a common sense approach to the recovery process.” (*Fannie Mae News Releases* [combined], 10/7/03 and 10/6/03)

## Freddie Mac

### SEC probing possible fraud at Freddie Mac

- Securities and Exchange Commission William Donaldson told the Senate Banking Committee that the SEC was looking into possible evidence of fraud at Freddie. In response to lawmakers' questions, Donaldson said the SEC is not Freddie Mac's regulator but it is the commission's job to investigate fraud. Donaldson declined from disclosing any details about the investigation when pressed by Senator Chuck Hagel (R-NE). Donaldson said, "If there is evidence of fraud...we would have a role there," adding, "We're looking at that right now. We're in touch with them, and we're in touch with any evidences of fraud that might be, or might not be." The SEC Chairman noted that Freddie Mac agreed to register voluntarily with his agency and that the SEC is helping the company conform with SEC registration rules on securities.
- The SEC probe comes on the heels of probes by the Department of Justice and the OFHEO. The announcement follows after Freddie announced September 25<sup>th</sup> it might boost retained earnings by more than \$4.5 billion – its previous top range – after a preliminary review of its finances and pushed back its final restatement until November. (David Weidner, *CBS.MarketWatch.com*, 9/30/03, *Reuters*, 9/30/03, *The Bureau of National Affairs*, No. 190, 10/1/03)

### Freddie's nemesis is Ohio AG aiming to lead shareholder lawsuit

- Former state auditor, now Ohio Attorney General Jim Petro, plans to seek lead plaintiff status on behalf of Ohio's public retirement systems in a class-action shareholder lawsuit against Freddie. Petro, with an interest in running for Governor in 2006, has a reputation for advocating for tax-dollar accountability. According to his web site set up for his campaign for state office, [www.JimPetro.com](http://www.JimPetro.com), he has uncovered waste, fraud and abuse in government, identifying millions of dollars in misspent public funds.
- The Ohio lawsuit alleges Freddie's admitted accounting troubles caused the Ohio State Teachers Retirement and Public Employee Retirement Systems to lose more than \$25 million in stock value. Petro said in a statement announcing the lawsuit that "Freddie Mac was so intent on maintaining its public image that its officers and board were willing to ignore the rules of proper accounting at the expense of investors." He described the "shoddy accounting and lack of corporate ethics" as "shameful."
- Former CEO Leland Brendsel, former CFO Vaughn Clarke and former President David Glenn are named as individual defendants in the 125-page complaint and the shareholder class period is specified as from April 18, 2000 through July 22, 2003. The lawsuit claims the two executives named knowingly misled the public through

vague disclosure practices and allowed lower-level managers without proper skills and information to make financial decisions.

- The U.S. District Court for the Southern District of Ohio has not yet determined class-action status of the lawsuit against Freddie Mac nor has it named a lead plaintiff. Large institutional investors that claim to have lost the most money in securities fraud cases typically get priority over individual investors for lead plaintiff status. (Jessica Swesey, *Inman News*, 9/29/03)

#### “Steady Freddie” morphs into “Fraudie Mac”

- Bill Mann writes that “Giant mortgage funding company Freddie Mac – or as some are starting to call it, ‘Fraudie Mac’ – announced yesterday that its restatement of three years’ worth of financial numbers would be delayed by up to two months. Further, the company warned that its previously announced maximum amount for restatement, \$4.5 billion, might not be high enough.”
- Mann sees Freddie and Fannie facing the likelihood of substantially stronger regulation, “brought on in no small part by Freddie’s recent foibles.” Raising the fact that federal regulators insisted that Freddie former Chief Investment Officer Greg Parseghian be fired rather than retired, depriving him of more than \$20 million, Mann says that, “what Freddie managed to do was to put what has been a pretty sweet deal at risk.” Fannie and Freddie, he points out, have no caps on their sizes, which was “more than fine when the companies had easy founts of growth in the form of taking market share at the highest credit levels, but once they saturated this market, the two were left with a choice – take on more aggressive types of debt or grow slower. Since they had the backing of the federal government, and the interests of the shareholders in mind, you can guess which way they went.”
- Congress is now thinking hard about the \$1.5 trillion in liabilities it would assume should the unthinkable occur- Freddie or Fannie’s collapse: “The duality of Fannie and Freddie as publicly traded ventures and government-backed entities is the real conflict, not whether or not executives at Freddie had a cookie jar for accounting. Focusing on the regulations overseeing them is like fixing a bridge with structural defects by giving it a new coat of paint.” (Bill Mann, “Freddie Mac’s Summer of Love,” *The Motley Fool*, 9/26/03)

#### Big campaign contributors gearing to support Freddie

- A powerful interest group coalition is lining up to back beleaguered Freddie Mac, “setting up a showdown over proposed legislation to reform the company and its older sister, Fannie.” The National Association of Realtors and National Association of Home Builders (NAHB), two of Washington’s biggest campaign donors have come out against the Administration’s proposal to shift oversight of the GSEs from HUD to the Treasury Department.

- The Realtors, the Homebuilders, Freddie and other allies met September 29<sup>th</sup> to strategize to fight the proposed legislation. NAHB Executive Vice President and CEO Jerry Howard said, “We’re gonna go at this with everything we have...I’ve been at NAHB for 18 years, and I have not seen our board of directors more energized or more aggravated...that’s the level of urgency we’re putting on this issue.” Howard claimed, “You’re giving [HUD’s] responsibilities to the one agency that...has been anti-housing.” (Michael S. Gerber, *The Hill*, 9/30/03)

Freddie COO calls scandal “embarrassing,” commits to “pristine” GAAP statements

- Paul Peterson, Freddie Mac’s Chief Operating Officer describes the accounting and management problems at Freddie as “one of those cases where the outcome of the weaknesses that we had was so terrible that nobody’s going to let it happen again.” In an interview with *Community Banker* magazine, Peterson said, “It’s embarrassing. We are in a business that relies on market confidence.” The Freddie COO pledged that Freddie is committed to “pristine, uncompromised GAAP financial statements – I can guarantee you that.” Peterson said lenders seem to be able to separate out the accounting problems from the business issues that matter to them, adding, “Frankly, we haven’t had anybody quit delivering to us out of concern for the accounting issues.”
- When asked why Freddie conducted such a large buyback of corporate debt on the heels of management changes made in the aftermath of the scandal, he replied, “Investors don’t like uncertainty, and that was done to let the market know that we are committed to the performance of our securities.” As to Freddie’s decline in market share, Peterson said in part “it has nothing to do with the restatement. We lost one major customer and had operational and contractual issues with another major customer. You can explain 90% of our market share drop over those issues.” (*Dow Jones International News*, 10/1/03)

MBS pioneer Ranieri, possible Freddie CEO, shows no interest in moving to D.C.

Industry sources say FHLBank president Alex Pollock angling to run Freddie

- Lewis S. Ranieri, who helped pioneer the mortgage-backed security while at Salomon Brothers in the 1980s, has been mentioned as a possible successor after Freddie Mac ousted its chief executive in the wake of the earnings restatement scandal. Recently, he voiced concerns that Freddie’s accounting improprieties would be a pretext for attacking the housing finance system he helped create. Ranieri noted Freddie’s erring in deferring income, but rationalized it as hardly Enron, only poor accounting. He said he would not object to creating a new regulator, but would oppose rewriting the GSE charters, imposing capital rules that lessen the ability of the agencies to function in the market or take away HUD’s mission and products authority.

- Ranieri's remarks echoed those by other high-profile mortgage executives, including Fannie chair, Franklin Raines. Whereas Raines told credit union executives that a group of big banks was lobbying Congress to impose cumbersome rules on Fannie, Ranieri cited a different threat: policy wonks, including certain unnamed staff at the Federal Reserve Board, the Treasury and the Office of Management and Budget who have argued that housing was an over-advantaged portion of the economy and that a portion of the economic pie going to housing would be better served going to small business or other economic sectors.
- Ranieri says these staff ought to say up front that there is an imbalance rather than using safety and soundness issues as a mask to redress a policy issue. OMB spokesman Trent Duffy responded that the views of the career staff are less important than the views of the elected leadership and presidential appointees. The leadership of the administration makes the policy decisions. The Fed responded by referencing Chairman Alan Greenspan's July 16 testimony before the Senate Banking Committee in which he called for a regulatory supervisor with capacity to view the GSEs in total, able to grasp fully the various major questions involved in these now very important financial institutions.
- The mortgage pioneer said he was flattered, but not interested in the Freddie CEO job, because as chairman of American Financial Realty Trust, he has plenty on his plate, adding he doesn't want to go to Washington. However, Ranieri did recommend T. Timothy Ryan for the post, who led the Office of Thrift Supervision during the first Bush Administration, at the height of the savings and loan crisis. Ryan, now a managing director at J.P. Morgan Chase Co., would not comment on the plug from Ranieri. (Marc Hochstein, *The American Banker*, 9/29/03)

Industry sources say FHLBank of Chicago President Alex Pollock angling to run Freddie

- Alex Pollock, President of the Federal Home Loan Bank of Chicago, and the mastermind behind the Mortgage Partnership Finance Program that competes against Freddie Mac, now wants to head the organization, according to industry sources. Mr. Pollock's spokesman declined to dispel the rumor. Pollock reportedly has been calling industry leaders to rally support, but few believe he has a chance. One Freddie source said the board "would never say yes" to Pollock running the company, but credited him with creativity. A former Freddie executive said when he first heard the rumor, it was "so over-the-top that I couldn't believe it."
- Industry officials say Fannie Mae seems to consider the MPF program a much bigger threat than Freddie Mac does. Pollock said he was not surprised Fannie has been circulating a document on Capitol Hill calling for limits to the MPF program, which he says "is a threat to their monopoly profit." Pollock points out that the FHLBanks are safer institutions to hold loans, because they are not driven to make the same kind of profit, citing Fannie and Freddie's returns on common equity after taxes at 28.3% and 25.8% in the 2nd quarter of last year, respectively, while the FHLBank system's return was 5%.

- Freddie hired Korn Ferry to headhunt for a replacement for its previous head, Greg Parseghian. Freddie's board is expected to find a suitable CEO candidate by year's end, but for now, the company has not set any specific timeframe. (Paul Muolo, *National Mortgage News*, 9/29/03; and Rob Blackwell, *The American Banker*, 10/10/03)

Freddie wins two US tax court cases
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- Freddie Mac prevailed in two significant U.S. Tax Court decisions involving its bid to write off the value of a debt financing benefit. The Tax Court issued decisions on September 4<sup>th</sup> and 29<sup>th</sup> involving a dispute over tax treatment of debt the company held in 1985. The IRS disputed Freddie's claim and sought to assess a \$146 million tax deficiency from 1985 through 1990.
- The issue at stake is whether Freddie could amortize the economic benefit of some debt issued with below-market interest rates that it held on January 1, 1985, the date when Congress officially subjected Freddie to payment of income taxes. Freddie claimed an intangible asset, "favorable financing," involving interest rates below market rates for debt it sold. Freddie claimed it could amortize \$456 million of its favorable financing using a fair market value basis.
- The latest decision on Freddie Mac establishes that the amortization of favorable financing is governed by pre-existing law. Given the comprehensiveness of the decision, it is not clear that the right to use borrowed money at a bargain rate (vis-à-vis open market interest rates) when such right is obtained in a transaction in which the taxpayer obtains a measurable basis in the right, can be amortized over the useful economic life of the right.
- The Tax Court compared the favorable financing to an interest in a favorable leasehold, or a lease with a rental rate below current market value. The court's decision was based primarily on favorable financing being analogous to a bank's "core deposits" or "deposit base" which the Tax Court consistently has held to be an intangible asset fully eligible for amortization. Freddie spokesman Douglas Robinson confirmed the decisions, but declined comment since litigation on another aspect of the case is continuing in Tax Court. (Rob Wells, *Dow Jones Newswires*, 10/2/03 and Robert Willens, *Daily Deal*, 10/6/03)

Freddie forecasts originations plunging by 43% from 3 <sup>rd</sup> to 4 <sup>th</sup> quarter
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- If Freddie Mac's latest forecast is accurate, lenders should be feeling a downdraft, since originations of conventional mortgages are projected to plunge by 43% from the third to the fourth quarter, with another significant drop coming in the first quarter of the new year. Freddie economists estimate that 3<sup>rd</sup> quarter originations totaled \$858

billion, while the forecast of 4<sup>th</sup> quarter originations is \$489 billion. Even though 30-year mortgages will remain steady at 6% over the next two quarters, conventional mortgage originations will drop by another 19% in the first quarter to \$395 billion, before rising to \$431 billion in the 2<sup>nd</sup> quarter.

- Originations of loans insured by the Federal Housing Administration or guaranteed by the Department of Veterans Affairs should decline by only 15% from the third to the fourth quarter, Freddie's economists project. Overall, Freddie's updated forecast calls for \$1.85 trillion in single-family mortgage originations in 2004, compared with \$3.26 trillion this year, as refinancings fall from two-thirds of originations to 36%. (*National Mortgage News*, 10/8/03)

#### Freddie follows Fannie, tightens underwriting guidelines on manufactured housing loans

- Freddie Mac, like Fannie Mae, moved to tighten its underwriting guidelines on manufactured housing (MH) loans by cutting off existing owners from refinancing into 30-year loans. Under Freddie's new seller/servicer guidelines, MH owners can only refinance into a 20-year loan with a loan-to-value ratio no higher than 65%. Michael O'Brien, executive vice president of the Manufactured Housing Institute, took issue with the new guidelines, "We have grave concerns about the impact of that change by both Freddie and Fannie on existing manufactured housing markets and the ability of existing homeowners to tap their equity." Freddie also capped the LTV on 30-year purchase loans at 95%, but did not go to a 90% cap like Fannie. Mr. O'Brien said he was pleased that "on the biggest issue, Freddie did not follow Fannie." The new MH guidelines go into effect January 2<sup>nd</sup>, along with a new 50-basis-point delivery fee on MH loans. (*National Mortgage Wire*, 10/7/03)

#### Freddie hires ML Strategies to monitor "general issues"

- According to *Roll Call*, "as the pressure continues to mount on government-sponsored enterprises on transparency issues and fiscal management, the home mortgage lender Freddie Mac has signed on ML Strategies to monitor "general issues" affecting GSEs, according to lobbying filings. ML Strategies is run by Mark Buse, a former top aide to Senate Commerce, Science and Transportation Chairman John McCain (R-AZ)." (*Roll Call*, "Fighting for Freddie," 9/22/03)

## Federal Home Loan Banks

Standard and Poor's lowers NY FHLBank rating to negative from stable

New York FHLBank discloses more investment problems

NY FLHBank's President DelliBovi, other FHLBank execs tell shareholders not to worry

- Although Fitch credit ratings agency said ratings would not immediately be influenced by the \$183 million loss on securities at the New York FHLBank, Standard and Poor's (S&P) Rating Services lowered its outlook for the New York bank from stable to negative. The loss prompted the New York bank to announce it would not pay a third-quarter dividend. S&P credit analyst Jonathan Ukeiley explained the lower rating: "While the bank has now disposed of these securities, which helps to reduce its credit risk profile, the FHLB-NY's retained earnings were cut more than half, and a significant quarterly loss will be recognized." Brian Rohman, a managing director of money management firm, Weiss, Peck & Greer, said, "The issue is going to be one here of another example of limited disclosure, limited oversight and perceived potentially meaningfully large government liability."
- Analysts said the bank's problems appear to be isolated, but added that limited disclosure makes it hard to be certain. An unnamed analyst remarked, "Barring unforeseen problems with the portfolio, they're in good shape, they can probably reinstitute a dividend in the fourth quarter, and the problem is probably behind them. The issue is what will disclosure look like going forward."
- Observers said the NY FHLBank's investment miscalculation raised questions about the capacity of FHLBanks -- which traditionally advance funds to members at discounted rates to fund home loans -- to take on a rapidly growing mortgage portfolio. "When you get into mortgages, you're getting into high octane stuff. It's like going from lemonade to vodka," said one analyst. Other observers said the New York FHLBank's announcement of its big portfolio loss is unlikely to lead Congress to assign oversight of the banks to a new regulator for Fannie Mae and Freddie Mac but has brought public attention to an obscure government-sponsored enterprise. (Mark Felsenthal, *Reuters*, 9/26/03)

### New York FHLBank discloses more investment problems

- On the heels of its announced \$183 million loss stemming from manufactured housing loans, the FHLBank of New York admitted to more problem investments, citing a \$6.6 million loss on \$944 million of securities backed by home and business loans. The loss, minor in relation to the bank's size, shows how some big players in the housing market are suffering reversals in the wake of the mortgage boom. The bank disclosed that it chose to sell the asset-backed securities and take a loss because the bonds "no longer met the credit standards of the bank due to recent deterioration

in the credit quality of the servicer.” Servicers, which collect payments on loans, often are also the originators of the loans used in asset-backed securities.

- Rumors had been circulating that the bank would disclose losses from another set of problem loans after the earlier mobile-home loans. Speculation focused on securities backed by loans originated by a Philadelphia subprime lender, American Business Financial Services Inc. (ABFS). The company suffered financial setbacks recently, but neither ABFS nor the New York FHLBank would comment on whether ABFS originated the loans underlying the securities.
- The “triple-A” rated securities the FHLB-New York sold are believed to be asset-backed securities supported by home equity loans. Although the asset-backed traders could not identify the seller, they said an investor on September 29<sup>th</sup> had sold roughly \$1 billion of triple-A rated asset-backed securities issued by ABFS. ABFS said in a recent annual filing that it has not been able to finance itself via the asset-backed securities market recently, which it believes is in part because of an inquiry from the Department of Justice regarding the company’s forbearance, or loan work out, practices.
- The New York FHLBank emphasized it expected “no significant additional losses” in its investments and its capital base remains strong. The Federal Housing Finance Board, which regulates the home loan banks, is considering tighter investment rules, but claims it is not a result of the recent flare-ups at the FHLBanks in New York and Pittsburgh.
- Congressman Jim Leach (R-IA) said during a recent House Financial Services hearing that news from the New York and Pittsburgh FHLBanks raises a lot of concerns and strengthens the case for placing FHLBanks under the Treasury Department along with Fannie Mae and Freddie Mac. Rep. Leach said he is afraid the Finance Board is a “captive agency” of the FHLBanks. The Iowa Republican said the Pittsburgh FHLB dipped into retained earnings to pay its dividends, prompting the Finance Board to issue an advisory to all 12 FHLBanks to review the adequacy of their retained earnings “with a view toward increasing” retained earnings.
- FHFB Chairman Korsmo stressed that the Finance Board is improving its supervisory capabilities, becoming the model of the kind of independent regulator Congress is looking for to oversee Fannie and Freddie. (John D. McKinnon and Patrick Barta, *The Wall Street Journal*, 10/1/03; Dan Wilchins, *Reuters*, 9/30/03; and Brian Collins and Ted Cornwell, *National Mortgage News*, 9/29/03)

NY FHLBank’s President DelliBovi, other FHLBank execs tell shareholders not to worry

- In a letter to shareholders, New York FHLBank president Alfred DelliBovi revealed losses on the bank’s portfolio sales will reduce its retained earnings to \$90 million in the third quarter, down from \$240 million at the end of the second quarter. The letter also disclosed the loss of \$6.6 million in another sale involving \$944 million in residential and business securities. Similarly, Chicago FHLB President Alex Pollock

provided reassurances: “I want to make sure all Chicago members understand that these events have zero impact on your Chicago FHLB stock investment.” Atlanta FHLBank president Raymond Christman mollified members in a September 30<sup>th</sup> letter saying, “the Atlanta bank continues to be in a strong financial position.” Atlanta, San Francisco and Cincinnati FHLBanks pointed out they do not invest in manufactured housing bonds. (*National Mortgage News*, 10/1/03)

Pittsburgh/Atlanta FHLBanks declare losses, fan concerns

Korsmo reacts to news that Atlanta FHLBank will pay \$30 million-plus in dividends

- Expected losses at two FHLBanks announced October 8<sup>th</sup> fueled fears about the integrity of the U.S. mortgage funding system and provoked demands for stricter regulation of the government-sponsored network that funds mortgages. The Atlanta FHLBank said it expects to record a \$9 million loss for the third quarter, compared with net income of \$54 million for the prior quarter, and FHLB-Pittsburgh forecast a \$7 million loss for the same period, compared with net income of \$3 million for the second quarter, and \$19 million income for the third quarter of 2002. Both FHLBs also decided to pay third-quarter dividends, which concerned some members of their regulating board.
- Both banks said their 3<sup>rd</sup>-quarter losses stemmed from historically low interest rates that pinched interest income and market values on their derivatives holdings. The losses tarnished the image of the FHLBank system, already harmed from bad investments at the New York FHLB, and could add to pressure for the banks to share a new, strengthened regulator with Fannie Mae and Freddie Mac.
- Wayne Abernathy, Assistant Treasury Secretary for Financial Institutions, responded, “Often bad news helps focus people’s minds on the problem...If we can get the home loan banks included in there, by all means, let’s do it.” The FHLBank System had been the least criticized of the three home finance agencies, until the New York FHLBank last month reported a loss of nearly \$200 million due to bad investments.
- The Pittsburgh and Atlanta banks said their losses are different from those suffered by their New York brother. Pittsburgh’s President James D. Roy ascribed the bank’s latest problems to continued fallout from the refinance boom, saying the bank had “revamped” its methods of acquiring mortgages “to assure that new assets are immediately hedged within tight parameters,” and taken other steps to reduce the impact of hedging on its earnings.
- The Atlanta bank, in a letter to shareholders, emphasized that bank’s belief that results don’t necessarily reflect its underlying financial condition. A spokesman for the Atlanta bank said most of the bank’s hedging was related to its core business of lending to member banks, not its mortgage portfolio assets. The bank’s responses were posted promptly on their web sites, reflecting a heightened sensitivity to

disclosure within the home loan bank system, actions that would have been unlikely in the recent past. Corporate scandals, Freddie's accounting blow-up and recent investment problems at several home loan banks, have made the FHLBanks more aware of their obligations to investors.

- To many analysts and politicians, the stumbles are evidence the FHLBanks may not be as sophisticated at hedging interest-rate risks as Fannie Mae and Freddie Mac. The Atlanta and Pittsburgh banks say they remain financially healthy. Nevertheless, Standard and Poor's Rating Services lowered the ratings outlook for both FHLBs to negative from stable, prompted by their anticipated losses. (*Reuters*, 10/9/03; Aleksandrs Rozens, *Reuters*, 10/8/03; and Patrick Barta and John D. McKinnon, *The Wall Street Journal*, 10/9/03)

#### Korsmo reacts to news that Atlanta FHLBank will pay \$30 million-plus in dividends

- John T. Korsmo, the Federal Housing Finance Board Chairman, expressed his concern at learning "...that another Federal Home Loan bank, the same day they are announcing they will experience a \$9 million-plus loss in the third quarter, albeit a FAS 133 loss, nevertheless the same day announces that they will pay \$30 million-plus in dividends," referring to the Atlanta FHLBank. Korsmo said the FHLBanks should only pay dividends after they have retained enough earnings to shore up their balance sheets. FAS 133 (Financial Accounting Standard 133) is a rule implemented in 2001 that mandates "mark-to-market" accounting of derivatives. Like rival GSEs Fannie and Freddie, the home loan banks use derivatives to hedge interest rate risk in their mortgage portfolios. When rates fell in late September, so did the value of the hedges. The banks blamed the accounting standards that govern hedging for their third-quarter losses.
- FHLBank officials sought to downplay the role the losses would have on the congressional debate over GSE regulation – "This is an FAS 133 accounting issue, not a regulatory oversight issue," said Raymond Christmas, the Atlanta FHLBank's president – but others speculated that the announcements weaken the banks' position. Bert Ely predicted the losses, which he described as more damaging politically than financially, would be "one more reason why the FHLBanks are going to be included in whatever sort of GSE regulatory reform bill we get." (Craig Linder, *The American Banker*, 10/9/03)

San Francisco FHLBank drops bad loans
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- Lehman Brothers Holdings Inc. repurchased millions of dollars of troubled mortgage loans out of securities owned by the FHLBank of San Francisco. The loans were part of an alleged fraud involving two Beverly Hills, California real-estate developers. Some \$60 million of the fraudulent loans were sold to the San Francisco FHLB before Lehman discovered the scam this spring, according to bank officials and Lehman. Lehman originally packaged the loans with other "super jumbo" and jumbo mortgages, and sold them to the FHLB in mortgage-backed securities valued at \$2 billion, according to FHLB officials.

- Lehman accused the Beverly Hills developers in a federal lawsuit, filed in the U.S. District Court for the Central District of California, of using phony appraisals, fictitious buyers and false credit reports to finance inflated mortgages on houses in Beverly Hills and other luxury areas in the state.
- Although the San Francisco bank didn't end up losing money on the loans, the episode illustrates the risks that can arise as the nation's 12 FHLBanks invest more heavily in home mortgages. Some critics believe the banks lack the necessary expertise to manage those portfolios. Markets were rattled recently when the New York FHLBank disclosed \$183 million in losses linked to investments in mobile-home mortgages. San Francisco home-loan bank officials say Lehman repurchased the \$60 million in loans included in their MBS before they became delinquent and have had no other problems with the remaining mortgages that comprise their MBS pools. (Dawn Kopecki, *Dow Jones Newswires*, 10/3/03)

America's Community Bankers switches position on FHLB regulation
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- The trade group representing thrifts and savings banks, America's Community Bankers, reversed its position on regulating the FHLBanks, siding with Rep. Ed Royce (R-CA) to include the FHLBanks in legislation designed to strengthen the regulation and supervision of Fannie and Freddie. ACB says it prefers the FHLBank regulator "not be combined with the new regulator of Fannie Mae and Freddie Mac," but supports creation of a new independent regulator for the banks housed inside Treasury.
- The Independent Community Bankers of America (ICBA), a rival trade group, reiterated its opposition to including the FHLBanks in the GSE reform bill. At its annual meeting held in New Orleans, the Board of Directors of the ICBA voted unanimously to oppose Rep. Royce's amendment to include the FHLBanks in the Fannie/Freddie legislation. In concert with the ICBA board's action, some 30 state community banking associations aligned with the group issued a joint memo, also opposing the anticipated Royce amendment, saying they are greatly concerned that shifting supervision and regulation of the FHLBs to Treasury "could hinder community banks in accessing this key funding source." Community banks make up a substantial part of the more than 8000 financial institutions that comprise the membership of the 12 regional FHLBanks.
- Norman B. Rice, president of the Seattle FHLBank, said, "The events of the last two weeks, and the indications from Congress, lend themselves to this change." Rice's bank outlined principles last week under which it would endorse a new regulator. Rice was subtly referring to troubles at the New York and Pittsburgh FHLBanks, with the New York bank announcing it would not pay a third quarter dividend because of a \$183 million loss on manufactured housing bonds. The New York bank announcement followed the Pittsburgh bank declaring its second quarter income would be 82% lower than a year ago.

- To date, only the San Francisco and New York FHLBanks openly support merging the new supervisor of Fannie and Freddie with the Federal Housing Finance Board, which is being promoted by House lawmakers like Ed Royce (R-CA), and James Leach (R-IA). Five other banks, Atlanta, Dallas, Pittsburgh, Topeka and Seattle, are all open to a potential merger, under certain conditions. A spokeswoman for the Des Moines FHLBank said it is also open to the idea of a new regulator, but would prefer not to share it with Fannie and Freddie.
- The House Financial Services Committee is unlikely to give a new regulator authority over the FHLBanks, and Committee chair Michael Oxley (R-OH) said he would not tackle the issue without consensus from the banks. The move is firmly opposed by three Home Loan Banks: Cincinnati, Indianapolis, and Boston, with Chicago not yet taking a position. (*National Mortgage News*, 10/6/03, John Connor, *Dow Jones Newswires*, 10/7/03; and *PRNewswire*, 10/6/03; Karen L. Werner, *The Bureau of National Affairs, Inc., Regulation & Law*, 10/7/03; Rob Blackwell, *American Banker*, 9/30/03)

## Postal Service

Former BRAC Commissioners endorse plan to close surplus postal facilities
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- Eleven former Commissioners who served on the Base Realignment and Closure Commission (BRAC) plugged a new plan to apply the BRAC model to close unneeded U.S. Postal Service facilities. The Commissioners wrote to Congressional leaders about the plan, originally proposed this summer by President Bush's plan considering the future of the Postal Service. The letter, circulated by former Representative Jim Courter, who chaired the 1991 and 1993 BRAC rounds and is also Chairman of the Lexington Institute, said "Because of its vast and outdated infrastructure, the U.S. Postal Service would benefit from the same kind of dispassionate review that we applied to the Department of Defense.
- Former U.S. Senator Alan Dixon, BRAC Commission chair in the 1995 round, also signed the letter, as did Arthur Levitt, former chair of the Securities and Exchange Commission, Harry McPherson, former Special Counsel to President Johnson, Robert D. Stuart, former CEO of the Quaker Oats Company, General Duane Cassidy, formerly Commander in Chief of U.S. Transportation Command, and former Representative Beverly Byron, among other prominent leaders.
- The BRAC Commissioners noted the savings of \$16 billion through 2001 from 4 BRAC rounds, with over \$6 billion in additional savings annually. Courter said, "The future effectiveness of the U.S. Postal Service is going to largely depend on controlling costs and increasing productivity...The BRAC process can help achieve those critical improvements." (Lexington Institute Press Release, 10/1/03)

## USPS files Report to Congress on CSRS “savings”

- The USPS filed its Report to Congress, the GAO, and the Bush Administration, “Postal Service Proposal: Use of Savings for Fiscal Years after 2002: P.L. 108-18.” The report asserts that when the “savings” are examined from the standpoint of the postal ratepayer, there are no “savings” under P.L. 108-18 after Fiscal Year 2005, as long as the escrow continues in effect as currently written.
- The USPS report refers to legislation Congress passed in April lowering the postal service’s contributions into the Civil Service Retirement System (CSRS), saving the USPS \$2.9 billion in FY2003 and \$2.6 billion in FY2004. The savings let Postmaster General John Potter guarantee that postal rates would not rise until calendar year 2006.
- After FY2004, savings from the legislation must be placed in escrow, and by October 1, 2005, the USPS must be prepared to pay \$3.2 billion toward the escrow fund.
- In addition, paying for the military benefits of its employees would cost the USPS \$27 billion, according to USPS chief financial officer, Richard Strasser.
- The Postal Service urges Congress to put its future CSRS reform savings towards paying for postal employee retiree health benefits, an estimated \$40-50 billion liability, and recommends Congress relieve it of the responsibility to pay for its employees’ military service benefits, a burden no other federal agency shares. Strasser points out that if Congress abolished the escrow requirement and lifted the military benefits burden, the USPS would have an excess of \$10 billion.
- If Congress chose not to take those actions, the USPS alternative recommendation would be to take some of the money in the escrow fund and use it to begin pre-funding the health benefits of postal employees hired after 2002, Strasser stated. The remainder of the escrow fund could be used to lower the effect of new expenses on rates beginning in 2006.
- The Treasury Department and the Office of Personnel Management are also making recommendations to Congress. Treasury and OPM recommend that the USPS pay the estimated \$27 billion its employees who are military veterans are scheduled to receive for military service when they retire. Treasury advocates that USPS fund all its expenses through postal rates. Although other agencies do not have to pay for military service benefits, the cost ultimately is borne by the taxpayers whether the expense is charged to Treasury or to the individual agency.
- Postal employees, Treasury explains, receive credit for the military service toward their pensions under CSRS, so it would be fair to make USPS pay military benefits of all employees hired after June 30, 1971, when the postal service became independent.

- Under the Administration’s approach, as explained in the Treasury/OPM Joint Report, the payment of military service costs is consistent with the funding of the Federal Employees’ Retirement System (FERS), the funding system on which the new law (P.L.108-18) was patterned. “Although the old law static funding of CSRS did not require the Postal Service to fund the cost of military service, it also did not contemplate that the actuarial gains or losses of the retirement system would be attributed to the Postal Service.
- Experience shows that the retirement system benefited from extremely high interest rates during the 1980’s. The gains from interest earnings in excess of the static interest rate far exceed the additional costs of military service. The Postal Service should not benefit from the positive dynamic experience of the pension fund without assuming the other responsibilities that come with dynamic funding. The Joint Report provides the following evidence to make its case:

The gains from interest rate earning in excess of the static rate far exceed the additional costs of military service. Assuming that the Treasury were to fund all military costs, the present value of all interest rate gains to the Postal Service from July 1, 1971 through September 30, 2002, would be approximately \$106.6 billion. The cost to the Treasury of military service would be \$16.6 billion, resulting in a net gain of \$90 billion.

- GAO has 60 days to issue a report on the recommendations, after which Congress has established a target of 180 days on which to act on the issue. Congress’ target time is non-binding but the timing is key, Strasser pointed out, because the USPS will start planning for its next rate case soon after.
- Mailers expect the USPS to file the next rate case by the end of 2004 and many are concerned that without Congressional action, the rate case will be in the double digits, as Deputy Postmaster General John Nolan warned before the National Postal Forum in Kansas City last month. ([www.nonprofitmailers.com/](http://www.nonprofitmailers.com/) 10/02/03 and Scott Hovanyetz, *DMNews*, 10/1/03 and 10/02/03 and the OPM-Treasury Joint Report, “*Financing of Benefits Attributable to the Military Service of Current and Future Employees of the USPS*)

USPS asks Postal Rate Commission to speed approval of negotiated service agreements
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- The Postal Service urges the Postal Rate Commission (PRC) to accelerate the process of approving negotiated service agreements (NSAs), which provide pricing incentives to mailers based on increased mail volume and productivity gains. The USPS recommends the PRC set a time limit of 150 days to review NSA requests. It took 239 days for the PRC to endorse the first NSA, give to credit card company Capital One Financial Corp. in May. Postal officials said a streamlined approval process is needed to encourage other mailers to pursue discounts.

- In the Capital One deal, the credit card firm will get discounts of 3 cents to 6 cents per piece for the next three years if its annual First-Class bulk volume exceeds 1.225 billion pieces. The discounts rise as Capital One's volume increases. The agreement commenced September 1<sup>st</sup>. (Melissa Campanelli, *DMNews*, 10/02/03)

EBay in concert with USPS to expand shipping services
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- The U.S. Postal Service and EBay Inc. announced an agreement to expand shipping options available directly through EBay. In a press release, the USPS explained that EBay users will be able to print shipping labels, pay postage and check delivery status on items, through the EBay web site. EBay users will also no longer need to conduct transactions at post offices, USPS said. (Gregg Henglein, *The Wall Street Journal Online*, 10/6/03)

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