

# The **GSE** REPORT™

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## **Major Events**

House Financial Services Committee Holds Second Hearing on Administration's Plans to Shift GSE Oversight to Treasury; and on Cong. Richard Baker's Bill to move GSE regulation to OTS

Fannie and Freddie Executives Testify, as do FHLB Representatives

- The House Financial Services hearing September 25<sup>th</sup> included the following major witnesses:
  - Armando Falcon, Jr., Director, OFHEO
  - John Korsmo, Chairman, Federal Housing Finance Board
  - George Gould, Director, Freddie Mac
  - Franklin Raines, CEO, Fannie Mae
  - David Heman, President and CEO, Federal Home Loan Bank of Cincinnati
  - Dean Schultz, President and CEO, Federal Home Loan Bank of San Francisco
- The hearing centered on the Bush Administration's proposal to create a new bureau in the Treasury Department and on H.R. 2575, Rep. Richard Baker's (R-LA) bill to create a new office in the Office of Thrift Supervision (OTS). Chairman Michael Oxley (R-OH), in his opening statement, said, "There is broad agreement that the current regulatory structure for the GSEs is not operating as effectively as it should. OFHEO is underfunded, understaffed, and unable to fully oversee the operations of Fannie and Freddie." Rep. Baker in his opening statement said he is pleased with recommended changes to his bill from Treasury and HUD and that few modifications are needed to make it conform to the Administration's proposal. Baker's bill differs from the Administration's by creating the new office within OTS and placing new program approvals in HUD, rather than in a new regulator within Treasury.
- Ranking member Barney Frank (D-MA) and other members such as Paul Kanjorski (D-PA) and Maxine Waters (D-CA), cautioned the committee against crafting legislation that would harm the U.S. housing market. Congressman Frank, a skeptic of the regulatory reforms under consideration, said that if the regulatory transfer goes through, he will press to make sure the housing oversight function is not only protected, but strengthened.
- Lawmakers stressed the need for the new regulator to be independent, much like Treasury's OCC, meaning the new regulator would not have to vet testimony, rules, enforcement actions or litigation through Treasury.
- Congressman Ed Royce (R-CA), sponsor of H.R. 2803 to include the Federal Home Loan Banks in legislation creating the new regulator, said the arguments for a new Fannie/Freddie regulator are comparable with those for the FHLBanks. The debts, Rep. Royce pointed out, of outstanding derivative portfolios for the banks are similar in size to Fannie and Freddie and the FHLBanks lacks depth and experience to

oversee these risks. Chairman Korsmo said that the Federal Housing Finance Board does not have a formal position on whether the banks should be included under the new regulator, and denied that leaving them out would harm their market competitiveness with Fannie and Freddie. Armando Falcon said if Congress decides it is appropriate to put the banks under the new regulator, “we could make it work.”

- FHFBoard Chair Korsmo stressed that independence is a paramount feature for a regulator. OFHEO’s Armando Falcon testified the new agency should be able to promulgate regulations based on what agency officials believe to be the best public policy without review by Treasury (OFHEO regulations currently go through OMB review). Falcon stated that OFHEO’s personnel, regulations and other infrastructure should be transferred to the new agency and the regulator should have discretion over setting minimum and risk-based capital standards.
- Fannie Mae Chairman Franklin Raines testified in favor of strengthening the federal regulator and shifting responsibility to Treasury, but opposed higher capital requirements, saying those requirements should remain at 2.5% for on-balance-sheet assets and 0.45% for off-balance-sheet assets. Raines told the committee that there is substantial concern that putting new program approval authority with a safety and soundness regulator could have a detrimental impact on housing. The standard in the Baker bill, Raines argued, would allow HUD to reject new programs even if in compliance with Freddie’s and Fannie’s charters. Falcon said there is no need for a formal new process on new product approvals and the members should consider whether HUD has the requisite enforcement authority. Chairman Oxley said the issue of new program approvals is “still kind of out there.”
- Freddie Mac board member Gould testified in favor of a stronger regulator within Treasury, agreeing with Raines that minimum capital requirements are adequate and shouldn’t be increased. Gould also maintained that Fannie and Freddie’s housing mission oversight should stay with HUD. Rep. Bob Ney (R-OH) emphasized that HUD should keep its role in overseeing Fannie and Freddie’s mission.
- Committee Chairman Michael Oxley (R-OH) said, “This committee may be faced with an issue, as early as next week, in terms of the markup,” that issue being what authority the new regulator would have to approve new finance products at Fannie or Freddie.
- Freddie pledged last year to voluntarily register its stock with the Securities and Exchange Commission under the Securities and Exchange Act of 1934, but Freddie board member George Gould told Congress Freddie will not register until mid-2004.
- Similarly, OFHEO Director Armando Falcon, asked to predict when Freddie might join Fannie in submitting to some elements of SEC-like registration, responded, “that will not begin to happen until the company is able to produce timely, quarterly financial statements in the timeframe that they have developed for reauditing and then restating.” Falcon continued, “the restatement, when it comes out, will be for

quarters leading up to the end of 2002. They still have work to do to produce financial statements for quarters for 2003. We hope that will be done by the end of this calendar year,” saying it will be “maybe summer or fall” of next year before Freddie is ready for the SEC process.

- Rep. Chris Shays, who sponsored legislation requiring Freddie and Fannie to register the equity and debt with the SEC, questioned witness George Gould, a Freddie board member, as to whether Freddie’s under-reporting of income constituted fraud. Shays asked Gould if someone in the private sector understated earnings by \$4.5 billion, “wouldn’t that be fraud?” Gould’s response was that although he lacked a legal background, it was his understanding that “fraud implies intent.” (*The Bureau of National Affairs, Inc.*, Regulation & Law, No. 187, 9/26/03); Mark Felsenthal, *Reuters*, 9/25/03; David Hilzenrath and Kathleen Day, *The Washington Post*, 9/26/03; Jessica Swesey, *Inman News*, 9/25/03; Dawn Kopecki, *Dow Jones International*, 9/26/03 and John Shaw, *Market News International*, 9/25/03, and *Reuters*, 9/25/03)

Freddie delays earnings restatement by 2 months; predicts even bigger earnings
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- Freddie, its reputation tarnished by its accounting scandal, delayed its earnings restatement by two months (previously to be released by September 30<sup>th</sup>) and warned its underreporting of earnings may be larger than previously thought. Freddie admitted its senior officials ignored accounting standards to push earnings into the future to sustain the image of steady earnings growth.
- The company estimated in June that it had underreported 2000-2002 earnings by between \$1.5 billion and \$4.5 billion, but announced on September 25<sup>th</sup> the amount is likely to be closer to or greater than the higher estimate. This most recent news is ill-timed, with Congress on the verge of creating a tougher regulator for Freddie and sibling Fannie to reassure financial markets. Company stock plummeted 18% and wiped out \$8.4 billion in market value since the earnings scandal surfaced in January.
- Freddie blamed the delay on problems with computer system changes it must put in place to account for asset transfers and bundling of home loans to create mortgage-backed securities that are sold to investors. Freddie’s Chief Financial Officer, Martin Baumann, said, “This delay does not result from new accounting errors,” noting that the company is in the “final process of validating our restated results.” In an interview with the *Washington Post*, Baumann said accounting errors eventually could total \$4.5 to \$4.7 billion, but didn’t think “it’s going to be materially above” \$4.5 billion.
- Despite the turmoil, Fox-Pitt Kelton analyst Chris Buonafede has a buy rating on Freddie’s stock and says the earnings restatement delay is a “disappointment, but not a disaster.” (Mark Felsenthal, *Reuters*, 9/25/03; David Hilzenrath and Kathleen Day, *The Washington Post*, 9/26/03); Jessica Swesey, *Inman News*, 9/25/03; Dawn

Kopecki, *Dow Jones International*, 9/26/03) and John Shaw, *Market News International*, 9/25/03, and Reuters, 9/25/03)

Senator Corzine introduces bill to monitor Fannie, Freddie

- Senator Jon Corzine (D-NJ), a former co-chief executive of Goldman Sachs, introduced a bill September 25<sup>th</sup>, the “Federal Housing Enterprise Oversight Modernization Act of 2003,” to make Fannie and Freddie subject to stiffer disclosure requirements and yearly audits by a new Treasury Department agency. Corzine’s bill is significant because he has been an aggressive champion of the twin GSEs and his support for reform suggests Senate Democrats may believe legislation is necessary this year and seek to shape its key elements.
- The GSEs under the Corzine bill would also undergo regular reviews of how they measure portfolio risk and would have to adopt liquidity guidelines created by central bank governors from the U.S., Japan, and other industrialized nations. Corzine and other lawmakers are advocating for tighter oversight of the government-chartered, shareholder owned companies to reassure investors and taxpayers after Freddie’s June admission it had understated profit by as much as \$4.5 billion in the last three years.
- Corzine said his bill would disband OFHEO in favor of a new, independent regulator as a bureau within the Treasury Department, modeled after the Office of the Comptroller of the Currency and the Office of Thrift Supervision. It would require the new Treasury regulator to assess every five to seven years the formula Fannie and Freddie use for measuring portfolio risk, whereas under the current statute, there is no such obligation. Corzine’s bill wouldn’t change the reserve requirements for Fannie and Freddie, but would allow the new regulator when necessary to increase the risk-based capital requirements of the two companies. Corzine slighted the Administration’s proposal because the entity “lacks independence” from Treasury officials.
- The bill, Corzine said, reflects his background over 24 years at the securities firm, Goldman Sachs. Andrew Parmentier, a policy analyst at Friedman, Billings, Ramsey and Co., declared that Corzine’s bill, “clearly reflects the sentiment of a lot of people on Wall Street.” (*Bloomberg News*, 9/10/03); *Congress Daily*, 9/25/03 and John Shaw, *Market News International*, 9/25/03)

Treasury clarifies it is not proposing changing minimum capital standards for GSEs

- Following Treasury Secretary Snow’s recent congressional testimony on September 10, Treasury spokesman Rob Nichols, in an email to reporters, clarified that “the administration is not proposing that the legislation itself change any capital standards. We are also not suggesting that the statutory minimum capital standard of 2.5% be changed.” Secretary Snow testified that the new regulator should “set prudent and appropriate minimum capital adequacy requirements” for Fannie and Freddie, called

for the new regulator to have enhanced authority to adjust that standard, but also said the risk-based capital standard is in its first year of application after 10 years of development and should not be changed too often.

- OFHEO currently measures the companies' capital adequacy using two standards, the first, the minimum capital standard, which is calculated as a percentage of assets plus 0.45% of adjusted off-balance sheet operations. The risk-based standard is supposed to take into account the companies' risk hedges and determines what capital the companies would need to survive a long-term collapse in the housing market or gyrations in interest rates. The companies are held to whichever of the two standards yields the greater amount, which in recent quarterly tests has been the minimum capital standard.
- Critics say the companies should meet a higher capital standard because of their \$1.5 trillion in debt. The companies argue their capital requirements are appropriate because their business is restricted to financing home loans, a traditionally low-risk and highly collateralized form of borrowing. The GSEs are unwilling to hold greater amounts of capital because to do so would cut into company profits or force the companies to charge their business partners larger fees. (*Reuters*; 9/15/03)

President Bush asks Congress to approve a \$7.5 million boost to investigate Freddie/Fannie
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- Two days after the first GSE hearing on Sept. 10, when Treasury Secretary Snow urged stronger regulation over the twin GSEs and in the wake of accounting troubles at Freddie Mac, President Bush asked the Congress for an additional \$7.5 million to boost supervision and investigation of the mortgage finance companies. In a letter sent to Congress, the White House said it expects the money in OFHEO's budget – now a requested \$39.9 million – to be transferred to the new agency after Congress enacts the administration proposal to revamp the regulatory regime. The request is comprised of \$4.5 million for special reviews of Fannie Mae (\$3 million) and Freddie Mac (\$1.5 million) and \$3 million for more routine regulatory and oversight activity.
- The request backs up a \$4.5 million request for additional funding by OFHEO Director Armando Falcon in July that was rejected by House appropriators. The President's September 12 letter indicates that he expects Congress to act quickly to strengthen GSE regulation as encouraged by his Treasury Secretary in his September 10<sup>th</sup> testimony: "It is expected that these and other resources available to OFHEO would be transferred to a new strengthened housing GSE regulator upon enactment of the proposal announced by Secretary Snow."
- The accounting scandal at Freddie triggered the ouster of two chief executives since early June and investigations by the Justice Department and the Securities and Exchange Commission, in addition to OFHEO's ongoing inquiry. Freddie disclosed accounting errors and manipulations of internal accounts resulting in its underreported earnings by \$1.5 billion to \$4.5 billion in the 2000-2002 time frame.

Fannie, in mid-July, reported a 25% drop in its second-quarter earnings caused by changes in value of contracts used to hedge against interest-rate swings, even though its business expanded. Fannie also said it will be less profitable in the second half of the year. (*AP Online*, 9/12/03 and *National Mortgage News*, 9/16/03)

OFHEO says Freddie probe report ready in early-to-mid October

- OFHEO spokeswoman Corinne Russell said the Office of Federal Housing Enterprise Oversight's investigation into events leading to Freddie's decision to restate its earnings will not conclude until early or mid-October. The issuance of the statement was designed to squelch rumors that the report might be released shortly. Russell explained, "We have been and are conducting additional interviews that were not anticipated," and "These interviews and the review of complex transactions takes time." (*National Mortgage News*, 9/23/03 and *BNA's Daily Report for Executives*, 9/25/03)

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

### GSE Regulator Proposals

MBA Supports Administration's Position

Homebuilders Call for HUD to Keep Program Oversight

*Washington Times* says rein in Freddie and Fannie, endorses Administration reforms

*Christian Science Monitor* urges Congress to loosen apron strings of Fannie/Freddie

Citizens Against Government Waste sees missing ingredient in reform legislation

*Barron's* says tougher rules may reduce growth, hurt Fannie/Freddie shareholders

### MBA Supports Administration's Position

- The Mortgage Bankers Association (MBA) in a September 22<sup>nd</sup> letter to the Chairman of the House Financial Services Committee, commended Chairman Oxley for addressing the issue of regulatory oversight of the GSEs and expressed the organization's "keen interest in maintaining the safety and soundness of our country's real estate finance system." MBA supports "funding the regulators without Congressional appropriations," and supports Treasury Department responsibility for safety and soundness regulation of Fannie Mae and Freddie Mac, as well as a "strong,

independent, and well-funded regulator for the GSEs because of the important role they play in the American financial system.”

- MBA also argues that it is “critical for Treasury to have program approval responsibility” for Fannie and Freddie, pointing out that national banks and federal thrifts routinely seek prior approval for their new activities from Treasury, and Treasury has proven its ability to handle that responsibility with no disruption to financial markets. “The appropriateness of new activities is, in part, a safety and soundness question – an activity which may be appropriate for a strongly capitalized institution may be entirely inappropriate for an institution in financial distress. Treasury’s proven expertise in financial regulation can only serve to strengthen the new program approval process for Fannie Mae and Freddie Mac.”
- The MBA letter also stressed that an important part of new program regulation is “maintaining a clear distinction between the primary and secondary mortgage markets,” and said the GSEs should not employ their “special advantages to compete in the primary mortgage market or to expand into other markets that are already well served by others.” GSE activities, rather, should focus strictly on maintaining liquidity and stability in the secondary market and on affordable housing goals, proposing a consultative role for HUD in new program approvals. MBA also supports continuing HUD oversight of Fannie and Freddie’s affordable housing goals, with greater flexibility in setting and enforcing the goals. (John Courson, Chairman and Robert M. Couch, Chairman-Elect of the Mortgage Bankers Association/MBA Letter to the Honorable Michael G. Oxley, 9/22/03)

#### Homebuilders call for HUD to keep program oversight

- The National Association of Home Builders (NAHB), with 1500 board members representing 835 state and local home builders associations unanimously adopted a policy resolution stating that moving program oversight of Fannie and Freddie from HUD to Treasury would subvert HUD’s role as the primary housing advocate and undermine the vibrant housing market that has sustained the economy in recent years. NAHB President Ken Conine said, “ The Administration’s proposal would irreparably harm HUD’s ability to focus the efforts of the two giant mortgage lenders on supporting homeownership opportunities for low-and-moderate income and minority families...HUD is the only Cabinet agency with a thorough understanding of, and extensive involvement in, housing-related issues. It makes no sense to transfer mission oversight of Fannie and Freddie to the Treasury, an agency that has virtually no experience in evaluating the effectiveness and appropriateness of housing policies, especially those pertaining to housing for working families.”
- Conine argued that stripping HUD of its mission oversight of the two major lenders would be a “catastrophe for housing,” and asserted that the Administration is making a “brazen attempt to divert capital from housing to other sectors of the economy.” Conine claimed opposition is growing to the Administration proposal, with the National Association of Realtors and other housing groups also opposing the shift.

NAHB, under its late past President Leon Weiner, fought in the 1960s to win Cabinet status for HUD. (*Reuters*, 9/22/03)

Washington Times says rein in Freddie and Fannie, endorses Administration reforms

- A *Washington Times* editorial, “Reining in Freddie” gauges the Administration’s regulatory proposal for Freddie and Fannie as striking the “right balance.” Freddie and Fannie, the paper points out, own or guarantee 42% of the nation’s \$7 trillion mortgage market and are among the four largest financial institutions in the nation. The twin giants have experienced exceptional growth “generated primarily by their special treatment by government.” The editorial further explains, “Freddie and Fannie enjoy an implicit guarantee from the government, meaning investors believe they are backed by the federal government, although this guarantee is not explicit. They are exempt from state and local taxes and some disclosure requirements placed on other publicly traded firms.” OFHEO reacted too slowly to the troubles at Freddie, with Freddie announcing January 22 it would be restating its earnings for the past three years, yet OFHEO not saying until June 4 that accounting irregularities and employee misconduct were discovered during a re-audit. “Given the companies’ quasi-public status, the administration is right in calling for greater regulation. Seeing a company the size of Freddie Mac’s totter with financial malpractice is unnerving enough. When coupled with lax oversight, action is called for.” (Editorial, *The Washington Times*, 9/13/03)

Christian Science Monitor urges loosening apron strings of Fannie/Freddie

- The home-mortgage giants, Fannie and Freddie, leading the \$6.6 billion U.S. mortgage market, are overdue for more oversight, argues a *Christian Science Monitor* editorial. The editorial backs the Treasury Secretary’s recommendations for a “tough new regulatory agency within his department with muscle to oversee the two cousins,” and his request to Congress to eliminate all presidential appointees from the Fannie/Freddie boards, which would serve to “reduce their political clout on Capitol Hill and send a signal that these companies should serve their stockholders and customers exclusively.” Fannie and Freddie, the editorial concludes,

...have grown partly because they get special treatment – they enjoy a line of credit from the Treasury Department, and hence the government’s backing. That’s allowed them to buy up huge numbers of home loans from banks and bundle them into securities to sell on Wall Street. In fact, they have about \$1.6 trillion in mortgage-backed securities; critics say that exposes them to an undue amount of interest-rate risk. The pair’s current structure could force taxpayers to pick up the costs of a massive bailout, were they to fail. Fannie and Freddie have long since grown up. It’s high time for Congress to help loosen the apron strings. (*Christian Science Monitor* editorial, “Fan and Fred’s Apron Strings,” 9/18/03)

Citizens Against Government Waste sees missing ingredient in Fannie/Freddie reform legislation

- The Council for Citizens Against Government Waste (CCAGW), a nonpartisan/nonprofit consumer organization, decries the fact that Congress failed to include a

legally binding requirement that the two quasi-governmental corporations meet the accounting disclosure rules of the Securities and Exchange Commission. “Every other company in the country must make financial disclosures to the SEC and the GSEs should also be required to do so,” argued Leslie Paige, special projects director for CCAGW. Fannie and Freddie are the only publicly traded companies exempt from U.S. securities laws, with neither required to file earnings reports or other disclosures with the SEC.

- Mandatory SEC compliance, Paige said, would “provide another level of protection for the American taxpayer and is one more line of defense against a potential GSE bailout that would make the Savings and Loan bailout of the 1980s look like a picnic.”
- Freddie said on September 25<sup>th</sup> it would delay by two months the previously announced September 30<sup>th</sup> filing for earnings restatements and said earlier this year it would restate its earnings for 2000, 2001 and 2002 because of accounting irregularities that cause earnings to be understated by as much as \$4.5 billion. Paige said the delay in financial restatements will delay Freddie’s voluntary SEC filing until mid-2004. Paige said the GSE charters are “too broad and lack clear parameters” and that Congress needs to provide full immunization to the taxpayers from GSE liabilities by stripping the GSEs of their government perks, downsizing them, and setting them on a privatization path. (*Inman News*, 9/26/03)

*Barron’s* says tougher rules may reduce growth, hurt Fannie/Freddie shareholders

- Strengthening regulation of Fannie Mae and Freddie Mac would likely require them to set aside more capital, thereby reducing growth and hurting shareholders, according to a *Barron’s* report. *Barron’s*, citing Sonic Capital hedge fund’s Lawrence Kam and Mark Haefele, say Fannie stands to lose more from tighter controls because of the company’s more opaque accounting. Kam and Haefele estimate that Fannie has obscured losses on hedges and investments through its accounting, including a \$4 billion-\$5 billion loss from an interest-rate mismatch in July, although a Fannie spokeswoman denied the firm was hiding losses. *Barron’s* also cited Karen Petrou, managing partner at Federal Financial Analytics, predicting that if a new regulator treats Fannie and Freddie like banks, their minimum capital might double to 5 percent, cutting return on equity in half. The *Barron’s* report said Fannie shares could turn lower on a stream of negative stories as the regulation proposals draw more scrutiny, bringing the stocks from a level of nearly \$68 on September 12 down closer to a 52-week low of \$58.50. (*Reuters*, 9/14/03)

Should the GSEs’ line of credit at Treasury be cut?
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- Lawmakers are evading fundamental issues that strike at the heart of GSE-reform such as whether Fannie and Freddie ought to keep a line of credit at the Treasury Department. The goal of enacting legislation this year means avoiding controversial issues of Fannie and Freddie’s competitive advantages, which in addition to a \$2.25

billion credit line, include tax breaks. The GSEs' rivals argue that the credit line lowers Fannie and Freddie's borrowing costs, and is seen as the government's promise to stand behind the companies should they get into trouble, though the present and past administrations have said no such guaranty exists.

- Treasury Secretary Snow testified to Congress that the administration does not want to alter Fannie or Freddie's charter, meaning no change to the line of credit. During an emergency, Treasury may buy as much as \$2.25 billion of securities from Fannie or Freddie to give them liquidity. Snow's position contrasts with testimony from more than three years ago by then-Treasury Undersecretary for Domestic Finance, Gary Gensler, who supported closer oversight of the twin GSEs and repealing the credit line. The market reacted to Gensler's statement by pushing down the stock price of Fannie and Freddie and a rebuke of Gensler's comments by the companies and their allies.
- House Financial Services Committee chair Michael Oxley (R-OH) agreed with Snowe that a repeal of the credit line would be a tactical mistake: "Understanding that politics is the art of the possible, we want to try to make those changes as quickly and effortlessly as possible so that the markets are not roiled." Similarly, Rep. Richard Baker sought to eliminate the credit line three years ago, but not in his current bill. There is widespread agreement that severing the line of credit and risking a disruption to the strong housing sector, would have damaged the existing consensus with Fannie and industry groups on a GSE oversight bill. (Rob Blackwell, *American Banker*, 9/17/03)

OFHEO Nominee Mark Brickell denies Senate Democrat's conflict of interest claims; defends comments on derivatives
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- Mark Brickell, nominated in February to head OFHEO, wrote the Senate Banking Committee to respond to Senator Jack Reed's (D-RI) questioning of the decision of Mr. Brickell and his wife not to sell her shares and options in Citigroup valued at more than \$1 million. Reed had asked the OFHEO nominee, "Why have you chosen to allow a situation to arise that many view as tantamount to the appearance of a conflict of interest?" Brickell responded, as part of a 16-page response to lawmakers' queries released by the Banking Committee on September 15, that the Office of Government Ethics had reviewed his financial holdings and concluded they "meet or exceed the requirements of applicable laws." (Rob Blackwell, *The American Banker*, 9/16/03)
- Brickell also has defended his view that financial derivatives are no worse than other financial trading activities. Brickell was the banking industry's leading advocate in the 1990s to fight regulation of derivatives, financial contracts companies use to guard against losses from sudden market losses. They also can be used to speculate on market movements. Senator Jon Corzine (D-NJ) posed detailed questions to Brickell challenging his past deregulatory positions on derivatives. Corzine cited

concentration of derivatives exposure in a handful of U.S. banks, saying this could lead to major risks to the financial system. Corzine questioned, in light of concentration of derivatives dealers, whether Brickell still stands by his past statements, citing 1993 congressional testimony by the OFHEO nominee: “It was hard to find justification for the view that derivatives pose a greater systemic threat than other financial activities.”

- Brickell replied: “Events and comments of the past 10 years tend to validate the judgment that the risks of derivatives are similar to the risks of other, related financial and trading activities,” adding that derivatives “should be managed with similar care.” Brickell explained that derivatives make it easier for companies to manage “risks with greater precision,” by transferring those risks to others, therefore strengthening the position of individual firms, and in the process, strengthening the financial system and the economy.” (Rob Wells, *Dow Jones Newswires*, 9/16/03)

FM Policy Focus faults the GSEs on underserving 1st-time homebuyers; overserving shareholders
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- In a report released September 24<sup>th</sup>, FM Policy Focus (FMPF), a watchdog organization and critic of the two mortgage giants, faults the GSEs for underserving the first-time homebuyers market. Analyzing their reports filed with HUD, a 2001 CBO study and Fannie and Freddie’s own housing activities reports, FMPF says that as part of their overall home loan purchases between 1996 and 2002, the two bought a “declining percentage of loans made to first-time homebuyers.” FMPF also says the two GSEs together buy less than 10% of home mortgages made by private lenders to first-time African-American and Hispanic homebuyers.
- The report makes the case that “the GSEs’ weak affordable housing performance is troubling considering the \$10.6 billion taxpayer subsidy they receive. The majority of the subsidy goes to GSE shareholders and to the purchase of second mortgages; of the 30% that actually supports home purchase loans, only 8% supports first-time homebuyers.” According to their own and government data, the GSEs:
  - Support three times as many repeat homebuyers as first-time homebuyers
  - As part of their overall home loan purchases purchased a declining percentage of loans made to first-time homebuyers
  - Together buy less than 10% of loans made by private lenders to first-time African American and Hispanic homebuyers; and
  - Bought more loans made to absentee landlords, vacation homes, and second mortgages than first-time homebuyers loans.
- A Fannie spokeswoman countered the charge, saying FMPF “has no credibility on this issue.” She said some of the group’s members have been fined for predatory lending practices, and pointed out that: “We’re the number one provider of mortgage financing through our lenders. Our numbers increased significantly in 2002.” FMPF

supporters include American International Group, G.E. Mortgage Insurance, Household International, and Wells Fargo, among others. In a speech the day before the FMPF report was released, Fannie chairman Franklin Raines labeled FMPF's backers his competitors. (*National Mortgage News*, 9/25/03 and FM Policy Focus, "Closing Doors to the American Dream – II, Fannie Mae and Freddie Mac Still Failing First-Time Homebuyers," 9/03)

Wally Bock predicts mortgage industry headed for disaster
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- Author, speaker and consultant Wally Bock warns that amidst the good news of Americans buying 6.4 million homes last year, refinancing 10 million mortgages, there is "rumbling that signals danger." Bock's rumbles include data from the first quarter of 2003, with the percentage of mortgages in foreclosure climbing to a record level, and foreclosure rates, as expected, among folks with lower incomes and lower credit ratings. Another rumble is Harvard University's Joint Center for Housing Studies finding that 1 in 7 U.S. households devotes more than half of its income to housing. Stories, he warns, are surfacing about unscrupulous appraisers jacking up appraisals leaving borrowers vulnerable if the market slows and prices drop. The Mortgage Asset Research Institute says that 21% of the fraud cases it tracked in 2000 involved appraisal fraud, four times the rate of 5 years ago.
- Another rumble for Bock is Freddie Mac's Board firing its Chief Operating Officer for not cooperating with an internal investigation into corporate accounting, and the retiring of its CEO and resignation of its Chief Financial Officer. He points out that Freddie and Fannie receive federal subsidies worth \$10 billion and can borrow money cheaply because people think the federal government will cover any losses, "But the federal government has no, repeat no, obligation to do that." Bock sees the process since the creation of Fannie and Freddie as one where no one is responsible for the entire process of the mortgage except the homeowner, with Fannie and Freddie originating the mortgage loan and servicing it, but not carrying it on their books as banks would have in the past. Bock parallels the recession of the 1890s with specialized mortgage banks disappearing and the Roaring Twenties, when mortgage banks started selling bonds to generate loans to fund the construction boom of the time, to current times.
- The Great Depression, he reminds, destroyed this whole industry and the government had to intervene -- and it can happen again. Good loans, he says are "based on character and capacity and collateral," not on computer programs and slick dealing. "Maybe that sound you hear isn't rumbling," says Bock, "Maybe it's the roaring sound of flapping wings as the chickens come home to roost." (*Broadcast Interview Source, Inc., The Yearbook of Experts, Authorities and Spokespersons*, 9/14/03)

## Profiles of Presidentially-Appointed Fannie/Freddie directors

- In light of the Administration's proposals for tighter regulation of Fannie and Freddie, including abolition of the presidential appointments to their boards, the *AP* has provided information on GSE directors, some appointed by former President Clinton and some by President Bush:

Both companies have five presidentially appointed directors on their 18-member boards.

### **President Clinton appointees:**

#### **Fannie Mae:**

- Former White House counsel Jack Quinn, who represented Clinton in the Whitewater proceedings and other legal matters.
- Garry Mauro, who unsuccessfully ran against Bush for the Texas governorship in 1998;

#### **Freddie Mac:**

- Former Senator Dennis DeConcini (D-AZ), now a lobbyist.
- Former White House aide Harold Ickles, now a lobbyist/political consultant.
- Former White House aide Rahm Emanuel, now a U.S. House member from Illinois. Because of his connection to the firm, Emanuel – a member of the House Financial Services Committee – has abstained from participating in panel hearings related to the two GSEs.

### **President Bush appointees:**

#### **Fannie Mae:**

- Knoxville, TN Mayor Victor Ashe, a Yale classmate of the President's;
- Molly Bordonaro, a former congressional candidate from Oregon active in Bush's 2000 presidential campaign

#### **Freddie Mac:**

- David J. Gribbin, III, a former aide to Vice President Cheney, now a lobbyist;
- Michelle Engler, wife of former Michigan Governor John Engler;
- William Powers, former head of the state Republican committee in New York, now a lobbyist. (*Associated Press Online*, 9/10/03)

## **Fannie Mae**

### Fannie investment portfolio grows 47 percent, duration gap shrinks to +4 months

- Fannie Mae's duration gap shrank to +4 months in August from +6 months in July, consistent with the company's aim to keep its duration gap between negative 6 months and positive six months. Fannie's duration gap was minus one month in June.
- Fannie said its mortgage investment portfolio leaped 46.4 percent (annualized rate) in August, the greatest increase December, as low rates earlier in the year generated high refinancing and a large volume of mortgages to buy. Fannie's portfolio of home loans rose 14% this year through August, up from 10% growth in July. The portfolio grew \$27.1 billion to \$863.2 billion in August as new loans made at record-low interest rates settled. Fannie bought a record \$82.7 billion of mortgages and mortgage securities for its portfolio in August.
- The portfolio, which accounts for two-thirds of the company's profit, grew at a brisk pace despite heavy prepayments that contributed to a decline in the number of its outstanding mortgage-securities held by others. The value of the mortgage-backed bonds issued by the GSE and bought by other investors fell at a 19% annual rate, despite \$109.7 billion of new issuance. The decline was the first since October 2000. Fannie's stock appreciated after this announcement, and closed at \$68.05, up 6 cents or 0.09 percent even as the S&P 500 index fell slightly. The company said it expected fast portfolio growth, a key driver of earnings growth, to continue for the next few months.
- The company's exposure to interest-rate risks also fell in August. The company over the last several months has agreed to buy another \$101.3 billion in mortgage loans in coming months, fueling future portfolio growth. (*Reuters*, 9/15/03 and Rob Blackwell, *The American Banker*, 9/16/03; *Market News International*, 9/16/03 and *The Washington Post* Financial Section, 9/16/03)

### Fannie OK'd to buy ADC Loans

- Fannie has won regulatory permission to purchase acquisition, development and construction loans (ADC) on a "permanent" basis, a move that could create a robust secondary market and help local builders. The change allows Fannie, and eventually Freddie Mac, to enter the \$200 billion a year market for ADC loans. Over the past dozen years, Fannie, with support from the National Association of Home Builders (NAHB), has been conducting an ADC pilot project under the scrutiny of its mission regulator, HUD. To date, Fannie has purchased 50% participations in 75 ADC loans, totaling \$180 million. Over 80% of the units financed by Fannie's ADC program are either in under-served, low-and-moderate-income and/or minority census tracts. With HUD's final approval, Fannie projects it will become a \$400 million a year business

that advances its affordable housing goals and provides liquidity for lenders. NAHB President Kent Conine believes it is the “first giant step” towards creating a national secondary market for ADC loans that will help small and medium-sized residential builders.

- Fannie’s critics see approval as permitting the GSE to expand into a market that is dominated by large banks. The ADC program, however, may not fit into the critics’ definition of GSE “mission creep” because it is referenced in a House Banking Committee report on the 1992 law that established the current regulatory system for Fannie and Freddie. The Committee report directed Fannie to seek approval from HUD if it wanted to continue the ADC pilot program, which HUD has now approved on a permanent basis. The NAHB pushed for the pilot in 1990 when banks and thrifts were failing and builders were losing access to credit. Absent a credit crunch today, lenders have problems instead because of loan-to-one borrower limits and because banks generally have a limited risk appetite for making ADC loans. NAHB President Conine explains, “We fixed the permanent loan market 20 years ago, now it is time to fix the ADC market.” (*Mortgage Wire*, 9/16/03 and *National Mortgage News*, 9/15/03)

Fannie’s CFO Howard gives oversight bill 50% chance of passage

Fannie CEO Raines calls on trade groups to lobby against some GSE legislative changes

- Tim Howard, Chief Financial Officer at Fannie Mae, said Capitol Hill efforts to shift oversight of the GSEs to Treasury has a 50% chance of passing in the current Congressional session. He admitted to a “very high probability” that our existing regulatory structure will be changed, and the most likely course is for a regulator to exist within Treasury.” He also acknowledged a “consensus around the important points.” Howard said, “The Treasury did not propose any changes to Fannie Mae’s mission, status or charter, and that’s a big positive... This is not about Fannie Mae. It’s about the regulator.” (*Bloomberg News*, 9/17/03)

#### Raines calls on trade groups to lobby against some GSE legislative changes

- Fannie CEO Franklin Raines in a speech before the National Association of Federal Credit Unions appealed to the trade group to help Fannie lobby against any legislative changes that would “stifle” his company and make it more “cumbersome” to introduce new products. Raines said Fannie opposes “any move to raise capital if our risk is low” but said he favors empowering any new regulator to set and adjust risk-based capital requirements. Raines said the “Coalition for Higher Mortgage Costs (Fannie’s nickname for FM Policy Focus) is lobbying elected officials for legislation to require Fannie to seek approval for “any new activity or process.” FM Policy Focus has complained about Fannie’s “mission creep.” (*National Mortgage News*, 9/23/03)

### Fannie allows N.A.D.A. Appraisal Guides for manufactured home appraisals

- Fannie Mae approved N.A.D.A. Appraisal Guides, the world's biggest publisher of value guides and information, as an estimate guide that housing appraisers may use for completing a manufactured home appraisal. Appraisers previously were allowed to use only one other competitive estimate guide per Fannie guidelines for manufactured housing. With this announcement, N.A.D.A. becomes one of only two Fannie-approved cost approaches for manufactured housing appraisals. N.A.D.A. announced its pleasure at joining a "very elite and very exclusive manufactured housing estimate guide club," and said it offers products that "contain more features and more options than competitive products."
- Specifically, the newcomer offers a modified summation approach – or cost approach – to manufactured housing appraisals. Its products are manufacturer and trade name specific, features never before offered. Additionally, with the competitor's products, appraisers had to match manufactured homes cost and accompanying features with pictures or sketches of six grade qualities to determine cost, an often tedious, complex process. N.A.D.A. eliminates the need for appraisers to make those determinations – ultimately removing the guesswork out of the cost approach for manufactured housing structures. (*PR Newswire*, 9/16/03)

### Fannie won't tolerate "front running"

- Fannie's Tim Howard, chief financial officer, said Fannie can refrain from hedging when it thinks market players are trying to profit by anticipating its trades. Howard warned during a speech to an investor conference in San Francisco: "If we sense that we have...hedge funds or even the dealer community saying 'I'm going to buy the hedges, mark them up, and sell them to Fannie Mae,' our consistent message has been: 'We hope you like what you bought, because you're going to own it for awhile.'"
- Fannie manages interest rate risk by placing trades that would offset losses under various market conditions. It employed the practice extensively over the past few months as bond yields rose dramatically. Howard said, "We think we can maintain (portfolio duration) rebalancing discipline in spite of the fact that there has been a tendency of people to try to anticipate what we do." Fannie needs to adjust the average life of its assets and liabilities as interest-rates shift and consumers grow more or less likely to refinance their mortgages. It can do so by trading mortgage securities, Treasuries, swaps, or other means. (*Reuters*, 9/17/03)

Rep. Barney Frank pressures Fannie to ease up on manufactured housing loan restrictions

Editorials slam Fannie for changes in manufactured housing

Rep. Barney Frank pressures Fannie to ease up on manufactured housing loan restrictions

- Congressman Barney Frank (D-MA), ranking Democrat on the House Financial Services Committee, is pressuring Fannie Mae to loosen newly implemented underwriting restrictions on manufactured housing loans. Rep. Frank, along with members of the Congressional Black Caucus, and the so-called Blue Dog Democrats, who are politically moderate to conservative, are asking to meet with Housing Secretary Martinez to discuss Fannie's action along with other "adverse developments" hitting the manufactured housing sector. The Black Caucus and the Blue Dogs join me in saying, "Look you can't do this to manufactured housing," Congressman Frank told reporters. Frank emphasized that manufactured housing is an important source of housing for low to moderate income citizens, noting that he is in discussions with Fannie officials: "I think we can come to some agreement," he said. (*National Mortgage News*, 9/25/03)

Editorials slam Fannie for changes in manufactured housing

- A series of editorials such as the *Omaha World Herald's* "Discrediting the American dream," fault Fannie Mae for "bizarre rules that steepen the challenge for buying manufactured homes." The newspaper regards the homes as a low-cost, popular option for buyers, especially in rural areas, with an average price of \$49,000, well below the comparable price of a traditional, single family home at \$164,000. Fannie combats the problem, stemming from rising delinquencies and foreclosures, by requiring a 10% down payment for 30-year mortgages on manufactured homes, plus a fee of 0.5% of the loan amount (previously, no fee and no more than 3% down was required). Fannie targets the product, rather than bad lending rules, which are the problem. The requirement, it argues, should be rescinded in favor of better credit checks.
- In a similar vein, *The State* in Columbia, S.C., points out that in the late '90s, loans were extended to buyers with poor credit histories and not enough income to pay their mortgages. Fannie's changes, it warns, could price out some would-be homeowners out of the market, particularly in a state where mobile homes are more common than any other. *The Orlando Sentinel* offered more criticism, with a sales manager of a mobile home business saying the new changes are discriminatory because regular conventional houses are not under the same restrictions. In Florida, manufactured homes account for one of every five new home sales. The tough new financing standards, the paper conjectures, will price out one eighth of would-be buyers. (*Omaha World-Herald*, 9/15/03 and *The State*, 9/12/03, and *The Orlando Sentinel*, 9/12/03)

Edward Jones brokerage firm changes “model portfolio,” deletes Fannie

- Edward Jones believes Fannie has grown so large it could face a harder time growing earnings in the future while facing the prospect of increased regulatory oversight. The brokerage firm has modified its “model portfolio” and deleted Fannie Mae. (*National Mortgage News*, 9/22/03)

## **Freddie Mac**

Freddie declares total mortgage portfolio rose at annual rate of 20.6% in August

- Freddie Mac announced on September 24 that its total mortgage portfolio was lifted to \$1.31 trillion, rising at an annual rate of 20.6% in August, as low interest rates generate massive lending activity. The August growth in Freddie’s mortgage portfolio is attributed to heightened buying of mortgage debt from banks. August’s growth is the fastest so far in 2003 and augurs well for the second-largest U.S. mortgage finance company’s earnings, analysts agree. Bill Van Arnum, analyst at Principal Global Investors in Des Moines, Iowa, said the news was “obviously a positive. One of the keys to this company’s growth is growing its retained portfolio.” The housing giant also said its retained or investment portfolio increased at an annualized rate of 41.9% in August, the largest such increase of the year, following July’s growth rate of 18.1%. Freddie’s retained commitments fell to \$23.5 billion from July’s \$44 billion. (Aleksandrs Rozens, *Reuters*, 9/25/03)

House Energy and Commerce Subcommittee on Commerce, Trade and Consumer Protection probes Freddie’s Accounting Scandal

- The House Energy and Commerce Subcommittee on Commerce, Trade and Consumer Protection included the following witnesses for the September 25<sup>th</sup> hearing:
  - James R. Doty, Partner in Charge, Baker Botts LLP;
  - James W. Barratt, Senior Managing Director, Forensic and Litigation Advisory, FTI Consulting;
  - Baruch Lev, Philip Bardes Professor of Accounting and Finance, Stern School of Business, New York University
- Rep. Cliff Stearns (R-FL), chairman of the Subcommittee, said at the onset of the hearing that Congress is not the body to set accounting standards. After listening to the testimony, he said whether “these large brokerage houses are participating in something that they knowingly realize is sheer manipulation has to be answered by the Justice Department or a congressional oversight committee.”

- James Doty, a Baker/Botts attorney who investigated the understated past earnings matter for Freddie’s board of directors said that investment banks Salomon Smith Barney and Morgan Stanley were Freddie’s counterparties in some of the complex deals that were improperly booked. Doty’s report absolves the Freddie board from responsibility for the accounting errors, although Doty said his report should not be read as a vindication of Freddie Mac. Doty said Freddie’s management was unresponsive to the board’s growing insistence roughly two years ago to clean up the company’s accounting and bring in better accounting talent.
- Witness Baruch Lev, professor of accounting and finance at New York University’s Stern School of Business, described “a climate of manipulation and intrigue which must have permeated Freddie Mac.” Professor Lev said such earnings manipulation, which he condemned as “a very sinister thing,” was widespread. Lev, in contrast to Doty, who opened his statement with an aside about distinguishing between “crimes” and “blunders,” testified he disbelieved such “elaborate schemes over an extended period of time were benign.” Lev explained that accounting principles have mushroomed to tens of thousands of pages of extremely detailed instructions and has become hopeless, with the Financial Accounting Standards Board releasing new instructions which smart bankers, lawyers and accountants take about 10 minutes to transact around.
- Rep. Diana DeGette (D-CO) noted that investigations into other corporate scandals such as Enron Corp revealed companies using accounting rules – the generally accepted accounting principles (GAAP) – “as a kind of mantle to shield their actions.”
- During the last four fiscal quarters, Lev testified, 40 percent of the S&P 500 companies have exactly met analysts’ forecasts or have beaten them by a penny: “To meet by a penny an outside target without manipulation is an impossibility.” Lev explained, “companies that understate profits typically do so because they know they will need the deferred profits in the future.” (David Hilzenrath and Kathleen Day, *The Washington Post*, 9/26/03, Rob Wells, *Dow Jones Newswires*, 9/25/03; and Todd Davenport, *The American Banker*, 9/26/03)

<p>Freddie alters low downpayment products, some concerned it will follow Fannie’s lead on manufactured housing</p>
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- In response to rising delinquencies and foreclosures, Fannie in June made it tougher to get manufactured home loans. Critics say the changes could price some would-be homeowners, especially low-income families, out of the market and hurts manufactured homes dealers, already hit by a surplus of recently built, repossessed, manufactured homes. (*GSE Report*, 9/15/03: Genaro C. Armas, *Associated Press*, 9/12/03)

- Freddie denied it planned to change its rules on manufactured housing in the wake of Fannie’s modifications, although industry observers suspect such changes may be under consideration by the housing giant.
- Freddie recently announced enhancements to its low downpayment product, with changes taking effect October 6th: Freddie’s 3% downpayment Alt97, Affordable Gold 97 and Affordable Gold Alt 97 mortgages, as well as its 100% loan-to-value Freddie Mac 100 mortgage, can be used for no cash-out refinances and are eligible for delivery to the GSE beginning October 6<sup>th</sup>. In addition, Alt 97, Affordable Gold 97 and Freddie Mac 100 no cash-out refinance mortgages also can be evaluated through the company’s Loan Prospector automated underwriting service beginning September 7, and are eligible for delivery to Freddie on or after October 6<sup>th</sup>. Freddie added new securities execution choices for sellers, regardless of their size or sale volume, through addition of Guarantor and MultiLender Swap executions options for the Freddie Mac 100 mortgage, eligible for deliveries beginning October 6<sup>th</sup>. The GSE said it would reduce the required level of mortgage insurance coverage from 40-35% for all Freddie Mac 100 mortgages, beginning October 1<sup>st</sup>. (Rick Grant, *National Mortgage News*, 9/15/03)

## **Federal Home Loan Banks**

FHLBank’s board votes to register bank stock with SEC
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Atlanta Fed study says FHLBs can compete with Fannie and Freddie
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- The Federal Home Loan Bank’s Board of Directors voted to register the FHLBank’s stock with the Securities and Exchange Commission under the voluntary registration provisions of the 1934 Securities Exchange Act. The Bush Administration has been strongly urging the FHLBs to register a class of their securities voluntarily with the SEC, but the plan has not been warmly embraced by the FHLB community, although resistance is fading in the face of inevitability. As Alfred DelliBovi, president and chief executive officer of the New York FHLB, noted, “The winds have changed; they’re blowing from Washington.”
- DelliBovi was optimistic that officials at the New York FHLB will make a “best effort” to register with the SEC in 2004 and said the debate over registration has been protracted and “it’s time to put it behind us.” The Topeka FHLB’s board made the same decision, approving on September 19th a pro-SEC registration resolution. Earlier this month, the Federal Housing Finance Board, the independent federal agency regulating the FHLBank system, approved a proposed rule requiring each of the FHLBs to register a class of its securities with the SEC under the 1934 Act. The proposed regulation has a 120-day comment period. Before the Finance Board acted, the Atlanta FHLB’s board adopted a resolution saying if registration was inevitable, “the Bank should suggest that a regulation mandating such registration could help

alleviate concerns regarding potential liability associated with voluntary registration.”  
(John Connor, *Dow Jones Newswires*, 9/23/03)

#### Atlanta Fed study says FHLBs can compete with Fannie and Freddie

- The Atlanta Fed study, “Federal Home Loan Bank Mortgage Purchases: Implications for Mortgage Markets,” maintains the FHLB programs have the ability to compete with Fannie and Freddie in the secondary mortgage market, yet acknowledges, “it is unclear whether they can become significant competitors to Fannie Mae and Freddie Mac because their continued growth will require the FHLBs to restructure their balance sheets by either selling more equity stock to members or selling assets.”
- The study, by economist Scott Frame of the Federal Reserve Bank of Atlanta, said that if competition reduces Fannie and Freddie’s profits, the firms “will be faced with either accepting the lower expected returns or taking more risk.” Any such risk-taking, according to the study, “might manifest itself through the selection of riskier investments, less effective hedging, holding less capital, or entering new markets,” and regulators should be cognizant of increased competition on risk-taking incentives for Fannie and Freddie.
- Analysts at Fox-Pitt Kelton said in another study, “GSE Competition – It’s Getting Tougher” that competition from the FHLB banks could potentially intensify, and result in a slowing of market share gains, revenue and earnings growth for Fannie Mae and Freddie Mac in the intermediate to longer term (two-plus years). Refinements in the FHLBs mortgage purchase programs have moved those programs closer to being on par with Fannie and Freddie: “This, along with the projected reduction in overall mortgage volume (as lenders will have more time available to explore alternatives), may enable further market share gains for the FHLBanks in the years ahead.” (*Dow Jones Newswires*, 9/19/03)

Treasury official finds no problems with “shared funding”
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- The Treasury Department has no qualms about the FHLBanks purchasing mortgages from their members, despite complaints from some critics that the banks are taking on more risk than they can manage. Treasury Assistant Secretary Wayne Abernathy told the Senate Banking Financial Institutions Subcommittee that the quality of the mortgages that the FHLBanks are purchasing in connection with their Mortgage Purchase Program and the Mortgage Partnership Finance program are comparable to the collateral the FHLBanks accept for advances.
- While Abernathy had no problems with “shared funding” transactions in which FHLBank members securitize mortgages and sell the highly rated securities to a FHLBank, he cautioned that Treasury would have a problem if the FHLBanks sold the securities to parties outside of the FHLBank system.

- Four months ago, Treasury initiated a review of the FHLBank system to look at the way banks have implemented the capital requirements and other changes mandated by the Gramm-Leach-Bliley Act of 1999, as well as the MPP and MPF secondary market programs. Mr. Abernathy said the first phase of the review is almost complete: “The initial step in the second phase will be to discuss specific topics with the Finance Board.”
- FHFBoard chair John Korsmo told the subcommittee members that the FHLBanks are not permitted to issue guaranteed mortgage-backed securities and that he has no plans to change that. He added, no further action is planned with respect to multidistrict membership. Korsmo emphasized that he supports the Bush Administration’s efforts to get the FHLBanks to register their stock with the SEC. (*National Mortgage News*, 9/15/03)

FHLBanks adopt oversight resolutions
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- As many as six FHLBanks have adopted resolutions or statements of principle that might guide their acceptance of legislation placing the FHLBank system under Treasury oversight. However, these resolutions insist the new regulator, which may also oversee Fannie Mae and Freddie Mac, be independent of Treasury control and recognize unique features of the FHLBank system. The Pittsburgh FHLBank’s statement of principles said, “Neither the Treasury Department (nor the independent GSE regulator unit) should have the ability to impede or limit the FHLBanks’ access to the capital markets (other than the current ‘traffic cop’ role served by Treasury).” Four banks reportedly oppose giving up the Federal Housing Finance Board as their regulator and two others are staying neutral in the debate. (*National Mortgage News*, 9/23/03)

FHFBoard Chair Korsmo questioned by Congress on problems with NY, Pittsburgh FHLBs
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- In Congressional testimony before the House Financial Services Committee, Korsmo was pressed about recent problems with the FHLBanks of New York and Pittsburgh, which according to the *Wall Street Journal*, have opened a “new front in the battle over how to regulate the \$6 trillion U.S. mortgage-finance market.”
- The banks began to muscle in on Fannie and Freddie’s business between 1996 and 2002, when the FHLBanks’ assets swelled 161%, with net income growing during those years 35% to \$1.8 billion. The banks used their government advantage, like the twin housing GSEs, to accumulate a big portfolio of home loans, increasing the banks’ exposure to interest rate shifts. While the amount of mortgage loans held by the home-loan banks is small measured with Fannie and Freddie, such fast growth in its portfolio represents unnecessary risk, driven by bank profits from the recent housing boom, and leaving the banks highly leveraged.
- On June 30<sup>th</sup>, the Pittsburgh Federal Home Loan Bank held \$9.8 billion in MPF assets, a sharp increase of 276% in one year. The drop in earnings by the Pittsburgh

FHLB in the second quarter to just \$2.4 million was explained by bank President James Roy as reflecting “accelerated premium amortization in the mortgage portfolio resulting from unprecedented refinancings in the low interest rate environment.” The drop precipitated concerns about the “mortgage partnership finance” program, as well as reports that the Chicago bank has had a tough time hedging MPF assets. Terri McKay, spokesperson for the Pittsburgh FHLBank, said the bank’s troubles don’t suggest a need for more regulation and blamed the bank’s problem on an unprecedented surge of refinance activity caused by falling interest rates.

- The Federal Home Loan Bank of New York announced September 24<sup>th</sup> that it had to cancel its third quarter dividend payment to compensate for \$183 million in losses from bonds backed by troubled manufactured housing loans.
- Representative Leach, former Republican chair of the House Financial Services Committee, compared the banks’ asset growth to the S&L scandal: “There’s been an exponential growth in assets at these banks, this exponential growth has some analogies to the savings and loan issue of the 1970s.” Leach added, “The case for putting you all under Treasury is just profound...I am very concerned with the supervision of these banks.” Congressman Ed Royce (R-CA) said he thinks the home-loan banks’ current regulator, the obscure and thinly-staffed Federal Housing Finance Board, “failed to protect against systemic risk” in the current rash of surprises. Peter Fisher, departing Undersecretary at Treasury, has been reported to say he “loses more sleep” over the FHLBanks than over Freddie Mac and Fannie Mae.
- Korsmo admitted, “The deterioration of the credit quality of asset backed securities is a concern.” He said the agency has been monitoring both problems and has issued an advisory to review the banks’ policies on retained earnings “with a view to increasing retained earnings in the system.” Korsmo said the board, an independent agency who’s (sic) sole responsibility is to oversee the home-loan banks, was inadequately focused on safety and soundness prior to his arrival in 2001.
- The FHFBoard chair defended he and his colleagues efforts, saying they have “undertaken a disciplined, continuing, and I believe, successful effort to improve the agency’s supervision and regulation of the Federal Home Loan Banks,” citing numerous initiatives, including increasing the amount of FHLBoard’s examiners. The FHLBank System is an active issuer of global dollar-denominated agency debt, which is rated triple-A by S&P. As of August 31<sup>st</sup>, the system had some \$716 billion in debt outstanding and \$890 billion in assets, compared with Freddie Mac’s \$764 billion in debt outstanding, versus Fannie Mae’s \$892 billion.
- Treasury Secretary Snow wants to consolidate the Finance Board, currently independent, with Fannie and Freddie’s federal regulator under Treasury’s auspices, but the 12 banks are split on whether they should consolidate regulation with the two housing GSEs. Fannie Chairman, Franklin Raines told reporters after the hearing that he doesn’t think Congress should consolidate oversight at this time: “We don’t think

the issue is ready to be dealt with because we don't think anyone's really thought through all the issues involved in it... We don't think it's as simple as creating a sub office and saying bring the whole thing over the way it is." (Paul Muolo, *National Mortgage News*, 9/20-21/03 and Dawn Kopecki, *Dow Jones International News*, 9/25/03 and Patrick Barta, Jathon Sapsford, and John D. McKinnon, *The Wall Street Journal*, 9/26/03)

#### Rep. Baker balks at adding FHLBanks to GSE bill

- A key advocate of legislation to overhaul regulation of GSEs is dragging his feet on including the FHLBanks regulator into the bill, despite recent high-profile problems at two FHLB institutions. A Home Loan bank official acknowledged the New York and Pittsburgh disclosures come at an inopportune time, and that lawmakers will seize upon the announcement as "ammunition" in their quest to move oversight for all the GSEs to a single regulator.
- Representative Richard Baker (R-LA), chair of the House Financial Services subcommittee with GSE jurisdiction, claims, "No consensus is developing" on the issue. The Louisiana Congressman said a larger sticking point over whether to move the Home Loan Banks into the new regulator is that "it seems the two camps within the [Home Loan Bank] system are becoming more entrenched in their views, with some desperately thinking this is the right time to do it and others thinking it will never be the right time to do it."
- Baker said he supports the move, but would not push for it, adding "I will leave it to the committee consensus to come to a determination." He committed to supporting an amendment to add the Home Loan Banks to the bill, if it were offered. The committee is expected to vote on the bill as early as next week. The two bank heads who testified at the September 25<sup>th</sup> hearing in House Financial Services Committee took different sides on the issue, with Dean Schultz, President of FHLBank of San Francisco, endorsing the move into the new regulatory unit, and the Cincinnati FHLBank President, David Hehman, arguing, "there is no problem in need of a solution." (Michele Heller, *American Banker*, 9/26/03)

### **Farm Credit**

#### Farm Credit Administration (FCA) Board approves agency's Fall 2003 agenda

- The Farm Credit Administration (FCA) Board on September 11<sup>th</sup> approved the agency's Fall 2003 Unified Agenda of Federal Regulations and Deregulatory Actions and the Regulatory Performance Plan for Fiscal Year 2004. The Board approved the agency's FY04 revised budget of \$42,338,400, including an assessment of FCS institutions of \$38.4 million, and the FY05 proposed budget of \$44,003,089.

- FCA granted final approval, effective 1/1/04 for a merger of two agricultural credit associations with subsidiaries. AgSouth Farm Credit, ACA, and its PCA and FLCA subsidiaries, headquartered in Statesboro, Georgia, will merge into Palmetto Farm Credit, ACA and its PCA and FLCA subsidiaries, headquartered in Orangeburg, South Carolina, which will be the continuing associations and renamed AgSouth Farm Credit, ACA, with subsidiaries AgSouth Farm Credit, PCA and AgSouth Farm Credit, FLCA. The merged associations' headquarters will be in Statesboro, Georgia.
- A decision was made to publish notice and request for public comment in *The Federal Register* on a proposal by a FCS institution to offer farm management and agricultural trust services as related services. The related services request was published with a 60-day comment period.
- A determination was made that AgStar Financial Services, ACA's issuance of class H preferred stock qualifies as permanent capital and total surplus. The FCA Board imposed several conditions that have been applied to other preferred stock proposals. The proposed disclosure to prospective purchasers also was cleared. (*Farm Credit Administration News Release, 9/11/03*)

FCA's Director of Examinations writes Board of Directors on stock issuance programs; raises specter of additional conflict of interest provisions directed to stock issuances

- Roland E. Smith, the Director of the Office of Examination for the Farm Credit Administration, advised the Chairman, Board of Directors and CEO of all Farm Credit Institutions on September 9<sup>th</sup>, that FCA recently experienced a marked increase in requests from Farm Credit System institutions to review their preferred stock issuance programs, reminding them of FCA's regulatory and supervisory responsibilities in this regard. Smith says in reviewing certain institution requests where preferred stock is offered to eligible borrowers, a number of policy and safety and soundness issues have arisen that warrant review of capital adequacy regulations. Smith says, "it is necessary to take appropriate action to ensure that each FCS institution's capital continues to be fundamentally composed of equities that are of high quality and that are likely to be a permanent feature of the institution's capital base. For this reason, the agency is evaluating the need to establish additional regulatory parameters and limits on certain types of preferred stock programs.
- Smith states that the agency is concerned that board and management may not treat all preferred stockholders equitably regarding stock retirement, or that insiders could become aware of financial difficulties of the FCS institutions and retire their stock before other shareholders. He reminds them the FCA's Standards of Conducts regulations apply to preferred stock issuances and prohibits employees from using their position or information to obtain a personal benefit, but warns: "Nevertheless, the agency is considering the need for additional conflict of interest provisions specifically directed to stock issuances." (September 9, 2003 Letter to Chairman, Board of Directors, Chief Executive Officer/All Farm Credit Institutions from Roland E. Smith)

## **Postal Service**

### Senators hear from Postal reform commission co-chair on vision for mail service

- James Johnson, co-chair of the commission appointed by President Bush to suggest means to overhaul the USPS, outlined his vision to the Senate Governmental Affairs Committee of a “dramatically streamlined” mail system with far fewer employees. He emphasized he would reduce the workforce through attrition, pointing out that 47% of postal employees will be eligible for retirement in the next seven years. Johnson revealed that although the commission recommended the postal service continue as a public entity, he believes “What guides us through all this activity is ‘best execution.’ If the best execution is a public execution, through postal employees who are in place today, then that is absolutely what should be done. If the best execution happens to be through a contracting mechanism...then we go that direction.”
- Senator Thomas Carper (D-DE) who introduced postal reform legislation in June, expressed concurrence with 90% of the commission’s recommendations, demurring from the report’s several recommendations regarding the postal labor force. Johnson said the postal service has more employees than are required, with 76% of the current postal budget spent on personnel.
- Senator Collins said the committee would continue its hearing this fall and next year, hoping to hear from the Postmaster General and the GAO in November. (Zach Patton, *National Journal*, 9/18/03)

### Postal Service may win exemption from e-filing security regulation

- The Homeland Security Department’s Customs and Border Protection Bureau (CBP) is weighing exempting USPS from meeting a new regulation to strengthen port security. In December, CBP plans to implement the electronic filing regulation requiring all air, sea, rail and truck carriers to file electronically cargo information before arrival or departure from the U.S. to try to prevent high-risk terrorist threats.
- The Postal Service “may or may not be included within the scope of the proposed rule,” according to the CBP’s economic analysis, which would exempt some 30 million letters and parcels the USPS ships to foreign destinations each year. CBP predicted USPS compliance would cost of \$4-6 per parcel, for a total annual impact of \$120-140 million.
- The Air Courier Conference of America (ACCA), representing an express-delivery service industry that competes directly with the Postal Service, objected to the exemption: “Since the stated purpose of this regulation is to enable CBP to identify

high-risk cargo and protect national security, ACCA believes that shipments carried by all entities should be covered under the regulation.”

- The agency conceded a competitive advantage it would give the Postal Service by waiving the requirement. Former Office of Management and Budget security official Bruce McConnell said the exemption poses a security risk: “You need uniform policy if you want a successful security system.” Center for Strategic and International Studies (CSIS) senior fellow Jim Lewis disagreed, “It’s not clear to me what the advantage would be to a terrorist to mail something out of the United States.” (Greta Wodele, *National Journal*, 9/12/03)

#### House of Representatives passes Postmaster Equity Act

- On September 16, the House enacted by a unanimous vote of 426-0, the Postmaster Equity Act. The Senate passed identical legislation that was subsequently signed by the President. NAPUS President Wally Olihovik praised the bill’s passage: “With remarkable bipartisan support, the Postmaster Equity Act has departed Capitol Hill and is arriving on the desk of our President.”
- The bill expresses the Sense of Congress, which is nonbinding, in amending Chapter 10 of Title 39, United States Code, to include postmasters and postmasters organizations in the process for developing and planning certain policies, schedules, and programs. It gives postmasters the same options afforded to postal supervisors when negotiating pay and benefits with the USPS. ([www.nonprofitmailers.org](http://www.nonprofitmailers.org) 9/16/03, and [www.postcom.org](http://www.postcom.org), 9/17/03)

#### Postal Service 2<sup>nd</sup> ranking official misspeaks on 10% rate increase for October ’04

- John Nolan, deputy Postmaster General recently announced that the USPS planned to request a postage rate increase of at least 10 percent, or about 4 cents, in October 2004. The rate increase would likely take effect in October 2005, Nolan informed attendees at the National Postal Forum in Kansas City, Mo.
- Nolan’s newsworthy comment turned out to be a false alarm and he subsequently apologized, promising that the USPS is committed to holding the current rates steady until calendar year 2006.
- An important factor influencing postal rates is whether the Postal Service can access billions of dollars because of reduced pension contributions. The Administration’s discovery last year that the USPS was on track to overpay the Civil Service Retirement System pension fund by \$78 billion led to Congress approving a measure in April to reduce the USPS’ annual payments into the fund (decreasing the USPS contribution by \$2.9 billion in FY03 and \$2.6 billion in subsequent years). The law also calls for Congress to hold the surplus in escrow after 2005, a provision that irks the Postal Service. The Postmaster General has written House Government Reform

chairman Tom Davis (R-VA) to complain that the escrow plan complicates the mail service's revenue and rate planning. Nolan warned in Kansas City that without legislative changes to correct shortcomings in the CSRS reform bill, the next rate hikes will be much larger than necessary. (*PostalWatch*, 9/24/03 and [www.nonprofitmailers.org](http://www.nonprofitmailers.org) 9/24/03)

PostCom President said postal reform possible when “anachronistic concepts” jettisoned

Heritage Foundation President laments, “we always can't count on the post office”

CATO scholars says pay for Iraq with privatization initiatives, inc. selling USPS

PostCom President said postal reform possible when “anachronistic concepts” jettisoned

- Gene Del Polito, President of PostCom, speaking before the American Enterprise Institute, said “any real postal reform is possible (sic) until we jettison the anachronistic concepts of ‘attributable’ and ‘institutional’ costs. Instead, the concepts such as ‘marginal,’ ‘incremental,’ and ‘stand-alone’ costs should be substituted as an economically more rational alternative.” (PostCom Association for Postal Commerce, 9/26/03)

Heritage Foundation President laments, “we always can't count on the post office”

- Edwin Feulner, President of The Heritage Foundation, writing in *Capitalism Magazine*, states, “If I tell you, ‘The check's in the mail’ you probably won't look for it anytime soon – if at all. But if I tell you I've sent the check via FedEx, you'll probably plan a trip to the bank. We know we can count on private services such as FedEx and United Parcel Service to deliver on time. If they didn't, they would go out of business. And we also know – many of us from bitter experience – that we always can't count on the post office. That's because the post office is a government-protected monopoly; 19<sup>th</sup> century laws make it illegal for anyone else to deliver letters. It's also exempt from state and federal taxes and free from most government regulations. That combination is a recipe for disaster.” ([www.postalwatch.org](http://www.postalwatch.org) 9/24/03)

CATO scholars says pay for Iraq with privatization initiatives, inc. selling USPS

- According to two scholars with the CATO Institute, “if the President wants to toss an extra \$87 billion at Iraq, he should think about cutting the \$90 billion devoted to corporate welfare...The work of many government employees can be privatized...The federal government should also sell its defective business operations, including the Postal Service, Amtrak and electric utilities.” CATO is holding a conference on the U.S. Postal Service on Thursday, October 2 from 8:45 a.m.-12:30 p.m. at its Massachusetts Avenue offices: “Conference on the Future of the U.S. Postal Service” featuring experts in the field and affected parties to examine the future of the USPS. (*PostCom Association for Postal Commerce*, 9/26/03 and *PostalWatch* 9/26/03)

Sen. Clinton seeks to ward off closures of Colonie and Fishkill processing centers

Rep. Candice Miller (R-MI) joins bipartisan panel on Postal Reform & Oversight Senator

Susan Collins (R-ME) protests USPS reducing rural services

Governor Gray Davis asked to sign direct mail disclosure law

Sen. Clinton seeks to ward off closures of Colonie and Fishkill processing centers

- Senator Hillary Rodham Clinton (D-NY) announced she has written the postmaster general of the USPS urging him not to close the processing centers in Colonie and Fishkill, in response to the USPS September 5<sup>th</sup> announcement that it would close three processing centers nationwide by March 2004. At the Colonie site, 492 part-time positions are being eliminated. Unlike the 83 career postal workers who may relocate to other jobs in the company, the part-time workers will not be offered jobs in the Postal Service. (*The Bulletin's Frontrunner* [from the *Albany Business Journal* 9/9/03], 9/10/03)

Rep. Candice Miller (R-MI) joins bipartisan panel on Postal Reform & Oversight

- Congresswoman Miller announced her membership on the postal reform special panel, saying, "the postal service is a \$900 billion industry, and whether you are an individual user or a catalogue like *Land's End* or *Time Magazine*, postal rates have a huge impact on our economy and our ability to communicate." The Republican rep cited the panel's task as finding a more cost-effective manner to maintain postal operations, saying, "we must not sacrifice its core elements such as six-day universal service...the functions and services that citizens and businesses rely on must not be compromised." The panel will focus on reforming the current postal service. (*PostCom Association for Postal Commerce*, 9/24/03)

Senator Susan Collins (R-ME) protests USPS reducing rural services

- With oversight of the Postal Service, Chairman Collins has demanded the Postmaster General explain cutbacks on rural post office hours in Maine, including closure of facilities during lunch hours and the scaling back of services. Collins claims 425 post offices have been affected, and another 99 have posted notices on upcoming cutbacks. She requested criteria used to determine daily operation hours for post offices and expected savings. ([www.nonprofitmailers.org](http://www.nonprofitmailers.org) 9/16/03)

Governor Gray Davis asked to sign direct mail disclosure law

- Faced with a whopping budget deficit and a recall election pending, California legislators passed several harsh privacy laws before ending their session, among them Sen. Kevin Murray's anti-spam bill and Liz Figueroa's direct mail disclosure bill. Governor Gray Davis is expected to sign these bills. The Direct Marketing Association has labeled the Figueroa legislation a "serious attack on direct and interactive marketing in a state that accounts for over \$60 billion in sales." ([www.nonprofitmailers.org](http://www.nonprofitmailers.org) 9/16/03)

Postal Service offers changes in rules governing fundraising appeals by nonprofits

- Nonprofit advocates are warning that the USPS' proposed changes to the cooperative mailing rule, which governs use of reduced postal rates for fundraising by nonprofits, could open the door to mail solicitations that could enrich commercial fundraisers operating under the guise of raising money for charity. The new exemption would lift the ban on use of preferred mailing rates by partnerships between nonprofits and for-profit businesses such as direct mailers. The ban was meant to ensure that only nonprofits benefited from cheaper postal rates, which can shave as much as a dime off each piece of mail.
- The USPS defends the change, saying it will benefit nonprofits that lack the size or expertise to mount successful fundraising campaigns, but nonprofit advocates claim the Postal Service is yielding to pressure from well-connected fundraising firms and hoping to increase mail volume since it has lost money every year since 1999. The Alliance of Nonprofit Mailers, Independent Sector and the Direct Marketing Association proposed that the rule include safeguards, specifically, the nonprofit and not the commercial partner, would control the mailing list, and the money generated would be deposited in a bank account under control of the nonprofit, but USPS rejected the alternative suggestion, arguing it should not be in the business of writing contracts between fundraisers and charities.
- A spokeswoman for the Independent Sector, an umbrella organization of more than 700 philanthropic organizations, said the change could radically increase the mail flow and undercut credibility of all nonprofit fundraising appeals. The USPS says its change is backed by five members of Congress, Senators Arlen Specter (R-PA), Rick Santorum (R-PA), Thomas Carper (D-DE) and Congressmen John McHugh (R-NY) and Tim Murphy (R-PA), as well as by the National Association of Retired Federal Employees.
- Senators Joseph Lieberman (D-CT) and Congressman Henry Waxman (D-CA), ranking Minority Members on the Senate and House Committee with postal jurisdiction, wrote Postmaster General Potter asking him to reconsider the Postal Service's proposed change to the cooperative mailing rule, opposing a rule that might "open the door again" to fundraising abuses, but holding the door open for "reasonable changes" in the rule.
- As an example, the letter to Potter highlighted the 1989 case of Little Orphans, Inc., "a charity that existed to provide food and shelter to homeless animals. An unscrupulous commercial fundraiser sent out a mailing for Little Orphans that raised well over \$100,000, but kept over 99% of the proceeds for itself. In the end, the charity received only \$589 from the solicitation to care for animals." (Christopher Lee, *The Washington Post*, 9/2/03 and [www.nonprofitmailers.org](http://www.nonprofitmailers.org) 9/16/03)

### Postal Service job cuts pass 25,000 mark

- The USPS has trimmed its gigantic work force, second only behind Wal-Mart Stores, by 3,700 jobs in the 4-week period ending August 8<sup>th</sup>, boosting the total number of jobs eliminated over the past year to more than 25,000. The Postal Service work force, at 762,077 as of August 8<sup>th</sup>, is at a nine-year low, without hurting service quality, according to regulatory filings. Worker productivity is inching up and the agency has budgeted \$1.69 billion next year for automation-related equipment, double this year's capital commitment of \$849 million.
- The agency's most recent financial report shows the USPS has eliminated about 1,400 of 164,882 routes in cities nationwide in the past year, assigning those to other carriers.
- These cuts come despite 1.8 million addresses added in the past year, which means carriers are making more delivery stops per day. (*Dow Jones Newswires*, 9/11/03)

### PostalWatch files Amicus Brief in postal antitrust case

- On September 15, PostalWatch filed a friend-of-the-court brief in the U.S. Supreme Court antitrust case, *United States Postal Service v. Flamingo Industries*. The brief strongly supports the 9<sup>th</sup> Circuit Court's finding that the USPS does not enjoy broad "status-based" sovereign immunity from the nation's antitrust laws. Rick Merritt, Executive Director of PostalWatch, defined this as a "landmark" case but one which has received scant media attention. "If the Supreme Court overturns the 9<sup>th</sup> Circuit, the Postal Service would be free to wreak havoc on any non-postal market it chooses. Markets typically dominated by small business would be particularly vulnerable to the behemoth's wrath," noted Merritt, who described it as a question of "conduct-based" versus "status-based" immunity.
- Merritt praised the 9<sup>th</sup> Circuit for limiting the Postal Service to "conduct-based immunity for only those activities associated with its statutory mail monopoly." When it operates outside its mandated mail function, he propounds, basic notions of fair play would dictate the USPS not be allowed immunity from our competition and consumer protection statutes. The PostalWatch head criticized the USPS for evading accountability for anticompetitive behavior and "hiding behind the imperial robes of sovereignty," adding, "Surely the Supreme Court will see that the Emperor has no clothes." ([www.postalwatch.org](http://www.postalwatch.org) 9/16/03)

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