

The **GSE** REPORT™

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Major Events

Fannie Mae issues first quarter 2004 results with glaring omissions, leading critics question what *is* going on in Fannie Mae's "black box"?

- Fannie Mae announced that its profits for the first quarter dipped by 2.1% from a year ago and, contrary to normal practice, it delayed releasing its first-quarter balance sheet. The balance-sheet delay reflected the time needed to complete a review of complex figures related to shareholder equity and to provide more "background and context" said a spokeswoman Janis Smith, adding that its omission was part of an effort to "streamline" its reports. "This is not a one-time change for this quarter, and you should not infer anything about the data from this change," Smith added. The GSE's March 31 balance sheet data will be available on May 10, when Fannie Mae files its 10Q with the SEC.
- Under generally accepted accounting principles, Fannie Mae earned \$1.9 billion or \$1.90 a share in the first quarter of 2004, down from \$1.94 billion or \$1.93 a share for the same period last year. Fannie Mae's lower earnings resulted from losses on financial transactions used to hedge against risk and from lower fees and other income. During the first quarter, Fannie Mae said losses on certain derivatives whose value must be marked-to-market each quarter totaled \$959.3 million, up from \$624.6 million a year earlier.
- Core earnings that exclude unrealized changes in the value of derivatives were up 9.2% percent to \$2.02 billion (\$2.03 a share), up from \$1.85 billion (\$1.84 a share) a year earlier. Core earnings benefited from a 34% increase in Fannie's guarantee fee income. The GSE reported an average guarantee fee of 22.1 basis points for the quarter, up 1.8 basis points from a year earlier.
- For the month of March, Fannie reported an average duration gap of zero compared to negative one month in February. The GSE said that its book of business grew at an annualized rate of 5% in March, compared to 7% in February. Total business volume rose to \$59.1 billion in March from \$50.8 billion in February. Outstanding mortgage-backed securities grew at an annual rate of 9.5% compared with 16.6% growth in February. Fannie's mortgage portfolio declined at an annualized rate of 1.6% in March, following a 6.0% decline in February. Conventional single family and multi-family delinquency rates were unchanged at 0.61% and 0.24%, respectively.
- Timothy Howard, Fannie Mae vice chairman and chief financial officer, said that the extremely low interest rates of the first quarter caused "considerable movement in most of the line items in our income and balance sheets," and the "effects more or less offset one another." Fannie Mae's mortgage portfolio declined by an annualized 7.6% in the first quarter to \$881 billion and its portfolio growth is expected to remain

negative for the second quarter of 2004. “The level of spreads is not sufficiently attractive and we do expect positive growth at some point of time,” but said Howard. “We are expecting growth just short of negative double digits,” he added. Management cautioned that the GSE’s financial results could be more variable in coming quarters as the wave of refinancing, brought about by tumbling mortgage rates, comes to a close and mortgage volumes ease.

- Howard said loan losses dropped sharply during the quarter, causing some speculation that Fannie had overestimated losses for the year. Howard expressed some concern that the housing market in some parts of the country is becoming overheated, but acknowledged that the limit of the maximum size loan Fannie Mae makes can make insulates it to a degree from excessive risk in the “frothier” areas.
- Howard expressed disappointment that Congress has not yet been able to agree on legislation for a new regulatory system, but said he is hopeful something can be worked out that will provide strong regulation without “undermining our mission.”
- Critics immediately reacted to Fannie Mae’s omission of its March balance sheet from its earnings report. Executive director of FM Watch Mike House said, “Like many observers, we are surprised at Fannie Mae’s decision to delay reporting vital investor information that had, until today, been made public. Shareholder equity is a critical number in evaluating a GSE’s safety and soundness. We trust it will quickly be released and validated.” Longtime GSE critic and independent consultant Bert Ely said, “Anytime a significant disclosure is dropped -- and this is a very significant disclosure -- it raises all sorts of red flags.”
- Some questioned how the decision to disclose less squared with Fannie’s repeated contentions it makes “best in class” disclosures. “The balance sheet is the most significant information they can provide ... in these releases,” said Mark Haefele, a portfolio manager at Sonic Capital, which has sold short Fannie stock but is holding Freddie Mac shares.
- In its lead editorial, the *Wall Street Journal* addressed its concerns about the Fannie Mae disclosure, noting, “There she goes again. ... Fannie Mae, the leveraged hedge fund that calls itself a housing finance company. On Monday Fannie released its quarterly earnings but failed to include its balance sheet, leaving investors to guess about losses on derivatives and stockholder equity. In the past, Fannie has included its balance sheet, as other large financial companies do. Now it is delaying release of this information until May 10.”
- “This omission is just one of many problems with Fannie’s financial disclosure. We are thinking especially of its refusal to make public the salaries of about 20 of its most highly compensated employees. Late last year, the House Financial Services Committee requested that Fannie’s regulator, the Office of Federal Housing Enterprise Oversight, share information on the compensation of Fan’s most senior executives. OFHEO complied. But suddenly staff members of the committee

received e-mails from Fannie warning them that release of the information would violate the Trade Secrets Act and subject blabbermouths to “criminal proceedings.” Just for good measure, the e-mail noted that former Whitewater special prosecutor Ken Starr is Fan’s outside counsel on this issue.”

- “But wait, it gets better. In January, the House Subcommittee on Commerce, Trade and Consumer Protection requested the same information. OFHEO complied. And you guessed it: Fannie’s e-mails struck again. To her credit, committee member Janice Schakowsky (D-IL) is considering releasing the info anyway. As chairman Cliff Stearns (R-FL) says, ‘If a corporation is going to have the benefits of government advantages and protections, then they certainly should be as forthright as possible. If they want all the advantages of being secret, then they should be private corporations.’”
- “Fannie’s political intimidation only raises questions about what, exactly, is going on inside the black box that are its business operations. Perhaps Fannie’s most highly compensated include not financial risk managers but, instead, political risk managers. This is a company of 4,700 employees, of whom fully one-third are in the persuasion business, either as legal, lobbying or public relations minions who try to influence politicians.”
- “And just where does this money for the highly compensated come from? Well, a nice chunk comes from the implicit subsidy that Fannie enjoys as a government-sponsored enterprise. According to a recent study by the Federal Reserve Board (which joins a long list of studies with similar conclusions), the perception that the federal government stands behind Fannie gives it a 40-basis-point funding advantage over private competitors. In dollar terms, the Fed study found that the implicit subsidy to both Fan and its sibling Freddie Mac came to between \$119 billion and \$164 billion, with more than half retained by the companies. A nice chunk of change, that.”
- “And what of the vast population of homeowners that Fan says it serves? The study finds that Fan reduces mortgage rates by about seven basis points (.07%). In other words, a trifle. As the study observes, the implicit subsidy does not appear to have substantially increased homeownership or homebuilding.”
- “The benefits that Fan receives from its special relationship with the federal government are huge. The costs of that relationship -- especially the potential costs of a bailout -- are also huge, but they are shouldered by taxpayers.”
- “All the more reason that Fannie should not be allowed to pick and choose what it wants to disclose. Information about its operations is especially crucial. And if Fannie is having troubles with its accounting system -- one possible reason its balance sheet has been delayed -- investors and taxpayers deserve to know. We hope that when Fannie does release her balance sheet, the numbers don’t tell us she is having trouble with her risk management, too.”

- In response the *Wall Street Journal's* editorial, Fannie Mae's senior vice president of investor relations Jayne Shontell released a written statement saying, "Our decision to include our balance sheet with the greater detail of our cash flow derivatives in our forthcoming 10-Q instead of the quarterly press release was made to ensure an abundance of caution regarding the accuracy of our new disclosures. We will continue to provide this expanded information in our future 10-Q and 10-K reports filed with the SEC."
- Shontell also included Fannie's CFO Tin Howard's statement made during his conference call on April 19, in which he said, "A final point about the earnings release is that with the expanded breakouts of our accumulated other comprehensive income, or AOCI, that we began reporting in our 2003 10-K, we will no longer be including the balance sheet summary table that contains these data in our quarterly releases. Instead, we'll be publishing all of the balance sheet data in our 10-Q. With the accelerated filing schedule now in place for the 10-Q, these disclosures will be available approximately three weeks after we put out our press release."
- Howard went on to say, "We now have an extraordinarily large number of transactions whose market values need to be ascertained and validated in preparing our AOCI data. Given the stringent standards to which we hold ourselves in our financial reporting, I concluded that the most prudent course of action was to take the additional time to ensure that these expanded AOCI disclosures are done to the highest possible degree of accuracy and integrity." (*Washington Post*, Albert Crenshaw, 04/20/04; *New York Times*, 04/20/04; *Reuters*, Mark Felsenthal, 04/19/04; *Wall Street Journal*, James R. Hagerty, 04/20/04; *Dow Jones Newswires*, Julie Haviv, 04/19/04; *Dow Jones Newswires*, 04/20/04; *American Banker*, Rob Blackwell, Jody Shenn, Marc Hochstein, 04/20/04; *Wall Street Journal*, 04/21/04; *Fannie Mae press release*, Jayne Shontell, 04/21/04)

OECD recommends curtailing GSE growth

- In a report on the U.S. economy, the Organization for Economic Cooperation and Development (OECD) recommended that the United States eliminate the special status of Fannie Mae and Freddie Mac and limit their growth. OECD, a group of 30 major industrialized nations, said that "rapid growth and systemic importance" of the GSEs requires tighter regulation, and that the reforms suggested by the Bush administration do not go far enough. The OECD, headquartered in Paris, said reforms "should go beyond" creating a new regulator to "eliminating their special status." The group said, "This status has led to the market perception of an implicit government guarantee and hence slightly lower borrowing costs, allowing them to expand strongly and move into activities beyond their original mandate of supporting the secondary market for residential mortgages."

- According to the report, the U.S. government should limit the growth of the companies' mortgage-related asset portfolios "so that mortgage-backed securities traded in public markets, and not GSE debt, become the dominant source of secondary-market funding for mortgages." OECD's recommendation echoed Federal Reserve Board Chairman Alan Greenspan, who told Congress in February that it should cap GSE growth. (*American Banker*, Rob Blackwell, 04/16/04; *Reuters*, 04/14/04)

Fannie Mae and Freddie Mac

While outlook for GSE reform legislation is clouded -- the issue is <i>not</i> going away

- Senate Majority Leader Bill Frist (R-TN) will work with Senate Banking Committee Chairman Richard Shelby (R-AL) and ranking member Paul Sarbanes (D-MD) to try to bring up legislation to reform regulation of the housing government-sponsored enterprises, but the schedule is tight for the remainder of the year, a Frist spokeswoman told *BNA*. There is currently no timeline for bringing the legislation to the floor, noting that the Bush administration's decision to pull support from the bill further clouds the prospect for floor action said Frist's spokeswoman. (*BNA Banking Report*, Karen L. Werner, 04/12/04)
- Shelby said he will continue to push in Congress for stronger oversight of Fannie Mae and Freddie Mac in spite of obstacles to legislation this year. "The future of the bill remains uncertain, but I intend to continue to press the issue of GSE reform in the Senate," Shelby said, noting it's clear that the present housing GSE regulators are "woefully inadequate to supervise the [GSEs]." He added, "Fannie and Freddie, the second and fifth largest financial institutions in the United States, are too important to have a regulator with less power than the regulator of a small country bank." Shelby said, "We've moved the debate along... The issue is not going to go away."
- Shelby acknowledged, "It has been extremely difficult to create a consensus bill that will enjoy broad support among Republicans and Democrats, and is acceptable to the Administration. The tight 12-9 vote on the committee demonstrated that even with the expansive affordable housing mandates and watered down receivership authority, we could not attract enough (support) from across the aisle to ensure enactment into law," he added. (*Reuters*, 04/23/04; *Dow Jones Newswires*, John Connor, 04/23/04; *Dow Jones International News*, Rob Well, 04/20/04)
- Senator Paul Sarbanes (D-MD), the minority leader on the Senate Banking Committee, said efforts have stalled to create a new regulator for GSEs. "We've reached something of an impasse here," Sarbanes said. "I'm not sure where, if any

place, that legislation will be going,” he added. Sarbanes told *Dow Jones Newswires* he wasn’t aware of any promising efforts to build a bipartisan proposal. “I don’t know,” Sarbanes said, when asked if a consensus was on the horizon. “We put a proposal in to get a consensus but it didn’t pan out.” Sarbanes noted the relatively brief number of working days left for lawmakers this year and said he didn’t expect a rush of activity in that short timeframe. (*Dow Jones International*, Rebecca Christie, 04/19/04)

- Representative Michael Oxley (R-OH), chairman of the Financial Services Committee, said he had promised Shelby that his panel would take up the legislation again if the Senate acted. “I wish them luck,” he told Reuters in an interview. Oxley sounded a note of pessimism about passing a regulatory overhaul of GSEs this year, saying the Bush administration may have been seeking too much. “I think the administration, for whatever reason, wants to do a lot more than maybe is possible,” said Oxley. “A lot of times in this town the perfect becomes the enemy of the good.” He added, “We had a perfectly good bill in our committee last year.” Oxley was “relaxed” about the Senate’s compromise on the issue of receivership for the GSEs, saying “If you got to a situation where you had Fannie, Freddie in a meltdown kind of situation or even whispers about receivership - Congress is going to get in the act anyway.” (*Reuters News*, 04/20/04)
- Representative Barney Frank (D-MA), the minority leader on the House Financial Services Committee, accused the Bush administration of exaggerating the risk of failure at Fannie Mae and Freddie Mac and of torpedoing reform legislation in the process. Frank said he was “baffled” that so much attention had been devoted to whether the federal government should be able to put the companies into receivership in the event of a financial crisis. “I think it is an artificial issue created by the administration,” he said. “People tend to pay their mortgages. I don’t think we are in any remote danger here. This focus on receivership, I think, is intended to create fears that aren’t there.”
- More broadly, Frank said the underlying dispute concerns the role of government in encouraging affordable housing. Instead of trying to put new limits on Fannie Mae and Freddie Mac, Frank said the administration should use the special advantages given to the two firms to pressure them to do more. By contrast, he claimed, the administration sees no true public policy role in creating affordable housing, saying, “Those are the battle lines.” Franks also levied criticisms of GSE critics, competitors and the financial press for creating a “sense of crisis that’s not justified,” blaming the media for allowing critics to dominate the debate. “[The GSEs have] had some accounting problems,” said Frank, added that he believed most of it is related to their derivative portfolio. “I can’t decide whether accounting for derivatives more closely resembles astrology or alchemy,” said Franks. (*Dow Jones International News*, Dawn Kopecki, 04/21/04; *American Banker*, Damian Paletta, 04/21/04; *Daily Report for Executives*, R. Christian Bruce, 04/23/04)

- Representative Richard Baker (R-LA), chairman of the House Financial Services Committee on Capital Markets, reiterated his desire to eliminate federal subsidies of Fannie Mae and Freddie Mac that are widely seen as providing an implicit federal guarantee, but conceded the two massive government sponsored enterprises are “probably” ... “too big to fail” in the eyes of most of his congressional colleagues. “[The GSEs] have extraordinary power within the financial marketplace ...and they still are extremely persuasive in the Congress,” said Baker. “I can’t see today a mechanism whereby a reversal of market conditions would not be met rather quickly and directly by the Congress, not that I think that would be the appropriate remedy, but I do think it is political reality. As much concern as is expressed today about a potential uptick in rates because of our governance discussion one can only imagine what the discussion would be like if it centered on the question of failure.” Baker added, “When I look at the reaction of the market to revelations (about GSEs) it is clear to me that those individuals making investment decisions are looking completely around the business fundamentals (of the GSEs) to the implicit guarantee of the U.S. government.” Pending further investigation, Baker said he is unsure about what final shape a GSE regulator should take. “I do not believe today that I fully understand the risks that are undertaken in relation to the capital adequacy of the enterprises,” he said. (*Market News International*, Steven K. Beckner, 04/19/04)

<p>Bush administration keeps focus on need for GSE regulatory reform</p>
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- Treasury Secretary John Snow said he’s “very encouraged” by recent progress in the effort to reform the regulatory regime of housing GSEs, even if Congress may take its time in completing the process. “We are miles away from where we were a year ago at this time, when the popular view was” not to tinker with Freddie and Fannie Mae, Snow said. “We have occupied” the GSE issue. “We have survived. I recognize that legislation takes time, and I don’t expect instant results, but the progress has been very encouraging.” Snow said. GSE reform has “gotten jump-started. I really see this as having legs now.” Snow added, “I recognize that Congress takes time.” Nonetheless, “The progress here is really very, very encouraging.” Continued growth of GSEs could pose a threat to financial markets, Snow said. “There are clear systemic risks in the continued growth of entities this large relative to the whole financial system.” (*Dow Jones Newswires*, Rebecca Christie, 04/22/04, *Market News International*, Claudia Hirsch, 04/22/04; *Reuters*, 4/22/04)
- Treasury Undersecretary for Financial Institutions Wayne Abernathy said the market must be made to realize the true risk of GSE debt, if not this year, then next. “What we would like to do is expose Fannie and Freddie more to the marketplace without changing the nature of their charter,” he said. “Part of their charter is that they offer uninsured, unguaranteed securities in the marketplace. But for that to be effective the marketplace has to evaluate those securities based on the real risk that is present.” Abernathy added, “We are engaged in finding out just what authorities OFHEO has to improve supervision. We are not sitting on our hands. We’re also using what tools

we have available to improve supervision. If legislation isn't enacted this year, it will be enacted next year.”

- At a Mortgage Bankers Association Conference on April 20, Abernathy said, “This administration will continue to call for [GSE] reform” and repeated Treasury’s demands for a properly equipped new GSE regulator, with receivership authority, full power to set and adjust both minimum and risk-based capital levels, approval authority over new and existing lines of business and independent funding outside of the annual congressional appropriations process. Additionally, HUD must set “meaningful housing goals that it can properly enforce,” Abernathy said. The GSEs must “outstrip” the market on affordable housing, he said. “That’s why they were created - to do more than what the market would do.” Current GSE supervisors are “doing their best,” but their tools, resources and stature are “inadequate,” Abernathy said.
- The portfolios of mortgages and mortgage-backed assets that the two GSEs hold for their own investments result in a “very significant and problematic conflict of interest,” Abernathy said. Although GSEs’ mission is to reduce the cost of mortgages, Abernathy said the companies have a vested interest in buying mortgages with high interest rates for their own portfolios. Those high rates, combined with the lower funding costs they enjoy, mean more earnings for Fannie and Freddie shareholders, he said, which may be distracting the two GSEs from the more important goal of serving first-time homebuyers, low and moderate-income homebuyers, and minorities. “Maybe this conflict of interest is starting to draw them away from what they were created to do,” Abernathy said. (*Bloomberg News*, James Tyson, 04/13/04; *The Main Wire*, 04/14/04; *Daily Report for Executives*, R. Christian Bruce, 04/21/04; *Market News International*, Claudia Hirsch, 04/20/04)
- Treasury Under Secretary for Domestic Finance Brian Roseboro said that movement toward reforming the regulatory regime of the GSEs has, for now, stalled. “We’re in a pause period,” Roseboro said. “It is still something that’s important to the administration that is not shelved.” Roseboro also reiterated Treasury’s view that there is no “problem” currently at Fannie or Freddie. “Both institutions have excellent risk management capability and practices,” he said. “But there is risk. It is only prudent, given their importance to the housing market and the importance of the housing market to the economy, for there to be a strong, credible, world-class regulator.” (*Market News International*, Claudia Hirsch, 04/22/04)

Federal Reserve Chairman Alan Greenspan responds to Senate Banking Committee questions

- In a written response to lawmakers on issues concerning GSEs, Federal Reserve Chairman Alan Greenspan criticized the FHLBank System’s affordable housing program, which is funded with 10% of the FHLBank system’s net income. Greenspan said the program has “led to a ballooning of the FHLBanks’ non-advance

portfolio, leading to even greater issuance of GSE debt and increasing concerns about systemic risks.” Greenspan argued against setting up a similar program for Fannie Mae and Freddie Mac, as legislation passed by the Senate Banking Committee on April 1 would do. “The GSEs can apparently borrow at subsidized rates without any realistic limit and invest the proceeds in any asset whose price is market determined,” Mr. Greenspan wrote in response to a question from Senator Jack Reed (D-RI). “It can thus automatically profit from the investment. Taxing their income to support affordable housing will encourage them to expand their portfolios all the more.” (*American Banker*, Rob Blackwell, 04/23/04)

- In response to an inquiry from the Senate Banking Committee, Greenspan noted that Fannie Mae and Freddie Mac, by expanding their combined holdings of mortgages to \$1.5 trillion, haven’t been able to cause mortgage rates to decline and may have exposed the U.S. financial system to potential instability. Portfolio growth at the two largest U.S mortgage finance companies doesn’t “influence mortgage rates up or down,” Greenspan said. Meanwhile, their portfolios pose “potential costs” to financial markets. (*Bloomberg News*, Brennan Burgess, 04/22/04)
- In his letter to the Committee, Greenspan confirmed that in July 2003 the European Central Bank responded to an unfolding accounting scandal at Freddie Mac by planning to shed holdings of all Fannie Mae and Freddie Mac debt. Greenspan said that the ECB announced its intention to eliminate holdings by the GSEs and said it would advise its national central banks to do the same. At the time, the ECB declined to confirm rumors it was paring U.S. agency debt, but market participants said they noticed large volumes of ECB sell orders for such securities. U.S. markets were rattled by the reports, fearing a sell-off after Freddie Mac replaced its senior management in a \$5 billion earnings understatement. (*Reuters News*, Mark Felsenthal, 04/21/04)
- Along with written comments to the Senate Banking Committee, Greenspan included a brief paper by Fed economist Wayne Passmore and Fed staffer Shane Sherlund, which reviewed Dr. William Greene’s critique of Passmore’s study of Fannie Mae and Freddie Mac subsidies. Passmore and Sherlund concluded that “Overall, incorporating Dr. Greene’s remarks seem to generally lower our estimate of mortgage rate reduction produced by GSEs and thus raises our estimate of the GSE subsidy retained by shareholders.” (*Dow Jones Newswires*, John Connor, 04/23/04)

Federal Reserve Board Governor Ben Bernanke says interest rate move poses risk for GSEs
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- Federal Reserve Board Governor Ben Bernanke said a sharp interest rate move could pose risks for Fannie Mae and Freddie Mac. “The risk is, of course, that if interest rates change rapidly or unexpectedly or there were errors made of some type, that the (hedging) strategy would create an insolvency or at least an illiquidity in these large agencies,” he said. Bernanke said that he had no information and nor expectation of

any kind of near-term problem at either GSE. "As far as I know, they are well managed," he said. However, Bernanke urged improvement of regulatory oversight of the GSEs. (*Reuters*, 04/23/04)

CBO updates its analysis of GSE subsidy of \$23 billion for Senate Banking Committee

- In an April 8 report to the Senate Banking Committee, CBO formally updated its analysis of the GSEs' subsidy, which totaled \$23 billion in 2003. According to CBO estimates, the GSEs' subsidy rose almost 70% from their earlier estimate of \$13.6 billion in 2000, largely as a result of the GSEs' increase in the scale of their business. If CBO had employed a different assumption about the way Fannie and Freddie operate, CBO said, "the federal subsidy would be over \$46 billion, up from \$20 billion 2000."
- In his report to the Committee, CBO Director Douglas Holtz-Eakin compared CBO analysis of the GSEs' subsidy to the analysis by the Federal Reserve staff paper, prepared by economist Wayne Passmore. Holtz-Eakin noted, "While the gross estimates differ, CBO's and Wayne Passmore's results are generally consistent." The CBO report stated that the main difference in the Fed's calculations is that the Fed study accounts for the GSEs' total outstanding debt and mortgage-backed securities, while the CBO focused its analysis on the value of the subsidy for debt and MBS issued in a given year. "That difference - the value of the stock rather than the change in the value, or the flow - is the principal reason that Passmore's estimate of the gross subsidy is higher," the report concluded.
- Passmore's estimates on the GSEs' effect on mortgage rates is also significantly lower than the CBO's - 7 basis points compared with 25 basis points. CBO explained that Passmore used a two-step process that takes into account secondary benefits not incorporated into the CBO's estimates, such as differences in transaction costs, credit risk and prepayment risks, rather than (only) the difference between the spread on conforming and jumbo mortgage rates.
- Like Passmore, the CBO also said a large share of the GSEs' subsidies never make it to consumers. The CBO estimates that borrowers received about 60% of the \$23 billion in benefits last year, or \$13.6 billion, while Fannie and Freddie retained \$6.3 billion and the FHLBanks retained \$3.2 billion. "In sum, both CBO and Passmore conclude that the housing GSEs receive large subsidies that only a portion of those subsidies reach borrowers in the conforming market," CBO said. CBO didn't cite any of the problems in Passmore's calculations or methodologies, which Fannie Mae officials have openly criticized.
- CBO said a bulk of the GSEs subsidy is generated through their lower costs of borrowing on Wall Street, which stems from their implied federal backing. Despite disclaimers to the contrary, investors price the GSEs' debt as if it has the full faith

and credit of the U.S. government. CBO valued that benefit alone at \$12.5 billion-- \$5.4 billion for Fannie, \$3.9 billion for Freddie and \$3.2 billion for the FHLBanks.

- Federal subsidies also lowered Fannie and Freddie's MBS costs by about \$9.2 billion, with Fannie netting the bigger benefit at \$7.2 billion and Freddie receiving about \$2 billion last year. CBO said that the GSEs exemptions from state and local income taxes and securities filing fees, along with other regulatory advantages, provide the smallest benefit of at \$1.3 billion. (*Washington Post*, David S. Hilzenrath, 04/13/04; *Dow Jones Newswires*, Dawn Kopecki, 04/08/04)

Former HUD Secretary Cuomo says Sarbanes-Oxley reforms "long overdue" for GSEs

- Andrew Cuomo writes in the *American Banker* that Sarbanes-Oxley-type reforms are "just the change that the housing finance world needs to make -- changes long overdue. ... While Congress is deciding which bureaucracy should be responsible for GSE regulation, the underlying and long-needed debate is over the future of these multibillion-dollar GSEs and their accountability to shareholders, taxpayers, and consumers."
- Fannie was formed in 1938 as a government corporation to spur development of the housing finance system. It worked. Indeed, it worked so well that Fannie was "semiprivatized" in 1968, with a continued strong connection to the federal government. ... [I]n the spirit of Sarbanes-Oxley, it is time for a fundamental reevaluation of the public's "deal" with the GSEs."
- "The GSEs should not be "fully privatized" and stripped of their public role and subsidy, as has been proposed by some in Congress. Rather, they should be forced to earn taxpayers' hard-earned money by meeting the needs of underserved borrowers, which they are uniquely qualified to do."
- "The argument in favor of full privatization is neither politically possible nor good public policy. Having battled these giants before Congress for many years, I believe the GSEs will argue that termination of their federal connection could dissuade global investors who rely on the 'implicit guarantee' of U.S. government subsidies. With the dollar weakening, this argument has political appeal. Moreover, there is a public role that needs to be filled. The private market alone is not the solution to the nation's affordable housing crisis. Charging the poorest people the highest interest rates -- the strategy of the subprime lending industry -- is not the answer. ... Lending discrimination is pervasive and lower-income and minority communities are struggling to gain access to affordable home mortgages. Older urban markets and poor rural communities need help in attracting capital."
- "Fannie and Freddie have the resources, reach, and market control to make a real difference. Their potential to promote lending and redevelopment is unmatched. But it is also true that they are underperforming and do not deliver on the subsidy they

currently receive. The Congressional Budget Office reports that the GSEs receive more than \$15 billion annually from their special relationship with the federal government through favorable borrowing rates, reduced Securities and Exchange Commission fees, forgiven taxes, and other benefits. Fifteen billion dollars is a handsome sum, even in Washington. It is about half of the HUD budget -- the total housing budget for the entire nation. What do the taxpayers get in return? Apparently, not enough.”

- “The Federal Reserve released a study in December which concluded that Fannie and Freddie do no more affordable lending at the bottom end of the market than private banks. The GSEs are not living up to their end of the bargain. Unfortunately, this is not a new problem. As HUD secretary I was responsible for establishing the legally mandated benchmarks for the GSEs’ public benefit efforts. In 1998 we dramatically raised them by requiring that loans to low and moderate-income families account for more than 50% of Fannie and Freddie’s business activity, with 31% being targeted to geographically underserved areas. The increase provided hundreds of thousands of working families with access to credit. Many in Congress, mobilized by Fannie and Freddie’s lobbyists, argued that we were being too aggressive. But the Federal Reserve study noted above proved the opposite.”
- “HUD recently proposed raising these legal benchmarks again, i.e. the “affordable housing goals.” While I disagree with much of the Bush administration’s policies, on this proposal I say, “Bravo!” HUD has pointed the goals in the right direction; Congress should now work to raise them even higher.”
- “Senator Paul Sarbanes of Maryland and Senator Jack Reed of Rhode Island have creative proposals in this regard. One proposal would tighten the definition of “affordable” housing so these GSEs would be mandated to make more loans to lower-income individuals than the present goals require. Another proposal would mandate that these GSEs pay 5% of their net profit to a fund that would finance affordable housing construction and new innovations in affordable housing finance. Both proposals are effective and meritorious and would be a positive change if enacted by Congress.”
- “At the same time, Fannie and Freddie should stop resisting their public obligation and welcome the mandate as a lifeline in this new culture of accountability. It will justify their continued public subsidy and stave off the “privatization” proponents. That’s good news for the entire housing industry.”
- “Meanwhile, Congress is debating whether to support the Bush administration’s proposal to shift GSE regulation from HUD’s Office of Federal Housing Enterprise Oversight to the Treasury Department or a newly formed department. Two regulatory functions are performed: oversight of the financial safety and soundness of the GSEs, and regulation of the extent and nature of their housing mission. Even if Treasury or a new department were the more appropriate agency for financial safety and soundness, HUD should maintain regulation of the housing mission. HUD’s

mandate, unlike Treasury's, is to keep the focus on affordable housing, where the GSEs are already underperforming. This proposal is a continuation of the Bush administration's degradation and diminution of the federal government's responsibility to poor and working families who are struggling to meet their housing needs."

- "In conclusion, the repercussions of Sarbanes-Oxley have invigorated a debate over GSE responsibility. I hope it is just the beginning of a reform movement that will reverberate throughout the entire housing industry. ...Accountability, trust, and transparency are critical to raising that confidence. A little revolution once in a while is good for the system." (*American Banker*, Andrew Cuomo, 04/16/04)

Freddie Mac's executives speak out on GSE reform
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- In a speech at the Bond Market Association, Freddie Mac Chairman and CEO Richard Syron said that an election-shortened legislative year means odds are "not very good" that Congress will complete work on a regulatory reform measure for GSEs. "The chance for a GSE bill this year is not very good. I think it's quite low," Syron said. Few legislative work days remain in the congressional schedule to wrap up the federal budget for the year, let alone other priorities, Syron said. "I think this is next year's issue," he added.
- While there remain "many contentious issues" regarding GSE supervisory overhaul before Congress, Syron said he's "optimistic that Congress ultimately will produce" legislation that "reaffirms the nation's public policy commitment to housing, instills public confidence, and does not undermine the value of our (government) charter."
- Syron said that he believes that Freddie Mac enjoys a "market advantage" in the pricing of the GSE's debt of about 38 basis points because of its government charter, of which he says about 24 basis points passes through to homeowners.
- On the issue of receivership, Syron later told reporters it is "not an issue" for GSEs because they are not depository institutions. Granting a new GSE regulator the power to place a failing entity into receivership, could potentially jeopardize some securities holders' investments. Syron said his company's focus is on making sure "nothing affects" its debt ratings. "The issue for us is market perception," Syron said, adding that Freddie Mac must "reassure bond holders" that they have the "same rights" as ever.
- Addressing recent criticism by a Treasury official that GSEs' own mortgage portfolios present a conflict of interest with mortgage borrowers, Syron told reporters, "Everything we do is to be neutral to either a rise or a fall in interest rates."

- Syron also noted that Freddie Mac is tying the compensation of its senior management more to the expansion of homeownership and other affordable housing goals. He later told reporters that 30% of the quarterly scorecard used to determine executive bonuses are being tied to “mission centric” data in the (preceding) first half. Syron said that Freddie Mac still hopes to release its 2003 earnings by June 30, although the potential for glitches remains. (*The Main Wire*, Claudia Hirsch, 04/23/04; *American Banker*, Jody Shenn and Erick Berquist, 04/23/04; *Dow Jones International News*, Rebecca Christie, 04/22/04; Dow Jones Newswires, 04/22/04)
- Freddie Mac’s chief operating officer Paul Peterson reiterated the company’s view that handing a new regulator the power to place a failing GSE into receivership would translate into lost market confidence and higher borrowing costs. According to Peterson, receivership would raise the question in the market of “whether that signals a drop in support by the government.” In turn, that could affect the market’s attitude toward Freddie’s securities, likely resulting in the company’s issue further debt, Peterson said. He added that such “restrictions” on the GSEs must be balanced against the “benefits we get.” (*The Main Wire*, Claudia Hirsch, 04/20/04)

<p><i>Economist</i> says GSEs have America’s financial system on “verge of a tremor”</p>
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- According to the *Economist*, “Of all the things that might upset America’s financial system, top of most lists are Fannie Mae and Freddie Mac. The two companies stand behind \$4 trillion worth of mortgages; when that much money is involved, even a minor glitch can send tremors through financial markets.”
- “Recently both [GSEs] have had more than their share of problems with their accounts. There are shortcomings in their regulation. If there were a disaster, no one could say that it had come without warning.”
- “Re-regulation has been talked about for years. But Fannie and Freddie are reckoned to be among the cleverest and most generous lobbyists in Washington. When the prospect of new rules looms, as it did recently, they seek popular support by running melodramatic advertisements claiming that change could make homes unaffordable for many Americans. Their most recent victory over their critics came on April 2, when their allies in Congress thwarted the efforts of the Bush administration to tighten their regulation.”
- “Fannie and Freddie enjoy an implicit guarantee of their debt by the federal government. This gives them a great advantage in a business where the most significant cost is funding. The two have long argued that the true beneficiaries of this are homeowners, who pay lower interest rates than they otherwise would.”
- “This is nonsense, according to no less an authority than Alan Greenspan, chairman of the Federal Reserve. Citing a Fed study, Greenspan told Congress in February that

the government guarantee gave the twin companies a funding advantage of 40 basis points (hundredths of a percentage point). However, a mere seven basis points were passed on to mortgage interest rates - an amount too trivial to have a substantial impact on home ownership. The rest went to Fannie and Freddie.”

- “Worse, the guarantee means that Fannie and Freddie are not subject to normal market disciplines. That might encourage them to take extra risks - for which taxpayers would be expected to pay if anything went wrong. Fannie and Freddie are highly leveraged and do not pay for the associated risk. “There are many ways to enhance the attractiveness of home ownership at significantly less potential cost to taxpayers,” Greenspan said.”
- “Republicans on the Senate Banking Committee pushed through a new regulatory package, with the initial support of the Bush administration. This would have ended Fannie’s and Freddie’s exemption from bankruptcy laws and placed any insolvency in the hands of a new regulator, who would also set minimum capital requirements and be funded by levies on the companies. Just before the final vote a provision was added, putting Congress in charge should Fannie or Freddie go bust. This would maintain the ties between legislators and the companies that the administration had hoped to sever. The administration therefore withdrew its support for the new law. Now nothing is expected to happen this year. If the Democrats take the White House in the autumn, nothing is likely for the next four years. Unless, of course, Fannie or Freddie blows up.
- “Short of outright disaster, the case for re-regulating Fannie and Freddie could hardly be stronger. Each has had problems with its accounts. Freddie’s have looked the worse. It has acknowledged that it went too far in smoothing earnings in the past. It will not announce its profits for 2003 until at least the end of June. At the end of last year, it fired its chief executive, at great expense. Gregory Parseghian had spent half a year in the job, having being promoted from chief investment officer; he received a salary of \$1m, a bonus of \$4m and severance benefits of \$14m. Yet many believe Freddie is in better shape than its sister, if only because its clean-up is more advanced. A deep accounting audit is under way. New contracts for its executives stipulate that bonuses will be paid only if there are no nasty surprises.”
- “Fannie’s accounting problems are more subtle. On April 1 its regulator, the Office of Federal Housing Enterprise Oversight (OFHEO) said that Fannie might have to restate its accounts, because its loans for manufactured (i.e., prefabricated) housing and other assets had become impaired. The company issued a denial that was labeled “inaccurate and misleading” by OFHEO’s director, Armando Falcon. It is hard to imagine such a dispute between a big bank and the Fed or the Securities and Exchange Commission.”
- “Fortunately, Fannie’s manufactured-housing portfolio, at \$8 billion, is not big enough to cause a panic. More significant is its use of derivatives, which, according to John Barnett, of the Centre for Financial Research and Analysis, provides a

technically correct, but misleading impression of earnings. When interest rates fall, homeowners refinance, creating a potential loss for mortgage holders. When this happened to Fannie, rather than take the loss up front, the company used derivative contracts that under generally accepted accounting standards amortized the cost over several years. Had the decline in the market value of its bond portfolio since 1997 been fully recognised, by last year Fannie's capital would have been 20% lower - enough to push its capital below the regulatory minimum."

- "Doubts about Fannie's figures have not gone entirely unnoticed in the markets: Its share price is depressed. If there are more questions about the twin companies' accounts, even their friends in Congress may one day bow to change. That, however, has been said before." (*The Economist*, 04/16/04)

Freddie's COO Peterson and Fannie's COO Mudd "debate" HUD's housing goals

- HUD's newly tightened affordable housing goals for the housing GSEs might be "unaffordable" for the companies, according to Freddie's Chief Operating Officer Paul Peterson. While Freddie Mac hasn't finished evaluating or figured out its official stance on HUD's recently released proposal, Peterson said the rule appears to jack up the companies' financing goals to low and moderate-income borrowers to unattainable rates. "I'm very concerned about some of the sizes of the increases," Peterson said. Stopping short of saying the proposed increases of HUD's goals are unrealistic, Peterson said that they raise questions about whether Freddie Mac could meet them. He noted that the loss of bonus points effectively raised housing goals by 6 percentage points for Freddie Mac.
- During a panel discussion at the Mortgage Banker's Association annual secondary market conference, Peterson suggested that overly aggressive goals would increase systemic risk under certain circumstances. "If the housing mission isn't carefully regulated, in terms of both what's required and expected, it can come into conflict with safety and soundness," said Peterson. "How you find and maintain that balance I think is going to be an important big challenge," he said.
- Fannie Mae's COO Daniel H. Mudd said the GSEs should not be expected to lead the market too much on affordable housing. "We can only receive business that everybody in this room chooses, based on a market price, to sell us or not to sell us," he said. "I always keep an eye out for housing goals that outstrip what the market naturally delivers." Fannie wants "to be encouraged to do more to help solve this problem, and if the carrot is just a little bit out there, it's a good thing," Mr. Mudd said. "If it's too far out there, I would be concerned about creating market distortions." After the panel presentation he told reporters: "What we don't want to do is get so far out ahead ...that lenders are originating and looking for an execution on business that's not naturally there in the marketplace according to their standards and policies." (*Reuters News*, Mark Felsenthal, 04/19/04; *American Banker*, Marc Hochstein, 04/20/04; *Dow Jones Newswires*, Dawn Kopecki, 04/20/04)

OFHEO sets up Compliance Office to conduct special reviews of “focused issues”

- OFHEO has created an Office of Compliance to assure that Fannie Mae and Freddie Mac comply with applicable laws by conducting special reviews and examinations “on focused issues.” The agency also has established an Office of Chief Accountant to provide advice on all accounting matters relating to the two housing-related government-sponsored enterprises.
- In its final rule published in the Federal Register, OFHEO unveiled these “structural changes” which were “recently implemented by the director,” Armando Falcon. The Federal Register filing didn’t specify any of the focused issues on which the office may be working, and OFHEO spokespersons couldn’t be reached for comment. “The Office also assists in enforcement actions and other activities as requested by the director,” the agency said.
- OFHEO said the Office of Chief Accountant, in addition to providing advice to the agency on all accounting matters related to the GSEs, “develops policies regarding accounting and financial reporting and monitors accounting standards that affect the enterprises.” The agency added, “The Office supports and coordinates accounting resources within the OFHEO and supports other offices in providing consistent accounting policy interpretation across OFHEO and works with external constituencies on accounting issues.”
- Elsewhere on the accounting front, OFHEO included a provision in a newly proposed corporate governance rule to “require the chief executive officer and chief financial officer to reimburse the enterprise if the enterprise is required to prepare an accounting restatement due to the material noncompliance of the enterprise, as a result of misconduct, with any financial reporting requirement.” Peter Eavis, writing in *TheStreet.com*, noted that this provision could make life “very difficult” for Fannie’s Chairman and CEO Franklin Raines.
- Eavis notes that OFHEO’s sudden taste for confrontation marks something of a sea change for the agency, which has been criticized in the past for allowing Fannie and Freddie to become “so dysfunctional” under its watch. The OFHEO’s new governance proposals, which include the separation of the chairman and CEO positions, ten year limits on service by directors, and change of external auditors every ten years, are in line with the efforts of shareholder advocates at other big companies, notably Disney. In fact, OFHEO has stated that Fannie has to have a new auditor by the end of next year. Eavis notes that OFHEO must understand that its proposed rules serve to turn up the heat on Raines, who has “managed Fannie for Wall Street-pleasing earnings growth, while undermining balance sheet strength and bringing about a near collapse in Fannie’s shareholders’ equity in 2002.”

- Eavis points out that it was Freddie's change in auditor that led to the discovery of its accounting shenanigans and adds, "Because Fannie has a far weaker balance sheet than Freddie, a big restatement resulting from an auditor change, or the current OFHEO accounting inquiry, could really hurt the company -- and perhaps even lead to Raines' ejection. If Fannie does end up restating its accounts, the new OFHEO rules might conceivably deprive Raines, who also oversaw billions of dollars in derivatives losses, of a large options grant he was set to receive this year." While these new rules make life very difficult for Raines, Eavis believes that Fannie would be foolish to fight OFHEO's proposals. "OFHEO Armando Falcon is in no mood for compromise, and he may just be tempted to make a stand on what promises to be a widely lauded proposal." (*Dow Jones International*, John Connor, 04/12/04; *TheStreet.com*, Peter Eavis, 04/08/04)

As Fed moves to tighten its policy on GSE daylight overdraft plan, the "moaning" begins

- John Darr of the FHLBank's office of finance said that planned changes to the Fed's daylight overdraft policy will have big implications for GSEs and the overall financial markets. In 2006, the Fed has proposed to end the GSE's exemption from daylight overdraft restrictions, which deprives the GSEs of billions of dollars in "cash management wiggle room" during the business day. "There's a lot of implications for us issuers," said Darr, who urged bond dealers to read the Bond Market Association's comment letter on the plan.
- In its comment letter, BMA said the new Federal Reserve policy proposal could seriously hurt U.S. financial markets if the Fed doesn't help Wall Street prepare properly. The new constraints on the GSEs could hurt the rest of the market's cash flow, possibly creating a big financing gap that interrupts payments throughout the industry, the BMA said. Without substantial changes to Wall Street's operations, BMA said the policy would have a "severe and adverse market impact." In its letter, BMA stated "A lack of requisite liquidity would cause severely illiquid conditions to occur in the financial markets, and potentially 'gridlock.' Such gridlock, at worst, would render financial institutions unable to meet their financial obligations, raising the possibility of systemic risk." BMA urged the Fed to create a task force of regulators, GSEs and affected firms. Darr endorsed that suggestion.
- In comments to *Dow Jones Newswire*, Fannie Mae and Freddie Mac said they plan to work with the Fed on the transition to the new policy. Neither GSE submitted a formal comment letter on the plan. (*Dow Jones Capital Markets Report*, Rebecca Christie, 04/21/04; *Dow Jones Capital Markets Report*, Rebecca Christie, 04/22/04)

Countywide Financial exec urges Fannie and Freddie to cut their minimum servicing fee

- At the Bond Market Association conference, David A. Spector, a senior managing director at Countywide Financial Corp's Countywide Funding Corp., said Fannie and

Freddie should cut their minimum servicing fee requirements in half to 12.5 basis points. Spector said that the 25 basis points that lenders currently must hold in capital on securitizations is not an “incentive” to securitize, but rather an impediment, because it unnecessarily ties up capital that could be better used elsewhere. “It’s difficult to operate efficiently,” he added, when one must hold 25 basis points in capital on assets that only cost 3 basis points to service. (*American Banker*, Jody Shenn and Erick Bergquist, 04/23/04)

Fannie Mae

Fannie Mae is still on the airwaves, spinning their “dream”

- On April 7, Fannie Mae aired the following 30 second radio advertisement on homeownership on KMJQ-FM, Houston, Texas:
 - “KATRINA JONES: I would think if there were no Fannie Mae, um who would be the champion around home ownership? It’s a dream that people have of owning a home. Who would be there to make those dreams possible? So, I think if it weren’t for Fannie Mae, I would not see us as a country that would be able to have opportunities that homeownership makes available.”
 - “MALE ANNOUNCER: Katrina Jones works for Fannie Mae. Fannie Mae works for America. As the American Dream grows, so do we.” (*KMJQ-FM*, 04/07/04)

Fannie Mae announces its quarterly common and preferred stock dividends

- On April 20, 2004, Fannie Mae’s Board of Directors voted to approve a \$0.52 per share dividend on its common stock, unchanged from the first quarter dividend announced in January 2004. This second quarter payment will be made to registered holders common stock at the close of business on April 30, 2004, payable on May 25, 2004. The Board also announced dividends for Fannie Mae’s preferred stock Series D, E, F, G, H, I J, K, L, M and N, for shares outstanding on June 15, 2004 and payable June 30, 2004. (*Fannie Mae Press Release*, 04/20/04)

Fannie Mae announces tracking system for callable debt securities

- Fannie Mae launched a new tool on its Web site to help investors monitor call-related information for the company's outstanding callable debt securities. In response to investors' requests, Fannie Mae developed DebtCallTracker to allow investors to view, print and download call dates and actions for callable debt securities in which they have invested. Investors may download data from the Company's website for up to 50 CUSIPs at a time to either a "comma delimited file" or an "extensible markup language file" (XML). DebtCallTracker will be available 24 hours a day, seven days a week under the "Debt Securities" section of www.fanniemae.com. Fannie Mae plans to update data overnight on a daily basis with all dates based on U.S. Eastern time. (*Fannie Mae Press Release*, 04/16/04)

According to Fannie's housing survey, key gaps found in home buying information

- Although mortgage interest rates were at historic lows in recent years, many minorities are still missing out on the benefits of home ownership, due in part to high real estate prices. According to Fannie Mae, a sizable information gap exacerbates this problem. Minorities are particularly at risk for letting misperceptions prevent them from buying. According to Fannie, 73% of the general population know you don't have to have perfect credit to qualify for a mortgage, while only 57% of African Americans, 64% of English-speaking Hispanics, and 22% of Spanish-speaking Hispanics recognized that "pristine" credit isn't a prerequisite. According to Fannie Mae, its survey illustrates a significant "Information Gap" between the general public and minority communities in their levels of accurate information about the homebuying process with the gap particularly pronounced among Spanish-speaking Hispanics. (*Time Magazine*, Barbara Kiviat, 04/26/04; *Fannie Mae Press Release*, 04/14/04)

Freddie Mac

Freddie considers offering lenders (more) cash incentives to sell them loans
needed to meet affordable housing goals

- Freddie Mac's chief operating officer Paul Peterson said that the GSE will consider offering lenders cash incentives to sell it the home loans it needs to meet federal goals for increasing homeownership. Referring to Freddie Mac's plan for expanding housing finance to low-income people in 2004, Peterson said, the company may implement "some of those types of transactions" involving the incentives.

- At Freddie Mac’s annual meeting on March 31, Freddie’s CEO Richard Syron said that the company will rely less on the so-called swap transactions. In 2003, Freddie Mac paid \$100 million to Washington Mutual and \$65 million to Citigroup to swap its mortgage securities for \$6 billion and \$5 billion, respectively, of multifamily home loans. Syron’s comments preceded an April 5 proposal by the Bush administration to require the GSEs to channel 57% of their mortgage financing by 2008 toward homes for people with incomes no greater than the median of their geographic areas, an increase from the current level of 50%.
- “I’m very concerned about some of the sizes of the increases that they have talked about -- I know what it took for us to make those goals in previous years,” Peterson said. “This would be my big concern: We might be asked to run a seven second 100-yard dash.” Echoing Fannie Mae COO Daniel Mudd, Peterson said Freddie Mac hasn’t yet formulated a detailed response to the proposed higher housing goals. (*Bloomberg News*, James Tyson, 04/19/04)

Two Ohio pension systems named lead plaintiff in class action lawsuit against Freddie

- The State Teachers Retirement System of Ohio and the Ohio Public Employee Retirement Systems were named lead plaintiffs in a national class-action lawsuit against Freddie Mac. On August 8, 2003, Attorney General Jim Petro filed the lawsuit against the GSE, accusing Freddie Mac of vague and misleading accounting practices that led to more than \$25 million in losses for the pension systems. “Lead plaintiff status will allow Ohio to have a strong say in the direction this litigation takes,” Petro said. “All members of this class action will benefit from our aggressive stance against fraud and abuse.” Virginia, New York and West Virginia are also suing Freddie Mac.
- Freddie Mac spokeswoman Sharon McHale declined to discuss the case because it involves ongoing litigation. (*Dayton Daily News*, Susanne Cervenka, 04/17/04; *Associated Press*, 04/16/04)

Freddie Mac’s mortgage portfolio shrinks in March, for fifth straight month

- Freddie Mac said its loan portfolio contracted by \$1.44 billion to \$635.6 billion in March. The portfolio, which provides about two-thirds of the GSE’s profit, shrank at an annualized rate of 2.7% in March after declining at a 4.9% pace in February. The GSE’s portfolio peaked at \$655.5 billion at the end of October. During March, Freddie Mac committed to buy \$17.4 billion in mortgages, compared with \$11.3 billion a month earlier, the company said.

- Mortgage purchase agreements for its retained portfolio of rose to a net \$20.6 billion in March, up from February's \$11.5 billion said Freddie Mac.
- Freddie Mac's duration gap, a measure of interest- rate risk, was unchanged from February at 0 months in March. (*Dow Jones Newswires*, Madeleine Lim, 04/22/04; *American Banker*, 04/23/04)

Freddie Mac hires ex-assistant Treasury secretary

- Freddie Mac has hired former Assistant Treasury Secretary Hollis McLoughlin to serve in the newly created position of chief of staff. McLoughlin was an assistant Treasury secretary during the first Bush administration from 1989 to 1992. Earlier, he served as chief of staff to Senator Nicholas Brady (R-NJ) and Representative Millicent Fenwick (R-NJ).
- At Freddie Mac, McLoughlin will report directly to Freddie Mac's chairman and CEO Richard Syron. In the newly created chief of staff position, McLoughlin will help prioritize both day-to-day activities as well as long-term strategic issues for Syron.
- "I am very pleased that Hollis is joining Freddie Mac," said Syron. "He will be a key member of my executive team. His expertise in both government and business will be invaluable as we shape Freddie Mac's future and ensure that more families realize the dream of homeownership." (*Reuters*, 04/19/04; *Freddie Mac Press Release*, 04/19/04; *Dow Jones International*, 04/19/04)

Freddie creates tools to combat predatory lending

- Freddie Mac introduced new seller/servicer tools and resources to help fight against predatory lending. The GSE offers special mortgage products, such as CreditWorks, Affordable Merit Rate and Lease Purchase Plus, for lenders to help borrowers work with past credit issues. Freddie also provides EarlyIndicator and Workout Prospector to mortgage services to help borrowers avoid foreclosure.
- Freddie Mac has taken specific actions to help protect borrowers from predatory lenders. The GSE no longer invests in subprime mortgages originated on or after August 1, 2004, that contain mandatory arbitration clauses. This policy allows homeowners to choose the mortgage dispute resolution option that best suits their interests. Freddie Mac refuses to do business with financial institutions that engage in predatory lending practices and requires originators to provide complete credit information about borrowers to all credit bureaus and reporting agencies. Freddie Mac refuses to invest in mortgages that are originated in connection with single-premium credit insurance; are high-rate or high-fee mortgages covered by the

Homeownership and Equity Protection Act of 1994; and are subprime mortgages originated on or after October 1, 2002 with prepayment terms that exceed three years. (Freddie Mac Press Release, 04/16/04)

Freddie introduces new selling system to handle all cash selling needs

- Freddie Mac's new web-based selling system, allowing lenders to price, commit and fund mortgages for cash on a single platform, has added new capabilities to make it easier and faster for lenders to sell mortgages to the company. Lenders can now use the selling system to sell to Freddie Mac best efforts and mandatory cash contracts for both servicing-retained and servicing-released mortgages. This summer, a pilot for the Guarantor Swap program will begin using the new selling system. The selling system currently enables lenders to sell loans to Freddie Mac for cash 24 hours a day using an Internet connection, and receive next day funding, if needed. Under the old system, lenders needed a dedicated computer with special software to sell loans to Freddie Mac, or they telephoned the Freddie Mac cash desk. More than 1,000 lenders are selling mortgages to the company for cash using the selling system, which handles approximately 80% to 90% of Freddie Mac's cash mortgage purchases. (Freddie Mac Press Release, 04/13/04)

Freddie Mac launches Initial Interest Mortgage Products

- At the Mortgage Bankers Association National Secondary Market Conference & Expo, Freddie Mac announced that it will purchase and securitize a range of Initial Interest mortgages, offering more financial flexibility to borrowers. Freddie Mac also announced a new Weighted Average Coupon (WAC) Adjustable-Rate Mortgage (ARM) Cash execution for lenders using its new Web-based selling system.
- The new Initial Interest products include several constant maturity treasury (CMT) and LIBOR-indexed ARMs and two fixed-rate mortgages, where the initial loan payments are only interest. Fully amortizing principal and interest payments would begin at the expiration of the initial interest only period. Initial Interest mortgages will be available for assessment through Freddie Mac's Loan Prospector automated underwriting system beginning July 1.
- Beginning July 1, lenders can choose from a variety of sale executions to deliver Initial Interest mortgages to Freddie Mac, including Freddie's WAC ARM Guarantor execution, with a reduced \$1,000 minimum commitment for Initial Interest ARMs only, and traditional fixed-rate Guarantor paths. Lenders originating fixed-rate Initial Interest mortgages can also take advantage of the \$1,000 minimum commitment feature that is part of our MultiLender Swap execution.

- Freddie Mac's Initial Interest product enables borrowers to make lower interest-only monthly payments during the initial interest-only period, but still gives them the opportunity to pay down principal. The monthly payment during the initial interest-only period will adjust each time the borrower makes a principal payment. With a traditional mortgage, when the borrower makes a principal prepayment, it lowers the principal balance amount owed but does not change the monthly payment amount unless the borrower requests a change. The Initial Interest mortgage still becomes a fully amortizing mortgage after the initial interest-only period even if a borrower makes early principal payments.
- For lenders using its Web-based selling system, Freddie Mac's new Weighted Average Coupon ARM Cash execution provides an integrated process from pricing to settlement, aiming to improve a lender's ability to manage its pipeline more efficiently on one system.
- The WAC ARM cash execution permits eligible ARMs with different note rates, margins, servicing spreads, months to adjustment, and life caps to be delivered together under a single contract, subject to tolerances established by the selling system. Previously Freddie Mac only offered lenders a WAC ARM execution through its Guarantor program. (*Freddie Mac Press Release, 04/19/04*)

Freddie Mac enhances mortgage participation certificate disclosures

- In July 2004, Freddie Mac will enhance its disclosures for all PC pools. Freddie will disclose three new elements, including First Payment Distribution, First P&I Payment, and Weighted Average Original Loan Size. Freddie Mac is also improving its Weighted Average Loan Age (WALA)/Weighted Average Remaining Maturity (WARM) calculation for fixed-rate PCs. Under the new methodology, WARM plus WALA will not exceed two months more than the stated maturity of the pool.
- Freddie Mac will provide enhanced breakout disclosure for its PCs by disclosing the seller name, as well as the Weighted Average Coupon (WAC), WARM, and WALA and the high and low ranges in the breakout files for the loans associated with each seller. In addition, the WAC, WARM, and WALA and their high and low ranges will be available for each servicer of loans in a PC. Entities selling or servicing less than 1% of the UPB of the loans in a PC Pool will be combined under a separate heading designated as "Less than 1% UPB." (*Freddie Mac Press Release, 04/22/04*)

Federal Home Loan Banks

FHLBank-Seattle flies key lawmakers, their wives and aides to Hawaii for Easter

- The FHLBank-Seattle flew three key House lawmakers, their wives and top aides to Hawaii to attend a board of directors meeting at the exclusive Four Seasons Resort, where ocean-view bungalows start at \$540 a night. The four-night, five-day excursion over Easter recess at the Ka'upulehu-Kona resort cost the FHLBank-Seattle \$43,000 in airfare and lodging expenses alone for Representatives Michael Oxley (R-OH), Richard Baker (R-LA), and Paul Kanjorski (D-PA); their wives and three of their aides, FHLBank officials said. The average cost per couple, excluding meals, taxes and entertainment, was about \$9,000.
- “Yes, it’s a costly event, but we felt it was worth the investment to engage these members with our board rather than flying our board out to Washington, D.C.,” said the FHLBank-Seattle’s lobbyist Erik Strom, who helped organize the trip. “It’s Hawaii, there’s no doubt about it, it’s a nice location. But there was a full schedule, and we wanted the members [of Congress] to ...understand several issues before the FHLBanks.” The FHLBank-Seattle scheduled its Hawaii session for lawmakers in conjunction with the Bank’s regular bi-monthly board meeting, which is held outside its Seattle headquarters at a different regional location twice a year.
- All three lawmakers are key players on Capitol Hill in the debate over regulatory reform legislation for three housing GSEs. Oxley chairs the House Financial Services Committee, while Baker and Kanjorski are the top Republican and Democrat, respectively, on the subcommittee that specifically oversees the secondary mortgage market. The trip, while not necessarily unusual for Washington, follows on the heels of a “weekend of policy briefings and camaraderie” Fannie and Freddie sponsored for legislative aides in February at an upscale Utah ski resort. At the last minute, organizers canceled the trip, citing a busy legislative schedule and heightened media attention.
- “Congressman Baker thought it was valuable, and thought they spent many constructive hours talking about several important topics,” said Baker’s spokesman Michael DiResto, citing a pending rule requiring the banks to register with the SEC as well as risk-management issues as major discussion topics.
- House ethics rules allow private corporations to cover travel, hotel and meal costs for members of Congress, their aides, and certain family members as long as the trip is related to official House business and the expenses are considered “necessary” and “reasonable.” (*Dow Jones Newswires*, Dawn Kopecki, 04/21/04)

Castaneda hopes to improve cooperation at FHFB

- Speaking at a board meeting on her first day as chairman of the Federal Housing Finance Board, Alicia Castaneda said she will work closely with her board colleagues and continue efforts to strengthen the oversight of the FHLBanks. She thanked fellow board members for the “warm reception” they have given her since she became a director in January and said she would strive to cultivate their “productive relationship.” Castaneda said, “I am confident that I, my fellow directors, and the staff will work well together as a real team to carry out the important work of the Finance Board.” Her remarks obliquely referred to recent criticism of the agency and the tenure of her predecessor, John T. Korsmo, which was marked by infighting among board members. Castaneda is the fifth chairman of the agency in four years and the first woman and Hispanic to hold the position. Castaneda added, “I believe the Finance Board must be a strong, ‘arm’s-length’ regulator of the Federal Home Loan Banks, and I will work tirelessly to ensure that this agency has whatever regulatory tools, staffing and resources it needs to fully discharge its safety and soundness and mission-related responsibilities, including the affordable housing program.”
- Her three board colleagues, including Democrats Allan Mendelowitz and Franz Leichter, and Republican John Weicher, said they were looking forward to her role as chairman. Leichter said that he had nothing but praise for Castaneda, noting that she had shown more willingness to work with her fellow board members than Korsmo, whom he said “marginalized” the rest of the board. “I feel very optimistic that the board is going to work together very well and collaboratively,” Leichter said. “The issues are not basically partisan issues. I’ve gotten to know Alicia Castaneda, and I have great respect for her and I think she will be a strong and effective leader. She certainly has my support, and Allan’s support.” Leichter also said that he expected her chairmanship not to face partisan divisions, noting, “She doesn’t come from the political world. She doesn’t bring any partisan baggage with her. She is a banker, she understands banking, and I think any partisan issue would really mean nothing to her.”
- Observers say collaboration will be vitally necessary for the foreseeable future. With Korsmo’s departure, the board now has two Republicans (including Castaneda) and two Democrats. The White House is not expected to fill Korsmo’s board seat soon, so if Castaneda wants to pass any proposals, she will need at least one Democrat to vote with her.
- Alfred DelliBovi, the president of the FHLBank-New York, said he had expected to meet with Castaneda only briefly when he stopped by the agency in February to introduce himself. Instead, the two talked for more than two hours about several issues facing the board, he said. “I clearly came away believing she is a thoughtful individual who understands that in order to make things work you need collegiality on the board,” DelliBovi said in an interview. “She clearly knew a great deal about

the system.” (*American Banker*, Rob Blackwell, 04/14/04; *Federal Housing Finance Board Press Release*, 04/14/04; *American Banker*, Rob Blackwell, 04/15/04)

FHLBank’s MPF programs may increase competition for Fannie and Freddie

- According to a study issued by the Federal Reserve Bank of Atlanta, Fannie Mae and Freddie Mac may face increased competition from the FHLBanks’ Mortgage Partnership Finance program (MPF) and the revised (Basel II) capital requirements that will apply to large U.S. financial institutions. The authors conclude that greater competition in the primary and secondary mortgage markets from the MPF program and large U.S. financial institutions will be beneficial for borrowers and will likely reduce the relative size and importance of Fannie Mae and Freddie Mac. Increased competition is likely to erode the GSEs’ profits and hence their franchise value and effective capital. Thus, the GSEs will be faced with either accepting these lower expected returns or taking on more risk to try to regain some or all of their lost returns, unless restrained by safety-and-soundness regulation. The authors conclude “the speed at which competition is increased into the secondary market and the ability of regulators to effectively monitor risk profiles of the GSEs are important elements to consider in any [GSE] reform proposal.” (*Federal Reserve Bank of Atlanta Working Paper 2004-4*, W. Scott Frame and Lawrence J. White, 02/04; *National Mortgage News*, Brian Collins, 04/19/04)

Funding down in FHLBanks’ Mortgage Partnership Finance Program during first quarter 2004, while number of participants increase 54%

- During the first quarter of 2004, approximately \$4.9 billion of mortgages were funded through the FHLBank’s Mortgage Partnership Finance program (MFP), down sharply from \$16.2 billion for the same quarter a year ago. The first quarter drop in funding reflects the “significant slowing of volumes across the mortgage industry,” said the FHLBank-Chicago. At the first quarter, the number of MPF participants increased 753, up 54% from one year earlier, while more than 100 additional lenders are in process of joining the program. According to the FHLBank-Chicago, approximately 83% of MPF lenders are community financial institutions with assets less than \$548 million; while 13% are mid-sized institutions (assets \$548 million to \$5 billion) and 4% are large institutions with assets exceeding \$5 billion. MPF assets held in portfolio increased 1.5% from year end to \$88 billion, up from \$53.2 billion in the same period in 2003 said the FHLBank-Chicago. The credit performance of MPF loans continues to be excellent with only 0.12% of conventional MPF loans are more than 90 days delinquent, far below the fourth quarter 2003 national average for fixed-rate conventional loans of 1.10%, as reported by the Mortgage Bankers Association. (*Mortgage Partnership Finance Press Release*, 04/19/04; *Reuters*, 04/19/04; *American Banker*, Rob Blackwell, 04/20/04; *Dow Jones Newswires*, John Connor, 04/19/04)

FHLBank chiefs face pay cuts

- When Congress lifted limits on compensation of the 12 FHLBank presidents five years ago, the CEOs' pay soared even in years when financial performance soured. However, times have changed and five of the presidents received smaller paychecks in 2003. Hardest hit were Alfred A. DelliBovi, president of the FHLBank-New York, and James D. Roy, president of the FHLBank-Pittsburgh, whose institutions suffered both a sharp drop in profits and a raft of negative headlines.
- DelliBovi's overall compensation dropped 37% to \$512,000, while Roy's plunged 48% to \$505,000. With banks citing poor financial performance as the reason, neither executive received a bonus last year. They were the only two FHLBank presidents who did not receive incentive pay.
- In 2003, the FHLBank-New York's net income declined more than 80%, in part because of losses on its manufactured housing portfolio. "You should know that the effect on net income and dividends from our recent actions has negatively affected the compensation of the officers and other employees of the bank," the bank noted in its annual report. Similarly, a spokeswoman for the FHLBank-Pittsburgh said the board withheld management bonuses after net income fell nearly 42%, in part because of changes in accounting standards governing hedging. "I don't think it is any secret our financial performance was disappointing," but net income is just one factor in pay considerations, the spokeswoman said.
- Compensation for the different FHLBank presidents varied significantly last year -- from \$505,000 for Roy to \$1.35 million for Alex Pollock of the FHLBank-Chicago, according to data supplied by the Office of Finance, an arm of the Federal Housing Finance Board. The total compensation for 11 of the presidents fell nearly 1% from the previous year, to \$7.7 million. David Hehman, president of the FHLBank-Cincinnati was excluded, because he did not start until March 2003). The bank CEOs' compensation for 2003 was a very different scenario from the previous year, when the bank presidents' pay increased nearly 20% while their institutions' net income dropped 19%.
- Several critics said the 2003 statistics were good news, since the presidents' compensation appears to be now more closely tied to the financial performance of their institutions. "What really stuck out at me was that there was great variation in the financial performance from a historical perspective and how that led to variation in compensation," said James Bothwell, the chairman of Mortgage Market Strategies Group in Fairfax, Va., and a former managing director of the Finance Board. "Usually it was a matter of somebody getting an increase beyond someone else, but everyone at least got an increase. Now it is going down for some." Bert Ely, an independent consultant in Alexandria, Va., agreed that in the past "it didn't seem like there was a linkage" between financial performance and compensation, he said. "I think it is developing. I think that is healthy."

- Not all of the pay packages appeared to be linked to performance. For example, the total compensation for Raymond Christman, the president of the FHLBank-Atlanta, dropped 4.5%, to \$715,000. However, critics questioned why he received a \$228,000 bonus when the bank's net income fell 43%. A FHLBank-Atlanta spokesman said the bonus covered the previous year's performance and was merely paid early last year. (The FHLBank-Atlanta's net income fell 10% in 2002.)
- There were other discrepancies as well. Compensation for Patrick J. Conway of the FHLBank-Des Moines dropped 4%, to \$565,000, while his bank's net income skyrocketed 72%. A spokeswoman said Conway's pay suffered because a sluggish economy and slack loan demand prevented the bank from achieving one of its goals. "We did not make one of the incentive compensation goals. We met or exceeded two of the goals, but we did not meet the advances growth goal that we had," said the spokeswoman.
- Two of the presidents received a supplemental bonus labeled "long-term incentive compensation." Dean M. Schultz of the FHLBank-San Francisco received \$902,000 in total compensation, including a "long-term" bonus of \$217,000 and an annual bonus of \$165,000. Pollock with the FHLBank-Chicago received a \$449,000 in addition to his \$319,000 annual bonus and a \$588,000 salary. A spokesman for the Chicago bank said Pollock's long-term bonus was based on his meeting three years of goals set by the board. Allen H. Koranda, its chairman, defended Pollock's pay package in a statement to *American Banker*. "More than half of his 2003 compensation was incentive pay based on performance last year, and over the past three years," Koranda said. "Given the bank's exceptional results during both periods, the board believes his compensation is appropriate and well deserved." The Chicago bank's net income jumped 55%, to \$355 million, the highest total among the Home Loan banks. The bank also noted that for the third consecutive year it led the Home Loan Bank System in return on equity, at 8.92%. (The closest competitor was the Seattle bank, with a 5.95% ROE.)
- Even Ely, a long-time critic of the GSEs and a proponent of privatization of the Home Loan banks, gives credit to Pollock for his key role in creating the Mortgage Partnership Program. There were "two key factors" in Pollock's pay package, Ely said. "One is the financial performance of the institution, and No. 2, his role as an innovator in the system. Pollock has been the innovator. He is probably the only meaningful innovator in the system."
- Long-term bonuses, which appear to be granted just once every three years, could skew next year's results. For example, Pollock will almost certainly appear to suffer a decline in compensation. In fact, Roy was a victim of that last year. He was the only president to receive a long-term bonus in 2002, of \$316,000.
- Bothwell said the Finance Board should take a careful look at the bonuses being paid, because they are playing a larger role in overall pay. "The Finance Board should

review those incentive structures to make sure they are appropriately targeted and not easily manipulated,” he said. “In the past, they were pretty easily manipulated, but they weren’t such a large component of compensation, so it wasn’t that large an issue.”

- Franz Leichter, a member of the Finance Board, said he regrets that the Gramm-Leach-Bliley Act of 1999 removed his agency’s oversight of pay packages. “It would be helpful to have the final word...to be in a position to say we consider a presidential pay package to be unreasonable,” he said in an interview. He warned the banks’ boards to be cautious. “The board of directors of the individual banks should be very careful about looking at the incentive packages to make sure that incentives are related to performance. Performance doesn’t just mean profits. It means performing your mission, increasing your economic development, and looking at the affordable housing program.” (*American Banker*, Rob Blackwell, 04/16/04)

FHLBank-New York announces 1.58% dividend for first quarter

- The FHLBank-New York announced it will pay a first quarter 2004 dividend to members at an annualized rate of 1.58%. Alfred DelliBovi, the Bank’s president and chief executive, said he expects the dividend will remain below 2% for the remainder of 2004. After the FHLBank-New York suffered investment losses that reduced net income by about \$140 million, the Bank paid no dividend in the third quarter of 2003 and paid a 1.45% dividend for the fourth quarter of the year.
- “During the first quarter [of 2004], the FHLBank completed an organizational restructuring designed to incorporate industry best practices by creating a risk management function that is separated from the FHLBank’s business functions while exercising close oversight of all aspects of the FHLBank’s business,” DelliBovi said. “At the same time, the FHLBank implemented revised investment policies and rebuilt the investment portfolio to achieve reasonable returns on member capital with reduced risk,” he said. “Similar measures have been taken to align the FHLBank’s funding with its new investments, while redemption of excess member capital has been carefully managed to enhance the dividend.” DelliBovi said, “I anticipate that, in this record low-interest environment, earnings will remain less than 4% on capital and dividends will remain below 2% for the rest of 2004.”
- Under the FHLBank-New York’s 2004 dividend policy, 50% of the FHLBank’s net income for the quarter will be added to retained earnings and the remaining 50% will be paid in dividends to member financial institutions. “After the payment of the dividend, the Bank’s retained earnings will be approximately \$124 million,” said DelliBovi, who added that the Bank will continue to increase retained earnings to insulate member capital stock from risk. (*Dow Jones Newswire*, John Connor, 04/16/04)

Ginnie Mae

HUD plans drop minimum values for Ginnie Mae securities

- HUD is proposing remove a regulation specifying the current minimum face amount at \$25,000 for any security issued by Ginnie Mae. The proposal has a comment period ending June 14. According to Stephen Ledbetter, director of securities policy and research at Ginnie, the agency's objective is to "remove unnecessary hurdles that limit investors' ability to own Ginnie Mae securities." He added that currently investors can own Fannie Mae and Freddie Mac securities in \$1,000 increments, while Ginnie requires a \$25,000 minimum. This disparity does not make sense, said Ledbetter, since Ginnie Mae securities are of "higher quality" as they carry the full faith and credit guarantee of the U.S. government. "The notion is to broaden the investor base," said Ledbetter. The removal of the required minimum will likely increase the demand for Ginnie securities, thus creating more value, and ultimately resulting in lower costs for lower- and moderate-income homeowners.
- In addition to this proposal, Ginnie Mae is moving on several fronts to increase the demand for its securities. In July, the agency will roll out a stripped MBS product, similar to Fannie and Freddie's program. The stripped product results from the creation of interest- and principal-only carve-outs using a Grantor trust structure, rather than the usual REMIC platform. The trust is designed to provide more liquidity to the strips that are created. "All of these changes share the central mission of broadening the investor base for Ginnie Mae securities, which is part of delivering on our mission," said Ledbetter. (*Asset Securitization Report*, Karen Sibayan, 04/19/04)

Sallie Mae

Sallie Mae's net income fell 30% in first quarter

- Sallie Mae posted a 30% decline in its first-quarter net income, reporting a net income of \$291.5 million or \$0.64 a share, down from \$416.5 million or \$0.88 a share, a year earlier. Sallie Mae's latest results included pretax gains on student-loan securitizations of \$114 million, approximately 63% lower than the company's pretax student-loan securitizations gains of \$306 million for the prior year period.
- Sallie Mae's "core cash" net income rose 14% to \$231 million, or \$0.51 a share, from \$203 million, or \$0.43 a share, a year earlier. "Core cash" includes securitizations as financings, but excludes amortization and changes in market value of goodwill and acquired intangible assets, as well as nonrecurring items such as floor income and gains and losses on certain sales of securities and derivative contracts. Core cash net

income doesn't conform with generally accepted accounting principles, the company said.

- Loan-loss provision fell 6.4% to \$39.8 million. The company had total assets of \$73.26 billion at the end of the quarter, up 35% from a year earlier.
- Sallie Mae said its “preferred-channel” loan originations—those created by the company’s owned or affiliated brands-- rose 19% to an estimated \$5.8 billion and its total loan portfolio exceeded \$92.0 billion. (*Dow Jones Newswires*, Yolanda E. McBride, 04/15/04; *Asset Securitization Report*, 04/19/04; *CBS MarketWatch*, Greg Morcroft, 04/15/04)

Sallie Mae execs are “cashing in”

- Albert L. Lord, Sallie Mae’s vice chairman and chief executive officer, advised the company that he intends to sell approximately 200,000 shares of SLM common stock over the next several months, subject to market conditions. Lord is taking the action with the encouragement of Sallie Mae’s Board as a means to diversify his personal investments. Lord owns approximately 2 million shares and share units in Sallie Mae. Lord’s contemplated sale(s) would reduce his total equity ownership interest, including stock options, by approximately 2%.
- John Remondi, executive vice president for Sallie Mae, earned more than \$9.3 million in 2003 from exercising stock options and then selling the underlying shares. He also received a \$300,000 salary and \$600,000 bonus, more than double the prior year’s bonus. Altogether, Remondi earned more than \$10.5 million in 2003. (*CFO.com*, Stephen Taub, 04/05/04)

Sallie’s CEO ranks #6 on Fortune’s highest paid CEOs in 2003

- According to *Fortune Magazine*, Sallie Mae’s vice chairman and CEO Albert L. Lord ranked number six in their list of highest paid executives in 2003 with aggregate compensation of \$32.2 million. According to the magazine, 10% of Lord’s compensation was comprised of salary and bonus, 74% in options, and 16% in restricted stock. (*Fortune*, Matthew Boyle and Christopher Tkaczyk, 05/03/04)

TVA

TVA announces layoffs of 106 employees and 550 early retirements

- On April 22, the TVA issued layoff notices to 106 employees and said 550 employees had chosen to leave voluntarily. TVA also plans to eliminate 281 contractor positions in the coming months. In February, the utility offered some voluntary early retirement and buyout packages as part of efforts to prepare for industry deregulation by reducing expenses and paying down its more than \$25 billion debt.
- Previously, TVA announced it planned to eliminate 600 to 800 jobs. Not enough employees chose to take voluntary retirement or resignation in some areas, and those departments were targeted for layoffs, officials said. "Decisions involving people are the most difficult aspects of running a successful business, but TVA must adapt in order to succeed in an increasingly competitive environment," said a utility spokesman.
- The TVA did not say which departments or types of jobs were included in the layoffs. Employees who are laid off will receive severance pay and retirement benefits, and TVA will help them find new jobs. TVA has about 13,000 employees, 2,500 contractors who supplement TVA's work force in temporary jobs or specialized needs and 7,000 contractors at TVA's nuclear and coal-fired plants. (*YahooNews*, Elizabeth A. Davis, 04/22/04)

Farm Credit System/Farmer Mac

FCA board blocks lenders from property management

- In a unanimous vote, the Farm Credit Administration's board of directors denied the application of a farm credit lender to offer farm management and agricultural trust services, thus blocking financial institutions from entering property management. The National Association of Realtors (NAR) met with FCA officials and submitted a letter arguing that financial institutions would face inherent conflicts of interest if they were allowed to offer farm management services.
- "Property management is a commercial activity that essentially creates obvious conflicts of interest and could expose the FCA to significant liability," NAR Senior Vice President David Lereah said in a letter to FCA Chairman Michael Reyna. "Whenever a financial institution may act as lender and fiduciary, there is the potential for self-dealing and conflicts of interest. There are clearly potential conflicts where the financial institution provides lending and anticipates management

fees on the gross income of the property once it is operational. Permitting FCA institutions to provide farm management services is an unwarranted expansion into activities currently provided by real estate professionals. The proposed farm management services will give an unfair competitive advantage to member banks. Moreover, it is quite inappropriate for a government-sponsored enterprise to move into farm management at this juncture. To do so extends to member institutions benefits with which the private sector farm management firms simply cannot compete.” (*National Association of Realtors Press Release, 04/23/04*)

FCA board approves rule governing funding and discounting relationships for FCS banks

- The FCA Board approved a final rule that amends FCA regulations governing the funding and discount relationship between other financing institutions (OFIs) and FCS banks. This final rule is designed to make it easier for OFIs to obtain funding for short- and intermediate-term loans to farmers, ranchers, aquatic producers and harvesters, and rural homeowners through System banks. The rule streamlines the existing regulations to increase the flow of credit, removes provisions that do not enhance safety and soundness, and amends existing capital adequacy regulations for OFIs. The rule will become effective 30 days after publication in the Federal Register during which either or both Houses of Congress are in session. In a related action, the Board also directed agency staff to develop a proposal on investments in Farmer’s Notes, which was originally in the OFI proposed rule, as soon as possible for further public comment. (*FCA Press Release, 04/22/04*)

Postal Service

Difficult politics makes passage of USPS reform bill unlikely

- Representative John McHugh (R-NY), Chairman of the House Government Reform Committee’s Special Panel on Postal Reform and Oversight, said in a speech to the Direct Marketing Association that Congress is closing in on a “bipartisan, bicameral solution” to postal service reform. McHugh also said it is critical to move quickly before the legislative year passes away because the “crisis is upon us.” McHugh added, “If we don’t act now, the consequences of deferring our actions until the crisis is full blown would be disastrous.” At the Direct Marketing Association conference, Senator John Sununu (R-NH) told attendees that the biggest obstacle to postal reform legislation this year is “getting the momentum and the political will to take this on.” Nevertheless, Sununu said that Senator Susan Collins (R-ME), chairman of the Senate Governmental Affairs Committee, still expects to introduce a bill in the near future. Sununu also sits on the committee.

- Postal service reform entails a volatile mix of forces with two labor unions representing postal service workers, who often don't agree on many of the issues under consideration. A postal rate hike hangs over the deliberations of the unions with the size of the rate hike heavily dependent on how much if any military service retirement costs will be transferred from the Treasury Department to the USPS. To complicate matters further, there is also battle brewing between lobbyists representing the USPS and private sector package delivery companies, who fear that the Postal Service is using its monopoly on first class mail delivery to muscle in on the package delivery business.
- The Bush Administration is pushing to transfer the military service retirement costs, estimated at \$27 billion, which could have a major impact on the rate increases required by the USPS for its first class mail operation. Fearing this situation could have an adverse impact on their business, mass mailers have made postal reform a top legislative priority, according to a knowledgeable source. McHugh told the Direct Marketing Association that while he and ranking member Henry Waxman want to move the pension costs back to Treasury, the Bush Administration "doesn't agree with us."
- According to McHugh, the general thrust of postal reform legislation is expected to try and force the USPS to operate more like a private business, which has sparked an ideological debate among conservatives who believe that a government entity that does not pay taxes, has no shareholders, and which operates a monopoly on first class mail should not be allowed to compete with private sector companies. Some argue the USPS' status as a GSE confers unfair advantages when the Postal Service competes with private sector companies such as FedEx and UPS.
- Critics are particularly concerned about the USPS' use of Negotiated Service Agreements (NSAs). Under NSAs, the Postal Service can potentially approach companies with high mailing costs and offer to cut their first class mail costs in exchange for winning a bigger percentage of those companies' package delivery business. Private companies, like FedEx and UPS, are not able to compete effectively with the USPS since private companies cannot offer first class mail delivery. Moreover, private companies must bear the burden of taxes, while the USPS does not. According to one source, the net effect of NSAs would leave small businesses, who pay first class rates since they don't qualify for mass mailing discounts, subsidizing the mailing costs of large businesses. A knowledgeable source said that while mass mailers would love to see NSAs incorporated into legislation, their focus remains heavily on the military pension issue, and the NSA issue is "not a deal killer."
- Many participants in the postal reform debate point to these difficult political issues as a major reason why Congress is unlikely to produce a reform bill this year. (*White House Bulletin*, 04/22/04; *Postcom*, Association for Postal Commerce, 04/23/04)

<p>Mailer groups are hopeful about postal reform bill</p>

- Observers expect that postal reform bills will be introduced in shortly to address the U.S. Postal Service's financial needs and give it some of the freedoms it's long sought. "The bills will give the postal service the pricing flexibility it's [wanted] for years and mentioned in the President's Commission report," said Neal Denton, executive director of the Alliance of Nonprofit Mailers. The legislation will allow the USPS to set rates more in keeping with market conditions and to free it up from inflexible laws, Denton noted. Along with that is likely to come calls for the USPS to be more transparent with its finances, Denton added.
- One of the most important financial issues the bill will have to address is the issue of whether the USPS will pay the military pensions of its retirees, said Bob McLean, executive director of the Mailers Council. "The bills probably will address the military pension and Civil Service Retirement System CSRS issues because those are the two money issues that seem to generate the most consensus," said Louis Mastria, spokesman for the Direct Marketing Association. "The issues of governance and labor relations that seem to create greater controversy may not be included, but we'll see."
- "We've heard from the [congressional] leadership that if the bill gets out of committee this year, it will see floor time," said McLean. "The president has shown interest in this by naming the commission, and when the president shows interest it usually goes somewhere." But there may obstacles. "The big question is: Where does United Parcel Service stand?" added McLean. "Unfortunately there are constituencies out there that want to see the status quo remain," said Louis Mastria, spokesman for the Direct Marketing Association. (*Direct*, Larry Riggs, 05/01/04)

To hold down costs, Congress may privatize some post office functions

According to the Kiplinger Letter, "Congress will soon privatize many post office functions. Expect the move to hold down rate increases as private companies help make the Postal Service's mail and package delivery more efficient. Legislation coming late this year or early in 2005 will pave the way for private firms to sort and ship mail. They'll also run postal outlets in shopping malls, etc., allowing some traditional post offices to close." (*The Kiplinger Letter*, 04/16/04)

USPS pension issues debated

- In a report titled "Postal Service's Funding of the Civil Service Retirement System (CSRS)," the Office of the Inspector General of the USPS (OIG) concluded that the USPS overpayments, being held in escrow, should be released to the USPS and that requiring the USPS, and no other federal agency, to pay pension costs for military service constitutes a hidden tax on *mailers*. Additionally, the report supported an actuarial review of OPM's calculation of CSRS retirement costs, such as reevaluating

whether the costs associated with postal employees' prior government service should be included in the calculation. (*Alliance Report*, Association for Nonprofit Mailers, 04/23/04)

- In the CRS Report for Congress entitled "Pension Issues Cloud Postal Reform Debate," the Congressional Research Service notes the report issued in July 2003 by the blue-ribbon presidential commission gave new momentum to the reform of the business model of the USPS. The commission concluded that USPS faces a long-term decline in mail volume and revenues, and unless its finances are shored up, a taxpayer bailout or loss of universal service is threatened. While Congress has held a dozen hearings on the commission's report, broad reform proposals, however, have been somewhat overshadowed by controversy over two pension funding issues left unsettled by passage of P.L. 108-18, the Postal Civil Service Retirement System Funding Reform Act of 2003. The first issue to be resolved is what to do with the "savings" to the USPS from the reduction in its payments to the Civil Service Retirement Fund allowed by law. The second issue concerns the provision in the 2003 act transferring from the Treasury to the Postal Service responsibility for paying the retirement benefits earned by postal employees when they were members of the armed forces, a \$27 billion obligation. Because the Postal Service has said it must raise rates in 2006, there is some urgency to resolving these two issues before rate preparations begin this summer. If there is no resolution, the new postal rates for 2006 will reflect \$3 billion for an escrow fund that cannot be used and \$1.5 billion of pension costs related to prior military service. To date, parties focused on postal reform have packaged acceptable escrow and military retirement provisions with a broader postal reform measure that enacts some of the bold recommendations of the Presidential blue-ribbon commission. In the dozen congressional hearings on USPS reform, these two issues have overshadowed discussion of the commission's recommendations, creating an impasse for postal reform. (*CRS Report for Congress*, 04/12/04)

USPS comp program so flawed that 102 year old man is able to "pass up" retirement

- According to Senator Susan Collins (R-ME), the USPS's workers' comp program is so flawed that a 102-year-old employee is able to pass up retirement in favor of continuing benefits. As a result, the USPS's system that encourages continuing workers' comp benefits over retirement causes "enormous unfunded liability." Collins, who chairs the Senate Governmental Affairs Committee, told a recent hearing on postal reform the USPS is "laboring under financial liabilities, including \$7 billion for workers' compensation claims." There are more than 1,000 cases of employees who were injured on the job more than 30 years ago and although eligible for retirement, stick to the workers' comp benefits plan, Collins said. Walter Olihovik, president of the National Association of Postmasters of the United States, told the committee that while "we have to do the right thing for injured [workers] ... the system is out of control and in need of an overhaul." (*Risk & Insurance*, Kathleen Filipczyk, 04/01/04)

According to the president of NALC, pay is not the problem at USPS

- In response to Sam Ryan's Letter to the Editor in the *Washington Post* entitled "Postal Pay at a Premium," William L Young, president of the National Association of Letter Carriers, said, "Far from being out of control, labor costs are falling. The Postal Service has reduced its workforce by 70,000 employees during the past five years. Labor costs as a share of total costs have declined from 86 percent in 1976 to 76 percent in 2003. Contrary to Mr. Ryan's claim, postal employees earn wages and benefits that are comparable to workers doing similar jobs for national delivery companies such as FedEx and UPS. In inflation-adjusted terms, postal wages or overall postage rates have not increased significantly since 1971. Congress can do many things to help secure the long-term viability of the Postal Service. Attacking the middle-class pay and benefits of postal workers is not among them." (*Washington Post*, William H. Young, 04/19/04)

APWU prepares large scale media campaign, targeting postal reform

- The American Postal Workers Union, AFL-CIO (APWU) is preparing to finance a large-scale media campaign to battle anti-worker, anti-consumer "reform" aspects of proposed postal reform legislation should it become necessary, said APWU President William Burrus. "Nine months ago, the APWU National Executive Board authorized a special assessment of union members' dues to fund such a campaign," Burrus said. "I am prepared to implement the assessment if legislation is introduced that is detrimental to postal workers and the American public." The assessment would generate \$2 million. Vowing to do "whatever it takes" to defeat anti-worker "reform" efforts, the board approved an \$8 assessment per member at its July 8, 2003, meeting, to be paid in \$2 increments over four pay periods. "We intend to raise enough money to thwart any legislation that would undermine postal services, or the rights of postal workers," Burrus said. "And we will work to end giveaways to the mailing industry that threaten the viability of the USPS," he said. "We will do whatever is necessary to defeat any plan that would weaken the nation's mail system." (*American Postal Workers Union press release*, 04/12/04)

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