

The **GSE** REPORT™

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Major Events

U.S. Justice Department and Congressional Research Service conclude that Treasury *can* limit Fannie Mae and Freddie Mac's debt

- The U.S. Justice Department has provided the Treasury Department a legal opinion that says the agency has authority to limit future debt issuance by Fannie Mae and Freddie Mac, a significant step toward curbing the GSEs' growth. The legal opinion says the Treasury Department has broad authority over the GSEs' debt issuance and says Treasury can limit debt sales by Fannie and Freddie to ensure their safety and soundness and to protect financial markets and the economy as a whole, according to an official familiar with it. The opinion rejects several legal arguments the GSEs had used to question the Treasury's authority. Justice's opinion also would allow Treasury officials to restrict debt issuances of the FHLBs.
- Despite the legal opinion, Treasury officials are proceeding cautiously to avoid roiling financial and housing markets. A Treasury decision to limit the companies' borrowing could lead some equity and debt investors to shy away from their securities, at least temporarily, says Jim Vogel, a senior vice president at FTN Financial Capital Markets, Memphis, TN. Bush administration officials hope the opinion will pressure the GSEs to negotiate a deal over long-stalled legislation to toughen their oversight.
- Even without Treasury intervention, the companies' growth is likely to slow from the torrid pace of the past decade, says Jonathan Gray, an analyst at Sanford C. Bernstein & Co., New York. After growing faster than the overall mortgage market in that period, the two companies are finding it harder to gain market share without hurting profit margins.
- Some Democrats view the administration's initiatives as part of a broader effort by conservatives to reduce government's support for housing. "What's the argument for restricting what [the GSEs] do overall except you don't like them?" says Representative Barney Frank (D-MA), the minority leader on the House Financial Services Committee.
- Treasury officials declined to discuss the opinion letter. Treasury spokeswoman Ann Womack-Kolton said only that "Treasury has broad authority in this area." She added that Treasury officials would not "speculate on future action ...but we continue to monitor and review all aspects of the ...matter."
- The Congressional Research Service (CRS) concurred with the U.S. Justice Department, issuing an opinion that the Treasury Department has the authority to limit debt sales by Fannie Mae and Freddie Mac. In a report dated July 26, the CRS

concluded the laws chartering the GSEs clearly give the Treasury Secretary the right to approve debt sales. “The statutory language at issue here unambiguously grants approval power to the Secretary of the Treasury without any qualifying language limiting the exercise of this power in any way,” said CRS in its six-page report. The CRS opinion may carry more weight than that issued by the Justice Department, because CRS is independent of the executive branch. CRS provides bipartisan, objective research to Congress. (*Wall Street Journal*, John D. McKinnon and James R. Hagerty, 07/06/04; *Reuters*, 07/16/04; *American Banker*, Barbara Rehm, 07/30/04)

HUD opens formal inquiries into international operations of Fannie and Freddie

- According to the *Wall Street Journal*, HUD has opened formal inquiries into the international operations of Fannie Mae and Freddie Mac and into Fannie financing of loans in key congressional districts. HUD’s inquiry into the GSEs international operations was triggered by a May 25 speech in Cairo by then-Egyptian Finance Minister Medhat Hassanein, who announced plans for a joint venture between Fannie Mae, the World Bank’s International Finance Corp., and Egypt’s National Investment Bank to “securitize home loans and help spur on the nascent Egyptian mortgage market.” A Reuter’s news service story of Hassanein’s remarks prompted a complaint to HUD by FM Policy Focus.
- Fannie Mae officials have since confirmed that the GSE is bidding on a multi-year U.S. contract to help Egyptian officials develop a system to finance mortgages through government debt, mortgage-backed securities and other investments. Fannie is bidding on this project as a subcontractor to international consultant PADCO Inc. Previously, Fannie Mae officials had characterized their dealings with Egypt as “informal discussions,” saying they “talked to Egypt before just like we’ve talked to lots of other countries to share our experiences.” The larger \$37 million project, funded by the U.S. Agency for International Development, will develop the legal, technical, regulatory and financial infrastructure for Egypt’s real estate industry. According to another bidder, US AID is expected to announce the contract winner within the next 30 days.
- “We are a subcontractor bid for a very small part of an overall bid through US AID,” said Fannie Mae spokeswoman Janice Daue. “We would provide consulting services after being approached by the consortium.” Daue added Fannie Mae has worked as a subcontractor on several US AID projects in the past. “This is the same type of work we’ve done with the U.S. government to provide consulting services for the last 14 years,” she said.
- Representative Jeb Hensarling (R-TX) has asked HUD and the US AID to look into Fannie Mae’s involvement in the bid on the government contract to help Egypt build and stabilize its mortgage market. Hensarling, who sits on the House Financial Services and Budget Committees that oversee Fannie and its regulators, questioned the appropriateness of Fannie’s work overseas, saying in a recent letter to US AID

Administrator Andrew Natsios and HUD Secretary Alphonso Jackson that he has “serious concerns” about Fannie’s involvement in the bid process.

- In a letter dated July 21, Hensarling asked Jackson and Natsios to provide data on Fannie Mae’s involvement in Egypt as well as in other US AID bids, among other things. “Does Fannie Mae’s participation in the US AID solicitation and in a joint venture with a foreign government-related entity comport with its special mission under its Congressional [sic] charter?” asked Hensarling. He also asked if Fannie’s federal charter allows it to provide to foreign governments consulting services that don’t benefit the U.S. mortgage markets and if Fannie’s participation as a subcontractor to US AID increases risks for U.S. taxpayers.
- According to documents available on US AID’s web site, Fannie Mae has worked as a subcontractor on numerous projects in South Africa (dating back to 1999), Russia (dating back to 1995), Mexico, Egypt, and most recently China. In July, Fannie Mae also announced that it will be provide training and consulting services on real estate securitizations in China. Fannie Mae spokeswoman Janice Daue said Fannie Mae has worked on numerous international projects with the Asian Development Bank, International Finance Corporation, Inter-American Development Bank, U.S. Treasury Department, HUD and The World Bank.
- Fannie Mae and Freddie Mac have been expanding their reach in recent years into international markets as a source of funds to finance their massive mortgage portfolios. Fannie Mae has also branched out into international markets as a consultant, offering an array of services from product development to portfolio management to dozens of foreign nations considering creating their own secondary mortgage market.
- “All of us can profit from sharing our ideas, practices and innovations,” Fannie CEO Franklin D. Raines told a group of international housing experts last April. “By charter, Fannie Mae must apply all of our financial capital towards residential mortgages in the United States. But we are happy to share our intellectual capital with any nation seeking to improve its housing finance system.” (*Wall Street Journal*, Dawn Kopecki, 07/15/04; *Wall Street Journal*, Dawn Kopecki, 07/19/04; *Wall Street Journal*, Dawn Kopecki, 07/27/04; *South China Morning Post*, Lin Li Shangai, 07/03/04)

OFHEO Director Falcon and Finance Board Chairman Castaneda testify before House Financial Services Subcommittees
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- OFHEO Director Armando Falcon, Jr. and Finance Board Chairman Alicia R. Castaneda testified before a joint hearing of the Capital Markets, Insurance and Government Sponsored Enterprises and the Oversight and Investigations subcommittees of the House Financial Services Committee. Both Falcon and Castaneda testified that each of their charges are financially safe and sound, following

a handful of recent supervisory actions. The regulators noted that Fannie Mae, Freddie Mac and the FHLB System generally pass muster with regard to capital adequacy, asset quality, management, earnings, liquidity and interest-rate and market risk sensitivity.

- OFHEO Director Falcon testified that in 2004 OFHEO adopted the federal banking regulators' system of "CAMELS" in analyzing and reporting on the condition of the Fannie Mae and Freddie Mac. [CAMELS is the acronym for six areas of evaluation, including capital adequacy, asset quality, management, earnings, liquidity and sensitivity].
- Falcon told the lawmakers that both Fannie Mae and Freddie Mac exceeded their minimum and risk-based capital requirements for all quarters in 2003, and were classified as adequately capitalized. Based upon the agency's examination activities to date, OFHEO has concluded that Fannie Mae and Freddy Mac have strong asset quality and prudent credit risk management practices.
- Regarding management at Freddie Mac, OFHEO conducted a special examination of the events leading to the GSE's restatement and replacement of senior management. Freddie Mac subsequently agreed to implement corrective measures and pay a civil money penalty of \$125 million as part of a consent order with OFHEO. During the period of the consent order, Freddie Mac's board of directors has elected a new chairman and has hired a number of senior executives as its new management team. To date, the company is making good progress on its remediation obligations.
- Regarding Fannie Mae's management, Falcon testified that the overall management of operational risk at Fannie Mae comports with applicable safety and soundness standards, but *this judgment may be subject to change as a result of a special examination*. OFHEO has initiated a special examination of the accounting policies and practices at Fannie Mae. The scope of this review includes accounting policies and controls at the enterprise, including the identification of any control weaknesses or unusual transactions. Pending completion of that examination, Falcon told lawmakers, a definitive assessment of Fannie Mae management must be deferred.
- Falcon told lawmakers that Fannie Mae and Freddie Mac's earnings in 2003 were strong, totaling \$7.9 billion and \$4.9 billion respectively. OFHEO has been monitoring Freddy Mac's progress in compiling and issuing delayed quarterly financial statements for 2004 and will continue to work with the company to resolve problems so that investors receive accurate and full disclosure of financial information on a timely basis.
- Falcon testified that OFHEO found that Fannie Mae and Freddie Mac demonstrated reliable access to sufficient sources of funds on cost effective terms to remain liquid and meet their obligations throughout 2003. OFHEO also found that both GSEs have adequately managed their exposure to sensitivity risk.

- Falcon testified that while OFHEO is making progress in its special examination of Fannie Mae, he is not satisfied with the GSE's cooperation. Fannie's cooperation has been "spotty," he told the panel. Falcon later told reporters after the hearing that some document submissions were not complete and there have been problems in getting some employees scheduled for interviews. While no enforcement actions have been taken, Falcon said these problems have been raised with Fannie executives so that everyone understands the importance of cooperating. So far, 30 individuals have been interviewed as part of the special examination of Fannie's accounting policies and practices. Falcon could not give the lawmakers a timeline for completing the special examination, which was initiated late last year in the wake of the Freddie Mac accounting scandal. Falcon noted that the special examination "may result in earnings restatements that could affect the calculation of the company's capital requirements."
- House Financial Services Capital Markets Subcommittee Chairman Richard Baker, R-La., said he was "very interested" in the special accounting review underway at Fannie Mae. Baker asked Falcon to respond in writing to a series of questions, including whether Fannie Mae is making information available to his office, and that of the external auditor, in a timely manner. Baker also asked Falcon to provide information on the GSEs' executive compensation and on fees the companies charge lenders when purchasing loans.
- Falcon also revealed that OFHEO is asking Congress for additional funds for the special examination. "Larger resources than anticipated are required to complete it," he testified. OFHEO is seeking \$59.2 million for fiscal year 2005 - a 45% increase over this year's budget to pay for a larger staff and the special examination of Fannie Mae. The increased funding, if approved by Congress, will include \$3.3 million for the special examination and allow OFHEO to increase its staffing by 58 new positions, including 40 examiners.
- Falcon also told lawmakers that he supports the GSEs' new affordable housing goals recently proposed by HUD. While Fannie Mae and Freddie Mac argue that the AH rule has the potential to negatively affect their business, Falcon didn't raise concerns about safety and soundness. "Whether these companies can meet these goals remains to be seen," Falcon said. At the same time, Falcon said he doesn't believe it would be a "stretch" for either one. He also stressed that Congress should view the new targets as "goals and not mandates."
- Finance Board Chairman Alicia Castaneda told lawmakers that the agency has "attained a level of expertise, experience and capabilities that makes the Finance Board an accomplished, effective financial regulatory agency." While the agency has made great strides over the past two years, Castaneda told lawmakers "there is still more to do." She added, "My intention is to continue building our staff, adding necessary resources, and fostering a world-class regulatory culture at the Finance Board." The clearest evidence of progress at the Finance Board is the tripling of its examination staff, Castaneda said. "We have also hired highly qualified mortgage

specialists, bank analysts, community development specialists, accountants and economists,” she said. “We are upgrading our technology and systems.”

- Castaneda testified that the FHLBs are now required to file with the SEC by June 30, 2005 in compliance with the Securities and Exchange Commission Act of 1934. Castaneda also recently pushed through a consent order for the FHLB-Chicago to correct deficiencies in its risk management, internal audit, capital management, accounting and record-keeping activities after several years of informal warnings. “After a series of incremental steps dating back several years, my colleagues and I on the Finance Board determined that a formal written agreement was the necessary and appropriate next step to improve the bank’s management and oversight of these issues,” she testified. She added that the Finance Board has begun a systemwide review of the banks’ affordable-housing programs to ensure they are operating in a safe and sound manner.
- Representatives Barney Frank (D-MA) and Louis Gutierrez (D-IL) urged Castaneda to address the impact of large bank mergers on the distribution of affordable housing funds among the FHLB districts. Castaneda indicated no interest in taking up the issue of multidistrict membership, noting that Finance Board data shows that distribution of AH funds has not changed over the years despite the acquisition of some of the largest FHLBank members by institutions outside the member’s FHLBank district.
- Financial Services Oversight and Investigations Subcommittee Chairwoman Sue Kelly (R-NY) said the subcommittee supports OFHEO’s \$59.2 million FY05 budget request, and is pleased with the “tremendous strides” OFHEO and the Finance Board have taken to strengthen their oversight role. Nevertheless, Kelly said both regulators remain “ill-equipped” to effectively regulate the housing GSEs. (*CongressDaily AM*, Molly M. Peterson, 07/14/04; *Dow Jones International News*, Dawn Kopecki, 07/14/04; *American Banker*, Rob Blackwell, 07/15/04; *Associated Press*, 07/13/04, *Market News International*, Claudia Hirsch, 07/13/04; *Reuters News*, Mark Felsenthal, 07/13/04; *Dow Jones Newswires*, Dawn Kopecki, 07/13/04; *Dow Jones Newswires*, John Connor, 07/14/04; *Federal Document Clearing House*, Armando Falcon, Jr., 07/13/04)

<p>Federal Reserve Chairman Alan Greenspan says Fed is agnostic on structure of GSE regulator</p>

- In testimony before the House Financial Services Committee, Federal Reserve Chairman Alan Greenspan said the central bank has not weighed in on the potential structure of a new regulator for Fannie Mae and Freddie Mac, but the Fed would prefer to see a larger degree of securitization of mortgage-backed instruments. “I ... have argued the necessity of increasing the share of purchased home mortgages by the GSEs which are securitized rather than kept in portfolios that we at the Fed perceive is a significant subsidized rate,” he said. “But we haven’t thought through

any of the issues with respect to the structure of where the regulator is located and what he does,” the Fed chairman said to lawmakers (*The Main Wire*, Chris Middleton, 07/22/04)

“Sinking feeling intensifies” at Fannie, as the GSE reports its second quarter results

- Fannie Mae announced a slight increase in second-quarter profits, but lowered its earnings forecast for the remainder of the year. The GSE earned \$1.11 billion, or \$1.10 a share, compared to \$1.1 billion, or \$1.09 a share, a year ago. Fannie’s core earnings, rose 1.9% to \$1.9 billion, or \$1.91 a share, compared to \$1.86 billion, or \$1.86 a share, a year ago. By that measure, Fannie beat the Thomson First Call estimate of \$1.83 a share in the latest quarter.
- In a press release, Fannie Mae’s management lowered their outlook for the rest of the year, mainly due to an accounting change OFHEO recently forced it to follow. The accounting change mandated by OFHEO forced Fannie Mae to take a \$278 million impairment expense on the value of its mobile home mortgage-backed bonds. The GSE said it expects core earnings to rise in the “mid-single digit range,” down from an earlier prediction that core earnings would rise by about 10%.
- Net interest income at Fannie fell 11% due the changing interest rate environment, and its guarantee fee rate declined 2 basis points to average 20 basis points for the second quarter. Fannie Mae CFO Tim Howard said Fannie experienced initial interest-rate purchase spreads 40 basis points lower in the second quarter because of the pick up in adjustable rate lending as fixed mortgage rates increased. “If that holds for the full year, at year end, the margin on the book at that time would be 10 basis points lower than if you didn’t have that product mix,” Howard said. As a result, Fannie Mae now expects to see the net interest margin move below 100 basis points during the second half of the year.
- Fannie said its mortgage portfolio, which it relies on to generate profits, grew by 9.4% during the quarter compared to a year ago. Fannie’s exposure to potential derivative losses was \$534 million as of June 30, up from \$327 million on March 31.
- “This is just a bad climate for Fannie’s business, as consumers’ demand for adjustable-rate mortgages is higher ... and banks still have an appetite for mortgage assets -- making investing in MBS less profitable,” wrote Bradley Ball, an analyst at Prudential Equity Group LLC in a research report. Paul Miller, a Friedman, Billings, Ramsey Group Inc. analyst, said the disclosure of increased ARM purchases may have alarmed investors, who believe Fannie has no funding advantage over banks when it comes to buying such loans. “I think that’s going to be the question these guys are going to get in the next six months,” he said. In an investor conference call, Fannie Mae’s senior vice president for investor relations Jayne Shontell said that because of the tighter spreads between risky and safe tranches, the private-label share of new mortgage bond issuance has exceeded those of Fannie and Freddie Mac.

While Shontell said the trend in market share should reverse, Miller said the revelation was another cause for investor concern.

- Fannie backtracked from a plan it announced last quarter to omit balance sheet and stockholders' equity information from its earnings releases. Instead of deferring the data until its 10-Q filing, Fannie said it will "extend the typical timing of these press releases by several days" and provide the data as a part of its earnings release. The GSE announced that total stockholders' equity climbed 25%, to \$26 billion during the second quarter.
- Fannie Mae also announced approval of its quarterly dividend of \$0.52 a share for common stock, unchanged from its first quarter dividend announced in April 2004. (*TheStreet.com*, Matthew Goldstein, 07/21/04; *Dow Jones Newswire*, Janet Morrissey, 07/06/04; *American Banker*, Jody Shenn, 07/22/04; *Dow Jones Newswires*, Paula L. Stepankowsky, 07/21/04; *PRNewswire*, Fannie Mae, 07/20/04)
- Peter Eavis writes in his column on *TheStreet.com* that the "sinking feeling intensifies at Fannie," following the GSE's release of its second quarter results. Eavis said, "With Washington pols breathing down its neck and its regulator growing increasingly critical, Fannie Mae has long needed to report a strong, clean set of quarterly financial results to show detractors it doesn't need to be reformed. But the government-sponsored mortgage giant failed to do so. ... There was some evidence that Fannie's balance sheet stopped deteriorating in the period, but a cut in earnings guidance, a large charge and some unsettling noise in the numbers will ensure that Fannie remains squarely in its critics' sights. And of course, Wall Street's doubts won't be assuaged either. ... Fannie's stock, which has been rising recently, dropped \$2.31 to \$71.97 [after the earnings release]"
- "... In the second quarter, shareholders' equity increased by \$5.3 billion, or 26%, to \$26.1 billion. The main reason for this was that derivatives that are used to borrow at fixed interest rates moved up in value as interest rates rose in the quarter. The line in which these derivatives' value is booked gained \$7.9 billion in the second quarter. But it would be truly foolhardy to assume that Fannie's balance sheet strengthened substantially in the quarter. That's because shareholders' equity doesn't take into account any changes in the value of hundreds of billions of dollars of assets on Fannie's balance sheet. These would have gone down in value as rates rose. What investors need is something called a fair-value balance sheet, which shows the market value change of all assets, liabilities and derivatives. Fannie has talked a lot about providing this on a quarterly basis, but it hasn't done so. It only comes out once a year in the annual report -- and it hasn't been at all flattering to Fannie in the past two years."
- "Absent the fair-value balance sheet, investors are left to make their own calculations. One rough-and-ready approach is to mark down all the assets to show what would have happened to them as rates rose. Usefully, the change in the value of one set of assets does show up on the balance sheet. We can apply that percentage decline to

the far larger set of assets that don't get marked to market on the balance sheet. If we do that, we see that the value of these so-called held-to-maturity assets fell by \$9.4 billion, which would have more than offset the \$7.9 billion gain in the line that contains the derivatives. In other words, the best that Fannie can say is that the decline in its balance sheet strength was arrested for one quarter."

- "...[T]he cut in earnings-per-share guidance reverberated around Wall Street Wednesday. Fannie had lots of excuses up its sleeve. It pointed to the \$278 million charge to some distressed bonds that it made after coming under pressure from its regulator, the Office of Federal Housing Enterprise Oversight. ...Fannie also said that the spread between its debt and assets has been slimming, and predicted that it would fall below 1 percentage point in the next two quarters. This has happened partly because more adjustable-rate mortgages are being written, and these carry lower interest rates in the earlier years. "
- "Also, as rates have risen, Fannie's debt costs have also risen. What we're seeing is not just something temporary. It is what was always bound to happen at the end of the largest credit boom the U.S. has ever seen. Profitability is going to get socked at all lenders as rates go up -- and Fannie is no exception. Indeed, the weakness of its equity bases makes it more vulnerable than other financials, regardless of its government support. Fannie's leverage ratio -- which measures assets to equity -- is a stunning 38 to 1."
- "There were other reasons Fannie's second-quarter numbers smelled bad. The tax rate, at 13%, was far lower than in the year-earlier period, with no explanation. And Fannie's numbers benefited enormously from the fact that it had no debt extinguishments expense. The Street wasn't expecting a large expense in this line in this quarter, but it certainly wasn't expecting a small gain."
- "The second-quarter numbers say very little that is reassuring about Fannie. OFHEO has every reason to continue its probe, and the pro-reform forces in Washington still have plenty of ammo if they want to paint a picture of barely accountable execs abusing government advantages to build a risky, undercapitalized company."
(*TheStreet.com*, Peter Eavis, 07/22/04)

Fannie Mae and Freddie Mac

Debate over HUD's proposed changes in affordable housing rule rages on
HUD ramps up the pressure on GSEs and stands up to critics on revised HUD goals

- HUD received more than 260 comment letters from Fannie Mae, Freddie Mac, and other groups who work closely with the GSEs, sharply criticizing HUD's plan to raise affordable-housing goals for the two companies. The bulk of the comment letters support new housing rules that force the GSEs to "stretch" their resources to finance low-income and minority borrowers, while many cautioned HUD against setting goals are too aggressive and will result in unintended consequences.
- Fannie Mae and Freddie Mac both argued that HUD is overestimating how strong the housing market will be over the next four years. "We concluded that the estimates about the share of goal-qualifying originations and resulting goal levels contained in the proposed rule are, in many cases, so far beyond what the primary market is likely to produce that the goals may be infeasible unless the GSEs restrict some non-goal-qualifying purchases," Freddie wrote. "The proposed rule would have a destabilizing effect on markets to the extent that regulatory requirements overshadow market incentives in mortgage lending and investment decisions." Freddie concluded, "We believe the goals are overly aggressive and will result in negative unintended consequences for borrowers and markets."
- The two GSEs also suggested that HUD had improperly, and perhaps illegally, focused on one part of the 1992 statutory language authorizing the affordable housing goals that said the GSEs should "lead the market" in their purchase of mortgages from low- and moderate-income borrowers. "Each goal-setting provision requires HUD to consider, among other things, 'the ability of the enterprises to lead the industry,'" wrote Fannie. "HUD has converted this criterion into a requirement, which Congress never adopted, that each company must in fact lead the market. ... Further, HUD has elevated this factor that it is not simply one of six criteria that HUD must consider and balance, but constitutes an absolute obligation that the companies must meet without regard to the other statutory criteria." A footnote in Fannie's letter said, "HUD's application of the statutory factors ...is vulnerable to [legal] challenge as inconsistent with the governing law."
- Freddie also claimed that HUD had "converted it from a 'factor' to a 'requirement' " and then "made it, in essence, the sole overarching requirement in setting each goal." Freddie initially requested that HUD withdraw its 496-page proposal; several hours later, Freddie rescinded that request and submitted a new comment letter. The revised letter deleted a line saying several deficiencies in HUD proposal "may render the proposed rule legally unreasonable or arbitrary and capricious." A Freddie Mac

spokeswoman said the initial letter was sent in error and that she did not know how the mistake occurred.

- Fannie and Freddie both proposed that HUD eliminate refinanced mortgages from its calculations, arguing that a high number of refinanced loans can distort Fannie and Freddie's affordable housing performance.
- Fannie asked HUD to give the GSEs "bonuses" to direct money to the "most difficult markets to serve, such as first-time homebuyers, rural housing, extremely low-income households, manufactured housing, small multifamily and high-minority census tracts." Fannie also asked HUD to "avoid regulation" that would outlaw large financial transactions designed to help the companies boost their affordable housing performance. "Our concern is that such regulation could create impediments to the smooth functioning of the secondary mortgage market," Fannie said.
- Several bankers also submitted comment letters about HUD plan, including Joseph Seidel, the managing director of external affairs and public policy for Credit Suisse First Boston and Jason P. Bohrer, executive vice president at SunTrust Banks Inc., Atlanta, GA. Seidel wrote that HUD's affordable-housing goals for multi-family mortgages could hurt the private sector. "The multifamily mortgage market is now well-served by a number and variety of capital sources," Seidel wrote. "By mandating greater market share to the GSEs, the delicate balance may be undone and the GSEs will be forced to adjust their business practices to effectively take business away from private-sector competitors." Bohrer wrote that SunTrust also worries about the "potential adverse effects" of the proposal. "If the goals are not attainable, conforming loan limits may be curtailed, resulting in higher interest rates for many consumers," Bohrer wrote.
- David Bianucci, a vice president at Morgan Stanley Dean Witter Credit Corp. wrote that he's concerned that HUD's proposed rule will increase the GSEs' needs for riskier loans, placing a premium on loans that qualify towards their financing goals. "The by-product may be a marketplace that reacts contrary to a 'normal' credit curve, by creating a price premium for higher risk loans, and price discounts for lower risk loans," Bianucci wrote. "The access to affordable housing is critical, but should not supplant rational economics."
- The American Bankers Association, America's Community Bankers, and the Independent Community Bankers of America all contended in their letters that HUD's AH goals are too high. The Mortgage Bankers Association (MBA) questioned HUD's basis for predicting the potential market that the GSEs are expected to lead. MBA said, "Unless the goals reflect true market size...we are likely to see a number of market disruptions that will ultimately hurt the very families and communities that HUD is attempting to serve." This argument may not go very far since HUD based its market projections on numbers provided by the MBA, Fannie Mae, Freddie Mac and other industry groups, said HUD Assistant Secretary for Housing John Weicher.

- The Consumer Mortgage Coalition (CMC) encouraged HUD to include a new goal in the final rule to implement Section 1335 of the 1992 Act that requires each GSE to purchase CRA-eligible loans. In setting the CRA Affordable Housing Goal and CRA subgoals, HUD should use its regulatory authority to require the GSEs to develop appropriate underwriting standards, business practices, repurchase requirements, pricing, fees and procedures to assure that the benefits of the GSE status flow through to the low- and moderate income borrowers and underserved areas that are served by CRA mortgage lending. CMC also recommended that each of the GSE goals and subgoals for affordable housing should be discrete for the single family and multifamily sectors. Further, HUD should use HMDA and CRA data to verify the GSEs' performance and report the agency's analysis to Congress.
- The Housing Policy Council for the Financial Services Roundtable wrote that the group supports HUD's efforts to expand affordable housing and provided five recommendations to refine the HUD proposal. Their recommendations included (i) goals should be more effectively targeted to meet the needs of low and moderate income borrowers; (ii) goals should be based on income definitions consistent with other federal housing programs and CRA; (iii) goals should include a strong program for the GSEs to purchase new and seasoned CRA loans; (iv) achievement of the goals should be transparent and verifiable; and (v) goals should be monitored on a regular basis to ensure that they do not adversely affect successful programs such as FHA.
- The Consumer Bankers Association supports HUD's efforts to increase homeownership by improving the housing goals for the GSEs. However, CBA, notes, HUD's housing goals do not address the need for GSEs to provide greater liquidity for CRA loans. CBA provided suggestions on how HUD could encourage the GSEs to provide greater liquidity for these loans. CBA also outlined recommendations on ways to redefine underserved areas goals, focus on special affordable housing goals, and use HMDA data to track performance within the context of the HUD Proposal.
- Jerry Howard, president of the National Association of Home Builders, wrote "Changes in HUD's proposal are needed so as not to impair the ability of the [GSEs] to meet their statutory mission of providing liquidity to the broader finance market. The basic problem is that HUD has overestimated the amount of financing that could meet the goals and has not appropriately factored in the potential for future volatility in the mortgage markets." NAHB called on HUD to incorporate updated data into its market estimates; to eliminate single-family refinancing transactions from its goals calculations; and to set its goals levels at the midpoint of its market range estimates instead of the high point.
- Sixteen Democrats on the House Financial Services Committee submitted a comment letter, stating that they favor setting housing goals higher but "do not think the level of increase can be intelligently formulated under the current framework." The Democratic legislators, which included Representative Barney Frank (D-MA), the committee's lead Democrat, Representative Maxine Waters (D-CA), and

Representative Paul E. Kanjorski (D-PA), wrote that HUD should exclude any refinance loans from the total numbers used for determining affordable-housing goals.

- The National Community Reinvestment Coalition wrote that HUD's proposed rule takes the "right step" to improve the GSEs performance in underserved markets, but doesn't go far enough in certain areas, such as affordable rental housing.
- Some groups, such as AARP, asked HUD to provide a second extension of 60 days to comment period. The regulation, which is a year overdue, has been available for public comment since April 5, when HUD sent it to Congress. If HUD doesn't adopt a final rule by the end of this year, the higher affordable housing goals won't go into effect until 2006. "Clearly they don't want us to implement the rules in 2005," HUD Secretary Alphonso Jackson recently told *Dow Jones*.
- HUD's proposal was supported by the National Community Reinvestment Coalition (NCRC). John Taylor, NCRC's president of wrote, "The GSEs have demonstrated that they can meet HUD's affordable-housing goals while maintaining healthy profits and operating in a safe and sound manner." NCRC recommended that HUD go further and establish a goal for purchases of mortgages from minority borrowers, a market that the GSEs have not tapped, the coalition argued. "NCRC believes that an explicit goal is a more effective means than exhortations alone for achieving acceptable GSE performance to minorities," Taylor wrote. (*Dow Jones Newswires*, Dawn Kopecki, 07/16/04; *American Banker*, Rob Blackwell, 07/15/04; *Dow Jones Newswires*, Dawn Kopecki, 07/16/04; *PRNewswire*, National Association of Home Builders, 07/16/04; *Reuters*, Richard Leong, 07/16/04; *Consumer Bankers Association comment letter*, Steven I. Zeisel, 07/16/04; *Consumer Mortgage Coalition comment letter*, Anne C. Canfield, 07/13/04; *Housing Policy Council for the Financial Services Roundtable*, Paul Leonard, 07/16/04)

HUD ramps up the pressure on GSEs and stands up to critics on revised HUD goals

- HUD ramped up political pressure on Fannie Mae and Freddie Mac, releasing a new analysis of statistics, showing that the GSEs lagged the general mortgage market in financing loans to low- and moderate-income borrowers in 44 states from 1999 through 2002. Over this period, HUD found that 41.6% of the private market's volume would have qualified under the low- and moderate financing goal, compared to 40.6% for Fannie and 39.9% for Freddie. The data also showed that 15.1% of the market's total volume would have met the very low-income target, while 13.9% of Fannie and 13.6% of Freddie's volume met that goal. The market similarly surpassed the GSEs in financing loans to underserved areas with 27.6% of the volume qualifying under that measurement, compared to 26.0% for Fannie and 24.6% for Freddie.
- "While the [GSEs] met the affordable housing goals in 2002, they must further utilize their entrepreneurial talents and power in the marketplace to genuinely lead the mortgage finance industry as Congress intended," said HUD Secretary Alphonso

Jackson. HUD's proposed AH rule would "simply push the GSEs to do what is expected of them - helping low- and moderate-income families at least at the same percentage levels as primary market lenders," Jackson added. (*Dow Jones International News*, Dawn Kopecki, 07/09/04)

- Representatives of both Fannie Mae and Freddie Mac discounted the HUD study. The *American Banker* writes, "A close look at the [HUD] report shows, though, that Fannie outdid the market in 12 states, including big ones such as California and Florida, as well as in the District of Columbia. Freddie outperformed the market only in Hawaii, Rhode Island, and the District of Columbia. A HUD spokesman said it reached its 44-state figure by combining the Fannie and Freddie percentages in each state and then dividing by two. For example, in Minnesota, Fannie outperformed the market 58.2% to 57%, while Freddie lagged with 54.5%. But averaging the two GSEs' percentages yields a figure of 56.35% -- so HUD declared them both behind the market." (*American Banker*, 07/12/04)
- Jackson told *Dow Jones Newswires* that he was troubled by comments made by Freddie Mac's new Chief Executive Richard Syron, who told the U.S. Conference of Mayors that HUD's aggressive housing targets could raise mortgage rates and costs for all borrowers. "That's not what he said to us when he met with us," Jackson said. "He was very apologetic. He admitted that they had not done all they could do. He said he was willing to work with us and felt that we had reasonable goals ... it was more like a confession." Jackson added, "And then to hear him say something else publicly was very disconcerting." (*Dow Jones International News*, Dawn Kopecki, 07/09/04)
- Later in a news conference, John Weicher, the Assistant Secretary for Housing for HUD, vigorously defended the agency's proposal to raise affordable housing goals for Fannie Mae and Freddie Mac and rejected criticism that the plan could raise interest rates and force the GSEs enterprises to buy fewer loans. Fannie and Freddie "can meet the goals by doing a better job in the markets they are now serving of reaching families whose mortgages fall into one of the" affordable housing categories, Weicher said.
- In response to some lawmakers' claims that the goals might be too tough and could raise interest rates, Weicher said "There is no reason at all for rates to go up that I can see." Rates might rise only if Fannie and Freddie try to engage in "denominator management," where the GSEs effectively buying fewer overall loans so that they can have a higher percentage of low- and moderate-income mortgages, he said. But he did not think they will do that. The GSEs do not need to do that to meet the goals, Weicher said. "They just need to buy a proportional share of what is in the market -- the market that they serve -- and if they do that they will be meeting the goals that we set."
- Weicher also rejected some lawmakers' concerns that the GSEs would effectively lower the conforming loan limit to assure a higher percentage of loans that meet the

affordable housing targets. “They don’t have to pull back from that market ... They just have to reach out more into the low-mods and ...underserved area of the conventional market -- they can do that,” he said.

- Weicher emphasized that, while meeting past AH goals, the GSEs have consistently lagged the market in serving low- and moderate-income families. He said HUD was increasing the goals significantly because the agency wants them to match it. “Other lenders -- banks, thrift institutions ... are doing more of the business in the conventional lending market than the GSEs are,” Weicher said. “The goals have always been set below the market. The GSEs have not been expected to do as much business in any one of these loan categories proportionally as much business as there is to be done in the market.”
- Weicher said that at least part of Fannie and Freddie’s opposition to the proposal is due to concerns about the GSEs’ profitability. “The lower the goals are from their standpoint, the easier it is for them to meet them, the less risk there is to the public relations issue, and probably the more profitable they are,” he said. “It’s probable that the rate of return that they are going to get on low-mod loans is a bit lower than the rate of returns they get on loans that are not low-mod, for example.”
- Fannie and Freddie would have the opportunity to request a waiver from fulfilling targets if the mortgage market makes unexpected shifts or if they view a particular goal as not feasible, Weicher noted. (*American Banker*, Rob Blackwell, 07/15/04)

HUDwinked?

- In its *Review and Outlook* column, the *Wall Street Journal* writes, “As corporate lobbyists go, nobody does it better than Fannie Mae and Freddie Mac. Consider how friends of the mortgage giants in Congress are griping that the Bush Administration is forcing them to lend too much, but also not enough, to lower-income Americans. You’ve got to be good (and sneaky) to pull this one off.”
- The *WSJ* reminds us that 76 House Democratic members recently sent a letter to President Bush, complaining that the Administration’s “emphasis on the GSEs’ safety and soundness” was hurting the poor. *WSJ* writes, “...The disconnect here is that the Bush Administration is trying to do exactly that. ...HUD has proposed a rule that would require Fan and Fred to purchase more mortgages from lower-income households. ...HUD is on the right track.”
- “Although Fan and Fred make a big deal (see their TV ads) about the sacredness of their mission to provide affordable housing, their record isn’t exactly stellar. HUD data show that they lagged other mortgage lenders in financing loans to low- and moderate-income borrowers in 44 states from 1999 through 2002.”

- “Simply put, Fan and Fred and their supporters are trying to have it both ways: pretending that the companies are tribunes of the poor, even as they use their implicit subsidy to pad their bottom lines and raise their stock price for private investors. Do the Members of Congress realize how foolish they look? Republicans like [Representative Gary] Miller betray their market principles and embrace subsidies to please the home-builder and Realtor lobbies that are in bed with Fannie. And Democrats invoke the poor even as most of the federal subsidy they want to protect merely helps the rich get richer. HUD decides today whether to go ahead with the new higher targets for Fan and Fred. We hope it doesn’t let them get away with their double lobbying game.” (*Wall Street Journal*, 07/16/04)

Representative Baker says his subcommittee may schedule GSE hearings this fall

- Republican Representative Richard Baker (R-LA), chairman of the House Financial Services Subcommittee on Capital Markets, Insurance and GSEs, said his subcommittee may schedule a GSE hearing in September or early October, depending on when OFHEO can respond to written requests Baker plans to submit to the agency. Baker’s letter to OFHEO will address the guarantee fees that GSEs charge mortgage lenders, as well as details on the companies’ executive compensation, the number of first-time homebuyers’ mortgages in the GSEs’ portfolios and Fannie Mae’s level of compliance with OFHEO’s requests during its forensic accounting review of the secondary mortgage market giant.
- Baker told reporters that he does not anticipate “in the near-term” the full committee taking up the GSE regulatory reform legislation passed earlier this year by Senate Banking Committee Chairman Richard Shelby. Earlier, Representative Ed Royce (R-CA) called on the House Financial Services Committee to mark up Shelby’s bill and put members formally “on the record” regarding GSE reform. “Congress needs to act,” Royce said. Until then, lawmakers must be held responsible for any financial failure that might occur at a housing GSE, he added. (*Market News International*, Claudia Hirsch, 07/13/04)

Federal Reserve Governor Bies concerned about GSEs’ “lack of market discipline

- Federal Reserve Governor Susan Bies said she is concerned about what she sees as a “lack of any market discipline around Fannie and Freddie.” She added, “If they would [securitize] the loans and sell them in the secondary market, I would be happy.” (*Dow Jones Newswires*, 07/15/04)

Were obits on GSE regulatory reform in 2004 premature?

- In his *Capital Views* column, John Connor asks the question if the obituaries for GSE regulatory reform were premature. While many involved in the GSE regulatory

reform debate may deny that presidential politics have had anything to do with the way the fracas has played out this year, Connor says don't believe them. If you're a GSE taking serious heat from the Bush Administration, and it looks like Democratic presidential nominee John Kerry has a chance of running the show after the next inauguration day, you don't rush to cut a deal with the current administration, especially if the Democrats are far more favorably disposed to your cause.

- Connor ponders another scenario where, perhaps two months from now, President George W. Bush's re-election prospects look considerably brighter than they do today. When faced with the prospect of a "vengeful" (with respect to GSEs) Bush team returning to the job in 2005 and the likelihood of another onslaught of political risk and negative headlines, might the GSEs be willing and perhaps eager to cut a "quickest" deal before Congress calls it quits for the year? Just a thought, Connor writes, perhaps induced by the incessant blathering about presidential politics. (*Dow Jones Capital Markets Report*, John Connor, 07/07/04)

GSEs riding the waves of "violent bond sell-offs"

- Howard Simons writes in *RealMoney.com*, "Much has been made, and rightfully so, of the financial sector's ability to dodge certain bullets so far. Fannie Mae and Freddie Mac have been able to ride out huge waves of refinancing and a couple of violent bond market sell-offs in the past three years. Hopefully the occasional executive dismissals and accounting scandals bother only the squeamish. But, as noted here in September 2002, the mortgage giants are nothing more than big bets on a continued steep yield curve at lower rates." (*RealMoney.com*, Howard Simons, 07/27/04)

Tricky hedging standards of FAS 133 give GSE critics ammunition

- Todd Davenport writes in the *Wall Street Journal* that the very nature of Fannie Mae's and Freddie Mac's business of buying and managing fixed-rate mortgages demands hedging, which "plunges" the GSEs into some of the densest black holes of generally accepted accounting principles--FAS 133, the Financial Accounting Standards Board's standard for derivatives and hedge accounting. FAS 133 is "typically acknowledged as the most difficult to interpret and apply to public companies," writes Davenport. "One has to ask themselves literally how many people truly understand 133 in order to be able to do the calculations and understand the calculations," said an accountant at a large bank, who spoke off the record. "If you put in a room the number of people who truly have a comprehensive understanding of these things, you start getting into a very small population."
- It's "gotten to the point that someone who is very specialized in [FAS 133] probably understands it, but even the chief financial officer probably only has a very cursory

understanding,” said Ben Neuhausen, the national director of accounting at BDO Seidman LLP in Chicago.

- The general purpose of FAS 133 is to give the companies’ financial statements “some relief” from the volatility that hedges can create, since the value of a derivative designed to hedge an asset may fluctuate wildly from period to period, while the hedged asset is carried at its amortized cost. Under GAP, if the hedge precisely covers the asset, it is assumed to be effective and qualifies for hedge accounting and its value fluctuations are not recognized in the income statement.
- Davenport writes, “[E]ffectiveness is difficult to achieve, so the GSEs must run many of their derivatives’ value changes through the income statement, an action that can cause tremendous volatility. Because investors hate volatility, the cost of capital rises with it.” Fannie and Freddie “are required to mark-to-market derivative-based debt but not straight debt that has exactly the same economics,” said Mike McMahon, an analyst in the San Francisco office of Sandler O’Neill & Partners LP. “If you’ve got something that is identical in the economics but is accounted for differently, that is distressing. When you have to mark-to-market half your debt but not the other half -- and not the assets that the debt is supporting -- that creates even more distortions.”
- While companies try to get around the distortions caused by these accounting treatments by representing core or operating earnings, investors’ skepticism can undermine the value of those representations. Many analysts and investors have learned not to trust management representations of operating results, after seeing “nonrecurring” items recur in financial statements,
- Davenport notes, “...Fannie and Freddie are in a particular bind.” McMahon said, “I don’t think there is any doubt that if a team of 40 accountants went in to review every single transaction -- whether it be Fannie, Freddie, Citigroup, Microsoft, or anybody else -- they could find something questionable, because there is a judgment applied in accounting. If you’re under a cloud of suspicion to begin with, then the alleged accounting error or misapplication, whether through honest intention or not, is exaggerated, or could be.”
- After being forced to restate 2000-2002 earnings, Freddie Mac certainly earned investors’ suspicion. Fannie has its own problems with questions raised about its valuation of manufactured housing loans and the resulting OFHEO review of the GSEs asset quality and accounting controls.
- Davenport writes, “Confusing accounting makes it relatively easy to take potshots at Fannie and Freddie.” George Wilson, a teacher of seminars for the SEC Institute in Coral Gables, FL, said “It doesn’t have to be something that’s wrong. It’s just something you disagree with, or you just take a different interpretation.” The GSEs’ politically charged atmosphere has made it easy for critics to “conflate” disagreements and allege error, Wilson added. (*American Banker*, Todd Davenport, 07/29/04)

Proposed rules for complex transactions such as derivatives
to place ultimate responsibility on the board of directors debated

- In May, the Federal Reserve, the Treasury Department, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the FDIC and the SEC jointly proposed rules are aimed at curbing transactions created to manipulate the accounting of earnings such as those engaged by Freddie Mac. The rules would require Wall Street investment banks and financial institutions that offer or use complex structured financial transactions to maintain formal oversight policies and procedures.
- Investment banking firms would be responsible for ensuring that their clients' accounting, disclosure and tax treatment of a complex financial transaction are correct and the deal is appropriate for them. A firm that designs and offers such deals should also make sure investors understand the risks and rewards. These structured deals include derivatives, asset-backed securities and highly specialized finance vehicles. The rules would also place ultimate responsibility for the deals on a financial institution's board of directors.
- Wall Street investment banks, which are major players in structured finance deals, said the proposed rules overreach and that they are already meeting global disclosure standards and tough internal policies. "The proposed guidance could impose significant burdens on market participants and discourage innovation," said Micah Green, president of The Bond Market Association. "The current proposals could disrupt sound risk management practices by introducing overly onerous controls," said Robert Pickel, CEO of the International Swaps and Derivatives Association. (*Reuters*, 07/20/04)

Former President of FHLB-Chicago Pollock is drafting proposal
to *fully* privatize Fannie, Freddie and the FHLBs

- According to the *Wall Street Journal*, the former President of the FHLB-Chicago Alex J. Pollock is drafting a proposal to fully privatize Fannie Mae, Freddie Mac, and the FHLBs. Based upon his 12 years as president of the FHLB-Chicago, Pollock said he believes that the housing GSEs can thrive without government backing and that elimination of government support would make the mortgage market more competitive and efficient. Pollock said he favors legislation that would cut government support of the GSEs over a ten year period, in a manner similar to that of the privatization of Sallie Mae. During the transition, Pollock said Congress should encourage more competition between the FHLBs, Fannie and Freddie to drive down mortgage costs for consumers. Pollock said he favors the elimination of differences in the GSEs' tax burdens and providing the GSEs a single regulator. If the GSEs are privatized, Pollock said it was probable that some of the GSEs would merge, resulting in six or seven competitors, speculated Pollock.

- The Wall Street Journal notes that privatization is at “best a distant prospect for the GSEs, which have strong support in Congress.” Other FHLB veterans, along with Fannie Mae and Freddie Mac officials, oppose privatization. FHLB-NY president Alfred A. DelliBovi called privatization “a terrible idea” and said it would lead to lower levels of home ownership. (*Wall Street Journal*, James R. Hagerty, 08/03/04)

Tiny (independent) think tank wields big stick on regulation in Washington
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- When it comes to business regulation in Washington, Mercatus Center has become the most important think tank you’ve never heard of. Staffed by veterans of the White House office that reviews and often scales back proposed rules, Mercatus, with its free-market philosophy, has become a kind of shadow regulatory authority.
- Members of the Mercatus’ 2002 “Founder’s Circle,” of contributors giving at least \$10,000, included ExxonMobil Corp., Fannie Mae, Freddie Mac, General Motors Corp., Gillette Co., Microsoft Corp., Morgan Stanley Dean Witter Co., the NYSE and Pfizer Inc.
- Mercatus says it isn’t beholden to any company. After Mercatus scholar Jay Cochran published a November 2001 report that detailed mortgage giant Fannie Mae’s government subsidies, the GSE’s top lobbyist, Arne Christenson, chewed out Cochran over the telephone for not showing the study to Fannie in advance. Christenson says he felt blind-sided, and just wanted a chance to present Fannie’s views. “I considered Mercatus to be a soul mate,” he said. Cochran held firm. “Just because you’re the subject of the study doesn’t give you the right to shape it,” Cochran said. Fannie Mae no longer contributes to Mercatus. Christenson, who has left Fannie, says the incident didn’t play a role in that decision. A Fannie Mae spokesman declined to comment. (*Wall Street Journal*, Bob Davis, 07/16/04)

Presidential politics: GSE dollars going to the Democrats

- Fannie Mae and Freddie Mac have more at stake in this presidential election than in others in recent memory, and it shows. The GSEs have shifted their donations away from Republicans since the last election, and they have been very active behind the scenes at the Democratic presidential convention.
- Many lawmakers, lobbyists, and industry representatives say Fannie and Freddie could gain significantly if Senator John Kerry (D-MA) wins the November election. President “Bush has become adversarial to them in a way nobody previously had,” Representative Barney Frank (D-MA) said. Over the past year, the Bush administration has pushed legislation to reform the regulation of GSEs and has backed supervisory efforts to rein-in the GSEs’ activities, including threatening to limit the GSEs’ debt issuances and beginning inquiries into their international

consulting and partnership offices. Most observers say that pressure on the GSEs would evaporate with a Kerry win, and that any GSE regulatory reform bill that gets passed would look significantly different.

- Fannie and Freddie representatives downplay their stakes in the presidential election. “We look forward to working again with the current administration or a new administration,” said Dwight Robinson, Freddie’s senior vice president of corporate relations. However, the GSEs’ political donations suggest otherwise. In previous election cycles, Freddie has given more donations to Republican candidates than to Democrats, while Fannie’s contributions leaned “slight” toward Democrats.
- In the 2003-2004 cycle, Fannie and Freddie shifted their donations significantly to the Democrats. According to the Center for Responsive Politics, Fannie Mae has given 62% of its donations to Democrats this cycle, while 72% of Freddie Mac’s donations were given to Democrats. Both GSEs’ political contributions have dropped significantly from the 2001-2002 cycle, most likely because of recent changes in campaign finance laws.
- In the presidential race, Fannie employees have given \$33,000 to President Bush and \$29,000 to Senator Kerry, said the center. Approximately 66% of Fannie’s donations to President Bush came before June 30, 2003, months before any administration official took a position on GSE matters. According to the center, Freddie employees have given \$11,800 to the Kerry campaign, 22% more than they have given to the Bush campaign. Sources said there has not been a concerted effort by either GSE to steer employees’ contributions toward a certain candidate or party. Fannie’s political action committee has given equally to both parties this cycle and Freddie has not yet started a PAC.
- Fannie Mae and Freddie Mac are making their presences known at the Democratic convention, having each given between \$250,000 and \$500,000 to the Boston host committee and have provided additional funding to several individual parties. Fannie, Freddie and four of their allies during the GSE debate hosted a party in the Boston Harbor Hotel’s Wharf Room. Attendees could not help but notice the event’s theme—the American dream of homeownership. A replica of a house entrance stood next to a red, white and blue picket fence with mailboxes and “proverbial” apple pies sat in a faux window. Most of Freddie’s management team attended, including chairman and CEO Richard Syron, general counsel Ralph Boyd, chief of staff Hollis McLaughlin, lead lobbyist Clarke Camper, and Mr. Robinson. Several lawmakers, including Senator Paul Sarbanes (D-MD), the Senate Banking Committee ranking Democrat; Representative Paul Kanjorski (D-PA); Representative Mel Watt (D-NC); and Senator Jack Reed (D-RI) also attended. While no company was willing to provide an exact price on the party, several sources agreed that the cost was more than \$300,000.
- Fannie and Freddie say that they are also making plans to donate to the host committee of the Republican National Convention in New York and will fund parties

there. According to *The Hill.com*, one of the hottest tickets at the Republican's New York convention will be a housing-industry party at Rockefeller Center, where Fannie Mae and Freddie Mac and housing and banking trade groups will transform the venue's well-known ice-skating rink into a set of partially built homes.

- The GSEs, particularly Fannie Mae, may have more than just lawmakers in their corner with a Kerry victory. Fannie has a wealth of inside connections with the campaign. James Johnson, Fannie's former CEO, was Senator Kerry's chief adviser during his search for a vice presidential pick. Tom Donilon, Fannie's chief lobbyist, has a brother, Mike, who is one of Senator Kerry's lead advisers. John Sasso, the general election manager for the Democratic National Committee and a close friend of Senator Kerry, sat on Fannie's board. And Franklin Raines, the GSE's current CEO, is routinely touted as a leading pick for several Kerry administration posts, including Treasury Secretary. Freddie's strongest connection is Chairman and CEO Richard Syron, who hails from Boston and donated money to the Kerry campaign before becoming the company's head.
- While most agree Fannie and Freddie would find their situation improved with a Kerry victory, few expect the GSE issues to go away entirely. In interviews of lawmakers by *The American Banker* attending the Fannie-Freddie event, all of the lawmakers said they were intent on establishing a new, tougher regulator. They said they would be more focused on housing issues, rather than exclusively on safety and soundness. "I think you are going to see some legislation," said Senator Reed (D-RI). "More importantly, I think you will see, with a Kerry administration, hopefully a very fast movement toward housing production policy."
- Under a Kerry administration, it's unlikely that a new emphasis on housing would be all good for Fannie and Freddie. Frank has repeatedly said that not all of the GSEs' business lines need to be profitable, and many Democrats have said the GSEs should be doing more to help poorer people. Fannie and Freddie supporters say the Democrats may be more aggressive about attempting to saddle the companies with more housing requirements.
- Fannie and Freddie are already complaining that the Department of Housing and Urban Development's recent proposal to raise the affordable housing goals was excessive. Former HUD Secretary Andrew Cuomo in the Clinton administration sounded less than sympathetic to the GSEs when he spoke at an FHLB-San Francisco event. While making no reference to the Bush administration's recent proposal, Cuomo said, "The GSEs are the main entity for affordable housing in the nation. They need a little provocation, they need a little regulation, but at the end of the day they do more than ever before." He noted that past AH goal hikes were also met with criticism from Fannie and Freddie. "The GSEs screamed," Cuomo said. "Boy, did they scream. They said they were too high. ... I think the goals should be even higher." (*American Banker*, Rob Blackwell, 07/29/04; *The Hill.com*, Josephine Hearn, 07/26/04; *American Banker*, Rob Blackwell, 07/30/04)

Raines' "ragged" tenure at Fannie may knock him off Kerry's Treasury list, while Jim Johnson can "do anything" in a Kerry Administration

- Alexis Simendinger writes in *The National Journal* that some Democrats say Franklin Raines, who served Clinton as budget director and is now Chairman and CEO of Fannie Mae, could be the first African-American Treasury Secretary. One source, however, thought that Raines's tenure at Fannie Mae had been "ragged" enough to knock him off [Kerry's] Treasury list. (*The National Journal*, Alexis Simendinger, 07/29/04)
- James Johnson, the former CEO of Fannie Mae, won high marks for that leak-proof search for Kerry's running mate, brings an intimate knowledge of financial markets coupled with experience running a major corporation. Moreover, Johnson is a true Washington insider. "Jim Johnson can do anything," said Kerry supporter Robert Dugger, managing director at Tudor Investment Corp. "He's an enormously, enormously experienced, savvy guy." Many observers think Johnson can write his own ticket if Kerry wins in November, and the plum economic post of Treasury Secretary will likely be his prize. (*Reuters*, Tim Ahmann, 07/26/04)

Federal Reserve Governors Gramlich and Olson reveal GSE bond ownership

- Federal Reserve governors Mark Olson and Edward Gramlich disclosed that they own or have owned bonds issued by GSEs that the central bank has said warrant tighter regulation. In their annual disclosure statements, Olson reported that he recently owned and sold a FHLB bond worth \$50,000 and Gramlich reported he owns a Freddie Mac bond worth between \$100,000 and \$250,000. Gramlich had disclosed that ownership in previous disclosure statements. The disclosure marked the second time in two months that senior U.S. policymakers advocating stricter regulation of GSEs have acknowledged owning bonds issued by GSEs. (*Dow Jones Newswires*, Greg Ip and Joseph Rebellio, 07/06/04)

After 30 years with HUD, Markison joins the Mortgage Bankers Association

- After 30 years with HUD, Ken Markison is joining the Mortgage Bankers Association as the senior director and regulatory counsel in MBA's government affairs shop. Most recently, Markison was HUD's assistant general counsel for GSEs and the Real Estate Settlement Procedures Act. (*CongressDaily*, 07/14/04)

Fannie Mae

OFHEO re-examines its method of calculating regulatory capital, raising questions about Fannie Mae's capital adequacy

- OFHEO is “looking at” what some critics see as a flaw in the regulator’s method of assessing whether the two GSEs hold enough capital, said OFHEO spokeswoman Corinne Russell. At issue is whether OFHEO should follow the example of bank regulators and limit the extent to which deferred tax assets, consisting of tax benefits a company hopes to gain at some point in the future, can be counted as capital. Russell declined to elaborate on OFHEO’s review of this issue. Any change in OFHEO’s methodology could have negative implications for Fannie Mae, because unlike Freddie Mac, Fannie has large amounts of deferred tax assets (DTA) on its balance sheet. While the issue could hardly be more arcane, DTAs could add more urgency to the debate.
- Critics argue that capital is supposed to be available to pay off creditors if a company gets into a jam and if a company is going “bust,” it won’t be able to turn potential future tax credits into cash. These credits would likely be worthless in a liquidation, which is why U.S. bank regulators limit the amount of deferred tax assets that a bank may include in its regulatory capital to the lesser of the amount that the bank expects to realize within a year or 10% of Tier 1 core capital. Fannie and Freddie should be subject to the same limits, argues Lawrence Kam, a portfolio manager at Sonic Capital, in Quincy, Mass. As one of Fannie’s more persistent critics, Kam says he has a short position in Fannie stock.
- On December 31, 2003, Fannie listed net deferred tax assets of \$9.14 billion, which is equivalent to about a quarter of its core capital. Fannie Mae spokesman Chuck Greener says \$6.7 billion of that total hasn’t been included in core capital calculations, since this portion of the GSE’s deferred tax assets relates to losses or potential losses -- recorded in the accumulated other comprehensive income, or AOCI, account -- on derivative contracts used to hedge Fannie’s interest-rate risks. Excluding these tax assets, the amount in question potentially subject to future limits would be \$2.4 billion, representing 7% of Fannie’s core capital. It’s unclear, however, that OFHEO would take exactly the same view as Fannie, if the agency decided to limit the inclusion of tax assets in computing capital. The Office of the Comptroller of the Currency and the FDIC don’t make the distinction made by Fannie on different types of tax assets. While FDIC’s chief accountant Robert Storch says there might be a case for such a distinction, he said that large losses on derivatives could themselves give rise to questions about whether an institution needs to hold more capital.
- For Freddie, DTAs appears not to be an issue at this time, since the company had no deferred tax assets on a net basis at the end of 2002. Because of its accounting

problems, Freddie won't disclose its deferred tax data for the end of 2003 until September. (*Wall Street Journal*, James R. Hagerty, 07/26/04)

Fannie skips its debt sale in July, giving the market the jitters

- In a terse statement, Fannie Mae said it “elected not to issue a Benchmark Note in July,” leaving analysts to wonder if the GSE’s decision indicates slower portfolio growth at the firm or a caving in to regulatory criticism that the GSE is getting too big. Fannie Mae followed this surprise announcement with a second-quarter earnings report that warned of possible future auction cancellations to provide the company with “additional flexibility.”
- Analysts suggested a slowing in Fannie Mae’s portfolio simply means the corporation needs less debt to support its activities. Analyst Jim Vogel at FTN Financial said, “Even though the broad implications of slower portfolio growth have been widely discussed in the market, investors may not have anticipated its full impact on actual debt issuance.” Vogel added, “The question is whether investors might react more aggressively to [Fannie Mae’s] slowing growth story after today’s calendar pass.” (*Market News International*, Joe Plocek, 07/16/04; *Washington Post*, 07/19/04; *The Main Wire*, Claudia Hirsch, 07/27/04)

What is Fannie Mae?

- Peter Overby on *NPR Morning Edition*, told his listeners “one rival lobbyist calls Fannie Mae a political organization that happens to be in the mortgage business.” (*NPR Morning Edition*, Peter Overby, 07/21/04)

Fannie Mae enhances its MBS disclosures

- Beginning in August 2004, Fannie Mae will include data for Mega pools on the monthly Supplemental file and will provide a new file for MBS pools with initial interest only periods on the Pool Data Direct™ and on PoolTalk sections of Fannie Mae’s website. Fannie Mae will include pool data for its Mega securities issued on or after May 1, 1996 on its monthly supplemental file. The additional Mega data will include loan-to-value ratio, loan purpose, credit score, occupancy type, property type and identity of loan servicers, said Fannie Mae. (*M2 Presswire*, Fannie Mae, 07/30/04)

Fannie Mae introduces temporary “fix” to provide mortgages on Indian lands

- At the annual meeting of the National American Indian Housing Council, Fannie Mae introduced a temporary fix to help alleviate the almost total lack of mortgage

infrastructure on Indian lands. Since there are often no comparable sales due to lack of real estate sales or a mortgage market on Indian land, Fannie Mae will now allow a cost-based property valuation on Indian mortgages it buys, allowing a comps market to build up slowly as sales are done. Fannie has pledged to invest \$1.25 billion in tribal areas over 10 years, the largest housing commitment ever made, either through equity investment or by buying mortgages made by lenders. (*Tribune Business News*, Mark Fogarty, 07/14/04)

Fannie Mae and NAHB chose Atlanta as AH housing “lab”

- Fannie Mae and the National Association of Home Builders announced their choice of the Atlanta metropolitan area as the first national demonstration site for their “Housing America’s Workforce Initiative.” They are working together to explore a variety of creative ways to produce more homes -- priced for and located where wage-earning families need them -- starting in 11 demonstration sites around the Atlanta area over the next 10 years.
- Fannie Mae and NAHB made their announcement at Cascade Parc, the first of the 11 development sites in the Atlanta area planned under their workforce housing initiative. At Cascade Parc, Sharon McSwain Homes -- assisted by the Atlanta Development Authority (ADA) and Fannie Mae -- is building new homes to be priced from \$110,000 to \$220,000. The pilot program will test financing methods and mortgage products to help create housing for households with annual incomes of between \$25,000 and \$45,000, said Archibald B. Hill III, who directs Fannie Mae’s Atlanta office. (*Fannie Mae Press Release*, 07/22/04; *Atlanta Journal Constitution*, Janet Franston, 07/23/04)

DC Mayor Williams can’t afford a house of his own

- According to *Washingtonian Magazine*, D.C. mayor Anthony Williams earnestly extols the joys of owning a home in the District of Columbia: Homeownership means “stronger neighborhoods ... a place for your children to come home to” in a TV commercial for the Fannie Mae Foundation. After five years as mayor making \$142,500, Williams still rents an apartment in Foggy Bottom. “He’s a victim of his own success,” said Williams’ spokesman Tony Bullock. “He’s driven the price of housing beyond his ability to pay.”
- Fannie Mae Foundation’s Beverly Barnes, said “We think the mayor is an effective spokesman for getting people thinking about homeownership.” The *Washingtonian* concludes, “He’s thinking, he’s thinking.” (*Washingtonian*, Ellen Ryan, 08/04)

Freddie Mac

Freddie Mac narrows its search for top lobbyist amid GOP pressure

- As Freddie Mac narrows its search to replace top lobbyist Mitchell Delk to a short list of Republican political operatives, GOP leaders are pushing to get the seat filled with a Republican before November's election, said sources familiar with the matter. Senate Republican Conference Chairman Rick Santorum (R-PA) discussed the issue at his regular monthly meeting with top corporate lobbyists who track key lobbying jobs in town, said people familiar with the matter. Delk's opening is among those being targeted by the "K Street Project," a GOP initiative to get partisan followers into key lobbying slots.
- Santorum "has made it very clear that he would like to see like-minded Republicans placed in top lobbying positions on K Street," said Freddie Mac spokesman Robert Traynham, who couldn't specifically comment on the Delk opening. Freddie Mac's board of directors initially told executive headhunter Korn/Ferry International to provide only Republican candidates, according to people familiar with the matter.
- Senate Minority Leader Tom Daschle (D-SD) has said he would like to see a Democrat in the job. Daschle recently told Freddie's CEO Richard Syron that Delk's interim replacement, Clarke Camper, a former aide to Senator Chuck Schumer (D-NY), is well-qualified to fill the position, said a Hill aide.
- "We're now talking to candidates, but have not decided when or whether we will directly replace Mitch at this point," said Freddie Mac spokeswoman Sharon McHale.
- The three candidates vetted at Santorum's meeting include the top lobbyists at the Mortgage Bankers Association and American Insurance Association, Kurt Pfothenhauer and Leigh Ann Pusey, respectively, and Janet Mullins-Grissom, who recently left the helm of Ford Motor Co.'s lobbying operation and served as a high-ranking, and controversial, White House aide under the first Bush administration.
- Pfothenhauer has nearly 20 years of lobbying and legislative experience, joining the MBA in 2002 after serving as chief of staff to Senator Gordon Smith (R-OR). He also served as chief of staff for Representative Denny Smith (R-OR), and lobbied for United Parcel Service and Union Pacific Corp.
- Pusey has deeper roots in the Republican Party, having served in top communications roles with former House Majority Leader Newt Gingrich (R-GA) and at the Republican National Committee. In 1996, Pusey joined AIA, the nation's largest trade group for property-casualty insurers, as head of communications. She is now a leading candidate to replace long-time President Robert Vagley, who is leaving for personal reasons at the end of this year. Pusey was a key industry player in behind-

the-scenes negotiations on the Gramm-Leach-Bliley Act of 1999 and the Terrorism Risk Insurance Act, which passed after large insurers raised rates or refused to cover terrorist acts altogether following the Sept. 11, 2001, attacks. Through AIA spokeswoman Julie Rochman, Pusey said that she “has not had any discussions with anyone at Freddie Mac or Korn/Ferry for that job.”

- Mullins-Grissom is a divisive figure in the Republican Party. She was the target of an independent counsel investigation in the early 1990s for pulling then-presidential candidate Bill Clinton’s passport records to help Bush in his reelection bid.
- People familiar with the matter say Freddie Mac may broaden its search to Democrats, since it tapped Republican Ralph Boyd as general counsel and restructured its legal team to give Boyd oversight of Freddie’s lobbying operations.
- Santorum, however, is pressing Freddie to fill the job, which Delk had used to raise tons of money for GOP candidates, with another Republican before the November elections. “The reason why the senator feels very strongly that these positions should be filled with Republicans sooner rather than later is because we will increase our majorities in the House and the Senate and will keep the White House,” Traynham said. (*Dow Jones Newswires*, Dawn Kopecki, 07/23/04)
- Brody Mullins writes in *Roll Call* that a number of corporations (like Freddie Mac) and industry trade groups will not fill top positions in their Washington offices until after the November elections. Associations and companies “want to see how the election turns out,” said one Republican lobbyist who represents several businesses with vacant lobbyist positions. “If the Democrats were to win the presidency and take control of the Senate, they are going to want to hire Democrats.” While the momentum on K Street hasn’t yet shifted toward hiring Democrats over Republicans say lobbyists, the fact that some associations and corporations are growing more concerned about who will control Washington next year marks a rare pause in the decade-long rush to hire Republicans for key lobbying jobs. (*Roll Call*, Brody Mullins, 07/12/04)

Freddie Mac’s plans to report 2004 results in 2005 raises questions at OFHEO, in Congress and at the NYSE
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- OFHEO has raised questions about Freddie Mac’s timetable for returning to regular quarterly financial reporting. On June 30, 2004, Freddie reported its 2003 results and said it “aims” to report quarterly and full year results for 2004 by March 31, 2005. According to the Company, this delay in reporting 2004 results will give Freddie time to fix “material weaknesses in our controls surrounding financial reporting.” “OFHEO is concerned that it could be nine months before any additional financial information is released by Freddie Mac,” said Corinne Russell, spokeswoman for the regulator. (*Wall Street Journal*, 07/09/04)

- Representative Baker (R-LA) echoed OFHEO's concerns about Freddie Mac's delays in reporting earnings and said he would ask "those responsible for making those determinations as to what constitutes their judgment in having Freddie remain as a listed entity." Baker said the letter to NYSE officials has not yet been sent and is in the process of being written. Ending a self-imposed silence on his concerns about Fannie Mae and Freddie Mac, Baker said, "I'm returning back to the view that continued public discussion about the [GSEs'] conduct is in everyone's best interest," he said. "There may be people's pension funds now invested in Freddie Mac stock. They may not even be aware of it. As a function of the fact, that they are a listed stock, I have concerns about it." (*Reuters News*, Mark Felsenthal, 07/28/04)
- The New York Stock Exchange continues to monitor Freddie Mac's delays in filing earnings reports, said NYSE spokesman Ray Pellecchia. "Timeliness of filing financial reports is one of a number of qualitative and quantitative data we consider in evaluating continued eligibility for listing," said Pellecchia. "To the extent there is lateness of filing, it's a situation we monitor very closely. It's been the case with Freddie Mac. We have been and continue to monitor the case very closely."
- In all other quantitative measures, including market capitalization and average share price, Freddie Mac exceeds NYSE's standards, said Freddie spokeswoman Sharon McHale. "We maintain ongoing communications with NYSE and we've kept the Exchange fully briefed on the status of our financial reporting and other issues since the restatement announcement in January of 2003," McHale said. "The Stock Exchange has conducted frequent due-diligence reviews of Freddie Mac and our progress toward delivering timely financial reports."
- In response to Baker's comments, McHale said, "Freddie Mac maintains ongoing communications with the New York Stock Exchange as a matter of good corporate governance practice and has kept the exchange fully briefed on the status of our financial reporting." (*The Main Wire*, Claudia Hirsch, 07/29/04; *Reuters News*, Mark Felsenthal, 07/28/04)

Freddie Mac's "impending fiasco"

- In *Forbes.com*, Richard Lehmann writes, "after spending more than \$150 million dollars on an army of accountants, lawyers and consultants, what does management have to say about Freddie's financial performance? The revised numbers show that Freddie broke even for the second half of 2003, after a profitable first half. Losses from its derivatives trading--the source of the accounting problems and of some \$4.3 billion in losses in the second half of 2003--were the cause of the poor second-half showing. To refresh your memory, interest rates fell in the first half of 2003, and they rose in the second half. Perhaps you need not be reminded where they've gone since April of this year."

- “What’s especially disturbing is that little guidance was given for any quarter of 2004 and, despite promises of greater transparency, management stated there would be no reporting of 2004 results until March 2005! The reason given is that the accounting is still not up to snuff. In fact, detailed financials for 2003 won’t be published until September, so analysts will have to wait another three months to find out what wasn’t said on June 30.”
- “Given the declining results in the second half of 2003, it was not inappropriate for one analyst to quiz Freddie’s chief financial officer on the company’s conference call what the effect of rising interest rates would have on its trillion-dollar-plus portfolio of derivatives. **His astounding reply: ‘I don’t know.’ So much for transparency.**”
- “Reporting bad news still does not come easily at Freddie, so we need to look to other sources of information. First, we hear that banks are reporting they expect to benefit from interest rate rises, contrary to past experience in rising rate environments. Since they are big in the derivatives markets, where Freddie is one of the biggest players, it may well be that their optimism is because they are the counterparties to Freddie’s derivatives contracts. Also, look to Fannie Mae’s reporting for the first quarter of 2004. It reported losses of \$1 billion on derivatives, and this was before rates started rising in April. Since both companies have about \$1.3 trillion in such contracts, Fannie’s loss may be a fair estimate of Freddie’s loss, if only it were as smart. ...[T]he concern has always been that rising rates could cause Freddie to implode, much like the Long Term Capital Management or the Orange County investment fund. Only, this time, the fallout could cause a system-wide financial panic.”
- “In any case, it’s fair to say that Freddie’s stockholders are in for some sleepless nights, and the U.S. Congress might be, too. Freddie could be just one car in the slow-motion train wreck that may be coming due to the artificially low interest rates engineered by the Federal Reserve in 2001.” (*Forbes.com*, Richard Lehmann, 07/06/04)
- In *Datamonitor’s Company Profiles*, the SWOT analysis of Freddie Mac analyzes the company’s highly volatile earnings stream, its potential tax liabilities and new CEO-related worries. *Datamonitor* points out that Freddie Mac “has substantial exposure to derivatives, and may use derivatives to speculate on the direction of interest rates.” The GSE’s earnings stream is highly volatile as a result of this rate exposure and its derivative use. At December 2001, Freddie Mac’s total notional amount of derivatives was \$1,052 billion. According to OFHEO disclosures, the GSE’s total notional amount of derivatives at December 2002 was \$866.8 billion, including \$16.5 billion of Treasury-based contracts. Management has indicated that a majority of the derivatives in 2001 and 2002 will not qualify as hedges for accounting purpose after the reaudit. As a result, the mark-to-market effects of these derivatives will flow through income statement in each accounting period, causing large swings in GAAP earnings. “Steady Freddie is no more,” said Monica Roman in *Business Week*. (*Datamontior Company Profiles*, 07/21/04; *Business Week*, Monica Roman, 07/12/04)

In setback for Freddie Mac, judge allows class action suit to proceed

- Judge John E. Sprizzo of the U.S. District Court for the Southern District of New York dealt a setback to Freddie Mac and several former executives, allowing the Ohio Public Employees Retirement System to proceed in its class action against the company. Sprizzo denied Freddie Mac's motion to dismiss the case, which has been stalled for months as federal courts transferred it to New York and consolidated or dismissed similar cases. Freddie Mac officials declined to comment on the pending litigation.
- Last August, Ohio Attorney General Jim Petro filed the lawsuit on behalf of the State Teachers Retirement System of Ohio and the Ohio Public Employee Retirement Systems, which Petro said lost in aggregate more than \$25 million due to the GSE's "shoddy" accounting practices. "Freddie Mac was so intent on maintaining its public image that its officers and board were willing to ignore the rules of proper accounting at the expense of investors," Petro said. "This shoddy accounting and lack of corporate ethics is shameful."
- Former employees Chann Martin and Dana Wilson are also suing Freddie, its employee pension plan and several former executives for allegedly violating the Employee Retirement Income Security Act by investing large sums of their retirement money in company stock.
- Sprizzo dismissed a "derivative" lawsuit, seeking damages on the company's behalf from five former executives, by shareholder Esther Sadowsky. "It's a technical snafu. They won one battle, but they lost the war," said Sadowsky's attorney, Joseph Weiss, of Weiss & Yourman. Weiss plans to refile the case within weeks, seeking a technical "demand" for action from Freddie's board of directors that Sprizzo said was missing from the original complaint. The new complaint will likely seek board action against some of Freddie's business partners, Weiss said, citing those identified in a report by OFHEO, which could include Morgan Stanley, Solomon Smith Barney, UBS Warburg, Lehman Brothers, Merrill Lynch, Goldman Sachs & Co., JP Morgan Chase, Credit Suisse First Boston, Citibank, Bear Stearns and Bank of New York.
- The SEC, U.S. Attorneys Office in Alexandria, VA, IRS, and Department of Labor are also running related investigations of Freddie and its current or former executives. (*Dow Jones Newswires*, Dawn Kopecki, 07/20/04)

Judge questions OFHEO's power to freeze Ex-Freddie CEO compensation

- In U.S. District Court for the District of Columbia, Judge Richard J. Leon questioned whether OFHEO has the authority to freeze executive pay at Fannie Mae and Freddie Mac in a possible precedent-setting case over the regulator's enforcement powers.

Former Freddie CEO Leland Brendsel is suing OFHEO to release approximately \$53.7 million in compensation, citing the regulator's untested authority to freeze assets and arguing that he wasn't afforded due process before the assets were frozen last year.

- Leon was skeptical of OFHEO's enforcement powers, repeatedly asking the agency's attorneys to provide evidence that the 1992 statute that created OFHEO gave it unquestionable authority to withhold Brendsel's pay. "The only question is whether or not it is an authority that is, because of the legislative history, implicit...Because clearly there is no case anywhere in this circuit or another circuit, even another district, that gives it the authority," Leon said to Justice Department Attorney Marcia Tiersky, who is representing OFHEO and its Director Armando Falcon on behalf of the federal government. Leon is expected to rule shortly on the case.
- Leon dismissed Tiersky's arguments that lawmakers were able to clarify the legislation's powers through floor debate, saying Senator Carl Levin (D-MI) "didn't get what he wanted" in the final bill. "His attempts during the floor debate to [clarify intent] are suspect, initially, as to whether or not that would be a sufficient base to find explicit authority of the agency," Leon said. The judge also seemed unconvinced of Tiersky's argument that the enforcement powers OFHEO cited in freezing Brendsel's assets, though not specifically provided for in the agency's statute, are "implicit" since that legislation was based on other regulators that were explicitly handed those powers. "Congress was aware of the statutory consequences," Leon said. "Congress was well aware that, at other statutory agencies, they had specifically provided the ability to execute cease-and-desist orders. And they didn't choose to do it [for OFHEO]."
- Brendsel's attorneys at Williams & Connelly say their client has no means to recover the withheld compensation, even if he is ultimately cleared of OFHEO's charges. "That's a deprivation, theoretically, of a person's property interests without any proceedings, without any hearings either at the agency level or in court of that person's property rights," Leon said, offering a similar hypothetical scenario. "Where did you find in the statutory or legislative history the basis to believe that a temporary cease-and-desist order (negates) due process for a person situated as the plaintiff?" (*Dow Jones Newswires*, Dawn Kopecki, 07/07/04)

Freddie Mac announces process and timeframe for submitting shareholders proposals

- Freddie Mac expects to publish its 2003 annual report in late September 2004 and to hold the company's related annual stockholders' meeting in November 2004. To be considered for inclusion in the proxy statement, stockholder proposals must be submitted in writing to Freddie Mac and received by August 27, 2004. The procedural requirements for submitting proposals, as well as a description of Freddie Mac's process for addressing stockholder proposals, are available on the company's Web site. (*Freddie Mac press release*, 07/22/04)

Freddie Mac's portfolio expands for second month

- Freddie Mac's loan portfolio increased for a second straight month, growing by \$10.3 billion to \$645.2 billion in June. Freddie Mac agreed to purchase \$25.5 billion in mortgage debt in June, the most since July 2003, 60% more than in May. Outstanding mortgage-backed securities guaranteed grew at an 8.3% annual rate to \$794 billion.
- Freddie Mac also said its so-called duration gap, a measure of interest-rate risk, was unchanged at zero months in June.
- Still dealing with accounting woes, Freddie Mac also restated several figures from its monthly volume summaries for the first five months. While most of the revisions were expected, the company also reduced "mortgage purchase agreements, net" because of double counting it had discovered. Freddie Mac said it would revise certain figures again next year when it releases its 2004 results. (*Bloomberg News*, Al Yoon, 07/23/04; *American Banker*, Jody Shenn, 07/26/04)

Freddie Mac forms "FreddiePac," a political action committee to for candidates who support "Freddie's mission"

- On July 29, Freddie Mac filed paperwork with the Federal Election Commission to create FreddiePAC, a political action committee that will steer money to lawmakers "who share a belief in the importance of Freddie Mac's mission," the GSE's officials confirmed. Spokeswoman Sharon McHale said Freddie Mac executives made the decision to start the PAC and received approval from the Company's board of directors within the last week. Management had previously passed on the idea when Fannie Mae filed the paperwork to create a PAC in December 2003.
- "We are in a very different position" from last December, McHale said. "Now that we are working on the process of getting (our financial disclosures) current, the restatement is complete, our 2003 financials are done, we can start to think about other things. This was one of them."
- Fannie created its PAC two days after the Supreme Court upheld a ban on unregulated soft money in the McCain-Feingold campaign finance law. PACs can only contribute a maximum of \$5,000 to a candidate during a primary campaign and another \$5,000 during the general election. Fannie Mae has raised approximately \$575,000 for federal candidates as of June 30 through its new PAC, boosted by the more than 600 employees that contribute to Fannie Mae PAC through bi-weekly payroll deductions. Fannie's employees have donated another \$192,000 directly to federal candidates or campaigns, according to the Center for Responsive Politics.

Freddie Mac executives, by comparison, have contributed a little more than \$90,000 to federal candidates and campaigns during this election cycle so far, according to the center.

- Historically, Freddie and Fannie have ranked among the nation's top soft money donors, giving \$4 million and \$1.8 million respectively to federal parties during the 2002 election cycle through June 9, 2003, according to the Center for Responsive Politics. Freddie was the 6th largest corporate donor while Fannie ranked 23. (Dow Jones Newswires, Dawn Kopecki, 08/02/04)

Patricia Cook named Freddie Mac's EVP for investments

- Freddie Mac said Patricia Cook, a Wall Street veteran with 25 years of experience in fixed-income securities markets, has been named executive vice president, investments. When Cook assumes her duties on August 2, she will be responsible for the GSE's approximately \$630 million retained mortgage portfolio and debt issuance, as well as asset/liability risk management strategies. She takes over the position previously held by Gregory Parseghian. Cook will report directly to Freddie Mac Chairman and CEO Richard F. Syron.
- Before joining Freddie Mac, Cook served as managing director and chief investment officer, global fixed-income, for JP Morgan Fleming Asset Management. Previously, Cook served as managing director and chief investment officer, fixed-income, for Prudential Investment Management. (Dow Jones International, John Connor, 07/15/04; National Mortgage News, 07/19/04)

Freddie Mac appoints SVP and general internal auditor

- Freddie Mac has appointed Stan Martin as senior vice president and general auditor. Martin, who has served as interim general auditor since February 2004, will report directly to the audit committee of the board. His appointment to the position was effective June 21. (Reuters, 07/09/04)

Federal Home Loan Banks

Finance Board's crackdown on FHLB-Chicago leaves industry "confused"

- The Federal Housing Finance Board's decision in June to crack down on the FHLB-Chicago's mortgage-purchasing program is leaving some in the industry confused and causing others to criticize their action. While FHLB executives say they are unconcerned by the limits put on the FHLB-Chicago's Mortgage Partnership Finance program, several sources say that FHLB executives are more worried than they publicly admit. "Right now all the Federal Home Loan banks are concerned that there's been this big shift at the Finance Board, and they don't really know what to expect," said a person familiar with the FHLBs, speaking on the condition of anonymity. "They're sort of making it up as they go along."
- According to sources, the Finance Board's action did not give executives at the other FHLBs a clear picture of how they should operate their own mortgage-purchasing programs. That uncertainty could imperil the growth of the programs and diminish the FHLBs' competition with Fannie Mae and Freddie Mac, the sources said. "I would be very confused if I was another Home Loan bank," said James L. Bothwell, a former Finance Board managing director. "I was really shaking my head."
- Stephen Cross, the Finance Board's director of supervision, said FHLB executives receive plenty of guidance from their regulator through the bank examination process, which allows examiners to provide advice that is best suited to each bank's individual circumstances. "At the end of the day, I think that the bank presidents should prefer the way we do business: to talk to them about the specific practices at their banks," he said. "The banks should look to their direct communications from us for guidance."
- Cross said the agreement regulators reached with the FHLB-Chicago can also be instructive for executives at the other banks as they try to steer their programs. The FHLB-Chicago regulatory agreement focuses on what the Finance Board calls the Bank's "ineffective management of risks stemming from operations, credit, and market fluctuations; deficiencies in its board's oversight of the MPF program; and the low quality of the capital management and record-keeping practices." According to Cross, each is an area of particular concern for the Finance Board; the presidents of the other 11 FHLBs would do well to ensure that their institutions are not slipping in any of these areas. "They can learn something from the agreement, and that is that we mean business," he said.
- Ann Grochala, the director of lending and accounting policy at the Independent Community Bankers of America, said, "The other Federal Home Loan banks are probably looking at this to see if they are potentially up for criticism because they don't have the kind of management or internal controls the Finance Board is looking for."

- The Finance Board’s action highlights the growing role of the MPF programs, allowing commercial banks and thrifts to sell mortgage loan originations to the FHLBs rather than to Fannie or Freddie. While mortgage loans acquired in the MPF programs made up 13.4% of the \$856 billion of assets held by the FHLB System on March 31, 2004, some of the 12 banks are more involved than others. On March 31, 2004, the FHLB-Chicago held 52.2% of its \$91.9 billion of assets in mortgages and 29% in advances to banks and thrifts. The FHLB-Des Moines, the program’s second-largest member, had 34.3% of its assets in mortgages. The FHLB-Dallas and FHLB-New York, both which participate in the MPF program, had the lowest mortgage asset percentages; the Dallas bank held 1.4% of its \$62 billion in home loans, while the New York bank held just 0.9% of its \$83 billion in mortgages.
- While FHLB executives insist they are losing little sleep worrying whether they will become Finance Board targets, it is unclear whether the executives are confident or are trying to improve a relationship with regulators that has already been strained by fights over stock registration and multidistrict membership. “Anything that improves the safety and soundness of the system is a good thing,” said Alfred DelliBovi, the New York bank’s president.
- John L. von Seggern, the president of the Council of Federal Home Loan Banks, said that while regulators are focusing more directly on the MPF programs than they had in the past, the programs will likely emerge from the review intact. “There will be a Finance Board look at the success and growth of the mortgage programs. There may be some tweaking going on,” he said. “The scrutiny by the Finance Board is a precautionary step. What comes next, I just don’t know.” (*American Banker*, Craig Linder, 07/26/04)

FHLB Directors in a “balancing act”

- In its recent regulatory agreement with the FHLB-Chicago, the Federal Housing Finance Board wisely focused on risk management and board governance of the Bank, writes Mitchell Berns in the *American Banker*. As a cooperative organization serving their 8,000 primarily bank and thrift members, the FHLBs present challenges in managing the complex risks associated with their growing mortgage portfolios.
- Each of the 12 FHLBs is governed by a board, composed of elected industry directors and a minority of public-interest directors appointed by the Finance Board. The industry directors represent the members, which provide the capital to support the system. These industry directors typically have more hands-on familiarity with the FHLB operations than the appointed ones, but they wear two hats. They represent their members as owners, but they are also customers of the wholesale bank they govern. Industry directors are serious about their responsibility to monitor FHLBs to ensure that they operate safely and soundly in the public interest. They can be counted on to keep the banks responsive to their members’ housing finance needs.

- However, writes Berns, “it would be unreasonable to expect chief executives to forget their interest as customers when assuming a seat on a FHLB’s board. As such, they are concerned about the prices and terms governing the wholesale loans -- called advances -- made to their institution. They also want the best prices and terms if they sell loans to the bank through a mortgage purchase program.”
- Like other bank managers, the FHLBs must balance revenue-generating opportunities and operational risks and Board members oversee those choices. As organizations grow in size and complexity, it is a challenge to ensure that those in charge of balancing rewards and risks remain motivated. With customers on their boards, the FHLBs must be especially careful to ensure that board members and managers keep the interests of the organization paramount. As fiduciaries, board members will consider the risks and rewards of various strategies and products. But as customers, they will be urged to bargain against the bank, and that could dilute their fiduciary attention.
- This dual role could create issues when dealing with pricing and hedging complexities, such as those presented by MPF programs. Whether the FHLBs are correctly pricing the loans they buy from members may become apparent only over time. The profitability of a portfolio will turn largely on how its hedging and funding holds up as interest rates change and the portfolio ages. The FHLBs do not act as dealers, so they do not get the immediate pricing feedback that reselling mortgages would provide.
- The FHLBs deal with concerns arising from being overseen by their customers by:
 - Creating structures that help ensure that the board and management stay focused on maintaining a healthy bank. One approach is giving several directors responsibility for risk management.
 - Embracing a culture that holds senior managers responsible for ensuring that risks and rewards are actively considered up and down the chain of command. Everyone responsible for figuring out how to make money should also be thinking about risk.
 - Thinking about how any special risks of new products will be managed within the system’s cooperative structure. (*American Banker*, Mitchell Berns, 07/23/04)

Moody’s affirms FHLB-Chicago’s top deposit rating

- The FHLB-Chicago’s top deposit rating was affirmed by Moody’s Investors Service after the Bank entered into a written agreement with its regulator to fix its accounting and risk management. The long-term deposit rating was kept at Aaa and its Prime -1 short-term deposit rating, said Moody’s. The rating agency said it views the

regulatory action as a “precautionary measure.” Moody’s stated, “While there is uncertainty surrounding the potential outcomes of the independent consultant reviews, Moody’s does not believe that the deficiencies identified in the supervisory agreement impair protections for depositors to a degree that is inconsistent with” current ratings. The deposit ratings are supported by the Bank’s status as a GSE, Moody’s said. It’s “extremely unlikely” the government would fail to support a federal home loan bank in financial crisis, it added.

- “Compared to the Chicago Bank’s traditional loan advance business, the MPF program is more susceptible to credit losses, and in particular carries heightened interest-rate risk and operational complexity,” Moody’s said. The bank’s management hasn’t kept pace with the growth of the program, Moody’s added. Earlier this month, S&P cut its long-term counterparty rating on the bank to AA+, citing the increased risk from the addition of mortgage assets. (*Bloomberg News*, Al Yoon, 07/19/04; *FHLB-Chicago Press Release*, 07/19/04)

FHLB-Chicago posts strong second quarter results
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- For the six months ending June 30, 2004, the FHLB-Chicago reported net income of \$169.0 million or 6.97% return on equity for the highest ROE among the FHLBs. Overall the Bank’s net income declined slightly from record levels in the first half of 2003. The Bank’s total assets increased 16.5% from last year, as outstanding advances increased 12.1% to \$28.3 billion, while MPF assets grew 23.1% to \$49.1 billion. The level of the Bank’s advances continued to increase steadily as the MPF Program has grown. Since 2000, the FHLB-Chicago’s level of outstanding advances has risen 53.0%, nearly double the FHLB system’s average advance growth.
- The Bank’s regulatory capital rose 19.1% to \$4.8 billion as of June 30, producing a regulatory capital to assets ratio of 5.16%, the highest of the FHLBs. The Bank’s cushion of retained earnings increased 23.4% over the past year.
- On June 30, the FHLB-Chicago’s duration gap was +0.2 months. Over the past year, the Bank’s month-end duration gap has varied within a range of -0.7 months and +1.1 months, while Fannie Mae’s average monthly duration gap ranged between -1 months and +6 months over the same period. (*FHLB-Chicago Press Release*, 07/22/04)

Ginnie Mae

Subprime lenders attracting market share away from Ginnie Mae

- With Ginnie Mae issuances noticeably declining, analysts are looking at factors that may be taking Ginnie borrowers away from the sector. “Evidence suggests that the private sector [as well as Fannie Mae and Freddie Mac] are taking market share away from Ginnie Mae,” wrote Peter DiMartino, managing director at RBS Greenwich Capital. Ginnie Mae borrowers seem to be suitable prospects for the expanded underwriting standards currently offered by competing lenders.
- Subprime loan volumes increased substantially during the first half of this year and, subprime mortgages currently make up more than 60% of U.S. ABS issuance volume. While subprime lending soared during the first half of 2004, Ginnie Mae volume dropped over 30% during the same period, DiMartino said. Ginnie issuance dipped to \$72 billion in the first half of the year from \$105 billion for the same period last year.
- “Frankly, there is no way to be certain about how much of Ginnie Mae’s volume shifted to the private sector versus Fannie Mae and Freddie Mac (also competing for FHA borrowers),” said DiMartino. He said that the trend is significant because a typical Ginnie borrower now has other possible alternatives to the Ginnie Mae mandate, and this has pushed volumes in competing sectors that have stated income underwriting, LTV in the 90% to 95% range and FICOs typically in the 600 to 640 area. Furthermore, he says, the trend could cause the credit profile of Ginnie Mae pools to change, thus affecting performance characteristics.
- After looking at rate surveys on various websites, the Ginnie Mae fixed-rate mortgage seems to hold a rate advantage versus fixed-rate subprime loans. DiMartino estimates the advantage is in the 0.35% to 0.85% range. However, subprime lenders are attracting traditional Ginnie borrowers by growing their broker and sales networks nationwide and penetrating new sectors. They are also offering innovative products with higher loan amounts and higher LTVs compared to Ginnie Maes, providing more flexibility to borrowers. Aside from these, hybrid ARM loans are now helping private lenders compete in terms of pricing. There is also the intense marketing focus on debt consolidation and the first-time purchase borrower, as well as the emphasis on greater efficiency and client service.
- Subprime lenders have definitely invested considerable resources to become time- and cost-efficient when underwriting loans, DiMartino said. “It is probably not an understatement to say that reducing origination costs was a key factor in the survival of many subprime mortgage lenders,” he wrote. “Also, there is a perceived difference in the private sector’s lending culture relative to the bureaucratic government lending mandate.”

- Ted Foster, vice president of MBS at Ginnie, said subprime products are not competitive in terms of pricing with those that could be securitized by Ginnie Mae. “If subprime lending were competitive with FHA/VA, it will be at the product level,” said Foster. He added that it is only in a situation where borrowers wanted a product that wasn’t available through the FHA or VA system, that these government agencies will lose borrowers to the subprime market. He explained that if one were to compare product to product - the 30-year fixed-rate mortgage available through either a subprime lender or through a government lending institution - the subprime lender would not be price-competitive because of the ability to securitize FHA/VA mortgages through GNMA.
- Foster also said that although GNMA gross volume has gone down for the last six months, the firm had historical volume levels in the last fiscal year - over \$200 billion. “Gross volume is down but that’s relative to a historical high,” Foster said. He added that decreasing volumes are more a function of market dynamics, specifically rising interest rates, than losing market share to either the GSEs or the subprime market. (*Asset Securitization Report*, Karen Sibayan, 07/19/04)

International GSEs

Fannie Mae and Freddie Mac are “the old fashioned approach”

- While Fannie Mae and Freddie Mac often brag that the American method of financing home loans is the “envy of the world,” Bruno De Gasperis, head of the international department at the Italian Bankers Association in Rome, disagrees. De Gasperis describes America’s housing-finance system built around the Fannie Mae and Freddie Mac as “an old-fashioned approach.”
- Housing officials and bankers outside the U.S. have recently tuned into the American political squabble over how to tighten regulation of Fannie and Freddie. Some have concluded, writes James R. Hagerty in the *Wall Street Journal*, that “U.S. backing for Fannie and Freddie is an unjustified government subsidy, largely enjoyed by people who don’t need it, and a potential time bomb. If Fannie or Freddie ever blows up, U.S. taxpayers probably would have to pay for the wreckage.”
- “That’s not a contingent liability that the British taxpayer wants to take on,” said Adrian Coles, director general of Britain’s Building Societies Association. At the request of the British Treasury, university professor David Miles recently conducted a study on country’s mortgage market in which he concluded that there is no need for a British Fannie Mae.

- The European Union, whose 25 members have a mishmash of mortgage systems, is studying how it might create more harmony in this area. Rob Thomas, an independent British economist who formerly worked for UBS AG and the Bank of England, has drawn up a proposal for the EU to back an agency loosely based on Fannie Mae. Thomas says the agency should be owned by the mortgage banks that use its services, not by investors seeking the highest possible return on their money. Under the control of its customers, he reasons, “this institution wouldn’t get too big for its boots.” Thomas admits that EU officials so far have shown little enthusiasm for his ideas. The European Mortgage Federation, an organization of mortgage bankers, has rejected Thomas’s plan as an unwarranted “distortion” of competition.
- Officials of the European Union have given a cool reception to a proposal that they should set up a European version of Fannie Mae. Many who oppose the proposal cite the difficulty of funding it through a Europe-wide tax. Alan Boyce, a trader for Soros Funding, said that he would “love to see one gigantic, liquid European mortgage market.” However, Boyce said that if such a market were tax funded it would be something he “wouldn’t wish on his worst enemy.” Louis Hagen, secretary general of German mortgage bank association Verband Deutscher Hypothekbank, also spoke against the creation of a European GSE on tax grounds. “I don’t see any need to create such an enterprise,” he said. “Why should English taxpayers pay for German mortgage borrowers?” “Although,” he added, “that would be great.”
- Colombia and Mexico are setting up programs promote mortgage lending, but both are deliberately limiting the involvement of government agencies. In Mexico, a state-owned company, Sociedad Hipotecaria Federal, or SHF, recently began encouraging “securitization” of mortgages and providing limited guarantees, when needed, to boost the ratings on mortgage-backed securities to triple-A. Unlike Fannie and Freddie, SHF won’t buy large amounts of mortgages or mortgage securities for its own portfolio. “The Mexican government cannot allow itself to have such a large contingent liability,” says Guillermo Babatz Torres, director general of SHF.
- Colombia’s government has limited its role in mortgage finance to providing guarantees for mortgage-backed securities that provide financing for low-income borrowers. Columbia relies on a new private-sector company to acquire mortgage loans and turn them into securities. Through this approach, Columbia didn’t have to create a government agency that might be difficult to close down if it outlives its original purpose.
- While South Korea has borrowed heavily from the U.S. model, the country rejected a mixture of private owners and public-policy duties. In March, the government formed the Korea Housing Finance Corp. to develop bond-market financing for home loans, as an entirely state-owned entity. (In 1938, Fannie Mae was created as a government agency and partially privatized 30 years later).
- In Italy, the bankers association is setting up a privately-owned computer service that will help small banks sell mortgage loans, which will free the small lenders to make

more loans than they can hold in their portfolios. Bruno de Gasperis, chief executive officer of the Italian company Credit Circle, which is working on an electronic secondary market trading platform for unsecuritized loan portfolios, said he does not consider the creation of a European GSE worth pursuing.

- Denmark's mortgage system is often cited as the "right" model. The Denmark system has a long track record with the country's first specialized mortgage bank founded in 1797. Today, Danish mortgage banks obtain money for lending by issuing bonds whose terms correspond to those of the home loans. For instance, if a bank makes a 30-year mortgage loan of two million kroner (about \$333,000), it typically will sell the same amount of 30-year bonds. If the loan is repaid early, the bonds will be paid back early, too. This method helps the banks keep their cost of funds closely in line with the interest payments they receive from borrowers. The Danish government's role is confined to regulating the market.
- Soula Proxenos, who heads Fannie Mae's department offering advice to other nations for a fee, describes the Danish model as "ingenious." Proxenos says it would be hard for developing countries, which lack Denmark's legal structure and thriving bond market, to emulate. She added that many foreigners are eager to learn about the U.S. system. "In the housing-finance space," Proxenos said, "there is no question that the U.S. is in the lead."
- Fannie Mae officials concede that no system is right for every country. But they say some of the European resistance to the U.S. model comes from bankers who fear it would mean tougher competition. (*Wall Street Journal*, James R. Hagerty, 07/12/04; *National Mortgage News*, 07/12/04)
- In a Letter to the Editor in the *Wall Street Journal*, Torben Gjede, director General of the Association of Danish Mortgage Banks, Copenhagen, responded to Fannie Mae representative Soula Proxenos' comments about the Danish model. Gjede writes, "Ms. Proxenos is wrong in her assertion ... that the Danish model cannot be an inspiration to other countries, including developing countries. In fact, Chile has a Danish-inspired mortgage system, and Mexico is working on a similar project. And the countries of Ireland, Poland, Norway, Finland, the Czech Republic, Slovakia, Hungary and Latvia have all developed new mortgage systems in recent years that are inspired by the German and Danish bond-based mortgage model." (*Wall Street Journal*, Torben Gjede, 07/26/04)
- Also in a Letter to the Editor in the *Wall Street Journal*, Peter Williams, Deputy Director General of the Council of Mortgage Lenders, writes, "Ms. Proxenos' statement that 'there is no question that the U.S. is in the lead' is a very challengeable assertion. Certainly U.S. homeowners enjoy one of the most subsidized housing systems in the world. But despite this, the U.S. homeownership rate is well below a number of other countries. Few other countries would opt to replicate the U.S. system, which costs the U.S. government and taxpayers a great deal through tax relief, tax credits and, of course, the implicit guarantee/contingent liability to the

government-sponsored enterprises. And via those GSEs, U.S. housing market risk is sold on to other countries. One might reasonably ask, ‘In the lead of what?’” (*Wall Street Journal*, Peter Williams, 07/26/04)

Sallie Mae

\$6 billion in “unnecessary subsidies?”

- Robert Shireman writes in *The Chronicle of Higher Education*, “In the assessments of Education Department programs that appear in President Bush’s 2005 budget, significant inefficiencies are cited as a problem for only one program: the Federal Family Education Loan Program, also known as government-guaranteed student loans. That program’s assessment says that “unnecessary subsidies are provided to some lenders,” and “significantly lower” subsidy rates in the alternative program, direct lending, “call into question the cost-effectiveness of the FFEL program structure.” According to the president’s numbers, if all loans were direct loans, we would have over \$6 billion more to spend.”
- “To be sure, the journey will be difficult. Sallie Mae, the banks, and the state bureaucracies that administer guaranteed loans will fight fiercely to keep their federal entitlements. Hundreds of lobbyists and public-relations hacks feast on those excessive fees and subsidies. But it will be worth the effort. When we reach our destination, we will have the \$6-billion that we need to help millions of students prepare for and attend college.” (*The Chronicle of Higher Education*, Robert Shireman, 06/18/04)

Privatization *must* be working for Sallie Mae, as profits jump 65% in second quarter

- Sallie Mae said its second-quarter profit rose by almost two-thirds from the same quarter a year ago due to a sharp jump in loan originations. The company earned \$615 million or \$1.36 a share, up from \$373 million or \$0.80 a share. Its core cash earnings, which Sallie Mae says are a better way of tracking the business, rose to \$237 million (\$0.52 per share) from \$210 million (\$0.44 per share), which matched the average forecast of analysts surveyed by Thomson First Call. For the first six months of the year, the company reported profit of \$906 million (\$2.00 per share) up from \$789 million (\$1.68 per share) for the first six months of 2003.
- During the quarter, Sallie Mae said loans originated by its owned or affiliated brands rose 24% to \$2.3 billion. The company’s managed loan portfolio was \$94.9 billion at June 30, 2004, a 14% increase from June 2003 levels. (*Washington Post*, 07/16/04)

Farm Credit System/Farmer Mac

FCS of America to be acquired by Rabobank, a Dutch agri cooperative

- Rabobank, the Dutch banking cooperative, and Farm Credit Services of America (FCSA), one of the largest agricultural lenders serving Iowa, Nebraska, South Dakota and Wyoming, announced an agreement for Rabobank to acquire FCSA. Rabobank will acquire FCSA, which had assets of approximately \$7.8 billion as of June 30, 2004. Under the terms of the agreement, Rabobank will acquire all of the shares of FCSA for a cash purchase price of \$600 million. If all approvals are granted, including a stockholder vote, and the proposed transaction closes, the total purchase price will be allocated among the FCSA stockholders primarily on a patronage basis, based on each stockholder's loans outstanding with FCSA over a specified period. The agreement also permits FCSA's current board to nominate eight of its existing directors to fill four seats on the initial eleven-member board of the new entity.
- "We believe that Rabobank and FCSA are an excellent strategic fit, and this transaction offers meaningful benefits to both organizations and their customers," said Cor Broekhuysse, Regional Head of the Americas for Rabobank. "FCSA will significantly enhance Rabobank's U.S. agricultural finance offering with the addition of its comprehensive portfolio of loan products, powerful technology platform for loan delivery, and talented leadership."
- "FCSA also brings strong credit risk expertise, gained from nearly a century of experience in agricultural credit management. In turn, FCSA stands to increase its performance by leveraging Rabobank's tremendous resources, expanding beyond its current geographic constraints, and broadening its product and service offering."
- It is expected that following FCSA's withdrawal from the Farm Credit System, the Farm Credit Administration (FCA) will award charters for Iowa, Nebraska, South Dakota and Wyoming to other Farm Credit System institutions, as provided for in FCA regulations. Because FCSA will continue to operate in these states following its acquisition by Rabobank, there is expected to be an increase in financing options available to customers within those states. In connection with its withdrawal from the FCA System and as part of the transaction, FCSA expects to pay over \$800 million back to the Farm Credit System. This exit fee is required by FCA regulation and goes directly to the Farm Credit System insurance fund. It is anticipated that this payment may lower insurance premiums for all Farm Credit System entities for a considerable time.
- The proposed transaction was approved by the FCSA board and is subject to certain regulatory approvals and conditions, including FCA approval for FCSA to withdraw from the Farm Credit System, and FCSA stockholder approval. FCSA expects to submit its application to withdraw from the System later this summer, after which the

FCA has 60 days to respond. (*Farm Credit Services of America Press Release, 07/30/04*)

- FCA chairman and CEO Nancy C. Pellett said in a statement, “The Farm Credit Administration today received word that the Board of Farm Credit Services of America has agreed for the Association to be acquired by the Dutch banking cooperative, Rabobank. ... We have not yet received the formal notification. However, under the Farm Credit Act of 1971 and its implementing regulations, we have an important role to play in the approval or disapproval of the proposed termination of any institution of the Farm Credit System. The FCA Board will exercise its authority and work to ensure that affected farmers and ranchers have continued access to a permanent and reliable source of credit in good times and bad, and a safe and sound Farm Credit System.” (*Farm Credit Administration Press Release, 07/30/04*)

Rabobank’s acquisition of FCSA raises the question: Is the FCS still needed?

- Bert Ely writes in *Farm Credit Watch*, “While much of [the \$600 million purchase price for FCSA] presumably would go to the association’s member-borrowers, key beneficiaries of this sale would be CEO Webster, other senior management at FCS of America, and the association’s directors, which may explain the primary motivation for this deal. If completed, this acquisition would add to Rabobank rapidly expanding U.S. agricultural lending activities. In 2002, it bought the \$2.2 billion Valley Independent Bank of El Centro, California. More recently, it purchased an Iowa feed-and-seed lender and the agricultural loan portfolios of several life insurance companies.”
- “Technically, Rabobank would purchase FCS of America’s loans, which it would have to fund outside the FCS since Rabobank would not qualify as an FCS institution. Presumably FCS of America would then be liquidated, opening up its four-state territory for grabs by other FCS associations.”
- “Under the statute governing the termination of an FCS institution’s status as an FCS institution, all of FCS of America’s capital exceeding 6% of its assets would have to be paid into the Farm Credit Insurance Fund, which is the FCS’s version of the Bank Insurance Fund. This exit fee would total almost \$900 million, based on March 31, 2004, data. That would leave slightly less than \$400 million in retained earnings to distribute to FCS members, Webster, other FCS of America officers, and directors. That amount would be sweetened by whatever premium Rabobank paid. Viewed another way, much of the premium Rabobank paid would go into the Insurance Fund, but then one must ask: Why would Rabobank pay such a high premium when it would lose access to FCS’s of America’s extremely cheap funding and generous tax breaks?”

- “Rabobank proposal raises a significant public policy question: Is the FCS still needed? If FCS of America’s member-borrowers vote for the Rabobank deal, effectively they will be stating, loud and clear, that they do not need taxpayer-subsidized credit. If they do not need cheap FCS credit, does any American farmer or rancher need FCS taxpayer-subsidized loans?”
- “Perhaps fear that this question will be asked is why Jack Cassidy, CoBank’s chief lobbyist, told the *Congress Daily* newsletter, that CoBank is “concerned about [the Rabobank deal]. The [FCS] is concerned about it, too.” According to Cassidy, CoBank officials “have encouraged appropriate system bodies to get on top of the matter.” Presumably these “system bodies” are other FCS institutions who do not want continuation of the FCS to be questioned.”
- “The real question is this: Who will lay claim to the FCS’s \$14 billion in unallocated retained earnings? If Rabobank acquires FCS of America, other FCS managers surely will try to strike similar deals in order to capture a piece of that capital. These retained earnings cash-outs would decapitalize the FCS, set up rural America for another FCS crisis, and open the door to another taxpayer bailout of the FCS. If this rumored transaction goes through, it will confirm my assertion, reported many times in *FCW*, that the FCS no longer is needed and therefore should be privatized.” (*Farm Credit Watch*, Bert Ely, 07/04)

Healthy Mae?

Majority Leader Senator Frist proposes establishment of “Healthy Mae”

- In a speech at the National Press Club, Majority Leader Senator William H. Frist, M.D. (R-TN) outlined key policy proposals for reforming America’s medical system. Among the proposals, Frist advocated “the establishment of a new national publicly-chartered, privately-run “Healthy Mae.” This [GSE] would help insurers more broadly share risk, reduce administrative costs, and create a vibrant secondary market for health insurance just as [the U.S.] has done for home mortgages. It would make health insurance-- particularly in the individual market-- more stable and affordable.” (*Press Release from the Office of Senator William H. Frist, M.D.*, 07/12/04)

Postal Service

Postal Reform blues

- The postal reform bill was not included on a list of legislative items to be considered by the House of Representatives the week of July 19th, casting doubt on hopes for swift passage of the bill. On July 23rd, Congress recessed for the Democratic and Republican national conventions and its traditional summer and Labor Day holidays. Congress reconvenes on September 7, and tentatively plans to end the current legislative session October 1m leaving little time for passage of the reform bill.
- Should the session end without passage of a reform bill, the issue would be stalled until the start of the next session in January, said Ed Gleiman, former chairman of the Postal Rate Commission and consultant to the Direct Marketing Association. At that point, supporters such as Senator Susan Collins (R-MA) and Representative Tom Davis (R-VA), chairs of the Senate Governmental Affairs and House Government Reform committees, respectively, could reintroduce the bills. “It’s a setback but not a significant setback,” Gleiman said. “You don’t go all the way back to the drawing board.” (*DM News.com*, Scott Hovanyetz, 07/20/04)

Postal Reform “unclothed”

- Gene Del Polito writes in *Postcom*, “Just about every kid over the age of five has heard the story of “The Emperor’s New Clothes”--where the Emperor was buck naked. Everyone knew it, but only a child had the common sense and audacity to acknowledge it. Well, for the past several months, just about everybody in Washington has been lauding the Emperor’s new postal reform clothes (H.R. 4341 and S. 2468). To a person, the adoring crowd shouted “marvelous!” “wonderful!”, while muttering that just about the only suit in which the Emperor was attired was the one God gave him on the day he was born.”
- “Let’s see...I’m over the age of five and I’ve heard the story before. So here goes: “THE EMPEROR HAS NO CLOTHES”--and he’s not likely to get a postal reform suit of clothes before this legislative year ends. Postal reform is going down for the three-count, if it’s not already dead in the water. A gander at the legislative calendar shows that time’s running out, and since this year’s House and Senate committee actions no substantive progress has been made in putting a reform measure on the President’s desk.”
- “Congress, however, has not yet adjourned sine die, and some precious time remains to take stock of reality and move quickly to rectify an injustice that will exact an unnecessary cost from the bottom lines of thousands of companies, schools, churches, and charities across America. That cost, of course, will be a postal rate increase

swollen unnecessarily by the imposition of an escrow on the savings derived from an overpayment mailers have made for years toward postal retirement pensions.”

- “Everybody who’s been following the postal reform saga knows what this is about. Just think back to the enactment of P.L. 108-18. Remember the imposition of an unnecessary escrow of Civil Service Retirement System overpayments that should have been released to the Postal Service? Remember Treasury’s fobbing off to postal rate payers the military portion of postal retiree pensions? These two matters are of vital importance to mailers, since both will be reflected in the rates businesses and consumers will pay to communicate and transact business by mail. Both promise to add billions of dollars in unnecessary costs to thousands of businesses whose fortunes are tied to a universal mail delivery system.”
- “Whether we like it or not, postal reform has reached an impasse. Politics, in part having nothing with postal policy, has overtaken events and is choking the life out of any hope of enacting postal reform. In the meantime, mailers’ hopes for CSRS relief are still being held hostage to an increasingly futile hope for the enactment of postal reform. I don’t blame the Members of Congress who have poured hours into this issue to try to keep mailers hanging together in support of a legislative effort, but time’s running out, and about the only thing certain is that without swift action mailers are going to hang.”
- “It should be obvious by now that the many unresolved issues that are a part of the postal reform debate will not be addressed to everyone’s satisfaction before the House Speaker and the Senate Majority Leader make their call to the President to tell him that the 108th Congress has adjourned. There is still time, though, for persons of good will who have no interest in punishing businesses and consumers for the vagaries of the legislative process to release two more years worth of CSRS savings before the Postal Service files for its next postal rate increase.”
- “Why two years? Because the Postal Service most likely will be using a 2006 fiscal year as the basis of its break-even calculations. A release of savings for fiscal 2005 and 2006 will ensure that rates aren’t overblown by any escrow imposition. A release of two year’s funds doesn’t require anyone to compromise whatever principles he or she holds dear with regard to postal reform. Those principles can still serve as the foundation of some future discussion and debate. In the meantime, however, mailers wouldn’t have to watch their bottom lines plummet because of some unnecessary and unjustifiable postal tax.”
- “My advice to all mailers is to start taking the names of anyone and everyone at either end of Pennsylvania Avenue who fails to do what is right and to hold them accountable in the only forum that means anything to them--the voting booth.”
(*Postcom Association for Postal Commerce*, Gene Del Polito, 07/27/04)

AEI scholar Geddes argues that *Flamingo* anti-trust ruling
makes postal reform imperative

- American Enterprise Institute adjunct scholar Rick Geddes writes, “In *United States Postal Service v. Flamingo Industries (USA) Ltd.*, the Supreme Court decided that the postal service is exempt from antitrust liability. From a policy perspective, the ruling is disturbing for three reasons. The Court assumes that firms with goals besides profit maximization will not behave anti-competitively. Second, it presumes that the Postal Rate Commission currently has sufficient authority to control anticompetitive behavior by the postal service. Third, the Court displays a disturbing lack of concern for firms competing with the postal service in non-postal activities. The Court’s ruling in *Flamingo Industries* makes effective postal reform more imperative.”
- “...*Flamingo Industries* case illustrates the inherent contradictions that arise when government performs activities that are fundamentally commercial in nature. The Postal Service is a \$68 billion company with 827,000 employees, about 38,000 retail postal outlets, 446 mail processing facilities, and 215,000 vehicles, which operates several business lines. It has a legally enforced monopoly in its core business and receives numerous government-granted privileges and immunities. Yet it is exempt from the antitrust laws, SEC disclosure requirements, and truth-in-advertising laws. If the antitrust laws are valuable in preventing the abuse of market power in other industries, it is unclear why they would not be beneficial in postal services as well. The decision in *Flamingo Industries* may well be inevitable given current institutional arrangements, but it makes for bad policy and opens the door to potential abuse.
- Congress is now considering reform of the U.S. Postal Service. The decision in *Flamingo Industries* makes robust postal reform even more imperative. Congress should consider ways to adapt reform legislation to this antitrust exemption. Strict limits on the Postal Service’s monopoly powers or elimination of those powers should be understood as helpful not only in enhancing efficiency but also in reducing subsidization of non-postal activities. Congress should also expand significantly the powers of the Postal Rate Commission, giving it final authority to set rates, to gather information, and to control what products the Postal Service offers. *Flamingo Industries* also suggests that Congress should require the Postal Service to focus only on its core activity of mail delivery. If the USPS truly has a public service mission in the delivery of mail to all addresses, then diversification into unrelated (and, as best we can tell, money losing) non-postal activities is a distraction from that core function. The Supreme Court’s decision in *Flamingo Industries* is yet another admonition that the time for muscular postal reform has come. (*American Enterprise Institute Postal Reform Paper No. 5*, Rick Geddes, 07/04)

Geddes reviews timid –but much needed—steps toward postal reform

- Rick Geddes, adjunct scholar at American Enterprise Institute, writes “The time for postal reform in the United States has come. Both Houses of Congress are now considering bills that would thoroughly reform the U.S. Postal Service. The bills are disappointing in light of the extensive reforms carried out in other developed countries, including privatization and complete de-monopolization. They do contain several proposed improvements over the status quo, however. They would enhance the authority of the Postal Service’s regulator, they would clearly separate monopolistic from competitive products, and they would limit the Postal Service’s delivery monopoly so that private firms might compete as long as they charged no less than six times the prevailing stamp price”
- “While the postal reform bills before Congress do not address many important issues, they would improve the process under which the Postal Service is regulated, define clearly the delivery monopoly, enhance the transparency of the Postal Service, and help restrict it to its core mission of providing universal delivery service. Rather than tackling the really big issues facing the Postal Service, this legislation would instead set the stage for additional future reforms. The bills would institute some improvements relative to the current system.”
- “But what is the price tag to the American public? The Postal Service would be relieved of its obligation to pay pension benefits to retirees for prior military service, shifting the responsibility to the Treasury. The tab to the U.S. taxpayer is an estimated \$27 billion over several decades. That is a rather high price for the modest reforms in these bills. Given the rapid progress in other countries, Americans could have justifiably expected Congress to deliver more constructive, effective postal reform. Postal reform, however, is a notoriously difficult political proposition, and another opportunity to institute change may not arrive for some time. Half a loaf may indeed be better than none.” (*American Enterprise Institute Postal Reform Paper No. 6*, Rick Geddes, 07/04)

USPS sees “steady” rates until 2006

- The U.S. Postal Service expects to hold rates steady through 2006 following its positive third-quarter performance, said chief financial officer Richard J. Strasser Jr. in his quarterly fiscal update to the Board of Governors. The USPS reported net income of \$259 million for the period, Strasser said. The third quarter, which ended June 30, also had an \$80 million increase in energy costs compared to the third quarter of fiscal 2003, Strasser said. Nevertheless, expense growth was held to 2.8% and estimated mail volume increased 2%. Postmaster general John E. Potter has promised mailers that the postal service won’t implement another rate case until at least calendar year 2006. (*DMNews.com*, Scott Havanyetz, 07/21/04)