

The **GSE** REPORT™

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Major Events

Greenspan reiterates his concern about Fannie and Freddie's asset growth

St. Louis Federal Reserve Chairman Poole says new problems at GSEs would revive legislative efforts

- Rapid expansion of Fannie Mae and Freddie Mac's assets could have a destabilizing effect on the U.S. economy, Federal Reserve Chairman Alan Greenspan testified before the Senate Banking Committee. "The size of the subsidy ... creates a problem of expanding assets -- mortgage assets or indeed any set of assets -- in a way which could become destabilizing if it continues on very much beyond where they are, because they have become very large financial institutions," Greenspan told the Committee. Greenspan said that while the GSEs are well managed, they are not subject to market adjustment forces that would constrain their growth because of their ties to the government. Acknowledging that in recent months Fannie and Freddie have slowed their debt issuances, Greenspan said, "I trust that's the beginning of a conscious trend to slow things down," he said.
- Greenspan said that if higher interest rates slow the U.S. housing market, Fannie Mae and Freddie Mac would likely see minimal impact. "That doesn't concern me," Greenspan said in response to a question from Senate Banking Chairman Richard Shelby (R-AL) about the impact of a housing slowdown on the two firms. (*Reuters*, 06/15/04; *Dow Jones Newswires*, Jennifer Corbett Dooren, 06/15/04)
- St. Louis Federal Reserve President William Poole said that any further accounting or other "perceived problems" at Fannie Mae or Freddie Mac could shift expectations for "near-term" legislative action. "If there is another problem then that would probably change the betting" that now assumes no regulatory overhaul for the GSEs this legislative year, Poole said. (*The Main Wire*, Claudia Hirsch, 06/16/04)

NAH, NAR and MBA plan to fight HUD's affordable housing goals

- According to the *Wall Street Journal*, the National Association of Homebuilders (NAH), the National Association of Realtors (NAR), the Mortgage Bankers Association and other groups allied with Freddie Mac and Fannie Mae are preparing a letter to the Secretary of HUD, warning that the agency's proposed rules to require the GSEs to finance more affordable housing "may have unintended consequences," hurting some poor and middle-income people struggling to afford houses, said several sources. The issues raised by the lobbying groups closely track objections raised by Fannie Mae and Freddie Mac themselves, who stress that while they favor more

efforts to promote affordable housing, HUD has made some unrealistic assumptions about how much more the GSEs can do over the next few years.

- David Crowe, a senior vice president of NAH, said HUD should avoid putting onerous low-income requirements on the GSE, which may compel them to slash financing of middle-income homebuyers. Crowe points out that one way to meet the rules would be to buy fewer middle-income loans so that low-income loans would be a larger proportion of the total. Ultimately, borrowing costs for middle-income homebuyers may rise. A recent Fannie analysis prepared for NAR said Fannie Mae would have had to reduce the dollar value of its mortgage purchasing 43% over the 2001-2003 period, had the proposed 57% rule been in effect. The GSEs and their allies warn that these rules could also weaken the FHA, since the goals would push the GSEs to “cherry-pick” the FHA’s most creditworthy customers and leave FHA with only the weakest credits. Over time, FHA’s performance will deteriorate, the lobbying groups say.
- Some mortgage bankers fear that if the HUD rules reduce the GSEs’ profitability, Fannie Mae and Freddie Mac will use their market power to exact tougher terms from banks that sell loans to them.
- In contrast, the White House has taken a tougher line than HUD. A spokesman for the OMB said the percentage requirements were raised after HUD submitted its initial proposal to the agency. (*Dow Jones*, James Hagerty, 06/17/04)

S&P to revisit Fannie Mae’s positive governance rating

- Standard & Poor’s is updating the corporate governance evaluation it gave Fannie Mae in 2003, a review that resulted in a gold star for the GSE. As part of an annual evaluation, S&P will update its opinion on Fannie Mae sometime this summer, said George Dallas, manager of S&P’s global governance services. Dallas stressed that the review will not necessarily lead to a change in Fannie Mae’s score. S&P is taking into consideration the controversies swirling around Fannie Mae the past year. “We’re factoring all of these issues into the assessment,” he said. Dallas declined to provide details of S&P’s thinking at this point, indicating that investors will have to wait for the report to be released. (*Dow Jones Newswires*, Phyllis Plitch, 06/17/04)

Senator Nickles places indefinite “hold” on postal reform legislation

- According to *Postcom*, sources say that Senate Budget Committee chairman Don Nickles (R-OK) has placed an indefinite “hold” on the Senate’s postal reform bill [S. 2468], effectively preventing the measure from coming before the entire Senate. Nickles’ hold will remain in effect until issues concerning the budgetary impact of the measure are resolved. (*Postcom Association for Postal Commerce*, 06/15/04)

One for the Gipper

- The Postal Service will issue a new postage stamp next year to honor former president Ronald Reagan, following his death at the age of 93, said agency officials. Under the USPS' policy, a stamp bearing the likeness of a deceased former president is issued on the first birthday after his death. The Postal Service plans to issue the Reagan stamp on February 6, 2005, the day that would have been his 94th birthday. The agency is working with the Reagan family on arrangements for the stamp. (*Agence France Presse*, 06/06/04; *Bloomberg News*, Kevin Orland, 06/16/04)

Fannie Mae and Freddie Mac

GSE legislation languishes

- Action is increasingly unlikely this year on a bill that would create a new regulator with expanded supervisory powers for Fannie Mae, Freddie Mac, and the FHLBanks. According to House Financial Services Committee Chairman Michael G. Oxley (R-OH), the legislation could even be stalled next year. In a recent interview, Oxley indicated that he has not put the legislation on his priority list and is not interested in pursuing a bill. Oxley blames the Bush administration's broad reform demands for stalling the Committee's legislative efforts.
- In May, Senator Wayne Allard (R-CO) said that the passage of a bill "will be in the next Congress, if anything happens at all," but stressed that the matter will remain a priority. He said that the Senate Banking Committee may hold more hearings on the issue this year, "particularly on the matter of receivership" of the GSEs in a financial crisis.
- Given Congress' inaction, the Bush administration is evaluating regulatory options. According to Brian Roseboro, Treasury's undersecretary for domestic finance, the Bush administration is weighing its options on regulating the GSEs, and hasn't yet decided on a course of action or a timetable. He said that while the administration hasn't decided whether to rein in the borrowing powers of the GSEs, it appears Treasury has the legal authority to do so. "A preliminary look at the statute says we have the authority [to limit Fannie Mae and Freddie Mac borrowing]. This is worth studying further," Roseboro said. He said Treasury was weighing many options on how to address the GSE issue, not just a possible red light on future borrowing. "We like to think we have more options than just flicking a light switch on, flicking a light switch off," he said. (*American Banker*, 06/10/04; *Dow Jones Newswires*, Rebecca Christine, 06/16/04)

Senator Bond expresses “grave concerns” about OFHEO

- Senator Christopher Bond (R-MO) said he is still waiting for the results of investigations of OFHEO. Bond, a key appropriator for HUD, asked the agency’s inspector general to investigate whether OFHEO had acted improperly. “The inspector general will do a very thorough report and get back to us, and GAO as well, in their time frame,” Bond said. “I’ve had grave concerns about OFHEO for as long as it has been funded by my committee,” Bond said. (*Dow Jones Capital Markets Report*, Rebecca Christie, 06/04/04)

TheStreet.com’s Eavis says Fannie and Freddie won’t cheat judgment day

- Peter Eavis writes in *TheStreet.com*, “A lull in Washington reform efforts shouldn’t be misconstrued as surrender. The defeat of a bill to regulate them is being oversold by lobbyists. Debt caps remain a serious threat to stockholders. ...Fannie Mae and Freddie Mac have lost the political battle to remain high-growth companies -- and Wall Street is being stupidly slow to recognize that the good old days are over. ...[W]hile there has been something of a lull in the efforts in Washington to reform Fannie and Freddie in recent weeks, this should not be mistaken as a defeat or a setback for the pro-reform forces, which include the White House, numerous congressional lawmakers, housing regulators and the Federal Reserve.”
- “It has been government, however, that has done so much recently to curb Fannie and Freddie’s growth prospects and undermine the advantages afforded by their charters. ...[E]fforts to reform and restrict the two companies [have] spread and gathered momentum, particularly during the past two years of the Bush administration, which has made curbing the two GSEs a top priority. Today, Fannie and Freddie face a formidable multi-front onslaught that has already resulted in the ousting of Freddie’s old management team and an ongoing accounting probe of Fannie Mae. While the two companies still retain substantial power, this pro-reform alliance has effectively dashed Fannie’s and Freddie’s plans to move into new areas of business, and it has ended hopes that they will be able to show rip-roaring levels of portfolio growth for any extended period. ...[I]nvestors are only slowly accepting that this paradigm shift -- which would almost certainly extend into a possible Kerry presidency -- has taken place.”
- “In April, the Senate Banking Committee approved [a GSE regulatory reform] bill, but it contained an amendment that softened a key provision that would have let the new regulator put the GSEs into receivership in a financial crisis. The bill is almost certainly not going to progress because of White House opposition to the change to the receivership provision. Through ferocious lobbying, Fannie and Freddie have

been able to portray that stymieing as a major victory. Don't believe it. As one congressional source that has long been involved in the GSE reform process says: 'What the Senate committee did was far more monumental than people think. Someone, somewhere finally had a vote -- and it went against Fannie.'"

- "Knowing that Fannie and Freddie can still generate support among vote-hungry congressmen through their lobbying machines, the reformers have chosen other fronts on which to attack. Perhaps the most effective has been the regulatory front. One of the most remarkable developments has been the assertive stance taken by the Office of Federal Housing Enterprise Oversight toward Fannie after Freddie's accounting scandal, which broke through 2003. OFHEO pressured Fannie into changing accounting principles for valuing some bonds after it felt that Fannie had misapplied accounting rules."
- "Fannie defenders argue that if OFHEO had anything else that was damning, it would have leaked out by now. However, OFHEO, which declined to comment on the Fannie probe, seems to be looking in many areas and may well be turning up juicy leads. ...[T]he *Financial Times* reported that OFHEO is now examining an earnings-related options grant that this column focused on last year. According to a person familiar with the investigation, OFHEO has threatened to issue a subpoena to obtain information relating to the options grant. When asked whether Fannie had been threatened with or actually been issued a subpoena in relation to the options grant, Fannie didn't comment. A pay scandal resulting in the removal of Fannie's current management, led by CEO Franklin Raines, would almost certainly result in a more soundly managed but slower-growing company. Raines has a clear track record of making earnings growth a higher priority than balance-sheet strength."
- "...[T]he Bush administration has also introduced new rules through ...HUD, that increase the amount of mortgages to low- and moderate-income borrowers that the GSEs have to finance. This makes it much harder for Fannie and Freddie to go off looking for new, possibly higher-growth sources of business that might stray from their stated mission of supporting the residential real estate market."
- "[S]ince John Snow has been at the Treasury, that institution has taken a tougher stance toward Fannie and Freddie. That may not initially appear to be the case, given that Bush Treasury officials have not seriously floated the idea of removing the ability of Fannie and Freddie to seek to borrow up to \$2.25 billion from the Treasury. According to the GSE-related statutes, it is in the Treasury secretary's discretion whether the line gets extended or not. In 2000, when Clinton Treasury undersecretary Gensler said he would support legislation that would remove the emergency credit line, Fannie and Freddie's bonds tanked. Wayne Abernathy, assistant Treasury secretary for financial institutions, said last year that if Congress wants to take on the issue of repealing the credit line, 'we're open to having that discussion.'"
- "...[S]ome GSE critics ...say that the Treasury should state that it would not extend the credit line to pressure Fannie and Freddie. While new legislation would be

needed to get rid of the line altogether, announcing that it would never be used under a Bush presidency would be a direct way of signaling to the market that the government doesn't implicitly guarantee GSE debt. The market's perception that it does offer such a guarantee has led to borrowing costs that are well below that of competitors. The desire not to make the credit line a big issue, however, should not be seen as a sign of timidity among the reformers."

- "First off, talking about not extending the credit line now would have a lot less impact than it would have had four years ago. If a big statement is made about not extending it, the market might respond with a shrug, causing the Bush administration embarrassment. And both institutions can easily raise over \$2.25 billion in liquidity quickly."
- "Instead, the administration is far more enthusiastic about using existing rules that would allow the Treasury to restrict debt issuance by the GSEs. This approach ... can be used to bring the GSEs to heel by capping the amount of debt they issue, without roiling bond markets. If GSE borrowing rates stayed close to current low levels, anti-reform forces wouldn't be able to argue that reforms were driving up mortgage rates for the individual borrower. Of course, a debt cap would hurt the stock, but angry money managers make up very few votes."
- "So why hasn't the Bush administration actually used debt caps? One reason could be that it wants to get all the legal preparations completed before doing anything concrete. Secondly, Fannie and Freddie's portfolio growth has slowed markedly after a three-year boom. Of course, a strong possibility is that the administration doesn't want to do anything that would even remotely risk upsetting an already frothy housing market before the November presidential election. And yes, that is the sort of political expediency that doesn't make the administration look like committed reformers."
- "But even if the debt caps don't get used before the election, they will always be there as a tool for any government that wants to rein in Fannie and Freddie. Up until last year, Wall Street was happy to think government agencies didn't have any real way of curbing [the GSEs] growth. Now it is clear that they have this trump card at the Treasury that can be used by any president -- Republican or Democrat. That is a huge setback for Fannie and Freddie and their fans. Along with pressure from HUD to stay away from new noncore, higher-growth businesses, the Treasury debt limits could dampen earnings growth. Investors in Fannie and Freddie stock have the most unenviable of long-term outlooks. Despite doing business through what may turn out to be the biggest housing boom in U.S. history, Fannie and Freddie's stocks are only 15% higher than they were five years ago. The pain is far from over for the equity investor."
- "If Bush gets back in, his administration will be far more aggressive than it was till now -- and Fannie and Freddie will wish they had gone along with reforms already proposed. If it is Kerry that ends up winning, there are plenty of pro-GSE reform

Democrats who will protest any moves to allow Fannie and Freddie free rein again. And if Fannie's management is in the thick of a compensation scandal due to the OFHEO investigation, there is very little chance that a Democratic president would jump to Fannie's defense."

- "Wall Street, wake up." (*TheStreet.com*, Peter Eavis, 06/10/04)

OFHEO receives comments on its corporate governance regulations

- OFHEO received seventeen comments on the agency's proposed Corporate Governance Amendment during the comment period ending on June 15. Comment letters are available for review on OFHEO's website, www.ofheo.gov/news.

Fannie and Freddie Comments:

- In critiquing agency's provision to require the GSEs' top two executives to pay for the costs for an accounting restatement and disgorge profits if misconduct is to blame, Fannie Mae argued in its comment letter that the legal foundation for this provision doesn't give OFHEO the authority to impose such penalties. Fannie Mae's argument is supported by a legal memo prepared by Christopher Landau with Kirkland & Ellis LLP, submitted as an addendum to Fannie's letter, which said "This proposed amendment is invalid on both substantive and procedural grounds."
- While Freddie Mac's opposition to this provision wasn't quite as forceful, the GSE argued that OFHEO's measure was unclear and that agency shouldn't enforce this rule with current officers until Freddie Mac puts into place all of its remediation plans following last year's accounting scandal. "Although Freddie Mac's top priority is the issuance of timely and accurate financial statements, there is no good regulatory reason why Freddie Mac's senior officers should or need to be subject to the threat of substantial monetary sanction" until the GSE can implement plans to address operational weaknesses that hamper its ability to release timely financial statements, said Freddie's General Counsel Ralph Boyd, Jr. in his comment letter.
- OFHEO's regulations would also split the companies' chairman and chief executive posts, would additionally require the companies to rotate their audit partner every five years and auditor every 10 years - issues Fannie Mae and Freddie Mac vehemently opposed. Fannie argued that OFHEO's provisions exceeds what Congress required of public companies in the Sarbanes-Oxley Act on corporate accountability, saying lawmakers instead opted to study the issue. "The [GAO] concluded that the issue is not yet ripe for decision," said Fannie's General Counsel Ann Kappler. Freddie's Boyd, likewise, said OFHEO shouldn't deviate from what is already required under Sarbanes-Oxley, which instituted new rules to ensure auditor independence. Fannie ardently opposes splitting Franklin Raines' dual duties as chairman and chief executive. "There is not a current consensus that separation of the chairman and CEO should be split given the then-current facts and circumstances," Kappler said. While Freddie has agreed to splitting the chairman and CEO positions as a part of its

remediation plan with OFHEO, the GSE argued in its comment letter that its board ought to be able to give both jobs to one executive in the future. (*Dow Jones Newswires*, Dawn Kopecki, 06/15/04;

- Fannie Mae's letter also said that OFHEO's plan is wrong to prohibit compensation that is not "reasonable and appropriate." Fannie Mae is concerned that "the term 'appropriate' is not defined by the proposal, and therefore does not allow the companies to determine what standards OFHEO will apply when determining compliance," the letter said. Fannie asked that OFHEO amend the language to mirror the 1992 law that created the agency, which prohibits executive compensation that is not "reasonable and comparable" with that of similar businesses.
- In a comment letter filed with the OFHEO, Fannie Mae's Nominating and Corporate Governance Committee said that "we are concerned that the proposal's focus on the federal charter and 'public mission' of the enterprises [Fannie Mae and Freddie Mac] may detract from our role as representatives of Fannie Mae's shareholders. As directors, our duty is to act in the best interests of the shareholders." Ann Korologos, the committee's chairwoman wrote, "While we obviously recognize, oversee and support Fannie Mae's important public mission and the significance of Fannie Mae's operations in capital markets, we must be accountable to Fannie Mae's shareholders. As directors, our duty is to act in the best interest of the shareholders." (*American Banker*, Rob Blackwell, 06/16/04; *Dow Jones Newswires*, Dawn Kopecki, 06/15/04)
- The committee said OFHEO's proposal to limit the service of a Fannie Mae board member to no more than 10 years or past the age of 72, whichever comes first, would restrict the board's flexibility in selecting and retaining qualified, capable director nominees. Regarding OFHEO's proposal to require Fannie's board to meet at least twice a quarter, the committee said "we believe that such micromanagement of the board's meeting schedule is particularly inappropriate." It also said OFHEO's proposal to bar compensation in excess of what's "appropriate" is a matter of concern in light of the lack of any standard by which appropriate compensation is to be determined. The Committee is also believes that OFHEO's proposal to require the GSEs to change its outside auditors at least every 10 years should be abandoned and existing standards left in place. (*Dow Jones Newswires*, John Connor, 06/16/04)

ACB Comments:

- In its comment letter, America's Community Bankers (ACB) said that many of OFHEO's proposals go beyond "best practices" and are the types of requirements best left to each company's board of directors. "For example," ACB said, "a company's board of directors is in the best position to determine whether the same person should hold the role of chairman and chief executive officer depending on the individuals involved and the board dynamic." The group also criticized OFHEO's proposed requirement that the GSEs change auditing firm every 10 years, terming the proposal "unnecessarily disruptive and counterproductive." (*Dow Jones Newswires*, John Connor, 06/10/04)

CMC Comments

- In its comment letter, the Consumer Mortgage Coalition (CMC) called on OFHEO to strengthen its corporate governance proposal to ensure that Fannie Mae and Freddie Mac are subject to the corporate governance and financial disclosure rules of the New York Stock Exchange (Section 303A of the NYSE's Listed Company Manual), the Sarbanes-Oxley Act, and the SEC, whether or not their stock is listed on the New York Stock Exchange or whether they are reporting companies subject to the public disclosure requirements of a public company. The CMC said that, "Although the proposed rule refers to certain sections of Sarbanes-Oxley, it does not refer to all of the provisions that should be applicable to the GSEs. For example –
 - There is no reference to Sections 201 and 202 of Sarbanes-Oxley. These provisions set forth the non-audit services that outside auditors are prohibited from performing, and the procedural steps necessary for the Audit Committee of a company to take in approving non-audit services not prohibited under Section 201. These rules go to the very heart of Sarbanes-Oxley because they address the fundamental relationship between the outside auditors and a public company.
 - The proposed rule refers to provisions of Section 302 of Sarbanes-Oxley governing certification by the CEO and CFO of internal controls of the company on a quarterly basis, but does not refer to Section 404, which requires an annual certification on internal controls, and an attestation by the outside accounting firm of the certification.
 - The proposed rule also does not refer to SEC rules that implement the relevant sections of Sarbanes-Oxley. The SEC rules should be incorporated by reference. Otherwise, the OHFEO corporate governance rules will not be as broad as the rules applicable to publicly reporting companies. For example, the SEC rules address possible circumvention of the five-year rule limitation applicable to lead and review auditing partners. Sarbanes-Oxley does not address possible circumvention. Other examples include the SEC rules requiring the CEO to be subject to the Codes of Conduct specified in Section 406 of Sarbanes-Oxley, although Section 406 does not specify the CEO.
 - The proposed rule refers only to the NYSE rules relating to the audit, compensation, and nominating/corporate governance committees, but omits any reference to other essential provisions such as (1) the details on holding regularly scheduled executive sessions without management, and, at least once a year, holding an executive session which includes only independent directors; (2) adoption and disclosure of corporate governance guidelines; (3) director qualification standards; (4) director access to management and, as necessary and appropriate, independent advisors; (5) director compensation; (6) director orientation and continuing education; (7) management succession; (8) annual performance evaluation of the Board; (8) adoption and disclosure of a code of business conduct and ethics for directors, officers and employees, and disclosure of

- any waivers of the code for directors or executive officers; and (9) elements of the code of business conduct and ethics.
- The proposed rule leaves open the possibility that Freddie Mac will not register its common stock with the SEC. See Section 1710.19(c)(1). Whether through an OFHEO rule or directive, both GSEs should be subject to all of the reporting and proxy requirements of the SEC. See Section 1710.19(c)(1).”

The CMC noted that “Without making these changes, they [the GSEs) will lack the transparency expected and required of major American corporations.

The CMC also recommended as an alternative to OFHEO’s proposal to change auditors every ten years that OFHEO be given the authority, in regulation, to remove an outside auditor if it has reason to believe that the outside auditor is not sufficiently independent of the company, has performed audits in the past that are inadequate, or is otherwise disqualified to serve as the company’s outside auditor. This is the approach followed by the federal banking agencies. See rules on Removal, Suspension, and Debarment of Accountants from Performing Audit Services (12 CFR Part 19, Part 263, Part 308, and Part 513, effective October 1, 2003). (*Consumer Mortgage Coalition Comment Letter to OFHEO, 06/11/04*)

ICBA Comments:

- Ann M. Grochala, Director of Lending and Accounting Policy for the International Community Bankers of America (ICBA), said in a comment letter, “ICBA believes that OFHEO should look to the requirement already in place for public companies and for federally regulated financial institutions to ensure consistency for issues such as codes of conduct, prohibitions of extension of credit to board members and executive officers, disclosure certifications and other issues. While Fannie Mae and Freddie Mac serve a special public purpose, imposing overly burdensome and unfairly stringent corporate governance requirements may inhibit their performance towards that purpose and the result may well be higher home ownership costs.” (*International Community Bankers of America Comment Letter, Ann M. Grochala, 06/14/04*)

U.S. Chamber Comments:

- The U.S. Chamber of Commerce (Chamber) expressed concern in its comment letter to OFHEO “with [its] proposal ...to separate the positions of Chairman of the Board and CEO and to require mandatory auditor rotation.” The Chamber stated “that these proposals are not in the interest of shareholders and will not strengthen corporate governance. In addition, several of the proposed rules duplicate existing rules adopted by the Securities and Exchange Commission and the stock exchanges. Although the proposed rules apply to only two companies regulated by OFHEO, Fannie Mae and Freddie Mac, the Chamber is concerned the rules may affect other, regulated companies.” (*The Main Wire, 06/15/04*)

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AICPA Comments:

- In their comment letter, the American Institute of Certified Public Accountants (AICPA) urged OFHEO to defer any decision to require audit firm rotation until experience has been gained with other reforms contained in the rule. AICPA wrote, “We strongly recommend that OFHEO not mandate audit firm rotation and [instead] monitor the effectiveness of audit partner rotation requirement and other corporate governance provisions applicable to entities regulated by OFHEO.” In separate comment letters, KPMG, LLP, Deloitte & Touche LLP, PriceWaterhouseCoopers and Ernst & Young LLP all urged OFHEO that the mandatory audit firm rotation be removed from the agency’s proposed regulations. (*American Institute of Certified Public Accountants Comment Letter*, Ian A. Mackay, 06/10/04; *KPMG, LLP Comment Letter*, 06/11/04; *Deloitte & Touche LLP Comment Letter*, 06/11/04; *PriceWaterhouseCoopers Comment Letter*, 06/10/04; *Ernst & Young LLP Comment Letter*, 06/07/04)

NACD Comments:

- In its comment letter, the National Association of Corporate Directors wrote “[P]rescribing rigid requirements with respect to board leadership and tenure would not improve corporate governance and could have significant negative consequences. Accordingly, we urge OFHEO to reconsider its proposed amendments in these areas.” (*National Association of Corporate Directors*, Roger W. Raber, 06/10/04)

MICA Comments:

- In a comment letter to OFHEO, Susan C. Hutchinson, executive vice president of Mortgage Insurance Companies of America (MICA), wrote “MICA believes that OFHEO should, with various clarifications and expansions, finalize the proposed corporate governance rules [for GSEs].” Hutchinson urged the addition of new standards in the areas of operational risk management; credit risk transfer guidance; new programs related to risk and structured finance; and conflict of interest standards. (*Mortgage Insurance Companies of America Comment Letter*, Susan C. Hutchinson, 06/11/04)

FM Policy Focus Comments:

- FM Policy Focus urged in its comment letter to OFHEO that the agency delete a reference in a proposed corporate governance rule to GSE “subsidiaries.” The coalition wrote, “FM Policy Focus believes that this reference should be deleted to avoid any inference that OFHEO intends that the GSEs establish subsidiaries for any purpose.” The coalition urged OFHEO “to avoid any terminology that might lead the enterprises at some point going forward to argue that OFHEO sanctions the establishment of subsidiaries.” (*Dow Jones Newswires*, John Connor, 06/16/04)

Individual Comments:

- Former Assistant Treasury Secretary Sheila Bair argued against special new corporate governance rules in a comment letter to OFHEO. Blair wrote, “I believe OFHEO’s first priority should be to ensure that Freddie Mac fulfills its commitment as quickly as possible to submit to SEC jurisdiction, and full compliance with the Exchange Act

as well as the Sarbanes-Oxley Act. Blair added, "...OFHEO should defer to the SEC and NYSE in defining and enforcing corporate governance standards applicable to the enterprises as publicly traded companies." She continued, "Creating separate rules for the enterprises reinforces the notion that they are 'exceptions' subject to differing standards of corporate responsibility. OFHEO should not substitute its own judgment for that of Congress, the SEC or the NYSE on corporate governance matters, absent a clear nexus to OFHEO's oversight responsibilities of safety and soundness and charter enforcement," said Bair. (*Dow Jones Newswires*, John Connor, 06/18/04)

- David Foreman, a Freddie Mac shareholder, said to OFHEO in a comment letter, "I fully support your efforts to hold Fannie and Freddie to the highest standard of corporate governance, financial accounting standards and management compensation. As a shareholder, I know that these companies have opportunities to make plenty of money without recklessly endangering the capital that I have invested in them. .. The pay packages at Fannie Mae are obscenely excessive and are structured in a way as to promote reckless accounting and risk. ...I urge you to seek to replace any CEO who resists these simple safeguards that you propose. ...Fannie Mae is being run recklessly with lopsided hedging, obtuse accounting, [and] excessively short-sighted compensation schemes. Shareholders own these companies and we want a sound conservative management structure and conservative accounting. The measures you propose will only strengthen the companies and make them more valuable to shareholders." (*Freddie Mac Shareholder Comment Letter*, David S. Foreman, 04/09/04)

OFHEO issues its Report to Congress on GSEs

- In its annual report to Congress for 2003, OFHEO said that despite management turmoil and regulatory action against Freddie Mac, the GSE's underlying economics are "sound." The regulator said Freddie Mac enjoys "strong asset quality and prudent credit risk management practices" as well as consistent access to liquidity, even in a "challenging and highly unusual operating environment."
- "OFHEO identified some areas where they could see improvement, but they didn't raise any issues about our safety and soundness, and that's the key," said Freddie Mac spokeswoman Sharon McHale. Freddie Mac is "on track" to release its 2003 financial restatement on June 30, both quarterly and full-year, and will provide an estimate on when its 2004 quarterly earnings figures will be available, McHale said.
- In its Report to Congress, OFHEO deemed Fannie Mae financially safe and sound. The agency is in the process of conducting a special exam of Fannie Mae, focused on how Fannie values its manufactured housing asset-backed securities portfolio and, reviewing the company's accounting and internal controls for financial reporting. OFHEO spokeswoman Corinne Russell said the examination is proceeding, but will "probably not" be completed in 2004.

- Jerry Lucas, chief Treasury and Agency strategist at Banc of America Securities in New York, said that one benefit of OFHEO's tighter supervision of Fannie and Freddie is that it has sparked stricter self-examination at the GSEs themselves. "Both of them appear to be adopting a more conservative profile going forward," Lucas said, referring to the GSEs' expected lower growth of their mortgage portfolios. (*The Main Wire*, Claudia Hirsch, 06/17/04)
- In its Report to Congress, OFHEO said it reorganized its Office of Capital Supervision late last year and expanded its analysis and research capacity. "These efforts will focus on exploring and developing alternative measurements of risk at the enterprises, various 'what if' analysis, and other tools to expand OFHEO's assessment of capital adequacy," said OFHEO. "The reorganization also directs more staff resources to supervising and monitoring the capital management processes at each GSE, while continuing to enhance and expand the existing risk-based capital stress test model." (*Dow Jones Newswires*, John Connor, 06/16/04; *Market News International*, Claudia Hirsch, 06/17/04)

<p>OFHEO meets with housing finance reps and bankers in Japan and Korea and finds interest by Bank of Japan to invest in Fannie's and Freddie's securities</p>
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- OFHEO met with central bankers, housing finance representatives and government officials from Japan and Korea to discuss issues surrounding the U.S. secondary mortgage market. Armando Falcon, director of the OFHEO, met with Bank of Japan Governor Toshihiko Fukui as well as with the top official of Japan's Government Housing Loan Corporation, OFHEO officials confirmed. Falcon also held meetings in Seoul, South Korea with the chief executive of Korea Housing Finance Corp., the state supplier of long-term mortgages and the Financial Supervisory Service, OFHEO's counterpart in South Korea.
- According to a source, the Bank of Japan may consider purchasing securities issued by Fannie Mae and Freddie Mac, although the Bank has no immediate plans to make such investments. Historically, the Bank of Japan has only held U.S. Treasuries and securities issued by supranational borrowers such as the World Bank, the source said. The central bank "sees investment in Fannie Mae and Freddie Mac as one option in the future," the source said. "The U.S. regulator sees the [Bank of Japan], as well as other central banks in Asia, as potential investors."
- OFHEO spokeswoman Corrine Russell said the agency covered the cost of the weeklong trip, requested by Japanese and Korean officials, for Falcon and one other agency official. The excursion comes as HUD probes OFHEO's expenditures in accounting probes at Fannie and Freddie at the request of Senator Christopher Bond (R-MO), chairman of the Senate Appropriations Subcommittee on HUD. (*Dow Jones International Newswire*, Dawn Kopecki, 06/18/04; *Dow Jones International News*, Kyung Kim, 06/17/04)

U.S. Treasury expands types of collateral for borrowing customers

- The Treasury Department issued an order expanding the types of collateral registered government securities brokers and dealers may pledge when borrowing customer securities. The Treasury said the expansion “will potentially increase liquidity in the securities lending markets and lower borrowing costs for registered government securities brokers and dealers.”
- Under the order, the Treasury will allow entities registered with the SEC as specialized government securities and broker dealers that borrow fully paid or excess-margin securities from customers to pledge a wider range of collateral, including securities issued or guaranteed as to principal or interest by Freddie Mac, Fannie Mae, Sallie Mae, and the Financing Corp. (*Dow Jones Newswires*, John Connor, 06/15/04)

By 2013, mortgage debt will exceed \$17 trillion—more than *double* today’s debt

- Over the next ten years, “America’s families will likely need 125 million mortgage loans for home purchase or refinance totaling \$27 trillion in mortgage originations,” said Frank Nothaft, Freddie Mac’s chief economist. “First-time buyers will remain a major component of the purchase market,” he added, purchasing approximately 24 million homes. By 2013, outstanding mortgage debt will total about \$17 trillion, said Nothaft, more than double today’s \$8 trillion. Fannie Mae’s chief economist David Berson predicts that housing prices will slow from the 8% rate of recent years to 4% to 6% over the 2004-2013 period. (*multi-housingnews.com*, 06/04/04)
- In a speech at HUD’s Fair Housing Awards Dinner, Fannie Mae chairman and CEO Franklin D. Raines said “While a record 68% of Americans own their homes, and 75% of white families do, only 50 % of Americans of color own their homes.” He pointed out that projected population growth suggest “the emerging markets [of the minority population] of today will be the surging markets of tomorrow.” While the white population is projected to grow by about 9% by the year 2020, the African-American population will grow by 28 percent, Hispanic Americans by 75 percent, and Asian Americans by 80 percent, said Raines. (*Fannie Mae Press Release*, Franklin D. Raines, 06/16/04)

A bearish view of the housing market

- John Talbott, a former investment banker at Goldman Sachs Group and author of *The Coming Crash of the Housing Market* discussed his bearish outlook of the U.S. housing market with Jim Carlton with the *Wall Street Journal*. Talbott said, “[H]ousing, and specifically home mortgages, do not act at all like perfect markets, and so the public should not gain any comfort that these prices being paid for homes

today are sustainable. First, homebuyers are not that sensitive to high prices because they are financing most of the purchase price. Lenders don't care about the price paid or the amount of leverage on the home because they sell most of their mortgages to Fannie Mae and Freddie Mac. And Fannie Mae and Freddie Mac aren't concerned that much with credit quality because they have an implied guarantee from you, the American taxpayer."

- "So, we find ourselves in a period of very loose mortgage credit, with home purchases being completed at very high prices and with very aggressive borrowing terms, and interest rates beginning to rise from a 40-year low. How long can prices continue to rise? According to the National Association of Realtors, prices have already peaked and have begun to fall from their peaks in much of the country. Nationally, NAR reports that prices are off some 4% [seasonally adjusted] since July of 2003, and the Southern states are off approximately 10%. A portion of this decline may be due to seasonal factors, but realize that this decline is beginning after housing prices have increased some 35 years in a row. And this is for data reported as of March of this year, and so does not include any effect of the recent rise in interest rates."
- "Where are prices headed from here? Further down. The best case: Housing prices nationally will drop approximately 10% to 15% from their peaks. Worst case: They will fall between 15% and 25%. Changes of this magnitude are large enough to wipe out many people's entire equity in their homes. Under this scenario, major players in the mortgage business -- such as the primary mortgage bankers, providers [of private mortgage insurance], second-mortgage issuers and even Fannie Mae and Freddie Mac -- will run into financial trouble due to credit problems on their loans." (*Wall Street Journal*, Jim Carlton, 06/11/04)
- In *Mortgage Banking*, Scott Cooley points out the role that automated underwriting systems have played in skyrocketing housing prices. Cooley writes, "The automated underwriting systems (AUS) are approving far more borrowers today than ever before. Remember the old "top and bottom ratios" of 28 and 36? These consistent rules served us well for at least 25 years, and we understood their performances through the worst of times. At the beginning of the current housing boom (the mid-1990s), the GSEs came out with their AUS. One of their marketing statements touted how these systems would approve more borrowers, and in fact they did. In addition, almost every year since their introduction, the GSEs have tweaked their models to further "refine" their AUS to accept even more borrowers. While we all want to approve more borrowers and increase the homeownership rate, there may be a price to pay for this."
- "The real issue is that neither Freddie Mac's Loan Prospector™ nor Fannie Mae's Desktop Underwriter™ has been through a housing downturn. I'm concerned that these new technologies are glossing over the reality that the old top and bottom ratios have been increased each year for almost 10 years. In their defense, I do agree that AUS are better at predicting defaults than the old ratios, but these models need real-

world testing in a housing downturn before we bet so heavily on them. To rely on them so blindly could become a recipe for disaster. Why are default rates as high as they are with such low interest rates?" (*Mortgage Banking*, Scott Cooley, 05/01/04)

The "law of unintended consequences" in affordable housing

- In a newspaper editorial, *The Indianapolis Star* writes, "Indianapolis and increasingly its suburbs are faced with a growing blight of vacant homes. Nearly one of 30 houses in Marion County was vacant last year. These 8,000-plus empty houses translate into urban blight... Economic conditions have a lot to do with abandoned housing. 'Probably 90 percent of the vacant properties are there because of foreclosures,' Mildred Watkins, a former foreclosure specialist at Fannie Mae, told *Star* reporter John Fritze."
- "The city has the second-highest mortgage foreclosure rate in the country. And its home vacancy rate is considerably higher than in surrounding Midwestern cities facing similar economic woes. That suggests more work needs to be done locally at the front end of the problem, providing tougher screening and better financial counseling for first-time home buyers." (*The Indianapolis Star*, 06/07/04)

Assemblyman challenges Wisconsin's pilot program
to provide undocumented immigrants home loans

- State Rep. Glenn Grothman (R-West Bend) is challenging the Wisconsin Housing & Economic Development Authority's (WHEDA) pilot program to provide undocumented immigrants with affordable home mortgages. Grothman wants WHEDA to end the program or face the threat of legislation curtailing its ability to provide mortgage loans to undocumented immigrants. Grothman's move comes at a time when financial services providers nationwide are working to remove barriers to such loans.
- In late April, WHEDA started the program that provides mortgage loans to undocumented immigrants through three Milwaukee banks and one bank in Madison. The loans use individual taxpayer identification numbers, rather than Social Security numbers for borrower identification. Freddie Mac had said it was monitoring the pilot program closely. WHEDA hasn't yet made any such loans, but several are in the pipeline, said Antonio Riley, the agency's executive director. Since many borrowers are likely to be immigrants unfamiliar with the U.S. financial system, the agency has added financial literacy to its regular monthly homebuyer seminars as part of the new program, he said.
- Grothman wants WHEDA to cease writing taxpayer ID loans altogether. "We have honest people waiting years to become citizens, hard-working immigration employees

protecting our borders and we're going to give low-interest loans to illegals," he said. (*The Business Journal* (Wisconsin), 05/21/04)

Presidential politics in the GSE world

- Frank Partnoy writes in the *Financial Times* (London, England), "As part of a proud tradition of dodging campaign finance rules, Wall Street banks and their favorite politicians have found a mouth-watering loophole in the 'soft money' ban enacted as part of the 2002 election reforms known as the McCain-Feingold law." Financial firms, like Fannie Mae, are (legally) able to lavish meals and parties on politicians during the political conventions. Partnoy describes these events as a "form of 'regulatory arbitrage' – a term for innovative ways to avoid legal rules." Partnoy writes, "Fannie Mae, the much scrutinized quasi-government mortgage lender is sponsoring a party at the Roxy in Boston. The bottom line is, notes Partnoy, "soft money buys access and influence." According to the *Wall Street Journal*, Freddie Mac has refused political solicitations so far in this election cycle. (*Financial Times*, Frank Partnoy, 06/14/04; *Wall Street Journal*, Jeanne Cummings, 06/07/04)
- "There's a good chance that Kerry would go much easier on Fannie Mae and Freddie Mac," says Tom Gallagher, analyst at research firm ISI Group. Bush wants tougher oversight of the GSEs, possibly driving up the agencies' borrowing costs. Kerry would probably leave the GSEs alone. (*Time Magazine*, Daniel Kadlec, 06/21/04)

Fannie Mae

Fannie Mae's mortgage investments shrink for eight straight month

- Fannie Mae says its portfolio of mortgage investments shrank in May for the eighth straight month, but it expects that streak to end in June. "Liquidations peaked in May," Fannie Mae said, with the portfolio shrinking at a 2.8% annual rate to \$878.4 billion. "Lower liquidations coupled with current levels of mortgage commitments are consistent with a return to positive portfolio growth in June," the GSE said. "You'll see a reversal of the negative trend in June," Mary Lou Christy, Fannie Mae's vice president of investor relations said. "Liquidations have outpaced for the most part new commitments. That will turn around." She added, "Liquidations will come down to a more normalized level." The combination of lower liquidations and new investments should result in growth in Fannie Mae' investment portfolio in June. "That's a certainty," said Christy.
- On May 31, Fannie had open commitments to buy \$28.3 billion of loans, essentially flat from the two previous months. Its portfolio ran off at a 38.1% rate, up 2.5% from

April, as mortgage refinancings from late winter worked its way through the market. The portfolio, Fannie Mae's main source of profits, has declined 4.2% since peaking at the end of September.

- Fannie Mae's duration gap remained at positive three months for a second month. In the seven previous months, the GSE's gap has hovered between positive and negative one month.
- Delinquency rates declined in April (the most current data available) with conventional single-family mortgage delinquency rate down two basis points to 0.56% and multi-family delinquency rate down one basis point to 0.16%. (*American Banker*, Jody Shenn, 06/16/04; *Reuters*, Richard Leong, 06/15/04; *Dow Jones Newswires*, Madeleine Lim, 06/15/04)

Datamonitor's SWOT analysis of Fannie Mae

- In an analysis of Fannie Mae's strengths, weaknesses, opportunities, and threats, *Datamonitor* writes, "The Company has a strong credit performance history and has maintained high earnings growth in the past. However, in spite of hedging risks, the company carries a substantial amount of interest-rate risk because of the difficulty of hedging its primary asset, namely the fixed-rate mortgage." Further, Fannie Mae's core capital was only 3.3% and only 1.5% of total insured loans at the end of 2002, ratios which are less than half ...that which a commercial bank or thrift holds. Fannie Mae's "risk of failure is high." (*Datamonitor*, 06/18/04)

Apartment owners sue Fannie Mae over escrow accounts—seeking billions (\$)

- In a lawsuit, the owners of three housing projects for low-income residents charge that Fannie Mae swept money out of their escrow accounts and used the funds for its own benefit. The lawsuit was filed in federal district court in Texarkana, TX, on June 2 on behalf of Medlock Southwest Management Corp. of Lubbock, which built a low-income apartment complex in Marshall; Jasper Housing Development Co., which owned apartments in Jasper; and the Porkolabs family. The apartment owners are seeking class-action status, which would allow up to 2,000 other owners to join the case.
- The apartment owners claim in the lawsuit that Fannie Mae secretly tapped the escrow accounts periodically and mingled the funds with its own and with money from other mortgage companies. They claim that Fannie Mae invested some of the money but didn't share profits or interest with the apartment owners.
- One of the plaintiffs, Alfred Porkolab, an 89-year-old retired insurance man in Maineville, Ohio, said he earned 6% annual return on the schoolhouse that he

converted into a 36-unit apartment complex in 1969 after taking out a \$400,000 mortgage. Porkolab said he lost “many thousands” in interest on the escrow accounts, which he said sometimes contained more than \$200,000. “We were providing a service -- affordable housing for the needy,” Porkolab said. “I was very much dismayed with Fannie Mae that they would take advantage of us.” He said they estimated the owners’ losses nationwide in the billions.

- Cari Kaye, a spokeswoman for Fannie Mae, said the company had not received the lawsuit and had no comment. (*Associated Press*, David Koenig, 06/09/04)

Fannie Mae markets DUS to credit unions

- Fannie Mae has begun marketing the funding of multi-family projects to banks, thrifts and credit unions as a way to comply with their Community Reinvestment Requirement Act requirements. Credit unions’ interest in these type of investments have increased, following the passage of a NCUA rule in May 2003, allowing Reg-Flex-eligible credit unions to invest up to 50% of their net worth in commercial mortgage-backed securities that are Triple A rated. The commercial-backed securities give credit unions a way to diversify their holdings, while providing the potential for a little bit more yield than traditional residential mortgage-backed securities. Frank Santucci, director of asset/liability management at credit union bond house First Empire Securities, said that these securities are popular for both their safety and their yields-as much as 100 basis points over comparable Treasuries. These securities, guaranteed by Fannie Mae, have large prepayment penalties on the underlying loans which significantly reducing prepayment risk. Typically, there are no partial prepayments because they secured by a single loan. (*Credit Union Journal*, Ed Roberts, 06/07/04)

Fannie Mae in negotiations on Waterside Mall office space in DC

- Fannie Mae is moving ahead with plans to lease office space along the Southwest Waterfront in the Waterside Mall. According to Fannie Mae spokesman Alfred King, the GSE has signed a nonbinding letter of intent with Waterfront Associates LLC, reflecting Fannie Mae’s agreement to pursue putting together a deal that would create a new office along the waterfront. Many months of negotiations and due diligence work remain ahead before a lease is finalized, said King. “Our decision to the Waterside Mall location reflects our long-standing commitment, through the D.C. Partnership Office and other corporate activities, to be a part of the District’s revitalization and to persuade others to view the city as attractive for investment,” said Chuck Greener, Fannie Mae senior vice president. (*Roll Call*, John McArdle, 06/14/04)

Former Fannie Mae Foundation president joins Mexican American Defense League

- Mexican American Legal Defense and Educational Fund, Los Angeles, CA, has appointed Ann Marie Tallman, a senior vice president at Fannie Mae and former president and chief executive officer of the Fannie Mae Foundation to be president and general counsel. (*The Chronicle of Philanthropy*, 04/29/04)

Fortune ranks Fannie Mae among the 50 best companies for minorities

- Fannie Mae ranked second, behind McDonalds in its list of 50 best companies for minorities. *Fortune* writes, “When it comes to diversity in the very upper echelons of the corporate tree, this mortgage finance giant takes the title, with 15 minorities among its 50 best-paid employees (including CEO Franklin Raines). The key? Employees say Fannie Mae focuses less on race and more on developing effective leaders.” (*Fortune*, 06/28/04)

Fannie addresses major barrier to lending on Native American tribal trusts

- At the National American Indian Housing Council’s (NAIHC) Annual Convention, Freddie Mac announced that a major barrier to mortgage lending on Native American tribal trust and restricted lands has been addressed by temporarily allowing a cost-based property valuation alternative during the mortgage process. Fannie Mae will now allow the use of the cost-based valuation alternative when sales comparables are not available. “Providing decent, affordable homeownership opportunities for Native Americans living on the reservation is a goal the National American Indian Housing Council shares with Fannie Mae,” said Gary L. Gordon, executive director of NAIHC. “Allowing alternative property valuation techniques will go a long way to helping more Native Americans achieve a home of their own.” (*Fannie Mae Press Release*, 06/07/04)

Fannie Mae Home Counselor Online™ launches tools in Spanish

- Fannie Mae has launched Home Counselor Online™ tools in Spanish to help expand homeownership among Hispanics. The free, web-based technology tool, will help counseling agencies, non-profit groups and other entities guide potential homeowners through the mortgage process via user-friendly counseling support functions. (*Fannie Mae Press Release*, 06/10/04)

Freddie Mac

Scuttlebutt on Freddie Mac's 2003 earnings

- OFHEO provided a “taste” of Freddie Mac’s unpublished 2003 earnings, estimating them at \$5.2 billion for the year. This estimate represents a sharp drop from Freddie’s restated earnings of \$10.1 billion in 2002. A regulatory official cautioned against making such a comparison, saying the 2002 result was unusually large because of accounting inaccuracies in previous years.
- Although Freddie Mac replaced five senior executives and restated earnings by \$5 billion over the 2000-2002 period, the GSE was financially sound during 2003 and made money, said OFHEO in its annual report. “Based on analysis of internal reports of business activities and results, as well as risk positions taken during the year and their relationships with actual interest-rate movements, OFHEO concludes that the underlying economics of the firm are sound and were substantially profitable in 2003,” the agency said.
- OFHEO said Freddie Mac reported to regulators that its retained earnings rose \$4.3 billion in 2003. “Combined with dividends paid, that implies earnings of \$5.2 billion for the year,” OFHEO said. This [\$5.2 billion] figure corresponds with Freddie Mac’s net income, a regulatory official noted. OFHEO said Freddie Mac made these calculation using accounting policies it had used before its restatement, many of which were not consistent with generally accepted accounting principles. Since Freddie Mac has overhauled its accounting policies, the estimate could be “off the mark,” the regulator said. So why release estimated numbers for Freddie Mac at all? “Earnings are part of the financial safety and soundness of the company,” which Congress requires OFHEO to report on each June, said a spokeswoman for the agency. “Therefore it’s relevant,” if given with appropriate disclaimers.
- While OFHEO’s estimate “is a very believable number,” said Paul Miller, an analyst with Friedman, Billings, Ramsey & Co., “you’re talking about throwing darts in a blindfold in a hurricane.” Moshe Orenbuch, a Credit Suisse First Boston analyst, published a report saying OFHEO’s estimate could be used as a proxy for retained earnings to arrive at a “guess” for Freddie Mac’s 2003 profits. He said that OFHEO’s latest report made it clear that agency was relying on methods deemed inconsistent with GAAP. If Freddie’s capital levels should change, Orenbuch said it “probably not anywhere near the magnitude of the restatement we had before.”
- Bear Stearns analysts said recent meetings with Freddie Mac executives left them with the impression that the release of 2003’s results by a self-imposed June 30 deadline “won’t be easy, but that it is still possible.” David Hochstim and Scott R. Coren, the two Bear Stearns analysts, wrote in a report that the GSE expects “some demands for additional data by” PricewaterhouseCoopers, its auditor, “could result in

a delay of perhaps one or two weeks.” However, a Freddie spokesman denied that a delay is expected. “We haven’t changed our guidance on that. We’re still on track for June 30,” said the Freddie Mac spokesman.

- According to the Bear Stearns analysts, John Woods, the GSE’s principal accounting officer, told them “he is comfortable that Freddie Mac has finally satisfied most of [its] staffing needs in accounting” after increasing the head count from about 200 to between 350 and 400. “But apparently, there is still significant work to be done upgrading systems and infrastructure” before Freddie can return to timely reporting, the Bear Stearns report said. The analysts expect Freddie Mac to give guidance on the release of its 2004 results when it reports last year’s financial statements. (*Reuters*, Mark Felsenthal, 06/15/04; *American Banker*, Jody Stern, 06/15/04; *American Banker*, Jody Shenn, 06/17/04)

Over the next five years, Freddie will slow its mortgage growth by 33% to “restore investor confidence” says CEO Syron
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- Freddie Mac will probably slow the growth of its mortgage investments during the next five years to about one-third the average rate since 1996 to restore investor confidence, CEO Richard Syron said. “People saw us as a growth stock; I don’t think it’s attractive as a growth stock,” he said. Freddie Mac should be a high-yield, “low-volatility” equity, he added. Syron said the Freddie Mac’s investments will grow between 8% and 10%, compared with average growth of 26% since 1996. He said he wants to transform Freddie Mac into a business with slower, steadier earnings, citing Johnson & Johnson as a model.
- Syron said he has discussed slower growth with Freddie Mac investors and U.S. lawmakers. “Their reaction has been overall: ‘That’s realistic,’” he said. A slower-growing Freddie Mac would be “a different model” that wouldn’t appeal to everyone, including the Company’s executives hoping to prosper on stock options, Syron said. The new model wouldn’t enable executives to “leave here in four years and retire in Maui. It’s not that kind of a deal, and it’s not that kind of a deal for a shareholder either.”
- Syron’s comments reflect efforts to respond to criticism by Federal Reserve Chairman Alan Greenspan and Treasury Secretary John Snow. Both have warned since October that surging growth in Freddie Mac’s portfolio, now at \$632 billion, and that of its larger rival, Fannie Mae, threatens to destabilize the financial system. Greenspan “is going to get a diminution of portfolio growth,” said Syron. “It has already happened.” Freddie Mac’s portfolio shrank by \$4.1 billion in April, the sixth straight month it has contracted. “I don’t think it would be desirable or feasible for Freddie Mac to keep growing at the rate its mortgage-investment portfolio has increased over the last decade,” Syron said. Under such a scenario, Greenspan’s predictions of future problems for the GSEs would be “self-fulfilling,” he said.

- Syron criticized HUD's plans to expand by 2008 the amount of capital Freddie Mac channels toward increasing homeownership for low-income people. He said it would backfire by pushing many new homeowners toward foreclosure. Syron said he aimed to make expanding homeownership Freddie Mac's top goal, nine weeks after the Bush administration said it would require the company and Fannie Mae to direct 57% of their mortgage financing by 2008 toward homes for people with incomes no greater than the median of their areas. The current level is 50%. Still, 57% "is not the optimal number," Syron said. "You might be making loans to put people in homes" they can't afford, he said. Instead, HUD should set a threshold not much higher than 50%, he said.
- Syron is placing a greater emphasis on Freddie's mission for its executives' compensation, basing 30% of their bonus pool on the GSE's performance against HUD's affordable housing goals. The remaining 70% of executive bonuses for 2004 are based on bringing Freddie Mac current on its financial disclosures. Going forward, Syron is plans to maintain a healthy split between mission-related bonuses and those tied to financial performance. OFHEO said Freddie's previous bonus structure, largely tied to annual EPS performance, gave incentives to executives to manipulate its accounting.
- "The ultimate trickiest question in this organization is the share of your economic benefits that go toward the mission side and the share that is going toward the shareholder side," Syron said. "If you err on the side of putting too much on the mission side, then you won't do well with your shareholders and then you won't be able to have the capital to do the job, period. If on the other hand, you do too little on the mission side, you threaten your charter which is valuable to the shareholders. We have to have something that takes into consideration both (mission and financial performance) and doesn't do it on a one-year basis, but does it on a multiyear basis. The other thing you have to take into consideration is institutional development," he said, citing accounting systems and internal controls. "We're not 100% ... where we want to be; we're much farther than where we started."
- Syron said the Treasury will undercut Freddie Mac's government-mandated mission to expand homeownership among low-income people should the department curtail debt sales by the GSE. Limits on debt sales "could be highly counterproductive," he said. "You'd frighten the market in a way that takes an awful long time to revert." Syron said Treasury's proposal to cap the GSEs' debt issuance would "be pretty serious if it got some legs." However, he said the agency's authority is not clear and has traditionally been interpreted narrowly. "It's not clear to me the Treasury has the power to greatly curtail or shut down the GSE's," he said. The Treasury says it's considering such limits to mitigate the risk that Freddie Mac and Fannie Mae will trigger instability.
- Syron warned that tightening regulations, including giving OFHEO the authority to sell Fannie Mae's and Freddie Mac's assets in the event of default, may crimp the

flow of mortgage capital and harm prospective homeowners. (*Bloomberg News*, James Tyson, 06/15/04; *Dow Jones Newswire*, Dawn Kopecki, 06/15/04)

Freddie Mac submits corporate governance plans to OFHEO

- Freddie Mac has completed plans for the succession of top executives and for ensuring compliance with accounting rules and other laws, the company said, but provided no details. Freddie Mac submitted the procedures to its regulator in response to a December 9 Consent Order, said Corinne Russell, a spokeswoman for OFHEO. “So far, they are ahead of schedule on everything in the Consent Order,” she said. The plans parallel efforts by Richard F. Syron, appointed Freddie CEO to restore confidence in the company.
- “They still have quite a way to go,” said George Xie, an analyst at PNC Advisors in Philadelphia, which owns 2.1 million Freddie Mac shares. The company’s most important need, he said, is to provide timely financial statements. Also, Syron needs to go beyond attempts to revive the company’s public image and provide a “strategic vision” for mitigating portfolio risk and meeting other corporate objectives, Xie said. (*Bloomberg News*, James Tyson, 06/11/04)

Thomas S. Johnson elected to Freddie Mac Board of Directors

- Freddie Mac announced that Thomas S. Johnson, chairman and chief executive officer of GreenPoint Financial Corporation, was elected to Freddie Mac’s Board of Directors during its June 4th board meeting. Freddie Mac Chairman and CEO Richard F. Syron called Tom Johnson “an outstanding executive with a wealth of experience who will provide valuable insight and leadership to the Freddie Mac board.” Johnson is expected to serve on the Finance and Capital Deployment Committee and the Mission and Sourcing Committee of Freddie Mac’s board.
- Johnson is an accomplished business leader whose banking career spans nearly 35 years. Johnson, 64, has served since 1993 as chairman and CEO of GreenPoint Financial, a leading national specialty mortgage lender and New York consumer banking company. In February 2004, GreenPoint Financial announced that it had entered into an agreement and plan of merger with North Fork Bancorporation, Inc., under which GreenPoint and its subsidiaries will be acquired by North Fork in an all-stock merger transaction. Prior to joining GreenPoint, Johnson served as president and director of Chemical Bank and Chemical Banking Corporation and then of Manufacturers Hanover Trust Company and Manufacturers Hanover Corporation. He is also a director of Allegheny Corporation, RR Donnelley & Sons, Inc., and The Phoenix Companies. (*Freddie Mac Press Release*, 06/07/04)

- In an effort to restore public trust and recast its troubled image, Freddie Mac has adopted a new mission-focused logo and tagline, reading “We Make Home Possible.” According to a company spokesman, the logo reflects Freddie Mac’s renewed focus on its vital housing mission. Freddie had used its previous logo for nearly two decades. “We needed a logo that embodies our values and helps tell our story. Freddie Mac’s new logo does this by reflecting the positive, mission-centric focus that we envision for the company,” explained David Palombi, vice president, Corporate and Marketing Communications, Freddie Mac. “We’ve been exploring the possibility of a new logo for a long while. With the positive changes taking place in the company, the timing seemed appropriate now.” To avoid any business disruption, Freddie Mac is proceeding slowly with its logo adoption and expects the full switchover to take up to a year. (*Freddie Mac Press Release, 06/14/04*)

Federal Home Loan Banks

Finance Board to consider SEC registration for FHLBs

- According to the *American Banker*, the Federal Housing Finance Board is expected to approve a rule unanimously that would require the FHLBs to register with the SEC at their meeting on June 23, several sources said. The Finance Board unexpectedly announced that it would vote June 23 on the issue, which has “roiled” the FHLB System for two years. Many observers had assumed that Alicia Castaneda, who became the board’s chairwoman in April, would take more time or possibly even overhaul the plan. According to sources, board members Franz Leichter and Allan Mendelowitz, who in the past had publicly argued against elements of the proposal, have been working closely to craft a compromise. Apparently, the Finance Board members have struck a compromise and are prepared to vote on the issue. A vote approving the rule would be a significant victory for the Bush administration’s policy on GSEs.
- The final rule is expected to incorporate an agreement reached with the SEC that the Banks’ stock is to be treated as equity, not debt. The rule is also expected to provide that the SEC not disrupt the system’s cooperative nature. The Finance Board has been assuring its constituency that SEC registration will not cost the Banks millions of dollars or disrupt their debt issuances, as asserted in a First Manhattan Consulting Group study last year. Perhaps the most fundamental question is whether the Finance Board has the legal authority to force the FHLBs to register with the SEC. The final rule is expected to include a legal memorandum addressing this issue.

- A Finance Board spokesman would not discuss the details of the rule. The vote was scheduled because “Chairman Castaneda believes no one is served by continued uncertainty about the issue,” the spokesman said.
- Although industry officials have not seen the details, some said the rule might interfere with talks between the banks and the SEC, while others speculated the Finance Board’s rule could prompt a lawsuit. John von Seggern, the president of the Council of Federal Home Loan Banks said, “We have made tremendous progress with the SEC, and the resolution of the issues with the SEC has been moving along at a good pace. I’m concerned about the Finance Board pushing this issue.”
- America’s Community Bankers has led the fight against the SEC registration proposal, with the assistance of the law firm Venable LLP. ACB’s law firm provided an opinion on the original proposal, which argued the Finance Board may not force the banks to “voluntarily” register with the SEC when they have a statutory exemption, and that the Board may not delegate its authority to mandate disclosures to another agency. Many expect ACB to sue the Finance Board unless the final rule is significantly different than the proposal. An ACB spokesman said that it was “surprised and dismayed” by the Finance Board’s plan to move forward.
- Edward Yingling, the executive vice president of the American Bankers Association, said his group will be interested to see the Finance Board’s legal analysis. The ABA is concerned about possible future disruptions to the system. “Our concern has always been that five or six years from now we could find ourselves in a situation, in ways we cannot foresee now, that the SEC could cause the Home Loan Bank System real problems,” Yingling said. “It’s one thing to say we can work it out with the SEC now, but once the SEC has this kind of authority, you don’t know how it will play out.” (*Dow Jones Newswires*, John Connor, 06/17/04; *American Banker*, Rob Blackwell, 06/18/04)

FHLB-Chicago’s CEO Pollock resigns and announces plans to join AEI
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- Alex Pollock has resigned as president and CEO of the FHLB-Chicago to accept a position as resident fellow with the American Enterprise Institute, Washington, D.C. During Pollock’s 12-year tenure at the FHLB-Chicago, the Bank created the Mortgage Partnership Finance (MPF) program, a mortgage purchase program that competes in the secondary mortgage market with Fannie Mae and Freddie Mac. Pollock said he’s “exceptionally proud” of his accomplishments at the FHLB-Chicago and acknowledged that the MPF program was “one of the best ideas I’ve ever had.” He added, “The MPF program will continue to be an outstanding success, as it is today. The thing that is most satisfying about it: So many told me it was impossible, and yet we did it.” Pollock said, “it has been my plan for a long time, at this age [61], to move to the broader areas of national policy issues.” He added, “I decided this was a very good transition point for me. The Bank has a great management, which we have built up over the past 10 years. They will carry on and

do great.” Pollock told reporters that there was no discord over strategy between him and the Bank’s board and that the Bank’s financial condition remains “superb.”

- Pollock said he’s “pleased and honored” that he has been given this opportunity by the AEI, a leading think-tank. He said he was attracted to the AEI, because of his background in philosophy and public policy studies and a desire to work on bigger projects. Pollock said, “With luck, I will be able to make some important contributions on a broader level to the national debates.” While he said it would not be appropriate to discuss whether he supports GSE privatization until he leaves the Chicago bank, Pollock did say he plans to focus on accounting issues and the role of the Financial Accounting Standards Board.
- Peter Wallison, an outspoken advocate of GSE privatization and an AEI fellow, helped recruit Pollock. He acknowledged that Pollock did not have to “sign in blood” anything promising to support privatization. “I personally was delighted at the prospect that we could work together on a number of different projects,” Wallison said.
- Bert Ely, an Alexandria, VA. consultant and longtime critic of the GSEs, said, “Alex’s shift to AEI is a loss to the Home Loan Bank System and a big gain for AEI.” John von Seggern, the president of the Council of Federal Home Loan Banks, said “He has been such an influential force” at the Chicago bank “and such an influential force in the system.”
- Some observers were surprised by Pollock’s abrupt departure. The FHLB-Chicago said it will make “a management succession announcement” on June 30. A source familiar with the discussions said Mark Brickell, CEO of Blackbird Holdings Inc., a supplier of technology for trading in derivatives contracts, is a candidate to succeed Pollock. A Bank spokesman declined to comment on whether Brickell will succeed Pollock and Brickell didn’t respond to requests for comment. Early last year, the White House nominated Brickell to be director of the OFHEO. Brickell, a former J.P. Morgan Chase executive, withdrew his name from consideration after running into congressional opposition. (*Dow Jones Newswires*, John Connor, 06/08/04; *Chicago Tribune*, 06/09/04; *American Banker*, Rob Blackwell, 06/09/04; *Wall Street Journal*, James R. Hagerty, 06/09/04)

Ginnie Mae

ACB wants to keep the minimum face value requirement for GNMA's

- America's Community Bankers (ACB) wants to keep the minimum face value requirement for Ginnie Mae securities, the trade group said in a comment letter. Ginnie Mae has proposed dropping the requirement that its bonds have a minimum face value of \$25,000, so investors would have access to different denominations of GNMA. ACB said that this change could put Ginnie Mae in direct competition with banks and thrifts for small investors' assets.
- "We do not believe that offering notes in different small denominations should be a goal of Ginnie Mae, nor does offering such notes further the mission of Ginnie Mae," said ACB in a letter to HUD dated June 10. "Securities issued in these small amounts would compete with insured deposit products offered by insured depository institutions. Over time, this could eliminate options for liquidity for community banks and weaken the ability of insured depository institutions to respond to the credit needs of their communities," ACB said. (*Dow Jones Newswires*, Rebecca Christie, 06/10/04)

Sallie Mae

What school loan scandal?

- Robert Shireman, a senior fellow at the Aspen Institute, writes in an editorial in the *New York Times*, "...Some members of Congress have been making noises as if President Clinton's student loan reforms had turned out to be a bust. [Clinton] believed that student loans could be made more efficiently if they were offered directly, rather than guaranteed through banks. But opponents are pointing to a federal [GAO] study, asserting that it found the direct loan program borrowed over \$90 billion more from the Treasury than it repaid between 1995 and 2003."
- "That sounds like a problem; the program borrowed more than it paid back. But let's look at where that number comes from, and how it compares to the program Mr. Clinton aimed to replace. The GAO said: "Amounts borrowed from Treasury, which are expected to be repaid using borrower payments in future years, totaled \$137 billion from fiscal years 1995 through 2003, of which about \$92 billion was outstanding as of September 30, 2003." Contrary to the implication that there's something inappropriate going on, the GAO points out that the money the Education Department borrowed is being used to make loans that will be paid back, with interest. The actual cost -- after borrowers pay back the loans, after accounting for those who default on their loans, and after the Education Department pays interest to

the Treasury for its borrowing -- is estimated at \$2.7 billion. That's a lot less than the shocking \$90 billion figure."

- "Is \$2.7 billion too much to make \$137 billion in loans to students? That depends on the alternatives. Oddly, Congress hasn't asked the GAO to provide that comparison. The current alternative, of course, is to guarantee loans made by banks and other lenders like Sallie Mae. As the cosigner on these loans, the federal government takes on the same default risk as it does when making the loans directly. How much does it cost the government -- net costs, after defaults, interest subsidies and other fees-- to make the same loans to students in the guarantee program? That's the most important question."
- "But the student loan industry's friends in Congress don't seem to want to know that answer. Every independent, apples-to-apples cost comparison -- whether by the GAO, by the [CBO] or by the president's [OMB] -- has shown that the direct loan program is cheaper. If all loans granted from 1995 to 2003 had been direct, more than \$20 billion would have been saved, according to Bush administration budget figures. That's enough to fully finance the first three years of the No Child Left Behind Act, or to provide an extra \$4,000 to every one of the five million low-income students in college today. They should come first." (*New York Times*, Robert Shireman, 06/14/04)

House Committee on Education & Workforce introduces the College Access and Opportunity Act
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- Republican leaders of the House Committee on Education and Workforce introduced the College Access and Opportunity Act, H.R. 4283, which include the following provisions:
 - Prevents a scheduled change of loan interest rates from variable to fixed rate with a rate cap of 8.25%;
 - Increases student loan limits to \$3,500 for freshmen and \$4,500 for sophomores and boosts maximum unsubsidized graduate student loan amounts to \$12,000;
 - Allows colleges with default rates below 10% for three consecutive years to waive the normal 30-day delay in disbursement of loan funds for first-time borrower freshmen;
 - Provides year-round Pell funding for students attending four-year colleges with graduation rates above 30%.
 - Gradually phases out from 2007 to 2015 the current campus-based student aid formula that guarantees participating colleges receive no less than what they received in 1985, regardless of enrollment changes;

- Increases the amount a dependent student could earn without losing aid eligibility. Simplifies and expands eligibility for use of the “simplified needs test” to determine how much aid a family qualifies to receive. Specifies that home-schooled students are eligible for financial aid. (*Enrollment Management Report*, 06/17/04)

Student aid administrators back H.R. 4283

- In testimony before the House Education and Workforce Committee, A. Dallas Martin, Jr., president of the National Association of Student Financial Aid Administrators (NASFAA), backed some of the most controversial elements of the College Access and Opportunity Act. NASFAA supports the legislation’s proposal to establish a market-based variable interest rate for student loans, Martin told the Committee.
- While that rate cap (8.25%) is higher than the 6.8% proposed by the NASFAA, “we still believe the change to a variable rate for all future borrowers establishes” a more equitable system, Martin said. If the variable interest rate structure was currently in effect, “all borrowers would have the advantage of participating in the current low student loan interest rate environment,” he said. Similarly when interest rates rise in the future, “all borrowers will be equally affected,” he added. NASFAA did suggest some bill changes, calling for higher increases in loan limits and providing a variable borrower subsidy based on income.
- Other higher education associations were critical of the legislation. H.R. 4283 includes many new reporting requirements and “greatly expands” the Education Department’s reach into accreditation and transfer of credit, said David Ward, president of the American Council on Education. “I do not think any Washington associations will be able to support [it] in its current form,” said Ward. H.R. 4283 would “seriously undermine program integrity” and represents an “unprecedented federal incursion into academic policy prerogatives” of colleges, said Barmak Nassirian, associate executive director of the American Association of Collegiate Registrars and Admissions Officers. (*Enrollment Management Report*, 06/17/04)

Will a Kerry presidency be “bad” for Sallie Mae?
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- *Barrons* writes that concerns about rising short-term interest rates and the prospect of a John Kerry presidency are holding Sallie Mae’s stock “back.” These fears, writes *Barrons*, appear largely unwarranted. In fact, higher earnings growth may be in the cards for the company because Sallie Mae is gaining market share in an expanding industry. Sallie Mae leads the industry with a 26% market share in the \$72 billion

student loan market, including loans backed by the federal government and private loans. “Sallie Mae’s target is to grow to 50% market share, and I think that is feasible in the next five-to-seven years,” says Matt Snowling, an analyst with Friedman, Billings, Ramsey. Since 1997 when the company entered the government guaranteed student loan market, Sallie Mae has captured approximately 24% market share of the estimated \$52 billion market. Over this period, the Department of Education’s market share has fallen to 27.5% market share from its peak of 34%.

- Despite Sallie Mae’s growth prospects, *Barron’s* concedes that a John Kerry presidential victory may be bad for Sallie Mae. Kerry has proposed ways of making the student lending system “fairer” through an overhaul of the lending system, potentially hurting Sallie Mae’s bottom line. A total overhaul of the system seems unlikely, writes *Barron’s*. (*Barron’s*, 06/17/04)

Farm Credit System/Farmer Mac

FCA proposes to limit Farmer Mac’s non-program investments

- As Congress turns its attention to the Farm Credit System, FCA proposed rules to impose limits on Farmer Mac’s non-program investments. “We are proposing the regulations to ensure that Farmer Mac holds only high-quality, liquid investments to maintain a sufficient liquidity reserve, invest surplus funds, and manage interest-rate risk, while not holding excessive amounts of non-program investments considering Farmer Mac’s status as a government-sponsored enterprise,” FCA said in the proposed rules published in the Federal Register. The regulator proposed that Farmer Mac’s non-program investments can’t exceed the greater of \$1.5 billion “or the aggregate of (1) 30% of total assets; and (2) a reasonable estimate of off-balance sheet loans covered by guarantees or commitments that Farmer Mac likely will be required to purchase during the upcoming 12-month period, not to exceed 15% of the total off-balance sheet obligations.” FCA said, “We are proposing these regulations because as Farmer Mac continues to grow, its exposure to various business risks, including liquidity risk, also can be anticipated to grow. In addition, excessive or inappropriate use of non-program investments is not consistent with the corporation’s status as a government-sponsored enterprise.” FCA acknowledged that Farmer Mac uses non-program investments in managing interest rate risk and providing flexibility in responding to fluctuating liquidity and economic conditions. “Any non-program investments not appropriately related to the above needs warrant specific attention and justification,” FCA said. The comment period for FCA’s proposed regulations ends September 13, 2004. (*Dow Jones Newswires*, Rebecca Christie, 06/17/04)

FCA considers changes which may spur Farmer Mac credit rating

- The Farm Credit Administration is considering changes to its rules that could spur Farmer Mac to obtain a credit rating from an approved rating agency. According to the *Wall Street Journal*, the FCA board approved a proposal providing for a lower capital requirement for Farm Credit System institutions holding some home mortgage loans, (highly rated) mortgage backed securities, and derivative contracts with highly rated counterparties. The FCA board approved the proposal as presented by staff and added an 18-month phase-in period after the passage of any final rule, which also will take some time to develop. The phase-in period may be an effort to ease pressure on Farmer Mac, said Bert Ely, a consultant on FCS issues. “They’re giving Farmer Mac as much slack as they can,” he added. Ely questioned the need for the proposed changes on risk weights for home mortgage lending, saying these changes may give FCS lenders more leeway to lend to rich homeowners in rural areas. While these loans that are good quality, they don’t “have much to do” with the FCS mission of providing credit to farmers and ranchers, said Ely.
- “The proposed rule would allow Farm Credit System institutions to use their capital more efficiently because it better aligns the capital requirements with risk,” said FCA spokeswoman Dana Wyckoff. Wyckoff also noted that many of the changes would bring FCA in line with other bank regulators on this issue. FCA hasn’t released the proposal yet, although it is expected to be published soon in the Federal Register.
- Farmer Mac said it hasn’t decided how to respond to the proposed rule. “We have not seen the proposed regulation yet and until we have a chance to see it and review it we could have no comment on it,” said Farmer Mac’s vice president and general counsel Jerry Oslick.
- Last fall, the GAO noted that Farmer Mac is the largest unrated issuer of debt in the U.S. and urged FCA to require Farmer Mac to get rated. In response to GAO, Farmer Mac said that the benefits of obtaining a rating didn’t appear to outweigh the cost, given that Farmer Mac’s GSE status. Farmer Mac’s vice president and general counsel Jerry Oslick recently said Farmer Mac might revisit the issue. “We look at whether a rating is something we should be seeking at various times and we continually reconsider that,” Oslick said. “We’ll see what the provisions of this proposal are and whether they would lead us to do so.”
- In addition to the proposed changes to capital requirements, the FCA board last week approved a final rule on domestic and international lending and related services. This rule appeared to be directed at CoBank, the only FCA institution that provides international lending services. (*Dow Jones Newswires*, John Connor, 06/15/04; *Dow Jones Newswires*, Rebecca Christie, 06/17/04)

Postal Service

A “good” postal reform avoids the prickly issues

- The most notable thing about the postal reform legislation pending before Congress is that all the important constituencies involved support it, including the unions, competitors, and USPS management. If everyone favors “good reform,” as Rick Merritt executive director of PostalWatch says, then Congress has fashioned a “good reform.” There’s only one way to please everybody and that is to avoid the prickly issues that might offend somebody, which is what the reform bills have done.
- Postal reform legislation doesn’t include important provisions that would encourage USPS to control its personnel costs. Rather, the proposed legislation transfers the unfunded \$27 billion pension obligation to the U.S. Treasury for taxpayers to pay. The bill leaves out one of the more important reforms the presidential commission emphasized--a mechanism allowing the USPS to close inefficient post offices and mail distribution centers, which are kept open through political and union pressure. If these facilities were closed, it would save the American taxpayers tens of millions of dollars in future costs.
- These failures of “nerve” will require Congress to revisit postal reform again, probably within the next decade. Meanwhile, Senator Susan Collins (R-MA) is proud that she and her colleagues are addressing the issue, doing their jobs, she says, “just as postal workers [refuse to] let anything stand in their way of delivering the mail every day.” (*Bloomberg News*, Andrew Ferguson, 06/08/04)

Senator Collins contends that postal reform legislation is lifesaver for USPS

- In an editorial appearing in the *Atlanta Journal-Constitution*, Senator Susan Collins (R-MA) writes that the Postal Accountability and Enforcement Act of 2004, “represents the most sweeping reforms to the Postal Service since 1970 and is strong medicine to resuscitate the failing behemoth.” Collins notes that bill preserves the basic features of universal service, including affordable rates, frequent delivery and convenient community access to retail postal services. The bill stabilizes the rate setting process, in place of the current system which is unpredictable, costly, lengthy and litigious. The USPS is a labor-intensive organization with \$3 out of every \$4 in revenue going to pay employees’ wages and benefits. The reform legislation reaffirms the rights of USPS employees to bargain collectively and includes reforms to expedite the bargaining process. Lastly, the legislation frees up \$78 billion over a 10-year period from overpayments to the Civil Service Retirement System, which can be used toward the postal service’s massive retiree health liabilities. This legislation will make the necessary reforms to ensure that the 9 million jobs in the mailing industry are protected and Americans, regardless of where they live, can rely on the UPSP well into the 21st century. (*Atlanta Constitution-Journal*, Senator Susan Collins, 06/07/08)

- An editorial in the *Atlanta Journal-Constitution* notes, “Supposedly Congress is riding to the rescue of the U.S. Postal Service, which has been troubled for years by an arcane labor system and shortsighted financing. But the legislation that is proposed fails to offer critical fixes to put the post office on better footing. The USPS is still mired in a twilight world --- neither a government body nor a real private enterprise, either. To control its costs, the Postal Service needs more authority to manage wages and benefits --- something the Senate measure contained at one time -- - but those powers will not be forthcoming. Lobbyists for unions and other players exercise the power to veto those changes. And Congress is not about to take them on, especially in an election year.”
- “In the latest postal reform measures, trumpeted as the most comprehensive in three decades, Congress pretty much leaves the restrictions on management in place, while requiring the post office to continue to give “universal” service, including deliveries and pickups six days a week. That job grows, making it virtually impossible to trim the letter carrier force. And at the same time, Congress, in the new legislation, places stricter controls over postage rates, requiring them to stay in step with the cost of living.”
- “On the income side, Congress proposes to give the postal service new power to price certain premium services competitively, such as priority and overnight mail, giving the post office new power to compete with the likes of UPS and FedEx, which have all but sewn up those premium services. It is doubtful that income can be raised fast enough to cover heavy manpower and operating costs.”
- “The post office is fighting losing battles against two powerful forces, including technology and the struggle to reorganize successfully in a new environment. On the technology front, letter writing is out and e-mail is in. Secondly, people are paying more bills online, thus eliminating or reducing a huge volume of profitable first class letters. The postal service has trimmed personnel as fast as retirements have permitted, cutting manpower by 90,000 since 1999, even though service obligations grow, adding some 1.7 million new addresses every year. But that will not be enough to keep books balanced --- without more flexibility to control costs.” (*Atlanta Journal Constitution*, 06/07/04)

IRET addresses the question: Will proposed postal reform legislation lower costs?

- The House Committee on Government Reform unanimously sent to the House floor “The Postal Accountability and Enhancement Act” (H.R. 4341), and the Senate Committee on Governmental Affairs, also unanimously, sent to the full Senate a bill (S. 2468). These bills, which have many similarities and some differences, would significantly change the legal framework under which the U.S. Postal Service operates.
- High costs have troubled the Postal Service throughout its existence, causing chronic financial problems. The proposed reforms scaling back statutory restrictions where they conflict with best business practices and better insulating the Service from political pressure will be particularly helpful for Postal Service’s operations.
- A panel, modeled on successful military base closing and consolidation commissions, could help the Postal Service rationalize its inefficient facility network. Instead, the bills provide the weaker alternative of letting the Service send Congress a report offering a plan the agency would develop.
- The USPS has a large postal pay premium relative to compensation in the private sector. Since over 75% of the Service’s costs are labor related, reducing the USPS’ pay premium could save billions of dollars yearly. H.R. 4341 and S. 2468 largely avoid this issue. S. 2468 calls for trimming disability benefits, which is a sensible reform. However, H.R. 4341 could hinder future efforts to control labor costs by reserving for a postal-union nominee one of the seats on the Postal Service’s Board of Governors.
- The bills would save the Service several billion dollars annually by reducing the agency’s contributions towards pension benefits and ending the escrow account. A provision opposed by the Office of Personnel Management and the Treasury would shift certain pension liabilities from the Postal Service to the Treasury. Although that within-government transfer would lower the Postal Service’s costs, it is not a cost saving for the government as a whole.
- IRET concludes, “With regard to reducing costs through greater efficiency and less waste, the bills are disappointing. A few small steps in the right direction are included, but big reforms are lacking.” (*Institute for Research on the Economics of Taxation*, Congressional Advisory No. 175, 06/08/04)

Private carriers could cause havoc with USPS pricing under reform legislation

- Competition over parcel delivery, the real growth area of the mailing industry, has become a major sticking point in laws that restructure the way the USPS handles its

business and its role in the marketplace. Groups representing package shippers say the private express carriers successfully pushed a House committee to add new requirements on the USPS, which puts the Postal Service disadvantage in the parcel delivery market. “It’s UPS’s staging attempt to eliminate [the Postal Service] as any kind of competitor in the package business,” said attorney Timothy May, who represents the Parcel Shippers Association. “What we fear is this would raise the bar so far for the Postal Service that it would be impossible for them to compete in the package business.” The Postal Service also fears the current bill would put a serious crimp in its parcel business and might put it out of the parcel business completely.

- The change in the bill’s language would give UPS or other interested parties an opportunity to delay rate changes for the Postal Service’s competitive products. Supporters of this provision say the procedure is necessary to allow the USPS to compete against the private sector, while opponents argue the change is a Trojan horse, effectively allowing UPS or other competitors to indefinitely delay postal rate changes. Under the House bill, the Postal Service would have to publish its proposed rates for competitive products at least 30 days before making changes.
- In late May, Postmaster General John Potter told the Postal Customer Council that he is concerned about how competitive products will be treated in the legislation. “The language will likely result in added costs being shifted to packages,” Potter said. “That could result in significant upward price pressure, which could put the \$2.5 billion in contributions that we gain annually from our package services in jeopardy.” Potter told the shippers that they should be concerned about the proposed changes, saying “What does that mean to you? Well, if we lose \$2.5 billion in contribution to universal service costs, it will have to be found somewhere else, most likely in higher rates on other classes of mail.”
- Even with the argument over parcels, many supporters of reform at the USPS say postal reform effort stands its best chance in years of getting through Congress. In May, the House Government Reform Committee unanimously approved a postal reform bill sponsored by Representative John McHugh (R-NY). McHugh’s chief of staff Robert Taub said “This is not a post office-naming bill. This is affecting a huge part of our economy. It’s certainly more wind at our back than in front of us. But on the other hand, this is still the legislative process.” He added, “It’s not a slam dunk. But on the other hand, getting his bill out of committee 40-0 is a major achievement. We’d never reached that point.” Congressional observers say House leadership plans to bring McHugh’s bill to the floor for the full House to debate in late June. (*Traffic World*, Angela Greiling Keane, 06/07/04)

USPS overpayment of \$103 million of bonuses caused by “the computer misreading the instruction it was given”
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- More than 41,000 postal workers received a little something extra in their paychecks recently, but they can’t keep it, which totaled more than \$103 million. USPS

spokesman Gerry McKiernan said that a computer error caused it to send on average about \$2,500 in overpayments to more than 41,000 postal workers across the country. “The computer misread the instruction that it was given, said McKiernan. The Postal Service has written these employees, explaining the error. “We’re asking all the employees to write a personal check to the postal disbursing office,” he said.

- The Postal Service had intended to send bonuses that were owed to about 1,900 workers, but it accidentally began sending the money to a list of about 77,000 employees who had received bonuses in 2002. The agency didn’t realize the error until after the payments had been processed. The USPS could attach the wages of employees who don’t return the money, but McKiernan said he doesn’t anticipate any problems. “We’re hoping for good compliance,” he said. (*Washington Post*, Brian Faler, 06/17/04; *Govexec.com*, David McGlinchey, 06/17/04)

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