

# The **GSE** REPORT™

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## **Major Events**

Freddie Mac announces FY2003 net income declined 52%  
FY2004 results delayed until March 2005

- Freddie Mac reported a 52% plunge in net income for FY2003 and warned of continuing delays in reporting 2004 results until March 2005. For FY2003, the GSE's net fell to \$4.89 billion, or \$6.79 a share, from \$10.09 billion, or \$14.18 a share, a year earlier. The company's performance varied widely throughout FY2003, ranging from a net loss of \$288 million in the third quarter to earnings of \$2.5 billion in the second quarter. Freddie Mac blamed the decline in its income mainly on wide swings in the value of derivative contracts used to hedge its interest-rate risks. The gyrations were largely due to an accounting rule known as FAS 133, issued in 1998, which requires companies to estimate the market value of certain types of derivatives each quarter but leaves other types of assets, such as mortgage loans, at historic values. Freddie's accounting scandal stemmed partly from attempts to mask the fluctuations in reported earnings caused by FAS 133.
- Freddie Mac's earnings were also hurt by \$2.13 billion of losses on securities classified for accounting purposes as available for trading, compared with gains of \$921 million on such securities a year earlier. Mortgage refinancings during 2003 adversely impacted the value of some of Freddie's mortgage-backed securities. In addition, Freddie recorded a \$208 million write-down in the value of securities backed by loans to buyers of mobile homes. As previously reported, Freddie Mac also paid a \$125 million fine to OFHEO to settle charges it manipulated accounting and understated current earnings to make its financial performance less volatile.
- To get its accounting systems in order, Freddie has relied heavily on outside expertise, paying \$124 million last year on accounting, auditing and consulting services and \$48 million on legal costs related to the accounting problems during 2003. "We do have an army of consultants here," said Freddie Mac chairman and CEO Richard F. Syron. "It drives me absolutely mad." Freddie Mac's use of consultants should decline once Freddie fixes its accounting systems, he said, but the accounting overhaul is "far from finished." Syron said the company's fair-market value net-asset growth exceeded its long-run expectations, increasing about \$4.5 billion or 20%. Management warned that fair market value was prone to short-term volatility and other flaws that make it an unreliable gauge. The company plans to publish an annual report in late September and hold its annual meeting of shareholders in November.
- Management could not say when Freddie Mac would be able to make timely financial statements each quarter or fulfill a promise to file financial reports with the SEC. Acknowledging investor frustration, the GSE's executives promised to give briefings

on the company's business and progress on accounting "repairs" on at least a quarterly basis, starting in October. Freddie Mac warned investors that "To the extent changes in interest rates continue to be significant, [Freddie Mac's] overall net income will remain volatile." Syron also repeated his view that Freddie Mac won't grow as fast in the future as it did over the past decade.

- Wayne A. Abernathy, assistant secretary for financial institutions at the Treasury Department, was critical of Freddie Mac for delaying its return to regular quarterly reporting until 2005. "We believe it's past time for Freddie Mac to fulfill their commitment to meet the highest standards of disclosure by filing with the Securities and Exchange Commission," he said.
- Rating firms Standard & Poor's and Moody's Investors Services said their debt ratings for Freddie Mac were unchanged. After reviewing Freddie Mac's 2003 results, Fitch Ratings reaffirmed a long-term rating of triple-A on Freddie's long-term senior debt and called Freddie's financial performance "solid."
- Jim Vogel of FTN Financial Capital Markets sees Freddie's growth prospects hurt by accounting delays, which also provides "more fuel" for GSE critics. On cue, FM Policy Focus, said that "today's restatement shows that Freddie Mac is still a long way from providing complete and current numbers" and willing to stand accountable for them. "There is an urgent need for a new regulator with full power to determine what is going on," the coalition added. (*Dow Jones Capital Markets Report*, John Connor, 06/30/04; *Wall Street Journal*, James R. Hagerly, John D. McKinnon, 07/01/04; *Reuters*, 06/30/04; *Dow Jones Newswires*, 06/30/04; *Washington Post*, David S. Hilzenrath, 07/01/04; *Bloomberg News*, Al Yoon, 06/30/04; *Reuters*, 07/01/04, *Los Angeles Times*, 07/01/04)
- Peter Eavis writes in *TheStreet.com*, "[Freddie's] 2003 performance wasn't at all bad, though investors had every reason to be frustrated with the company's announcement that it won't report current-quarter results until March 2005. The latest delay hasn't escaped the notice of key GSE reformers in Washington."
- "Freddie execs also made remarks that suggest the company's systems had been in a state of great disarray and were taking a long time to put straight. They insisted, however, that risk-management systems had always been good. When asked how operational systems could be bad and risk systems could be good, given that the risk systems may rely on data contained in the operational systems, a company spokesman replied: 'In the past, Freddie Mac made sufficient investments in the systems that we use to evaluate and manage credit and interest rate risk. The company, however, did not make similar investments in our financial reporting and accounting systems.'" [An analyst covering Freddie Mac said he feels like being a passenger on an airplane that has "just flown from San Francisco to Singapore, but there was no pilot."]
- Eavis writes, "Freddie made \$6.79 per share last year, which puts the company on a price-to-earnings ratio of 9.3 times, which is on the low side for a financial

institution. However, it may be appropriate for one that is having so much trouble reporting current financial results.”

- Eavis concludes, “OFHEO has demanded that Freddie hold surplus capital until it is able to report up-to-date numbers. Freddie CEO Richard Syron held up the possibility -- perhaps to try and woo back investors angered by the news that Freddie can’t report regularly until March next year -- that surplus capital could get spent on a share buyback.” (*TheStreet.com*, Peter Eavis, 07/01/04; *American Banker*, Jody Shenn, 07/01/04)
- Some analysts speculated that OFHEO would lift a requirement that Freddie Mac carry extra capital upon either the publication of the 2003 results or the release of the 2004 results. An OFHEO spokeswoman said the agency has “no plans to remove the 30% surplus capital requirement until Freddie Mac is a timely filer.” (*American Banker*, Jody Shenn, 07/01/04)

Finance Board unanimously approves rule requiring the FLHBs to register with SEC
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- The Federal Housing Finance Board voted unanimously to require the FHLBs to register with the SEC by August 2005. While the rule eased some industry officials’ fear that the registration deadline would be this year, the Board strongly dismissed the industry’s arguments that it lacks the legal authority to impose such requirements, issuing a 25 page legal opinion to support their contention.
- Mark Tenhundfeld, the Board’s general counsel, said enhanced disclosures by the FHLBs would lead to better market discipline and would strengthen the Banks’ safety and soundness. “Any rule that has the purpose or effect of enhancing safety and soundness operations of the banks or their contingency access to capital markets is within the authority of that given to the Finance Board,” said Tenhundfeld. The Board’s opinion disputed industry arguments that the Board was delegating its disclosure authority to an outside agency. “By adopting the regulation, the Finance Board is not abdicating its role as bank supervisor or giving up any enforcement power,” said the opinion. “Rather than delegating decision-making authority, the Finance Board is using authority granted [under the Federal Home Loan Bank Act] to direct the banks to avail themselves of an established securities registration regime so that the Finance Board may do its job better.” America’s Community Bankers might sue to stop the rule, but Chairman Alicia Castaneda said the opinion should dissuade such a law suit.
- The Board should not oversee the banks’ disclosure regime itself, because the SEC is better equipped to do so, said Castaneda. “No matter how good a job the Finance Board does,” she said, “I believe the market would continue to perceive a qualitative distinction between a Finance Board-administered regime and an SEC-administered one. Such a perception could well disadvantage the Federal Home Loan Banks’ access to capital markets.”

- In a victory for the banks, the rule said the SEC has agreed to treat the FHLBs' stock as equity. Castaneda and other board members said that they had received assurances from the SEC that questions about the treatment of the cooperative nature of the FHLBs would be addressed in no-action letters. The rule said "recipients of such a letter may rely on it even if the SEC were to reach a different conclusion when considering the issues at a later time." Democrat Board member Franz Leichter said the SEC "has ...been cooperative in addressing these issues. Most, if not all, have been resolved. There is some concern from the banks [about] the permanence of the commitment the SEC is making. ...I think we have the assurances that the SEC will not change the no-action letter, that the SEC will not change the commitments it made."
- The Finance Board and FHLBs had been fighting since the Bush administration began pushing two years ago for all housing GSEs to register with the SEC. Former Chairman John Korsmo' battled with the two Democrats on the board, who questioned the Board's authority to act on the measure. After Korsmo resigned in April, Castaneda moved quickly to win the two board members to her side. The two Democrats on the Board credited Castaneda with bridging the differences of a normally divisive board and with finding solutions to technical questions with the SEC. "This is a major day," Castaneda said.
- HUD Secretary Alphonso Jackson attended the Finance Board meeting to vote in favor of the rule, demonstrating the Bush administration's commitment to this GSE issue. Normally, Assistant Secretary John Weicher serves as the HUD's designee.
- Industry reaction to the rule was guarded. The Independent Community Bankers of America said it was "disappointed" by the agency's rule. "We would have preferred that the Finance Board respond to the request by all the nation's major bank trade associations to re-propose the rule and provide an opportunity for additional comments," said ICBA's president Camden R. Fine.
- Diane Casey-Landry, the president of America's Community Bankers, which argued that the original SEC proposal was illegal, said her group is still "digesting" the rule and that it would discuss the rule with its board before deciding whether to sue. "We will take the time to review what they have done and we will make a determination of action once we are through," Casey-Landry said.
- In her first extensive interview as the chairman, Castaneda said the time had come to act decisively and move on the SEC registration issue. "We didn't see any reason why" giving the industry another 30 days to comment "was going to make any difference," Castaneda said. "The completeness and the strength of our record, and the very good legal analysis that our general counsel did -- everything was ready. Why postpone something?"

- Castaneda said that she is not worried if banking industry groups sue to block the rule on the grounds that the board exceeded its authority. “The Finance Board decision was pursuant to the safety-and-soundness authority given by the Federal Home Loan Bank Act,” Castaneda said. “Our people did a very extensive analysis and search to confirm the Finance Board has the authority to do it, so I do not expect” litigation. (*Dow Jones Newswires*, Dawn Kopecki, 06/23/04; *American Banker*, Hannah Bergman, Rob Blackwell, 06/24/04; *American Banker*, Rob Blackwell, 06/25/04)

<p>FHLB-Chicago enters into regulatory agreement with Finance Board, leading S&amp;P to reduce the Bank’s credit rating</p>
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- The FHLB-Chicago has voluntarily entered into a 13-page agreement with the Federal Housing Finance Board (“Finance Board”) to implement changes to enhance its risk management, capital management, governance and internal control practices and procedures. Pursuant to the agreement, the Bank will promptly address all areas of concern identified by the Finance Board during its recent examination. The Bank’s Board of Directors will also submit to the Finance Board a three-year business and capital management plan focused on ensuring a strong capital structure and establishing capital stock, retained earnings and dividend policies appropriate for the Bank’s business strategies. The Bank will maintain its capital ratio of 5.1% and will not increase its market, credit or operational risk profiles. The FHLB-Chicago will submit periodic reports to the Finance Board, detailing the Bank’s progress. In addition, the Bank will retain independent, outside consultants to review and report on the Bank’s management and board oversight, its risk management policies and practices, its internal audit function, and its accounting, recordkeeping and reporting practices and controls.
- To ensure the Bank continues growing at a manageable rate, the Bank has agreed to restrict the growth of on-balance sheet MPF® assets to 10% per year. A Bank spokesman said that its MPF program grew 108% in 2003, but roughly 4% in the first half of this year due to the decline in the mortgage market. He pointed out that the 10% limit is on the net growth of MPF assets. “Given the recent slowdown of mortgage volumes and the declining portfolios at the two secondary market agencies, this provision is unlikely to affect our member’s ability to sell us their loans,” said acting president Charles Huston. The Bank plans to resume the MPF Shared Funding® program. “As with MPF generally, the MPF Shared Funding program gives our members more choices and options to finance their homebuying customers’ needs,” said Huston. “The structure also enhances our ability to serve our housing finance mission.” (*FHLB-Chicago Press Release*, 06/30/04; *American Banker*, Barbara Rehm, Dean Anason, 07/01/04)
- Stephen M. Cross, director of the Finance Board’s supervision office, said that improvements in the Bank’s auditing and risk-management skills haven’t “kept pace” with the rapid growth in its holdings of mortgage loans. “This written agreement

says, ‘Let’s slow down,’” and make certain practices are adequate, Cross said. The Bank has promised to cooperate with the regulators.

- The Bank’s announcement of the regulatory agreement comes three weeks after the abrupt announcement that Alex J. Pollock, 61 years old, was stepping down as president and CEO of the Bank. At the time, Pollock and other Bank officials cited his desire to pursue his interests in public policy as a resident fellow at the American Enterprise Institute in Washington, D.C. Pollock said in an interview with the *Wall Street Journal* that he decided to leave the Bank late last year, well before he knew of the regulatory crackdown. He said one factor in his decision was his belief that a trend toward heavier regulation “was going to make the Home Loan Banks less creative and less interesting.” (*Wall Street Journal*, James R. Hagerty, 07/01/04)
- Supporters of the FHLB-Chicago contend that the regulatory agreement is an isolated incident centered on two things: the Bank’s overall strong financial condition and the fact that the Bank’s former CEO Pollock, who led the buildup of the MPF program, was a lightning rod for controversy. Because “Chicago is a bit of a pioneer,” it is the Bank most likely to attract regulatory attention, said John von Seggern, the president of the Council of Federal Home Loan Banks. Von Seggern said the agreement was less serious than a full cease-and-desist order and noted that the Bank announced plans to pay out a 70% [stock] dividend to members August 13. “There is no way they can pay that kind of [stock] dividend if there is a real problem.” (*American Banker*, Dean Anason, 07/02/04)
- Standard and Poor’s lowered its long-term counterparty rating on the FHLB-Chicago to double-A plus from triple-A and affirmed the Bank’s A-1+ short-term rating. S&P’s outlook for the Bank’s ratings remains negative. S&P’s lower ratings reflect the agreement reached between the Bank and the Federal Housing Finance Board to address shortcomings in the bank’s risk management, internal audit, capital management, accounting and financial record-keeping practices. “The agreement confirms many of the concerns Standard & Poor’s has had with the rapid growth in the bank’s on-balance-sheet, longer-dated, fixed-rate mortgage assets, which had led to the negative outlook revision in November 2003,” said S&P analyst Jonathan Ukeiley. (*Wall Street Journal*, Julie Haviv, 07/01/04)
- In a press release, FHLB-Chicago acting president Charles A. Huston said, “Today’s action by Standard and Poor’s should be understood in the context of the ratings for all housing government sponsored enterprises (GSEs). Standard & Poor’s individual FHLB ratings are similar to their ‘risk to the government ratings’ of Fannie Mae and Freddie Mac, both of which are AA-. As the mortgage assets on our balance sheet have increased due to the success of the MPF® Program, Standard and Poor’s has consistently indicated to us their intention to align our individual rating with those of the other housing GSEs.” The Bank said in a written statement “Our portfolio of MPF loans continues to be very tightly hedged” with its MPF portfolio duration gap standing at -0.3 month on May 31, 2004. (*FHLB-Chicago Press Release*, 07/01/04; *Reuters*, 07/01/04)

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

### ***Debate on affordable housing heats up:***

GSEs and GSE allies rally against HUD's proposed AH rule

Democrats accuse Bush administration of maligning the GSEs

HUD Secretary Jackson rebuts Democrats' criticisms and chastises GSEs on the AH proposal

HUD extends comment period on AH proposal

### GSEs and GSE allies rally against HUD's proposed AH rule

- Freddie Mac chairman and CEO Richard Syron voiced concern that affordable housing (AH) goals proposed for Freddie Mac and Fannie Mae by HUD could be counterproductive at a meeting of U.S. Conference of Mayors. In fact, Syron said the proposed AH goals could force Freddie Mac to reduce other mortgage investments to meet the "aggressive" affordable lending targets, which "could raise interest rates and costs for everyone." He added, "We are concerned, however, about proposed regulations that would hamper our ability to serve all families," Syron said, telling the mayors that HUD proposed AH goals "that rise so far and so rapidly above the current levels that our ability to help middle-class families may be harmed."
- In lieu of the AH proposal, Syron proposed that HUD "look at our affordable lending as a percentage of our new home loans, removing refinances from the calculations of our performance." He continued, "Doing this will make us more accountable, and focus Freddie Mac on bringing more potential first-time homebuyers into the market, particularly minority and other underserved borrowers. Backing refi's out of the calculation will give a more accurate picture of our activity, and will establish a metric that will clearly measure the progress we intend to make in this area. I do not believe our mission is a zero-sum game. We need to increase our commitment to the most underserved communities amongst us, but not at the expense of the middle class." (*Dow Jones Newswires*, John Connor, 06/28/04)
- During an investor conference call following the release of Freddie Mac's 2003 earnings, Syron reiterated his concerns about the proposed AH goals, saying that part of the market might not be as big as HUD believes. "You can only do as much as there is a market," Syron said. "There is some question as to what the size of the market is, particularly in a rising interest rate market." He added that the GSEs could be put in a position where all it is doing is financing low- and moderate-income loans and not providing financing for higher-income borrowers. Syron said, "We now face significant pressure in Washington from people who believe that the market alone can meet housing needs." This opposition includes mortgage financiers in the private

sector who would like to see the GSEs “go away” and their own profit opportunities improve, Syron added. (*Dow Jones Newswire*, Jennifer Corbett Dooren, 06/30/04)

- Housing, lender and consumer groups rallied around the GSEs’ cause, urging HUD to take more time to evaluate AH goals. According to *Minnesota Public Radio’s Marketplace*, “Fannie Mae and Freddie Mac have some friends. Home builders, the National Association of Realtors and the Mortgage Bankers Association have teamed up to tell the Department of Housing and Urban Development to lay off the two mortgage companies. The two are being forced by regulators to increase financing for low-income would-be homeowners. They and their allies worry that will wind up raising rates for middle-income home buyers.” (*Minnesota Public Radio, Marketplace Morning Report*, 06/14/04; *National Mortgage News*, 06/21/04)
- The National Association of Home Builders, National Association of Realtors and Mortgage Bankers Association argue that HUD’s AH goals will undermine FHA’s loan programs, leaving the FHA single family and multi-family loan programs with a “deteriorating risk profile” and forcing the government’s insurance program to raise premiums as a result of rising defaults and foreclosures. “Ironically, the result of higher AH goals on the GSEs could mean less access to affordable housing for those who need it most,” said MBA senior vice president Kurt Pfothenauer. (*National Mortgage News*, Brian Collins, 06/28/04)
- According to *National Mortgage News*, HUD originally proposed to raise AH goals for Fannie Mae and Freddie Mac to 52% through the year 2008. Following a review of the goals by the Office of Budget and Management, HUD’s AH goals were raised to 57% by 2008. Insiders say that the Bush administration’s “ramping up” of AH goals could spark further controversy as the AH battle heats up. (*National Mortgage News Online*, 06/22/04; *Inside GSEs*, 06/30/04)

#### Democrats accuse Bush administration of maligning GSEs

- In a letter to President Bush, 76 House Democrats urged the Bush administration to abandon their attacks on Fannie Mae and Freddie Mac and work with Congress to improve the GSEs’ performance, particularly in the area of expanding affordable housing. The letter marked a “ramping up” of partisan tensions over housing, as the presidential campaign season heats up with President Bush touting the housing market’s strong performance on his watch in campaign ads.
- The Democrats’ letter accused the Bush administration of giving short shrift to affordable housing in its efforts to pass legislation during the last year that would rein in the housing GSEs. Their letter largely ignored the Bush administration’s current effort to beef up regulatory goals for affordable housing for Fannie Mae and Freddie Mac. Instead, the Democrats specifically requested the President to “join us in advocating more innovative loan products and programs for people who desire to buy manufactured housing, similar products to preserve as affordable and rehabilitate

aging affordable housing, and more meaning GSE affordable housing goals form HUD.”

- Among those signing the letter were Representatives Nancy Pelosi (D-CA), the House Democratic leader; Barney Frank (D-MA) the ranking minority member on the House Financial Services Committee, and Paul Kanjorski (D-PA), the ranking Democrat on the House Capital Markets subcommittee. The Democrats said their position isn't based on institutional loyalty, but rather their concern for the GSEs' affordable housing function (*Dow Jones International News*, John Connor, 06/29/04; *The Wall Street Journal*, 06/30/04; *Committee on Financial Services Democratic Office Press Release*, 06/29/04)

#### HUD Secretary Jackson rebuts Democrats' criticisms and chastises GSEs on the AH proposal

- HUD Secretary Alphonso Jackson rebutted criticism from House Democrats that the Bush administration has been unnecessarily disparaging of housing finance GSEs. HUD “recently proposed new housing goals, which over the next four years, would simply push the [GSEs] to do what is expected of them - helping low- and moderate-income families at at least the same percentage levels as primary market lenders,” Jackson said in a statement. “To date, the GSEs are failing in their obligation to lead the industry.” Jackson argued that strengthening GSE regulation wasn't a partisan issue, noting public comments critical of the GSEs' affordable housing performance from Clinton HUD Secretary Andrew Cuomo and Freddie Mac CEO Richard Syron. Publicly, Syron said Freddie hasn't financed as many affordable housing projects as it can afford. “I applaud [Syron's] candor,” Jackson said, “and encourage both GSEs to embrace the goals we have proposed to ensure a proper focus on their mission.” (*Dow Jones Newswires*, Dawn Kopecki, 06/29/04)
- Separately, Jackson also chastised Fannie Mae, Freddie Mac and their allies Thursday for questioning the administration's methodology in setting new low-income financing targets for the companies. Executives at the GSEs have questioned HUD's estimate of the available market, saying that the number of qualifying loans is lower than what HUD projects. Freddie Mac's CEO Richard Syron recently told *Dow Jones Newswires* that he's concerned HUD's targets are unrealistic. Fannie Mae officials have also indicated that the GSEs might be forced to cut back on funding to middle- and upper-income borrowers to meet HUD's aggressive targets for less well-to-do homebuyers. “I'm really not concerned with what Fannie and Freddie say. We are the regulatory body ...those numbers are factual,” Jackson said. “We've said to them, ‘we're not concerned about the high end of your market, we're more concerned with you addressing the market your congressional charter mandates you serve,’” Jackson said. “If I were them, I'd be more worried about derivatives that I have invested in than...serving more low- and moderate-income people.” (*Dow Jones Newswires*, Dawn Kopecki, 06/24/04)

- In a letter dated June 22 to Fannie Mae CEO Franklin Raines, Jackson said he disagreed with Fannie Mae's analysis of the mortgage financing market for low and moderate-income families from 1999 through 2002. "You took special exception to recent comments that I made regarding 'Fannie Mae's failure to lead the housing market in providing mortgage financing to low and moderate income families,'" Jackson wrote. The HUD secretary said he had reviewed Fannie Mae's analysis and concluded his comments needed no revision. "I believe that HUD's data proves that, on average, Fannie Mae lagged the mortgage finance market to low- and moderate-income families, especially with regard to minority first-time home buyers," Jackson said. He added, Fannie Mae is "particularly weak" in financing first-time home purchases among minority buyers. (*Reuters*, Mark Felsenthal, 07/01/04)
- In an interview with *Bloomberg News*, Jackson said that Fannie Mae and Freddie Mac should buy home loans throughout the year to meet federal AH goals and halt large year-end purchases that may hamper reaching those objectives. By making the bulk of their transactions at year-end, the GSEs are less likely to provide low-income borrowers and their lenders with a steady stream of capital that best meets their financing needs, Jackson said. "We don't think [that Freddie Mac] buying the portfolio of Washington Mutual is expanding affordable housing," Jackson said. "You should do this on an incremental basis, month after month, buying new, and if they do that I think they will reach their goals." HUD assistant secretary John Weicher, said "Large purchases of seasonal portfolios wasn't what Congress contemplated when it wrote the statute in 1992" specifying how the companies should meet their goals. He added, "It is also not what HUD expected would be happening." (*Bloomberg News*, James Tyson, 06/23/04)

#### HUD extends comment period on AH proposal

- HUD extended by two weeks the public comment period on proposed rules that would require Fannie Mae and Freddie Mac to finance more housing for low-income people. The agency said it's extending the comment period from July 2 until July 16 because of consideration of the holiday weekend and requests for additional time. The two week extension fell far short of the 60 day delay requested by housing and industry groups and organizations representing local housing agencies, cities, counties and mayors. National Association of Home Builders president Bobby Rayburn said the extension will give "NAHB and other organizations the ability to work with the Bush administration to establish more meaningful goals." The government's goal of having new AH goals in place by January 1 is not affected by the delay, said HUD spokesman Doug Duvall. (*Wall Street Journal*, 06/28/04; *Reuters*, 06/25/04; *National Mortgage News Online*, 06/29/04; *PR Newswires*, National Association of Homebuilders, 06/25/04)

## Bush administration's regulatory offensive against GSEs appears bogged down

- The Bush administration's regulatory offensive against Fannie Mae and Freddie Mac seems to be a bit slow in coming. A move by the Treasury Department to rein in, in one way or another, the surging debt of the two GSEs apparently won't happen anytime soon. Word that Treasury was contemplating such a move has generated a number of legal briefs arguing that the agency lacks statutory authority to limit the GSEs' borrowing and debt and that the Department's only real jurisdictional hook is that of a "traffic cop." Treasury disagrees with this interpretation. Treasury Undersecretary for Domestic Finance Brian Roseboro said recently that the Administration hasn't decided whether to rein in the borrowing powers of the GSEs. Thus, observers believe that any test of competing legal theories looks to be far, far down the road, if ever.
- However, other observers said that the Treasury Department may decide to "revive talk" about restricting the GSEs' growth, now that Fannie and Freddie are back in the market increasing their purchases of mortgages. For the past seven months, the GSEs' mortgage portfolio shrank, a fact that some said helped keep the debate about Treasury action theoretical. "While they were in the shrinkage mode it kind of took the issue off the table," said Bert Ely, an independent consultant and GSE critic from Alexandria, VA. "The frying pan was taken off the flame," he added. Many others doubt the Treasury proposal to check the GSEs' debt will pass. "I think the Treasury is making noise only with this," said Paul Miller, an analyst with Friedman, Billings, Ramsey Group Inc. "I don't think they're actually going to use it." (*American Banker*, Jody Shenn, 06/25/04)
- On another front, OFHEO had been contemplating a conservatorship rule to facilitate the orderly wind-down of the Fannie and Freddie, if either GSE got into financial trouble. In its semiannual regulatory agenda, OFHEO said it remains "to be determined" when it might actually publish a notice of proposed rulemaking on this matter. (*Dow Jones International News*, John Connor, 06/28/04; *Dow Jones Capital Markets Report*, John Connor, 06/29/04)

## St. Louis Federal Reserve summarizes GSE reform proposals and their implications

- In the July issue of the St. Louis Federal Reserve's *Regional Economist*, senior economist William R. Emmons, assistant vice president Mark Vaughan, and economist Tim Yeager examine the pros and cons of the housing GSEs and examine the risks they pose to the economy. From 1992 to 2000, Fannie Mae, Freddie Mac and the FHLBs assets together grew nearly 600%, about 1.5 times faster than the combined growth of the top five commercial banks. Many economist argue that this rapid growth has made the health of the financial system dependent upon the health of the housing GSEs.

- The authors write, “Many economists believe that the implicit subsidization of the housing GSEs distorts the allocation of scarce funds in the capital markets. Left alone, these markets would allocate funds to the business and household borrowers capable of putting them to the best use. Cheaper funding for the housing GSEs means more new homes, more larger homes and higher rates of home ownership. On the other hand, this distortion might lead to fewer funds being available for business investment, possibly resulting in slower economic growth.
- “...Three problems are clearly associated with housing GSEs, however: moral-hazard problems related to risk-taking, incomplete pass-through of subsidies intended for mortgage borrowers and risk-shifting to the Federal Deposit Insurance Corp. When a firm can take risks, enjoy the full benefits and avoid the full costs, economists say a moral hazard is present. ...Because the capital markets view their debt as virtually free of default risk, Freddie, Fannie and the FHLBanks can enjoy all the upside of risk-taking and little of the downside. ...The burden of the extra risk does not, of course, go away just because the housing GSEs do not bear it. Indeed, taxpayers ultimately would bear the extra risk if the federal government were to stand behind a failing GSE.”
- “Taxpayer exposure to risk-taking by housing GSEs is not limited to potential losses from default. Risk-taking by housing GSEs could undermine the stability of the financial system because so many banks depend on them for liquidity. Commercial banks hold more than one-half of their securities portfolios—a key source of emergency liquidity—in the form of mortgage-backed securities and GSE debt. Moreover, the portion of commercial bank loans backed by real estate is at an all-time high. Banks are comfortable holding mortgage-related securities because these securities can be sold quickly with minimal transaction costs, and banks are comfortable holding real-estate-backed loans because these loans can be pledged against advances from the FHLBanks or sold to Freddie or Fannie. A severe shock to one or more of the housing GSEs could lead to a market lockup, in which investors become reluctant to hold GSEs’ direct or indirect obligations. This could, in turn, lead to a temporary suspension of mortgage purchasing, mortgage securitizing or mortgage “advancing,” thereby forcing the Federal Reserve to intervene to re-liquefy the mortgage markets.”
- “Who actually benefits from the subsidy—homeowners or the employees and shareholders of GSEs? ...Lower funding costs can be used to reduce mortgage rates for homeowners or to raise employee salaries or dividends for housing-GSE shareholders. Estimates vary about the division of the subsidy; one recent study estimated that the subsidy to Freddie and Fannie lowered mortgage interest rates by about 7 basis points (0.07 percent), yielding a savings to homeowners of about \$44 billion. At the same time, the gain to Freddie’s and Fannie’s shareholders was estimated at \$72 billion.”
- “The housing GSEs generally have been successful in achieving their dual housing mandates—increasing liquidity in the secondary mortgage market and encouraging

home ownership, especially among low- and middle-income households. Reform proposals, therefore, are typically focused on the risk of GSEs' operations.”

- “A radical approach to reform of the housing GSEs is true or complete privatization. All of the special privileges and exemptions currently enjoyed by the GSEs, including the lines of credit they have with the Treasury, would be eliminated. ... Sallie Mae, the Student Loan Marketing Association, provides a roadmap for GSE privatization. Its special status was dismantled piece by piece over several years. It will become the fully privatized SLM Corp. in the near future.”
- “Privatization may address some of the aforementioned moral-hazard issues, and it could eliminate the government subsidy that the housing GSEs currently are failing to pass through to mortgage borrowers in full. Yet, privatization does nothing directly to eliminate the systemic importance of the housing GSEs. That is, a fully privatized Fannie Mae still might be considered too big to fail by the Federal Reserve and by the Treasury.”
- “Other reform proposals include greater regulatory oversight, higher (or more flexible) statutory capital requirements, more transparency of GSE operations and greater financial disclosures. A beefed-up GSE regulator would enjoy stronger powers with respect to on-site examination, setting of both minimum and risk-based capital standards, intervention in internal control and governance functions, and authority to set up a conservatorship or a receivership in the event of default. The new regulator would be able to assess larger dollar penalties for malfeasance than currently allowed, would have discretion over new activities and products proposed by a housing GSE and would be able to order a firm to cease and desist from certain activities. The new regulator might even be empowered to limit the amount of borrowing a GSE could do—an intervention recently suggested by Federal Reserve Chairman Alan Greenspan and being investigated by the Bush administration.”
- “Another approach to reforming the governance of the housing GSEs is to encourage more competition in their market. One initiative already under way is the Mortgage Partnership Finance Program operated by the Federal Home Loan Banks. This unique mortgage program, begun in 1997, competes with the mortgage-backed securities programs offered by Fannie and Freddie. In contrast to the traditional mortgage-backed securities allocation of credit risk to the GSEs and interest-rate risk to the buyer of the securities, the FHLBanks' new program reallocates the risk-sharing. The FHLBanks bear the interest-rate risk, while the originating institution retains the majority of the credit risk. Many banks like this program because they can sell their loans to the FHLBanks for a better price than they can get from Freddie and Fannie.”
- “Another example of increasing competition—in this case, for the FHLBanks—is the reform of the Federal Reserve's discount-window procedures. The Fed now offers collateralized primary credit to highly rated depository institutions with no questions asked. This transaction resembles a short-term advance offered by a Federal Home

Loan Bank to a depository institution and could eventually reduce the share of such wholesale funding provided by the FHLBanks.”

- “...Freddie Mac was created, in part, to provide competition for Fannie Mae. The housing GSEs have been so successful that the process could be repeated today. Granting new GSE charters to create competitors for Fannie and Freddie might force the GSEs to pass through more of the subsidy intended for mortgage borrowers.”
- “Finally, Congress could encourage the housing GSEs to restructure themselves in ways that make them more competitive and transparent, fostering market discipline. Fannie Mae and Freddie Mac operate two distinct lines of business— a mortgage-backed security guaranty business and a retained-mortgage portfolio business. The first involves managing credit risk, while the second involves managing interest rate and liquidity risks. Fannie and Freddie each could be enticed to split themselves into two companies, one that provides only guarantees (as several private bond-insurance companies do) and another that only invests in mortgages (as many private mutual funds and thrifts do). This split would foster greater market discipline on the retained portfolio business because investors could assess the interest rate and liquidity risks independent from the credit risk. Meanwhile, the 12 FHLBanks could be split into several groups to compete with one another nationwide. Currently, the FHLBanks operate in non-overlapping territories, although interstate branching is blurring these territories.”
- “The housing GSEs and their many advocates in the financial sector, in Congress and across the country argue that the housing GSEs have yet to cost taxpayers a nickel. They also note that stand-alone ratings of housing-GSE debt, that is, the bond ratings Moody’s and Standard & Poor would award absent implicit federal-government backing, are quite high. Finally, supporters point to the millions of Americans whose dream of home ownership became a reality due to housing-GSE activity. Because this reality is so vivid to most taxpayers, the downside of Fannie Mae, Freddie Mac and the FHLBanks is easy to overlook. An informed judgment about the proper scope of housing-GSE activity must take into account the potential costs of misdirected subsidies and financial instability.” (*St. Louis Federal Reserve The Regional Economist*, William R. Emmons, Mark D. Vaughan and Timothy J. Yeager, 07/02/04)

## **Fannie Mae**

Freddie Mac's 2003 results raise questions for Fannie
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- Writing in *TheStreet.com*, Peter Eavis notes that Freddie Mac's FY2003 financial statements actually raise many questions about Fannie Mae. Fannie, whose books are being probed by OFHEO, has shown many signs of using aggressive accounting. Soon after starting its examination, OFHEO said that it believed Fannie hadn't adequately written down the value of some bonds backed by mobile-home loans. Fannie Mae said it will take an extra writedown on those assets in its second-quarter numbers, which will be released in July.
- Freddie's FY2003 results suggest that even with the July writedown, Fannie has been slow to mark down the troubled assets. It also appears that Fannie has been much more aggressive than Freddie in valuing an asset and liability associated with its mortgage-guarantee business. Fannie's fair-value balance sheet has benefited substantially from the company's valuation of this guarantee asset and liability.
- Eavis writes, "Fannie's management must be dreading the questions that Freddie's 2003 numbers will raise in the market. First, note the seeming failure to properly mark down the mobile-home-backed bonds... This column had always proposed that Fannie's downward adjustments were insufficient, going by a proportionally much larger writedown at a government-sponsored lender called the Federal Home Loan Bank of New York. Fannie fans pooh-poohed the comparison, but Wednesday's numbers show that Freddie's markdown has been proportionally much greater than Fannie's, too. With the extra writedown that came after the run-in with OFHEO, Fannie will have written down its mobile-home loan bonds by a cumulative \$460 million. That works out at about 5.6% of its \$8.2 billion in mobile-home bonds. Freddie's 2003 numbers show that it has taken a writedown of \$300 million on around \$2.3 billion of mobile home bonds -- a 13% decline. And Freddie took a much larger hit even though the credit worthiness of its mobile-home portfolio is far higher than Fannie's. Some 81% of Freddie's bonds are triple-A rated, whereas only 27% of Fannie's are."
- "The other place in Freddie's 2003 results that investors rushed to see was the fair-value balance sheet, which attempts to give investors a market value -- actual and estimated -- for all assets and liabilities. It is incredibly important for Fannie and Freddie, because U.S. generally accepted accounting principles can distort balance sheets and income statements for companies such as these. The health of neither company can be accurately gauged without it. The change in the fair value of equity (assets minus liabilities) gives the best indication of how Fannie and Freddie have performed. Importantly, Freddie said on its conference call that it was going to start releasing a fair-value balance sheet when it resumes reporting current results. If

Freddie does that, Fannie, which has said it is weighing such a move, may be forced to follow if it hasn't done so by then."

- "One of the pitfalls of using the fair-value balance sheet, however, is that it is calculated in-house, leaving investors at the mercy of the companies' own figures. This risk shows up well in the treatment of the guarantee assets and liabilities. Fannie appears to value the future expected profits from its guarantee business much more aggressively than does Freddie, going by the latter's 2003 numbers. On the fair-value balance sheet, Freddie estimates the net value of its future mortgage guarantee business (guarantee asset minus guarantee liability) at \$2.1 billion, vs. \$7.6 billion at Fannie. Of course, the numbers are meaningless on their own. But relative to the size of the portfolios of mortgages that the companies are guaranteeing, Fannie appears to be much rosier when estimating profits from that business. Its \$7.6 billion is 0.58% of the mortgages it is guaranteeing, compared with only 0.28% at Freddie. This suggests Fannie may have been inflating the value of its fair-value balance sheet by attaching too high a value to its guarantee business."
- "Clearly, it makes sense to exclude the guarantee business at both companies when calculating the all-important change in the fair value of equity. Leaving out the change in the net guarantee asset and preferred stock issuance, and adding back common stock dividends, gives a much cleaner view of the change in fair value equity. That calculation gives an increase in fair-value equity of \$5.7 billion for Freddie in 2003, and \$7.5 billion for Fannie. Measuring the increase as a percentage of end-2002 fair value of mortgages gives a 0.96% return for Freddie, higher than Fannie's 0.86% return. However, Freddie is much more of consistent performer. The fair value of its equity went up by \$6.1 billion in 2002, compared with a meager \$1.1 billion for Fannie. Moreover, Fannie has shown a greater proclivity for the occasional shock. In 2002, Fannie's balance sheet got shellacked because the company bet against a big drop in interest rates. Freddie was sufficiently protected."
- "And the pattern continues: A press release from OFHEO shows that Fannie had positioned its balance sheet for a drop in interest rates at the end of the first quarter, just as rates jumped in the second quarter. Freddie was much better hedged. There must be real relief over at Fannie that the next numbers from Freddie won't be out till next March." (*TheStreet.com*, Peter Eavis, 07/01/04)
- Dawn Kopecki with the *Wall Street Journal* agreed with much of Eavis' analysis of Fannie Mae and Freddie Mac's mobile home portfolio loss provisions. Kopecki wrote, "If the performance of Freddie's mobile home loan investments disclosed Wednesday is any indication, Fannie Mae's losses could be substantially higher than previously disclosed or projected." In FY2003, Freddie recorded \$208 million in pre-tax losses on its \$2 billion manufactured housing portfolio, 10.4% of its total investment last year, while Fannie has recorded \$217 million in total losses through March 31, 2004, representing 2.8% on its current mobile home portfolio of \$7.7 billion. More than half of that charge, \$128 million, was taken against past sales as opposed to current holdings, further reducing Fannie Mae's write-offs for recent

periods. Notably, the percentage of Fannie and Freddie's mobile home holdings that were triple-A rated (or insured by a triple-A rated company) as of Dec. 31, 2003 stood at 24% and 81%, respectively, according to both companies.

- By March 31, 2004, only 76% of Fannie's mobile home loan securities were rated investment grade or better with the remainder downgraded to junk status. (Freddie Mac statistics are not available at this time). By the end of the first quarter, Fannie had also substantially reduced its manufactured housing portfolio to \$7.7 billion from about \$10 billion in 2002. (*Dow Jones Newswires*, Dawn Kopecki, 07/01/04)

#### OFHEO warns again of a Fannie Mae restatement

- In OFHEO's analysis of Fannie Mae's capital levels as of March 31, 2004, the agency wrote "Fannie Mae's capital calculation is based on financial information and the application of accounting policies currently under review by OFHEO. The outcome of the review may result in a restatement of prior period results and a revision of the respective capital calculations." According to OFHEO's statement, Fannie Mae's core capital of \$35.7 billion exceeded its minimum capital requirement by \$4.3 billion. (*OFHEO Press Release*, 06/30/04)

#### S&P affirms Fannie Mae's corporate governance score

- Standard & Poor's affirmed its corporate governance score (CGS) of "9" on Fannie Mae, based on its strong governance practices. "We have judged Fannie Mae's governance practices to be very strong on a global comparison. The affirmation of this score incorporates both positive and negative considerations since the last review," said S&P's governance analyst Dan Konigsburg. (*Reuters*, 07/02/04)

#### Fannie Mae's spokesman Chuck Greener responds to *Barron's* article on Fannie

- Fannie Mae's senior vice president of communications Chuck Greener writes in a Letter to the Editor in *Barron's*, "*Swept Away*, the May 17 article about Fannie Mae by Jonathan R. Laing, states that mortgage securitization is our 'traditional' business and that we have only lately emphasized keeping mortgages in our portfolio. In fact, purchasing and keeping mortgages in our portfolio has been our primary business since our establishment in 1938 in order to keep mortgage funds flowing to lenders. We did not start a mortgage-securitization business until 1981. It has grown faster than our portfolio business the past four years."
- "The article states that we bought 'some of the crummiest vintages of Conseco housing securities.' In fact, the overwhelming majority of our Conseco purchases -- 97% -- were senior bonds with a rating of AAA at the time of purchase. And we

began purchasing Conseco securities (or those issued by its predecessor, Green Tree) in 1995. As the underwriting standards in this industry declined, we curtailed our purchases. We made our last purchase of a Conseco security in early 2000. Conseco continued to issue in the public securities market through 2002.”

- “The article states that we ‘buried’ our year-end fair value balance sheet in our SEC Form 10-K. It is located as a financial statement footnote as required by Generally Accepted Accounting Principles (GAAP) -- in the same location it has been for years.”
- “It is ironic that our massive disclosures were used as the source material to accuse us of obfuscation. Our financial statements are prepared in accordance with GAAP. Fannie Mae’s financial statements have been audited by an independent auditor, certified to by our chief executive officer and chief financial officer, and a number of the accounting policies utilized have been subjected to review by the SEC. We have supplemented our financial statements with extensive disclosures that allow readers to reach their own judgments about our businesses. Accounting standards have shortcomings, but the blame for those shortcomings should be placed with the accounting standards setters, not with the companies required by law to comply with GAAP.”
- “Laing’s main quarrel is with how Federal Accounting Standard 133 mandates the treatment of derivatives in the income statement and balance sheet. Prior to the promulgation of FAS 133, Fannie Mae primarily used historical cost accounting for debt issued in the cash market and the economically equivalent liabilities synthetically created using the cash market and derivatives. FAS 133 mandated derivatives to be marked to market and recognized in either the income statement or on the balance sheet. The assets held to maturity and funded with debt and derivatives cannot be marked to market while the derivative hedges must be marked to market. We do not see how this partial mark-to-market approach can give the reader of our financial statements a clear understanding of the results of our portfolio business. We argued against the approach with the Financial Accounting Standards Board, to no avail.”
- “We supplement our GAAP financials with core business earnings, which provide more consistent treatment of debt and derivatives by substituting amortization for the FAS 133 mark to market of options. We recently supplemented our balance-sheet disclosures, providing extensive data on derivatives, our equity account, and Accumulated Other Comprehensive Income. Within the requirements to give due emphasis to GAAP, Fannie Mae has gone to extraordinary lengths to inform investors about the performance of our portfolio business.”
- “We know that FAS 133 has given our relatively simple business complicated accounting. So do our investors. Our disclosures are presented to help fair-minded analysts come to independent conclusions about the quality of our business.”

- “Fannie Mae continually passes a stringent risk-based capital stress test developed by our regulator. It ensures that we will be adequately capitalized even under extremely adverse conditions.” (*Barron’s Online*, Chuck Greener, 06/21/04)

Is Fannie Mae’s new “joint venture company”  
with Egyptian government a pyramid scheme?

- FM Policy Focus Chairman J.C. Watts sent a letter on June 16 to HUD Secretary Alphonso Jackson expressing concern that Fannie Mae’s recent overseas initiatives and joint ventures with the Egyptian government may be outside the scope of the GSE’s charter and will benefit America’s homeowners very little, if at all. In his letter, Watts writes, “The GSE charters were clearly premised on the expectation that the billions of dollars of taxpayer-supported benefits granted to the Enterprises would be used serve the interest of American mortgage borrowers and the liquid secondary market on which they depend. Fannie Mae’s ‘American Dream’ marketing campaign strongly implies that all of its efforts are dedicated solely to the enhancement of American homeownership. Therefore, any taxpayer dollars provided to the GSE subsidy that are diverted from the American market directly undermine the GSE mission.”
- Watts continues, “Fannie Mae’s overseas activities and the Egyptian proposal are particularly troubling in view of the GSE’s criticism of HUD’s proposal to toughen affordable housing goals for the GSEs. It is disingenuous for Fannie Mae to claim it cannot meet tougher standards for affordable housing in the United States, while simultaneously spreading its largess overseas by offering international consulting – and possibly even direct investment in more than 30 countries, across all continents.”
- As HUD is currently examining Fannie’s international activities, Watts questions, “How does providing consulting services to foreign governments advance Fannie Mae’s core mission? What benefits, if any, do American taxpayers and homeowners derive from Fannie Mae’s international consulting services? What fees, if any, are paid to Fannie Mae for such consulting services? Does Fannie Mae’s charter permit it to engage in these overseas activities, consulting and otherwise?”
- Watts then turns to broader issues, asking “Would it not be preferable in emerging market nations that HUD and Ginnie Mae advise these governments about desirable mortgage programs so that foreign governments and their people see the direct link between the United States and their own goals? Would HUD’s work in Russia support programs such as the Egyptian venture contemplated by Fannie Mae?” A complete copy of Watts’ correspondence is available on the Internet at [www.fmpolicyfocus.org](http://www.fmpolicyfocus.org). (*FM Policy Focus Press Release*, 06/16/04)

*Fast Company's* CEO See-Ya!: Franklin D. Raines, CEO of Fannie Mae.

- In *Fast Company*, Carleen Hawn writes, “What kind of CEO can’t manage a mortgage business in an era of low rates and a hot real-estate market? A government-sponsored one, apparently. With the help of Glass, Lewis & Co. LLC, we vote to “repo” Fannie Mae CEO Franklin D. Raines.” Hawn notes that during Raines’ five year tenure, Fannie Mae has reported a 5.2% return on shareholder equity versus peer index return of 14.6%.
- Hawn adds, “Fannie Mae trades cash or securities for lenders’ mortgages, then manages the portfolio. Translation: Wake up breathing, earn fee. Yet Raines, who made \$17 million in 2003, has presided over a flat stock price and bruised shareholder’s equity. Worse, the Office of Federal Housing Enterprise Oversight says Fannie Mae used improper accounting.” (*Fast Company*, Carleen Hawn, 07/01/04)

Fannie Mae Foundation finds alarming number  
of minorities are experiencing affordability problems

- More minorities are finding ways to buy homes, but a Fannie Mae Foundation study indicates many spend about half their family income to keep them. While homeownership rates among black and Hispanic families climbed significantly from 1990 to 2000, many faced “severe affordability problems” which threaten the health of the nation’s urban neighborhoods. The Fannie Mae Foundation study, which examined trends over the decade of the 1990s in the 25 largest U.S. cities, found that the rate of families spending at least 50% of their income on housing was one in seven (14.29%) for blacks and one in eight (12.5%) for Latinos.
- In New York and Los Angeles, 20% of the black and Hispanic families that owned their homes in 2000 spent half their income on housing. Using U.S. Census data, the Foundation study found that the percentage of blacks considered “cost-burdened” rose fastest in New York, Los Angeles, Seattle and the District of Columbia.
- “The last decade was one of the best for minority homeownership in American history” with minority ownership rates growing by 16% for blacks and 54% for Hispanics, said Stacey D. Stewart, president and chief executive officer of the Fannie Mae Foundation. She noted that those minorities have become a disproportionate share of owners facing severe affordability problems, which grew 39% and 98% respectively. Stewart added that the increases in affordability problems are due in part to the expanded availability of loans for people with impaired credit.
- In San Diego, Calif., 25% of the 27,000 people who became homeowners during the 1990s were Hispanic. But in that same time, the number of Latinos spending at least half their money on housing doubled.

- “The rapid growth in severe homeowner affordability problems among urban minorities threatens to undermine homeownership gains among minorities during the 1990s and also threatens the health of our urban neighborhoods,” said Stewart. “The Fannie Mae Foundation supports emphasizing early detection and remediation of mortgage repayment problems, property tax relief for low-income homeowners, homeownership and financial education and counseling, and actions designed to curtail predatory lending.”
- Stewart told the *Associated Press*, “It’s one thing to say we’ve gotten new homeowners, but it’s another thing to say that over a long period of time we’ve been able to maintain people as homeowners.” (*PR Newswire*, 06/23/04; *Associated Press*, 06/24/04; *Reuters News*, Mark Felsenthal, 06/23/04; *Dow Jones International*, 06/23/04)

Senator Schumer (D-NY) “delivers” \$300 million (more) from Fannie Mae for down payment assistance for New Yorkers

- The *Mid-Hudson News Network* wrote that Senator Chuck Schumer (D-NY) “brought officials of Fannie Mae with him as he made stops in Fishkill, Kingston, and Middletown [NY] to announce the agency has raised its \$200 million pot for down payment assistance to \$500 million. That means that prospective homeowners could pay as little as \$500 for their closing based on their income.” [Senator Schumer is up re-election in November 2004.] (*MidHudsonNews.com*, 06/30/04)

Fannie Mae establishes employer assisted housing plans for 600 employers nationwide

- To date, Fannie Mae says it has helped establish employer assisted housing (EAH) plans to nearly 600 public and private employers nationwide, providing benefits such as down payment and closing-cost assistance, interest rate buy-downs and free homebuyer education. A recent National Housing Conference (NHC) study indicates that EAH plans have gained enough popularity nationwide that the product may become as mainstream as health care assistance and start new trend in the affordable housing market. “With federal spending cuts greatly reducing the role that government programs have historically played in providing affordable housing, private sector partnerships are without question proving highly effective and are growing in popularity as a result,” said NHC chairman G. Allen Kington. The NHC report stresses that EAH options have proven to be a “win-win-win” solution that serves employers as a workforce retention tool, while employees benefit from living near work and communities are revitalized due to increased investment. (*National Mortgage News*, 06/28/04)

Fannie Mae launches multimedia course for lenders  
on how to better serve minority markets

- Fannie Mae launched “Delivering the American Dream: Strategies for Reaching Out to Minorities, Immigrants, and Other Underserved Borrowers,” a free, fully-narrated, multimedia tutorial that is available on the company’s website, [www.efanniemae.com](http://www.efanniemae.com). The course helps mortgage lenders develop marketing strategies to increase their outreach to underserved, minority and immigrant borrowers. The course, which takes 30 to 40 minutes to complete, is targeted to loan officers, loan originators, underwriters, secondary marketing officers and compliance officers, provides effective strategies for reaching underserved markets. (*Fannie Mae Press Release, 06/25/04*)

## **Freddie Mac**

Freddie Mac’s portfolio rises for first month in seven months

- In May, Freddie Mac said its portfolio increased for the first month in seven, as higher interest rates slowed loan refinancings. The portfolio, which provides about two-thirds of the GSE’s profit, rose by \$2.4 billion to \$633.9 billion, as purchases outpaced the \$17.7 billion in loans retired from the portfolio, said Michael Cosgrove, a Freddie Mac spokesman. Loan liquidations totaled \$19.5 billion in April. Freddie Mac has been slow to replace the “liquidated” loans since October, as competition for the assets increased prices on mortgage bonds, making them unattractive to Freddie Mac relative to the rates it pays to borrow, Freddie Mac has said. The market for loan purchases turned more “favorable” in March and April, Cosgrove said.
- “Rising interest rates help Freddie Mac on one side, but they still aren’t purchasing much,” said Kevin Jackson, a senior mortgage analyst at RBC Dain Rauscher Inc. At this rate, Freddie Mac’s portfolio growth is still declining 3.9% this year, he added.
- The return to portfolio growth “is a positive sign for the stock,” said Chris Buonafede, an analyst at Fox-Pitt Kelton in New York, in a research note. He rates the stock “outperform.”
- Freddie Mac’s total mortgage-backed securities issuance rose at an annualized 10.8% in May. The GSE’s structured securitizations totaled \$16.7 billion in May, down from \$27.7 billion in April.

- Freddie Mac said its duration gap, a measure of interest-rate risk, was unchanged at zero months in May. The company aims to keep its duration gap at zero.
- Freddie Mac's single family non-credit enhanced delinquency rate was 24 basis points in the May, down from the 25 basis points in the prior month. (*Bloomberg News*, Al Yoon, 06/24/04; *Dow Jones Newswires*, Madeleine Lim, 06/24/04; *Freddie Mac Monthly Volume Summary*, May 2004)

OFHEO deems Freddie Mac is adequately capitalized
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- According to OFHEO, Freddie Mac's risk-based capital requirement was \$7.131 billion on March 31, 2004. On that date, Freddie Mac's total capital of \$34.898 billion exceeded the requirement by \$27.767 billion. Further, Freddie Mac's core capital of \$34.781 billion exceeded its minimum capital requirement of \$24.472 billion by \$10.309 billion. (*OFHEO Press Release*, 06/30/04)

### **Federal Home Loan Banks**

Has the Federal Housing Finance Board become an "activist regulator?"
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- The Federal Housing Finance Board's recent crackdown on the FHLB-Chicago, following its unanimous vote to require the FHLBs to register with the SEC, has some industry officials wondering if the Board will "keep flexing its muscle" under Chairman Alicia Castaneda. The repercussions -- including higher borrowing costs and lower dividends -- from the FHLB-Chicago's enforcement order may ripple out to the banks and thrifts that own the Banks. The growth limit on the MPF program also could make it tougher for bankers to sell as many mortgages. Diane Casey-Landry, the president of America's Community Bankers, said she had a broader concern: whether the FHLB System might be undermined by an activist regulator. The board seems more interested in appearing tough than in operating in the best interest of the FHLB System, Casey-Landry said. "This is part of the Finance Board's efforts to demonstrate that they can be their view of a world-class regulator."
- Stephen Cross, the Finance Board's director of supervision, denied any suggestion that it is acting extraordinarily or that it plans similar disciplinary actions for other banks. He said a formal move was necessary in this case, because informal requests last year had not been properly heeded. "I would object to anyone believing that the motivation here was to send a message that we are a tough regulator," Cross said. "The motivation is wholly and completely to deal with a situation at the Chicago bank."

- However, others described the agreement, which the Finance Board said it had to make public under a disclosure requirement of the Gramm-Leach-Bliley Act, as a warning for the rest of the system. “I’m sure that this agreement will be noticed by the other banks,” said Allen H. Koranda, the chairman of the FHLB-Chicago.
- Casey-Landry noted that there have been other signs. The SEC registration was widely opposed by the industry, but the Finance Board proceeded anyway, she said. “That is not the way to develop a working relationship with the industry.” Further, a recent move to increase Banks’ retained earnings “was done by directive -- not rulemaking,” she said. “So it’s an increase in judgment and control in the hands of the regulator.” [America’s Community Bankers led the fight against the Finance Board’s proposal to require the FHLBs to register with the SEC; ACB has threatened to sue the Finance Board over this regulation, challenging their statutory authority to pass such a rule] (*American Banker*, Dean Anason, 07/02/04; *Dow Jones Newswires*, John Connor, 06/17/04; *American Banker*, Rob Blackwell, 06/18/04))

Finance Board Chair prepares for “round two”
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- In an interview following the Federal Housing Finance Board’s unanimous approval of a rule requiring the FHLBs to register with the SEC, Alicia Castaneda, the Chair of the Board said her current focus is to improve the overall supervision of the FHLBs. She said her job is to continue to add staff and resources to the supervision department to ensure that the board stays up to date on any risks to the FHLBs.
- Asked how she felt about proposals to allow a member institution to belong to more than one FHLB, Castaneda noted that the issue has not come up during her tenure on the board and said, “It is not on the agenda at this time.” Similarly, she said the board would continue to monitor the FHLBs’ acquired member asset programs, but she made no promises to release a proposal soon that would expand such programs. These programs, the best known of which is the Mortgage Partnership Finance Program, allow the banks to purchase members’ loans and sell them to investors and play an important role in the FHLB System. Castaneda added, “The acquired member asset program should not be at any disadvantage to the plain advances that the banks make. It is another way for Home Loan banks to provide liquidity to their members.”
- In response to a speech by Senator Paul Sarbanes (D-MD) about predatory lending, Castaneda said she has ordered a review of the FHLBs’ mortgage purchase programs to make sure these programs do not facilitate predatory lending. Castaneda said, “I have asked the Office of Supervision to look into that,” she said, to make certain there are no predatory-lending issues related to the FHLB loans. Predatory lending is “an issue that is important to me,” she added.

- Castaneda would not take a position on bills that would replace the Finance Board with a single regulator for the FHLBs, Fannie Mae, and Freddie Mac, saying she would leave such a decision to Congress. (*American Banker*, Rob Blackwell, 06/25/04; *National Mortgage News*, 06/25/04)

Standard & Poor's changes outlook on FHLB-Des Moines' AAA rating to "negative"
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- Standard & Poor's changed its outlook on the FHLB-Des Moines triple-A rating to negative, noting the Bank has increased its exposure to interest rate risk. The Bank's risk exposure stems from its participation in the Mortgage Partnership Finance (MPF) Program, in which the regional FHLBs share the risk of mortgage lending with their member banks, S&P said. Through the MPF Program, the FHLB-Des Moines has increased its investment in fixed rate mortgage and has in increased vulnerability to interest-rate volatility. "We think that managing fixed rate longer-dated mortgage-backed securities poses more volatility to earnings and creates a higher risk profile," said Jonathan Ukeiley, an S&P analyst. "As these banks have chosen to go that route, we think it's appropriate to recognize that," he added.
- S&P has changed its outlook to negative for the FHLBs in Pittsburgh, Atlanta, Chicago, Indianapolis and Seattle over the last year, some due to increased interest rate risk too, others due to reduced profitability.
- "The criteria we use to determine the FHLB [rating] on a consolidated basis takes into account its financial as well as public policy and GSE status," Ukeiley said. "Even if we were to downgrade all the ones with a negative outlook, that would still give us leeway to maintain the triple-A on the consolidated obligations," he added. Ukeiley noted that S&P recently revised its methodology for rating GSEs includes not just the implied government backing, but also a review of their underlying financial condition. The underlying credit ratings of the regional FHLBs don't present a threat to the consolidated rating, Ukeiley said. He declined to comment on whether further rating action could raise the possibility of a rating change at the consolidated level. (*Dow Jones Capital Markets Report*, Christine Richard, 06/22/04)

FHLBs undeterred by mortgage risk, despite rating concerns
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- Despite recent warnings from Standard & Poor's, the FHLBs won't slow their lending under the Mortgage Partnership Finance (MPF) Program, which allows them to compete effectively with Fannie Mae and Freddie Mac. Under the MPF Program, FHLB members, including community banks, credit unions and other financial institutions, retain the credit risk on a mortgage loan while letting a FHLBank assume the interest rate risk. "The FHLBanks believe the mortgage programs provide a valuable service to our members," said Michael Ciota, a FHLB spokesman. "They

are an attractive alternative to traditional secondary market securitization, and rather than concentrate risk, they actually disperse risk throughout the financial system.”

- The MPF program is proving especially popular with smaller institutions such as First Federal Bancshares, Inc., a small rural community bank which funded around 90% of its residential mortgage loans over the last two years through the FHLB-Chicago. “We’re just not going to put a 5% 30-year fixed rate mortgage on the balance sheet,” said James Stebor, First Federal’s president. The Bank lacks sufficient mortgage origination volume to do in-house risk management on such loans, he said. Selling loans to Fannie Mae and Freddie Mac isn’t economical without sufficient volume, Stebor added. Fannie Mae and Freddie Mac charge lenders around 20 basis points on average to take over the credit risk of a loan they purchase, or about \$400 on a \$200,000 loan. This fee is negotiable and can be significantly higher or lower depending on volume. Under the FHLB program, the FHLB member receives a fee for keeping the credit risk that averages 10 basis points of a loan. On a \$200,000 loan the originator receives around \$200. That’s a risk many financial institutions, particularly small ones that know their customers, are comfortable taking, said Stebor.
- The MPF program is a departure from the FHLB’s traditional business of raising funds in the capital markets and lending those funds as advances to its members. Some regional FHLB banks have shifted their business model dramatically toward taking on mortgage exposure. Mortgage lending made up more than 50% of the FHLB-Chicago’s asset mix at the end of the first quarter of 2004, with the FHLB-Des Moines and FHLB-Seattle having about 33% if their assets in mortgage loans. In contrast, the FHLB-Dallas and the FHLB-Topeka have put only a small fraction of their assets in mortgages. On March 31, 2004, total mortgage assets in the MPF Program totaled \$88 billion. (*Dow Jones Newswires*, Christine Richard, 06/23/04)

FDIC examines risk of banks that rely heavily on FHLB advances
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- According to a new FDIC study, community banks that rely heavily on FHLB advances need to “stay alert” even though they generally are managing their risks well. Over the past 10 years, Banks have relied more heavily on FHLB advances as an alternative to traditional customer deposits. The FHLBs loan money to the banks in the form of advances, available at low cost because FHLBs can borrow at below-market, GSE rates. “Most banks manage these products prudently, but the exceptions have given rise to supervisory concern,” the FDIC said. Commercial banks were liable for \$237 billion in FHLB advances as of Sept. 30, 2003, representing 52% of the total \$456 billion in FHLB advances, with the remainder held by savings associations and savings banks.
- While the FHLBs haven’t been hurt by recent scrutiny and negative press coverage of the FHLB system, banks could suffer if the FHLBs face tighter regulation that raises the cost of advances, the study said. “While there is no immediate systemic overall threat to the overall cost and availability of advances, individual institutions must be

mindful of the risks undue reliance on advances can pose,” the FDIC said. (*Dow Jones Newswires*, Rebecca Christie, 06/29/04)

FHLB System bolsters retained earning 20% over last year

- In the year since the Federal Housing Finance Board ordered the FHLBs to bolster their retained earnings, the FHLB System’s equity has increased 20%. In the wake of portfolio losses at the FHLB-New York and the threat of rising interest rates, the Federal Housing Finance Board ordered the FHLBs to put new policies in place by the first quarter of 2004. All of the FHLBs have complied with the Board’s policy with nine FHLBs already increasing their reserves significantly and the three FHLBs saying they are working on it. Each FHLB has responded differently to the Finance Board directive. Some have outlined specific targets for their retained earnings and have restricted dividend payments until further notice.
- While some officials are feeling a bit better about the FHLB system’s resilience, there are a handful of FHLB members recalling times when the federal government dipped into the FHLB System resources to defray \$3 billion of costs from the savings and loan crisis in the late 1980s. That experience makes the FHLBs and their members reluctant to build up the System’s retained earnings. “There is no question it is still hanging out there,” said Alfred DelliBovi, president of the FHLB-New York. “The specter of two nationalizations is clearly on people’s minds.”
- Much has changed, however, since the 1980s. An amendment in the Gramm-Leach-Bliley Act of 1999 officially designated the earnings of the FHLBs as the property of the Banks’ member institutions, which would allow FHLB members to sue the government if it confiscated the FHLB System’s retained earnings again.
- Board Chairman Alicia Castaneda expressed sympathy for the members’ concerns. The banks have raised “a valid point,” Castaneda said. “On the other hand, as a financial institution you do have to have the cushion there,” and to increase it. “I think they are working on it,” Castaneda said. “I think they do understand it.”
- FHLB officials conceded that the Finance Board is right to focus on retained earnings. Raymond Christman, the president of the FHLB-Atlanta, said retained earnings are important not just to avoid dipping into capital but to keep dividends steady for member institutions when the FHLB’s earnings are low. “The ability to have retained earnings to deal with contingencies and events... adds considerably to the security and the longevity of the Home Loan Bank System,” Christman said.
- Although the FHLBs seem willing to add to their retained earnings, doing so comes at a price. Any money they put aside for such purposes comes out of the dividends they pay their members. If they pay too little, member banks and thrifts could seek out another FHLB to join or withdraw from the system altogether. The dividend “represents an attractive point for our members,” Christman said. “The two principal

ways in which banks serve their members,” he said, are “through the attractive pricing of advances - they can borrow money very cheaply” - and the dividends they pay.

- “I don’t think that the risk of having the retained earnings confiscated or utilized ever goes away,” said Christman of the Atlanta Home Loan Bank. “If at any time another financial crisis occurred that the Federal Home Loan banks were associated with in any way - whether we were the cause of it or not - I’m sure Congress would once again look to the assets of the Federal Home Loan banks.” Thus, the added cushion of FHLB System reserves may increase one set of anxieties as it alleviates another. (*American Banker*, Rob Blackwell, 06/20/04)

FHLB-Chicago names Charles A. Huston acting president and announces plans for 6% <i>stock</i> dividend
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- The Board of Directors of the FHLB-Chicago has named Charles A. Huston as Chairman of the Management Committee and Acting President of the Bank effective June 30, 2004. As Executive Vice President of Member Relationship Management, Huston, 56, has been responsible for new business and customer relationships since he joined the FHLB-Chicago in 1991. Huston has over 30 years experience in corporate and correspondent banking, including 12 years at the FHLB-Chicago. Board Chairman Allen Koranda announced the formation of an executive search committee to identify a permanent replacement for former president Alex J. Pollock, who is leaving the FHLB-Chicago to become a Resident Fellow at the American Enterprise Institute in Washington, D.C. “We have begun the search to identify the best candidate and will conduct it as quickly as possible, but there is no deadline for the completion of this process,” Koranda added. (*FHLB-Chicago Press Release*, 06/30/04)
- The FHLB-Chicago announced it intends to declare a second quarter stock dividend to its members at an annualized rate of 6%, payable on August 13, 2004. The dividend is expected to represent approximately 70% of second quarter earnings with the remaining 30% to be added to the Bank’s retained earnings. The formal dividend declaration is set to occur later this week. “The Bank continues to generate strong profitability while remaining very well capitalized,” said Huston. “Our performance allows us to pay our shareholder members a very attractive dividend while also building our retained earnings, already the largest among the FHLBs by far.”
- At the end of May, the Chicago FHLB’s regulatory capital-to-assets ratio was 5.09%, the highest of the FHLBs and far above the required minimum of 4%. Its return on equity since the beginning of the year was 7.24% compared to the average of 4.61% for all FHLBs. Complete financial results for the second quarter will be published in several weeks. “In all respects, the financial condition of the Bank is excellent,” said Huston. (*FHLB-Chicago Press Release*, 06/30/04)

## FHLB-Boston hires chief information officer

- The FHLB-Boston has hired William L. Oakley as its chief information officer and a senior vice president. Oakley was the chief technology officer and a vice president at John Hancock Financial Services, Inc. (*American Banker*, Christopher Wood, 07/01/04)

## **International GSEs**

Mexican government planning to create the SHF, an agency similar to Fannie that is “as independent as possible” from the government

- U.S. government officials and representatives of U.S. investment banks and ratings agencies are working with Mexican officials in an effort to establish a secondary market in Mexican mortgages through a new independent entity known as the Federal Mortgage Society, or “SHF” according to its Spanish acronym, Deputy Treasury Secretary Samuel Bodman said. “The main thing here is to get the mechanism going...getting the underpinnings of a securitization program,” Bodman said of SHF, an entity which will be similar Fannie Mae and Freddie Mac. He said the U.S. hopes SHF will be as independent as possible of the Mexican government. Bodman said current expectations are for the SHF to begin business by the end of 2004 and would complement government-run Infonavit, Mexico’s biggest mortgage lender. “The goal here is SHF would be a securitizer of the mortgages, and that Infonavit would be a buyer,” he said. There is a potential for both Mexican and U.S. purchasing of SHF securitized mortgages, Bodman added.
- Housing is among the fastest-growing sectors of the Mexican economy, and President Vicente Fox’s administration has set a goal of 750,000 mortgages granted each year by 2006, compared with about 500,000 mortgages granted in 2003. (*Dow Jones Newswires*, Campion Walsh, 06/28/04)

## **Sallie Mae**

### Bush administration's welfare queen

- The *Berkshire Eagle* (Pittsfield, Massachusetts) writes in an editorial, "...Congressional Republicans are itching to gut or even eliminate the direct student-loan program when the federal Higher Education Act is renewed this year. Direct student loans go straight from the government to students. From 1995 to 2003, the government lent about \$137 billion to Americans going to college. Of that, \$2.7 billion went to interest payments to the Treasury and to cover defaults. That's a small price to pay for the social and economic benefits of an educated citizenry."
- "GOP ideologues, however, will try to expand the more costly guaranteed student-loan program, where banks serve as middlemen. Its supporters call this a market-oriented approach. But all it does is jack up interest rates so that the lenders who need never fear losses are guaranteed hefty profits. Less money for profits would free up additional cash for needy students. But that's not the sensible way student loans are headed under Mr. Bush."
- "...Genuine free-market competition often does result in lower prices and better quality for taxpayers and consumers. There are many examples, but few when government negates the competition that is the backbone of free enterprise. Most of the Bush privatization arrangements are sweetheart deals that amount to massive corporate welfare. Mr. Reagan's crafty welfare queens of the '80s are today's defense contractors and Wall Street raiders [and commercial banks]." (*Berkshire Eagle*, 06/20/04)

### Sallie Mae names Maurer vice president of credit

- Sallie Mae named Doug Maurer vice president of credit, a position in which he will lead Sallie Mae's credit function and participate in the development of its private credit lending activities. Maurer previously served as chief financial officer for Electronic Consulting Services Inc., a government contractor. (*Dow Jones Newswires*, Erica R. Davis, 06/26/04)

## ***Farm Credit System/Farmer Mac***

FCA proposed rule could end FCA institutions' use of preferred stock  
as way of gathering deposits

- Bert Ely writes in *Farm Credit Watch* that on June 4 the FCA published for public comment a proposed regulation governing the issuance and retirement of preferred stock by FCS banks and associations. The readily redeemable “preferred stock” several FCS associations have been issuing merely disguises yet another FCS attempt to collect deposits, said Ely. This regulation could end this abuse.
- While the FCA staff has acknowledged that readily redeemable preferred stock is tantamount to a deposit, the Farm Credit Act does not authorize FCS institutions to accept deposits except in highly limited circumstances, such as advanced repayment of a loan. Further, the one mention of bank-like deposits expressly bars CoBank from engaging “in the business of accepting domestic deposits.” Preferred stock should only be a component of an FCS institution’s equity capital, not a way to gather deposits.
- Ely writes, “The proposed regulation is a step in the right direction, but it needs to be strengthened to ensure that when FCS institutions sell preferred stock, they are doing so to raise equity capital, not to gather deposits. ... The proposed regulation would prohibit redemption [of preferred stock] within one year after issuance. That would knock out preferred stock as a substitute for money-market bank accounts. However, preferred stock must be outstanding for much longer since bank certificates of deposit can be outstanding for as long as four or five years. Therefore, FCS preferred stock should not be eligible for redemption within five years of its issuance. That would eliminate any possibility that FCS member-borrowers would view FCS preferred stock as a substitute for bank CDs. This would largely solve the preferred-stock problem.”
- “The 5-year minimum conforms with regulations established by the banking regulators that non-perpetual preferred stock issued by banks and thrifts must have an initial maturity of 5 years or more in order to count fully as regulatory capital. The FCA readily acknowledged that 5 years is a reasonable minimum period in which preferred stock must be outstanding before it can be retired by stating: “We invite comments on whether FCA should institute a longer prohibition on retirement of preferred stock, such as 5 years (rather than 1 year as currently proposed).” The discussion of the proposed regulation reinforces this point with a table showing that less than 100% of preferred stock with an effective maturity of less than 5 years will be included in regulatory capital. Even with an effective maturity of more than three years, only 60% of a preferred stock issue would count as capital.”
- “The proposed regulation also needs strengthening in three other areas: preferred stock should be retired only on a pro rata basis by class of stock and not when

individuals tender their stock for redemption, the regulation should require prominent disclosure that FCS preferred stock is not insured by the FDIC or any other federal agency, and registration of FCS preferred stock with the Securities and Exchange Commission should be mandated. Commenters should commend important features in the proposed regulation, including the requirement that FCS boards of directors must declare dividends on preferred stock before they are paid, bank-like capital regulation of FCS preferred stock, and provisions preventing preferred-stock abuses, such as restrictions on insider-dealing and preferred stock transactions between FCS institutions.” The comment period for this rule ends August 3. (*Farm Credit Watch*, Bert Ely, 06/04)

## **Postal Service**

CBO releases cost estimate for H. 4321,  
the Postal Accountability and Enhancement Act

- CBO has released a cost estimate for H.R. 4321, the Postal Accountability and Enhancement Act. While CBO previously estimated that the net cost to the federal budget would be \$8.4 billion over ten years, the new estimate is a cost of \$8.7 billion over the 2005-2014 period. (*Congressional Budget Office Cost Estimate H. R. 4341 Postal Accountability and Enhancement Act*, 06/23/04)

Congress needs to amend its postal reform

- The Postal Service operates under a severely outdated 30-year-old model, suffering from weak mail volumes, rising labor and infrastructure-related costs, significant debt loads, network inefficiencies and rigid statutes. If postal reform legislation is not passed in 2004, mail volumes will continue to decrease while rates increase, putting American jobs at risk. Postmaster general John E. Potter recently reported that over the past two years, First-Class mail volume has decreased more than 3.5 billion pieces, while 1.7 million new addresses have been added annually during the same period, pushing up delivery costs at a time revenue was declining. As a result, the Postal Service has had to raise rates four times over the past five years.
- Comprehensive postal reform legislation has been approved by the authorizing committees in both chambers of Congress for the first time in 34 years. Several issues still need to be resolved, including Civil Service Retirement System, rate index, competitive products, work sharing, factor 3 -- cost floor requirement, negotiated service agreements and service standards. (*The Financial Services Roundtable: Coalition for a 21<sup>st</sup> Century Postal Service*, 06/29/04)

## Mailers Council calls for amendments to postal reform bills

- The Mailers Council sent letters to Senate Majority Leader William Frist (R-TN) and Speaker of the House, J. Dennis Hastert (R-IL) as well as the chairmen and ranking minority members of the budget and postal oversight committees, proposing four “amendments” to the postal reform bills in each chamber. “The hope is that we’ll be able to get both house and senate bills to be identical because there are differences between the two,” said Bob McLean, executive director of the Mailers Council.
- At present, S. 2468 and H.R. 4341 differ on several different issues. The Council’s proposed new amendments concern retirement issues, a new rate index system, competitive product pricing and service standards. On retirement issues, the Council calls for a compromise between the House and Senate proposals, calling for steady payments with the low initial contribution level of the House bill, and stretched over 20 years. “This compromise would moderate rate hikes in 2006, while also moderating future payments for the Postal Service,” said McLean.
- The House bill calls for the USPS to pay half of its retiree health care obligation over 10 years with low initial payments that would escalate sharply over a short period of time, making it difficult for the Postal Service to make payments without raising rates or cutting service, argued the Council. The Senate version calls for the USPS to pay down the full amount of the retiree health care obligation over 40 years with high initial payments, likely leading to a substantial rate increase for mailers in 2006. (*Direct Newsline*, April 3, 2003).

## “Postal reform I just don’t get”

- In an editorial on *DMNews.com*, Cary Baer writes that Senator Susan Collins (R-ME), chairwoman of the Senate Governmental Affairs Committee, wrote an editorial whose purpose appears to be to communicate that the postal legislation she co-sponsored “will make the necessary reforms to ensure that nine million jobs [dependent on the USPS] are protected and that Americans, regardless of where they live, can continue to rely on services from this vital 225 year old organization into the 21st century.” Baer writes, “In other words, don’t worry, I’m here to ensure that none of our small rural Maine post offices will be closed. But will the bill really help the U.S. Postal Service?” Collins outlines the key problems facing the USPS, including the declining volume of First-Class mail; difficulty in cutting costs from its nationwide infrastructure; and highly labor-intensive organization, making up 75 percent of expenses.
- Baer writes, “Given her analysis, which I am in general agreement with, what do the somewhat different House and Senate bills propose to do to solve the problems? First, and probably most importantly, both bills provide relief from onerous and unfair

pension requirements. Both require a determination of the actuarial value of the postal pension plan in relationship to payout requirements. The bills then require the USPS to pay into the pension system based on the actuarial requirements. If it is determined that a surplus exists in the pension plan, both bills require certain surplus funds to be transferred into the postal service's retiree health benefits fund. This fund apparently has a significant deficit."

- "In addition, both bills transfer back to the Treasury Department the responsibility for the pension liability expense incurred by USPS employees when they were in the military. It should be noted that both pension changes discussed above, even though appropriate and correct, will increase the federal budget deficit, and therefore are likely to cause difficulty gaining final approval."
- "The major element of the bills, and the element that industry seems to be hanging its hat on, pertains to rate setting. The bill simplifies the process as it lets the USPS raise rates on its monopoly products annually, as long as the increase doesn't exceed an inflation index. Many in the mailing industry think this section will act as a control over USPS labor costs. Their rationale is that the rate inflation limit will act as a ceiling on wage increases."
- "In other words, the industry thinks that labor contract negotiations, or the arbitrator in a binding arbitration process, will limit any wage increase because of the limitation on rate increases. But what should happen to wage increases if/when First-Class mail volume drops 10 percent and delivery addresses continue to grow? Should/will the inevitable arbitration process award a minimal wage increase? I doubt it."
- "Another important area to industry deals with the accuracy of the postal service's costing systems, cost allocations to product lines and work-sharing costs. I agree that accurate costs and cost allocations are important. However, unless legislation gives the USPS the ability to control costs, this issue is a bit like the deck chairs on the Titanic analogy."
- "To me, some issues have gotten too little attention, such as workers' compensation. The USPS spends \$1 billion yearly on workers' compensation. The Senate bill tries to bring this cost under some control. It would withhold pay for the first three days of a temporary disability, requiring the employee to use sick leave or annual leave for compensation. Second, the bill would not permit a disabled employee to stay on permanent disability when reaching retirement age. American Postal Workers Union, the largest postal union, strongly opposes this provision. It will be interesting to see what happens to it."
- "Another issue involves management compensation. General agreement exists that compensation for senior management is less than equivalent compensation in private industry. And industry often has spoken of the need to introduce incentives into the compensation process. Though the Senate bill is silent on the issue, the House bill

provides for bonus payments that could exceed the current statutory limit on compensation.”

- “The House bill requires the new Postal Regulatory Commission to provide prior approval to the “form and manner” for the bonus, and approval prior to payment that the bonus terms and conditions have been met. This is a section, given the right bonus objectives, that could improve the postal service’s operation. Yet industry has been noticeably silent on it. Why?”
- “Lastly, even a casual reading of the bills makes clear that the new Postal Regulatory Commission would be given the responsibility to determine the regulations, including rates and service, under which the postal service will operate. Consistent with that responsibility, both bills state that ‘commissioners shall be chosen solely on the basis of their technical qualifications, professional standing and demonstrated expertise in economics, accounting, law or public administration.’”
- “However, the Senate recently approved an individual who, though quite honorable, does not appear to meet these criteria. Until the USPS and the mailing industry fight to receive the respect due a \$900 billion industry, the future of the postal service will remain in doubt.” (*DMNews.com*, Cary H. Baer, 07/01/04)

Postal Service’s income \$919 million <i>over</i> budget
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- From October 1 to May 31, the Postal Service had net income of \$2.9 billion , \$918.9 million over budget. Mail volume was up and expenses are under plan for the period. According to the USPS’s fiscal and operating statements, revenue was \$46.65 billion, 0.5% better than planned, while expenses of \$43.75 billion were 1.5% under the planned budget.
- Mail volume rose 0.7% compared with last year. Standard mail and international mail grew 3.8% and 6.9% respectively, while other classes of mail experienced declines, including periodicals (fell 4.4%); Express Mail (4.2%); Priority Mail (2.4%); First-Class (1.7%); and Package Services (0.2%). For the month of May, total mail volume fell 2.5%, said the USPS. (*DM News.com*, Melissa Campanelli, 06/22/04)

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