

# The **GSE** REPORT™

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## Major Events

Senate Banking Committee narrowly passes GSE regulatory reform bill on 12-9 (nearly party-line vote)

Bush Administration withdraws its support of the GSE regulatory reform bill, possibly killing regulatory reform efforts for GSEs in 2004

Senate Banking Committee narrowly passes GSE regulatory reform bill on 12-9 (nearly party-line vote)

- Prospects for Congress clearing comprehensive regulatory reform of the housing GSEs this year were imperiled when a bill passed the Senate Banking Committee on a mostly party-line vote on April 1. The Senate Banking Committee cleared an amended version of Chairman Richard Shelby's sweeping overhaul of the regulatory regimes covering Fannie Mae, Freddie Mac and the FHLBanks on a 12 to 9 vote, reflecting the partisan discord among committee members. Only one Democrat, Senator Zell Miller (D-GA), voted with Republicans to pass Shelby's proposal.
- Shelby's bill would create a new, independent regulator for the three GSEs, placing their financial safety and soundness supervision and housing mission oversight under the same roof. The new regulator's GSE-assessed funding would be removed from the annual congressional appropriations process. Shelby's measure would also grant the new supervisor the power to adjust the GSEs' minimum and risk-based capital requirements, and would provide the regulator prior-approval authority over any new lines of business the enterprises seek to enter. Additionally, Shelby's measure would strengthen the GSEs' affordable-housing goals. Under his bill, the director of the new agency would also chair an advisory board, whose three other members would include the secretaries of Housing and Treasury and the chair of the Securities and Exchange Commission.
- During markup, the Senate Banking Committee waded through over 30 amendments to the bill, the bulk of which were geared toward increasing the new regulator's authority over the GSEs' affordable housing goals. Republicans agreed to a broad measure aimed at bolstering the companies' performance in financing affordable housing projects. In an amendment sponsored by Senator Jack Reed (D-RI), the GSEs would be required to invest 5% of their pretax profits to finance underserved markets and affordable housing projects. If passed into law, this amendment would provide roughly \$900 million each year, according to the *Wall Street Journal*.
- On a 9 to 12 vote, the committee also defeated a substitute amendment offered by Ranking Member Paul Sarbanes (D-MD). Sarbanes' measure would have established a board to oversee both the mission and financial safety and soundness of Fannie, Freddie and the FHLBs. Under Sarbanes' proposal, the bill omitted any mention of receivership and provided the supervisory board limited authority to adjust the GSEs' minimum capital level on a temporary basis.

- The linchpin of the GSE regulatory reform debate, however, centered on Shelby's proposal to bestow the regulator's director with the authority to appoint a receiver for any GSE that failed. This issue emerged as controversial, forcing Shelby during the markup to back a compromise amendment offered by Senator Bob Bennett (R-UT). Bennett offered this "amendment in exchange for my vote," he told *Dow Jones*. [Bennett's son is a Fannie Mae executive in Utah]. Bennett's amendment would give Congress veto power over the regulator's receivership decision. Under this provision, the new regulator would be required to give Congress up to 45 days to reverse its decision to place a GSE in receivership; the regulator would proceed as planned, if lawmakers failed to act within that timeframe.
- "I supported the receivership compromise and many other provisions adopted today, in the hopes of putting together a package that might attract support from across the aisle," Shelby said. In a prepared statement following the committee vote, Shelby said. "I will not support such a compromise in the future. I do not believe that the receivership provisions that the committee has adopted today provide a workable solution for resolving a GSE crisis."
- Senator John Sununu (R-NH), said supporters of the Bennett amendment were seeking to muddy the waters, and thereby strengthen the so-called implied federal guarantee. For the GSEs' supporters, "there is a belief that a little ambiguity goes a long way," Sununu said. But the amendment "is effectively misleading markets."
- If Shelby's bill heads straight to the Senate floor, a bitterly partisan fight is expected. Democrats have an array of parliamentary delaying tactics at their disposal that could ultimately kill the measure, which they criticized for potentially threatening the housing finance system and raising mortgage rates. Sarbanes said the changes approved in markup don't go far enough to win his support on the Senate floor. "In achieving a first-class regulator, we have to be careful not to diminish the housing mission and not to upset the housing system, which has served us well," Sarbanes said. "This bill does more than advertised. It opens the door to the complete privatization of Fannie Mae and Freddie Mac - the end of GSEs as we know them," said Senator Chuck Schumer (D-NY). "Without bipartisan compromise, we're not going to get a bill."
- In response to the actions taken by the Senate Banking Committee on GSE regulatory reform, Jerry Howard, EVP and CEO of the National Association of Home Builders, issued a statement stating that "The bill to restructure the regulatory framework of the housing government sponsored enterprises (GSEs) that was approved today along party lines by the Senate Banking Committee is a bad bill for the nation's home buyers and represents a retrenchment from national policies that have expanded housing opportunities over the past several decades. ...[T]he bill that emerged today unfortunately falls far short of protecting a priority for housing in America. ...[T]he shortcomings of this bill are so great that they cannot be corrected through amendments, and for that reason we cannot support it. Enactment of this legislation

faces a steep uphill climb and we have every intention of making that upward path as rocky as possible to help ensure its defeat.”

- “The bill lives to fight another day,” said Charles Gabriel, a Washington-based political strategist at Prudential Securities. “But in current form, it still has to fight Democrats, who want to dilute or block it, and the White House, who wants to strengthen or block it.”
- When meeting with the press after the vote, Shelby remarked that the Banking Committee “advanced the debate” by clearing such a measure for the first time. “While I understood that this would be the likely result this afternoon, I felt it was necessary to go through the mark-up to keep the pressure on for meaningful reform,” Shelby said. “This is a big step in the right direction.” When asked if he expected Senate leaders to schedule a full-chamber vote on the bill this year, he responded, “I don’t know if we’re going to see anything this year except appropriations.”
- Shelby questioned whether Democrats want to see a bill passed and he labeled Fannie and Freddie as “outside forces” that slowed his effort. “We’re swimming in a river with some of the most powerful lobbyists Washington has ever seen,” Shelby said. “These people don’t want a regulator that’s powerful... It’s obvious they want the status quo.” Shelby said he will continue working with Democrats to craft an acceptable bill, which contains three basic components: a strong new regulator, receivership capabilities and certain powers over capital requirements.
- Fannie Mae spokesman Chuck Greener said the company would continue to negotiate on the legislation with Congress. “Fannie Mae supports a strong, well-funded, best-in-class regulatory regime,” Green added.
- Lawmakers, however, remain unconvinced. If Fannie and Freddie had agreed to this bill, Shelby said, “We would have had a unanimous vote.” Shelby said he believes the GSEs are deliberately hampering the bill’s progress so they can avoid any big changes to the regulatory regime. He added, “It’s obvious they like the status quo because they have a weak, weak regulator and they know it,” he said.
- Instead, the GSEs have been advertising heavily, raising concerns about the regulatory reform effort and suggesting that consumers will pay higher mortgage rates if Congress acted. Senator Chuck Hagel (R-NE) harshly chastised Fannie Mae for its aggressive new ad campaign that questions Congress in its efforts to strengthen the company’s oversight. The commercials, which began running in heavy rotation in the Washington market during the last week of March, feature a minority couple talking over their kitchen table about new congressional regulations for Fannie Mae. “Will that keep us from getting that lower mortgage rate?” the woman asks in the ad. “Some economists say rates may go up,” her partner responds. “But that could mean we won’t be able to afford the new house,” she says. A narrator cuts in to warn Congress against taking the “wrong path” and closing the door of homeownership for millions of Americans.

- “I find it astounding, astounding that an organization created by Congress would question our ability” to strengthen its oversight, Hagel said. “I am damned concerned about this.” Hagel added, “this kind of junk doesn’t add to the debate, scaring the American people ...that’s not right.” (*Market News International*, Claudia Hirsch, 04/02/04; *Wall Street Journal*, John D. McKinnon and James R. Hagerty, 04/02/04; *Dow Jones Newswires*, Rebecca Christie and Dawn Kopecki, 04/01/04; *CBS MarketWatch*, Matt Andrejezak, 04/01/04; *Dow Jones Newswires*, Dawn Kopecki and Rebecca Christie, 04/1/04; *Dow Jones International News*, Dawn Kopecki, 04/01/04; *Dow Jones Capital Market*, Dawn Kopecki, 04/01/04; *PR Newswire*, National Association of Home Builders, 04/01/04)

Bush Administration withdraws its support of the GSE regulatory reform bill, possibly killing regulatory reform efforts for GSEs in 2004

- The Bush administration pulled its support from Senate efforts to reform oversight of housing GSEs, saying Senator Bennett’s receivership amendment adopted by the Senate Banking Committee would “significantly weaken one of the core powers needed for a strong regulator.” In a joint statement, Treasury Secretary John Snow and Alphonso Jackson, the Secretary of HUD, said the amendment would reinforce the incorrect perception that investments in GSEs are guaranteed by the federal government. The amendment, which would give Congress 45 days to approve or reject receivership for an undercapitalized GSE, was adopted as a compromise to ease Democrats’ concerns about the bill in order to win passage in the narrowly split Senate. Snow and Jackson said the amended bill “is now unworthy of the reform efforts.” Snow and Jackson said although they oppose the bill in its current form, the Bush administration remains “committed to strengthening regulatory and market discipline under existing authorities” and will continue to push for new legislation to improve GSE oversight.
- While there were other forces at work against the bill, Snow’s comment underscored the administration’s unwillingness to compromise on “any issue” related to GSE regulation. Several lawmakers said that while a broader consensus was possible and that Fannie and Freddie were negotiating to help find some agreement, the administration did not want to bend on any of its demands for new regulatory powers.
- Though the administration would argue its inflexibility is the result of a principled stance, some speculated it may have as much to do with concerns that another GSE crisis is around the corner. If administration officials accept a new regulator, “then it becomes their responsibility if something happens in the marketplace,” said Edward Yingling, the executive vice president of the American Bankers Association. “That may cause them to look at it differently than those that don’t have that responsibility.”
- The administration’s position appears calculated to anticipate some kind of Fannie restatement or a similar event. Observers said such an event would leave the administration in a better bargaining position when lawmakers return to the issue.

The tough stance now also ensures that the administration would take no blame for such an event and could argue that it had pushed for better regulation, observers say.

- According to a committee spokesman, Senate Banking Committee Chairman Richard Shelby (D-AL) was not “taken aback” by the news that the Bush administration now opposes his legislation creating a new regulator for the housing GSEs, in light of a controversial amendment adopted at the committee markup last week. “It’s not surprising for him at all,” the spokesman said, noting that Shelby had raised “grave concerns” about the receivership amendment to the bill’s receivership provision but supported it during last week’s markup in the interest of moving the bill forward. “It’s obviously going to be very difficult to attract a consensus due to the competing interests,” but Shelby will continue working to pass a bill “based on the principles in his original proposal,” said the spokesman. “
- Former Senate Banking Committee chairman Phil Gramm agreed with the Bush Administration’s position on the GSE reform bill, saying any reform of Fannie Mae and Freddie Mac shouldn’t leave a decision about any possible receivership of the GSEs in the hands of Congress. Gramm said he was “adamantly opposed to Congress voting on taking a GSE into receivership, noting that “it politicizes the whole process and is a prescription for chaos.”
- Peter Wallison, a resident fellow at the American Enterprise Institute and a proponent of GSE privatization, said that the administration could be trying to force Fannie to embrace privatization. “There is a possibility the administration, seeing what effect the concern about Fannie and Freddie has had on their stock prices,” believes the GSEs could “come forward with their own privatization stance,” Wallison said. If President Bush is reelected, the administration could continue to send strong signals that the GSEs do not have an implicit government backing. That stance would likely further hurt their stock price.
- “A determined administration could accomplish a lot even without legislation,” said Richard Carnell, former senior counsel to the Senate Committee on Banking, Housing and Urban Affairs. “It could state even more explicitly that the government does not stand behind the GSEs -- and could repeat that message frequently, so that it really starts to sink in. The administration could also significantly strengthen affordable housing requirements. If it forcefully took those two steps, it would reduce the GSEs’ incentive to retain their government sponsorship.”
- Some industry representatives said they fear the lack of compromise will only hurt the markets and leave the GSEs with a regulator everyone agrees does not have enough power. “Nobody wins with this outcome,” said Diane Casey-Landry, the president of America’s Community Bankers. (*Washington Post*, David S. Hilzenrath, 04/03/04; *Dow Jones Newswires*, Michael Mackenzie, 04/01/04; *American Banker*, Rob Blackwell, 04/07/04; *CongressDaily*, Molly M. Peterson, 04/05/04; *BNA Banking Report*, Brett Ferguson, 04/05/04)

OFHEO makes startling disclosure: Fannie's financials may need to be restated

Fannie Mae publicly dismisses OFHEO's disclosure and OFHEO publicly strikes back

- While the Senate Banking Committee was busy at work on the GSE regulatory reform bill, OFHEO said an examination of Fannie Mae's accounting policies could lead to a restatement of the company's past results. In its routine quarterly filings, OFHEO said that both Fannie Mae and Freddie Mac met its capital requirements as of December 31. But, OFHEO said, that the outcome of Fannie Mae's accounting probe "may result in a restatement of prior period results and a revision of the respective capital calculations." According to a source, OFHEO is discussing with Fannie Mae whether the company correctly accounted for and valued key assets. The amount of money at issue could not be determined.
- In a rare and potentially costly misstep, Fannie Mae gained OFHEO's ire with some bullying comments to *The Washington Post*. The GSE's spokesman Charles V. Greener said that OFHEO's review started only recently and will examine all aspects of the company's finances and that the regulator has reached no conclusion. Greener added that the GSE just filed its "fully audited" annual report with the SEC. "We are not aware of anything that backs the assertion that there may be a need for us to restate our financial results," he said. "If anyone has evidence to the contrary, they should share it with us directly. Otherwise, it is irresponsible to speculate on this topic and affect markets where billions of dollars of securities are traded every day. *The [Washington] Post* should not use anonymous sources for such an irresponsible allegation."
- In a prepared statement, Fannie further commented, "The language in the letter with respect to the OFHEO special examination straightforwardly states the fact that it is ongoing. As previously announced, OFHEO has recently retained a national accounting firm to supplement the agency's efforts and obviously has not reached any conclusions. We look forward to continuing to work with OFHEO on the examination."
- In response to Greener's comments, OFHEO Director Armando Falcon, Jr. quickly responded in a written statement saying, "Yesterday OFHEO issued its quarterly capital classification announcement for Fannie Mae and Freddie Mac. If OFHEO has reason to believe that the capital calculations may be subject to change, we have an obligation to caveat the capital information with such a disclosure. Accordingly, OFHEO's announcement continued to note Freddie Mac's restatement and the possibility of change, and for the first time noted the possibility of a Fannie Mae restatement and a subsequent effect on the capital calculations. A statement made by Fannie Mae in today's *Washington Post* concerning OFHEO's investigation was inaccurate and misleading."

- Falcon added, “OFHEO’s investigation of Fannie Mae’s accounting policies and practices is proceeding with a broad review of all accounting matters but has also been intensely focused on several specific issues. One involves Fannie Mae’s accounting for impairments. Our review of this particular matter, while not concluded, has led to concerns that Fannie Mae may not have applied the proper accounting guidance in this area. This could affect not only the company’s manufactured housing portfolio but other assets as well. The impact of this possible misapplication of GAAP on Fannie Mae’s financial statements is under examination.”
- While it is rare for the head of a federal agency to respond directly to statements made by an official at a particular company, clearly Falcon was irked with Greener when he told the *Washington Post* that OFHEO’s warning was “irresponsible.”
- According to the *American Banker*, several sources familiar with the matter said that OFHEO examiners are scrutinizing Fannie Mae’s manufactured housing portfolio and “the agency has serious concerns that Fannie may not be showing enough of a loss.” In a column on *TheStreet.com*, Peter Eavis notes that Fannie Mae had \$8 billion of mobile home bonds on its books on December 31, 2003, 70% of which were originally serviced by Consec. Eavis believes that Fannie’s writedowns on the bonds -- just over \$200 million at the end of last year -- were insufficient. Using a similar writedown taken by another institution on similar bonds, Eavis calculated that a writedown of around \$1 billion might be in order. (*American Banker*, Rob Blackwell, 03/30/04; *Wall Street Journal*, James R. Hagerty and John D. McKinnon, 04/01/04; *Washington Post*, David S. Hilzenrath and Kathleen Day, 04/01/04; *OFHEO Press Release*, 04/01/04; *TheStreet.com*, Peter Eavis, 04/01/04; *American Banker*, Barbara A. Rehm, 04/02/04)

<p>HUD investigates Freddie Mac’s \$100 million give-away</p>
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- In its annual assessment of GSEs’ affordable housing goals, HUD has asked for a “separate explanation” of a large transaction between Freddie Mac and Washington Mutual (Wamu) because “[HUD] has not previously seen this type of transaction used to meet goals,” said HUD spokesman Lemar C. Wooley. The deal in question was a swap in October of \$6 billion of Wamu multifamily loans for securities backed by the loans. Freddie paid Wamu a \$100 million fee and gave it the “unilateral” right to unwind the securities after a year and take back the loans. According to Washington Mutual’s 10-K, this swap was “undertaken by Freddie Mac in order to facilitate fulfilling its 2003 affordable housing goals as set by the Department of Housing and Urban Development.” HUD assistant secretary John Weicher said, “HUD is looking at the details of the Wamu transaction to ensure that housing units associated with the transaction are eligible for credit under HUD’s [affordable housing] regulation.”
- Many observers wondered why a lender would want such an unusual clause, which would make the securities unappealing for other investors or for counterparties in long-term repurchase transactions. Others said that if the loans perform well or

market conditions improve, Wamu could benefit by unwinding the securities, which would eliminate the cost of Freddie's guarantees. Some GSE critics said the deal with Wamu sounded like a short-term "parking" or "renting" of the loans, especially because Wamu still has to account for them on its books, while others argued that by agreeing to terms favorable to the lender, Freddie was aiding the multifamily market.

- Several sources said Fannie Mae also entered into a transaction for \$8 billion of similar multifamily loans held by Wamu late last year. To sweeten that deal, two sources said, Fannie gave Wamu the right to buy adjustable-rate mortgages originated under Fannie's Delegated Underwriter and Servicer multifamily program this year. In an e-mail response to questions from *The American Banker*, Fannie Mae spokesman Jon Searles wrote that the GSE "conducted several multifamily transactions with Washington Mutual during 2003, including a series of MBS transactions." Occasionally, "we enter into transactions that are motivated, in part, by our need to support affordable housing goal activities," Searles wrote. "The series of MBS transactions with Washington Mutual are an example."
- If either GSE fails to meet its housing goals, HUD could force the GSE to submit a plan for doing so. Freddie noted in its annual report that "HUD also has the authority to issue a cease-and-desist order and to assess civil money penalties against Freddie Mac in the event that we fail to submit a required housing plan or fail to make a good-faith effort to comply with a plan approved by HUD."
- Freddie's new CEO Richard Syron admitted that the GSE might not have met its affordable housing goals without the Wamu transaction. Syron, who joined Freddie in January after the exchange occurred, indicated that he didn't approve of the transaction and said he doesn't plan to use those types of deals to meet Freddie's housing goals in the future. (*Dow Jones Newswires*, John Connor, 03/31/04; *Washington Mutual 10-K/A*, 12/31/03; *American Banker*, Jody Shenn, 03/30/04; *National Mortgage News*, Brian Collins, 04/05/04; *Dow Jones Newswire*, Dawn Kopecki, 04/07/04)

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

Bush Administration ramps up pressure on GSEs

HUD sets aggressive housing goals for Fannie and Freddie

OFHEO proposes new GSE corporate governance rules to prevent abuse

### HUD sets aggressive housing goals for Fannie and Freddie

- On April 6, HUD sent to Congress aggressive new affordable housing regulations for Fannie Mae and Freddie Mac, sharply increasing the GSEs' mandatory financing targets for low- and moderate-income homebuyers by 2008. If adopted, the proposal would provide healthy annual increases in low and moderate income lending goals

and institute two new “subgoals” - loans to first-time homebuyers and loans to purchase a home. HUD designed the proposal to push the GSEs to lead the market in several key lending areas. “[HUD] must ensure that the GSEs’ strategies address national credit needs, especially as they relate to housing for low- and moderate-income families and housing located in underserved geographical areas,” the proposal states.

- According to the proposal, “the addition of Home Purchase Subgoals to the regulatory structure provides an additional means of encouraging the GSEs affordable housing activities to address identified, persistent credit needs while leaving the GSEs the specific approaches to meeting these needs.” The home-purchase goal requires that:
  - 45% of the mortgages that Fannie and Freddie count toward their low- and moderate income housing goal must be from home purchase loans in metropolitan areas. This goal would increase to 47% in 2007 and 2008.
  - 33% of the companies’ loans that qualify toward their underserved areas goal must also be from home purchase loans in metropolitan areas. This percentage rises to 35% in 2007 and 2008.
  - Of the GSEs’ loans for “very low-income” homeowners, 17% must be for home purchase loans in metropolitan areas.
- For 2005, HUD proposed to increase the low-and moderate-income housing goal from 50% to 52% of units financed, rising to 57% in 2008. The underserved areas goal was proposed to increase from 31% to 38% in 2005 and eventually 40%. The special affordable housing goal was proposed to rise from 20% of units financed to 22% in 2005 and upward to 28% in 2008. One unit may count toward several goals.
- HUD decided not to renew a bonus point system that awarded the GSEs extra credit for financing smaller apartment buildings. HUD retained the GSEs’ multifamily housing goals at current requirements of 1% of Fannie Mae and Freddie Mac’s average annual dollar volume of total mortgage purchases over the 2000-2002 period, which totaled \$5.49 billion for Fannie Mae and \$3.92 billion for Freddie Mac.
- The proposal attempts to curtail the GSEs’ use of complicated financial transactions designed to help meet their lending targets without providing tangible benefits to homeowners. In the proposal, HUD asks for comment on whether it should change how it defines mortgage purchases to ensure the “appropriate counting of large transactions.”
- The proposal would also set new regulations for mortgage data reported by the GSEs and establish penalties for “inaccurate and incomplete” reports. It seeks to broaden HUD’s ability to enforce civil money penalties and cease-and-desist orders against the GSEs if there are “errors, omissions or discrepancies” in the numbers they report

to HUD that aren't quickly corrected. The proposal would set up a process for auditing and correcting errors in the numbers reported by the GSEs and allow HUD to issue cease-and-desist orders or fines of up to \$25,000 a day for noncompliance.

- The HUD proposal states that the GSEs “have both the resources and the expertise to improve credit access for low- and moderate-income families, minority families and families in underserved areas. Yet studies by HUD and others show that the GSEs generally have been less active in historically underserved markets where there is a need for additional sources of financing to address persistent housing and credit needs, and fully private companies, operating without the benefits of GSE status, perform better in these markets.”
- The HUD proposal appears to address concerns of some of the GSEs' biggest critics, who argue that Fannie and Freddie primarily finance loans to borrowers who are already established. In an analysis of HUD data for 2003, FM Policy Focus, a coalition of mortgage and insurance companies, found that Fannie and Freddie supported repeat homebuyers over first-time homebuyers by almost 3-to-1 in 2002. The FM Policy Focus study also showed the companies financed more loans for absentee landlords, vacation homes and second mortgages than for first-time homebuyer loans in 2002.
- According to a lobbyist familiar with the proposal, HUD has significantly increased the lending goals that Fannie and Freddie must meet, calling the new rules “punitive.”
- Lawmakers have 15 days to review the proposed regulations before they are officially made public, at which time they will be submitted to the Federal Register for a 60-day comment period. (*Dow Jones Newswires*, Dawn Kopecki, 04/06/04; *The Hill*, Michael S. Gerber, 04/07/04; *Reuters*, Jonathan Nicholson, 04/05/04; *Dow Jones Newswires*, Dawn Kopecki, 04/07/04)

#### OFHEO proposes new GSE corporate governance rules to prevent abuse

- OFHEO has proposed new standards for corporate governance for Fannie Mae and Freddie Mac to address current weaknesses and help reduce the potential for future corporate misconduct. “As government-sponsored enterprises, Fannie Mae and Freddie Mac should be held to the highest standards of business conduct and corporate governance and that is why I am proposing to implement stronger corporate governance requirements,” said Armando Falcon, Director of OFHEO. The rule changes stem, in part, from the findings and recommendations of OFHEO's special examination of accounting and management problems at Freddie Mac.
- The improvements suggested in OFHEO's proposed rule include:
  - separating CEO and Chairman functions;
  - limiting directors to ten years of service and an age limit of 72;
  - enhancing information flows to the Boards of Directors;
  - requiring audit partner rotation every five years and auditor rotation every ten years;

- requiring the Board and Committees to meet more frequently; establishing additional rules for the independence of Board members;
  - requiring “appropriate and reasonable” compensation that looks to legal compliance and organizational stability and not just to earnings;
  - requiring at a minimum of every three years, a review of codes of conduct; and
  - requiring the Boards of Directors to remain informed of the companies’ growth plans and resources to manage risks.
- Under the proposed regulations, Fannie and Freddie’s chief executive and chief financial officers would be liable for the costs of an accounting restatement “due to the material noncompliance of the Enterprise, as a result of misconduct, with any financial reporting requirement.”
  - Some of the strongest wording of OFHEO’s 28-page proposal addressed compensation issues. OFHEO included language prohibiting excessive pay to “underscore the impropriety of compensation incentives that excessively focus the attention of management and employees on short-term earnings performance.” To bring its standards in line with the requirements of the Sarbanes-Oxley Act, OFHEO said if Fannie or Freddie were required to restate accounting results because of “material non-compliance . . . as a result of misconduct”, the chief executive and chief financial officer would have to reimburse the GSE any compensation tied to those results.
  - OFHEO’s provisions on compensation took industry observers by surprise. “Sounds like OFHEO is laying the groundwork to force Fannie to restate, then yanking Frank Raines’ pay afterwards,” said portfolio manager Lawrence Kam at Sonic Capital, a Boston investment firm that has a large short position on Fannie Mae.
  - Upon publication in the Federal Register, the rule will be open for public comment for a 60-day period. Representatives for Fannie Mae and Freddie Mac said the GSEs would review the proposals. “We are appreciative of OFHEO’s continuing focus on corporate governance best practices. Fannie Mae has demonstrated a commitment to leadership in this area,” said Chuck Greener, Fannie’s senior vice-president of communications. “We look forward to reviewing the proposed rule and providing our comments to OFHEO as it finalizes the rule,” Greener added. Representative from Freddie Mac said the proposal “appears to contain things that Freddie Mac is doing under its corporate guidelines” and indicated that the company would review the proposal and decide “whether and what to comment on.” (OFHEO press release, 04/07/04; *Financial Times*, Stephen Schurr, 04/08/04; *Reuters*, 04/07/04; *Dow Jones International*, Dawn Kopecki, 04/08/04)
  - *The American Banker* noted that OFHEO is in the midst of a massive reorganization that will produce exam teams dedicated to each GSE. OFHEO plans to appoint an “examiner-in-charge” at Fannie and one at Freddie, who will have two deputies each and will be backed up with a slew of examiners, accountants, and compliance

specialists. OFHEO plans to more than double its exam staff to 63 positions. According to OFHEO's advertisements for the examiner jobs, candidates need just six years of experience if they have a master's degree and 10 years experience if they hold a bachelor's degree. Apparently, OFHEO is willing to hire applicants without a college degree, if they have 15 years of experience. The pay range for these positions is \$127,236 to \$203,508 a year. (*American Banker*, Barbara A. Rehm, 04/01/04)

CBO says GSEs' implicit subsidy has grown to \$23 billion

- CBO Director Douglas Holtz-Eakin estimated that the subsidies of Fannie Mae, Freddie Mac, and the Federal Home Loan banks have reached \$23 billion a year, an annualized increase of 17% from the \$13.6 billion estimated subsidy just three years ago. While Holtz-Eakin did not release a new study, he said CBO used the same methodology used in its 2001 study and incorporated 2003 data to provide the updated number. He estimated Fannie's and Freddie's subsidy at \$19.9 billion collectively, and said about \$6.3 billion of that is retained by the companies, with the remainder passed on to the housing market.
- CBO's subsidy calculation includes the GSEs' exemption from paying state and local income taxes and securities filing fees and takes into account the preferred rates the GSEs get in the secondary mortgage markets because of their implied federal backing, among other things, said Holtz-Eakin. If different assumptions are made about the maturity of debt issuances, the total housing GSE subsidy could be as high as \$45 billion, he added.
- In a speech at a Women in Housing and Finance luncheon, Holtz-Eakin said "In an era where budgetary resources are scarce, a subsidy of that magnitude stands out. The budgetary competition for resources will become more pronounced." Holtz-Eakin said that he mentioned the revised subsidy figures because Congress could be forced to make hard choices ahead about what pro-housing programs to pursue, including evaluating the cost and benefits of the GSEs. He said that the current GSE subsidies are not accounted for in the budget, and leave some lawmakers with "the impression that these programs are in fact free." Holtz-Eakin added that he wants to include the subsidy estimates in budget presentations to Congress and the Bush administration so that policymakers can see where these resources are being used relative to other government programs. He also pointed out that evaluating the effectiveness of pro-housing policies, and their costs, was difficult. "At present, our budgetary information is incomplete regarding the subsidies of housing," Holtz-Eakin said. "It does not allow clear, transparent comparisons across programs and does not allow clear transparency to the cost of benefits."
- Holtz-Eakin said Congress could do a number of things to reduce the companies' benefits, such as privatizing them. "Or, in more modest steps, (Congress could) have their regulatory surroundings modified in ways to make them compete more directly,

hold equity more comparable and otherwise operate closer to private sector entities in other areas,” he said.

- Congress may want to use the GSE subsidies for other purposes or to target the subsidy more effectively on housing programs, Holtz-Eakin said. “One possibility would be to earmark a piece of their net income and target those funds toward low-income housing programs,” he said. Alternatively, Congress could redirect the subsidies to pay for housing vouchers or rent subsidies for low-income families, said Hold-Eakin.
- Fannie officials criticized Holtz-Eakin’s speech, arguing that the company “does not receive a penny in subsidy payment from the federal government.” Fannie Mae’s senior vice president for communications, Chuck Greener, added “The methodology behind the 2001 CBO study that the director cited today has been widely criticized.” (*American Banker*, Rob Blackwell, 03/19/04; *Dow Jones Capital Markets Report*, Dawn Kopecki, 03/18/04; *Origination News*, Brian Collins, 04/04)

#### GAO questions need for *three* housing GSEs

- David Walker, head of GAO questioned the need for three housing government-sponsored enterprises. “How many GSEs do you need...and what are the fundamental differences?” Walker, the U.S. Comptroller General, asked in an interview with *Dow Jones Newswires*. “It’s a relevant question to ask.” (*Dow Jones Newswires*, Jennifer Corbett Dooren, 04/02/04)

#### Will the next financial crisis be OTC interest rate options?

- In a Credit Suisse First Boston Equity Research Report dated March 11, 2004, Paddy Jilek writes that the over-the-counter (OTC) U.S. interest rate options are a prime candidate to be a conduit for the next financial crisis for four reasons.
- “First, OTC options are now a \$40 trillion market, dwarfing the cash market in fixed income (Treasuries, Agencies, corporate bonds etc), which is only an \$18 trillion market.”
- Second, holdings of OTC options have become increasingly concentrated among a small number of broker dealers. The largest three FDIC insured banks in the U.S. OTC interest rate options market are JP Morgan Chase, Bank of America Corp., and Citigroup. Together, they hold more than two thirds of the U.S. OTC interest rate options outstanding among FDIC insured banks. JP Morgan Chase alone holds over 40% of U.S. OTC interest rate options among FDIC insured banks, and about 25% of U.S. OTC interest rate options among all dealers. Further, the growth in the size of the derivatives portfolios of these banks is far outpacing the growth in their equity capital. Profits generated by derivatives are one of the main reasons for the marked increase in banks’ non-interest earnings.”

- “Third, dealers are selling a lot more interest rate options to customers than they are buying, which is a unique feature of this market. Most recently, the residual had grown to more than \$800 billion, implying dealers have substantial exposure to changes in the level and volatility of interest rates.”
- “Fourth, the size of the interest rate risk transfer from customers to dealers is growing along with a growing gap between interest rate options being bought and sold by dealers. There has been a roughly \$1 trillion swing in the residual dealer risk in three years. Dealers sell a lot more interest rate options to customers than they buy, which makes the market inherently unstable.”
- “Dealers try to dynamically hedge the interest rate risk being channeled through interest rate options. But this is creating a powerful feedback loop since they buy Treasuries, for example, when rates are falling and sell them when rates are rising, much like owners of mortgage bonds. In effect, the dealers take on two types of market risk: the risk that the level of interest rates change and the risk that interest rates become more.”
- “Volatility risk could quickly translate into liquidity risk. This market structure can play host to spillover risk and financial contagion. The source of much of the interest rate risk is the prepayment option imbedded in fixed rate mortgages. The reason for the growth in the residual of dealer positions in the interest rate options market is that this risk is being passed on from owners of mortgage bond portfolios. The combined effect of the large mortgage market and the concentration of mortgage coupons mean that holders of mortgage-backed securities are finding it very difficult to maintain a stable portfolio duration.”
- “Nowhere is this more evident than at the government sponsored enterprises (GSEs). The GSEs have been busy trying to redistribute this prepayment risk to broker dealers, among others. One way they do this is by buying an OTC interest rate option, which explains why the notional amount of interest rate options purchased by Fannie Mae (net of maturities) has increased from about \$27 billion at the end of 1998 to a whopping \$444 billion by September last year. All these factors helped amplify the move in interest rates last summer, when Treasury yields increased roughly 150 basis point (a 50% increase in yields) and swap spreads almost doubled in a matter of weeks. This was a warning of the inherent instability in the structure of the interest rates markets. The market remains hyper sensitive to a large move in interest rates, as is evident in the market today.”
- “There’s much focus on Fannie Mae and Freddie Mac as being a source of systemic risk. However, there is another elephant in the living room that few want to discuss. Interest rate risk has become concentrated among in a small group of broker dealers. Greater return in derivatives and greater risk come hand in hand. There is no free lunch for derivative dealers.”

- “If interest rates change significantly – up or down -- a prime candidate for amplifying the move will be interest rate options, where the market has become huge, the risks concentrated and the feedback loops powerful. A move up in rates is likely to be more disruptive than a move down. The imbalances in the interest rate options markets make them a prime candidate to host spillover risk and financial contagion. It’s an unavoidable conclusion that this is one area of the financial markets where volatility risk could quickly translate into liquidity risk.” (*Credit Suisse First Boston Equity Research*, Paddy Jilek, March 11, 2004)
- When derivatives dealers from around the world gathered in Chicago for their annual meeting in late March, Patrick Parkinson, an Associate Director on the Federal Reserve Board’s research and statistics division, echoed some of Jilek’s concerns. Specifically, Parkinson said that he was concerned about the exposure of broker-dealers to Fannie Mae and Freddie Mac, two of the world’s biggest users of interest-rate derivatives. If either Fannie or Freddie were to “fail,” their collapse could also bring down one or more of the major dealers, Parkinson said. (*Financial Times*, Jenny Wiggins, 04/05/04)
- John Plender wrote in the *Financial Times* that “Fanny and Freddie make the financial world a very dangerous place for everyone else.” As GSEs, Fannie Mae and Freddie Mac enjoy low borrowing costs because they are regarded as “too big to fail.” With ultra-low interest rates, securities issued by GSEs, mainly Fannie and Freddie, have soared by 2003 to \$5.6 billion, representing 161% of the value of all U.S. Treasuries. Both GSEs hedge continuously against changes in the duration of their assets, as borrowers refinance their mortgages. Wall Street analysts have estimated that a 50 basis point rise in long-term interest rates requires hedging sales of \$200 billion of securities, which amplifies any rise as hedgers sell into falling markets and makes the financial world a perilous place for everyone. (*Financial Times*, John Plender, 04/01/04)

GSE Foundations support the Left
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- In *FrontPageMagazine.com*, Thomas Ryan writes that Freddie Mac tops the list of the 250 largest publicly traded companies which disproportionately fund left-wing groups over right-wing, scoring an “F” on the Capital Research Center’s “Patterns of Corporate Philanthropy” study for being overtly polarized in their philanthropic giving. Included in the recipients of grants from Freddie Mac are the Center For Policy Alternatives (CFPA) and the Alliance for Justice (AFJ), which claims to seek “progressive solutions built on American values.” According to their “2004 Progressive Agenda,” CFPA’s solutions include same-sex marriage, the abolition of the death penalty, preventing school choice, medicinal marijuana legalization, reformation of the sentencing of felons, and making sure as many unregistered voters as possible register Democrat. AFJ also seeks “progressive solutions” in the form of a push for an “independent” judiciary. This group has been outspoken against each of

President Bush's judicial appointments, favoring instead pro-criminal, pro-abortion, pro-big-government activist appointees.

- Fannie Mae is also culpable for funding a variety of left-wing groups. They have awarded grants to the Association of Community Organizations for Reform Now (ACORN) and the Center for Community Change (CCC). ACORN, the self-proclaimed largest left-wing activist organization in the nation, implements an anti-capitalist agenda which has roots in the National Welfare Rights Organization, a 1960's radical group formed to inundate the welfare system with enough recipients to break America's financial back. The CCC states their goal is to "create better communities and policies" and enlists such celebrities as Susan Sarandon and Russell Simmons to propagate "the Vote Democrat" message.
- Part of the blame for corporations funding of left-wing groups may fall on the regulatory policies, says Ryan. Christopher Yablonski, from the Capital Research Center, said "Regulatory policies often give corporations a built-in incentive to pay-off left-wing activists. For example, the financial services industry has given generously to activist groups like ACORN. ACORN uses the federal Community Reinvestment Act (CRA) to pressure lending institutions into making low-interest loans." Yablonski added, "By threatening to use CRA provisions to hold up federal approval of bank mergers and acquisitions, ACORN, its affiliates, and other ACORN-like groups have forced banks to make billions of dollars in high-risk loans. These agreements often include hefty pay-offs to activist groups that file the complaints. In 1996, ACORN affiliates across the country secured nearly \$570,000 in contributions from leading companies—a 40% increase over 1995." (*FrontPageMagazine.com*, Thomas Ryan, 04/06/04)

SEC prepares rules on asset-backed securities
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- The SEC plans to propose new rules for asset-backed securities, seeking to improve disclosure without drastically altering the current system. The proposed rules would apply only to so-called "private label" issuers. Ginnie Mae is government owned and Freddie Mac and Fannie Mae are public companies but are (technically) exempt from registering their securities with the SEC. The GSEs could comply voluntarily, however. The formal rules, which should be published by June 30, will replace SEC's staff interpretations and so-called "no action" letters, which granted flexibility in sales and disclosure of asset-backed deals. After the rules are published, a comment period, likely 60 days, will take place to give those in the industry a chance to respond, said Paula Dubberly, assistant director of the SEC's Division of Corporate Finance. The SEC's commissioners have the final say on the rules before they become law.
- The SEC has been considering instituting formal regulations for the growing asset-backed securities industry for the past 15 years, Dubberly said. Up to this point, the SEC had governed the asset-backed securities industry with a patchwork of rules devised over the years. But informal rules are no longer enough to regulate a \$7

trillion market backed by mortgages, student and auto loans, credit card receivables and other securities.

- Dubberly said the new proposals are both big and small. They are big in the sense that this is the first effort to codify in one place all the rules governing the asset-based securities industry, she said. “On the other hand, they are not big because we codified current practice with incremental changes.” If practitioners put the new rules side by side with current practice, “you will see it pairs up pretty well,” she said. According to Dubberly, the definition of asset-backed securities will be standardized and broadened to include all types of asset-backed securities. The new rules will propose that foreign securities issues will be subject to the rules if they meet the definition of asset-backed securities.
- The SEC also wants more information on sponsors of the securities, although it is stopping short of requiring audited financial statements and also wants more information to be made available to investors about the servicers who actually administer the deals. “Investors are telling me that they want financial statements of servicers,” Dubberly said. “We’ll need your help to find out what is really useful data.”
- In addition to codifying financial information, the SEC also wants to codify communication that takes place between securities issuers and investors and streamline filing time periods, Dubberly said. The proposed rules are also looking at a requirement that asset-backed issuers report events other than distributions on an 8-K form, which is the form required when material events take place. She said new 8-K rules governing all securities will go into effect in August, and that the SEC wants to get the asset-backed securities industry “in the same place” corporations are in terms of requirements.
- Dubberly said that instead of combining many deals into one 10-K annual report or one 8-K, issuers will be required to file reports for each deal. “We really think this has gotten out of hand” Dubberly said. “I’m seeing 100 trusts combined in one 10-K and 8-K. They need to be separate.” (*Dow Jones Newswires*, Paula J. Stepankowsky, 04/05/04)

## ***Fannie Mae***

Fannie Mae relies upon “misleading” accounting methods to smooth out its earnings
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- According to the Center for Financial Research, Fannie Mae has relied heavily on legal but misleading methods to “smooth out” its reported earnings. In a presentation at the American Enterprise Institute session on Fannie Mae accounting, John Barnett, a senior analyst with the research firm, said the GSE favored a method of extending its losses from interest rate movements over several years rather than immediately taking a big hit to earnings. Barnett also argued that Fannie Mae hasn’t taken large

enough write-downs to adjust for the deterioration of its \$8 billion of securities backed by manufactured-housing loans. “I’m fairly confident that the number they have [written off] is too low, but I can’t give you what the right number is,” said Barnett. (*Wall Street Journal*, James R. Hagerty, 04/06/04; *Washington Post*, David S. Hilzenrath, 04/06/04)

#### Presidential election rumblings in the GSE world

- Andrew Cuomo, former Secretary of HUD in the Clinton Administration, has emerged as a “player” in the housing debate policy as advisor to Democratic presidential candidate Senator John Kerry (D-MA). In an interview with *American Banker*, Cuomo said that Fannie Mae and Freddie Mac need to buy more loans made to low-income borrowers. “Let them earn their subsidy,” he said. “They have a role to play. Let them serve the underserved.” Citing the December Federal Reserve study that concluded that private lenders were making more credit available to low-income borrowers than Fannie and Freddie, Cuomo supported lenders’ recent calls for the GSEs to take on more credit risk. “There are loans which are good loans, but they are somewhat riskier than the predominance of private-sector loans, and Fannie and Freddie can be helpful there,” Cuomo said. “Fannie and Freddie should see their public benefit mission as a lifeline,” he said, and helping more low-income people “is the answer to their critics who want to see privatization and an end to the subsidy.”
- Cuomo suggested that the GSEs’ two-pronged regulatory structure with OFHEO monitoring the safety and soundness of GSEs and HUD overseeing the GSEs’ promotion of affordable housing need not be overhauled. “You need HUD’s presence to keep the housing agenda alive,” said Cuomo. He said that if OFHEO had more resources, it could “hire the same sort of talent you have at Treasury.” Cuomo noted that the Clinton administration backed a bill that would have given OFHEO such resources, but *the GSEs opposed it and the measure died.* (*American Banker*, Erick Bergquist, 04/05/04)
- If there is a Kerry White House, many believe that Fannie Mae’s Chairman and CEO Franklin Raines may leave the GSE for a top position in the new administration. According to *National Mortgage News*, one seller/servicer suggested that the Fannie Mae board may *not* be sorry to see Raines go. *NMN* wrote “the executive, requesting anonymity, pointed out that Fannie’s stock has appreciated little the past five years. Indeed, back in late 1999, Fannie’s stock was trading at about \$70 a share. He suggested that ‘boards don’t like to see the stock go nowhere.’” (*National Mortgage News online*, Paul Muolo, 04/05/04)

Must see TV: Fannie Mae on BET-TV

- Fannie Mae airs a television program on home ownership on Sundays at 12:30 p.m. on the cable network, Black Entertainment Television. On BET-TV's website, Fannie Mae also provides information on homeownership. (*BET-TV.com*)

Fannie Mae plans to introduce new servicing guidelines to avoid abusive practices

- According to Fannie Mae's deputy counsel Jon Seward, the GSE is preparing new service guidelines to clarify its policies and make certain its servicers don't engage in abusive practices. According to Seward, the new guidelines will be "closely aligned" with the provisions of a \$40 million settlement agreement of Fairbanks Capital Corp., a subprime lender, with the Federal Trade Commission. Seward said that Fannie Mae's servicing guidelines will address loss mitigation, customer service, fees and charges, posting of payments, escrows, force-placed insurance and credit reporting. These new predatory guidelines are expected to ban mandatory arbitration clauses, limit the duration of payment penalties to three years and ban balloon loans with a term of less than seven years. He also said that Fannie Mae is "stepping up" its pre-purchase reviews of subprime mortgage pools to make sure it is not helping predatory lenders. "It is very important to Fannie Mae that we are not providing liquidity that will go to predatory lenders who are ripping off consumers," Seward said. (*Mortgage Servicing News*, Brian Collins, 04/04)

Fannie's "answer" for predatory lending: provide list of low cost lenders to realtors

- In Franklin, Tennessee, Fannie Mae launched its "Borrow With Confidence Campaign," a program that puts realtors at the forefront of preventing predatory lending to first-time homebuyers and immigrants. At a meeting with the Williamson County Association of Realtors office in Franklin, Fannie Mae provided local realtors with a list of lenders that offer sound mortgage products and a list of counseling agencies that help borrowers who may need guidance through the home-buying process. (*Fannie Mae press release*, 04/07/04)

Class action suit filed against Fannie, claiming DU is discriminatory

- After having been denied a conventional mortgage, Safiyyah Rahmaan learned the hard way that Fannie Mae's warm-and-fuzzy image in its ads and Web site is a far cry from how the company operates behind closed doors. After several banks had turned down her loan applications, Rahmaan, discovered that Fannie Mae had investigated her financial life and had "branded" her without her knowledge. "Fannie Mae isn't really helping the masses like the impression it gives," Rahmaan said. As a result of her loan denials, Rahmaan had to finance her property with 10.25% subprime loan.
- Represented by the Tampa law firm of James, Hoyer, Newcomer & Smiljanich, Rahmaan is leading a class action lawsuit that aims to force Fannie Mae to treat

minorities seeking home loans fairly. At issue in the suit is whether in computerizing mortgage lending, Fannie Mae has penalized black and Hispanic homebuyers, the very clients it is mandated to help. Her attorneys are suing Fannie and Freddie for racial discrimination, arguing that the firms' "credit scoring" programs for rating mortgages violate the civil rights of minorities.

- Collins, one of Rahmaan's attorneys, contends that credit scoring "is the latest proxy used by insurance companies to redline coverage areas and focus on wealthy white customers. Whether you're talking mortgages or insurance, we think the evidence will show credit scoring hurts minorities, single parents, renters, city dwellers, old people who like to pay in cash, people who've never bothered to create a credit history (so-called "thin files") and members of ethnic groups in which families tend to lend money to its own. "Fannie Mae, therefore, slams the doors in the faces of minority homebuyers and perpetuates the discrimination it is supposed to cure. Furthermore, Fannie Mae fails to give prospective homeowners notice of the adverse action Fannie Mae takes against them."
- As the lawsuit moves forward, Rahmaan says she has to remember that Fannie Mae is not a charitable organization, as many people may believe after seeing the agency's upbeat ads. "This is a business," she said. "A cutthroat business that discriminates." (*St. Petersburg Times*, Bill Maxwell, 04/04/04)

President of NAHB named chairman of Fannie Mae's National Advisory Council
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- Fannie Mae named 24 new members to its 44-member National Advisory Council and made James R. Rayburn, the president of the National Association of Home Builders, the council's chairman. The Mississippi builder joined the council last year.
- Among the new council members are Kevin M. Shannon, the president of consumer real estate for Bank of America Corp. in Charlotte; Carl E. Levinson, the head of Citigroup Inc.'s U.S. consumer assets division in Stamford, Conn.; Elizabeth Duke, the executive vice president for community bank development at SouthTrust Bank in Virginia Beach; and John D. Koch, an executive vice president of Charter One Bank and a director of Charter One Financial Inc. in Cleveland. (*American Banker*, Damian Paletta, 03/31/04; *Fannie Mae Press Release*, 03/30/04)

## Freddie Mac

### Sounds of Silence: Freddie Mac holds annual shareholders meeting

- In a year of angry shareholders flexing their muscles at Disney, Safeway and Hewlett-Packard, the “natives” were calm at Freddie Mac’s annual shareholder meeting held on March 31, 2004. Given the accounting improprieties of the GSE and the fact that the company is still late in its financial reporting for fiscal year 2003, “you would think that shareholders would be howling for the heads of the Freddie Mac directors who were snoring in the boardroom,” wrote Gretchen Morgenson in the *New York Times*. Instead, she wrote, “the [Freddie] stockholders seem to be the dogs that do not bark.” Morgenson noted, that directors of Freddie Mac, who failed “rather spectacularly in their responsibility to shareholders,” did not take themselves out of the running for re-election shows that “shame is not a dominant gene in corporate America’s DNA.” (*New York Times*, Gretchen Morgenson, 03/28/04)
- Directors of Freddie Mac were overwhelmingly re-elected at the annual shareholders meeting at a relatively subdued meeting, presided over by Freddie Mac’s chairman and CEO Richard Syron. About 100 shareholders, mostly individual investors rather than pension and mutual funds, posed questions concerning the GSE’s financial reporting systems and the role of PricewaterhouseCoopers (PwC) and criticized the directors failure to exercise their oversight duty. Freddie Mac’s shareholders re-elected all directors up for re-election except for Donald Schuenke, 75, who passed away on March 30. William Ledman, Freddie Mac’s senior vice president for information services was elected in Schuenke’s place. Twelve of the original 18 board members have left since June 2003. The shareholders ratified the reappointment of its auditor PwC with 98% of the vote cast.
- In a speech to shareholders, Syron said that Freddie Mac has set a target of June 30 to bring its financial statements current by reporting its 2003 earnings. “You have my commitment to get this job done as quickly as possible,” Syron told the shareholders. “Our highest priority is to return to timely financial reporting.” he said. “You have my commitment that we will fix what is wrong, and we will do more that is right. All this will require some amount of change. When change is necessary, it must happen. And at Freddie Mac, change is here to stay.” (*Associated Press*, Marcy Gordon, 03/31/04; *PR Newswire*, 03/31/04; *Bloomberg News*, Al Yoon and James Tyson, 03/31/04; *Reuters News*, 03/31/04)

### “Steady Freddie” increases lobbying expenditures 75% in face of accounting probe

- During the second half of 2003, Freddie Mac increased the amount of money it spent to lobby the government by 75% amid the OFHEO probe into its accounting practices and Congressional hearings on the matter. Freddie Mac spent \$10 million to lobby Congress during the last six months of 2003 compared to \$5.7 million in the same

period in 2002. Freddie Mac spent more than twice the \$4.9 million that Fannie Mae spent during the last half of 2003. According to *PolicalMoneyLine*, Freddie Mac is second among all organizations in lobbying expenditures after AARP. Freddie Mac had 20 outside lobby firms on retainer the past six months of 2003 and six actively in-house lobbyists, according to the GSE's disclosure forms.

- “They have had everybody on the payroll out,” said Senator Chuck Hagel (R-NE). “They’ve turned that Bunsen burner up and sicked the dogs on all of us.” Senator Banking Chairman Richard C. Shelby (R-AL) said, “We’re swimming in a river with some of the most powerful lobbyists that Washington’s ever seen. That is Freddie Mac, Fannie Mae and their friends.” (*Bloomberg News*, Michael Forsythe, 04/06/04; *Washington Post*, 04/05/04)

Freddie introduces new “float-to-fixed-to float” option for multi-family mortgage lenders
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- Freddie Mac has introduced a “float-to-fixed-to-float” option for multifamily mortgage lenders, which enables borrowers to get higher cash flows from their properties earlier in the life of a mortgage, by taking advantage of low short-term floating rates. The borrower could also lock in a fixed rate up front for the remainder of the mortgage term, which will eliminate the risk of exposure to rising rates. Up to an additional year of floating-rate debt could be used at the end of the loan term to “arrange an exit strategy.”
- Under the float-to-fixed-to-float option, the interest rate is based on the one-month Freddie Mac reference bill index during the initial floating rate period of the loan. For the fixed portion of the term, the rate of interest is based on Treasury securities that have a similar maturity profile to the combined initial floating-rate and fixed-rate periods.
- To enhance the borrowers’ flexibility, Freddie Mac has also introduced additional prepayment options to its capped and standard ARM products. With these options, borrowers could get a lower spread over the applicable index for mortgages paid off before they mature or convert to a fixed rate, in exchange for a higher prepayment premium and a longer prepayment period. (*Mortgage Servicing News*, 04/04)

## **Federal Home Loan Banks**

Bush names Alicia Castaneda to chair the FHFB
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- President George W. Bush announced his plans to designate Alicia Castaneda as chairman of the Federal Housing Finance Board, an elevation that does not require Senate approval. Last year, Castaneda was confirmed by the Senate to the serve on

the board. A native of Colombia, Castaneda immigrated to the U.S. in 1970. With more than 27 years of commercial banking experience, Castaneda was serving as senior vice president, International Private Bank, with Bank of America in Washington, D.C before joining the board. Her areas of expertise include fixed-income instrument sales and trading, short-term investments, and arbitrage and liability management. Castaneda will succeed Chairman John Korsmo, who has resigned effective April 13. (*Dow Jones Newswires*, John Connor, 04/08/04)

#### Tenhundfeld selected as FHFB's General Counsel

- The Federal Housing Finance Board announced that Mark J. Tenhundfeld, currently the assistant director of the Office of the Comptroller of the Currency's legislative and regulatory activities division, will join the FHFB as General Counsel in May. Tenhundfeld will succeed Arnold M. Intrater, who retired in January. (*FHFB* press release, 03/30/04; *Dow Jones International News*, John, Connor, 03/30/04)

### **TVA**

#### TVA announces plans to lay off 600 to 800 employees

- The TVA announced that it may lay off between 600 and 800 employees during 2004, representing the largest downsizing at the federal utility in a decade. This reduction in force is part of the TVA's strategic plan, which the agency adopted in January to prepare it for industry deregulation through reducing expenses and paying down its multibillion-dollar debt. While TVA has offered early retirement incentives to its 13,000 employees, it is unknown how many workers have voluntarily agreed to retire. TVA officials said layoff notices, if needed, will be issued April 22nd. (*Dow Jones Newswires*, 03/31/04)

### **Sallie Mae**

#### Sallie Mae pays CEO Lord \$2.5 million bonus in 2003

- During fiscal year 2003, Sallie Mae paid CEO and Vice Chairman Albert Lord a bonus of \$2.5 million for 2003, up 67% from \$1.5 million the previous year, according to the GSE's proxy with the SEC. Lord's bonus level was based on progress toward completion of the wind-down of the Student Loan Marketing Association subsidiary, solid growth in loan originations and fee income, management of operational controls and information technology resources, management of the company's relationships with members of Congress and the administration, and leadership development and succession planning, according to the

filing. According to Sallie Mae, at least 40% of Lord's bonus was paid in common stock.

- The company gave Lord stock valued at \$5.28 million in 2003 under a long-term compensation plan, compared with stock valued at \$4.3 million in 2002. The stock given in 2003 consisted of 150,000 restricted stock units that vest on Dec. 31, 2004, and are to be converted into common stock the year after Lord leaves the company.
- In 2003, SLM gave Lord options for 1.5 million common shares, compared with options for 3,459,951 shares given in 2002. The 2002 options include some provided under a replacement option program, according to the filing. The options issued in 2003 expire in January 2013 and have an exercise price of \$35.20 each. SLM estimated the value of the options on the grant date were \$9.5 million.
- As of December 31, Lord held 2,675,709 exercisable options worth \$36.44 million and 4.5 million unexercisable options valued at \$30.76 million. Lord's salary for 2003 was unchanged at \$750,000. (*Dow Jones Newswires*, Todd Goren, 04/02/04)

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

Farm Credit System reports financial results for third quarter 2003
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- For the third quarter of 2003, the Total Farm Credit System (FCS) reported net income of \$462.0 million, representing a 1.58% return on assets and 10.08% return on equity. The FCS reported an aggregate gross loan volume of \$91.3 million and non-accrual loans of \$1.1 million, representing 1.38% of gross loans. (*Farm Credit Administration*, 03/18/04)

FCA Board approves rule to serve young farmers
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- In a split vote, the Farm Credit Administration (FCA) Board approved a final rule designed to enhance the Farm Credit System's (FCS or System) service to young, beginning, and small farmers, ranchers and producers or harvesters of aquatic products (YBS farmers and ranchers). The final rule requires System banks to ensure that their affiliated direct-lender associations adopt YBS programs, as required by statute, under the policies of the System banks. It also amends the existing YBS regulation and delineates the minimum components that each System association must include when developing programs for YBS farmers and ranchers.
- The rule gives System associations the flexibility to design programs unique to the needs of the YBS borrowers in the territories they serve and encourages, but does not require, the establishment of advisory committees comprised of YBS farmers and ranchers. It requires each System association to: develop a mission statement describing its YBS program objectives; include quantitative targets and qualitative

goals in its strategic and operating plans; and establish internal controls over YBS programs for safety and soundness. System banks and associations also are required to include information on loans and programs for YBS farmers and ranchers in their annual reports to shareholders and investors. (*Farm Credit Association press release*, 03/11/04)

FCA's general counsel rules syndicated loans must be treated as direct loans
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- On February 10, the General Counsel of the Farm Credit Administration (FCA) reaffirmed that syndicated loans to eligible FCS borrowers must be treated as direct loans, not loan participations. Thus, syndicated loans must meet clear-cut statutory requirements, including:
  - Each lender must comply with borrower rights requirements under the Farm Credit Act;
  - The borrower must purchase stock in each lender extending credit to him;
  - The FCS association assigned the territory where the borrower is located must consent to the loan; and
  - Each lender must maintain a first lien position on the borrower's FCS stock and any real estate collateral.
  
- In *Farm Credit Watch*, Bert Ely concludes that this legal opinion effectively bars FCS associations from treating loan syndications as if they were loan participations. Ely states that the Farm Credit Council (FCC) clearly dislikes this legal opinion. By acquiring loan syndications originated by non-FCS lenders, the FCC cannot sidestep the rights borrowers have under the Farm Credit Act. Further, the FCC cannot dodge the Act's requirement that an association can lend to a borrower located in a territory served by another association only with the permission of that association. Permitting FCS associations to lend anywhere they want, through the guise of joining loan syndications organized by non-FCS lenders, represents a "stealth national charter," states Ely, which would launch unhealthy, taxpayer-subsidized competition within the FCS. (*Farm Credit Watch*, Bert Ely, April 2003)

Is there a need for the Farm Credit System?
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- In the April issue of *Farm Credit Watch*, Bert Ely argues that the need for the Farm Credit System (FCS) no longer exists. When Congress chartered the FCS in 1916, commercial banks were barred from real estate lending or limited in the amount of real estate credit they could provide to farmers. In 1933, FCS's lending authority was broadened to include short- and medium-term loans, after 9,000 (mostly rural) banks failed during the Great Depression. Ely points out that rural America is far different today, with commercial banks and other private-sector lenders able to meet rural America's credit needs -- on and off-the farm. Ely states that while there may once have been a need for the FCS, today the FCS is an anachronism. Congress should privatize the FCS when it follows Greenspan's advice and privatizes the housing GSEs, if not beforehand, concludes Ely. (*Farm Credit Watch*, Bert Ely, April 2003)

## Farmer Mac declares preferred stock dividend

- Farmer Mac's Board of Directors declared a quarterly dividend on the Corporation's 6.40% Cumulative Preferred Stock, Series A. The \$0.80 per share dividend, which is for the period from April 1, 2004 through June 30, 2004, will be payable on June 30, 2004 to stockholders of record as of June 20, 2004. (*Farmer Mac Press Release, 04/06/04*)

## **Postal Service**

### Postal reform on front burner – or back burner?

- While postal reform isn't the "hottest issue" in an election year, legislators in both the House and Senate seem determined to move bills that would mandate changes in the Postal Service's operations. Whether those bills are enacted in a year when politics overshadows policy, however, remains to be seen.
- As Congress began its second session, Senator Susan M. Collins (R-MA), chair of the Senate Governmental Affairs Committee, indicated she considers this issue a priority. Collins laid out an "aggressive timetable" for a Postal Service overhaul bill, saying she plans to introduce bipartisan legislation with Senator Thomas Carper (D-DE) by the end of the April. A committee aid said Collins hoped to mark up the bill in May.
- Rather than introducing companion legislation in the House, House Government Reform Committee chairman Tom Davis (R-VA) will introduce a postal reform bill by the end of April with Rep. John McHugh (R-NY), who chairs the House committee's postal panel, a McHugh spokeswoman said. Davis recently told a meeting of the National Association of Postal Supervisors that House and Senate leaders are "unenthusiastic" about moving a bill, according to his spokesman. While the White House is committed to postal overhaul this year, he said, Congress has faced "heavy lobbying" by groups that oppose full-scale changes, such as private-sector competition with the USPS.
- Although each body will introduce its own legislation, sources predict a smooth conference process with little disagreement. A McHugh aide said she expects "nothing earth-shattering or lengthy or difficult" when the bill goes to conference. Another House source said he expected the House and Senate committees to mark up and report bills in time for conference "by early summer."
- At a recent luncheon at the Capitol Hill Club, House Appropriations postal subcommittee chairman Ernest Istook (R-OK) said Congress operates in a crisis mode

before it takes action and lawmakers are unconvinced an urgent need exists for comprehensive postal reform this year, according to his spokeswoman.

- While mailers expect postal reform bills to be introduced shortly, many are growing less confident that legislation will be passed before the end of the year because of the fall elections. “I don’t think we can say with any certainty that a postal reform bill is going to pass or it’s not going to pass this year,” said Bob McLean, executive director of the Mailers Council. “Certainly, we would have liked to have one bill introduced by now. But that doesn’t preclude passage. It just makes it a little more difficult.”
- Congress’ schedule for the remainder of the year is problematic. From April through July, Congress is off one week each month. Between July 26 and September 3, Congress adjourns for the “summer district work period.” Following a September with three vacation days for Labor Day, Rosh Hashanah and Yom Kippur, the schedule shows a “targeted adjournment” date of October 1. During this period, many members of Congress will be focused on their own re-election campaigns. According to Gene Del Polito, President of the Association for Postal Commerce (Postcom), “By the time the Senate can put a bill together that’s close enough to the House bill to be supported in conference, and when you look at the number of legislative days available in the calendar, the probability that anything’s achievable is less than 50%.”
- Despite Congress’ abbreviated schedule, McLean is optimistic. “The leadership in both chambers have indicated the willingness to schedule time to debate these bills,” he said. “That’s an essential step.” He also predicts a smooth conference committee process, saying “One of the most significant things that has occurred during this prolonged series of hearings is that we’ve seen opinions coalesce. We’ve been able to build consensus in some ways that probably didn’t exist six months ago. That tells me we’ve got a hint that something might occur.” However, if there are stark differences between the two bills, McLean said, “the chances for passage go down dramatically.”
- An aide for Collins said the Senate bill probably will contain workforce reform proposals. In general there is common ground between the two chambers, she added. The most hotly debated topics probably will be workforce issues, such as reducing the size of the postal workforce and opening employee health benefits to collective bargaining. Collins also has said she intends to change the postal worker compensation system. Other potentially contentious issues include scaling back the number of mail distribution centers and determining the Postal Service’s ability to compete with private-sector mailers. The two biggest potential fights involve issues on which all postal overhaul players in Congress agree -- shifting the payment of military retirement benefits for civil service workers back to the Treasury and releasing \$3 billion, currently in escrow, to the Postal Service.
- Neal Denton, executive director of the Alliance of Nonprofit Mailers, Washington, said he expects the House and Senate bills to resemble previous reform packages.

“HR 4970, a House bill that had been promoted in 2002, and S. 1285, a measure introduced by Senator Tom Carper (D-DE) in 2003, will likely serve as general blueprints,” he said. If so, the rate-setting process will be one focus of the legislation. Denton said a provision in a final bill may be that classes of mail be identified as either “market dominant” or “competitive.” A stronger Postal Regulatory Commission (PRC) would establish the new system for determining rates for “market dominant” products such as First Class, Standard and Periodicals. This new PRC might consider price caps, revenue targets and cost-of-service regulations, and could set limits to rate increases by tying average increases to the Consumer Price Index. Rate setting for “competitive” products such as Priority, Express, International and Parcel Post mail would be much more flexible and set by the Board of Governors.

- McLean agreed that rate setting likely will be the heart of the legislation and that it also will include language “outlining in more specificity what the universal service delivery requirement will be.” According to Denton, other elements might provide for annual audits of finances, governance, increased borrowing authority and “perhaps a loosening of the private express statutes to allow more private delivery of mail.” Workforce issues likely will be examined, such as reducing the size of the postal workforce and opening employee health benefits to collective bargaining. Although another year will likely pass without postal reform, legislators, trade groups, unions and mailers agree that it is urgently needed. McHugh, who presided over the House hearings this year, said the Postal Service “is not sustainable going forward into the 21<sup>st</sup> century.” (*DM News*, Melissa Campanelli, 04/05/04; *Presstime*, 04/04; *CongressDaily*, Zach Patton; *Catalog Age*, Paul Miller, 04/01/04)

#### Postmaster General Potter urges appropriations for USPS for FY2005

- In a Senate appropriations subcommittee hearing, Postmaster General John E. Potter urged Congress to include funding for postal appropriations not in President Bush’s 2005 fiscal year federal budget. The largest expense is \$779 million for emergency preparedness. Potter told members that the funding would support deployment of the biohazard detection system, the ventilation and filtration system and construction of a Washington-based mail-irradiation facility. Senator Ted Stevens (R-AK), the Appropriations Committee chairman, said his committee will work with the Senate Governmental Affairs Committee to “push this because, after all, we were the target” of bioterrorism attacks in the mail. By declaring it an “emergency,” it would put the money out of the scope of the budget limits, “and the House will accept it,” Stevens said. (*DM News*, Melissa Campanelli, 04/05/04)

#### Senate Committee holds hearing on rate setting by USPS

- On April 7, the Senate Committee on Governmental Affairs held a hearing on postal rate setting by the USPS and received testimony from George Omas, Chairman of the U.S. Postal Rate Commission, and David Fineman, Chairman of the U.S. Postal Service Board of Governors.

- Omas told the Senate panel that the two pieces of postal reform legislation drafted in the last Congress, S. 1285 and H.R. 4970 “...provide a good basis for developing an effective vehicle for achieving real reform.” He said that the Postal Service’s longstanding preference for limiting the circumstances in which data and information will be disclosed has been a perennial source of frustration in regulatory proceedings. He said that unequivocally identified enhanced transparency as one of five fundamental postal reform principles. Developing a working understanding of what transparency should mean in the Postal Service environment and incorporating this understanding into legislative policies and directives, Omas said, must be a priority if the spirit of the current reform effort is to survive. Since the Postal Service has a long history of attempting to shield information on its activities from the public, reform legislation must clearly enunciate that open access to Postal Service information is public policy.
- Omas said that while he agreed that attribution of postal costs needs to be improved, he said it would be inappropriate to set a target percentage for attributable costs. He said it is understandable that businesses that compete with the Postal Service are concerned that competitive products cover their attributable costs and make adequate contributions to Postal Service overhead. He noted the best way to assure that proper contributions to overhead are collected from each product is to directly address the size of the contribution that competitive products should make in the legislation. Omas criticized the Postal Service’s view of what would constitute an appropriate rate cap. He said it would fail to impose any meaningful fiscal discipline on the Service’s operations.
- David Fineman, Chairman, U.S. Postal Service Board of Governors, told the Senate committee that the ratemaking process is too long and too complex. He said he was hard-pressed to determine what, if any, additional information anyone could want to construct rates. He said that if the Governors were appointed in the manner recommended by the President’s Commission, the Senate’s statutory role of “advice and consent” would be greatly diminished. At the least, there should be standards drawing a clear line between what is appropriately a managerial function within the oversight of the Governors or Directors, what is a regulatory function committed to the regulator, and what is a public policy function reserved to the nation’s lawmakers. Fineman said that “stringent qualifications” also should be required of those who sit on a postal regulatory board. The board, however, should not be empowered to make decisions about the monopoly or universal service. Major public policy issues of this sort should include Congress’ input into the equation.
- Fineman said board appointments should not be as short as three years or as long as the present nine. Imposing age limits for Governors is reasonable, but 70 years may not be an appropriate limit. Those who are appointed should have the experience and qualifications to sit on private sector boards. Business qualifications alone, he said, aren’t enough, since the postal board is a public board.

- In response to questions from the panel, Omas said he didn't think it would be difficult for the Postal Rate Commission to conduct an after-the-fact administrative review of any USPS proposed rates. Ninety-days, he said, would be enough time to get the job done if the necessary transparency were in place. Fineman said he disagreed, and that management needs added flexibility to operate the system properly. If you're going to have a price cap regimen, he said, then management should be permitted to manage within the cap without external rate review. He said that sufficient provisions must be made to ensure the USPS can deal with unavoidable exigencies. (*PostCom Association for Postal Commerce*, 04/07/04)

#### Postal pay at a premium

- According to Sam Ryan, senior fellow with the Lexington Institute, the real problem with the Postal Service is out-of-control labor costs. According to the presidential postal commission, postal employees receive on average a 28.4% pay increase, upon hire. Labor accounts for nearly 80% of Postal Service costs, compared with roughly 50% for private delivery firms. The exorbitant pay premium is a contradiction of federal law stating that postal pay should be comparable to private-sector pay. If the Postal Service reduced its compensation premium, it could save over \$8 billion per year. That would allow it to operate in the black while lowering postal rates. (*Washington Post*, Samy Ryan, 04/06/04)

#### IRET warns of dangers of the USPS operating in competitive markets

- According to the *IRET Congressional Advisory*, "the Postal Service has long argued that current price regulation is too burdensome and should be loosened. A natural concern, however, is that less regulation of core products would increase the danger that the Service would abuse its monopoly power. It might seem at first glance, though, that little pricing supervision is needed in markets where competition protects customers against excessively high prices. In fact, careful regulatory oversight is also needed there. The danger in competitive markets is that the Service will cause damage by setting prices that are too low." (*IRET Congressional Advisory*, 04/01/04)

#### *Richmond Times Dispatch* urges Congress to act on postal reform

- The *Richmond Times Dispatch* writes in an editorial that "for what seems like the fiftieth time, dire warnings are coming from Washington about the financial shape of the Postal Service. Congressional hearings, a high-powered commission, and the General Accounting Office agree that the future looks bleak. Having suffered losses for several years, the independent agency turned a profit last year through an accounting maneuver worthy of Virginia's General Assembly. The question at hand asks what, if anything, should be done."

- “Defenders of the service can make a reasonable argument that ...the Postal Service faces competition from other sources in ways that other agencies do not: E-mail and the Internet have siphoned away business that once was handled primarily through first-class mail. Last year the share of mail categorized as first-class fell below half for the first time in the service’s history. Addressees proliferate even as the volume of first-class mail declines. So even though the Postal Service has trimmed employment by 70,000, it still faces a long-term financial squeeze. Recommendations from inside the Beltway deal primarily with marginal matters such as labor-arbitration deadlines and a simplified rate-setting system.”
- “Yet the service’s problems go deeper than cumbersome bureaucracy. The fundamentals have not changed in decades, chiefly because - until recently - the Postal Service had a captive customer base. Banks, brokerages, and other businesses have offered more services and updated marketing techniques to keep pace with a changing marketplace, but the Postal Service still looks like a 1950s operation (and some of the branches look like operations from the 1950s-era Soviet Union). Opening first-class mail delivery to competitors might force the agency to join the modern age.”
- “Officials will respond - and fairly so - that the Postal Service bears the burden of delivering to rural and remote locations; it cannot cherry-pick major metro areas the way (for example) airlines can. True enough, and the nation eventually might have to make a policy decision about rural delivery. It could decide mail service is important enough societally to subsidize. Or it could decide that the blessings of rural life, such as peace and quiet, entail trade-offs - such as pricier or less frequent mail service (ameliorated by electronic communication).”
- “Whatever Washington decides, it cannot let the agency drift endlessly along without reform. On that point everyone agrees. It would be refreshing - if not miraculous - to see Congress take action before the next dire report about the Postal Service is published two, three, or five years from now - as one almost surely will be.”  
(*Richmond Times-Dispatch*, 04/04/04)

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